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I. INTRODUCTION

This Article surveys selected issues in state business taxation. The topics were chosen with the hope that they would be of general interest to the conference for which this Article originally was prepared. The Article therefore eschews the detailed case analysis that typifies much of the law review writing about state and local taxation—including my own—and focuses instead on broader policy and economic questions that those concerned with state business taxation should find no less important. Part II of this Article considers business taxes and state tax incentives. Part III discusses federal and state tax conformity. Part IV addresses a number of issues that fall under the rubric of economic analysis and state business taxation.

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II. Business Taxes and State Tax Incentives

The assumption (or the assertion) that state business taxes affect choices in business location typically informs debates over state business tax policy. Concerned state legislators as well as business lobbyists frequently contend that if the state enacts a tax, raises a tax rate, or denies a tax incentive, business will locate in some other jurisdiction with a friendlier tax climate. Massachusetts' erstwhile sobriquet of "Taxachusetts"[1] was not, after all, a term of corporate endearment.

Anecdotal evidence suggests that talk of taxes and business location may not be mere rhetoric. Perhaps the most significant illustration of this phenomenon in recent years has arisen out of the controversy over worldwide unitary combination of multicorporate, multinational enterprises. For years the states and the business community have been at loggerheads over the justifiability and constitutionality of the states' efforts to require corporations to report their income on a worldwide basis. In *Container Corporation of America v. Franchise Tax Board*[2] the Supreme Court ended the constitutional debate over this issue by upholding California's worldwide combined approach to the taxation of an American corporation carrying on a unitary business with its foreign subsidiaries.[3]

Freed of constitutional restraint, some state legislatures initially responded by enacting legislation embracing worldwide unitary combination.[4] But pressure from business lobbyists, who predicted dire economic consequences for states that jumped on (or failed to jump off) the worldwide unitary combination bandwagon led to a dramatic reversal of this trend.[5] Florida, which had adopted worldwide unitary combination after *Container*,[6] changed

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1. *See* Pomp, *A New York Perspective on Tax Incentives: The Role of State Tax Incentives in Attracting and Retaining Business*, 1985 MULTISTATE TAX COMM. REV. 1, 6 (1985).

2. 463 U.S. 159 (1983).

3. The Court limited its decision in *Container* to a worldwide combination of multicorporate enterprises with an American parent. The Court, however, did not pass on "the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." 463 U.S. at 189 n.26.

4. *See* J. HELLERSTEIN & W. HELLERSTEIN, STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES ¶ 8.14[2] at S 194 (Cum. Supp. 1986).

5. *Id.*

6. FLA. STAT. ANN. § 220.135 (West Supp. 1986); *see* ENGLAND, *Commentary on Florida Unitary Tax Legislation*, 3 INTERSTATE TAX REP., Oct. 1983, p. 1.

course and repealed its worldwide unitary legislation.[7] Intense pressure from the business community, which stressed the adverse impact that worldwide unitary combination would have on business location, was responsible for the change.[8] Oregon likewise abandoned worldwide unitary combination at a special legislative session called by the Governor for that very purpose.[9] Oregon's action reportedly spurred foreign investment in the state.[10] Akio Morita, Chairman and chief executive officer of Sony Corporation, predicted that "[i]f California does repeal the unitary tax, . . . investment from Japan would dramatically increase there."[11]

Minnesota's experience in the early 1960s provides an even more striking example of the perceived link between state tax policy and business location.[12] The demands of two world wars had depleted the supply of iron ore in Minnesota's Mesabi range, and in the 1940s the iron mining industry undertook a global search for other possible sources of supply.[13] Although Minnesota's iron ore industry still provided eighty-three percent of the nation's requirements in 1950, the state's contribution had fallen to forty-two percent by 1960.[14] Moreover, the quality of Minnesota's iron ore, as determined by its natural iron ore content, was lower than that of competing foreign ores.

In addition to iron ore, however, Minnesota possessed vast reserves of taconite. Taconite contains iron bearing particles, but in its natural state taconite is not merchantable as iron ore and requires extensive processing to make it merchantable.[15] Although development of Minnesota's taconite resources has become economically feasible, the state's historical pattern of heavy mineral taxation was viewed as an obstacle to further development of Minnesota's taconite industry. In 1961 the Minnesota legislature con-

7. 1984 Fla. Laws, ch. 84-549, § 1 (codified at FLA. STAT. ANN. §§ 220.03 - 220.131 (West Supp. 1986)).

8. *See* TAX NOTES Nov. 7, 1983, at 502.

9. 1984 Or. Laws, Ch. 1, 2d Spec. Sess.

10. Kristoff, *Investment in Oregon Spurred by Tax Repeal*, N.Y. Times, Dec. 17, 1984, at D1, Col. 1.

11. DAILY TAX REP. (BNA), Jan. 18, 1986, p. G-4.

12. The discussion of Minnesota's experience with tax incentives is taken from W. HELLERSTEIN, STATE AND LOCAL TAXATION OF NATURAL RESOURCES IN THE FEDERAL SYSTEM: LEGAL, ECONOMIC, AND POLITICAL PERSPECTIVES 198-99 (1986).

13. Weaton, *The History of Minnesota Mining as Influenced by Taxation* in SYMPOSIUM ON MINE TAXATION 7-26 (1969).

14. *Id.*; *see also* Hamilton, *Taxes and Taconite: Iron Ore Tax Legislation in the Lake Superior Region*, 7 NAT'L TAX J. 342 (1954).

