

**Fannie Mae**

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# **States and Their Cities Partnerships for the Future**

**Prepared for the Fannie Mae Foundation by the George Washington Institute of Public Policy at George Washington University, and Cleveland State University's Office of Economic Development**

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# States and Their Cities

## Partnerships for the Future

### Executive Summary

Cities are an important determinant of state economic performance. As a consequence, states that ignore the economic well-being of their cities risk falling behind. Cities whose economies are stagnant, whose residents suffer from poverty and unemployment, whose budgets are in chronic fiscal stress, and who require state aid to sustain basic services are a drag on the entire state economy. Cities whose economies are vibrant, whose residents are productive, whose budgets are fiscally stable, and who do not require massive infusions of state aid are assets to the entire state.

Our study examines the relationship between states and their cities and the impact of state activity on cities. To understand how states can help cities — and thereby themselves — succeed, the George Washington Institute of Public Policy and Cleveland State University's Office of Economic Development began a study of state policies that contribute to successful urban performance. As background for this paper, we visited seven states (California, Illinois, Michigan, North Carolina, Oregon, Pennsylvania, and Washington; see Box 1 on p. 5 for selection criteria). As a result of our research in these states, we identified a set of principles that, when they serve as guides to state actions and policies, can help cities prosper and at the same time benefit all state residents.

The body of this report presents the rationale for our contention that these principles should guide state behavior toward cities. The first part of the report sets forth a variety of generalizations (which we term principles) about the kinds of approaches that are likely — and the kinds that are unlikely — to help cities achieve success. We also look at a number of specific state and city programs that seem consistent with these principles. In the last portion of the paper we focus on policy domains that are important to cities and summarize what we have learned about state activities in these areas. We also discuss the principles as they relate to housing and housing affordability, community development, economic and workforce development, education, and transportation.

A summary of the study's main findings follows. We begin with two principles that we found to be *prerequisites for success*.

***Vision and leadership are the foundations of success.***

Time and again we found that in cities that had successfully transformed their economic and residential base, vigorous leadership was present and was driven by a well-articulated vision. At times, that vision was seated in the state house; other times, it was located at city hall and/or in the community. In city after city where progress had occurred, vision and leadership, sustained over time and backed by resources, played a decisive role.

***State government understanding of the importance of cities and the nature of productive state-city cooperation is essential.***

In most of the states that we visited, we did not come across any comprehensive expression of an "urban policy." However, in states whose cities were successful, we found productive and cooperative state-city relationships coalesced around specific programs and focused on well-defined problems. In other states, the relationship between states and their cities was characterized by, at best, benign neglect.

Based on our research as well as a review of literature, we believe the next set of principles should guide state government behavior toward their cities. These principles include:

***Do no harm.*** The Hippocratic Oath deserves a privileged place among the tenets guiding state governments. At a minimum, states should abstain from activity that harms cities. Given the need, sometimes, to implement policies that benefit the state overall but do not necessarily benefit cities (and may even harm them), states should at least be aware of any potentially adverse impact on cities and should take this into account when making decisions. At the very least, the state has a responsibility to provide local government and city interests (mayors, city caucuses in the state legislature, professional associations representing local government and city interests) with the opportunity to express their concerns.

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**Do the basics well.** State government is responsible for a set of core functions, which, if performed well, benefit both cities and the state as a whole. These include providing:

- A modern, productive, and integrated infrastructure that promotes growth
- A high-quality, state-funded higher education system that educates state residents, attracts out-of-state students, and promotes research and development
- High standards and expectations for the K-12 public education system and a state education finance system that provides all districts with the resources necessary to meet those standards and expectations
- An effective criminal justice system
- Well-managed state government departments and agencies, transparent state government processes and procedures, and honest, law-abiding state government officials

**Promote home rule while exercising responsible oversight.** States should support local government choice, innovation, and flexibility, but also provide effective and responsible oversight. State governments cannot administer and manage city governments, but they can provide the tools that make effective home rule possible. At the same time, irresponsible local government behavior can harm the entire state by raising the costs of living and of production, creating political crisis, or inhibiting economic change. Some form of proactive state fiscal oversight is both prudent and necessary. Arrangements consistent with this principle include:

- States should grant cities some degree of autonomy in determining the form of municipal government.
- States should make it easy for cities to annex land and difficult for areas surrounding cities to incorporate.
- States should permit local governments to impose more than one type of major local tax.
- States should not impose extreme limits on local government spending and revenue-raising.
- States must recognize that local governments are part of an overall state-local fiscal system; transferring state fiscal problems to local governments (by reducing state general aid to local governments, for example) relocates the problem rather than solving it.

**Be innovative.** States should engage in innovation and experimentation in the development of urban policy and should encourage cities to experiment as well. One of the most compelling arguments for the federal system is that the states can serve as laboratories for experimentation or “laboratories of democracy,” as Judge Louis Brandeis termed them. The body of this report details a wide range of promising innovations that we found during our site visits.

**Be focused.** State policies toward cities should be strategic and focused. In some states, urban policy is little more than a collection of small, poorly funded programs designed to express concern for the problems of cities. In most cases such programs are just too small, scattershot, or ill-conceived to have real impact.

**Think regionally.** States should encourage problem solving at the regional level for problems that affect the entire region or have spillover effects from one jurisdiction to others.

**Eliminate funding inequities.** States should provide an equalization grant to local governments to compensate for differences in local tax capacities.

**Seek a balance between change and continuity.** It is difficult for cities to pursue a successful vision or to project stability if they must contend with frequent, unanticipated, and sometimes dramatic discontinuities in state policy. Nobody would reasonably argue that partisan changes in state control should not occur or should not be accompanied by policy changes. That said, there are several forms of instability that limit the ability of cities to contribute to the economic and social development of the state.

- Newly elected state leaders, both governors and legislators, should evaluate the effectiveness of existing state programs that affect cities, retaining and improving those that are working, even if they are associated with the policies of the opposing party.
- Tax limits, expenditure limits, and term limits introduce instability into the management and governance of cities. The initiative and referendum process, which played a major role in three of the states we visited (California, Oregon, and Washington) and a moderate role in Michigan, is another generator of sharp and unexpected discontinuities to which cities must adjust. California’s Proposition 13 and its effects serve as a good example of

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fiscal instability, which we term “mandated public policy incoherence.”

We also looked at specific policy areas in each state and, based on our examination, have formulated a series of recommendations:

- States should actively encourage cities to think of housing as an integral part of development efforts — especially downtown development.
  - States should recognize that one size does not fit all: State policy must respect the diversity among cities. This is particularly the case with vitality and amenity packages. State policy should recognize the importance of each city’s uniqueness — the characteristics that set it apart from all other cities.
  - States should provide local governments with the tools they need, including local economic development tools. However, states should not provide tools (such as local tax concessions) that encourage local governments to compete against one another.
- In view of the potential importance of universities in state and urban economic and workforce development, states should develop, sustain, and adequately fund high-quality university systems. States should see their universities not only as a means of educating the children of existing residents but also as a way to attract talent from elsewhere.
  - States should ensure that all children have access to an adequate education and are not denied access as a result of insufficient income or the weak tax base of the school district in which they live.
  - States should make state transportation funding to local governments as flexible as possible so that cities retain the authority to determine the best use of these funds.

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## State Governments and Their Cities: What Do States Have at Stake?

State economies exist within a fiercely competitive international environment, an environment that no longer rewards business-as-usual approaches. In this global economy, cities are an increasingly important determinant of state economic performance. States that ignore the economic well-being of their cities will pay dearly, because cities are at the heart of real economies of goods and service production and innovation. From the perspective of economic geography, state economies really do not exist. A state's economy is an amalgam of metropolitan-based regional economies and rural natural resource economies. This simple fact is critical to understanding the role of cities in the knowledge-intensive economy of the future.

Cities are frequently viewed in stereotypical terms, with two diametrically opposed stereotypes prevailing:

- **Stereotype 1: Nirvana cities.** America's large central cities are the key to the economic future of the nation and are central to wealth building in the states. Cities house the creative class, gather scarce talent from all corners of the globe, give birth to the industries of the future in university test tubes, hospitals, and recycled industrial lofts. Employers are rediscovering cities because what they need most to succeed is talent, and that talent no longer prefers to live and work huddled next to the exit ramps of metropolitan highway systems. If a state does not have healthy and vital cities, it will miss out on the next economic era.
- **Stereotype 2: Apocalyptic cities.** America's large central cities are drags on the finances of state governments. They are havens for the nation's undereducated and are littered with the abandoned wreckage of the industrial past, with outdated public sector work habits, uncompetitive tax rates, and failed public schools. The redistributive politics of the past have found sanctuary in the remnants of a political coalition that is dying nationally and is more interested in protecting public sector jobs than in providing services to the public. As soon as they feel concern for their children's education and safety, knowledge workers drive to family friendly suburbs where the quality of schools trumps the entertainment cravings of parents. Once new-economy firms have incubated, they

search for suburban campus environments close to the homes of their CEOs and key employees.

Like all stereotypes, these are simplifications; and, like all stereotypes, each contains a bit of truth. The fact is that states have huge economic interests in their cities, and cities cannot operate effectively without the full partnership of their state governments. Cities whose economies are stagnant, whose residents suffer from poverty and unemployment, whose budgets are in chronic fiscal stress, and require state aid to sustain basic services are a drag on the entire state economy. Cities whose economies are vibrant, whose residents are productive, whose budgets are fiscally stable and do not require massive infusions of state aid are assets to the entire state.

The economy is a relentless, self-healing system of investment that writes down and writes off assets that no longer provide value, discards what does not work, and invests in and supports what does work. Governors could leave the decline of cities to mayors of another party. But in the long run, doing so will be costly. The fact is that the state wins if cities succeed, and the state's viability comes into question if its cities fail.

The question for states, then, is whether their cities will represent costs — part of the social overhead burden that must be borne by the entire state, or assets — areas where innovation, entrepreneurship, productivity, and opportunity will flourish and drive the state as a whole. Over the course of the past half-century, too many of our cities have become costs, degraded assets that impose burdens not only on their own residents but on the state as a whole.

Obviously, state governments do not bear sole responsibility for the good or bad performances of their cities. This is not a one-way street. There are many factors that are likely to be as important or more important than state actions and policies — a city's own policies, the effectiveness and competence of its government, the vision (or lack thereof) of its elected officials and its major civic leaders, its history and culture, the industrial legacy and economic structure that it inherited, the industriousness and entrepreneurial skill of its residents — and, we hasten to add, sheer good luck in terms of its legacy, geography, natural attributes, the quality of the companies located there, and the market demand for goods and services that local firms produce. Nonetheless, states

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have made and can make a difference in whether cities succeed and whether they drive overall state economic performance or serve as a drag.

Cities have choices to make in terms of their patterns and practices of governing and operating. Will older, formerly industrial cities, with histories of political machines that give public employment primacy over effective and efficient service delivery, continue to practice the politics of patronage — a politics of managing their decline? Or will they create a different future with a more cooperative bargaining style and programmatic accountability and be willing to practice the politics of performance — a politics that means change in their policies, practices, and cost structures? If not, the economy will continue to bypass them.

In this report, we report on lessons learned from intensive case study research performed by scholars at the George Washington Institute of Public Policy at the George Washington University, and at Cleveland State University's Office of Economic Development. As background for this report, we visited seven states (see Methodology, below). While performance was mixed in all states, most of the cities in Oregon, North Carolina, Illinois, and Washington performed better than expected from 1990 to 2000 in terms of income, population, and job growth, and worse than expected in terms of housing affordability. In California and Michigan, we saw the opposite pattern of performance. And in Pennsylvania, cities largely performed poorly across the board.

### **Methodology: How Were the Case Study Cities and States Selected?**

To understand how states can help cities and thereby themselves succeed, the George Washington Institute of Public Policy and Cleveland State University's Office of Economic Development began a study of states and state policies that contribute to successful urban performance.

