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Tax Incentives for Economic Development: Personal (and Pessimistic) Reflections

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PANEL 2: COMMUNITY EFFORTS TO ATTRACT AND RETAIN CORPORATIONS: LEGAL AND POLICY IMPLICATIONS OF STATE AND LOCAL TAX INCENTIVES AND EMINENT DOMAIN

TAX INCENTIVES FOR ECONOMIC DEVELOPMENT: PERSONAL (AND PESSIMISTIC) REFLECTIONS

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INTRODUCTION

The topic of this essay—state and local tax incentives for economic development—is a deeply personal subject for me. For almost twenty years, I served on the Board of Aldermen of New Haven, Connecticut, and then on that community's Board of Finance.

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For all of those years, the city's finances were a central concern in my life.[1]

During these two decades, I shepherded through the legislative process many municipal property tax abatements awarded to developers in return for their promises to invest in the community. I now suffer from buyers' remorse as to these deals.

In another incarnation, I have found myself in the middle of vigorous academic debate with those who assert that the dormant Commerce Clause rule of nondiscrimination prohibits state and local tax incentives designed to attract and retain investment. In that debate, I have argued that there is no constitutional barrier to such tax incentives. In particular, I have argued that it is doctrinally incoherent to view dormant Commerce Clause nondiscrimination as outlawing tax incentives while permitting economically and procedurally equivalent direct expenditures.[2] I have also argued that the concept of dormant Commerce Clause nondiscrimination fails to explain which tax reductions are constitutionally prohibited and which are constitutionally permitted.[3]

My support for municipal tax abatements during my years as a city official, combined with my more recent writings about the constitutional permissibility of state and local tax incentives, might lead some to infer that I am today a supporter of such incentives to lure investment. The reality is more complex: As a matter of policy, I am now intensely skeptical of state and local tax incentive packages designed to stimulate economic development. Unfortunately, I am equally skeptical that there is a good way to police such incentives.

I. PERSPECTIVES

For purposes of this discussion, it is useful to contrast three different perspectives on state and local tax incentives. There are those who view such incentives as essentially benign phenomena. One rationale for this perception is that government is an insatiable Leviathan, which will unproductively consume whatever resources it

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[1] For some earlier reflections on this experience, see Edward A. Zelinsky, *The Once and Future Property Tax: A Dialogue with My Younger Self*, 23 CARDOZO L. REV. 2199 (2002).

[2] For some of the more recent interchanges in this debate, see Edward A. Zelinsky, *The Incoherence of Dormant Commerce Clause Nondiscrimination: A Reply to Professor Denning*, 77 MISS. L. J. 653 (2007); Edward A. Zelinsky & Brannon P. Denning, Debate, *The Future of the Dormant Commerce Clause: Abolishing the Prohibition on Discriminatory Taxation*, 155 U. PA. L. REV. PENNUMBRA 196 (2007), *available at* http://www.pennumbra.com/debates/debate.php?did=7; Edward A. Zelinsky, Davis v. Department of Revenue: *The Incoherence of Dormant Commerce Clause Nondiscrimination*, 44 ST. TAX NOTES 941 (2007), *in* 118 TAX NOTES 57 (July 2, 2007).

[3] *See* Zelinsky, *Reply to Professor Denning*, *supra* note 2.

can grab. If so, it is good whenever government is forced to reduce its grasp. The best known proponent of this rationale is Professor Friedman, whose skepticism of an ever-hungry public fisc led him to favor any tax reduction.[4]

Professor Gillette offers more nuanced support for state and local tax incentives. In Professor Gillette's telling of the story, such incentives are economically efficient signaling devices that help firms locate where their presence is most beneficial.[5]

In contrast are those who oppose interjurisdictional tax competition. Professor Enrich is among the outspoken opponents of such tax competition.[6] Professor Enrich brought the *Cuno* litigation, which raised a dormant Commerce Clause challenge to the income and property tax incentives that Ohio and its municipalities granted to Daimler-Chrysler to locate a new plant in Toledo.[7] That litigation stimulated much of the recent controversy about the dormant Commerce Clause concept of nondiscrimination.[8] Professor Shaviro is also skeptical about state and local tax competition.[9] While Professors Enrich and Shaviro are careful to note that they favor (or, at least, do not oppose) interjurisdictional competition as to tax rates, their writings suggest a dim view of other forms of tax competition.

