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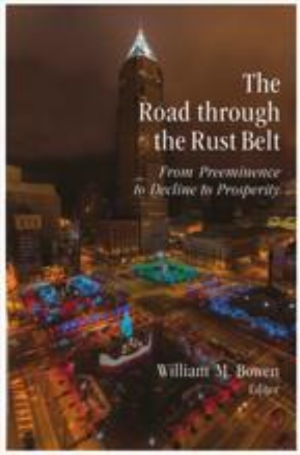

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From Preeminence to Decline to Prosperity

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Can Tax Expenditures Stimulate Growth in Rust Belt Cities?

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An oft-used arrow in the quiver of those overseeing local and regional economic development is the incentivization of tax expenditures (public investment via tax abatements and credits, infrastructure improvements, and workforce training). Most states and communities, including those in the Rust Belt, participate in the game to some extent, leading to competition for promised jobs and economic activity. Despite the willingness to offer such incentives, there is at best scant evidence that these incentives are an efficient use of public funds.

Why do some cities thrive economically and others sputter and decline? Are success and failure dependent on luck, or is there something more profound at play? While there are many ways to address these issues, and certainly many contributing factors, this chapter will examine one part of the question: Can tax expenditures play a role in stimulating the growth of these cities? Consideration of the role of tax rates, rather than tax expenditures, is also important but is outside the scope of this chapter. Instead, the discussion will focus on how and why state and local governments use tax expenditures to attempt to improve the conditions of their communities.

This chapter seeks to demonstrate that tax expenditure policy is a highly inconsistent use of public funds. Local governments are at the mercy of a larger macroeconomic environment, over which they have little influence (Rubin and Rubin 1987). The lack of control leaves localities with few tools to create positive change in their communities. The device that these governments often turn to is tax expenditures. As will be indicated, unfortunately, tax expenditures have been demonstrated for the most part to play little-to-no role in positive economic development. Further, despite this evidence, politicians continue to see tax expenditures as one of the most important options available to them.

Using a case study of an intraregional corporate headquarters move, this chapter will investigate how competition among jurisdictions transfers wealth, yet creates few, if any, benefits. It then explores how cities, counties, and other countries are dealing with the competition for jobs that leads to tax expenditures and associated movements of wealth. Finally, there will be a brief examination of some alternative economic development tools that do not result in the large shifts of wealth associated with tax expenditures.

WHAT ARE TAX EXPENDITURES?

The bundle of tools that state and local government officials use within the tax code to try to encourage development are called tax expenditures; they may also be viewed simply as spending that has been initiated through the tax code. Surrey (1970, p. 706) describes them as "special provisions . . . which represent government expenditures made through [the tax] system to achieve various social and economic objectives." The state of Ohio's Executive Budget describes tax expenditures in the following way:

> Both tax expenditures and direct budgetary expenditures incur a cost to the state in order to accomplish public policy goals. Unlike direct budgetary expenditures, unless there is a pre-existing termination date, tax expenditures may remain in effect indefinitely with little or no scrutiny by policy makers. In most states, tax expenditures are not analyzed and reviewed as part of the budget appropriation process; Ohio is one of the relatively few states that do produce a tax expenditure report in conjunction with the state budget. It is probably safe to assume that if it were not for this report, the fiscal impact of the various Ohio tax expenditure provisions would not be systematically estimated (Testa 2011, p. 1).

Tax expenditures include tax deductions, tax abatements, and tax credits. Two examples are the federal mortgage interest deduction and hybrid car tax credits. While there is a general belief that the original goal of the mortgage deduction was to encourage homeownership, the subsidy came about largely by accident (Lowenstein 2006). Though the origin may have been accidental, the inability of opponents in Congress to rid the tax code of this tax expenditure could largely be tied to the myth that it is the backbone of increasing homeownership. The benefits generated from the mortgage interest deduction accrue to those that own homes, have mortgages, and itemize their tax returns—which ends up being about 37 million people, or about half of the individuals who own homes (Lowenstein 2006). It does not directly benefit renters or even the lower-income homeowners who do not make enough money to itemize their deductions.

In a less accidental turn of events, the early adopters of the Toyota Prius received tax credits the year they purchased the car. The size of this hybrid car credit varied from year to year, but it provided a direct subsidy, through the tax system, that encouraged the ownership of fuel-efficient automobiles. And like spending on roads or other goods and services, all tax expenditures are transfers of resources from one group to a designated priority; however, in the case of tax expenditures, the wealth transfers are manifested in lower tax payments for select groups or firms.

Tax expenditures are found at all levels of government. State and local governments have been using tax expenditures to lure and develop businesses since colonial times—in fact, Alexander Hamilton was the beneficiary of a tax expenditure by New Jersey in 1791 to locate a factory in the state (Buss 2001). Despite the long history of tax expenditures in the United States, it was not until after the end of World War II that their use gained significant traction. The changing political moods of the 1980s and 1990s further fueled the practice, leading many to see tax expenditures as “free money,” by simplifying them as foregone revenues rather than a true expense.

The flawed view of tax expenditures is problematic for budgeting and makes fiscal policy evaluation exceedingly difficult. Some states, such as Ohio (where the case study in this chapter takes place), do try and estimate the budget impact of tax expenditures. Further, the evidence, even if it may not be precise, presents a story of a big budget hole, \$7.4 billion in fiscal year 2012 and \$7.8 billion in fiscal year 2013 of “foregone revenues” or tax expenditures for Ohio (Testa 2011, p. 9). Taken together, at more than \$15 billion, Ohio would not have had a deficit to work around for the biannual budget for fiscal years 2012–2013 and would have actually been in surplus for both years. The magnitudes for local governments will clearly be much smaller, but the comparative impacts can be just as large.

States often “prefer not to evaluate tax incentive programs in any way,” thus avoiding the difficult question of their effectiveness (Buss 2001, p. 93). Rigorous evaluations are often requested when direct expenditure subsidies are provided to individuals or businesses (i.e., grants, food stamps, welfare checks), but they are frequently not required when tax expenditures are being considered (Buss 2001). This results in a huge void in our understanding of their impact on the fiscal condition at all levels of government. The state of Ohio report on tax expenditures specifically states that it “offers no conclusions about the validity of those expenditures. The responsibility of evaluating the expenditure’s merit with regard to public policy belongs jointly to the General Assembly and the Governor” (Testa 2011, p. 1).