15. MINN. STAT. ANN. § 298.23 (West 1972).

sidered a proposed constitutional amendment designed to create a healthier tax climate by limiting taxes on taconite. The liberal majority defeated the amendment.[16]

The proposal for a taconite amendment soon became a major political issue in Minnesota. Conservatives argued that tax relief was necessary to attract the taconite industry to the state. Liberals replied that a restraint on the state's tax power would sell Minnesota's "birthright to its natural heritage."[17] In 1963 a conservative legislature adopted a proposed taconite amendment and posed the following question to the voters of the state: "Shall the constitution of the State of Minnesota be amended by . . . prohibiting the amendment, modification, or repeal for a period of 25 years of [l]aws . . . relating to the taxation of taconite and semitaconite, and the facilities for mining, production, and beneficiation thereof . . .?"[18] The liberal elements in the state, which were represented by the Democratic Farm Labor Party, opposed the amendment until Senator Hubert Humphrey induced the Party to change its stand.[19] With both liberal and conservative backing, the amendment passed with a greater than eighty percent majority.[20] Within twenty-four hours after the voters approved the amendment, the United States Steel Corporation and the Hanna Mining Company announced that they would begin constructing new taconite plants in Minnesota within two weeks.[21] Taconite has since become Minnesota's commercially most significant mineral.

Despite sporadic anecdotal evidence linking industrial location and state tax policy, the overwhelming weight of empirical research concludes that state and local taxes generally have little if any effect on industrial location decisions. This is the key finding of the illuminating report on state taxes and business location prepared by the staff of the New York Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law.[22] The Commission based the report on a review of over

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16. Weaton, *supra* note 13, at 7-27.
17. *Id.* at 7-29.
18. *Id.* see MINN. CONST. art. X, § 6 for the text of the amendment.
19. Weaton, *supra* note 13, at 7-28.
20. *Id.*
21. *Id.*
22. Report of the New York Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law, "Interstate Business Locational Decisions and the Effect of the State's Tax Structure on After-Tax Rates-of-Return of Manufacturing Firms" 7 (Preliminary Report, Decemher 31, 1984) (mimeographed). The ensuing discussion draws heavily from this Report.

thirty years of research on this subject, which amounted to more than one hundred papers, articles, and reports.[23] The report should be required reading for anyone concerned with the role of state tax incentives in affecting business location, especially for those charged with state business tax policymaking.

Beyond the central conclusion that state business taxes do not play a significant role in determining where businesses locate, the Commission makes a number of other critical observations that underlie its conclusion. The Commission points out that many nontax factors, the importance of which easily can outweigh interstate variations in state taxes, are crucial to state business location decisions. These factors include plant or site availability; access to financing; access to and cost of transportation; quality and cost of labor; proximity to markets; the cost of utilities; proximity to supplies; proximity to other company facilities; the regulatory environment; the quality of a state's schools, colleges, and universities; the cost of housing; the level of public services; and other amenities that determine the quality of life in a particular location.[24] Individually, any one of these factors can dwarf state taxes as a consideration for businesses choosing a location. Taken cumulatively, these factors almost invariably overwhelm state tax considerations.

The Commission further observes: (1) the deductibility of state and local taxes from the federal corporate income tax base reduces the burden of state taxes and the impact of interstate tax differences; (2) differences in state and local taxes may reflect differences in the level or quality of public services that affect business location decisions; (3) low taxes may not necessarily attract businesses if the low taxes mean that firms will have to supply at their own expense services and facilities that the public sector supplies in other states; (4) if low taxes mean inferior schools, a state may lack the educated labor force that is essential to certain businesses; (5) because most companies that relocate plan to stay at their new sites longer than any group of officials is likely to stay in office, the reliability and the significance of any current tax concession are limited; (6) if tax incentives are effective at all, a state will gain only a short-run advantage because other states will follow suit with their own tax incentives; and (7) many factors other than tax levels, including zoning regulations, public officials' attitudes, red tape, state assistance, and stability and uniformity in business

23. *Id.* (Executive Summary).

24. *Id.* at 2-5.

taxation, contribute to perceptions about a state's business climate.[25]

In short, despite the public officials' concern with the importance of state tax incentives to business location decisions, the empirical evidence indicates that state taxes have little impact on these decisions. The lesson for business tax policymakers should be apparent. As the New York report declared:

> The use of tax incentives as a tool for attracting business should be de-emphasized, to reduce waste, slippage, and inefficiency in the tax system. The money that would be raised from eliminating ineffective provisions could be used to finance rate reductions in the corporate and the personal income taxes and to finance programs that are more effective at facilitating economic development.[26]

III. FEDERAL AND STATE CONFORMITY

A central problem for state business tax policymakers—at least in those states with broad based corporate income taxes—is the question of conformity to the federal tax base. Conformity can assume a variety of forms. In its purest form, the state tax amounts simply to a percentage of the federal tax.[27] The states, however, generally have been unwilling to take such an all-embracing approach to conformity.[28] More frequently, the states adopt various elements of the federal tax base, such as "gross income" or "taxable income," and require taxpayers to make adjustments to this tax base according to the dictates of state tax policy[29] and the requirements of federal law.[30]

The advantages of state conformity to the federal tax base are that conformity simplifies tax preparation and facilitates tax compliance.[31] "Pressure from taxpayers for easing compliance and au-

25. *Id.* (Executive Summary).

26. *Id.*

27. *See, e.g.*, NEB. REV. STAT. § 77-2715 (Supp. 1985) (tax rate for individuals), § 77-2734.02 (Cum. Supp. 1984) (tax rate for corporations).

28. J. HELLERSTEIN, STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES ¶ 7.2 at 266 (1983).

29. *Id.*, ¶ 7.2[1] at 267.

30. Because federal law prohibits states from taxing income from federal obligations, 31 U.S.C. § 3124 (1982), the States must permit taxpayers to reduce their federal tax base by the amount of that income.

31. Angelini & Horvitz, *Federal-State Policy Differentials: Why Piggybacking Will Never Work*, 4 J. STATE TAX. 125 (1985). The Federal-State Tax Collection Act of 1972, 26 U.S.C. §§ 6361-6365 (1982), increased the incentives for states to conform their personal income taxes to the federal model. In substance, the Act provides that a state with a "qualified state individual income tax," *i.e.*, a tax closely conforming to the federal model, 26 U.S.C. § 6362, may enter into an agreement with the United States to have the state's indi-

diting burdens has been the prime force responsible for the very wide conformity of the State corporate net income measures to Federal taxable income . . . ."[32] Although administratively convenient, conforming the state corporate tax base to the federal corporate tax base raises fundamental issues of state tax policy, issues that have assumed greater importance in recent years because of the major shifts in federal corporate tax policy.

