Nos. 04-1704, 04-1724

In The
Supreme Court of the United States

DAIMLERCHRYSLER CORPORATION, *ET AL.*,

Petitioners,

v.

CHARLOTTE CUNO, *ET AL.*,

Respondents.

WILLIAM W. WILKINS, TAX COMM'R
FOR THE STATE OF OHIO, *ET AL.*,

Petitioners,

v.

CHARLOTTE CUNO, *ET AL.*,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Sixth Circuit

BRIEF OF *AMICI CURIAE* ECONOMICS AND PUBLIC POLICY PROFESSORS RANDY ALBELDA, HOWARD CHERNICK, PETER FISHER, ROBERT LYNCH, THOMAS MALONEY, ANN MARKUSEN, DICK NETZER, ROBERT REICH, ANDREW RESCHOVSKY, JOHN SOLOW, KENNETH THOMAS, AND JOHN YINGER IN SUPPORT OF RESPONDENTS

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INTERESTS OF THE *AMICI CURIAE*

Amici are distinguished economics and public policy scholars with long histories of academic research and public policy engagement in the field of tax policy and economic development.[1] A list of the *amici* and brief biographical information are attached in the addendum to this brief. *Amici* are interested in this matter based on their professional and public concern that state tax incentives like the Ohio investment tax credit at issue in this case produce wasteful interstate tax competitions that harm the national economy. They are filing this brief because they believe that the negative economic consequences that stem from tax incentives weigh in favor of declaring the Ohio investment tax credit unconstitutional.

SUMMARY OF ARGUMENT

1. The purpose of the Court's dormant Commerce Clause jurisprudence is to prevent states from enacting tax policies designed to improve their own economic positions at the expense of the national marketplace. *Hughes v. Oklahoma*, 441 U.S. 322, 325 (1979). Toward this end, the Court has repeatedly held that state policies that preference in-state business activity in a manner that

[1] This *amici curiae* brief in support of the briefs of the Respondents is submitted pursuant to Rule 37 of the Supreme Court Rules. The parties have consented to the filing of briefs *amicus curiae* and have filed blanket consent letters with the Clerk of the Court. Pursuant to Supreme Court Rule 37.6, counsel for *amici* state that this brief was not authored in whole or in part by counsel for a party and no person or entity other than *amici* or their members has made a monetary contribution to the preparation or submission of this brief.

harms out-of-state competitors improperly infringe on the federal government's core authority to regulate commerce. *See, e.g., Maryland v. Louisiana*, 451 U.S. 725 (1981). Because of the Court's role as arbiter of disputes over interstate commerce, it has grown increasingly attuned to the practical economic effects of state policies. *See, e.g., American Trucking Assocs., Inc. v. Michigan Public Serv. Comm.*, 125 S.Ct. 2419 (2005). Following the Court's lead, *amici* believe that an empirical analysis of the economic and public policy impact of state tax incentives like the Ohio investment tax credit (ITC) on interstate commerce would illuminate the Court's constitutional analysis in this case.

2. What the empirical evidence shows is that state tax incentives like the Ohio ITC do, in fact, have substantial negative consequences for interstate commerce. Competition among the states for business activity through the offering of such state tax incentives is largely a zero-sum game in that economic gains to the state that enacts tax incentives are offset by losses to other states. Moreover, tax incentive competition has an overall negative effect on the national economy by producing business location decisions that are either economically inefficient (because firms do not locate in states with the lowest real costs of production) or wasteful (in that firms are given incentives to locate in states where they would go anyway). Finally, by fostering a "race to the bottom" in which states must continually increase tax incentives in order to lure businesses, tax incentive competition undermines the ability of state and local government to finance the investments in public education and infrastructure that provide the foundation for future economic growth. Because these consequences are precisely the type of harms

that the Commerce Clause was designed to prevent, *amici* believe that they provide support for the Sixth Circuit's conclusion that the Ohio ITC impedes interstate commerce in violation of the Constitution.

3. This harm to the national economy, moreover, is not offset by gains to the states engaging in incentive competition. Indeed, the local economic benefits claimed by advocates of such policies are negligible and, to the extent that they do exist, could be accomplished by alternative state polices that do not harm the national economy. In particular, the general conclusion based on extensive research on state tax incentives is that incentives are, at best, only marginally effective in changing the location of business activity. And even when they do, it is at the expense of spending on local infrastructure (education, utilities, transportation) that undercuts long-term growth. Because state investments in workforce development, technology, education, and public infrastructure are viable alternative means of enhancing state economic growth, tax incentives like Ohio's ITC can only be viewed as costly, inefficient policies.

ARGUMENT

I. AN ANALYSIS OF THE ECONOMIC IMPACT OF STATE TAX INCENTIVES IS RELEVANT TO THE CONSTITUTIONAL ISSUE AT STAKE

The Court's Commerce Clause jurisprudence is rooted in a fundamental concern about the destructive impact of certain types of state economic regulation on the national economic welfare. Though the Commerce Clause itself – which confers upon Congress the "Power . . . To regulate

Commerce . . . among the several States," U.S. Const. art. I, § 8, cl. 3 – imposes no explicit limitation on the power of the states over their own economic activity, it has long been interpreted as providing an essential bulwark against self-interested state policies that injure the national market. Indeed, the inclusion of the Commerce Clause in the Constitution reflected

> the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation.

Hughes v. Oklahoma, 441 U.S. 322, 325 (1979). In order to protect against such "Balkanization," the Court has, through the "dormant" or "negative" aspect of the Commerce Clause, sought for nearly two hundred years to protect interstate economic activity by rooting out discriminatory state regulation. *See West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 192 (1994). Thus, even though the Commerce Clause itself is simply a grant of regulatory power to the federal government, what the "dormant" Commerce Clause jurisprudence stands for is the principle that the individual states may not usurp the federal role by enacting their own regulations that impede interstate commerce.

