The world as a region: urban development strategies in a global economy.

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Abstract: Traditional models of urban economic development focus on regions. For example, States and localities are usually seen as being in competition with one another within a region or economic area of specialization and they base their economic development strategies on the positions and strategies of their perceived competitors.

For some cities, however, this regional strategy may not be appropriate. For cities such as New York, London, Tokyo or Paris, the competition is often not so much Philadelphia, Manchester, Kyoto or Lyon as it is other international cities which are comparable to them in specific economic niches (for example, the first three are competitors for attracting international financial institutions).

This paper examines recent models of urban and economic competition in the international economy (most notably those developed by Paul Krugman) and assesses how the increasing interdependence in the world economy is changing local economic development strategies in the United States. Existing strategies are examined in selected U.S. cities with special focus on some of their specific development niches. The paper focuses on New York (headquarters for international firms and international capital markets), Chicago (international capital markets), Los Angeles (international entertainment and Pacific Rim enterprise), and Miami (international tourism and recreation).

Introduction

Imagine for a moment that you are an economic development official for the City of New York, hurrying on your way to a meeting during a balmy summer day during the early 1980's. As you move through the crowded streets, with head down and body moving quickly, you notice a brightly enameled golden oil lamp in the gutter by a curb. Intrigued, you stop for a moment, pick up the lamp and rub off the dirt from it to get a better look at its condition.

Suddenly, a gust of pink smoke spews forth from the nozzle of the lamp and a large genie, bearded and dressed like you would expect a genie to be dressed, stands before you. You have heard this story before and, short of breath, begin to think of the three wishes you will make, carefully wording each one so as to avoid falling into the familiar traps that genies like to draw their hapless victims into.

Before you can say a word, however, the genie surprises you. He tells you, in deep and mellifluous tones, that he has been sent by a great social scientist of the ages to offer you the following choice: you may remain in the present time in your present job as a development official, or you may return to a time twenty years previous, in the same job and in the same city. Either way, the genie will track the challenges that you face and your responses to them for a twenty year period. Other genies in other lamps have been placed in other parts of New York and in other cities, enough so that a random sample of development officials making either choice can be assembled, tracked and compared.

An interesting proposition, you think to yourself. You could just live your life as you would have without the genie, or you could back in history and live that same life in a past twenty years earlier. You are an economic development official, and apparently, according to the terms offered by the genie, you will be one for another twenty years. The question is, in which time period — your unknown future, or this unknown past — will your job be cushier?

A tale of two time periods

The answer to this question is not as easy as it may appear. On the one hand, American cities at the beginning of the 1960's, the period to which our notional genie could send our notional urban development official, were in something of a golden age economically, as was the United States generally. The U.S. was far and away the leading economic power in the world and cities like New York were imperial cities in this economic empire. Moreover, government resources for economic development were flush and would become more so as the decade wore on, with programs such as the War on Poverty and Urban Renewal becoming enacted and backed up with major infusions of cash at the Federal level. As important, perhaps, the era began with great confidence in the ability of government to solve social problems, a confidence which inspired commitment on the part of national and local leaders.

But, of course, those with even a cursory knowledge of urban history know how the era turned out, with once visionary programs being deemed a failure, the rise of stagflation and growing Federal deficits leading to shrinking Federal resources and overburdened local governments, and the onward march of suburbanization coupled with social upheavals such as the inner city riots of the late 1960's and the rapid rise of violent crime leading to fiscal and social collapse in many inner cities. The era which had started so hopefully, ended with many pundits predicting the demise of the American polis.

That is one scenario available to our economic development official, but what of the other, the choice to remain in the early 1980's and go forward to a still as yet unknown future in the early part of the next millenium? On the one hand, this era started out rather bleakly with shrinking Federal commitment to economic development at the Federal level, the aftermath of the deepest recession since the Great Depression, and more than a decade of rapid urban decline all taking their toll. The brief recovery during the mid 1980's provided some relief but the stock market crash of 1987 and its attendant real estate collapse took the wind out even healthy urban growth areas like Los Angeles.

