

Sales Tax Revenue Rebates: Running Amok in Illinois

by Geoffrey Propheter

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Since the tax revolts of the 1970s and 1980s, local governments have been in a perpetual state of strained resources, increasingly unable to exercise fiscal autonomy to raise the revenue to fund the level of services citizens demand. The proliferation of state exemptions and increased consumption of largely untaxed services and e-commerce further erode local sales tax bases.

Given the bleak outlook of local revenue streams, it is becoming increasingly difficult for municipalities to appropriate funds to combat blight. Indeed, this problem is persistent, and over the years local governments have turned to creative tax incentive programs such as tax increment financing, enterprise zones, low-interest loans, property tax refunds and credits, and sales tax refunds on qualified property to encourage economic growth. Determining the effectiveness of those programs is an ongoing academic debate, but most research appears to conclude that they are ineffective for achieving the desired goal, result in more forgone revenue than revenue generated, or are unnecessary because development would have occurred regardless of the incentive.

In the last decade and a half, more and more local governments across the country have begun to embrace sales tax revenue rebates (STRRs) as a tax incentive to encourage development.¹ STRR pro-

grams involve a contractual agreement between a municipality and a firm in which the locality rebates a percentage of the generated local sales tax revenue to the tax-paying business to subsidize infrastructure improvements or building rehabilitation, or for no explicit reason other than to attract a revenue-generating business. Unlike state-level programs, rebated revenue comes strictly from the state allocation portion or the local option portion of the sales tax that in some instances may be funded through concurrent local option rate increases. STRRs also differ from other local incentive programs in that they always sunset, although city councils may decide to extend an existing agreement or enter into a new one when an old agreement expires.

A recent lawsuit filed in the Circuit Court of Cook County, Ill., has promised to shine some light on the use of STRRs; they generally have been kept buried in the often ignored annals of city council meeting minutes.² Filed by the area Regional Transportation Authority, the suit seeks to invalidate STRR agreements entered into by nearby communities Kankakee and Channahon with various firms and to force those cities to repay the agreements' resultant revenue that the claimants argue should have remained in the Chicago area. The practice of diverting revenue to surrounding communities by promising a kickback raised the ire of Chicago Mayor Rahm Emanuel (D), who criticized STRRs as "gaming the system and cheating Chicago's taxpayers" (Bellandi, 2011). The seriousness of this challenge is surprising considering that Illinois municipalities have been using STRRs in one form or another since the late 1980s.³

¹Sales tax revenue rebates are also commonly referred to as "sales tax rebates" and "sales tax revenue sharing agreements" However, these phrases are also used to identify unrelated sales tax schemes, which may cause potential confusion. Sales tax rebate is in wide use to denote a different kind of rebate, particularly one in which state governments return a portion of collected sales tax from purchases of

(Footnote continued in next column.)

qualified property. Meanwhile, revenue sharing agreement is widely used in public finance to denote a pool of shared revenue distributed across jurisdictions.

²See *Regional Transportation Authority v. City of Kankakee*, 11-CH-29744.

³The earliest STRR agreement I found was between the city of O'Fallon and property developer Melvin Simon & Associates in 1987.

The political outrage now leveled against STRRs in Illinois has already come and gone in California. In the 1990s STRRs were a staple of economic development in Southern California. Many California cities began using them as incentives during the early 1990s recession that was hurting local sales tax receipts. In what William Fulton (2001) described as “Sales Tax Canyon,” the cities of Oxnard, Ventura, and Camarillo formed a submetropolis that regularly exploited STRRs as a means of enticing businesses into their jurisdiction because “under California’s peculiar taxation laws a retail store is a city’s best cash crop.”

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In response to what many perceived as poor tax policy, the California State Legislature began a long journey in 1998 to stop the proliferation of STRRs, but it was not until 2009 that the state made statutory changes that effectively arrested the practice. Thus, California’s experiences can serve as a guide for policymakers in Illinois who are concerned about the deleterious effect that the use of STRRs may have on neighboring communities and regional economies.

In the hopes of further shedding light on STRRs, this report sets out to examine the political and economic forces that drive municipalities to perceive them as sound tools of local fiscal policy. To this end, I focus on criticisms often leveled against tax incentives in general, and I show that STRRs are just as pernicious as other incentives. To keep the content relevant to the current debate, the bulk of the examples I cite are from Illinois and California municipalities. Also, I describe the evolution of California legislation that was eventually able to discourage further widespread use of STRRs as well as judicial decisions in other states that may be helpful for legislatures to consider when addressing concerns with rebate incentives more generally.

Background on STRRs

Arguably, property tax incentives have commanded the bulk of researchers’ attention. Consequently, local sales tax incentives have been comparatively less studied. An interesting exception is a polemic by Edward Shils (the Shils Report) published in 1997 that traces the modern usage of STRRs to various municipalities in the late 1980s and early 1990s as incentives for car dealerships

and land developers.⁴ To spur revitalization in the face of growing economic decay, many cities approved distributing sales tax revenue to businesses as a development stimulus. In 1987, for instance, O’Fallon, Ill., agreed to rebate up to \$2.2 million in sales tax for public improvements to developer Melvin Simon & Associates. In 1993 Tinley Park, Ill., approved \$1 million over 10 years in revenue rebates to the owner of a strip mall in exchange for a commitment to spend \$8 million in property renovations. In 1994 Cathedral City, Calif., agreed to reimburse a property owner for up to 90 percent of his costs for land improvements by rebating 75 percent of the sales tax receipts generated by the property.