We began by analyzing typical urban performance indicators (e.g., per capita income, jobs, poverty rates) for the 325 central cities that had 1990 populations of at least 50,000. Using statistical models that analyzed changes in these indicators for our cities during the 1990s, we projected what these cities would look like in 2000, given their demographic, economic, and social characteristics in 1990. We then calculated their actual change on the indicators from 1990-2000 and identified cities that performed either markedly better or markedly worse than what we had projected. (For more on our methodology, findings on predicted and actual city performance and our analysis, see our paper presented at the Urban Affairs Association conference in 2005.<sup>1</sup>)

In the process, we recognized several states in which most cities had either overperformed or underachieved their projected performance. In order to determine the role of state governments (both beneficial and adverse) in these unusually high- and low-performing cities, we selected states from both categories for more intensive analysis, including California, Illinois, Michigan, North Carolina, Oregon, Pennsylvania, and Washington, and two cities in each state (one in Oregon).<sup>2</sup> Illinois' cities performed close to the predictions of the model, but the state was selected due to the perception of many that Chicago and its satellite cities were places that were on the move and had unusually strong performance from 2000 on. To discover how states contribute to successful urban performance, we conducted case studies in each of the states, visiting both the cities and state capitals to interview state and city elected and appointed officials, members of professional associations and interest groups, academics and researchers, journalists, and other knowledgeable observers. We also conducted focus group sessions with four expert panels in Washington, D.C., and at least one such session in each of the states we visited.

While the statistical work that we used to identify our case study states and cities utilized city performance data from 1990-2000, the interviews, case studies, and expert panels were not confined to that time period. Our quest was to understand the role states have played and continue to play right up to the present in terms of city performance. These case studies and expert panels form the basis for our findings and conclusions.

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As we visited, we began to observe a number of principles that, as the drivers of state action and policy, helped cities prosper while benefiting state residents in general.

As a result of our observations, we have extracted a set of principles that are useful in guiding state activities with respect to cities. These principles are general guides to action. In addition to these principles, we derived more specific lessons from our visits that we present in the form of policy recommendations.

The successful state-city partnerships that we observed shared two common elements that we saw frequently enough that we term them *prerequisites for success*. First, there was a *workable vision* of the future, based on the self-interest of those involved, that was adopted by succeeding state administrations and embraced by local community leaders. Second, the state government and cities recognized that they had a stake in each other's success and that *effective cooperation* was important to that success.

### **Prerequisite 1: Vision and Leadership Are the Foundations of Success**

Vision for the city's future is critical: Cities must be able to build upon their history without being prisoners of past practices. Time and again, we learned that in cities that had successfully transformed their economic and residential base, vigorous leadership was present and was driven by a well-articulated vision. At times, that vision was seated in the state house; other times, it was located at city hall and/or in the community.

Economic development time is measured by how long it takes to change the structure of the regional economy; this is much longer than political time, which is the length of the political election cycle. Vision and leadership are the two factors that bridge these two time scales.

We observed, in city after city where progress was made, that a few key players with vision and resources make a difference. While we acknowledge that leadership in a city or state matters, we less often appreciate the vital role that a deeply held vision, appropriate for a city and sustained over time, plays in bringing about long-term city success. This kind of vision leads cities to a clear identity, distinct from that of other cities.

How did this vision manifest itself in our successful cities? In several of the cities and states we visited, the strategic and targeted investment of public funds was a key component of the vision that leaders articulated and embraced. For instance, for nearly half a century North Carolina has sustained a vision for developing a knowledge-based, technology-rich economy rooted in the quality of its higher education system, community colleges, and the Research Triangle Park, a vision that has nourished the development of cities in the Durham-Chapel Hill-Raleigh area.

At the southern end of the state, the extraordinary vision of Hugh McColl, the CEO of NationsBank (which merged with Bank of America in 1998), supported by CEO Ed Crutchfield from First Union (later to merge with Wachovia) and William Lee, CEO of Duke Power, led to the revitalization of the city of Charlotte. Based on his experience in London, McColl believed early on that he could not have a great bank without a great city. As a result, his vision centered on creating a vibrant city, which involved creating amenities for his employees in the downtown, changing low-income and blighted neighborhoods into safe, attractive, mixed-income communities, and generally improving the quality of life throughout the city. Charlotte's turnaround began when this private vision took hold in the public arena, in part due to supportive state policies and in part due to the ability of the public and private sectors to advance a mutually beneficial vision.

In Oregon, Tom McCall's gubernatorial vision was to protect the region from "coastal condo-mania, sagebrush subdivisions and the ravenous rampage of suburbia."<sup>3</sup> Together, he and Portland Mayor and later Governor Neil Goldschmidt advanced this vision by crafting policies that encouraged urban development and redevelopment in existing urban areas while simultaneously preserving farmland, open space, and natural resources. The well-known "urban growth area" of Portland arose from this commitment to preserving the environment and preventing land-consumptive, low-quality new development. This visionary leadership has guided the Portland area for more than 30 years in its development as an environmentally conscious, non-automobile-oriented culture known for its "new urbanism." Portland's accomplishments in terms of housing initiatives, transportation investment, and land acquisition can be largely attributed to the visionary leadership of its politicians and the working partnership between the city and the state house.

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Mayor Daley's vision of Chicago, described to us as "a marriage of quality of life and a good place for families to live, work, and play," has guided Chicago's success story over the past 15 years. Purposeful investment, coupled with a clear articulation of the objectives associated with that investment, create a sense of direction and efficacy. Multibillion dollar investments in infrastructure are credited with bringing neighborhoods back to life. As Terry Nichols Clark observed in the introduction to his book on the post-industrial city, "In the 1980s and 1990s, Chicago's government changed hugely, perhaps more than in all previous decades of the twentieth century ...The younger Daley (Daley II) has increasingly stressed making the city a good place to live, as well as work ...His park and tree-building efforts symbolize the drastic shift in thinking about the city, its people, and politics. It symbolizes a broader effort to recognize the interdependence of the human and natural environment, to elevate aesthetic and consumption concerns to a par, or better, with those of making a living, and to redirect political vision away from exchanges between self-interested individuals toward the public good. This is a political revolution, all the more dramatic as it has happened silently, largely undeclared and under recognized, [sic]."<sup>4</sup> As for the state, it has given Daley and Chicago freedom to invest in itself, and the mayor has been given more authority over the schools, including the key ability to revamp the hiring system and to give principals and parents greater power.

Leadership vision in Aurora, Ill., dates back more than 30 years to Mayor Albert McCoy, who had the foresight in 1973 to annex a huge parcel of land — the second largest annexation in the state's history, after the O'Hare Airport annexation — that became Fox Valley Mall. In the 1980s, Mayor Jack Hill, who saw both residential and business development as critical to the city's future, created an economic development commission. Hill, a former union steward, changed the city's zoning laws to prevent the conversion of single-family homes and instituted other laws that created strict health and safety standards for multiple-unit buildings. Subsequent Aurora leaders have built upon that visionary foundation, bringing to town a casino and housing attractive to Chicago commuters.

Mayor Norm Rice's vision for the redevelopment of Seattle's downtown, with its focus on creating an "18-hour" downtown, is similarly viewed as a successful revitalization effort. The strategy entailed making transportation changes that

favored shoppers and residents over commuters, bringing retail back to the downtown core, and encouraging residential development through rezoning and affordable housing subsidies. Under Rice's leadership, the city also formed a partnership with the Downtown Seattle Association. The partnership made additional investments in public projects downtown, including infrastructure investment and stadium construction.

Tacoma, Washington, experienced a renaissance of sorts during the 1990s as a result of a sustained partnership between city government officials and prominent civic leaders. The vision for the revitalization of Tacoma's downtown originated with the Executive Council for Greater Tacoma, a small set of the city's large business leaders' council. The council commissioned a study for the redevelopment of the Foss Waterway, which bordered Tacoma's corporate downtown and had been identified as a Superfund site, into an area that combined commercial development with museums, retail, and residential development. The partnership with the city provided the crucial element needed to bring the council's vision to fruition. The city bought the waterfront property, took responsibility for the cleanup effort, and issued bonds to pay for the reconstruction of the historic Union Station building, which now houses federal courts. The council was also responsible for convincing the University of Washington to place its Tacoma branch downtown instead of in the suburbs.

All of the examples of vision and leadership discussed above share a common quality. Each vision shaped politics and investments for years, if not decades, to come. The vision that can be traced to an individual or an administration outlasted its author's tenure and became an essential part of the civic fabric. Portland's commitment to quality architecture and urban design did not come about by accident; it was intentional. Chicago's commitment to quality of life, green investment, and public transportation transcended Daley's first mayoral campaign and became a civic expectation. Aurora's commitment to its downtown as a quality live-work environment was more than a tactic supported by a casino; it was an intentional change in future expectations. Charlotte's drive to urban sophistication that reflects its regional culture was also intentional. Each of these intentions served as a widely shared, aggressive, yet obtainable vision that shaped the investments and politics that followed.

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## **Prerequisite 2: State Government Understanding of the Importance of State-City Cooperation Is Essential**

In most of the states that we visited, we did not come across any comprehensive expression of an “urban policy” (although we would argue that all states have an unarticulated urban policy in that a wide variety of their activities affect cities, albeit unintentionally) or of the need for cooperative state-city relationships. However, that does not mean that such relationships did not exist or were not important. Instead, productive and cooperative state-city relationships coalesced around specific programs and well-defined challenges.

Illinois, where a succession of governors, both Republican and Democratic, has engaged in close and effective interaction with Chicago, is a good example of this. Republican governor James Thompson (1977–1991) was able to work effectively with Democrats, including Harold Washington and Richard M. Daley. As John Coyne observed, “Many Republicans who do business in Chicago believe he [Thompson] has handled the city as well as can be expected. And they give him high marks for working behind the scenes with Mayor Daley and House Speaker Mike Madigan of Chicago to bring off the sleight-of-hand tax increase that made Chicago’s unprecedented public-school reform program possible.”<sup>5</sup>

Governor George H. Ryan, also a Republican, helped pass subsidies to bring Boeing to Chicago, and it was under his administration that the legislature passed Illinois First, a \$12 billion public works program commonly perceived as extremely favorable to Chicago.

In Michigan, Democrat David Hollister became mayor of Lansing after almost 20 years in the Michigan House of Representatives, where he was regularly in conflict with Republican governor John Engler. Hollister and Engler set aside their past differences and worked together to improve the capital city, including undertaking a successful campaign to keep a General Motors plant in Lansing. Lansing often served as the pilot for the governor’s initiatives.

Too often, however, the big-picture relationship of state governments with their cities can be better characterized as one of benign neglect and, in a few situations, disdain. In Pennsylvania, for example, a state official observed, “The

General Assembly is hostile to cities. It goes out of its way not to help Philadelphia. Cities are just a big, dark drain.” Similarly, a consultant in city-state fiscal relationships noted that in California, “Public policy begins and ends with whether it’s good or bad for the general fund.” This approach does not produce successful cities. Several observers in California noted the state’s lack of interest in cities: “Benign neglect is the best you can hope for. When the state does notice you, it’s not good news. There is no real idea on the part of the state of the role of cities, what they should be and can be doing.”

In North Carolina, where the state’s focus is on distressed *rural* areas, a Charlotte city official complained that, “We’ve done these things despite the state. We’re viewed as a cash cow by the state. It’s hard to get them to pay attention, to say ‘We are going to invest in Charlotte.’” The state is continually nibbling away at the city’s revenue. Charlotte wants more options for raising revenue. For example, the state lets the counties [but not the cities] have a local option sales tax. The state is not helpful in granting city alternatives.”

In Portland, one city official summarized the consensus in the region when he stated that, “Portland has been successful despite the lack of investment from the state.” And in Pennsylvania, one policy-maker noted that the state’s smaller cities, in particular, “are suffering from neglect by the state.”

## **Principles for State Relationships toward Cities**

### **Do No Harm**

At a minimum, states should strive not to engage in activity that harms cities. Given the need, sometimes, to implement policies that benefit the state overall but harm cities, states should at least be aware of any potential adverse impact on cities and take that impact into account when making their decisions. States have a responsibility to provide local government and city interests (mayors, city caucuses in the state legislature, professional associations representing local government and city interests) with opportunities to express their concerns.

