What's Wrong with Tax Giveaways in Business Location Beauty Contests and What to Do About It

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Scope of Issue

- Concern is with one at a time "deals" to induce a specific business to locate or stay in a particular jurisdiction through tax giveaways
- Not concerned here with broad laws of general effect that relate to how businesses are taxed. Reform of how businesses are taxed often advisable
- What of law that appears broad, but really only affects one business? Substance over form?
- If Cuno invalidates all ITCs, rather than enhanced ITCs focused on location decisions, it is broader than "deals" concern discussed herein, and single factor sales apportionment is vulnerable
- Sole concern addressed today is on tax giveaways in business location deals

My Goal Here Today

- Get reaction of both industry representatives and tax administrators to my understanding of the issue
- Encourage both sets of people to reconsider the wisdom of legislation to overrule Cuno and to consider the wisdom of federal legislation to ban tax giveaways in business location beauty contests
- Deepen my own understanding based on your reactions

How Things Have Gone Awry

- If one does not ask the right questions, one is unlikely to come up with the right answers
- Giveaways are being analyzed using a competition model
- I want you to consider analyzing them with reference to the role of taxation in American society and the importance to our way of life of separation of powers
- I believe we are sliding down a slippery slope here that leads to a location to which none of us wants to go

Competition Model Analysis

- Competition is good. Those who deliver improved goods, services and governmental operations prosper, and they should
- Businesses compete. The measure of success is profit. Cost reductions enhance profits. Taxes are costs; tax reductions enhance profits; and tax reductions are therefore good.
- The states are laboratories of democracy; within them, the cities and townships likewise. Competition between them is good because it causes them to strive to be better places to live and do business.
- In a market economy, the organizing principle for getting things done is private contract – a two sided relationship in which each side agrees to do something

The Mistake Is Contractual Confusion

- We are imposing competition model analysis in which private, two party contracts are the norm, on taxation that involves the social contract
- Private contract: two parties, each agreeing to do something, an exchange
- In business location beauty contests, the alleged exchange is location for tax breaks
- Taxation is not a matter of private contract; it results from the social contract

The Social Contract and Taxation

- Under the social contract, we the people formed government because we recognized that we need it
- Government provides services that people (including businesses) need
- Those services are paid for by taxes
- Taxation is not a deal between the government and each taxpayer; it is part of the social contract between the people as a whole and the government

Separation of Powers in the United States

- Our success as a society is intimately related to private contracts and competition, but also to separation of powers, so that no one person or group can easily have his, her or its way and stifle change and progress
- Separation of powers among legislative, executive and judicial branches
- Separation of church and state
- Separation of public and private functions: government is public; business, nonprofits and individuals are private

Long Term Tax Giveaway Deals and the Separation of Powers

- Generically, they violate the public/private separation
- In particular instances, they may violate the legislative/executive, or state/local separations
- They repudiate our claim to being a government of laws, not men
  - Taxation is about laws
  - Private contract is about men (or rather people)

How Tax Giveaway Deals Violate the Public/Private Separation I

- The basic exchange of the social contract is government services for taxation in accordance with law, not private contract
- Jobs are part of the very existence of businesses; no jobs means no business
- Specifically bounded land is part of the very existence of government
- Businesses are free to choose where to locate
- Location in a state implies acceptance of that state's social contract, which includes payment of taxes imposed by law

How Tax Giveaway Deals Violate the Public/Private Separation II

- In tax giveaway deals, the state gives away future tax revenues even though its future service obligations are increased by the presence of the business
- This begins as a losing economic proposition for the state, unless the giveaway is minor and other taxes make up for the loss
- If the business succeeds in grand fashion, the state may come out even or ahead, as the taxes on employees or on the activities caused by the favored business of other businesses and their employees may more than offset not only the costs caused by the favored business, but the additional costs of the additional activity by others

How Tax Giveaway Deals Violate the Public/Private Separation III

- But this dependence on success of the favored business means either that
  - The state is in a joint venture with the business, or
  - The state is betting on the success of the business
- Either way, the public/private separation has been violated by the state's deliberately incurred dependence on the success of the particular favored business

Proposed Fundamental Propositions

- An agreement to locate in a state cannot legitimately be traded for exemption from the taxation side of the social contract.
- Neither individuals nor businesses have the right or the power to decline to be bound by, or to contract by private contract out of, the social contract

How Did We Get to This Point?

