



THE ECONOMIC FUTURE OF UPPER MIDWEST STATES

RCF, Inc.

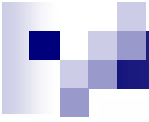
Chicago, Ill.

August 16, 2006

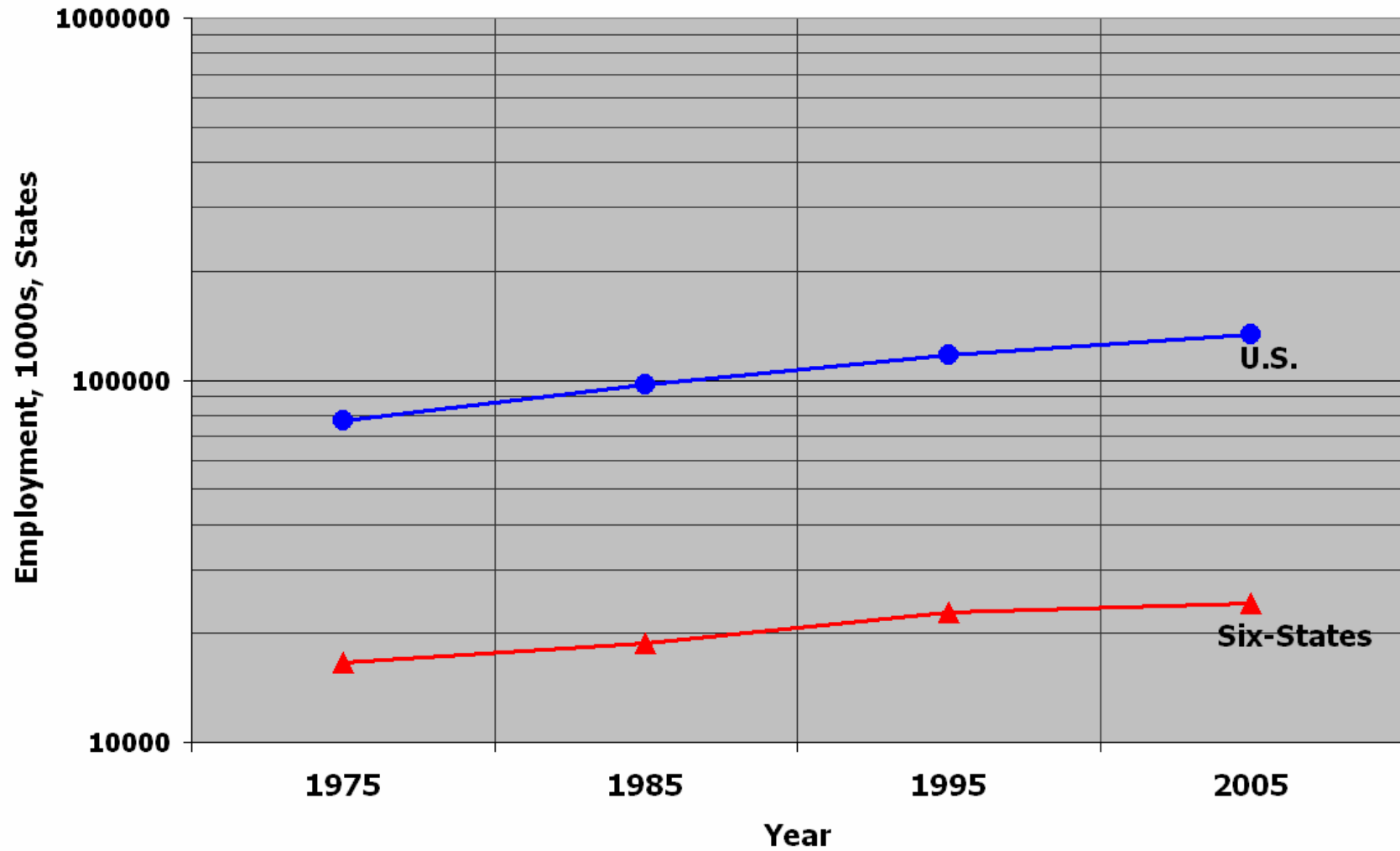


Total Employment Changes 1975-2005

- The U.S., Minnesota, Wisconsin, Illinois, Indiana, Michigan and Ohio have all experienced growth over the past few decades.
- The overall growth at first glance seems quite similar.

