The Politics of State Taxation: Helping States to Hurt Themselves

by David Brunori

In The Politics of State Taxation, State Tax Notes contributing editor David Brunori criticizes the Economic Development Act of 2005, which would overturn the Sixth Circuit's decision in Cuno, which held that Ohio's investment tax credit was unconstitutional.

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The Politics of State Taxation is a column by State Tax Notes *contributing editor David Brunori, who welcomes comments at dbrunori@tax.org.*

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I've been writing about state tax policy for a decade. Over that time there has been one idea that few quarreled with: Tax incentives are no good. They violate the principles of sound tax policy. They reflect the worst in "politics first, policy second" legislative action. And they don't work -- no business executive worth his salt will make a location decision based on state tax incentives.

Virtually every public finance expert who has ever opened his or her mouth on the subject agrees. The scholarly criticism of tax incentives has filled thousands of pages. Government leaders -- those not tripping over themselves to curry favor with corporations -- have long lamented the perceived need to use incentives.

Business leaders who have spoken publicly on the issue have said tax incentives are irrelevant in their decisionmaking process. The most noted example was former Treasury Secretary Paul O'Neill. During his confirmation hearing, the former executive with several Fortune 500 companies said that, as a businessman, he wouldn't turn a tax break down but would not base an investment decision on it. "I never made an investment decision based on the tax code," he said. "Good business people don't do something because of [tax] inducements."

I couldn't possibly list all of the folks who have criticized the use of tax incentives. Incentives cost a state hundreds of millions of dollars. They violate the ideal that the tax law should be as neutral as possible when it comes to markets.

So why would Congress pass a law that ensures that states will be able to provide incentives? And why would so many thoughtful people support that congressional action?

In the wake of the Sixth Circuit's decision in *Cuno v. DaimlerChrysler*, federal lawmakers from Sixth Circuit states mobilized to introduce the Economic Development Act of 2005. (For the Sixth Circuit's decision in *Cuno*, see *Doc 2004-17647* [**PDF**] or *2004 STT 173-28*.) The proposed legislation says states can offer tax incentives without fear of running afoul of the U.S. Constitution's Commerce Clause. The proposed law sets limits but essentially authorizes the use of policies that have decimated the corporate income tax.

The proposal allows states to say, "Build your factory here and you will not have to pay income taxes." Worse, it allows corporations to continue to say, "Pay us through tax breaks or we won't come."

The sponsors of the legislation gave speeches and released statements about how states should be free to do what they need to do in terms of economic development. Congress and the courts shouldn't interfere with these fundamental state rights. That's akin to saying we shouldn't interfere with the drug addict's right to buy heroin or the suicidal person's right to purchase a revolver.

U.S. Sen. George Voinovich, R-Ohio, one of the sponsors of the bill, said, "This bill would override the *Cuno* case by authorizing states to grant tax incentives that otherwise would impermissibly interfere with interstate commerce." So, the senator is in favor with interfering with interstate commerce?

Congress clearly has the power to approve this legislation. But that does not mean it should. In fact, back in 1995 there was serious discussion of Congress doing the opposite. Melvin Burstein and Arthur Rolnick of the Federal Reserve Bank of Minneapolis argued that Congress should act under the U.S. Constitution's Commerce Clause to ban all tax incentives.

The National Conference of Mayors, the National Governors Association, the National League of Cities, and the National Association of Counties are all -- inexplicably -- endorsing the bill. More than anyone else, they should know the problems associated with tax incentives. They are all crowing about sovereignty. You would think they would be relieved that the *Cuno* decision might lead to an end to the disastrous war between the states for economic development.

The National Association of Manufacturers (NAM) wrote to Voinovich in support of the proposal. NAM says that without tax incentives, there would be less investment and lower economic growth. NAM actually took a principled position before Congress that tax incentives were of little value to manufacturers. Of course, that was in 1982.

The Teamsters are supporting the bill in the mistaken belief that tax incentives create jobs. But that belief runs counter to the findings of decades of research.

Bruce Johnson (R), Ohio's lieutenant governor and state development director, testified before the House Judiciary subcommittees on May 24 about how wonderful tax incentives are. He said they've led to $34 billion in investment. I will tell you this: That investment wasn't the result of corporate tax incentives.

