1980

Can Tax Policy Be Used to Stimulate Economic Development?

Richard Pomp
University of Connecticut School of Law

Sandra Kanter

Kenneth D. Simonson

Roger Vaughan

CAN TAX POLICY BE USED TO STIMULATE ECONOMIC DEVELOPMENT?

*Richard D. Pomp, Moderator**
*Sandra Kanter***
*Kenneth D. Simonson****
*Roger Vaughan*****

RICHARD POMP: Chief Justice Marshall once wrote that "the power to tax involves the power to destroy." This morning we are going to examine the 1979 version of that statement: whether the power *not* to tax involves the power to create. To put it more generally, what is the relationship between tax incentives and economic growth at the state and local level?

Economists are fond of reminding us that "there is no such thing as a free lunch." Recently, however, we have been told that a cut in federal tax rates will so stimulate the national economy that more tax revenue will be collected at the higher rates. To put it simply, a cut in federal tax rates will produce a free lunch. At the state and local level this kind of thinking has manifested itself in the use of tax incentives, a selective rather than an across-the-board cut in taxation. Our states, municipalities, and big businesses currently are playing a high stakes game. The premise of this game is that a healthy state and local economy can be maintained by providing tax incentives that will attract new business and support existing business. If a jurisdiction does not meet the going ante in terms of incentives, it runs the risk that business will relocate to areas offering greater inducements. It is a high stakes game that pits neighbor against neighbor, North against South. Many of you are familiar with the game.

The pressure to adopt tax incentives and similar measures is irresistible. State and local officials often feel that they have little power to

---

* Professor of Law, University of Connecticut; President, Board of Directors, Institute on Taxation and Economic Development. S.B., 1967, University of Michigan; J.D., 1972, Harvard University.

** Professor, University of Massachusetts. B.A., 1966, Connecticut College; M.A., 1970, University of Pennsylvania; Ph.D., 1980, Massachusetts Institute of Technology.

*** Tax Economist, United States Chamber of Commerce. B.A., 1969, University of Chicago; M.A., 1970, Northwestern University.

**** Deputy Director, New York State Office of Development Planning. B.A., 1968, Oxford University; Ph.D., 1977, University of Chicago.

affect their local economies and thus feel compelled to do something—to do anything. Certainly a policymaker does not want to be perceived as being opposed to jobs and economic development; no official wants the blood of a runaway plant on his hands. Clearly no state wants other states to get a jump on it. It is not surprising, therefore, that tax incentives are easy to legislate. They give lawmakers a feeling that they have done something constructive.

The use of tax incentives is not new. Recently, however, there has been a rapid increase in the adoption of incentives. Indeed, some commentators have dubbed tax incentives the new ammunition in the latest war between the states. Tax incentives clearly are in vogue, but their use raises a series of nagging questions. For example, do these incentives work? Do firms really chose a location on the basis of state and local taxation, or do they base their decisions on other grounds and then simply bargain with various jurisdictions for the best deal they can get? What percentage of business costs are actually represented by state and local taxes? Keep in mind that such taxes are deductible for purposes of the federal income tax and that businesses, therefore, do not bear the full burden of such taxes. Indeed, a reduction in state and local taxes will increase the federal income taxes paid by businesses to some extent and thus produce the kind of reverse revenue sharing illustrated by Proposition 13.

How important are state and local taxes compared with other factors, such as transportation, utilities, climate, the cost of labor, right-to-work laws, the education and skill of the work force, the size of the local market, the projected growth of a state, access to raw materials, and a favorable political milieu? Some would argue that tax incentives, whether effective or not, at least reflect a political climate favorable to business. Once a firm has decided where to locate, and these other factors are neutralized, do local and state taxes then become important?

In thinking about the use of tax incentives, what weight should we give to the effect of tax capitalization, that is, the effect that the level of property taxation has on the price of land? If the price of land and the level of property tax are so related that the higher the property tax, the lower the price of land, then all other things being equal, property tax differentials will be reflected in the price of land. In other words, a firm moving into an area with high property taxes might pay less for its land than it would pay in an area with low property taxes. The question raised by tax capitalization effects is whether a high property tax community needs to grant an abatement or exemption from its property tax as an incentive to new business. Perhaps it is existing businesses that need the incentive more.

Because state and local jurisdictions all feel pressure to adopt tax incentives, what can be gained in the long term if a number of jurisdictions adopt similar incentives? What role can incentives play if all jurisdictions offer them? Tax revenue would decline everywhere, and no jurisdiction would gain any competitive advantage.

Assuming that tax incentives do play a role in encouraging economic development, will the revenue forgone through these incentives be proportionate to the benefit received? What are the benefits to the community when a firm changes its location? Are the kinds of firms or investments attracted by tax incentives necessarily responsive to the community's needs? Will the new firm's employment, investment, and environmental policies necessarily comport with the needs of the community? For example, will the new firm bring its own work force with it, or will it absorb local unemployed manpower—the latter being one of the goals of an incentive? From a national perspective, we would like to know whether, when a firm moves from state A to state B, any employment that is created in state B is merely offset by unemployment that is created in state A. More generally, we would like to know whether these tax incentives create new industry or simply act to transport existing industry?

Is it possible that a tax incentive may be shortsighted? For example, should a state try to retain its manufacturing base if its future clearly lies in the direction of encouraging the service industry, a question that is very relevant in the Northeast. Will the profits of firms that respond to tax incentives be reinvested locally, or will they be invested outside the state? Will such firms purchase raw materials from local firms, or will they purchase raw materials and supplies from out-of-state firms? The answers to these questions may vary. Much depends on whether the tax incentive attracts the branch office of a multistate or multinational corporation or whether it attacts a smaller, community-oriented firm.

Who really benefits from an incentive intended to encourage capital investment, such as an investment tax credit? What types of firms have access to capital? What types of firms do not? In other words, who is in a position to take advantage of investment tax credits? Finally, do these incentives merely shift capital from one sector of the state's economy to another?

Assuming that tax incentives do have some influence on individuals and firms, how can such incentives be improved? How can they be refined so that they reach only those firms that offer the benefits that a community or a state seeks? Should incentives be limited by amount or duration? Should we incorporate a circuit-breaker approach into tax incentives and tie a tax exemption to a percentage of a firm's profits? In other words, once a firm has become profitable and demonstrates an ability to pay taxes, should the tax incentives be phased out? Under present approaches, a community can find itself locked into a program of tax incentives long after they served their purpose. New York City, for example, is currently re-evaluating its extensive program of tax incentives for industrial and commercial real estate in the light of its greatly improved market. Other jurisdictions may benefit by following New York City's approach and by reconsidering whether they must continue to be as generous with their exemption policies as they have been in the past.

