Congress Should End the Economic War Among the States

Testimony

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> *[The Constitution] was framed upon the theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division.*
>
> Justice Benjamin Cardozo
> U.S. Supreme Court, 1934 [1]

There is likely no major metropolitan area in this country that has not been held hostage at some point by the owner of a sports franchise who threatened to move the team elsewhere if the owner did not receive a new taxpayer-funded sports complex. Indeed, such economic blackmail even affects many of our smaller communities, as minor league sports teams have also learned to play this rent-seeking game.

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Being from Minnesota, I can personally attest to this rent-seeking game, as the Minnesota Twins—after a 10-year campaign—finally persuaded a previously reluctant state Legislature to hand over about $400 million in public financing for a new stadium that is now under construction in downtown Minneapolis. Not to be outdone, the Minnesota Vikings are currently pressing the Legislature for their own share of the public largesse. And who can blame them? As long as governments are willing to hand over limited public resources, these teams would be foolish not to accept them.

But make no mistake, it's not just sports teams that demand public money from cities and states. The state and local funds spent competing for sports franchises, though conspicuous, probably represent only a fraction of the billions of dollars spent by the more than 8,000 state and local economic development agencies competing to retain and attract businesses through the use of preferential taxes and subsidies. Businesses know they can get public funding by threatening to move, forcing state and local governments into competition for businesses that has become economic warfare.

While states spend billions of dollars competing with one another to retain and attract businesses, they struggle to provide such public goods as schools and libraries, police and fire protection, and the roads, bridges and parks that are critical to the success of any community.[2] Indeed, we in Minnesota have special cause to speak to the importance of adequate funding for infrastructure following the tragic collapse of the I-35W bridge over the Mississippi River. Surely, something is wrong with this picture. As Justice Cardozo suggested, the framers of the Constitution had something different in mind in granting Congress the power to regulate interstate commerce under the Commerce Clause. The objective was to create an economic union, particularly by ending the trade war among the states that prevailed under the Articles of Confederation. However, it was the Supreme Court, not Congress, that applied the Commerce Clause to end the trade war among the states.

It is now time for Congress to exercise its Commerce Clause power to end another economic war among the states. It is a war in which states are actively competing with one another for businesses by offering subsidies and preferential taxes. Economists find that there is a role for competition among states when it takes the form of a general tax-and-spend policy. Such competition leads states to provide a more efficient allocation of public and private goods. But when that competition takes the form of preferential treatment for specific businesses, not only is it not "admirable," it interferes with interstate commerce and undermines the national economic union by misallocating resources and causing states to provide too few public goods. Moreover, the success of a state in attracting and retaining particular businesses is not a mitigating circumstance.

This testimony will largely concern itself with an analysis of economic development programs and a recommendation to end this inefficient use of scarce public resources. However, in addition, I will offer a proposal for a better use of public resources for economic development—early childhood education for at-risk children. This proposal is only briefly described here; more details on early childhood education as economic development can be found in Appendix B and on the Web site of the Federal Reserve Bank of Minneapolis (minneapolisfed.org; details below).

The economic merits of ending the war among the states

To understand why economists conclude that the use of public funds to attract and retain specific businesses does not serve a legitimate local public purpose, we need to understand what they mean by public purpose. Economists' view of public purpose relies critically on a distinction between public and private goods. A public good, unlike a private good, is one in which a single person's consumption of that good does not subtract from another person's consumption. A lighthouse is an often cited example of a pure public good: The light from a lighthouse used by one ship on a foggy night does not prevent its use by another ship. Providing for the national defense, clean air and a legal system are other examples of goods that any citizen can consume without subtracting from what can be consumed by any other citizen in the community.

Besides pure public goods there are some goods that lack the explicit quality of a public good but give off external effects that qualify them as such. Health care provided to an individual is a private good because it subtracts from the consumption of other individuals; nevertheless, it may have external effects that are public. For example, having one person inoculated for some communicable disease makes for a healthier environment, and a healthier environment is a good that any person can consume without subtracting from the consumption of any other person. Similarly, educational services consumed by one individual subtract from the consumption of other individuals, but education increases a community's stock of knowledge and is critical to a well-functioning democracy, two highly regarded public goods.

