Testimony of Peter D. Enrich

on

***Cuno* and Competitiveness:**
Where to Draw the Line

Before the

Subcommittee on International Trade

Of the

Committee on Finance
United States Senate

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I am honored by the invitation to appear before the Subcommittee, and I welcome this opportunity to share my views on possible legislation addressing the proper limits on the states' use of location-based tax incentives as a means to compete for business investment.

I am presently a professor of law at Northeastern University School of Law in Boston, where my research and scholarship focus on issues of state and local taxation and state and local government law. I received my undergraduate degree *summa cum laude* from Yale, did doctoral studies in philosophy at Princeton, and received my law degree *magna cum laude* from Harvard Law School. Before teaching law, I worked for Massachusetts state government for seven years, serving as general counsel for the Commonwealth's Executive Office of Administration and Finance under both Democratic and Republican governors. It is in that setting that I first came to focus on the problematic nature of the competition among the states to offer ever more aggressive tax incentives to mobile businesses and on the important role of constitutional limitations on such incentives.

In my fifteen years as a law professor, the topic of the constitutionality of state and local business tax incentives has been one of my primary areas of scholarly interest, and I have written a number of articles on the topic.[1] As a result, I was invited to serve, on a *pro bono* basis, as lead counsel for the plaintiffs in *Cuno v. DaimlerChrysler*, which challenges the constitutionality of the two tax breaks which comprise the bulk of the incentive package offered to DaimlerChrysler in return for its decision to locate a Jeep assembly plant in Toledo, Ohio. However, I do not appear here today on behalf of any client, and the views I am expressing reflect my independent professional judgment.

In my testimony today, I want to focus on two points: First, the accelerating proliferation of state and local business tax incentives that are conditioned on business location and that discriminate in favor of in-state activity is contrary to the national interest and should not be encouraged by federal legislation. Second, legislative efforts, like S. 1066, that seek to authorize certain location-based tax incentives, such as investment tax credits, while not authorizing other location-based incentives of kinds previously invalidated by the courts, are doomed to failure, because the line they attempt to draw is arbitrary and insubstantial. Because the first of these points is the focus of Prof. Peter Fisher's testimony, with which I am in complete agreement, I will devote the majority of my time to the second point.

I. THE PROLIFERATION OF STATE TAX INCENTIVES FOR BUSINESS LOCATION DECISIONS IS HARMFUL BOTH TO THE STATES AND TO THE

[1] *See, e.g.*, Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377 (1996); Peter D. Enrich, *The Rise – and Perhaps the Fall – of Buisness Tax Incentives*, in THE FUTURE OF STATE TAXATION 73 (David Brunori ed., 1998); Peter D. Enrich, *Business Tax Incentives: A Status Report*, 34 URB. LAW. 415 (2002).

NATIONAL INTEREST.

In recent decades, the states have found themselves in an accelerating competition to offer ever more generous tax breaks to businesses that site their facilities in the state. From a national perspective, the effect of these incentives on economic activity has been, at best, a zero-sum game, and, in fact, has likely been a net loss due to the inefficiencies that result from distortions of economic decision-making. Meanwhile, the effect of these incentives on the ability of the states to derive revenues from the taxation of mobile business sectors has been substantial. The result is increased tax burdens on individual taxpayers and small businesses and reduced resources for state services, such as education and infrastructure, that are real contributors to economic vitality. Even if tax incentives may, on occasion, provide some local benefits in the form of increased economic activity in a particular state, from a national perspective there are no net economic benefits, and very real and substantial societal losses. These observations are spelled out and documented in detail in the testimony of Prof. Fisher and in the supporting materials he references. A few points, however, warrant brief additional discussion.

First, decades of empirical evidence show that state and local tax breaks have, at most, a very small, marginal influence on levels of economic activity. State and local taxes are simply too small a component of business costs for tax breaks to significantly influence the economics of business location decisions, as compared to such factors as the availability and costs of skilled workers, access to supplies and markets, utility costs, and regulatory requirements. And any possible effects of tax incentives in an economic calculus are typically mitigated by the fact that competing locations offer competing packages of tax incentives that further reduce the scale of any differences in tax burdens.

But, even to the extent that tax incentives are a factor that influences some business location decisions, such influence does not provide benefits to national economic well-being. No one seriously suggests that state or local tax breaks are of a sufficient size to affect overall levels of economic activity; their purpose is to affect *where* new investment is located, not *how much* new investment takes place. While national economic welfare may be affected – positively or negatively – by where in the country new economic activity locates, there is no reason to anticipate that the incentive competition among the states will steer economic activity where it is most needed, and no evidence that it has done so. There is no national interest in encouraging an incentive competition among the states which merely shuffles jobs and investment from one state or community to another.