- The U.S. and some if not all state constitutions simply assume, without stating, a public/private separation
- We have had 200+ years of economic, technological and social evolution
  - Private contract and the market economy have exploded in importance
  - Mobility of capital and labor have vastly increased
  - Individual businesses have unprecedented economic power, often far in excess of the governments with which they are dealing
  - A business of securing government subsidies for businesses has arisen

Just Exactly What Point Are We At?

- Its all about money
- Tax giveaways reduce future costs, thereby enhancing future profits
- That makes them worth working to get
- People now specialize in getting them
- Its seen as virtually free money by the states – its off budget giveaways of future revenues, and also as a necessary tool with which to compete
- Recent presentation to business people titled: "Turning Your State Government Relations Department from a Money Pit into a Cash Cow"

What Are Businesses Being Told?

- "Provide government with justification: quid pro quo"
  - "Public doesn't like 'corporate welfare'"
  - "Caretakers of the state's economy, not your business"
  - "Unique opportunity to 'partner' with government"
- "A Strong Business Case"
  - "Identify 'public benefits' of the project"
    - "Economic and fiscal impacts"
  - "Corporate citizenship"
  - "'But for' threat"
- "Form a complete team: facilities, operations, tax, legal, communications, human resources, government relations"
- All of this to get paid for doing what businesses do anyway: provide jobs to people who can help them profit

What Long Term Tax Giveaways Amount To

- Free money: its off budget, so there's no political pain and the masses never notice the small cost to the individual
- Political gain: credit for bringing jobs
- Leverage: free money can make a big difference with those to whom a pile of it is presented
- The political class, business owners and subsidy entrepreneurs ganging up on all the other taxpayers
- Reverse Robin Hood: Rob the middle class and the poor to increase the profits of the rich

Why We Should Be Concerned

- Tax system integrity matters in a world in which we depend upon voluntary compliance – for how long will our system be one of the wonders of the world if this is how we act?
- Not only subsidies involve money, cost reductions and profit enhancement – so do bribery, extortion, child labor, slavery, environmental depredation, economic exploitation
- How close are we already coming to legalized bribery and extortion with long term tax giveaways in business location beauty contests?
- Are we headed for a society in which corruption is the norm, like it is in many other countries, probably none of which has a healthy tax system?

Translation of the Mistake into Legal Terms

- Taxation and the social contract are fundamental aspects of sovereignty that underlie our federal and state constitutions
- Separation of powers is both explicit and implicit in those constitutions
- Citizens should be entitled to count on the social contract being honored and the separation of powers respected
- The complaint that they are being violated by improperly importing the concept of private contract into the social contract is essentially a demand for due process of law

Implications of These Contentions I

- Consistent with Cuno: inducing businesses to expand in state with tax giveaways that cut taxes on other operations discriminates against interstate commerce
- More fundamental: this is not just about commerce and its regulation; it goes to the very core of our form of government

Implications of These Contentions II

- Consistent with the views of many economists that these programs do not make economic sense, either because state and local taxes are not really significant enough to sway location decisions or because the subsidies far exceed the benefits to the state from the jobs actually produced
- But no need to resolve the issue of whether there is economic sense – that is present in, e.g. child labor too. The Constitution does not require that actions make economic sense. Stupidity in legislation is perfectly legal. This isn't wrong because it doesn't work economically or right because it does. It's wrong because it violates the principles on which our government is based
- And removes the temptation for business people to lie about how important these benefits are in their decision making process. The contention is that these practices are just plain wrong due to their inconsistency with the fundamental underpinnings of American government

Implications of These Contentions III

- Is this an attempt to resurrect substantive due process?
- If this is a due process violation, the proposed federal legislation is unconstitutional
- Even if not unconstitutional, do the concerns warrant rethinking the current effort to enact federal legislation to bless tax giveaways in business location beauty contests?

How Broad is the Concern?

- Long term major tax giveaways by contract
- What about short term transactional giveaways by contract or special statute
  - ITC
  - Sales tax exemptions
- What about short term giveaways by broad statute?
  - ITC
  - Sales tax exemptions
- What about long term discrimination by Statute?
  - Commerce Clause would continue to govern

Minnesota's Role in This Drama

- Olson v. State of Minnesota challenges two economic development laws on six constitutional grounds
- Two state grounds are very straight forward and the Court may decline to go beyond them. Even if it does, Olson's national importance may be questionable due to the important state grounds
- There is a very long road to walk before Olson could solve the problem we are here discussing
- Olson also illustrates the extent to which such subsidization may be taken, creating a crazy quilt of subsidized businesses all over a state

