FRAMEWORKS FOR GROWTH: HOW LOCAL INSTITUTIONS AND STATE GOVERNANCE INFLUENCE ECONOMIC DEVELOPMENT POLICY

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This study explores how economic development policy is affected by the choice of "venue" in which decisions are made. Using case studies of four communities, it suggests that when the delegation of economic development responsibility increases within a municipality, such as from the elected council to an appointed commission, or when the state government does little to equalize resources, spending tends to be more heavily oriented toward providing targeted technical and financial assistance to businesses rather than general infrastructure and services. The study provides insights for officials to consider when developing policies for local economic development.

INTRODUCTION

Few challenges have grown more significant to local government in recent times than economic development. For the past 40 years, much of the economy has been deregulated and competition between communities has intensified. These and other shifts have left municipalities in need of new strategies to promote development.

This raises a series of questions. Should economic development focus on infrastructure and basic services, or on specialized assistance to prospective businesses? What should the community hope to achieve from its efforts? Should responsibilities for economic development reside with city council members or a non-elected authority?

Answering these questions is critical at a time when many municipal governments are suffering from reduced intergovernmental spending. Municipal governments must spend resources wisely, as cutbacks by both state and federal agencies have limited the "fiscal toolbox" available to local officials. Mistakes in economic development policy can fuel a backlash among voters, leaving long-range development plans to linger.

To help answer these questions, this study analyzes how the choice of "venue" in which economic development policies are created affects municipal policy. It asks whether shifting responsibility for policy decisions from a city council to a subcommittee or community development corporation will result in a long term shift in policy choices. Similarly, it explores whether the "rules of engagement" established by the state affect the policies chosen by cities. If a state has measured steps to pool resources or equalize spending across cities, for example, municipalities could be expected to set policies in vastly different ways than those in states with a more laissez-faire approach.

To explore these concepts, the study draws upon the author's detailed case study analysis of four Midwestern cities: Hibbing and Ely, Minn., and Sterling and Rock Falls, Ill. Analysis of these communities – all of which have between 3,000 and 20,000 residents and are in rural areas relatively far from major cities – illustrates the many factors that affect community development decisions. The study develops hypotheses about the factors affecting development policy while drawing upon a wide body of scholarly research, including studies by Baumgartner & Jones (2009), Pagano (2003), and Pralle (2003).

The methodology behind these case studies includes interviews with community leaders and analysis of official records and local media materials. Members of city councils, mayors, boards and commissions handling economic development, as well as business leaders and former public officials, were among those interviewed, with some of the conversations occurring as far back as 2006. Each was asked to identify their priorities for their home community. In addition, high-priority projects were tracked from inception to completion or failure and analyzed with respect to funding, political support, partners (inside or outside local government), and speed and effectiveness of delivery.

The Minnesota communities provide a valuable contrast to the Illinois pair due to the higher level of centralization of policy in Minnesota. The State of Illinois shares significant resources with local government but does not allocate those resources based on need. While Illinois supports its cities with population-based sharing of income tax and point-of-origin-based sharing of sales and motor vehicle excise taxes, Minnesota emphasizes financial equalization through need-based municipal aid. Statewide, there is general purpose "Local Government Aid" in Minnesota, calculated on the basis of tax capacity. The effort to equalize resources is particularly pronounced in the Minneapolis-St. Paul metropolitan region and the northeastern iron-ore-producing region. This is due to Minnesota's Fiscal Disparities Act, which redistributes 40% of post-1971 growth in the commercial tax base from wealthier municipalities to poorer ones within these two regions.

Another noteworthy aspect in northeastern Minnesota is the degree to which economic development policy is centralized through the Iron Range Resources and Rehabilitation Board (IRRRB), a state agency created in 1941 under Governor Harold Stassen and funded through mining production taxes. This board manages a wide range of programs, ranging from economic development grants to school construction and infrastructure improvements.

