

# Commerce Clause Restraints on State Business Development Incentives

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# COMMERCE CLAUSE RESTRAINTS ON STATE BUSINESS DEVELOPMENT INCENTIVES

*Walter Hellerstein† & Dan T. Coenen††*

INTRODUCTION .....	790
I. STATE TAX INCENTIVES .....	793
A. State Tax Incentives as State Tax Discrimination: General Principles .....	793
B. State Tax Incentives as State Tax Discrimination: Case Law .....	794
1. Boston Stock Exchange .....	794
2. Bacchus .....	796
3. Westinghouse .....	797
4. New Energy .....	801
C. State Tax Incentives as State Tax Discrimination: Analysis .....	802
1. <i>Giving the Court's Language Full Sway</i> .....	802
2. <i>Alternative Readings of the Court's Opinions</i> .....	804
a. <i>The Justification for a More Restrained            Approach</i> .....	804
b. <i>The In-State Favoritism/State-Coercion Rationale</i> .....	806
c. <i>The Penalizing-Activity-in-Other-States Rationale</i> .....	813
D. State Tax Incentives as State Tax Discrimination: Specific Implications .....	816
1. <i>Income Tax Incentives</i> .....	817
a. <i>Credits</i> .....	817
b. <i>Deductions</i> .....	818
c. <i>Apportionment Formulas</i> .....	820
2. <i>Property Tax Incentives</i> .....	825
3. <i>Sales and Similar Transaction Tax Incentives</i> .....	829
II. SUBSIDIES .....	834
A. <i>West Lynn Creamery</i> and Subsidies .....	836
B. The Teachings of Precedent and Policy on the Constitutionality of Ordinary Subsidies .....	838
1. <i>Supreme Court Precedent</i> .....	839

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a.	West Lynn Creamery .....	839
b.	<i>Pre-West Lynn Creamery Subsidy Cases</i> .....	840
c.	<i>The Market-Participant Cases</i> .....	845
2.	<i>Policy</i> .....	846
C.	Subdividing Subsidies (I): Looking at Who Gets the Subsidy .....	848
1.	<i>The "Ordinary" Business Subsidy</i> .....	849
2.	<i>The Targeted New-Business Subsidy</i> .....	849
3.	<i>The Targeted "Stay at Home" Subsidy</i> .....	853
D.	Subdividing Subsidies (II): Looking at How the Subsidy Is Structured .....	855
1.	<i>Infrastructure Improvements</i> .....	856
2.	<i>Educational Benefits</i> .....	857
3.	<i>Below-Market Leases and Land Sales</i> .....	858
4.	<i>Land Giveaways</i> .....	860
5.	<i>Flat-Amount Cash Subsidies</i> .....	862
6.	<i>The Per-Unit Subsidy</i> .....	863
7.	<i>Loan Forgiveness</i> .....	865
8.	<i>User Fee Exemptions</i> .....	866
III.	TAX BREAKS, SUBSIDIES, AND LEGAL THEORY .....	868
	CONCLUSION .....	870
	APPENDIX: PROCEDURAL ISSUES RAISED BY CHALLENGES TO TAX	
	INCENTIVES AND SUBSIDIES .....	871
	A. Tax Incentives .....	871
	B. Subsidies .....	873

## INTRODUCTION

The states' provision of governmental incentives to encourage industrial development within their borders has long been a feature of American political and economic life. These incentives have assumed a wide variety of forms, ranging from tax abatements and credits to below-market leases and outright cash subsidies. Today, every state provides tax and other economic incentives as an inducement to local industrial location and expansion.<sup>1</sup> Scarcely a day passes without some state offering yet another incentive to spur economic development,<sup>2</sup> often in an effort to attract a particular enterprise to the state.<sup>3</sup>

<sup>1</sup> See Mark L. Nachbar et al., *Income Taxes: State Tax Credits and Incentives*, Tax Mgmt. (BNA) No. 1180 (Jan. 26, 1996); Mark Taylor, Note, *A Proposal to Prohibit Industrial Relocation Subsidies*, 72 TEX. L. REV. 669, 679 (1994).

<sup>2</sup> See, e.g., ME. REV. STAT. ANN. tit. 36 §§ 6651-6659 (West 1995) (reimbursing taxpayers for local property taxes paid on new business machinery and equipment).

<sup>3</sup> See, e.g., 1993 Ala. Acts 93-851 (the so-called "Mercedes-Benz legislation"), discussed in Harriet Hanlon, *Steel or Steal? Gulf States Challenges Alabama's Tax Incentives*, 9 ST. TAX NOTES 923 (1995).

The debate over the efficacy and wisdom of state business development incentives is intense and important.<sup>4</sup> Arrayed against the persistent pleas that financial incentives are essential to a state's economic growth is a large body of evidence that incentives have little effect on industrial location decisions.<sup>5</sup> In addition, one must weigh the perceived economic benefits associated with such incentives—additional jobs and investment—against the economic dangers they may engender—misallocation of resources and inefficient selection of beneficiaries.<sup>6</sup> Opposition to state tax incentives has spawned at least one proposal for a sweeping federal prohibition on their use.<sup>7</sup>

Our purpose is not to enter this fray; instead, it is to consider the thorny legal questions these incentives raise under the Federal Constitution.<sup>8</sup> The most perplexing question arises under the dormant commerce clause: how is a constitutionally benign incentive designed to attract industry to a state to be distinguished from an unconstitutionally discriminatory incentive designed to do the same thing? This question reflects a palpable tension in the Supreme Court's decisions. On the one hand, the Court has sustained (or implicitly approved) programs adopted by states—particularly in the form of subsidies—intended to encourage business activities inside their borders. On the other hand, the Court has invalidated (or implicitly condemned) state programs—particularly in the form of tax incentives—intended to accomplish precisely the same result.

The Court's rhetoric reveals this tension. The Court has observed that “[d]irect subsidization of domestic industry does not or-

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<sup>4</sup> See Walter Hellerstein, *Selected Issues in State Business Taxation*, 39 VAND. L. REV. 1033, 1034-38 (1986).

<sup>5</sup> See James A. Papke, *Interjurisdictional Business-Tax Cost Differentials: Convergence, Divergence, and Significance?*, 9 ST. TAX NOTES 1701 (1995) (casting doubt on proposition that general tax incentives can have a decisive impact on investment location decisions); Richard D. Pomp, *The Role of State Tax Incentives in Attracting and Retaining Business: A View from New York*, 29 TAX NOTES 521, 525 (1985) (concluding, after extensive review of the literature, that business tax incentives play only an insignificant role in attracting or maintaining in-state firms and probably result in a needless loss of state revenue). *But see* William J. Barrett IV, Note, *Problems with State Aid to New or Expanding Businesses*, 58 S. CAL. L. REV. 1019, 1024-25 (1985) (citing FORTUNE study showing practical importance of business incentives).

<sup>6</sup> See WILLIAM SCHWEKE ET AL., *BIDDING FOR BUSINESS* 35 (1994) (noting the weight of scholarly opinion against using development incentives to attract new industry); Taylor, *supra* note 1, at 678-92 (concluding that industrial relocation subsidies are undesirable from an economic and political standpoint).

<sup>7</sup> See Nathan Newman, *Proposition 13 Meets the Internet: How State and Local Government Finances Are Becoming Roadkill on the Information Superhighway*, 9 ST. TAX NOTES 927, 933-34 (1995) (proposing federal prohibition on “subsidy abuse” by local governments in competition for business).

<sup>8</sup> *Maready v. City of Winston-Salem*, 467 S.E.2d 615, 626 (N.C. 1996) (“To date, courts in forty-six states have upheld the constitutionality of governmental expenditures and related assistance for economic development incentives” against state constitutional attack.).

dinarily run afoul' of the negative Commerce Clause."<sup>9</sup> But the Court has also held that at least some subsidy programs offend the Commerce Clause anti-discrimination principle.<sup>10</sup> The Court has declared that its decisions "do[ ] not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry."<sup>11</sup> The Court, however, has also disapproved state tax measures designed to achieve that very objective on the ground that they "foreclose[ ] tax-neutral decisions"<sup>12</sup> and " 'provid[e] a direct commercial advantage to local business.' "<sup>13</sup>

In this Article, we explore the ill-defined distinction between the constitutional carrot and the unconstitutional stick in state tax, subsidy, and related cases. Part I examines the restraints that the Commerce Clause imposes on state tax incentives. It canvasses the general principles limiting discriminatory state taxation, explores the Court's decisions addressing state tax incentives, and proposes a framework of analysis for adjudicating the validity of such incentives. Part I concludes by considering the constitutionality of a variety of state tax incentives within our suggested framework and also under alternative approaches that courts might utilize.

Part II examines the restraints that the Commerce Clause imposes on state subsidies. It begins with a consideration of the Court's seminal case in this field, *West Lynn Creamery, Inc. v. Healy*.<sup>14</sup> After demonstrating that *West Lynn Creamery* does not jeopardize ordinary business subsidies, Part II considers the constitutionality of subsidies along two dimensions. First, it looks at subsidies in terms of their intended beneficiaries, focusing on whether it matters for Commerce Clause purposes that the subsidy targets a particular firm rather than a general class of businesses. Second, it evaluates whether the particular form the subsidy takes—for example, a cash grant, a property transfer, or a user fee waiver—alters the constitutional calculus in applying the dormant commerce clause. Part II concludes that neither the target nor the form of the subsidy ordinarily makes a difference. Rather, discriminatory subsidies, unlike discriminatory tax breaks, are almost always constitutional.

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<sup>9</sup> *West Lynn Creamery, Inc. v. Healy*, 114 S. Ct. 2205, 2214 n.15 (1994) (alteration in original) (quoting *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988)).

<sup>10</sup> See *West Lynn Creamery*, 114 S. Ct. at 2211-14 (invalidating Massachusetts milk-producer subsidy program, closely connected with the state's milk tax). Part II.A, *infra*, discusses the *West Lynn Creamery* decision at length.

<sup>11</sup> *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 336 (1977).

<sup>12</sup> *Id.* at 331.

<sup>13</sup> *Id.* at 329 (quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959)).

<sup>14</sup> 114 S. Ct. 2205 (1994).

In Part III, we consider the theoretical underpinnings of the strong tax-break/subsidy distinction that permeates this field. We suggest that this distinction resonates with the law's deep regard for considerations of form. We observe, in particular, that the distinction may grow out of the same "cautionary function" that helps explain many rules that require use of specified formal structures to achieve legally enforceable results in the private-law context.<sup>15</sup>

## 1

## STATE TAX INCENTIVES

A. State Tax Incentives as State Tax Discrimination:  
General Principles

The prohibition against state taxes that discriminate against interstate commerce has been a fundamental tenet of the Court's Commerce Clause jurisprudence from the very beginning.<sup>16</sup> The concept of discrimination, however, is not self-defining, and the Court has never precisely delineated the scope of the doctrine that bars discriminatory taxes. Nonetheless, the central meaning of discrimination as a criterion for adjudicating the constitutionality of state taxes on interstate business emerges unmistakably from the Court's decisions: a tax which by its terms or operation imposes greater burdens on out-of-state goods, activities, or enterprises than on competing in-state goods, activities, or enterprises will be struck down as discriminatory under the Commerce Clause.

State tax incentives, whether in the form of credits, exemptions, abatements, or other favorable treatment<sup>17</sup> typically possess two features that render them suspect under the rule barring taxes that discriminate against interstate commerce. First, state tax incentives single out for favorable treatment construction, investments, or other activities that occur within the taxing state. For example, when South Carolina afforded BMW a sales tax exemption on all machinery ac-

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<sup>15</sup> Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 800 (1941). In an appendix to this Article, we briefly explore the remedial and procedural implications of the rules we have advanced.

<sup>16</sup> See *Welton v. Missouri*, 91 U.S. 275 (1875).

<sup>17</sup> In this Article, we use the term "tax incentive" to embrace any provision designed to encourage new or expanded business activity in the state, which (1) seeks to induce the taxpayer to take action it might not otherwise take if the tax were constructed according to generally accepted principles of sound tax policy (economic neutrality, administrability, and equity) and (2) is not an inherent part of the tax structure. Accordingly, the typical business expense deduction in an income tax or sale-for-resale exemption in a retail sales tax is not a "tax incentive" as that term is ordinarily understood, because such a deduction or exemption is an essential structural feature of an income tax or a retail sales tax. If the deduction or exemption were granted on a more favorable basis to in-state than to out-of-state activity, however, it might lose its character as an essential structural feature of the tax and would therefore amount to a "tax incentive." See *infra* part I.D.1.b.

quired for the company's new multi-million dollar facility, the State did so only because BMW located that facility in South Carolina. Indeed, if state tax incentives were not limited to in-state activities, they would hardly be worthy of the appellation "state" tax incentives.

Second, state tax incentives, as integral components of the state's taxing apparatus, are intimately associated with the coercive machinery of the state. They therefore fall comfortably within the universe of state action to which the Commerce Clause is directed. Although "[t]he Commerce Clause does not prohibit all state action designed to give its residents an advantage in the marketplace,"<sup>18</sup> it plainly applies to "action of that description *in connection with the State's regulation of interstate commerce.*"<sup>19</sup> And the Court has recognized in scores of cases that state tax laws affecting activities carried on across state lines are "plainly connected to the regulation of interstate commerce."<sup>20</sup>

## B. State Tax Incentives as State Tax Discrimination: Case Law

The Court's treatment of state tax incentives suggests that the constitutional suspicion surrounding such measures is well justified. Over the past two decades, the Court has considered four taxing schemes involving measures explicitly designed to encourage economic activity within the state.<sup>21</sup> In each case, the Court invalidated the measure. Moreover, the Court did so with rhetoric so sweeping as to cast a constitutional cloud over all state tax incentives.

### 1. Boston Stock Exchange

In *Boston Stock Exchange v. State Tax Commission*,<sup>22</sup> the Court considered a New York stock transfer tax that included an incentive

<sup>18</sup> *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988).

<sup>19</sup> *Id.* (emphasis in original).

<sup>20</sup> *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 114 S. Ct. 1345, 1354 n.9 (1994); see also *Massachusetts v. United States*, 435 U.S. 444, 455 (1978) ("a tax is a powerful regulatory device"); *Walling v. Michigan*, 116 U.S. 446, 455 (1886) ("A discriminating tax . . . is, in effect, a regulation in restraint of commerce among the States . . .").

<sup>21</sup> See *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269 (1988); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984); *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984); *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318 (1977). During this time frame, the Court has considered many other cases involving allegations of state tax discrimination. None, however, involved measures deliberately designed to encourage business location or expansion within a state, even though, in effect, they may have encouraged in-state business operations. See, e.g., *Associated Indus. of Mo. v. Lohman*, 114 S. Ct. 1815 (1994) (striking down statewide use tax on goods purchased outside the state insofar as use tax exceeded sales tax on goods purchased within state); *Oregon Waste Sys.*, 114 S. Ct. 1345 (1994) (striking down a tax on in-state disposal of out-of-state waste, which was higher than the tax on in-state disposal of in-state waste); *American Trucking Ass'n, Inc. v. Scheiner*, 483 U.S. 266 (1987) (striking down flat highway taxes, which imposed higher per mile burden on interstate than upon intrastate trucks).