However, this era, still unfinished, has been turning out better than its beginning might indicate. For inner cities are experiencing something of a renaissance. City finances have generally stabilized, people and investment have moved back into the center cities, and the fall in violent crime rates have restored some of the lost luster to urban living. Much of this movement is, of course, incomplete and tentative, but the trends seem positive.

Paper Overview

So the question once again: in which era would the development official's job be easier and how would the job in the later -- our present -- era, differ from that of the earlier time? This paper will focus on that question in a number of ways. First, the paper will review both the "old" and the "new" thinking surrounding economic geography and urban economics and what it suggests about effective urban development policies and trends. This review will suggest that many of the trends which were once threatening to cities, such as innovations in transportation, the rise of information-based industry, and increasing economic globalization, are now actually playing to their comparative advantage. Then the paper will briefly examine the economies of four U.S. cities — New York, Chicago, Los Angeles, and Miami — and assess how these global economic dynamics are playing out in these four locations and what they suggest about economic development policies in those cities. This examination will indicate the importance of regionalization on a global scale, i.e. the new tendency of economic regions to cross national boundaries, and how that globalization is, or should be, transforming urban development policies. Finally, the paper will close with some speculation about the future of U.S. cities in the world economy and the types of government policies and administrative structures which might best work to make that future a happy one for urban areas.

Economic geography: old and new

The traditional discipline of economic geography (along with the related disciplines of urban economics and regional economics) focuses on the three elements of market activity — production, consumption and exchange — the same elements which constitute the core of traditional economics, but with the difference that the dimension of physical space is incorporated into each of these elements. (Much of the following discussion is drawn from Lloyd and Dicken, 1972 and Mills and Hamilton, 1989; There are many other references, but these two present comprehensive and clear discussions of the "old" economic geography and urban economics respectively).

Economic geography is founded on the same sorts of behavioral premises that regular economics is based on, namely rational, self-interested and atomistic agents who busily maximize on an individual basis and whose aggregate activities are guided by the "invisible hand" of Adam Smith. By introducing physical space into the analysis, economic geographers add the "friction" that maximizing over physical distances implies. Overcoming friction requires additional effort on the part of economic agents and this effort adds additional costs and planning to each individual's maximization calculations.

The addition of this single element deepens the traditional spaceless economic model considerably. Since overcoming friction is costly, economic agents, whether they are producers or consumers, set about minimizing the costs associated with that friction. The two most obvious ways to minimize those costs are either to minimize the friction itself, i.e. limit the distances which must be covered, or minimize the costs associated with overcoming that friction, such as lowering transportation costs through transport innovation or building efficient transportation networks.

Simple elements these are, but they lead to some profound insights. Central place theory and urban hierarchy arise from these behavioral implications, for one way that economic agents economize on friction and its associated costs is to concentrate activities in places where either the beneficiaries of those activities are closest (and hence need to travel least to get the goods and services they need) or where the inputs necessary to make outputs are closest, or some combination of the two. This is one rationale that economic geographers give for the existence of cities themselves, namely that the concentration of consumers and producers in one place to limit the friction of distance and its associated costs.

Closely related to, and even arising from these insights are two traditional economic concepts, namely economies-of-scale and agglomeration economies. Economies-of-scale refers to the relationship between the scale of production and marketing of output and the use and management of the necessary inputs. For example, if as a steel manufacturer grows in size it can get more value of steel product for a given unit cost of inputs (such as labor and capital), then the steel manufacturer can be said to be reaping increasing economies-of-scale. That is, as the scale of the enterprise grows, the given value of a unit of output increases per given unit cost of input.

Economies-of-scale are generally “internal” to the economic agent in question and related to a number of factors, only one of which is physical concentration of the activity. Agglomeration economies are much more directly related to physical space for they refer to economic synergies which result from a concentration of separate producers, consumers and/or input sources at one location. A classic agglomeration economy is the garment district in New York where highly skilled laborers and firms are all located in an approximately five square block area on the west side of Manhattan. The producers themselves may be relatively small, and the laborers and producers may be acting as individuals not in concert, but the fact that they are so close to one another leads to a free flow of information and services with minimal search, transportation and other transactions costs thus causing the unit costs of all producers to fall. This proximity and relatively costless exchange of information and knowledge may also lead to technical and other innovations which might not otherwise occur if the separate economic agents were more disparately located. In this sense, agglomeration economies are “external” to the agents, arising in the aggregate, not in the individual units themselves, although these aggregate effects do ultimately ripple through the individual units.