Neither of the preceding parties has offered a comprehensive in-depth analysis of the effectiveness of these programs. This demonstrates that, even in a state that has made efforts to actually account for and report on the size of the tax expenditure budget, there still remains a huge hole in our understanding of how effective these policies are at achieving their goals. More broadly, however, tax expenditures decrease the transparency of government budgets. Tax expenditures “allow politicians to appear to be reducing the size of government (reducing taxes) while actually increasing it (increasing spending)” (Steuerle 2000, p. 1639).

At the local level, tax abatements are one of the most common types of tax expenditures. Tax abatements are the product of a process that is both bureaucratic and political in nature and result in lowering the property tax burden on specific parcels of land. The political aspect of tax abatements demonstrates how they are meant for more than just tax relief, to encourage redevelopment of an area or economic growth more broadly (Dalehite, Mikesell, and Zorn 2005). Finding a comprehensive study of a state’s local tax expenditures is not possible. States that allow tax expenditures at the local level have “established the fiscal framework under which local governments operate, including determination of the tax options available to them and the extent to which those governments may adopt exceptions to the general structure” (Mikesell

2002, p. 41). While some states track major local taxes, “local tax expenditures are not detailed to particular local governments” (p. 41). What this all means for state and local governments is that they need to allocate more resources to investigate the effectiveness of tax expenditures if they are going to use them—something that just is not happening right now.

Why Are Tax Expenditures Being Used? Are They Effective?

Poor and rich cities alike have been employing tax expenditures to attempt to spur economic development across the country, and not just in the Rust Belt. The strategy is used to encourage development and attract new jobs, under the assumption that if net taxes (taxes minus all tax expenditures) in one city are higher than in its neighbor’s, jobs will flow to the jurisdiction with the lower net tax rate.

Unfortunately, this generally accepted and overly simplistic notion is not consistent with the evidence. A firm’s decision to locate in a community (leading to an inflow of jobs to that community) is far more complex than making a comparison of taxes across jurisdictions (Chi and Hoffmann 2000; Wassmer 2007). The location decision-making process falls under a much broader concept of business climate—although there is significant disagreement over how we can actually measure climate—but it typically includes the quality of life, government policies, and the quality and cost of resources (Buss 2001). Some business climate measures amount to seeking out the state with the lowest wages, taxes, and utility cost, paired with the weakest regulations, the absence of a unionized workforce, and high subsidies for capital (p. 98). However, it is clear that if that were the only possible determinant for firm location, the states with the nation’s highest tax burdens, such as New Jersey, New York, and Connecticut, would be without employers, and that is clearly not the case.

What does have a clearer connection to a firm’s location decision is the linkage between the levels of revenue collected and the services provided by a jurisdiction. Consequently, the bundle of features a firm seeks out, including tax rates and expenditures, involves not just the taxes, but the taxes and level of service provided (Buss 2001). As with any sort of investment, firms seek ones (in this case, in their location) that will bring the biggest “bang for their buck,”where most are willing to pay a higher tax rate if the service they are receiving is also higher quality or more comprehensive.

The Impact of Tax Expenditures

Ideally, investments yield positive returns. Similarly, the appropriate use of tax expenditures "should produce economic benefits greater than [their] costs. An even better [tax expenditure] is one that is cost-effective, meaning that it delivers more benefits for a given cost than other similarly targeted initiatives" (Weiner 2009, p. 6). Tax expenditures, particularly those targeted at large firms, have failed "to produce significant net benefits for their host communities, calling into question the high-stakes bidding war over jobs and investment" (Fox and Murray 2004, p. 78). Weiner (2009) shows that "for each dollar of credit granted, states usually collect less than one dollar in new tax revenue. Thus most credits do not appear to 'pay for themselves.' It is therefore important to understand the benefits states are gaining for the revenues they are giving up" (p. 4).

The discussion of benefits foregone is often one that is not had by states and local governments. A great deal of effort goes into crafting tax expenditure policies, for little or no payoff, while much of what affects local/regional economic growth (labor costs, skilled workers, energy cost, natural resources, or climate) is beyond the control of these governments (Bradbury, Kodrzycki, and Tannenwald 1997).

When a government entices a large firm to move to a particular jurisdiction with a host of incentives, including tax expenditures, "the location of a large company can crowd out other economic activity by shifting sales from existing firms, congesting local infrastructure, and raising prices in factor markets" (Fox and Murray 2004, p. 79). A large organization locating in an area can create a diminishing return (Fox and Murray 2004; Porter 1999). This may come about because a large firm may choose to locate in an area without other significant competition in order to dominate that place and discourage other large companies from locating there (Fox and Murray 2004); these businesses may actually be hampering further economic development, rather than encouraging it.

Examples of this can be seen in Mercedes-Benz locating in Tuscaloosa County, Alabama (where the firm claims to be the "state's largest exporter, with more than $1 billion exported each year to countries throughout the world" [MBUSI 2011]); and BMW in Spartanburg, South Carolina (where the company asserts that it is "one of several powerful engines driving the state's growth" [BMW 2011]); and Volkswagen in Chattanooga, Tennessee (where the "plant is expected to generate $12 billion in income growth and an additional 9,500 jobs related to the project" [Volkswagen Group of America 2011]); and Kia Motors locating in West Point, Georgia (where the "project is the largest in history for the State of Georgia" [KIA Motors 2011]).

The incentive packages that these firms received were substantial, but they were only a small part of the firms' decision-making process. Ultimately, the data on firm site selection show that "the location of a large firm has no measurable net economic effect on local economies" if it is examined holistically (Fox and Murray 2004, p. 79). This means that the aggressive effort to recruit firms "fails to create positive private sector gains and likely does not generate significant public revenue gains either" (p. 79). This can be interpreted to mean that the siting of a firm, often lauded as a major "win" by state and local development agents, may not actually have the great effect promised. Because "there is little evidence of positive or negative growth impacts associated with the location of large firms," local governments should instead try to make more cost-effective economic strategic moves (p. 91).

