# DELAWARE: A STATE OF OPPORTUNITY?

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# *Executive Summary*

*Over recent decades the performance of Delaware's economy has steadily deteriorated. Growth in output, income and jobs has slowed, converging on the national average. Slower growth diminishes opportunities for all of Delaware's citizens.*

*The contention of this report is that providing increased opportunities to individuals and firms fuels the "creative destruction" process that is essential to economic growth and development. The report identifies areas where economic freedom in Delaware may be unnecessarily constrained. Further in-depth examination of these areas of freedom deficiency will be the focus of the Caesar Rodney Institute's Center for Economic Policy and Analysis for the immediate future.*

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Enhancement of human freedom is both the main object and the primary means of economic development and growth.[1] As the pace of technological change has accelerated, it is increasingly evident that no expert or government official can accurately anticipate what the economic "winners" of tomorrow will be. The best a state like Delaware can do is provide a framework of regulations, laws, taxes, spending and services that facilitate the process of economic change…the process of "creative destruction;" an environment that maximizes the freedom of individuals to make the most out of their lives.

The focus of the central issues for economic development and growth then shifts to such questions as: Is there freedom of choice in education? Are all communities equally safe? Are private property rights encouraged and protected? Can healthcare, particularly preventative care, be obtained by anyone wishing to take the initiative? Is there bias in financial markets? Are there economic structures that inhibit employment growth, such as the concentration of economic power (e.g., monopoly; state ownership of the means of production), unnecessarily high taxes or regulatory barriers to entry that stifle competition?

The structure of this report is simple. First, bottom-line, how has Delaware's economy performed in recent years? Has the structure of jobs and income changed over the past decade? Second, how does Delaware measure up to other states on simple measures of economic freedom? Could Delaware better encourage the pursuit of economic opportunity?

The objective of the report is to identify areas of freedom deficiency that would benefit from more in-depth research by Caesar Rodney Institute's Center for Economic Policy and Applied Research. Research that could identify changes that would return Delaware to the top tier of state economies.

## HOW GOES DELAWARE'S ECONOMY?

Some general measures of positive economic performance are growth in per capita output, the growth and distribution of income, and the robustness of labor markets.

*Output.* Output is the inflation-adjusted value added by labor and capital located in a state during a year. As of 2007 output per capita in Delaware was a whopping 57% above the nation, $71,402 to $45,523. Before celebrating, however, two facts must be taken into account.

First, the majority of the difference between the state and the U.S. is due to the concentration of financial and insurance services in Delaware. When the finance and insurance industry is removed, the state's output advantage drops to 12%. The remaining industries where Delaware retains an output advantage include chemical manufacturing with its concentration of executive and research positions, rental and leasing services, the corporate focused legal industry, scientific research, management of companies, and hospitals.

The fly in the ointment with finance and insurance is the portion of output that actually remains in Delaware. Output is estimated for any industry by the summation of employee compensation, taxes and gross operating surplus. Gross operating surplus is composed primarily of proprietors' income and corporate profits. The direct and indirect economic impacts of the wages, salaries and benefits paid to employees tend to stay concentrated in the state where the producing industry is located. A portion of taxes also goes to state and local government. Much of the gross operating surplus, on the other hand,

[1] **Amartya Sen, 1999, *Development As Freedom*, Anchor Books, NY, p 53.**

accrues to the parent corporation and its stockholders.

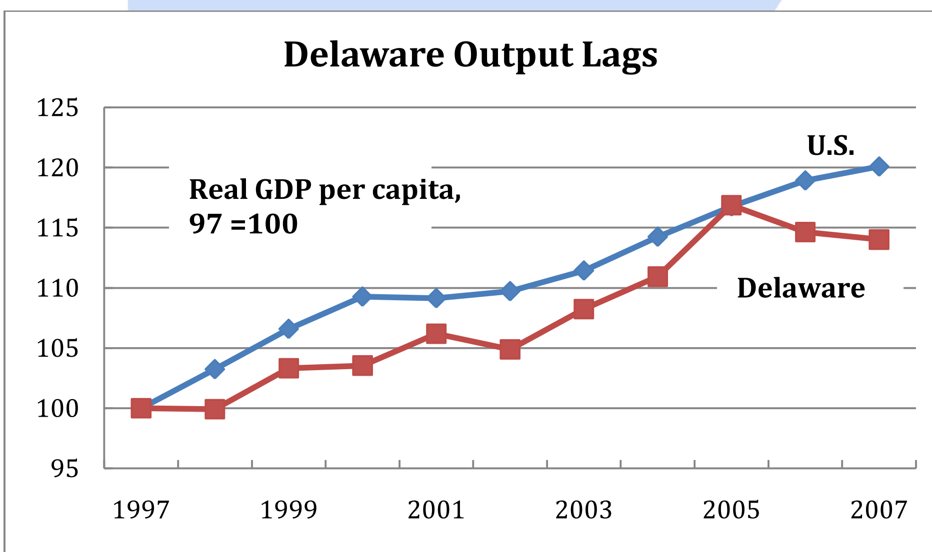
During 2007, only 18% of the output in finance and insurance was accounted for by compensation of employees and 80% went to gross operating surplus. For all other industries 54% of output went to employee compensation and 40% to gross operating surplus. Most of the output of the credit card operations and insurance companies in Delaware, in other words, drifts out of state to corporate headquarters and stock holders.

The second fact to take into account is that over the past decade output per employee in Delaware has been growing at a slower pace than the nation (Chart 1). The trends causing this low ouput growth are expected to continue.

First, manufacturing output has been falling faster in Delaware, especially in durables, including auto production. Even in nondurable manufacturing, such as the chemistry industry, Delaware's advantage is diminishing. Second, credit card bank jobs have peaked and are retrenching. Finally, Delaware has undergone a structural shift with output growth disproportionately concentrated in lower productivity sectors such as accommodations, food services, gambling, social services and healthcare.

How can the relative downward trend in output per employee in Delaware be reversed? What private sector or governmental actions will effectively change the incentives of individuals and agencies to invest in Delaware so that output levels can rise faster than national averages?

*Chart 1*




*Source: BEA*

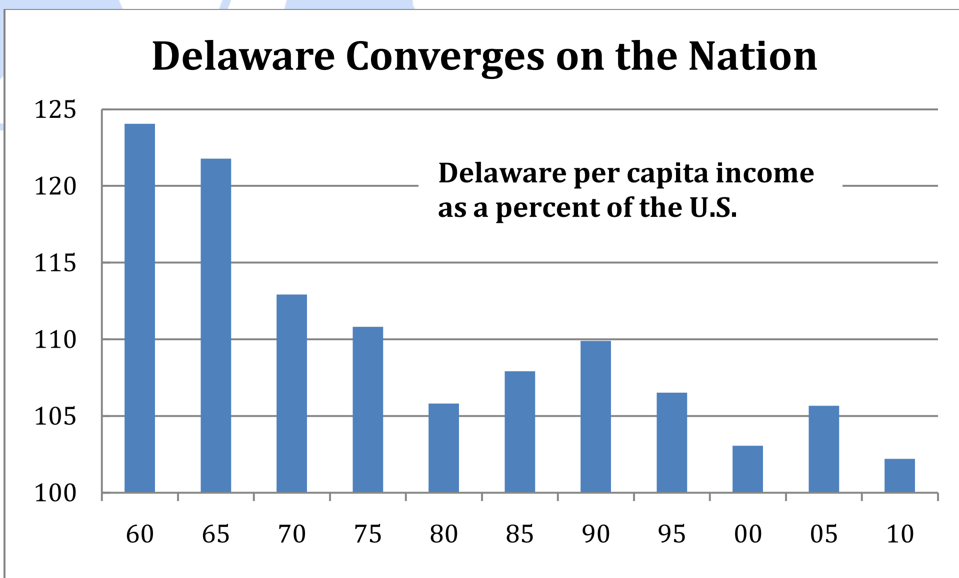
*Personal Income.* Personal income is the income received by individuals from all sources by place of residence. It includes the summation of wages and salaries, proprietors' income, dividends, rents, interest and transfer payments.

Over the past decade Delaware personal income has been growing at about the same rate as the nation. Since Delaware population growth has exceeded the nation's however, per capita income in Delaware has thus dropped from 4% above the nation to 2% above, the continuation of a five decade trend where the state's per capita income started at 24% above the nation in 1960 (Chart 2). This per capita income convergence is driven mainly by demographics and the changing structure of the state's economy.