The paradigmatic violation of the dormant Commerce Clause is when a state imposes a tariff on goods imported from other states that is not imposed on in-state goods. *See West Lynn Creamery*, 512 U.S. at 193. However, the Court has made it clear that this paradigm does not exhaust the situations in which state regulation of economic activity will constitute a violation of the Commerce Clause. To the contrary, the Court has affirmed that state regulation that preferences in-state economic actors to the detriment of their out-of-state counterparts is equally suspect from a constitutional perspective. *See New Energy Co. of Indiana v. Limbach*, 486 U.S. 269 (1988) (holding that an ethanol tax credit limited to ethanol produced in Ohio or in a state with a similar tax credit provision violated the Commerce Clause principle of nondiscrimination); *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984) (striking down New York tax credit for export-oriented corporations based on the proportion of New York business activity); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) (invalidating a Hawaii state law exemption on liquor tax for locally produced alcoholic beverages); *Maryland v. Louisiana*, 451 U.S. 725 (1981) (striking down a Louisiana tax scheme that provided tax credits solely to in-state producers of natural resources); *Boston Stock Exchange v. State Tax Comm.*, 429 U.S. 318 (1977) (holding that a New York statute that reduced the tax on in-state stock transfers in order to prevent the loss of stock trades from the New York Stock Exchange violated the Commerce Clause).

It is the concern with the detrimental impact of preferential state regulation on interstate commerce that lies at the heart of the Court's examination of the Ohio investment tax credit (ITC) at issue in this case. *See* Ohio Rev. Code Ann. §§ 5733.33(C)(1), (C)(2).[2] The key question before the Court is whether the ITC – which was given to DaimlerChrysler to construct a new vehicle-assembly plant in Toledo – constitutes economic discrimination in violation of the Commerce Clause.

[2] We note that the Ohio tax credit in its general outlines is similar to the type of investment tax credits currently in place in 38 states. *See* COMMERCE CLEARING HOUSE, 2005 STATE TAX HANDBOOK 275-80 (2005).

At the core of this constitutional inquiry is a set of very practical questions: What are the real interstate economic impacts of state tax incentives like Ohio's ITC? Does the adoption of tax incentives by one state influence the level of economic activity in other states or otherwise impair the free flow of trade across state borders? Do state tax incentives actually yield economic benefits for states that adopt them? In order to assess whether the Ohio ITC and others like it impermissibly burden interstate commerce or actually promote productive economic competition between the states, it is therefore helpful to consider what we know as an empirical matter about the actual economic effects of such policies.

In its recent Commerce Clause jurisprudence, the Court has underscored the importance of examining the practical economic impact of challenged state policies.[3] For instance, in *American Trucking Assocs., Inc. v. Michigan Public Serv. Comm.*, 125 S.Ct. 2419 (2005), the Court held that Michigan's $100 flat fee imposed on trucks that "undertake point-to-point hauls between Michigan cities," *id.* at 2422, did not violate the Commerce Clause, *id.* at 2423. In reaching this conclusion, the Court emphasized that "the record contains little, if any, evidence that the $100 fee imposes *any significant practical burden* upon interstate trade." *Id.* at 2423-24 (emphasis added). Particularly given

[3] In a forthcoming article, Professor Kirk Stark and Federal Reserve Bank economist Daniel Wilson discuss the constitutional importance of considering the economic effects of tax incentives in the context of the *Cuno* controversy. *See* Kirk J. Stark & Daniel J. Wilson, *What Do We Know About the Interstate Economic Effects of State Tax Incentives?*, 4 GEORGETOWN JOURNAL OF LAW & PUBLIC POLICY (forthcoming), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=868692.

the Court's central institutional role in resolving interstate commercial disputes, *Gibbons v. Ogden*, 22 U.S. 1 (1824), we believe it appropriate for the Court to give attention to the practical economic effects of state tax incentives in considering this case.[4]

[4] The significance of undertaking such an analysis is highlighted by the frequency with which *amici* for the Petitioners invoke the practical economic impact of state tax incentives to support arguments in favor of their constitutionality. Indeed, a prominent theme in the *amici* briefs for Petitioners is that state tax incentives foster healthy economic competition between the states. *See* AlphaGenetics, Inc. *et al. Amici Curiae* Brief, at 19 (arguing that "the decision of the Court of Appeals will result in the unintended consequence of impeding innovation among early-stage companies and impacting on entrepreneurship"); City of New York *Amicus Curiae* Brief, at 2 (stating that an investment tax credit "helps to encourage increased local business activity"); National Governors Association, *et al. Amicus Curiae* Brief, at 13 (stating that "while there is no record here, the ITC likely functions in a manner that promotes interstate commerce" by reducing the purchase price of goods and serving as an export subsidy); Nissan *Amicus Curiae* Brief, at 25 (suggesting that Nissan's tax break package in Tennessee "transformed Tennessee's economy"); Pacific Legal Foundation *Amicus Curiae* Brief, at 3 (suggesting that state tax incentives like Ohio's promote "competitive federalism," "in which states compete with one another to provide the best regulatory regime for mobile citizens"); Tax Executives Institute, Inc. *Amicus Curiae* Brief, at 7 ("Investment tax credits, along with an array of other tax incentives, are widely used by States to encourage growth in economically distressed areas, spur investment, increase jobs, and hence, enlarge the tax base."); Tax Foundation *Amicus Curiae* Brief, at 14 (stating that the sensitivity of companies like DaimlerChrysler to state tax systems "provides the opportunity for meaningful and beneficial tax competition among the States for jobs and investment"); The Right Place, Inc. and the City of Grand Rapids, Michigan *Amici Curiae* Brief, at 12 (arguing that if all states adopted a tax credit similar to the Ohio investment tax credit, "it would result in lower corporate taxes and more national commerce"). However, while these *amici* suggest that negative economic consequences would result from the elimination of state tax incentives like the Ohio ITC, there is a complete lack of empirical evidence provided to support this claim.