In between these polar positions are the mushy moderates like me. On the one hand, I find compelling the argument that tax competition among states and localities is healthy because such competition disciplines political officials and allows taxpayers to sort themselves among jurisdictions by taxpayers' tax and public spending preferences. On the other hand, targeted tax incentives are generally inefficient and unfair.

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4 *See* George F. Will, *Stimulating Talk, Redux*, NEWSWEEK, Jan. 28, 2008, at 64 ("Nobel laureate Milton Friedman . . . finally concluded that any tax cut of any size, at any time, for any purpose, should be supported because individuals spend money more productively than governments do and waiting to cut taxes until government spending is cut is like waiting for Godot.").

5 *See* Clayton P. Gillette, *Business Incentives, Interstate Competition, and the Commerce Clause*, 82 MINN. L. REV. 447, 486-87 (1997).

6 *See* Peter D. Enrich, *The Rise—And Perhaps The Fall—of Business Tax Incentives*, *in* THE FUTURE OF STATE TAXATION 73 (David Brunori ed., 1998) [hereinafter FUTURE]; Peter D. Enrich, *Saving The States From Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377 (1996).

7 *See* Daimler-Chrysler Corp. v. Cuno, 547 U.S. 332 (2006).

8 For my own contribution to the *Cuno* oeuvre, see Edward A. Zelinsky, Cuno: *The Property Tax Issue*, 4 GEO. J.L. & PUB. POL'Y 119 (2006); Edward A. Zelinsky, *Ohio Incentives Decision Revisited*, 37 ST. TAX NOTES 859 (Sept. 19, 2005), *in* 108 TAX NOTES 1569 (September 26, 2005); Edward A. Zelinsky, Cuno v. DaimlerChrysler: *A Critique*, 34 ST. TAX NOTES 37 (2004), *in* 105 TAX NOTES 225 (2004).

9 *See* Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 908–09 (1992).

II. PROBLEMS

Much contemporary discussion of tax competition starts with the seminal argument of Charles Tiebout. Tiebout's initial insights have spawned a vast literature exploring the potential benefits of tax competition among municipalities and states.[10] In the Tiebout world, local taxes signal the price of local public services. In this world, taxpayers' mobility among jurisdictions permits them to sort themselves so that each taxpayer can reside in the jurisdiction with the combination of public services and taxes he or she finds congenial. The potential mobility of dissatisfied taxpayers disciplines local officials to restrain taxes and provide good public services to keep those taxpayers from leaving for adjacent jurisdictions with better tax climates and superior public services. The tax price of local public services also allows taxpayers as voters to compare their respective communities with surrounding jurisdictions. Such comparison enables taxpayers, as voters, to further discipline local officials if such officials perform poorly relative to their peers in other communities, and to reward such officials for superior performance in terms of taxes and public services.

The Tiebout model is elegant. Perhaps more importantly, it was validated in practice by my years as a municipal official. Residents, both in their capacities as homeowners and as voters, are acutely sensitive to the tax price of living in their community as compared to the tax price of residing in neighboring municipalities. Local officials are aware of this sensitivity and continuously monitor the taxes they impose in relation to the taxes levied in adjacent jurisdictions.

This analysis suggests that Tieboutian tax competition among jurisdictions is, in theory and in practice, desirable to discipline municipal officials and to permit taxpayers to reside in communities with tax and spending packages corresponding to such taxpayers' preferences.

However, targeted tax incentives are a different matter. As I look back on the incentive packages that I helped to implement, I am troubled on both procedural and substantive grounds. Procedurally, there is, to start with, an inherent and irremediable information asymmetry in negotiations between state and local officials and the corporations and developers with which such officials bargain over tax incentives. The corporations and developers know their locational choices and preferences and have no reason to disclose these to the

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[10] *See, e.g.*, THE TIEBOUT MODEL AT FIFTY (William A. Fischel ed., 2006); Edward A. Zelinsky, *Metropolitanism, Progressivism, and Race*, 98 COLUM. L. REV. 665 (1998).

officials with whom they are bargaining for tax benefits. Indeed, those negotiating for tax benefits from states and localities have every reason to hide their true choices and preferences. Consequently, the message corporations and developers advance in such negotiations—give us a tax break or we will ignore (or leave) your community—is difficult for officials to evaluate. Perhaps the corporations and developers are bluffing; it is difficult for state and local officials negotiating with them to know, and politically risky for such officials to find out.