The big "win," as seen in high-profile "mega-events" like the Super Bowl and Olympics, which cities constantly fight over, also provides very little help in spurring economic development. Activities like the Super Bowl or Olympics "have no real effects on spending in host communities," a result that can in part be blamed on the "crowding-out phenomenon," where long-term economic activity and investments lose out to short-term jobs (Fox and Murray 2004, p. 79).

Distributional Issues

The intent of many property tax abatements is to draw employers to an area that might have otherwise been ignored; this can help to create conditions that improve economic equality. When the tax expenditures are constrained only to high-poverty and high-unemployment areas, research suggests that tax expenditures can provide a disproportionate benefit to minorities and low-income individuals (Bartik 2007; Peters and Fisher 2004; Wassmer 2007; Wassmer and Anderson 2001).

However, most applications of economic-development-oriented tax expenditures create an environment of inequality (Bradbury, Kodrzycki, and Tannenwald 1997; Chi and Hoffmann 2000; Goss and Phillips 1999; Greenbaum, Russell, and Petras 2010; Kocieniewski 2011; Reese 1991; Reese and Sands 2006; Wassmer 2007). Tax expenditure policies tend to exacerbate inequality across a region, rather than abate it. The wealthy jurisdictions can afford tax expenditures that the poor ones cannot, which can lead to the rich getting richer (more jobs and economic development) and the poor jurisdictions getting poorer (Dewar 1998; Goss and Phillips 1999; Reese 1991; Reese and Sands 2006). This is not to say that poor cities are not using tax expenditures, but that these expenditures often put additional stress on communities in an already difficult financial position (Rubin and Rubin 1987). For rich and poor cities alike, these incentives rarely provide the benefit they promise, and those benefits they do provide rarely exceed the costs (Reese and Sands 2006; Wassmer and Anderson 2001).

Moreover, the benefits associated with tax expenditures tend not to accumulate where policymakers state they are supposed to accummulate (which is often in economically distressed areas). Goss and Phillips (2001), for example, find that "business tax incentives have had a positive effect on economic growth in low-unemployment counties, but not in high-unemployment counties" (p. 237) and "tended to be undertaken in areas with historically higher investment activity, thus contributing to greater economic performance differences among counties in the state" (p. 217). Tax expenditures have often been "criticized because they are only effective at the margins in business location decisions" (Reese and Sands 2006, p. 72). Negative relationships have been found between some types of tax expenditures and the improvement of a jurisdiction's economic health spanning a 20-year period. While this does not mean that in all instances tax expenditures will have a negative impact on a jurisdiction, the research indicates that by not using tax expenditures jurisdictions are not hindering their growth (Reese and Sands 2006).

Tax expenditures may foster inequality by favoring one industry over another. A great number of tax expenditures concentrate exclusively on manufacturing, but in the process end up ignoring other important sectors such as business services, health care, and finance (Buss 2001).

At the federal level, the corporate tax system can rightly be considered both uneven and highly complex (Kocieniewski 2011), in large part because of tax expenditures that benefit individual firms or specific industries. The inequity can spread to an intra-industry inequality, where two companies in the same industry, producing very similar products, have different tax rates. This is often a result of the larger firm having more power and wealth, allowing it to have its effective rates reduced through new tax expenditures. At the federal level, tax expenditures that "intentionally benefit specific companies or industries, cost an estimated $100 billion more a year" (Kocieniewski 2011). However, Greenbaum, Russell, and Petras (2010) show that when controlling for the location of tax expenditures, neither distressed areas nor specific industries were seen to benefit, and that instead tax expenditures (or incentives) were distributed in a pattern that "largely reflects the local industrial mix" (p. 155). This same study did find disparities between urban and rural areas, where the benefits of tax expenditures accrued at higher rates to rural than to urban locales.

Many who support interjurisdictional competition claim that it reduces taxes for all competing jurisdictions. This assertion, however, is only valid when jurisdictions "are similarly endowed with taxable resources and face similar fiscal challenges" (Bradbury, Kodrzycki, and Tannenwald 1997, p. 12). Reality tells us that jurisdictions within a region are rarely in the same resource/fiscal position, because some "jurisdictions are continual winners and others perpetual losers in the competitive process, especially in the absence of equalizing aid from a higher level of government" (p. 12).

To make matters worse, most states do not have any written guidelines for determining how and when tax expenditures to business are offered (Chi and Hofmann 2000). This can result in inequality in the distribution of tax expenditures and make evaluation of the programs very difficult. Iowa, seeing some of the problems in Minnesota, where "tax incentives tend to be focused on those areas already primed to do well," limited its tax expenditure program to "business investment in areas of the state lagging in economic performance" (Goss and Phillips 1999, p. 226). Focusing on a particular socioeconomic group does not necessarily mean that the tax expenditures will provide a greater benefit than cost, but, in terms of creating policy aimed at alleviating inequality, Iowa at least targets communities in greatest need.

Information and Competition

If tax expenditures are only effective at the margins, as Reese and Sands (2006) indicate, a significant information asymmetry problem arises for local jurisdictions. They are faced with a task of determining which of those employers seeking the tax expenditures are the marginal cases and which are just seeking additional rents (or profit seeking) for a decision they have already made. Unfortunately, these governments have no good way to determine which cases are marginal and which are not. Traditionally, the outcome of negotiations between a firm seeking a tax expenditure and a local government depends on the relative power of the respective sides (Byrnes, Marvel, and Sridhar 1999). If a jurisdiction has little to lose if the firm leaves, it can certainly try and call the firm's bluff, wait it out, and hope for the best.

In Ohio, as the ability to offer tax abatements extends to more jurisdictions, the competition among these areas leads to larger abatements (Cassell and Turner 2010). From 1993 to 2009, nearly half of the 2,059 tax expenditures in Ohio that were approved by the state Tax Credit Authority "were terminated or canceled before completion" (Lieb 2011). The failure rate to which the state of Ohio is admitting is simply pointing out that these projects were terminated or cancelled, not that they were actually successful in creating the jobs or economic gains that they set out to attain. The current year projection puts tax expenditures approved in one year for eight northeast Ohio (the area that includes Cleveland/Akron/Canton) projects at $49.5 million over a period of 15 years (Schoenberger 2011). This results in large sums of money being promised for projects over the long term, which come with very high incompletion rates.