II. THE ECONOMIC EVIDENCE SHOWS THAT STATE TAX INCENTIVES, AT BEST, PRODUCE A ZERO-SUM COMPETITION AND, AT WORST, RESULT IN A NATIONAL ECONOMIC LOSS

This part addresses the most fundamental concern of the dormant Commerce Clause: What are the inter-state economic consequences of state tax incentives?

A. Tax incentive competition is at best a zero-sum game

To the extent that a state is successful in attracting more business investment through the offering of tax incentives, it does so at the expense of other states. That, in fact, is the stated rationale for incentive policies: to change the location choices of business firms. Moving business activity from one place to another has been described as a zero-sum game: the gain to one state is offset by a loss to another, with no net benefit to the nation. *See* Barry Rubin & Kurt Zorn, *Sensible State and Local Economic Development Policy*, 45 PUBLIC ADMINISTRATION REV. 333 (1985).

Recent studies on research and development (R&D) spending support this conclusion. While previous studies have looked at state tax levels and certain measures of economic growth in order to discern the influence of general tax reductions on economic activity, these more recent studies attempt to isolate the discrete effect of state tax incentives on firm investment behavior. In one recent study, for example, economist Dan Wilson of the Federal Reserve Bank examines firm-level data on research and development (R&D) spending in order to estimate how sensitive firm R&D spending is to its after-tax price or "user cost," and specifically to state R&D credits. Daniel J. Wilson, *Beggar Thy Neighbor? The In-State vs. Out-of-State Impact of State R&D Tax Credits*, FEDERAL RESERVE BANK OF SAN FRANCISCO WORKING PAPER 08 (2005). Relying on comprehensive data of after-tax R&D prices, Wilson finds that state R&D tax credits do appear to spur R&D spending within the state adopting the credit. Wilson also finds, however, that the out-of-state effect is roughly opposite and equal in absolute value to the in-state effect. The key finding of Wilson's research that is most relevant for the dormant Commerce Clause analysis is the influence of R&D tax credits on R&D spending *in other states*. Thus, as the cost of research and development undertaken inside of State A decreases, as it would when State A enacts or increases R&D tax credits, the level of R&D activity undertaken outside of State A falls.

These results provide support for the view that a state's adoption of R&D tax credits has adverse practical effects on the level of R&D undertaken within other states. Over the past quarter-century, numerous states have adopted R&D tax credits, ostensibly to provide a friendly business climate for high-tech investment. *See* Daniel J. Wilson, *The Rise and Spread of State R&D Tax Credits*, FEDERAL RESERVE BANK OF SAN FRANCISCO ECONOMIC LETTER, Number 2005-26 (October 14, 2005). For example, California adopted its R&D tax credit in 1988, allowing businesses a credit equal to 20 percent of the excess of the taxpayer's "qualified research expenses" over a specified base amount.[5] Based on Wilson's findings, the

[5] For a description of California's R&D tax credit, see BRONWYN HALL & MARTA WOSINKA, THE CALIFORNIA R&D TAX CREDIT: DESCRIPTION, HISTORY, AND ECONOMIC ANALYSIS (1999).

expected effect of a state's adoption of such a credit would be an increase in R&D spending in that state and a corresponding decrease in other states. It is as though a single state has appropriated for itself the power to direct the geographical sourcing of R&D spending – precisely the sort of "regulation of interstate commerce" that the Court's dormant commerce clause jurisprudence is meant to foreclose.

B. Tax incentive competition produces economic inefficiency

When viewed from the perspective of the national economy, the evidence suggests that state tax incentive competition is likely more damaging than a zero-sum game: It is, in fact, a negative-sum game in that the distortions it creates produce inefficient locational decisions that result in a national economic loss. *See* Melvin L. Burstein & Arthur J. Rolnick, *Congress Should End the Economic War Among the States*, 9 THE REGION (Federal Reserve Bank of Minneapolis) 3 (March 1995). In order to understand the harmful national consequences of state tax incentives, we must first consider the range of factors that a business considers when choosing a location in which to build, relocate, or expand a facility:

i. Access (transport cost and reliability) to raw materials or components;

ii. Access to the major markets for the finished products;

iii. Availability of labor with needed skills and the productivity of that labor;

iv. Wage rates;

v. Employee health insurance costs;

vi. Energy and telecommunications services costs; and

vii. Quality of local public services, particularly those related to education and training of the labor force, infrastructure investment, and public safety.

Businesses naturally seek locations with the lowest resource cost. That is, they seek to minimize the costs of transporting raw materials or finished products, the total cost of labor embodied in the finished product, and the costs for energy, water, sewer, and communications services. These costs to the firm also reflect the real social costs associated with consumption of scarce resources. When firms minimize transport costs, for example, society gains: For a given volume of finished product, the economy consumes the minimum tons of concrete and gallons of gasoline required for the transportation services needed to produce and deliver those finished products. The efficient operation of the national economy requires that firms choose the least-cost locations, a result generally produced by the competitive pressures on firms to reduce costs.

The purpose of tax incentives is to change location decisions. Two Federal Reserve economists have argued that incentives, if they are effective in changing the location of economic activity, change the distribution of facilities from the set of least-cost locations as described above to one that consumes more resources and is therefore less efficient. *See* Burstein & Rolnick, *supra*. These economists describe this as a "negative-sum" result because the benefits and costs to local economies offset each other (the zero-sum game), but the losses to the national economy produce a negative sum.

