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SHOULD CONGRESS AUTHORIZE STATES TO CONTINUE GIVING TAX BREAKS TO BUSINESSES?

By Michael Mazerov

Summary

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 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 co-authored by the leading expert on the impact of the Constitution on state taxation, Professor Walter Hellerstein of the University of Georgia.

Cuno is now on appeal to the U.S. Supreme Court. However, identical bills have been introduced in the Senate and House to short-circuit the appeals process, reverse *Cuno*, and affirmatively authorize state and local governments to continue granting a wide array of economic development-oriented tax incentives to businesses. The legislation is the "Economic Development Act of 2005" (S. 1066/H.R. 2471), sponsored by Ohio Senator George Voinovich and Ohio Representative Patrick Tiberi.

KEY FINDINGS

- The *Cuno* decision declared unconstitutional many of the most costly, ineffective, and unaccountable business tax breaks granted by states and localities.
- Such tax breaks chiefly shift jobs among states while impairing the states' ability to fund education and transportation services that do enhance job growth and national productivity.
- The proposed "Economic Development Act" would reverse *Cuno*, thereby preserving such unproductive incentives.
- Enacting the "Economic Development Act" also could open a "Pandora's Box" of new forms of state tax discrimination against interstate commerce.

The Economic Development Act is structured as a statement that explicitly protects from a Commerce Clause challenge all state and local tax incentives, followed by seven exceptions to that protection. These exceptions are complex and ambiguous; for example, one provides that the bill does not protect a “tax incentive earned with respect to one tax [that] can only be used to reduce a tax burden for or provide a tax benefit against any other tax that is not imposed on apportioned interstate activities.”

Complexity aside, enactment of the Economic Development Act would not be in the national interest for the following reasons:

- It encourages a zero-sum game. A substantial economics literature finds that the kinds of tax incentives voided by Cuno have at most a small, marginal impact on business investment decisions. Indeed, the federal government abandoned its investment tax credit nearly 20 years ago because policymakers realized it was stimulating more real-estate tax shelters than productive investment. To the extent that state corporate tax credits affect business decision-making at all, they chiefly affect where jobs are located rather than the number of jobs created. This is close to a “zero-sum game” for the country as a whole, and the states collectively would be better off if all states were prohibited from offering these kinds of credits.
- It harms national productivity by impairing education funding. Giving tax breaks to businesses to attract investments and jobs from other states is actually worse than a zero-sum game with respect to the national interest. The kinds of tax credits disallowed by Cuno have seriously eroded the state corporate income tax as a source of revenue. In turn, the loss of revenue is impairing the ability of states to fund education, infrastructure improvements, worker retraining, and other public services that make a vital contribution to healthy state economies and a productive national economy. At a time when there is growing evidence that the educational attainment of foreign nations is gaining on or surpassing that of the United States — particularly in scientific and technical fields — and when states are struggling to meet their commitments under the No Child Left Behind Act, it is difficult to understand why federal policymakers would wish to enable states to give away their limited tax bases in an effort to steal jobs from their neighbors.
- It blocks an effective curb on the “race to the bottom.” It is extremely difficult for individual states or localities to stop offering corporate tax credits unilaterally; elected officials do not want to be vulnerable to charges that they did not do everything in their power to attract and retain jobs in their states. Many public officials state quite openly that they believe that granting tax incentives is not a cost-effective economic development strategy but feel they have no choice but to offer them so long as other jurisdictions do. While “state sovereignty” in tax policy is generally desirable as a matter of principle, states are not sovereign in any meaningful sense when corporations are able to pit them against each other in ever-more-costly bidding wars for the latest auto or computer assembly plant.
- It discourages across-the-board tax cuts for businesses. Many free market-oriented economists oppose efforts by states and localities to lure or retain companies with tax incentives. Rather than picking “winners and losers,” these economists

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encourage states to keep their taxes on businesses as low as possible for all businesses. If all states were foreclosed from offering corporate income tax credits as a result of U.S. Supreme Court affirmation of *Cuno*, some states might well follow this course of action. As observed by a spokesperson for the conservative National Taxpayers Union, “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 taking piecemeal approaches to lure firms.”

- It opens a “Pandora’s Box” of additional discrimination against interstate commerce. There is substantial potential for federal legislation reversing *Cuno* to make the problem of discriminatory interstate tax competition worse. States have a long history of deliberately using their tax systems to give in-state businesses an unfair competitive advantage over out-of-state businesses. A healthy national marketplace demands that a line be drawn somewhere between state tax policies that discriminate against interstate commerce and those that do not. The Economic Development Act draws that line in a way that would seem to sanction new forms of discrimination. Under the bill it appears that a state could — as just one example — provide a corporate income tax deduction for wages paid to employees working within the state while denying such a deduction for employees working outside the state. Such a law would almost surely be unconstitutional in the absence of an enacted S. 1066/H.R. 2471. While this legislation was drafted much more carefully than a version introduced last year, it still has left open numerous opportunities for states to discriminate against interstate commerce in ways that would be widely recognized as both unfair and economically damaging.
- It is not a permanent solution. Given the vast array of state tax laws and the determination of economic development officials to manipulate their states’ tax policies in ways that advantage in-state business interests, it is unlikely that any federal law can draw the line between discriminatory and non-discriminatory tax incentives in a way that will be sustainable for a significant period of time. Congress is likely to have to constantly revisit and update any legislation it enacts to address this issue once it decides to intervene. Moreover, such legislation is unlikely to suppress litigation against tax incentives to a significant degree since there are ample state law grounds for such litigation in many states.

Corporations have become adept at pitting states against each other to obtain large reductions in their tax obligations by raising the possibility of in-state investments or hinting that they are contemplating downsizing or leaving a state. Interstate tax competition has reached the point where it has become a quintessential “tragedy of the commons” phenomenon. It is damaging to the interests of society as a whole because it is seriously eroding the revenues state and local governments need to fund education, infrastructure, and other public services that actually do make them attractive places to do business and that also enhance national productivity. At the same time, granting economic development tax incentives is perceived by policymakers in individual jurisdictions to be either in their self-interest, or at least something that they dare not refrain from doing.

The proposed “Economic Development Act” could open a “Pandora’s Box” of new forms of state tax discrimination against interstate commerce.

At the very least, the enactment of the Economic Development Act seems ill-advised until such time as the U.S. Supreme Court takes final action on the Cuno case.

The Cuno decision will by no means eliminate interstate economic development competition, or indeed even interstate tax competition. Nor should it; competition that takes the form of offering all businesses the greatest value of public services for their tax dollars is appropriate and provides incentives to improve the efficiency of government for businesses and individuals alike. Cuno has the potential to channel interstate competition in such a productive direction by removing from the states' economic competition arsenals a set of weapons — corporate income tax credits — that provide almost no “bang for the buck” with respect to job creation.

If the Supreme Court ultimately sees fit to allow the Cuno decision to stand, there are strong policy grounds for Congress doing so as well. At the very least, the enactment of the Economic Development Act seems ill-advised until such time as the Court takes final action on the case. Supreme Court affirmation of Cuno could potentially delineate the line between legal and illegal interstate tax competition with greater clarity than will the complex and ambiguous provisions of S. 1066/H.R. 2471.

The Cuno Decision and the Legislative Response

In October 2004, a three-judge panel of 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.”¹

Although the decision voided only Ohio's investment tax credit (ITC), its reasoning would apply as well to many other credits granted against state corporate income taxes, such as those aimed at rewarding corporations for conducting research in-state. However, other kinds of state and local tax incentives, such as sales tax exemptions for materials used to construct an in-state plant, would not be invalidated by the court's analysis. Indeed, the court explicitly upheld the constitutionality of local property tax abatements that were granted to DaimlerChrysler's Toledo Jeep plant along with the voided ITCs.

