



Rethinking the State-Local Relationship: Local Economic Development

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Summary

The state government is directly involved in California's two major local economic development efforts: redevelopment and enterprise zones. Because state money is invested in these programs, their fate has become enmeshed in the current budget debate, raising fundamental questions about whether the state or localities should bear responsibility for these programs.

Determining who should bear responsibility for local economic development should be part of a broader consideration of realigning state programs. As with corrections, child welfare services, and other program areas that realignment typically refers to, sound principles should guide the balance of state and local responsibility for local economic development. On the one hand, greater state responsibility allows the state to use local economic development to achieve statewide goals, such as equity, and to consider the costs or benefits of local economic development that might spill over into other localities. On the other hand, greater local responsibility would give localities the incentive to invest in economic development efforts that pass the local cost-benefit test and would allow economic development initiatives to be more tailored to local needs. But rethinking the roles of the state and localities in economic development bumps up against constraints. For one thing, localities have few options for raising and allocating revenue for economic development.

Rethinking state and local roles in local economic development is not—and should not be—just a matter of saving the state money. Getting these roles right would make local economic development programs more efficient and effective. Under the status quo, with state funding for redevelopment and enterprise zones, participating localities gain a larger share of benefits than they pay for in costs. However, PPIC's in-depth studies of redevelopment and enterprise zones show that, in both programs, effectiveness varies widely across individual geographic areas. This suggests an important point for consideration in the current realignment debate: If the constraints on local funding were relaxed, thereby allowing localities to assume responsibility for more of the costs, localities would have greater authority to make choices about economic development investments and stronger incentives to support only the most effective projects and programs.

Contents

Summary	2
Introduction	4
History and Current Program Status	5
Redevelopment	5
Enterprise Zones	6
Other Local Economic Development Programs	8
Principles	9
Principles in Favor of State Responsibility	9
Principles in Favor of Local Responsibility	10
Constraints	12
Fiscal Constraints	12
Political and Legal Constraints	12
Funding	13
Local Financing of Capital Projects	13
Command of Local Revenue	14
Conclusion: The Future of Local Economic Development	15
References and Resources	16
Redevelopment	16
Enterprise Zones	16
General Economic Development	16
Related Topics	16
About the Author	17

Introduction

Governor Brown's January 2011 budget proposes eliminating the state's two primary local economic development programs: redevelopment and enterprise zones. These programs, if eliminated, would reduce California's fiscal-year 2011–12 general fund gap of \$17.2 billion by \$1.7 billion (redevelopment) and \$581 million (enterprise zones). His May 2011 revised budget proposal significantly scales back and refocuses the enterprise zone program instead of eliminating it, for modest initial savings of \$70 million in fiscal year 2011–12. In the current budget debate, the value and effectiveness of these programs have been weighed against those in a wide range of other programs and services, including education, public safety, and everything else supported by the state's general fund.

However, making decisions about these programs at the height of a fiscal crisis obscures some of the fundamental questions about local economic development and precludes a more considered debate about various possibilities. For example, why is the state involved in local economic development, and what stands in the way of localities funding these activities and deciding for themselves how to weigh local economic development against other local needs? These questions matter, whatever the fate of redevelopment and enterprise zones. If the programs are preserved, these questions might help guide future reforms. If the programs are eliminated, these questions might help shape new local economic development policies.

Rethinking the roles of state and local governments in local economic development efforts echoes much of the current debate in California over realignment, which involves shifting the relative responsibilities of state and local governments, generally in terms of social services and related programs. For example, the governor's January 2011 budget proposal calls for shifting the responsibility and funding for foster care and some corrections activities to counties.

Local economic development is usually not included in realignment discussions. Whereas education, corrections, and many social services programs are subject to state or federal mandates and must be provided by *some* level of government, local economic development is more discretionary: If the state decides that local economic development is not a priority, there is no requirement that local governments provide the service instead.