One counter argument is that incentives simply reinforce the existing geographic pattern of costs. However, this argument does not save them from the charge of inefficiency. To the contrary, to the extent that incentives do reinforce existing cost patterns, they are entirely inefficient since the same location decisions would have been made in the absence of incentives. Incentives only make a difference when they trump economic considerations and induce inefficient location choices.[6]

There is an additional way in which incentive competition can produce net losses. When a business firm actually

[6] We do not suggest that the Commerce Clause prohibits, or that sound economic development policy should avoid, all state policies that pursue other values at the cost of economic efficiency. First, the Commerce Clause, in this context, applies only to tax policy and leaves states free to pursue economic development or social policy goals by other means. *See New Energy*, 486 U.S. at 278 ("The Commerce Clause does not prohibit all state action designed to give its residents an advantage in the marketplace, but only action of that description in connection with the State's regulation of interstate commerce. Direct subsidization of domestic industry does not ordinarily run afoul of that prohibition; discriminatory taxation of out-of-state manufacturers does."). Second, the Commerce Clause prohibits only those tax policies that seek to enrich one state by moving economic activity to that state from another state. The Commerce Clause does not prohibit states from using tax policy to encourage desired corporate behavior within a state, or even to encourage location decisions within a state that may be economically inefficient but meet other policy objectives. *Id.* Similarly, the Commerce Clause obviously does not limit the ability of the *federal* government to encourage location decisions based on factors other than economic efficiency. Rather, the basic constitutional limitation is a narrow one: States cannot use their sovereign taxing power to pursue the goal of strengthening their own economies by undermining the economic base of other states. In setting this policy, the framers of the Constitution were not only establishing an important rule to protect political and social harmony among the several states, they were also practicing fundamentally sound economic theory.

relocates an existing facility, it moves from a locality with the necessary public infrastructure and services already in place, to a locality that must expand services to accommodate the facility and the population growth that ensues. The result is redundant public investment in the old locale that must then be maintained with revenues from a smaller tax base, while resources must be committed to provision of new public investment in the new locale.[7] While these effects are felt locally, they represent real national economic costs.

C. Tax incentive competition harms long-term economic growth

As part of the interstate competition, one state's decision to provide tax incentives to businesses induces reciprocal behavior on the part of other states. In order to "win" the interstate competition for new business activity, states are therefore placed in the position of having to continually increase tax breaks to lure businesses. As a result of this "race to the bottom," over time the zero-sum game becomes more costly to states as they devote larger shares of their budgets to the provision of tax incentives.[8]

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[7] Several studies have estimated the cost of public investments, particularly streets and highways, necessitated by new business development. For a review of research on this topic see ALAN ALTSHULER & JOSE GOMEZ-IBANEZ, REGULATION FOR REVENUE: THE POLITICAL ECONOMY OF LAND USE EXACTIONS 77-96 (1993).

[8] In a study of 20 states that together accounted for 75% of the manufacturing investment in the U.S., Alan Peters and Peter Fisher documented the growth of incentive programs from 1990 to 1998 and found that the average set of state and local tax incentives for manufacturing activity had approximately doubled in value (measured as the percentage reduction in total state-local taxes) over that eight-year

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This country has a well-developed intergovernmental system that places responsibility on states and localities for providing the public services that businesses directly use and depend on: education for entrants into the labor force, police and fire service, and the provision of local infrastructure (such as streets, 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 provide those services by diverting revenues to a costly and wasteful competition with one another. *See* Burstein & Rolnick, *supra*. As such it operates to degrade the quality of basic services that the nation needs to foster future growth.

D. Tax incentive competition does not enhance international competitiveness

Some have argued that incentive competition drives down the average level of state and local taxes on business activity in the U.S., which in turn makes the nation more competitive in the world economy. However, there is reason to be skeptical of this claim. For one, U.S. state and local taxes are a small part of the overall cost of doing business and are already quite low compared to other industrialized countries. Among the 30 nations in the Organisation for Economic Cooperation and Development, the U.S. ranks 29th in terms of total federal, state and

period. ALAN PETERS & PETER FISHER, STATE ENTERPRISE ZONE PROGRAMS: HAVE THEY WORKED? 56-69 (2002); *see also* KENNETH THOMAS, COMPETING FOR CAPITAL 158-59 (2000) (finding that state and local business tax incentives and subsidies had grown in the 1990s and approached $49 billion in 1996).

local taxes as a percent of gross domestic product. *See* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, REVENUE STATISTICS 1965-2003 (2004). Furthermore, when one considers the range of economic factors that play a significant role in firm location decisions – transportation, wages, and productivity – there is obviously enormous variation across the globe. U.S. state-local taxes are inconsequential when compared to differences in wages between, for example, Ohio and China. Because of this, a reduction in Ohio taxes would not have a decisive influence on a firm's decision to locate in China.

Moreover, to the extent that international competitiveness is an important policy concern, it is not of constitutional importance here. To the contrary, under the explicit terms of the Commerce Clause, the regulation of international commerce is squarely within the domain of the federal government. U.S. Const. art. I, § 8, cl. 3 (leaving to Congress the power to "regulate Commerce with foreign Nations").

III. STATE TAX INCENTIVES DO NOT PRODUCE MEANINGFUL INTRASTATE ECONOMIC BENEFITS THAT JUSTIFY THEIR HARMFUL INTERSTATE EFFECTS

Once we understand the negative consequences of state tax incentives on the national economy, the question arises: Are they nevertheless worth it for the states that enact them? Under the Supreme Court's dormant Commerce Clause jurisprudence, even a discriminatory tax incentive may be upheld if "it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." *New Energy*, 486 U.S. at 278. Do state tax incentives of the sort at issue here produce the types of intrastate economic benefits that might still warrant their use? As we discuss in this section, the weight of the economic evidence suggests that the answer to this question is no. Specifically, we present evidence that the effects of state tax incentives on business location are small; incentives are costly to the states that offer them; and states have available to them a wide array of alternative economic development policies that are in fact cost-effective and beneficial to the national economy.