Paralleling the informational imbalances between those seeking tax benefits and those dispensing tax benefits are the collective action problems of decentralized government. These problems represent the flip side of the interjurisdictional competition celebrated by the Tiebout model. If community X refuses to grant tax incentives to attract or retain a particular firm, community Y will. This makes it difficult for officials in community X to resist demands for tax largesse. Even if communities X and Y can enter into an effective nonaggression pact under which each will not compete against the other, there is always community Z and, waiting in the wings, communities A, B and C.

States and localities are also handicapped in negotiations about tax incentives by the short time horizons of voters, which translates into short time horizons for the elected officials these voters pick. Put less charitably, voters and their representatives can be myopic in granting tax incentives.

The costs of tax incentives often extend far into the future. For example, the property tax abatement challenged in *Cuno* lasted for ten years.[11] Few voters think that far in advance; even fewer elected officials do. Consequently, the political calculations strongly favor the granting of tax incentives since the apparent benefits are immediate and visible—the decision of corporations or developers to build and invest—while the costs in the form of reduced tax revenues fall heavily in the future when others will be in office.

Finally, a significant portion of both the electorate and state and local officialdom succumbs to framing effects, erroneously perceiving tax incentives as different from economically and procedurally equivalent direct expenditure subsidies.[12]

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[11] Cuno v. DaimlerChrysler, Inc., 386 F.3d 738, 741 (6th Cir. 2004), *vacated in part*, 547 U.S. 332 (2006).

[12] Edward A. Zelinsky, *Do Tax Expenditures Create Framing Effects? Volunteer Firefighters, Property Tax Exemptions, and The Paradox of Tax Expenditure Analysis*, 24 VA. TAX REV. 797 (2005).

In light of these procedural problems, the tax incentives states and localities grant are, as a substantive matter, often inefficient and typically unfair. This inefficiency is both technical and allocational.[13] The tax benefits bestowed by states and municipalities are technically inefficient in that such benefits reward corporations and developers for investments they would have made anyway. State and local officials—outbargained because of their lack of information compared with the firms with which such officials are negotiating, pressured to grant tax breaks by the likelihood that other communities will grant such breaks if they do not, and compelled to produce the immediate benefits of investment in the community—award tax benefits for investments which would have occurred anyway. The public fisc is accordingly reduced, but nothing is thereby accomplished for the local economy since these investments, nominally lured by tax benefits, would have occurred anyway.

Moreover, tax incentives entail allocational inefficiency as taxpayers pay discrepant rates for the same public services. Because economic development incentives place part of the community's tax base off limits, the remainder of the community's tax base must be taxed more heavily to provide needed revenues. The higher tax rates that result interfere with the economic decisions of those more heavily taxed community members, which leads them, in turn, to demand the same relief granted to others.

Consider, for example, a city approached by a developer who promises to construct a new office building in the city's downtown, but only if he is given property tax abatements for a number of years. Municipal officials (e.g., me) may suspect that the developer is bluffing and will in fact build even without the tax relief he is demanding. But such officials do not know this for sure and are likely to be risk averse: Who wants to be accused of driving investment and jobs from the community? And, the internal debate runs, if the city does not grant the tax abatement, a neighboring community will grant it and thereby obtain the proposed building. Since either way the city will not receive any taxes, it might as well get the investment.

Subsequently, as the city's need for municipal revenue grows, the city must increase its tax rates, but it cannot increase the rates for the developer who built his new building in reliance on a long-term abatement. Tax rates consequently go up for other property owners, who find themselves increasing their rents to pay such taxes and

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[13] On the distinction, in the context of tax incentives, between technical and allocational efficiency, see Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973 (1986).

deferring maintenance to reduce their operating costs. At the end of the day, older buildings are increasingly burdened with the costs of the community's public services, which hastens the decline of those structures. At a minimum, those older buildings find themselves at an artificial competitive disadvantage since they must pay property taxes that their new competitor does not.