At a general level, the most frequently stated policy concern raised by federal-state conformity is loss of autonomy by the states in fashioning their own tax systems.[33] The loss of autonomy, of course, varies with the degree and nature of conformity. A state whose tax provisions closely mirror the Internal Revenue Code on a continuing basis plainly suffers a greater loss of autonomy than a state that adopts particular federal provisions as they exist on a particular date but does not take account of future changes in the Internal Revenue Code. A state that adopts the latter course, however, fails to reap the principal benefits of continuing conformity—simplicity and ease of compliance. The truth of this statement becomes painfully clear to anyone who attempts to comply with the income tax requirements of a state like Georgia, which has adopted the Internal Revenue Code as it existed on January 1, 1981, without subsequent modification.[34] Dealing with Georgia's tax requirements has led this writer to conclude that a little conformity, like a little knowledge, can be a dangerous thing.

A state loses autonomy by conforming to the Internal Revenue Code because Congress, not the state legislatures, is making the critical determinations regarding the definition of tax base and taxable income—decisions about such matters as deductions, credits, depreciation, and capital gains. Moreover, by conforming to the federal tax base, the states could lose fiscal control as well. Thus, the State of Nebraska, which bases its tax on a percentage of federal tax liability,[35] estimated that the Tax Reform Act of 1969 would cost the state almost nineteen million dollars in lost revenue, with such losses accelerating annually.[36] The Accelerated Cost

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vidual income taxes collected and administered by the federal government. *Id.* § 6363. As of this writing, no state has, in fact, entered into such an agreement. *See generally*, Stolz & Purdy, *Federal Collection of State Individual Income Taxes*, 1977 DUKE L.J. 59 (examining the arguments for and against conformity).

32. J. HELLERSTEIN, *supra* note 28, ¶ 7.2[1] at 267.

33. *See generally* Stolz & Purdy, *supra* note 31.

34. GA. CODE ANN. § 48-1-2(14) (Supp. 1984).

35. *See supra* note 27.

36. O. OLDMAN & F. SCHOETTLE, STATE AND LOCAL TAXES AND FINANCE 675 (1974).

Recovery System (ACRS),[37] which Congress enacted as part of the Economic Recovery Tax Act of 1981,[38] affects states conforming to federal depreciation rules even more dramatically. Estimates of losses increasing from 500 million dollars annually in 1981 to 8.8 billion dollars by 1986[39] sent shock waves through many state capitols. As a result, many states unhitched themselves from the Internal Revenue Code, at least with respect to ACRS.[40]

Beyond the broad question whether a state should accede to congressional determinations of business tax policy and the revenue considerations that this accession may entail, federal-state tax conformity raises a host of specific policy issues. The federal income tax allows a deduction for all qualifying charitable contributions, but might not a state legitimately limit this deduction to contributions to charities that benefit the state? Particular provisions of the federal income tax (such as ACRS) may be designed to promote broad national goals such as economic growth, price stabilization, national defense and security, and income redistribution. When deciding whether to adopt these provisions, states must determine whether to embrace these national goals as a matter of state tax policy or to adjust them to state-specific concerns, and, if so, how to make the appropriate adjustment. Furthermore, a myriad of state goals, such as maintaining a high level of environmental quality or supporting a particular local industry, cannot be pursued by blind reliance on the federal tax code.

An appreciation of the difficulties that state business policymakers confront in addressing questions of federal-state conformity can best be gained by considering an example of one state's effort to come to grips with this question. We are again fortunate in having the contribution of the New York Tax Study Commission,[41] which provided the material on tax incentives discussed above.[42] One of the Commission's reports addressed the specific question, "Should New York Adopt ACRS?"[43] Because adoption of ACRS would have resulted in substantial revenue loss to the state,

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37. I.R.C. § 168 (1982).

38. Pub. L. No. 97-34, § 201, 95 Stat. 172, 203 (1981).

39. J. HELLERSTEIN, *supra* note 28, at ¶ 7.2[1] p. 268.

40. *Id.*

41. The Commission's formal name is the New York Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law.

42. *See supra* notes 22-26 and accompanying text.

43. New York Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law, "The Article 9-A Franchise Tax: Should New York Adopt ACRS?" (Decemher 31, 1984) (mimeographed).

New York decoupled its tax provisions from the federal ACRS provisions.[44] The Commission considered whether or not New York should remain decoupled.

The Commission's conclusions, which reflect the tension between revenue impacts, policy concerns, and administrative considerations, effectively illustrate the problems a state faces in pursuing the course of federal-state conformity, as well as the problems a state faces in not pursuing conformity.[45] Concerning revenue impacts, the Commission concluded that New York would incur losses of approximately one billion dollars for taxable years 1985 through 1987 if it adopted ACRS. Most of the revenue loss would come from property that corporations owned in other states and not from investments in New York. Regarding state-specific policy concerns, the Commission concluded that adoption of ACRS was unlikely to have a significant impact on investment in the state. The Commission therefore recommended that if New York adopted ACRS, it should be limited to New York investments. The Report, however, did not dwell on the possible constitutional flaws in such a limitation.[46] Finally, concerning simplicity and ease of compliance, the Commission observed that adoption of ACRS would provide both taxpayers and the tax department with a simpler and more administrable tax law. The Commission was quick to point out, however, that the goals of simplicity and administrability conflicted with the goal of encouraging capital investment in New York and that if a New York taxpayer did business in other states that had decoupled from ACRS, the gain in simplicity might not be substantial.

IV. Economic Analysis and State Business Taxation

It is difficult to overstate the impact that economic analysis has had on legal scholarship and, to a lesser extent, on judicial decisionmaking in the past fifteen years—the time that has elapsed since the publication of the first edition of Richard Posner's *Economic Analysis of Law*.[47] The influence of economic analysis has been strongly felt on the state tax field. To be sure, economists have long been interested in problems of state and local taxation,

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44. *Id.* (Executive Summary).

45. The conclusions set forth in the ensuing paragraph appear in the executive summary and are elaborated in the body of the report.