If the benefits that are promised by these tax incentives do not materialize, how will the lost revenue be made up? A community may offer so many incentives that it is unable to provide the services required by the new industry or to maintain existing levels of services. Indeed, we have recently seen some school districts actively lobbying against property tax exemptions. These districts fear that the quality of existing educational services will be threatened by an erosion of the tax base from the use of tax incentives.

Another question is one of fairness between new businesses that a community hopes to attract and existing businesses. Is it fair, for example, to exempt a new hotel from the property tax when an already existing hotel must pay that tax?

Finally, do tax incentives represent a form of government spending that is equal in amount to the taxes that would have been collected without the incentives? For example, any tax exemption can be viewed as if the taxpayer actually had paid the full amount of tax owing in the absence of the exemption and had simultaneously received a grant equal to the tax savings. Under this analysis a tax incentive is only one means of providing government assistance. Other means of providing government assistance include direct grants, loan guarantees, interest subsidies (which will, of course, become more important at the current level of interest rates), state training programs, state programs to promote research and development, state assistance in bidding on federal procurement contracts, and programs to develop the state and local infrastructure. Each of these alternatives is likely to have different distributional and economic effects; the effects of these alternatives must be compared with the effects of using tax incentives. Also, a jurisdiction should remember that it can offer some inducements to business that do not cost money. For example, outdated building codes can be revised, zoning restrictions can be re-examined, state and local red tape can be minimized, and ombudsmen can be appointed.

Whether tax incentives or any of these alternatives are used, we still face the same basic question: is the approach working? How do the benefits compare with the costs? Are the objectives being achieved? Who is actually benefiting from the assistance being provided? These are the normal budgetary questions that we ask about any spending program. Unfortunately, because the use of tax incentives tends to obscure the fact that money is being spent, many of these questions do not get raised.

Well, I hear my panelists' pencils scratching madly, which is a signal to me that it is time to turn matters over to them. Obviously, my list of questions can be extended. In the hopes of having a lively exchange, I hope that everyone will feel free to attack my list for being unfair or unrepresentative. Of course, one of the luxuries of being moderator is that I get to raise all the difficult questions without having to answer any of them.

Roger Vaughan, who has a Ph.D. in Economics and is currently an Assistant Vice-President in the Economics Department of Citibank of New York, will begin. He has devoted much of his professional interest to the subject of economic development and fiscal policy.

ROGER VAUGHAN: Thank you very much, it is a pleasure to be here this morning. A recent editorial in the Wall Street Journal highlighted low business taxes as the major reason for the economic growth in the sunbelt and high business taxes as one of the reasons that the Northeast has not faired as well.[1] I would like to take issue with this view. The belief that taxes are important for local economic development has created more problems than it has solved.[2] State and local taxes have played a very small role in shaping regional growth patterns. Further, I would like to argue that even if we could influence local development by tinkering with the tax structure, we should seriously question whether this is an appropriate approach.

There is no doubt that we behave as if state and local taxes affect economic development. Public development officials tour the country trying to seduce footloose firms with succulent tax incentives. State governments are annually lobbied to cut business taxes in order to provide jobs. Unfortunately, for these development practitioners and lobbyists, the vast majority of research indicates that low taxes are not the key to development. The reasons are not hard to find. First, state

---

1. Adams, *Taxbelt Versus Growthbelt*, Wall St. J., Sept. 21, 1979, at 18, col. 1 (citing R. Genetski & Y. Chin, *The Impact of State and Local Taxes on Economic Growth* (Nov. 3, 1978) (study published by Harris Trust and Savings Bank, Chicago, Ill.)).

2. *See generally* R. VAUGHAN, STATE TAXATION AND ECONOMIC DEVELOPMENT (1979).

and local taxes—which are deductible when computing federal taxable income—average less than 5% of corporate income, represent a tiny fraction of the wage bill, and cost less than the energy bill for the average company.[3]

Second, the multistate companies that state development officials seek can spread their taxable income across so many states that taxes in any one location further diminish in importance. Third, high taxes may reflect, though regrettably they do not always reflect a high level of local public services including educational facilities (from which to draw the work force), cultural amenities, good transportation, and water and sewerage facilities. These assets may compensate for the high tax rate. Fourth, the immigration of footloose firms is not an important source of local growth. Most local growth comes from employment expansion in existing companies and from the birth of new companies. The major difference between New York City and Houston is the rate at which jobs are created by the growth of new firms, rather than the contribution of footloose firms. Finally, a large part of inter-area variations in local property taxes—which are a greater burden than state corporate income taxes—is capitalized in the value of land.

Other factors explain the growth of the sunbelt and the decline of the frostbelt. These shifts primarily result from the postwar deconcentration of economic activity and residential settlements. Changes in technology and the expansion of the national transportation network into rural areas and the South have also played a big role. The process has been aided by federal grants for roads, flood control, sewer and water projects, and other federal programs. These grants reduced the cost of economic and residential expansion in suburban areas and in new cities.[4] They were not available when older northeastern cities were building their own infrastructures. Typically, the federal tax structure offered more generous incentives for new construction than it did for the rehabilitation of existing structures.[5]

The importance of these other factors to local development officials is a recognition that development policy is not simply a question of offering the right kind of tax incentives. It must encompass a much broader range of policies, including the training of labor, the development of finance programs, and the creation of the appropriate infrastructure.

---

3. *Id.*

4. *See generally* R. VAUGHAN, THE URBAN IMPACTS OF FEDERAL POLICIES: VOLUME 2, ECONOMIC DEVELOPMENT (1977).

5. *See generally* Peterson, *Federal Tax Policy and Urban Development*, in FEDERAL TAX POLICY AND URBAN DEVELOPMENT (1978).

This does not overlook the importance of a careful assessment of state and local spending and the taxes needed to pay for it. Inflation and expanding social programs have led to an explosion of state and local spending and a concomitant increase in taxes. We can no longer tolerate this growth rate. Taxpayers in California and many other states have demonstrated that they are opposed to the present high levels of public spending. Certainly, many of those states with very high tax rates are going to have to reduce tax levels; but, the tax cuts should not be made to spur development. Taxes should be reduced in order to improve the efficiency and the equity of the tax structure.

There are several guidelines to follow to achieve these goals. First, some of the tax burden should be shifted from households to business. In 1947, personal income taxes and corporate income taxes contributed an equal share to state revenues—about 8%. By 1972, the share of personal income taxes tripled to almost 22%, while the share of business income taxes actually declined to 7.4%.[6] The taxpayer revolt is a revolt against personal taxes rather than business taxes. Second, expanding the use of property tax circuit breakers will improve its equity and assist those most in need of relief. Third, we should increase the progressivity of income and sales taxes. We also should insure that business taxes do not burden small enterprises. We should index the tax structure to allow for the erosion in real income that inflation causes each year.