The principles and constraints that underlie questions about local economic development, however, are similar to the principles and constraints that guide the realignment of education, corrections, and social services; and any comprehensive proposal to realign California's public programs must consider all of the roles and responsibilities of state and local government—including local economic development—and the common fiscal structure that supports all of these programs.

This examination of the state-local relationship in local economic development thus uses the same framework as the other reports in this PPIC series. We begin with the history and current status of local economic development in California, focusing on redevelopment and enterprise zones and explaining the shared responsibility of state and local governments for these programs. We next discuss a number of principles that may prove helpful in determining how the responsibility for local economic development might best be divided between the state and local levels. We then identify fiscal, legal, and other constraints that stand between the status quo and the goals suggested by these principles, and we outline some alternative funding mechanisms. We conclude by tying these questions of state and local responsibility to the crucial question of how local economic development might be made more effective.

History and Current Program Status

In its broadest terms, economic development is “the art of using public policy, often in the form of financial incentives, to stimulate economic growth, usually in the form of more jobs and higher tax revenues.”¹ Economic development can be approached in two ways, through broad regional and statewide efforts or through targeted local efforts.

Regional and statewide efforts, such as promoting particular industries and supporting major infrastructure projects (e.g., airports), seek to increase economic activity in a metropolitan region or state without regard to the specific jurisdiction or neighborhood where the economic activity is located. California’s statewide efforts span a broad range of activities, including providing financing for infrastructure, supporting workforce development, assisting small businesses, facilitating job searches, and assisting businesses looking to expand or relocate. Many of these activities are coordinated under the Governor’s Office of Economic Development. These state-focused activities are outside the scope of our discussion. In this report, we are concerned with local economic development efforts that target individual jurisdictions or neighborhoods.

California has two primary local economic development programs: redevelopment and enterprise zones. Although these programs have different structures, funding mechanisms, and specific goals, they both fit under the broad definition of local economic development. We focus on these two programs because of their budgetary and political importance. However, the principles, constraints, and funding issues we discuss in this report apply to local economic development programs in general.

Redevelopment

Redevelopment areas are specific locations designated by cities or counties as “blighted” and thus subject to revitalization. Redevelopment agencies receive a portion of the increase in property taxes—the “tax increment”—that are expected to accrue within a project area as a result of redevelopment. The agencies use these revenues to finance redevelopment bonds, which fund land acquisition, capital improvements, and other investments supporting the revitalization efforts. Redevelopment agencies have the authority to issue bonds without voter approval and can use eminent domain—the authority of government to take privately owned land, with compensation but not consent, for a public purpose—to assemble land for private development.

Redevelopment began in California in the mid-1940s in an effort to combat post-war urban blight, and it accelerated with the adoption in 1952 of tax-increment financing (the issuance of bonds backed by the expected increase in property tax revenue). The number of redevelopment agencies and project areas rapidly increased in the 1980s after the passage of Proposition 13, which limited localities’ ability to raise taxes. In fiscal year 2008–09, California had 425 redevelopment agencies with 749 project areas generating \$5.7 billion in tax-increment revenue, or roughly 11 percent of the total property tax revenue of \$50 billion. Most redevelopment areas are active for 30 to 40 years and typically continue to claim their share of the property tax increment for 10 years after the conclusion of redevelopment activities.

Of course, the creation of a redevelopment area alters the allocation of property tax revenues. In the absence of redevelopment, a county collects and allocates property tax revenues to cities, schools, special districts, and itself according to formulas established by Assembly Bill 8 (1979). In redevelopment areas, the property tax

¹ Fulton (2010), p. 196. The regional vs. local distinction discussed in this report draws on Fulton and Shigley (2005).

increment is allocated in a different manner: Twenty percent of the tax increment goes to low- and moderate-income housing; 22 percent (on average) gets passed through to local governments, school districts, and other local jurisdictions; and the remaining 58 percent (on average) is then available for redevelopment debt obligations and redevelopment agency activities. The pass-through rate and the remainder available for redevelopment debt and activities vary across individual redevelopment areas.²

