A DEFENSE OF THE COMMERCE CLAUSE'S ROLE IN CONSTRAINING STATE BUSINESS TAX INCENTIVES

Peter D. Enrich, Northeastern University School of Law

THIS IS A PAPER ABOUT CONSTITUTIONAL constraints and institutional roles. It addresses what is perhaps an inevitable problem in a federalist structure like ours: To the extent that governmental subunits – states and local governments – have the autonomy and authority to arrange their own tax and fiscal systems, they will do so in ways which further their own parochial interests by seeking to maximize their shares of private investment and economic activity. The resultant competition, however, threatens to trap the competing jurisdictions in a counterproductive cycle, which diminishes each of their capacities and harms shared national economic interests. The question, then, is how a federal system can constrain these damaging tendencies, while preserving the values of local autonomy.

In the United States, much of the responsibility for such constraint has fallen on the Constitution's Commerce Clause, and on judicial interpretation and enforcement of its limits on state (and local) interventions influencing interstate economic activity. This paper offers a brief review of the extent to which the Commerce Clause doctrine serves to restrict what has become the most intense and problematic area of state competition for business investment, namely the rapidly proliferating use of state tax incentives directed at business location decisions. And it examines the extent to which judicial interpretation and enforcement of a somewhat Delphic federal constitutional provision offers an appropriate institutional response to the problems of interstate tax competition, particularly in light of a number of recent critiques of this judicial role.[1]

Ordinarily, in addressing these topics, I would begin with some discussion of why the ubiquitous and escalating use of state business tax incentives is so deeply problematic as a matter of public policy (Enrich, 1996 and 2006). But in this forum, I will stick closer to my comparative advantage as a legal scholar, and focus on the constitutional issues and their institutional implications. Only a few basic points, which are effectively exemplified by the two other papers presented together with this one (Chirinko and Wilson, 2007; Markusen, 2007), are essential as background.

First, recent decades have seen the states engaged in an aggressive competition to offer ever more extensive and expensive tax breaks to reward in-state business investment. Chirinko and Wilson (2007) document the region-by-region spread of investment tax credits, and similar patterns characterize the proliferation of a wide array of other tax incentives, such as jobs credits, targeted property tax abatements, and adoption of income-apportionment formulae that are heavily weighted toward the sales factor. The cumulative cost of these incentives is high; Thomas (2000) estimated the annual cost of state and local incentive measures in 1996 as nearly $50 billion, and that cost has surely grown dramatically over the ensuing decade. Yet, the overwhelming weight of the econometric and anecdotal evidence is that these incentives have only a minimal effect on actual business location decisions (LeRoy, 2005; Lynch, 2004; Peters and Fisher, 2004).

But, for all of the reasons that Markusen (2007) explores, state policy makers are powerfully inclined to continue and to escalate the incentive competition, notwithstanding the evidence of its high costs and minimal benefits. As in a classic prisoners' dilemma, no one state is in a position to unilaterally withdraw from the competition, so long as other states remain free to continue it. These dynamics are exacerbated by the emergence of a site-consulting industry, which fans the competitive flames while widening the informational asymmetries that fuel the states' competitive efforts. And, even when decision makers recognize the minimal practical influence of their tax incentives on businesses' location decisions, political motivations – particularly the imperative to be perceived by voters as doing whatever they can to strengthen the local economy – impel them to continue the competition. The states, in short, are caught in a costly and unproductive cycle of offering ever larger tax breaks to mobile businesses.

In the context of this problem, I want to make two points in this paper: First, the antidiscrimination jurisprudence which lies at the heart of judicial interpretation of the Commerce Clause can be invoked to invalidate and prohibit a wide range of the tax incentives deployed by the states. And second, despite doubts and objections raised both by legal scholars and litigants, this antidiscrimination jurisprudence offers a relatively robust tool for judicial intervention in an area where such intervention is institutionally important.