The fastest growing segments of Delaware's population…blacks, Latinos and the elderly…all tend to have lower per capita income than average. According to the Delaware Population Consortium these groups will continue to be the fastest growing segments for the long term.

At the same time, wage and salary income growth in Delaware has fallen behind the nation over the last decade due to a series of previously cited structural shifts within the state's economy. Financial services stopped growing and job cuts in the industry tended to focus on the higher wage positions. Automobile manufacturing disappeared. The chemical industry continued to shrink. Most job growth occurred in the lower wage industries such as retail trade and tourism or in healthcare where wages are average.

*Chart 2*




*Source: BEA*

Significant shifts have also been taking place in the composition of Delaware's personal income. Between 1998 and 2008, wage and salary income has become moderately less important as a component of personal income. Due to demographic changes and the current recession, income from dividends, interest and rents has dropped from 21% to 17% of total income.

The segment of Delaware personal income that grew over the past decade has been transfer payments which jumped from about 12% to almost 17% of total income. This shift is found across the nation, but is occurring more rapidly in Delaware. The two major components of transfer payments, medical benefits and social security, have been rising considerably faster than the nation.

About 46 cents out of every dollar of transfer payments received by residents in Delaware is for medical benefits, split between Medicare and Medicaid. Between 1998 and 2008 medical benefit transfer payments have risen almost one and a half times faster in Delaware than throughout the U.S. The driving forces behind this growth have been a surge in the in-migration of retirees and increased utilization of Medicaid. Delaware's strongest performing industry, healthcare, is very dependent upon Federal funds and will be significantly affected by the recently enacted healthcare reform legislation.

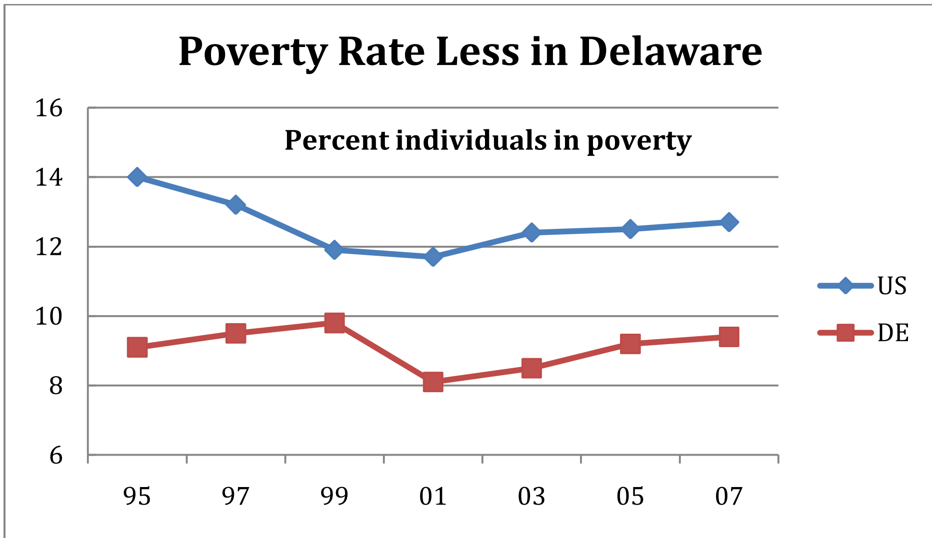
Social security payments account for almost 37 cents of every dollar of Delaware transfer payments. Not surprisingly, given the rapid migration of seniors into southern Delaware, this component of transfer income has been increasing 25% faster than the nation. Despite the recession, unemployment compensation is only a minor part of total transfer payments.

Because of demographic and economic trends, the decline in Delaware's personal income advantage will persist. The importance of transfer payments, which are income flows not related to production of current goods and services, will continue to grow. This means political sector shifts will increasingly impact people more compared to what is occurring in the private market economy. The growing contribution of transfer payments limits state personal income tax revenue and shifts some portion of control for the state's economic future to Washington, D.C. With the first wave of the baby boomers reaching 65 years old this year, even without sustained in-migration the elderly population in Delaware, and therefore transfer payments, will soar. While Delaware personal income won't underperform the nation, without some shift in direction, the state's income growth performance will be average.

As important as the growth of personal income from an economic development perspective is the distribution of income. Over recent years the individual poverty rate in Delaware has averaged 25 to 30% below the national rate (Chart 3). This means that based on a national standard of income by household size, proportionately fewer individuals in Delaware are desperately poor.

"About 46 cents out of every dollar of transfer payments received by residents in Delaware is for medical benefits, split between Medicare and Medicaid."

*Chart 3*



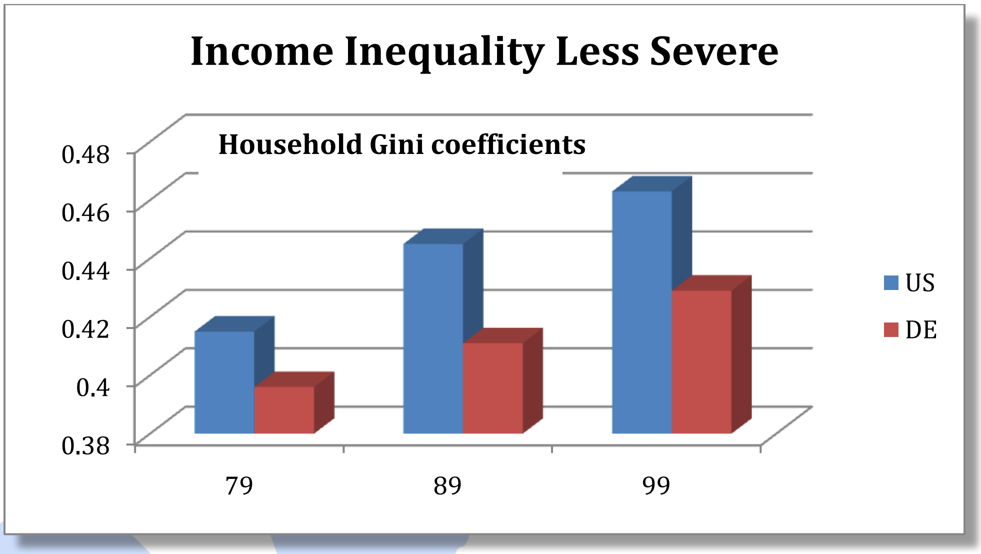

*Source: BOC, 3 year moving average for Delaware*

The poverty gap between Delaware and the nation is, however, somewhat misleading. Delaware has a higher cost of living than the nation, yet the income thresholds used to determine poverty by household size and composition are unadjusted for cost of living differences across the country. The poverty thresholds thus understate the extent of poverty in higher cost of living states. For example, the current poverty income threshold for a family of four, including two children, is $21,756. This amount of income purchases far more goods and services in Mississippi than in Delaware.

Other factors that impact the poverty gap are economic and demographic. Because the higher cost of living is picked up in wages, Delaware has higher per capita and median family income than the nation, resulting in a lower poverty rate. Delaware also has a larger proportion of elderly than the nation. The poverty rate for the elderly is lower than the overall poverty rate, and this further reduces the state's overall poverty rate. Finally, although Delaware has a larger proportion of blacks than the nation (21% compared to 13%), the impact of the significantly higher black poverty rate is offset by a Delaware Latino population that is less than half the proportion found throughout the U.S.

Another standard measure of the distribution of income is the Gini coefficient. The Gini coefficient is a measure of income equality that can range from zero (perfect equality) to one (complete inequality). The gap between households with the highest and lowest incomes has persistently grown over the recent 20 years. The only positive aspect of this trend is that the national income disparity has grown more rapidly than that in Delaware (Chart 4).