Maybe Johnson should have testified about the *Cincinnati Enquirer* exposé on Ohio's dismal record of taxing corporate income. The paper reported that in 2001, 6 of the largest 100 corporations in the state paid the minimum $50. I probably paid more in Ohio taxes, and I don't even live there. Forty-five of the corporations paid less than $155,000. All 100 corporations reported more than $5 billion in sales.

It seems the one thing Ohio doesn't need is incentives to alleviate the heavy burden of corporate taxes.

Worse, Johnson quoted "a national expert" as saying that many corporations have decided not to invest in Ohio if *Cuno* isn't overturned. That national expert is Jay Biggins, who works for a firm that persuades companies to ask for incentives and simultaneously persuades states to offer them.

Two distinguished professors also testified. Cardozo School of Law Prof. Edward Zelinsky told the lawmakers that he was sympathetic to the effort to overturn *Cuno* legislatively. He believes states should be able to pursue tax policies that have effects solely within their jurisdiction. From his testimony, it appears that he thinks the incentives at issue in *Cuno* had such a limited impact.

Prof. Walter Hellerstein, the preeminent legal scholar in the field, also testified. He argued that the Economic Development Act of 2005 was a better policy option than narrowly addressing *Cuno*. I agree. But he also argued that the proposal was better than doing nothing. He believes doing nothing would leave the system in a mess for years to come.

But nothing is precisely what Congress should do. Rushing into this legislation would validate most tax incentives used today. The only check on incentives would be the political will of the states. If there's one thing we've learned, it's that the states have little willpower when it comes to tax incentives.

Neither Hellerstein nor Zelinsky endorsed the use of incentives per se. I have to believe both think that tax incentives are unsound policy choices. I should note that both agreed that tax incentives are no different from a constitutional perspective than direct subsidies. I agree that for purposes of the Commerce Clause there perhaps should be no difference.

But there is a practical, political difference. Tax incentives are almost always granted in the form of credits and exemptions that never expire. They're the gifts that keep giving until repealed. Direct subsidies almost always have to be appropriated every year. For incentives, you only need to lobby the legislature once. For subsidies, the business community has to keep coming back with its hat in its hand.

At the end of the day, if the legislation becomes law the states will still be pitted against each other. Governors and legislators will continue to offer incentives to companies to do what most will do anyway. They'll offer the incentives out of fear of losing the chance to land a big employer. They will offer incentives because it is politically expedient to say "I just created 10,000 jobs."

Competition among the states is good when it's based on low tax burdens that apply to everyone. Tax incentives violate the centuries-old principle that the system should be built on low rates and a broad base.

I advocate state autonomy. The states do so many things so well. But the Economic Development Act of 2005 would not do the states any favors.

Speaking of Tax Breaks . . .

The Nebraska Unicameral Legislature passed and Gov. David Heineman (R) has signed a bill (LB 312) that would grant $50 million in additional tax breaks in the name of economic development. That's in addition to the $130 million a year in tax breaks that the state doles out right now.

Some of the tax breaks are actually good ideas. The measure would provide sales tax exemptions for manufacturing equipment. Everyone knows business inputs shouldn't be taxed.

But most of the provisions are run-of-the-mill bad tax policy. There are credits for new job creation if the corporation invests money. There are other credits for new job creation if the corporation doesn't invest money. There are other credits for high-tech companies that create jobs. There are more credits for manufacturing companies that create jobs. There's a new credit for microenterprises that invest in economically depressed areas. And there's a new credit for research and development for businesses in urban and rural areas. That last credit is interesting because the entire state is made up of urban and rural areas.

So Nebraska will remain a tax incentive spigot.

Still More Tax Breaks

The Oklahoma Senate passed a multimillion-dollar tax break for energy companies drilling for natural gas. Energy companies are making record profits. Energy companies are already drilling for natural gas in Oklahoma. They don't seem to need much incentive.