THE ANTIDISCRIMINATION PRINCIPLE'S ROLE

The problem posed by the states' competition over business tax incentives is not a new one. Indeed, a central cause behind the calling of the Constitutional Convention of 1787 and behind the drafting of the Constitution was the intensifying economic competition between the states in the pre-Constitutional period, most notably in the form of tariff barriers and related economic retaliation (Denning 2005-2006; *Hughes v. Oklahoma*, 1979; *Hughes v. Alexandria Scrap Corp.*, 1976). The heart of the Framers' response to this fundamental problem was the Commerce Clause. On its face, the clause is an affirmative grant of authority to the federal Congress to "regulate Commerce . . . among the several states." But the clause also serves an equally important negative or "dormant" function, as a prohibition barring the states from using their sovereign powers to interfere with interstate economic activity for local advantage.

Over the centuries, the Supreme Court has deployed this dormant Commerce Clause hundreds of times to strike down a wide variety of state tax and regulatory measures that were found to impermissibly interfere with the free flow of economic activity in a national common market. In the course of this history, the Court has deployed a wide range of different, and at times inconsistent, rules and standards to distinguish permissible from impermissible state conduct, and its current jurisprudence identifies four distinct tests that state tax measures must pass to survive Commerce Clause scrutiny (*Complete Auto Transit, Inc. v. Brady*, 1977). But, throughout this history, one standard has remained a "fundamental principle" in the Court's reasoning, namely that "No state . . . may impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business." (*Boston Stock Exchange v. State Tax Comm'n*, 1977, at 329).

The courts have used this "antidiscrimination principle" to invalidate a wide range of state tax measures that impose heavier taxes on goods produced or services performed outside the state than on their in-state competition (*Bacchus Imports, Ltd. v. Dias*, 1984; *West Lynn Creamery v. Healy*, 1994), or that provide tax benefits for businesses that locate their activities or their entities in the state (*Westinghouse Electric Corp. v. Tully*, 1984; *South Central Bell Tel. Co. v. Alabama*, 1999). The common thread that runs through these cases is that each fits the Court's straight-forward definition of "discrimination" as "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter" (*Oregon Waste Systems, Inc. v. Dep't of Envtl. Quality*, 1994, at 99). In determining whether a particular measure is discriminatory, the Court calls for "a sensitive, case-by-case analysis of purposes and effects" (*West Lynn Creamery v. Healy*, 1994, at 201), but those measures which discriminate "on their face," i.e. where the differential treatment is explicit in the terms of the applicable statute, are singled out for particular scrutiny and are deemed "virtually per se invalid" (*Fulton Corp. v. Faulkner*, 1996, at 331), even if their practical effects are minimal.

How does this antidiscrimination principle apply to the wide array of business tax incentives deployed by the states in recent decades? A definitive answer is not yet available. The Supreme Court has struck down several measures with close resemblances to some of the common tools, and lower courts have struck down some more (Enrich, 2006). But, when the Supreme Court in 2006 had the opportunity to directly address the question, in reviewing a lower court ruling that invalidated Ohio's investment tax credit on antidiscrimination grounds, the Court declined to reach the Commerce Clause merits and vacated the lower court's decision, on the procedural ground that the plaintiffs who had brought the case lacked the requisite personal interest in the dispute to give them "standing" to pursue it in the federal courts (*DaimlerChrysler Corporation* v. *Cuno*, 2006).[2]

Nonetheless, the argument that many of the familiar business tax incentives violate the antidiscrimination principle is straightforward and compelling, as I and others have argued in detail elsewhere (Enrich, 1996; Hellerstein and Coenen, 1996). Consider, for example, the very widespread investment tax credit (ITC), which allows a business to reduce its state income tax liability by a specified percentage of the cost of new investments in plant, machinery, and equipment that it places in service in the taxing state. Companies that do business in a state pay income taxes to that state (using a statutory apportionment formula to determine what share of their income is taxable by the state), whether or not they locate their plants and equipment there. But, because of the ITC, a company that locates a new plant in the state will be able to pay less tax (and, more particularly, a lower effective *rate* of tax on its income apportioned to the state) than an otherwise identically situated competitor which locates its new facility elsewhere.