Economists have found that while the production of private goods is best left to market forces, the production of public goods should be the principal role of government because the market fails to produce enough public goods. The reason the market fails is that since people cannot be excluded from consuming public goods, charging people for what they consume is difficult. It is often impossible to say if and how much of a public good a person consumes. How much does one consume of a healthy environment or national defense or a lighthouse beam? A private firm producing a public good might try to survey the citizens of its community to uncover how much each consumes of a public good and charge accordingly. However, knowing they will be charged based on how much they say they benefit from the public good, and knowing they will get to consume as much as they want, regardless of the charge, people will tend to understate the benefits. Moreover, private firms could not enforce payment for such goods even if they knew how much to provide. Consequently, left to the market, too few public goods, if any, will be produced.

I turn to the government, then, to finance and provide for the use of public goods. Government, by its very nature, can solve the financing problem, for it has the power to appropriate funds from its citizens (the power to tax) for the provision of public goods. Solving the provision problem of public goods is more difficult.

Competition among states through general tax and spend policies leads to the right amount of public goods

For state and local governments there is a form of intergovernment competition that guides them to provide the right amount of public goods. This type of competition among government entities has been compared to the invisible hand that guides private business to produce the right amount of private goods.

Charles M. Tiebout argued in 1956 that as state and local governments compete through general tax and spending programs to attract people and businesses, these government entities are led to produce the desired level of public goods. Tiebout notes that people can vote with their feet and choose to live in the community that provides them with the public services for which they are willing to pay. As a result, people in effect reveal their true preferences, and state and local governments provide more public goods than if these governments were not competing. The problem of providing the right level of public goods is alleviated by competition among state and local government entities.

But competition among states for specific businesses is harmful

When states compete through subsidies and preferential taxes for specific businesses, the overall economy suffers. From the states' point of view, each may appear better off competing for particular businesses, but the overall economy ends up with less of both private and public goods than if such competition was prohibited.

State and local officials often boast about the new businesses they have attracted, the old ones they have retained and the number of jobs they have created. And in many instances these officials should boast. Either they have managed to maintain their tax base by enticing a local business to stay or they have added to their tax base by enticing an out-of-state business to relocate. As long as the subsidies and preferential taxes given to a business are worth less than the revenue the business will contribute to the state over its operating years, the citizens of the state are better off than if their state officials had not played this competitive game. The state has more jobs and hence more tax revenue to pay for public goods than if it had not competed.

But even though it is rational for individual states to compete for specific businesses, the overall economy is worse off for their efforts. Economists have found that if states are prohibited from competing for specific businesses, there will be more public and private goods for all citizens to consume.[3] To illustrate this point, I will consider several possible outcomes of this competition.

In the first outcome, no business actually moves to a new location. In other words, suppose that each state goes on the offensive to lure businesses away from other states, but defensive strategies prevail; local subsidies and preferential taxes to businesses that might consider moving, keep them from leaving. While each state could claim a victory of sorts (for no state loses a business), clearly all states are worse off than if they had not competed. Competition has simply led states to give away a portion of their tax revenue to local businesses; consequently, they have fewer resources to spend on public goods, and the country as a whole has too few public goods.

It is unlikely, of course, that businesses will not be enticed to relocate. In this second outcome, the damage to the overall economy can be even greater. At first glance, when businesses relocate there appears to be no net loss to the overall economy; jobs that one state loses another gains. Yet on closer examination we can see that this is not just a zero-sum game. As in the case with no relocations, there will be fewer public goods produced in the overall economy because, in the aggregate, states will have less revenue. This follows because the revenue decline in the losing states must be greater than the revenue increase in the winning states. (If this was not true, businesses would not have relocated.) In addition to this loss, the overall economy becomes less efficient because output will be lost as businesses are enticed to move from their optimal locations.

Each business that is enticed to relocate represents a potential loss of efficiency for the overall economy and hence less output, less tax revenue and fewer public and private goods. To be more concrete, let us suppose a company chooses to relocate its manufacturing plant from a warm climate state, like Louisiana, to Alaska, even though its operating costs are substantially higher in a cold weather climate. I will assume that the company is more than fully compensated by Alaska for the move and for the additional operating costs. However, it now takes more resources for this company to produce the same quantity of output in Alaska than it did in Louisiana.

