

# Chicago Fed Letter

## Managing economic development in times of fiscal uncertainty

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On April 4, 2013, the Federal Reserve Bank of Chicago and the Civic Federation held a conference to examine the impact of state and local tax adjustments, as well as fiscal policy uncertainties, on economic development. Also, conference participants explored state and local governments' recent experiences in dealing with fiscal difficulties, as well as their strategies to attract businesses to stimulate economic growth while still balancing their budgets.

Currently, many states and localities across the United States face dire fiscal circumstances. For example, the State

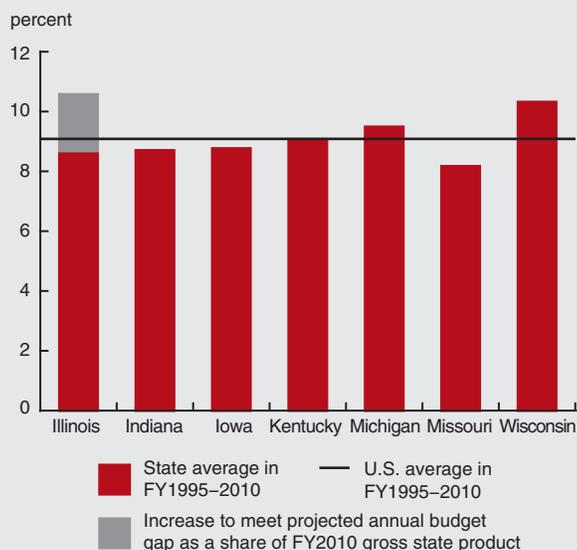
of Illinois has about \$9 billion in unpaid bills and is approaching \$100 billion in unfunded pension liabilities, making the state's fiscal condition unsustainable.<sup>1</sup> Government officials, academic researchers, and economic development specialists from the Chicago area, Michigan, and California gathered at the conference to discuss how tax policy adjustments, as well as fiscal policy uncertainties, may affect the ability of a state or locality to simultaneously provide public services, meet its liabilities, and attract private sector investment. Additionally, by reviewing recent cases of state and local governments

adjusting to the Great Recession and its aftermath, conference participants examined strategies that can be pursued to entice business investment.

### Impact of taxes on growth

William Testa, vice president and director of regional research, Federal Reserve Bank of Chicago, provided an economist's perspective on the relationship between taxes and economic growth for states and localities. According to Testa, the academic literature shows that raising taxes tends to reduce economic growth but that the size of the effect is difficult to quantify because some "business taxes" are difficult to isolate and other varying local factors (e.g., available talent pool, location and climate, and industry mix) obfuscate the effect. Nevertheless, most studies that do attempt to measure this tax effect across states and metropolitan statistical areas (MSAs) estimate that a 1% increase in the state and local tax burden reduces business activity by 0.1%–0.3%, implying that tax rate differences among states and MSAs have a modest impact on business location decisions. Other studies that focus on measuring this tax effect across local communities within the same area report a relatively larger effect: A 1% increase in the tax burden results in a loss of 1% or more in business activity. This implies that compared with tax differences among states and MSAs, tax differences among local communities matter much more for business location

1. Tax revenues as a share of gross state product



NOTE: The projected annual budget gap is an annual average over the fiscal years (FY) 2011–23.

SOURCES: Calculations by William Testa, vice president and director of regional research, Federal Reserve Bank of Chicago, based on data from the Institute of Government & Public Affairs at the University of Illinois, Fiscal Futures Project, Fiscal Futures Model; U.S. Census Bureau; and U.S. Bureau of Economic Analysis from Haver Analytics.

decisions. Accordingly, much of Illinois's business activity may be sensitive to tax rate differences both within and across its borders because the Chicago metropolitan area, which accounts for two-thirds of the state's economy, not only encompasses many competing localities but also cuts across three bordering states. Testa said that historically, Illinois's aggregate state and local tax rate has been modestly below the national average, and indicated that its rate has been competitive with those

because of difficulties in constructing appropriate models for measuring regional economic growth. She then went on to present her study<sup>3</sup> on the growth effects of restraining tax hikes based on what occurred following the passage of Colorado's Taxpayer Bill of Rights, or TABOR, as a state constitutional amendment in 1992. TABOR limits the annual growth rate of tax revenues to the sum of the population growth rate and the inflation rate. McGuire said her study's results suggest that TABOR had no effect

interviewed executives at 3M in the mid-1980s and found that the predictability of state taxes was a more important factor to them in their business location and hiring decisions than the level of state taxes. Furthermore, McGuire explained that her research for the Minnesota commission suggested that taxes used to fund education and infrastructure had a positive effect on economic growth.