<sup>22</sup> 429 U.S. 318 (1977).

designed to assist the New York brokerage industry. The transfer tax applied to "all sales, or agreements to sell, or memoranda of sales and all deliveries or transfers of shares or certificates of stock" in New York.<sup>23</sup> Because the "bulk of stock transfers . . . funnels through New York,"<sup>24</sup> New York's stock transfer tax applied to the lion's share of stock *transfers*, regardless of where the stock *sale* occurred. In order to encourage nonresident stock sellers and sellers of large blocks of stock to effectuate their sales through New York—rather than out-of-state brokers, New York amended the statute to offer these sellers a tax break. In lieu of the tax that had previously applied uniformly to the transfer of securities through a New York stock transfer agent without regard to the situs of the sale, New York provided a reduced stock transfer tax for these sellers if they made their sales through New York brokers.

The Court found that this reduction in tax liability, designed to encourage in-state business activity, offended the Commerce Clause nondiscrimination principle. Prior to the statute's amendment, "the New York transfer tax was neutral as to in-state and out-of-state sales"<sup>25</sup> because, regardless of where the sale occurred, the same tax applied to all securities transferred through a New York transfer agent. The amendment, however, "upset this equilibrium"<sup>26</sup> because a seller's decision as to where to sell would no longer be made "solely on the basis of *nontax* criteria."<sup>27</sup> Instead, a seller would be induced to trade through a New York broker to reduce his or her transfer tax liability.

By providing a tax incentive for sellers to deal with New York rather than out-of-state brokers, the State had, in the Court's eyes, "foreclose[d] tax-neutral decisions."<sup>28</sup> Moreover, New York had done so through the coercive use of its taxing authority. As the Court noted, "the State is using its power to tax an in-state operation as a means of 'requiring [other] business operations to be performed in the home State.'"<sup>29</sup>

Because tax incentives, by their nature, are designed to "foreclose tax-neutral decisions" by bringing "tax criteria" to bear on business decisionmaking, courts could easily interpret *Boston Stock Exchange* to mean that a constitutional infirmity afflicts every state tax incentive. Perhaps for this reason, the Court was moved to note that its "decision

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<sup>23</sup> N.Y. Tax Law § 270.1 (McKinney 1966).

<sup>24</sup> *Boston Stock Exch.*, 429 U.S. at 327 n.10 (quoting PUBLIC PAPERS OF GOVERNOR NELSON A. ROCKEFELLER 553 (1968)).

<sup>25</sup> *Id.* at 330.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 331 (emphasis added).

<sup>28</sup> *Id.* (emphasis added).

<sup>29</sup> *Id.* at 336 (alteration in original) (quoting *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 145 (1970)).



. . . does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry."<sup>30</sup> The Court did not explain, however, how states could effectively pursue this objective under the constraints of the reasoning in *Boston Stock Exchange*. If a state may not "use discriminatory taxes to assure that nonresidents direct their commerce to businesses within the State,"<sup>31</sup> and "discriminatory taxes" include those that reduce the effective tax rate when taxpayers conduct economic activity inside rather than outside the state's borders, the effectiveness of tax policy as a means "to encourage the growth and development of intrastate commerce and industry" would be severely curtailed.<sup>32</sup>

## 2. Bacchus

In *Bacchus Imports, Ltd. v. Dias*,<sup>33</sup> the Court confronted a Commerce Clause challenge to an exemption from Hawaii's excise tax on wholesale liquor sales for certain locally-produced alcoholic beverages. It was "undisputed that the purpose of the exemption was to aid Hawaiian industry."<sup>34</sup> The exemption for one of the beverages at issue—a brandy distilled from the root of an indigenous Hawaiian shrub—was intended "to encourage and promote the establishment

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<sup>30</sup> *Id.* at 336.

<sup>31</sup> *Id.* at 334-35.

<sup>32</sup> The Court drew upon the reasoning of *Boston Stock Exchange* to invalidate a state tax in *Maryland v. Louisiana*, 451 U.S. 725 (1981). *Maryland v. Louisiana* is not a "tax incentive" case in the sense of the cases discussed in the text, however, because the provisions at issue were designed to insulate local business from the economic impact of a new exaction rather than to encourage new or expanded business activity in the state. The case nevertheless reinforces the teachings of the tax incentive cases that a state may not impose a tax on specified activities and then provide a credit against or reduction of the tax if the taxpayer engages in other local activities. In *Maryland v. Louisiana*, the Court held that Louisiana's First-Use Tax on natural gas, which applied to gas extracted from the Outer Continental Shelf (OCS) and subsequently "used" in Louisiana, unconstitutionally discriminated against interstate commerce because various credits and exclusions available only to local interests effectively immunized local interests from the tax. The Court's condemnation of the First-Use Tax credit against the state's severance tax, which is paid only by those who sever gas in Louisiana, would similarly condemn any such credit specifically designed to encourage economic development in the state:

On its face, this credit favors those who both own OCS gas and engage in Louisiana production. The obvious economic effect of this Severance Tax Credit is to encourage natural gas owners involved in the production of OCS gas to invest in mineral exploration and development within Louisiana rather than to invest in further OCS development or in production in other States.

*Id.* at 756-57 (footnote omitted). By thus denouncing the levy's inducement for firms to shift business activities into the state, *Maryland v. Louisiana* (like the cases discussed in the text) renders constitutionally suspect the whole range of state tax incentives. See also *Halliburton Oil Well Cementing Co. v. Reilly*, 373 U.S. 64 (1963) (invalidating use tax that encouraged taxpayers to locate their activities in the taxing State).

<sup>33</sup> 468 U.S. 263 (1984).

<sup>34</sup> *Id.* at 271.

of a new industry.”<sup>35</sup> The exemption for the other beverage—pine-apple wine—was “intended “to help” stimulate “the local fruit wine industry.”<sup>36</sup>

These lofty purposes, however, could not sanctify a tax incentive that unmistakably defied the prohibition against taxes that favor in-state over out-of-state products. The Court explained that, however legitimate the goal of stimulating local business might be, “the Commerce Clause stands as a limitation on the means by which a State can constitutionally seek to achieve that goal.”<sup>37</sup> The means the State chose in *Bacchus*—taxing out-of-state but not in-state products—could not have been more offensive to the Commerce Clause’s nondiscrimination principle. It was “irrelevant to the Commerce Clause inquiry that the motivation of the legislature was the desire to aid the makers of locally produced beverage rather than to harm out-of-state producers.”<sup>38</sup>

The Court in *Bacchus* recognized that “a State may enact laws pursuant to its police powers that have the purpose and effect of encouraging domestic industry”<sup>39</sup> and even declared “that competition among the States for a share of interstate commerce is a central element of our free-trade policy . . . .”<sup>40</sup> The Court also stated, however, that “the Commerce Clause limits the manner in which States may legitimately compete for interstate trade.”<sup>41</sup> But beyond reiterating the ban on discriminatory taxation and applying it to strike down the Hawaii tax, the Court offered no new counsel on how far the Commerce Clause prohibition extends.

### 3. Westinghouse

*Westinghouse Electric Corp. v. Tully*<sup>42</sup> provides particularly useful instruction regarding the constitutionality of state tax incentives because the case involves the most common form of tax incentive, an income tax credit. *Westinghouse* arose out of New York’s response to Congress’s provision of tax incentives for American corporations to increase their exports. In 1971, Congress accorded preferred status to any entity that qualified as a “Domestic International Sales Corpora-

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<sup>35</sup> *Id.* at 270 (quoting *In re Bacchus Imports, Ltd.*, 656 P.2d 724, 730 (Haw. 1982) (quoting S.L.H. 1960, c. 26, Sen. Stand. Comm. Rep. No. 87, *in* 1960 Senate Journal, at 224)).

<sup>36</sup> *Id.* (quoting *In re Bacchus Imports, Ltd.*, 656 P.2d 724, 730 (Haw. 1982) (quoting S.L.H. 1976, c. 39, Sen. Stand. Comm. Rep. No. 408-76, *in* 1976 Senate Journal, at 1056)).

<sup>37</sup> *Id.* at 271.

<sup>38</sup> *Id.* at 273.

<sup>39</sup> *Id.* at 271.

<sup>40</sup> *Id.* at 272.

<sup>41</sup> *Id.*

<sup>42</sup> 466 U.S. 388 (1984).

tion" (DISC).<sup>43</sup> Under the federal tax laws, DISCs were not taxable on their income, and their shareholders were taxable only on a portion of such income. If New York had incorporated the federal DISC legislation into its corporate income tax, it would have suffered a substantial loss of revenue.<sup>44</sup> On the other hand, if New York had sought to tax DISC income in full, it risked discouraging the manufacture of export goods within the state.<sup>45</sup>

With these conflicting considerations in mind, New York enacted legislation that did two things. First, the legislation provided that a DISC's income should be combined with the income of its parent for state tax purposes. Second, in an effort to "provide a positive incentive for increased business activity in New York State,"<sup>46</sup> the legislation granted a partial credit for the parent against the tax on the income attributable to the DISC. The parent's maximum credit was determined by applying seventy percent of the parent's tax rate to the parent's share of the DISC income, as apportioned to New York by the parent's business allocation percentage.<sup>47</sup> (In substance, this lowered the effective tax rate on DISC income taxable by New York to 30% of the otherwise applicable rate.) The maximum credit figure, however, was then adjusted to reflect the DISC's "New York export ratio"<sup>48</sup>—the ratio of the DISC's receipts from New York export shipments to its receipts from all export shipments. For example, if 100% of the DISC's exports were shipped from New York, the parent could claim the full credit and in effect pay 30% of the otherwise applicable rate on the DISC income. If, however, only 50% of the DISC's exports were shipped from New York, the parent could claim only one-half of the maximum credit and would pay taxes on DISC income at 65% of the applicable rate.

It was this latter aspect of the credit—its limitation by reference to the DISC's New York export ratio—that proved to be constitutionally fatal. The New York State Tax Commission contended that "multiplying the allowable credit by the New York export ratio . . . merely ensures that the State is not allowing a parent corporation to claim a

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<sup>43</sup> I.R.C. §§ 991-997 (1994). In 1984, Congress largely repealed the DISC legislation and replaced it with special provisions governing new entities it described as "Foreign Sales Corporations" (FSCs). I.R.C. §§ 921-927 (1994).

<sup>44</sup> *Westinghouse*, 466 U.S. at 392.

<sup>45</sup> *Id.* at 392-93.

<sup>46</sup> *Id.* at 393 (quoting NEW YORK STATE DIVISION OF THE BUDGET, REPORT ON A. 12108-A AND S. 10544 (May 23, 1972), reprinted in Bill Jacket of 1972 N.Y. Laws, ch. 778, at 18).

<sup>47</sup> A corporation's New York business allocation percentage, which is employed to determine the amount of a multistate taxpayer's income that is fairly attributable to New York, is determined by taking the average of the ratio of the taxpayer's property, payroll, and receipts in New York to its total property, payroll, and receipts wherever located. N.Y. Tax Law § 210(3)(a) (McKinney 1986 & Supp. 1996).

<sup>48</sup> *Westinghouse*, 466 U.S. at 394.

tax credit with respect to DISC income that is not taxable by . . . New York."<sup>49</sup> The Court responded:

This argument ignores the fact that the percentage of the DISC's accumulated income that is subject to New York franchise tax is determined by the parent's business allocation percentage, not by the export ratio. In computing the allowable credit, the statute requires the parent to factor in its business allocation percentage. This procedure alleviates the State's fears that it will be overly generous with its tax credit, for once the adjustment of multiplying the allowable DISC export credit by the parent's business allocation percentage has been accomplished, the tax credit has been fairly apportioned to apply only to the amount of the accumulated DISC income taxable to New York. From the standpoint of fair apportionment of the credit, the additional adjustment of the credit to reflect the DISC's New York export ratio is both inaccurate and duplicative.<sup>50</sup>

Although this analysis of the propriety of reducing the credit by reference to the DISC's New York export ratio may seem technical, it lies at the heart of *Westinghouse* and is critical to understanding *Westinghouse's* implications for the constitutionality of state income tax incentives. In effect, the Court was saying that New York had provided the only kind of DISC income tax credit it could constitutionally offer when it lowered the effective tax rate on accumulated DISC income apportioned to New York.<sup>51</sup> In other words, the credit had to be apportioned to New York on the same basis that the DISC income was apportioned to New York, so that the effective New York tax rate on DISC income, though lower than the effective New York tax rate on other income, would not vary depending on the amount of the taxpayer's DISC activity in New York.

When New York took the additional step of limiting the credit by reference to the DISC's New York export ratio, it was tying the credit to New York activities in a manner that no longer corresponded evenhandedly to the DISC income being taxed. Rather, the effective New York tax rate on the DISC income being taxed (*i.e.*, the DISC income apportioned to New York by the parent's business allocation percentage) varied directly with the extent of the taxpayer's New York DISC-related activities. The greater the percentage of a DISC's export shipments from New York, the greater the relative credit<sup>52</sup> for taxes paid

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<sup>49</sup> *Id.* at 399.

<sup>50</sup> *Id.* at 399 (citation omitted).

<sup>51</sup> New York had accomplished this objective by providing a credit against 70% of the tax otherwise due on the DISC income, thereby reducing the effective tax rate to 30% of the original rate.

<sup>52</sup> One would expect the *absolute* amount of credit to increase as DISC-related activity in New York increased even under an evenhanded crediting scheme, such as described in the preceding paragraph, simply because more DISC-related income was taxable by New York, and therefore there would be more DISC-related income tax available for the credit.

upon DISC income within New York's tax power, and the lower the effective New York tax rate on such income. The lower the percentage of a DISC's export shipments from New York, the lower the relative credit for taxes paid upon DISC income within New York's tax power, and the higher effective New York tax rate on such income. New York thus released its grip on DISC income within its taxing power only to the extent that DISC-related activities were carried on in the state. It kept its grip firmly upon DISC income within its taxing power to the extent that DISC-related activities were carried on outside the state.

After examining the operation of New York's DISC credit scheme,<sup>53</sup> the Court in *Westinghouse* found that New York's effort to encourage export activity in the state suffered from constitutional infirmities similar to those that had disabled New York's earlier effort to encourage brokerage activity in the state.<sup>54</sup> Like the reduction in tax liability offered to sellers of securities who effectuated their sales in New York, the reduction in tax liability offered to exporters who effectuated their shipments from New York "creates . . . an advantage" for firms operating in New York by placing "a discriminatory burden on commerce to its sister States."<sup>55</sup> It was "irrelevant"<sup>56</sup> to the constitutional analysis that the earlier tax incentives the Court had considered "involved transactional taxes rather than taxes on general income,"<sup>57</sup> because a State cannot "circumvent the prohibition of the Commerce Clause against placing burdensome taxes on out-of-state transactions by burdening those transactions with a tax that is levied in the aggregate . . . rather than on individual transactions."<sup>58</sup> Nor did it matter "[w]hether the discriminatory tax diverts new business into the State or merely prevents current business from being diverted elsewhere";<sup>59</sup>

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The unacceptable feature of the New York scheme was that the proportional amount of credit—*i.e.*, the credit allowable per dollar of DISC-income being taxed—increased or decreased according to the extent of DISC-related activity in New York. *Westinghouse*, 466 U.S. at 400-01.

<sup>53</sup> The Court explicated the effect of the DISC credit scheme in detail, employing, among other things, a series of hypothetical examples demonstrating that "similarly situated corporations, each operating a wholly owned DISC, would face different tax assessments in New York depending on the location from which the DISC shipped its exports." *Westinghouse*, 466 U.S. at 400-02 n.9.

<sup>54</sup> See *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318 (1977) (discussed *supra* part I.B.1).

<sup>55</sup> *Westinghouse*, 466 U.S. at 406 (quoting *Boston Stock Exch.*, 429 U.S. 318, 331 (1977)).