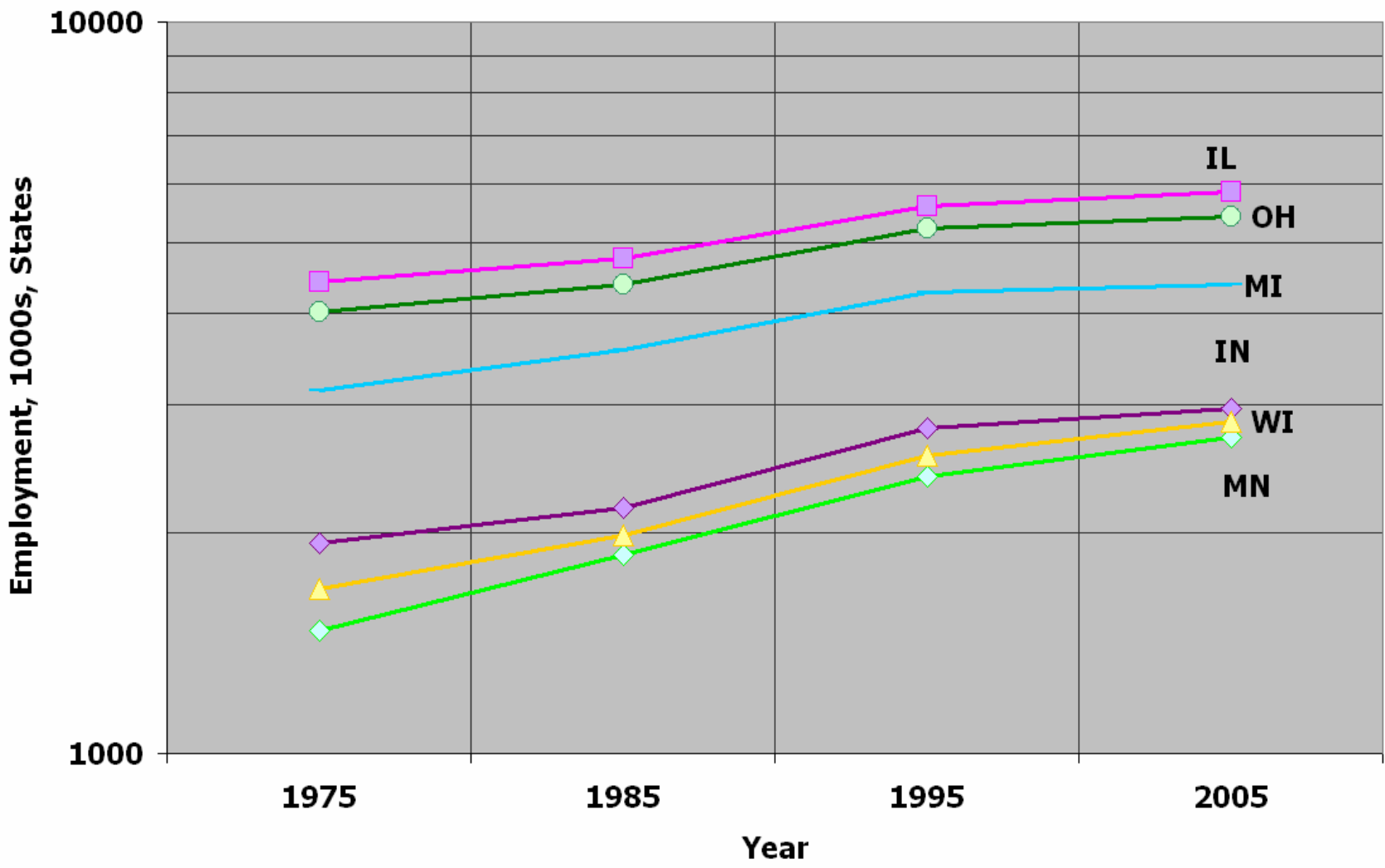


Total Nonfarm Employment, 1975-2005





Total Nonfarm Employment, 1975-2005





Total Employment Changes 1975-2005

- Minnesota, Wisconsin, Illinois, Indiana, Michigan and Ohio have all grown less rapidly than the U.S. as a whole. Average ten-year employment growth since 1975 was 13.4 % for the six states and 20.2% for the U.S.
- Within the region, growth was Minnesota 16.3%, Wisconsin 15.4%, Illinois 22.7%, Indiana 10.8%, Michigan 12.0% and Ohio 19.4%.
- Growth everywhere was slower in the most recent decade because of the recession beginning in 2001.

State Total Employment Changes 1975-2005

| | Percent Change | | | |
|------------|----------------|-----------|-----------|------------------------|
| | 1975-1985 | 1985-1995 | 1995-2005 | Average 10 Year Change |
| Minnesota | 26.5% | 17.6% | 4.9% | 16.3% |
| Wisconsin | 11.7% | 28.5% | 6.1% | 15.4% |
| Illinois | 26.5% | 28.0% | 13.4% | 22.7% |
| Indiana | 8.9% | 19.4% | 4.0% | 10.8% |
| Michigan | 13.5% | 20.0% | 2.6% | 12.0% |
| Ohio | 18.3% | 29.0% | 11.0% | 19.4% |
| Six-States | 12.3% | 22.0% | 6.0% | 13.4% |
| U.S. | 26.5% | 20.3% | 13.8% | 20.2% |

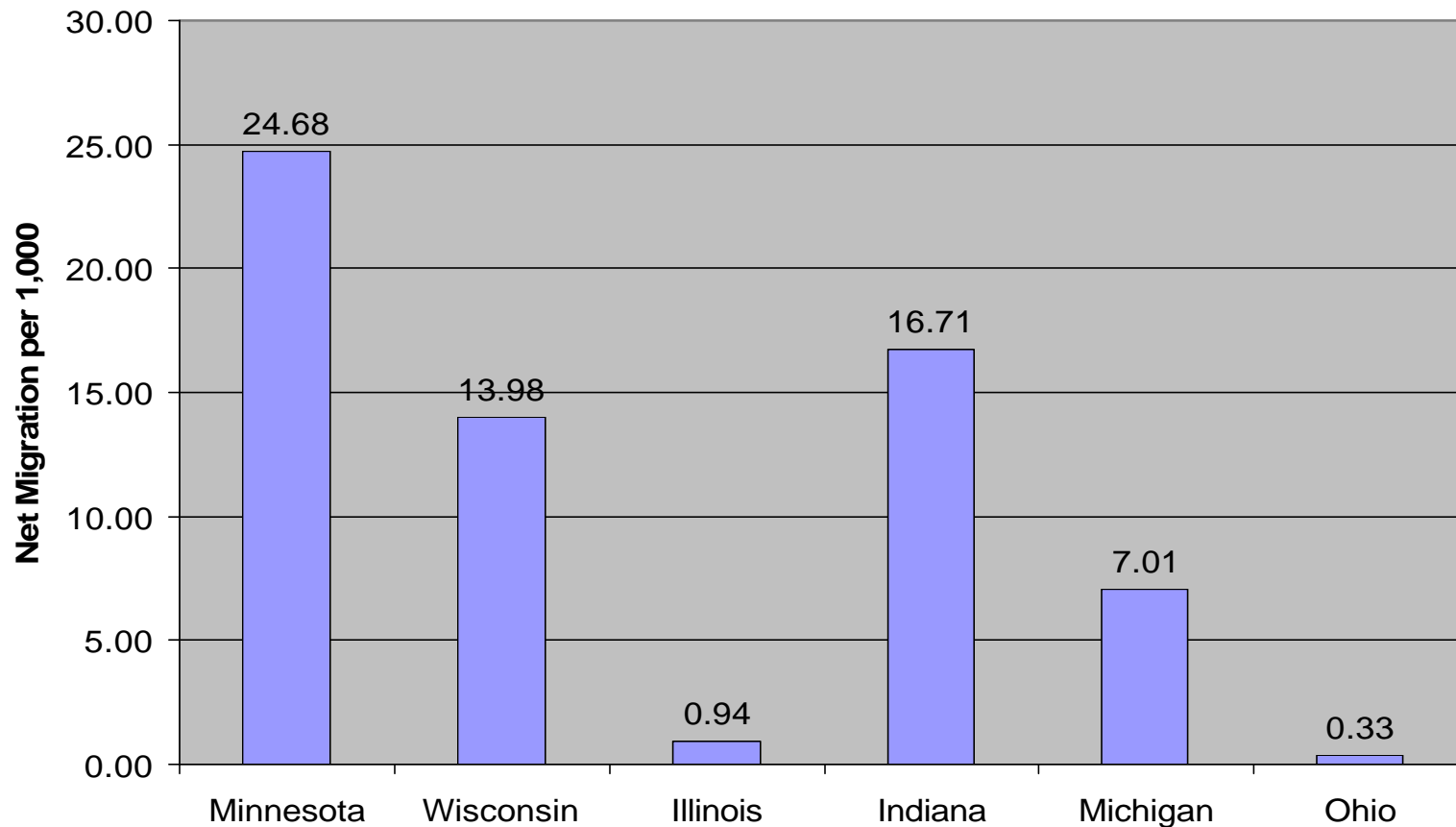


Total Net Migration

- All States had some in-migration
- Minnesota attracted the highest proportion of migrants followed by Indiana and Wisconsin
- Illinois and Ohio had the lowest proportion of migrants