46. *See* Michael, *The Constitutionality of Minnesota's Business Tax Credits After* Westinghouse Electric Corp., 4 J. State Tax. 163 (1985).

47. R. Posner, Economic Analysis of Law (1972).

and lawyers have long been involved with the study of public finance. Over the past few years, however, the concern of distinguished economists, such as Charles McLure, with the economic implications of the *legal* issues raised by state taxation has increased;[48] the dialogue between lawyers and economists over critical issues of state tax policy has intensified;[49] and the courts have begun to take more explicit account of the economic analysis of state tax problems than in the past.[50] This section explores several recent examples of this phenomenon in the context of state business taxation.

A. *State Tax Exportation*[51]

Tax exportation is a concept more familiar to economists than to lawyers. Of late, however, it is a concept to which lawyers have turned with increasing frequency in connection with the restraints that the federal system imposes, or should impose, on state taxation. Lawyers who mounted the constitutional attack on Montana's thirty percent severance tax on coal invoked state tax exportation as their rallying cry.[52] Lawyers who challenged Louisiana's first use tax on natural gas based their constitutional claim in part on the charge that Louisiana designed the tax to be exported to residents of other states.[53] Congressional hearings devoted to proposed limitations on state severance taxes focused on state tax exportation in

48. *See, e.g.*, McLure, *Tax Exporting and the Commerce Clause*, in C. McLure & P. Mieszkowski, Fiscal Federalism and the Taxation of Natural Resources 169 (1983); McLure, *Incidence Analysis and the Supreme Court: An Examination of Four Cases From the 1980 Term*, 1 Sup. Ct. Econ. Rev. 69 (1982).

49. *See, e.g.*, McLure, *Operational Interdependence is not the Appropriate 'Bright Line Test' of a Unitary Business—At least Not Now*, Tax Notes, Jan. 10, 1983, at 107; J. Hellerstein, *The Basic Operations Interdependence Requirement of a Unitary Business: A Reply to Charles E. McLure, Jr.*, Tax Notes, Feb. 28, 1983, at 723; McLure, *The Basic Operational Interdependence Test of a Unitary Business: Rejoinder*, Tax Notes, Oct. 10, 1983, at 91.

50. *See infra* notes 68-102 and accompanying text.

51. This section draws freely from W. Hellerstein, *supra* note 12, chs. 4 and 5, and W. Hellerstein, *Constitutional Limitations on State Tax Exportation*, 1982 Am. Bar Found. Res. J. 1.

52. *See, e.g.*, Brief for Appellants at 8, Commonwealth Edison Co. v. Montana, 453 U.S. 609 (1981); Brief for Amici Curiae Congressman Robert W. Edgar, *et al.*, at 2, *Commonwealth Edison* 453 U.S. at 609.

53. *See, e.g.*, Exceptions of tbe Plaintiff States and Brief in Support of Exceptions at 10-12, 28-31, Maryland v. Louisiana, 451 U.S. 725 (1981); Exception of the United States and the Federal Energy Regulatory Commission and Brief in Support of Exception at 38-42, *Maryland*, 451 U.S. at 725.

considering whether and how to legislate in this area.[54] The issues associated with state tax exportation, however, extend far beyond special excises on natural resources. Because any state tax may be borne by residents of other states in our highly integrated national economy, the problem of state tax exportation pervades virtually every aspect of the diverse tax structures that characterize state taxing systems. Although few would question that Nevada's tax on gambling or New York's tax on stock transfers can be exported, even local property taxes may be borne by residents of other states.

1. The Theory of State Tax Exportation[55]

To the extent nonresidents bear a state tax, the tax is said to be exported. Determining the precise extent to which a tax is exported requires identification of the tax's economic incidence on a geographic basis. This necessitates a determination whether the tax is absorbed by the taxpayer named in the taxing statute or is instead shifted. Answering this question in turn requires a consideration of the nature of the tax and the circumstances under which the tax is imposed. The nature of the tax is significant because the propensity of a tax to be shifted varies according to the type of levy involved. The circumstances under which a tax is imposed are significant because those circumstances influence the shifting and geographic movement of taxes.

The legal issues associated with state exportation have arisen largely in connection with state severance taxes on natural resources, and it is therefore appropriate to focus this discussion on such levies. Assume that a state imposes a coal severance tax of one dollar per ton payable by coal producers on every ton of coal produced in the state. Assume also that most of that coal is shipped and consumed outside the taxing state. When the state imposes the tax, the coal producing firms in the state will perceive

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54. *Coal Severance Tax: Hearing on S. 2695 Before the Senate Comm. on Energy and Natural Resources*, 96th Cong., 2d Sess. (1980); *Coal Severance Taxes: Hearings on H.R. 6625, H.R. 6654, and H.R. 7163 Before the Subcomm. on Energy and Power of the House Comm. on Interstate and Foreign Commerce*, 96th Cong., 2d Sess. (1980).

55. The following discussion owes much to the work of Charles McLure, whose pioneering work in this area has laid the foundation for much of what has followed. In addition to the references cited *supra* note 48; see McLure, *Market Dominance and the Exporting of State Taxes*, 34 NAT'L TAX J. 483 (1981); McLure, *Economic Constraints on State and Local Taxation of Energy Resources*, 31 NAT'L TAX J. 257 (1978) [hereinafter *Economic Constraints*]; McLure, *The Interstate Exporting of State and Local Taxes: Estimates for 1962*, 20 NAT'L TAX J. 49 (1967).

the tax as an increased cost of producing coal. Whether residents or nonresidents of the taxing state will bear the tax depends on a number of considerations, including the following:

(1) *Does the taxing state dominate the market for the taxed resource?* A critical factor in a state's ability to export its tax burden is the degree of dominance that the state enjoys in the relevant market. Market dominance depends on factors such as the geographic extent of the product market, the taxing state's percentage of the supply of taxed goods to nonlocal markets, and the industrial structure of the market. If the state imposing the one dollar per ton coal severance tax were responsible for only a small portion of national coal production, it is unlikely, under competitive market conditions, that the state would be able to export the tax to out-of-state consumers through higher prices charged by the taxing state's producers. Competition from untaxed coal producers in other states would largely preclude the taxing state's producers from raising their prices. In the short run, the tax likely would be borne principally by the taxing state's coal producing firms. These firms face an essentially fixed price for their coal and, therefore, must accept net proceeds that are lower roughly by the amount of the tax.[56] In the long run, the owners of the coal probably would bear the tax. If the producers or owners happened to be nonresidents of the taxing state, the severance tax would be exported, but not to out-of-state *consumers*, as is sometimes assumed.