Thus, the ITC is a paradigmatic example of discrimination: it provides for differential treatment of the company with the in-state plant and the company with the out-of-state plant thereby favoring the former over the latter. Just like a tariff, it results in a higher tax burden on businesses that produce their wares outside the state than on those who locate their production facilities in-state. And this differential treatment has both the purpose and the effect of favoring in-state economic activity over its out-of-state alternatives. Indeed, typical ITC statutes expressly limit the credit to investments located in the state, and thus are examples of "virtually per se invalid" facial discrimination. No wonder, then, that the U.S. Court of Appeals for the Sixth Circuit concluded in *Cuno v. DaimlerChrysler, Inc*. that Ohio's ITC violated the Commerce Clause.

Some defenders of state tax incentives argue that this sort of antidiscrimination analysis is far too sweeping, and would intrude to the very heart of state authority to levy taxes, forbidding a state, for instance, from reducing its business tax rates or from choosing not to levy a property tax on business personal property, because such measures have the effect (and, perhaps, the purpose) of favoring in-state economic activity. But, in fact, such measures are safe from antidiscrimination principle scrutiny, because, whatever their purposes or effects, they do not provide for *differentially favorable* treatment of in-state activity over out-of-state alternatives. The reduced tax rate applies equally to all businesses that are subject to the state's tax, wherever they locate their operations; and owners of out-of-state business personal property are not subjected to a differential burden because their property lies beyond the state's jurisdiction to tax at all. In short, such measures lack the hallmark feature of discriminatory treatment.

At the same time, a wide range of tax incentive measures do appear to violate the antidiscrimination principle. Any location-based credit against a generally applicable tax on business income, such as a credit for new in-state employees or for in-state research and development expenses, will fall victim to the same analysis that applies to ITCs. And, while generally applicable exemptions or exclusions from property or sales taxes appear immune from antidiscrimination scrutiny, widely used provisions that condition such exemptions or exclusions on the taxpayer engaging in additional in-state activity (e.g., provisions that condition a property tax exemption on hiring a specified number of new employees in the state or that offer a sales tax exemption only to businesses that locate their headquarters in the state) are a different story. Such provisions discriminate, not between a business that locates its property (or its sales) in-state and one whose property (or sales) are elsewhere, but rather between two businesses, both with in-state property (or sales), one of which engages in the required additional in-state activity (new employees or headquarters location) and the other of which does not.

Examples of this latter sort, involving discriminatory conditions on otherwise nondiscriminatory tax breaks, are controversial. The Sixth Circuit in *Cuno v. DaimlerChrysler, Inc*, while invalidating Ohio's ITC, held that an Ohio program allowing municipalities to grant property tax exemptions to businesses that committed to negotiated levels of local investment and employment did not violate the Commerce Clause, because it concluded that discriminatory conditions do not render an otherwise nondiscriminatory property tax exemption unconstitutional if the conditions relate to the use of the property itself and not to an independent form of commercial activity. The court's approach, however, has no apparent basis in preexisting Commerce Clause case law or reasoning, and it is inconsistent with a number of prior cases, including the Supreme Court's *Camps Newfound/Owatonna v. Town of Harrison* (1997) decision. Although the Supreme Court declined to review this element of the Sixth Circuit's *Cuno v. DaimlerChrysler, Inc*. ruling, its grounding is weak, and it should offer little comfort to proponents of these types of conditional tax breaks.

