

COMMENTS

“A DEFENSE OF THE COMMERCE CLAUSE’S ROLE IN CONSTRAINING STATE BUSINESS TAX INCENTIVES” BY PETER D. ENRICH

“A MARKET FOR JOBS APPROACH FOR ANALYZING THE COMPETITION FOR CAPITAL” BY ANN MARKUSEN

AND

“STATE INVESTMENT TAX INCENTIVES: WHAT ARE THE FACTS?” BY ROBERT S. CHIRINKO AND DANIEL J. WILSON

David E. Wildasin, University of Kentucky

INTRODUCTION

THE THREE PAPERS IN THIS SESSION EXAMINE issues raised by, or related to, the case of *Cuno v. DaimlerChrysler, Inc.* The policies under review in *Cuno v. DaimlerChrysler, Inc.* include an investment tax credit that reduces the state franchise tax burden for businesses in Ohio as well as local property tax relief for businesses in Toledo. These policies are purportedly targeted at increasing the amount of investment and employment in their respective jurisdictions.¹ Although the *Cuno v. DaimlerChrysler, Inc.* case may be unique in some respects, similar policies are employed by many subnational jurisdictions and they have attracted widespread attention. As *Cuno v. DaimlerChrysler, Inc.* illustrates, they raise important legal questions, the focus of the paper by Peter Enrich. They raise broader public policy questions, as discussed in the paper by Ann Markusen. And they raise many questions of interest to economists, ranging from the theoretical to the empirical; the paper by Robert Chirinko and Daniel Wilson, describing some findings from a newly developed data set on state tax policies, contributes to the empirical side of the economic discussion.

Each of these three papers is quite distinct, and readers can find much of interest in each of them. Rather than attempt to summarize and comment on each paper separately and in detail, however, the following comments highlight some issues that cut across all three papers and some of the directions for future research that they suggest.

LEGAL AND POLICY ISSUES

First and foremost, *Cuno v. DaimlerChrysler, Inc.* itself is a legal dispute. I refer readers to Enrich’s essay for a concise guided tour of “dormant” Commerce Clause interpretation. Evidently, a recurring question in this context is whether a particular policy is in some way discriminatory in its treatment of businesses, intruding upon the free flow of interstate commerce. Enrich argues persuasively that courts should insist that state policies should adhere to the principle of nondiscrimination in their treatment of in-state (domestic) and out-of-state (foreign) firms. We surely have not seen the end of legal disputes over the Commerce Clause and the restrictions that it imposes on state and local government policy making, since the Supreme Court elected not to address these matters in its resolution of *DaimlerChrysler Corporation v. Cuno*.

To some degree, legal argumentation about the Commerce Clause has evolved according to its own internal logic, but it has not been detached from broader considerations of public policy. A key legal question, and one of great importance for public policy generally, concerns the proper scope of state policy autonomy. In broad terms, few would disagree that subnational governments must enjoy substantial policy autonomy in a vibrant federation. There is likewise broad agreement that subnational government policy autonomy should not be absolute. As a matter of constitutional principle and as a matter of sound economic policy, these governments are and should be restricted

from acting in ways that obstruct the free flow of interstate commerce. Between these extremes, however, there is much room for differing opinions about whether any particular type of subnational government policy ought to be permitted or disallowed either on legal or on public policy grounds. Legal analysts might wish to restrict state policy autonomy differently than analysts focusing mainly on public policy issues.

Both Enrich and Markusen believe that tax policies like those under review in *Cuno v. DaimlerChrysler, Inc.* have adverse consequences, such as the erosion of state revenues, possible distortions in the interstate allocation of capital investment, the shifting of revenue systems toward less efficient or equitable tax instruments, and distortions of economic development policies. In Enrich's view, interstate competition for investment is a zero-sum game. States are trapped in a prisoner's dilemma, sacrificing their business tax revenues in self-interested but ultimately fruitless efforts to increase their shares of a fixed total stock of capital. Markusen is especially concerned with the nature of the bidding process whereby a firm can shop among the states (and localities) for favorable policy treatment. Firms may have informational advantages – magnified by the institutional context of the bargaining process – that enable them to extract substantial fiscal concessions from competing governments in exchange for modest economic development payoffs.