(2) *Is the demand for the resource elastic?* Even if the taxing state dominates the market for the taxed resource, it by no means follows that the state can export its severance tax burden to out-of-state consumers. For forward shifting to occur, the demand for the resource must be relatively inelastic, that is, an increase in the price of the resource must give rise to a comparatively smaller decrease in the demand for the resource.[57] The demand for most natural resources depends primarily on the demand for other products that require the resource as a production input and is therefore a

56. This reasoning assumes, among other things, that no contractual arrangements or regulatory requirements desigued to produce a different result are in place.

57. The elasticity of demand (or supply) measures the sensitivity of the quantity of a product desired by consumers (or offered by producers) to a change in that product's price. More technically, the elasticity of demand is the percentage change in quantity demanded that is induced by a one percent change in price; the elasticity of supply is the percentage change in quantity supplied that is induced by a one percent change in price. If tbe elasticity of demand (or supply) is large, demand (or supply) is said to be relatively elastic. Conversely, if the elasticity is small, demand (or supply) is said to be inelastic.

"derived demand."[58] The theory of derived demand teaches that the elasticity of demand for such a resource will vary with the elasticity of the demand for the products the resource is used to produce, the cost of the resource as a percentage of the final product's total cost, and the difficulty of finding substitutes for the resource.

Applying the analysis to the hypothetical coal severance tax, then, requires determining the elasticity of demand for products for which coal is an important resource (for example, electricity or steel), the relative cost of coal in comparison to other costs that are elements in the total cost of the final product (for example, transportation), and the difficulty of substituting other products for coal in producing the final product (for example, oil). Substitutability bears not only on the determination of the elasticity of demand for a product; it also relates to the consideration of the taxing state's dominance of the relevant market. Thus, if coal is considered as a source of energy, competition from other energy resources is a factor both in determining the taxing state's dominance in the relevant market for the taxed resource and in determining the elasticity of the demand for the taxed resource.

(3) *How mobile are the productive factors involved in the taxed activity?* Even if a state dominates the market for a taxed product and even if the demand for the product is relatively inelastic, a tax on that product is less likely to be exported to the extent that producers can relocate the factors of production beyond the tax collector's grasp. The obvious immobility of natural resources would enhance a state's ability to export a tax, such as the hypothetical coal tax, on their production. Whether labor engaged in coal production is mobile depends on factors such as training, tradition, and the availability of alternative employment. To the extent that labor is mobile, jobs in the coal extracting industry, rather than the coal severance tax, would tend to be exported. Capital tends to be extremely mobile between states and industries in the long run, although it may be geographically immobile in the short run.[59] Thus, the extent to which capital can be made to bear the burden of a production tax may depend simply on the relevant time frame.

(4) *What is the relevant time frame?* The extent to which a state will be able to export its severance tax depends in part on the

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58. McLure, *Economic Constraints*, *supra* note 55, at 257-58.
59. *Id.* at 258.

applicable time frame—short run or long run.[60] Because it takes time for capital and labor markets to adjust to price changes and because contractual restraints, for example, may insulate an economic actor from the impact of a tax during the term of the contract, the immediate effects of a tax may be different from its long-term impact. Hence, if contractual arrangements between coal producers and their utility customers allocate the production tax burden to the latter (who, in turn, pass the tax on to local consumers through established rate-making principles), a state may have considerable ability in the short run to export its severance tax burden to out-of-state consumers. In the long run, however, when existing contractual arrangements no longer control the allocation of the severance tax burden, out-of-state consumers are less likely to bear the production tax for the reasons discussed above. In sum, because "[b]oth supply and demand tend to be less elastic in the short run than in the longer run,"[61] the states possess greater power to export their taxes to nonresident producers or consumers in the short run than in the long run.[62]

(5) *Other factors*. Other factors that affect the likelihood that a state can export its severance tax burden include the industrial structure of the market,[63] government regulation,[64] collusion or conscious parallelism among states in their tax policies,[65] the existence of long-term contracts between producers and their customers (for example, utilities) regarding the allocation of the production tax burden,[66] and transportation costs that tend to segment the market.[67]

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60. McLure, *Incidence Analysis and the Supreme Court: An Examination of Four Cases From the 1980 Term*, *supra* note 48, at 76-77 (1982).

61. *Id.* at 76.

62. *See* D. PHARES, WHO PAYS STATE AND LOCAL TAXES? 64-82 (1980); McLure, *The Interstate Exporting of State and Local Taxes: Estimates for 1962*, *supra* note 55, at 49.

63. McLure, *Economic Constraints*, *supra* note 55, at 258.

64. Government regulation of resource prices, for example, either may facilitate tax exportation to out-of-state consumers by permitting a pass-through of severance taxes or may restrain exportation by requiring producers to bear the burden of such a tax. *Cf. Maryland*, 451 U.S. at 725.

65. If states collude, their collective market dominance will increase, which will increase their potential ability to export their tax burden. McLure, *Tax Exporting and the Commerce Clause*, in C. McLURE & P. MIESZKOWSKI, *supra* note 48, at 174-77.

66. In the Montana severance tax case, the plaintiffs alleged that out-of-state utilities were required to purchase coal from Montana producers and to reimburse the producers for any severance taxes the state imposed upon such coal. Complaint of Commonwealth Edison Co., at ¶¶ 13-17, Commonwealth Edison Co. v. Montana, No. 42657 (D. Mont. 1978).

67. *See* Shelton & Vogt, *The Incidence of Coal Severance Taxes: Political Perceptions and Economic Realities*, 22 NAT. RESOURCES J. 539 (1982).