<sup>56</sup> *Id.* at 404.

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.* at 406.

it was "still a discriminatory tax that 'forecloses tax-neutral decisions.'"<sup>60</sup>

Moreover, the New York DISC credit had one particularly problematic effect not encountered in the Court's previous tax incentive cases: the credit decreased when the taxpayer increased its DISC-related activities elsewhere, even if the taxpayer's New York DISC-related activities remained unchanged.<sup>61</sup> The Court in *Westinghouse* described this as "the most pernicious effect of the credit scheme."<sup>62</sup> As the Court explained, "not only does the New York tax scheme 'provide a positive incentive for increased business activity in New York State,' but also it penalizes increases in the DISC's shipping activities in other States."<sup>63</sup>

#### 4. New Energy

The Court's most recent encounter with a state tax incentive, *New Energy Co. of Indiana v. Limbach*,<sup>64</sup> involved an Ohio tax credit designed to encourage the in-state production of ethanol (ethyl alcohol). Ethanol, which is typically made from corn, can be mixed with gasoline to produce a motor fuel called "gasohol." Ohio provided a credit against the state's motor fuel tax for each gallon of ethanol sold as a component of gasohol, but only if the ethanol was produced in Ohio or in a state that granted similar tax benefits to Ohio-produced ethanol.

In *New Energy Co.*, the Court had little difficulty concluding that this tax incentive failed to satisfy the strictures of the Commerce Clause. It observed that "[t]he Ohio provision at issue . . . explicitly deprives certain products of generally available beneficial tax treatment because they are made in certain other States, and thus on its face appears to violate the cardinal requirement of nondiscrimination."<sup>65</sup> The Court gave short shrift to the State's arguments in support of its disparate treatment of in-state and out-of-state products.

The Court had previously rejected a "reciprocity" defense to a statute that discriminated against out-of-state products, observing that a state "may not use the threat of economic isolation as a weapon to force sister States to enter into even a desirable reciprocity agree-

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<sup>60</sup> *Id.* (quoting *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977)).

<sup>61</sup> This reduction in the credit resulted from the fact that the credit allowable per dollar of DISC income subject to tax varied according to the *relative* amount of DISC-related activity in New York. See *supra* note 51.

<sup>62</sup> *Westinghouse*, 466 U.S. at 401 n.9.

<sup>63</sup> *Id.* at 400-01 (quoting NEW YORK STATE DIVISION OF THE BUDGET, REPORT ON A. 12108-A AND S. 10544 (May 23, 1972), reprinted in Bill Jacket of 1972 N.Y. Laws, ch. 778, p. 18).

<sup>64</sup> 486 U.S. 269 (1988).

<sup>65</sup> *Id.* at 274.

ment.”<sup>66</sup> As for the claim that Ohio could have achieved the same objective by way of a cash subsidy, the Court responded that the Commerce Clause does not prohibit all state action favoring local over out-of-state interests, but only such action that arises out of the state’s regulation of interstate commerce.<sup>67</sup> While “[d]irect subsidization of domestic industry does not ordinarily run afoul of that prohibition . . . discriminatory taxation of out-of-state manufacturers does.”<sup>68</sup>

### C. State Tax Incentives as State Tax Discrimination: Analysis

#### 1. *Giving the Court’s Language Full Sway*

What, then, does the case law teach us about the constitutionality of state tax incentives under the Commerce Clause? A literalistic focus on key passages in the Court’s opinions might suggest that “all state inducement programs are likely to be unconstitutional.”<sup>69</sup> After all, it is the rare state tax incentive that results in “tax-neutral decisions”<sup>70</sup> made “solely on the basis of nontax criteria,”<sup>71</sup> because the very purpose of tax incentives is to use the tax system to encourage favored forms of business enterprise. Of course, the tax incentives struck down by the Court did not fail merely because they encouraged certain forms of commercial activity. The problem was that the challenged tax measures were not “neutral” as to in-state and out-of-state business activities.<sup>72</sup> But this refinement of the tax-neutrality principle to focus on *where* business activity occurs does not narrow its practical impact because almost every tax incentive is designed to induce business activity *only within the taxing state*.

Consider state income taxes. Almost no state income tax incentive—and there are hundreds of them across the country—meets the Court’s ostensible requirement of strict geographic neutrality. Alabama, for example, provides an income tax credit for new investment, but only if it occurs in Alabama.<sup>73</sup> Alaska provides an income tax credit for investment in gas-processing and mineral-development facilities, but only if they are built in Alaska.<sup>74</sup> Arizona provides an income tax credit for taxpayers that increase research activities in Arizona.<sup>75</sup>

<sup>66</sup> *Great Atl. & Pac. Tea Co. v. Cottrell*, 424 U.S. 366, 379 (1976).

<sup>67</sup> *New Energy*, 486 U.S. at 278.

<sup>68</sup> *Id.* We consider the distinction between taxes and subsidies in detail *infra* parts II and III.

<sup>69</sup> Barrett, *supra* note 5, at 1049.

<sup>70</sup> *Boston Stock Exch. v. State Tax Comm’n*, 429 U.S. 318, 331 (1977).

<sup>71</sup> *Id.*

<sup>72</sup> *Cf. Boston Stock Exchange*, 429 U.S. at 330 (“Prior to the 1968 amendment, the New York transfer tax was neutral as to in-state and out-of-state sales. . . . Section 270-a upset this equilibrium.”).

<sup>73</sup> ALA. CODE § 41-23-24(e) (1991).

<sup>74</sup> ALASKA STAT. § 43.20.042 (1990).

<sup>75</sup> ARIZ. REV. STAT. ANN. § 43-1168 (Supp. 1995).

Arkansas provides an income tax credit for any motion picture production company that spends more than a specified amount on filming or producing a motion picture in Arkansas.<sup>76</sup> California provides an income tax credit for qualified equipment placed in service in California.<sup>77</sup> Colorado provides an income tax credit for investment in qualifying property used in Colorado.<sup>78</sup> Connecticut provides an income tax credit for investment in certain new manufacturing facilities in Connecticut.<sup>79</sup> Delaware provides an income tax credit for investment in qualified new business facilities in Delaware.<sup>80</sup> Florida provides an income tax credit for investments in Florida export finance corporations.<sup>81</sup> Georgia provides an income tax credit for business enterprises that increase employment by five or more in designated counties in Georgia.<sup>82</sup> The list goes on and on.<sup>83</sup>

By providing a tax benefit for in-state investment that is not available for identical out-of-state investment, these incentives skew a taxpayer's decision in favor of the former. Each such incentive—in purpose and effect—“diverts new business into the State.”<sup>84</sup> Put another way, these incentives deprive out-of-state investments “of generally available beneficial tax treatment because they are made in . . . other States, and thus on [their] . . . face appear[ ] to violate the cardinal requirement of nondiscrimination.”<sup>85</sup>

A similar analysis jeopardizes almost every sales and property tax incentive designed to encourage economic development in the taxing state. Yet most states offer just such incentives. Some states provide sales and use tax exemptions (or credits or refunds) for sales of property purchased for construction of new or improved facilities within the state; others give favorable sales or use tax treatment to property purchased in connection with the relocation or expansion of a business in the state; still others provide sales and use tax exemptions for property used in an enterprise zone in the state.<sup>86</sup> Similarly, a number of states provide property tax incentives for new or expanded facilities in the state.<sup>87</sup>

<sup>76</sup> ARK. CODE ANN. § 26-4-206 (Michie 1992).

<sup>77</sup> CAL. REV. & TAX. CODE § 23649 (West Supp. 1996).

<sup>78</sup> COLO. REV. STAT. § 39-22-507.6 (1994).

<sup>79</sup> CONN. GEN. STAT. ANN. § 12-217e (West 1993 & Supp. 1996).

<sup>80</sup> DEL. CODE ANN. tit. 30, § 2011(a) (1985).

<sup>81</sup> FLA. STAT. ANN. § 220.188 (West 1989 & Supp. 1996).

<sup>82</sup> GA. CODE ANN. § 48-7-40(e) (Supp. 1996).

<sup>83</sup> One could continue to proceed alphabetically through the states with similar examples. See [1] Multistate Corp. Inc. Tax Guide (CCH) ¶ 180 (1995); Nachbar et al., *supra* note 1, *passim*.

<sup>84</sup> Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 406 (1984).

<sup>85</sup> New Energy Co. of Ind. v. Limbach, 486 U.S. 269, 274 (1988).

<sup>86</sup> See generally [1] Multistate Sales Tax Guide (CCH) ¶ 975 (1994) (listing tax incentives used by states to encourage new industry).

<sup>87</sup> See [2 All States] State Tax Guide (CCH) ¶ 20-200 et seq. (1995).



Given the near universality of state sales taxation in this country,<sup>88</sup> and the true universality of local property taxation, sales or property tax breaks for investment within the state or locality probably play some role in many taxpayers' business location decisions. All other things being equal, a rational taxpayer will allocate resources in a manner that maximizes after-tax profits; hence the taxpayer will steer investments toward those states that offer such tax benefits. Sales and property tax incentives, like income tax incentives, are therefore subject to attack on the ground that they offend the "free trade" purposes of the Commerce Clause<sup>89</sup> by inducing resources to be allocated among the states on the basis of tax criteria.

## 2. *Alternative Readings of the Court's Opinions*

### a. *The Justification for a More Restrained Approach*

The astonishing implications of a literalistic reading of the Court's pronouncements give us pause. Nonetheless the four cases in which the Court has considered and struck down state tax incentives make it clear that the Court's rhetoric cannot be dismissed as empty. In its decisions, the Court revealed a willingness to subject a wide array of fiscal measures to exacting scrutiny, striking down sales, income, and transaction taxes. The Court likewise showed no mercy to any form of tax break, invalidating rate reductions,<sup>90</sup> exemptions,<sup>91</sup> and credits.<sup>92</sup> Moreover, the four opinions were written by Justices whose attitudes toward the dormant commerce clause span the spectrum from the highly protective "free trade" views of Justice White (*Boston Stock Exchange* and *Bacchus*) to the more moderate views of Justice Blackmun (*Westinghouse*) to the "unabashed hostility" of Justice Scalia (*New Energy*).<sup>93</sup> Even more significantly, the Justices acted in these cases with an extraordinary degree of consensus. There was not a single dissent on the merits of the Commerce Clause issue in any of the Court's four state tax incentive decisions.<sup>94</sup> In short, these cases and the doctrine they espouse must be taken seriously.

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<sup>88</sup> Forty-five states and the District of Columbia impose a retail sales tax. [2 All States] State Tax Guide (CCH) ¶ 60-100 (1995).

<sup>89</sup> *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 403 (1984); *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 328 (1977).

<sup>90</sup> *Boston Stock Exchange*, 429 U.S. 318, discussed *supra* part I.B.1.

<sup>91</sup> *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984), discussed *supra* part I.B.2.

<sup>92</sup> *Westinghouse*, 466 U.S. 388, discussed *supra* part I.B.3; *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269 (1988), discussed *supra* part I.B.4.

<sup>93</sup> See Walter Hellerstein, *Justice Scalia and the Commerce Clause: Reflections of a State Tax Lawyer*, 12 CARDOZO L. REV. 1763, 1763 (1991).

<sup>94</sup> *Boston Stock Exchange*, 429 U.S. 318, *Westinghouse*, 466 U.S. 388, and *New Energy*, 486 U.S. 269, were unanimous decisions, and the three-member dissent in *Bacchus*, 468 U.S. 263, rested exclusively on the ground that the Twenty-first Amendment removed Commerce Clause restraints from state regulation and taxation of intoxicating liquors.

With that fact in mind, we nevertheless believe that these opinions can and should be read less expansively than their literal language permits. Our view rests in part on an instinctive sense that virtually all state tax incentives cannot *really* be unconstitutional. Such incentives, after all, constitute long-standing, familiar, and central features of every state's taxing system. Even more important, a somewhat narrower interpretation of the Court's opinions is, in our judgment, more consonant with accepted dormant commerce clause policy and the core rationales of the incentive decisions themselves. We recognize that one may question any effort to cabin the language of the Court's opinions, given that the Court itself has never displayed concern with their broad rationale. But because an unrestrained reading of the Court's tax incentive opinions would cut a lethal swath across state tax regimes, we believe, like others,<sup>95</sup> that a serious effort to offer a more moderate alternative is warranted.

There is another justification for heading toward a middle-ground position: a number of the Justices themselves have indicated that the Court's broadest pronouncements should not be read for all they might be worth. Justice Stevens, for example, wrote the Court's opinion in *West Lynn Creamery, Inc. v. Healy*,<sup>96</sup> in which the Court invalidated a business development "tax-rebate"<sup>97</sup> and broadly reaffirmed *Bacchus*. Yet in *Hughes v. Alexandria Scrap Corp.*,<sup>98</sup> Justice Stevens declared that:

[I]n my judgment, . . . [the Commerce] Clause [does not] inhibit a State's power to experiment with different methods of encouraging local industry. Whether the encouragement takes the form of a cash subsidy, a tax credit, or a special privilege intended to attract investment capital, it should not be characterized as a "burden" on commerce.<sup>99</sup>

Similarly, Chief Justice Rehnquist—who has shown no reluctance to join the Court in invalidating previously challenged tax incentives<sup>100</sup>—has suggested that at least in some contexts "tax breaks" may be treated like subsidies for purposes of the dormant Commerce Clause.<sup>101</sup> If Justices of the Court who have written and joined the

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<sup>95</sup> See Philip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 VAND. L. REV. 879, 928-37 (1986).

<sup>96</sup> 114 S. Ct. 2205 (1994).

<sup>97</sup> *Id.* at 2213. The *West Lynn Creamery* opinion is considered in detail *infra* part II.A.

<sup>98</sup> 426 U.S. 794 (1976).

<sup>99</sup> *Id.* at 816 (Stevens, J., concurring) (emphasis added).

<sup>100</sup> Indeed, Chief Justice Rehnquist's sole dissent from the Court's tax incentive cases was in *Bacchus*, where he joined Justice Stevens's opinion which did not dispute the Court's Commerce Clause analysis but argued that the Commerce Clause had been displaced by the Twenty-first Amendment. See *supra* note 94.

<sup>101</sup> *Chemical Waste Management, Inc. v. Hunt*, 504 U.S. 334, 349-52 (1992) (Rehnquist, C.J., dissenting). Justices Scalia and Thomas may also oppose sweeping invalidation

Court's key opinions in this field believe that those opinions permit at least some varieties of business-incentive tax breaks, then we should too. The more difficult question concerns what *forms* of tax relief constitute permissible means of attracting and retaining local business operations.

b. *The In-State Favoritism/State-Coercion Rationale*

In our judgment, two core principles, which we identified at the outset of this discussion,<sup>102</sup> underlie the Court's state tax incentive decisions and should guide their proper interpretation and future application. First, the provision must favor in-state over out-of-state activities; second, the provision must implicate the coercive power of the state. If, but only if, both of these conditions are met, courts should declare the tax incentive unconstitutional.

All four of the Court's tax incentive decisions fall comfortably within this analytical framework. First, in each of the four cases, the State favored in-state over out-of-state activities: in-state over out-of-state sales in *Boston Stock Exchange*, in-state over out-of-state production in *Bacchus* and *New Energy*; and in-state over out-of-state exportation in *Westinghouse*. Second, in each of the four cases, the coercive power of the State gave the tax incentive its bite. In *Boston Stock Exchange*, taxpayers would pay higher stock transfer taxes to the taxing state unless they engaged in in-state sales. In *Bacchus* and *New Energy*, taxpayers would pay higher liquor wholesaling or motor fuel taxes to the taxing state unless they sold products manufactured locally. In *Westinghouse*, taxpayers would pay higher income taxes to the taxing state unless their DISCs shipped their exports from within its borders.