Total Net Migration

Total Net Migration by State
1995-2000



Source: U.S. Census

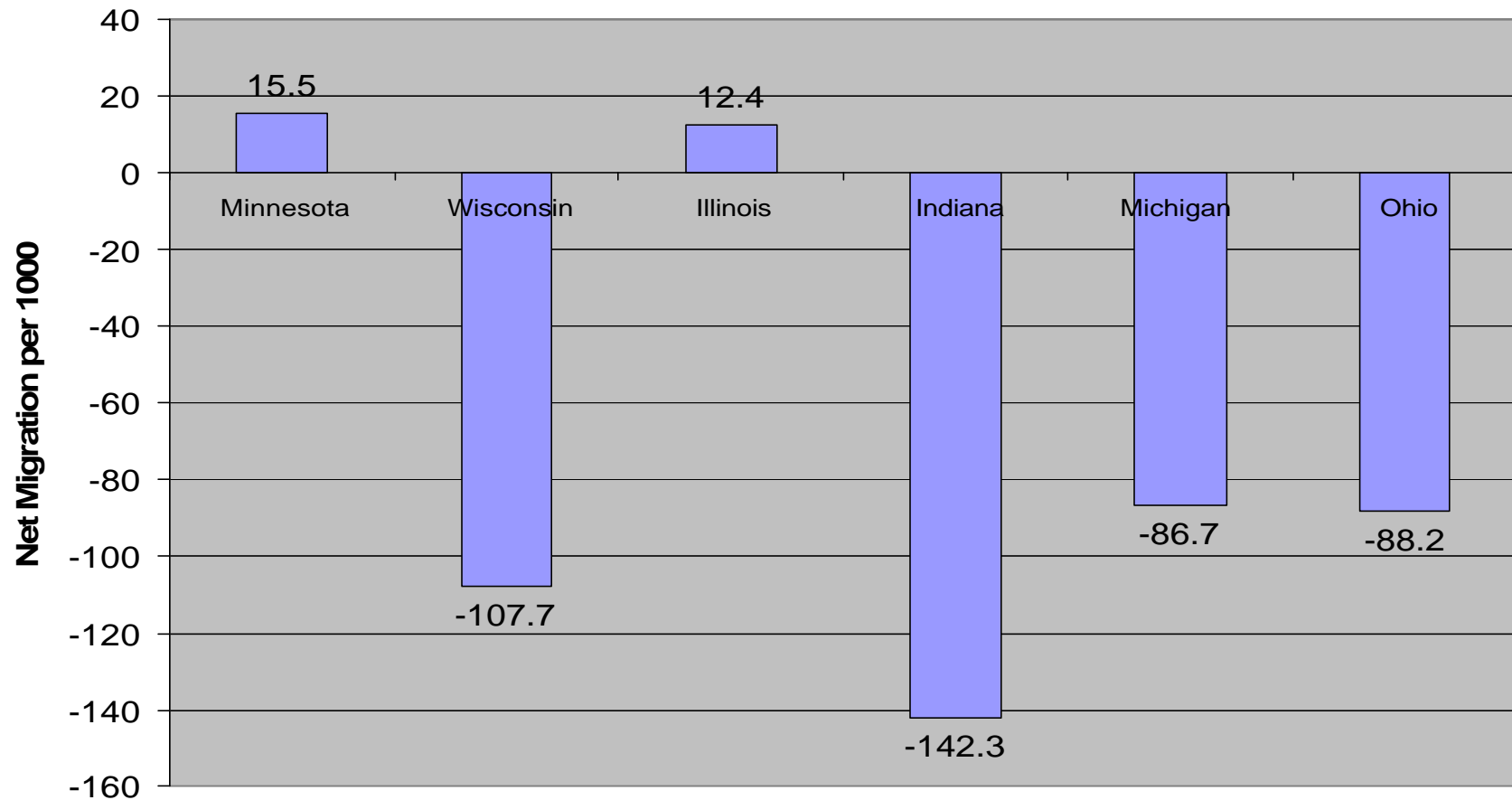


Net Migration of Young Professionals

- Minnesota and Illinois are the only two states in the region to attract young college-educated people.
- All other states in the region had significant outflows of young college-educated people.

Net Migration of Young Professionals

Net Migration by State Of Single, College-Educated, Age 25-39
1995-2000





Understanding Growth Differences

- To understand all these changes, we have to go back to root causes:
- Raison d'être of cities—Basic Industries. City not there if it were not for them.
- Two types of basic industries
 - Manufacturing industries
 - Modern-age non-manufacturing industries



Definition of Basic Employment Industries

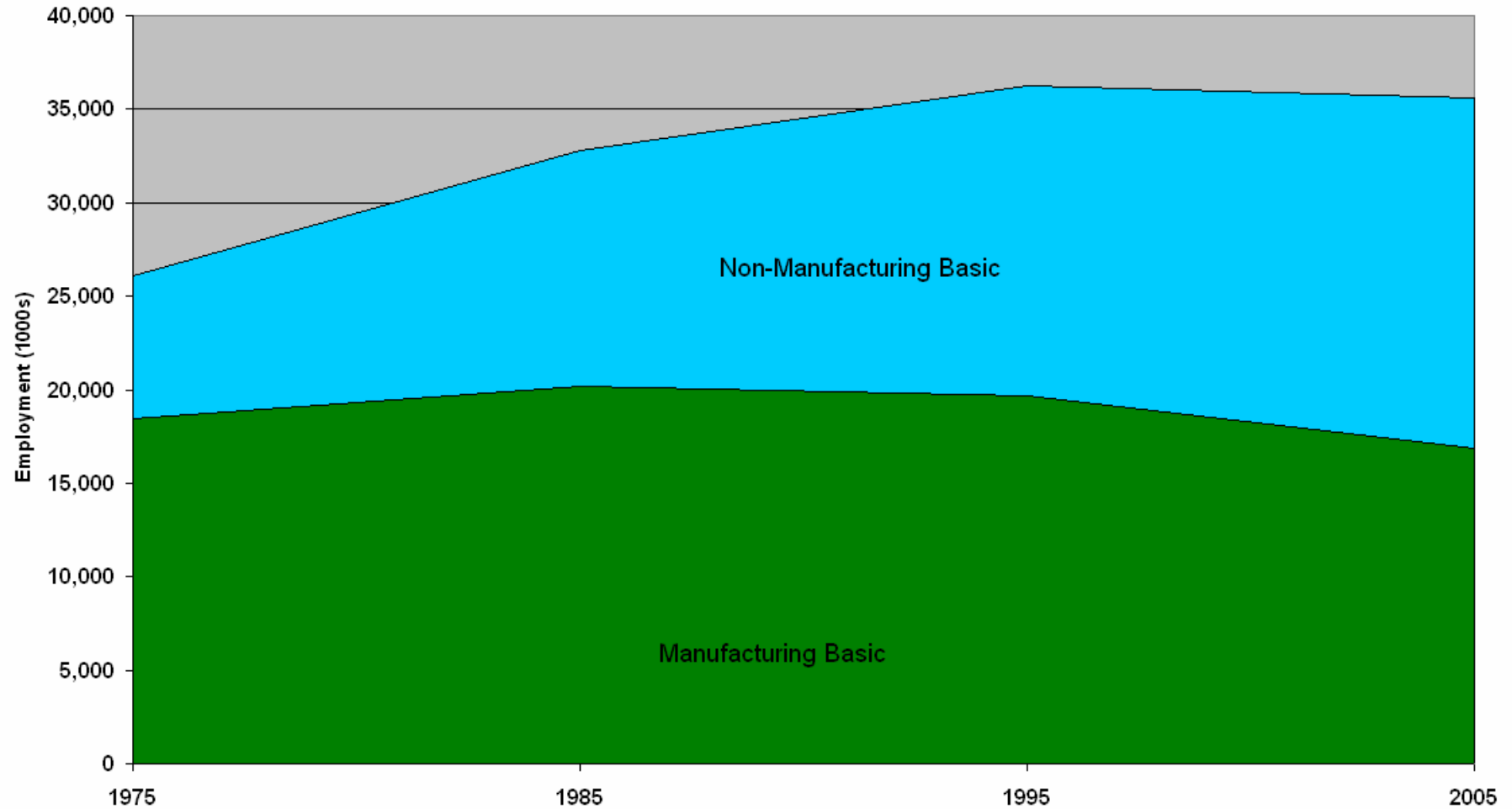
- Manufacturing and Mining= 100%
- Non-Manufacturing Basic
 - Wholesale = 50%
 - Transportation and Warehousing = 50%
 - Information = 50%
 - Finance and Insurance =50%
 - Professional Services = 50%
 - Administration and Support = 30%
 - Education and Health Services =30%
 - Leisure and Hospitality = 30%