There is another reason businesses will be less productive when states are allowed to compete for individual businesses. States may increase taxes on those firms that are less likely to move to offset the lost revenue from firms that have moved (or have threatened to move). It is a well-known proposition in economics that taxes generally distort economic decisions and at an increasing rate. Business taxes, in particular, induce firms to produce less efficiently. Again to make the argument concrete, consider the hypothetical example of a tax on machines like those used in car washes. Without a tax or with a very small tax, the most efficient and profitable way to operate a car wash is to invest in high quality machines that require only few workers. As the tax increases, the most profitable way to operate the car wash will be to invest in less sophisticated machines that require more labor; although fewer cars will be washed per day, having less expensive machines reduces the tax payment, more than compensating for the lower productivity. And since tax distortions generally grow at an increasing rate, at higher tax rates relatively fewer cars are washed.

In general, it can be shown that the optimal tax (the tax that distorts the least) is one that is uniformly applied to all businesses. Allowing states to have a discriminatory tax policy, one that is based on location preferences or degree of mobility, therefore, will result in the overall economy yielding fewer private and public goods.[4]

State competition for specific businesses involves one additional loss that could make those already mentioned pale by comparison. I have assumed that states have the information to understand the businesses they are courting, that is, their willingness to move, how long they will stay in existence and how much tax revenue they will generate. In practice, states have much less than perfect information. Assuming all states are so handicapped, they will on average end up with fewer jobs and tax revenues than they had anticipated, and at times the competition may not even be worth winning.

For example, Pennsylvania, bidding for a Volkswagen factory in 1978, gave a $71 million incentive package for a factory that was projected to eventually employ 20,000 workers. The factory never employed more than 6,000 and was closed within a decade.

Minnesota's 1991 deal with Northwest Airlines is another example of a Pyrrhic victory. A state agency agreed to provide the company with a $270 million operating loan at a very favorable rate of interest. In return, Northwest agreed to build (with an additional $400 million of state and local government funding) two airplane repair facilities that would eventually employ up to 2,000 highly skilled workers in an economically depressed region of the state. While the operating loan was made in the spring of 1992, the company has yet to fulfill its part of the bargain. Moreover, the commitment to build the two repair facilities that would employ 2,000 workers has been reduced to a commitment to build one very modest facility and an airline reservation center, which together would employ fewer than 1,000 workers.

Despite the fact that state deals have gone sour, some may still be tempted to argue that competition among states for specific businesses will lead to a good outcome for the overall economy. Some may be tempted to make this argument because it seems, as argued earlier in this essay, people can vote with their feet (or vote policymakers out of office). Hence, if people are unhappy with their state's economic development strategy, there is an internal political check. People, however, may not be unhappy with these strategies—the state is acting in their best interest. Not to compete, while other states are, may be detrimental to a state's economy. Moreover, there may not be a place to go because all states may be competing. For this type of competition there is no invisible hand (or more accurately, no invisible foot) to lead states to do what is best for the country.

Only Congress can end the war among the states

How can this war among the states be brought to an end? The states won't end this war, and the courts are not equipped to do so. Only federal legislation can prevent states from using subsidies and preferential taxes to attract and retain businesses.

The powers granted to Congress under the Constitution enable it to fashion the legislative tools necessary to prevent the states from using subsidies and preferential taxes to attract and retain businesses. For example, Congress could tax the receiving business on the direct and imputed value of these benefits, it could deny tax-exempt status on debt of states that offer such subsidies, or it could deny federal funding that would otherwise be payable to such states, much as it denies highway funds to states that fail to meet federal pollution standards.

The states

The states won't, on their own, stop using subsidies and preferential taxes to attract and retain businesses. There is anecdotal evidence that some state and local governments recognize they are all losing in this economic war. Nevertheless, as long as a single state engages in this practice, others will feel compelled to compete. New York, New Jersey and Connecticut all recognized that they were losing from this competition, and in 1991 they informally agreed to stop competing with each other. It was not long, however, before New Jersey broke the deal.

Even if a number of states were interested in formally agreeing to stop the practice of competing to attract and retain businesses, it would be a practical impossibility to devise an arrangement that would both cover all the forms of subsidies and preferential taxes the states might devise and provide an effective method of enforcement. Also, such a multistate treaty might run afoul of the Compact Clause of the Constitution, which prohibits a state from entering into a compact with another state, in the absence of the consent of Congress.

The courts

To understand why this problem cannot be left to the courts, it is important to know something of the history and purpose of the Commerce Clause and the role that the courts[5] played in its evolution and application.