That the result of each of these cases is the same under our in-state-favoritism/state-coercion approach reveals that it provides no panacea for state taxing authorities. Indeed, many tax incentives will fail to survive scrutiny under this reading of the Court's tax incentive

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of business tax incentives, given their openly declared skepticism regarding the dormant Commerce Clause and their avowed intention to honor only the strict holdings of the Court's past Commerce Clause decisions. See, e.g., *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 115 S. Ct. 1331, 1346 (1995) (Scalia, J., concurring in the judgment) (asserting that facial neutrality is the most the Court can demand of a state to establish compliance with the dormant commerce clause (citing *Amerada Hess Corp. v. New Jersey Dep't of the Treasury*, 490 U.S. 66, 80 (1989) (Scalia, J., concurring); *Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232, 254 (1987) (Scalia, J., concurring in part and dissenting in part)). Justice O'Connor, who joined the Court's opinions in *Westinghouse* and *New Energy*, and dissented in *Bacchus* only on Twenty-first Amendment grounds, see *supra* note 94, also appears to be sympathetic to at least some state tax incentives. See *Zobel v. Williams*, 457 U.S. 55, 72 n.1 (1982) (opinion concurring in the judgment) ("a State might enact a tax credit for citizens who contribute to the State's ecology by building alternative fuel sources or establishing recycling plants") (discussing legitimate state purposes under Equal Protection Clause).

<sup>102</sup> See *supra* part I.A.

decisions.<sup>103</sup> At least one significant category of tax incentives, however, should escape invalidation: those tax incentives framed not as exemptions from or reductions of *existing* state tax liability but rather as exemptions from or reductions of *additional* state tax liability to which the taxpayer would be subjected only if the taxpayer were to engage in the targeted activity in the state. In our judgment, such incentives neither favor in-state over out-of-state investment (except in a sense that should be constitutionally irrelevant) nor do they rely on the coercive power of the state to compel a choice favoring in-state investment.

A real property tax exemption for new construction in a state, for example, favors in-state over out-of-state investment only if one takes account of the taxing regimes of other states and assumes that a tax would be due if the property were constructed in such other state. But the Court generally has refused to consider other states' taxing regimes in determining the constitutionality of a state's taxing statutes. As the Court has explained, "[t]he immunities implicit in the Commerce Clause and the potential taxing power of a State can hardly be made to depend, in the world of practical affairs, on the shifting incidence of the varying tax laws of the various States at a particular moment."<sup>104</sup> If a state's taxing statute must stand or fall on its own terms, a real property tax exemption for new construction in a state would pass muster because no *additional* tax liability could be presumed to result from new construction outside the state. By contrast, each of the tax measures at issue in the Court's tax incentive cases resulted in differential tax liability that was created entirely by the state's own taxing regime, depending on whether the taxpayer engaged in in-state or out-of-state activities.

Moreover, insofar as the Court has looked to other states' taxing regimes to determine their constitutionality under the Commerce Clause, it has done so only to assure that the tax is "internally consistent." Under the Court's internal consistency doctrine,<sup>105</sup> a tax must not impose a greater burden on interstate commerce than on intrastate commerce on the assumption that the levy is imposed by every state.<sup>106</sup> As the Court has explained, "[t]his test asks nothing about

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<sup>103</sup> We consider more systematically in part I.D *infra* what particular taxes will and will not survive scrutiny under this mode of analysis.

<sup>104</sup> *Freeman v. Hewit*, 329 U.S. 249, 256 (1946); *see also Armco Inc. v. Hardesty*, 467 U.S. 638, 644-45 (1984) (asserting that the validity of West Virginia's tax laws cannot be made to depend on the laws of the other 49 states).

<sup>105</sup> *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 115 S. Ct. 1331, 1338 (1995) (noting that the internal consistency test has been used for over a decade to assess threats of malapportionment).

<sup>106</sup> *See generally* Walter Hellerstein, *Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation*, 87 MICH. L. REV. 138 (1988).

the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate."<sup>107</sup> A property tax exemption for new construction in a state would pass the internal consistency test because one would have to assume that every other state offered the same exemption. Under this assumption, every new construction, wherever undertaken, would result in precisely the same property tax consequence: it would not be taxed at all.

Beyond the lack of constitutionally significant favoritism for local over interstate commerce, a property tax exemption for new construction does not implicate the coercive power of the state, at least not in a way that can fairly be characterized as "the State's regulation of interstate commerce."<sup>108</sup> By adopting such an exemption, the state is saying, in effect: "Come to our state and we will not saddle you with any additional property tax burdens. Moreover, should you choose not to accept our invitation, nothing will happen to your tax bill—at least nothing that depends on our taxing regime."

The state's posture in such circumstances stands in contrast to its posture in the tax incentive cases the Court has confronted in the past. In each of those cases the state was saying, in effect:

"You are already subject to our taxing power because you engage in taxable activity in this state. If you would like to reduce your tax burdens, you may do so by directing additional business activity into this state. Should you decline our invitation, we will continue to exert our taxing power over you as before, and your tax bill might even go up."<sup>109</sup>

These two messages are very different. The latter, but not the former, reflects a use of the taxing power to coerce in-state business activity.

We recognize that our suggested reading of the Court's tax incentive decisions is not above criticism. Apart from any doubts one may have with regard to finding limiting principles in the Court's tax incentive opinions,<sup>110</sup> one may question whether the limiting principles we have suggested are intellectually defensible. Two major criticisms come to mind. First, one can argue that there is no basis in the Court's decisions for distinguishing tax incentives involving invitations to engage in additional in-state activity from tax incentives that utilize "existing" tax liability to coerce in-state activity. In our opinion, however, the Court's own language supports the coercion-based analysis

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<sup>107</sup> *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 115 S. Ct. 1331, 1338 (1995).

<sup>108</sup> *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988) (emphasis omitted).

<sup>109</sup> See *supra* notes 59-61 and accompanying text.

<sup>110</sup> See *supra* part I.C.2.a.

we have offered. The Court has declared that states may “structur[e] their tax systems to encourage the growth and development of intra-state commerce and industry.”<sup>111</sup> What a state may not do, by contrast, is to “us[e] its power to tax an in-state operation as a *means of requiring [other] business operations to be performed in the home State.*”<sup>112</sup> Our coercion-centered analysis, we believe, accommodates both of the high Court’s directives.

Second, one might say that there is no functional difference between the “carrot” of offering relief from additional tax liability attributable to activity in which the state is inviting the taxpayer to engage, and the “stick” of threatening maximization of existing tax liability attributable to activity in which the taxpayer already is engaged. For example, if one’s *ex ante* assumption is that the taxpayer has engaged in none of the activity that gives rise to tax liability in cases like *Boston Stock Exchange*, *Bacchus*, *Westinghouse*, or *New Energy*, the analysis we suggested above ought to dictate a different result in those cases. For example, if the taxpayer in *Boston Stock Exchange* was contemplating the sale of stock with transfer through a non-New York agent, or if the taxpayers in *Bacchus* and *New Energy* had never made any taxable wholesale liquor sales in Hawaii or taxable motor fuel sales in Ohio, or if the taxpayer in *Westinghouse* had not previously engaged in income-producing activity in New York, then one could articulate the state’s appeal to the taxpayers in those cases in the following terms:

“Come to our state and we will not saddle you with any additional tax burdens or at least not with the same tax burdens that we would ordinarily impose upon taxpayers engaging in such activity. Moreover, should you refuse our invitation, nothing will happen to your tax bill—at least nothing that depends on our taxing regime.”

This, of course, is the state position that we characterize as not “coercing” in-state activity, because the taxpayer is not already subject to the state’s tax power. Thus, our argument may prove too much by vindicating (at least in substantial part) the very taxing regimes the Court struck down in its tax incentive decisions.

Put another way, the distinction between selectively forgiving taxes otherwise due if a taxpayer engages in in-state activity and disclaiming the right to impose any taxes on a “virgin” tax base a state is seeking to attract may be a distinction that turns entirely on whether a particular taxpayer has previously engaged in some taxable activity in the state. This may be too thin a distinction to carry the constitutional weight we are asking it to bear.

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<sup>111</sup> *Boston Stock Exch. v State Tax Comm’n*, 429 U.S. 318, 336 (1977).

<sup>112</sup> *Id.* (emphasis added) (brackets in original) (citation omitted).

This criticism has some merit, and should and does enter into the analysis of the constitutionality of particular tax incentives.<sup>113</sup> However, we reject it as a blanket objection to our approach because it ignores and distorts the real-world context in which tax incentives operate and, therefore, must be evaluated.<sup>114</sup> It is theoretically possible that a generally coercive tax incentive may, as to a particular taxpayer, be noncoercive. Conversely, a generally noncoercive tax incentive may, as to a particular taxpayer, be coercive. But these exceptions should not be permitted to swallow the rule, which ought to reflect the expected impact of the tax incentive on most taxpayers.

Consider *Bacchus*. It is theoretically possible that some liquor wholesalers, with no previous sales in Hawaii, were induced by the exemption for locally-produced liquor to enter the Hawaii market to make exempt liquor sales. If that were the principal effect of the statute, it might not offend our proposed constitutional standard.<sup>115</sup> It seems much more likely, however, that the exemption affected few, if any, liquor wholesalers in this fashion. And obviously *no* liquor wholesalers took *any* account of the exemption to the extent they established operations in the state prior to the exemption's adoption. Once there, however, liquor wholesalers were subject to tax and were also "arm-twisted" by the taxing scheme to channel their sales in the direction of locally-manufactured products. Consequently, we believe that the challenged Hawaii statute involved, in essence, an exemption from an *existing* tax liability.

By way of contrast, consider a sales tax exemption for equipment purchased in connection with the construction of a new in-state facility. It is theoretically true that a buyer potentially subject to a sales tax could purchase a large item of equipment and only then feel "coerced" by the availability of a tax exemption to build a new factory to house the equipment in the would-be taxing state. If that were the principal effect of the statute, it would offend our proposed constitutional standard. But in the real world such a sequence of events is farfetched. Usually, the buyer will decide *before* it buys its equipment where the facility will be located and, hence, where the equipment will be used. Consequently, whatever influence the exemption exerts is almost certain to be felt before, rather than after, sales tax liability

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<sup>113</sup> See *infra* part I.D.

<sup>114</sup> It is a central tenet of the Court's contemporary Commerce Clause jurisprudence that the validity of state taxes should be determined on the basis of their practical economic impact. See *infra* notes 213-14 and accompanying text.

<sup>115</sup> Even under this unlikely assumption, however, the exemption in *Bacchus* would fail to pass muster if the condition of qualifying for the exemption—selling property produced in the state—were considered to be independent of the location or use of the property with respect to which the exemption was granted. See *infra* notes 206-15 and accompanying text.

attaches. In these circumstances, it makes no sense to characterize the tax exemption as coercive; instead, as we have suggested, the state simply offers the prospective buyer/developer an invitation to do business in the state, while threatening it with no adverse effects if it chooses not to do so.<sup>116</sup>

In short, the determination as to whether a tax incentive is coercive should depend on its "practical or economic effect"<sup>117</sup> and on " 'economic realities.' "<sup>118</sup> Basing the analysis on the remote possibility that a generally coercive tax incentive may be noncoercive in a few instances or that a generally noncoercive tax incentive may be coercive on occasion would allow the tail to wag the dog. It would also defeat the notion that "commerce among the States is not a technical legal conception, but a practical one, drawn from the course of business."<sup>119</sup>

In the end, we remain convinced that there is something to the distinction we have delineated here.<sup>120</sup> Perhaps this distinction is best captured by focusing on the nature of the constitutional *injury* alleged

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<sup>116</sup> With respect to the real-world impact of sales taxes, it also is worth noting that in light of the virtually universal exemption from sales taxation of property purchased in one state for out-of-state use, sales or use tax liability ordinarily attaches, if at all, *only* in the state in which the property is ultimately used. 2 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* ¶ 18.02[1] (1992); see *infra* text accompanying notes 203-05. In other words, there is ordinarily no tax cost at all in State A associated with buying property in State A for use in State B; in such circumstances, State A will impose no sales tax, but State B will impose a use tax. See generally HELLERSTEIN & HELLERSTEIN, *supra*, ¶ 16.01 (discussing use taxes generally).

<sup>117</sup> *Goldberg v. Sweet*, 488 U.S. 252, 262 (1989).

<sup>118</sup> *American Trucking Ass'ns, Inc. v. Scheiner*, 483 U.S. 266, 295 (1987) (quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)).

<sup>119</sup> *Swift & Co. v. United States*, 196 U.S. 375, 398 (1905).

<sup>120</sup> After much reflection, we have identified only one plausible way in which our governing "coercion" principle might be fruitfully refined. Under this refined approach, even ostensibly coercive conditions tied to in-state activities would be sustainable if they concern promotion of "aesthetics," the remediation of externalities, or other essentially non-commercial government objectives. See Dan T. Coenen, *Untangling the Market-Participant Exemption to the Dormant Commerce Clause*, 88 MICH. L. REV. 395, 469-70 (1989). It might be said that such forms of tax relief do not involve "business incentives" at all so that the rules proposed here as to business incentives simply have no application.

In a related dormant commerce clause context, one of the authors has suggested that the pursuit of such noncommercial purposes may shield otherwise impermissible conditions placed on receipt of a government benefit from constitutional challenges. See *id.*; see also *United States v. Lopez*, 115 S. Ct. 1624, 1630-31 (1995) (a developing commercial/noncommercial distinction in the "affirmative" Commerce Clause context). Under this approach an income tax credit for installing pollution abatement equipment within the state probably would be permissible. But—to pose a more difficult case—what about conditioning an income tax exemption on expanding operations in a targeted depressed area to reduce not only localized unemployment, but also visual blight and burgeoning crime? Cf. *City of Renton v. Playtime Theatres, Inc.*, 475 U.S. 41, 46-53 (1986) (refusing to apply strict First Amendment content-discrimination rule where an adult-movie theater restriction is designed to address "secondary effects" of such activity, including deterioration of the "quality of urban life").



in the two different contexts. In the situation addressed by the Court in its tax incentive decisions, the alleged injury is the greater tax that the taxpayer will pay *in the taxing state* if, instead of engaging in the targeted activity within the state, it conducts that activity in other states. When, on the other hand, there is no preexisting tax base that the state is offering to reduce (but rather only a potential tax base that the state proposes to tax at lower than ordinary rates or not at all), the alleged injury is the greater tax the taxpayer will have to pay *in other states* based on the presumed existence of a tax on the targeted activity in such states. We know of no principle, however, that requires remediation of this sort of "injury" under the dormant commerce clause.<sup>121</sup>

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The authors are firmly of the view that any condition on tax relief driven by the aim of generally increasing in-state jobs, or (worse yet) generally increasing in-state business activity, would not be shielded from attack by this limiting principle; otherwise the suggested "exception" would swallow our controlling rule. Beyond saying this much, we believe that consideration and elaboration of this principle is properly deferred to forums other than this already lengthy Article.