The community consequently finds itself on a treadmill with higher tax rates discouraging economic activity and more taxpayers threatening to depart in face of those rates. Moreover, increasingly burdened taxpayers can plausibly claim that they are treated unfairly since others, who received tax incentives, also get public services but do not pay (or do not pay as much) for such services. Residential homeowners become increasingly demoralized by the higher tax rates needed to provide municipal services.

No reader of the relevant economic and legal literature will be surprised by this scenario. For example, David Brunori observes the following:

> Commentators generally agree that incentives violate the most basic principles of sound tax policy. Incentives result in tax systems that are less accountable, less efficient, and less fair. Moreover, there is more than ample evidence that incentives do not work. Still, the use of tax incentives has increased primarily because political leaders lack the will to reject them. The political benefits of new jobs and increased economic activity are attractive inducements for offering incentives.[14]

In a similar vein, Professor Pomp notes that "tax incentives probably reward corporations for doing what they would have done anyway."[15] Moreover, he writes, legislators "fear that being perceived as anti-business or anti-jobs is worse than being seen as promoting highly visible, albeit ineffective, incentives."[16]

My contribution to the debate is that I have lived it.

III. SOLUTIONS?

All of these considerations lead me to a conclusion which is easy to state but, alas, is difficult to implement: I favor general, Tieboutian tax competition among jurisdictions to discipline political decision

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[14] David Brunori, *Introduction*, *in* FUTURE, *supra* note 6, at 6.

[15] Richard D Pomp, *The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer*, *in* FUTURE, *supra* note 6, at 54.

[16] *Id.*

makers, but I disfavor targeted tax incentives. The problem with this theoretically sound conclusion is that there is no feasible way to effectuate it.

For the reasons already identified, we cannot rely on the self-discipline of state and local officials to refrain from granting targeted tax incentives. The political rewards of granting such incentives—the ability to claim to have attracted investment and jobs—are immediate and visible. The economic costs of such incentives—reduced tax revenues—tend to fall in the future. The collective action problems of competing jurisdictions preclude effective nonaggression pacts among such jurisdictions.

The alternative is for higher levels of government to impose tax incentive truces on lower level jurisdictions, i.e., state legislation to prevent municipalities from granting incentives in competition with each other; federal legislation, enacted pursuant to Congress's authority under the Commerce Clause, to similarly stop tax competition among the states.

At the state level, the laws adopted in the wake of the U.S. Supreme Court's *Kelo* decision[17] provide interesting examples. Just as some state legislatures have, after *Kelo*, forbidden municipalities to exercise eminent domain power for economic development purposes,[18] state legislatures could proscribe municipalities from extending targeted tax breaks for economic development purposes.

Similarly, Congress has, over the years, used its Commerce Clause authority to preclude states' exercise of their taxing powers in ways Congress has deemed harmful to the national economy. The best known of these federal laws is Public Law 86-272, which forbids states from imposing income taxes upon certain interstate sellers of tangible personal property.[19] Other federal laws aim to prevent discriminatory taxation of certain interstate transportation corporations[20] while yet other federal laws preclude states and localities from taxing interstate e-commerce sales.[21] During the *Cuno* litigation, some members of Congress proposed legislation to

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[17] Kelo v. City of New London, 545 U.S. 469 (2005).

[18] Ilya Somin, *The Politics of Econimc Takings*, 58 CASE W. RES. L. REV. 1185 (2008).

[19] An Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555 (codified at 15 U.S.C. §§ 381–391 (2000)). For the Supreme Court's construction of P.L. 86-272, see Wis. Dep't of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992).

[20] *See, e.g.*, 49 U.S.C. § 11501 (2000) (forbidding states and localities from imposing any "tax that discriminates against a rail carrier providing [interstate] transportation"); *see also* 49 U.S.C. § 14502 (restricting the property taxation of "motor carrier transportation property" used in interstate commerce); 49 U.S.C. § 40116 (restricting the property taxation of "air carrier transportation property").

[21] Internet Tax Freedom Act, Pub. L. No. 105-277, §§ 1100–1308, 112 Stat. 2681 (1999) (codified as amended at 47 U.S.C. § 151 (2006 & Supp. 2008)).

authorize state tax incentives for economic development.[22] By the same token, Congress could enact legislation blocking state tax incentives for economic development purposes.

