

# LOUISIANA'S ECONOMIC BASE

Louisianians concerned about strengthening the state's economy often ask, "Are some of the state's industries more important than others? If so, do they warrant special attention and concessions?" The common responses to these questions are derived from the economic-base model of economic growth, and this model lies at the heart of many state and local economic-development policies. Unfortunately, the economic-base model is seriously flawed and policies tied to it are likely to result in fewer family-wage jobs and lower standards of living.

The economic-base model is straightforward. It divides an area's economy into two sectors: the "basic" sector, which produces goods and services for sale to buyers outside the area, and the "local" sector, which sells its products within the area. Because the export sector brings in money from the outside that is spent and respent on local goods, it is the "economic base" that "supports" the local sector. The economic base typically includes resource-extractive industries (mining, agriculture, fishing, timber) as well as heavy manufacturers, and the local sector includes everything else. As firms and workers in the basic industries buy goods and services from the local sector, the basic industries have a "multiplier effect" on employment and earnings. The local sector can expand and decline only as a result of growth or contraction in the basic industries. Hence, according to the economic-base model, economic-development policies should focus on protecting and stimulating growth in the basic industries.

**There are three conceptual problems with the economic-base model.** The first, sometimes called "the dumb-person bias," arises because the model assumes that investors, managers of firms, workers, and consumers are rigidly locked into their dependence on the basic industries. This problem surfaces most clearly when proponents of the model argue that a regulation or other restriction of a basic industry will have permanent, devastating impacts on the overall economy. Louisiana's chemical industry, for example, has estimated that the loss of one job in this industry will cause the loss of 9.2 jobs elsewhere in the state.<sup>1</sup> This multiplier effect will manifest itself, however, only if the chemical-industry job were eliminated and:

- The displaced chemical worker never worked again, but also did not move.
- The local and regional establishments that sold goods and services to the displaced worker permanently lost that business and obtained no replacement business (and also did not move).
- Those enterprises in the region that used the output of the displaced chemical worker obtained no replacement input (and also did not move).
- Everyone throughout this chain who lost his or her job acted exactly the same way as the original job loser, in that they never worked again and did not move.

### **The Economic-Base Model Runs Aground on Common Sense and Simple Arithmetic**

Industry-sponsored research using the economic-base model indicates that each worker in the oil/gas and petrochemical industries supports as many as another 9 workers in other industries. Thus, the industries support, not only the approximately 100,000 workers employed directly in them, but as many 1 million workers total.

If this view were correct, then employment in the industries and total statewide employment would be highly correlated. During the 1980s, however, employment in these industries shrank by 23,000 while the rest of the economy grew by twice this amount. These industries have not been a major source of *new* jobs for three decades.

The economic-base model (and economic-development policies derived from it) cannot be correct if the overall economy moves in the opposite direction as the basic industries.

In reality, workers, firms, and consumers will not sit immobile, but, instead, will react and adjust. Economic-base models can tell us how many jobs (or, more generally, how much economic activity) *currently* depend on a given industry or line of work, and they can shed light on who stands to gain or lose in the short run from a change in the industry. They tell us very little, however, about what the local economy will look like after it adjusts to growth, decline, or other changes in a basic industry. In short, using the economic-base model for forecasting is like trying to drive by looking in the rearview mirror.<sup>2</sup>

### **The second problem** arises

when proponents of economic-base models assume that increasing the sale of exports from the basic industries is the only way to increase the welfare of local residents. All else remaining unchanged, the welfare of local residents increases if any of the “local” industries becomes more efficient or if there is an increase in the local quality of life, such as an improvement in air and water quality. The economy also can benefit if it produces products that it otherwise would import from elsewhere. These changes can affect the export sector itself. If improvements in water quality, for example, make a community more attractive to workers and their families, an export firm will be able either to hire more productive workers at the same wage or to hire equally productive workers at a lower wage than its competitors elsewhere. The resulting decrease in unit labor costs will allow the firm to decrease its price and sell more of its product.

**The third problem** occurs when proponents disregard the importance of local actions, such as rational land-use management or improvements in schools. Such actions directly increase residents' welfare. Furthermore, they lower the cost of locally-produced inputs for local exporting firms, increasing their productivity, output, employment, and net revenues. In the economic-base model, schools, land-use planning, and other public-sector services rest on the shoulders of the basic industries. It's the other way around, however, in today's world, where firms compete in global markets and both firms and workers are footloose. Here, the competitiveness of all firms, especially those that export, depends heavily on the quality of the workforce and the efficiency of local public services.

**Louisiana needs a better model.** The economic-base model underlies many of the economic-development policies in Louisiana and elsewhere, where it has been used to justify tax breaks, development incentives, and regulatory relief for resource-extraction and manufacturing industries. It is important to recognize, though, that the models came to light when resource extraction and manufacturing dominated the economic landscape, local economies changed slowly, and both firms and households stayed put. None of these conditions is true today. To evaluate these industries' role in a diverse economy dominated by services and footloose firms, economic-base policies may be not just inaccurate but counterproductive.

A better approach for evaluating the role of extractive and manufacturing industries is to focus directly on the costs and benefits Louisianians derive from them. No industry warrants preferential treatment when it imposes large, net costs on Louisianians. These costs can occur when industries export profits to stockholders living elsewhere and offer Louisianians dim prospects for growth in jobs and earnings, while degrading Louisiana's environment, extracting tax concessions from Louisiana's communities, and displacing economic growth in other sectors of Louisiana's economy. It is time to make economic decisions with an eye on the future, not on the outmoded models of the past.

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For a broader discussion of the problems, see Barkley, P.W. and T.H. Allison, Jr. 1968. "Economic Base Studies in Resource Administration." *Land Economics* 44 (4): 470-479. Cunningham, T.J. 1995. "Structural Booms: Why the South Grows." *Federal Reserve Bank of Atlanta Economic Review* May/June: 1-10. Krikelas, A.C. 1992. "Why Regions Grow: A Review of Research on the Economic Base Model." *Federal Reserve Bank of Atlanta Economic Review* July/August: 16-29. O'Sullivan, A.M. 1993. *Urban Economics*, Second Edition. Irwin. Richardson, H.W. 1985. "Input-Output and Economic Base Multipliers: Looking Backward and Forward." *Journal of Regional Science* 25 (4): 607-661.

<sup>1</sup> Scott, L.C. 1993. *The Chemical Industry in Louisiana: Economic Profile*. Louisiana Chemical Association. April.

<sup>2</sup> Power, T.M. 1996. *Lost Landscapes and Failed Economies: The Search for a Value of Place*. Washington, D.C.: Island Press.

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