We should not cut business taxes, either across the board or through special tax incentives, simply to encourage development. Nor should we slash taxes in a way that makes them more regressive, as many states did in 1979. One of the barriers to designing a rational tax structure is that we have a short-sighted view of state budgets. Much of the pressure to cut taxes in 1979 arose because some state governments ran surpluses. Those surpluses are often mythical. In some cases, they reflect obligations to pension funds. More importantly, they reflect the fact that 1978 and 1979 were particularly good years for the economy. Social service expenditures were low because the unemployment rate was relatively low. Revenues were high because of inflation-driven increases in money incomes and property values. We are headed for a period of slower growth. In 1980, those same states that slashed sales taxes and cut income taxes will be forced to restore those taxes which were cut to eliminate programs, or to rely on the federal government for increased fiscal assistance.

---

6. TAX FOUNDATION, FACTS AND FIGURES ON GOVERNMENT FINANCE (20th ed. 1979).

Rather than view the state budget on an annual basis, it should be viewed against the overall business cycle. We should be accumulating a surplus in good years that could be used to maintain the integrity of state expenditures or to avoid a sudden tax increase during recessions.

Let me summarize what is wrong with cutting taxes to stimulate development. First, it does not work. Second, it leads to a concentration on the wrong type of taxes. Business taxes are cut rather than personal taxes, and often the taxes on large corporations are cut rather than the taxes on small businesses. It reduces equity. Most of the state tax incentive programs go to large businesses. They go to businesses that are new to the area at the expense of those that are already established in the area. We also increase the regressivity of household taxes in the process. Finally, it is a myopic policy. Cutting taxes one year, only to have to raise them the next, is not a rational fiscal policy.

Let me pose an even more basic question. Even if we could encourage local economic growth by slashing state and local taxes, would we want to do so? The basic question that we must ask is: to whom should this development be directed? Are we better off if we can raise the level of local employment by 1% by cutting local expenditures by 25%? The reduced expenditures will be felt most by the poor. The first programs to be pruned are social services and cost of living increases to welfare recipients. This is done at a time when the cost of necessities—food, housing, and medical services—is rising at a more rapid rate than the overall cost of living. But the poor are not the ones who benefit from any development produced by the tax cut. We have had enough experience at the national and local level to realize that the benefits that trickle down are negligible. Therefore, we must refocus our development policies and realize that, if we set up an equitable and efficient tax system, most firms and households can look after themselves. The public sector, in a necessarily reduced role, should concentrate on helping those who need it.

RICHARD POMP: Thank you for a rather sobering look at the use and effectiveness of tax incentives. I would like to give the audience a chance to write down any questions that it might have as the panel responds to or elaborates on or takes issue with the opinions expressed by Roger and myself.

KENNETH SIMONSON: Until the very end I was a little worried that I was going to agree with Roger on all points. I am glad to see that that will not be necessary. I would like to take issue with his last statement: that the trickle-down effect of stimulation and growth is negligible. In fact, I think that the trickle-down may be just what we need

SANDRA KANTER: I worry about Roger's reference to the burden of personal income tax, and his fear that we are creating an environment for another incentive. Otherwise, I have little disagreement with the substance of his arguments.

RICHARD POMP: I would like to elaborate on two of Roger's points. First, whenever we talk about tax incentives at the state level, the relationship between the federal corporate income tax and the state corporate income tax must be understood. Most states base their corporate income tax on the federal corporate income tax. Consequently, these states automatically embrace many of the tax incentives that are contained in the federal corporate income tax. But, not all of these tax incentives are necessarily in the interests of a particular state. For example, should a state allow a firm to reduce its corporate income tax because of an investment made in another state? If the question is phrased in this manner, many state officials would answer with a resounding "No." Yet, by basing its corporate income tax on the federal model, a state implicitly may grant a deduction for accelerated depreciation attributable to investments made out-of-state. A state might want to re-examine its corporate income tax from this perspective to determine whether state goals are being undercut.

Second, I would like to emphasize the shift that has been occurring between the percentage of tax revenue contributed by the federal corporate income tax and the percentage contributed by the federal personal income tax. A healthy number of tax incentives for capital investment now exist at the federal level,[7] and despite perennial cries of a capital shortage, a serious question can be raised as to whether the federal tax structure is biased too much in favor of capital investment. If you are a policymaker in a state that faces a problem of unemployment, perhaps you should consider offsetting the federal bias toward capital investment and tilt your state and local tax structure more toward labor. In that vein, let me ask Roger and the other panelists for their thoughts on a state tax credit geared towards employment. For example, how do they feel about a credit that is a function of the size of a company's payroll, its social security taxes, or the number of persons it employs?

ROGER VAUGHAN: I am a little nervous about the kind of employment tax credits that often are proposed. In 1977, the federal government introduced a program which allowed companies an additional tax

---

7. OMB, SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 1981, Analysis G, at 207 (1980); *see also* S. Surrey, PATHWAYS TO TAX REFORM (1973).

write-off for labor costs, provided they increased the size of their work force.[8] In effect, this constituted a subsidy for growth areas rather than declining areas where it was really needed. I think that tying an employment tax credit to employment growth is mistargeted. Most of the tax expenditures will go to areas where the local unemployment rate is well below the national average. We now have a policy of targeting these job tax credits—which does not allow a firm to deduct simply because it increases its work force. Rather, the credit benefits only those firms that hire certain types of labor—certain youths under the age of 25, those unemployed for a period not less than 30 days, and those from poverty households.[9] Another problem with tax credits is that they tend to be enjoyed more by large businesses than by small businesses. Many small businesses are not aware of the programs. The policy, however, is on the right track in trying to reduce labor costs. Furthermore, interarea differences in payroll taxes are more important than differences in corporate income tax rates in explaining disparities in employment growth.

SANDRA KANTER: An employment tax is as dangerous as a corporate income tax credit. The difference is that less is known about the effect of the former. For example, several years ago, the Commonwealth of Massachusetts gave a $500 tax credit to firms that hired people receiving public assistance or unemployment compensation or who were in training or rehabilitation programs.[10] In four years, the state dispensed $15 million worth of employment tax credits. In some cases the credit was simply misused. One large company saved almost three-quarters of a million dollars in one year's taxes by putting a thousand of its employees through a two-week in-house training program. Other firms simply ignored the credit until tax time. Such firms had managers to make decisions about whom to hire. Those decisions were based on economic judgments about the value of a potential worker. In a completely separate process, the firms hired tax accountants to reduce their tax obligations. They were the ones who looked at workers' profiles and filed for the appropriate employment tax credits. In other words, employment tax credits do not change firm behavior. They merely redistribute revenues from individuals to businesses.

---

8. I.R.C. § 44B, 51-53 (amended 1980).

9. *Id.*

10. MASS. ANN. LAWS ch. 63, § 31(c) (Michie/Law Co-op). *See also* J. Kittredge, The $500 Tax Credit (1979) (unpublished memorandum of the Massachusetts Equal Opportunity Council on file with J. Kittredge).