A. Tax incentives are at best marginally effective in altering business locations

Some state and local government officials believe that business tax incentives are an effective policy tool to promote economic development in their states and localities. This belief is not supported by the evidence. Economists have researched this issue extensively over the past three decades. In fact, over 75 studies have been conducted exploring the question: Do taxes, or tax incentives, produce growth in investment or jobs? *See* Michael Wasylenko, *Taxation and Economic Development: The State of the Economic Literature*, NEW ENGLAND ECON. REV. 37 (March-Apri1 1997).[9] The general conclusion that

[9] Much of this research has investigated the effects of reductions in the level of taxation rather than the effects of tax incentives per se. However, a tax incentive is by definition a reduction in a tax, so that the effects of "tax reductions" or "incentives" on economic activity will be similar. In discussing the research literature, we will use the term "incentives" to refer to tax reductions of whatever form. In doing so, however, we are not suggesting that tax reductions be subject to same constitutional scrutiny as tax incentives. Indeed, the Court has made it clear that general reductions in state tax levels do not raise dormant Commerce Clause concerns. *See West Lynn Creamery*, 512 U.S. at 199

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can be drawn from this large body of research is that incentives are, at best, only marginally effective in changing the location of business activity. *See* ROBERT G. LYNCH, RETHINKING GROWTH STRATEGIES: HOW STATE AND LOCAL TAXES AND SERVICES AFFECT ECONOMIC DEVELOPMENT (2004); Alan Peters & Peter Fisher, *The Failures of Economic Development Incentives*, 70 J. OF THE AMERICAN PLANNING ASSOC. 27 (Winter 2004); Wasylenko, *supra*. In addition, recent research has called into question whether the location of new firms produces significant net benefits for the host community. *See* William F. Fox & Matthew N. Murray, *Do Economic Effects Justify the Use of Fiscal Incentives?*, 71 SOUTHERN ECON. J. 78 (2004). As a result, there is reason to believe that tax incentives are both costly and potentially counterproductive even to the states that use them "successfully."

Firms consider the whole range of factors discussed earlier (access, labor productivity and cost, energy cost, public services) when choosing a location for a new facility or for relocating an existing facility. States vary widely on all these dimensions. Differences in state and local taxes are actually of little significance when stacked up against differences in these other costs. On average, state-local taxes falling on businesses represent only about 1.2% of the total cost of doing business in the U.S. *See* LYNCH, *supra*, at 4. A tax incentive that reduces this tax burden, therefore, would obviously represent an even smaller percentage of the total cost of doing business.

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n. 15 (stating that "it is undisputed that States may try to attract business by creating an environment conducive to economic activity, as by maintaining good roads, sound public education, or low taxes").

For the vast majority of investment and location decisions, therefore, tax incentives will be swamped by differences in other economic factors. Labor costs, for example, are about 14 times the average state and local tax cost. *See* TIMOTHY BARTIK, WHO BENEFITS FROM STATE AND LOCAL ECONOMIC DEVELOPMENT POLICIES? 61 (1991). Thus even a tax incentive equal in value to 50% of the total state-local tax burden in a state would be more than offset by a mere 4% difference in wages between that state and another, because 4% of the wage bill is worth more than 50% of the annual tax bill. Furthermore, the incentive is temporary, while the wage difference may well persist for years. Thus we should expect, from the beginning, to find that tax incentives rarely tip the balance one way or the other; they would do so only in those few cases where the other cost factors are equal between two locations.

The effectiveness of tax incentives in stimulating economic activity can be researched by exploring the following hypotheses: If incentives are effective, then states or places that offer incentives should experience more growth than those that do not; states or places with larger incentives should experience more growth than those with smaller incentives; and states or places that adopt incentives should experience a higher growth rate after adoption than prior to adoption. These hypotheses can be tested statistically, by comparing growth across states to the incentives in those states, controlling for the other factors that influence growth rates. The hypotheses can be tested over time as well, comparing growth rates before and after the adoption or expansion of incentives, again controlling for other factors that changed over the time period in question.

Earlier studies (in the 1950s through the mid-1970s) generally concluded that incentives make little or no difference in the location or investment behavior of firms. *See, e.g.*, John Due, *Studies of State-Local Tax Influences on Location of Industry*, 14 NATIONAL TAX J. 163 (1961). Later studies that were more sophisticated methodologically found small effects.[10] One of the important differences is that these more recent studies found better ways to control for the influence of public services on growth. That is, they were better at finding the independent influence of incentives, holding all other factors (including public service levels) constant. It is important to understand what this means. What the recent studies found, in effect, is that states that offer larger incentives can expect some modest increase in economic activity provided that they can somehow do so without cutting public services.[11] The research findings are thus much more limited in scope than is often claimed, for they mean only that if a state can somehow be more efficient, providing the same level of services with lower taxes, then it will experience more economic growth (though not a lot more). It certainly does not mean that business tax incentives financed by service cuts will produce growth. *See* LYNCH, *supra*.

In the real world, state and local governments must, for the most part, balance their budgets. Business tax

[10] For one of the earliest reviews of several studies showing positive effects, see Robert Newman & Dennis Sullivan, *Econometric Analysis of Business Tax Impacts on Industrial Location: What Do We Know, and How Do We Know It?*, 23 J. OF URBAN ECONOMICS 215 (1988).

[11] Reviews of these studies can be found in BARTIK, *supra*; LYNCH, *supra*; Peters & Fisher, *The Failures of Economic Development Incentives*, *supra*; and Wasylenko, *supra*.

incentives must be offset by cuts in spending or increases in other taxes. Studies have found that public services, particularly education and infrastructure, are important factors contributing to growth. *See* LYNCH, *supra,* at 43-46; *see also* Ronald Fisher, *The Effects of State and Local Public Services on Economic Development*, NEW ENGLAND ECONOMIC REVIEW 53 (March/April 1997). If a state provides business tax incentives and cuts services at the same time, the research suggests that the magnitude of the negative effects of the spending cuts could be enough to offset the positive effects of the tax cut. *See* LYNCH, *supra*; Fisher, *supra*. In fact, research indicates that tax increases that finance spending increases can actually provide some economic stimulus. *See* LYNCH, *supra* (discussing the results of five separate studies). The positive effects of spending may (depending on the nature of the spending) be greater than the negative effects of business tax increases. *Id.*

