

**ASSESSING THE MIDWEST ECONOMY**  
***Looking Back for the Future***

***Report of Findings***

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## Foreword

*The dramatic comeback of the Midwest's economy and the outlook for its future were the subject of this comprehensive study by the Federal Reserve Bank of Chicago, Assessing the Midwest Economy: Looking Back for the Future. The root causes and full dimensions of the Midwest's revival have not been fully examined and understood. How did the Rust Belt of old become an apparently high-performing economy? To what extent is this characterization accurate and how secure are the new economic foundations? The Bank's study offers a more complete understanding of these issues. This is key to forecasting future performance and, more importantly, to developing policies that will enhance the region's prospects for continued economic improvement. By focusing on the region's longer-term challenges and opportunities, we see this study's value as both avoiding complacency about current midwestern prosperity and helping set a course for its future.*

*The Federal Reserve Bank of Chicago is uniquely positioned to provide this service to the region's residents. The Bank is a truly regional institution having a firm and longstanding midwestern foundation. Over the 83 years of the Bank's operations, it has monitored and studied the regional economy which has moved from the pinnacle of economic strength, to one whose prospects appeared destined to be in perpetual decline, to today's economy of growth and optimism.*

*The findings contained in this volume are a compilation and summary of a yearlong effort, during which Federal Reserve Bank of Chicago economists worked with experts from the public and private sectors to produce more than two dozen papers focusing on critical subjects, including industry trends, the agricultural and urban sectors, global markets, taxes and regulation, the labor force, education, and technology. To enable researchers to present and discuss their works in progress, the Bank held a series of six workshops, each focusing on one aspect of the regional economy. Thanks are due to William A. Testa, project director, and Thomas H. Klier and Richard H. Mattoon, assistant project directors. We are also especially indebted to our advisory board representing a cross section of Midwest leaders, including the governors of Seventh District states, which provided guidance for the project. We look forward to further work and cooperation with these advisors, along with our many other regional partners and customers.*



Michael H. Moskow  
President



William C. Hunter  
Senior Vice President and Director of Research

# Executive Summary

In cooperation with national and regional researchers, the Federal Reserve Bank of Chicago began a yearlong assessment of the Midwest economy in late 1995.<sup>1</sup> The project's primary mission was to document the dramatic turnaround in the region's economic fortunes since the early 1980s. The project was motivated by the belief that regional prosperity has often proved fleeting and a thorough understanding of the internal and external forces that have contributed to the region's recovery would allow public and private policymakers to craft policies to sustain the Midwest's economy. The Midwest assessment project was designed to investigate the interrelationships and key emerging trends in such areas as globalization, labor force development, industry structure, government policy, and geographic shifts in industrial location. Public and private decisionmakers, academic researchers, and economists from the research department of the Federal Reserve Bank of Chicago addressed these issues at a series of workshops held at the Bank over the course of the year.

## Why Did the Region Recover? Internal and External Factors

Evidence abounds of the region's economic recovery over the last ten years, ranging from state governments with record fund balances, to recent population in-migration, to resurgent strength in the region's mainstay industries—manufacturing and agriculture. Perhaps the broadest measure of recovery can be found in the region's labor markets, where the aggregate unemployment rate has been below that of the nation for five consecutive years.

The breadth of this recovery has helped the Midwest shed its Rust Belt image and has brought renewed attention to the region. The Midwest is increasingly being recognized for innovation in both the public and private sectors, often in sharp contrast to its previously staid image.

The region's recovery is clearly the product of both favorable external forces that have boosted the prospects of key regional industries and internal policies by public and private sector decisionmakers that have positioned the region to respond to global competition and the painful restructuring that faced the Midwest's economy during the Rust Belt days of the 1970s and early 1980s. Throughout the six workshops

held in conjunction with the study, the following internal and external factors were identified. The internal factors contributing to recovery include:

- *Technology and organization*—The way that business is conducted in the region has changed in terms of business organization, mode of operation, and the application of technology. For example, the application of lean manufacturing technologies is contributing to the region's manufacturing revival.
- *Costs of business operation*—The Midwest has changed its image as a high-cost place to do business. In recent years, wage and energy costs have tended to converge with national averages, in contrast to the 1970s and early 1980s when these costs were well above the national averages.
- *Public sector policies*—Midwest states have pursued prudent fiscal policies that have restored state fund balances, while developing a national reputation for innovative policy efforts in areas like school funding and welfare reform.
- *Institutional capital*—Midwest states have a rich array of public and private organizations that can help improve the quality of decisionmaking in the region. Chambers of commerce, industry trade groups, councils of government, and public and private research groups all help identify critical policy issues that need to be addressed to sustain the economy.

The external factors include:

- *The new geography for production location in the auto industry*—U.S. auto assembly plants have tended to reconcentrate in the Midwest since 1980. A change in the industry's product mix has changed the economics of plant location in favor of the midsection of the nation. The number of auto assembly plants in the region increased from 27 in 1979 to 31 in 1996.
- *Federal spending patterns*—The recent reduction in federal spending, particularly related to defense, has not hurt the Midwest. While the West Coast and New England have faced the difficult task of restructuring their economies away from a heavy reliance on defense industries, the Midwest has avoided this restructuring to a large degree. In addition, the region's mix of defense-related industries suggests that conversion of these firms to civilian products and services might be easier in the Midwest than in other regions.