Despite my skepticism of targeted tax incentives as a matter of policy, for two reasons I doubt that either federal or state legislation along these lines is appropriate. First, I fear that such legislation, as finally enacted, would prove to be the proverbial cure that is worse than the disease. Once the decision has been made at the state or federal level to restrain tax competition legislatively, it is politically naive to suppose that only targeted tax competition for economic development purposes will be outlawed. State and local officials prefer greater freedom to pursue their personal, political, and policy objectives. They will thus seek broader legislation that proscribes, not just the targeted tax competition that is troubling as a matter of policy, but the healthy Tieboutian competition that is a desirable feature of our decentralized system of state and local finance.

On more than one occasion during my career as a local official, I would have welcomed participation in a state-enforced cartel of local governments and the consequent release from the discipline imposed by neighboring communities' tax rates. By the time legislation curtailing tax competition emerges from the state or federal legislative process, it would likely wind up inhibiting healthy, as well as undesirable, tax competition.

Of course, those who believe that all tax competition is good (or bad) do not need to distinguish in this way. But for those of us who believe that Tiebout tax competition is desirable but targeted tax incentives are not, it is a real danger that legislation initially aimed at the latter will end up proscribing the former.

Second, even if there is agreement to ban targeted tax incentives for economic development purposes without inhibiting more generalized and desirable forms of tax competition, I am skeptical that there are workable standards to implement such agreement. To paraphrase Justice Stewart, I know the targeted tax incentives I oppose when I see them.[23] That, however, does not mean that I can formulate a workable legal test to identify such incentives.

Suppose, for example, that a state legislature outlaws any municipal tax policy enacted to stimulate economic development. Such a standard is overly broad. Communities reduce their general tax rates, *inter alia*, to create more favorable tax environments for

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[22] Walter Hellerstein, Cuno *and Congress: An Analysis of Proposed Federal Legislation Authorizing State Economic Development Incentives*, 4 GEO. J.L. & PUB. POL'Y 73, 73 (2006).

[23] Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).

business. Such tax rate reductions lie at the core of the Tiebout vision of beneficial tax competition among jurisdictions.

Suppose that the legislature instead proscribes all tax policies aimed at a single taxpayer. Intuitively, that standard is initially compelling. However, any tax policy can be made to appear generally available to a class of taxpayers, e.g., a property tax abatement for everyone who will construct a twenty story office building within the next twelve months. We could, in such cases, ask the courts to probe the legislative motivation for such legislation to determine if there is a subjective intent to help a particular taxpayer. However, I am skeptical that such judicial policing is feasible or desirable. At best, such policing is likely to lead to a continuing cat-and-mouse game whereby legislators adopt more elaborate and more opaque statutory formulas to obscure the intent to benefit a single taxpayer.

Or suppose that Congress outlaws states with income taxes from extending accelerated depreciation deductions for economic development purposes. Here again there is a serious problem: Some believe accelerated depreciation more accurately reflects the economic decline of tangible property than do slower forms of depreciation.[24] If so, there is no workable standard distinguishing the state legislature that adopts accelerated depreciation as a targeted tax subsidy from the legislature that embraces such depreciation as the best way to measure firms' net incomes.

CONCLUSION

At the end of the day, these considerations lead me to doubt that an acceptable solution to the problem of targeted tax incentives can be articulated or implemented.

My skepticism about targeted tax incentives does not imply that state and local governments have no constructive role bolstering their respective economies. To the contrary, by providing at reasonable cost good public services which make communities safe, clean, affordable, well-educated and well-governed, states and municipalities make themselves desirable places to live and invest. The political dilemma is that the electoral costs of restraining public spending are typically acute and short-term, while the benefits of efficient and productive government may not manifest themselves until well into the future. This makes it difficult for elected officials to pursue sensible business-attracting policies for the long-run. Such political calculations reinforce the tendency of officials to pursue the

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[24] *See* Douglas A. Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1 (1979).

kind of targeted tax incentives that yield apparent short-term benefits while delaying the fiscal and economic costs until later.

I wish I could end this personal and pessimistic essay on a high note, perhaps by proposing a solution or, more modestly, by suggesting the direction in which we might search for a solution. Instead, I must end with the admonition that not all problems have acceptable solutions and, at least for the foreseeable future, the problem of targeted tax incentives for economic development is one of these.