We found a wide range of state actions that had an adverse impact on cities. Some, including such fiscal limitations

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California's Proposition 13, are obvious, since they prevent the city and its residents from taxing themselves or spending at the level they might prefer. Others may be more subtle. Both Pennsylvania, through Act 111, and Michigan, through PA 312, require compulsory arbitration in labor negotiations between cities and their employee unions. In both states, city officials have complained that the fiscal stress of cities is not taken into account in arbitration decisions and that cities are frequently saddled with expensive settlements that add an anti-business environment and fiscal challenges. These acts also make it very difficult to reshape municipal workforces in the face of population declines, shifts in service demands, or changes in technologies.

Education is another area in which states may inadvertently shortchange cities. In Oregon, for example, the state education equalization formula, which is designed to provide equivalent resources for all school districts, fails to take into account the higher cost of education in Portland. Thus it disadvantages, probably unintentionally, the city's school system. Portland's higher education costs result from the need to pay higher salaries to attract teachers as compensation for the city's higher cost of living as well as for the greater challenges of teaching in an inner-city school system. Similarly, unfunded pension liabilities, a problem for all school districts in the state, impose greater cost for the Portland school district because of the higher pension benefits in its contract.

Many states impose unfunded mandates on their localities. However, California's constitution requires the state to reimburse local governments when the state mandates a new local program or higher levels of service. The California Commission on State Mandates, created in 1985, adjudicates local jurisdictions' claims that a state agency has imposed a reimbursable state mandate. In 2005, for example, the Commission found that a law on pupil promotion and retention that required policy development, special instruction, and summer instruction constituted an unfunded mandate and required reimbursement for the period going back to 1997. Implementation is a separate matter, though; despite the constitutional limitation and the commission, a 2004 report noted that the state owed local agencies about \$2 billion for the previous year's costs for all unfunded mandates.

Some states have gone beyond doing no harm and have tried to help cities by locating state facilities that could have gone elsewhere in downtown areas. In 2000, the Pennsylvania legislature passed the Downtown Local Law to direct state buildings and state-leased space into downtowns, but critics argued that it defined the concept of downtown too broadly. In February 2004, Governor Ed Rendell signed Executive Order 2004-2, the Utilization of Commonwealth-Owned and Leased Space, to reinforce the direct intent of the Downtown Local Law. The Executive Order asserts that "agency heads are strongly encouraged to lease space in downtown areas, whenever possible," noting that Pennsylvania at the time owned approximately 11,000 buildings and its executive agencies leased approximately 700 buildings. Michigan's Executive Directive 2003-22 has a similar intent: It encourages adaptive use or rehabilitation of historic buildings or reuse of other buildings within urban areas, use of vacant buildings or land in urban areas, and use and rehabilitation of brownfield areas.

### **Do the Basics Well**

State government performs a set of core functions, which, if performed well, can benefit cities as well as the state as a whole. These include providing:

- A modern, productive, and integrated infrastructure that promotes growth
- A high-quality higher education system that educates state residents, attracts out-of state students, and promotes research and development
- High standards and expectations for the state's elementary and secondary education system and a state education finance system that ensures that all districts have sufficient resources to meet those standards and expectations
- An effective criminal justice system
- Well-managed state government departments and agencies, transparent state government processes and procedures, and state government officials who are honest and obey the law

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## General Guidance for Formal Structure and Rules of the Game

### Choice with Responsibility

State rules governing local government structure should support local government choice, innovation, and flexibility, but include responsible state oversight. Cities, like people, operate within a set of structures that limit and condition their actions. As constitutional creatures of the state, cities are subject to the limits set by the state government. Sometimes these limits are embedded in state constitutions, and at other times they are statutory.

State rules govern the choice of municipal government; the city's authority to tax, spend, and borrow; the kinds of taxes and fees the city may impose and the process for imposing them (whether through a vote of the council or through a referendum and, if through a referendum, whether a majority or supermajority vote is required); the activities it can engage in and services it can provide; the framework that defines its authority to control land use and annex unincorporated territory; and the framework within which it conducts labor-management relations. These rules vary substantially from state to state. All of them are important, and some are critical to city performance and success.

While state governments cannot administer and manage city governments, they provide the tools that make meaningful home rule possible. Local grassroots democracy underpins American democracy; indeed, it is frequently given nearly religious obeisance. It is not necessary to recite here the rationale for local democracy in terms of government's role in adequately reflecting local preferences and opinion, fostering civic participation, and ensuring efficient administration. At the same time, irresponsible local government behavior can have an impact on the entire state by raising costs of living and of production, creating political crisis, and inhibiting economic change. Proactive state fiscal oversight of cities is both prudent and responsible.

There is an unavoidable tension between local control and state oversight. The state must ensure that localities are fiscally solvent, well managed, and law-abiding. The state must also encourage local government to be responsive to new service demands and to be a local problem-solver.

### Fiscal Control and Local Discretion

States determine the kind of taxes that local governments can levy and, in many cases, the maximum rate at which they can levy them. States also place restrictions on what some taxes can be used for. This state authority has sometimes led to abuse and fiscally imprudent decisions that have made it difficult for some cities to invest in their own future. These unfortunate consequences could be averted if state legislatures embraced more prudent principles when structuring the fiscal environment for local government.

#### *Fiscal integration*

States must recognize that local governments are part of an overall state-local fiscal system and that exporting state fiscal problems to local governments merely relocates the problem rather than solving it. This principle leads to a number of recommendations. The most contentious issues between states and cities arise through the state-local fiscal system. That system encompasses not only state grants to local governments but shared taxes and the extent to which the state funds services for which local governments would otherwise be responsible. Based on our analysis, we suggest several corollaries to the principle of fiscal integration — additional principles that would likely soften the tension between states and their cities while also giving cities the autonomy necessary to promote local economic growth and ensure the efficient provision of services.

#### *Choice in Local Taxation*

States should permit local governments to impose more than one type of major local tax. Local governments should not be limited to the property tax, as they are, for example, in Oregon. Like states, cities need a balanced tax system so that at least a portion of their tax base will grow with the economy (income or sales tax) while another portion will remain relatively stable during economic downturns. Historically, the property tax has proved the most stable, while the income and sales taxes track the economic cycle.

#### *Fiscal Discretion*

States should not impose extreme limits on local government revenue. In Oregon and Washington (through limitations on the property tax) and in California, where the initiative process has created limits on both property tax and additional taxes and fees, state limits reach the extreme. Not only do such limits make it difficult to respond to the needs

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of local residents, they often influence the behavior of residents and of the local government in negative ways. California's Proposition 13, adopted in 1976, limits the property tax rate to 1 percent of assessed value and limits increases in assessed value to 2 percent annually until the property is sold, at which time it is reassessed at its market value. In Oregon, there is competition for high-valued new home construction as a way to replenish diminished public coffers.

The predictable result for residents is a slowdown in house sales and the anomaly of neighbors paying different property taxes despite living in identical houses. Additionally, because local property taxes are limited but local option sales taxes are not, critics contend that municipalities zone too much land for big box retail in the hopes of landing a Best Buy store and a mall-induced tax windfall. Proposition 13 has also meant a virtual state takeover of education funding and a high dependence on state funding for other specific purposes. As a result, one of our interviewees in California observed, "Our cities are terribly hamstrung by Prop 13 in a way that skews city actions. City governments now represent a collection of specific companies, each of which has a specific revenue source."

North Carolina takes a different approach to state oversight. Its Local Government Commission (LGC) exercises oversight over local fiscal and financial behavior. Additionally, the commission has the authority to require municipalities that are over budget either to reduce services or to increase taxes to bring their budgets immediately into balance. The commission, which came into existence in the 1930s as a result of a series of bankruptcies by local governments in North Carolina, must approve all bonds issued by local governments. This is in sharp contrast to Pennsylvania, where Pittsburgh, in severe financial trouble in 1998, issued \$255 million in noncallable bonds through the Internet to cover its growing pension obligation. The city invested the proceeds in the stock market in time to experience the downturn in 2000. One report notes that the city is paying nearly \$17 million in interest annually on these bonds, which adds significantly to its operating costs.

Through annual audits, the North Carolina LGC also oversees, although with a very light hand, the fiscal conduct of local governments. LGC has the authority to require localities to change their budgets through budget cuts or revenue increases, and in extreme cases, it is authorized to take over

local governments. However, the commission rarely needs to exercise its takeover authority because the many intermediate interactions between the LGC and local governments flag fiscal problems and allow localities to rectify them before they become crises. This benign protection creates a cordial relationship with North Carolina cities. In fact, many public officials appreciate the commission's oversight and feel that it contributes to good government.

Pennsylvania's form of fiscal oversight stands in sharp contrast. Act 47, the state's Distressed Municipalities Act, comes into play only after local governments are already in serious trouble — as one of our Pennsylvania interviewees noted, "after they can no longer pay their firemen and police." In other words, the state does not step in to help cities in distress until they are on the verge of bankruptcy and request state help. Even then, it does not provide fiscal aid but rather "watches cities that come under the act like a hawk" and allows them to tax more and benefit from other non-aid mechanisms. As one assistant to the state legislature asserted, the combination of a sharp drop in a city's credit rating and the heavy state oversight makes the option of asking for the application of Act 47 an extremely unattractive one for a city. This also contrasts with the Illinois Distressed River Towns law, which allowed certain cities to open casinos as a way of averting serious financial hardship. The law is credited in part with helping to keep these cities viable and turning them around.

### **Competition**

States should permit competition among local governments in terms of the type, level, and quality of services they wish to provide, the rate at which they wish to tax themselves to provide these services, and the effectiveness and efficiency of local government. However, they should not allow or encourage local government competition through tax abatements/concessions to businesses. Economies are regional in scope. Therefore, giving local governments widespread authority to attract economic activity through tax concessions merely results in moving activity from one place in the economic region to another, not in creating new economic activity. Incentives have their strongest influence on the locational behavior of firms within a metropolitan region. This is because businesses make location decisions on the basis of worker cost and quality and on access to markets, factors that are regionwide in scope and almost always far outweigh

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property tax costs in importance. As a consequence, publicly provided tax concessions can tip the scales in the favor of one community within a region over another. However, from the perspective of the region and the state, this shift in location does not bring forth any new economic activity — the business was going to locate in the region anyway. Therefore the relocation simply shifts tax money among municipalities and provides a windfall to the business. This is bad public policy.

The exception to this rule occurs when the state has a narrowly targeted incentive program that builds up the tax base or employment base of an impoverished community. However, experience has shown that it is extremely hard for state legislatures to maintain narrowly targeted tax incentive programs; in the process of building coalitions, they invariably face pressure to widen the scope of benefits. The question of “What’s in it for my constituents?” leads to legislative logrolling and the distortion of (once) narrowly targeted incentives.

Tax incentives tend to reduce themselves to one-at-a-time, firm-specific, “let’s make a deal” business tax reform. Indeed, the state’s tax abatement authority fosters inefficient competition among municipalities.

Several of the states we visited had programs permitting local governments to grant tax relief as an economic development tool. Michigan and Pennsylvania pursue deep abatements rather than fundamental business tax reform. Michigan’s Renaissance Zones waive business and residential taxes for 10 to 15 years, prompting one interviewee to call them “enterprise zones on steroids.” The state also provides tax relief through its industrial facilities property tax abatement (PA 198), personal property tax abatement (PA 328), Neighborhood Enterprise Zones (locally initiated, provides tax incentives for housing development and improvement), and many other forms of tax relief. In Pennsylvania, some of the people with whom we spoke felt that the Keystone Opportunity Zones (areas that the community, with state approval, designates as tax-free) had originally worked well when they were limited and well-targeted. However, the rapid spread of the tax abatement zones has led to a substantial loss of tax revenue for the state and local governments without necessarily helping areas that are most in need. It is better to restructure the tax and service environment than to engage in “let’s make a deal” tax reform.

## **The Principle of Choice**

States should permit some degree of choice in the form of municipal government. States either determine the form of government that municipalities can adopt or provide a menu from which they can choose. The cities we visited had a wide range of government forms — from mayor-council in Chicago, San Francisco, Philadelphia, and Lansing to council-manager in Grand Rapids, Sacramento, and Charlotte, and the commission form in Portland. Some city councils are elected through district or ward elections, other cities use at-large council elections, and yet others use mixed systems.