So, the antidiscrimination principle provides the courts with a tool that can invalidate a wide range of the business tax incentive programs enacted by the states. By contrast, another class of state business incentive programs, those that offer non-tax benefits, such as worker training, low-cost loans, road and sewer infrastructure, and perhaps even direct cash subsidies, appear immune to antidiscrimination scrutiny, even when such benefits are provided exclusively to in-state businesses. The reason is that the Supreme Court has determined that its dormant Commerce Clause jurisprudence only applies to states' exercises of their regulatory and taxation powers, and not to their activities as purchasers or providers of goods or services or as ordinary participants in market transactions. This so-called "market participant exception" draws a bright-line distinction between exercises of state sovereignty, which threaten to "regulate" interstate commerce in violation of the Commerce Clause's delegation of that power to the federal government, and state exercises of ordinary proprietary powers grounded in property and contract, where the Court holds that states should be as free as private parties to choose with whom they do business and on what terms. One important consequence of the market participant exception is that a wide array of business incentive programs that rest on state spending measures, rather than on state tax incentives, are immunized from Commerce Clause scrutiny.

IN DEFENSE OF THE COURTS' ANTIDISCRIMINATION JURISPRUDENCE

Defenders of state business tax incentives and critics of the Supreme Court's antidiscrimination jurisprudence have raised a wide range of arguments why the courts should not apply the dormant Commerce Clause to invalidate tax measures designed to reward in-state investment and economic activity. In Enrich (2007), I attempt to catalogue and respond to the full range of arguments. Here I focus on the most interesting and substantial set of challenges – those which ground their critiques on the undeniable fact that the Court's antidiscrimination approach entails some delicate and questionable boundary calls. In particular, the antidiscrimination principle outlaws certain types of tax measures, like those in *Bacchus Imports, Ltd. v. Dias* (1984) or *Westinghouse Electric Corp. v. Tully* (1984), that are crafted to favor in-state activity, while allowing others, like Iowa's sales-based apportionment formula (*Moorman Manufacturing Co. v. Bair*, 1978) or generally applicable property tax exemptions or rate reductions, which have identical purposes and comparable effects. Likewise, while the Court's antidiscrimination jurisprudence strikes down a variety of incentives delivered through the tax system, its market participant exception excuses from Commerce Clause scrutiny a range of alternative measures that deliver financially identical incentives through direct expenditures of public funds.

The critics take these distinctions as indicators that the Court's jurisprudence is unprincipled and arbitrary. Some, such as Zelinsky (2002) and Graetz and Warren (2006), conclude from the arbitrariness that this is not an issue appropriate for judicial intervention and resolution at all, that the courts should abandon the attempt to enforce antidiscrimination norms for state taxation. Others, such as Hellerstein and Coenen (1996) and Tatarowicz and Mims-Velarde (1986), suggest instead that the courts should respond by restricting the reach of the antidiscrimination principle to limit its impact on state economic development measures. Still others, such as Steele and Vallejo (2006), propose the need for a more nuanced approach than the courts alone can provide, grounded perhaps in Congressional articulation of appropriate standards to be applied by an expert adjudicatory body.

In response, I want to suggest, first, that, notwithstanding the real difficulties of judicial line drawing in this vicinity, institutional realities leave little choice but for the courts to continue to play the role that the Commerce Clause has historically demanded of them as guardians against state overreaching. And second, given the need for judicial intervention, the particular standards that the Court has invoked – the antidiscrimination principle and the market participant exception – do a reasonably effective job of drawing needed distinctions on intelligible grounds.

But this is not to deny or diminish the difficulties on which the critics focus. Given the wide range of governmental activities and the natural tendencies of policy makers to structure those activities in ways that further local interests, it is virtually inevitable that we find a continuum of measures, ranging from those so basic to governmental functioning that there can be no question of their legitimacy in a federal system to others so weighted in favor of the local economy that they are deeply problematic for the functioning of a national common market.

In fact, there are two key dimensions along which these measures can be arrayed. The first dimension is internal to tax policy. At one pole are unquestionably legitimate choices concerning tax rates; at the other end are unquestionably impermissible tariff provisions that single out interstate transactions for taxation. See Figure 1. The other dimension extends across the different ways that governmental action provides benefits to (and imposes burdens on) private sector economic actors. At one pole of this dimension are unquestionably legitimate restrictions of basic governmental services to those within the government's borders (e.g., only building roads within the state; excluding nonresidents from the public schools); at the other end are unquestionably impermissible tax and regulatory measures that selectively burden out-of-state businesses (e.g., tariffs or regulations barring out-of-state companies from engaging in transactions in the state). See Figure 2.