Finally, the two states differ with respect to policy on Home Rule (HR), with Minnesota offering far fewer revenue-raising powers than Illinois. HR cities in Minnesota are weak compared to their Illinois counterparts, lacking even authority to levy sales tax after a successful local referendum, a power that non-HR communities in Illinois can freely exercise. In Minnesota, communities must first seek an act of the state legislature, and these taxes are typically time-limited. To date, only around 50 Minnesota cities and counties have attained this authority.[1]

A key reason for studying how institutional arrangements affect economic development is that institutional reform can be inexpensive compared to the alternatives. Evidence is growing that some municipalities in Illinois are financially strained by the need to provide resources to compete for business development with other local governments. Many are highly aggressive and willing to offer generous subsidies to attract new businesses, sometimes in ways that are unproductive for a region as a whole. Moreover, there is growing political pressure in Illinois to promote greater tax revenue equalization, which, as is noted below, has significant consequences that policymakers need to understand.

The current system in Illinois clearly puts pressure on municipalities to maximize the impact of economic development, a situation that results in significant inter-city competition. The consequences of this can be expensive. Chicago Metropolitan Agency for Planning (CMAP, 2013), the federally designated metropolitan planning organization for northeastern Illinois, has noted that, while such competition can foster economic development resources, it puts local governments in a weak bargaining position with private businesses. This can lead to municipalities getting into "bidding wars" for even relatively small developments. Communities in states that work to equalize resources, one might expect, engage in fewer or less vigorous bidding wars.

The competition between municipalities, as well as between states, is playing out at a national level. A web-interactive study by *The New York Times* released in 2012, titled "United States of Subsidies," concludes that local governments in this country spend approximately $80 billion a year on economic development subsidies. This is compared to a total of $20 billion spent by all countries in the European Union, whose rules limit the scope for economic development funding and require substantial developer impact fees, often to upgrade existing infrastructure (Thomas, 2011). Thus, economic development accounts for nine percent of all U.S. local government spending, a percentage that puts Illinois near the national average. In Minnesota, spending on economic development averages a mere five percent.

Another factor that affects local policy is how municipalities assign responsibility for decisions within their communities. Sterling and Hibbing have arrangements in which significant economic development policymaking occurs away from the respective city councils. Sterling channels much of its activity through a semi-private development corporation. Hibbing does so through the community's Economic Development Authority, whose seven-member board includes only three elected officials. In contrast, much of the power for decision making resides at a city council level in Ely and Rock Falls.

LITERATURE REVIEW

Before turning to the case studies, it is useful to review the expanding literature on the topic. As this research notes, economic development policy has changed sharply from 30 years ago, when policy was often dominated by the pursuit of big manufacturers through policies often described by critics as "smokestack chasing" (Eisinger, 1988). Such policy has now been replaced by more diverse strategies that include such mechanisms as property tax abatement, tax increment financing, and site-specific infrastructure spending.

Despite all the change, one thing remains constant. The U.S. political system, with its orientation toward federalism, emphasizes a widespread devolution of authority to local government. This framework leaves local government vulnerable to the exit of businesses and allows companies (and individuals) to relocate to lower-tax, lower-cost jurisdictions (Peterson, 1995).

The literature suggests that the more a community relies on locally generated funding sources (rather than the state), the pressure is greater to seek taxpaying businesses from outside the community and to retain existing businesses. CMAP's observation of the Chicago area is not unique; businesses and individuals across the country can easily "shop around" for the best deal, taking advantage of differing rules on wages, land use, and building permitting, as well as a highly mobile workforce (Sassen, 2001; Sassen, 2012). Eminent geographer David Harvey has even spoken of an "economic imperative" for local government to seek capital over social provision (Harvey, 1989). It adds up to a picture in which no city, no matter how large, appears to be safe from bidding wars. Small to medium-sized cities appear to be particularly vulnerable.

