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Ideas for Ending (or, At Least, De-escalating) the Economic War Among the States

The “Economic War Among the States” involves public tax dollars rather than military hardware, with Governors and Mayors using public funds to provide a variety of subsidies to individual businesses in an effort to convince them to relocate from one state or city to another or to stay where they are. This phrase was coined by senior officers of the Federal Reserve Bank of Minneapolis in a series of influential publications in which they have argued that the large amounts of money that states and localities spend on such firm-specific subsidies are an inappropriate use of public resources. They see these subsidies as both (1) an unjustified intervention by government into the workings of the market and (2) a diversion of essential resources from those activities (such as education and infrastructure) in which government must invest in order for the private sector economy to function effectively.

For practical and political reasons, the nation's mayors and governors are loathe to "unilaterally disarm" within the current context in which being “competitive” is frequently taken to ridiculous extremes. In analyzing this "prisoners' dilemma," two senior officers of the Minneapolis Fed, Melvin L. Burstein, Executive Vice President and General Counsel, and Arthur J. Rolnick, Senior Vice President and Director of Research, concluded that only Congress can end the economic war among the states and that it should. The idea is that the Congress, utilizing its plenary power to implement the U. S. Constitution's Commerce Clause, must step in to "save the states from themselves."

The Minneapolis Fed's initial work on this subject (an essay by Burstein and Rolnick entitled “Congress Should End the Economic War Among the States” which was featured in their bank’s 1994 Annual Report) generated a good deal of national attention. For example, the Ford Foundation funded Minneapolis Public Radio's Civic Journalism Initiative to host a major national meeting in May 1996 at the National Academy of Sciences on the Minneapolis Fed's proposals. The featured speakers included Robert Reich and Alice Rivlin and a very good mix of business, labor and governmental leaders, academics and advocates from throughout the country participated. But the idea that a consensus could be forged during this one and a half day meeting proved to be unrealistic.

Over the next several years, the Minneapolis Fed continued to work on this issue. In March 1999, U. S. Representative David Minge of Minnesota introduced legislation (H.R. 1060) that contained a variation of a proposal advanced by Rolnick and Burstein - a federal confiscatory tax on the value of firm-specific state and local subsidies received. The argument for this proposal is that it would eliminate the incentive on the part of businesses to seek (and, therefore, the incentive on the part of state and local governments to provide) such subsidies and that it would either eliminate or substantially de-escalate the economic war among the states. Some advocates of this proposal call it "a tax that would never be paid" – that its very existence would eliminate

the kinds of activities that it would tax. In an article discussing this approach, Mr. Rolnick argued that, "Such a bill would not only put an end to the economic subsidy war, but would also allow local governments to make better use of their public funds and to create an attractive business environment based on general tax rates, education and infrastructure." (The Minge bill imposed a tax, at the federal corporate income tax, rather than a confiscatory tax on the value of corporate subsidies. Such a tax would not have the same effect as a confiscatory tax.)

In addition to the "Confiscatory Tax" approach, there are a number of other steps that the federal government could take to end or to help de-escalate the "economic war among the states." These include the following:

A. *The Strong "Carrot" Approach.* This approach has been used repeatedly by the Congress to encourage the states to take actions that the Congress deems to be in the national interest. This was the approach used by Congress to encourage the states (1) to increase their legal drinking ages to 21, (2) to establish 55 mile per hour speed limits, (3) to eliminate the exemption from federal income tax of the interest earned on state and local bonds issued in bearer (rather than registered) form and, most recently, (4) to establish .08 as the blood alcohol level for "driving while intoxicated." For example, 23 U.S.C. 158, as enacted by Congress in 1984, in effect established a "national minimum drinking age" by requiring the U. S. Secretary of Transportation to withhold 10% of the money due to any state under several federal aid programs during any fiscal year beginning on or after October 1, 1986 "in which the purchase or public possession in such State of any alcoholic beverage by a person who is less than twenty-one years of age is lawful." This statute was upheld by the U.S. Supreme Court in *South Dakota V. Dole, Secretary of Transportation* 483 U.S. 203 (1987) as a valid exercise of the Congress' spending power under Article 1, Section 8, Clause 1 of the U. S. Constitution.

B. *The Not So Strong "Stick" Approach.* This approach would involve prohibiting the use of federal monies to subsidize the movement of jobs from one state to another. Provisions of this type currently exist in a number of federal programs and an omnibus bill (H.R. 1842) on this subject was introduced in Congress in 1995 by the Republican and Democratic co-chairs of the Northeast- Midwest Congressional Caucus. This approach could be made much more useful by the development of standard or omnibus language and by the development of language that would not allow for a narrow interpretation of the fungibility of federal and state-local funds.