2. State Tax Exportation, the Commerce Clause, and the Supreme Court

In *Commonwealth Edison Co. v. Montana*[68] a number of coal companies and their out-of-state utility customers attacked Montana's thirty percent coal severance tax on the ground that the tax violated the commerce clause. The plaintiffs claimed that because Montana was excessively exporting its tax burden to residents of other states, the state's tax discriminated against interstate commerce. The Court observed, however, that it was not confronted with the typical allegation of "differential tax treatment of interstate and intrastate commerce,"[69] which had led the Court to find unconstitutional tax discrimination in other cases. Rather, "the gravamen of appellants' claim [was] that a state tax must be considered discriminatory for purposes of the Commerce Clause if the tax burden is borne primarily by out-of-state consumers."[70]

The Court was unwilling to characterize the "assertion that Montana may not 'exploit' its 'monopoly' position by exporting tax burdens to other States"[71] as a claim of discrimination. In part, this conclusion stemmed from the Court's rejection of the taxpayers' premise that "the Commerce Clause gives residents of one State a right of access at 'reasonable' prices to resources located in another State that is richly endowed with such resources, without regard to whether and on what terms residents of the resource-rich state have access to the resources."[72] In addition, however, the conclusion was rooted deeply in the Court's "misgivings about judging the validity of a state tax by assessing the State's 'monopoly' position or its 'exportation' of the tax burden out of State."[73] The Court elaborated on these "misgivings" in the following terms:

> The threshold questions whether a State enjoys a "monopoly" position and whether the tax burden is shifted out of State, rather than borne by in-state producers and consumers, would require complex factual inquiries about such issues as elasticity of demand for the product and other alternative sources of supply. Moreover, under this approach, the constitutionality of a state tax could well turn on whether the in-state producer is able, through sales contracts or otherwise, to shift the burden of the tax forward to its out-of-state

68. 453 U.S. 609 (1981). In the interest of full disclosure, it should be noted that I played a substantial role in drafting the briefs for the State of Montana in the *Commonwealth Edison* case. The thoughts expressed here, of course, are entirely my own and do not necessarily represent those of the State of Montana.

69. *Id.* at 618.

70. *Id.*

71. *Id.* at 619.

72. *Id.*

73. *Id.* at 618.

customers. As the Supreme Court of Montana observed, "[i]t would be strange indeed if the legality of a tax could be made to depend on the vagaries of the terms of contracts." It has been suggested that the "formidable evidentiary difficulties in appraising the geographical distribution of industry, with a view toward determining a state's monopolistic position, might make the Court's inquiry futile."[74]

The Court's refusal to embrace a doctrine of excessive state tax exportation as part of its commerce clause jurisprudence was wise. As the earlier discussion demonstrates, the economics of state tax exportation are sufficiently complex to justify, if not to compel, the conclusion that state tax exportation is an inappropriate instrument for constitutional adjudication. Moreover, even if after canvassing such issues as the state's dominance of the relevant market, the geographic mobility of the factors of production, and the elasticity of demand for a taxed product, a court could determine the extent to which a state exported a tax, the court still would have to determine whether the amount of the tax exported satisfied some judicially cognizable standard of fairness that would relate the amount of a tax to the value of the benefits provided to the taxpayer. Defining such a standard might be impossible if one includes within the universe of relevant benefits the intangible and long-range value of maintaining civilized society.

The economics of state tax exportation also suggest that the underlying reality may be quite different from the picture of state tax exportation that has captured the popular imagination. The political rhetoric invoking images of "blue-eyed Arabs" in the energy-rich states who exploit their locational advantages to exact tribute from shivering energy consumers in the Northeast and Midwest rests on some questionable economic assumptions, at least in the long run. Furthermore, because all states export their taxes and all state taxes are exported,[75] a constitutional principle limiting state tax exportation would have a virtually unlimited sweep and would embroil the courts in endless controversies that they may be incapable of resolving.

B. *State Taxes on Federal Contractors*

Although the Court declined the invitation to constitutionalize the concept of excessive state tax exportation in large part because of the difficulty of the economic issues involved, the Court has

74. *Id.* at 619-20 n.8 (citations omitted).

75. *See* D. PHARES, *supra* note 62; McLure, *The Interstate Exporting of State and Local Taxes: Estimates for 1962, supra* note 55.

been more willing to engage in applied economics with respect to other state tax issues. State taxation of federal contractors is a case in point. The supremacy clause bars the states from imposing taxes whose *legal* incidence falls on the federal government.[76] The clause, however, does not bar the states from imposing taxes whose *economic* incidence falls on the federal government.[77] This somewhat curious combination of constitutional principles has led to a problem that arises in the following general form. A state has a general taxing scheme whose legal incidence falls on a class of taxpayers that would include the federal government in the absence of the supremacy clause. In order to include the constitutionally exempt transaction or property in the state tax base, the state shifts the legal incidence of the tax, insofar as it would fall on the federal government, to a private party who deals with the federal government. The question then becomes whether a tax that discriminates on its face against the federal government in apparent violation of the supremacy clause (because the tax falls only on those who deal with the federal government) is nevertheless constitutionally tolerable in light of the existence of taxes that allegedly impose an equivalent burden on those who do not deal with the federal government.