Both Enrich and Markusen would like to reshape state policymaking in order to limit harmful competition. They would do so in rather different ways, however. For Enrich, states “unquestionably” do and should have the prerogative to set overall tax rates, to build infrastructure, and generally to exercise a high degree of policy autonomy, provided that they do not discriminate between domestic and foreign firms. However desirable or undesirable they might be on policy grounds, broad, nondiscriminatory reductions in tax rates would certainly be permissible under the nondiscrimination principle. By contrast, Markusen focuses on achieving better economic development outcomes, especially as measured by increased employment. Nondiscrimination is a secondary consideration. For instance, instead of relying upon “indiscriminate incentives” or “across-the-board tax cuts,” Markusen suggests that governments might usefully target fiscal instruments at job creation in counties or industries with high rates of unemploy-

ment. Targeted or selective fiscal policies of this type might well run afoul of the non-discrimination principle advocated by Enrich.

ANALYTICAL CHALLENGES

Let us momentarily set aside normative legal and policy issues in order to focus on the empirical issues addressed by Chirinko and Wilson. The particular focus of this paper is to derive an economically meaningful and empirically based description of state tax business tax policies for all 50 states over a period of four decades, summarized by new estimates of state business tax “wedges.” While each state's policy trajectory is unique, the authors identify some interesting general trends. Statutory tax rates have generally risen over time, but so have investment tax credits, as strikingly demonstrated in Figure 1 of the Chirinko-Wilson paper. For this reason, statutory tax rates are poor indicators of trends in tax wedges. Indeed, rising statutory rates have been offset, or more than offset, by increases in investment tax credits, resulting in *declining* tax wedges (Figure 2). The authors also find evidence of spatial and temporal clustering in the use of tax credits. Readers of the Chirinko-Wilson paper will be impressed with the effort and care that has gone into these measurements. Empirical researchers will be indebted to them for the compilation of data that should be useful for future analyses of the effects of state tax policies on business investment and on other economic and fiscal variables of interest.

In highlighting the challenges involved in measuring state tax policies, the Chirinko-Wilson paper illustrates one of the reasons that empirical (and policy) analysis of the effects of taxes on business investment has proven to be a thorny problem: it is hard to analyze the determinants of the left-hand-side variable (investment, employment, revenues) if one does not measure the right-hand-side variables (tax policies) accurately. Data deficiencies, however, are by no means the only difficulty facing empirical researchers. Attempts to assess the economic and fiscal impacts of competition among governments face several daunting challenges.

First, recall some of the fundamental insights from the “Tiebout” approach, as applied in the context of business taxation. The Tiebout perspective emphasizes that state and local taxes on business are only one piece of the total policy mosaic that influences business and household behavior. Taxes

on businesses may repel investment, but competition for mobile capital does not mean that there is a “race to bottom,” if this is understood to mean that taxes fall immediately to zero. Taxes may finance public services that attract investment, for example by providing infrastructure that raises business profits. Business taxation may also affect other important components of state (and local) fiscal systems that affect investment incentives more indirectly but no less importantly. If taxes paid by businesses help to finance tax relief for households (e.g., through reduced personal income taxes) or pay for public services that they value (e.g., higher-quality schools), higher business taxes may indirectly attract workers and consumers whose presence raises profits and thus stimulates investment and employment. Accounting simultaneously for all of these direct and indirect channels through which the totality of state and local fiscal policies influence business investment is very difficult indeed. Chirinko and Wilson’s improved measures of the tax wedges on business investment enhance our understanding of one important part of the total fiscal system, but other policy instruments also affect investment, employment, revenues, public expenditures, and other economic and fiscal variables.

The Chirinko-Wilson findings indirectly highlight another vexing problem facing empirical analysts, namely, the endogeneity of subnational government policies. States do not choose their policies at random, but rather through a process that results in continuous adaptation of policy to changing conditions. The causal connections between fiscal policies and investment (and other economic variables) are thus bidirectional. To see this, suppose, quite plausibly, that the imposition of very heavy taxes on some narrowly defined type of business investment in any one state would lead to large reductions in investments there as businesses (and perhaps also workers and consumers) relocate to a more favorable fiscal environment. Such a policy would presumably not be adopted by state policy makers if its consequences could be foreseen. (If not, its consequences would become apparent enough *ex post*.) In such a world, heavy taxes on particular types of business investments would never occur (or, if once introduced, would not be sustained). More generally, rational policy adjustment in a competitive environment is expected to produce a constellation of policies – business taxes, regulatory policies, public services, taxes

on households and consumers – such that, at the margin, modest policy changes do not give rise to large consequences, whether adverse or beneficial. In short, in a competitive system, observed policies and policy changes should generally result in *small* impacts on investment, employment, output, and revenues, not large ones.