Chart 4

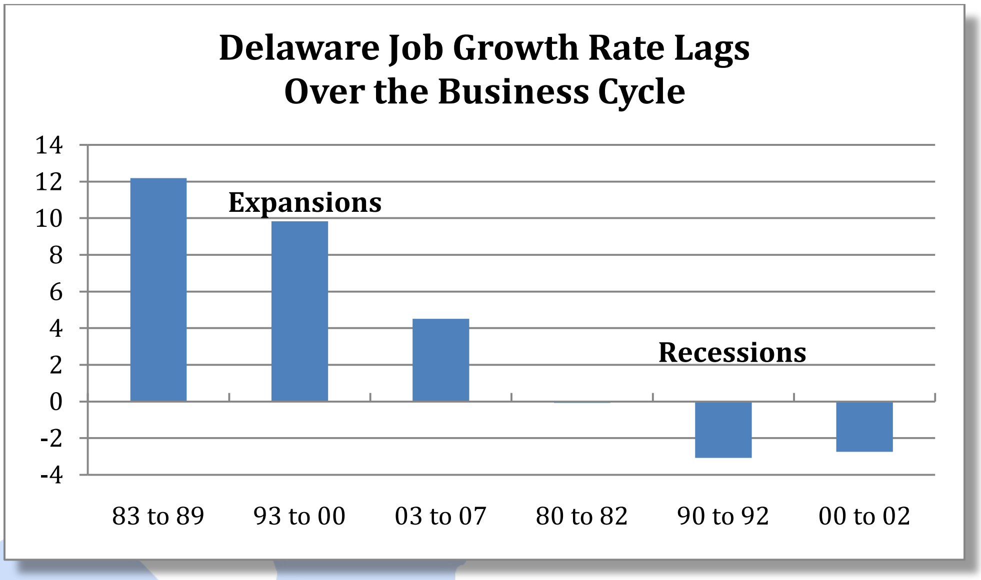



Source: BOC, Censuses of population

*Employment.* The current recession underlines the great importance of jobs. When large numbers of people lose work and wages, mortgage payments stop, retail sales fall, state tax income drops. Gloom sets in. Of all economic issues, the bottom line for most people is jobs. Although Delaware's unemployment rate has risen during the recession (from 3.4% to 9.2% from February, 2007 to February, 2010), over time it consistently has ranged from 20 to 25% below the U.S. Delaware has had a less cyclically sensitive industry mix than the nation.

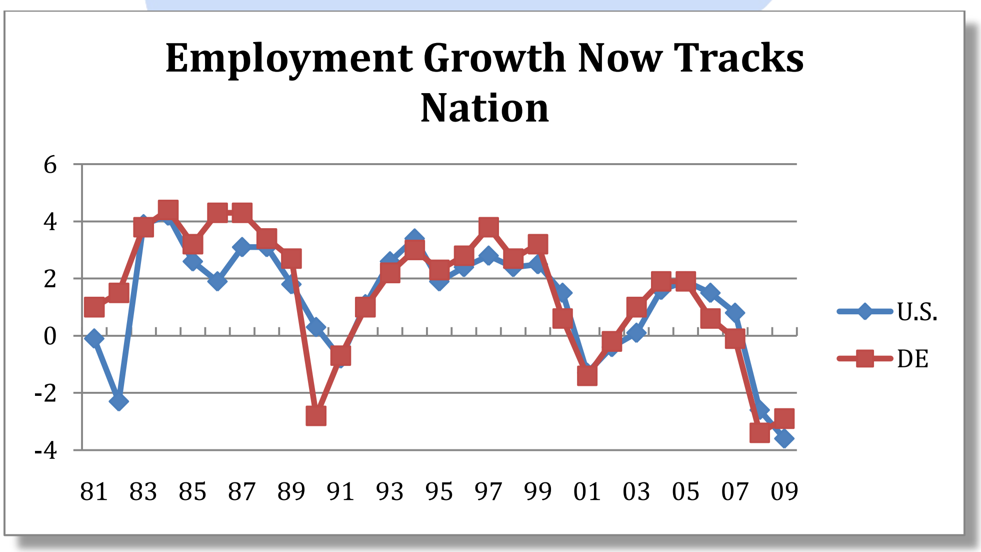
On the other hand, Delaware's employment growth rate has been moderating. The rate of job growth during expansions has been less robust and the loss rate during the current recession has become the steepest in three decades (Chart 5). After exceeding the nation during the 1980s following the passage of the Financial Center Act and positive job growth during most of the 1990s, the net annual change in Delaware jobs between 2000 and 2009 has been negative. The financial services industry passed its peak in 2001. Other traditional state growth-driver industries have faded (e.g., chemicals, auto production). Delaware's employment growth has converged on the nation's (Chart 6). Nothing on the horizon signals a shift back to above average performance.

Chart 5




*Source: BLS, CES series*

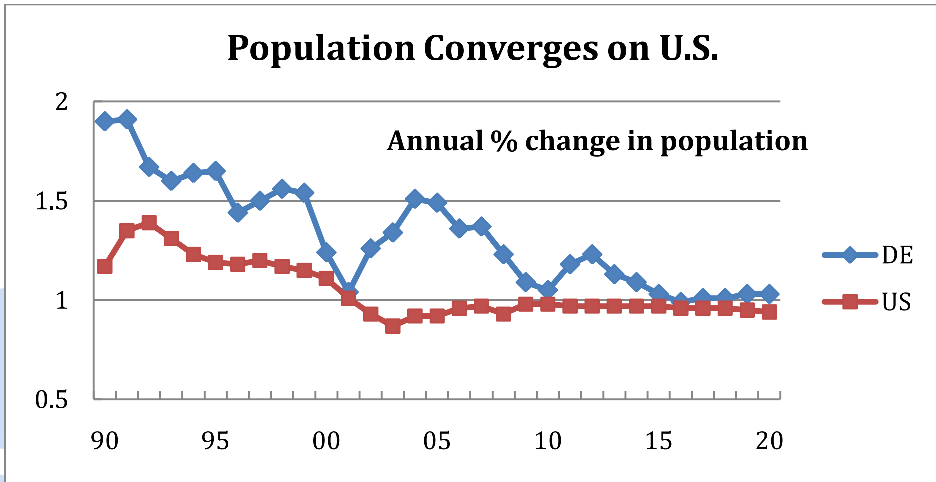
Chart 6




*Source: BLS, CES series*

Population growth in any state is determined primarily by the in- and out-migration of folks. The natural component of population change, births minus deaths, provides a minimal steady influence. While there is an in-flow of retiring seniors to Delaware, migration of younger folks from other states and abroad is driven by labor market conditions. Continued decline of Delaware's employment growth rate will lead to a drop in the state's population growth, especially among young adults, causing population growth to converge on the national average (Chart 7).

*Chart 7*




*Source: BOC*

*The Economy In Summary.* While distributional issues (e.g., poverty, income inequality, unemployment) are less severe in Delaware than the nation, the growth rates of output, income and employment have become average. But is robust economic growth all that important? According to the research literature, higher growth is correlated to higher income, and residents in higher income states are healthier, live longer, have lower rates of mental illness, lower divorce rates, increased high school graduation rates and experience less violent crime.[2] It also has been well established that economic growth is a tide that lifts all ships—reducing poverty, unemployment and labor force participation rates across all the segments of society.

The next section examines whether Delaware has in place the various elements of economic freedom that encourage the process of "creative destruction" and economic growth.

"…higher growth is correlated to higher income, and residents in higher income states are healthier…"

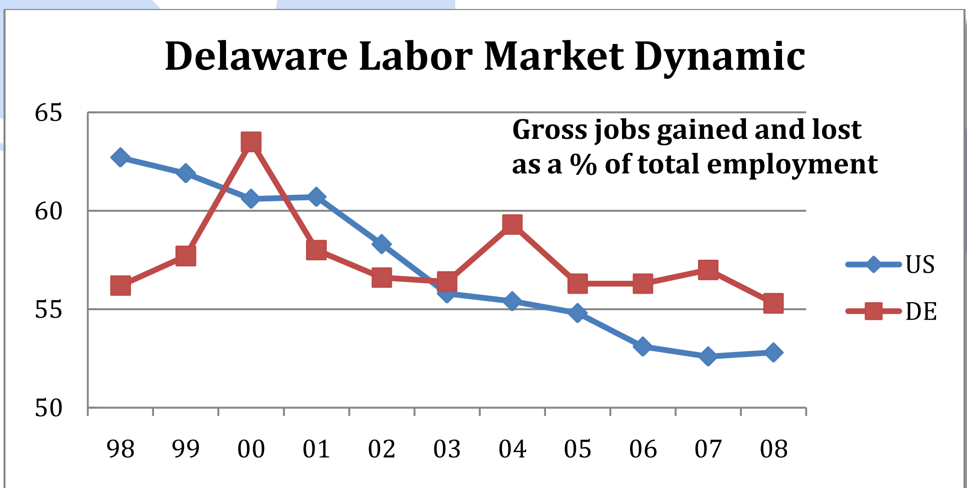
[2] **Russell S. Sobel, 2007, *Unleashing Capitalism*, the Public Policy Foundation of West Virginia, chpt 1.**

CAN DELAWARE CHANGE COURSE?