To conclude, McGuire presented a three-part strategy for improving economic development and restoring fiscal balance in states such as Illinois:

- Devise a clear and immutable path to paying off state debt.
- Devise a clear and credible plan for not taking on new debt unless it is associated with capital projects (such as infrastructure improvements).
- Reform the tax system so that it supports the functions of government most crucial to economic growth—i.e., the development of human capital (e.g., through enhancing education and health care) and the provision of infrastructure (e.g., through improving transportation networks).

Some materials presented at the conference are available at [www.chicagofed.org/webpages/events/2013/economic\\_development\\_crises\\_strategies.cfm](http://www.chicagofed.org/webpages/events/2013/economic_development_crises_strategies.cfm).

of neighboring states. However, Illinois's tax structure has not produced adequate revenues to pay for the level of state services that have been provided. To bridge this gap, the State of Illinois has been borrowing against its future by deferring liabilities, including delaying bill payments and underfunding pension funds. Testa provided a projection for what future tax revenues might have to rise to in order to pay off these liabilities. Using data produced from the Fiscal Futures Model,<sup>2</sup> Testa estimated that Illinois's projected annual budget gap over the fiscal years (FY) 2011–23 is roughly 1.9% of its FY2010 gross state product (GSP). Figure 1 shows the magnitude of the increase in tax revenues necessary to close this budget gap. This increase translates into an aggregate tax rate that is 22% higher than what it was for Illinois in FY2010 (and 15% higher than the national average for that fiscal year). Testa concluded that the magnitude of this tax adjustment when coupled with cross-border competition might well have a significant impact on Illinois's economic growth.

Therese McGuire, professor, Kellogg School of Management at Northwestern University, shared another economist's perspective on the relationship between state and local taxes and economic growth. To begin, she argued that the link between state taxes and state economic growth has been weak in part

on the growth rate of real per capita income over both the short and long run. In terms of employment growth, there was a positive effect from TABOR in the first five years after its passage, although this was offset by an even stronger negative effect in the next five years. Thus, limiting tax growth did not boost the state's economy. Additionally, in summarizing the findings from several other studies, she noted that the evidence for a relationship between state and local taxes and economic growth was either inconclusive or lacking—in contrast with Testa's view.

McGuire next discussed the potential impact of uncertainty about future tax levels on economic growth. To expand on this point, McGuire discussed the macroeconomic research by Nick Bloom of Stanford University and his colleagues, which finds that over the period 2006–11 uncertainty about tax, spending, monetary, and regulatory policies led to a decrease of about 2.5% in industrial production and a loss of 2.3 million jobs in the United States.<sup>4</sup> Based on this research, McGuire argued that policy uncertainty impacts the real economy by making firms very cautious about making investments and hiring.

These findings may also matter at the state level, McGuire contended. For McGuire's own research with the Minnesota Tax Study Commission,<sup>5</sup> she

### Managing fiscal problems

Mitch Bean, founding principal, Great Lakes Economic Consulting, and former director, Michigan House Fiscal Agency, said that it seemed to him that Michigan has been through a recession of at least ten years. Since FY2000, the State of Michigan has seen large declines in its inflation-adjusted revenues—e.g., its general fund has been down by 40% and its School Aid Fund has been down 8.7%. Consequently, state aid has been reduced significantly for localities and institutions of higher education. Bean noted that the decline in state revenues has reflected problems in Michigan's economy, particularly in its critical automotive industry.

Bean then discussed the evolution of Michigan's business tax structure, providing conference attendees with some recent examples of the state's fiscal policy responses to economically difficult times. Michigan has had three distinct business taxes since 1976. Over the period

1976–2007, the state used the Single Business Tax (SBT), which was a fairly low-rate value-added tax that had broad coverage of firms throughout the state.<sup>6</sup> The SBT was unpopular—particularly with small business owners who argued that they should pay fewer taxes than their large business counterparts—so it was replaced during the Great Recession. The SBT’s successor, the Michigan Business Tax (MBT), lasted over the period 2008–11. This was a hybrid tax, with a 4.95% tax on business income and a 0.8% tax on modified gross receipts. The MBT also covered a fairly broad base of companies, but it lessened the tax burden for many firms. The MBT was then replaced in 2012 by the current Corporate Income Tax (CIT) as part of a tax reform package designed to lower business taxes in the state. Some of the revenues lost through this reform are made up through closing tax loopholes and broadening coverage of the personal income tax to include pension income. The CIT is a 6% tax on income that only applies to certain corporations; it covers a much smaller base of companies than its predecessors.<sup>7</sup> Bean estimated that roughly 94,000 businesses no longer have to pay the corporate tax now that the CIT has been enacted.