- *Falling energy prices*—Delivered prices of all major fuels to the Midwest have declined since the mid-1980s. Given the energy intensive nature of the Midwest economy, lower energy costs have clearly contributed to the region’s rebound.
- *Exports*—Exports have become more important to the U.S. economy. With its mix of capital goods and agricultural products, the Midwest has proven particularly adept at taking advantage of this trend. Evidence produced as part of this study suggests that the region’s success in growing exports with key trading partners owes more to improved regional productivity and expanding foreign markets than to currency depreciation.

### The Midwest at a Crossroads

Despite the fundamental changes that have put the Midwest’s economy on a higher growth path, this confluence of good fortune cannot be expected to continue indefinitely. Throughout this project, analysts identified key challenges that the region must address if it is to continue to prosper. First, policymakers need to respond to the new economic order that has emerged from the region’s restructuring. For example, while manufacturing and agriculture have revived their competitive fortunes, they continue to shed employees in favor of new technology. Similarly, while labor markets have tightened considerably, the region has yet to see a complete recovery in terms of per capita income.

Other challenges relate to the continuing process of adapting to change. For example, two mainstay farm segments, hog and dairy production, have seen their national market shares of production erode as mega-farms and new production methods have favored other regions of the country. Meanwhile, mid-western metropolitan areas, particularly highly populous ones, continue to move toward a more service-based economy. However, given older infrastructure, environmental contamination, and, often, a mismatch between the skills of the urban work force and the needs of business, the conversion is often more challenging than in other regions of the nation.

Finally, the Midwest, like all regions, faces the challenge of designing policies in an environment in which the federal government is actively shifting responsibility to the states. This will provide the region’s policymakers with more freedom to create region-specific policies, but it also will make them more dependent on region-specific resources.

### Describing the Policy Strategies

Three themes from the project “Assessing the Midwest Economy” can serve as a regional blueprint for further analysis and action. These policy strategies are:

- increased emphasis on education and work force training;
- greater attention to and evaluation of region-specific public policies; and
- improving our understanding of, and adaptation to, changing industry technology, locational preference, and internal restructuring.

On the surface, these themes appear simple, but designing policy to enhance the region’s economy requires a careful understanding of the interconnections between these areas. In many ways, all of these themes reflect the importance of regional adaptation to globalization. Ironically, as the world economy becomes more integrated, regional differences and policies become more important.

### Understanding the Three Policy Strategies

**Increased emphasis on education and work force training**—As the world economy continues to place a higher premium on human capital, particularly in fast growing, knowledge-based industries, a region’s ability to develop and attract the best possible work force is key to its future prosperity. It is important that education and training models prepare individuals to be life-long learners and that workers can adapt to changing labor market needs. Models for continuous improvement in the skills of current workers and effective education systems for elementary and secondary students are critical. In addition, programs need to be designed to bring the disadvantaged into the work force.

**Greater attention to and evaluation of region-specific public policies**—A significant portion of the Midwest’s trade of goods and services flows between states in the region. Therefore, reducing interstate differences in occupational licensing, freight hauling standards, and tax and regulatory structures could provide significant economic advantages. In addition, efforts should continue to identify regional and international cost differentials that reduce the economic attractiveness of midwestern states and to reduce these costs based on sound economic principles. For example, the Midwest assessment project found that taxes paid by businesses exceed the benefits of the services these businesses received from government. Aligning business tax structures more closely with the costs of the services provided by government would help economic development. Finally, regional policies need to address the continuing trend of transferring federal program responsibility to the states. This might include sharing information on the best practices for newly created state programs, such as welfare-to-work, as well as forming strategies to address issues facing the region as a whole, such as global trade agreements.

**Improving our understanding of and adapting to changing industrial technology, locational preference, and internal restructuring**—Changing industrial technology and internal restructuring are clearly playing major roles in determining the location of economic activity. In metropolitan areas, technology is a critical factor in explaining the deconcentration of economic activity from the city toward the suburbs and urban fringe. Similarly in rural areas, technology has spurred the development of manufacturing facilities, while permitting production agriculture to continue to increase farm yields with fewer workers. An understanding of these processes and their implications will allow the development of policies that support economic growth rather than create barriers that can slow the region’s ability to take advantage of economic change.

## The Need for Regional Information

The Midwest assessment project has made it clear that regional information is critical to the region’s continued prosperity. One-size-fits-all policy options will become less relevant as specific regional conditions and behaviors increasingly need to be taken into account in policy formation. It is equally important that this information be disseminated efficiently to decisionmakers in both the public and private sectors. This project represents the first step in this process.

<sup>1</sup>Unless specified otherwise, the Midwest refers to the states of the Seventh Federal Reserve District: Illinois, Indiana, Michigan, Iowa, and Wisconsin.

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