The findings of Chirinko and Wilson, as displayed in their Figures 1 and 2, reveal a process of policy evolution in which states are simultaneously adjusting their statutory tax rates and their use of investment tax credits. The combined effect of these policy adjustments is a downward drift of the net tax wedge. Some future researchers may wish to use these estimated tax wedges – not to mention other state and local policies – as right-hand-side variables that can help to explain variations in business investment. An equally interesting and closely related task for future research is to use these tax wedges – not to mention other state and local policies – as left-hand-side variables whose variation over the past four decades is to be explained. Clearly, explaining endogenous policy choice is a formidable analytical challenge, but one that cannot be ignored: a failure to account properly for policy endogeneity precludes reliable estimation of the economic, fiscal, and other impacts of business tax policy.

SOME CONJECTURES AND OPEN QUESTIONS

As noted, the (static) theory of fiscal competition does not imply that taxes on mobile resources converge (or “race”) toward zero (the “bottom”). It does, however, imply that competitive jurisdictions will find it disadvantageous to impose “net fiscal burdens” on (or to offer net fiscal benefits to) mobile resources – that is, in the language of Stigler (1957), to attempt to redistribute income toward or away from mobile resources.²

The relocation of capital and other resources, however, is a dynamic process, and not all capital is necessarily equally mobile. Some kinds of “capital,” such as liquid financial assets, can be relocated quickly at minimal cost. Other kinds of capital, such as the fixed capital investments that define the nonhuman component of a major metropolitan area, cannot move quickly and freely from place to place. Major industrial complexes are built over long periods of time, and, even in the face of adverse fiscal treatment, can disappear no faster than they can depreciate. All capital (and perhaps

all labor) may be mobile in the “long run,” but competition does not prevent a jurisdiction from using fiscal policies to impose net fiscal burdens upon (or award net fiscal benefits to) capital in the “short run,” a period that may in some instances be as long as several decades. Indeed, the residents of a competitive jurisdiction might well benefit in the short run, and on balance over the entire policy horizon, from the imposition of a net fiscal burden on sunk or historically given capital (Wildasin, 2003). In the remaining comments, and in the interest of identifying areas that may warrant further study, I build on these ideas to offer some conjectures about the policy evolution described by Chirinko and Wilson.

To begin, suppose that each state contains an existing stock of “old” capital, accumulated at various dates in the past and momentarily fixed and immobile. Over time, gross investment in each state offsets some or all of the depreciation of this existing capital and may add to it. Assume that the “new” capital represented by this gross investment can easily be located in many states or localities. In other words, the *stock* of “old” or “inframarginal” capital is immobile, but “marginal” units of new capital (investment *flows*) are freely mobile. Much of this capital, both old and new, may be owned by nonresidents. The returns to capital investments by large multistate or multinational corporations like DaimlerChrysler accrue mainly to nonresidents because the ownership of these firms is widely dispersed through financial markets. From the viewpoint of any one state, like Ohio, it would be highly desirable to redistribute income from the nonresident owners of such firms, but an attempt to impose net fiscal burdens on *marginal* units of investment by them is self-defeating: competition for new capital makes it optimal for states to minimize the net fiscal burdens on “new” investment. The taxation of “old” capital is a somewhat different matter, since it is immobile in the “short” run. Taxation of old capital reduces the net incomes of its owners but it may not reduce the level of investment, local employment, or output. By taxing old capital, partially or substantially owned by nonresidents, a state (or locality) obtains revenues that can be used to benefit residents through tax relief or by providing public services.