While these risky moves may be good for firms, the evidence that tax expenditures provide a net benefit is not very strong. Interjurisdictional competition is a zero-sum game, in which companies pit neighboring cities against one another for the best deal, and can hardly be described as good for development across jurisdictions. The consequences are the "job gains" for one city and "job losses" for its neighbor, a strategy that does not provide net benefits to the region. And, in many cases, the businesses have no intention of moving but just want to get a better tax expenditure deal in their current location (Lynch, Fishgold, and Blackwood 1996). Wohlgemuth and Kilkenny (1998) note that "acquiescing to the rent-seeking behavior of firms leads to socially suboptimal outcomes” (p. 140). The best case tax expenditures scenario, say Peters and Fisher (2004), “is that incentives work about 10 percent of the time, and are simply a waste of money the other 90 percent” (p. 32).

IF TAX EXPENDITURES ARE A LARGELY INEFFECTIVE TOOL, WHY ARE THEY USED SO FREQUENTLY?

If tax expenditures aimed at economic development have at best a 10 percent success rate, and are a waste of money the other 90 percent of the time, why do governments continue to use them? The reason appears to be political, rather than their economic value. Although nothing is inherently wrong with a strategy based on politics, tax expenditures programs are frequently sold to the public based on their effectiveness. It is time that politicians acknowledge that these are frequently political actions, not economic ones.

One reason tax expenditures are used so commonly is that politicians frequently do not view them as actual outlays of government revenues. The fight over what constitutes a tax expenditure and what constitutes a tax can pit long-time ideological allies against each other. For instance, in 2011, there was a battle over eliminating ethanol tax expenditures, which, coincidentally, were commonly referred to as subsidies in the media. Grover Norquist, iconic antitax champion and head of the group Americans for Tax Reform, was pitted against Senator Tom Coburn, an antitax conservative from Oklahoma, who was himself a signatory to Norquist’s famous antitax pledge. Norquist claimed that the elimination of ethanol tax expenditures was an increase in taxes for farmers and producers. In his view, a tax expenditure was not an expenditure at all but a part of the tax rate, so that any attempt to eliminate a tax expenditure was actually a tax increase. On the other hand, Senator Coburn rightly saw tax expenditures for what they are: spending. As a result, two natural allies publicly opposed one another because they could not agree on what constitutes an expenditure. This is problematic for the government’s ability to manage its finances and budget.

While two self-defined fiscal conservatives have fought over what is and is not a tax expenditure, the broader political marketplace is even murkier. Beyond the debate over the definition of tax expenditures, our political climate in recent decades has made new expenditures very difficult to justify. This has led to expenditures masquerading as tax cuts, and policymakers pushing for tax expenditures because they are more politically palatable than additional spending.

Job and industry mobility within the United States and internationally, or at least the perception of that mobility, increases the pressure to do something (Wolman and Spitzley 1996). However, it appears that the fear of relocation is not necessarily based on verifiable reality. Lee (2008) finds "a relatively small role for relocation in explaining the disparity of manufacturing employment growth rates across states" (p. 436). Also, firms moving from one jurisdiction to another, while not uncommon, cannot be explained by the incentive programs trying to keep or pull them to or from a jurisdiction. In some situations, these incentive programs are even positively correlated with a loss of jobs or shuttering of factories. This may just indicate that state and local governments are acting too late to keep firms that are moving jobs, but it may also show that tax expenditures simply are not what drives the decision to locate or relocate. A number of tax expenditures, particularly those for capital purchases, actually have a negative impact on employment because they are making the machinery and equipment that replace laborers cheaper, resulting in layoffs (Lee 2008).

Cutbacks in state and federal intergovernmental aid are putting burdens on local governments to do more with less (Wassmer 2007). At the heart of the $1.4 billion budget impasse that shut down the state of Minnesota in July 2011 was more than $400 million in cuts to local governments (Dunbar 2011). Ohio's 2011–2013 biennial budget cut its support to local governments by nearly half a billion dollars (Marshall 2011). The challenges that many local governments face are not just found in shrinking intergovernmental aid, but also in the ways and amounts of money that can be raised. Here again politics is a primary agent. State lawmakers are compelled to do *something*, which often results in the institution of property tax restrictions that further hinder the ability of local governments to raise money. These cutbacks and restrictions cause local governments to seek out alternative ways to redevelop their economic situation. The result has often been the use of tax expenditures policy, "not because it was effective but because it was a remarkably easy path to follow, one that allowed [politicians] to claim they were mounting a serious attack on the economic problems of the city" (Swanstrom 1985, p. 149). The tax expenditures allow politicians "to take a bow for causing some massive private project" or "point to towering skyscrapers downtown and say, 'without my help these never would have come about'" (pp. 149–150).

Often it appears as though "the solutions not only precede the problems, they may supersede them and provide their own motivation" (Rubin and Rubin 1987, p. 57). As a consequence, short-sighted public officials trying to maximize reelection probabilities "may offer more incentives than required. That is, the closer the negotiation with business is to an election, the less chance the government official will take in 'losing' the business, and the more likely the incentive package will be larger" (Byrnes, Marvel, and Sridhar 1999, p. 809). To counteract these self-serving political aspirations, adding citizen involvement could be beneficial in tax expenditure negotiations with firms.

Another element of the political calculation is the number of jobs the projects supported by tax expenditures will create. Both politicians and firms have a motivation to overestimate job numbers to justify spending. Gabe and Kraybill (2002) find that tax expenditure programs result in firms on average overestimating the number of jobs the tax incentives will create by 28.5 jobs with each facility's expansion. Their results "suggest that [tax expenditure] incentives do not result in the creation of more jobs than would have been created without the programs" (p. 724). Again, politicians are willing enablers of these approaches because they want to be seen doing "something" and want to be able to take credit for benefits—if any materialize. Voters are left without sufficient information to do post hoc evaluations of these programs, uncertain if the jobs were created as a result of the tax credits or not. The lack of an analysis of the promises made by the companies creates an incentive for these organizations to overestimate the benefits and to garner larger tax credits.