What is the net impact of redevelopment on property values and tax revenues? The answer is complicated. It depends, first, on whether the redevelopment is entirely responsible for the increase in property values in a project area, or whether those property values would have increased anyway. The net fiscal impact on the county and state also depends on whether increased property values in a project area are net gains in property values for the county or state overall, or whether redevelopment shifts local investments away from elsewhere in the county or state. In its 1998 report on redevelopment,³ PPIC found that roughly half of the increase in property tax revenues in redevelopment areas reflected an actual increase in value due to redevelopment and half was diverted from other jurisdictions in the county. PPIC considered the half diverted from other county jurisdictions to be a “subsidy” to redevelopment areas from counties and their cities, schools, and special districts. Of course, the pass-through of tax-increment revenues to local jurisdictions offsets a portion of this implicit subsidy to redevelopment, in effect returning some of the diverted tax increment to the jurisdictions from which it was diverted. Later reforms in redevelopment have increased the pass-through level relative to the level in the years examined in the 1998 PPIC study.

Redevelopment directly affects the state budget through school funding. Each school district has a per-pupil funding entitlement for basic school operations. If a district’s share of local property taxes falls below that entitlement, the state’s General Fund covers the gap. When redevelopment reduces local property taxes allocated to schools, the state makes up the difference. The Legislative Analyst’s Office (2011) estimates that redevelopment reduces property tax revenues for schools by over \$2 billion (after netting out pass-through payments). Of course, if redevelopment results in a net increase in taxable economic activity, eliminating redevelopment could reduce state personal income, corporate income, or sales tax revenues, offsetting some of the savings to the state budget.

The debate over redevelopment is wide, ranging from whether redevelopment results in the expected production of affordable housing, to what constitutes “blight” and which kinds of investments are appropriate for redevelopment agencies to undertake, to whether it is appropriate for redevelopment funds to pay for portions of police services or elected officials’ salaries. And redevelopment has evolved over time: Originally, redevelopment included no mandated pass-through payments to local jurisdictions and no state backfill of school revenues in the event of a property tax shortfall. However, this has become a key issue in the debate today over state-local relationships and responsibilities—that is, the appropriate role of the state in supporting redevelopment: By having to close the gap between a school’s property tax revenue allocations and minimum funding standards, the state in effect helps pay for redevelopment.

Enterprise Zones

The enterprise zone program was established in 1986 to spur the creation of businesses in economically distressed areas and to create job opportunities for economically disadvantaged workers. Enterprise zones are

² These percentages represent statewide averages and vary across counties. AB 1290 (1993) established uniform pass-through treatment for new redevelopment areas.

³ Dardia (1998).

designated by the state and seek to encourage business activity by offering hiring credits and other tax incentives to businesses located within the zones. The hiring credit is the largest incentive. Businesses can claim up to roughly \$40,000 over a five-year period for each “disadvantaged” employee hired. Workers qualify as disadvantaged if they belong to one of several “eligibility groups,” have been unemployed for a long time, or live in a Census tract with relatively low median household income. Other tax incentives include credits for purchased machinery and accelerated depreciation.

The current program authorizes up to 42 concurrently active zones (zones are designated for fifteen years plus, typically, a five-year extension). New zones are designated when existing zones expire. The Department of Housing and Community Development administers the program and is responsible for selecting zones. Localities apply to the program when there are openings. Eligible areas must be economically distressed and include an industrial or commercial area. Selection is based on the level of economic distress as well as on the local applicant’s proposal for bundling additional local incentives, administering the plan, evaluating outcomes, and other criteria. Often there are many more applicants than slots available, but in the 2006 application round, when the original 1986 zones expired and 23 slots became available, all 25 applicants received enterprise zone designation, after a few applicants were combined into larger zones.⁴