In approaching this question, the Court often frames the issue as one of economic equivalence: is the tax that the state imposes on the private-sector property or transaction economically equivalent to the tax that the state imposes on the public-sector property or transaction? If so, the state's taxes do not discriminate against the federal government. This approach requires that the Court make critical economic assumptions. For example, in holding that taxes on private lessees of federal property did not discriminate against the federal government in *United States v. City of Detroit*[78] and in *United States v. County of Fresno*,[79] the Court assumed that lessors pass on to their lessees the burden of property taxes. *City of Detroit* involved a local property tax levied against private parties who used tax-exempt property for business purposes. In rejecting the claim that the tax singled out lessees of tax exempt property for discriminatory treatment in violation of the supremacy clause, the Court explained that the legislature was merely "trying to equate the tax burden imposed on private enter-

76. *See* Kern-Limerick, Inc. v. Scurlock, 347 U.S. 110 (1954).
77. *See* Alabama v. King & Boozer, 314 U.S. 1 (1941).
78. 355 U.S. 466 (1958).
79. 429 U.S. 452 (1977).

prise using exempt property with that carried by similar businesses using taxed property. Those using exempt property are required to pay no greater tax than that placed on private owners *or passed on by them to their business lessees*."[80]

In *County of Fresno* the Court quoted this language[81] in rebuffing a claim of discrimination raised by a group of United States Forest Service employees whom California taxed on the value of their possessory interests in federally owned housing in national forests. After quoting the language from *City of Detroit*, the Court observed that California imposed a property tax on owners of nonexempt property that those owners passed on to their lessees. Therefore, the appellants, who rented from the Forest Service, were no worse off under California's tax laws than those employed in the private sector.[82]

Although no member of the Court challenged its economic analysis in *City of Detroit*,[83] Justice Stevens, who dissented from the Court's opinion in *County of Fresno*, took issue with the Court's assumption that the lessor's property tax was necessarily passed on to the lessees. Justice Stevens argued:

> The discrimination between the federal employee and the private tenant is not eliminated by the fact that the *owner* of the private residence pays a real estate tax which the Federal Government does not. The private owner's tax obligation is one of the factors that determines the fair rental value of his property—and no doubt, the fair rental value of Government-owned property as well—but it is not correct to say that the owner's tax is paid by the tenant.[84]

In fact, neither the Court's assumption that a lessor automatically shifts the burden of property taxes to the lessee nor Justice Stevens' suggestion that the Court's approach oversimplified the question even began to capture the complexity of the tax incidence issues. As noted above in the context of state tax exportation,[85] the economic incidence of a tax depends on a variety of factors, including supply and demand elasticities, the structure of the market,

80. 355 U.S. at 473-74 (emphasis added).

81. 429 U.S. at 465 (emphasis in original).

82. *Id.*

83. The dissents from the Court's opinion in *City of Detroit* were not directed at the Court's incidence assumption. 355 U.S. at 475-83 (Whitaker, J., dissenting).

84. 429 U.S. at 470. (Stevens, J., dissenting). For this reason and others, Justice Stevens concluded that the possessory interest tax on federal employees violated the supremacy clause. *See* Hellerstein, *State Taxation and the Supreme Court: Toward a More Unified Approach to Constitutional Adjudication?*, 75 MICH. L. REV. 1426, 1440-41 (1977). Justice Stevens, however, was a lone dissenter in *County of Fresno*.

85. *See supra* notes 55-67 and accompanying text.

and the relevant time frame. Economists disagree on whether forward shifting is possible,[86] although the view that it is not "has gained increasing acceptance among economists in recent years."[87] Moreover, it is the "standard view" among economists that a landowner cannot shift a tax on land value to any other party.[88] As one economist has succinctly summarized the matter, there is simply "no short answer to the question 'Who bears the burden of the property tax?' "[89]

In its 1983 decision in *Washington v. United States*,[90] the Court took a less dogmatic approach to the issue of tax incidence in holding that Washington's sales and use tax on federal contractors did not discriminate against the federal government. The Court's analysis focused explicitly on whether a Washington tax on purchases by federal contractors, when considered in conjunction with the state's exaction on sales by private contractors, was discriminatory with regard to the resulting economic burdens.[91] The Court did not make a specific determination of the tax's economic incidence because it believed that, if all other things were equal, market forces would produce an identical distribution of tax burdens in the public and the private sectors. The Court believed that

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86. The "old view" of the property tax incidence holds that owners of capital are able to shift the burden of such taxes onto consumers of goods and services produced by the taxed property. *See* H. AARON, WHO PAYS THE PROPERTY TAX? A NEW VIEW (1975); McLure, *The "New View" of the Property Tax: A Caveat*, 30 NAT'L TAX J. 69 (1977); Mieszkowski, *The Property Tax: An Excise or a Profits Tax*, 1 J. PUB. ECON. 73 (1972); Netzer, *The Incidence of the Property Tax Revisited*, 26 NAT'L TAX J. 515 (1973). The "new view" of property tax incidence, on the other hand, holds that forward shifting is not possible and that owners of capital bear the tax in the form of a reduced rate of return. McLure, *supra*, at 69.

87. R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE (4th ed. 1984). The answer to the question whether the property tax is shifted arguably should depend on the context in which the question is raised. Charles McLure has suggested that, if one is examining the question from a national perspective, "the property tax on improvements is borne, on the average, by owners of capital." McLure, *supra* note 86, at 70. On the other hand, if one is examining the impact of an increase in a local property tax in a particular jurisdiction, one would conclude that the tax is "borne, in some combination, by consumers of locally produced goods and services not subject to competition from outside the locality and by owners of geographically immobile factors, such as land and perhaps labor." *Id.* Because the Court seems to be concerned with the incidence of the property tax on lessors and lessees in light of the levy's broad application throughout the United States, and not merely with the incidence of an increase in property taxes in a particular jurisdiction, the national perspective appears to be more relevant to the Court's inquiry.

88. Heilbrun, *Who Bears the Burden of the Property Tax*, in THE PROPERTY TAX AND LOCAL FINANCE 57, 58 (C. Harris ed. 1983).

89. *Id.* at 57.

90. 460 U.S. 536 (1983).

91. *Id.* at 544.

the appropriate question was whether a contractor who considered working for the federal government would face a cost he would not incur were he to do the same work for a private party.