Agglomeration economies and economies-of-scale both arise from and lead to economic forces driving producers and consumers to concentrate in or disperse from different physical locations. What they tend to do, in classic economic fashion, is to lead to specialization in function across space, working in tandem with the notion of comparative advantage. Again central place theory comes to mind: one place may become a center of high finance, another a center of watch manufacturing because it is more efficient for one place to do the one thing and the other place the other so long as the two places trade with one another.

In a very abbreviated nutshell, that is the “old” economic geography. What about the “new” economic geography. Paul Krugman’s Geography and Trade, (1991: MIT Press) is an excellent and very readable summary of the field (and indeed, Krugman has much to do with inventing the “new” field).

On the one hand, there is much that is not very new about the “new” economic geography. Krugman’s definition of economic geography as “‘the location of production in space’; that is, the branch of economics that worries about where things happen in relation to one another.” (p. 1) applies equally to the old and the new fields. The behavioral assumptions of rational and self-seeking maximization are common to both disciplines and many of the concepts remain the same. Even some of the supposedly profound new policy insights are very much presaged in the old field, as will be discussed in more detail below.

So in one sense, there is not much that is truly revolutionary about the “new” economic geography. But in another sense, the world has changed quite a bit since the “old” field developed and the “new” thinking has taken much of this change to heart. In particular, and as summed up by Krugman, the new economic geography takes the old foundation and goes in two separate directions from it: (1) the recognition that there may be multiple equilibria across space (and here the role of history, accident, pervasive increasing returns and imperfect competition are important); and (2) the recognition that such equilibria, in the form of economic regions, are increasingly occurring across national boundaries (i.e. that economic regions are becoming less and less likely to be subsumed within a single nation).

The first point about multiple equilibria is best understood by reference to en example Krugman himself uses. Consider the table below:

Distribution of Manufacturing Employment	Costs of typical firm if it produces in...	EAST	BOTH	WEST
EAST ONLY	Fixed	4	8	4
	Transportation	3	0	7
	Total	7	8	11
50-50 SPLIT	Fixed	4	8	4
	Transportation	5	0	5
	Total	9	8	9
WEST ONLY	Fixed	4	8	4
	Transportation	7	0	3
	Total	11	8	7

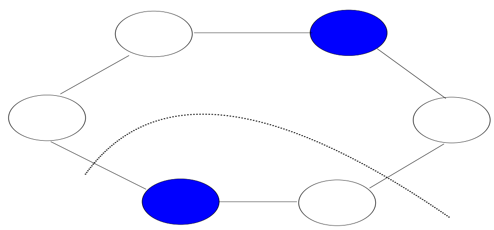
Assume that there are only two sectors in the economy — Agriculture (A) and Manufacturing (M) — and that A provides 60% the labor force. M's location is going to be driven by a few factors. First there are the fixed costs of M which, for a single plant, is always equal to 4. Then there are transportation costs of goods to market. These costs will be lower if the demanders of goods are located in the region where the goods are produced. If M is already concentrated in the East, then the M industry will concentrate in the East as well. One plant can be built there for a fixed cost of 4, and transport costs are lowest there because so much of the demand is already there and relatively little has to be transported outside the area. Total costs for producing in the region are 7, less than splitting production between regions (which lowers transport costs to 0 but now requires construction of two plants at a cost of 8) or of locating the West (which has higher transportation costs because so much product has to be shipped out of the region).

But this is not the only equilibrium. For if M concentrates in the West, then all M firms will want to locate there; if the sector ends up being split, then firms will want to split their locations as well. Where you end up depends on where you began and where you are headed and none of that is predetermined. In fact, location will depend on sufficiently strong economies of scale; sufficiently low costs of transportation; and sufficiently large shares of "footloose" production not tied down by natural resources. If these are large enough, then "history" matters; if not, then pure economics matters and there is likely to be a single equilibrium.