Virtually everywhere we traveled, city officials lauded the superiority of their system. The research literature suggests advantages and disadvantages for each. Council-manager systems are typically more efficient (and less prone to corruption) than mayor-council systems, but they are also less able to focus on policy-making and less able to represent the diverse interests in the municipality. In addition, it is difficult to provide a transformational vision of the future and build necessary coalitions when the chief executive of the municipality is a hired professional manager rather than a politician.

At-large elections support a focus on the well-being of the city as a whole but are likely to disenfranchise minorities and reduce the power of neighborhoods. Ward-based elections are more likely to give representation to minorities (if minorities are concentrated, as is frequently the case, in a small number of districts). They also better represent neighborhood interests. At the same time, this system increases the probability of the delivery of “pork” to neighborhoods, encourages NIMBY (Not In My Back Yard) behavior, and makes targeted transformative investments more difficult.

Given the advantages and disadvantages of ward versus at-large systems of election (and the fact that the at-large systems are increasingly seen as violating civil rights protections by preventing or limiting minority representation), we were impressed by the merits of a mixed system of ward and at-large elections, such as those that exist in Aurora, Charlotte, Durham, Lansing, and Philadelphia. Whatever formal governing system exists, cities need to be able to pursue a common view of what is in the city’s best interest and to protect the interests of those who are in danger of being left behind. The cities we visited were experiencing all sorts of transitions — economic, ethnic, and social. Their greatest challenge was to balance change with tradition, economic growth with economic fairness, and political control with market control.

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## The Principle of Annexation

States should make it easy for cities to annex land and difficult for areas surrounding cities to incorporate. States set the rules of the game for annexation and municipal incorporation. Annexation gives cities the ability to grow and reduces the flow of residents and businesses to incorporated suburbs. It enables residents to exercise their preference for suburban-style living while remaining within city borders. Annexation also protects and expands the city's tax base. Nearly everyone we interviewed in North Carolina attributed the success of their cities to the ease of annexation and the difficulty of undertaking municipal incorporation to avoid being annexed. We were told that when it comes to municipal success, "annexation policy is enormous."

Unlike most other states, North Carolina cities can annex surrounding unincorporated territory without a vote of the residents living in that territory. Annexation requirements include minimum density qualifications, contiguous boundary and land use specifications, city ability to extend services, and unincorporated status of the territory. North Carolina strengthens its ease-of-annexation policy with policies that make it difficult to incorporate as a municipality. An area seeking incorporation must be able to offer four of several basic services (police, fire, solid waste protection, water distribution, street maintenance, street construction, street lighting, and zoning) and to levy a property tax of at least five mills within three years of incorporation. Furthermore, it cannot incorporate if it is within five miles of a city of more than 50,000 without the permission of that city.

## Principles to Guide State Policies toward Cities

### The Principle of Innovation

States should engage in innovation and experimentation in the development of urban policies and should encourage cities to experiment as well. One of the most compelling arguments for the federal system is that the states can serve as laboratories for experimentation or "laboratories of democracy," as Louis Brandeis termed them. In our research, we found a wide range of state innovation and experimentation, some of which we have already discussed. Below we provide a sample of these innovations:

- Oregon and Washington have growth management boundaries. Oregon's land use act requires all cities and counties to develop a comprehensive plan for complying with the act's planning goals. The plan is then subject to a formal approval process. All land within the state's Urban Growth Boundaries (UGB) must be rezoned to accommodate high-density development, and the UGB must include enough land to absorb 20 years of population and job growth. Washington's law differs from Oregon's in that not all of its local governments are required to submit growth management plans; local plans do not have to be formally approved unless they are challenged. In addition, Washington's sanctions of localities that fail to comply with the Growth Management Act are significantly less onerous than Oregon's.
- Oregon's Transportation Planning Rule, first adopted in 1991, aims to reduce auto dependency by requiring all local governments to reduce vehicle miles traveled per capita (VMT) by a predetermined percent. Each locality is required to have a specified transportation plan to reduce VMT and to encourage mass transit, bicycle, and pedestrian travel. The state's transportation department supports these plans through its transportation investment programs, using a combination of federal funds, state gas tax revenue, and license tag fees.
- Oregon's Metro Government for the Portland area, which is the only elected general regional governing body in the country, is an elected regional government, with limited, but important, powers
- California requires each local government to include in its general plan an explanation of how it will meet its housing goals. The Housing and Community Development Department assigns regional housing goals based on population projections from the state Department of Finance. The regional council of governments then translates these regionwide goals into allocations for each jurisdiction. The goals address all income levels: very low (0 to 50 percent of the area median income), low (50 to 80 percent), moderate (80 to 120 percent), and above moderate (120 percent and higher). The housing plan does not require new housing construction; instead, it requires the jurisdiction to ensure that such housing *could* be built, addressing such issues as zoning and land-

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use controls, building codes, developer fees, and permit procedures. Because there is no construction requirement, the plan has been more exhortatory than binding, although it has also given localities that wish to build affordable housing a political rationale for doing so.

- Michigan, which created a state land bank authority in 2003, authorizes local land bank authorities to help governments assemble and clear title to properties for economic development. This program is viewed as a development and land-use planning tool; it allows land bank authorities to obtain title to vacant or abandoned properties through an improved tax reversion process, clear title to these properties, assemble parcels, and provide them to nonprofit and other developers for community development.
- Washington mandates the use of 80 percent of its federal private activity tax exempt bond cap for low-income housing. This is an unusual use of the bond cap, which most states use for capital and infrastructure improvements.
- California, like most states, authorizes tax increment financing (TIF) as a tool for economic development. The increase in property tax revenue resulting from the new development in the TIF-designated area is set aside to finance development. However, California requires redevelopment authorities that use tax increment financing to set aside (although not necessarily to use) 20 percent of the increased revenue for affordable housing. Redevelopment authorities are responsible for the construction or rehabilitation of more than 63,000 units of affordable housing since 1994, making them the state's second-largest funder of affordable housing in California after the federal government.
- North Carolina is at the national forefront in the development of pre-kindergarten programs for its children. In 1996, Governor Jim Hunt initiated Smart Start to provide a variety of supports to children. This flexible program serves locally determined priorities. While generally targeted toward children of lower-income families, Smart Start also supports capacity and quality improvements in child care and other areas that might be accessible to higher-income parents. County Smart Start advisory panels, made up of educators, mental health experts, and

others determine the investments that need to be made. Nonprofit partnerships for children, working with the local Smart Start board, distribute money for appropriate needs. Funded activities include health screenings for children and tuition reimbursement for accreditation classes for childcare providers. The program is administered through local Smart Start boards, which also have 501(c) (3) status. Governor Michael Easley, with the support of the Department of Health and Human Services and the Department of Education, subsequently implemented "More at Four," an innovative program for at-risk children.

- Michigan has devised a system of public school choice that gives a student the right to leave the school system in which he or she lives to attend school in another district, should the receiving district agree to participate in the program. The incentive for participation is that the receiving district receives the full state foundation grant for that child. Because Michigan, unlike other states, finances its local school systems primarily from the state sales tax on an equalized basis, and because local districts are effectively prohibited from increasing funding for education out of their own property tax base, the incentive of receiving full state aid for an additional student is substantial. The per-pupil state aid is likely to far exceed the cost of actually educating an additional student.
- Pennsylvania has set up community action teams (CATs) to help cities access state development programs by pulling together state funds and assistance from a variety of sources across state government. The state helps assemble teams from different agencies who work jointly to create a rehabilitation package for older communities that includes housing, community and economic development, and transportation.
- Illinois subsidizes employers, who in turn subsidize their employees' purchase of homes near where they work. The idea is to reduce the spatial mismatch between jobs and housing and to ensure that housing near work is at least relatively affordable. The Illinois Employer Assisted Housing Program is a public-private venture. It grew out of a pilot program initiated by the Metropolitan Planning Council in which about 25 employers were encouraged to participate without state incentives but with the

motivation of reduced employee attrition and increased worker satisfaction and productivity. The state then “adopted” the program and turned it into REACH Illinois, providing both tax credits and matching grants to participating employers. The formula for state funding requires an 80 percent of area median income cap for a matching grant and 120 percent for tax credits. There is no specific distance-from-work requirement, but the employer-developed plan must address the transportation issue in order to qualify for state assistance.<sup>6</sup>

- Pennsylvania, recognizing that refurbishing the downtown core alone will not produce results, has begun to urge cities to combine business with residential development. The state’s Elm Street initiative, which focuses on residential areas that surround a city’s historic center, complements its Main Street initiative, which focuses on the business district.

### **The Principles of Scale and Meaning**

State policies towards cities should be strategic and focused. In some states, urban policy is little more than a collection of small, poorly funded programs that, in many cases, seems to have been designed more for credit-claiming purposes than for impact. They are too small, scattered, or ineffective to change the path of city development. Michigan and Pennsylvania, with their patronage, pork-barrel political heritages, are both subject to this tendency. For example, Pennsylvania’s Keystone Innovation Zones (KIZ) program targets funds to companies through five-year grants. In its current incarnation, the program’s three-year fund of \$10 million has 15 KIZ recipients. While \$10 million would appear to be serious money, the average KIZ receives only \$222,000 per year. This is insufficient to change the long-term operating cost structure of a business or to significantly write down the cost of land assembly. Michigan’s “Cool Cities” program suggests similar problems. Funded at \$1 million, it provides cities with grants of \$100,000 that are intended to be catalytic, bringing communities together and helping them develop a transformative vision of the future. While the program has been well-received by grant recipients, the transformative benefit of the program is open to question.

The Reinvestment Fund, which authored a comprehensive study of Pennsylvania’s housing investment programs in 2004, issued a stinging assessment that seems to characterize many of the state’s development programs in other areas as well:

“[F]unding decisions are made at the state and local levels, not by evaluating the impact of an investment and its ability to move a market or meet a strategic need, but by:

- regulations that guide a program
- political interest and the ability of select communities to get things done
- state response to developer interest; developer connections
- ability to create any development within the confines of local zoning regulations

“Most of the programs do not distribute enough money to any one deal to enable it to simply happen. Most require so much leverage of other resources that the funding system acts as a deterrent to interested developers or unintentionally precludes certain development.”<sup>7</sup>

In other cases, states and their cities appear to be susceptible to the fad of the year without any real attempt to think carefully about whether it will work. Several of our cities, frequently with state encouragement, seem to be engaged in an effort to create city success by following Richard Florida’s prescription to attract the “creative class.” We think this misses Florida’s point. *The lesson from Richard Florida’s research is not to seek a particular class of person but to try to develop a city that has distinctive and desirable characteristics, something that distinguishes it from other cities.* In so doing, it attracts other individuals who value that same distinctiveness, creating yet additional support for that uniqueness.

Portland, for example, has done this. The physical, political, and cultural attributes of the city serve to attract young, creative, entrepreneurial, well-educated residents who wish to live in an urban environment but also value proximity to environmental and natural resources or, as one of our interviewees put it, “white people voting blue.” Path depend-

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ency, or the presence of other young, creative, liberal people, supports this culture by attracting similar in-migrants to the region. In addition, the region's unique land use and transportation planning system, aggressive downtown revitalization efforts, and environmentally conscious policies both embody and reinforce Portland's distinctive culture.

Some cities are still seeking a silver bullet to their economic woes through construction of projects such as downtown convention centers, without any sense that there is a limited demand for conventions and without understanding that if every city has a convention center, many will not experience beneficial effects. The point is not to drag out the usual list of misfired silver bullets — waterfront festival malls, aquariums, convention centers, sports stadiums — simply because in some places they have worked. The point is that an investment should be chosen in light of an identifiable market or a credible theory of change. Mayor Daley told a meeting of CEOs for cities that it is important for cities to “imitate [good ideas] without copying.” If all you do is copy, distinctiveness is lost.