DaimlerChrysler and the other defendants — which include the state of Ohio and the city of Toledo — petitioned for a rehearing of the case by the full Sixth Circuit court. That petition was denied in January, 2005, and Ohio and DaimlerChrysler are now seeking review of Cuno by the U.S. Supreme Court. The plaintiffs in the case are also seeking Supreme Court review of the Sixth Circuit Court's holding that the property tax abatements were not barred by the Commerce Clause. The Supreme Court is likely to announce whether it will hear the case shortly after it reconvenes this October; oral argument would likely occur in January or February 2006 if the Court does accept an appeal.

Meanwhile, on May 18, 2005, legislation was reintroduced in both the House and the Senate to nullify Cuno and explicitly authorize states and localities to continue offering a wide array of economic development tax incentives. This year's version of the bill is the "Economic Development Act of 2005"; Ohio Senator George W. Voinovich is lead sponsor of the Senate bill (S. 1066), and Ohio Representative Patrick J. Tiberi is the lead sponsor of the identical House counterpart (H.R. 2471). A joint oversight hearing on the issues raised by the Cuno decision was held by two House Judiciary Committee subcommittees on May 24th. Whether an additional hearing will be held on the bill itself prior to mark-up is unclear.

The validity of the legal analysis underpinning the Cuno decision will be determined by the Supreme Court. If the Supreme Court declines to review the case, Cuno will remain binding legal precedent in the four Sixth Circuit states — Kentucky, Michigan, Ohio and Tennessee. If the high Court accepts review, its decision in the case obviously will determine the applicability of Cuno on a nationwide basis.

The introduction of federal legislation that would short-circuit the Supreme Court's consideration of the case, however, raises the question of whether barring states from granting corporate tax credits is good public policy.² There is substantial evidence that such incentives are not a cost-effective means of stimulating investment and job creation. Eliminating them could improve state tax and economic development policy by freeing-up billions of dollars that could be used more productively for some combination of general tax cuts, worker education and training, and infrastructure improvements. For this reason alone, reversal of the Cuno decision would not be in the national interest. Moreover, the enactment of the Economic Development Act holds substantial potential to make the longstanding problem of state tax discrimination against out-of-state businesses significantly worse.

Cuno: Modest "Arms Control" in the Interstate War for Jobs

Assessing the pros and cons of reversing Cuno legislatively necessarily requires an understanding of its potential impact on the ability of states and localities to continue providing tax incentives and other economic development assistance to businesses. That impact has been significantly exaggerated, as has the allegedly path-breaking character of the decision itself (see the text box on p. 6).

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- that are structured as tax credits against state and local corporate income taxes (and, by logical extension, personal income taxes);

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Cuno: A “Leap of Legal Logic”?

Some opponents of *Cuno* have expressed shock about the decision and criticized it for being based on a dubious, illogical legal theory. In fact, corporate taxpayers and their legal representatives have long known that the kinds of tax incentives voided by *Cuno* were highly vulnerable to a Commerce Clause challenge:

- Articles began appearing immediately after the U.S. Supreme Court’s 1984 *Westinghouse* decision questioning whether state corporate income tax credits remained constitutional.¹
- Anticipating a decision like *Cuno* and wishing to preserve corporate tax credits, two leading state tax attorneys published a law review article in 1986 propounding an alternative approach to drawing a line between state tax laws that do and do not discriminate against interstate commerce.²
- The lead attorney representing the plaintiffs in *Cuno*, Northeastern University Law Professor Peter Enrich, published an article in the prestigious *Harvard Law Review* in 1996 explaining in detail why the U.S. Supreme Court’s previous state tax discrimination decisions led almost inevitably to the conclusion that state corporate income tax credits were unconstitutional.³
- University of Georgia Law School Professor Walter Hellerstein, perhaps the leading expert on the constitutionality of state tax policies, co-authored another law review article in that same year making a similar argument.⁴

In short, the *Cuno* decision came as no surprise to anyone who has studied the U.S. Supreme Court’s jurisprudence on state tax discrimination. Far from being a “leap of legal logic,” it was a logical extension of earlier Supreme Court decisions. This was confirmed by Professor Hellerstein in recent congressional testimony on the *Cuno* case:

[W]as *Cuno* a judicial aberration inconsistent with preexisting dormant Commerce Clause Doctrine[?]. . . I believe the short answer is “No.” I could hardly say anything different, because the *Cuno* court explicitly relied on the analysis that Professor Coenen and I set forth in our *Cornell Law Review* article in reaching its conclusion.⁵

¹ See, for example: Joel Michael, “The Constitutionality of Minnesota’s Business Tax Credits After *Westinghouse Electric Corp.*,” *Journal of State Taxation*, 1985; W. Eugene Seago and Wayne M. Schell, “Tax Credits and the Commerce Clause After *Westinghouse Electric Corporation*,” *Journal of State Taxation*, 1984.

² Philip M. Tatarowicz and Rebecca F. Mims-Velarde, “An Analytical Approach to State Tax Discrimination Under the Commerce Clause,” *Vanderbilt Law Review*, 1986.

³ Peter D. Enrich, “Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business,” *Harvard Law Review*, 1996.

⁴ Walter Hellerstein and Dan T. Coenen, “Commerce Clause Restraints on State Business Development Incentives,” *Cornell Law Review*, 1996.

⁵ Walter Hellerstein, testimony before the Subcommittee on the Constitution and the Subcommittee on Administrative and Commercial Law, House Committee on the Judiciary, May 24, 2005.

- that are conditioned upon the conduct of favored activities (for example, investment, research and development, job creation) at an in-state location; and
- that can be used to offset the pre-existing tax liability of a claimant.

As noted above, the decision explicitly rejected a parallel claim that the property tax abatements Toledo and local school districts provided to the new DaimlerChrysler plant also discriminated against interstate commerce.³

Even if the Cuno decision were ultimately upheld and applied nationwide, states and localities would still be free to — and no doubt would — engage in vigorous competition for business investment and jobs:

- Many tax incentives would still be legal. State and local governments throughout the U.S. would remain free under Cuno to use a wide array of tax incentives under their property, sales, and excise taxes in an attempt to attract businesses. Thus, it is a gross exaggeration to imply — as do some proponents of federal legislation reversing Cuno — that the court’s decision bars the state from adopting any tax incentives.
- Across-the-board tax cuts for business would still be legal. If state and local officials believe that business tax reductions are an effective means of competing for business investment and encouraging job creation and retention, the decision also leaves them free to compete with across-the-board tax reductions (such as cuts in the tax rate) that benefit all businesses, not just those making new investments in the state or engaging in particular, favored activities. Economists from across the political spectrum have long urged just such a course on states and localities as an alternative to tax incentives:
 - For example, a “Joint Resolution on State Economic Development Policy” issued by a group of conservative economists and policy analysts in September 1995 stated: “[S]tate governments should terminate targeted business assistance such as . . . selective tax incentives and abatement programs and adopt a comprehensive economic development strategy based on statewide tax relief for all businesses and citizens, a ‘fair field with no favors’ approach. . . .”⁴
 - An economist with the Tax Foundation recently concurred: “[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.”⁵
 - A spokesperson for a conservative, anti-tax group, the National Taxpayers Union, acknowledged that eliminating the authority of states and localities to grant targeted corporate income tax incentives actually might encourage them instead to focus on general business tax reform: “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 taking piecemeal approaches to lure firms.”⁶
 - Commenting on Cuno, an economist for the non-partisan research office of the Minnesota House of Representatives recently observed: “Some level of tax competition among states is positive for many of the same reasons that market economies are much better than the

alternatives. But the competition should take the form of competing on tax rates, overall levels of taxes, and the quality of the government services financed with the taxes, rather than special preferences for local businesses.”⁷

Even with corporate tax credits disallowed, every state would have plenty of tools left in its economic development toolkit with which to compete against other states.