By the mid-1990s cities had expanded the use of rebate agreements to include big-box retailers. The advocacy group Good Jobs First published a report in 2004 that details many of Wal-Mart’s earliest tax incentive agreements, including:

- 1991 — Redlands, Calif., rebated sales tax revenue through a parking lot leaseback agreement. *Total subsidy: \$1 million.*
- 1991 — Villa Park, Ill., rebated revenue over 10 to 14 years for infrastructure and site preparation. *Total subsidy: \$1.4 million.*
- 1992 — Cathedral City, Calif., provided a 10-year revenue rebate to the developer of a Wal-Mart discount store to pay for infrastructure improvements. *Total subsidy: \$1.8 million.*
- 1993 — Gilroy, Calif., funded infrastructure improvements around the site. Wal-Mart made the initial allocation and was reimbursed through a sales tax rebate. *Total subsidy: \$408,000.*
- 1994 — Corona, Calif., agreed to lease a parking lot of a development that includes a Wal-Mart, grocery store, and many smaller stores and restaurants for a period of 20 years. Wal-Mart keeps 50 percent of its sales tax revenue and sends the rest to the city. Half the sales tax generated by the entire shopping center also goes to Wal-Mart, and the other half is paid to the developer; the city will receive no sales tax revenue from the other stores until 2013 or until the full amount of the lease is paid. *Total subsidy: \$5.5 million.*

During the same late 1980s to mid-1990s period, rebate agreements with auto dealerships became commonplace in Illinois. A quick search of *Chicago*

⁴In 1962 Canada offered a sales tax revenue rebate program to the nation’s manufacturing industry as a sweetener to gain support for its 1962-1963 budget. Manufacturing firms were entitled to a 50 percent rebate of tax revenue from increased sales. Given the apparent infrequency Canada offered such rebate programs, however, that seems to be more of an isolated case than a trend toward a new fiscal policy.

Tribune archives shows a plethora of examples, including a 1987 deal between the village of Bolingbrook and Arena Auto Auction for \$425,000; a 1994 deal between Fox Valley and Gartner Buick for \$1.36 million; a 1998 deal between Elmhurst and North Avenue Honda for \$325,000; and a 2001 deal between Aurora and Fox Valley Investments for half of the city's 1 percent local option revenue for 10 years.

More recent rebate agreements have grown in complexity and the targeted industries receiving them have diversified. A representative sample of agreements is detailed in Table 1 (next page). It is common now, for instance, to adopt a temporal and fixed-dollar limit as two criteria of agreement fulfillment. Moreover, many agreements tie rebate amounts to ranges of taxable sales or sales tax revenue generated: If a specified threshold is not reached, no sales tax revenue is rebated. In the earlier Wal-Mart agreements, rebated amounts were not conditional on retail output, and thus there was no additional incentive to increase local economic performance. On the surface, these types of contingencies appear to mitigate an agreement's negative economic outcome as well as improve its effectiveness.

The STRR agreements just detailed all involve a municipality entering into a compact with a specific business or a specific developer. There is a second type of agreement that is the primary target of Emanuel's ire. Like California and nine other states,⁵ Illinois has a situs-based allocation method for sales tax revenue — that is, revenue is allocated to the jurisdiction in which the point of sale occurred, not where the delivery of goods occurred. Businesses and local governments can conspire to use this system to establish so-called buying companies that are essentially consolidated sales offices. If a buying company is located within a single jurisdiction, all sales tax revenue from transactions throughout the state are diverted to that municipality. Much of the frustration voiced in Cook County focuses on local governments' encouraging businesses such as United Airlines and American Airlines to form buying companies in exchange for a sizable return of the revenue for jet fuel sales.

The same practice was commonplace in California. In 2003, for instance, United formed a buying company in Oakland, and the California Legislative Analyst's Office (2007) estimated that the deal saved the company \$6 million annually while Oakland's sales tax revenue increased \$3 million. In 2008 Modesto enticed three business-to-business petro-

leum companies (Breshears Petroleum, Boyett Petroleum, and General Petroleum) to consolidate their sales operations. Analyses by city staff estimated the total additional revenue to be roughly \$850,750 in fiscal 2010, or about 0.7 percent of the city's fiscal 2009 general fund. Also in 2008, Manhattan Beach formed an agreement with DeWitt Petroleum whereby the city would receive an estimated \$350,000 annually, or about 11 percent of the city's fiscal 2009 general fund.

Moreover, in Fillmore, Calif., city officials agreed to rebate 85 percent of the city's 1 percent share of sales tax revenue generated by businesses brought into town by two separate consulting firms. The consulting firms would then rebate a portion to the businesses according to a different contract. As in Modesto and Manhattan Beach, the consulting firm enticed businesses to set up consolidated sales offices in Fillmore to obtain all the tax revenue generated by the businesses' sales throughout the state. By one estimate, between 2003 and 2007, the city's 15 percent share generated about \$1.5 million (Schifanelli, 2008).

Unlike increment financing, STRR agreements are generally not explicitly sanctioned by state governments.

As a final piece of background, it may be helpful to contrast STRRs with the more familiar tax increment financing district. There are four differences that I consider to be substantial. First, unlike increment financing, STRR agreements are generally not explicitly sanctioned by state governments; Illinois has one notable partial exception that will be discussed in detail later. Second, increment financing occurs within predetermined enterprise zones or development districts. By comparison, municipalities may on their own accord require recipients of revenue rebates — such as with auto dealerships or retail businesses — to locate themselves in close proximity to each other, but compacts are generally formed within ad hoc boundaries (often dictated by the business) with recipients being scattered throughout the city. Third, because rebate agreements are not restricted to enterprise zones or development districts, increment revenue does not remain within a specific area but goes instead to the local general fund. Fourth, STRRs do not require a city council to cede some of its authority to a redevelopment agency to oversee the agreement. Instead, the primary authority remains with the local legislative body. Thus, the political appeal of STRRs should be immediately apparent. They do not sequester a property tax base for 20 to 30 years, as in

⁵States that are members in the Streamlined Sales Tax Project are allowed to maintain situs-based sourcing rules for intrastate sales.