### **The Principle of Appropriateness: Part 1**

Redistributive policies are more appropriately a state government function than a local government function. Cities find it difficult to engage in redistributive tax policies because the taxpayers who provide the funds for redistribution can easily escape those taxes by moving across city boundaries to suburban jurisdictions. Redistributive policies are better lodged at the state level, since escape from the state is more difficult and less likely. Some large central cities have functions and responsibilities that are vestiges of the late 1800s and early 1900s, when they were the exclusive centers of wealth in a state and assumed responsibilities that are appropriately those of the state. Court systems, penal systems, hospital networks, and city-owned colleges are useful sources of patronage, but they increase local tax burdens, lower the quality of services delivered, and therefore can contribute to the loss of the middle-class taxpayers. Returning traditional state functions to the state gets the city out of another set of redistributive politics. Vestiges of the dominance cities once enjoyed are found in the prohibitions that prevent cities from benefiting from state motor fuel gas collections in Ohio and Missouri.

### **The Principle of Appropriateness: Part 2**

States should encourage problem solving at the regional level for problems that affect the entire region or have spillover effects from one jurisdiction to others. The American system of urban government is the most fragmented among developed nations.

Fragmentation brings with it both advantages and disadvantages. The advantages are that it affords area residents substantial choice in terms of the kind of community in which they wish to reside. Residents, for example, can choose among various tax and service packages. Many small communities also foster a stronger sense of place, a greater opportunity for political participation, and a greater potential for holding government accountable.

But there are disadvantages as well. Fragmentation makes it difficult to pursue policies that benefit the region as a whole. Coordination across local boundaries requires substantial effort, and economies of scale for capital-intensive activities usually require the creation of a regional single-purpose special district. A Pennsylvania official explains: “Pennsylvania has a fundamental structural problem: [there is ... simply such a huge number of governments. The state is expected to help them all do things, but the state doesn't have as much control as it would like, especially with land control decisions.”

Without a system of state equalization grants such as we recommend below (or without effective regional tax-sharing, which exists in only a few U.S. metropolitan areas), local governments within a metropolitan area are likely to compete with one another for local tax base. Local government competition for tax ratables is a zero sum game that does not result in benefits to the region, although it may benefit one jurisdiction within the region at the expense of others. In most areas, the competition is over the location of high-value property (which yields more in revenues than it costs to service). However, in California, Proposition 13 imposes severe limits on the taxation of existing property. As a result, the competition is either over the location of new ratables or, since a portion of the state sales tax is still available to local governments on a point-of-origin basis, the location of retail stores that either sell in high volumes or sell high-priced goods (such as power centers anchored by big box stores or auto malls). This competition over the local tax base drives

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land use policy in California (which has been termed “the fiscalization of land use policy”) and makes it difficult to construct and implement a region-wide growth management strategy.

Given this localism, state governments should encourage cooperative activity on an intergovernmental and regional basis. Widespread acceptance of full-scale regional governments has not proved politically feasible in the American context and, given the benefits of large numbers of local governments, may not even be desirable. However, options that stop short of creating a single metropolitan government are available.

As noted above, the Oregon state legislature created Portland Metro, which is responsible for regional land use planning in the Portland metropolitan region. Metro also plans for activities of regional importance, including the operation of regional facilities (such as the Oregon Zoo and the Convention Center), transportation, parks and open spaces, water quality, air quality, solid waste disposal, and the development and dissemination of data. The agency has jurisdiction over the 25 cities and parts of three counties that are in the Oregon portion of the Portland region. Metro is governed by the Metro Council, which is composed of a council president who is elected regionwide and six councilors elected by district. To date, Metro is the only directly elected regional planning organization in the United States.

Both Oregon and Washington have passed legislation, with the support of their largest cities (Portland and Seattle), that establishes a growth management boundary around these cities’ regions. In both cases, the growth management boundary is designed to channel growth to the high-density regional core around a functioning downtown. This mandated growth at the regional core preserves land on the periphery and reduces the amount of tax base siphoned to competition among peripheral exurban communities.

States with more traditional political cultures have adopted less radical, but still region-based, measures. Pennsylvania, with its political culture of localism and with coordination problems because of its unusually large number of local governments, has recently begun seeking voluntary mechanisms for regional cooperation. In June 2000, it amended the Municipalities Planning Code, adding an article that permits multiple governments to organize and plan together.

Jurisdictions that do so gain preferential treatment in obtaining state planning funds and funds for the adoption and implementation of regional activity. Regional activity authorized for participating municipalities under the act includes the sharing of tax revenues and fees among municipalities in the region, the power to adopt a transfer of development rights, and the authority to adopt a countywide or multimunicipal comprehensive plan for any commercial and industrial part of the area covered by the plan

In Michigan, where local government incorporation has left major cities landlocked, the state permits cooperative conditional land transfers through PA 425, enacted in 1984. Referred to as “contractual annexation,” a 425 agreement between two jurisdictions provides for sharing property tax revenues generated by a conditional land transfer. The agreement must state which jurisdiction will own the property at the end of the contract period, which cannot exceed 50 years. These agreements, which are available to any city, village, or township, are commonly used when a local jurisdiction does not have adequate land or infrastructure for a business that wants to locate or expand. Structured as a conditional land transfer, the property is treated as if it belongs to the receiving jurisdiction. These agreements have been used by dozens of towns and cities, including Lansing, which entered into an agreement with the town of Delta when General Motors wanted to construct a new plant and Lansing did not have sufficient land. Delta had the land required to house the new plant, and Lansing had both the infrastructure to accommodate the new plant and the ability to offer a tax incentive that Delta could not. Lansing and Delta shared in the revenues from the development.

Other states have similar devices, such as Ohio’s joint economic development districts, in which local governments can trade tax revenues for infrastructure extensions as an economic development alternative to annexation.

### **The Principle of Complexity**

States and local urban governments should be alert to the complexity of policies affecting urban areas and the powerful impact of secondary effects and unintended consequences. Public policies frequently come tied together in complex packages that have diverse effects, some desirable, others not; some widely acknowledged, others heatedly contested. Oregon’s statewide land use planning

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program is a classic example. The program's primary goal — to channel growth and development within the boundary while preserving farmland and open space — has clearly been met. In the process, it has helped make Portland's urban area distinctive and has attracted in-migrants who are drawn to a highly urbanized and mass transit-oriented lifestyle.

At the same time, by the inexorable law of supply and demand, the growth boundary has raised the price of land. In response, developers have built housing on smaller lots, emphasizing multifamily units and townhouses rather than traditional suburban development with single-family houses and large yards. As a consequence, households who prefer traditional suburban development must either pay a very high premium for it or look elsewhere. Thus the Urban Growth Boundary has limited residential choice. Whether this is the result of building more housing units on smaller plots of land that are more expensive per acre or the result of per-unit housing costs is unclear. It is clear that a standardized unit of housing is now more expensive than it would be were there no growth boundary. In addition, land owners outside the growth boundary have lost the development value of their land, a loss that has been recognized in a recently passed statewide initiative petition and successfully defended before the state Supreme Court. The state legislature has instigated a multiyear review of Oregon's land use planning system by an external panel in what has become known as "The Big Look."

## **Principles to Guide State Policy on Grants to Cities and Local Governments**

### **The Principle of Equalization**

States should provide an equalization grant to local governments to compensate for differences in local tax capacities. Local governments, even when they levy the same tax rate on their residents, differ in their ability to provide services. This results from the fact that the same tax rate may generate differing amounts of revenue because of differences in community tax bases. Some local governments, for example, have a high property tax base per capita, while others, particularly poorer communities, have a much lower per capita property tax base. Cities are not always deprived

with respect to tax capacity; some cities have higher tax capacity than the state average, and in many states, rural or natural resource-dependent regions are at a particular disadvantage.

However, communities should not be penalized because of poor tax capacity. Nearly all states have an equalization component in their education finance system, but few have an equalizing mechanism for noneducation purposes. An equalization program would put all communities on a more equal basis in the delivery of essential services.

In the extreme case of full equalization, each jurisdiction would receive, through its own sources and through a state equalization grant, the same amount as all other jurisdictions for a given tax rate levied. Thus, some jurisdictions might prefer to tax themselves at 3 percent of property tax value and others at 5 percent; but all cities taxing themselves at three percent would generate the same revenue, while cities taxing themselves at 5 percent would generate more revenue. This redistribution would not inevitably and always help cities. In many states, the beneficiaries would be rural areas with low property values and low tax capacity.

Local governments frequently complain that they are not receiving their fair share of state government aid, sometimes citing per capita aid figures to support their argument. However, overall calculations of state aid per capita are not a good measure of the way in which the state government is treating cities. What is a "fair share" will differ according to the purpose of the state activity and, on a program-by-program basis, cities will not always receive above-average amounts of state aid. To take an extreme example, it is obvious that state aid for agriculture will go disproportionately to rural communities. Indeed, as already noted, economically vital cities should be exporters of state aid. Of the cities we visited, data from the Census of Government Finances for 2001-2002 show that only Grand Rapids and Lansing received less state aid per capita than the average for the state, while Portland and Tacoma received approximately the same amounts as the average. All of the other cities received more per capita aid than the average municipality in their state.

### **The Principle of General Support**

Some states provide general support to local governments through revenue sharing, shared taxes, and/or block rather

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than categorical grants, to enable cities to make decisions based on their own priorities. These types of grants frequently are allocated on at least a partial equalization basis. However, general support programs have been cut back in many states over the past decade. Michigan has had a state revenue-sharing program for many years, but it has been severely eroded by budget cuts. Other states also operate local government funds that provide general support. Ohio has a Local Government Fund (LGF) with dedicated funding sources and a minimum share of the state budget that is to be deposited into the fund. However, in FY 2004, the legislature, anticipating a decline in state revenues, tried to divert LGF funds to the state's general revenue fund in response to the continued fall in anticipated state tax revenue.

There is no easy response to a widespread tax revolt among voters. The answers lie in tying together several of the principles we have outlined: looking at the state-local fiscal system as a unified whole; guarding against overdependence on a single, cyclically sensitive tax source; providing the state oversight necessary to ensure fiscal responsibility; and moving redistributive functions of government to the state and away from cities.

## **The Impact of State Policy on the Political Climate**

### **States with Stable Policy Environments Will Reap Benefits**

It is difficult for cities to pursue a successful vision or to project stability if they must contend with frequent, unanticipated, and often dramatic discontinuities in state policy. Nobody would reasonably argue that partisan changes in state control should not occur or that they should not be accompanied by policy changes (or, indeed, that policy changes should not occur even without changes in partisan control). It is also impossible to defend ineffective programs and spending. And it is difficult to make investments — whether public or private — when the fiscal environment is unpredictable. That said, there are several forms of instability that hurt the ability of cities to contribute to the economic and social development of the state.

We observed in some of our case studies that changes in state government control (sometimes even if they did not

reflect partisan changes) were accompanied by sweeping changes in policies and programs that reflected an attitude of, "Let's put our stamp on state government and get rid of or eviscerate the signature programs of the previous administration," even if the previous programs were operating successfully. This leads to an additional principle for managing state-local relationships.

New state administrations should evaluate the effectiveness of existing state programs affecting cities, retaining and improving those that are working, irrespective of their association with the policies of the previous administration. A prime example is Pennsylvania's Ben Franklin Innovation Partnership Program, which was the pride of then-Governor Richard Thornburgh's economic development program and received national acclaim during the 1980s. The program was dramatically downgraded by the succeeding Casey Administration, which launched Industrial Resource Centers (IRCs). The IRCs were supposedly a response to the federal government's Manufacturing Extension Partnership and the state's need to address problems in its existing manufacturing base. But the switch from the Ben Franklin Partnership to the IRC program reflects not the relative merit of one program versus the other but the state's tendency to reflexively change policies as administrations change. As one person commented, "The Ben Franklins, initially the leading edge for technology in Pennsylvania, became invisible." While the program continues to exist, those we interviewed in Pennsylvania mentioned it merely as an afterthought. Businesses like predictability, so this type of policy instability hurts economic development.

Charlotte stands in stark contrast. The city has maintained a predictable policy record over time, with the explicit goal of reducing uncertainty in order to increase entrepreneurial investment in communities. Indeed, several interviewees pointed to this strategy as an important element in the city's successful redevelopment. They asserted that "the business of Charlotte is business."

Tax and expenditure limits and term limits are introducing instability into the management and governance of cities. The initiative and referendum process, which played a major role in three of our states — California, Oregon, and Washington — and a moderate role in Michigan, is another generator of sharp and unexpected discontinuities.