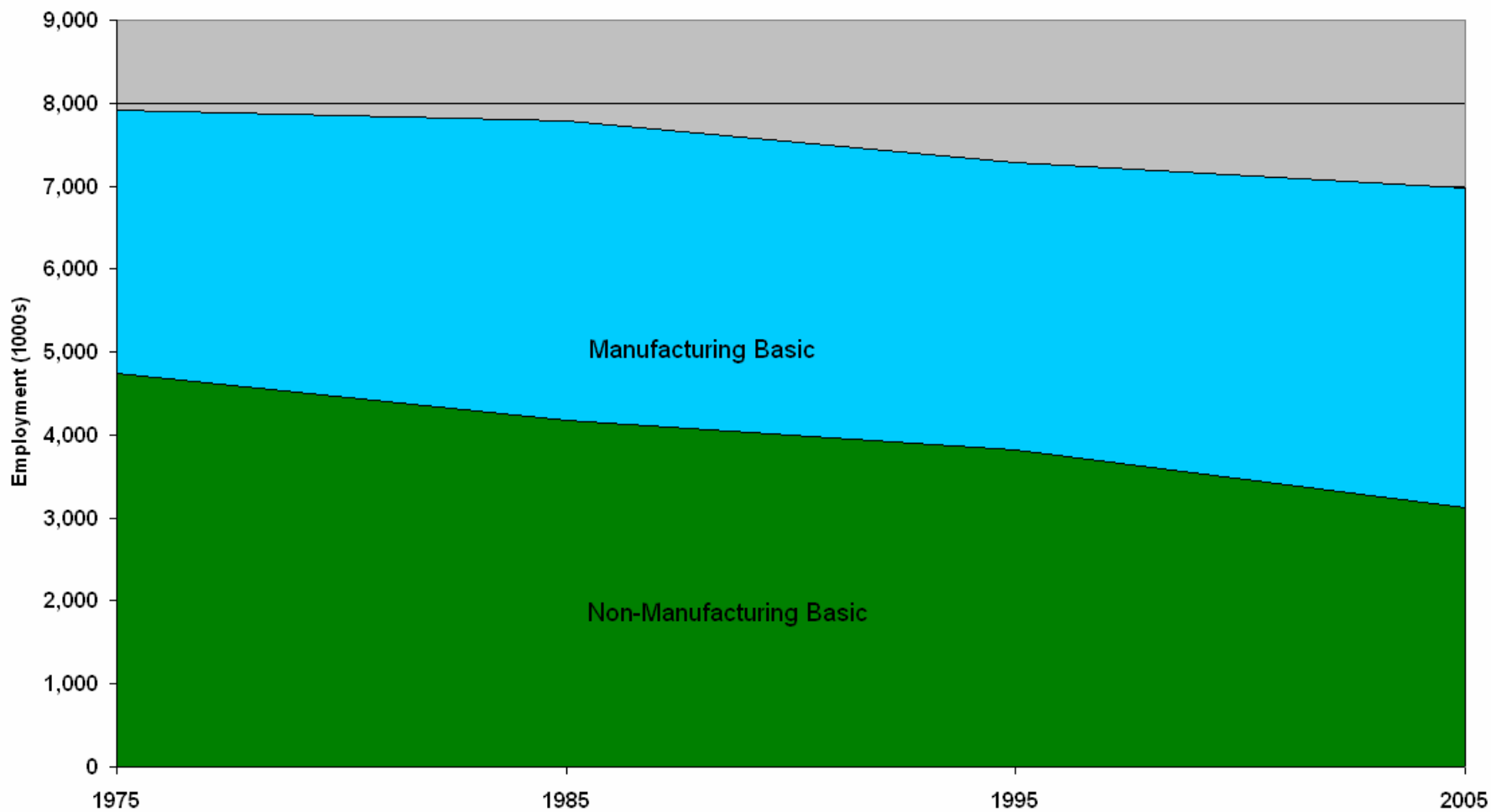
Basic Industries

- The fate of basic industry growth has been a race between decline of manufacturing and expansion of basic non-manufacturing.
- The outcome for the U.S. contrasts with the six-state region we are considering.

U.S. Basic Employment



Six-State Basic Employment





Basic Industries (cont'd)

- The states have had varied experiences in changes as between manufacturing and the basic non-manufacturing industries.
- See the next slide for comparisons of 3-decade averages.

**Average 10-Year Percent Change
Manufacturing and Basic Non-Manufacturing Employment
1975-2005**

| | Manufacturing | Basic Non-Manufacturing | Total Basic |
|-------------------|----------------------|------------------------------------|------------------------|
| Minnesota | 2.2% | 14.2% | 8.2% |
| Wisconsin | 2.9% | 8.1% | 4.5% |
| Michigan | -14.0% | 8.9% | -4.5% |
| Illinois | -18.6% | -0.1% | -8.8% |
| Indiana | -12.6% | 13.0% | -3.9% |
| Ohio | -17.5% | 10.9% | -6.3% |
| Six-States | -12.9% | 6.9% | -4.1% |



State Strengths

- Each state has a unique set of industries that has contributed positively to basic employment.
- See next slide for top 3 contributors in each state.
- Policy Question: Should states play to their strengths?