The difficulty, of course, is that, on each dimension, there is a dense continuum of measures extending from the one pole to the other. And all of the measures, from one end to the other on each continuum, are factors that affect (and are often deliberately designed to affect) the attractiveness

Figure 1

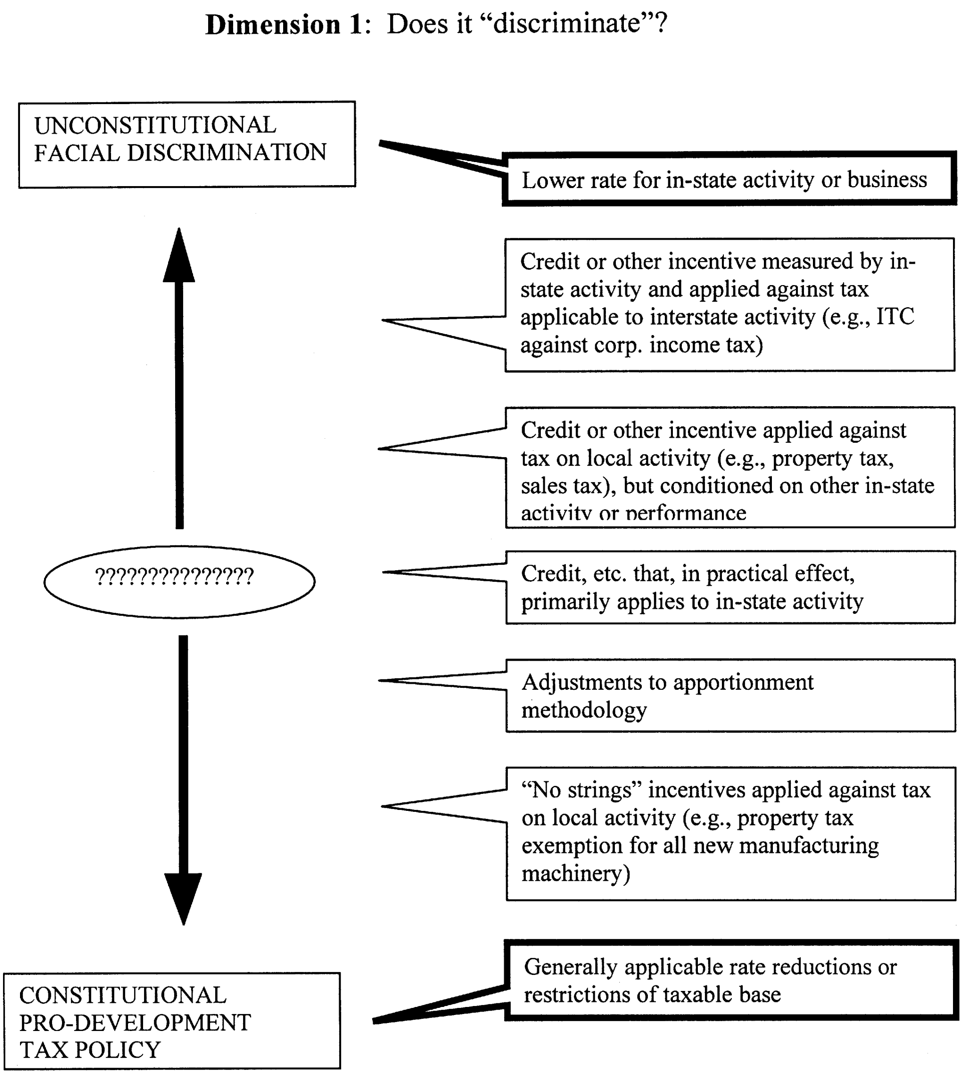