A paradox with economic development spending is that it is often politically unpopular when compared to spending on schools, streets and infrastructure, law enforcement, and other general-purpose activities.[2] In some cases, voters even object when economic development policy is too successful, or promotes changes that occur too fast, as when it leads to more intense development than they desire. In areas that are growing rapidly, these disputes occur over issues such as gentrification and high-rise-friendly zoning (DeLeon, 1992).[3]

Communities that face an economy that is stagnant rather than flourishing (or overheating) can also face the burden of making their economic development policies popular among an often-skeptical populace. One of the most decisive drivers of development is having a widely shared vision of a community's future among its leaders. Even apparently tax-poor and declining communities can deliver policy more effectively than their wealthier and faster-growing peers if their goals are clearly defined and shared (Pagano & Bowman, 1995). In contrast, disputes and divisions among community leaders can "kill" even the best-laid development plans. Communities may find themselves deadlocked over competing visions of economic development (Cook, 1993).[4]

A notable implication of this is that efforts to explain economic development incentives based on rational choice theory from the field of economics may be prone to fail (Peters & Fisher, 2004). This can occur not only because many policies fail to meet their modeled or predicted targets, thereby promoting a citizen backlash, but also due to asymmetrical bargaining power between cash-strapped cities and private businesses, who play potential locations against one another.[5]

Research also shows that when state governments or regional institutions take steps to promote equality or interaction among municipalities, or provide other resources that support community and economic development, local governments gain a stronger bargaining position with the private sector when forging economic development deals (Savitch & Kantor, 2002). In poor communities, funds spent to equalize revenues can foster the so-called "flypaper effect"[6] in the form of higher local government spending (Deller, Maher & Lledo, 2007; Deller & Maher, 2005). Governments that might otherwise be weaker are also made stronger by the policy of regional governments to equalize this power, which is documented to be the case in the Minneapolis-St. Paul (Orfield, 1999) and Portland, Ore., areas.

Protecting financially weaker municipalities and enabling them to compete with their wealthier neighbors will also encourage them to focus on high-quality public services. More modest reform efforts pursued without changes in state law, such as city-county mergers, have, not surprisingly, less effect on changing the balance of power between communities (Savitch & Vogel, 2004).

HYPOTHESES

Against the backdrop of this theory, this section explores two hypotheses:

HYPOTHESIS 1

> *A decentralized governance structure that allocates state revenue simply based on population and the location of retail transactions, as is the case in Illinois, will generally lead to higher local spending for economic development than one which centralizes power and provides a safety net of state funding, as is the case in Minnesota.*

When evaluating this hypothesis, it is important to keep in mind that citizens expect a certain level of services from government and have an expectation that their governments will meet these expectations in accordance with their preferences (Einstein & Kogan, 2016). When a city's financial condition is stable and healthy, the incentive to use economic development as a means to expand the tax base is lower than in situations where a city's financial situation is profoundly affected by the entry and exit of businesses.

HYPOTHESIS 2

> *At the local level, the relative unpopularity of direct business subsidies suggests that concentrating power in the city council will lessen expenditures on these subsidies. Conversely, delegating economic development policy away from an elected authority may tend to boost such subsidies, including direct financial and technical assistance to business.*

Delegated power means a handoff of power to a board or commission that is only partially composed of city council members or has no council members at all. Funding for such a board and its activities may well be "firewalled" from the general fund. In the event that delegation goes as far as creating a separate development corporation, open meeting law requirements may not apply. Overall funding for loans or grants to private business would be expected to remain fairly stable from year to year.

When power over economic development policymaking is concentrated at the city council, policy is likely to be driven more by general citywide needs and by electoral politics. This will result, the hypothesis suggests, in less spending on direct assistance and focusing more heavily on building up community infrastructure and public services, and marketing the community as attractive to business for those reasons. Unpopular line items such as direct assistance to business tend not to be well funded, while popular line items such as public infrastructure and services tend to be better funded. In communities where power resides with the city council, there may be significant variations from year to year in spending on economic development and other items that are seen as nonessential to the city's core mission.