Tax Breaks for Verizon in New Hampshire

The New Hampshire House of Representatives passed a bill (SB 11) that would continue the property tax exemption for telephone poles and wires. That exemption was scheduled to expire in 2006 and under the legislation would run until 2010. The exemption saves telephone giant Verizon somewhere between $10 million and $40 million. (One would think it would be possible to be a little more precise.) The proposal passed based on the argument that Verizon already pays $70 million a year in communication services tax.

Good for Montana

Montana has decided not to renew a contract with a Texas company hired to collect back taxes. There was some controversy over whether the company, GS Services, was rude and unprofessional to Montana citizens.

But whether GS Services was rude to folks in Montana is beside the point. Collecting taxes is one of the most important responsibilities of government. I've always believed it was far too important to outsource. The people who collect taxes should work for the department of revenue. The Montana Department of Revenue has a reputation of being a professional, well-run shop. It should be charged with collecting the taxes.

Bad for Poor Smokers

The Minnesota Revenue Department released a study that shows cigarette taxes are by far the most regressive levy. Families earning less than $30,000 a year pay more than half of all cigarette taxes in Minnesota. I will concede that smoking is bad. But there is little justice in a tax that hammers the poor.

Tax Politics 101

The Republican Governors Association has launched an ad campaign against Virginia Democratic gubernatorial candidate Timothy Kaine. The ad accuses Kaine, the incumbent lieutenant governor, of wanting to raise taxes. The funny thing is that Kaine, like his Republican opponent, Jerry Kilgore, has promised to cut taxes, particularly property taxes. And, when he was mayor of Richmond, Va., Kaine led an effort to cut the property tax rate (although tax bills climbed because of rising assessments).

Kaine is no crazy liberal tax-and-spender. So why would the Republican Governors Association say such things? Maybe it has to do with who put together the ad -- the same group that made the Swift Boat Veterans for Truth commercials opposing John Kerry. But maybe the ad emanates from the school of thought that says, "If you say it often enough, people will believe it."

Why We Pay Taxes

The Tennessee deputy finance commissioner got stuck in an elevator last week at the state Capitol. He picked up the phone in the elevator and found out that it didn't work. So he remained stuck in the elevator for 13 hours. Apparently the state never paid the phone bill and the phone company cut off service.

Taxing the Velvet Elvis

The Washington Department of Revenue will aggressively pursue art collectors who don't pay use taxes on work purchased out of state. Art collectors have been ignoring the use tax laws since, well, 1935. The state loses $25 million a year because collectors don't pay.

This has been a touchy issue. The folks who collect art are usually very wealthy. I'm not talking about tapestries of those cute dogs smoking cigars, drinking whiskey, and playing poker. I am talking about high-end stuff that looks like a first-grader spilled a bottle of ink on a canvas. You know, the modern stuff that sells for hundreds of thousands of dollars.

Anyway, these wealthy people have been quietly lobbying politicians to lay off the tax collection activities. The argument from the rich and powerful is that enforcement would lead them to refrain from lending their art to museums. The poor public, craving the finer things in life, would be terribly deprived. Personally, I think the public would rather have the $25 million. But as a longtime admirer of the velvet Elvis, what do I know?

Everyone Must Pay

The Atlanta Journal-Constitution reported that the Georgia Department of Revenue is attaching the wages of two Georgia legislators who are delinquent on their taxes. Democratic lawmakers Ron Sailor and Vincent Fort are having their wages garnisheed. Sailor owes the state $12,000, and Fort owes $11,000.

Oh, to Be Young . . .

Recently I read in a business journal how television stations air sexually themed stories when ratings are being determined. The thought is that covering sex sells. I'm tired of covering the effort of the hookers in Nevada to get themselves taxed to gain legitimacy.

So I found this little tidbit: The Danish government is contemplating taxing sperm donors. Sperm donors receive 500 kroners (about 85 bucks) for their "work." The Danes, who know a thing or two about the subject, want to impose an excise tax on those offering the service. Danish men are apparently very good at this, with donors contributing to more than 1,000 pregnancies a year.

Sperm donors offer their services anonymously. Everyone fears that imposing a tax would result in identities being revealed. But many of the donors are crazy college kids looking to earn a couple of kroners. Danish newspapers reported that some kids come back to donate four and five times a week.

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