The economic union—from the Articles of Confederation to the Constitution

A driving force in the nation's movement from the Articles of Confederation to the Constitution was that the Articles did not provide a national economic union. The Annapolis Convention of 1786 was convened to discuss the removal of the impediments to commercial activity, both among the states and between the United States and foreign nations, under the Articles. It ended with a call for a meeting the following year to discuss changes to the Articles to correct the defects that adversely affected commerce. The 1787 meeting evolved into the Constitutional Convention as it became apparent that the commercial problems could not be remedied by simply amending the Articles.

Under the Articles, the states had freely engaged in destructive economic warfare by imposing all types of trade barriers against one another. To address this, James Madison, the recognized father of the Constitution, added the Commerce Clause to the Constitution, to help promote an economic union of the states. The Commerce Clause grants Congress the power to regulate "Commerce ... among the several States. ..." [6]

Madison expected that Congress would do little to regulate interstate commerce. It was his concept that the Commerce Clause would, in effect, preempt the states from interfering with interstate commerce. In practice, the Commerce Clause did not discourage the states from interfering with interstate commerce and Congress did little, if anything, to constrain them. As a consequence, while Madison intended that the Commerce Clause would almost be self operating in fostering economic union, in the absence of congressional action the courts were left to implement the economic union through ad hoc interpretation of the Commerce Clause.

The courts and the Commerce Clause

The Commerce Clause contains an ambiguity: It gives Congress the power to regulate interstate commerce but does not expressly prohibit the states from interfering with interstate commerce. To address this ambiguity, the Court developed a doctrine known as the "dormant" or "negative" Commerce Clause, which it applies, in the absence of congressional action, to strike down state laws that it has determined excessively burden interstate commerce.

The Court has supported the ideal of an economic union through its application of the dormant Commerce Clause. However, contrary to Madison's vision of the Commerce Clause, the Court will tolerate some state action that imposes a burden on interstate commerce if the burden is not excessive in relation to the benefit accruing to the state from a legitimate local public purpose. A legitimate local public purpose is one for health, safety or welfare, including the economic welfare of the state. The Court recently has said that "a pure subsidy funded out of general revenues *ordinarily imposes no burden on interstate commerce, but merely assists local business*."[7] (Emphasis added.) In an earlier decision, and more directly to the point of this essay, the Court said that "a State's goal of bringing in new business is legitimate *and often admirable*."[8] (Emphasis added.)

Therefore, if the Court were to consider the constitutionality of a state subsidy or preferential tax to attract or retain businesses, one would expect it to hold[9] that subsidies or preferential taxes impose no burden on interstate commerce. Even if the Court were to decide that such a state subsidy or tax preference burdens interstate commerce, it would weigh that burden against what it would undoubtedly regard to be a legitimate local public purpose, attracting and retaining businesses.

In any case, the Court may not wish to act because Congress has remained silent.[10] The failure of Congress to speak to an issue can have a profound effect on the Court. When Congress remains silent after the Court has clearly expressed a position in the area of interstate commerce, the Court is likely to regard that silence as tacit approval. Therefore, the Court, having clearly expressed the view that state subsidies to attract and retain businesses do not interfere with interstate commerce, including twice during its 1993-94 term, may take the silence of Congress to be tacit approval.

Finally, the courts are not a practical vehicle for preventing the states from using subsidies and preferential taxes to attract and retain particular businesses. The courts, including the Supreme Court, do not have the power to prevent the states from interfering with interstate commerce. A court can only consider the constitutionality of a state law in the context of a particular case that is before it. As a consequence:

Spasmodic and unrelated instances of litigation cannot afford an adequate basis for the creation of integrated national rules which alone can afford that full protection for interstate commerce intended by the Constitution. We would, therefore, leave the questions raised ... for consideration of Congress. ...[11]

Congress can and should prohibit state business subsidies and preferential taxes

The Supreme Court must be credited with implementing the Commerce Clause and preserving Madison's objective of an economic union. Congress has done little to foster the intended purpose of the Commerce Clause. However, the Court can only decide the cases and controversies that come before it. It can't create laws to implement the Commerce Clause.

Only Congress has the power to enact legislation to prohibit and prevent the states from using subsidies and preferential taxes to compete with one another for businesses. In addition to its power under the Commerce Clause, Congress has the ancillary power it derives from its power to tax and appropriate money, and the power to make all laws that are needed to carry out its enumerated constitutional powers. Moreover, under the Supremacy Clause the Constitution and the laws of the United States are the supreme law of the land.