<sup>121</sup> This point is reinforced by considerations of causation and standing. The taxpayer who challenges a tax incentive on the ground that its choice to engage in activity outside the incentive-granting state has a tax cost (in the form of foregone reduction of tax liability) within that state is complaining of an identifiable injury caused by the state's taxing regime. The taxpayer is therefore stating a claim that falls within familiar boundaries—the defendant has caused it injury by denying it a right: the alleged right to a tax benefit for engaging in certain activity irrespective of the situs of such activity. By contrast, the taxpayer who challenges a tax incentive on the ground that its choice to engage in activity outside the incentive-granting state has a tax cost based on the assumption that it will pay taxes in other states is not complaining of an identifiable injury caused by the incentive-granting state's tax regime. Rather, the taxpayer is complaining of an injury allegedly caused by an actor other than the incentive-granting state. Consequently, the taxpayer's suit is subject to the objection that standing to sue for constitutional purposes exists only if the injury alleged "fairly can be traced to the challenged action of the defendant, and not injury that results from the independent action of some third party not before the court." *Simon v. Eastern Ky. Welfare Rights Org.*, 426 U.S. 26, 41-42 (1976); *see also Maryland v. Louisiana*, 451 U.S. 725, 736 (1981). *Cf. Tatarowicz & Mims-Velarde, supra* note 95, at 937.

This analysis explains why a challenge to a state tax incentive that does not involve a claim of right to a reduction of existing tax liability is unlikely to be successful. Consider a taxpayer that wishes to challenge a State A real property tax exemption for new construction in State A. Assume that the taxpayer has a preexisting taxable facility in State A. Further assume that the taxpayer has just constructed a new, taxable facility in State B, which would have qualified for the exemption if constructed in State A. Because State A has not offered anyone a *reduction* in existing property taxes for constructing a new facility in State A, a court is unlikely to find that the taxpayer has stated a cause of action against State A under the Commerce Clause based on the fact that, prior to State A's offering of the tax exemption, the taxpayer engaged in taxable activity in State A. Moreover, the taxpayer's State A tax liability clearly was unaffected by the fact that it constructed a facility in State B. Indeed, insofar as there is any substance to the taxpayer's complaint that State A has treated it unfairly *vis-à-vis* other State A taxpayers who have constructed new in-state facilities, the claim would appear to implicate equal protection rather than Commerce Clause concerns, because it involves a tax classification differentiating two forms of *intra-state* activity.

For all of these reasons, the line between “coercive” and “noncoercive” tax incentives is meaningful and comports with longstanding principles of the Court’s dormant commerce clause jurisprudence. At the least, in our opinion, analysis of tax incentives built on the coercive/non-coercive distinction makes far more sense than a free-wheeling doctrine based on only the vague admonition that a state may not “foreclose[ ] tax-neutral decisions.”<sup>122</sup>

c. *The Penalizing-Activity-in-Other-States Rationale*

Our state-coercion principle does not provide the only way to limit the scope of the Court’s state tax incentive decisions. Motivated by the same concern we have voiced—that an unrestricted reading of the tax incentive decisions would have a devastating impact on the existing pattern of state tax incentives—two observers have suggested another way to confine the Court’s holdings.<sup>123</sup> In their view, the Court’s opinions comport with the principle that “a state tax incentive that focuses exclusively on a taxpayer’s in-state activities does not have the sort of negative impact on interstate commerce with which the [C]ommerce [C]lause is concerned.”<sup>124</sup> From this perspective, “the key to finding a tax incentive unconstitutionally discriminatory appears to be a reliance by the state tax provision on both a taxpayer’s in-state and out-of-state activities in determining the taxpayer’s effective tax rate.”<sup>125</sup> Thus, the critical inquiry is whether the incentive creates “penalties for out-of-state activities.”<sup>126</sup>

Under this approach, the decision in *Boston Stock Exchange* rests on the fact that the tax incentive “tied the effective rate of tax not only to the New York activity with which the state identified the taxable moment, but also to whether another activity (*i.e.*, sale on an exchange) took place in New York or in another state.”<sup>127</sup> Similarly, *Westinghouse* is viewed as a case in which the unconstitutional evil was not showing favoritism toward in-state investment, but rather assessing “penalties for out-of-state activities.”<sup>128</sup> Accordingly, it may be argued that “[t]here is no indication . . . that these cases require a state to offer incentives regardless of the state in which the desired activities occur; the cases indicate only that the effective tax rates must not be tied to out-of-state activities.”<sup>129</sup>

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<sup>122</sup> *Boston Stock Exch. v. State Tax Comm’n*, 429 U.S. 318, 331 (1977).

<sup>123</sup> *Tatarowicz & Mims-Velarde*, *supra* note 95, at 928, 931-32, 935.

<sup>124</sup> *Id.* at 928-29.

<sup>125</sup> *Id.* at 929.

<sup>126</sup> *Id.* at 936.

<sup>127</sup> *Id.* at 930.

<sup>128</sup> *Id.* at 936.

<sup>129</sup> *Id.* at 933.

Although this penalty analysis provides a basis for limiting the scope of the Court's tax incentive decisions, we believe that, as a mechanism for distinguishing constitutional from unconstitutional tax incentives, it is not as useful as the coercion-based analysis we have proposed.<sup>130</sup> First, the penalty analysis fails to draw a meaningful line between a tax incentive that penalizes out-of-state activity and one that merely rewards in-state activity. For example, it is unclear why *Boston Stock Exchange* should be placed in the former category rather than the latter. New York, after all, was not trying to penalize those who utilized out-of-state brokers, but only to reward those who used in-state brokers. In these circumstances, it seems fair to say that New York's "state tax incentive . . . focuse[d] exclusively on a taxpayer's in-state activities."<sup>131</sup>

Second, the Court already has declared in no uncertain terms that the Commerce Clause brooks no distinction between laws that "benefit" in-state activity and laws that "burden" out-of-state activity.<sup>132</sup> To us, this principle leaves no room for a rule that tries to distinguish instead between "rewards" and "penalties."

Third, and most significantly, the penalty-based analysis falters because it focuses on only one of the two core principles underlying dormant commerce clause restraints on discriminatory state taxation—whether the tax incentive favors in-state over out-of-state activities. It does not address the other critical aspect of the Court's dormant commerce clause jurisprudence—whether the incentive is effectuated by the coercive power of the state. In this respect, the proposed "penalty" analysis would fail to strike down tax incentives that, in our judgment, should be invalidated. For example, the proponents of the penalty-based analysis suggest that the following illustration of a tax incentive would pass constitutional muster:

[I]f an out-of-state business investing one million dollars in a state is entitled to the same investment credit that an in-state business would receive if it likewise decided to invest one million dollars in the state, and no reduction in the credit results from out-of-state investment, then the credit does not have a negative discriminatory impact on protected commerce.<sup>133</sup>

We disagree. If the taxpayer is subject to state income tax (and thus within the coercive power of the state), and the opportunity to reduce that income tax is conditioned on making an in-state investment, then it makes no difference that an in-state business would be treated in the same way or that the taxpayer's credit is not reduced by

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<sup>130</sup> See *supra* part I.C.2.b.

<sup>131</sup> *Tatarowicz v. Mims-Velarde*, *supra* note 95, at 928-29.

<sup>132</sup> *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 272-73 (1984).

<sup>133</sup> *Tatarowicz & Mims-Velarde*, *supra* note 95, at 936.

out-of-state investment (as it was in *Westinghouse*). The critical point is that the state is using its coercive taxing power to skew an *existing* taxpayer's investment decision: the state will reduce the taxpayer's income tax liability only if it makes an in-state investment.

The fact that the in-state taxpayer's decision would be as skewed as the out-of-stater's decision does not render the incentive constitutional. The Commerce Clause precludes discrimination against interstate commerce, not just discrimination against out-of-state taxpayers.<sup>134</sup> Moreover, it makes no difference that there may be no reduction in the credit should the taxpayer make an out-of-state investment. Although the Court in *Westinghouse* indicated that the "most pernicious effect of the credit scheme"<sup>135</sup> was that the credit declined as out-of-state activity increased,<sup>136</sup> this was plainly not the *only* effect of the credit that the Court found objectionable. The clear thrust of the opinion was that any provision that reduces the taxpayer's "effective [in-state] tax rate"<sup>137</sup> as the taxpayer engages in more in-state activity violates the Commerce Clause.<sup>138</sup>

In short, despite our sympathy with efforts to limit the scope of the Court's state tax incentive decisions, we do not believe that either the decisions themselves, or the underlying purposes of the Commerce Clause, fairly support the proposition that "a state tax incentive that focuses exclusively on a taxpayer's in-state activities does not have the sort of negative impact on interstate commerce with which the [C]ommerce [C]lause is concerned."<sup>139</sup>

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<sup>134</sup> Indeed, in *Boston Stock Exchange*, the tax incentive discriminated *in favor* of nonresident taxpayers as compared to similarly situated resident taxpayers. 429 U.S. 318, 324-28 (1977). It should be noted, however, that the incentive favored only those nonresidents that engaged in specified in-state activity. *Id.*

<sup>135</sup> *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 401 n.9 (1984).

<sup>136</sup> *See id.* at 400-01.

<sup>137</sup> *Id.* at 401 n.9.

<sup>138</sup> *Id.* at 403-07.

<sup>139</sup> *Tatarowicz & Mims-Velarde*, *supra* note 95, at 928-29.

Notably, the reported state judicial and administrative decisions involving challenges to provisions that may be characterized as state tax incentives take a view of the Court's state tax incentive decisions that is much more like our coercion-based approach than the more restrictive penalty-based approach. *See Sprint Communications Co. v. Kelly*, 642 A.2d 106, 113-18 (D.C.) (property tax exemption for personal property used by a telecommunications company to produce taxable gross receipts and a sales tax exemption for property purchased by a telecommunications company for use in producing services subject to gross receipts tax discriminates against interstate commerce), *cert. denied*, 115 S. Ct. 294 (1994); *Division of Alcoholic Beverages & Tobacco v. McKesson Corp.*, 524 So. 2d 1000 (Fla. 1988) (tax preference for alcoholic beverages made from citrus fruits and other agricultural products grown primarily, though not exclusively, within the state discriminates against interstate commerce), *rev'd on other grounds*, 496 U.S. 18 (1990); *Delta Air Lines, Inc. v. Department of Revenue*, 455 So. 2d 317 (Fla. 1984) (corporate income tax credit for fuel taxes limited to Florida-based air carriers discriminates against interstate commerce), *appeal dismissed*, 474 U.S. 892 (1985); *Russell Stewart Oil Co. v. Department of Revenue*, 529 N.E.2d 484 (Ill. 1988) (tax preference for gasohol made from products used by almost all

#### D. State Tax Incentives as State Tax Discrimination: Specific Implications

The question remains as to how the existing pattern of state and local tax incentives fares under the modes of analysis we have identified above. The answer depends on the type of tax incentive at issue and the particular analytical construct that a court employs to evaluate it. In this Section, we assess the constitutionality of various types of state tax incentives under both our and others' proposed frameworks for constitutional analysis.

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in-state producers but few out-of-state producers discriminates against interstate commerce); *Comptroller of the Treasury v. Armco, Inc.*, 521 A.2d 785 (Md. Ct. Spec. App. 1987) (exemption from state corporate income tax for DISC dividends which conditioned at least 50% of the net taxable income of the DISC as being subject to taxation in the state discriminates against interstate commerce); *Archer Daniels Midland Co. v. State ex rel. Allen*, 315 N.W.2d 597 (Minn. 1982) (tax reduction for gasohol produced in state discriminates against interstate commerce); *Northwest Aerospace Training Corp. v. Commissioner of Revenue*, [2 Minn.] St. Tax Rep. (CCH) ¶ 202-603 (Minn. T.C. Apr. 4, 1995) (exemption for receipts from leases of flight equipment if lessees annually made three or more flights into or out of the state discriminates against interstate commerce); *Giant Indus. Ariz., Inc. v. Taxation and Revenue Dep't*, 796 P.2d 1138 (N.M. Ct. App. 1990) (gasoline excise tax deduction for ethanol-blended gasoline manufactured exclusively within the state discriminates against interstate commerce); *AT&T v. New York State Dep't of Taxation and Fin.*, 637 N.E.2d 257 (N.Y. 1994) (deduction for access charges paid by long-distance telephone companies to local telephone companies, which is reduced only for interstate long-distance companies by their state apportionment percentage, discriminates against interstate commerce); *R.J. Reynolds Tobacco Co. v. City of New York Dep't of Fin.*, 643 N.Y.S.2d 865 (N.Y. Sup. Ct. 1995) (accelerated depreciation deduction limited to in-state property discriminates against interstate commerce); *Burlington Northern, Inc. v. City of Superior*, 388 N.W.2d 916 (Wis. 1986) (exemption from occupation tax on iron ore dock operators, when iron ore is taxed under occupation tax on local mineral producers, discriminates against interstate commerce), *cert. denied*, 479 U.S. 1034 (1987); *Wisconsin Dep't of Revenue v. NCR Corp.*, [1990-93 Transfer Binder Wis.] St. Tax Rptr. (CCH) ¶ 203-412 (Wis. Cir. Ct., Dane City Apr. 20, 1993) (deduction for dividends received from subsidiaries limited to subsidiaries more than 50% of whose income was taxable by the state discriminates against interstate commerce); *Beatrice Cheese, Inc. v. Wisconsin Dep't of Revenue*, [1990-93 Transfer Binder Wis.] St. Tax Rptr. (CCH) ¶ 203-396 (Wis. Tax App. Comm'n Feb. 24, 1993) (accelerated depreciation deduction limited to in-state property discriminates against interstate commerce); *cf. Pelican Chapter, Associated Builders & Contractors, Inc. v. Edwards*, 901 F. Supp. 1125 (M.D. La. 1995) (property tax exemption for new manufacturing establishments, limited to taxpayers maintaining 80% in-state work force and using 80% in-state materials, discriminates against interstate commerce). *But see Archer Daniels Midland Co. v. State*, 690 P.2d 177 (Colo. 1984) (gasoline tax reduction for certain gasohol that benefited only in-state producers is a permissible incentive for development of fuel-grade alcohol industry) (*post-Bacchus*); *Caterpillar, Inc. v. Department of Treasury*, 488 N.W.2d 182 (Mich.) (deduction for capital acquisitions, which was limited by percentage of taxpayer's property and payroll in the state, is a legitimate incentive for encouragement of in-state business), *cert. denied*, 506 U.S. 1014 (1992); *Williams Cos. v. Director of Revenue*, 799 S.W.2d 602 (Mo. 1990) (restricting right to file consolidated state tax return to affiliated groups of corporations that derive more than 50% of their income from sources within the state does not discriminate against interstate commerce), *cert. denied*, 501 U.S. 1260 (1991). The *Sprint* case is discussed *infra* note 193; the *Northwest Aerospace* case is discussed *infra* note 215; the *AT&T* case is discussed *infra* note 153; and the *Beatrice* case is discussed *infra* notes 148-54 and accompanying text.

## 1. *Income Tax Incentives*

### a. *Credits*

The most common form of state tax incentive in this country is the income tax credit. As the litany of income tax credits described above indicates,<sup>140</sup> virtually all such credits tie the tax benefit offered by the state to specific in-state activity. The in-state activity may consist of investing in in-state property, hiring in-state employees, or expanding in-state facilities. Accordingly, under the broadest reading of the Court's state tax incentive decisions, these credits cannot survive scrutiny because they fail the test of strict "tax neutrality" articulated by the Court in *Boston Stock Exchange* and its progeny.<sup>141</sup>

State income tax credits similarly fail to pass muster under the narrower reading of the Court's tax incentive decisions that we have embraced. Such credits violate the two principles that we have identified as central to the Commerce Clause analysis of the validity of state tax incentives: First, they favor in-state over out-of-state activity because income tax credits are almost invariably confined to the former. Second, they implicate the coercive power of the state, because the taxpayer can reduce its state tax bill only by engaging in in-state activity.<sup>142</sup>

<sup>140</sup> See *supra* notes 73-83 and accompanying text.