Enterprise zones are funded by the state and administered jointly by the state and local governments. Funding consists of the tax incentives noted above, which reduces the state’s tax revenues. Governor Brown’s January 2011 budget proposal estimates that the state could save \$581 million in fiscal year 2011–12 by eliminating enterprise zones.⁵ The annual cost to the state budget of the enterprise zone program includes tax credits that businesses claim retroactively for hiring in earlier years. While the state selects zones and has the authority to de-designate zones (though it never has), local zone administrators are active in marketing the program to local businesses, helping to facilitate the earning of tax credits, offering additional local tax incentives, credits, or discounts, and other activities. Even though the state tax incentives are uniform across all zones, local incentives and activities vary. In addition, local zones are diverse: Some are urban, others are rural; some are industrial, others or more retail or commercial; and they vary in the skill level of the local workforce and in access to transportation and other infrastructure.

PPIC’s 2009 study of enterprise zones found that, on average, these zones fail to increase employment relative to comparison areas.⁶ In addition to strong skepticism about the program’s effectiveness, there is also debate over what the goals of the program should be, whether to disallow retroactive hiring credits, and whether to tighten the qualifications for considering workers “disadvantaged.” Although questions about the program’s effectiveness and design may determine the future of enterprise zones, the program also raises a fundamental question about realignment: Should programs designed to boost economic growth in targeted geographic areas be a state or local responsibility?

Redevelopment and enterprise zones represent local economic development programs with different goals, program designs, and funding mechanism, but they are similar in that the state, through them, plays an essential role in encouraging economic development in targeted local areas. Enterprise zones are funded by the state, but jointly administered by both the state and local governments. Redevelopment is jointly funded

⁴ Redevelopment areas and enterprise zones often overlap, even though the designation processes for the two programs are different.

⁵ This estimate includes the elimination of enterprise zones and a set of similarly designed but much smaller programs targeting specific geographic areas (i.e., Targeted Tax Areas, Manufacturing Enhancement Areas, and Local Agency Military Base Recovery Areas). This estimate approximates the annual tax expenditure reported by the Franchise Tax Board for these programs, which includes credits used in a given tax year for hiring in earlier tax years. The governor’s January 2011 proposal eliminates tax benefits both for recently earned and for previously earned but unused credits.

⁶ Kolko and Neumark (2009).

by the state (by backfilling school budgets) and local governments (through diverted revenue from cities, counties, and special districts), but administered locally. The principles supporting state and local control, and the constraints that may limit whether control of local economic development can be realigned, apply to both redevelopment and enterprise zones.

Other Local Economic Development Programs

Although redevelopment and enterprise zones serve as the major instruments in local economic development, other programs and policies are also used. For instance, the state often sites government offices in economically distressed downtown neighborhoods. Several federal programs also attempt to spur local economic development. Empowerment Zones and Renewal Communities (which are similar to the state's enterprise zones) offer hiring credits and other federal tax incentives to businesses located in distressed areas. Foreign Trade Zones offer deferrals or exemptions from customs duties for businesses located in their zones. And the federal government allocates Community Development Block Grants directly to larger localities and provides additional money for the states to allocate to their smaller localities to support business loans, infrastructure improvements, and other targeted local economic development activities. Although these federally funded programs lie outside the scope of this report on state-local relations, they represent an important piece of the local economic development landscape.

Principles

Redevelopment areas and enterprise zones illustrate ways in which the state can play a role in local economic development. But why is the state involved? Why not assign local economic development entirely to localities to control, administer, and fund? In this section, we discuss some basic principles for determining state or local responsibility for local economic development: Some favor greater state control, some favor greater local control. Of course, control can be shared: Both redevelopment and enterprise zones illustrate how the state and localities are jointly involved in local economic development. Thus, realignment can refer to a shift in the relative responsibilities of states and localities, even if neither steps entirely out of the picture.