Minnesota's Job Opportunity Building Zone (JOBZ) Program

- Legislature authorized Department of Employment and Economic Development ("DEED") to create 10 JOB Zones of up to 5,000 acres each and 5 Agricultural Processing Facility (APF) Zones
- 12 year giveaway of all significant taxes, state and local
- DEED created one APF Zone
- DEED spread the 10 JOB Zones around parts of 76 counties, 325 cities and townships, and 900+ parcels of land. So far 28,000+ acres. May not be done yet.
- Purpose is to use tax giveaways to induce businesses to locate in areas in need of economic development
- DEED employee describes JOBZ as "economic development on steroids"

Minnesota's Bioscience Zone Program

- Part of a larger Biosciences Initiative; similar structure to JOBZ Program
- Legislature authorized DEED to create one Bioscience Zone with potential multiple subzones. They created in Minneapolis and St. Paul near the U of M and in Rochester near the Mayo Clinic
- Similar 12 year tax giveaways. Big difference is local governments have vote on local property tax giveaways
- Giveaways not yet fully funded
- Benefiting businesses must be in biosciences. Similar in that respect to APF Zones, where business must be an agricultural processing facility
- Purpose is to help create cluster of biosciences businesses near U of M and Mayo Clinic research facilities

Who Does What in MN’s Tax Giveaway Programs I

- Legislature created the programs and set forth a blizzard of criteria, only sometimes conflicting, by which DEED would establish zones
- Pursuant to applications from local governments or consortiums thereof DEED established zones
- The zones themselves appear to be completely meaningless, other than as aggregations of subzones, except the APF Zone, which is one contiguous piece of land on which a soybean processing plant will be built
- Subzone administrators decide who gets the goodies. These are local officials giving away state tax dollars, by the millions if the programs “succeed”

Who Does What in MN’s Tax Giveaway Programs II

- As DEED described it:
  - “Remember: JOBZ is a local program. The Legislature’s clear intent was that the …program would be a locally managed initiative…. Local authorities are the leading actors in this show.”
  - Most business development transactions will be conducted locally, without state involvement.
- Local officials decide which businesses benefit
- Each business and the subzone administrator sign a Business Subsidy Agreement for each deal. Well over 100 JOBZ deals; 1 APF Zone deal; don’t yet know on Bioscience Zone

Practical Problems with Minnesota's Programs

- Taxation without representation
- Businesses having to compete with competitors who operate tax free
- Businesses having to pay higher taxes to make up for those who are exempted
- Less pressure for business tax reform to benefit all, or whole classes of, businesses
- Intimidation

- Communities stealing businesses from each other
  - DEED says: "JOBZ Policy Prohibits 'Poaching'. While it is always appropriate to encourage businesses located outside of a JOBZ area to expand onto any parcel in the zone, remember that communities are expressly prohibited from actively recruiting business from other JOBZ communities – a practice sometimes referred to as 'poaching.' It's not just DEED policy, but wise business practice to refrain from poaching. If anyone becomes aware of a JOBZ community that intends to use JOBZ benefits to recruit businesses away from another JOBZ community, please contact DEED immediately. The department will then conduct an investigation to determine whether a state intervention is necessary."
  - Looks like its just fine to poach from anywhere else
  - "Business practice"?? How about the separation of public from private spheres?
  - "DEED policy"?? What about rules, statutes? Is DEED the benefit giver, investigator, prosecutor, judge and jury? Is this due process of law?
- An invitation to corruption

The Minnesota Emperor Has No Clothes?!

- "The power of taxation shall never be surrendered, suspended or contracted away." MN Const, Art X, Sec 1
- Surrender: to DEED by the Legislature and to the subzone administrators by DEED
- Contracting Away: Each deal is a contract in which the state agrees not to tax, or tax at a reduced rate, for 12 years
- Pro-plaintiff case precedents on each ground

Other Constitutional Issues in Minnesota's Programs

- Uniformity/Equal Protection
  - Is it irrational to allow local officials who want a business to locate there and a business which would like to get tax freebies to agree to give away 12 years' worth of state taxes?
- Commerce Clause
  - If Cuno is good law, JOBZ and Bioscience Zone Programs are, in part, bad law
- Local or special law
  - If Legislature can be saddled with these giveaways at the local level, do the statutes violate Art XII, Sec 1, which prohibits local or special laws exempting property from taxation or granting to any private corporation, association or individual any special or exclusive privilege, immunity or franchise
  - This is pretty technical and probably not of national importance
- Due Process
  - Will the Court be moved by the problem explained?
  - Does an individual citizen or taxpayer have a due process right to have the social contract, the separation of powers and the integrity of the tax system respected?