Our contention is that providing increased opportunities to individuals fuels the “creative destruction” process that is essential to economic development and growth. Few persons realize the extent of the “creative destruction” process that occurs continually in a market economy. Even when an economy seems to be “standing still” with virtually no net change in aggregate activity, still the economy is changing every day. New businesses start up and existing businesses expand, contract or even close. A “churning” economy reflects the fact that households and firms are adjusting to the ongoing changes in the availability of resources, relative prices, taxes, technology, preferences and needs.

How extensive is this “churning”? Every year in Delaware and the nation more than half of the jobs come and go. Jobs are gained through business expansion and startups. Jobs are lost through closures and contraction (Chart 8). The speed and amount of structural volatility in market economies are extraordinary and unparalleled in past centuries. It is separate from the normal labor market process of individuals coming and going from particular positions.

*Chart 8*




*Source: BLS, business dynamics*

It represents a progressive restructuring of the economy as firms and families explore and react to opportunities and pressures induced by changes in technology and income.

Governments that facilitate this churning process also encourage economic growth by cooperating with forces that lead to job creation. International research by the Fraser Institute and the Heritage Foundation has shown a high correlation between economic freedom and increased economic growth. Similarly, the Mercatus Center has found the same relationship between freedom and economic performance among states in the U.S.

The Mercatus Center ranks Delaware 26th among the 50 states with regard to freedom.[3] Of the four aspects of freedom, Delaware scores best on regulatory freedom, followed by

**[3] William P. Ruger and Jason Sorens, 2009, “The Freedom in the 50 States: An Index of Personal and Economic Freedom,” Mercatus Center, George Mason University, VA.**

economic freedom, then fiscal and finally personal freedom. Many of the more than 200 individual factors that determine the degree of freedom in a state are under the direct influence of state and local governments.

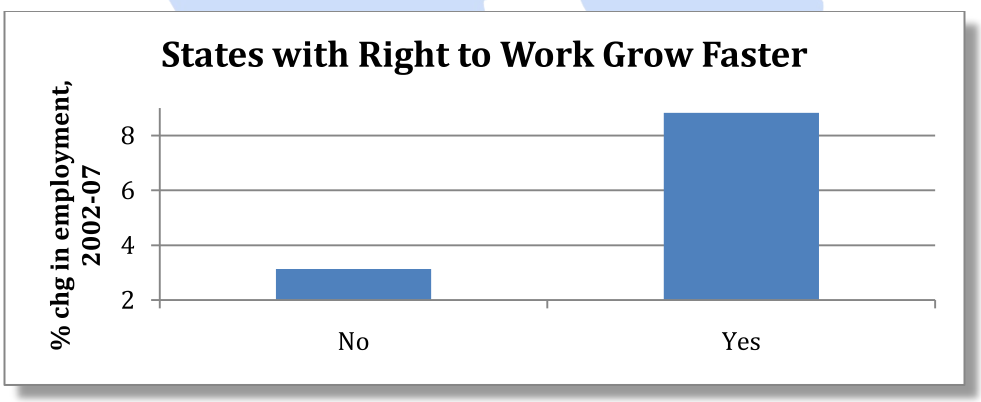
Each of the four major areas of freedom will now be discussed relative to Delaware. The objective is to encourage people to consider policy changes could enhance individual freedom in Delaware, leading to increased economic opportunity and encouraging economic growth. At the same time, those policies that restrict economic freedom can be modified.

In the Mercatus Institute analysis, Delaware ranked 16th among the states in regulatory freedom. Major areas examined below include labor regulations, health insurance, occupational licensing, property rights, education and personal safety.

*Labor.* Labor accounts on average for two-thirds of the costs of production. Critical issues with regard to labor regulations include "right to work" laws, workmen compensation rates and regulations, and the prevailing wage statue.

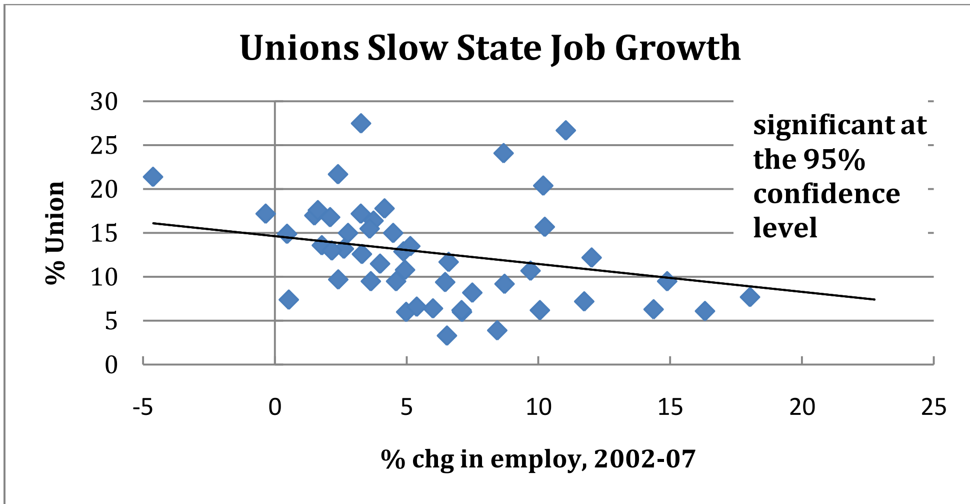
Data from the most recent expansion (2002-07) demonstrate that states with "right to work" laws have higher job growth than states without such laws. States with high proportions of union workers have lower employment growth rates. The descriptive data does not identify the causes of slower growth. It could be that firms tend not to locate to states that allow "closed shops" or are highly unionized. Union rules and regulations may deter innovation and start-ups. Certainly, the shift away from heavily unionized manufacturing toward services has favored the South and West relative to the Northeast and Midwest. Recent union growth concentrated in the public sector might reflect government "crowding out" private sector job growth.

Chart 9




*Source: BEA*

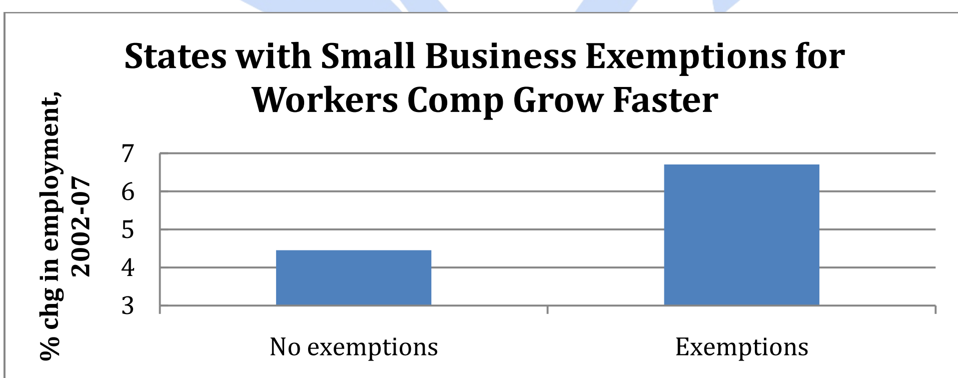
Chart 10




Source: BEA

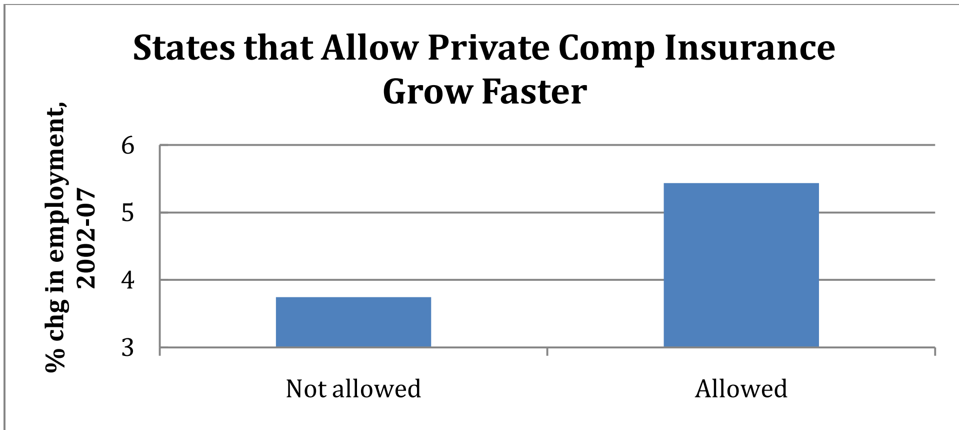
Research makes clear that over time higher worker compensation rates and more complex regulations discourage job growth. The BEA data for 2002-07 evidences that job growth in states is encouraged when small businesses and some agricultural workers are exempted from worker compensation costs. States where private comp insurance is allowed or in states that do not require short-term disability insurance, job growth is also higher. Alternatively, jobs grow as rapidly in states that have their own occupational safety and health agency covering all industries. Job growth is suppressed, however, in states where such agencies apply only to public sector employees.