Table 1.
Recent Sales Tax Rebate Agreements, Select Cities

Year	City	State	Firm	Rebate Terms
2000	Corona	California	Robertson's Ready Mix	50 percent of sales tax revenue for one year.
2003	Carol Stream	Illinois	Lowe's	From \$100,000 to \$700,000 of sales tax revenue, 70 percent is rebated for five years.
2003	Addison	Illinois	Wal-Mart	\$3.5 million in total sales tax revenue over 15 years.
2003	Mokena	Illinois	Home Depot	40 percent of total annual sales tax revenue generated by shopping center for a period of 17 years.
2005	Evergreen Park	Illinois	Wal-Mart	All annual sales tax revenue above \$550,000 for a period of 20 years until \$5.25 million in total has been rebated.
2005	Greenwood Village	Colorado	East Berry Avenue Associates	50 percent of all sales tax revenue generated by the developed property paid quarterly for 20 years and not to exceed \$16,983,720 in total.
2005	Burelson	Texas	Rovin Inc.	100 percent of sales tax revenue in the first year and 100 percent in the second year up to \$16,271 maximum.
2006	Montgomery	Illinois	Wal-Mart	\$3.7 million in total sales tax revenue over 13 years.
2008	Modesto	California	Boyett Petroleum	Quarterly sales less than \$5 million, 0 percent; between \$5 million and \$25 million, 45 percent of Bradley-Burns; greater than \$25 million, 65 percent of Bradley-Burns.
2008	Modesto	California	Breshears Petroleum	Quarterly sales less than \$5 million, 0 percent; between \$5 million and \$25 million, 45 percent of Bradley-Burns; greater than \$25 million, 65 percent of Bradley-Burns.
2008	Modesto	California	General Petroleum	Annual taxable sales less than \$20 million, 0 percent; between \$20 million and \$100 million, 50 percent of Bradley-Burns; greater than \$100 million, 65 percent Bradley-Burns.
2010	Moore	Oklahoma	Target	50 percent of annual sales tax revenue up to \$2 million.
2010	Westminster	California	Best Buy	From \$0 to \$500,000 in annual sales tax revenue, 20 percent of is rebated. From \$500,000 onward, 50 percent is rebated. Program runs for 10 years.
2010	Buena Park	California	M&D Properties	55 percent of the annual sales tax revenue the developed property generates for a period of 30 years.
2010	Manhattan Beach	California	DeWitt Petroleum	Annual taxable sales less than \$0 million, 0 percent rebated; between \$40 million and \$59,999,999, 35 percent of Bradley-Burns rebated; between \$60 million and \$79,999,999, 50 percent of Bradley-Burns rebated; greater than \$80 million, 65 percent of Bradley-Burns rebated.
2010	Homewood	Alabama	Colonial Properties	\$9 million over 10 years from sales tax revenue generated by a Target store in the shopping center. \$1.4 million in sales tax revenue to cover road improvement costs.
2010	Birmingham	Alabama	Gus Mayer	\$500,000 over two years.
2010	Orland Park	Illinois	Meijer	45 percent of annual sales tax for five years up to \$1.5 million.
2011	Colorado Springs	Colorado	Lowe's	\$50,000 a year for five years.
2011	Orland Park	Illinois	Nissan/Infiniti	50 percent of annual sales tax revenue in excess of 2010 amounts for five years or up to \$1.5 million.
2011	Frisco	Texas	Costco Wholesale	\$2.7 million over 10 years.
2011	Naperville	Illinois	Janko Group	1 percent of sales tax and 4.4 percent of hotel tax up to \$7.5 million in total. Above \$7.5 million, 0.5 percent of sales tax and 2.2 percent of hotel tax up to \$10 million in total or for 20 years, whichever comes first.

tax increment financing, they allow for more flexibility in directing businesses toward blighted areas throughout a city, and they do not require establishing an additional local agency whose authority may be wholly or partially outside the city council's control.

Criticisms of Rebate Agreements

Governments justify the use of tax incentives for a number of reasons: to retain businesses, to protect businesses from extraregional competition, to rescue failing businesses, to attract new businesses, or to encourage start-ups (Buss, 2001). Despite those potential benefits, there are substantial criticisms that can be leveled at STRRs — namely, interregional inequities, tax competition, and the uncertainty of creating new revenue. I consider each in turn.

Interregional Inequity

The first substantial criticism is that rebate agreements are inequitable because they compel municipalities to grant special favors to some businesses at the expense of others. STRRs, and targeted tax incentives more generally, may equally discriminate against interregional businesses in favor of extraregional businesses or big-box retailers against small businesses. According to the Shils Report, large corporations are “in effect being subsidized by municipalities, school districts and taxpayers with the employment of millions in funds to build their stores.” The use of public funds in these ways violates Principle 8 of Keith Ihlanfeldt's (1995) 10 principles of tax incentives: tax incentive programs should benefit all businesses within the targeted industry groups. As David Brunori says, “Targeted tax incentives create a much more regressive system of taxation by foisting the financing of government services on those least able to do so. The government provides general services to everyone in the state, including the recipient corporations that are substantially removed from the tax rolls.”

We see the discrimination against small retailers prominently in the study by Good Jobs First on Wal-Mart tax incentives, but it is also apparent in other STRR agreements. For example, an agreement between Home Depot and Mokena, Ill., promised the corporation 40 percent of the total sales tax revenue generated by every retailer in a new shopping center in addition to revenue generated by the Home Depot. If we assume that the public improvement and infrastructure costs are completely covered by the 40 percent rebate, all the retailers contribute to the costs proportional to their revenue. But as a proportion of the shopping center's overall sales tax liability, Home Depot is responsible for 60 percent, while the other retailers, presumably smaller and lower-revenue-generating retailers, are

responsible for 100 percent. Thus, on an ability to pay principle, rebate agreements are not vertically equitable.