The power of Congress under the Commerce Clause is so sweeping that to enact legislation to prohibit the states from using subsidies and preferential taxes to compete with one another, it need only make a finding, formal or informal, that such subsidies and taxes substantially affect interstate commerce. The Supreme Court will defer to such a congressional finding if there is any rational basis for the finding. No Supreme Court decision in at least the past 50 years has set aside federal legislation on the ground that Congress did not have a rational basis for such a finding.[12] The Court has recognized that the power of Congress under the Commerce Clause even extends to intrastate activities that have a substantial effect on interstate commerce. Moreover, Congress can legislatively supplement, revise or overturn any of the Court's decisions under the dormant Commerce Clause doctrine.

To illustrate how Congress might discourage states from using subsidies and preferential taxes to compete with one another for businesses, consider the variety of subsidies and preferential taxes a city and state might use to attract a sports franchise away from another city. It would not be unusual for them to offer some or all of the following: 1) build a stadium funded by public, tax-exempt debt, 2) lease the stadium to team owners at bargain rent, 3) rebuild streets and highways to provide stadium access, 4) loan or grant the team owners relocation funds, 5) pay for land with tax increment financing on which team owners can build an office building, and 6) grant the team owners a real estate tax abatement on the building. To implement a legislative prohibition, Congress could impose sanctions such as taxing imputed income, denying tax-exempt status to public debt used to compete for businesses and impounding federal funds payable to states engaging in such competition.

Conclusion and a proposal for effective economic development

Unfettered competition among private businesses has generally proven to be a very successful economic system. As Adam Smith predicted over 200 years ago, individuals acting in their own best interest are led, as if by an invisible hand, to produce what is best for the overall economy. And experience has shown that Smith was right. Those countries that have relied on a market-oriented economy have outperformed (based on virtually all measures of success) those countries that have relied on a central planning strategy.

But what is true of individuals acting in their own interest is not necessarily true of state governments acting on behalf of their local citizens. Competition among governments based on their general tax-and-spend policies leads to a better outcome for the overall economy. However, when that competition takes the form of preferential financial treatment for specific companies, the overall economy is made worse off. Such competition results in a misallocation of resources and, in particular, too few public goods.

Competition among states for specific businesses is commonplace and growing more costly. Most states today have put in place some type of economic development program to attract and retain businesses. While some state officials have questioned the economic wisdom of this type of competition, there is little likelihood that the states will successfully establish either formal or informal noncompete agreements, because it appears that the incentive to cheat is too great.

The Supreme Court, which has, for the most part, been the surrogate for Congress in preventing activities that interfere with interstate commerce, is not equipped to end this economic war among the states. To the extent that it has power to do so, there is little, if anything, in its decisions to date that suggest that it would.

Only Congress, with its sweeping constitutional powers, particularly under the Commerce Clause, has the ability to end this economic war among the states. And it is time for Congress to act. There is congressional precedence for such action: In 1999, then-Rep. David Minge, Minn., introduced the Distorting Subsidies Limitation Act. This bill would end these harmful subsidies by, in effect, taxing them out of existence. Under the bill, subsidies provided by a state or local government to a particular business—to locate into or remain within that government's jurisdiction—would be taxed at such a level so as to render the subsidy moot. In other words, if subsidies were taxed at 100 percent, for example, they would be rendered ineffective. State and local governments would thus lay down their arms in this escalating economic war, and the resulting truce would benefit all of society. (See Appendix A.)

It is also time for congressional action on a proposal that makes better use of limited public resources for economic development. This proposal has gained national attention in recent years through the introduction of programs at the city, county and state level—early childhood education for at-risk children. Careful academic research demonstrates that tax dollars spent on early-childhood development provide extraordinary returns compared with investments in the public, and even private, sector. Some of these benefits are private gains for the children involved, in the form of higher wages later in life. But the broader economy also benefits because individuals who participate in high-quality early-childhood-development programs have greater skills than they otherwise would, and they're able to contribute productively to their local economies.

The promise of early-childhood programs is based on fundamental facts about early human development. A child's quality of life and the contributions that child makes to society as an adult can be traced to his or her first years of life. From birth until about the age of 5, a child undergoes tremendous development. If this period of life includes support for growth in language, motor skills, adaptive abilities, and social-emotional functioning, the child is more likely to succeed in school and to later contribute to society. Conversely, without proper support during these early years, a child is more likely to drop out of school, depend on welfare benefits, and commit crime—thereby imposing significant costs on society. Early-childhood-development programs recognize this potential—and this risk—and seek to nurture healthy development from the earliest years.