Chart 11



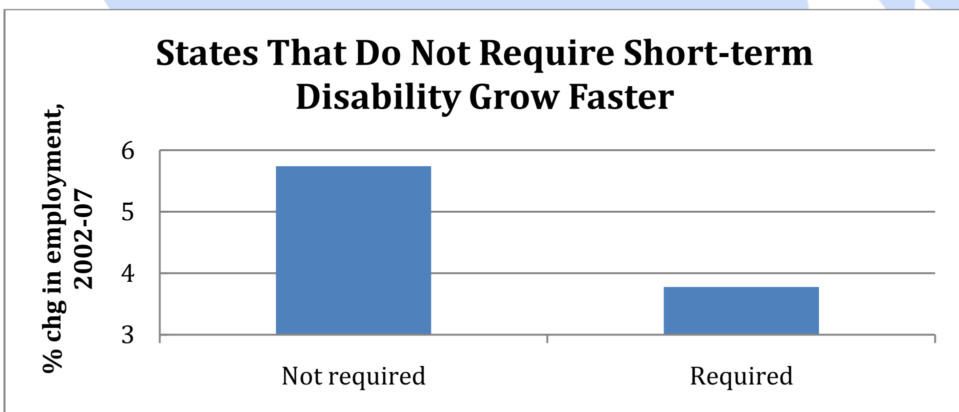

Source: BEA

*Chart 12*




*Source: BEA*

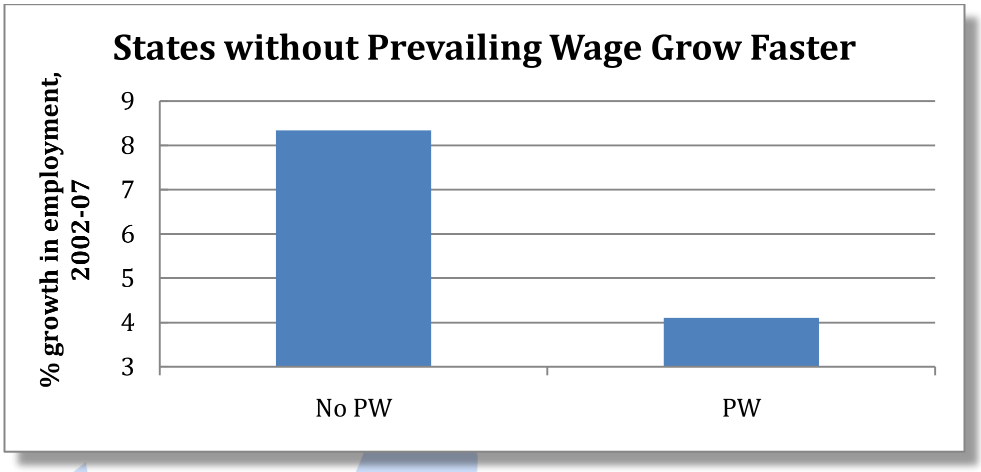
*Chart 13*




*Source: BEA*

Finally, employment grows faster in states that do not have prevailing wage laws. Not surprisingly, states where the work force is more unionized are far more likely to have prevailing wage laws.

*Chart 14*




*Source: BEA*

Are there changes in labor regulations that could be made in Delaware to enhance job growth? The answer is "yes." Delaware could become a "right to work" state. Delaware could exempt small businesses from workmen's comp and not require short-term disability insurance. Finally, Delaware could eliminate its prevailing wage law. These changes would make Delaware a more wide-open economy and more attractive to business investment and growth.

*Healthcare Insurance-Regulation.* State healthcare regulations can impact the costs of doing business. The Mercatus study tested to see if healthcare regulations impact economic growth among states. Only three regulations stood out. Most notable was health insurance market rate restrictions. Current rules run from no restrictions to community rating restrictions that prohibit variation in insurance rates by age and sex. Economic growth as measured by employment gets slower the more the state shifts away from no market rate restrictions.

States that allow small businesses the option of group coverage and of COBRA continuation coverage grew faster than states that either disallowed or mandated both. Otherwise, health policies such as mandated external review for grievances, a high risk insurance pool, and guaranteed access to insurance for the self-employed had no noticeable impact on economic performance.

Another dimension related to public policy is the degree of access to health care insurance. Here Delaware rates fairly well. Only 11% of the state's citizens are without health insurance, ranking Delaware 11th among all states, and the proportion uninsured drops even lower for households where at least one person is employed full-time. Delaware also ranks well on the proportion of uninsured by gender and race. Unfortunately, the proportion of uninsured jumps to 24% among Delaware's poor children. Delaware has a slightly above average proportion of residents receiving Medicaid and ranks 19th in Medicaid payments per capita. Delaware Medicaid spending per capita ranks particularly high for adults (4th) and children (10th).

Can Delaware take health policy steps that strengthen the economy and economic opportunity? At the least, Delaware should stay the course. Don't allow rate restrictions to be introduced nor mandated COBRA or group insurance for small businesses. The state should open the gates to health insurance competition from anywhere in the nation, encourage health savings accounts (HSA) and consider tort reform.

Competition is the reliable force that brings prices under control. If Delaware permits health insurance companies from anywhere in the nation to offer products in the state, insurance costs will fall…just as prices for trucking services, air travel and telecommunications fell following deregulation.

Health care markets are now structured so that consumers have weak incentives to care about costs. Out-of-pocket payments accounted for 46 cents out of every dollar spent on healthcare in the U.S. in 1960. Today that is down to 12 cents and drops as low as 3 cents for hospital care. Research shows that increasing direct patient payments also increases discretion with regard to health care consumption and brings prices down. As Indiana governor, Mitch Daniels, states: "a system built on 'cost plus' reimbursement (i.e., the more a physician does, the more he or she gets paid) coupled with 'free' to the consumer, is a machine perfectly designed to overconsume and overspend."

HSAs are part of High Deductible Health Plans. HSAs permit contributions on a pre-tax basis. Funds put in can be carried over from year to year and give individuals an explicit budget constraint. Funds are accessed with a debit card. Over 8 million Americans are now enrolled in HSAs and the coverage ceiling for families is over $6,100. All of Delaware's government employees could be moved into a high deductible, HSA system. In addition, contributions to HSAs should be exempted from the State income tax. This will restrain health care price inflation and increase the proportion of small businesses who can afford to offer health care benefits to employees.

A most effective and simple step in health care tort reform is to put a cap on "pain and suffering" awards. In 2003 Texas capped "pain and suffering" at $250,000. Since that time health insurance premiums for doctors have fallen. Compensation to plaintiffs for lost earnings and future required medical care expenses have not decreased.

At this time, 33 states have introduced some component of health care reform. The recently passed Federal healthcare reform regulations provide insurance coverage to many persons who previously had none, but do nothing effective to address the issues of competition, cost control, and tort reform. Delaware need not wait for Washington, but can seize the day and take action on this service that is of such great importance to citizens and businesses.

*Licensing.* Occupational licensing does not appear to be a serious negative issue in Delaware. Delaware ranks in the bottom 15 states with respect to licenses required to practice a variety of occupations. Some consumer protection may result; however, occupational licenses in many instances simply serve as a barrier to entry keeping competition limited (e.g., auctioneer) and the cost of work high. Regardless, no significant relationship is found between the number of occupational licenses required and state economic performance.

*Property rights.* Delaware is among the states that have enacted eminent domain reform in response to an ill-conceived U.S. Supreme Court ruling. Also, Delaware does not have a binding state land use plan and instead mandates local plans. And while the state has a wetlands protection program, it does not have wetland protection statutes. Overall, at the state level, Delaware does not appear to unduly restrict use of private property.