State Strengths

Percent Positive Contribution to State Basic Employment, Top 3 Industries, 1995-2005

| Minnesota | | Indiana | |
|---|--------|---|--------|
| <i>Total Change in Basic</i> | 4.20% | <i>Total Change in Basic</i> | -2.40% |
| Wholesale Trade | 1.12% | Food Manufacturing | 0.35% |
| Computer Systems Design | 0.85% | Chemical Manufacturing | 0.20% |
| Architectural, Engineering, and Related | 0.41% | Trucking and Warehousing | 0.27% |
| Wisconsin | | Michigan | |
| <i>Total Change in Basic</i> | 0.90% | <i>Total Change in Basic</i> | -8.00% |
| Insurance | 1.07% | Consulting | 0.58% |
| Wholesale Trade | 0.94% | Arts, Entertainment, and Recreation | 0.45% |
| Trucking and Warehousing | 0.68% | Architectural, Engineering, and Related | 0.33% |
| Illinois | | Ohio | |
| <i>Total Change in Basic</i> | -5.50% | <i>Total Change in Basic</i> | -7.10% |
| Computer Systems Design | 1.13% | Air Transportation | 0.90% |
| Consulting | 0.44% | Computer Systems Design | 0.72% |
| Trucking and Warehousing | 0.42% | Consulting | 0.34% |



Local Industries

- Basic Industries considered so far account for only about 30% of total employment averaging over the six states.
- The rest, or the lion's share, is made up of employment in local industries serving the people living in a city or town and not selling to the rest of the nation or world.
- Local industries used to be neglected as “secondary” tag alongs and not causal to growth.



Local Industries (cont'd)

- While basic industries are the reason that cities exist, it would be foolhardy to neglect the key role of local industries in building on and contributing to growth once a city exists.
- First reason for importance of local industries: *The demand for local services is growing rapidly. They outpace the demand for goods produced by the basic industries that produce for national markets.*



Local Industries (cont'd)

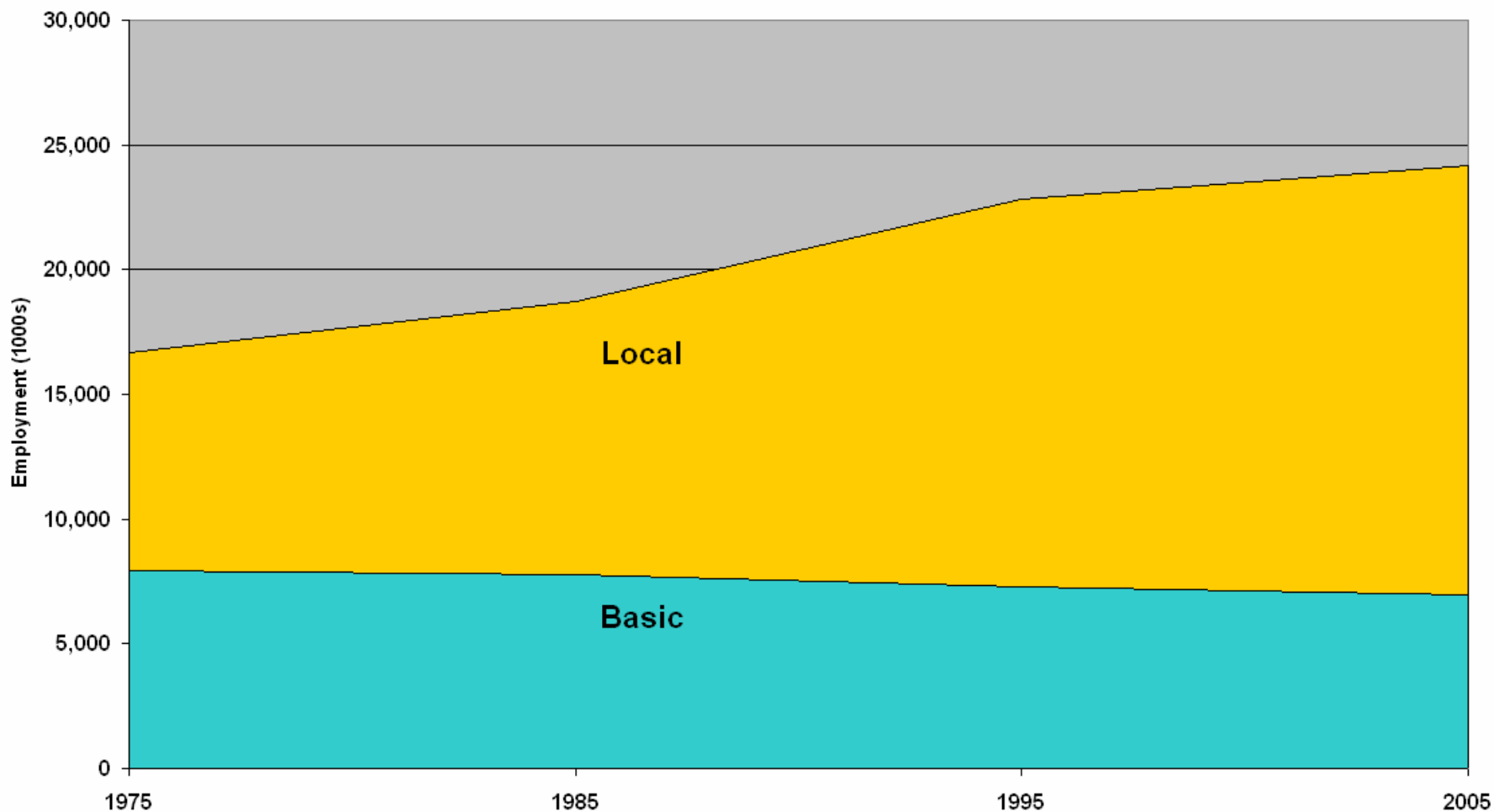
- While people value cars, TV's and other things produced for national markets, they increasingly want the other accoutrements of the good life: services! entertainment!
- Because people are spending more and more on outputs of local industries, these industries have been a more major contributor to state growth than basic industries.



Local Industries (cont'd)

- The next slide shows the composition of total employment in the six-state region subdivided into basic and local employment since 1975. Any decline in basic employment has been more than offset by increases in local employment. Local employment then is virtually the sole enabler of overall employment growth.

Six-State Basic and Local Employment





Local Industries (cont'd)

- Local industries have been viewed traditionally as passive or induced, with basic industries viewed as what really wags the growth dog.
- It has been fashionable to calculate local “multipliers” where the multiplier is the ratio of total employment to basic employment designed to show how much a region will grow if basic employment is increased.
- But now we find that *increases* in multipliers are the predominant reason for growth of cities and towns in the U.S. economy.