- Direct assistance to businesses is unaffected by the decision. The Cuno decision also leaves state and local governments free to encourage and subsidize economic development and business location with direct assistance programs.⁸ The latter include donated land, infrastructure improvements (such as road and sewer extensions), low-interest loans, venture capital investments, specialized worker training, and similar in-kind goods and services. Of course, states and localities also can continue to stimulate economic development through the provision of high-quality public services that benefit all businesses, such as police and fire protection and community colleges.

In sum, the Cuno decision leaves states and localities free to compete for business location with many types of property, sales, and excise tax breaks, a virtually unlimited array of direct subsidies (such as targeted infrastructure improvements and low-interest financing), and across-the-board tax cuts. In light of this, it is simply not credible to argue (as the United Auto Workers union did in a friend-of-the-court brief filed in support of DaimlerChrysler’s petition for rehearing) that the decision creates an “un-level playing field” among the states because “some of the tools [that states use “in their efforts to convince businesses to invest locally”] are more available in one state than another.” There is no state that can only offer corporate income tax credits to attract business because its infrastructure is so good and its workforce is so skilled that it has no cost reductions to offer to businesses in those two areas. Even with corporate tax credits disallowed, every state would have plenty of tools left in its economic development toolkit with which to compete against other states. A dollar of cost reduction for a business is a dollar of cost reduction, whether it comes through a more productive employee, a less-congested road network, a below-market-rate loan, a tax break, or some other form of assistance.

Cuno’s Contribution to Rational State/Local Tax and Economic Development Policy

Although the upholding of Cuno by the courts would not put an end either to interstate competition for business investment and jobs or to the use of tax incentives in that competition, it would still have a positive impact on state/local tax and economic development policy.

Eliminating Costly and Ineffective Tax Incentives

Corporate tax incentives of the type barred by the Cuno decision are among the most costly, wasteful, and ineffective economic development policies implemented by state and local governments:

- Corporate income tax credits are quite costly and have played a major role in the erosion of the state corporate income tax over the past several decades. According to a study by University of Iowa economist Peter Fisher, the effective corporate tax rate on manufacturing companies in the 20 states he studied fell by 30 percent between 1990 and 1998 alone.⁹ Tax incentives offset 10 percent of corporate tax liability in these states in 1990; by 1998 that had risen to 30 percent. Ohio’s investment tax credit alone has cost the state more than \$400 million in forgone corporate income tax revenue since 1997.¹⁰ North Carolina’s “Lee Act” credits granted against its corporate income and franchise taxes have cost the state more than \$200 million since 1996, with potential additional costs of \$947 million from credits that can be carried forward to future years.¹¹
- The erosion of the state corporate income tax is impairing the ability of state and local governments to finance high-quality public services and infrastructure. An advisor to business on site selection has discussed the critical role that public services play in attracting business investment and jobs to a jurisdiction:

[T]he “services” side of taxes is also carefully measured — what the company will receive for its tax dollars in the way of services, such as police protection, education capabilities, and the like. For our clients, education has been found to be the single most important service, greatly exceeding the value of all other services combined. A distant second is highway adequacy, followed by public safety and then infrastructure. The value of education and highways should be self-evident but the ranking of public safety may be surprising. The companies’ concern is not only the effect that crime levels have on the safety and security of people and property, but also the effect on insurance rates. Effective crime prevention is important to companies considering locations.¹²

- Numerous studies have found that state corporate income tax incentives are not a cost-effective means of stimulating business investment, R&D, and other desired corporate behavior:
 - Summarizing a number of analyses, a 2002 study of California’s Manufacturers’ Investment Credit by the state’s Legislative Analyst’s Office (LAO) stated: “In general, the empirical evidence suggests that while taxes do influence economic activity, state-level investment tax credits have little impact on business decisions relative to other factors.”¹³
 - A 2004 analysis of “Lee Act” credits granted against North Carolina’s corporate income and franchise taxes (which include investment, employment, and R&D credits) employed a simulation model to conclude that approximately 4 percent of the jobs created by companies receiving the credits were actually induced by the credits. For all credits in all regions of the state, the cost per new induced job was almost \$150,000. (The cost was lower for some credits, and in the more distressed counties.)¹⁴
 - An evaluation by two Federal Reserve Bank of Dallas economists of the advisability of Texas adopting an R&D credit concluded that “Even when state

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R&D subsidies increase nationwide research, not enough of the spillover benefits may accrue to an individual state to warrant the revenue loss of the credit.”¹⁵

It is not surprising that studies of state investment tax credits have found them to be largely ineffective in stimulating investment; the federal investment tax credit, abandoned in 1986, had a similarly disappointing track record.

- One important reason that state and local tax incentives are usually not cost-effective as a means of stimulating economic development is that approximately one-third of the tax revenue forgone simply flows to the federal treasury. State and local tax payments are deductible against the 35 percent federal corporate income tax, so reduced tax payments to states and localities resulting from tax incentives are partially offset by higher corporate tax payments to the federal government.
- It is not surprising that studies of state investment tax credits have found them to be largely ineffective in stimulating investment; the federal investment tax credit, abandoned in 1986, had a similarly disappointing track record. A 1994 study of the federal ITC by economist Thomas Karier concluded that “investments were not significantly higher when the credit was in force than during periods when it was not. While the credit may have increased the rate of return on equipment investments, additional tests fail to find an increase in investment spending due to this particular incentive. The results also suggest that only a small fraction of additional corporate income generated by the credit was likely to have been spent on investment.”¹⁶ If the generous federal ITC granted against a federal corporate income tax levied at rates between 46 and 52 percent “did not have a perceptible impact on . . . the growth in real equipment expenditures,” it is highly unlikely that usually smaller state ITCs granted against state corporate tax rates typically in the 8-10 percent range will attract significant investment to a state.

Steering Away from Tax Break Entitlements and Toward More Accountable Mechanisms

Many of the investment, R&D, employment and enterprise zone tax credits that could be barred by Cuno take the form of entitlements that any business undertaking the tax-favored activities can claim. In offering such credits, states end up forgoing substantial tax revenues in connection with investments that would have been made even had the credits not been available. In contrast, when a state or locality negotiates a property tax abatement or some type of direct assistance to a business (such as a specialized training program in a local community college), it can sometimes compel the business to demonstrate that the investment would not have been made in the state “but for” the aid. As noted by economist Tim Bartik:

[E]ntitlement tax breaks, compared to discretionary tax breaks, do not allow the advantages of being selective, such as selecting projects in which the assistance is more likely to tip the location decision, or selecting projects in which various qualitative evidence suggests the project will have greater social benefits.¹⁷

Even if the Cuno decision were upheld by the courts and became applicable on a nationwide basis, it might not reduce the total costs to the states of targeted economic development assistance to firms because states would still be free to provide such aid in

the form of still-legal tax incentives (like property tax abatements) and direct subsidies (such as company-specific training programs in community colleges). But even that scenario does not mean that the decision would not be beneficial. Unlike most of the disallowed credits, the granting of property tax abatements and direct subsidies generally is publicly-available information, with the beneficiaries and cost of the assistance known and with on-the-record votes to provide it usually taken by elected officials. The public, assisted by the media, can hold both the companies and the officials accountable for the quantity and quality of promised investment and jobs.¹⁸ The public visibility of the types of economic development assistance that would remain available to states were *Cuno* upheld — and the potential accountability for results of the corporations receiving the aid — are key reasons that the corporate community is working so aggressively to overturn the decision.¹⁹ Businesses apparently prefer open-ended tax incentives whose costs and beneficiaries are shielded from public view by corporate tax return confidentiality laws.

