Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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# THE TAX FOUNDATION'S ANALYSES OF THE *CUNO* DECISION: INACCURATE AND INCONSISTENT

By Michael Mazerov

Last year, the federal Sixth Circuit Court of Appeals ruled that the investment tax credit granted against Ohio's corporate income tax violates the Commerce Clause of the U.S. Constitution. *Cuno* v. *DaimlerChrysler* was the latest in a long line of court decisions holding that state tax laws that provide tax advantages to in-state business activity sometimes illegally discriminate against interstate commerce. The Court agreed with the plaintiffs' argument that the credit unfairly "coerce[s] businesses already subject to the Ohio [income] tax to expand locally rather than out-of-state." The decision was explicitly based on a comprehensive legal theory of discriminatory state aid to businesses set forth in a law review article authored by two leading experts on the impact of the Constitution on state taxation, professors Walter Hellerstein and Dan Coenen of the University of Georgia Law School.[1] *Cuno* is currently on appeal to the U.S. Supreme Court. (For a longer discussion of the *Cuno* case, see: Michael Mazerov, *Should Congress Authorize States to Continue Giving Tax Breaks to Businesses?*, Center on Budget and Policy Priorities, June 30, 2005.)

**KEY FINDINGS**

- The Tax Foundation has long questioned the wisdom of offering "economic development" tax incentives to particular firms or types of businesses.
- Nonetheless, the Foundation has been harshly critical of the recent Sixth Circuit Court *Cuno* decision, which held that Ohio's investment tax credit illegally discriminates against interstate commerce.
- The Foundation is misreading *Cuno* in asserting that it would prevent states from cutting taxes for businesses across-the-board and in claiming that it is based on an illogical legal theory.
- Free-market-oriented organizations should support *Cuno* as a move toward economically neutral taxation and oppose proposed federal legislation that would reverse it.

## The Tax Foundation Generally Opposes Economic Development Tax Incentives

Like many policy research organizations across the political spectrum, the Tax Foundation has long questioned the wisdom of state and local government efforts to stimulate economic development by offering tax incentives to particular firms or types of businesses. Indeed, the Foundation ranks states each year on the "business-friendliness" of their tax systems and noted in its 2004 report:

> The touchstone of the State Business Tax Climate Index is neutrality. If a state's tax system maintains a "level playing field" for all types of businesses and business transactions, we consider it neutral and rate it highly. An economically neutral tax system benefits and punishes all businesses equally, so this index is a measure of each state's tax friendliness to all business activity, not just small businesses or large businesses, capital-intensive or service-intensive, existing companies or start-ups. Therefore, if a state's tax burden is relatively low and the state's tax system does not favor some economic activities while penalizing others, we conclude that the state's economy will be comparatively efficient, producing more jobs and yield higher incomes for everyone.[2]

Tax Foundation Senior Economist J. Scott Moody:

"[T]he special tax package game is often a futile approach. States are better advised to keep taxes low and simple. It's fair to existing business, it prevents boondoggles, and it works."

In keeping with this perspective, Tax Foundation Senior Economist J. Scott Moody has commented explicitly on the desirability of targeted tax incentives: "[T]he special tax package game is often a futile approach. . . . States are better advised to keep taxes low and simple. It's fair to existing business, it prevents boondoggles, and it works."[3] In the same article, Tax Foundation President Scott Hodge concurred: "The temptation is for state lawmakers to lure high-profile companies with packages of tax bonuses. . . . But that strategy can backfire."

In light of the above, one would think that the Tax Foundation would be applauding the *Cuno* decision. In fact, the Foundation has published two analyses that harshly criticize *Cuno*, and it recently filed a friend-of-the-court brief urging the Supreme Court to hear an appeal because the Sixth Circuit decision was wrong. These documents indicate that the Foundation has fundamentally misread the decision itself and the Hellerstein/Coenen theory underlying it. This misreading leads the Foundation to conclude that *Cuno* is a bad means to a justified end. A more careful reading of the decision and the Hellerstein/Coenen analysis should lead to the conclusion that none of the adverse side-effects of the decision asserted by the Tax Foundation are likely to transpire. Free-market-oriented organizations like the Tax Foundation should support *Cuno* as a move toward economically neutral taxation and should oppose proposed federal legislation that would reverse it.

### The Tax Foundation's Muddled Analysis of Cuno

Chris Atkins, a staff attorney with the Tax Foundation, has published two highly-critical analyses of *Cuno* and has been quoted to the same effect in at least two major news articles on the case.[4] Atkins has written that "the *Cuno* decision could have a chilling effect on tax competition between the states overall." In his comments to the media he went even further: "The general fear is that if this decision became the law of the land, states could not take any action that would lead companies to locate in their state."