KENNETH SIMONSON: I think that employment credits, like other types of tax credits, are quite treacherous for the reasons that Sandra just outlined. This point is best illustrated not by looking at a tax credit per se, but by viewing the CETA program. The vast majority of the employment that occurred in CETA resulted from the displacement of employees who were already there. People were laid off under one program and hired under another. The same type of displacement occurs under an employment tax credit, but it is probably more difficult to see. This type of issue pervades tax debates concerning the incidence of a tax or the effectiveness of an incentive. I do not think that we will ever have a definitive answer to the question. I base my reaction more on a gut feeling and hope that the studies pointed to are reliable in their methodology.

RICHARD POMP: Let me pursue one of Roger's other points. The state and local tax structure must be viewed as a family of taxes, and thus a balance must be struck in the reliance placed on various tax bases. For example, Connecticut does not have a broad-based personal income tax. In many quarters, the absence of an income tax is viewed as making Connecticut a tax haven for business. Many persons oppose the introduction of a personal income tax on the grounds that it would increase the cost of doing business within the state by fueling labor's demands for salary increases. The absence of an income tax is often singled out as the key to attracting business from New York. Because Connecticut does not have a personal income tax, however, it has one of the highest excise taxes on gasoline, liquor, and cigarettes. Certainly the levels of these taxes raise the cost of doing business in the state and, I would suspect, also are reflected in the level of salaries paid within the state.

If a state is going to forgo the use of a major tax, such as an income tax, then pressure will be exerted to reduce services. A low level of services may result in businesses providing those services which are supplied publicly in other jurisdictions. For example, businesses may spend more on educating and training their work force because too little is spent on education by the public sector. A firm may supply its own police and fire protection because it cannot rely on the level of protection offered publicly. A business may pay for its own garbage disposal because such service is not provided by the local jurisdiction. In other words, if low taxes mean a low level of public services, then low taxes also may mean higher business costs.

ROGER VAUGHAN: One common question is: If taxes are not important why do all businesses say that they are? There are a number of surveys addressed to business managers that found that taxes are important, especially for companies moving out of the area. In addition, there have been many surveys that found that taxes were less important than other factors, such as local government red tape—the difficulty of getting the appropriate planning permission or zoning changes, the availability of skilled labor, the uninterruptible energy, and the adequacy transportation.[11] Businesses will acknowledge the importance of taxes, just as any lobby group will insist that it needs an increase in allocations from particular federal, state, or local programs. That is the way the political system works.

In reference to the issue of tax incentives for employment, we would be much better off abolishing all tax incentives and concentrating on the overall tax structure. Tax incentives have the unfortunate attribute of not being regarded as part of state and local expenditures, and thus tax incentives are not budgeted or evaluated. Some states publish a review of tax expenditures. Michigan, California, and Maryland, for example, systematically evaluate their tax programs. North Carolina just started doing the same. The elimination of incentives and an examination of the overall tax structure will lead to far more effective and equitable federal, state, and local fiscal policies.

RICHARD POMP: In light of that last point, it is ironic that while state budgets are being scrutinized to identify any item that can be reduced, and while states are rushing to impose limitations on spending, a whole range of expenditures escapes this same scrutiny and these same limitations simply because such expenditures occur through the tax system. Indeed, as more states adopt spending limitations, the pressure to spend money through tax expenditures may increase.

Since 1974, the federal government has published a tax expenditure budget. The most recent budget indicates that the federal government still spends about $150 billion through the tax system.[12] Only a few states compile their own tax expenditure budgets, even though such an undertaking obviously would be extremely productive.

In response to the last question asked of Roger, I will share with you a recent article from the *Wall Street Journal.*[13] The article is about the increasing use of tax incentives. At one point it discusses Ohio's grant of a $60,000 per year tax abatement in order to attract Church and Dwight Company's new $20 million plant. According to

---

11. *See* R. VAUGHAN, *supra* note 4.

12. OMB, SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 1981, Analysis G, at 207 (1980).

13. Alsop, *Amendment Debate,* Wall St. J., June 30, 1978, at 1, col. 6.

the Ohio economic development official involved, "The tax incentive was the keystone of the deal." At the same time, Church and Dwight's controller had a different perspective: "The tax abatement was a nice kicker at the end, but we chose Ohio mainly because of its strategic location for distribution and market growth." State officials obviously want to believe that the abatements are a major factor in a company's decision to locate within a given area, but the picture that emerges from the company may be quite different. Is it so difficult to understand that firms will bargain for whatever they can get, whether it makes any critical difference or not? To some firms, that strategy is just sound business practice.

ROGER VAUGHAN: Another issue to consider is whether a progressive state personal income tax system with a high marginal rate acts as a disincentive to business investment. The answer is yes. Several studies have shown that high state and local personal burdens are capitalized in high wages.[14] The wage rate represents a larger part of the company's cost than direct state and local business taxes. The issue here, however, is whether we should try to moderate public spending and reduce all taxes. We should not cut taxes selectively for certain groups.

KENNETH SIMONSON: Thank you Richard. It is not often that I have a chance to make two disclaimers before I begin a talk. I am not speaking now for the Chamber of Commerce of the United States, nor am I speaking for Arnold Cantor of the AFL-CIO, who originally was going to participate in this program. The Chamber of Commerce of the United States deals almost exclusively with national policy issues that affect Congress and the Administration. The thrust of my work with the Chamber has involved federal taxation. I think, however that many of the issues that I deal with there carry over into this morning's discussion.

I agree with Roger and Richard that it is important to look at the overall level of taxation and not concentrate on particular business tax incentives. I think that personal taxes can be just as important, or perhaps more important, in affecting the decisions, not just of a firm, but of the individuals who, after all, provide the real economic development that we now are addressing. If you have all kinds of tax incentives for business, but compensate for those by imposing extremely high or punitive taxes on all certain categories of individuals,

---

14. *See, e.g.*, R. Goldfarb & A. Yezer, *Evaluating Alternative Theories of Intercity and Interregional Wage Differentials*, 16 J. REGIONAL SCIENCES 345 (1976); O. Izraeli, Differentials in Nominal Wages and Prices Between Cities (Aug. 31, 1973) (unpublished thesis at University of Chicago library).

you are likely to encounter economic development problems that will be just as severe as if you allowed businesses to be more heavily taxed.

This point cannot be stressed too strongly: you must be concerned about the overall level of taxation. At the same time, I do not think that you can rest all of your hopes for economic development on that one factor. If all state taxes were abolished, you would not find every business in the country flocking to your door. In fact, there is no detectible correlation between the growth rate of personal income per capita in states as a whole and the growth rate of their taxes. I did try running a correlation on this and found that there was a slight negative relationship (that is, if taxes per capita increased, growth decreased), but it was statistically insignificant. This result can be explained by recognizing that taxes are only one side of the picture. You also have to look at the level of services that the state and local governments provide.