EVALUATING THE FOUR CASES

As can be seen in Table 1, the case study encompasses one community in each "box" in the matrix, which classifies them on the basis of state policy and local delegation of responsibilities.

TABLE 1
Research framework, identifying the cases and vital statistics

Variable	**Municipal policymaking authority over economic development tends to be concentrated on city council**	**Significant economic development policy delegated to staff, board, commission and/or development corporation**
Centralized state; financial safety net for municipalities, but little discretion over raising revenue	Ely, Minn. Population: 3,408 2014 Median Household Income: $37,358	Hibbing, Minn. Population: 16,204 2014 Median Household Income: $38,112
Decentralized state; weaker safety net but broad discretion over local taxes including sales taxes	Rock Falls, Ill. Population: 9,087 2014 Median Household Income: $34,834	Sterling, Ill. Population: 15,057 2014 Median Household Income: $41,413

***Data source:** US Census, American Community Survey 2010-2014*

HIBBING, MINN. (16,204)

Hibbing, part of the state's mineral-rich Iron Range and with one of the region's largest mines, offers an example of a community in a state where power tends to be centralized, and where a quasi-independent authority oversees development. Many years ago, the city council delegated economic development decision-making to Hibbing Economic Development Authority (HEDA), a seven-member board that includes only three elected officials, the mayor, city clerk, and one council member (Figure 1). This authority manages a revolving loan fund that is separate from the city's general fund and directly assists local businesses with projects ranging from capital expenditure to worker training.

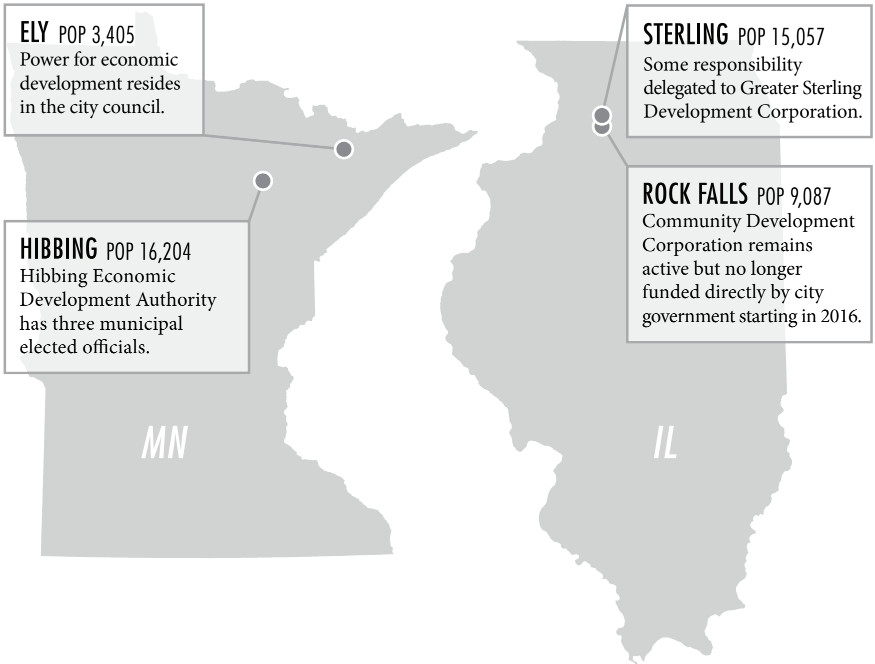
HEDA's business model has changed little over decades despite several major shifts in the city's politics, including the disqualification of the mayor and two council members in 1994 over open meeting law violations, and more recent shifts in voter preferences. A significant change occurred after the 2002 elections, which resulted in a city council composed heavily of members who favored an increased emphasis on assistance to business, including non-local as well as local firms. This was followed by an upset loss in 2010 of the bid for a third term by the mayor who had led the 2002 election's emphasis on business.