Tax Competition

The second significant criticism is that rebate programs induce jurisdictional competition for businesses, competition that amounts to a revenue shell game as businesses shop for the best deals. Competition between two California cities — Seal Beach and Huntington Beach — for Pinnacle Petroleum is an example. Pinnacle Petroleum was originally founded in 1995 in Huntington Beach. By 1998 Pinnacle had relocated its sales office nine miles north to Seal Beach because the city offered the company a 30 percent sales tax rebate while Huntington only offered 20 percent. At that time, the company employed seven people and earned about \$10 million annually, which by the city's estimates would amount to a \$30,000 annual rebate. The company's contract was for a term of five years. In 2007 Pinnacle offered to return to Huntington Beach if the city would increase its original offer to 30 percent; the city accepted the offer for a term of 10 years.

There are two dimensions to this sort of competition. First, there is vertical competition between municipalities and the state, because two jurisdictions competing over the same business ultimately produce no net change in economic output from the state's perspective. However, because one municipality will end up losing, it may require further aid from the state to compensate for the forgone revenue, which further suggests that a jurisdiction's demand for additional aid is correlated with the amount of resources expended on economic development and the frequency in which it loses the competition. Moreover, local governments may engage in land zoning practices that favor commercialization. The following fiscalization of land use is an additional externality to the state that may be realized through increased land costs and a decline in the availability of quality land for public purposes.

Interestingly, past state legislative action may be significantly responsible for the rise of revenue rebate agreements. If local land use decisions produce an externality to the state, the state is responsible for a self-inflicted wound. As Peter Detwiler, chief consultant to California's Senate Local Government Committee, testified in his analysis of SB 114 (2003), a bill designed to limit the use of revenue rebate agreements:

By shifting property taxes away from counties, cities, special districts, and redevelopment agencies to help schools and the State General Fund, the Legislature contributed to the local competition for sales tax revenues. Although it's pernicious, the practice of subsidizing the

relocation of stores is entirely rational in this statutory and fiscal environment. Legislators can't fault local officials for pursuing sales tax dollars. But many local officials despise the practice and may welcome SB 114 because it insulates them against the advances of commercial interests.

Second, there is horizontal competition in which two jurisdictions compete over a mobile tax base. Particularly if the jurisdictions are within the same geographic proximity, there may be a race-to-the-bottom effect wherein municipalities engage in inefficient competition to give the highest incentives for the lowest returns. In a recent study on intra-regional tax competition in Ohio, Cassel and Turner (2010) found that as the number of local governments offering incentives increases, the value of the incentives increases as well.

Unsurprisingly, horizontal competition has angered cities that have been on the losing end of rebate agreements. For example, the cities Livermore and Industry (both in California and both home to warehouses operated by Virginia-based medical supplier Owens and Minor) filed a claim against Fillmore and two consulting companies — MTS Consulting and Inspired Development, firms that are also defendants in the Regional Transportation Authority lawsuit. The cities' suit requested that the State Board of Equalization freeze any sales tax revenue generated by the businesses in Fillmore, including an Owens and Minor's consolidated sales office. Similar anger surfaced about Modesto's contract with Breshears Petroleum. The city of Oakdale estimates an annual loss of \$55,000 in revenue (roughly 0.7 percent of its general fund) and the city of Newman saw its 2009 first quarter sales tax receipts from Breshears drop from \$26,213 to \$75, prompting City Manager Mike Holland to say, "When the fourth quarter (revenues) came in, we were very upset that one of our sister cities would cut a deal to harm the city of Newman" (Albrecht, 2009).

The growth of rebate agreements appears to be self-sustaining — a phenomenon that is not unknown to most tax incentive researchers. One agreement establishes precedence for future agreements with few obstacles inhibiting their permeation. Unsurprisingly, after recently seeing his fellow council members approve a \$250,000 rebate incentive for a Lowe's Home Improvement store, Colorado Springs, Colo., council member Sean Paige lamented that the city was only encouraging other businesses to extend their hands for similar perks.

Nevertheless, many local governments are becoming convinced that STRRs are at least a partial solution to increasing or maintaining local resources. After his board approved a \$100,000 rebate for a Dunkin' Donuts, Westerchester, Ill., Trustee Nick Steker said recently, "I've talked to a number of

business owners and economic developers for municipalities and in this economic climate everyone is giving incentives because it's about the future. It's about bringing business in" (Kenealy, 2011). On the one hand, municipalities may be setting bad precedence, but on the other hand, as Vernon Hills, Ill., Trustee Jim Schultz observed, incentives are sometimes warranted when attracting and retaining retail tenants becomes problematic. He says of rebates, they're "a tough thing to swallow" (Zawislak, 2010). Vernon Hills, Ill., Mayor Roger Byrne likewise voiced his concern, "I'd like to lose the word 'rebate' pretty quick" (Zawislak 2011).

In many instances, municipalities begin to offer rebates only because neighboring jurisdictions offered them, as the Cassel and Turner (2010) study points out. In 2004 Belleville, Ill., offered Wagner Buick-Pontiac one of the city's first development rebates after 11 other dealerships left the city. Most of the relocated dealerships moved to nearby O'Fallon — a city that has been actively offering rebates since at least 1987. A similar series of exoduses prompted Joliet, Ill., to begin offering rebates.