Finally, the *Cuno* decision also might channel interstate tax competition in directions consistent with the principles of good tax policy. For example, to the extent that states were motivated to provide sales tax exemptions as an alternative to the types of corporate tax credits voided by the decision, they would be adopting tax policies that would be widely supported by public finance economists. Most economists agree that the extensive taxation of goods and services purchased by businesses is a significant flaw in most state sales tax structures. Granting economic development incentives in the form of new sales tax exemptions for business purchases would be widely applauded and arguably would have a number of positive effects, including enhancing the transparency of sales tax burdens and eliminating artificial incentives for businesses to engage in “vertical integration.”²⁰

Would Nullifying *Cuno* with Federal Legislation Be in the National Interest?

As noted above, federal legislation has been introduced that would permanently reverse the *Cuno* decision and authorize states to offer investment tax credits and a wide array of tax incentives aimed at economic development. The “Economic Development Act of 2005” (S. 1066/H.R. 2471) has been endorsed by organizations representing both businesses (such as the National Association of Manufacturers) and state and local officials (such as the National Governors’ Association and the U.S. Conference of Mayors).

It is not surprising that organizations representing business interests would support the Economic Development Act; it preserves tax breaks that save businesses billions of dollars of corporate income tax payments each year. It is understandable that organizations representing state and local elected officials would support the legislation as well; elected officials reap significant political credit for bringing jobs to their jurisdictions and can always credibly claim that a tax break awarded to a new or expanded facility was responsible for that investment.

Notwithstanding such support, significant questions can be raised as to whether the enactment of legislation reversing *Cuno* would be in the national interest:

- Why would Congress facilitate largely zero-sum interstate shifting of jobs? All state and local taxes combined represent less than two percent of corporate expenses, and state corporate income taxes constitute less than 10 percent of that two percent.²¹ Even assuming that reducing such a

National Governors' Association Executive Director: Education Trumps Tax Giveaways

In a recent interview, Raymond Scheppach, Executive Director of the National Governors' Association, stated:

The old state policy to give a tax credit to a manufacturing plant to relocate to a state is archaic. Today it is all about knowledge workers. . . . First, to compete in today's high-tech global marketplace, we must have the best-educated and most highly trained workers in the world. Second, states must build strong "clusters of innovation" to drive job creation and attract employers. The two long-run job creation strategies are not independent, but rather they are complementary. For example, in enhancing the education and training of the labor force, it is critical to ensure that it is tied to the labor force needs of the existing clusters in the state.

Source: Frank Shafroth, "Interview: NGA's Raymond Scheppach on Taxing Issues," State Tax Notes, March 28, 2005.

relatively insignificant expense through tax credits has any impact on corporate behavior, it is likely that the overwhelming impact of the type of credits voided by *Cuno* is simply to shift the location of investments from one state to another rather than to stimulate net new corporate investment.

Certainly that was the case in this instance, where DaimlerChrysler had clearly decided to expand its Jeep production capacity and the only question was whether it would do so near its existing Toledo Jeep plant or at some other location. If corporate tax incentives chiefly affect the location of investment within the U.S. — a largely zero-sum game — it is not clear why it would be in the national interest for Congress to enact legislation permanently allowing states to grant the types of credits voided by the decision.

- Why would Congress encourage states and localities to impair education and infrastructure funding? The credits at issue in *Cuno* either reduce the state revenues available to fund education, infrastructure, and other state services vital to a healthy U.S. economy or necessitate higher taxes on other, less favored businesses and individuals. If these are the consequences of the disallowed credits and no significant net gain in overall U.S. employment results from them, it is difficult to understand why Congress would want to foreclose the possibility that a U.S. Supreme Court upholding of *Cuno* would disallow the credits uniformly throughout the United States.

Numerous studies have indicated that the United States is falling further and further behind a large number of industrialized nations in both general educational attainment and the production of engineers and scientists in particular.²² States are struggling to achieve the requirements established by the No Child Left Behind Act and are likely to confront substantial financial burdens in closing achievement gaps in future years.²³ Reports continue to show that U.S. productivity is being impaired by overcrowded roadways — to name just one category of inadequate infrastructure that is largely the responsibility of state and local governments.²⁴ Under these circumstances, why would Congress enact legislation that would ensure that states and localities would continue to give away to corporations revenue that could be used more productively for investments in education and transportation?

- Do state and local tax incentives really keep U.S. jobs from going abroad? One argument frequently offered in favor of Congress' authorizing states to continue providing the types of corporate income tax credits voided by Cuno is that the credits might have a significant positive impact on overall U.S. job creation by attracting or retaining investments and jobs that would otherwise be located abroad.²⁵

No credible evidence has been offered in support of this argument, however, and it rests on a dubious premise. As documented above, the state corporate income tax is an almost insignificant expense for corporations. Accordingly, it is not credible to claim that the types of economic development credits granted against the corporate tax that are disallowed by Cuno are sufficiently large to tip corporate location decisions from a foreign location to a domestic U.S. location.²⁶ International differences in the costs of making the items and transporting them to customers would far outweigh any trivial incentive to locate production in the U.S. that might arise from the tax savings provided by state corporate income tax credits. This is particularly true in light of the fact (also noted above) that roughly one-third of any such savings is wiped out by higher federal corporate income tax liability.

In sum, proponents of the Economic Development Act have not made a compelling case that the nation as a whole would benefit from its enactment. The opposite effect seems more likely. By ensuring that efforts of states to steal jobs from each other with costly business tax breaks continue, such legislation is likely to impair state and local financing of education and infrastructure and thus harm the future competitiveness and productivity of the U.S. economy.

Opening a "Pandora's Box" of New Forms of State Tax Discrimination

The business community is quite aware that explicit congressional approval of any and all features of state/local tax laws that could be deemed "economic development incentives" would risk voiding numerous court decisions that have held state/local tax practices to be unconstitutionally discriminatory. In turn, this could open a "Pandora's Box" of new forms of state and local tax discrimination against interstate commerce. Accordingly — and unlike predecessor bills in the 108th Congress — the Economic Development Act was carefully drafted in an attempt to preserve most of these earlier court decisions while also authorizing the types of corporate income tax credits voided by Cuno. (The Act also was drafted to foreclose future legal challenges to other common state/local tax incentives, such as property tax abatements.)

After broadly authorizing "any State to provide to any person for economic development purposes tax incentives that otherwise would be the cause or source of discrimination against interstate commerce under the Commerce Clause of the United States Constitution," the Economic Development Act describe seven categories of tax incentives that will not receive such statutory protection from Commerce Clause-based legal challenges. Most of these categories or "exceptions" are intended to maintain the illegality of certain state tax practices established by earlier court cases. For example, one provision denies legal protection to tax incentives that are "dependent upon State . . . of . . . residence of an individual." This language is intended to preserve a recent U.S. Supreme Court decision that voided a Maine property tax exemption because it could only be claimed by Maine non-profit organizations whose facilities primarily served Maine residents.

Notwithstanding the months of drafting work that went into it, the Economic Development Act still contains some major loopholes. States could take advantage of these loopholes to provide tax advantages to in-state businesses at the expense of their out-of-state competitors in ways that members of Congress might well consider unfair and economically harmful. For example:

- Under the Act, it appears that a state could eliminate deductions from its corporate income tax for wages paid to employees working outside the state while preserving the current wage deduction only for workers employed within the state. Indeed, there appears to be nothing in the bill that would prevent a state from using the revenue thereby gained to offer a double deduction for in-state wages. Such a policy might well eliminate corporate income tax liability for many in-state corporations — effectively rendering the corporate income tax a tariff on out-of-state corporations.
- Under the Act, it appears that a state could allow corporations to deduct from their income taxes the full value of new, in-state investments in the year in which they are made (that is, to “expense” them), while requiring the value of out-of-state investments to be deducted over an extended period of time (that is, to be “depreciated”). Two state courts have already held that providing more generous depreciation allowances to in-state investments than to out-of-state investments is barred by the Commerce Clause.²⁷ S.1066/H.R. 2471 would apparently reverse these decisions. By making depreciation allowances for out-of-state investments less generous than under current law, states would gain revenue. That revenue gain might well substantially or completely offset the revenue loss that would result from allowing expensing of in-state investments. In other words, states not only could discriminate against out-of-state investments legally under the Act, but they could do so in a manner that could be almost completely costless to their treasuries.
- S. 1066/H.R. 2471 does not protect from a Commerce Clause-based challenge any tax incentives that “require the recipient of the tax incentive to acquire . . . property produced . . . in the state.” This “exception” is intended to ensure that tax laws that might be modeled on a Hawaii law voided in a 1984 Supreme Court case would remain unconstitutional. The overturned Hawaii law provided an exemption from the state’s alcohol tax for wine produced from Hawaii-grown pineapples but not for wine produced from pineapples grown elsewhere.