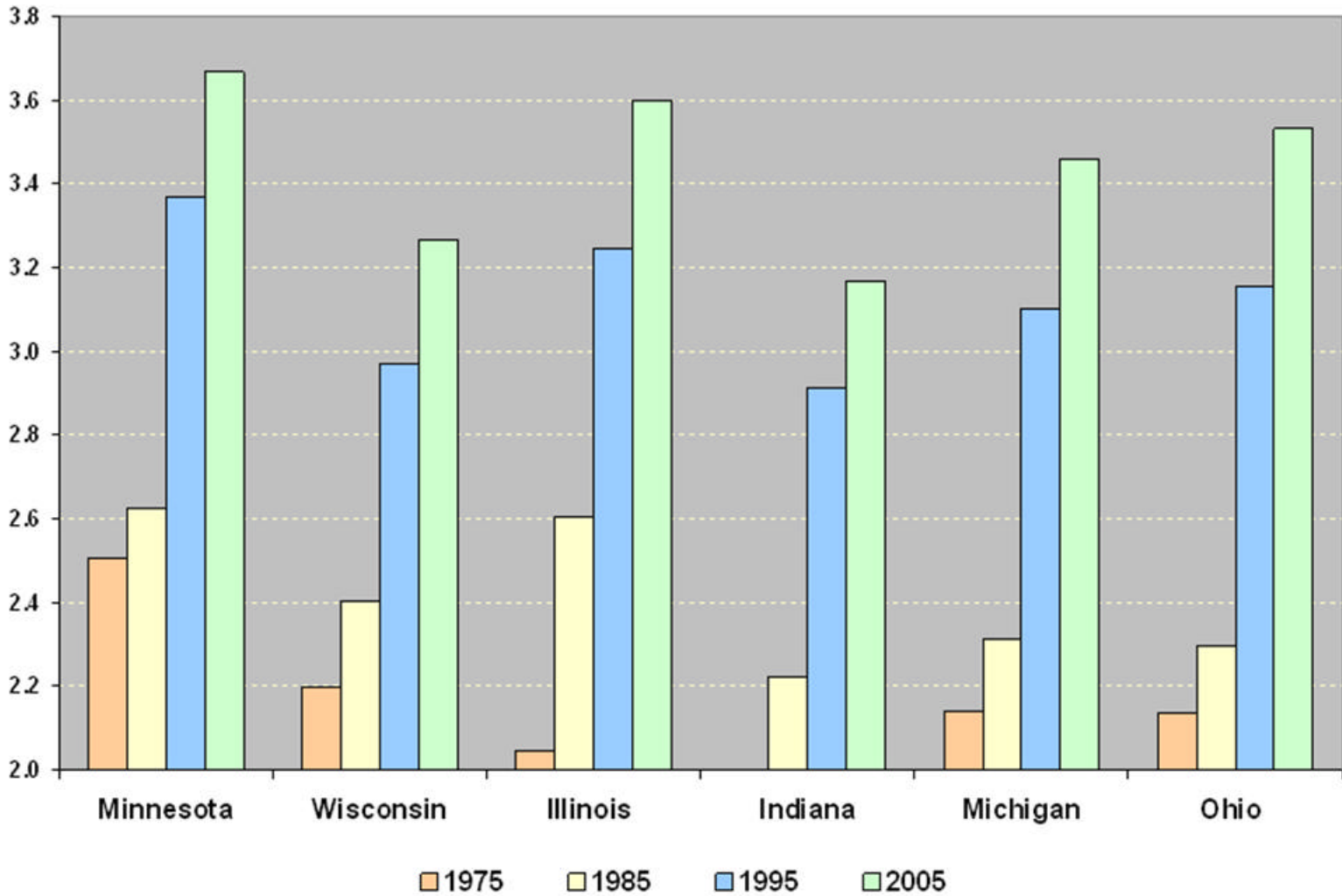


Local Industries (cont'd)

- The next slide shows the dramatic increase in multipliers in every state. Basic employment equal to 30 percent of total employment implies a multiplier of 3.3, which is close to the multipliers in the 6 states in 2005.
- Basic employment equal to 40 percent of total employment implies a multiplier of 2.5, close to the 1975 multipliers.



Employment Multipliers (Total/Basic)





Local Industries (cont'd)

- First lesson from local industries:

Recognize them as important direct contributors to growth. Don't neglect them. Encourage them. You can't fully understand the growth of a state if you don't have an idea of where local industries are going.



Local Industries (cont'd)

- Second reason for importance of local industries: Quite apart from their independent contribution to growth, *the amounts, variety and quality of local industries play a key role in attracting basic industries to a state.*
- Local industries are a part of the amenity story, which is important to CEO's, midlevel executives, and professionals. These are the people who drive modern industries. If they like a city, modern industries are more likely to locate there.



Local Industries (cont'd)

- Some people have gone so far as to say the cities have become nothing more than entertainment machines, characterizing the future as that of the “consumer city”.
- This goes too far, because it neglects basic industries and assumes that they pay attention to amenities and nothing else.



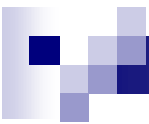
Local Industries (cont'd)

- There is a critical mass to entertainment and other local services. They increase with the number of people served, which further increases their desirability. The number of good restaurants tend to go up exponentially with population, making a city even more attractive. The same is true of variety in general.
- While policy cannot encourage these industries beyond what the market demands, several policies can be undertaken to make a city more attractive.



Local Industries (cont'd)

- Amenities include parks, museums and other cultural attractions which are supported directly or through philanthropy that can be encouraged.
- Amenities include the general attractiveness of the outdoor environment including lack of pollution of various kinds of scenic beauty.
- Policy lesson: A favorable climate for local industries and promotion of amenities more generally can be an important contributor to state growth.



Midwest States--Partners or Competitors?

- Notwithstanding the differences we have talked about, the six states all tend to have employment composition that is very similar to that in most other states and to the U.S. as a whole.
- Each of the six states is competing for a share of the national market. They are not in a zero sum game with their sister states in the region. They are partners in the promotion of economic development, in a race that helps themselves and comes at the expense if any primarily from states throughout the country.



Partners or Competitors? (cont'd)

- We noted above that each state has its own unique strengths. In activities nurturing these strengths, the states may act independently—in this area being neither partners nor competitors.
- If an industry is contemplating locating near a border between two states, difference in tax rates provide an important incentive influencing which state the industry will choose. In these situations, the states are competitors—as they are indeed to some extent with all other states in or out of the region.



Some Policy Questions

- The six states do not rank well in terms of tax treatment and other policies toward businesses that can be expected to affect economic development.
- See the next two slides giving sample state rankings of business climate indicators.