For many local governments, particularly those without prior experience in sales tax incentives, the shifting expectations for economic development may come as a surprise. Mark Russell, the president of the Huntsville, Ala., city council, said retailers are getting bolder in asking for incentives, adding: "It seems that over the past year, many more developers are calling me and asking for the City Council to get involved in their projects. The environment's changing . . . and I just want to make sure the city isn't missing out on any opportunities because we don't have a [retail incentive] policy" (Doyle, 2010). The perceived necessity of rebate agreements may force local governments into the unenviable position of choosing between two policy alternatives: reject rebate agreements at the risk of losing retail businesses or swallow the tough pill and at least guarantee that some businesses will remain for a short time.

Uncertainty of Creating New Revenue

The third major criticism centers on the uncertainty that any revenue generated above and beyond the rebated total would have been generated but for the rebate agreement. That is, in the absence of the rebate that the firm would not have relocated to the jurisdiction or that if the firm relocates to the jurisdiction it brings with it new jobs and new sales tax revenue, not just shifted jobs or shifted revenue. If neither result can be shown, one would have little faith in the sales tax rebate effectiveness as a sound tool of prudent fiscal policy.

Alan Blinder, former chairman of the Federal Reserve Board, recently expressed his concern in the legitimacy of a locality's fear that a firm won't

move to its jurisdiction as a motivating factor to offer tax incentives: “We know [some] things [about tax credits] for sure. Many new jobs that receive the tax credit would have been created anyway. In such cases, there is no real ‘bang,’ but deficit ‘bucks’ go up” (Blinder 2010). A STRR agreement offered by O’Fallon, Ill., to a car dealership illustrates those concerns. In 1997, after being pressured by General Motors to establish his car dealerships adjacent to a busy interstate highway, owner Jack Schmitt sought to move his Chevrolet lot approximately eight miles from Belleville to O’Fallon. To secure the move, O’Fallon offered Schmitt a revenue rebate up to \$500,000 over 10 years. In 2007 the city renewed the agreement for the same terms even though it had lost a chunk of its sales tax base from car sales when General Motors closed its Oldsmobile franchises in 2004. Moreover, in 2009 the city granted Schmitt an additional \$200,000 revenue rebate for 10 years to help offset the cost of adjacent land that he previously purchased for a Suzuki and Mahindra dealership.

Given the pressure General Motors had placed on Schmitt in 1998 to relocate near an interstate highway, it may have been unnecessary for O’Fallon to enter into the initial agreement considering the lack of alternative jurisdictions that met the car manufacturer’s requirements. Further questioning the wisdom of the initial agreement is a great deal of literature that says business relocation decisions tend to place greater emphasis on the surrounding infrastructure rather than the presence of incentives as a criterion (Brunori 2005). Regardless of the logic of the initial agreement, the 2007 extension and the 2009 addendum were both unnecessary: The former occurred despite a reduction in the city’s sales tax base and the latter occurred despite Schmitt’s earlier private business decision that the city opted to subsidize after the fact. It should be accepted as a tenet of responsible fiscal policy that local governments should not subsidize private business decisions that were carried out without public review.

Local governments should not subsidize private business decisions that were carried out without public review.

Moreover, a 1992 STRR agreement between Camarillo and Chelsea Realty for a retailer shopping center was invalidated by a Ventura County Superior Court judge. Despite not receiving the rebate, Chelsea still built the shopping center.

A related concern about rebate agreements surfaced in Vernon Hills, Ill. In June 2010 Forefront Properties LLC purchased a former Circuit City

store in Vernon Hills for \$2.55 million. By August Forefront sold the property to two investors, Shorewood Development Group and Oxford Development Partners, for \$3.45 million. The investors later secured a \$518,000 STRR package from the village board. By December the investors successfully exploited the guaranteed rebate as a sweetener and sold the property for \$6.1 million. Dangling public funds to increase profits shocked the Vernon Hills board; village officials concluded that if significant profits could be made quickly, tax incentives were probably unnecessary in the first place (Zawislak, 2011). Though the village board soon after adopted conditions that future rebates would have to be repaid if the property is sold, previous attempts by local governments to attach this contingency have met with little success. In 2004, for instance, after Carpentersville, Ill., proposed a no-leave clause, Home Depot backed out of its negotiations with the village. It was not until after the village board removed the stipulation that Home Depot returned to the table and was granted a \$900,000 rebate.

Legislative Responses to Rebate Agreements

The criticisms just outlined are not easily overcome. Indeed, recent research has found that local governments that extensively use tax incentives to lure businesses have a higher probability of suffering stagnating economies and lower tax bases (Zheng and Warner, 2010). Yet, in spite of the difficulties associated with gauging the effectiveness of tax incentives, local expenditures for rebates continue to proliferate.

In response to those concerns, California and Illinois — the two states whose municipalities have appeared to most heavily use STRRs for economic development — have attempted to limit or outright preclude the use of rebates. Because of California’s experience with anti-STRR legislation, the state is a standard that other states can look toward for guidance. Thus, it is instructive to begin with a recapitulation of California’s legislative history. We can then look at why Illinois’s legal framework may be inadequate.

California’s STRR Legislation

California’s first foray into limiting the use of STRRs began in 1998 with the introduction of AB 1835. The bill sought to preclude local governments or redevelopment agencies from offering

any form of financial assistance to an automobile dealership or big box retailer, or a business entity that sells or leases land to an automobile dealership or big box retailer, that is relocating from the territorial jurisdiction of one community, or city or county, to the territorial jurisdiction of another community, or city or county, but within the same market area.

The legislation specified that “relocation” meant the closing of one dealership or big-box retailer and opening an identical one in a neighboring city within one year, and a “big box retailer” was defined as a store with a business area in excess of 75,000 square feet. However, the bill twice failed to pass the Senate Local Government Committee.