Hibbing's economic development spending in 2014 included a wide range of business subsidies to manufacturers and service industries alike, including vendors to the mining industry as well as site development. Spending reached $1.46 million, mostly for capital funds in business park TIF districts[7] that benefited both long-term clients and new firms. This amount was almost 8.5 % of total current expenditures.[8]

ELY, MINN. (3,405)

This community, also an Iron Range town with a rich tradition, is similarly affected by Minnesota's centralized power. However, Ely has faced different economic challenges since mining left the area in 1967. Continuing IRRRB support is critical to this and other former iron-mining towns. But local policy frameworks are different: Unlike Hibbing, Ely concentrates most of the power for economic development in the city council, but this was not always this case. For many years, Ely delegated economic development policymaking authority (but not funding) to a regional joint powers board. In 2010, however, the city reactivated its statutory Economic Development Authority, with positions presently filled by the seven members of the city council.

FIGURE 1
Models of Economic Development in Four Case Study Communities



Upon revival of the EDA, Ely terminated the joint powers agreement and expanded an already ambitious program for infrastructure upgrades which in the past 15 years has seen an $11 million sewage plant (in partnership with state and federal authorities), $9 million spent on a public-works garage (in partnership with the county and with federal financial support), and a new library. This arrangement has also paid for a major renovation to City Hall and numerous improvements, often grant-assisted, to previously substandard streets and sewers. The city council's policy on economic development has largely avoided targeted assistance and largely rested on ensuring property availability, both for lease and for new build-out – a policy that has stood as a consistent and popular goal through two decades of often-turbulent politics. Ely spent $244,000 on current economic development in 2014, approximately 6.4 percent of total current expenditures.[9] Significantly, it covered the entire expenditure from rents and land sales.[10]

ROCK FALLS, ILL. (9,087)

Rock Falls, in the productive agricultural region of north-central Illinois, serves as an example of a community in a state with decentralized powers but having a centralized local power arrangement. Overall, Rock Falls has a strong mayor-weak council government, and this city government has traditionally closely supervised economic and community development. City Hall has prioritized public services and both general purpose and business-oriented infrastructure, but with few instances of direct support to specific businesses.

The city's involvement in economic development dramatically expanded after the 2001-02 recession, which caused massive job losses in Rock Falls as well as neighboring Sterling. That year, Rock Falls established a Community Development Corporation (CDC), and began providing $100,000 a year in support as the CDC took the lead on reclaiming the badly polluted but prime riverfront location of a bankrupt manufacturer. The Riverfront Tax Increment Financing district channeled both local resources and federal grants toward preparing the site with new infrastructure and opening it up to commercial, residential, and open-space development. The riverfront TIF district has already supported the development of a new hotel, and a $2.1 million bond issue is expected to provide for public facilities including an outdoor performing arts amphitheater.

With the CDC's primary mission of reclaiming the riverfront site complete, Rock Falls ceased subsidizing it in early 2016, instead directly applying the funds to other economic development activity. Aside from this project, Rock Falls' approach to economic development has centered on marketing its strong public utilities (including a hydroelectric plant) and, recently, city efforts to promote broadband Internet. Total economic development fund spending in 2014 was roughly $545,000, much of it preparing for the broadband project, compared to general fund spending of $6.3 million.[11]

STERLING, ILL. (15,057)

This northern Illinois city, across the Rock River from Rock Falls, is significantly larger in population and stronger in local tax base, serving as the region's most important retail center. Compared with Rock Falls, it delegates much of its economic development policy away from the city council. Much of the day-to-day work is delegated through a council-manager system, while the management of key economic development assets is further delegated to non-profit groups. The most significant of these groups, Greater Sterling

Development Corp., leads business recruiting and development efforts and also manages a business incubator.