State and Local Tax Burdens, 2006

| State | Combined State and Local Tax Burden |
|---------------|--|
| Alaska | 6.6% |
| New Hampshire | 7.3% |
| Delaware | 8.4% |
| Michigan | 10.8% |
| Illinois | 10.9% |
| Indiana | 11.0% |
| Wisconsin | 11.6% |
| Minnesota | 11.9% |
| Ohio | 12.0% |
| New York | 12.9% |
| Maine | 13.5% |

Source: Bureau of Economic Analysis, Department of Commerce, and Tax Foundation calculations

State Business Tax Climate Index Rankings 2006

| State | Overall Rank | Business Tax Index Rank | Individual Income Tax Index Rank | Sales and Gross Receipts Tax Index Rank | Unemployment Insurance Tax Index Rank | Wealth and Property Tax Index Rank |
|--------------|--------------|-------------------------|----------------------------------|---|---------------------------------------|------------------------------------|
| Wyoming | 1 | 1 | 2 | 22 | 19 | 35 |
| South Dakota | 2 | 1 | 1 | 42 | 31 | 9 |
| Alaska | 3 | 48 | 4 | 1 | 43 | 18 |
| Indiana | 11 | 20 | 10 | 14 | 7 | 19 |
| Illinois | 23 | 15 | 13 | 41 | 37 | 44 |
| Michigan | 26 | 49 | 11 | 32 | 40 | 20 |
| Wisconsin | 32 | 23 | 35 | 25 | 29 | 25 |
| Minnesota | 38 | 41 | 36 | 34 | 35 | 15 |
| Ohio | 47 | 37 | 48 | 45 | 13 | 48 |
| Rhode Island | 48 | 27 | 40 | 30 | 50 | 49 |
| New Jersey | 49 | 50 | 46 | 27 | 27 | 46 |
| New York | 50 | 30 | 50 | 39 | 47 | 43 |

Source: Tax Foundation's *State Business Tax Climate Index* available at <http://www.taxfoundation.org/publications/show/78.html>.



Some Policy Questions (cont'd)

- Because it is so current, proposed big box ordinances may be mentioned as especially harmful to development.
- Imposing higher minimum wages on large retailers drives them away, depriving those in need of work experience opportunities, lowering consumption opportunities of those living in affected neighborhoods, reducing tax base, and driving the retailers across city boundaries promoting suburban development at the expense of fiscally strained cities.



Some Policy Questions (cont'd)

- It goes without saying that the promotion of economic development promotes real estate values and real estate activity. Areas of other fostering policies that could be considered in depth include, among others:
 - Primary, secondary and vocational education contributing to a qualified labor force
 - Higher education and promotion of university R&D to supply modern industry personnel and promote high tech spinoffs
 - Promotion of innovation and entrepreneurship



Forecasts

- The next slide shows year-to-year employment growth since 2000 and 3-year forecasts for the U.S., the six states as a whole, and the individual states.
- The U.S. forecast is by Global Insights, and the state forecasts are our RCF forecasts based on analysis of how the states share in national fluctuations.

Six-State Regional Employment Forecast

| | Minnesota | Wisconsin | Illinois | Indiana | Michigan | Ohio | Six-State Region | U.S. |
|--------------|------------|-----------|----------|---------|----------|-------|------------------|-------|
| | Historical | | | | | | | |
| 2000 | 2.4% | 1.8% | 1.4% | 1.0% | 2.0% | 1.1% | 1.6% | 2.2% |
| 2001 | 0.2% | -0.7% | -0.8% | -2.2% | -2.5% | -1.5% | -1.3% | 0.0% |
| 2002 | -0.9% | -1.1% | -1.9% | -1.1% | -1.7% | -1.8% | -1.5% | -1.1% |
| 2003 | -0.2% | -0.3% | -1.2% | -0.2% | -1.5% | -0.9% | -0.9% | -0.3% |
| 2004 | 0.8% | 1.1% | 0.1% | 1.2% | -0.3% | 0.2% | 0.4% | 1.1% |
| 2005 | 1.0% | 1.2% | 0.8% | 0.9% | -0.2% | 0.4% | 0.6% | 1.5% |
| | Forecast | | | | | | | |
| 2006 | 2.0% | 1.2% | 0.8% | 0.6% | 0.2% | 0.6% | 0.8% | 1.2% |
| 2007 | 1.3% | 0.8% | 0.4% | 0.2% | 0.3% | 0.2% | 0.5% | 1.3% |
| 2008 | 1.4% | 1.1% | 0.6% | 0.6% | 0.3% | 0.5% | 0.7% | 1.4% |
| Forecast Sum | 4.7% | 3.0% | 1.7% | 1.4% | 0.8% | 1.2% | 1.9% | 3.9% |

Source: BLS; RCF Estimates



Real Estate

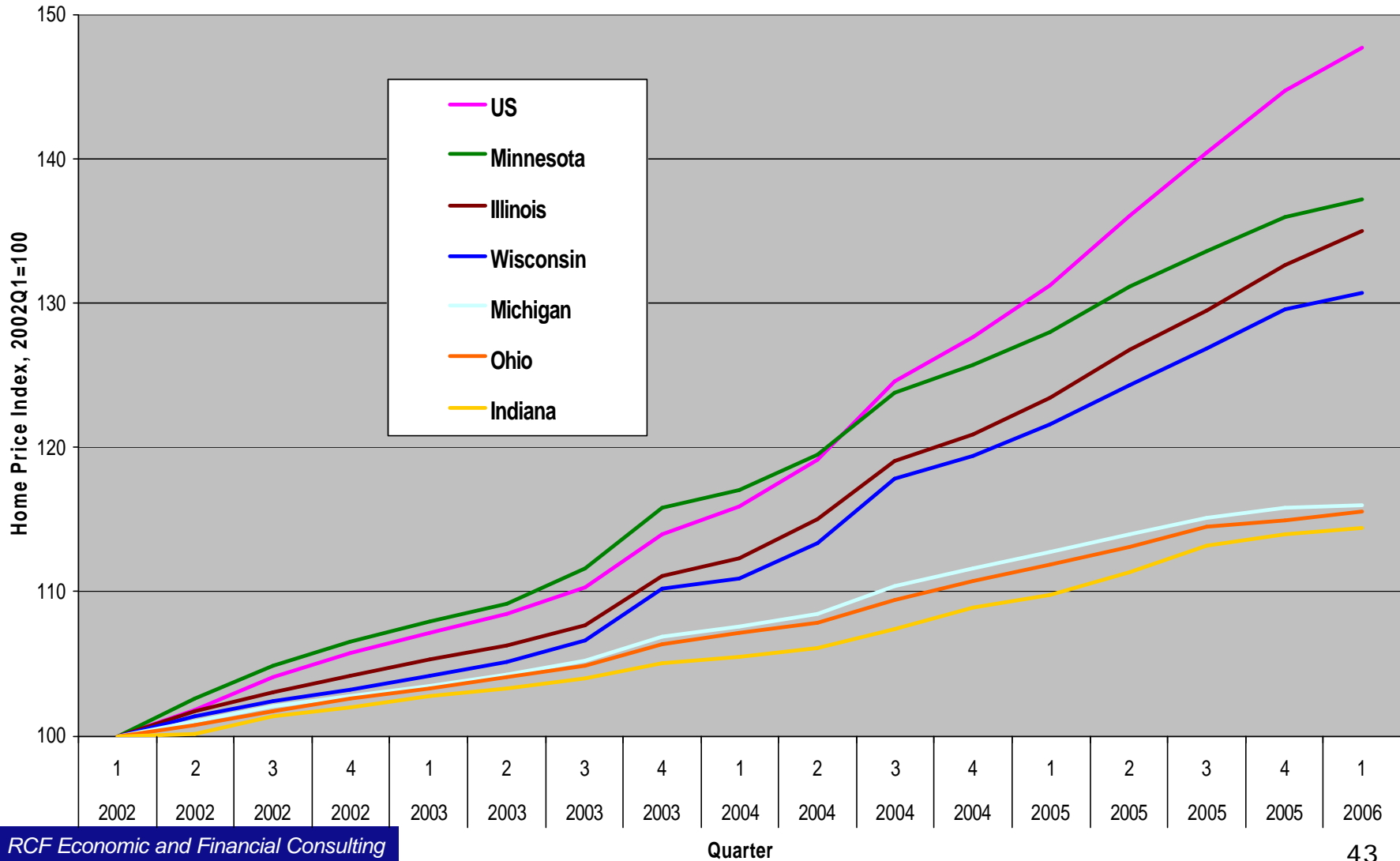
The closing slides present
some real estate information