As support for these assertions, Atkins cites Yeshiva University law professor Edward Zelinsky, who claims that "[i]f *Cuno* is correct, virtually no state tax policy . . . is immune from Commerce Clause challenge. Indeed, if *Cuno* is correct, virtually no state government activity is secure from Commerce Clause challenge."[5] In fact, Zelinsky's assertions are flatly contradicted by the *Cuno* decision itself. While ruling that Ohio's investment tax credit violated the Commerce Clause, the Sixth Circuit Court *upheld* the constitutionality of property tax abatements that were also granted to DaimlerChrysler's Toledo Jeep plant. Moreover, the decision favorably quoted language from an earlier U.S. Supreme Court decision that implies that direct state subsidies to businesses generally do not run afoul of the Commerce Clause.

On the issue of direct subsidies, moreover, Atkins appears to be trying to have it both ways. By quoting Professor Zelinsky's second sentence, Atkins raises alarm bells that *Cuno* will prevent states from directly aiding businesses in any way. Later in the same report he argues that *Cuno* is essentially worthless because it doesn't stop states from directly subsidizing businesses and will only encourage them to channel revenues that would have gone to tax incentives into direct subsidies instead:

> The second legal problem with *Cuno* is that the court, while striking down investment tax credits as incentives for in-state investments, gave its blessing to the use of direct subsidies. Whether the state gives a tax credit or direct cash subsidy will be of little account to businesses; the impact on the bottom line will be the same. The race will still be on, with businesses seeking direct cash payments or other in-kind benefits, rather than tax incentives. The means by which the states compete will change, but the game will be the same.[6]

Another example Atkins cites in both papers in support of his claim that the *Cuno* decision could have a "chilling effect" on interstate tax competition in general is its potential to disallow a "single sales factor" apportionment formula for the corporate income tax. This is a common tax incentive increasingly being adopted by states; it modifies the traditional method by which states determine the share of the nationwide profit of a corporation that they will seek to tax.[7] The single sales factor formula is an especially curious incentive for Atkins to cite; there is extensive discussion in the Hellerstein/Coenen law review article cited by the Sixth Circuit Court as the conceptual basis for the *Cuno* decision explaining why the formula would *not* be at risk under the legal analysis of interstate discrimination that led to *Cuno*.[8]

*Cuno* would not bar states from simply cutting their corporate income tax rates in order to attract businesses.

Of apparently greatest concern to Atkins is the possibility that the reasoning of *Cuno* would bar states from simply cutting their corporate income tax rates in order to attract businesses — the policy most consistent with the Tax Foundation's position that states should seek to maximize their attractiveness to businesses by minimizing their tax burdens in a "neutral" manner. Here again, Atkins is relying on Professor Zelinsky.[9] Here again, there is no support in either *Cuno* or the Hellerstein/Coenen article for this concern. A tax rate cut would apply equally to in-state and out-of-state corporations subject to a state's corporate income tax; there does not appear to be any way that an across-the-board rate cut could discriminate against out-of-state corporations or "coerce" them into expanding in states in which they are already taxable.

### Ends and Means

By putting at risk the legality of all tax credits granted against income taxes, *Cuno* could encourage economically neutral taxation.

In addition to making exaggerated claims about the legal impact of *Cuno*, Atkins has articulated what seem to be inconsistent positions about its merits from a policy standpoint. It is hard to reconcile Atkins' acknowledgment in his first paper that the "current system of tax incentives. . . violates the neutrality principle of sound tax policy" with his statement that, nonetheless, "states that do levy a corporate income tax should be free to design it in a manner they determine makes their state most competitive." Atkins does not address why state sovereignty is such an important principle that state discrimination against interstate commerce should be permitted. In granting Congress exclusive authority to regulate interstate commerce, the authors of the Constitution apparently did not share the view that state policy choices were always paramount.

In his second paper on *Cuno*, Atkins attempts to resolve and clarify these contradictory statements by arguing that *Cuno* is simply the wrong means to a justified goal. He alleges that *Cuno* is internally inconsistent, has some nonsensical results, and contains a giant loophole in allowing direct subsidies to businesses to continue. In fact, the Hellerstein/Coenen article lays out a quite coherent theory as to why an investment tax credit limited to in-state investment *would* "coercively" discriminate against interstate commerce in a way that a property tax abatement, a direct subsidy, or an across-the-board cut in the corporate income tax rate would not.[10] All of Atkins' criticisms are anticipated and answered in the Hellerstein/Coenen article — including his claim that the reasoning of *Cuno* would (illogically) allow a state to grant an investment tax credit to a business not already taxable in the state and his argument that the decision achieves nothing because direct subsidies are preserved.[11]