Several longitudinal evaluations all reach essentially the same conclusion: The return on early-childhood-development programs that focus on at-risk families far exceeds the return on other projects that are funded as economic development. Cost-benefit analyses of the Perry Preschool Program, the Abecedarian Project, the Chicago Child-Parent Centers, and the Elmira Prenatal/Early Infancy Project showed returns ranging from $3 to $17 for every dollar invested. This implies an annual rate of return, adjusted for inflation, of between 7 percent and 18 percent (see Appendix B).

The evidence is clear that investments in early-childhood-development programs for at-risk children pay a high public return. Helping our youngest children develop their life and learning skills results in better citizens and more-productive workers. Compared with the billions of dollars spent each year on high-risk economic-development schemes, an investment in early-childhood programs is a far better and far more secure economic-development tool.

For more information on early childhood education as economic development, please visit minneapolisfed.org/research/studies/earlychild/, which includes the following paper, "Early Intervention on a Large Scale."

Endnotes

1. Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511, 523 (1934).

2. Unless the context clearly indicates otherwise, all references to "state" or "states" are intended to include local government units as well. For purposes of the Commerce Clause, it should not make any difference whether subsidies and preferential taxes are offered by states or local governmental units. Most, if not all, subsidies and preferential taxes are offered by the local government under state enabling legislation, and part of the cost of the benefit is, directly or indirectly, borne by the state.

3. For a formal analysis of this proposition, see Thomas Holmes, "The Effects of Tax Discrimination When Local Governments Compete for a Tax Base," Research Department Working Paper 544, Federal Reserve Bank of Minneapolis, 1995.

4. Holmes (1995) finds that, in general, the overall economy is worse off when states use preferential tax treatment to attract or retain businesses. In those cases where the overall economy might be better off, the net gain is very small and turns negative if the tax on immobile firms becomes too high.

5. Most of our discussion about the judiciary's role in effectuating the Commerce Clause concerns the U.S. Supreme Court, which I will sometimes refer to as "the Court." Although the Court reviews only a very small number of all the cases involving the Commerce Clause, its holdings are controlling in the absence of federal legislation on the subject. Occasionally, however, I will make more general references to "the courts," which apply decisions of the Court on the Commerce Clause to the cases before them. The term "the courts" will usually include both federal and state courts. My use of the terms "the Court" and "the courts" is deliberate, and the difference in meaning should be clear from the context within which the term is used.

6. U.S. Const. art. I, sec. 8, cl. 3.

7. West Lynn Creamery, Inc. v. Healy, 114 S. Ct. 2205, 2214 (1994).

8. Metropolitan, 470 U.S. at 879.

9. The term "hold" or "holding" refers to the specific issue being decided by the Court. For example, in the West Lynn Creamery case, the Court held that the Massachusetts tax on fluid milk unconstitutionally discriminated against interstate commerce. The holding of the Court should be distinguished from observations the Court makes in its opinions. Although such observations may be persuasive evidence of how the Court or a particular justice might rule in a future case before the Court, the observation cannot be cited as authority for a legal proposition.

10. See, e.g., Federal Baseball Club of Baltimore, Inc. v. National League of Professional Baseball Clubs, 259 U.S. 200 (1922). In this case, the Court held that professional baseball was exempt from antitrust legislation because it was not engaged in commerce among the states. No one today would seriously argue that professional baseball is not engaged in commerce among the states; nevertheless, the Court has never overturned that decision, in part because Congress has been silent on the issue.

11. McCarroll v. Dixie Lines, Inc., 309 U.S. 176, 189 (1940), (Justices Black, Frankfurter and Douglas dissenting).

12. See United States v. Lopez, 2 F. 3d 1342, 1363 (5th Cir. 1993), cert. granted 114 S. Ct. 1536 (1994).

Appendix A

Distorting Subsidies Limitation Act of 1999 (H.R. 1060)

Introduced by U.S. Rep. David Minge of Minnesota

HR 1060 IH

106th CONGRESS
1st Session
H. R. 1060

To amend the Internal Revenue Code of 1986 to provide that economic subsidies provided by a State or local government for a particular business to locate or remain within the government's jurisdiction shall be taxable to such business, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

March 10, 1999

Mr. MINGE introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1986 to provide that economic subsidies provided by a State or local government for a particular business to locate or remain within the government's jurisdiction shall be taxable to such business, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the `Distorting Subsidies Limitation Act of 1999'.