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California's series of reactions to Proposition 13 and its effects serve as a good example of fiscal instability, which we have termed "mandated public policy incoherence."

California's state-local fiscal system is a virtual casebook on how local governments can become hostages to changes they cannot control. The 1976 passage of Proposition 13 was followed in 1979 by AB 8, in which the state tried to bail out the local jurisdictions by shifting a portion of the property taxes back to them and using general fund revenues to pay for education. Proposition 98, approved by voters in 1988, mandated a level of education funding, requiring the state to use general fund revenues to close any gap between the obligatory funding and locally generated property taxes. Property taxes were again shifted from cities to the schools in 1992 and 1993, when the state faced budget gaps of \$4 billion to \$14 billion. To provide some relief to local jurisdictions, in 1993 the state approved Proposition 172, which, among other things, imposed a one-half cent sales tax with revenue dedicated to local public safety. As cities, counties, and special districts tried to adjust to declining property tax revenues by imposing other property-related fees, the voters passed Proposition 218 in 1996, requiring voter approval for most property-related taxes and charges. As a city representative explained, "We can handle reduction but not uncertainty."

Another source of instability is legislative term limits, which contribute to policy instability through the frequent turnover of legislators and their staffs, the consequent decline in expertise, the increased difficulty in building legislative coalitions across geographic and party divides, and the emphasis on gaining recognition for legislative initiatives as a means of positioning legislators to run for the next office. These problems are well recognized in California, Michigan, and Oregon among the political class, as is the shift in expertise from the legislature to the executive branch and to lobbyists. However, it is not well-recognized by voters.<sup>9</sup>

Another example of state-induced instability in the local government policy environment is the frequent resort to cutbacks in state fiscal aid during times of state fiscal difficulties. For example, as a response to state fiscal problems, Michigan has cut back on the state revenue-sharing program to local governments. Lansing received \$20 million from the state in 1998 and 1999, with an increase to \$22 million in 2001, but a steady decrease since then, with revenues dipping below \$18 million in 2005.

For several years in the early 1990s, North Carolina failed to distribute the local share of the state utility tax because of a state budget crisis. This failure to share revenue produced a strong negative reaction from local governments, which lobbied to get it reinstated. Many of those we interviewed in North Carolina cited this incident as proof that state government was "constantly nibbling away at cities." California's jurisdictions experienced a similar withdrawal of revenues when the state reduced the vehicle license fee and promised to backfill lost revenues. When the state was unable to make good on this promise, it deferred the backfill payment to 2006.

### **States that Address Problems on the Horizon Will Succeed**

There is an understandable human tendency to deal with problems that are present and to put aside those that will not arrive in full fury for some time. However understandable, states and cities must prepare for known contingencies that will affect them in the future. Three of these kinds of problems appear in one or more of our case study sites:

#### ***Unfunded pension liabilities are facing cities we visited in Oregon, Illinois, and Pennsylvania<sup>9</sup> and, indeed, are a problem nationwide.***

Too many state and local governments followed the lead of private pension funds in the late 1990s, booking paper capital gains in their retirement portfolios as real income gains and cutting back their payments to public retirement plans. The bursting of the tech stock bubble, the slowing of the Initial Public Offering (IPO) market, and the recession of 2001 have had a lasting effect on the equities market. Making money through venture capital investments ended up being difficult, and many public plans are now severely underfunded.

Indeed, the National Association of State Retirement Administrators (NASRA) reported in December 2005 that almost one-third of all public pension funds are underfunded, a finding that Standard and Poor's replicated.<sup>10</sup> S&P found that state pension funds were underfunded by \$284 billion in 2004 and had a funded ratio of 84 percent, which can diminish the creditworthiness and borrowing capacity of state and local governments. Funded ratios ranged from West Virginia's 43.9 percent to North Carolina's 108.1 percent.<sup>11</sup> However, the S&P results do not include independent city, county, and independent school system plans. In the case of Illinois, for

example, the state system is in crisis while the Chicago teachers' retirement plan is reported to be in good shape. In Oregon, the problem resides in the teacher's retirement plan.

In October 2005, Wilshire Consulting reported on the performance of city and county retirement funds, using a mix of 2003 and 2004 data.<sup>12</sup> Wilshire reported on 104 systems, with some cities and counties having multiple systems. Funding ratios are reported for some of our study cities:

- Chicago municipal workers, 70.9 percent; firefighters, 44.1 percent; police, 55.0 percent; teachers, 84.6 percent
- Grand Rapids municipal workers, 99.7 percent; police and fire, 113.4 percent
- Philadelphia municipal workers, 58.8 percent
- Sacramento City, 108.4 percent; county, 78.8 percent
- Seattle City, 107.0 percent
- Tacoma municipal, 118.0 percent

***Major increases in immigration combined with new settlement patterns create problems.***

Aurora, Chicago, Portland, and Seattle share a common immigrant problem. New, lower-skilled foreign immigrants are bypassing expensive central city housing markets and moving directly into lower-priced housing units in unincorporated suburban areas or into low-value residential suburbs of the core city. The motivation is clear: access to suburban service sector work, shorter commutes, and cheaper housing. However, they are moving into areas without the dense network of social service supports that exist in the city, and their children are typically in financially strapped school districts.

***Recent mandates from the United States Environmental Protection Agency (EPA) will place substantial new fiscal burdens on cities.***

These mandates include:

- Requirements for the separation of storm water from waste water
- Control of surface water runoff
- Increases in water quality standards

The EPA is mandating that cities and counties comply with stricter clean water standards, requiring them to complete

huge new infrastructure projects within 20 years at a time when there is no federal assistance and states are contending with water quality issues in rural areas as well. Combining these unfunded federal mandates with an increasingly uncertain fiscal environment in which the initiative process may be used to impose tax and expenditure limits could impact the borrowing ability of both states and cities unless there is foresight and a coordinated response.

**States with Outmoded Political Cultures Will Fall Behind**

States and cities develop cultures over time, a way of doing business that may have an important impact on their performance. In the political sphere, cities that have incorporated into their routine behavior expectations of clean government, transparency, flexibility, and an emphasis on service delivery are more likely to succeed than those that continue to emphasize patronage and pork as the primary output of government, cast a blind eye on government corruption and payoffs, and are encased in sclerotic administrative structures. Similarly, cities (and states) where the political culture values problem solving and cooperation rather than confrontation and partisanship are more likely to have high-performing state and municipal governments. In the economic sphere, states and cities that have traditionally been major industrial producers developed entitlement mentalities and a veneration of the status quo rather than an appreciation of entrepreneurship and a desire for innovation and change. In places that were doing well, we saw performance politics trumping old-style patronage politics (or at least holding even), and cooperation besting entrenched hierarchy.

Pennsylvania offers an example of a state with a culture that can be detrimental to cities. With the second-largest legislature in terms of the number of members (253) and the largest number of members per 100,000 residents among the nation's largest 11 states,<sup>13</sup> Pennsylvania is viewed as focusing on "distributional issues rather than generation issues." Pennsylvania has been described as maintaining its industrial-age mindset. When considering regeneration of the Monongahela River Valley, formerly dominated by steel mills, the state offered programs to increase industrial activity rather than accommodating the community's desire to use its resources to reconnect with the river. As a former local official explained, "Pennsylvania is still doing business the old

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fashioned way and it's hurting us. ... We have important assets — access to national markets, airport, cultural institutions, and universities ... Unless we begin to change the government structure, taxes, and labor laws and break the hold of labor [on the state government], we won't be competitive and the window to change is getting short."

## **State Policies Directly Affecting Cities**

In the following sections we focus on what we have learned about state activities in specific policy areas that are important to cities. When relevant, we will also discuss city activities that are related to state policies or laws. Based on our research, we have set forth in the first part of this document a variety of generalizations (which we have termed principles) about the kinds of approaches that are more likely to be successful and the kinds that are less likely to be so. During our case study visits, we also came across a substantial number of specific state and city programs that seemed consistent with these principles, and it is to these that we turn in this section. We note, however, that our study did not include outcome or impact evaluations of these programs. Nor, in most cases, could we find assessments made by others. Consequently, when we discuss specific programs or activities, we do so because they seem to be interesting programs consistent with our principles, not because they have proved effective.

### **Housing and Housing Affordability**

Housing policy affects city residents' lives and community well-being in various ways; indeed, it is closely linked to decisions about land use/planning, transportation, infrastructure, and schools. Many amenities of city life are capitalized in housing prices, making them rough proxies for the general health of local communities.

From the perspective of cities and other communities in metropolitan areas, the most important housing problem is affordability. We note, however, that the problem presents itself in two different ways. In cities with low-performing economies, such as Pittsburgh and Lansing, the housing affordability problem is an offshoot of poverty problems. Low incomes make modest rent levels unaffordable. These cities have disproportionately large shares of their population paying more than 50 percent of their incomes on housing.

However, in cities with vibrant economies, such as San Francisco, Portland, and Seattle, housing affordability problems result from the cost of housing itself. In these cities we found that an unusually large proportion of households pay between 30 and 50 percent of their incomes for housing. This is the case in many of the West Coast cities we visited.

When the housing affordability problem lies in the demand side of the market (lack of effective buying power), the housing problem is concentrated among low-income households. When the cause of the problem lies in the supply side of the market — the cost of providing housing, as is true in San Francisco, Portland, and Seattle — affordability is a problem not only for low-income households but also for families securely into the middle class. In theory, the housing affordability problem could be addressed through either demand- or supply-side interventions. However, it is reasonably clear that when the affordability problem hits households approaching middle-class incomes, solutions to the problem lie more on the supply side, while solutions to the problem of affordability for lower-income households lie on the demand side.

Demand-side housing programs (i.e., programs to subsidize the income of households through housing vouchers or through federal subsidies sent directly to landlords to pay a portion of the household's rent) have been almost exclusively the province of the federal government because of their high cost. While there is no reason that state demand-side programs would not work — and, indeed, a few states do have such programs — the most common state approaches have been through supply-side measures and exhortations to plan for affordable housing.

The most common supply-side approach is to increase housing production by issuing housing bonds, which reduce the developer's cost by providing tax-exempt financing or low-interest loans. California, for example, issued a \$2.1 billion bond in 2002 that included grants to local governments to provide down payment assistance and loans to developers of affordable multifamily housing. Many states also have state housing finance agencies that administer housing trust funds that are capitalized through a variety of sources, including tax-exempt borrowings. These trusts provide funds to developers, nonprofit organizations, and public authorities in the form of low-interest loans and small grants. Frequently these funds have provided gap financing.

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States take different approaches to housing finance. In most states priority goes to low-income housing in mixed-income neighborhoods or developments. In those cases, local governments supplement state funding with a mixture of federal low-income tax credits, Community Reinvestment Act finance pools, tax increment financing, and tax abatement. Some states and localities follow the example of Montgomery County, Maryland, where development density bonuses are granted to developers for units set aside for publicly owned housing and affordable units. We were impressed by the commitment and creativity of many of these entities. We also must note, however, the relatively small number of additional units that result from these efforts.

***States should try to bring down the supply-side cost of housing through efforts to reduce the cost of unionized labor and minimize excessive impact fees.***

The cost of housing reflects more than simply the cost of the raw materials and labor. A study by The Reinvestment Fund of Philadelphia observed that, “The cost of construction in the Commonwealth’s urban centers is a barrier to increasing development in these areas. Some of the increased cost is the result of union work rules.”<sup>14</sup>

In San Francisco, housing supply is limited by lack of land combined with high impact fees assessed by the city and a burdensome and uncertain approval process, including environment impact assessments required by state law. The combination results in situations where, according to a California housing consultant, “a few win, some lose, and consultants thrive.” As a University of California economist noted, “Housing is affordable despite the policies of the state.”

***State and city governments must be cognizant of and attempt to moderate the housing cost consequences of growth management efforts, rent control, and other efforts to limit development.***

It is not unusual for public policies, desirable for some ends, to have undesirable consequences for other ends. And policy-makers must recognize this fact. Although the debate has raged for years, it is incontrovertible that when supply is restricted, prices will rise, unless some offsetting efforts are taken. Thus, Portland’s Urban Growth Boundary has increased the price of land per acre compared with what it

otherwise would have been. Developers have responded (as the proponents of the growth control boundaries wished) by increasing density (more multifamily units, more townhouses, fewer single family homes with yards) so that more housing is located on the same amount of land. As a result, housing prices per unit have not increased as much as they otherwise would have, although the price of a standardized housing unit certainly has increased, and choice has been restricted.