THE CASE OF BROOKLYN, OHIO, AND AMERICAN GREETINGS

The case of American Greetings (AG), the largest publicly traded greeting card company in the United States, provides a real-world example of the implementation of tax expenditures at the state and local levels in an attempt to keep or lure a firm. The predicament of Brooklyn, Ohio, a Cleveland suburb and site of AG's corporate headquarters, is all too familiar. In May of 2009, Brooklyn faced the challenge of choosing between drastic cutbacks to services and a tax increase in order to balance its budget. The citizens of Brooklyn voted, albeit narrowly, to raise the local income tax rate from 2.0 to 2.5 percent (Noga 2009). Between the time that this tax levy was put onto the ballot and the time that voters approved the measure, employers Key Bank, Hugo Boss, and AG all announced layoffs from their local facilities. In response, the city's leaders pledged that they would reduce the property tax millage from 6.9 to 5.9 if the income tax rate were increased, as it eventually was (Noga 2009). The total property tax rate for a Brooklyn property owner would be 75.9 mills for those without exemptions, and considerably lower for those who qualified for exemptions.

What transpired after the voters of Brooklyn approved the tax increase is a story that many cities face every year: AG threatened to move its headquarters out of the city because of the tax increase. The company stated that although it understood Brooklyn's predicament, it was "disappointed" in the action taken by the city (Cho 2010). AG then began a search for a new headquarters to locations not just in northeast Ohio, but throughout the nation. In return, Brooklyn promised to lower its income tax rate back to the 2 percent level at which it had been prior to the voter-approved increase, with some in the government pushing for it to be reduced to 1.5 percent. The challenge for Brooklyn Mayor Richard Balbier was that "you just can't take the taxpayers' money and give it to a company" (Cho 2011b).

By November 2010, AG had narrowed its new headquarters search to 15 Ohio sites, most of which were still in the Cleveland area, and to one in Chicago. Brooklyn prepared a tax expenditure package that would be worth \$6.5–\$10 million over 15 years (Cho 2011b). The state of Ohio got involved by passing a special tax credit for AG to remain in Ohio, signed ceremonially at the AG headquarters by Governor John Kasich. In total, the state package prepared to encourage AG to stay in Ohio equaled $93.5 million over 15 years (Cho 2011a). Days after this tax expenditure package was signed into law, AG announced that it was staying in Ohio.

A few weeks later, on May 20, 2011, AG announced that it was moving its headquarters to Westlake, another Cleveland suburb. Coincidentally or not, the new headquarters location is part of a larger development that is owned in part by members of the Weiss family, which leads AG (McFee 2011).

The move of AG's headquarters from Brooklyn to Westlake will be a devastating blow to its former home, as 13 percent of that city's revenues, or about $3 million, are generated from AG. Westlake may have won out over Brooklyn in part because of a lower tax rate (1.5 percent rather than Brooklyn's 2.5 percent), but company officials did make it clear that the decision was much larger than taxes. AG wanted "an environment that more accurately reflects and effectively supports our creative and innovative culture" (Cho 2011a). The firm also had an aging headquarters that needed to be replaced. If one considers total tax burdens, and not just the income tax, as is often the case, Westlake actually has a substantially higher property tax millage of 9.6. The total property tax burden for city residents is 100.9 mills, which includes city, library, schools, and county taxes (City of Westlake 2011a).

IF TAXES WERE NOT THE IMPETUS FOR AG LEAVING BROOKLYN, THEN WHAT COULD IT BE?

During the search for a new headquarters, executives of AG consistently stated that "they sought a location that would allow it to recruit and retain talent in an atmosphere fostering creativity" (Bullard 2011). The firm's chief executive officer stated that the new location, Crocker Park in Westlake, would provide AG with a "lifestyle center that will be attractive to our current and future associates. You will be able to shop, dine, and find a variety of leisure activities nearby. It is easily accessible from several local freeways. The amenities and environment at Crocker Park will give our associates in every department a place to flourish, and maximize their performance, innovation and creativity" (Bullard 2011).

The benefits of having more perks and services nearby have been mastered by Silicon Valley firms like Google, which have barbers, day care, dining, laundry, and recreation facilities. These perks for employees "have the added bonus of keeping the employee workforce in the office more often. Give employees enough reasons to stick around and you'll likely see productivity go up. Why head home when everything you need is at work?" (Strickland 2008). By moving to Crocker Park in Westlake, AG will have access to far more services that could potentially entice its workers to stay around the office longer and that perhaps could lead to higher productivity. This is clearly a benefit for AG that has nothing to do with tax expenditure policy.

By further comparing Brooklyn's and Westlake's infrastructures and finances, a clearer picture of AG regarding the move will start to surface. This is not to say that any one of these factors provides the answer as to why AG moved, but together they do create a picture of the differences between these two locations.

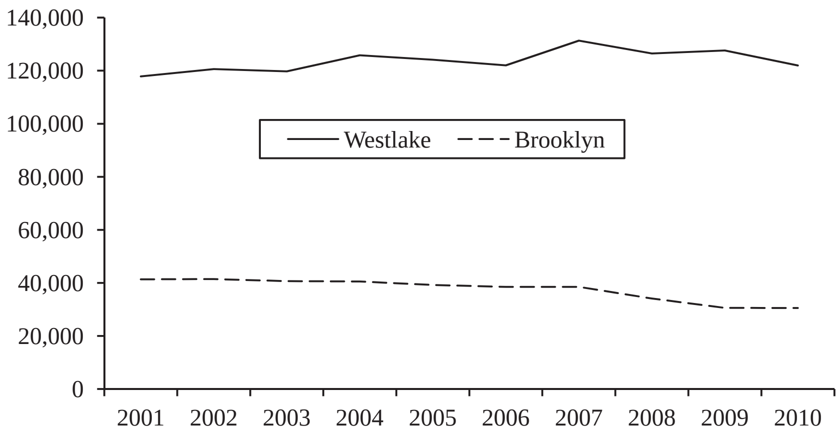
First and foremost, Westlake is a wealthier community than Brooklyn. This can be measured with two simple metrics: median household income and median value of homes. In 2010, the median home value in Westlake was about 89 percent higher than in Brooklyn, $234,000 and $124,100, respectively (U.S. Census Bureau 2010). Westlake's median household income in 2010 was 67 percent higher than Brooklyn's ($68,091 and $40,661, respectively). Westlake has fared substantially better during the housing bust that started across the country in 2008. Brooklyn saw the average sales price of homes drop by 24.33 percent between 2005 and 2010, while Westlake saw only a 12.12 percent decline. The 10-year change in prices for the two cities also shows a disparity: Brooklyn's average change from 2001 to 2010 was a decline of 8.02 percent, while Westlake saw a modest 0.56 percent increase (*Cleveland Magazine* 2011).