In this context, investment tax credits offer potentially valuable policy instruments that states can use, in combination with statutory tax rates, to achieve two different policy objectives – at

least theoretically. In order to compete for capital investment at the margin, states would optimally impose zero net fiscal burdens on “new” capital; in the terminology of Chirinko and Wilson, they would aim for small tax wedges. One way to do this would be to impose taxes at low statutory rates. Doing so, however, comes at the cost of sacrificing the tax revenues that could be derived from the existing stock of “old” (inframarginal) capital, a rent transfer from other taxpayers to the owners of the capital of existing firms. Alternatively, by maintaining statutory tax rates while using tax credits to target tax relief to “new” investment, states may be able instead to capture rents from the owners of old capital while still competing effectively for marginal units of investment.³ In practice, of course, differentiating between “marginal” and “inframarginal” units of capital is likely to be quite difficult, and impossible to achieve with precision, so this “two instruments, two targets” calibration of policy will be imperfect, at best.

These remarks offer one possible explanation for the evolution of business tax policy described by Chirinko and Wilson, although other explanations are certainly possible. They cast a new light on Enrich’s nondiscrimination principle and on the issue of rent transfers raised by Markusen. As explained by Enrich, the nondiscrimination principle is designed to prevent policies that favor “domestic” firms at the expense of “foreign” firms. In *Cuno v. DaimlerChrysler, Inc.*, for instance, the state tax preference offered to DaimlerChrysler is viewed as discrimination in favor of a “domestic” firm because it is available only to firms that pay state franchise taxes. However, while DaimlerChrysler is a “domestic” firm in Ohio in the sense that it has an existing plant in Toledo, it is a “foreign” firm in significant economic respects: it is a large, multinational corporation whose ownership is dispersed throughout the world. In this sense, a tax credit for a new DaimlerChrysler plant in Toledo discriminates *against* domestic firms (i.e., “old capital” embodied in the existing plant of other firms), not in favor of them.

This discrimination in favor of new capital does facilitate rent transfers, but not, as Markusen would suggest, *from* taxpayers in general to the firm contemplating an investment of “new” capital. Rather, by differentially targeting investment tax credits at new investment while maintaining statutory tax rates, a state can capture rents from “old” capital, owned by “domestic” (inframarginal) firms, and

transfer these rents *to* other residents – either to other taxpayers, in the form of taxes that are lower than they would otherwise be, or to the beneficiaries of the public expenditures financed by taxes on old capital.

In summary, the competition for mobile capital does raise questions about “fiscal discrimination” and about rent-seeking and rent-transfer. The analyses by Enrich and Markusen examine important aspects of these issues. The findings of Chirinko and Wilson raise new questions about the structure of state business tax policies and their evolution over time, however. When considered in a dynamic setting, competitive pressures may create incentives for states to discriminate between marginal and inframarginal units of investment, protecting (quasi) rents derived from the latter without burdening the former. Of course, opening up dynamic issues raises many important questions about time consistency and the durability of policy commitments. These topics have been somewhat neglected in the theoretical literature but empirical analyses are likely to bring them to greater prominence.

Notes

¹ It is apparently becoming somewhat customary to refer to such policies as “tax incentives.” This terminology may offer a convenient shorthand but is potentially misleading since all tax policies have incentive effects.

² At least this is so if these jurisdictions have sufficient flexibility in the range of policy instruments at their disposal. See Wildasin (2006) and references therein for further (largely nontechnical) discussion.

³ For related analysis, see Wildasin and Wilson (1998). In that paper, a property tax is viewed as a combined tax on immobile land and mobile capital. Individual jurisdictions have incentives to tax these two resources differentially, imposing heavy (even confiscatory) burdens on immobile land while relieving mobile capital of all net fiscal burdens. “Land” and “capital” in that analysis correspond to “inframarginal” and “marginal” capital here.

References

- DaimlerChrysler Corporation v. Cuno*, 126 S. Ct. 1854 (2006) (vacating *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738 (6th Cir. 2004)).
- Stigler, George J. The Tenable Range of Functions of Local Government. In *Federal Expenditure Policy for Growth and Stability*. Washington, D.C.: Joint Economic Committee, 1957.
- Wildasin, David E. Fiscal Competition in Space and Time. *Journal of Public Economics* 87 (October 2003): 2571-2588.
- Fiscal Competition. In Barry Weingast and Donald Wittman, eds. *Oxford Handbook of Political Economy*. Oxford: Oxford University Press, 2006, pp. 502-520.
- Wildasin, David E. and John D. Wilson. Risky Local Tax Bases: Risk-Pooling vs. Rent Capture. *Journal of Public Economics* 69 (August 1998): 229-247.