Such an “exception” for laws explicitly linking a tax incentive to in-state production of the tax-favored item underestimates the creativity of state economic development officials, whose job it is to provide a leg-up to in-state businesses using every legal tool at their disposal. For example, while this “exception” would bar a coal-producing state from exempting from its sales tax electricity produced from in-state coal, the same result could probably be achieved by limiting the exemption to electricity produced from coal meeting technical specifications closely corresponding to those of in-state coal (in terms of BTU output, sulfur content, and so forth).²⁸

- As just noted, the Economic Development Act does not protect from a Commerce Clause-based challenge any tax incentives that “require the recipient of the tax incentive to acquire . . . property produced . . . in the state.” The word “require” would seem to bar a state from conditioning the availability of an investment tax credit like that voided by *Cuno* on the equipment being produced in the state. It does not, however, seem to prevent a state from giving a larger investment tax credit for equipment produced in-state than for equipment produced out-of-state. Of course, providing a one-dollar ITC for a \$1 million piece of

equipment produced out-of-state and a \$50,000 ITC for the same piece of equipment manufactured in-state would be tantamount to conditioning the availability of the ITC on in-state production of the equipment. Nonetheless, if the current language of the Economic Development Act were enacted, a business that wanted to be free to purchase its equipment out-of-state yet still claim the large ITC arguably would have to litigate to establish that such a discriminatory ITC was not authorized by the Act.

In sum, a credible case can be made that S. 1066/H.R. 2471 would “green-light” new forms of state tax discrimination against interstate commerce; these new “incentives” might themselves generate additional litigation aimed at demonstrating they were not intended to be protected by the legislation.

“Economic Development” or Unfair Discrimination? Should Congress or the Courts Decide?

There is a long history of states enacting tax laws that clearly were intended to provide an economic advantage to in-state businesses over their out-of-state competitors.²⁹ Indeed, rampant interstate economic warfare using discriminatory taxes and tariffs was a major reason that the Articles of Confederation were replaced with a Constitution that gave Congress the explicit authority to regulate interstate commerce. Interstate tax discrimination did not end in the 1780s, however. Two of the U.S. Supreme Court decisions *Cuno* drew upon heavily in its reasoning involved tax exemptions enacted relatively recently by Hawaii and New York to assist their agricultural producers and stock exchanges, respectively, at the expense of out-of-state counterparts.³⁰

Congress Versus the Courts

Considerable damage to the economy could ensue if states were given a green light to enact any and all tax laws aimed at selectively reducing the tax burdens of in-state businesses or adding to the tax burdens of out-of-state businesses. Accordingly, it is clear that a line must be drawn somewhere between state tax policies that discriminate against interstate commerce and those that do not. Admittedly, that is not an easy line to draw, which is why there has been a significant Supreme Court case on the issue every 5-10 years or so. Nonetheless, the courts have been wrestling with these issues carefully for a long time; Congress has not.

As discussed in the preceding section, S. 1066/H.R. 2471 arguably still contains significant loopholes that would authorize new forms of tax discrimination against out-of-state companies and interstate commerce despite several months of drafting work and substantial input from state business taxation experts. State economic development officials will have considerable legal expertise at their disposal to uncover even more loopholes and tremendous motivation to do so. It is their responsibility to maximize in-state investment and job creation at a minimum cost to their state — which means

A credible case can be made that the Economic Development Act would “green-light” new forms of state tax discrimination against interstate commerce.

denying equivalent tax savings to out-of-state businesses to the greatest extent possible consistent with applicable law.

All this suggests that continued case-by-case adjudication may well be superior to federal legislation in delineating legitimate actions states may take to improve their economies for the benefit of their residents while not unfairly discriminating against out-of-state businesses.

Incentive-related Litigation Will Continue with or without the Economic Development Act

Members of Congress should have no illusions that a single statute on this matter will substantially eliminate the “uncertainty” and litigation businesses are confronting on the legality of state and local tax incentives — notwithstanding claims to this effect made by Economic Development Act proponents. Congress is likely to find itself repeatedly called upon by the business community to amend the statute as state economic development officials identify new, discriminatory ways to advantage in-state businesses that are green-lighted by the Act. More importantly, litigation on tax incentives is likely to continue unabated:

- The legislation itself contains substantial ambiguity that is likely to generate continued uncertainty for businesses and litigation to clarify the law.³¹ Several examples were cited above; one more is offered here. Buildings are often eligible for state investment tax credits. S. 1066/H.R. 2471 does not protect from Commerce Clause challenge any tax incentives that “requires the recipient . . . to use . . . property . . . assembled in the state.” Of course, buildings are usually assembled on-site. Does that mean that litigants like those that challenged the tax credits Ohio granted to DaimlerChrysler’s equipment could challenge investment tax credits for a factory building notwithstanding enactment of this legislation? The courts will be called upon to decide.
- There are ample grounds under state statutes and state constitutions to challenge many state and local tax incentives in court. In fact, it appears that all of the recent legal challenges to tax incentives that incorporate a federal constitutional challenge based on *Cuno* also include state-law arguments.³² There is no denying that depriving plaintiffs of a Commerce Clause-based argument in such litigation will increase the likelihood that the legality of the tax incentives will be sustained. Nonetheless, taking away one argument is unlikely to have a significant impact on the amount of litigation or the “uncertainty” for business about the legality of tax incentives. These challenges will continue to be brought because the political process at the state and local level has proven to be incapable of curbing ever-more-expensive giveaways demanded by ever-more-aggressive corporations.³³
- It appears that an entire new front in legal challenges to state tax incentives may be on the verge of opening up — challenges brought by foreign governments under the rules of the World Trade Organization (WTO). Such a challenge is being explored in response to a targeted tax incentive package enacted by the Kansas legislature in April to assist a cellophane manufacturing plant there.³⁴ On May 31, 2005, the European Union filed a countersuit in its long-running dispute with the United States regarding subsidies to Airbus and Boeing charging (among other things) that tax incentives granted by the state of Washington to Boeing are illegal under WTO rules.³⁵ Other state economic development tax incentives also have been identified as being vulnerable to a WTO-based challenge.³⁶

U.S. history from the founding of the nation right to the present day³⁷ demonstrates that in the name of “economic development” states and localities will seek to provide unfair advantages to in-state businesses vis-à-vis their out-of-state competitors. It is therefore essential that a line be maintained between legitimate and illegitimate forms of state economic competition if the benefits of free-flowing interstate commerce are to be preserved. Months of work by leading legal and business tax policy experts went into the drafting of S. 1066/H.R. 2471, which is an attempt to draw that line statutorily. Nonetheless, the legislation still allows some forms of arguably unfair interstate tax discrimination to continue; more loopholes in the law are likely to be found by state economic development officials and their attorneys as time goes on. These loopholes are likely to result in the business community repeatedly coming to Congress for amendments to the law aimed at closing them. Meanwhile, a number of ambiguous provisions of the law itself seem likely to generate litigation, even as legal challenges to state tax incentives based on state laws and WTO rules continue.

Many experts and observers have long urged Congress to put an end to the “economic war between the states” through federal legislation.