The costs of the incentive competition, by contrast, are real and substantial. The best available estimate of the cost to state and local governments of the incentives that they offer to influence business location was close to $50 billion in 1996,[2] and the continuing proliferation of incentives over the past decade means that the current number is far higher. These incentives have deeply eroded the portions of state and local tax revenues that are supplied by business taxpayers. Between 1979 and 1999, the share of state income tax revenues paid by businesses

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[2] *See* KENNETH THOMAS, COMPETING FOR CAPITAL 158-59 (2000). Note that this estimate includes both tax and non-tax incentives, with tax incentives constituting the majority.

declined from 29 percent to 15 percent,[3] and by 1998 state tax incentives were responsible for reducing corporate tax liabilities by 30 percent.[4] Thus, the effect of the incentive competition among the states is to shift tax burdens from the large, mobile businesses that receive the bulk of the incentives to individual taxpayers and small, immobile businesses and to reduce the resources available to state and local governments. It is far from clear why it might be in the national interest to reinforce these trends.

Recently, proponents of state and local tax incentives, apparently recognizing the difficulties of defending a zero-sum competition with such high costs, have begun to suggest that the real benefit of the incentive competition is its impact on international competitiveness, and particularly on the ability to attract businesses that otherwise would have located outside the United States. But this after-the-fact rationalization for incentive programs that were enacted on the basis of inter-state, not international, competition, is entirely lacking in any empirical support. And given the voluminous evidence that state and local tax incentives are too small to have more than a marginal effect on inter-state location decisions, the notion that they could substantially impact international choices, where the differences in all of the bigger factors – such as wage levels, skill levels, and transportation costs – are so much larger, simply defies plausibility.

In any case, under our federal system, the responsibility for issues of international trade has rested, since the ratification of the Constitution, with the federal government, not with the states, and for good reason. If Congress wants to provide incentives for businesses to locate their facilities at home and not abroad, there are far more powerful and efficient tools available to it than to rely on state and local tax policies designed largely for an entirely different purpose.

Moreover, for Congress to rely on state tax incentives as a tool to influence international investment decisions is likely to conflict with the United States' treaty commitments under GATT and NAFTA. The federal government's obligations under GATT restrict, not only the federal government's, but also the states' ability to grant subsidies to domestic economic activity.[5] Indeed, state tax incentives similar to the provision challenged in *Cuno* have already been challenged as violations of the United States' treaty obligations under the GATT Agreement on Subsidies and Countervailing Measures.[6] Similarly, state tax incentives that provide specially favorable treatment to in-state businesses may violate the provisions of

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[3] *See* Robert Tomsho, *In Toledo, a Tension Between School Funds and Business Breaks*, WALL ST. J., July 18 2001, at A1.

[4] *See* Peter Fisher, *Tax Incentives and the Disappearing State Corporate Income Tax*, ST. TAX N., March 4, 2002, at 767-774.

[5] The GATT Agreement on Subsidies and Countervailing Measures ("SCM") specifically applies to tax incentives granted by any level of government (see SCM, art. 1.1 (a)(1)(ii)), where access to the incentive is limited either to certain enterprises or to enterprises in a certain geographical region (see SCM, art. 2.1(a), 2.2). The restrictions on such incentives imposed by articles 3, 5 and 6 of the SCM Agreement are likely to apply to many of the forms of business tax incentives routinely offered by states and localities.

[6] For example, the European Community in June 2005 filed a demand for a WTO adjudicatory panel on US subsidies for Boeing's civil aircraft production, including the subsidies provided through the state and local tax incentive programs of Washington, Kansas, and Illinois. *See* Request for the Establishment of a Panel by the European Communities, *United States – Measures Affecting Trade in Large Civil Aircraft*, WT/DS317/2 (June 3, 2005). *See also* Arthur Rogers, *EC Will Investigate Kansas Tax Breaks Aimed at Luring British Production Plant*, BNA Daily Tax Report, April 15, 2005.

NAFTA's chapter 11, which requires that foreign companies be accorded treatment no less favorable than the most favorable treatment accorded to a local business.[7]

II. EFFORTS TO DRAW A STATUTORY BOUNDARY BETWEEN AUTHORIZED AND UNAUTHORIZED LOCATION-BASED STATE TAX INCENTIVES ARE FUNDAMENTALLY FLAWED BECAUSE THEY REST ON AN INSUBSTANTIAL DISTINCTION.