This section is abstract, but deliberately so. It presents principles that may be hard to quantify but that nonetheless help weigh the pros and cons of greater state or local responsibility. The principles here can apply to a wide range of local economic development programs, but redevelopment areas and enterprise zones serve as our primary illustrations because they represent the main local economic development programs in California and are both at the forefront of the current political debate. Many of these principles also apply to other program areas, including corrections, education, and social services, and are echoed in the companion papers in this PPIC series on realignment.

Principles in Favor of State Responsibility

Several principles might justify greater state involvement or control over local economic development.

Pursuing statewide objectives. Steering public resources for economic development to targeted neighborhoods may help achieve state goals. One such goal is “vertical” equity—targeting resources to locations lower on the economic ladder in order to reduce geographic inequalities. “Horizontal” equity—treating equally deserving places similarly—could also justify state involvement if some equally deserving localities have less capacity to pursue economic development objectives on their own. These two forms of equity are, in practice, related. Localities in which residents are worse off economically tend to face greater fiscal challenges and are therefore both lower on the economic ladder and less able to fund their own economic development.

Statewide objectives other than equity could also justify steering state resources to targeted neighborhoods. For example, the state might decide to steer economic activity toward locations near transit stations in order to support environmental goals: In fact, redevelopment has helped localities undertake “transit-oriented development” as encouraged by SB 375 (2008) as part of a larger strategy to reduce driving. Another example of pursuing statewide objectives: The state has an interest in increasing its level of tax revenues and thus might encourage economic activity in locations with the greatest potential for increasing income, sales, and other tax revenues.

Taking regional or statewide impacts into account. If local economic development affects other communities—either positively or negatively—then the state may play an important role by being able to take into account regional or statewide effects that a decisionmaking locality might discount. For instance, local economic development might affect other communities positively through investments in transportation that link communities together, but local funding may be insufficient. For example, the entire Bay Area might benefit from better transportation access by extending a BART line into Santa Clara

County, but the county might underinvest in BART if funding were only a local matter. In such a case, the state could step in and provide supplemental funding.⁷

Local economic development efforts might also have negative effects on other localities—for example, if there is competition among local communities for jobs and investments. If one locality’s gain is another’s loss, then localities could spend resources on economic development that yield little or no benefits to the state’s overall economy. The state has implemented a number of measures to address such problems. For example, it seeks to reduce inefficiency for businesses by coordinating local economic development information under the Governor’s Office of Economic Development, which assists businesses in site selection and identifying business incentives. Another example exists in AB 1290 (1993), which reformed redevelopment and which prohibits redevelopment agencies from receiving sales tax revenues, thus discouraging, at least to some degree, the interjurisdictional competition for retailers.

Concentrating and targeting resources. Communities can face formidable barriers in their pursuit of economic growth, and overcoming these barriers may require a concentration of effort—bringing together tax incentives, workforce training, infrastructure investment, and more. If a large minimum investment of resources is required for ongoing economic development, then concentrating resources in a few places may have greater aggregate impact than spreading the same total level of resources among many places. If few localities are able, on their own, to dedicate the resources necessary for local economic development, then it may be necessary for the state to concentrate statewide resources in targeted areas.

Providing oversight. Because local economic development often involves large, complex financial transactions, and the goals of local economic development can be subjective and difficult to measure, the state can play an important role in overseeing, evaluating, or auditing local economic development programs. When local economic development supports state priorities, the role for state oversight is obvious: to ensure that local development is meeting those priorities. But even in the absence of serving state goals, programs with an unusually strong need for oversight can justify greater state responsibility for the program.

Principles in Favor of Local Responsibility

The above arguments in favor of state control must be weighed against arguments that justify local involvement or control over local economic development.