New Castle County is an exception. With the County's Uniform Development Act of 1998, environmental and growth management land use restrictions have tightened. Private employment growth, especial in construction, has halted. Residential starts have fallen and shifted into the incorporated areas of the County, encouraging net out-migration. This parallels the experience in Washington, Oregon and California where strict land use regulations have reduced the supply of land available for development.

Restrictive and high cost licensing and bonding requirements for new construction and remodeling add directly to cost. They also add indirect cost because of reduced competition as contractors abandon the market.

Efforts to improve the quality of life and protect the environment through land use restrictions can work. One trade-off is a reduction in economic growth. What happens to the fiscal structure is complex. The unit served costs of some services, such as roads, sewer and water systems may fall, sprawl may be reduced; but land use restrictions will limit growth in the property tax base and ultimately require higher tax rates.

*Education.* The nation's future economic growth will be concentrated in human capital intensive service industries. Such industries locate in places accessible to critical mass pools of human capital. Biotechnology, for example, is projected to be 10$^{th}$ fastest growing industry in the nation in terms of employment and the 2$^{nd}$ fastest growing in terms of revenue. Thirty metropolitan areas presently account for over 60% of all the nation's biotech jobs and over 90% of all university employment. The average proportion of adults with a bachelors degree or higher among these metros is 32% (ranging up to 50% in Bethesda and 44% in San Francisco). These metros also average 32,000 employees in higher education and 53,000 in financial services.

The portion of Delaware's adults with a BA+ is about 27%, similar to the nation. This ranges from 32% in New Castle County to 19% in Kent County. The high water mark is 52% in the City of Newark. Presently, Newark has 6,500 adults who fall in the BA+ category, and most of whom are employed at the University of Delaware. The combined employment at the colleges and universities in northern Delaware is no more than 9,000 employees. Delaware has high proportions of doctoral scientists and engineers per 100,000, but with a total population not yet over 900 thousand persons, the depth of the labor pool is limited. For northern Delaware to succeed in the competition for the future growth industry it must be fully integrated into the human capital resources of the Philadelphia/Baltimore region.

School choice is a positive factor for Delaware. While no voucher programs are approved, the supply of charter schools is growing. The proportion of students in private schools leads the nation. There is no mandatory state registration or accreditation of private schools, or licensure of private school teachers, and curriculum control is broad. Delaware is also a homeschooling friendly state. Homeschooling is explicitly permitted by state statute. Certain school subjects are required and a curriculum must be in place, but a fixed curriculum is not imposed. Neither are teacher qualifications required or standardized testing beyond that for all students.

If the economic well-being of Delaware's fast growing black and Latino populations is to rise, Delaware's schools must serve them effectively. The research consensus is growing: increased spending per pupil, class size, graduate credits per teacher, and years of teaching experience are not correlated to student performance. Charter schools and voucher system schools out perform traditional public schools, especially among less advantaged populations. Charter schools and private voucher driven schools induce family participation and allow teachers and administrators freedom to innovate, generating outcomes that define effective education. This is especially important given the growing population of students from dysfunctional families.[4]

U.S. Department of Education data is clear. Despite being among the top five states in spending per pupil, Delaware's public school student tests scores have improved little and lag around average. The current Delaware public school system is over-administered. Too many resources diverted from the classroom. Teacher unions have been politically powerful. Further moves toward choice for families will be a struggle. Improved skills for low-income children will be a critical determinant of future economic development and growth.

*Safety*. Personal safety is essential for the exercise of economic freedom. Lack of security at home, school or work increases transactions costs and discourages investment. Accordingly, the degree of safety in Delaware is a foundational quality that supports economic activity.

While Delaware's property crime rate is average, the state ranks 7th with regard to violent crime…and the violent crime rate has been increasing. Efforts to support security appear high. Delaware ranks second among all the states in prison population per 100,000 and 13th in law enforcement officials per 100,000. The incidence of drug use is average. Crime and insecurity is spatially concentrated. Violent crime is concentrated in dysfunctional isolated communities.

For example, the 2008 Uniform Crime Report data shows that the murder rate in the City of Wilmington is seven times the national rate (Chart 15). Most murders are young black men killing other young black men and are concentrated in very specific neighborhoods (…resulting in a neighborhood murder rate that is hard to comprehend). Similarly, the rates of robbery and aggravated assaults in Wilmington are four to five times the national average and again are concentrated in specific neighborhoods (Chart 16). Simple economic activities such the journey to work or shopping for daily needs place people at risk in such an unsafe environment. Delawareans seem unwilling to devote the resources required to address these concentrations of havoc so long as violence does not spill out into the broader community.

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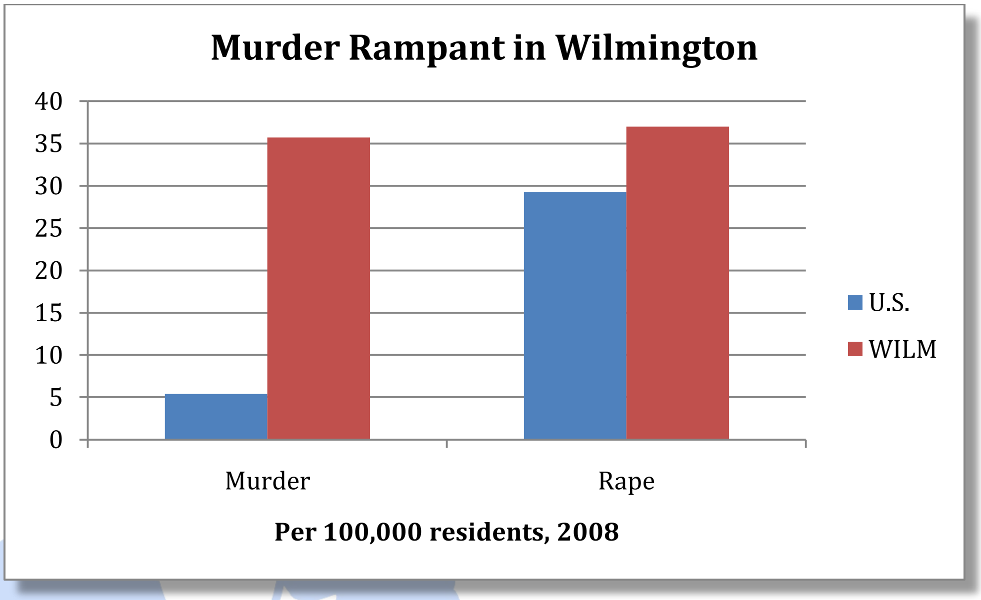
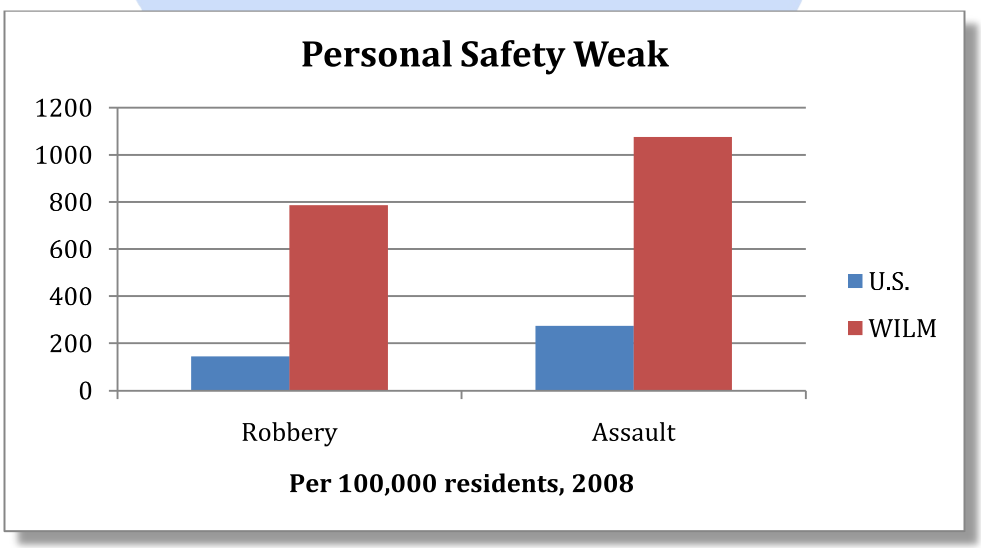
**[4] Eric A. Hanushek and Alfred A. Lindseth, 2009, *Schoolhouses, Courthouses, and Statehouses*, Princeton University Press.**

*Chart 15*




*Source: FBI Uniform Crime Reports*

*Chart 16*




*Source: FBI Uniform Crime Reports*

While violent crime may not be significantly linked in various studies to broader macro economic growth among states, it certainly discourages investment and reduces economic activity in specific neighborhoods. And these neighborhoods tend to have larger concentrations of the very populations projected to be the fastest growing in Delaware over the next decade: blacks and Latinos. Reducing Delaware's violent crime may not improve the performance of the state's economy, it absolutely will advance the goal of greater economic opportunity.