For the past century and a half, the courts have played the primary role in setting the limits to state taxation that disturbs the free flow of interstate commerce. The proponents of legislation to authorize state tax incentives that encourage in-state business locations do not question the wisdom of the long history of judicial decisions forbidding a wide variety of state tax measures that were found to discriminate against out-of-state business activity. Instead, they propose to draw a statutory line that leaves intact the bulk of the Supreme Court's recent cases striking down numerous discriminatory state tax practices, while at the same time authorizing investment tax credits and other incentives for in-state development not yet addressed by the Court. But the careful effort to implement this strategy in S. 1066 is deeply flawed; it would authorize a wide range of measures of sorts long recognized as discriminatory, and it may well fail to authorize many of the measures it is intended to permit. These flaws are not results of careless drafting, but rather of the inherently problematic approach of a strategy that attempts to draw a bright line between measures which are not functionally distinguishable.

The proponents of legislation designed to protect state tax incentives from judicial scrutiny could have followed a different course. Instead of complex line-drawing, they could have simply proposed a broad Congressional authorization of state tax measures serving economic development purposes. There is precedent for such a broad-brush approach, in the McCarran-Ferguson Act,[8] which responded to judicial decisions restricting state taxation and regulation of the insurance industry by granting to the states plenary power over the insurance industry notwithstanding possible Commerce Clause concerns.

Instead, proponents have chosen a far narrower and far more complex approach, presumably out of a recognition of the importance of preserving some judicial restrictions on the freedom of the states to use their tax systems to give advantages to in-state economic activity over its out-of-state competition. After all, a central purpose of the Commerce Clause has always been to avoid the revival of the tariff barriers which impeded the growth of a national common market in the years before adoption of the Constitution. An overly broad authorization of state tax measures to further in-state economic development could easily undermine this fundamental national purpose and invite the re-emergence of tariff-like barriers between the

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[7] *See, e.g.,* art. 1102. Under NAFTA art. 105, the United States expressly commits to take all necessary measures to ensure observance of NAFTA's provisions by the states, and, for violations of chapter 11, the United States is subject to private actions for damages by injured foreign businesses.

[8] 15 U.S.C. § 1011 *et seq. See, e.g., Western & Southern Life Ins. Co. v. State Bd. of Equalization,* 451 U.S. 648, 652-55 (1981).

states. And, indeed, the very businesses that are most interested in ensuring the continued availability of economic development incentives have historically been the parties most commonly seeking Commerce Clause protection against discriminatory treatment of out-of-state activities.

The proposed legislation, thus, takes a two-step approach. First, it provides a very broad authorization for state tax incentives for economic development purposes, regardless of any discriminatory impact on interstate commerce.[9] But second, it then limits that broad permission by identifying seven categories of tax incentives, of sorts previously found unconstitutional by the courts, which are excluded from the statute's authorization.[10]

The question then is whether this two-step strategy works to draw a line between, on the one side, tariff-like measures which pose a problematic threat to the free flow of interstate economic activity and which remain prohibited and, on the other side, economic development incentives, like investment tax credits, which, in the eyes of the proponents, are harmless (and perhaps beneficial) and which are authorized by the legislation. The short answer, explained below, is that S. 1066 fails in its effort to draw such a line, and that further efforts to refine its approach will not yield greater success.

The failings of S. 1066 can be seen in both the under-inclusiveness and the over-inclusiveness of its list, in section 3, of types of measures not covered by the bill's blanket authorization of economic development incentives. Because of section 3's under-inclusiveness, a wide range of measures of kinds long recognized as impermissibly discriminatory would be permitted, including some measures functionally equivalent to tariffs. Because of its over-inclusiveness, even provisions like investment tax credits, which the bill intends to authorize, would remain under a legal cloud. These observations about S. 1066 are not novel; they have been explicated in detail by several critics, including Professor Hellerstein.[11] I will not attempt to duplicate their discussions, but simply offer a few examples here.

First, consider the under-inclusiveness of the proposed exceptions. S. 1066 would allow the states to adopt a variety of measures that violate accepted expectations about the level playing field to be provided to out-of-state businesses. For instance, as Professor Hellerstein observes, states would be free to impose higher tax burdens on sellers that do not have a permanent business location in the state than on those that do, although such discrimination has long been recognized as impermissible by the courts.[12]

And S. 1066 would similarly authorize a range of measures that, like tariffs, would impose higher tax burdens on out-of-state services, products or activities than on their in-state

[9] *See* S. 1066, § 2 (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 . . ., except as otherwise provided by law").
[10] *See id.*, § 3.
[11] *See* Walter Hellerstein, Cuno *and Congress: An Analysis of Proposed Federal Legislation Authorizing State Economic Development Incentives* (2005) (a copy of which is included as an appendix to this testimony); Michael Mazerov, *Should Congress Authorize States to Continue Giving Tax Breaks to Businesses?* (revised June 30, 2005) (available at http://www.cbpp.org/2_18_05sfp.pdf).
[12] *See* Hellerstein, *supra* n. 11, at 16.