Providing proper incentives for allocating local resources. In the absence of spillover effects to other localities, the benefits of local economic development accrue to the locality investing in that development. This should provide localities with the incentive to invest in development only when the benefits exceed the costs. If, in contrast, the state funds local economic development almost completely (enterprise zones) or even in part (redevelopment areas), then the costs of any single investment are shared across the state, giving localities the incentive to spend more on local economic development than if they bore the costs in proportion to the benefits.

Ensuring fairness across localities. If the benefits or costs of local economic development clearly do not spill over into other localities, then taxpayers in one locality should not fund local economic development in other localities. Several mostly-rural counties in northern California and the Sierras have no

⁷ Transportation planning in California is primarily the responsibility of region-wide Metropolitan Planning Organizations (MPOs).

redevelopment project areas or enterprise zones—why should taxpayers there fund local economic development programs intended to boost economic activity in blighted or distressed areas of far-off cities?

Capitalizing on local knowledge of local needs. California’s cities and counties are diverse: Some are densely populated, others sparsely settled; some are rich, others poor; some rely on manufacturing, others on retail, and still others on office development and service industries. Localities differ in whether they would benefit most from job opportunities for disadvantaged workers, infrastructure redevelopment, workforce development, or another local economic development strategy. Assigning funding and responsibility for local economic development to localities would give them maximum flexibility to choose the mix of strategies best for their area.

Some of the principles in favor of local responsibility are similar to those in favor of state responsibility. For instance, “fairness across localities” suggests that each locality pays its own way; but if reducing economic disparities is a state goal, then “fairness” could be interpreted to mean that wealthier communities should support economic development in poorer communities. Also, weighing these principles against each other often depends on subjective criteria. For instance, the benefits of a local economic development project that accrue to other localities may be hard to quantify, even though these spillover benefits would justify greater state responsibility for that project.

These principles, on both sides of the equation, could weigh in favor of state or local control differently, depending on various local economic development programs; and in themselves alone, they are insufficient to explain or guide how local economic development works today or could be realigned in the future. In the next section, we discuss some of the influential constraints that also shape how levels of government share responsibility for local economic development.

Constraints

Ideally, principles such as those outlined above could be used to determine the responsibilities of the stakeholders in local economic development. But numerous constraints, rooted in fiscal, political, and legal relationships between the state and its local governments, also determine how local economic development works in California and, of equal importance, determine the amount and nature of the changes that might be introduced through realignment.

Fiscal Constraints

Two fiscal constraints limit the ability of localities to fund local economic development. The first is Proposition 13, which restrains property tax revenue by limiting both tax rates and increases in assessed value. Related legislation, such as AB 8 (1979), establishes formulas for the allocation of property tax revenue, much of which is directed toward schools. Localities are thus severely limited in their ability to raise or allocate property tax revenue to support local economic development. Subsequent propositions have further restricted their ability to increase taxes and other revenues by introducing or raising voter approval thresholds.

A second fiscal constraint depriving localities of revenue is the channeling of tax money to the state. Most of the revenue from the major taxes in California is allocated to, and used by, the state, including the personal income tax, the corporate income tax, the sales and use tax, and the vehicle license fee. If greater responsibility for local economic development were realigned to the local level, local governments would need to have access to a greater share of tax revenues. Some localities do use local tax incentives for economic development: San Francisco has a local payroll tax, from which it offers exemptions for economic development; in Los Angeles, enterprise zone businesses receive electricity discounts from the local utility. But, in general, localities control little in taxes and fees, relative to the state, that could be used as business incentives.

These constraints by themselves severely limit localities' scope for funding local economic development, but realignment of responsibilities to the local level would also face political and legal constraints, as discussed below.

Political and Legal Constraints

A strong political constituency prefers to retain the status quo of continued state funding for local economic development. As discussed above, the state pays for part of the cost of redevelopment programs and nearly all of the cost of enterprise zones. Thus, the benefits of local economic development accrue to localities while taxpayers throughout the state bear some or most of the costs. This gives localities a powerful incentive to maintain the status quo.