What Are Your Reactions?

- Would your state be better off if tax giveaways in business location beauty contests were prohibited?
- Would your business, or stable of business members or clients, be better off if tax giveaways in business location beauty contests were prohibited?
- Should American citizens and businesses have a due process right to have the social contract, the separation of powers and the integrity of our system of taxation respected by holding that tax giveaways in business location beauty contests violate due process?

Actions to Consider

- Oppose legislation to overrule Cuno
- Consider developing and supporting legislation to ban tax giveaways in business location beauty contests. See, e.g., the Distorting Subsidies Limitation Bill of 1999 (H.R. 1060)
- Consider filing pro-cert and pro-plaintiff amicus briefs in the Supreme Court in Cuno
- Try to identify a better test case for the due process theory than Olson
- Consider state against state suits to resolve the issue quickly
- Share your views on the case for due process and other issues with JPJ
- Share this presentation with others

Key Provisions of S.1066 Economic Development Bill of 2005

Sec. 2. Authorization. Congress hereby exercises its power under Article I, Section 8, Clause 3 of the United States Constitution to regulate commerce among the several States by authorizing any State to provide to any person for economic development purposes tax incentives that otherwise would be the cause or source of discrimination against interstate commerce under the Commerce Clause of the United States Constitution, except as otherwise provided by law.

Sec. 3. Limitations.

a. Tax Incentives Not Subject to Protection Under This Act – Section 2 shall not apply to any State tax incentive which -
   i. Is dependent upon State or country of incorporation, commercial domicile, or residence of an individual;
   ii. Requires the recipient of the tax incentive to acquire, lease, license, use or provide services to property produced, manufactured, generated, assembled, developed, fabricated, or created in the State;

iii. Is reduced or eliminated as a direct result of an increase in out-of-State activity by the recipient of the tax incentive;

iv. Is reduced or eliminated as a result of an increase in out-of-State activity by a person other than the recipient of the tax incentive or as a result of such other person not having a taxable presence in the State;

v. Results in loss of a compensating tax system, because the tax on interstate commerce exceeds the tax on intrastate commerce;

vi. Requires that other taxing jurisdictions offer reciprocal tax benefits; or

vii. Requires that a tax incentive earned with respect to one tax can only be used to reduce a tax burden for or provide a tax benefit against any other tax that is not imposed on apportioned interstate activities.

b. No Inference. Nothing in this section shall be construed to create any inference with respect to the validity under the Commerce Clause of the United States Constitution of any tax incentive described in this section.

Sec. 4. Definitions. Rules of Construction.

a. Definitions. For purposes of this Act.
   i. Compensating Tax System. The term "compensating tax system" means complementary taxes imposed on both interstate and intrastate commerce where the tax on interstate commerce does not exceed the tax on intrastate commerce and the taxes are imposed on substantially equivalent events.
   ii. Economic Development Purposes. The term "economic development purposes" means all legally permitted activities for attracting, retaining, or expanding business activity, jobs or investment in a State.
   iii. Imposed on Apportioned Interstate Activities. The term "imposed on apportioned interstate activities" means, with respect to a tax, a tax levied on values that can arise out of interstate or foreign transaction or operations, including taxes on income, sales, use, gross receipts, net worth, and value added taxable bases. Such term shall not include taxes levied on property, transactions, or operations that are taxable only if they exist or occur exclusively inside the State, including any real property and severance taxes.

iv. Person. The term “person” means any individual, corporation, partnership, limited liability company, association, or other organization that engages in any for profit or not-for-profit activities within a State.
v. Property. The term “property” means all forms of real, tangible, and intangible property.
vi. State. The term “State” means each of the several States (or subdivision thereof), the District of Columbia, and any territory or possession of the United States.

vii. State Tax. The term “State tax” means all taxes or fees imposed by a State.
viii. Tax Benefit. The term “tax benefit” means all permanent and temporary tax savings, including applicable carrybacks and carryforwards, regardless of the taxable period in which the benefit is claimed, received, recognized, realized or earned.

ix. Tax Incentive. The term “tax incentive” means any provision that reduces a State tax burden or provides a tax benefit as a result of any activity by a person that is enumerated or recognized by a State tax jurisdiction as a qualified activity for economic development purposes.

b. Rule of Construction. It is the sense of Congress that the authorization provided in section 2 should be construed broadly and the limitations in section 3 should be construed narrowly.