*Financing.* As with human capital, various measures of access to financial capital are strong for Delaware measured on a per capita basis although the critical mass of the financing is limited. Financial capital, especially in the electronic age, is highly mobile over space. Sound business plans have a fair shot at financing in any state in the nation.

One critical issue for Delaware is access to financing for potential and existing black business owners. Over 20% of Delaware's population is black compared to 12% throughout the nation. If one-fifth of Delaware residents have difficulty with access to capital, that is a serious constraint on the process of "creative destruction" and economic growth.

The bottom-line data is not encouraging. Compared to their 20% share of population, only 6.6% of Delaware businesses have black owners and these establishments account for just 0.2% of all business receipts and 0.3% of all business payroll.

While Delaware data is not available on black access to business capital, national data is not encouraging. Compared to whites, blacks starting a business are half as likely to obtain a business loan from a bank and more likely to use a credit card or make due on a shoe string. While conditions are changing, the research literature still shows that potential black business borrowers are less likely to be offered a loan and more likely to be offered a smaller loan than white business borrowers with similar characteristics.

Almost six out of every ten business start-ups, regardless of race, depend upon money from family and friends. Unfortunately, both in Delaware and the nation, the black poverty rate is more than double the poverty rate among whites. Throughout the nation the racial wealth gap is significant. Black families have only 10 cents of wealth for every dollar of wealth held by white families. With respect to collateral, only 49% of blacks are homeowners compared to 76% of whites.

Is there anything Delaware can do to break-up this log jam? Most black do not come from families with a history of business ownership nor have formal business education training. Other states have implemented programs to assist minorities to become franchise owners. Franchises come with packaged business plans, operating procedures, name recognition. Small Business Development Centers in some states offer starting out in business training at very low cost in sites with easy access such as black churches. Black bank lending officers can be mentors. Delaware's Pencader Business and Finance Charter High School has programs to encourage black students to gain skills necessary for success in business.

While not as severe, some of these same issues such as experience, training, access to capital and discrimination are a hindrance to the entry of females and Latinos into business ownership. To the extent that Delaware facilitates all potential entrepreneurs, the state will extend its competitive advantages.

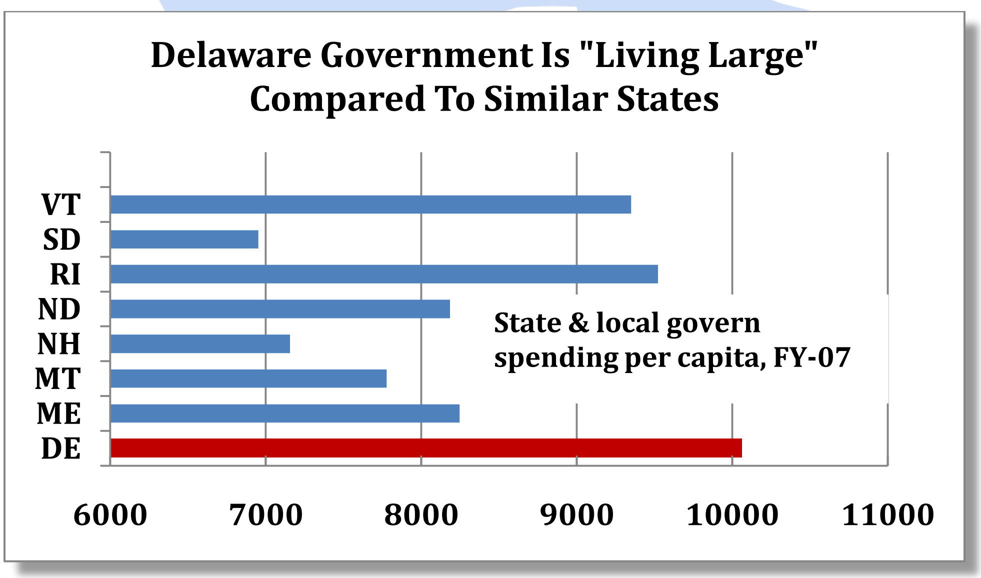
*State and local government.* Standards for evaluating the role of government in any economy are many. Simple points of reference for Delaware would be measures of how much and the trend of Delaware government spending per capita. More complex questions center on the effectiveness of government administration and services, the density and population age structure in communities, and the manner in which revenues are collected. Effectiveness is often implied by how much is spent. Money going into government services does not reflect service quality nor whether firms and households are receiving the services they prefer.

The cost of doing business is directly impacted by the quality of state and local government services relative to the costs borne for those services. Regardless of the quality of government services delivered in Delaware, the costs are kept below average because much of the revenue collected by state government comes from out-of-state sources. According to the Tax Foundation, 49% of state and local government tax revenue collected is not paid by Delaware businesses and residents. This compares to a state average of 32% and ranks Delaware fifth in tax burden exporting behind the energy producing states of Wyoming, North Dakota, Nevada and Louisiana.

Compared to states with similar size populations and to neighboring states, Delaware state and local government is living large (Charts 17 & 18). (Note that combined state and local government expenditures are considered as the distribution of functions between the two levels of government varies among states.)

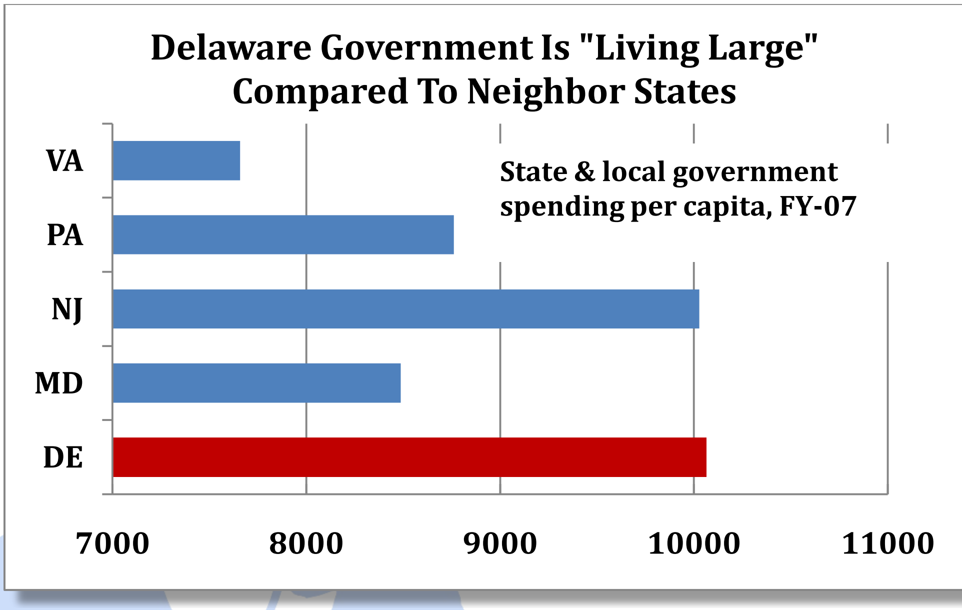
The similar sized Northeastern states of Rhode Island and Vermont have struggled over the recession. However, New Hampshire, the "live free or die" state, with the lowest government spending per capita, has had the top performing economy in the Northeast and is one of only eleven states in the nation to currently have year-over-year job growth. Overall, no statistical relationship was found between per capita state and local government spending in 2001-02 and the percent change in employment between 2002-07.

*Chart 17*




*Source: BOC*

*Chart 18*




*Source: BOC*

Why do governments in Delaware spend more? Perhaps money was going to those goods and services that promote future economic growth. Perhaps the governments of Delaware are poorly managed and wasteful. Perhaps high spending is matched by high quality as demanded by the firms and people of the state. Careful analysis is required to reach reliable solutions.