C. *A "Sunshine" Approach.* Federal legislation and/or SEC rules refining and clarifying the SEC's current requirement for the disclosure of the income taxes paid by publicly-traded companies. In addition to the information of federal income taxes paid and "foreign and other income taxes" (with the "other" including corporate income taxes paid to the state and local governments in the U. S.) that the SEC currently requires such firms to disclose in their 10-K's, those firms could be required to (1) disclose the aggregate amount of "foreign and other income taxes" even if this aggregate amount is below a "materiality" threshold, (2) disaggregate the total for "foreign and other income taxes" into several categories such as 1-foreign, 2-U.S. states, and 3-U.S. localities, (3) include in the 10- K a supplementary schedule that breaks down the aggregate payments to 1-other countries, 2-U.S. states, and 3-U.S. localities, by the specific countries, states, and/or localities involved (or to include in the 10-K a statement that such a supplementary schedule is available on request), and/or (4) disclose the value of government

subsidies received, either in the aggregate or broken down in a manner similar to that proposed above for the disclosure of tax payments.

D. *The “No Double Dipping” Approach.* Examples of this approach include (1) federal legislation denying federal depreciation deductions for any plant or equipment for which the taxpayer received a state or local subsidy and which involved the relocation of jobs, (2) federal legislation denying Work Opportunity Tax Credits to employers who have received a state or local subsidy for the relocation of jobs.

E. *A “Worker Protection” Approach.* The Congress could amend the WARN Act to require one year notice to employees whose jobs are being relocated to another labor market with a subsidy at the arriving location

G. *“International Trade Agreement” Approaches.* The states acting through the adoption of Congressionally-approved interstate compacts (or the Congress acting on its own) could adopt some of the notification and/or prior approval requirements that have been adopted by the European Union and/or by the World Trade Organization (WTO) as part of its Agreement on Subsidies and Countervailing Measures (SCM). Some steps in this direction include the following:

1. Establishing national subsidy disclosure standards. Under this alternative, Congress could enact a law that would define minimal criteria for state unified development budgets and reports. And, to avoid the imposition of an unfunded mandate, the federal government would provide full financing for the initial creation of the reporting system.
2. Creating national job cost standards. Rather than establish every detail of acceptable economic development programs, the federal government, instead, could define a maximum level of public spending for particular subsidy approaches. For example, for whenever federal funds were used in a project, this condition would apply.
3. Providing positive incentives for reform. The federal government could reallocate a portion of federal development funds to states that take certain reform actions – better disclosure, restraints on intra-state subsidy competition, improved targeting of subsidies to more economically disadvantaged areas, and so on.
4. Outlawing the most harmful subsidy practices. The OECD and the EU have both been active in identifying harmful business tax practices on the part of their member countries, publicizing these, and encouraging them to be dropped. A short list of the most egregious business subsidy approaches could be developed and these efforts would be targeted for termination. Again, to be constitutionally sound, the federal government must provide some fiscal incentives as part of its quid pro quo to regulate.

H. *A Federal-State Tax Coordination Approach.* Congress could provide a credit against a firm’s federal corporate income tax liability equal to the full value of corporate income taxes paid to states based on a standard allocation formula and a standard rate. This would be similar the

credit against the federal estate tax for state gift or inheritance taxes paid (up to statutorily specified levels). As such it would eliminate any benefit to a firm of a lesser state tax.

I. Federal-State Cooperation in Complying with WTO Reporting Requirements. To assist the federal government in completing the biennial subsidy disclosure reports that it is required to file with the WTO, the Congress could require the states to complete disclosure reports using the same definitions, etc. **and** provide financial assistance to the states to cover the cost of preparing these reports.

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While most Senators and Representatives are undoubtedly aware of the fact that state and local governments provide subsidies to individual businesses, it is unlikely that very many of them realize how costly and counter-productive the current situation is. Moreover, few if any of them are likely to be aware of the fact that Congress could do something about the current situation or that the Constitution enables the Congress to do so. This leads to the following conclusions:

First, if this issue is to be given serious consideration, it is essential that organizations concerned with the adequacy and stability of state and local revenues keep the members of Congress informed on a continuing basis of what is happening around the country in terms of the granting of firm-specific subsidies and why this is not helping to expand the U. S. economy or to make it more competitive, and how it is actually diverting resources from uses that would serve those ends more effectively.

Second, interested members of Congress should ask the General Accounting Office (GAO) to complete reports on relevant aspects of this problem. Such GAO studies could then serve as the basis for Congressional hearings on the subsidy competition issue or particular aspects of it.

Third, bond rating services such as Moody's or Standards and Poor's, and standard setting bodies like the Governmental Accounting Standards Board, could give additional visibility to this issue by pressuring state and local government to provide full accounting of subsidies and subsidy commitments in their income and expense statements and their balance sheets.

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For more information or to share ideas on this effort, please contact:

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