The disparities between Brooklyn and Westlake can be further examined by looking at the cumulative assessed value of both cities. Since the population sizes of the cities differ substantially, Figure 3.1 controls for assessed value based on population. What is demonstrated in this chart is that Westlake's assessed value per capita consistently hovers around a value that is about three times as large as Brooklyn's.

Next, Brooklyn also has 1.6 times as many people living below the poverty line as Westlake (6.6 percent below poverty for Brooklyn and 2.5 percent for Westlake). Why might a wealthier city attract AG? It may be that AG wants to project an image of prosperity to its employees, and clearly Westlake has a substantial advantage according to those two measures of community wealth.

Third, there are substantial and measurable differences in the performance of the two cities' education systems. Each year Ohio rates all of its school districts. In 2011 it rated Brooklyn's schools as "effective," while Westlake's were rated as "excellent." Each school district was additionally given performance ratings (ranging from 0 to 120); Westlake received a score of 107.2 and met adequate yearly progress (Ohio Department of Education 2011). While Brooklyn's performance rating score was 96.8, the district did not meet adequate yearly progress. Additional information comes from *Cleveland Magazine's* annual "Rating the Suburbs" issue. While rating systems in a magazine are bound to come with some controversy, they are still read by people in the community and by those planning to move to the area. Here again we see Westlake with substantially higher scores in education, receiving a rank

Figure 3.1 Assessed Value per Capita, Brooklyn and Westlake, Ohio (2011$)



SOURCE: Assessed valuation data come from the cities' Comprehensive Annual Financial Reports. Population estimates are from the U.S. Census Bureau.

of 10 out of more than 200 communities in the Cleveland metro area, as compared to Brooklyn, with a rank of 46 (*Cleveland Magazine* 2011).

Fourth, Westlake outperforms Brooklyn on a broad range of other "lifestyle" ratings. Westlake is perceived to be a safer community than Brooklyn. Again drawing from the *Cleveland Magazine* (2011) profiles, Westlake received a rank of 20 (lower being better) and Brooklyn received a rank of 73. These scores are based upon a variety of crime statistics for all metro Cleveland jurisdictions. Westlake's "total community services" rating is 13, while Brooklyn's is 15.

Finally, the financial stability of the two cities is quite different. One very broad indicator of financial condition is bond ratings. Brooklyn's bond rating, in September 2011, by Moody's (2011), was Aa2. Westlake's rating by Moody's, from December of 2011, was Aaa. While both cities' credit ratings are excellent, Westlake's rating is as high as a rating can be, considered a prime rating, while Brooklyn's rating is two notches lower. Westlake is unique in the entire state for being "the first suburb in Ohio to have been awarded all of the Aaa/AAA ratings" (City of Westlake 2011b).

We can also look at financial stability in terms of budget balances. The fund balances of both cities are exceptional. Both carry fund balances well in excess of the best practice recommendations of the Government Finance Officers Association (2009). This is particularly relevant in recent years of stagnating revenues (the Great Recession), where both cities have been very capable of providing a cushion from which to draw down excess funds without raising taxes or cutting services.

What can we tell from looking at the perceptions of infrastructure, safety, and financial stability? The case demonstrates clearly that taxes were not the main issue in AG's deliberations. Table 3.1 summarizes the potential deciding factors in AG's move from Brooklyn to Westlake. On all nontax elements, Westlake has a clear advantage over Brooklyn. If taxes were the main driver, then AG would have stayed in Brooklyn because the city offered to lower its income tax rate to one comparable to Westlake's, in addition to a tax expenditure package worth up to $10 million and lower property tax rates. The case further demonstrates a reality for many cities; they are at a great disadvantage relative to firms, particularly large companies. If a major employer wants a new facility, perhaps even one that it has been planning for years, it can leverage the

Table 3.1 Comparison of City Advantages, Brooklyn and Westlake, Ohio

	Advantage		
	Brooklyn	Westlake	
State tax expenditures	Neutral		Ohio offered the largest package, although there were no requirements to stay in Brooklyn.
Local tax expenditures	X		Brooklyn offered a larger package of tax expenditures.
Tax rates	X		Total tax burden in Brooklyn is lower. Brooklyn income tax rate was readjusted after AG threatened to move; Brooklyn previously had a lower property tax rate than Westlake.
Community wealth		X	
Home sale price		X	
Median household income		X	
Assessed value		X	
Poverty rate		X	
Education systems		X	
"Lifestyle" ratings		X	
Financial stability		X	

system to reap, at times, huge sums of money to do something it was already going to do, with or without the funds.

In the case of AG, a triggering event (a one-half percentage point income tax increase in Brooklyn) gave the company a strong negotiating position. Without access to AG's internal communications, there is no way of knowing if the firm truly wanted to leave the area prior to this circumstance. What can be seen is a company seizing the opportunity to extract rents from different jurisdictions by threatening to leave the city, county, and state.

One can question the actions of the state in the Brooklyn-AG case. Was the rush to keep AG in Ohio actually what killed Brooklyn's chance at keeping AG? The deal (nearly $100 million) provided by the state of Ohio may have kept AG in Ohio, but for the state it did not matter where AG was located, as long as it was within the state. This creates an environment for the rich to get richer: the company got nearly $100 million and the city of Westlake got a new large employer at apparently little direct cost themselves. This also provides an environment for the poor to get poorer: the state of Ohio's revenues dropped by nearly $100 million at a time when Governor Kasich was trying to fill an $8 billion budget deficit, and Brooklyn, a poorer Cleveland suburb, lost its largest employer, creating a big hole for it to dig out of. As stated by Cuyahoga County Executive Edward FitzGerald, with AG leaving Brooklyn, "You will have a community that will be the big loser [Brooklyn], and the state will have paid for that" (Niquette 2011).