To conclude, Bean said that while recent economic growth (due largely to a rebound in the auto sector) has helped stabilize the state’s budget, the recent spending and revenue adjustments may hurt future growth in the state. In particular, cuts to higher education may hurt investments in human capital development, and reductions in aid to localities have left several Michigan communities in very tough financial straits.

Next, Tom Tait, mayor, City of Anaheim, described the recent path of fiscal adjustment for his city. Local operating revenues began to decline appreciably in 2009. Tait, who took office as mayor in late 2010, said that in response, general fund expenditures were cut by over \$20 million by 2012. A significant part of this reduction was achieved by cutting city staff: The number of city employees dropped from over 1,250 in 2009 to 1,050 in 2012. The mayor stressed that the average annual cost for a full-time

city employee during 2008–12 was between \$135,000 and \$150,000 when wage, pension, health care, and retiree medical costs were accounted for. Not surprisingly, then, labor costs made up a significant portion of the city’s budget, and therefore, reductions in staff were a necessary part of Anaheim’s fiscal adjustment, Tait said.

While the mayor was able to bring Anaheim’s spending into line with its revenues by the end of 2012, his economic development plans for Anaheim were hurt by the California Supreme Court’s decision to dissolve redevelopment agencies.<sup>8</sup> In addition, Tait said that the State of California’s recent income tax hike, which does not directly benefit local governments, had the side effect of encouraging municipalities in other states to poach businesses from Anaheim. Given these developments at the state level, Tait has stressed regulatory reform to spur economic growth. According to one study, regulation in California leads to a loss of gross state output of \$493 billion per year and an estimated employment loss of 3.8 million jobs per year.<sup>9</sup> Tait recently launched a regulatory relief task force to streamline permitting and regulatory processes, which should help make it easier for businesses to start, operate, and expand in Anaheim. Thus far, business leaders and owners have reacted favorably to Anaheim’s efforts on this front, stated Tait.

### Strategies to attract businesses

Three speakers from the Chicago area discussed strategies that municipalities can pursue to attract businesses to their areas during economically difficult times. The first one was Stephen B. Friedman, president, SB Friedman Development Advisors. He oriented attendees to the challenges facing municipal economic development programs in the Chicago area by reviewing the characteristics of a twenty-first-century economy (i.e., a global knowledge-driven economy) versus the traditional Chicago area economy (i.e., an economy based chiefly on the manufacturing and food processing industries). He said that both economies are needed to support the state’s work force, and it is therefore important for

the State of Illinois and local governments to pursue development strategies necessary to maintain both. Friedman contended that the State of Illinois must repair its business climate by reforming its tax system and improving its infrastructure and educational system. Meanwhile, local governments are responsible for focusing on quality-of-life issues (e.g., crime and traffic congestion) and making appropriate development decisions for their communities based on evaluations of the public benefits and costs. For instance, it is especially important to determine whether public financing is absolutely necessary for a project. Friedman also described some of the tools of the economic development trade, such as tax increment financing (TIF),<sup>10</sup> and how best to evaluate their effectiveness for a particular project.

The second Chicago area speaker to discuss strategies that municipalities can pursue to draw business investment was Ivan Baker, director of economic development for the southwestern suburb of Tinley Park. Baker said that even during the Great Recession, Tinley Park managed to boost the net number of businesses operating within its borders and contributing to its broad and diverse

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tax base (it has gained, on net, 165 businesses since 2008 and currently hosts about 1,400 businesses, including those involved in manufacturing, retail, distribution, health care, and hospitality). Additionally, during the recent downturn, the village was able to maintain an AA+ rating on its debt and keep its budget balanced without raising taxes or laying off any municipal workers. Indeed, one of the main reasons businesses may be drawn to Tinley Park is that the village's budget is so well managed, lowering the chance of business taxes being raised during downturns. Baker shared that Tinley Park saves extra funds during good economic times to use toward its budget during bad ones—which is an important strategy not only to maintain municipal services during recessions but also to attract businesses during economically challenging times. Finally, the municipality encourages its residents and business owners to focus on the upkeep and quality development of their properties by enforcing village codes. The civic pride displayed in well-maintained residential and commercial properties may also compel additional businesses to locate there.

The third Chicago area speaker to talk about economic development strategies was Jon B. DeVries, director, Marshall Bennett Institute of Real Estate at Roosevelt University. DeVries gave conference attendees an overview of the

history of urban planning in Chicago, concluding that it is time for the city to develop a comprehensive plan for its future. Chicago has experienced massive demographic and economic shifts in the past two decades—with some neighborhoods experiencing strong increases in population and others suffering out-migration. That said, because planning has become defunded and fragmented, the city has not created a plan to cope with those changes and set the stage for future development. DeVries then noted some of the difficulties that may impede Chicago's ability to plan, such as its high level of debt. However, he emphasized that planning is crucial to the city's economic growth because strong planning can help draw and retain both businesses and residents.