competitors. For instance, while the bill would not authorize a measure that expressly exempted from the state's alcohol excise those fruit wines produced from in-state fruits,[13] it would allow a measure that achieved the same result by providing an exemption limited to wines produced from particular varieties of fruit that, in fact, were grown exclusively in the state.[14] Likewise, the bill, while it would not permit a tax that was applied exclusively to milk produced out of state, would authorize a state to achieve the same effect by imposing a uniform tax on milk and then allowing a credit based on how many dairy cows a taxpayer owned in the state.[15] Or, for one more example discussed in Professor Hellerstein's paper,[16] a major component of New York's discriminatory tax on stock transfers conducted through out-of-state stock exchanges, which was invalidated by the Supreme Court in the *Boston Stock Exchange* case,[17] would be authorized by the bill, while its other discriminatory component could be salvaged by a modest change that would do nothing to diminish its discriminatory impact.

Conversely, the very same exclusionary language that fails to reach a number of widely recognized examples of discriminatory treatment that the Commerce Clause has long forbidden, appears likely to reach provisions like investment tax credits and thereby to leave them subject to judicial invalidation, despite the drafters' evident contrary intent. As Professor Hellerstein has observed,[18] S. 1066's section 3(a)(2), which excludes from the bill's protection any measures that require the taxpayer "to acquire, lease, license, use or provide services to property produced, manufactured, generated, assembled, developed, fabricated, or created in the State" appears applicable to an investment tax credit program that allows credits only to the extent that the taxpayer places new machinery or equipment in service at a facility of the taxpayer's located in the state. Even if such a credit does not require that the qualifying property be manufactured or acquired in the state, it certainly does require that it be "use[d]" (i.e., that it be placed in service) in the state and that it be "assemble[d]" in the state in order to be used there.[19] And, likewise, such a credit certainly requires the taxpayer to "develop" in-state property that it either owns, leases or uses when it improves that property by the installation of the qualifying new machinery or equipment. Thus, the bill as drafted does not succeed in sheltering the very provision – the investment tax credit challenged in the *Cuno* case – that it was designed to protect.

At the very least, these difficulties with the design of S. 1066 undercut any suggestion that a statutory enactment could provide businesses and states with greater certainty about the range of permissible tax incentives or could reduce the need for litigation to settle unresolved questions. To some extent, of course, the under-inclusiveness and over-inclusiveness of S. 1066's provisions may reflect defects in the precision or clarity of its drafting.[20] And

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[13] *See* S. 1066, § 3(b) (excluding a measure that "requires the recipient of the tax incentive to . . . use . . . property produced . . . in the State").

[14] The courts have declined to draw such a distinction, striking down such provisions, whether the preference for in-state produce was explicit, as in *Bacchus Imports Ltd. v. Dias*, 468 U.S. 263 (1984), or implicit, as in *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18 (1990).

[15] Thus a state could achieve the very result that the Court disallowed in *West Lynn Creamery v. Healy*, 512 U.S. 186 (1994), albeit by slightly different means.

[16] *See* Hellerstein, *supra* n. 11, at 19-21.

[17] *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318 (1977).

[18] *See* Hellerstein, *supra* n. 11, at 10.

[19] The provisions of the Ohio investment tax credit challenged in the *Cuno* case requires that the qualifying manufacturing machinery or equipment be "installed in this state." Ohio Rev. Code § 5733.33(B)(1).

[20] Professor Hellerstein's article, *supra* n. 11, identifies a number of other portions of the bill where the drafting is

unquestionably, many specific shortcomings, once identified, could be remedied by additions, deletions, clarifications, and redefinitions in the terms of the legislation. But to imagine that technical improvements to the current bill would solve the underlying problems seems implausible. After all, the bill is the product of many months of effort, supported by many of the leading experts in the field.