The case of AG echoes the finding in the literature that the decision to move is not simple and pits neighboring cities and states against one another, to the direct advantage of the firm. AG's actions are rational, based on its operating environment, and the company cannot be faulted for how it handled the situation. This case is not meant to be a critique of AG, but rather a critique of the political ecosystem within which it operates.

A WAY FORWARD

AG's move within Cuyahoga County from Brooklyn to Westlake is having a significant local political impact. This case is an example of a kind of interjurisdictional competition that is seen across the United States. Clearly the move will be devastating to Brooklyn, and while it may not be a net loss for the county, it again feeds more inequality into the jurisdiction in this zero-sum game. This is leading Cuyahoga County and other places nationwide to start thinking less about competition and more about cooperation.

Cooperation among Jurisdictions

One step Cuyahoga County took in the Brooklyn-AG situation was to not provide any incentives to AG. Cuyahoga County did not "want to give them any incentive to move from one city in Cuyahoga County to another," especially in this case with, as Cuyahoga County Executive

FitzGerald notes, "wealthier suburb[s] that can afford more grants and tax incentives" (Cho 2011a). In an effort to stem the tide of cities within Cuyahoga County fighting with each other to land the next big headquarters, FitzGerald is trying to leverage his economic development budget by offering incentives to cities signing on to an antipoaching pact. Communities that commit to this will get revenue sharing and a piece of the county's $100 million economic development fund (Johnston 2011).

The fight for jobs through tax expenditures among U.S. jurisdictions is also going on elsewhere in the world. In 2003 all but one of Australia's states and territories "signed an historic pact to end interstate bidding wars for business investment and major events" (State of Victoria 2003). The pact, which was renewed in 2006 (State of Victoria 2006) and set for another renewal vote in 2011, came about as a result of a bidding war for a A$430 million News Corporation/Fox movie studio. Similar to the approach being taken by FitzGerald in Cuyahoga County, the Australian pact "includes protocols to avoid offering financial and other investment incentives to companies relocating from elsewhere in Australia—a situation where there is no national economic benefit." Australian subnational officials have found the pact to be very valuable in reducing the firms' rent extractions, because the businesses try to overstate "the incentives offered by the potential 'rival' location" (State of Victoria 2003).

One of the keys to the Australian and Cuyahoga County programs is the explicit goal of sharing information among governments. By doing so, these programs reduce the information asymmetry that exists when firms attempt to play one jurisdiction against another. At heart, the challenge for these potentially rival jurisdictions is a prisoner's dilemma, in which cooperation will yield a better outcome for both government parties, but with informational barriers present, one or both of the jurisdictions will tend to defect, resulting in a race to the bottom (Oates 1972, 1999).

The race to the bottom creates a fear in community officials of "losing local business and jobs [which] thus leads to suboptimal levels of state and local public goods" (Oates 1999, p. 1135). Alice Rivlin (1992), the first to head the Congressional Budget Office and a recent member of the Obama Administration's Debt Commission, sees the competition between neighboring jurisdictions as a fight that produces inadequate levels of public service delivery because the competition drives revenues too low. She has proposed a revenue-sharing scheme that would alleviate some of jurisdictions' worries about losing business (Rivlin 1992).

While Cuyahoga County strives to create a system in which its cities share information, the state of Ohio appears to be going in the opposite direction. It has privatized its development activities, which constrains access to information and citizen involvement. The limits that Ohio Governor Kasich seeks are thought by some people to be an economic advantage for the state, as it competes with its neighbors for companies. Site brokers, the agents working for firms trying to relocate, counsel governments to keep all bids secret. These consultants essentially threaten to blackball states and site brokers if they do not comply with the secrecy pacts (Markusen and Nesse 2007, p. 22). The firms benefit from having information asymmetry on their side, which keeps the fear of losing a deal alive by leaving cities and states in the dark. But it is obvious that cities and states may not be going in the same direction on this issue.

Jurisdictions are left in a quandary: they want to improve their fiscal and economic situations without being taken advantage of by firms or decimating neighboring jurisdictions. Rivlin (1992) suggests that

> States might provide higher-quality services if they shared some taxes and did not have to worry so much about losing businesses to neighboring states with lower tax rates. They would then have more incentives to compete on the basis of excellence of their services. They would have to attract businesses and residents with good schools, parks and transportation, rather than with tax breaks. The common taxes would also simplify the tax structure and lower the compliance costs facing companies that operate in many states, as well as reducing the enforcement costs of the tax collectors. (p. 142)

The Importance of Evaluating Results

We know that tax expenditures will continue to be used. It is also clear that under certain circumstances tax expenditures can be marginally effective policy tools, but only if the jurisdictions employing them take the time to analyze their use. Unfortunately, research suggests that "few municipalities place conditions on [tax expenditures], most never evaluate the performance of firms . . . and abatement requests are seldom or never rejected" (Sands, Reese, and Khan 2006, p. 44). When data are collected, the information is often not appropriate to help in evaluation of programs, nor is it timely (Buss 2001). One-third of governments place few, if any, conditions on who gets tax expenditure benefits, and 88 percent of governments reject virtually no one (Sands, Reese, and Khan 2006). Because most jurisdictions do not bother to evaluate the outcomes of tax expenditures, it is little wonder that this tool is so ineffective. The shotgun approach clearly is not working; targeting tax expenditures to distressed areas and evaluating the programs could turn tax expenditures from a 10 percent to a 90 percent success rate (Peters and Fisher 2004).

Further thought needs to be put into what types of firms are getting the benefits as well. Does the tax expenditure create negative externalities for a community (sweatshop work environments or major environmental burdens)? If so, does this really help to develop the community? Clear goals for development are necessary, rather than a mechanism "to provide political cover for the decision to grant an abatement" (Sands, Reese, and Khan 2006, p. 53); not rejecting any firm's applications for tax expenditures provides just such a situation. However, in most programs the evidence of targeting simply does not exist (Greenbaum, Russell, and Petras 2010).

In addition to a lack of actual evaluation of the tax expenditure policies, there is also some difficulty in defining the problem that is being addressed. How is growth defined? Is it growth of GDP, or employment, or some other factor? Why a company decides to move its headquarters to the Rust Belt, or out of it, is not a simple question. Trying to model this decision-making process is even more difficult. For example, Phillips and Goss (1995) note that "studies that use investment or income growth as the dependent variable find that taxes have a larger influence on growth than do studies using aggregate employment or individual firm data" (p. 325). Both income growth and employment would presumably measure the economic health of a region, but if they are leading to contrary conclusions, then modeling this question will be problematic, at best.