The other main insight of the "new" economic geography is the internationalization of economic exchange. Krugman makes the point that international economics needs to better integrated into economic geography since nations are political entities, economic regions are not and the latter often crosses the boundaries of the former. In this sense, Europe, with its market integration, is trying to replace international economics, which focuses on nations, with economic geography, which focuses on regions.

Again Krugman provides an example which is quite clear and which is represented in the picture below. In this simple example, there are six economic regions, each connected by the transportation links indicated (there are "impassable mountains" in the middle which make other connections impossible). The dotted line shows the national boundary dividing the regions. The one country to the north has an industrial center (indicated by the shaded circle) and so does the country to the south.

What happens if the national border is removed? One might expect the larger country, with 4 regions, to gain the smaller country's industry — the big nation becomes the industrial core, while the smaller nation becomes the industrial periphery. But there is another possibility. If the equilibrium ends up having 2 cores, then the small nation will not only retain its industrial center but this center will gain at the expense of the larger nation because the smaller nation now has full access to the other nation's hinterland. Again, all of this is driven by transport costs,



footloose industry and economies of scale. Depending on these factors there may be more than one core or perhaps no core at all.

Implications for the economic development official

What has all this to do with the economic development official and the job that official has to do either in the generation between Kennedy and Reagan or the generation of Reagan, Bush, Clinton and beyond? Quite a bit, as it turns out.

"New" and "old" economic geography share a quite common core, namely the factors which drive production, consumption and exchange. An urban economic development official has one primary goal: to ensure that more of these activities, particularly the high-value ones, come to the city which he or she serves. Both old and new theories identify the key components of such activities and the ways in which they are driven by physical space.

For example, producers are profit maximizers and, as such, are cost minimizers. Conceptually, one could imagine the following cost function:

Producer Costs = F(raw materials, energy, labor, capital, land, transportation, information, technical knowledge, etc.)

Each of these factors, and there are others, are affected by the location of production in various ways. A city located near a source of raw materials, such as coal, will have an advantage over other locations in the case of industries which rely heavily on the use of coal as an input. However, this same city may have scarcity of land, labor and other inputs which may raise producer costs and may thus advantage other locations. Similarly, a city with a good transportation network and a large market for the good being produced will have lower transport costs and thus be advantaged over other locations. If there are significant scale or agglomeration economies for particular inputs, this too may advantage one location over another.

The economic development official then can ask: in what particular ways is my city advantaged over others, in what ways is it disadvantaged and what, if anything, can the city do about it? A similar sort of analysis can be done for attracting consumers to the region, although in this case, the factors affecting consumer location may be somewhat different (e.g. good schools and amenities), though some will be common (e.g. good transportation networks and low transport costs).

For the economic development official in the 1960's, the analysis could very well stop here. U.S. cities at that time had a large, though declining, manufacturing base and that sector in particular was fairly sensitive to transportation and raw materials costs. And even service industries had higher fixed costs and were more labor intensive and less knowledge-based than now, so location close to large pools of qualified workers was an advantage. In this sense, larger cities in the manufacturing belt, such as New York or Chicago, or growing cities in growing economic areas, such as Los Angeles, were advantaged players in the economic era.

As is well known, though, the 1960's were the beginning of the end of a city-center based era. Manufacturing declined in both the cities and the country as a whole and internationalization of the U.S. economy slowly grew, a development which meant that producers could find radically lower labor and other input costs overseas and thus often relocated out of American urban areas as a result. And at a national level, this same desire for lower costs was driving suburbanization of service industries, such as the flight of corporate headquarters offices in New York to the Connecticut and Westchester suburbs and beyond where costs of land and transportation were lower and to which residents (and from the firm's perspective, its labor pool) were fleeing to anyway.