This leads to an equally important point: the tax system cannot, to any great degree, be used for either stimulating economic development or achieving other social policy aims. I think that it is particularly hazardous to try to make a state or local tax system overly redistributive. By having an excessively progressive tax system, people at the upper end of the income scale are encouraged either to move out of the cities and states and commute or to leave the area altogether. Such a result can be a very important element in setting the business climate for a state. Furthermore, I think that redistribution is an inappropriate goal of state taxation policy. Redistribution has to be accomplished at the federal level. State tax policy should be concerned almost exclusively with neutrality or efficiency in raising revenue.

Therefore, you need to concentrate on what Colbert, Louis XIV's finance minister, called "plucking the goose to get the most feathers with the least squawk." You want to try to make tax administration as painless and as fair as possible. You do not want to create a feeling among business or individual taxpayers, that they are being penalized while someone else is getting off lightly. This is often a problem that the federal government has to contend with. This may be one reason why there is more concern now with non-compliance. I think that it is one variable that is making some federal policymakers consider a value-added tax as a substitute for corporate, personal income, or payroll taxes.

Michigan has a form of value-added tax called the single business tax.[15] Other states have not been overly enthusiastic about adopting

---

15. Single Business Tax Act of 1975, MICH. COMP. LAWS § 201.1 (1970). For an excellent evaluation of the single-business tax, see ADVISORY COMM'N. ON INTERGOVERNMENTAL RELA-

this or the business activities tax that Michigan imposed from 1953 to 1967. The Michigan tax has many problems, and I certainly am not here to recommend that any state presently adopt it. It does have a significant advantage, however, in that in its ideal form—that is, with a minimum of exemptions and a very broad base—a value-added tax may be perceived as being a fairer and more neutral tax. It does discriminate between capital and labor, incorporated and unincorporated businesses, firms that rely heavily on turnover and firms that are more integrated through several stages of production. A value-added tax can resolve many of the problems created by having a variety of state taxes, such as a corporate income tax—which may heavily discriminate against capital—and smaller state taxes, which may add up to a much bigger nuisance than a revenue source. The value-added tax is not necessarily a solution to the problems of financing state government or the problems of providing tax incentives. It can help, however, to achieve what should be the primary goal of increased neutrality, efficiency, and perceived effectiveness in tax collection.

In some states, there is a great temptation to capitalize on what the states see as a form of natural monopoly; for instance, to use severence taxes in states that have a scarce resource such as oil or natural gas. To take a somewhat more exotic example, Kentucky had a distilled spirits production tax that was levied on distillers of Kentucky bourbon, blended whiskey, gin, and vodka.[16] An interesting study found that the tax did not perceptibly discourage production of Kentucky bourbon.[17] However, the tax drove production of the other liquors out of Kentucky and into other states. The study also noted that the growth of increase in the consumption of bourbon was much slower than the increase in the consumption of other beverages. The study wisely refrained from attributing the decline of bourbon drinking to the distillers tax alone. There is a warning, however, implicit in this illustration: even a seemingly safe tax levied on a tax base that appears secure is only a short-run solution. It will (1) encourage the development of substitutes in production processes that may lead to shifting production out of the state, and (2) encourage consumption of substitutes or discourage consumption of the product that is the sub-

TIONS, THE MICHIGAN SINGLE BUSINESS TAX: A DIFFERENT APPROACH TO STATE BUSINESS TAXATION (1978).

16. C. Garrison & D. Soule, *Economic Effects of Kentucky's Distilled Spirits Production Tax*, 20 NAT'L TAX J. 20 (1967).

17. *Id.* at 21-22.

ject of the state tax. That is the small warning that I would like to raise concerning the negative aspect of tax disincentives.

SANDRA KANTER: Perhaps I can make a few important comments. I have spent the last few years studying the formation of economic policy in the Commonwealth of Massachusetts. One of the matters that is being assessed is the formation of the state's tax policy. In the course of this research, I interviewed a number of state legislators about their views on economic legislation. The results were fascinating. For example, the most liberal legislators—those who support freedom of abortion, gay rights, and increased public spending—were asked their position on the use of tax incentives as tools for economic development. They wholeheartedly supported their use. Not surprisingly, almost every legislator interviewed believed that the strategy of lower taxes could be used to induce development. And yet we, as experts, unanimously agree that they have little effect on economic activity. What is happening? Why do public officials support programs that experts agree will not work?

With the exception of revenue bonds, which were first issued in the South, most tax incentives originated in the northeastern part of the country. They have been around for a long time. In fact, the Commonwealth of Massachusetts provided the first incentive in the 17th century. Over the years, older industrialized states have tended to be the ones that proposed new business incentives. These states also have a declining manufacturing base and, concurrently, high energy, transportation, resource, and building costs. This declining manufacturing base was once much healthier. Many of the firms so classified are no longer competitive. One way for them to survive temporarily is to reduce their cost of doing business.

For years, the same companies have been developing relationships with state legislators and state bureaucrats. In the beginning, they used their influence at the capitol to ask for outright tax reductions, but public officials found it difficult to support business tax reductions during periods when personal income taxes were rising. Consequently, the declining sector changed strategies, and in the 1940's and 50's it began to request tax incentives—hidden tax reductions camouflaged as special-purpose tax deductions or credits. Because tax incentives are not understood by the public and, consequently, are more politically acceptable than across-the-board reductions, business was more successful in getting tax incentives passed in the various state legislatures.

State economies have more than just declining sectors. There usually is a growing sector of the economy. In places such as California and Massachusetts, services and high technology are expanding quickly. What do growing companies need most? The answer is not tax incentives. Rather, they need roads and pipelines and vocational education schools. They want programs that make it easier to get skilled personnel. These growing firms, however, have not been around a long time. They have not built up a long-term relationship with state officials. Thus, they are not as successful as the older, marginal firms in getting the state to implement programs that serve their particular purposes.

There are three dangers to this scenario. First, businesses have ever-expanding tentacles. They are always asking for more. States begin competing with each other. A built-in frenzy develops in which each state wants to be the most able to please business. Yet business has no positive effect on the economy. Second, the process is a zero-sum game. Nobody wins, everyone loses—everyone except for the marginal corporation. Marginal corporations use tax incentives to stay in business a few more months, maybe even a few more years. Finally, the economic policy is irrational. We are concentrating our energies on helping firms that are not competitive at the expense of reducing expansion in the growing sectors. This is not only ineffective, but also may accelerate the decline of the older industrial states.

KENNETH SIMONSON: I would like to respond to Sandra and also to a question. The question reads, "It has often been said that corporate taxes are really paid by customers and clients when they buy a company's goods and services; is the corporate tax, in any form, just a governmental convenience which uses the corporation as tax collector rather than the taxpayer?"