Finally, numerous laws might constrain the realignment of local economic development. Proposition 22 (2010) prevents the state from borrowing or taking redevelopment funds (and other local funds), and there is disagreement over whether this proposition also prevents the state from eliminating redevelopment altogether. Proposition 1A (2004) prevents the state from using local revenues for state programs, state-mandated local programs, or previously state-run programs transferred to localities. Both of these laws have been mentioned as potential challenges to Governor Brown's January 2011 proposal to eliminate redevelopment; and contract law and due process law have been cited in objection to the proposal to eliminate enterprise zones. Until these laws are tested in court, one cannot judge how constraining they might be for proposals to realign local economic development; but clearly, numerous state and federal laws will shape how local economic development might be realigned.

Funding

The primary constraint preventing localities from assuming greater responsibility for local economic development is the limitation on their ability to finance such development, due primarily to restrictions on their revenue flexibility and to voter approval thresholds. Compared to other program areas—such as social services and corrections—where realignment might shift responsibility to localities, economic development has no minimum necessary funding level and no caseload. In addition, funding for local economic development often involves financing current investments through borrowing. Thus the options for local funding of economic development differ from the options available in the realignment of other programs.

Two allowances would improve the capacity of local governments to fund local economic development:

- Greater flexibility in raising or borrowing money to finance capital projects.
- Greater control of local tax revenue.

Local Financing of Capital Projects

Two preconditions are necessary for local governments to help finance economic development: 1) authority to borrow and 2) future revenue streams to back that borrowing. Current redevelopment law allows both by giving redevelopment agencies the authority to borrow without voter approval and by allowing some of the property tax increment to finance borrowing. Redevelopment is an exception to the current restrictions that generally require localities to obtain the approval of two-thirds of the voters to borrow money.

Aside from redevelopment, localities have other options for financing economic development projects. Infrastructure Financing Districts (IFDs) are like redevelopment areas but consist of public works projects in areas that need not qualify as blighted. Like redevelopment areas, these districts can issue bonds backed by incremental property tax revenue; but unlike redevelopment areas, the creation of these districts and any bond issuance require a substantial two-thirds voter approval, and they are not allowed to take property tax increment from other jurisdictions without their agreement or from school districts.

Local governments can also issue bonds backed by revenues other than incremental property taxes. These include general obligation bonds backed by revenues from a higher property tax rate; limited obligation bonds backed by existing general fund revenues from property, sales, or other taxes; revenue bonds backed by non-tax revenues from specific activities such as airports or parking fees; Mello-Roos Act bonds, typically funding new development, backed by a flat parcel tax; and assessment bonds backed by special assessments levied on the financed project's beneficiaries. General obligation, limited obligation, and Mello-Roos bonds all require two-thirds voter approval; revenue bonds require majority approval; and assessment bonds require a majority weighted by the property owners' level of benefit.

Governor Brown's January 2011 budget summary suggests lowering the voter approval threshold from two-thirds to 55 percent for general and limited obligation bonds for economic development purposes. Other ways to expand local funding for economic development include broadening the permitted purposes for IFD or other bonds, further lowering or eliminating the threshold for voter approval of some types of bonds, and broadening the types of revenue that can be used for backing some types of bonds.

Command of Local Revenue

Local governments can offer businesses tax breaks for economic development only if they have control over their tax revenues. For example, localities could not assume funding responsibility for the enterprise zone program because the primary tax incentives offered by the program reduce state taxes (income and sales) for businesses located in their zones, which localities are not authorized to reduce to meet local goals.

Governor Brown's January 2011 budget summary suggests lowering the threshold for raising local taxes from two-thirds to 55 percent, and SB 653 (2011), currently under debate, would allow localities to tax income and other sources with voter approval. The governor's January 2011 realignment proposal also calls for dedicating some of the revenue from the sales tax and vehicle license fee to localities, primarily to fund foster care, mental health, and corrections. An alternative, wider-ranging realignment could shift revenues to localities *without* directing those revenues to specific program areas. Localities would then have the flexibility to divide a larger base of revenues among local economic development and other programs as they see fit. Whether this is ultimately a good idea depends on the principles of realignment discussed above: Policymakers would have to weigh the advantage of local flexibility and proper local incentives against the state's desire to reduce geographic inequities, address spillovers, or shift economic activity for other reasons.