<sup>141</sup> See *supra* part I.B; Joel Michael, *The Constitutionality of Minnesota's Business Tax Credits After Westinghouse Electric Corp.*, 4 J. ST. TAX'N 163, 170-79 (1985); W. Eugene Seago & Wayne M. Schell, *Tax Credits and the Commerce Clause After Westinghouse Electric Corporation*, 3 J. ST. TAX'N 101, 111-12 (1984); cf. Woodrow H. Berry, *Does the Virginia Coal Tax Credit Violate the Commerce Clause?*, 13 J. ST. TAX'N 1 (Spring 1995) (gross receipts tax credit).

Many state tax credits are in fact limited to qualifying activities that take place in particular locations within a state (e.g., enterprise zones). It might be argued that such credits do not discriminate against interstate commerce because they deny tax benefits to in-state as well as out-of-state activity that is not conducted within the specified in-state location. This argument, however, cannot be maintained in light of cases holding that discrimination against interstate commerce is not rendered constitutionally acceptable because some intrastate commerce is subject to the same discrimination visited upon interstate commerce. See *C & A Carbone, Inc. v. Town of Clarkstown*, 114 S. Ct. 1677, 1682 (1994) (holding that a town ordinance requiring all solid waste from the town be processed at the town transfer station unconstitutionally discriminates against interstate commerce); *Dean Milk Co. v. City of Madison*, 340 U.S. 349, 354 n.4 (1951) (holding that an ordinance requiring all milk sold in the city be pasteurized within five miles of the city unconstitutionally discriminates against interstate commerce); cf. *United Bldg. and Constr. Trades Council v. Mayor and Council of Camden*, 465 U.S. 208, 222-23 (1984) (remanding case concerning an ordinance requiring contractors and subcontractors working on city projects to have a minimum of 40% of their workers be city residents to determine if the ordinance violates Privileges and Immunities Clause).

As the Court declared in *Maryland v. Louisiana*, 451 U.S. 725, 760 (1981), "[w]e need not know how unequal the [t]ax is before concluding that it unconstitutionally discriminates."

<sup>142</sup> We note one qualification—albeit a narrow one—of the rule we have set forth in the text. The presence of discrimination, as we have defined it, triggers a "*virtually per se*

The constitutionality of the vast majority of income tax credits in this country cannot be persuasively defended unless one adopts the view that tax incentives for in-state activity are constitutional so long as they do not penalize out-of-state activity<sup>143</sup> by raising the in-state tax bill when local activity remains constant but out-of-state activity increases.<sup>144</sup> Because most income tax credits merely reward in-state activity by reducing the taxpayer's income tax bill and do not impose a tax cost on out-of-state activity (aside from the opportunity cost of foregoing a reduction in in-state income tax liability), most income tax credits will survive scrutiny under the penalty-based approach. For the reasons advanced above, however, we do not believe that such a limited conception of Commerce Clause restraints on state tax incentives is warranted.<sup>145</sup> In particular, we do not see how credits for in-state activities can pass muster when the Court in *Boston Stock Exchange* struck down a tax precisely because it afforded a tax reduction for conducting business activity in the state.<sup>146</sup>

#### b. *Deductions*

Income tax deductions limited (or granted on more favorable terms) to in-state activities are functionally indistinguishable from income tax credits confined to in-state activities.<sup>147</sup> They therefore stand or fall according to the analysis set forth above.

A controversy in Wisconsin over income tax deductions restricted to in-state property is illustrative. In keeping with its general conformity to the Internal Revenue Code in determining taxable income, Wisconsin adopted the federal depreciation rules. In particular, the Wisconsin statutes permitted depreciation deductions for property located in Wisconsin to be taken according to the favorable federal Ac-

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rule of invalidity." *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 114 S. Ct. 1345, 1351 (1994) (emphasis on "virtually" added); *Chemical Waste Management, Inc. v. Hunt*, 504 U.S. 334, 344 n.6 (1992). It is thus open to states to argue that a given tax incentive is permissible, even though discriminatory, because it offers the only effectively available means of advancing a specific and compelling local interest of government. See *Maine v. Taylor*, 477 U.S. 131, 138, 146 (1986); *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 274, 278-80 (1988). One could argue, for example, that a very limited and carefully tailored income tax credit designed to address extremely severe unemployment in a specifically targeted locale might meet this standard. See SCHWEKE ET AL., *supra* note 6, at 45 ("[T]ax subsidies that result in increased employment in areas of relatively high unemployment may actually increase total local or national welfare."). In our view, however, this strict scrutiny test will be met only in unusual cases.

<sup>143</sup> See *supra* part I.C.2.c.

<sup>144</sup> As was the case in *Westinghouse*. See *supra* notes 51-53 and accompanying text.

<sup>145</sup> See *supra* notes 126-34 and accompanying text.

<sup>146</sup> *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 330-31 (1977).

<sup>147</sup> We recognize, of course, that for purposes other than those under consideration here, there may be significant differences between deductions and credits (e.g., their impact on the progressivity of a tax).

celerated Cost Recovery System (ACRS)<sup>148</sup> applicable to business-investment property. For the tax years in question, however, accelerated depreciation was not available for property located outside Wisconsin; instead, such property had to be depreciated according to the slower (and, therefore, less favorable) methods provided by an earlier version of the federal law.<sup>149</sup>

The limitation of ACRS depreciation to in-state property might well be viewed as designed "to encourage the growth and development of intrastate commerce and industry."<sup>150</sup> Relying on *Boston Stock Exchange* and *Westinghouse*, however, the Wisconsin Tax Appeals Commission concluded that providing lower effective income tax rates to taxpayers who made in-state rather than out-of-state investments violated the Commerce Clause prohibition against discriminatory taxation.<sup>151</sup> The Commission found a "clear parallel"<sup>152</sup> to the discrimination the Court condemned in *Westinghouse* because "the Wisconsin depreciation deduction statutes at issue are obviously 'designed to have discriminatory economic effects' on corporations locating depreciable property outside the state by taxing such corporations more heavily than those locating such property in the state."<sup>153</sup>

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<sup>148</sup> I.R.C. § 168 (1994).

<sup>149</sup> I.R.C. § 167 (1994).

<sup>150</sup> *Boston Stock Exch.*, 429 U.S. at 336.

<sup>151</sup> *Beatrice Cheese, Inc. v. Wisconsin Dep't of Revenue*, [1990-93 Transfer Binder Wis.] St. Tax Rep. (CCH) ¶ 203-396 (Wis. Tax App. Comm'n Feb. 24, 1993).

<sup>152</sup> *Id.* at 15,706.

<sup>153</sup> *Id.* (quoting *Westinghouse Elec. Co. v. Tully*, 466 U.S. 388, 406-07 (1984)). *Accord*, *R.J. Reynolds Tobacco Co. v. City of New York Dep't of Fin.*, 643 N.Y.S.2d 865 (N.Y. Sup. Ct. 1995). Following a similar logic, the court in *AT&T v. New York State Dep't of Tax'n and Fin.*, 637 N.E.2d 257 (N.Y. 1994), struck down New York's requirement that long-distance telephone companies apportion the deduction from their taxable gross receipts for access charges paid to local telephone companies in the same manner that they apportion their gross receipts for New York tax purposes. Under the state scheme, long-distance carriers that were unable to account directly for their New York revenues were required to apportion their gross receipts based upon the ratio of their New York property to their total property. See *supra* notes 73-83 and accompanying text for a description of state income tax apportionment formulas. As a consequence, an interstate long-distance carrier which owned property both inside and outside of New York would have received only a proportionate deduction for access charges paid to local telephone companies in the state. In contrast, local long-distance carriers (providing phone service, say, between New York City and Albany) would have received a deduction for 100 percent of their access charges. The court observed that "the statute has the practical and real effect of treating differently long-distance carriers similarly situated in all respects except for the percentage of their property located within New York State," *AT&T*, 637 N.E.2d at 259, and that it "plainly creates a direct commercial advantage to intrastate long-distance carriers." *Id.* If New York had permitted long-distance carriers to deduct all access charges, regardless of where incurred, it could have required the taxpayer to apportion the deduction to New York, just as the base was apportioned to New York. The vice in the statute was that the only deduction allowed was for in-state access charges. By reducing the deduction available to interstate carriers, the state effectively created a discriminatory tax incentive. Indeed, in this respect the case had the "most pernicious effect" of a state tax incentive identified in *Westinghouse*, 466 U.S. at 401 n.9, because it penalized out-of-state activity: as a carrier expanded its



The favorable depreciation deduction for investment in Wisconsin property would likewise fail to pass muster under the more focused reading of the Court's state tax incentive decisions that we have delineated above. The Wisconsin depreciation deduction violated both guiding principles we believe should govern Commerce Clause analysis of the validity of state tax incentives. First, it favored in-state over out-of-state activity. Second, it implicated the coercive power of the state, because the taxpayer could obtain the maximum reduction in its preexisting Wisconsin tax bill only by engaging in in-state activity.

The Wisconsin depreciation scheme would pass muster only if one embraced the view that, so long as state tax incentives for in-state activity do not penalize out-of-state activity, they are constitutionally acceptable.<sup>154</sup> The Wisconsin depreciation scheme passes this test because a taxpayer's Wisconsin tax does not increase as a result of its investment in out-of-state property.

### c. *Apportionment Formulas*

There is one category of income tax incentives that appears to enjoy smooth sailing under the Court's precedents, although it is not obvious why this should be so.<sup>155</sup> Most states employ a three-factor formula based on property, payroll, and sales to apportion income among the states for tax purposes.<sup>156</sup> As originally conceived, the three-factor formula gave equal weight to each of these factors.<sup>157</sup> Under this mode of apportionment, a taxpayer's income is attributed to the state by a percentage determined by averaging the ratios of the taxpayer's property, payroll, and sales within the state to its property, payroll, and sales everywhere.<sup>158</sup> In recent years, however, there has been a decided trend toward adoption of apportionment formulas that give additional significance to the sales factor, often by doubling

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investment in property outside New York—even if its activity in New York remained constant—its New York access fee deduction would decline.

<sup>154</sup> See *supra* part I.C.2.c.

<sup>155</sup> See Michael, *supra* note 141, at 190-91.

<sup>156</sup> [1] Multistate Corp. Inc. Tax Guide (CCH) ¶ 146 (1995) (indicating apportionment formulas of each state).

<sup>157</sup> 1 HELLERSTEIN & HELLERSTEIN, *supra* note 116, ¶ 8.06.

<sup>158</sup> See Uniform Division of Income for Tax Purposes Act §§ 10-17, 7A U.L.A. 331 (1985).

its weight in the determination of the apportionment percentage<sup>159</sup> and, in one instance, by eliminating the other factors altogether.<sup>160</sup>

The justification typically offered for giving additional weight to the sales factor in income tax apportionment formulas is that it will stimulate local economic development. Specifically, providing extra weight to the sales factor encourages a multistate taxpayer with sales spread throughout the nation to locate its property and payroll within the state on the theory that the extra weight given to the sales factor will reduce the percentage of the taxpayer's income assigned to the state.<sup>161</sup> As a key economic advisor to the Governor of Georgia recently observed in explaining the state's adoption of a double-weighted sales factor, the legislation "offer[s] economic incentives for business expansions and locations here . . . . By promoting the activities of firms that have a physical presence—property and labor—in Georgia, [the legislation] should clearly have a stimulative effect."<sup>162</sup> Something the Governor's advisor did not say, but which is equally true, is that giving additional weight to the sales factor increases the Georgia apportionment percentage for multistate taxpayers with sales spread throughout the nation (including Georgia) but whose property and payroll are located in other states.

The evils of an income tax apportionment formula that accords disproportionate weight to the sales factor, in the context of the widespread adoption of an equally-weighted three-factor formula, are not hard to discern. Indeed, they have already been described by Justice Powell in his critique of the extreme version of such a formula—

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<sup>159</sup> Under a three-factor formula with a double-weighted sales factor, a taxpayer's income is attributed to the state on the basis of a percentage determined by adding up the taxpayer's property factor, its payroll factor, and twice its sales factor and dividing the total by four. Of the 46 taxing authorities (45 states and the District of Columbia) with corporate net income taxes, roughly half now employ apportionment formulas that give more weight to the sales factor than to other apportionment factors. [1] Multistate Corp. Inc. Tax Guide (CCH) ¶ 146 (1995).

<sup>160</sup> NEB. REV. STAT. §§ 77-2734.05, 77-2734.16 (1990).

<sup>161</sup> To be sure, the "reduction" may be relative rather than absolute. If the taxing scheme has its intended effect of drawing property and payroll into the state, the decrease in the apportionment percentage attributable to the additional weighting of the sales factor may be more than offset by the increase in the apportionment percentage attributable to the larger property and payroll factors. Nevertheless, such an absolute increase in the apportionment percentage is likely to be offset by the reduction in the taxpayer's apportionment percentages in other states.

<sup>162</sup> Georgia Dep't of Revenue, *Passage of House Bill 50 Revamps Corporate Apportionment in Ga.*, No. 17 GA. REVENUE Q. No. 1 at 1 (1995) (quoting Dr. Henry Thomassen, economic advisor to Governor Zell Miller). Expressing similar sentiments, politicians and business groups in Massachusetts and Michigan have supported legislation to change their three-factor formulas with a double-weighted sales factor to a single-factor sales formula. See *Massachusetts: Governor Launches Drive for Single Sales Factor*, 9 ST. TAX NOTES 748 (1995); *Massachusetts: House Speaker Warmes to Single Sales Factor*, 9 ST. TAX NOTES 895 (1995); *Michigan: Single Sales Factor Bill Creates Controversy*, 9 ST. TAX NOTES 896 (1995).

Iowa's single-factor sales formula—which ignores property and payroll altogether:

Iowa's use of a single-factor sales-apportionment formula—though facially neutral—operates as a tariff on goods manufactured in other States . . . and as a subsidy to Iowa manufacturers selling their goods outside of Iowa. Because 44 of the 45 other States which impose corporate income taxes use a three-factor formula involving property, payroll, and sales, Iowa's practice insures that out-of-state businesses selling in Iowa will have higher total tax payments than local businesses. This result follows from the fact that Iowa attributes to itself all of the income derived from sales in Iowa, while other taxing States—using the three-factor formula—are also taxing some portion of the same income through attribution to property or payroll in those States.<sup>163</sup>

Justice Powell went on to explain:

This surcharge on Iowa sales increases to the extent that a business' plant and labor force are located outside Iowa. It can be avoided altogether only by locating all property and payroll in Iowa; an Iowa manufacturer selling only in Iowa will never have any portion of its income attributed to any other State. And to the extent that an Iowa manufacturer makes its sales in States other than Iowa, its overall state tax liability will be reduced. Assuming comparable tax rates, its liability to other States, in which sales constitute only one-third of the apportionment formula, will be far less than the amount . . . of sales in Iowa, where sales are the exclusive mode of apportioning income. The effect of Iowa's formula, then, is to penalize out-of-state manufacturers for selling in Iowa and to subsidize Iowa manufacturers for selling in other States.<sup>164</sup>

Justice Powell's characterization of Iowa's taxing regime suggests that it should fail to pass muster under the Court's state tax incentive decisions. The Iowa scheme "forecloses tax-neutral decisions"<sup>165</sup> by offering a reduction in state tax liability to manufacturers who locate their property and payroll in Iowa. Furthermore, it "penalize[s] out-of-state manufacturers for selling in Iowa"<sup>166</sup> if they do not yield to Iowa's pressure and locate their property and payroll there.<sup>167</sup> Justice Powell, however, made his critique of the Iowa formula *in dissent*.