SEC. 2. FINDINGS.

Congress finds the following:

(1) Competition among State and local governments for new and existing businesses has become the rule rather than the exception.

(2) State and local governments are being forced to compete against each other for businesses with scarce tax dollars that would otherwise be used for essential public goods and services.

(3) When State and local government competition takes the form of preferential treatment for specific businesses, it undermines our national economic union by distorting the allocation of resources.

(4) There is a role for competition between States and localities when it takes the form of general tax policies, regulation structures, and public services because such competition leads States and localities to provide better service, cost effective regulation, sound tax policies, and more efficient allocation of public and private goods.

(5) Federal program grants have been used by State and local governments to subsidize business location decisions to attract

businesses from other States and localities.
(6) Proceeds from tax-exempt municipal bonds have been used by one State or locality to attract business from other States and localities.
(7) No single State or local government can unilaterally withdraw from this competition. Only Congress with its enumerated powers can end the economic distortions and the public costs caused by economic distortions.

SEC. 3. TAXATION OF VALUE OF TARGETED SUBSIDIES PROVIDED BY STATE AND LOCAL GOVERNMENTS.

(a) IN GENERAL- Subtitle D of the Internal Revenue Code of 1986 (relating to miscellaneous excise taxes) is amended by inserting after chapter 44 the following new chapter:

`CHAPTER 45--EXCISE TAX ON TARGETED STATE OR LOCAL GOVERNMENT DEVELOPMENT SUBSIDIES

`Sec. 4986. Targeted State or local government development subsidies.

`SEC. 4986. TARGETED STATE OR LOCAL GOVERNMENT DEVELOPMENT SUBSIDIES.

`(a) GENERAL RULE- There is hereby imposed for each calendar year an excise tax on any person engaged in a trade or business who derives any benefit during such year from any targeted subsidy provided by any State or local governmental unit.
`(b) AMOUNT OF TAX- The tax imposed by subsection (a) shall consist of a tax computed as provided in section 11(b) as though the aggregate value (determined under regulations prescribed by the Secretary) of benefits referred to in subsection (a) accruing during the calendar year were the taxable income referred to in section 11.
`(c) DEFINITIONS- For purposes of this section--
`(1) TARGETED SUBSIDY-
`(A) IN GENERAL- The term `targeted subsidy' means, with respect to any person, any subsidy--
`(i) which is designed to encourage any trade or business operation of such person to locate in a particular governmental jurisdiction or to remain in a particular governmental jurisdiction, or
`(ii) which is reasonably expected to have the effect of a subsidy described in clause (i).
`(B) CERTAIN MORE BROADLY AVAILABLE SUBSIDIES TREATED AS TARGETED SUBSIDIES-
`(i) IN GENERAL- A subsidy shall not fail to be a targeted subsidy by reason of applying to (or being available to) more than 1 trade or business operation if such subsidy is determined (under regulations prescribed by the Secretary) not to be part of the general long-term taxing or spending policies of the governmental unit.
`(ii) GENERAL LONG-TERM POLICIES- A subsidy shall be treated as part of the general long-term taxing or spending policies of the governmental unit only if the subsidy is available to all trade or business operations

within the jurisdiction of such governmental unit without regard to the period during which any operation has been conducted within such jurisdiction.

`(2) SUBSIDY- The term `subsidy' includes--

`(A) any grant,

`(B) any contribution of property or services,

`(C) any right to use property or services, or any loan, at rates below those commercially available to the taxpayer,

`(D) any reduction or deferral of any tax or any fee (including any payment by any State or local governmental unit of any tax or fee),

`(E) any guarantee of any payment under any loan, lease, or other obligation,

`(F) any use of governmental facilities (including roads, facilities for the furnishing of water, sewage facilities, and solid waste disposal facilities) to the extent that the amount paid by (or assessed against the property of) the trade or business for such use is less than the amount it would pay were the charge for its use (or the assessment) determined under the same formula or other basis as is used by the State or local government with respect to other comparable facilities used by other trades or businesses, and

`(G) any other benefit specified in regulations prescribed by the Secretary.

`(d) EXCEPTION FOR SUBSIDIES FOR EMPLOYEE TRAINING AND EDUCATION- No tax shall be imposed by this section on the value of any subsidy provided for employee training or for other education programs.