House Price Appreciation for the US and Six States

Office of Federal Housing Enterprise Oversight (OFHEO)

Home Price Index

2002Q1 = 100



National Association of Realtors National and Local Chicago Housing Market Outlook

| Percent Change - Year Ago | Actual | | Forecast | |
|--|--------|------|----------|------|
| | 2004 | 2005 | 2006 | 2007 |
| National Housing Indicators | | | | |
| Existing Single-Family Sales | 9.8 | 4.4 | -6.5 | -0.4 |
| New Single-Family Sales | 10.8 | 6.7 | -12.8 | -6.5 |
| Housing Starts | 5.2 | 5.7 | -9.1 | -5.5 |
| Single-Family Units | 6.6 | 6.5 | -11.3 | -9.3 |
| Multifamily Units | -0.9 | 1.9 | 1.8 | 10.8 |
| Residential Construction | 10.3 | 8.6 | -2.9 | -6.7 |
| Chicago Region Housing Indicators | | | | |
| Home Sales | 4.4 | 1.9 | -6.4 | 1.8 |
| Home Prices | 4.1 | 13.5 | 5.7 | 4.3 |

Source: National Association of Realtors, Multiple Listing Service of Northern Illinois, August 2006



Effect of General Price Level on Home Prices

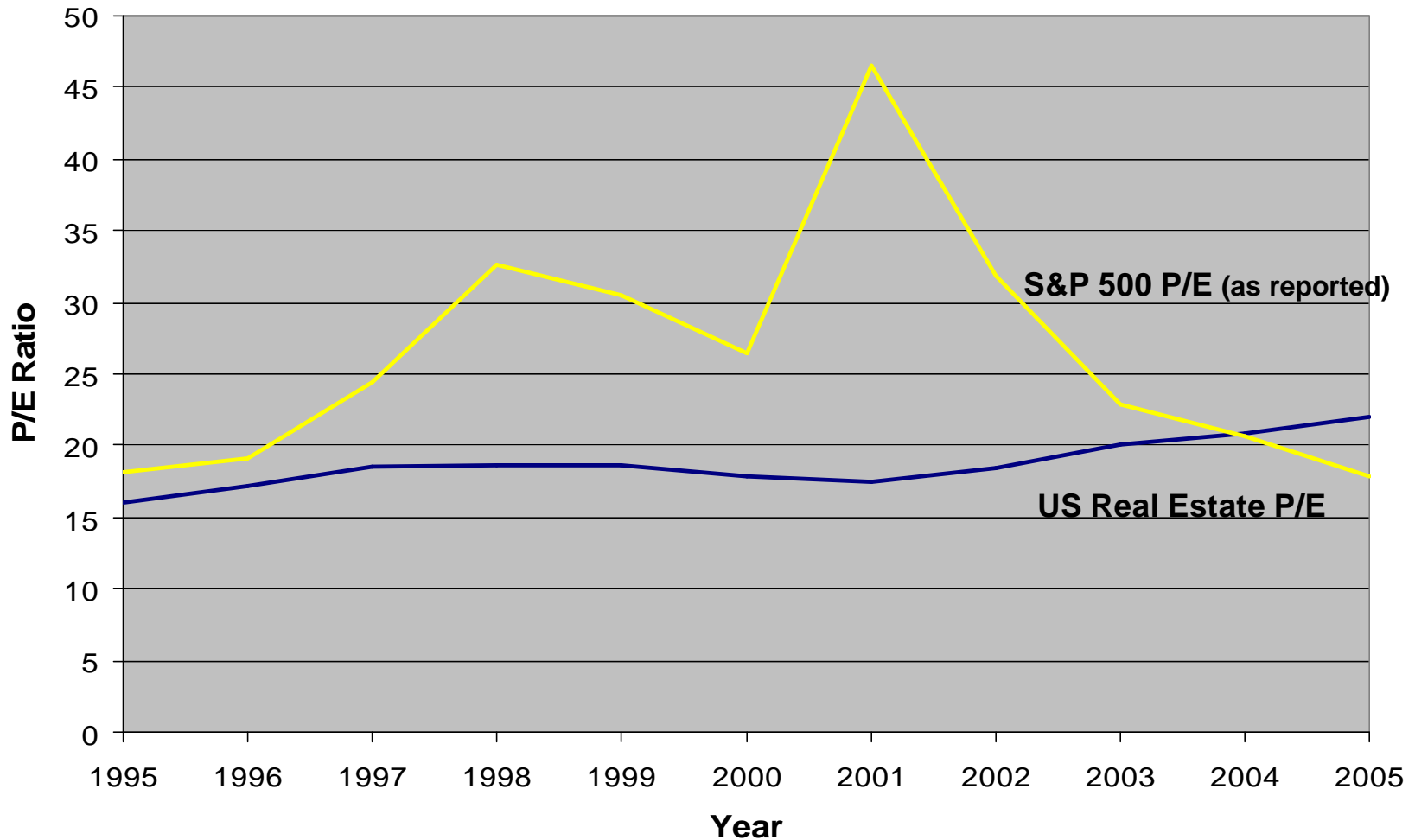
- o From 1995 to 2005, the median price of single-family homes in all major metropolitan areas in the US rose from \$114,200 to \$222,700 or by 95%^(a). About **28%** of the increase was due to inflation of all prices in the economy

| % Increase in Median Price 1995-2005 | % Increase in Price Level 1995-2005 | % Increase in Real Price 1995-2005 |
|--|---|--|
| 95% | 28% | 67% |

(a) *New and existing detached single-family and town homes for all US Metropolitan Statistical Areas (MSAs)*

Source: National Association of Realtors

Price-Earnings Ratio: Single-Family Homes Versus Capital Markets



Source: <http://www.standardandpoors.com> , American Housing Survey, National Association of Realtors