In the mid-1990s, some economists argued that a consensus of sorts had been reached on the long-term effectiveness of state business tax incentives. *See* Timothy Bartik, *Jobs, Productivity, and Local Economic Development: What Implications Does Economic Research Have for the Role of Government?*, 47 NATIONAL TAX J. 847, 852 (1994); Wasylenko, *supra*, at 49. The measure of their effectiveness is summarized in an elasticity: the percentage change in business activity produced by a given percentage change in tax incentives. The consensus was that this elasticity was around .2 or .3, which means that an incentive equivalent to a 10% cut in taxes would eventually produce a 2% to 3% increase in economic activity, provided, again, that incentives were not accompanied by cuts in public services.[12]

Is this a large effect or a small effect? One way of addressing this question is to ask: Given that level of influence, how much of the economic growth experienced by a state will be attributable to the incentives? Public officials routinely assert or assume that the answer to this question is: All of it. Once incentives are adopted, all subsequent growth is attributed to the incentives, as if no growth would occur on its own. This assumes that tax incentives are always the decisive factor, which flies in the face of the evidence that other factors are much more important, and tax incentives are rarely the decisive factor.

A typical array of business incentives offered for the average manufacturing business is equivalent to about a 30% cut in the state and local tax burden over a period of 20 years. *See* PETERS & FISHER, STATE ENTERPRISE ZONE PROGRAMS: HAVE THEY WORKED?, *supra* at 113. What the research shows is that, given incentives of this magnitude, and given the more generous estimate of incentive effectiveness (an elasticity of .3), only about 1 in 11 business investments can be attributed to the incentives. *See id.* The rest of the investment would have occurred anyway. Moreover, the effects of service cuts necessitated by the incentives may well offset even these modest gains, reducing the 9% effectiveness to near zero.

[12] An elasticity of .2 means that the percentage change in economic activity will equal .2 times the percentage change in taxes. This elasticity measures change over the long run; that is, the ensuing growth occurs not immediately but over a period of many years.

B. Tax incentives are costly

The crux of the problem for state governments is this: Since the vast majority of business decisions will hinge on factors other than taxes, when you offer tax incentives, you have to spend an enormous amount of money (in the form of tax breaks that were unnecessary) to get a small benefit. This makes the tax cut strategy expensive and wasteful. Furthermore, even that low level of effectiveness, gained at high cost, is attainable only if the state can finance the tax cuts in a way that does not drive business from the state. Cuts in spending on education and infrastructure will offset any gains from the tax cuts and in fact will damage the state's long-run economic prospects. Yet it will be difficult to finance significant tax cuts year after year without reducing spending for education, transportation, utilities, and public safety. Those categories account for the majority (55%) of state and local budgets.[13]

C. Tax incentives are an inferior policy tool given the alternative strategies available to encourage economic development

States have available to them a variety of strategies to foster economic growth. States invest in workforce development, for example, which benefits both the workers whose skills and earning potential are upgraded and the

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[13] This figure is calculated by dividing the sum of expenditure of all state and local governments in the U.S. for education, transportation, public safety, and utilities by the sum of direct general expenditure and utility expenditure. *See* UNITED STATES CENSUS BUREAU, 2002 CENSUS OF GOVERNMENTS, Table 1 (State and Local Government Finances by Level of Government and by State: 2001-2002), *available at* http://ftp2.census.gov/govs/estimate/02slsstab1a.xls.

businesses that then can draw from a pool of higher skilled labor. States invest in business development through university technology transfer programs, business incubation centers, small business development assistance, and support for the provision of venture capital. *See, e.g.*, PETER K. EISINGER, THE RISE OF THE ENTREPRENEURIAL STATE (1988) (analyzing state high technology initiatives and venture capital programs). Most importantly, states invest in public education, which is essential to the development of the kind of workforce demanded in a modern economy. And they provide, often through local government, the public infrastructure essential to economic activity: streets and highways, public transit, water and sewer systems, and police and fire protection.[14]

The common feature of all of these alternative strategies for enhancing state economic growth is that they are productive and important activities from a national perspective as well. They are not beggar-thy-neighbor approaches, but instead are efforts to reinforce and enhance the nation's economic base. Furthermore, they are not hampered by the fundamental problem with incentives: the asymmetry of information that leads governments to spend money without knowing whether or not it is needed (since the business investment likely would have occurred anyway). As such, these alternatives are bound to be more cost effective.[15]

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[14] Evidence of the importance of education, streets and highways, and public safety services on state economic growth can be found in Fisher, *supra*.

[15] Timothy Bartik is among those who have argued for a greater focus of state economic development policies on programs that enhance business productivity, and cites some evidence of the effectiveness of

(Continued on following page)

Far from creating irreparable harm to state economic development efforts, a court decision invalidating tax incentives would end a very inefficient, costly, and wasteful practice and free up state resources to devote to economic development strategies that are at once more cost effective to the states and beneficial, rather than harmful, to the national economy. From a constitutional perspective, the existence of these more effective economic development alternatives further undercuts the validity of discriminatory tax incentives like Ohio's ITC.

D. Incentive strategies are adopted for political, not economic, reasons

The economic war between the states continues unabated, not for sound economic reasons, but for a variety of political reasons. The opening of a new plant that benefited from tax incentives provides politicians with a valuable opportunity to take credit for something of tangible benefit to the state, even if the incentives in actuality played no part in the firm's decision. The investments in education and infrastructure that would be of greater long-term economic benefit, on the other hand, will produce results that are less tangible, harder to take credit for, and that occur long after most current elected officials have left office.