Decisions made in the past can haunt a city for years, even when the conditions are not the same today (see Box 2.1). If a large part of

Box 2.1 Minicase of Atlanta, Georgia

Atlanta's rapid growth has resulted in "traffic congestion so bad it threatens the region's vitality" (Hart 2011, p. A:1). No definitive plan has been developed, but Georgia's and Atlanta's leaders want to ensure that the area can continue to grow. A proposed new sales tax could be one way to fund a "balanced" approach (roads and public transit), but "fierce debate is under way over what that balance should be" (p. A:1).

Some leaders in the region are starting to recognize that, while "tax cuts may favorably tilt the cost-benefit analysis of investors pondering whether to build a manufacturing plant in Georgia," those benefits "may be quickly reduced if the end product is trucked through Atlanta, as plant owners incur the indirect, yet real cost of tractor-trailers slogging inefficiently across" the city (*Atlanta Journal-Constitution* 2010). The Atlanta metro area has been described as being a "region at odds with itself," as it contains cities poaching firms from one another in the same zero-sum game that the Rust Belt faces. Leaders in the region do recognize the inconsistencies, as Atlanta residents hate the traffic problems but also hate the idea of raising taxes to the level necessary to fix those problems. The prospect of resolving these issues is complicated by a lack of cooperation among governments in the metro area, "which makes it more difficult to create a thriving region and compete with our peer cities around the country and world" (Chapman 2011).

Atlanta's future hinges on its ability to solve not just its traffic challenges, but also its water problem. The state of Georgia has been in protracted disputes with Tennessee, Florida, and Alabama for access to river waters, and the Atlanta area constantly fights with south Georgia for waters within the state. Droughts in recent years have made access to water perhaps even more important than transit to Atlanta's future, and this debate is more complicated because of rainfall, something no one can control.

why a company stays or leaves a particular location is based on "softer" issues like quality of life, which are even harder to measure than economic growth, the subjectivity of the potential answers will bias study results. Some good first steps will be to collect data, make sure the data being collected can actually measure the outcome, and have that data collected and analyzed in a timely manner.

One of the basic themes of this book is that free trade in unfettered markets and the production of things people value, rather than tax expenditures and other forms of government intervention into local economies, offer the greatest promise for economic prosperity. The tools that surface time and again in the tax expenditure literature are investments in physical and human capital. These topics could necessitate entire chapters or books to cover their depth, but will be touched upon briefly here to illustrate alternative approaches.

Other Ways to Promote Industrial Development

Shifting the tax burden from businesses to residents often creates an environment that reduces the quality of services that are provided (Markusen and Nesse 2007). As has been mentioned earlier in this chapter, taxes and tax expenditures are only a small part of the decision-making process for firm location. The results of a higher tax rate or lower tax expenditures may actually be welcomed by companies because many of them place a high value on government services that benefit the firms directly or indirectly (Bradbury, Kodrzycki, and Tannenwald 1997; Wassmer 2007). For example, good school or university systems will provide quality workers to firms, and good transportation systems will allow for easier and cheaper shipping of goods to market. In the case of Brooklyn-AG, Brooklyn's infrastructure and schools were seen as insufficient (or even deteriorating), while Westlake's were viewed as some of the best in the region (and improving). This disparity provided yet another reason why AG would want to move its headquarters out of an area with inferior services to one with superior services.

Mathur (1999) provides evidence that investment in the development and accumulation of human capital is a more productive and prudent strategy to help support growth than are programs that focus on other aspects of developing an economy. An overreliance on simply luring companies based on tax rates or expenditures puts a region at risk in the long term; if a company locates somewhere simply because of the low rates, it is likely to jump ship as soon as another jurisdiction can offer a better rate. However, if a company has made a choice because of a region's broader set of advantages, then small changes in a tax rate or tax expenditures will be little noticed, given all of the other factors that brought the firm to its present location. As Mathur (1999) points out, “public policy that encourages human capital stock and R&D is in the long-term interest of a region, and the threat of interregional spillovers should not distract regional policy makers from initiatives that promote human capital stock of the region” (p. 214).

Investing effectively in physical or human capital infrastructure requires actual outlays of funds, which is why the tax expenditure route is taken so frequently—it offers much less resistance and conflict. Each city, county, or region has its own special needs, and there is no one-size-fits-all approach available for economic development. But it is clear that investing in physical and human capital can be an alternative to tax expenditures that has a more predictable and lasting effect on the local economy. The mayor of Westlake, for one, does not want to be faulted for the investments his city has made in infrastructure. He states that “Westlake put a lot of money into its infrastructure and quality of life. . . . Why shouldn’t we reap the dividends on that investment?” (Miller 2011). In the case of AG, clearly Westlake is reaping the dividends of its investment. Broadly speaking, one of the best things a city can do to ensure its future is to “take care of the basics, like infrastructure and education” (Talbot 2012, p. 74). This is particularly important when resources are idle during a recession, when building materials, capital, and labor are much cheaper, and will enable a city to prepare for its next industry or employer.

CONCLUSION

The challenges that Rust Belt communities face are substantial. Let us reconsider the question raised at the start of this chapter: Why do some of these cities thrive, as others decline? Clearly, special attention should be paid to the lessons that can be learned from the use of tax expenditures in economic development programs. The fiscal stresses that the region faces are substantial and reinforce the problems. Much of the political rhetoric surrounding the demise of the area and the rise of the South and Southwest tends to focus only on taxes, essentially ignoring all other relocation factors.

At the same time one needs to consider that these southern states were also very far behind economically when compared to northern states, so some of the geographical southern shift can be attributed to the equalization of regions rather than an outright flight. This is, of course, no comfort to the residents of Flint, Michigan, who have lived through decades of economic struggle, or to those of Cleveland, which once had among the greatest concentrations of corporate headquarters in the country, and is now frequently seen as an also-ran.

The problems facing Rust Belt communities are not isolated. Booming cities in the South, such as Atlanta, which were once the beneficiaries of the southern shift, are now facing the same challenges: companies leaving for greener pastures.

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