Similarly, rent control, while it has held down rents on controlled units, has reduced the construction of new units and raised the price of non-controlled units. Rent control has also had a number of secondary impacts on the housing market. First, it discourages maintenance as landlords try to minimize their costs. Second, lack of investment in properties will have a negative affect on surrounding properties and neighborhoods. Third, rent control has a negative impact on multifamily housing investment because of fears that price controls will someday be expanded to cover newer units. Finally, because controls are frequently lifted on the unit when existing tenants move, rent control encourages landlords to speed up turnover among tenants. At the same time, it also provides renters with a disincentive to move. In sum, rent control is a good deal if you occupy one of the controlled units, while it makes life more difficult for those who are not housed, own the property, or live in the surrounding neighborhood.

In San Francisco, 65 percent of the residents are renters, and 70 percent of the renters live in rent-controlled units, so 45.5 percent of the city’s population lives in rent-controlled units. The state interceded in the city’s rent control program in 1979, prohibiting rent controls on buildings constructed after June 1979. While many people continue to support rent control, others we spoke with called it “vacancy decontrol.” That is, units come out from under rent control once the unit is vacated, and rents can then drift up to meet market levels. Some noted that rent control does not keep prices down, because it is effective only for long-term residents, and San Francisco has a transient population.

***States should encourage effective housing market intermediaries by offering technical and operating assistance.***

One of the obstacles to increasing the affordable housing supply for low-income households appears to be the

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inadequate capacity of nonprofit housing developers and community development corporations (CDCs). In areas that are producing a relatively large amount of affordable housing, such as Charlotte, Grand Rapids, San Francisco, and Seattle, interviewees stressed the importance of the competence and sophistication of the local CDCs. Deep knowledge of housing programs, real estate finance, and the ways of city hall make local CDCs important players in providing decent housing for low- and moderate-income households. In other areas, housing and community development officials cite the lack of capacity of these intermediary organizations as one of the barriers to effective affordable housing policy. Some states, such as Michigan, have a program of technical assistance for nonprofit housing developers.

Some states have approached the affordable housing problem through their planning system and inclusionary zoning requirements. We discussed earlier California's requirement that all local governments include a housing element in their general plans. The housing element consists of a five-year plan that sets forth how the jurisdiction will provide housing for all income groups, including low-income households. The units of housing required, divided by income strata, are allocated to local governments through their councils of governments (COGs), which receive a regional allocation from the California Department of Housing and Community Development. However, there is no legal requirement that local governments actually implement the plan, so that it is, at best, exhortatory. While one interviewee asserted that the housing element "employs attorneys and planners, but doesn't get units built," another suggested that at a minimum, it resulted in a discussion about affordable housing in each jurisdiction. (Although as one interviewee pointed out to us, it does provide a cover for local governments that want to "do the right thing" because it allows elected officials to blame the state and claim that they had no choice but to implement such a policy.)

California has moved beyond the state planning requirement for housing in two ways. First, its widely used tax increment financing (TIF) program requires a 20 percent set-aside for housing for low- (80 percent of the countywide median income) and moderate- (80 to 120 percent) income families. (Unfortunately, as several interviewees told us, the requirement obligated cities merely to set aside the increment; only in the 1990s was actual use of the increment mandated.

Thus, while some local governments enthusiastically use their TIF set-aside for affordable housing, others have reportedly set aside their set-asides in a bank account.) Second, California recently began a Workforce Housing Reward Program that provides financial incentives to cities and counties that issue building permits for low- and very low-income households. Local governments that are in compliance with the housing element receive grants based on the number of bedrooms in qualifying rental or ownership units. These funds may be used for construction or the acquisition of capital assets. Washington also has a state inclusionary zoning requirement.

***Housing is frequently seen as an integral part of city development efforts. States, should actively encourage cities to think in this way, particularly in downtown development efforts.***

There are three sources of population in any downtown district: visitors and tourists, workers, and residents. Most traditional attempts to renew central business districts focused on the first two sources of pedestrian traffic — workers and visitors — rather than residents. However, many of the cities we studied are engaged in efforts to revitalize their core areas through the development of downtown housing, with the goal of having a substantial 24-hour resident population, including a high share of prosperous households.

When people live in a downtown area, they also generate shopping and entertainment activity there. People like to minimize their commutes; so if their talents are scarce, businesses will be inclined to locate closer to scarce pools of talent, thus resulting in a more vital city center. This approach is a major improvement over traditional urban renewal efforts that focused exclusively on commercial development, convention centers, and hotels.

## **Community Development**

***States and cities should see community development as an integral component of their city vitality strategies.***

Recent research has emphasized the importance of amenities as a factor driving population and job growth in cities and their metropolitan areas. Cities that are viewed as nice or pleasant places to live will clearly have an advantage in the competition for jobs and resources. However, what is some-

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times missed in the discussion of amenities is that people differ in their preferences and thus in their assessment of what counts as a nice place to live. This provides policy makers with wide latitude in deciding how to make the city attractive to residents and potential residents.

***In their efforts to achieve city vitality and amenity packages, cities should strive for distinctiveness — a set of attractive living and working conditions that will set them apart from all other cities.***

Cities that are striving to achieve positive amenity characteristics through their community development efforts — i.e., clean and safe streets, interesting neighborhoods, a vital downtown, a good park system, extensive recreation and entertainment opportunities, and vitality and distinctiveness (good schools are also critical, but will be discussed below) — will not only be competitive in attracting people and jobs, they will also improve the lives of existing residents. Portland and Seattle have made their natural environment and intense localness part of their distinctiveness. Chicago has embraced its built environment, neighborhoods, and reputation as a world-class city that is a livable alternative to New York.

***Community and economic development efforts should complement each other rather than be at odds with each other, as frequently happens in the cauldron of urban politics.***

Some local government investment, frequently supported at least in part by state funding, such as ballparks, parks and recreational facilities, or major streetscape improvements, make more sense when viewed from a community development perspective as opposed to an economic development perspective. Most static analyses of public funding for ballparks and other mega-projects suggest that they are unlikely to generate much, if anything, in the way of jobs or income for local residents. Instead, they will just divert spending from other businesses already in the area. However, if they are seen as a community development component of a long-term city revitalization strategy, they may serve as a community amenity that makes the city more attractive for both existing and prospective residents. Both Lansing and Durham built minor league baseball stadiums for teams a decade ago; Lansing straightforwardly justified the expenditure to us in terms of community morale, and Durham used its park to anchor an area targeted for development. Of

course, community morale must be considered in light of the economic cost (or benefit) of the project.

***Economic and Workforce Development  
States should provide local governments with the tools necessary to meet their needs, including local economic development tools.***

However, states should not give local governments tools such as local tax concessions that encourage them to compete unproductively against one another. Decisions about which sub-state areas (i.e., distressed cities or distressed rural areas) to promote through tax incentives or other means should be made at the state level.

States often seem to assume that their primary role in local economic development is to provide local governments with the authority to offer tax incentives in order to attract economic activity. Research results suggest that these tax incentives do not play a major role in regional economic development; they have little effect other than moving economic activity from one locality to another within the region. Such incentives might make sense for an individual local government to pursue for its own gain in terms of jobs and tax base. However, it makes little sense in terms of state policy (unless, of course the state intends to try to move economic activity from one set of communities to another — from, for example, a wealthier community to a poorer one, in which case it should provide incentives only to the community it wishes to benefit).

***State governments should encourage cities to reclaim degraded assets, especially land, based on potential for return and risk.***

State governments should approach local economic development strategically. The most obviously degraded asset is urban land, and this suggests that the state has a role in making land assembly as efficient as possible, both legally and financially. State authorization of TIFs is one proven means of making it financially feasible to redevelop degraded land assets, particularly for infill developments. However, TIFs have typically been restricted to local revenue sources. If a project is strategic and transformative for the state, the source of TIF revenue may be extended to include state taxes as well.

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Recent brownfields legislation in Michigan, for example, has encouraged development of previously contaminated properties. Michigan law protects new, innocent owners from liability for existing contamination, holds existing owners liable for cleanup costs only if they caused the contamination, and requires cleanup based on the new land use (so industrial sites do not need to be cleaned to the same level as residential sites). The law also authorizes municipalities to develop Brownfields Redevelopment Authorities that can use TIFs and tax credits to encourage investments in brownfield redevelopment areas created by local governments. Other financial options include revolving loan funds and site assessment and reclamation grants.

We saw several examples of efforts to return vacant land to productive uses. Durham used the state historic building tax credit program, which it put on top of the federal historic tax credit, to redevelop an abandoned downtown tobacco warehouse into a shopping center. Aurora converted an abandoned train roundhouse into a gathering place that combines a local brewery, a comfortable restaurant, meeting space, a gallery/exhibit area, and outside café seating. This development created a few new jobs but, more importantly, it created a new space attractive to the community, especially the younger, educated segment that Aurora wants to attract. Oregon reclaimed more than 2,000 units of vacant housing in Portland and turned them over to CDCs and nonprofits for development as permanent affordable housing.

States can also support city economic development by setting a state framework conducive to economic growth and development, part of what we earlier termed “doing the basics well.” State tax systems, a particularly critical component of the basics, are having difficulty keeping up with the globalization of the economy. Tax receipts have been falling in relative and, in some places, absolute terms as small businesses shift their corporate structure to subchapter S (merging the business’s balance sheet with the owner’s personal finances and shifting the tax receipt from a corporate tax payment to a personal tax payment) and as multi-state and multinational firms use sophisticated accounting methods to minimize taxes paid. In this context, states have begun to realize that their tax codes are *de facto* industrial policies. Spatial competition for economic activity and the increasingly footloose nature of business means that state and local government have limited ability to tax business to pay for

services consumed by residents. Going forward, state taxes will shift to residents through income, wage, sales, and property or land taxes. Business taxes will increasingly be assessed on economic resources that are difficult to move, such as wages paid to workers and land, or they will be assessed on in-state businesses that serve the local population. With the exception of excise or extraction taxes on coal, gas, oil, and natural gas the ability of state’s to export their tax burden is diminishing.

Attracting businesses and redeveloping degraded assets are not the only means of bringing about growth and development. In the long run, an area’s economic vitality will depend on the education and skills of its residents (or its human capital). Cities can build their human capital either by attracting highly skilled residents from elsewhere or by educating and training existing residents. Although these strategies are clearly not mutually exclusive, they sometimes are treated as if they are. As several interviewees told us in North Carolina, both the Research Triangle area and Charlotte have been extremely successful in attracting educated residents from throughout the United States; they have been much less successful in terms of providing sufficient skills to their own residents through their elementary and secondary education system. (We address this aspect of education in the next section.) As a state official told us, “Our high school outcomes put us near the bottom or the bottom of the pack for high schools. [We have a] 30 or 40 percent dropout rate across the state.”

North Carolina, however, has been the leader among states that have used their community college system and workforce development capacity as an economic development tool. The extensive community college system — the goal is to have a community college within 20 miles of every North Carolina resident — focuses on customized training for specific jobs, frequently in close collaboration with local businesses, rather than on preparing students for the final two years of the four-year university system (the 2+2 approach). The North Carolina system is flexible in that it offers businesses considering locating in the area (or already there) customized training for potential employees, targeted to the specific needs of the business. Interviewees in some of the other states we visited cited North Carolina as the national leader in providing customized training through the community college system.

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In both Washington and Oregon, the community college systems largely serve as the first two years of a bachelor's degree. In Washington, community colleges also play a significant role in workforce development, offering both degree and non-degree training programs that are highly flexible and effectively targeted to current labor market needs.

On the other hand, in Pennsylvania we were told that community colleges are both under-funded and underutilized. Despite an original state vision to place community colleges around the state and use them in strategic ways, the number of community colleges envisioned shrank, the vision was dissolved, and the colleges ended up being plunked down according to patronage rather than economic strategy, and with little funding.