The following year, a nearly identical bill was introduced. The new legislation, AB 178, differed from AB 1835 in only three respects. First, it contained a sunset clause that lifted the prohibition of STRR agreements effective January 1, 2005. Second, it allowed for STRR agreements to continue through the sunset date *only* if the new jurisdiction shared the sales tax revenue with the old jurisdiction. Third, it required the California Research Bureau to evaluate whether the revenue-sharing requirement was working as an effective discouragement tool. Unlike its 1998 counterpart, AB 178 was eventually enacted.

By 2003 the Legislature was again considering another anti-STRR bill.⁶ SB 114 modified existing law by removing the sunset clause instituted by AB 178, redefined automobile dealership to vehicle dealership, and eliminated the revenue-sharing clause. Although the Senate Local Government Committee’s chief consultant, Peter Detwiler, cautioned that AB 178 was a test program and that not enough time had passed to determine if the policy was effective, the bill passed.

By 2008 the Legislature was considering AB 697, which had much stronger provisions than the anti-STRR bills considered so far and was aimed at stopping the practice of using STRRs to encourage buying companies. The bill would have precluded a local agency, a consultant, an agent acting on behalf of a retailer, or any other person from entering into any agreement that transferred, diverted, or rebated any sales tax revenue when two conditions applied: the agreement results in a reduction in the amount of revenue that is received by another local agency from a retailer that is located within the territorial jurisdiction of that other local agency and the retailer continues to maintain a physical presence within the territorial jurisdiction of that other local agency. The bill passed both chambers, but then-Gov. Arnold Schwarzenegger vetoed it because he considered it a low priority. The following year, SB 27 was introduced with identical language, again passed both chambers, and was eventually signed by the governor.

AB 697 was not California’s first attempt at prohibiting buying companies, but it was certainly

the strongest response. The state’s first substantial piece of legislation targeting buying companies was AB 451 of 2005, which was introduced after anger surfaced over Oakland’s 2003 STRR deal with United Airlines. The new law required that revenue from jet fuel sales be allocated to the jurisdiction in which the fuel was delivered, not the jurisdiction where the sale for the fuel occurred, which is a significant exception to California’s situs-based sourcing method.

As is clear in the enacted legislation, California’s Legislature initially sought to preclude STRR agreements with retail businesses in an effort to discourage incentive shopping. By 2008, however, the focus shifted to precluding buying companies as well. Interestingly, even though AB 697 was vetoed, lobbyists representing Modesto convinced Assembly member Loni Hancock, AB 697’s author, to extend the effective date of her bill a few months so that the city could finalize rebate agreements with five different petroleum companies that promised to set up buying companies within city limits.

Illinois and STRR Legislation

Since 1995 Illinois law has allowed municipal authorities to enter into rebate agreements if:

- the property being developed has been vacant for at least a year;
- the project is expected to create or retain job opportunities within the municipality;
- the project enhances the tax base of the local economy; and
- without the agreement, the development project would not proceed.⁷

In 2004, however, the General Assembly instituted additional limitations on the rebate agreements, particularly those in which firms establish buying companies. More precisely, HB 4705 precluded corporate authorities of a municipality from entering into rebate agreements with retail businesses if the tax on those retail sales, absent the agreement, would have been paid to another unit of local government, and if the retailer maintains, within that other unit of local government, a retail location from which the tangible personal property is delivered to purchasers, or a warehouse from which the tangible personal property is delivered to purchasers.

If we consider California’s legislation, two flaws in HB 4705’s provisions are apparent. First, the burden of satisfying the counterfactual in the first condition is unclear and strikes me as being easily fulfilled with a bit of chicanery. A business could claim that if the receiving municipality had not offered the STRR agreement, it would have consolidated its sales office, and that would be difficult to

⁶The legislator sponsoring AB 1835 and AB 178, Assembly member Tom Torlakson, had in the intervening years been elected to the Senate. He is now the state superintendent of public instruction.

⁷See 65 ILCS 5/8-11-20.

disprove. Second, in SB 27, California precluded municipalities from forming STRRs with any businesses, whereas HB 4705 singles out only retailers (at least on what I consider a strict interpretation), which creates some confusion about what types of businesses the law applies to and what types of business it is intending to target. I discuss this in more detail shortly.

There are other criticisms of Illinois's treatment of STRRs. For starters, requiring that a project create job opportunities is a poor standard because it overlooks the meaningful difference between net job growth and gross job growth. It is not enough to require simply that a new business hire x amount of workers, because that could be satisfied by simply attracting workers from other businesses within the city or importing them from neighboring cities. In both cases, the net job growth in the city would be zero, and therefore the subsidy would have been given without any type of meaningful consideration in exchange. A similar argument can be made about the requirement that the project enhance the city's tax base. The critical criterion for growth is whether the project will increase net tax revenue. Part of that may be accomplished by exporting the tax base if the project has the capacity to attract outside shoppers, but in-city consumers who merely shift their consumption will not increase net revenue. From a state and regional economic perspective, municipal exchanges of gross workers and gross tax bases amounts to unproductive competition because there is no change in net total output.

The critical criterion for growth is whether the project will increase net tax revenue.

The General Assembly would not revisit STRRs until 2011, when it passed and Gov. Pat Quinn (D) signed SB 3952, which sanctioned the use of STRR as a tax incentive for consultants and developers and limited rebates to covering project costs. More importantly, however, SB 3952 clarified that rebate agreements with consultants and developers did not constitute an economic incentive agreement under which the requirements of job creation or retention, tax base growth, or any of the other criteria applied.