No; the corporate income tax falls largely on capital. Perhaps it falls only on corporate stockholders, but, in the long run, it is spread among all capital owners. I choose to bring this up now, in response to Sandra's last statement, to reiterate that many tax incentives are irrational economic policy in as much as they subsidize marginal, failing firms while penalizing both successful enterprises and the individual taxpayer. The converse is that there are many taxes now that *do* act as a disincentive. The corporate income tax is probably the worst disincentive that we have in our entire tax system because it does fall strictly on capital. It discourages corporate investment, and it may lead to over-investment in other sectors, particularly housing. A state needs to examine very carefully what the overall impact of an entire tax is. The state should devote more attention to getting rid of an onerous tax than to patching it up with an incentive which will just attract the footloose or failing firms.

RICHARD POMP: I am far less confident than Ken about the incidence of the corporate income tax—a hotly contested issue. For example, does the burden of the corporate tax fall on shareholders, the owners of all capital, or on consumers, suppliers, or employees? This controversy over income tax also has as its counterpart the taxation of property. For years the orthodox view was that the property tax was regressive in its incidence. In the last few years, however, economists have reexamined the traditional doctrines and now raise the question of whether the property tax in fact might not be progressive. The only safe conclusion to draw from all of this controversy is that we know dreadfully little about the economic effects of many taxes.

This lack of knowledge places policymakers in a difficult position. What should they assume about the incidence of a tax when deciding which taxes should be raised or lowered? My own feeling is that, given this uncertainty, policymakers should avoid placing all their eggs in one basket. In other words, because so little is known about the effects of taxation, we should allocate the risk of uncertainty and strive for a balanced tax structure, rather than rely too heavily on any one tax.

In response to one of Ken's other points, I have great difficulty in concluding that the federal corporate tax does not favor capital investment. Investment tax credits, accelerated depreciation, special rates on capital gains, DISC, percentage depletion, and similar provisions all favor capital investment. In addition, the rate of the corporate income tax has been reduced over the past few years. The tax expenditure budget contains estimates of the revenue lost due to these special provisions.

I disagree with Ken on another point. A state or local jurisdiction cannot avoid facing the distributional effects of its tax structure. Each major tax, whether income, sales, or property, has different distributional effects. In deciding which tax should be adopted, increased, or reduced, a state or local jurisdiction cannot ignore the equity implications that these changes may raise. To be sure, a redistribution of income is probably best handled at the federal level and is probably better handled through direct expenditures rather than through taxation. Indeed, some would argue that it is not feasible for small jurisdictions or even cities to impose progressive income tax. It would simply drive wealthier individuals to other jurisdictions and leave the city with a higher concentration of poor. Of course, the relationship between taxation and an individual's decision to move is just a subset of this morning's whole discussion. My point, however, is that a jurisdiction cannot simply ignore the distributional consequences of its tax system.

Ken also raises the issue of neutrality. To extol neutrality as a goal means that the tax system should not interfere with the existing allocation of resources. In effect, the adoption of neutrality as a goal means that we are satisfied with the existing distribution of income. If we are unhappy about the existing distribution of income, neutrality should not necessarily be a tax goal, because taxation can serve as a tool for redistribution.

Finally, I have a few comments on the value-added tax. In my judgment, the value-added tax is an alternative means of collecting a retail sales tax. Other countries have adopted a VAT for reasons that are unique to their history. The present debate in this country over a value-added tax should really be divided into two questions: should the United States adopt a federal tax on consumption? If so, should that tax be collected in stages, as is true of a value-added tax, or only at the time of actual sale, the way our state sales taxes are collected?

ROGER VAUGHAN: I would like to respond with a few quick points. First, I agree that the tax system is not a very good way to shift resources from those who can pay to those that need assistance. Targeting public expenditures is a much more effective way of achieving that objective. Second, the trouble with tax incentives is that they are easy to offer. Perhaps we need some federal policies that discourage local incentives. The federal government could attach a penalty to revenue sharing or reduce grants to localities that offer excessive tax incentives. This would require localities to actually document how much they are giving away through these incentives. A firm that moves into a town is not a free good. It needs services such as water supply, transportation, and waste disposal. It contributes to the wear and tear of the local infrastructure. These costs will be met through taxes paid by other firms. Thus, a successful tax incentive attracts new firms but drives other firms out.

Third, while at least part of the corporate income tax falls on capital, there also are many taxes, such as personal income and payroll taxes, that fall on labor. The object of the tax system should be to even out the tax burden on different factors of production to reduce the inefficiency cost of taxes. There are two issues relevant to New York. First, have taxes caused job loss in New York? Yes, undoubtedly taxes have played a role. I do not claim that high business taxes have had no impact at all. They have not contributed to the deterioration of the business climate in such high taxing locales as New York City, but other taxes have been much more important. Of course taxes affect business. They influence investment and labor supply decisions. We must not, however, attribute some mysterious economic power to high taxes. Taxes reflect the price of public services. Some areas are able to supply public services at a relatively low cost. Those areas will be attractive to businesses and residents. But returning to my basic question: are we really shaping development for business or are we trying to do something to address problems of market imperfections and equity? I think that we tend to ignore the equity issue when we start talking about taxes. We think that any development is good. We are redistributing resources, and the redistribution process will slow growth. But that is the price we must pay for assisting the poor.

Another pertinent issue is: what can be done about the difference in tax rates between cities and suburbs? Central cities spend a lot more per capita on redistributive public services than do suburbs. This leads to higher taxes. This disparity has contributed to the suburbanization of business and the population. The appropriate response does not involve cutting out central city services to low income groups. The state government must step in and provide fiscal assistance. The burden of helping the poor must be shared by all households. State governments have failed to target effective fiscal assistance to the jurisdictions that need it. States that do have some kind of tax sharing program distribute resources among jurisdictions based on population. This is scarcely an effective way to help the areas that need it.

One final issue requires an examination of the effectiveness of federal, state and local tax incentives, as well as the incentives used in other countries. Most of the discussion about local tax incentives is also applicable to federal incentives. Rather than subsidize these mistargeted programs, such as the marginal employment tax credit, the federal government should reduce taxes for all firms and households. There are many steps that can be taken at all levels of government to improve the efficiency and equity of taxation. In order to reduce expenditures, we have to reevaluate the object of their efforts.

SANDRA KANTER: The danger of the 1980's will arise from the general agreement that tax incentives are detrimental and, therefore, that the personal income tax should be reduced. Reducing state personal income taxes, however, is not going to determine whether a firm locates here or there. If Roger is right and taxes are shifted onto wages, then business should be advocating a graduated income tax.

I have a quick question from somebody in the audience: "Do only weak or marginal companies favor tax incentives?" Marginal firms like tax incentives. Other firms might be interested in obtaining tax incentives, but state tax incentives play no part in their location or growth decisions. Why spend money on something that is going to be done anyway? The use of tax measures is a very dangerous policy in the long run.