Where Atkins goes most astray in his analysis of *Cuno* is in his argument that the decision somehow is actually counterproductive to achieving a more economically-neutral state and local tax structure. In the absence of *Cuno*, states and localities can offer a vast array of tax incentives and direct subsidies to businesses. It is hard to understand how a decision that puts at risk the legality all tax credits granted against income taxes — a major subset of the existing set of economic development tools — could be counterproductive or, as he puts it, a "pyrrhic victory for economic neutrality." Other free-market-oriented analysts acknowledge that *Cuno* might well encourage states to provide the kinds of across-the-board tax cuts that Atkins would seem to prefer to targeted tax incentives; a spokesperson for the National Taxpayers Union observed: "The one silver lining in this [*Cuno*] ruling might be that states might be encouraged to have more broad-based, low-tax systems rather than taxing piecemeal approaches to lure firms."[12]

### Groups Like the Tax Foundation Should Support Cuno

Atkins is quite correct that *Cuno* is not "*the* remedy" to wasteful and economically irrational tax incentives and subsidies for businesses; tax incentives other than corporate income tax credits are not barred by the decision, and neither are direct subsidies.[13] But *Cuno* is a *partial* remedy. Atkins offers no alternative solutions of his own to what he agrees are bad state policies beyond a naïve faith that "Competitive pressure from other states, working through the ballot box, will change our state tax systems for the better." That faith is misplaced; ever-more-costly deals and incentive programs continue to proliferate, and elected officials admit that they cannot afford to take their states out of the race unilaterally.

Policymakers and policy analysts who believe that state and local economic development incentives inappropriately interfere with and impair efficient markets should support *Cuno* as a partial but meaningful limitation on these policies. They should also oppose the enactment of proposed federal legislation — the "Economic Development Act of 2005" (S. 1066/H.R. 2471) — that would nullify the decision.[14]

Atkins concludes that "*Cuno* may have good policy intentions, but it's not good law." Those who agree with the first part of Atkins' conclusion should want the Supreme Court, not the Congress, to decide if the second part is correct. As noted above, the Tax Foundation filed a brief urging the Supreme Court to hear the pending *Cuno* appeal; in doing so, the Foundation is taking appropriate action to encourage a definitive ruling on its legal validity. Whether the Foundation is prepared to accept the Court's judgment on that issue or would support enactment of the Economic Development Act *following* Supreme Court affirmation of *Cuno* remains to be seen.[15]

## Notes

[1] Walter Hellerstein and Dan T. Coenen, "Commerce Clause Restraints on State Business Development Incentives," *Cornell Law Review*, 1996, pp. 789-878.

[2] Scott A Hodge, J. Scott Moody, and Wendy P. Warcholik, *State Business Tax Climate Index*, Tax Foundation, October 2004.

[3] J. Scott Moody, Tax Foundation Senior Economist, quoted in William Ahern, "Tax Breaks for Businesses Usually Don't Work," December 1, 2004. Published on the Web site of the Heartland Institute, www.heartland.org.

[4] Chris Atkins, *Federal Court of Appeals Ruling May Hurt Tax Competition, State Tax Reform*, Tax Foundation, September 20, 2004; Chris Atkins, Cuno *v.* DaimlerChrysler: *A Pyrrhic Victory for Economic Neutrality*, Tax Foundation, April 18, 2005. Atkins quoted in Robert S. Greenberger and Michael Schroeder, "Tax Break to Lure Employers Is Attacked," *Wall Street Journal*, November 29, 2004; Malia Rulon, "Court Ruling in Ohio Could Threaten Future of Tax Incentives in 40 States," Associated Press, November 13, 2004.

[5] Edward Zelinsky, "*Cuno* v. *DaimlerChrysler*: A Critique," *State Tax Notes*, October 4, 2004.

[6] Of course, the Sixth Circuit in no way "gave its blessing" to direct business subsidies, since the constitutionality of such subsidies was not at issue in the case. The *Cuno* opinion merely, in passing, quoted language on the issue from an earlier Supreme Court decision.

[7] See: Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?*, Center on Budget and Policy Priorities, revised September 2001.

[8] See Hellerstein/Coenen article cited in Note 1, pp. 820-825.

[9] The complete quote cited above read "If *Cuno* is correct, virtually no state tax policy (*including a general reduction of corporate income tax rates*) is immune from a Commerce Clause challenge." (Emphasis added.) See the source cited in Note 5.