The political risk associated with "losing" a major employer, or failing to land a new manufacturing facility after an intense competition with other states, is enormous. The risk associated with spending money unnecessarily

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certain workforce training and technology programs. Bartik, *Jobs, Productivity, and Local Economic Development*, *supra*.

is small, particularly since, sooner or later, there will be business expansions or relocations somewhere in the state that can be attributed to the spending, and it will rarely be clear to the public that the spending was unnecessary. *See* Terry F. Buss, *The Effect of State Tax Incentives on Economic Growth and Firm Location: An Overview of the Literature*, 15 ECON. DEV. Q. 92 (February 2001). Furthermore, incentives can be couched as tax cuts, not spending programs, even though, as "tax expenditures," they are equivalent. It is difficult to run for office on a platform opposing tax cuts that appear to have little cost to the average taxpayer and that one's opponent will argue create jobs.

Thus the political incentives are all on the side of granting incentives. Benefits to the state can always be plausibly asserted, however weak the causal connection, and the costs in lost revenue are hidden. Disavowing tax incentives, on the other hand, presents great risks and few benefits to political leaders, as their opponents in the next election will attack them for failing to do all they could to capture development and increase jobs. It is no wonder that states, left to themselves, continue the race to the bottom.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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January 23, 2006

ADDENDUM

The *amici curiae* include the following economics and public policy scholars:

Randy Albelda is a professor of economics in the Public Policy graduate program at the University of Massachusetts, Boston. She has worked as research director of the Massachusetts State Senate's Taxation Committee and the legislature's Special Commission on Tax Reform. Her research and teaching covers a broad range of economic policies affecting low-income families. Her most recent work includes the edited volumes THE DILEMMAS OF LONE MOTHERHOOD: ESSAYS FROM FEMINIST ECONOMICS and LOST GROUND: POVERTY, WELFARE REFORM, AND BEYOND, and co-authored reports, *A Tale of Two Decades: Changes in Work and Family in Massachusetts 1979-1999* and *Beyond Welfare: Emergency Services in Massachusetts*. Other publications include the book, ECONOMICS AND FEMINISM: DISTURBANCES IN THE FIELD, co-authored books, GLASS CEILINGS AND BOTTOMLESS PITS: WOMEN'S WORK, WOMEN'S POVERTY; THE WAR ON THE POOR: A DEFENSE MANUAL; and UNLEVEL PLAYING FIELDS: UNDERSTANDING WAGE INEQUALITY AND DISCRIMINATION. She is the author or co-author of over 20 articles, ten book chapters and dozens of policy reports.

Howard Chernick is a professor at Hunter College of the CUNY Graduate School. He holds a Ph.D. in economics from the University of Pennsylvania and is a Research Affiliate of the Institute for Research on Poverty at the University of Wisconsin-Madison. Before coming to Hunter College in 1982, he was a senior researcher in the U.S. Department of Health and Human Services. From 1989-90 he was a Visiting Fellow at the Russell Sage Foundation.

Professor Chernick's research specializes in the economics of the public sector, with special attention to the distributional impacts of government spending and taxation. He is a recipient of the Presidential Award for Excellence for applied Scholarship, Hunter College, 2005. He is actively involved in public policy in New York, serving as a consultant to the City of New York Independent Budget Office and the Campaign for Fiscal Equity.

Peter Fisher is a professor in the Graduate Program in Urban and Regional Planning at the University of Iowa, where he has taught since 1977. His research and interests are centered on state and local government finance, economic development policy, and poverty and income inequality. He has consulted with state government agencies in Ohio and Iowa regarding tax incentives and economic development policy. He has written or co-authored three books: Peter Fisher and Alan Peters, INDUSTRIAL INCENTIVES: COMPETITION AMONG AMERICAN STATES AND CITIES (Upjohn Institute for Employment Research, 1998) Alan Peters and Peter Fisher, STATE ENTERPRISE ZONES: HAVE THEY WORKED? (Upjohn Institute, 2002); and Peter Fisher, GRADING PLACES: WHAT DO THE BUSINESS CLIMATE RANKINGS REALLY TELL US? (Economic Policy Institute, 2005). His article, co-authored with Alan Peters, *The Failures of Economic Development Incentives*, (JOURNAL OF THE AMERICAN PLANNING ASSOCIATION, Winter 2004), won the prize for the best article in that journal in 2004.

Robert G. Lynch is the Everett E. Nuttle Professor of Economics and Chair of the Department of Economics at Washington College, where he has taught since 1998. He is also a Research Associate with the Economic Policy Institute. From 1983 to 1998, he taught at the State

University of New York at Cortland where he served as Chair of the Department of Economics between 1991 and 1993. He also taught at Huanghe University (1985-86) in the People's Republic of China. Dr Lynch has served as a consultant to numerous organizations including private businesses, governments, labor unions, and research organizations. His areas of specialization include Public Policy, Public Finance, International Economics, Economic Development and Comparative Economics. Over the past 20 years Dr. Lynch has evaluated the adequacy and effectiveness of various state and local government economic policies, reviewed government economic growth strategies, and studied the efficiency, fairness, and stability of state and local tax systems. He is the author of numerous works that have analyzed the effectiveness of state and local government economic policies in promoting economic development and creating jobs including his 2004 publication RETHINKING GROWTH STRATEGIES: HOW STATE AND LOCAL TAXES AND PUBLIC SERVICES AFFECT ECONOMIC DEVELOPMENT. In addition, he has written several papers that examined issues related to the definition and measurement of income inequality.

Thomas Maloney received his Ph.D. in economics from the University of Michigan in 1992 and was a Post-Doctoral Fellow at the Center for the Study of Urban Inequality, University of Chicago, from 1992 to 1994. He is currently an Associate Professor in the Department of Economics at the University of Utah. His research on U.S. economic history, racial discrimination, migration, and labor markets has appeared in the JOURNAL OF ECONOMIC HISTORY, EXPLORATIONS IN ECONOMIC HISTORY, SOCIAL SCIENCE HISTORY, THE JOURNAL OF INTERDISCIPLINARY HISTORY, ECONOMIC INQUIRY, and elsewhere. He served on the editorial board of the JOURNAL OF ECONOMIC HISTORY from 2001 to 2005.