Sterling suffered even larger job losses than Rock Falls between 2001 and 2006, with Northwestern Steel & Wire collapsing, the Lawrence Hardware factory closing, and National Hardware merging with Stanley Works and outsourcing production. A large Walmart grocery distribution center and several smaller business expansions have softened the economic impact for this city (as well as Rock Falls). The community also worked to salvage the newer portion of the steelworks facility, which was reopened as Sterling Steel, Inc. by a former Northwestern Steel & Wire customer, Leggett & Platt. This was made possible through extensive legal and financial assistance from the city to deal with project management, a bond issue, and site remediation. The city hired Chicago law firm Bryan Cave to assist with the case, which not only facilitated Sterling Steel, but also supported the development of the Rock River Redevelopment Area, a TIF district that has reclaimed several hundred acres of the old factory site and provided infrastructure for Sterling Steel and several new businesses.

Sterling's economic development spending has been significantly higher than that in Rock Falls. Sterling's spending in 2014 totaled almost $2 million, mainly for infrastructure and reclamation in brownfield business-oriented TIF districts, compared to total general fund spending of just over $10.2 million.[12] This represents similar per capita general fund spending for both communities, but with Sterling's spending almost double Rock Falls' per-capita economic development spending.

LEARNING FROM THESE CASE STUDIES

The case studies show why the competitive urge for economic development remains strong when power is decentralized, as it is in Illinois. Subsidies and tax breaks are heavily concentrated on retailers, warehousing, and logistics, even though they have far lower multiplier effects than subsidies to corporate headquarters and manufacturing facilities, in part because the former categories are more accessible and easier to recruit. In the Chicago area, tax-base-poor working class and lower middle class suburbs use these incentives most aggressively (less so by Chicago itself and more by wealthier suburbs). In downstate Illinois, such as in Sterling and Rock Falls, they are used even more widely; there, the stakes are raised by lack of access to the range of opportunities in large urban areas.

In Illinois, as in most other states having large metropolitan areas, relatively little *state funding* is devoted directly to economic development. According to the Council for Community and Economic Research, this amounts to just $210 per business establishment. Minnesota's more centralized state government, in contrast, spends $1,039 per establishment, according to the same source.[13] However, due to Illinois' decentralized approach, its *local* business tax breaks are more numerous and competitive with neighboring states. When added together, the *total* tax breaks for economic development in Illinois and Minnesota are about the same on a per capita basis, amounting to $1.4 billion in Illinois versus $647 million in Minnesota.

The aforementioned 2012 *New York Times* study, which analyzed thousands of economic development incentives, found local government spending on economic development in Illinois to be $1.51 billion in 2011, versus just $239 million in Minnesota. On a per-capita basis, this represents $117 for Illinois, and a mere $45 for Minnesota. In fact, local "ED" spending amounts to a significant percentage of all local spending in Illinois, considering that general fund spending averages around $700 to $1,500 per capita in most municipalities (larger cities tend to spend more). Illinois essentially incentivizes economic spending by local government, due to the weakness of its revenue-sharing arrangements.

Minnesota's Local Government Aid and its tax base sharing under the state's Fiscal Disparities Act both afford a valuable opportunity to formally explore how state-level differences in policy affect local economic development spending. To examine their effects, a multivariate time-series regression was conducted of 841 Minnesota municipalities during 2006 through 2009 (excluding 16 small communities for which data were incomplete; the statewide total is 857). The regression demonstrated an enduring impact on economic development spending through a tumultuous period in spending and budgeting.

These findings showed that development spending in the Minneapolis-St. Paul metropolitan area was sharply lower than predicted, when taking into account socio-economic measures as well as basic measures of revenue such as tax capacity and property-tax levies (see Table 1). In both cases, the negative coefficient indicated around a $45 per-capita per-year lowering of economic development expenditure in the Metro Council and Trade Adjustment Assistance Act regions of the state.[14] Thus, regions that are the most fiscally centralized of Minnesota have lower spending, consistent with the hypothesis stated earlier.

DISCUSSION AND LESSONS FOR ILLINOIS

The following three findings illustrate how state-directed fiscal policy and local administrative structures can shape economic development policy.