Here is where the "new" economic geography comes into play. Beginning in earnest in the late 1970's and early 1980's, two new developments took hold of the economy. For one thing, the deregulation of ground and then air transportation in the United States began to drive down unit transportation costs. For another, the "information revolution," computerization and the expansion of the communications network all made the growing service industry more reliant on the one factor which often costs the least to transport across distance, namely knowledge.

All of this was transpiring in the midst of a growing binding of nations within an international economy.

For some analysts, these development spelled the final end of the city, for knowledge-based economies were thought to be especially footloose: one could be a computer programmer, say, in rural Utah serving clients in New York City or even Algiers since the main product being developed and exchanged was bits and bytes which would be relatively costlessly transferred over the rapidly improving communications and information network. In the few instances where face-to-face contact was necessary, lowered transportation costs made this less of an expense than before and hence less of an incentive for the producer to locate near the customer.

This scenario has not (yet) come to pass and at least part of it has to do with the insights of the "new" economic geography. Again, one could start by looking at the cost function above. For what is important to production location is not just absolute costs but relative costs. Lowered transportation and knowledge costs in particular cut both ways: as they fall, they lessen the advantage to locations close to sources of inputs or near customers, but at a certain point they get to be such a small part of the producer's costs that the producer is less sensitive to further reductions in that cost.

Thus in the 1960's, suburban and foreign locations often offered significantly lowered input and transportation costs and drew enterprises out of the cities. Now many of those costs may have fallen sufficiently that comparative advantage may be reasserting itself and for cities that comparative advantage may be in economies-of-scale and agglomeration economies, the very sorts of things that information-based services thrive on. In fact, the incentive may not be so much to locate in the country, away from other producers in similar businesses, but to locate in the city near other producers like you so that the economic synergies mentioned earlier may be realized. These synergies may more than enough to compensate in many instances for higher input and transport costs that still tend to prevail in center cities (and, in some especially declining cities, these costs may have fallen below the costs in nonurban locations anyway).

A tale of four cities

Here is where the "new" economic geography becomes especially powerful. Consider the insight that historical accident may be critical to location outcomes. In this case, cities which are already the center of particular industries may actually be able to enhance their advantage, an advantage which may have accrued as a result of shrewd entreprenurial decisions in the past or arisen as a counterpart to previously strong but now fading advantages in other markets.

Consider the 4 U.S. cities which are analyzed in more detail below: New York, Chicago, Los Angeles and Miami. New York quickly gained dominance in the U.S. as a commercial and trading center. Its specialization in high finance came along with that dominance. As a center of trade, New York's advantage has long since eroded, but it remains a financial center, just the sort of knowledge-based industry that is currently preeminent. This advantage is not unassailable, but it provides New York with an important head-start against other comers. Similarly with Chicago which was once a center of the meat industry and an entrepot for Midwestern agriculture and as a result developed the extensive commodities futures network that it still possesses today. The old comparative advantage is basically gone, but the other one remains.

With Los Angeles and Miami, the historical accident is more one of decisions made by entrepreneurs decades back, film producers in the former case, Walt Disney in the latter case. Combined with natural climatic advantages, these cities have a comparative advantage in films and tourism respectively, and present conditions suggest that this advantage may consolidate with time rather than wither.

Then consider the role of internationalization. For in the 1960's, New York's primary threat to its financial market advantage came from the suburbs and from Chicago while Chicago competed with New York. Miami competed with other locations in Florida, California and Hawaii to gain tourists. And Los Angeles' primary competitor, to the extent there was one, was New York. In the 1990's, the same forces that may be leading to consolidation of comparative advantage in existing locations within the U.S. are also working the same way in other markets outside the U.S. Thus London appears to be consolidating its position as the financial center of Europe while Tokyo, a little less obviously, may be becoming the financial center of Asia. As financial markets integrate New York is much more threatened by these overseas competitors and so also, for that matter, is Chicago. Similarly, Miami is competing more for a pool of international tourists than it is for domestic travelers. Only Los Angeles continues to remain relatively secure in its position as film capital of the world and this is due mainly to the fact that other countries seem thus far unable to develop viable international industries of their own. (Exceptions, such as India, which produce films largely marketable only to the Indian subcontinent and its emigres abroad, prove the rule). In this case, foreign firms such as Sony choose to join them rather than beat them by buying up Los Angeles based studios. To a lesser extent this also occurs in the financial industry as well.

