Testimony of Peter Fisher

on

The National Economic Policy Implications
of State Tax Incentive Competition

at the hearing

“Cuno and Competitiveness: Where to Draw the Line”

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**The National Economic Policy Implications
of State Tax Incentive Competition**

I am honored to be afforded this opportunity to present my views on state economic development tax incentives to the Subcommittee. I am a Professor of Urban and Regional Planning at the University of Iowa, and received my Ph.D. in economics from the University of Wisconsin - Madison in 1978. My particular area of expertise is state and local government finance. I have written and co-authored two books and several journal articles on state tax incentive policy, a subject that I have been researching for the past ten years.

I would like to focus my remarks today on the issue of whether or not it makes good economic sense, from the perspective of national economic policy, to encourage states to engage in competition with one another for business activity through the offering of tax incentives. I will argue that such competition is counterproductive, both for the states engaging in such activity and for the national economy. I would therefore conclude that federal legislation sanctioning or encouraging the use of tax credits and similar incentives by state governments is not in the national interest.

The Subcommittee is also referred to the "Brief of *Amici Curiae* Economics and Public Policy Professors" submitted to the U.S. Supreme Court in the case Daimler-Chrysler v. Cuno by Scott Cummings, UCLA law professor, on January 26, 2006. I was one of the twelve professors who signed that brief, and I drafted the economic sections of the brief. The brief contains further elaboration of and documentation for the arguments I will make today.

Tax Incentive Competition is at Best a Zero-Sum Game

State tax incentives are designed to change the location of economic activity by inducing a firm to locate in, expand to, or move a facility to, the state offering the incentive rather than another state. To the extent that such incentives are effective, they merely move economic activity from one state to another. This has been described as a "zero-sum game" since the gains to one state are offset by the losses to another. There is no national interest in encouraging economic activity to move in response to such incentives since no net gain in economic activity arises. Research has shown, for example, that state tax incentives aimed at encouraging research and development (R&D) result in increased R&D in the state offering the incentive, but reduced R&D in other states, with no net gain to the nation.

Tax Incentive Competition Harms Economic Efficiency

It is likely that state tax incentive competition is, in fact, a negative sum game; that is, it produces a net loss to the national economy. In the absence of incentives, firms would choose locations based on economic rationality: the location that minimizes the costs of production and distribution would be selected. Labor supply and productivity, labor costs, access to markets and to suppliers, and costs of utility services such as energy and telecommunications, are major determinants of location. Locating so as to minimize such costs maximizes the efficiency of the national economy since these costs represent the value of resources consumed. This is the virtue of market competition: firms seek to produce a given output of goods and services with the least use of society's scarce resources.

Tax incentives, however, are designed to alter the location choices of business and in so doing to override market considerations. This will result in a pattern of economic activity that requires greater use of real resources and hence reduces national economic efficiency. Furthermore, tax incentives will at times induce a business to move facilities from a location that has made a substantial investment in infrastructure and public services to support that facility to a new site, leaving redundant public investment in the old location and requiring new public investment at the new site. This is a waste of national resources.

Tax Incentive Competition Undermines Economic Growth

Our federal system places much of the responsibility on state and local governments for providing the public services that businesses directly use and depend on: education for entrants into the labor force, police and fire protection, the provision of streets and highways, and water and sewer systems. Investment in these services provides the foundation for economic activity. Tax incentive competition undermines the ability of state and local governments to finance those services and thereby degrades the quality of the basic services that the nation needs to support economic growth. At a time when even the most skilled workers face global competition, it is particularly counterproductive to divert resources from our education system to a wasteful interstate competition for jobs. Yet it will be difficult to finance increasingly expensive incentives year after year without cutting funding for the education and infrastructure services that make up the majority of state and local budgets.

Tax Incentive Competition Does Not Benefit the States

One must conclude from the extensive research on incentives within the U.S. that they are a marginally effective and very expensive tool for attracting business from one state to another. Since state and local taxes falling on businesses represent only about 1.2% of the total cost of doing business in the U.S., state tax incentives that reduce this fraction provide very little leverage over the location decision. For the vast majority of investment and location decisions, therefore, tax incentives will be swamped by differences in other economic factors. The typical tax incentive package offered routinely by a state to attract manufacturing investment can be expected to be a decisive factor in the location decisions of firms in only about one in ten instances. Ninety percent of the tax revenue lost from incentives thus goes to firms who would have made the same location decision without the incentives, and thus represents a waste of the state's money. Furthermore, if public services must be cut to finance the tax incentives, even this minimal level of effectiveness will an all likelihood be lost. Public services matter to business.

Interstate Tax Incentive Competition is an Inappropriate Vehicle for Enhancing the Competitiveness of the U.S. in the Global Economy

It might be argued that interstate tax incentive competition drives down the level of taxes on business activity and makes the U.S. as a whole more competitive internationally. This is a poor argument in defense of state tax incentives. First of all, state taxes are small relative to federal taxes. Second, state taxes are small relative to the enormous variation in transportation costs, labor costs, and labor productivity across nations. Thus even very large state tax incentives will not cause much variation in the overall tax bill facing a firm locating in the U.S. and will not be enough to offset even small differences in the other factors that are more important in determining the profitability of U.S. versus overseas locations.

More importantly, it hardly makes sense for Congress to delegate to the fifty states the task of ensuring that economic activity remains in the U.S. If this is a compelling national interest, surely it calls for measures at the national level. State tax incentive competition is neither an adequate nor a cost effective tool for stemming the outflow of jobs from the U.S. As stated above, incentives are a weakly effective and costly tool even for altering the location decisions of firms from one state to another within the U.S. As a tool for offsetting the much more substantial differences in cost between U.S. and overseas locations, they must be even less effective and more costly.

I would note furthermore that Congress some twenty years ago apparently determined that the federal investment tax credit was an ineffective tool for stimulating the U.S. economy and enhancing national competitiveness. It is not clear why Congress would now consider a multiplicity of state investment tax credits to be more effective.

Conclusions

States have available to them a variety of strategies for enhancing economic growth that are more cost effective and that do not require a beggar-thy-neighbor strategy. Investments in infrastructure, education, and workforce development are important not only to a state's economic growth potential but to the ability of the U.S. to compete in the global economy. Encouraging states to compete with one another through tax incentives deprives them of the resources to fund the investments that we as a nation must depend upon as we confront the challenges of globalization in an increasing number of economic sectors. We cannot afford a national economic strategy that relies on each of the fifty states to figure out for themselves how to stem the outflow of production and jobs from the U.S. and that encourages them to engage in an apparently never-ending race to cut taxes more than their neighbor. This is surely a self-defeating strategy in the long term.