[10] It is of course beyond the scope of this report to attempt to summarize a theory of what forms of state assistance to businesses are and are not constitutional under existing Commerce Clause jurisprudence that required a 90 page law review article with 488 footnotes to lay out. The basic idea in the Hellerstein/Coenen analysis is that there is no Commerce Clause violation if a state seeks to lure an additional investment (by an in-state or out-of-state business) by partially or completely abating a tax for which a business would only be liable if it made the investment. Such an abatement does not discriminate against interstate commerce because it does not penalize the company for choosing an out-of-state location; if the company chooses the out-of-state location, there will be no tax liability whatsoever to the state offering the incentive. The same is true of a direct subsidy of the investment, whether in cash or in-kind.

What rendered the investment tax credit unconstitutional in *Cuno* was that it was structured in such a way that it was not restricted to abating the tax on the marginal profit that a company would earn from a new Ohio plant but rather could be used to offset profits a company was already earning in the state — either from preexisting investments or merely by making profitable sales in the state with sufficient presence for the company to be taxable on those profits. That structure *was* discriminatory on its face, because the ability to use the full value of the credit to offset taxes flowing from preexisting investments or sales in the state only could be realized if DaimlerChrysler decided to build its plant in Ohio. The structure of the credit effectively coerced a company with preexisting tax liability in Ohio to make subsequent investments in the state and effectively penalized it if it made those investments outside the state.

Cuts in the nominal income tax rate for all corporations would not be discriminatory under such an analysis, because they offer only a "carrot," not a "stick," and would apply equally to in-state and out-of-state businesses subject to a state's corporate income tax regardless of where investments generating that income occurred.

[11] Hellerstein/Coenen anticipate and address Atkins' first criticism on pp. 809-813 of their article. They acknowledge that "a distinction [between constitutional and unconstitutional tax incentives] that turns entirely on whether a particular taxpayer has previously engaged in some taxable activity in the state. . . may be too thin a distinction to carry the

constitutional weight we are asking it to bear." They go on to argue, in effect, that most income tax incentives are, in fact, likely to be claimed by corporations already taxable in a state. They conclude: "It is theoretically possible that a generally coercive tax incentive may, as to a particular taxpayer, be noncoercive. . . . But these exceptions should not be permitted to swallow the rule, which ought to reflect the expected impact of the tax incentive on most taxpayers."

With respect to the criticism that most direct subsidies to business will pass Commerce Clause muster under their analysis, they echo the discussion in the paper cited in note 14, below. While the criticism may be correct, the outcome is still beneficial because such subsidies are generally subject to greater public scrutiny and accountability:

> "[O]ur synthesis [of Supreme Court jurisprudence] recognizes and reflects the Court's longstanding insistence that tax breaks and subsidies are constitutionally different. Under our approach, states will channel business incentives into the form of subsidies. They should. The use of subsidies, as we have explained, serves the salutary end of focusing state decisionmakers — and the voters to who they are accountable — on the costs and inequities that business development incentives can engender."

[12] National Taxpayers Union spokesperson Pet Sepp quoted in: Associated Press, "U.S. Appeals Court Strikes Down Ohio's Tax Credit Used for Jeep Plant," *Detroit Free Press*, September 2, 2004.

[13] Atkins is also correct that if consistently applied, *Cuno* would ban not only investment tax credits, but also other credits granted against corporate income taxes — such as credits for employer-provided child care (which Atkins specifically mentions). There is nothing lamentable about such an outcome. If a private activity is worthy of being subsidized by state and local government, it can be subsidized directly, on-budget and on the public record. The problem with tax incentives is that they are generally ineffective in stimulating the activity they are aimed at, are substantially wasted because companies are rewarded for engaging in activities they would have undertaken without the incentive, and are not easily subjected to public scrutiny and accountability for results because their recipients are shielded by taxpayer confidentiality laws. (See the source cited in note 14 for an expanded discussion of these shortcomings.) There is substantial evidence that several of these faults apply to state tax incentives for employer-provided child care. See: Christina Smith FitzPatrick and Nancy Duff Campbell, "The Little Engine That Hasn't: The Poor Performance of Employer Tax Credits for Child Care," *State Tax Notes*, March 3, 2003.

[14] For a discussion of this legislation, see: Michael Mazerov, *Should Congress Authorize States to Continue Giving Tax Breaks to Businesses?,* Center on Budget and Policy Priorities, revised (with this new title) June 30, 2005.

[15] Atkins' second *Cuno* paper was published months after the first version of federal legislation reversing the decision had been introduced and following substantial discussion in the media of imminent introduction of a more comprehensive version of the bill in the 109th Congress. Atkins' second report makes no mention of the legislation. It is unclear why Atkins has not taken a position on the legislation given his opposition to the *Cuno* decision itself.