Thus the job of the economic development official beginning in the 1980's and continuing into the millennium is somewhat different from that of the same official in the 1960's. In the earlier time, the primary focus was on lowering costs where possible, by building better transportation networks, providing industrial infrastructure, and cutting tax breaks and providing location incentives. In part this made sense because there were plenty of government funds to spare to do this and in part it made sense because cities were competing with each other and with other areas largely on the basis of costs. The problem, however, was that the cost differentials were probably too great to overcome even with extensive government subsidy. Poorly designed or untested policy programs (urban renewal comes to mind), together with some difficult social developments (such as rioting and the explosion in violent crime) made the period between 1960 and 1980 an especially troubling time for cities.

Beginning in the 1980's the situation began to change. Costs remain important to many industries, especially manufacturing, which is one reason why most older cities in the U.S. continue to bleed manufacturing jobs (though Chicago is an interesting exception). What seems to matter more now is comparative advantage, economies-of-scale and agglomeration economies. If you've got these things already, flaunt them and nurture them. If you don't have them, try to identify a niche and develop it.

The tools remaining to government have not changed much since the 1960's, namely direct investments such as infrastructure and indirect subsidies such as tax breaks. The difference is the strategy to which these tools are devoted. To a large extent, this is a time where tinkering with cost differentials, as least those that government can realistically do much about such as transportation costs, will probably not yield as much payoff as strengthening existing advantages or developing new ones.

The story does not end there, however. As mentioned before, manufacturing is probably driven more by the "old" cost factors and indeed, as Krugman points out, concentration of manufacturing in the US has been declining since 1985. This may be true of other industries as well and has to be taken into account when planning economic development strategies. In other words, the economic development official has to know well the cost structure of existing industries and industries which might be candidates for attraction in order to know what sorts of policies may be feasible.

In addition, industries are composed of many sub-specialties. To the extent that comparative advantage becomes the flavor of the day, it may mean that an industry once concentrated in one location may find various sub-divisions of that industry concentrating in other locations. The financial services industry is a good example. In financial markets there are commodities futures and stock exchanges, to name but two sectors. Chicago and New York have already, respectively, become centers of these two subspecialties. There are also commercial and investment banks (though the distinction between these two is becoming increasingly blurred), foreign exchange markets and venture capital, and the list could go on. There is a tendency for each of these specialized subsectors to become concentrated in locations where economies-of-scale and agglomeration economies can best be realized. Thus Texas is often mentioned as an emerging venture capital source, London is a center of foreign exchange, and investment and commercial banking continues to be centered in the New York metropolitan area.

Here is one clear implication for economic development strategists: if you are looking for a comparative advantage, consider the subsectors which may be most ripe for new development or cherry-picking from other sites. To continue with the financial markets example, a small city like Austin need not give up on developing a niche in financial service markets simply because New York, Chicago and even London dominate those sectors. There may be particular cottage industries within that sector that Austin can develop by somehow showing that it could have a comparative advantage.

On the other hand, if you are defending your existing advantage, you have to ask two questions: First, can my city reasonably protect what its got? Second, if not, what niches can my city develop even more, either attracting other operators from other locations or developing new home-grown additions. Thus, for example, New York may make a policy decision to cede the venture capital market to others (which really means that scarce government subsidies and attention will not be focused on that sector) to focus on consolidating the investment banking sector in the city.

Conclusion

The genie is waiting for an answer from the development official. Which answer that official will give will depend in part on personal preference. But the key point is this: the very economic factors which helped lead to the rise of cities in the first place, namely those of comparative advantage, agglomeration economies and economies-of-scale, are back and playing leading roles. In a general sense, that bodes well for the future of many cities. But development officials in this modern era cannot rest easy. Strategic advantage can be lost as well as won and there are fewer resources to work with than before. The tools of both the "old" and the "new" economic geography can ensure that the winning occurs more often the losing.

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