Instead, the failures likely reflect some fundamental flaws in the overall strategy behind the bill, namely the strategy of granting a broad authorization for a wide range of economic development incentives and then excluding specific categories previously found to be unconstitutionally discriminatory. Two flaws in that strategy are noteworthy:

First, the strategy presumes that the set of incentives that the courts have previously addressed and invalidated constitutes a self-contained and coherent universe that can be frozen in time and deployed as an intelligible limit on the realm of forbidden incentives. But in reality, the history of the courts' applications of the Commerce Clause as a restraint on discriminatory state tax measures suggests a very different picture. Over the past century and a half, the courts have continually encountered novel and unanticipated forms of discrimination, often involving new forms of business taxation and new commercial patterns and practices, and have had to develop new applications of underlying Commerce Clause principles to address the new practices. Indeed, many of the exceptions that S. 1066 seeks to codify would not have been on a similarly constructed list a couple of decades ago, because they reflect more recent case law developments. There is no reason to expect that the evolution of business and of taxation, or the ingenuity of state lawmakers and business tax advisers, will not continue to produce an array of new kinds of tax measures which, while not captured on the statutory list, involve comparable problems of favoritism for in-state business interests. Any list assembled on the basis of the cases decided as of a specific point in time is sure to prove partial and incomplete.

Second, and perhaps more fundamentally, the strategy behind S. 1066 assumes that there is an intelligible line to be drawn between the types of measures that have historically been invalidated by the courts and the types of economic development incentives that the bill seeks to authorize. But it is by no means clear that such a line exists, other than the temporal line between measures the Supreme Court has already invalidated and others that it has not yet addressed. Indeed, the plaintiffs' arguments for invalidation of Ohio's investment tax credit in *Cuno* rest on a body of legal scholarship, including articles by both myself[21] and Professor Hellerstein,[22] that concludes that investment tax credits are indistinguishable for Commerce Clause purposes from many of the provisions previously invalidated by the Court. But, if that is so, then it should come as no surprise that it is exceedingly difficult to draft a statute which forbids the measures previously invalidated, while authorizing investment tax credits.[23] The distinction is so hard to draw precisely because it is artificial and arbitrary.

By contrast, the anti-discrimination principle developed and deployed by the Supreme

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far from clear or precise in its drafting or interpretation.

[21] *See* note 1, *supra*.

[22] *See* Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on Business Development Incentives*, 81 Cornell L. Rev. 789, 817-18 (1996).

[23] *Cf.* Hellerstein, *supra* n. 11, at 3 (observing that, to draw the intended distinction, "Congress must act with surgical precision if it is to perform the operation without killing the patient").

Court to delineate the class of tax incentive measures that violate the Commerce Clause offers a coherent, reasonable and time-tested boundary line. As the Court has articulated this principle, "'discrimination' simply means differential treatment of in_state and out_of_state economic interests that benefits the former and burdens the latter. If a restriction on commerce is discriminatory, it is virtually per se invalid."[24]

The proponents of legislation seek to suggest that the Court's Commerce Clause jurisprudence is far from clear and consistent, and they often quote the Court's own description of its Commerce Clause case law as a "quagmire." This is, no doubt, a fair characterization of some aspects of the Court's analysis of state tax issues. But it does not apply to the aspect of Commerce Clause analysis – the anti-discrimination principle – that is at issue in the *Cuno* case and that the proposed legislation would supplant. As the Court has explained,

> From the quagmire, there emerge . . . some firm peaks of decision which remain unquestioned. Among these is the fundamental principle . . . : No State, consistent with the Commerce Clause, may impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business. The prohibition against discriminatory treatment of interstate commerce follows inexorably from the basic purpose of the Clause. Permitting the individual States to enact laws that favor local enterprises at the expense of out_of_state businesses would invite a multiplication of preferential trade areas destructive of the free trade which the Clause protects.[25]

Indeed, the anti-discrimination principle is the one element of the Court's Commerce Clause jurisprudence which has remained a central tenet throughout its history and which has commanded wide acceptance even from those Justices who have expressed deep doubts about other aspects of its Commerce Clause reasoning.[26] And it is noteworthy that those who emphasize the problems with the Court's jurisprudence as a justification for Congressional intervention are unable to point to any tensions or conflicts relating to the courts' application of the anti-discrimination principle to state tax incentives.

In short, the Supreme Court, over the course of the past one hundred and fifty years has developed a clear, straightforward and consistent boundary between those state tax measures which unconstitutionally discriminate against out-of-state activity and those which do not, a boundary that effectively furthers the fundamental purposes behind the Commerce Clause. Congress should be cautious about superseding the Court's careful and cogent approach, unless it is prepared to offer a similarly coherent and administrable alternative boundary. S. 1066 clearly fails to provide such an alternative, and its failings suggest the very great difficulties that will confront any attempt to devise legislation relying on a similar approach.

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[24] *Oregon Waste Sys., Inc. v. Dept. of Envtl. Quality*, 511 U.S. 93, 99 (1994).

[25] *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329 (1977) (internal quotations and citations omitted).

[26] *See* Enrich, *supra* n. 1, 110 Harv. L. Rev. at 426 & n.249.