Given this scenario, it seems that allowing the courts to continue to adjudicate the line between fair and discriminatory state tax competition would be preferable to enacting S. 1066/H.R. 2471. At the very least, the enactment of S. 1066/H.R. 2471 seems ill-advised until such time as the U.S. Supreme Court takes final action on the *Cuno* case itself. A Supreme Court decision in the case could potentially delineate the line between legal and illegal tax competition with greater clarity than will the complex and ambiguous provisions of the legislation itself.

Congress Could Affirm *Cuno*

If Congress is determined to intervene in this area, a very different course of action than the one under consideration could be taken. Congress could take the Sixth Circuit Court’s reasoning to heart, exercise its responsibility under the Constitution to prevent state tax discrimination against interstate commerce, and bar all states from offering corporate income tax credits that are based on the location of the activities generating the credits.

This is not to say that such a step would be advisable; as discussed above, congressional intervention in this area risks making the problem of unfair interstate tax competition worse. More importantly, it can be difficult to determine whether or not a provision of state/local tax law is an “economic development incentive.” But if Congress is determined to intervene, barring state tax incentives is an option that is also available.

Many experts and observers have long urged Congress to put an end to the “economic war between the states”.³⁸ As the *Des Moines Register* recently editorialized:

Nationally the bidding war between the states is a zero-sum game. It adds nothing to the economy; it merely relocates operations. To the extent that market forces are distorted by state incentives, they might actually harm the economy. That’s why the federal government should impose a moratorium on state incentives that affect interstate commerce.³⁹

Conclusion

Uniform national application of the Cuno decision through a U.S. Supreme Court decision upholding it would eliminate many of the most costly, ineffective, and unaccountable tax incentives granted by states and localities in their interstate war for economic development. Allowing Cuno to take corporate income tax credits out of their arsenals would help state and local governments afford improvements to their education systems and infrastructure, which in the long run will make a substantially greater contribution to the health of their economies and the productivity of the national economy than will a largely zero-sum effort to attract footloose corporations. Given this, and given the substantial potential for harm from legislation reversing the Cuno decision, the best course of action by Congress would appear to be to allow Cuno to proceed to final resolution by the courts before contemplating any legislation to reverse it.

Appendix:

Does Cuno Create a “Competitive Disadvantage” for the Sixth Circuit States?

At present, all of the Senate sponsors of the Economic Development Act are from the four Sixth Circuit states of Ohio, Indiana, Michigan and Tennessee. Seventeen of the 35 House cosponsors are from Sixth Circuit states as well. It seems likely that the introduction of the Act was motivated in substantial part by concern that the Sixth Circuit states could be at a competitive disadvantage in attracting investment and jobs if Cuno prohibited them from offering corporate income tax credits while all other states remained legally free to provide such incentives. This concern is unwarranted, for several reasons:

- The Sixth Circuit Court of Appeals stayed implementation of the Cuno decision until such time as the U.S. Supreme Court disposes of the case (either by denying review or issuing a decision after accepting review.) While the stay is in effect, Ohio is free to permit corporations to claim Ohio investment tax credits on their tax returns — and it is doing so.⁴⁰
- Even if the U.S. Supreme Court were to decide not to review the decision, Ohio would not be at a significant disadvantage in competing with other states for investment. A number of factors support this conclusion:
 - Even under Cuno, Ohio would remain free to offer businesses a wide array of direct subsidies, as well as tax breaks not taking the form of the voided investment tax credits. Since the Cuno decision was issued, Ohio’s Governor has continued to announce economic development deals providing an array of tax and non-tax subsidies to the corporations investing in the state; there is no indication that Cuno has significantly tied his hands.⁴¹
 - Approximately one-third of the states with corporate income taxes already have seen fit not to offer any type of ITC; California allowed its ITC for manufacturers to lapse at the end of 2003 because it had proven ineffective in preserving jobs.⁴² Ohio’s inability to offer an ITC obviously does not put it at a disadvantage vis-à-vis states that have chosen not to offer one.
 - With its own ITC found to be unconstitutional, Ohio “would unquestionably be a proper party to bring a suit challenging the constitutionality of . . . [another] state’s [investment tax] credit” on the grounds that Ohio was being economically harmed by the other state’s tax discrimination.⁴³ The filing of one or two such suits would throw a cloud over the legality of ITCs throughout the country, sharply decreasing the likelihood that businesses either would make location decisions on the basis of ITCs still on the books or would seek ITCs when they negotiated location deals with states.
- Were Cuno to be denied U.S. Supreme Court review, the other three Sixth Circuit states — Kentucky, Michigan, and Tennessee — really would not be in a significantly different position than any other state in the country. Cuno would not prevent them from offering ITCs and other corporate tax credits; only a specific legal challenge to those credits could do that. Indeed, subsequent to the Cuno decision, at least two of the three have continued to offer corporate tax credits for new business investment.⁴⁴ Moreover, these three states have already publicly asserted that their corporate tax incentives are “distinguishable from Ohio’s investment tax credit (‘ITC’) in numerous respects.”⁴⁵ None of these facts are consistent with a

claim that Kentucky, Michigan, and Tennessee are at a particular disadvantage in competing with other states for investment as a result of the Cuno decision.⁴⁶

- If the U.S. Supreme Court were to decide not to hear the Cuno appeal, all 50 states would be on notice that a federal appeals court considered a commonly-offered type of state corporate income tax credit to be unconstitutional and that the Supreme Court was not troubled enough by that outcome to want to review it. That would put substantial pressure on states to seriously consider repealing many of their corporate income tax credits. Failure to do so would open the door for their corporate taxpayers to begin asserting a right to claim investment tax credits for investments and R&D they undertook outside the state — a potentially costly and clearly wasteful outcome. (Recall that the Cuno ruling rests on the fact that Ohio’s ITC is only granted for in-state investment; if businesses could claim Ohio ITCs for out-of-state investments, there would be no discrimination.) It seems likely that many state legislators and governors would not want to run the risk of being forced in the future to forgo revenues to subsidize out-of-state investment and would seek to repeal their corporate income tax credits — eliminating any hypothetical “competitive disadvantage” for Ohio or any other Sixth Circuit state.

Notes

¹ For example, if the investment that generates the credit does not increase the company's profit, the credit can be used to reduce corporate income taxes on profits being generated by prior investments in the state. That makes the credit discriminatory against interstate commerce in the court's eyes because the possibility of reducing taxes on pre-existing profits only exists if the subsequent investment is made in the state — again, because only in-state investments generate the Ohio investment tax credit.

² New York City, the District of Columbia, and a relatively small number of other local governments levy corporate and/or personal income taxes and grant the types of credits against those taxes that could be voided by the reasoning in *Cuno*. In the interest of readability this report will generally refer only to state tax credits.

³ Of course, by seeking review of the decision by the U.S. Supreme Court rather than accepting the Sixth Circuit's decision, DaimlerChrysler has opened the door to having property tax abatements also found to be unconstitutional. For the moment, however, *Cuno* only voids corporate income tax credits.

⁴ Quoted in Lawrence W. Reed, *Time to End the Economic War Between the States*, Mackinac Center for Public Policy, April 4, 1996.

⁵ 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. In the same article, Tax Foundation President Scott Hodge agrees, "The temptation is for state lawmakers to lure high-profile companies with packages of tax bonuses. . . . But that strategy can backfire."

⁶ National Taxpayers Union spokesperson Pete 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.

⁷ Joel Michael, legislative analyst with the research department of the Minnesota House of Representatives, Letter to the Editor, *State Tax Notes*, January 3, 2005.