Is the Court's rejection of Justice Powell's analysis in *Moorman Manufacturing Co. v. Bair*<sup>168</sup> incompatible with the Court's state tax incentive decisions? Not if they are given a proper reading. Indeed,

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<sup>163</sup> *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 283-84 (1978) (Powell, J., dissenting) (footnotes omitted).

<sup>164</sup> *Id.* at 284 (Powell, J., dissenting) (footnotes omitted).

<sup>165</sup> *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977).

<sup>166</sup> *Moorman*, 437 U.S. at 284 (Powell, J., dissenting).

<sup>167</sup> *Cf. Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 400-01 (1984).

<sup>168</sup> 437 U.S. 267 (1978).

*Moorman* pointedly supports our central assertion: that the broad pronouncements of the Court's tax incentive decisions neither can nor should receive a literal interpretation.

In *Moorman*, the Court declined the taxpayer's invitation to hold that Iowa, rather than states which had adopted the three-factor formula, "was necessarily at fault in a constitutional sense"<sup>169</sup> for causing the multiple taxation that allegedly resulted from the coexistence of the three-factor and single-factor formulas. There was no proof in the record as to precisely where the taxpayer earned its income. Thus, invalidation of the Iowa formula would have had to rest on "the importance of avoiding any risk of duplication in the taxable income of an interstate concern"<sup>170</sup> in light of the existing pattern of other states' taxing statutes. But the "only conceivable constitutional basis" for so holding "would be that the Commerce Clause prohibits any overlap in the computation of taxable income by the States."<sup>171</sup> Whatever the merits of such a rule as a matter of national policy, the Court concluded that the power to establish uniform rules for the division of income lay with Congress, not the Court. It therefore refused to constitutionalize the three-factor formula.

Notwithstanding the legitimate criticisms that may be leveled against the Court's tolerance of Iowa's single-factor sales formula,<sup>172</sup> the formula does not offend the two core values that underlie the Court's state tax incentive decisions. First, a single-factor sales formula does not favor in-state over out-of-state activities,<sup>173</sup> unless one takes account of the taxing statutes of other states. As we have pointed out above, however, the Court has generally refused to consider other states' taxing regimes in determining the constitutionality of an individual state's taxing statute.<sup>174</sup> Moreover, insofar as the Court has taken account of the possibility of multiple taxation by ascertaining whether a tax passes the "internal consistency" test,<sup>175</sup> Iowa's taxing statute clears that hurdle with flying colors. If every state imposed a single-factor sales formula, the interstate enterprise would be subject to taxes no more burdensome than those imposed upon competing local enterprises. Rather, both intrastate and interstate firms would be subject to tax on neither more nor less than one hundred percent of their income.

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<sup>169</sup> *Moorman*, 437 U.S. at 277.

<sup>170</sup> *Id.*

<sup>171</sup> *Id.* at 278.

<sup>172</sup> See 1 HELLERSTEIN & HELLERSTEIN, *supra* note 116, ¶ 8.08[2][b].

<sup>173</sup> Indeed, Justice Powell himself recognized that Iowa's single-factor sales formula was "facially neutral." *Moorman*, 437 U.S. 267 at 283 (Powell, J., dissenting).

<sup>174</sup> See *supra* note 105 and accompanying text.

<sup>175</sup> See *supra* notes 106-07 and accompanying text.

Second, a single-factor sales formula does not implicate the coercive power of the state by linking a reduction in the state's taxes to the conduct of in-state activity. Even assuming a taxpayer has existing income-producing activity within a state that has adopted a single-factor sales formula, the taxpayer's relocation of its property and payroll to the state offers no assurance that its in-state liability will be reduced.<sup>176</sup> Indeed, if the taxpayer's in-state and out-of-state sales remain constant, shifting the taxpayer's property and payroll into the state will have no effect on the percentage of the taxpayer's income assigned to the state. The single-factor sales formula provides a lure to the multi-state taxpayer not because it is coercive in any way, but because it capitalizes on the tax systems adopted by other states. This fact may render the single-factor sales formula problematic; however, it does not render the formula unconstitutional under the Court's tax incentive decisions.

Finally, the single-factor sales formula does not "penalize[ ] increases in . . . activities in other States,"<sup>177</sup> as did the tax incentive the Court condemned in *Westinghouse*. Indeed, it does just the opposite. Although increases in property and payroll in other states have no impact on the percentage of the taxpayer's income attributed to the state, increases in sales to other states will reduce that percentage. The only "penalty" associated with the single-factor sales formula is that attributable to the different configuration of other states' apportionment formulas.

In short, *Moorman* demonstrates that the states remain free to "structur[e] their tax systems to encourage the growth and development of intrastate commerce and industry"<sup>178</sup> insofar as state income tax apportionment formulas are concerned. The adoption of an internally consistent apportionment formula that lowers the relative income tax cost of doing business in the state by effectively assigning income to other states, and which does not penalize out-of-state activity except by reference to "internally inconsistent" assumptions made about other states' tax regimes, is precisely the type of state tax incentive the Court has approved.<sup>179</sup> Functionally, a state adopting such a

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<sup>176</sup> See *supra* notes 159-60.

<sup>177</sup> *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 401 (1984).

<sup>178</sup> *Boston Stock Exch. v. State Tax Comm'n* 429 U.S. 318, 336 (1977).

<sup>179</sup> See *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 385-86 (1991). In *Trinova*, the taxpayer sought to attack Michigan's Single Business Tax, which is a form of value-added tax, on the ground that Michigan's use of a sales factor in the three-factor formula employed to apportion the tax discriminated against interstate commerce. The gravamen of the taxpayer's argument was that the use of a sales factor to apportion a tax base comprised largely of labor and capital favored Michigan businesses over out-of-state businesses, because it had the effect of attributing the local business's Michigan labor to other states (based on its non-Michigan sales) while assigning the out-of-state business's labor and capital to Michigan (based on its Michigan sales). In rejecting this argument,

formula does nothing differently from what it does when it establishes an attractive tax climate in which to operate, e.g., one with low rates, a narrow base, or generous deductions for expenses wherever incurred. Although such formulas may not comport with sound notions of where income is earned,<sup>180</sup> may give rise to duplicative taxation, and may maximize the revenues of particular states,<sup>181</sup> they do not exact a price under the state's own taxing regime for failing to engage in in-state activity.

## 2. *Property Tax Incentives*

In contrast to income tax incentives, many property tax incentives will pass constitutional muster unless one reads the Court's state tax incentive opinions as condemning any tax provision that tilts business decision-making toward in-state investment. Under this criterion, property tax incentives would fail to survive scrutiny, because they are tied to in-state investment and thus preclude business decisionmaking "solely on the basis of nontax criteria."<sup>182</sup> Under our more circumscribed view of the Court's decisions, however, property tax incentives should withstand Commerce Clause review if they do not favor in-state over out-of-state investment and do not implicate the coercive power of the state.

Property tax incentives that offer an exemption or abatement for new investment in the state (without collateral requirements discrete from the use or location of the property itself<sup>183</sup>) will survive scrutiny under these criteria. They do not favor in-state over out-of-state investment, if one assumes—as one ought to<sup>184</sup>—that other states have adopted taxing regimes similar to the one in question.<sup>185</sup> Nor do they implicate the coercive power of the state, because a taxpayer does not reduce its otherwise applicable in-state property tax liability by acquiring property in the state. Rather the taxpayer avoids only additional

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the Court observed that "[i]t is a laudatory goal in the design of a tax system to promote investment that will provide jobs and prosperity to the citizens of the taxing State." *Id.* at 385.

<sup>180</sup> As the Court declared in *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 561 (1965), "[t]he standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates," whereas "the geographical distribution of a corporation's sales is, by itself, of dubious significance in indicating the locus of either factor."

<sup>181</sup> A single-factor sales formula will tend to maximize the revenues of a "market" state like Iowa which has relatively more sales than property and payroll. Conversely, a single-factor property formula will tend to maximize the revenues of an industrial state like Ohio which has relatively more property than it has payroll and sales.

<sup>182</sup> *Boston Stock Exchange*, 429 U.S. at 331; see *supra* part I.C.1.

<sup>183</sup> See *infra* notes 186-88 and accompanying text.

<sup>184</sup> See *supra* notes 105-06 and accompanying text.

<sup>185</sup> *Id.*

in-state tax liability by acquiring the property in question, just as it would had it acquired property in some other state.<sup>186</sup>

We do not suggest that all property tax incentives may be implemented with constitutional impunity. Property tax incentives will be in constitutional jeopardy within the adjudicative framework we have proposed when they are tied to in-state activity *apart from investment in the property itself*. For example, property tax incentives limited to businesses that create a certain number of new jobs in the state, or that make overall investments of a certain magnitude in the state, run afoul of the principle that a state may not limit tax incentives to those with a specified economic presence in the state<sup>187</sup>—at least when the economic presence does not constitute the very tax base that the state seeks to attract. Such property tax incentives improperly link the tax benefit—exemption from local property taxes—to local activity distinct from the investment in the in-state property. Consequently, they

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<sup>186</sup> A recent Pennsylvania decision supports our thesis that property tax incentives of this nature will pass muster under the Commerce Clause. In *PPG Industries, Inc. v. Commonwealth*, No. 2355 C.D. 1987, Pa. Commonwealth Ct., Nov. 3, 1995 (panel decision) (unreported), *reprinted in* [2 Pa.] St. Tax Rptr. (CCH) ¶ 202-636, *aff'd*, Pa. Commonwealth Ct., June 19, 1996 (unreported), *reprinted in* [2 Pa.] St. Tax Rptr. (CCH) ¶ 202-657, the court sustained a capital stock tax exemption limited to “the capital stock of entities organized for manufacturing, processing, research or development purposes, which is invested in and actually and exclusively employed in carrying on manufacturing, processing, research or development within the state . . . .” PA. STAT. ANN. tit. 72, § 7602(a) (Supp. 1996). The taxpayer, only some of whose manufacturing activities were carried on in the state, attacked the exemption on the ground that it discriminated against interstate commerce. Relying on *Westinghouse* and *Boston Stock Exchange*, the taxpayer argued that there is a discriminatory effect upon multistate corporations with a low proportion of manufacturing within Pennsylvania who are allegedly placed at a commercial disadvantage to those businesses that conduct more of their manufacturing within the state.

The court rejected this argument on the grounds that the tax exemption was coterminous with the tax base and that there was no tax cost to the taxpayer in conducting economic activity across state lines. As the court observed,

Once the capital stock is apportioned to . . . Pennsylvania, then a manufacturing exemption applies to exempt property within the state that is related to manufacturing within the state. Both the tax and the exemption is [*sic*] based on in-state property and does not affect out-of-state property. The fact that a proportion of the corporate headquarters is taxed is a result of locating the corporate headquarters within the Commonwealth, not on locating some or most of the manufacturing out-of-state. Regardless of the location of the manufacturing, nothing moving in interstate commerce is measured or affected by the exemption.

*Id.* at 20,440. The court’s decision is significant in that it refuses to extend the teachings of cases like *Westinghouse* and *Boston Stock Exchange* beyond their proper limits.

Property tax incentives of the typed described in the text would also pass muster under the view that tax incentives tied to in-state activity are acceptable as long as they do not penalize activity in other states. See *supra* part I.C.2.c.

<sup>187</sup> *Maryland v. Louisiana*, 451 U.S. 725, 756-57 (1981); *Northwest Aerospace Training Corp. v. Commissioner of Revenue*, [2 Minn.] St. Tax Rep. (CCH) ¶ 202-603 (Minn. T.C. Apr. 4, 1995).

violate the rule that a state may not use its taxing power to coerce taxpayers to engage in in-state activity.<sup>188</sup>

In effect, these tax incentives say to the taxpayer that the state will refrain from imposing taxes on the taxpayer's property only if, in addition to acquiring property in the state, the taxpayer invests a certain amount of money in the state, or hires a certain number of employees in the state, or conducts operations of a certain size in the state. These incentives are distinguishable from those described earlier which in effect say to the taxpayer that the state will not issue the taxpayer a property tax bill if it acquires in-state property that meets specified conditions regarding the use or location of the property itself.

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<sup>188</sup> The Court's recent decision in *Fulton Corp. v. Faulkner*, 116 S. Ct. 848 (1996), illustrates this distinction. In *Fulton*, the Court struck down a North Carolina intangible property tax that varied inversely with the corporation's presence in North Carolina. Prior to the levy's repeal in late 1995, North Carolina imposed an intangible property tax on, among other things, shares of stock owned by resident individuals and corporations and on shares of stock having a business situs in the state. The tax was imposed at the rate of 0.25% of the fair market value of the stock. The value of the stock assessed under the tax, however, was reduced by a percentage equal to the percentage of the corporation's income subject to tax in North Carolina. This percentage was determined by the familiar three-factor income apportionment formula of property, payroll, and sales. See *supra* notes 156-58 and accompanying text.

Under this taxing regime, the stock of a corporation conducting all of its business in North Carolina would not be subject to North Carolina's intangible property tax. Such a corporation would have a 100% income tax apportionment percentage which would, in turn, permit a 100% reduction in the value of the corporation's stock subject to tax in the hands of its shareholders. Conversely, the stock of a corporation doing no business in North Carolina would pay an intangible property tax measured by all of the stock's value. Such a corporation would have a zero percent income tax apportionment percentage which would, in turn, permit no reduction in the value of the corporation's stock subject to tax in the hands of its shareholders.

North Carolina's intangible tax regime plainly discriminated on its face against interstate commerce. As the Court observed in *Fulton*, "A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce." *Id.* at 855. Indeed, the only disputed question in the case was whether the facially discriminatory tax could be saved by the "compensatory" or "complementary" tax doctrine. See generally Walter Hellerstein, *Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination*, 39 *TAX LAW.* 405 (1986). The Court held it could not. *Fulton*, 116 S. Ct. at 855.

For our purposes, *Fulton* reveals the fault line between property tax incentives that will survive or fail to survive Commerce Clause scrutiny. A tax exemption available to any taxpayer which brings its property into the state will pass muster because it does not "discourage . . . corporations from plying their trades in interstate commerce," *id.*; it merely lowers the cost of doing business in intrastate commerce. See *PPG Industries*, discussed *supra* note 186. By contrast, a tax exemption like that offered by North Carolina in *Fulton* will violate the Commerce Clause because it demands not only that the taxpayer bring its corporate stock into North Carolina (which any resident owner is deemed to do), but, in addition, that the corporation conduct its business in North Carolina. It is this collateral requirement—tying the exemption to the corporation's activity in state—that condemns the intangible property tax under the Commerce Clause.