`(e) SPECIAL RULES-

`(1) EXCEPTION FOR SUBSIDIES PROVIDED TO GOVERNMENTAL ENTITIES- No tax shall be imposed by this section on the value of any subsidy provided to--

`(A) an agency or instrumentality of any government or any political subdivision thereof, or

`(B) any entity which is owned and operated by a government or any political subdivision thereof or by any agency or instrumentality of one or more governments or political subdivisions.

`(2) AVOIDANCE OF DOUBLE TAX- No amount shall be includible in gross income for purposes of subtitle A by reason of any targeted subsidy on which tax is imposed under this section.

`(3) ADMINISTRATIVE PROVISIONS- For purposes of subtitle F, any tax imposed by this section shall be treated as a tax imposed by subtitle A.'

(b) DENIAL OF INCOME TAX DEDUCTION FOR TAX- Paragraph (6) of section 275(a) of such Code is amended by inserting `45,' after `44,'.

(c) CLERICAL AMENDMENT- The table of chapters for subtitle D of such Code is amended by inserting after the item relating to chapter 44 the following new item:

`Chapter 45. Excise tax on targeted State or local government development subsidies.'

(d) EFFECTIVE DATE- The amendments made by this section shall apply to any subsidy which is provided pursuant to an agreement or arrangement entered into more than 30 days after the date of the enactment of this Act.

SEC. 4. DENIAL OF EXEMPTION FROM TAX FOR INTEREST ON BONDS PROVIDING TARGETED STATE OR LOCAL GOVERNMENT DEVELOPMENT SUBSIDIES.

(a) IN GENERAL- Subsection (b) of section 103 of the Internal Revenue Code of 1986 (relating to interest on State and local bonds) is amended by adding at the end the following new paragraph:

`(4) BONDS PROVIDING TARGETED DEVELOPMENT SUBSIDIES- Any bond if any portion of the proceeds of such bond is to be used to provide any targeted subsidy (as defined in section 4986(c)).'

(b) EFFECTIVE DATE- The amendment made by subsection (a) shall apply to obligations issued after the date of the enactment of this Act.

SEC. 5. PROHIBITION OF USE OF FEDERAL FUNDS FOR TARGETED SUBSIDIES.

(a) IN GENERAL- Notwithstanding any other provision of law, none of the Federal funds provided to any State or local government may be used to provide any targeted subsidy (as defined in section 4986(c) of the Internal Revenue Code of 1986).

(b) RECOVERY OF FUNDS USED TO PROVIDE TARGETED SUBSIDIES- If the Secretary of the Treasury or the Secretary's delegate finds after reasonable notice and opportunity for hearing that any State or local government used Federal funds in violation of subsection (a), the Secretary or the Secretary's delegate shall take such actions as are necessary (including referring the matter to the Attorney General of the United States with a recommendation that an appropriate civil action be instituted) to recover the amount so used from the State or local government or the trade or business, whichever the Secretary determines to be appropriate.

(c) EFFECTIVE DATE- This section shall apply to funds provided after the date of the enactment of this Act.

Appendix B

Does preschool have long-term educational and economic benefits?

Research suggests the answer may be YES.

Intensive preschool interventions targeting disadvantaged children have been shown to yield significant gains that may last well into adulthood. Longitudinal studies have been conducted to evaluate the enduring outcomes of several well-known preschool programs.

• Michigan's Perry Preschool program served 123 4-year-olds for two years. Participants have been tracked to age 40.
• North Carolina's Abecedarian preschool served 111 children from age 4 months to 5 years. Participants have been followed to age 21.
• Illinois' Chicago Child-Parent Centers served 1,500 children. Participants have been followed to age 20 .

How did children served by these programs fare later in life?

• They were more likely to stay in the regular classroom and out of special education.
• They were more likely to go through school without repeating a grade.
• They were more likely to complete high school without dropping out.
• As adults, they were more likely to be employed and to have higher earnings.

Athough long-term benefits of such interventions have been demonstrated, the costs of some exemplary programs can be quite high. On an annual per-student basis, the Perry Preschool and Abecedarian programs, respectively, spent about $9,000 and $10,500 (adjusted to 2000 dollars). As a result, some have questioned the cost-effectiveness of such programs and the extent to which they can serve as models for larger-scale interventions.

Citations:

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