Ann Markusen is Professor of Public Affairs at the University of Minnesota and is the director of the Institute's Project on Regional and Industrial Economics. Currently, her research focuses on occupational approaches to regional development and on the arts, high tech and defense activities as regional economic stimulants. Before joining the Humphrey Institute, Markusen was State of New Jersey Professor of Urban Planning and Policy Development at Rutgers University. She has held faculty positions at Northwestern, the University of California at Berkeley, and the University of Colorado. Markusen has been an economic policy fellow with the Brookings Institution and a research economist with the Michigan speaker of the house's office. She was a Fulbright Lecturer in regional development economics in Brazil and has written on European, Korean and Japanese regional economies as well as on North American cities and regions. From 1995 to 2002, she served as a Senior Fellow at the Council on Foreign Relations in New York and in 2002, as a Visiting Fellow at the Public Policy Institute of California. Markusen has served as president of the North American Regional Science Association, regional planning track chair for the American executive committee and board member of the Economics Policy Institute in Washington, D.C.

Dick Netzer is Professor Emeritus of Economics, Planning and Public Administration at New York University's Wagner Graduate School. He has worked in urban public finance and urban economics as a researcher, teacher, consultant, and public official for more than 40 years. He is the author of ECONOMICS OF THE PROPERTY TAX

(Brookings, 1966), ECONOMICS AND URBAN PROBLEMS (Basic Books, 1974), and THE SUBSIDIZED MUSE (Twentieth Century Fund Press, 1978) and principal author of *Financing Government in New York City*. He is also the author of *An Evaluation of Interjurisdictional Competition Through Economic Development Incentives*, in Daphne Kenyon and John Kincaid, editors, COMPETITION AMONG STATES AND LOCAL GOVERNMENTS: EFFICIENCY AND EQUITY IN AMERICAN FEDERALISM. Urban Institute Press, 1991. In addition, he is the author or co-author of more than 200 other articles, papers, and book chapters, and is a nationally recognized expert in the economics of property taxation. From 1969 through 1982, Professor Netzer served as the dean of the Wagner School and was the founding director of the Taub Urban Research Center. He is a member of the Board of Directors of the Citizen's Union Foundation.

Robert B. Reich is Professor of Public Policy at the Goldman School of Public Policy at the University of California at Berkeley. He has served in three national administrations, most recently as secretary of labor under President Bill Clinton. He has written ten books, including THE WORK OF NATIONS, which has been translated into 22 languages; the best-sellers THE FUTURE OF SUCCESS and LOCKED IN THE CABINET, and his most recent book, REASON. His articles have appeared in the NEW YORKER, ATLANTIC MONTHLY, NEW YORK TIMES, WASHINGTON POST, and WALL STREET JOURNAL. Mr. Reich is co-founding editor of THE AMERICAN PROSPECT magazine.

Andrew Reschovsky is Professor of Applied Economics and Public Affairs at the University of Wisconsin, Madison Robert M. La Follette School of Public Affairs. His research focuses on tax policy and intergovernmental fiscal relations. Professor Reschovsky has worked in the Office of Tax Analysis at the U.S. Treasury and at the Organisation of Economic Co-operation and Development in Paris. He has conducted research for several state and local governments in the United States. His most recent articles have appeared in the PUBLIC FINANCE REVIEW, STATE AND LOCAL GOVERNMENT REVIEW, PUBLIC BUDGETING AND FINANCE, and the NATIONAL TAX JOURNAL. He has recently contributed chapters to RESTRUCTURING LOCAL GOVERNMENT FINANCE IN DEVELOPING COUNTRIES: LESSONS FROM SOUTH AFRICA; HELPING CHILDREN LEFT BEHIND: STATE AID AND THE PURSUIT OF EDUCATIONAL EQUITY; and CITY TAXES, CITY SPENDING.

John L. Solow is Associate Professor of Economics at the University of Iowa's Tippie College of Business. Professor Solow received his B.A. from Yale University and M.A. and Ph.D. from Stanford University and joined the Iowa faculty in 1981. He has published articles in the areas of energy and natural resource economics, tax incidence and durable goods markets, and his research interests include law and economics, antitrust, and public policy. He has worked at the Federal Energy Administration and the Electric Power Research Institute, served as a consultant to the U.S. Departments of Energy and Justice, Mid-American Energy, Qwest Telecommunications and numerous law firms, and has been a visiting scholar at Stanford University, the University of Auckland in New Zealand, and Monash University in Australia.

Kenneth P. Thomas received his Ph.D. in Political Science from the University of Chicago in 1992. An internationally known expert on subsidies, he is the author of COMPETING FOR CAPITAL: EUROPE AND NORTH AMERICA IN A GLOBAL ERA (Washington: Georgetown University Press, 2000), which compares subsidies and subsidy control in the EU, Canada, and the U.S. He has taught at the University of Missouri-St. Louis for 14 years, where he is also a Fellow in the Center for International Studies.

John Yinger is Trustee Professor of Public Administration and Economics at the Maxwell School, Syracuse University, and Director of the Education Finance and Accountability Program in the Maxwell School's Center for Policy Research. Professor Yinger has taught at Syracuse since 1986; he has also held academic positions at Harvard University, the University of Michigan, and the University of Wisconsin. His recent scholarly publications include articles on education finance, the incidence of the property tax, and the causes of housing discrimination. Professor Yinger has authored or co-authored four books, two on topics in local public finance, one on discrimination in housing markets, and one on discrimination in mortgage lending. His edited volume, HELPING CHILDREN LEFT BEHIND: STATE AID AND THE PURSUIT OF EDUCATIONAL EQUITY, was published in June, 2004. Professor Yinger has also been a Senior Staff Economist at the President's Council of Economic Advisors, and he was co-director of a tax study in Nebraska and an aid commission in Minnesota.