> If he works for the Federal Government, the contractor is required to pay a tax on the material he buys. The contractor will count the tax among his costs in setting a price for the Government. Depending on his bargaining power, he may pass some or all of the tax on to the Federal Government when he sets his price. If he works for a private party, the contractor is required to collect the tax from the purchaser and remit it to the State. The purchaser will count the tax as part of the price of the building. Depending on his bargaining power, the contractor may reduce his price to make up for some or all of the tax the purchaser must pay. If the tax is the same, and the parties have the same bargaining power, the amounts the purchasers pay and the amounts the contractors receive will be identical in the two cases. Thus, it makes no difference to the contractor (or to the purchasers) which of them is required to pay the tax to the State, so long as they have the opportunity to allocate the burden among themselves by adjusting the price.[92]

Although the Court's analysis is theoretically unassailable, the analysis runs into some trouble if the supremacy clause requires that state taxes do not discriminate *in fact* against the federal government.[93] Justice Blackmun remarked in his dissent that it is highly improbable that "a federal contractor has the same amount of bargaining power with the Federal Government as his private counterpart has with his contractual partner."[94] Hence, as a practical matter, the federal government may be able to require a contractor to absorb a greater portion of the tax on its purchases than the private contractor absorbs of the tax on its sales. Although the resulting discrimination is a function of economic rather than legal considerations, the discrimination is no less real. Moreover, because the taxes in question are not functionally equivalent—the private contractor collects a tax on the full price of the construction project at its completion, the federal contractor pays a tax on the construction materials as it purchases them—their economic impacts may differ. Under Washington's system, the state required the federal contractor to pre-pay additional tax money as the project progressed, to maintain special records, to hire personnel to keep those records, and to prepare and file returns. Because satisfying these requirements is expensive, their cost could exceed what

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92. *Id.* at 541-42 n.4.

93. Ample authority supports the proposition that the supremacy clause bars actual, not merely theoretical, discrimination against the federal government. *See* Phillips Chemical Co. v. Dumas Indep. School Dist., 361 U.S. 376 (1960).

94. 460 U.S. at 555 n.4 (Blackmun, J., dissenting).

would be the tax increment on labor and profit.[95]

Economic analysis no doubt will continue to influence the Court's decisions in cases involving state taxation of federal contractors. One can only hope that the Court will apply the pertinent economic principles with more sensitivity to those principles' complexity than the Court has displayed in the past.

C. Right to a Refund of Unconstitutional Taxes: The Passing-On Defense

The economics of tax incidence recently has come to occupy center stage in a controversy over a taxpayer's right to a refund of unconstitutional taxes. In *Bacchus Imports, Ltd. v. Dias*[96] the Supreme Court struck down an exemption for locally produced alcoholic beverages from an excise tax on the wholesale sale of liquors. The tax plainly discriminated against interstate commerce by providing a direct commercial advantage to local business.

Perhaps the most interesting question that *Bacchus* raises is one that the Court left unresolved. The state claimed that even if the taxpayers prevailed on the merits, they were not entitled to a refund of the tax because they allegedly had passed the economic burden of the tax on to others. The state relied on *United States v. Jefferson Electric Co.*[97] for this proposition. *Jefferson Electric* involved a federal tax refund statute that required taxpayers to demonstrate, as a predicate to recovery, that they bore the economic burden of the tax. The taxpayers in *Bacchus* claimed that they were entitled to a full refund of the levy because they were legally liable for the tax and that, in any event, the commerce clause required a refund. The Court, however, observed that the state courts had not addressed the refund issues, which essentially were "issues of remedy for the imposition of a tax that unconstitutionally discriminated against interstate commerce."[98] The Court further noted that the federal constitutional issues may be intertwined with state law issues and that resolution of those issues would require a more complete record. Therefore, the Court re-

95. *Id.* at 554.

96. 468 U.S. 263 (1984). In the interest of full disclosure, I should note that I have participated and continue to participate in the litigation over the refund issues raised in the *Bacchus* case as counsel to McKesson Corporation. Because of my ongoing role in this litigation, I deliberately bave limited my discussion to a description of tbe issues and have refrained from expressing an opinion on their appropriate resolution.

97. 291 U.S. 386 (1934).

98. 468 U.S. at 277.

fused to address the issues and reversed and remanded the judgment of the Supreme Court of Hawaii.[99]

On remand to the Hawaii Supreme Court, the parties filed extensive briefs on the issue of the appropriate remedy. The briefs considered whether the commerce clause precedents and policies required a full refund of the tax regardless of who bore its economic burden and whether courts are capable of determining the complex tax incidence questions that would require resolution if a taxpayer's right to a refund depended on the extent to which the taxpayer bore the economic burden of the tax.[100] Instead of writing an opinion on the merits of these questions, the Hawaii Supreme Court issued a brief remand order sending the case back down to the Hawaii Tax Court.[101] The order instructed the Tax Court to consider (1) the factual issues of the competitive effect, if any, that the tax exemptions imposed on the profits, pricing, and sales of the wholesalers; (2) the degree, if any, that the wholesalers shifted the economic burden of the tax backward to their suppliers or forward to their customers; and (3) the damages,if any, that the wholesalers sustained as a result of the exemptions.[102] At this writing, these and related issues are being litigated in the Hawaii Tax Court.

V. CONCLUSION

This brief survey of selected state business tax issues may have raised more questions than it has answered. Despite the well-documented conclusion that state tax incentives generally do not affect business location decisions, anecdotal evidence that appears inconsistent with this conclusion and pressure by business lobbyists no doubt will continue to fuel the controversy over the wisdom of such incentives. The conflict over federal-state tax conformity likewise will continue because of the basic tension between simplicity and administrability on the one hand and state autonomy and revenue concerns on the other. The role of economic analysis in the legal battles over state business taxes will remain controversial. Legal scholars, practitioners, and courts increasingly will recognize the value of the analytical insights that economics can bring to

99. *Id.*

100. *See*, Opening Brief of Plaintiff-Appellant Foremost-McKessan, Inc.; Opening Brief of Defendant-Appellee, Herbert M. Dias in Bachas Imports, Ltd. v. Dias, No. 7802 (filed April 22, 1985) (Hawaii).

101. Order of Remand, Bacchus Imports, Ltd. v. Dias, No. 7802, Supreme Court of Hawaii (Oct. 4, 1985).

102. *Id.*

bear on state tax problems. They may conclude, however, that the complexity and uncertainty that accompany the practical application of economic principles—particularly in the area of tax incidence—often will preclude reliance on those principles as a solution to legal problems.