Redevelopment and enterprise zones local funding, incentives, and program effectiveness

PPIC has questioned the effectiveness of redevelopment and enterprise zones. In discussing the realignment of these programs, we are not modifying our stance that these programs need to be effective if they are to be preserved. On the contrary, we are arguing that realignment could improve localities' incentives to weigh properly the benefits and costs of local economic development programs: By bearing more or all of the cost of local economic development, localities will have greater incentive to support only the most effective projects and programs. Greater local responsibility should prompt those localities with more effective local economic development to support their programs, and those with less successful programs to invest their money elsewhere.

In its 1998 redevelopment study and its 2009 enterprise zone study, PPIC found that some individual zones and areas meet their program's goals, while others are not so successful in doing so. Thus realigning local economic development might not make each individual project more effective, but localities will have greater incentive to support only the most effective projects, and the overall effectiveness of the programs would increase.

For instance, if the redevelopment pass-through rate to schools (discussed on p. 7) fully covered the loss of school funding that is now covered by the state's General Fund, then the share of the property tax increment going to redevelopment activities (excluding affordable housing) would have to drop sharply, from 58 percent to 23 percent. This calculation is based on the LAO's estimate that redevelopment agencies "divert over \$2 billion" from education that must be backfilled by the General Fund. Two billion is 35 percent of the total tax increment of \$5.7 billion. If redevelopment agencies scale back their activities to projects that could be financed with only 23 percent of the property tax increment, much redevelopment would become infeasible, but the redevelopment that survives would be entirely local-funded, removed from the state budget debate, and focused on only the most economically promising projects.

Conclusion: The Future of Local Economic Development

The current debate over redevelopment and enterprise zones—the state’s primary local economic development programs—hinges on their cost and effectiveness relative to other programs in the state budget. Certainly the state should support only those programs that justify their costs, and the current budget situation may even require scaling back programs with proven benefits and modest costs. The debate over redevelopment and enterprise zones, however, is circumscribed by the constraints on realigning local economic development. Because localities have few options for funding local economic development without at least partial help from the state, the only way the state can reduce its own spending on local economic development is to scale back these programs. If localities could more easily fund local economic development, the debate could shift from status quo vs. elimination to state vs. local responsibility. Local economic development could remain a local priority even if the state decided it is not a state priority, and the overall effectiveness of the state’s main local economic development programs could improve because local governments would face better incentives to support the most economically feasible investments.

Current and recent realignment proposals focus on social services and corrections but not on local economic development programs. Yet local economic development—like elements of these other programs in the realignment debate—*could be either state or local responsibilities*, and in practice are a mixture of both. Rational principles should guide decisions about who bears responsibility for local economic development, especially if the constraints on local funding could be relaxed. The future of local economic development is already enmeshed in the complicated fiscal relationship between the state and its localities, and bringing local economic development into the realignment debate would expand the options for improving economic development in California.

**Other publications in PPIC’s
Rethinking the State-Local Relationship
series:**

An Overview
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Jed Kolko is an associate director of research at the Public Policy Institute of California, responsible for managing the institute's economy research. He has conducted numerous studies of the California economy, economic development, housing, and technology policy. Before coming to PPIC in 2006, he was vice president and research director at Forrester Research, a technology consultancy, where he managed the company's consumer market research businesses and served as the lead researcher on consumer devices and access technologies. He has also worked at the Office of Federal Housing Enterprise Oversight, the World Bank, and the Progressive Policy Institute. He holds a Ph.D. in economics from Harvard University.

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