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Breaking the Incentive Cycle: A Role for the Courts

By Peter D. Enrich

The proliferation of state and local tax incentives designed to attract or retain business investment is a public policy problem that has proven troublingly resistant to reform. Despite a growing recognition, by both policymakers and academic experts, that the competition over business incentives is at best a zero-sum game, the range of tax breaks available to mobile businesses continues to expand, and the size of the incentive packages offered for large corporate facilities reaches ever new heights. As the states scramble to imitate, or to improve upon, the incentive measures adopted by their rivals, the only consistent winners are the large businesses that can pit one jurisdiction against another for reduced tax burdens, while other taxpayers and citizens pay the costs in constrained government services and higher taxes.

Yet, it is futile to look to state and local policymakers to call a halt to the competition. Even a legislator who fully understands that her jurisdiction is playing a game that the states and cities cannot collectively win still cannot ignore the political imperative to try to bring home jobs and investment to her city or state. In fact, it may well be economically (not to mention politically) rational for a particular state to continue to expand its arsenal of business incentives, so long as its rivals remain free to do so. While the empirical evidence suggests that tax breaks are a very minor factor in most business location decisions, public officials can hardly be faulted for using whatever instruments are legally available to them to protect or improve their competitive position.

The states and localities face a classic collective action problem: when they each pursue their individual self-interest, they all end up worse off. But finding a way to act cooperatively is far from simple. The efforts of the National Governors' Association to set some voluntary limits to the bidding wars, like the occasional attempts of clusters of neighboring states to establish incentive truces, have proven unable to survive the pressure of renewed opportunities to pursue large employers and renewed fears about the departure of key businesses. Nor does the prospect of federal legislation offer much promise. Despite suggestions from a number of observers and the modest proposals put forth by several legislators, Congress has shown little interest, to date, in tackling this complex topic that runs counter not only to the current rhetoric of devolution and states' rights but to the interests of the most influential elements of the business community as well.

If the political process holds out little hope of a solution, the courts may offer greater promise. After all, one of the functions of the judiciary is to sustain certain fundamental constitutional principles against the pressures of political expediency. And one of those fundamental principles, enshrined in the Constitution's commerce clause and actively enforced by the courts throughout our history, is the commitment to an open national economy, unimpeded by interstate rivalries and favoritism. Indeed, the Supreme Court has repeatedly struck down state actions that it found to conflict with "a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that . . . the new Union would have to avoid the tendencies toward economic Balkanization that had plagued the relations among the Colonies and later among the States under the Articles of Confederation." (*Hughes v. Oklahoma*, 1979.) If today's tax incentive battles are the modern counterparts of the eighteenth-century interstate tariff competitions, then judicial enforcement of the commerce clause offers a powerful tool for stemming the rivalry.

In the long, and sometimes tortuous, history of judicial interpretation of the commerce clause, one principle that has remained constant and central is the prohibition against state tax provisions that discriminate against interstate commerce by granting preferential treatment to in-state businesses or to economic activities that take place within the state. While the Supreme Court has typically focused more on the protectionist aspects of such tax provisions than on their role in attracting investment and jobs into the state, the Court has repeatedly struck down state tax provisions that selectively reward in-state economic activity.

For instance, in *Boston Stock Exchange v. State Tax Commission* (1977), it unanimously invalidated provisions of New York's stock transfer tax that imposed lower rates on transactions completed on in-state stock exchanges, thereby impermissibly encouraging investors to do their trading in New York and giving the New York exchanges an advantage over their out-of-state competitors. In *Bacchus Imports v. Dias* (1984), it found that a Hawaii provision exempting certain alcoholic beverages manufactured locally from the state's alcohol excise unconstitutionally favored local business activity over its external competition. And, in *Westinghouse Electric Corp. v. Tully* (1984), it struck down a state income tax credit that was based on the proportion of a company's exporting business that took place in the state, because it used a discriminatory tax scheme to encourage the development of local business activity.

Drawing on these and similar precedents, I have argued elsewhere that a wide array of familiar state and local tax incentives used to promote in-state economic activity are subject to commerce clause attack. And other prominent state tax scholars have agreed, although there is some divergence of opinion about the precise range of incentive measures that are likely to face judicial invalidation.