In light of SB 3952 and HB 4705, the Regional Transportation Authority lawsuit highlights some confusion in Illinois's statutes that hopefully the court will address. To illustrate, let us look at the statute enacted by HB 4705, which the Regional Transportation Authority cites:

The corporate authorities of a municipality shall not enter into any agreement to share or rebate any portion of retailers' occupation taxes generated by retail sales of tangible per-

sonal property if: (1) the tax on those retail sales, absent the agreement, would have been paid to another unit of local government; and (2) the retailer maintains, within that other unit of local government, a retail location from which the tangible personal property is delivered to purchasers, or a warehouse from which the tangible personal property is delivered to purchasers. (65 ILCS 5/8-11-21)

On a strict interpretation, before the enumeration of the conditions, it is unclear if the statute is precluding agreements between all municipalities and a particular subset of businesses such as retailers, consultants, or developers, or if it is precluding agreements between all municipalities and all businesses. That is, we do not know what types of businesses the law is intending to target: We know only that it applies to all municipalities. In the second enumerated condition, though, retailers are singled out. It is unclear whether "the retailer" is intended to apply to the whole statute (and is therefore implicit throughout) or if it applies only to the portion in which it is explicitly expressed. If the former is true, municipalities are not precluded from forming STRRs with consultants and developers because consultants and developers are not engaged in the sale of retail and therefore are not retailers according to the Retailers' Occupation Tax Act. Thus, the practice of establishing buying companies is valid. If the latter is true, it leaves unanswered just what types of businesses are precluded from forming agreements with municipalities.

Furthermore, it is unclear what constitutes "project costs" according to SB 3952, and therefore consolidating sales offices could still be valid under 65 ILCS 5/11-74.3-3 (SB 3952's enacting statute) rather than under 65 ILCS 5/8-11-21 (HB 4705's enacting statute). Consultants who encourage businesses to set up buying companies must rebate a portion of their sales tax revenue disbursed by the municipality to the businesses brought into the jurisdiction. The consultants' rebates are their project costs, and those costs, by all appearances, are permitted under SB 3952 in part because what constitutes project costs is not defined. And, of course, cities could still form STRR agreements with firms like United Airlines directly under the same interpretation. The challenge, then, is to clarify how HB 4705 and SB 3952 can coexist, particularly if HB 4705 is interpreted broadly to apply to all businesses including consultants and developers.

Judicial Responses to Rebate Agreements

In addition to the two states' legislatures weighing in, courts in multiple states have questioned the legality of local tax subsidies for economic development more generally. A quick overview of relevant cases may prove useful for states like Illinois that are looking to combat STRRs.

In 1976 the city of Pigeon Forge, Tenn., imposed an additional 1 percent gross receipts tax on all businesses in city limits and later earmarked 75 percent of the funds for businesses and tourism. In 1980 the Tennessee Supreme Court sought to determine in *Smith v. City of Pigeon Forge* (600 S.W.2d 231) if the earmarked expenditures violated article 2, section 29 of the state's constitution, which the court previously had interpreted as meaning that public revenue could be spent only for public purposes. In prose that might be helpful for framing legal challenges to STRRs, the court said:

The express language of Pigeon Forge ordinance 143 mandates the use of seventy-five percent of the tax revenue for the benefit of the business community and tourism, leaving the public at large with only the remote hope that it may derive some incidental benefit from the promotion of private business enterprises wherein neither it nor its representatives have any participation in management or profits.

The court found that the allocation of tax revenue to aid businesses was in violation of the state constitution and it nullified the city's ordinance. And though the court in *Smith* did not specifically address the use of a STRR, Pigeon Forge's ordinance was sufficiently similar in verbiage and intent that we would likely expect a similar decision if the issue of rebates was considered today.

More recently, in 2010 Arizona's Supreme Court was asked in *Turken v. Gordon* (CV-09-0042-PR) to determine the legality of STRRs. In 2007 Phoenix entered into a sales tax rebate agreement with real estate developer NPP CityNorth LLC. Under the agreement, the city used a \$97.4 million sales tax rebate to subsidize the firm's development of a \$1.8 billion high-end retail center by purchasing nonexclusive rights to 2,980 parking spaces and exclusive rights to 200 park-and-ride spaces. Article 9, section 7 of the Arizona Constitution — the "gift clause" — states that no state or local government can give, loan, donate, or grant its credit to any private company or corporation.

In its decision of whether the rebate agreement violated the gift clause, the court applied the facts to a two-prong test. Government expenditures do not violate the gift clause if they have a public purpose and in return for the expenditure, the governmental agency receives something proportional or greater to what it gave up. The court found that the Phoenix City Council in ratifying the agreement was allocating funds for a public purpose (the use of parking spaces), but also found that "the City's payments to NPP under the Parking Agreement are grossly disproportionate to the objective value of what NPP has promised to provide in return." Despite reaching that conclusion, the court opted against invalidating

Phoenix's agreement and said that its judgment on the constitutionality of STRRs should be applied prospectively.

Other states without restrictive gift clauses have also used a two-pronged test. The New York Court of Appeals dismissed a complaint in 2010 charging that a state development agency appropriating funds to private businesses for economic development was an instance of gifting state money⁸ because "an appropriation is valid under the Constitution so long as it has a predominant public purpose and any private benefit is purely incidental" (see *Bordeleau v. State of New York*, 74 AD3d 1688). The North Dakota Supreme Court ruled in 2008 that state appropriations to private entities are not prohibited by the state's gift clause⁹ so long as some consideration is given in exchange (see *Teigen v. State of North Dakota*, ND 88). And although the court said that "if consideration exists, courts generally will not inquire into the adequacy or value of the consideration," it also said that "if that amount of money becomes too disproportionate to the services required under the contract, we are not precluded from revisiting this issue."