⁸ It has been suggested by *Cuno* critics that there is little or no logical distinction between tax incentives and direct subsidies (whether cash or in-kind) and that upholding *Cuno* will encourage Commerce Clause-based challenges to such subsidies. That is a highly debatable proposition. The Sixth Circuit Court explained in *Cuno* that the U.S. Supreme Court "has intimated that attempts to create location incentives through the state's power to tax are to be treated differently from direct subsidies despite their similarity in terms of end-result economic impact. The majority in *New Energy* noted in dicta that subsidies do not 'ordinarily run afoul of the [Commerce Clause]' because they are not generally 'connect[ed] with the State's regulation of interstate commerce.'" In any case, making exaggerated claims about the inability of states to aid their home-grown businesses with programs on the spending side of the budget as a justification for the enactment of the Economic Development Act is disingenuous, since: a) Congress could enact legislation to protect direct assistance to businesses from legal challenge without also protecting tax incentives; and b) the legislation in fact does not have any provisions to protect direct assistance.

⁹ Peter Fisher, "Tax Incentives and the Disappearing State Corporate Income Tax," *State Tax Notes*, March 4, 2002, pp. 767-774.

¹⁰ Unpublished data, Ohio Department of Taxation. The Department reports that \$395.9 million in investment tax credits were claimed on corporate franchise tax returns filed from 1997 through 2003. Undoubtedly, additional credits will be claimed on 2004 tax returns. In addition, an unknown amount of ITCs were claimed on personal income tax returns from eligible investments of Subchapter S corporations and other passthrough entities.

¹¹ Michael I. Luger, *2003 Assessment of the William S. Lee Tax Act*, Report prepared for the North Carolina Department of Commerce, July 31, 2003, p. 16.

¹² Discussion of symposium paper by Robert M. Ady, Executive Consultant, Deloitte & Touche/Fantus Consulting, in "The Effects of State and Local Public Policies on Economic Development," *New England Economic Review*, March/April 1997, p. 79.

¹³ California Legislative Analyst's Office, *An Overview of California's Manufacturers' Investment Credit*, October 2002, p. 11.

¹⁴ Michael I. Luger and Suho Bae, “The Effectiveness of State Business Tax Incentive Programs: the Case of North Carolina,” draft dated July 30, 2004; forthcoming in the *Economic Development Quarterly*.

¹⁵ Fiona Sigalla and Alan D. Viard, “Would a Research Tax Credit Be a Good Investment for Texas?” *Southwest Economy*, March/April 1999, p. 7.

¹⁶ Thomas Karier, *Business Tax Incentives and Investments*, Jerome Levy Economics Institute Working Paper 103, February 1994.

¹⁷ Timothy J. Bartik, *Incentive Solutions*, W.E. Upjohn Institute for Employment Research State Working Paper No. 04-99, February 2004, p. 20.

¹⁸ A recent *New York Times* article discussing facility closings by Illinois and Florida companies that had earlier received property tax abatements on those facilities is illustrative of the public scrutiny and debate that is possible when the tax benefits are public. See: Timothy Egan, “Towns that Handed Out Tax Breaks Cry Foul as Jobs Leave Anyway,” *New York Times*, October 20, 2004.

¹⁹ At least two formal coalitions have already been organized seeking to reverse the Cuno decision either in the courts or through federal legislation, one organized by the Council on State Taxation and the other by the Ernst & Young accounting firm.

²⁰ “Vertical integration” refers to the decision of a business to make an input or perform a service internally, with its own employees and capital, rather than purchase it from an independent firm. Sales taxation of business inputs can create an incentive for vertical integration because the input or service generally is not subject to sales taxation when provided internally but is subject to sales taxation when purchased from an independent firm.

²¹ Patrice E. Treubert, “Corporation Income Tax Returns, 2001,” *Statistics of Income Bulletin* (Internal Revenue Service), Summer 2004, p. 138; Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, *Total State and Local Business Taxes*, Ernst & Young, January 2004.

²² See, for example: Programme for International Student Assessment, *Problem Solving for Tomorrow’s World; First Measures of Cross-Curricular Competencies from PISA 2003*, OECD 2004; Task Force on the Future of American Innovation, *The Knowledge Economy: Is the United States Losing Its Competitive Edge?*, February 16, 2005.

²³ The National Conference of State Legislatures has assembled a variety of studies evaluating the cost of state compliance with the No Child Left Behind Act at <http://www.ncsl.org/programs/educ/NCLBCostStudy.htm>.

²⁴ Texas Transportation Institute, *2005 Urban Mobility Study*, available at <http://mobility.tamu.edu/ums/>.

²⁵ “America’s ability to maintain its manufacturing base is at stake, said Sen. George Voinovich, R-Ohio. Other countries, including China, offer subsidies to corporations that locate there, he said. ‘This is no time to tie the hands of the states,’ said Voinovich, a former governor. ‘At this stage of the game, it’s us against the world.’” Kent Hoover and John R. Karman III, “States Fight to Preserve Tax Breaks for New Facilities,” *MSNBC.com*, May 29, 2005.

²⁶ A 1995 study by Professor James Papke found that “General [state and local] tax incentives (e.g., investment tax credits and property tax abatements) have only marginal effects on the net returns from new investment.” James A. Papke, *The Differential Impact of State-Local Tax Incentives on Small versus Large Firms*, report commissioned by the U.S. Small Business Administration, 1995.

²⁷ *R.J. Reynolds Tobacco Co. v. New York City Department of Finance* (1997); *Beatrice Cheese, Inc. v. Wisconsin Department of Revenue* (1993).

²⁸ Even if such a practice might theoretically remain challengeable under another provision of the Constitution (such as the Equal Protection Clause), a disadvantaged business likely would have less chance of success than under the Commerce Clause. Moreover, the potential need for legal attacks on discriminatory tax incentives protected from Commerce Clause challenge by

S. 1066/H.R. 2471 belies the claim of proponents of this legislation that it will forestall widespread litigation that Cuno is (allegedly) likely to generate.

²⁹ Professor Hellerstein's May 24, 2005 testimony cited in the text box on p. 6 lists more than 20 cases in which federal or state courts have struck down state or local tax incentives because they discriminated against interstate commerce. It seems likely that there are numerous incentives still in effect that are inconsistent with these precedents but are still being offered because they have never been challenged.

³⁰ See: *Bachus Imports v. Dias*, 1984 (Hawaii) and *Boston Stock Exchange v. State Tax Commission*, 1977 (New York). The two tax exemptions challenged in *Bachus* had been enacted in 1971 and 1976; the tax provision challenged in *Boston Stock Exchange* had been enacted in 1968.

³¹ Proponents of congressional intervention into state business tax policy constantly assert that this will reduce litigation and eliminate "uncertainty" that impairs business' ability to make investment decisions and thereby harms the economy. Such claims are not credible; except where such legislation addresses a very narrow matter, history has shown that federal regulation of state and local tax practices is itself likely to generate substantial litigation. Numerous court cases on the meaning of two previous interventions — "Public Law 86-272" and Section 306 of the "4-R Act" — attest to this. See Bureau of National Affairs Multistate Tax Portfolio number 1410, *Limitations on States' Jurisdiction to Impose Net Income Based Taxes* and number 1810, *State Taxation of Transportation, Telecommunications, and Energy Companies*, for an extended discussion of litigation under P.L. 86-272 and the 4-R Act, respectively.

³² In the case of *DeCamp v. Nebraska*, the plaintiff's original legal challenge to the state's tax incentives programs was based on the state constitution's equal protection and uniform taxation guarantees. Originally filed in May, 2004, it was amended to incorporate a Cuno-based analysis following the Sixth Circuit Court's decision in October 2004. See: Gregory A. Castanias, "National Movement Against Economic Development Incentives Makes Inroads in the Sixth Circuit and Raises Questions About Similar Incentives Elsewhere," World Wide Web site of the Jones, Day law firm, February 7, 2005. In the *Olson v. Minnesota* case filed earlier this year, only one of six counts against a number of Minnesota tax incentive programs is based on the Commerce Clause of the U.S. Constitution and Cuno. See: Jennifer Carr and Cara Griffith, "Litigation and Tax Incentives after the Downfall of Ohio's ITC," *State Tax Notes*, May 2, 2005. In North Carolina, a legal challenge to a package of tax incentives received by Dell Computer Corporation (see Note 34) has been brought by an organization headed by former North Carolina Supreme Court Justice Robert Orr. The challenge is based on seven separate provisions of the North Carolina Constitution in addition to the U.S. Constitution's Commerce Clause. See the "questions and answers" document on the Dell litigation at the Web site of the North Carolina Institute for Constitutional Law, at www.ncicl.org/LITIGATION/QA.html#2.