In recent years, several prominent courts have confirmed these predictions by striking down a variety of familiar economic development tax incentives on commerce clause grounds. A New York appellate court has invalidated a provision of New York City's income tax granting preferential depreciation treatment for property placed in service in New York. The federal court of appeals for Louisiana has declared unconstitutional a provision of that state's property tax that conditioned exemptions for new or expanded manufacturing plants on a requirement of preferential use of in-state supplies and labor in constructing the plant. And, earlier this year, the Pennsylvania Supreme Court struck down an element of Pennsylvania's corporate franchise tax's apportionment rules that granted preferential treatment to in-state manufacturing operations, by excluding the property, payroll and sales related to those manufacturing operations in calculating the fraction of the corporation's overall activity occurring (and therefore taxable) in the state.

In order to build on this growing body of favorable precedent establishing the unconstitutionality of business location incentives, I have been working with Ralph Nader and several public interest groups to initiate litigation challenging strategically selected corporate tax incentives. Last winter, we began the process of framing a suit to challenge the extravagant tax breaks that Connecticut was offering in an effort to lure the New England Patriots football team to Hartford, but the team abandoned its planned move before the suit could be filed. At present, we are finalizing the pleadings for a suit challenging the multi-million dollar package of state and local tax breaks deployed by Ohio to secure a large automotive plant.

In each of these cases, and in multitudes of others waiting to be brought, the case for the unconstitutionality of the challenged tax incentives flows directly from established precedents and principles. The biggest obstacle facing these lawsuits is not their legal merits, but rather the difficulty of identifying appropriate plaintiffs to bring the suits. Large multi-state businesses, who often could complain that they suffer competitive disadvantages due to special tax breaks given to their competitors who locate in a particular state, have generally been reluctant to bring challenges to these provisions, presumably because they recognize that doing so would endanger similar tax breaks in other states from which they themselves derive economic advantages. After all, the real losers from the accelerating cycle of business tax breaks are not businesses, but rather the states themselves and their citizens and taxpayers who must bear the loss of state and local revenues no longer paid by large, mobile businesses.

The states themselves are one potential class of challengers of other states' tax breaks. Indeed, in the controversy over the New England Patriots, the Massachusetts Attorney General was seriously considering suing Connecticut for using unconstitutional means to try to woo away Massachusetts' football team. But,

as we learned there, the business community's support for existing tax incentive competition, together with the recognition that a successful challenge to another state's tax breaks will raise serious questions about the validity of benefits offered by the home state as well, create potent political pressures against suits by one state challenging another's tax incentives.

Citizens and taxpayers who recognize the extent to which they are burdened by the unconstitutional tax breaks given to big businesses offer another promising class of potential challengers. The impending suit in Ohio largely reflects the concerns and interests of such citizen/taxpayers. While the federal courts disfavor suits brought by citizen/taxpayers who cannot demonstrate a particularized and direct, individual stake in the legal challenge, many states (like Ohio) are far more open to use of their state courts to redress state and local measures that unconstitutionally deplete governmental resources to the general disadvantage of the taxpaying citizenry.

My hope in writing this column is to encourage concerned citizens and organizations to consider the option of bringing constitutional challenges to problematic tax incentives used in their own states and localities. Such legal challenges appear to offer the best available path toward breaking the cycle of proliferating and ever more costly tax incentives for businesses. I would be happy to hear from anyone who is interested in exploring the possibility of initiating or participating in such litigation.

Case Citations

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

Hughes v. Oklahoma, 441 U.S. 322 (1979).

Westinghouse Electric Corp. v. Tully, 466 U.S. 388 (1984).

Bacchus Imports, Ltd. v. Dias, 468 U.S. 263 (1984).

Pelican Chapter, Associated Builders & Contractors, Inc. v. Edwards, 128 F.3d 910 (5th Cir. 1997).

PPG Industries v. Commonwealth, __ A.2d __, 1999 WL 396902 (Pa. 1999).

R.J. Reynolds Tobacco Co. v. Department of Finance, 667 N.Y.S.2d 4 (App. Div. 1997).

For Further Reading

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 Business Tax Incentives*, in *The Future of State Taxation* 73 (David Brunori ed., 1998).

Walter Hellerstein and Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 Cornell L. Rev. 789 (1996).

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