KENNETH SIMONSON: I think that Sandra's last point is a very good one. The goal should be to provide the right climate for the economy as a whole, rather than to save a particular firm. Therefore, a tax program should not be tailored to a particular firm or a particular industry. You really must consider the trickle-down possibilities. I think that the investment tax credit on the federal level, far from being a tax expenditure, has been quite an effective incentive to increasing national productivity. If you review the list of tax expenditures, you will find that most of the expenditures relating to capital actually represent a reduction in the tax system's very strong bias against capital. The term "tax expenditures" is basically rhetorical. It overlooks the fact that these provisions either mitigate a bias against capital in general or reduce a bias against one kind of capital in particular. For instance, if you look at accelerated depreciation strictly in terms of how the productive capacity of a particular piece of equipment declines over its useful life, you might say that accelerated depreciation allows excessive write-offs in the early years. The relevant comparison, however, is with the replacement cost of that investment and the time when the asset would be replaced absent tax considerations. When that question is asked, you find that accelerated depreciation in its present form is an *inadequate* incentive in many cases. We need a wholesale reform of the depreciation system. The Jones-Conable bill,[18] provides for a ten year accelerated write-off for business structures, a five year accelerated write-off for equipment, and a three year accelerated write-off for $100,000 of investment in autos and light trucks. It represents a good first step. The Chamber worked actively to develop a compromise for reforming depreciation that would satisfy major business groups. This legislation would help large and small businesses in all industries, not just capital-intensive industries. Finally, I think that it would not only benefit business, but the entire work force..

This is where trickle-down comes into play again. Once you have a more rational and balanced system for taxing all returns to income, you will have greater savings and a more productive capital stock that will translate very quickly into higher wage payments and a higher standard of living for everyone. I do not believe that there is a free lunch, in the sense that an investment tax credit or depreciation reform necessarily raises the overall level of federal revenues above the level maintained prior to the reduction. There will be, however, very

18. H.R. 4646, 96th Cong., 2d Sess. (1979); S. 1435, 96th Cong., 2d Sess. (1979).

substantial feedback along those lines. Not only will this compensate for some of the initial revenue loss, it will also leave a healthier and more competitive economy. The message to state and federal governments is clear. You need to reduce the prejudice against investment in your tax system without trying to concentrate that reduction on one particular firm or industry.

RICHARD POMP: Defining a tax expenditure is not an impossible task. As a working definition, one could define a tax expenditure as any provision in the tax code that is used to achieve a goal that is extraneous to the normative structure of the income tax. Although it is often difficult to reach a consensus on the normative structure of the income tax, many tax expenditures can be readily identified. Consider, for example, the home insulation credit. Obviously granting individuals a tax reduction for insulating their homes has nothing to do with the normative structure of an income tax. Identifying the insulation credit as a tax expenditure, however, does not mean that the credit is necessarily bad. It simply means that the credit has no necessary or logical relationship to an income tax. By identifying the credit as a tax expenditure, we are reminded to ask the normal budgetary questions, i.e., how much money is being spent, how is this money being distributed, and are the desired goals and objectives being reached. After raising those questions, we might conclude that the high price of heating oil already provides the necessary incentive for homeowners to insulate. We might also conclude that a bottleneck exists on the supply side such that, if the credit increases demand, the only short-term effect will be an increase in the price of insulation. If the price does rise, the credit inures to the benefit of only a few manufacturers. This kind of analysis, however, is seldom undertaken when a tax expenditure, as opposed to equivalent spending program, is adopted.

I also have a few responses to the comments made about depreciation. In many cases the depreciation allowances that a taxpayer claims may have little bearing to reality. For example, useful lives for tax purposes are often shorter than economic lives, and estimates of salvage value for tax purposes are often lower, especially under inflationary conditions. In the case of the ADR (asset depreciation range)—which big businesses use for purposes of the federal corporate income tax and also use for any state corporate income tax that is modeled on the federal tax—the useful lives are much shorter than the actual economic rate of depreciation.

Ken shifts focus a bit by talking about replacement cost depreciation. In my mind, depreciation is merely a means of allocating the historic cost of an asset in order to make a proper determination of income. Replacement cost depreciation is really part of a much larger problem: what adjustments, if any, should occur in a tax system to account for inflation? Actually, we have made such adjustments in the federal income tax on an ad hoc basis, i.e., raising the personal exemption to $1,000 and raising the zero bracket amount.[19] If you want the tax system to be adjusted automatically, I suggest that we should not start by focusing on the owners of capital assets. Proposing replacement-cost depreciation or inflation adjustments in the calculation of capital gains, for example, strikes me as a means of granting relief to many persons who have actually gained from, rather than been injured by, inflation. Consider how the owners of capital assets have fared compared with the holders of cash. In addition, consider that industries often purchase capital assets with borrowed money, which becomes cheaper to pay back under inflationary conditions. The whole topic of inflation and the income tax is incredibly complex. A full discussion of the issue would take us far afield.[20]

I would like to make a few other short responses to some earlier points that were raised. The business community is not united behind the Jones-Conable bill, which is now before Congress.[21] Smaller businesses are not quite as enthusiastic as they once were because they realize they would be better off with alternative approaches. This bill is really just part of a much larger debate over the existence of a capital shortage in the United States. I think that the fear of a capital shortage will permeate much of the debate over tax changes in the coming decade. Unfortunately, critical analysis of the issue is long overdue.

Regarding the comments made on the multiplier effect of new business, my response is "it depends on the situation." For example, if a jurisdiction merely attracts the branch office of a multistate or a multinational corporation, the multiplier effect would be rather modest. Each situation, however, must be examined individually.

When evaluating the city versus suburb issue, keep in mind that federal policies for many years, intentionally or unintentionally, helped create the suburbs. For example, federal funds for highways, a pro-suburb FHA mortgage policy, and deductions for property taxes and mortgage interest all encouraged home ownership and the growth of the suburbs.

---

19. *See* I.R.C. §§ 1, 151.

20. For a complete discussion, see BROOKINGS INST., INFLATION AND THE INCOME TAX (H. Aaron ed. 1976).

21. H.R. 4646, 96th Cong., 2d Sess. (1979); S. 1435, 96th Cong., 2d Sess. (1979).

ROGER VAUGHAN: Several questions have been raised concerning what should be done about Chrysler. The Chrysler debate illustrates many of the typical false arguments for government assistance. Some people believe that, if we collect taxes from the State of Michigan, or from the entire nation, and use those resources to provide money for Chrysler, we will somehow save jobs. There are probably several automobile firms worldwide that would be happy to purchase some of Chrysler's auto production facilities or to enter into some type of agreement with Chrysler. That would mobilize world capital to restructure the firm instead of using taxes to keep an inefficiently managed company alive. I think Chrysler is a very clear example of a situation where the use of tax incentives is an inappropriate response to threatened job loss.