***In view of the potential importance of universities in state and urban economic and workforce development, states should develop, sustain, and adequately fund high quality university systems within the state.***

States should see their university systems not only as a means of educating the children of residents, but also as a way to attract talent from elsewhere.

State government should see its higher education system as a means of economic and workforce development that has particular impact on the city and region in which major research campuses are located. The quality and reputation of major research universities — such as the University of North Carolina and Duke in the Research Triangle area, the University of California near San Francisco, the University of Chicago and Northwestern in Chicago, the University of Pennsylvania in Philadelphia, Carnegie-Mellon in Pittsburgh, and the University of Washington in Seattle — attract large numbers of students at both the undergraduate and graduate levels, some of whom stay in the area after they finish their education, particularly if the area is vital and attractive as a place to live.

Universities play an important economic role in other ways as well. The most important products of any university, and the one most underappreciated in the worlds of economic development and public policy, are degrees granted in exchange for tuition paid. Universities are a major employer, providing income for a substantial number of residents whose spending, along with those of students attending the university, supports other businesses and jobs in the area. Additionally,

we are not aware of a major research university that does not have a broad and excellent undergraduate program. The undergraduate program provides stable funding for the enterprise, is the foundation of its intellectual character, and establishes a good part of the reputation of the university as a whole.

Second, universities have the potential to attract employers by providing deep pools of labor that are scarce in national or global labor markets. Labor pooling has long been recognized as a critical source of agglomeration economies. In a technology-based economy, labor pooling can trigger a virtuous cycle of positive feedbacks: Employers come to the region in search of talent, more talent comes in search of employers, and on and on. A good example is the concentration of pharmaceutical companies in the greater Philadelphia region, attracted by the presence of legal experts who can deal with the Federal Drug Administration regulatory process.

Third, another underappreciated source of economic development activity is the production of knowledge for sale. Research universities produce knowledge under contract from governments, foundations, and corporations. The best of this research is externally funded and driven by the principal investigator's curiosity. Externally funded, curiosity-driven or demand-responsive research produces knowledge that becomes an exported economic product supporting income inside the local economy.

A fourth product of research universities — commercial spin-offs from university-based research — has received a disproportionate amount of attention in the economic development community. First, most spin-offs come not from university labs but from university talent — graduates who set up their own company or develop products in local companies. Second, universities license their inventions in global intellectual property markets. The knowledge will take root locally only if there is a finance and entrepreneurial base that can take it to market. Finally, technology will generate the formation of a company only if it can be translated into a product. However, the benefit from local, university-based research has clearly been demonstrated in the Research Triangle area, the San Francisco Bay, Seattle, and Boston.

In some places universities have also played a more direct and fundamental role in an area's economic development. Research Triangle Park has generated jobs and income in the

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Raleigh-Durham-Chapel Hill area. Conceived by a state commission appointed by Governor Luther Hodges in 1955, Research Triangle Park began as an initiative by the three major area universities — the University of North Carolina, North Carolina State, and Duke — with funding from the private sector. The focus of the Park’s recruitment efforts has been knowledge-based businesses (it limits the amount of manufacturing), and over the years these businesses have worked closely with the local universities.

## Education

***States should ensure that all children have access to an adequate education and that they are not denied that access as a result of insufficient income or the low tax capacity of the school district in which they live.***

Particularly for larger cities, the viability and quality of local schools are key elements in bringing about urban vitality. Poorly performing schools and parents’ fear that their children will not receive a good education are disincentives for families with children to stay in cities. Quality public education is thus key to city competitiveness. It increases the willingness and ability of families to live in cities. Well-performing neighborhood city schools are capitalized in increased housing prices that enable wealth accumulation for city owners. High-quality schools have the potential to attract new businesses, not only because such schools are likely to produce a well-trained labor force but also because they make it easier for businesses to recruit employees from outside the area.

Unfortunately, city school systems that deliver quality education and high graduation rates are rare in U.S. cities, including those we visited. There are two possible approaches for cities to take to change this: improve the quality of schools in large city school systems, or sever the traditional link between a child’s place of residence and his or her school. While these strategies are not mutually exclusive, until recently most effort has been placed on improving the existing school system, generally with disappointing results. It appears that schools populated predominantly by children from low-income families who begin their formal schooling already behind in skill development are not good learning environments.

A conventional state response to the failure of city school systems, sometimes forced upon states by the courts, has been to increase per-pupil spending through equalization funding. California, Michigan, and Oregon now have systems that produce (or will soon produce) nearly equal per-pupil spending in all school districts. However, this equalization effort has not necessarily expanded funding for large city school districts. It may, in fact, have reduced overall funding. In any case, there has been a longstanding dispute about whether more money is likely to make a difference in student outcomes. Recent research, although contested, suggests that smaller class size does matter in the education of very young children, particularly those from low-income families. Recent research has also shown that better qualified teachers, such as those with college degrees in the subjects they teach (who will cost more money to hire), also make a difference.

More recently attention has focused on the cognitive deficits with which many children from low-income families enter school and the need to expand early education as a means of dealing with this. State funding for Head Start, which was never very high, is down in some states, including Oregon, which cut its state supplementary funds by 11 percent for the 2003-05 period. Washington cut its state supplement altogether after 2002, making Pennsylvania the only state we visited that still supplements federal Head Start funds with state money.<sup>15</sup>

None of these states has state-financed, universal pre-kindergarten (UPK) education, but Illinois Governor Blagojevich recently announced his intention to make Illinois, which already has one of the highest-quality and most accessible pre-K systems in the country, the first UPK state for both three- and four-year-olds. North Carolina’s “More at 4” program uses funding for a variety of pre-K initiatives, including Head Start, to enhance pre-K education. This program has a model childcare rating system, which includes standards for teaching and class sizes.

The second approach is to end the linkage between where students live and where they attend school. Families with sufficient resources achieve this by sending their children to private schools, either religious or secular. We were told that Grand Rapids has done relatively well in retaining its population in part because a large proportion of families, for religious

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reasons, have chosen to send their children to private religious schools. The decline in public school quality in Grand Rapids has not driven the middle class to the suburbs simply because middle-class children were being educated in the private religious schools. Charter schools and school voucher programs are two other means of breaking the geographic link between home and school and providing families with more education options.

Within the public school system, there has been movement towards increased choice. Magnet schools and choice within the public school system are becoming increasingly common. In fact, with the exception of North Carolina, our case study states all have public school choice policies in which parents may enroll their children in any school within their district or even in other districts. These policies differ depending on whether district participation in the program is voluntary, as in Michigan and Pennsylvania, or mandatory, as in Washington and Illinois. In North Carolina, although there is no statewide public school choice policy, several school districts, including Mecklenburg County (Charlotte), have adopted an intra-district school choice program.

Both Charlotte and Durham have consolidated their city and county school districts, with Charlotte known until recently as one of the most successful desegregated systems in the country. Students were bussed across city lines to integrate schools. However, a recent court case eliminated busing, and we were widely told that the schools are becoming more at risk. Durham's system change is more recent, and we heard mixed reports on its effectiveness. In the years prior to school system consolidation, the city school system boundary was frozen, and land annexed to the city remained in the county school system. The consolidation of the city and county systems dispersed resources into the neglected city system, and there was a significant improvement.

Less widely hailed is Durham's division of the consolidated county school district into wedges that start in the center city and extend into the suburban parts of the district. Parents can send their children to any school in the wedge in which they live. While the system has made strides in achievement results, observers report that suburban children can stay in their prior neighborhood school and that inner-city children are not reaping the expected benefits from an integrated wedge system. Michigan has instituted, as noted earlier, a form of cross-district public school choice. A child may attend school in a district other than where he or she lives if that district has agreed to accept enrollees from outside its district. The incentive for receiving districts is the full per-student state aid that follows the student to the new district.

### **Transportation**

***States should make state transportation funding to local governments as flexible as possible so that cities can use the funds to best meet their needs.***

Traditionally, state transportation funds have been disbursed by state highway departments and used primarily for highway purposes. Changes in federal law have made it easier for federal transportation funds to be used for public transit, bike-ways, and walkways as well as highways. Some of the states we visited (such as California and Oregon) seemed to be avidly embracing these changes, while others (such as Michigan and Pennsylvania) appeared to continue to be dominated by a highway mentality. One possible method for encouraging non-highway transit options is to eliminate such state laws as the Washington law requiring gas tax revenues to be used solely for roads. A balance of highway/road, mass transit, and bicycle and pedestrian travel should be encouraged.

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## Endnotes

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- <sup>2</sup> Cities selected are Aurora, Charlotte, Chicago, Durham, Grand Rapids, Lansing, Philadelphia, Pittsburgh, Portland, Sacramento, San Francisco, Seattle, and Tacoma.
- <sup>3</sup> Tom McCall, "Address to the Oregon State Legislature, January 8, 1973." 1000 Friends of Oregon, The McCall Gallery, <http://www.friends.org/resources/mccall.html> (accessed October 12, 2006).
- <sup>4</sup> Terry Nichols Clark, "Introduction: Trees and Real Violins in the Post-Industrial City," in *Trees and Real Violins: Building Post-Industrial Chicago*, ed. Terry Nichols Clark, 2. Book Draft, (Chicago: University of Chicago, December 2002 draft). Fiscal Austerity and Urban Innovation (FAUI) Project Archives, <http://faiui.uchicago.edu/archive.html> (accessed October 12, 2006).
- <sup>5</sup> John R. Coyne, "Blowing in the Wind - Profile of Illinois Governor James R. Thompson," *National Review*, 41, no. 22 (November 24, 1989). [http://www.findarticles.com/p/articles/mi\\_m1282/is\\_n22\\_v41/ai\\_8134917#continue](http://www.findarticles.com/p/articles/mi_m1282/is_n22_v41/ai_8134917#continue) (accessed October 12, 2006).
- <sup>6</sup> See <http://www.housingactionil.org/training-technical/pages1-11/index04.html> for more details.
- <sup>7</sup> The Reinvestment Fund, *Choices in Pennsylvania: Developing a Rational Framework for Housing Investment in Pennsylvania*, March, 2004: 31.
- <sup>8</sup> Term limits in Oregon were ruled by the state Supreme Court to be unconstitutional on a technicality. The state had enough experience with term limits before they were overturned that we could not find anyone in the political class who supported their reimposition.
- <sup>9</sup> Len Boselovic and Nanette Byrnes, "Think Tank Sees Trouble for PA Pension Funds," *Pittsburgh Post-Gazette*, February 24, 2006. Illinois Business Roundtable, *Illinois Pension Funding: The Consequences of Funding Deferred*, December, 2005. Nanette Byrnes, "Sinkhole! How Public Pensions Are Draining State and City Budgets," *BusinessWeek*, June 13, 2005.
- <sup>10</sup> Parry Young, "Rising U.S. State Unfunded Pension Liabilities Are Causing Budgetary Stress," *Standard & Poor's*, February 22, 2006. Deborah Solomon, "Public Pensions Press State Budgets," *Wall Street Journal*, February 23, 2006.
- <sup>11</sup> The reported funding ratios for the state public retirement plans in our study states are: California 85.3 percent, Illinois 59.9 percent, Michigan 83.9 percent, North Carolina 108.1 percent, Oregon 95.1 percent (2003 data), Pennsylvania 92.8 percent, and Washington 84.4 percent.
- <sup>12</sup> Julia K. Bonafede et al., *2005 report on City & County Retirement Systems: Funding Levels and Asset Allocation*. Wilshire Consulting, October 5, 2005.
- <sup>13</sup> IssuesPA, *The Cost of Pennsylvania's Legislature: Assessing the Dollars and 'Sense,'* July 2005. <http://www.issuespa.net/articles/14001/> (accessed October 12, 2006).
- <sup>14</sup> The Reinvestment Fund, *Choices in Pennsylvania: Developing a Rational Framework for Housing Investment in Pennsylvania*, p. 39.
- <sup>15</sup> W. Steven Barnett, Jason T. Hustedt, Kenneth B. Robin, and Karen L. Schulman, *The State of Preschool: 2004 State Preschool Yearbook* (Rutgers, the State University of New Jersey: National Institute for Early Education Research [NIEER], 2004), 179.



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