1. When policy is delegated from the state to the municipality, or within the municipality from the elected council to an appointed board or commission, the more we can expect to see economic development policy oriented towards direct technical and financial assistance to businesses rather than general infrastructure and services. Fewer centralized arrangements encourage spending on economic development but also risk creating "beggar-thy-neighbor" competition between neighboring cities, often for little real economic gain. The economic development authorities in Hibbing and Sterling both offer examples of the benefits of institutional stability in states with agencies tasked with bringing cohesion to economic development, with relatively stable results over a long period of time.

2. More centralized arrangements at the state level that promote sharing of revenues and resources can result in significantly lower spending on direct assistance to business, depending on how incentives to local governments are structured. The aforementioned quantitative analysis indicates that in the Minneapolis-St. Paul metropolitan area, spending on economic development incentives is low for such an economically active region. Review of financial statements shows that in both communities in which economic development policy making is more centralized within the city council, economic development spending is significantly lower than in the "delegated" cases. Spending in these "centralized" cases is more oriented toward general infrastructure.

3. Communities should recognize that delegating power away from the city council will affect how economic development dollars are spent. Interpreted broadly, these cases illustrate how the way that municipalities internally assign power affects outcomes. It behooves community leaders to think carefully about how much they want to insulate decision makers dealing with economic development from the electoral politics that can be associated with city hall. At a time when infrastructure spending is often persistently inadequate, the trade-offs associated the delegating authority should not be taken lightly. Similarly, the powerful patterns driven by state policies and fiscal structures strongly influence how local governments operate, and can significantly limit their freedom of action.

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[1] The source of this information is the Minnesota House of Representatives Information Brief, *Local Sales Taxes in Minnesota*, updated December 2015. Note that Duluth, Minn., unilaterally adopted a one-percent local sales tax, with no expiration date, in 1973, before state restrictions on local sales taxes were adopted; this tax is still in effect.

[2] See the SurveyUSA/Kansas Policy Institute poll of Wichita residents in April 2014 on proposed new economic development spending compared with other spending lines, at http://www.surveyusa.com/client/PollReport.aspx?g=79f09fe6-f6cb-4c05-a391-3b2639a6ce1c

[3] Another example in smaller towns or rural areas, especially those desirable to second-home owners, is the backlash from residents against new construction, which can encourage cities to curb development (Nevarez, 2003).

[4] Alternatively, the responsibility for promoting development may be left with those who resist change the most, as happened in the 1980s and 1990s on Maryland's Eastern Shore following the improvement of highway links over Chesapeake Bay (Ramsay, 1996).

[5] A notable example of the former is the dispersal of Chicago's garment and printing industries in the 1970s and 1980s, which came about not entirely because of market forces, but also due to flawed assumptions about the market by city policymakers who effectively zoned these two major business sectors out of their concentrations in the south and west Loop, at significant economic cost (Rast, 2002).

[6] The flypaper effect is a concept from the field of public finance that suggests that a government grant to a recipient municipality increases the level of local public spending more than an increase in local income of an equivalent size.

[7] City of Hibbing 2014 Financial Statement.

[8] The source of this information is the Minnesota State Auditor.

[9] The source of this information is the Minnesota State Auditor.

[10] The source of this information is the City of Ely 2014 budget summary; does not include enterprise funds.

[11] The source of this information is this City of Rock Falls 2014 financial statement (total of broadband fund, spending on TIF districts and industrial development fund). It does not include spending on enterprise funds.

[12] The source of this information is this City of Sterling 2014 financial statement (spending on TIF districts, industrial development fund). It does not include spending on enterprise funds or public hospitals (CGH Medical Center).

[13] State Economic Development Program Expenditures Database (www.stateexpenditures.org), Council for Community and Economic Research: 2016 budgeted ED spending divided by 2014 third quarter data on the number of business establishments from the US Bureau of Labor Statistics QCEW.

[14] Not counting economic development grants to TAA communities from the region's main economic development authority, the Iron Range Resources and Rehabilitation Board is

primarily supported by iron-ore-mining production taxes

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