Another issue is how the tax burden should be apportioned at the state and local level between business and individuals? There is no simple answer. We do not know enough about tax incidence to calculate how the burden of business tax is shared among the consumers of the goods, the stockholders of the company or even the workers of the firm. We are not aiming for some type of utopian tax system. We can only hope to identify the real inefficiencies and change the taxes accordingly.

My final statements will address the issue of the Harris Bank Study, a study conducted by Genetski and Chin, that assesses how tax burdens have affected income growth in different states.[22] The study, which was the basis of a series of editorials in the Wall Street Journal, concluded that high taxes significantly deter employment growth. There are problems with the study, but I think such problems are encountered in every tax study. It is very difficult to analyze the relationship between taxes and employment growth, company birth rates, personal income growth, or some other growth measurement. The problem is that it is difficult to assess the true local tax burden on business in a given location. If you use the corporate income tax rate, an explanatory variable in many studies, then tax incentives and other special allowances are ignored. The effective tax rate is often very different from the nominal tax rate. All of these studies have a fundamental flaw—they use inaccurate measures of the time-tax rate. All one can conclude is that the vast majority of studies find that taxes are not important.

RICHARD POMP: Here is a question from the audience: "Is the battlefield moving from the state and local arena to the international

22. *See* R. Genetski & Y. Chin, *The Impact of State and Local Taxes on Economic Growth*, (Nov. 3, 1978) (study published by Harris Trust and Savings Bank, Chicago, Ill.).

arena? What part do state and local taxes play in international taxation?" To answer this question, I will begin by pointing to the recent debate that took place over the proposed United States tax treaty with the United Kingdom.[23] Article 9 of this treaty would have prevented states from applying what is called the "unitary method of taxation." Basically, the unitary method of taxation refers to a system whereby a state, for purposes of taxation, does not respect all of the subsidiary corporations that make up a large multistate or multinational corporation. California is the major proponent of this method of taxation. In certain cases, California will pierce all of the corporate veils and treat a multinational firm as if it had no subsidiaries.[24] In other words, California will tax the corporation and its subsidiaries as if they were a unified entity. This approach creates many problems in international tax planning, because it undercuts the use of tax havens and dummy corporations.

The IRS uses a contrary approach, called the "arm's-length approach."[25] The IRS respects the existence of foreign corporations and examines the transactions that take place between a United States corporation and its foreign subsidiaries to ensure that each transaction is recorded at a bona fide price. But how can the IRS police the price at which IBM transfers technology from the parent corporation to one of its subsidiaries? There are many provisions in the Federal tax code that are meant to control this transfer pricing problem and to undercut the use of tax havens and dummy corporations.[26] Nonetheless, such games are played, and the dollars involved are quite large. By completely disregarding the existence of a corporation's foreign subsidiaries, California avoids many of the problems that plague the IRS.

The issue in the proposed treaty with the United Kingdom was whether California could continue applying its unitary approach.[27]

---

23. Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, *reprinted in* SENATE COMM. ON FOREIGN RELATIONS, TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND, S. EXEC. REP. NO. 18, 95th Cong., 2d Sess. 54 (1978).

24. *See* R. Pomp & F. Church, *The Unitary Method: Thirteen Questions and Answers*, 10 TAX NOTES 891 (1980).

25. I.R.C. § 482. *See* R. Pomp & F. Church, *supra* note 24; Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 HARV. L. REV. 1202 (1976).

26. *Id.*

27. When first proposed, Art. 9(4) of the treaty restricted use of the unitary tax methods by the states. Article 9(4), however, was dropped from the final treaty. *See* 124 CONG. REC. 9838 (1978); R. Pomp & F. Church, *supra* note 24.

Many persons were outraged that Congress tried to determine state tax policies through the treaty-making process, basically because it cuts off state input. The whole problem of state taxation of multistate and multinational corporations is a difficult one and a solution will be found only after considerable compromise by all parties concerned. Unfortunately, tax treaty negotiations are not the proper setting in which to reach that compromise.

SANDRA KANTER: One quick question: If we are all in agreement, how do we convince the state legislature? This is a really difficult issue for state legislatures. I am convinced that you cannot isolate states and convince them to reduce their tax incentives. You have got to have a coalition, such as the Multistate Tax Commission, before reform can occur.

KENNETH SIMONSON: I also was asked to respond about Chrysler and about indexing. I agree with Roger about Chrysler. I do not think it is appropriate to quickly enact new tax incentives to save this one firm. It established a very bad precedent at the local, state, or federal level. I suspect that the decision as to whether Chrysler stays in business in its present form, reorganizes, or closes down will be made regardless of whether tax incentives are brought into play.

With respect to indexing, I have serious reservations about it, and my endorsement of more accelerated depreciation and my discussion of replacement value do not rest simply on the idea that the cost of assets continues to rise and that something should be done about it. Rather, the technological obsolescence associated with nearly all fixed assets which the present tax code does not recognize properly is far more important. Ideally you would expense all capital investments. Failing that, there should be substantially more accelerated depreciation even if our inflation rate miraculously drops to zero. As for using a standardized, simplified depreciation system in place of our present one, this also would benefit small business. Only a minute fraction of small businesses are now able to take advantage of the asset depreciation range because the provisions and restrictions attending it are so complex and the paperwork requirements so daunting that most small businesses stay with the simple system instead of the most advantageous system available under law. The 10-5-3 plan would be a vast improvement over the present method currently facing small businesses. Although it is true that there is no unanimity among business groups, one of the earliest backers of the 10-5-3 plan was the National Federation of Independent Business, the largest small business association.

In general, indexing does have some attractions. The state and federal governments should not be benefiting unduly from inflation.

They should be forced to look at their priorities every year and decide what services really ought to be provided and at what level. The notion that there will be a sudden slash in services if taxes are cut should not necessarily intimidate taxpayers. In many cases it would be more appropriate to have services provided privately than by the state or local government. The isolated cases in which municipal services are provided privately demonstrate that there is good reason to encourage this course of action. In Scottsdale, Arizona, for instance, fire protection is provided by a private company. A number of studies show that private firms provide more innovative and less costly fire protection than the standard municipal fire department.[28] Similar examples can be found with respect to a wide range of services provided by the government. General Accounting Office and other government studies show that contracting out or using performing services in-house would be far more cost-effective.

This is a lengthy response to the question of whether we need indexing. I think that indexing is one way to assure that governments do not expand without limitation and unduly benefit from inflation. At least at the federal level, it is more appropriate to have Congress regularly assess how the entire tax system should be structured. Indexing would eliminate some of the current impetus for doing this. On the state level, however, indexing may be more appropriate.

---

28. *See, e.g.*, ADVOCACY TASK GROUP ON GOVT. COMPETITION WITH SMALL BUSINESS, U.S. SMALL BUSINESS ADMINISTRATION, GOVERNMENT COMPETITION: A THREAT TO SMALL BUSINESS (1980).