FY-07 spending data per capita for 31 government service categories is shown in Table 1. Because all the comparison states have population levels roughly similar to Delaware, this helps rule out the claim that higher spending per capita is due to Delaware's "small size" or a lack of economies of scale. In only 11 of the 31 categories do Delaware governments spend less per capita that similar size states. Raw spending per capita does not mean high or low quality services are provided and does not mean high costs burdens in Delaware when and if persons and businesses "outside" the state pay the costs.

Looking first at infrastructure, Delaware government is spending far more per capita on electric power, transit, public buildings, sewer systems, solid waste management and parking facilities. The higher expenditures such as on health services, libraries, higher education, and primary/secondary education might be sound investments, if service quality is high. More questionable are the higher expenditures on protective inspection and regulation, financial administration, corrections, police protection, unemployment compensation and interest on the general debt. Higher spending on judicial and legal services is an understandable consequence of Delaware's position as the nation's center for corporate law.

*Table 1 – State and local government expenditures per capita in Delaware relative to similar size states, FY-07*

| Expenditure Category | Per capita DE/Per capita in similar size states |
|---|---|
| Electric power | 541 |
| Transit | 327 |
| General public buildings | 226 |
| Protective inspection and regulation | 215 |
| Sewerage | 197 |
| Financial administration | 184 |
| Solid waste management | 184 |
| Health | 166 |
| Judicial and legal | 166 |
| Correction | 164 |
| Parking facilities | 157 |
| Police protection | 157 |
| Libraries | 129 |
| Unemployment compensation | 128 |
| Interest on general debt | 127 |
| Higher education | 126 |
| Public welfare | 109 |
| Elementary & secondary | 106 |
| Employee retirement | 103 |
| Housing and community development | 102 |
| Parks and recreation | 96 |
| Insurance trust expenditure | 92 |
| Natural resources | 78 |
| Water supply | 77 |
| Highways | 76 |
| Employment security administration | 64 |
| Cash assistance payments | 52 |
| Fire protection | 37 |
| Hospitals | 33 |
| Air transportation (airports) | 24 |
| Workers' compensation | 9 |

*Source: BOC*

Areas of lower expenditure, and directly important for economic development, include highways, the water supply and natural resources. Low expenditures on hospitals and fire protection result from unique arrangements in Delaware, while low spending on workers’ compensation is certainly attractive to businesses.

Table 2 shifts the basis of comparison from population size to spending per capita in nearby states. Higher government spending per capita in Delaware compared to neighbor states might put Delaware at a competitive locational disadvantage. The state and local government expenditure data are for FY-07. Since neighborhood states are all much larger than Delaware, economies of scale may now be an explanation for higher expenditures per capita in some services.

On infrastructure, Delaware governments are spending far more per capita on electric power, public buildings, sewer systems, and solid waste management. Spending on parking facilities is now average and, as expected for a less urbanized state, transit spending is lower per capita as well. Expenditures on health services, higher education and libraries remain high, but spending on elementary/secondary education falls below the regional average. Questionably high expenditures persist on financial administration, protective inspection and regulation, corrections, police protection and interest on the general debt. Spending remains high on judicial and legal services and low on hospitals and fire protection.

Per capita spending on natural resources and highways is now above the neighbor states and spending on water supply is average. This may reflect the fact that many of the similar size states are in the West and are hard pressed to keep highway and water infrastructure capacity up with rapid population growth. It may be that Delaware wins higher proportional shares of federal money for such services as highways. Low spending on workers' compensation remains an advantage within the proximate region. Public welfare expenditures are high relative to the surrounding states; but federal cost sharing formulas may help fund higher Delaware spending.

***Table 2*** *– State and local government expenditures per capita in Delaware relative to neighbor states, FY-07*

| Expenditure Category | Per capita DE/Per capita in neighbor states |
|---|---|
| Electric power | 1606 |
| Financial administration | 254 |
| Natural resources | 240 |
| General public buildings | 227 |
| Sea and inland port facilities | 194 |
| Protective inspection and regulation | 189 |
| Health | 184 |
| Sewerage | 163 |
| Solid waste management | 155 |
| Higher education | 151 |
| Judicial and legal | 141 |
| Libraries | 127 |
| Police protection | 126 |
| Highways | 121 |
| Correction | 120 |

| | |
|---|---|
| Interest on general debt | 117 |
| Public welfare | 115 |
| Vendor payments | 113 |
| Employment security administration | 103 |
| Water supply | 101 |
| Parking facilities | 96 |
| Housing and community development | 94 |
| Elementary & secondary | 93 |
| Unemployment compensation | 89 |
| Parks and recreation | 89 |
| Employee retirement | 77 |
| Insurance trust expenditure | 76 |
| Transit | 70 |
| Fire protection | 39 |
| Cash assistance payments | 35 |
| Hospitals | 34 |
| Workers' compensation | 27 |

*Source: BOC*

Per capita spending on government employee retirement relative to similar size and to neighbor states evidences that the state of Delaware's retirement benefit fund is nearly fully funded. This is good for the state's bond rating and future Delaware taxpayers. Unfortunately, according to the Pew Center for the States, Delaware now has unfunded health benefits obligations to retirees of $5.6 billion, almost twice the current budget. This is a time bomb.

Does state and local government enhance economic opportunity and economic development in Delaware? Analysis of any function of government must examine both the costs and the benefits. As mentioned, high spending on infrastructure and education in the near term can lead to higher long term economic performance. Several areas of state and local government deserve analysis given the per capita spending ratios.

With regard to infrastructure, areas that warrant closer examination include electric power, public buildings, sewer systems, and solid waste management. Unusually high per capita expenditures on financial administration, protective inspection and regulation, corrections, police protection and interest on the general debt also deserve closer scrutiny. Finally, the state can continue to pretend that its unfunded health care obligations won't come home to roost, but this will no longer escape the attention of bond rating agencies.

A last question to be addressed is: are government employees in Delaware overpaid? As of 2008 the average pay per FTE government employee was slightly above the similar size states and below neighbor states. Part of the disparity with neighboring states is due to higher costs of living in New Jersey, Maryland and Virginia.

On the other hand, per capita expenditures on government salaries and wages in Delaware are nearly 50% higher than those in similar size and neighboring states. The difference with neighboring states is partially a function of population base relative government employment. According to the Taxpayers Network, Delaware ranked second in the nation in 2007 in state and local government employees per 10,000. New Jersey ranked $16^{th}$, Virginia $22^{nd}$, Maryland $36^{th}$ and Pennsylvania $49^{th}$.

The population base does not play a major role with similar size states. The difference with similar states is the higher average wages for full and part-time government employees in Delaware. The average full-time Delaware government employee in 2008 was paid $43,248, 13% higher than in the similar size states. The average pay for part-time government employees in Delaware was $17.72, almost 18% higher than in the similar size states. Finally, part-time employees were more extensively used in comparison states. During 2008, 25% of Delaware government employees were part-time relative to 32% in the comparison states.

So, the average pay of Delaware government employees is in line with neighboring states. It is higher than among the similar size states, including most of those comparison states in the Northeast. Again, cost of living may play a role, especially in Maine, New Hampshire and Vermont. The similar size states are more aggressive than Delaware in their use of part-time employees, which not only reduces the wage per hour, but significantly cuts benefits as well.

## SUMMARY

On balance our review leads us to conclude Delaware is losing ground as a state of economic opportunity. Delaware's economic performance is flagging. Growth in output, income and jobs is slowing and converging on the national average. Slower economic growth diminishes opportunities across all groups of Delaware citizens. Delaware state and local governments are spending at above average amounts per capita for many services while exporting the costs of government at above average levels.

Can anything be done? Yes. Delaware can change its labor regulations and deregulate health care. New Castle County can revisit its Uniform Development Code. Widespread dissatisfaction with the high cost and weak average performance of public schools has resisted effective change for many years. Delaware can promote school choice and confront the violence in high risk communities. Access to capital for minority and female entrepreneurs should be increased. Delaware's high government spending on infrastructure and on financial administration, regulatory enforcement, corrections and police should be analyzed. Government's use of debt financing to avoid tax increases needs to be examined. Finally, the state government must face up to its huge and growing unfunded health care benefit obligation.

These changes don't require more government spending and higher taxes, they simply require changing the way we do things in Delaware. The immediate focus of the research efforts of the Center for Economic Policy and Analysis will be on these issues.

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