In these states there are two clear requirements that must be realized to satisfy their constitutions' respective gift clauses: the expended funds must be for a public purpose and there must be consideration in exchange. Two questions of proportionality immediately arise, however. First, to what extent must the agreement be for public purpose? And second, to what extent must there be consideration? In *Turken*, the construction of shopping center parking spaces was argued to be mostly for public purpose, but the amount of parking spaces was not proportional to the appropriations. That is, the incentive passed the first test but failed the second. In New York and North Dakota, public appropriations were upheld as constitutional because they were argued to be mostly for a public purpose and there was at least some service or good provided in exchange.

Historically, gift clauses were adopted to prevent waste and abuse of subsidies that many states experienced during the early and mid-1800s (Barr 2007), and the cases just described illustrate the importance of gift clauses for purposes of preventing the proliferation of potentially wasteful incentive schemes like STRRs. For comparative purposes, California's gift clause (article 16, section 6) limits only the agreements the Legislature can make with private interests; it places no limitations on local

⁸See Art. VII, section 8(1) of New York's constitution.

⁹See Art. X, section 18 of North Dakota's constitution.

governments.¹⁰ Moreover, Illinois does not appear to have a gift clause along the lines considered but only a loose provision that public funds, property, and credit shall be used for public purposes,¹¹ while the state's requirement that rebate agreements be in the best interest of the municipality is sufficiently vague that it offers Illinois courts no assistance in determining how consideration in light of a two-prong test should be weighed.¹²

Lessons to Be Learned

Given this background, we can make a partial inventory of lessons thus far learned about STRRs and recommendations for states and municipalities. First, I must acknowledge that I agree with Detwiler that at some level it is not in the best interest of states or municipalities to have the former micromanage the finances of the latter.¹³ To that end, I applaud Illinois for allowing local authorities to enter into STRRs of the non-buying company kind even if the guidelines for STRR approval are insufficiently vague. By comparison, California appears to be micromanaging.

Unarguably, the largest obstacle in further understanding the effect of either type of STRR is a lack of data. Because each sales taxing district in Illinois, for instance, can draft STRR agreements and has no obligation to report them to the state, it is essentially impossible to tell how widespread the practice is or how much in sales tax subsidies has been paid. Therefore, it is impossible to evaluate STRRs' efficacy and what effect they may have on other municipalities or the state in terms of economic development. States that decide to sanction STRRs, then, should also require that municipalities report each agreement and its terms to the appropriate state entity.

It is essentially impossible to tell how widespread the practice is or how much in sales tax subsidies has been paid.

It is also important that if a state opts to sanction one type of STRR while precluding the other type, clear guidelines are also provided that identify what types of businesses the laws are intended to target. However, targeting particular business types may

run afoul of many state constitutions' clauses requiring uniform treatment of taxpayers. Also, state laws that allow in-state companies such as retailers to enter into STRRs but prohibit out-of-state consultants that encourage establishing buying companies from doing the same may violate commerce clause protections. If that is plausible, I think a reasonable, but insufficient rebuttal is that there is no nondiscriminatory alternative that protects state and regional interests from the deleterious effect of out-of-state business-hunting consultants (see *Maine v. Taylor*, 477 U.S. 131 (1986)). I believe it is insufficient because there is a nondiscriminatory alternative, namely, prohibiting any municipality from entering into any STRR agreement of any kind with any person or business entity, as California did with SB 27. Alternatively, states concerned with the formation of buying companies could enact destination-based sourcing; however, the administrative costs associated with doing so may be too high.

There is a trade-off between unproductive competition (from the state's perspective) and municipal fiscal autonomy. The Regional Transportation Authority lawsuit will offer states an additional opportunity to see how the courts reason through a legal framework that does little to identify at what point the trade-off is not permissible. Indeed, I suspect that most states pass the buck on the question and leave it to the courts to draw the line, which is an unfortunate practice because it gives municipalities an incentive to conceal STRR agreements because of the threat that courts might invalidate their efforts. Instead, a legislature should explicitly identify the conditions under which local funds can be used — that is, what they can be used for, how much can be used, and what is the appropriate level of consideration that is necessary in exchange. In addressing those issues, particularly the level of consideration, state and local legislative bodies should concern themselves primarily with net changes in economic development.

One final insight I think is worthwhile. California's AB 178 (1999) required that any resultant revenue from a STRR be shared between the new and old jurisdiction if the STRR required a business to relocate. That provision strikes me as a reasonable balance between limiting the pernicious effects of STRRs and not micromanaging local finances. First, there was no blanket preclusion, as was eventually instituted in SB 87, so municipalities retained some fiscal autonomy. Second, because the revenue from a STRR must be split somehow between three entities rather than two, the marginal benefit to be enjoyed by either the new jurisdiction or the business decreases. Consequently, there is less incentive to relocate unless it is for a business decision unrelated to the rebate, in which case the rebate would have been unnecessary anyway.

¹⁰A 1992 STRR between Camarillo and a developer, Chelsea Realty, was held to be a violation of California's gift clause in an unpublished opinion from the Ventura County Superior Court.

¹¹See Art. VII, section 1 of Illinois's constitution.

¹²See 65 ILCS 5/8-11-20.

¹³See Detwiler's analysis of AB 178 (1999).

Conclusion

The uproar in Illinois over STRRs has once again pitted the interests of municipalities against the interests of the state. Although STRRs have a long history, particularly in California and Illinois, their existence has remained largely unknown except to local government insiders. When California municipalities on the losing end of STRR agreements experienced sharp declines in revenue, they successfully mobilized and lobbied the state to pass laws barring the use of the tax incentive. By comparison, Illinois has opted to sanction STRR agreements for local retailers and dealerships while prohibiting STRR agreements for buying companies. The decision to treat STRR agreement types differently breeds a level of ambiguity that I have argued the Illinois General Assembly has failed to address. Unless the Regional Transportation Authority lawsuit is preempted by clearer law, the courts will once again have to impart some order on statutes that are in disorder.

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