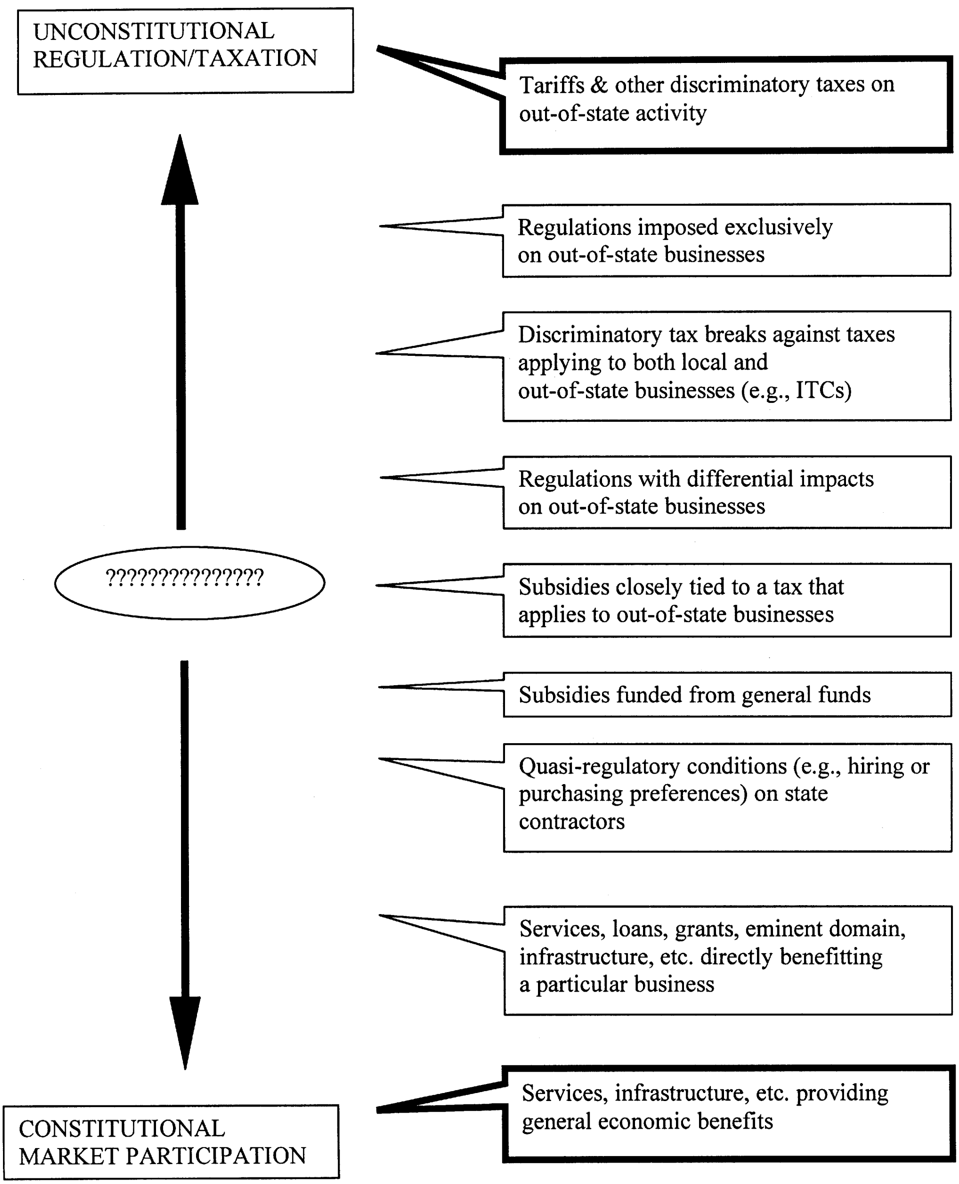


Figure 2

Dimension 2: "Regulation" or "Market Participation"?



of the jurisdiction as a place to locate or conduct business activity. So, a line cannot be drawn on the basis of whether or not the measure influences, or is designed to influence, business location choices.