#### Keynote address

Steve Koch, deputy mayor, City of Chicago, stated Mayor Rahm Emanuel's economic development efforts have put Chicago's economy on the right trajectory, as evidenced by its having drawn in the past year 75 companies and the 25,000 associated jobs. He added that the city only invests in economic incentives to businesses when absolutely necessary because a city's talent, infrastructure, and pro-business reputation matter far more than incentives to attract businesses.

While unemployment remains high in Chicago, Koch said Mayor Emanuel is

making investments in areas that will promote job growth in the years to come. For example, the city has made investments in tourism development; improvements to its infrastructure (e.g., the subway system); and new programs at the City Colleges of Chicago that get students ready for specific careers in promising industries. The economic development issues that the city continues to work on include revamping the TIF program; reducing its long-term debt and pension obligations; and improving the coordination of its economic development initiatives with those of Cook County and the State of Illinois. In closing, Koch shared some anecdotes highlighting the mayor's commitment to bringing jobs to Chicago, including the mayor personally phoning the CEOs of companies looking to relocate to Chicago.

#### Conclusion

With the paths of fiscal adjustment still uncertain for Illinois and other states, managing economic development will remain challenging for them. Clearly, state governments, as well as local governments, are still trying to position themselves for future growth by attracting businesses to their areas; however, the effects of higher taxes, reduced services, or looming future liabilities for some will complicate their economic development efforts.

<sup>1</sup> These values are as of the end of fiscal year (FY) 2012; see Institute for Illinois' Fiscal Sustainability at the Civic Federation, 2013, *State of Illinois FY2014 Budget Roadmap: State of Illinois Budget Overview, Projections and Recommendations for the Governor and the Illinois General Assembly*, Chicago, February 25, pp. 10, 51, available at [www.civiced.org/sites/default/files/Civic%20Federation\\_\\_FY2014StateBudgetRoadmap.pdf](http://www.civiced.org/sites/default/files/Civic%20Federation__FY2014StateBudgetRoadmap.pdf).

<sup>2</sup> For details, see <http://igpa.uillinois.edu/fiscalfutures/about>.

<sup>3</sup> Therese J. McGuire and Kim S. Rueben, 2006, "The Colorado revenue limit: The economic effects of TABOR," Economic Policy Institute, briefing paper, No. 172, March 21, available at [www.epi.org/publication/bp172/](http://www.epi.org/publication/bp172/).

<sup>4</sup> Scott R. Baker, Nicholas Bloom, and Steven J. Davis, 2013, "Measuring economic policy uncertainty," Stanford University and University of Chicago Booth School of Business, working paper, April 29, available at [www.policyuncertainty.com/media/BakerBloomDavis.pdf](http://www.policyuncertainty.com/media/BakerBloomDavis.pdf).

<sup>5</sup> Minnesota Tax Study Commission, 1986, *Final Report of the Minnesota Tax Study Commission*, 2 vols., St. Paul, MN: Butterworths.

<sup>6</sup> For more on the SBT (and value-added taxes in general), see [www.michigan.gov/taxes/0,1607,7-238-43533-154440--,00.html](http://www.michigan.gov/taxes/0,1607,7-238-43533-154440--,00.html).

<sup>7</sup> For a definition of a taxable corporation in Michigan, see [www.michigan.gov/taxes/0,4676,7-238-59553-265028--,00.html](http://www.michigan.gov/taxes/0,4676,7-238-59553-265028--,00.html).

<sup>8</sup> For details, see, e.g., Maura Dolan, Jessica Garrison, and Anthony York, 2011, "California high court puts redevelopment

agencies out of business," *Los Angeles Times*, December 29, available at <http://articles.latimes.com/2011/dec/29/local/la-me-redevelopment-20111230>.

<sup>9</sup> Sanjay B. Varshney and Dennis H. Tootelian, 2009, "Cost of state regulations on California small businesses study," Varshney and Associates, September, available at <http://arc.asm.ca.gov/member/3/pdf/CostofRegulationStudyFinal.pdf>.

<sup>10</sup> TIF is a financial mechanism used by municipalities and other governments to promote economic (re)development. It is intended to generate economic (re)development activity that would not otherwise occur. TIF works by establishing a specifically defined district, using incremental growth in revenues over a frozen baseline amount to pay for (re)development costs. TIF may utilize property, sales, or utility tax revenues.