³³ Intel Corporation has been lobbying aggressively for the past several years in Arizona for a corporate income tax incentive called the "single sales factor formula." No less a person than the (just-retired) CEO of Intel, Craig Barrett, warned in a speech delivered in the state that "The corporate income tax issue in Arizona [that is, the legislature's failure to enact the single sales factor formula] is in fact absolutely designed to demotivate us to make further investments in the state." Quoted in Associated Press, "Intel Considers Chandler Expansion," *Arizona Daily Sun*, January 16, 2005. After making clear her opposition to this particular incentive on policy grounds and resisting for months, Arizona Governor Janet Napolitano gave in to Intel's pressure and signed the formula into law in May 2005.

Dell Computer Corporation recently negotiated a major economic development tax incentive package with the state of North Carolina and its local governments that will save the company over \$250 million in exchange for the construction of a roughly \$100 million assembly plant. Confidential state files on the negotiations that the state was compelled to release as a result of legal action by several advocacy groups reveal that Dell was demanding that the tax breaks be sufficiently generous to ensure that the company would pay no corporate income taxes to the state for at least 20 years. See: Greg LeRoy, *The Great American Jobs Scam*, forthcoming, July 2005, pp. 35-37.

³⁴ See: Arthur Rogers, "EC Will Investigate Kansas Tax Breaks Aimed at Luring British Production Plant," *BNA Daily Tax Report*, April 15, 2005.

³⁵ Bloomberg News, "U.S., EU Swap Complaints Over Plane Subsidies," *Baltimore Sun*, June 1, 2005.

³⁶ Charles E. McLure, Jr. and Walter Hellerstein, "Does Sales-Only Apportionment of Corporate Income Violate International Trade Rules?" *State Tax Notes*, Sept. 9, 2002.

³⁷ On June 3, 2005 the Kansas Supreme Court found that the state's practice of taxing interstate natural gas gathering systems at a higher effective property tax rate than comparable systems that are located entirely within a single county is facially discriminatory under the Commerce Clause. See: *In the Matter of the Appeals of CIG Field Services Company from Orders of the Director of Property Valuation of the State of Kansas*.

³⁸ See: Melvin Burnstein and Arthur J. Rolnick, "Congress Should End the Economic War Between the States," *The Region*, (Federal Reserve Bank of Minneapolis), March 1995.

³⁹ Editorial: "Congress Should End States' Business Giveaways," *Des Moines Register*, June 8, 2005.

⁴⁰ Ohio Department of Taxation, Corporate Franchise Tax Information Release — Questions Regarding Ohio's Manufacturing Machinery and Equipment Tax Credit, Information Release 2004-03, Revised February 2005 (noting issuance of stay by the Sixth Circuit Court pending final disposition of the case by the U.S. Supreme Court).

⁴¹ See: Office of Governor Bob Taft, "Taft Applauds Honda's Russells Point Expansion Plan," press release, November 9, 2004 (announcing a \$100 million expansion of a Honda transmission manufacturing facility in the state; the plant will receive \$2.1 million in direct grants for roadwork, training, and equipment acquisition). See also: Office of Ohio Governor Bob Taft, "Job Creation Tax Credits Approved for Business Expansion Projects to Create 527 Jobs for Ohioans," press release, December 6, 2004 (reporting on the awarding to nine businesses of \$3.2 million in Job Creation Tax Credits granted against Ohio's corporate income and franchise tax, in addition to several other types of direct subsidies); Ohio Department of Development, "Job Creation Tax Credits Approved for Business Expansion Projects to Create 1,131 Jobs for Ohioans," press release, June 28, 2005 (reporting on the awarding of Job Creation Tax Credits to 16 companies).

⁴² Written sources provide conflicting information concerning the exact number of states that offer investment tax credits either throughout the state or in isolated "enterprise zones." (DaimlerChrysler received both types of ITCs.) Press reports have cited numbers as high as 40. This is likely exaggerated. According to an October 2002 California study (see Note 19), only 19 states offered statewide ITCs to manufacturers. (This study did not list states that only offered ITCs in enterprise zones.) A 1997 study cited in several of the briefs filed in support of DaimlerChrysler cited the same figure, but several of those credits were apparently against excise taxes, not corporate income taxes. (See: Chris Micheli, "A 50-State Comparison of Tax Incentives for Manufacturing Equipment Purchases," *State Tax Notes*, June 9, 1997.) The 2004 *Multistate Corporate Tax Guide* (Aspen Publishers) lists 24 states with general ITCs and an additional 8 with enterprise zone ITCs only, but from the description it is clear that not all of the credits are ITCs.

The author conducted a detailed review of the current CCH State Tax Guide. Even counting as ITCs some state tax credits that abate a proportion of total corporate income tax liability for firms investing in-state rather than credit a share of investment expenditures, it appears that at least 14 of the 46 states with a corporate income tax (counting Michigan's Single Business Tax) do not have either a general or enterprise-zone-only ITC.

⁴³ "Appellant's Memorandum in Opposition to Petitions for Rehearing En Banc" in *Cuno*, November 2004. The Memorandum cites the U.S. Supreme Court's 1992 *Wyoming v. Oklahoma* decision, which upheld the right of "Wyoming to challenge Oklahoma's discriminatory incentives favoring in-state coal production."

⁴⁴ See: Amanda York, "Firms to Expand Operations," *Kentucky Post*, November 17, 2004 (announcing a \$75 million expansion of a Kentucky plant manufacturing stainless steel products; the plant will be assisted with industrial revenue bonds issued by the state). See also: "Governor Fletcher and Belcan Announce New Engineering Design Center in Lexington," press release on the Web site of Kentucky Governor Ernie Fletcher, December 2, 2004 (noting that the "Kentucky Economic Development Finance Authority (KEDFA) Board preliminarily approved Belcan for tax benefits under the Kentucky Jobs Development Act"). For Michigan deals, see: Amy Lane, "\$506.8M DaimlerChrysler Plan [sic] in Sterling Heights Gets Tax Credit," *Crain's Detroit Business*, February 15, 2005 (reporting on \$18.8 million Single Business Tax Credit granted by Michigan to DaimlerChrysler). See also: Michigan Economic Development Corporation, "Governor Granholm Announces Five Major Economic Development Projects," press release, November 16, 2004 (reporting on the provision of "brownfield" credits against the Michigan Single Business Tax, which is Michigan's analog to the Ohio corporate income tax); Alejandro Bodip-Memba, "State Offers GM Breaks to Invest in Flint Plants," *Detroit Free Press*, December 1, 2004 (reporting on \$28.2 million single business tax credit provided by MEDC); Alejandro Bodip-Memba, "790 Federal-Mogul Jobs Saved," *Detroit Free Press*, December 15, 2004 (reporting on a \$65 million single business tax credit provided to that corporation); John Gallagher,

“Severstal Wins Incentive to Upgrade Mill,” *Detroit Free Press*, June 22, 2005 (reporting on MEDC granting of \$28.7 million in single business tax credits for expansion of a Dearborn-based steel manufacturer).

⁴⁵ “Brief of Amici Curiae State of Michigan, Commonwealth of Kentucky, and State of Tennessee in Support of Appellees’ Suggestion for Rehearing En Banc” in *Cuno*, p. 2.

⁴⁶ Of course, like Ohio these three states also remain free to offer non-tax subsidies to businesses.