But this reality does nothing to mitigate the importance of a judicial role enforcing the constitutional norm against state interference with interstate economic activity. As history has repeatedly demonstrated, from the 18th century to the 21st, states are compellingly drawn to prioritize parochial over national economic interests and to do so in ways that fuel mutually injurious cycles of competitive imitation. The political incentives faced by locally elected leaders point them in that direction, and powerful private players have strong financial reasons for pushing them along. Nor is there much reason to expect that Congress will step in to protect broader public interests, given its members' sensitivities to the interests of state officials and representatives of big business.

Even with the current, relatively robust judicial oversight, the states are continually testing the limits to give advantages to local economic interests. If the Framers' concerns over the deleterious consequences of tariff-like measures remain valid, then a judicial role remains essential – and, with it, the need for line drawing that can distinguish between the indisputably legitimate measures at one end of our two continua and the concededly unacceptable ones at the other. At the same time, the interest in a healthy federalism, in which the states preserve substantial autonomy in the conduct of their governmental affairs, argues for judicial rules in this area that are relatively simple, intelligible, and predictable.

I would suggest that the Court's antidiscrimination principle does an admirable, if inevitably imperfect, job in drawing a line on the first dimension, and that its market-participant exception does at least a workable job along the second dimension. Each draws a relatively simple and predictable line, one that gets the easy cases at both ends of their respective continua right, and one that focuses scrutiny on considerations that are comprehensibly connected to the underlying common-market goals animating the Commerce Clause.

In the case of the antidiscrimination principle, not only has it stood the test of time as a stable and readily applicable benchmark for a wide range of the Court's numerous Commerce Clause state tax cases, but it also focuses attention on a factor (i.e., preferential treatment) that is directly salient to the dangers at which the Commerce Clause is directed – dangers reflecting the natural tendency of legislators representing a single state to design tax measures that favor in-state actors and activities at the expense of out-of-state competitors and alternatives. Indeed, the most effective measures for furthering those ambitions – the ones that can provide the greatest benefit to local actors at the least cost in lost revenue – are likely to be precisely the ones that authorize differential tax treatment of in-state and out-of-state actors. So, while the Court's antidiscrimination principle proves both under- and over-inclusive in a range of cases, it is reasonably well targeted at many of the most problematic practices.

The market participant exception similarly succeeds both in its simplicity and in its ability to shelter from Commerce Clause attack a wide range of governmental policies whose preferential treatment of local actors seems unproblematic, while keeping many of the more troubling discriminatory measures under the courts' scrutiny. While the doctrine's rationale, in its distinction between the regulatory and proprietary functions of government, is somewhat wooden and disconnected from underlying Commerce Clause concerns, the market participant exception nonetheless succeeds in singling out for judicial attention what are, in practice, the most tempting and most troubling types of preferential measures, namely tax breaks, as opposed to non-tax programs. As the Court noted in *Camps Newfound/Owatonna v. Town of Harrison* (1997, at 589), tax incentives and direct benefits may serve similar ends, but they differ in important respects. Not only are tax measures, from the perspective of government decision makers, less visible and subject to fewer procedural constraints in the legislative process, but they also, from the perspective of businesses, smack far less of governmental hand-outs. It is no accident that tax breaks remain the tools of choice in state economic development programs and in the deals assembled for particular businesses. The market participant exception might well benefit from further judicial elaboration narrowing its scope to reach only those governmental measures that truly resemble market behavior of private actors (and not to reach, for example, pure cash subsidies). But even in its present form, it provides a workable and necessary tool to define the scope of state measures to which judicial Commerce Clause scrutiny should apply.

Notes

1 This paper offers a summary and overview of a longer paper (Enrich, forthcoming), which addresses these same topics in greater detail and which provides the more comprehensive citations to authority that are customary in legal scholarship.

2 In the interests of full disclosure, I note that I represented the citizen plaintiffs in this case, on a *pro bono* basis, throughout the litigation, and will continue to represent them for their forthcoming state court suit pursuing these same claims.

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