It might be argued that our proposed distinction between defensible and indefensible property tax incentives is merely semantic. Thus one might contend that property tax exemptions for property constructed within the state for specified purposes (e.g., for new manufacturing facilities) or in specified locations (e.g., in enterprise zones) require some in-state activity "apart from the investment in the property itself." It is true, of course, that property tax incentives that offer an exemption or abatement for new investment in the state invariably require some in-state activity "apart from the investment in the property itself," namely, that the investment be for the legislatively prescribed in-state purpose and no other. Nevertheless we believe that there is a significant difference between relieving a taxpayer of a property tax burden ordinarily associated with ownership of property when the taxpayer acquires property under conditions that depend on the use or location of the property itself, and relieving a taxpayer of a property tax burden ordinarily associated with ownership of property only because the taxpayer acquires property under conditions that bear little or no relation to the use or location of the property itself. In the former case, the taxpayer is required to engage in no in-state activity that fairly can be characterized as independent of the acquisition and disposition of the property. In the latter case, the taxpayer is required to engage in in-state activity that it might undertake even if it had never invested in the property (e.g., creating a certain number of jobs in the state or making in-state investments of a certain magnitude).<sup>189</sup>

The distinction we suggest is hardly a stranger to the dormant commerce clause field. Both the Court and commentators have suggested the constitutional infirmity of "downstream restraints" placed on the recipient of a state-conferred benefit, including state subsidies.<sup>190</sup> We see no reason why the same sort of restriction should not

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<sup>189</sup> We recognize that the line we are drawing—between conditions that relate to the use or location of property and other conditions independent of the use or location of the property—may seem fuzzy at the edges. For example, one could maintain that conditioning a property tax exemption on the creation of ten new jobs in the state—a condition we would find constitutionally objectionable—is a condition of "use," namely, use in a business that creates ten new jobs. How, one may ask, is such a condition different from a requirement, for example, that the property be "used in a new manufacturing facility"—a condition we would find constitutionally acceptable? Although reluctant to proffer a blanket response to this question and others like it, we would submit that the answer lies in the distinction suggested in the text: The requirement that property be used in a new manufacturing facility is intimately connected with the acquisition and disposition of the property itself and involves no collateral conditions that could be fulfilled independently of the physical use of the property. The requirement that property be used in a business that creates ten new jobs imposes "downstream" conditions capable of satisfaction without regard to the physical use of the property. See *infra* note 206 and accompanying text.

<sup>190</sup> See *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 96-98 (1984) (White, J., plurality opinion); *Foster-Fountain Packing Co. v. Haydel*, 278 U.S. 1, 10-11 (1928);

apply as forcefully to state-conferred tax breaks. To be sure, the "independent activity" standard we have offered to flesh out the principle in this context will engender some difficulties in application.<sup>191</sup> But this is hardly surprising because "it is an essential part of adjudication to draw distinctions, including fine ones, in the process of interpreting the Constitution."<sup>192</sup>

In any event, real-world property tax incentives seldom impose any conditions other than those linked to the use or location of the property itself.<sup>193</sup> Accordingly, they will rarely breach the constitutional limits we have proposed.

### 3. Sales and Similar Transaction Tax Incentives

Constitutional analysis of sales and similar transaction tax incentives should track the analysis of property tax incentives that we have offered.<sup>194</sup> If one reads the Court's state tax incentive opinions as condemning any tax provision that influences business decisionmak-

Coenen, *supra* note 120, at 463-73 (observing that market-participant exception to the dormant commerce clause is confined to cases in which state does not impose "downstream restraints" on in-state preferences); Walter Hellerstein, Hughes v. Oklahoma: *The Court, the Commerce Clause, and State Control of Natural Resources*, 1979 SUP. CT. REV. 51, 79 (arguing that state power to distribute state-owned resources does not extend to conditions on disposition that "independently burden interstate commerce").

<sup>191</sup> See *supra* note 189; *infra* note 216.

<sup>192</sup> Walz v. Tax Comm'n, 397 U.S. 664, 679 (1970).

<sup>193</sup> See [2 All States] State Tax Guide (CCH) ¶ 20-200 et seq. (1995). But compare Sprint Communications Co. v. Kelly, 642 A.2d 106 (D.C.), *cert. denied*, 115 S. Ct. 294 (1994), where the District of Columbia violated the anticoercion principle when it granted a property tax exemption for personal property used by a telecommunications company to produce receipts subject to the District's gross receipts tax, as well as a sales tax exemption for property purchased by a telecommunications company for use in producing services subject to the gross receipts tax. Consequently, only companies with District property and sales (a necessary condition to having District property and sales tax liability) could benefit from the exemptions, and then could do so *only* when they channeled their services into the intra-District market. As the court observed,

the District of Columbia may not enact a tax scheme whereby the only company that can fully benefit from the available exemptions is one that sells in the District of Columbia only what it produces there, and does not afford the same benefits to a company outside of the District that sells within it or indeed to a District company that sells outside it.

*Id.* at 116-17; *accord* Op. Or. Att'y Gen. No. 8236 (Apr. 20 1995) (arguing that the enterprise zone property tax exemption is unconstitutional under Privileges and Immunities Clause because it was conditioned on hiring a certain percentage of enterprise zone residents).

<sup>194</sup> By "similar transaction tax" we mean a tax that is imposed on, or with respect to, a transaction or event associated with the transfer of personal property or services for a consideration (or the use of such property or services) and that is measured by the sales price or cost price of the property or services. Specifically, we mean to include compensating use taxes; specialized excise taxes on the sale or use of fuel, alcohol, and tobacco; and other taxes, regardless of their label, that in substance constitute retail sales taxes (such as Illinois's retailers occupation tax, ILL. REV. STAT. ch. 35 ¶ 120 et seq. (1993), and Arizona's transaction privilege tax, ARIZ. REV. STAT. ANN. §§ 42-1301 et seq. (Supp. 1995)).

ing, every sales or similar transaction tax incentive tied to the conduct of in-state activity lies in the constitutional danger zone.<sup>195</sup> In our view, however, sales and similar transaction tax incentives—like all other tax incentives—ought to survive Commerce Clause scrutiny if they do not simultaneously favor in-state over out-of-state activity and implicate the coercive power of the state. Many sales and similar transaction tax incentives will pass this test.

For example, sales and use tax exemptions, credits, or refunds for property purchased for construction of new facilities in the state (or for use in connection with the relocation of a business in the state, or for use in an enterprise zone in the state)<sup>196</sup> are unobjectionable under these criteria. They do not favor in-state over out-of-state activity, unless one indulges in the unwarranted assumption that other states would tax the same transaction if it were effectuated in those states.<sup>197</sup>

Nor do these tax breaks implicate the coercive power of the state. A taxpayer does not reduce its in-state tax liability by purchasing property for use within the state. It merely ensures that there will be no in-state tax cost from engaging in the transaction, just as there would be no in-state cost if it engaged in the transaction in some other state. For this reason, such a sales tax incentive would also pass muster under the view that tax incentives tied to in-state activity are acceptable as long as they do not penalize activity in other states.<sup>198</sup>

There is, however, one aspect of the typical sales tax incentive that arguably distinguishes it from the typical property tax incentive and renders the former susceptible to attack under the Commerce Clause. Although incentives associated with both sales and property taxes are confined to property used within the state, the possibility that the tax could apply to property used outside the state exists only in the context of a sales tax. There is plainly no possibility that a property tax could apply to real property used outside the taxing state, since real property can be used (and hence taxed) only in a single state. Nor can a property tax ordinarily apply to tangible personal property used outside the taxing state, because constitutional "nexus" strictures prohibit a state from taxing tangible personal property located outside its borders.<sup>199</sup> By contrast, a state clearly would have the

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<sup>195</sup> See *supra* part I.C.1.

<sup>196</sup> See generally [1] Multistate Sales Tax Guide (CCH) ¶ 975 (1994) (listing tax incentives used by states to encourage new industry).

<sup>197</sup> See *supra* notes 104-06 and accompanying text.

<sup>198</sup> See *supra* part I.C.2.c.

<sup>199</sup> *Frick v. Pennsylvania*, 268 U.S. 473, 488-96 (1925); *Union Refrigerator Transit Co. v. Kentucky*, 199 U.S. 194, 204-05 (1905). There is a limited exception to the statement in the text: tangible personal property used in State A for part of the year and then transported to State B could be taxed in State A for the portion of the year it was located there.

power to impose a sales tax on property purchased within the state for use outside its borders.<sup>200</sup>

Because state sales tax incentives apply only to the sale of property purchased for use within the state, it may be argued that such incentives both discriminate on their face against interstate commerce and violate the Commerce Clause's internal consistency test.<sup>201</sup> If every state exempted property purchased for in-state—but not for out-of-state—use, then property purchased in State A for use in State B would be subject to tax while property purchased in State A for use in State A would not be. This would amount to a paradigmatic violation of the internal consistency principle and would plainly discriminate against interstate commerce.<sup>202</sup>

This potentially serious problem is not a problem at all, however, in light of the actual structure of sales tax regimes. Sales taxes are levies confined to the final sale of a product for "use or consumption"<sup>203</sup> within the taxing state. In keeping with this design (as well as the desire not to disadvantage local vendors with respect to their out-of-state competitors), "[m]ost states exempt from tax all sales for delivery outside the state."<sup>204</sup> Because states generally do not tax the sale of property for out-of-state use, there exists little risk of discrimination against interstate commerce (or violation of the internal consistency doctrine) when a state provides a tax break for the sale of certain property intended for in-state use. In other words, because the state taxes sales of goods only for *intrastate* use, there cannot possibly be a discrimination against *interstate* commerce when sales for some, but not other, *intrastate* uses are made tax-exempt.<sup>205</sup>

This does not mean that all sales and transaction tax incentives are constitutionally unobjectionable. The Court's decisions in *Boston Stock Exchange*, *Bacchus*, and *New Energy*—each of which involved a sales or sales-like tax—establish that such incentives may well be vulnerable to constitutional attack. Indeed, many sales and similar transaction tax incentives are constitutionally suspect under the analysis we have articulated above: specifically, those sales and similar transaction tax exemptions, credits, or refunds that are tied to in-state activity *apart*

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<sup>200</sup> Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 115 S. Ct. 1331, 1339 (1995).

<sup>201</sup> See *supra* notes 105-06 and accompanying text.

<sup>202</sup> American Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266, 283-97 (1987).

<sup>203</sup> JOHN F. DUE & JOHN L. MIKESSELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 16 (2d ed. 1994).

<sup>204</sup> *Id.* at 271; see also 2 HELLERSTEIN & HELLERSTEIN, *supra* note 116, ¶ 18.02[1].

<sup>205</sup> If there is discrimination in such a sales tax scheme, it is against in-state sales that do not qualify for the exemption. But that is not a concern of the Commerce Clause. See *supra* note 121.

from the in-state use of the property or services with respect to which the tax is imposed.<sup>206</sup>

Consider, for example: (1) the Arizona law that grants a refund of transaction privilege taxes to motion picture companies that spend more than \$1 million per year in the state to produce one or more motion pictures in the state;<sup>207</sup> (2) the Arkansas exemption from sales and use taxes of purchases of natural gas and electricity by steel mill operators that invest over \$120 million in an Arkansas steel mill;<sup>208</sup> (3) the Illinois exemption from sales and use taxes of purchases of certain property used by businesses that make investments of at least \$40 million in the state or that create a minimum of 200 full-time equivalent jobs in the state;<sup>209</sup> (4) the Nebraska provision for refund of sales and use taxes for certain businesses that increase employment by two full-time employees in the state and that make specified minimum investments in the state;<sup>210</sup> (5) the New Mexico credits for sales or use taxes paid for purchases of qualified equipment incorporated into a manufacturing operation if the taxpayer employs one additional full-time employee in the state for every \$250,000 in value of qualified equipment invested in the state;<sup>211</sup> (6) the Oklahoma exemption from sales and use taxes of purchases of tangible personal property by a qualified manufacturer for incorporation into a new manufacturing plant in the state if the total cost of construction exceeds \$5 million and at least 100 jobs are created and maintained for at least 36 months in the state;<sup>212</sup> and (7) the South Dakota provision for a credit or refund of contractors' excise taxes paid for construction of new or expanded manufacturing facilities, and for sales and use taxes paid for the purchase of business equipment, if the project costs exceed \$20 million.<sup>213</sup>

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<sup>206</sup> For example, assuming *arguendo* that the exemption at issue in *Bacchus* was not invalid on the ground that it represented an exemption from existing tax liability, *see supra* notes 115-16 and accompanying text, it might still be struck down on the ground that it imposes "downstream" conditions on new investment in the state. One could argue that the condition of the exemption in *Bacchus*—that the exemption applies only if one sells property *produced in the state*—goes beyond the scope of acceptable conditions bearing strictly on the in-state use of the property sold. Linking an exemption to the in-state use of the property, which is intimately connected with the design structure of a sales tax directed at in-state consumption, is a far cry from linking it to the in-state production of the property, which bears no structural relationship to the tax being imposed and arguably imposes a condition independent of those activities that give rise to the liability in the first place.

<sup>207</sup> ARIZ. REV. STAT. ANN. § 42-1322.01 (Supp. 1995).

<sup>208</sup> ARK. CODE ANN. §§ 26-52-901 to 914 (Michie 1992 & Supp. 1995).

<sup>209</sup> ILL. REV. STAT. ch. 35, ¶ 120/1f (1993).

<sup>210</sup> NEB. REV. STAT. § 77-27,188 (1990 & Supp. 1994).

<sup>211</sup> N.M. STAT. ANN. § 7-9A-7.1 (Michie 1995).

<sup>212</sup> OKLA. STAT. tit. 68, § 1359(8) (Supp. 1996).

<sup>213</sup> S.D. CODIFIED LAWS ANN. § 10-45B-1 to 5 (Supp. 1995).

All of these sales and similar transaction tax incentives share a common constitutional defect: they link the tax benefit—reduction of state sales or similar transaction tax liability—to in-state activity that is independent of the use of the property or services with respect to which the tax is imposed. Consequently, they offend the fundamental principle that a state may not use its taxing power to coerce taxpayers to engage in in-state activity. These tax incentives—like the income tax credits and deductions we have discussed above<sup>214</sup>—in effect tell the taxpayer that the state will release its grip on the taxpayer's tax dollars associated with transactions consummated in the state *only* if the taxpayer invests a certain amount of money in the state, hires a certain number of employees in the state, or conducts operations of a certain size in the state.<sup>215</sup> Such incentives are therefore distinguishable from the benign form of transaction tax incentives, which say to the taxpayer that the state will not seek to establish a grip on the taxpayer's dollars for transactions consummated in the state, so long as the property or services on which the tax is imposed are dedicated to the prescribed in-state use.

It might be argued, along the lines advanced above in the context of property tax incentives, that the distinction we have drawn between defensible and indefensible sales and transaction taxes lacks substance. One might contend, for example, that there is no real distinction between a sales tax exemption for property purchased for use in new facilities in the state and a sales tax exemption for property purchased for use in a facility that creates ten new jobs in the state. In

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<sup>214</sup> See *supra* parts I.D.1.a, I.D.1.b.

<sup>215</sup> A recent Minnesota case is illustrative. In *Northwest Aerospace Training Corp. v. Commissioner of Revenue*, [2 Minn.] St. Tax Rep. (CCH) ¶ 202-603 (Minn. T.C. Apr. 4, 1995), Minnesota provided an exemption from its sales and use tax on the receipts from the lease of airflight equipment to airline companies that paid Minnesota's Flight Property Tax. Only airlines that made three or more flights per year into or out of Minnesota were subject to the tax. A lessor of flight equipment to federal agencies and miscellaneous third parties challenged the exemption on the grounds that it discriminated against interstate commerce in violation of the Commerce Clause. Sustaining the objection, the court cited *Boston Stock Exchange and Westinghouse*, declaring:

All United States domestic airlines who pay the Flight Property Tax are exempt from the sales tax when they rent airflight equipment. The Flight Property Tax is paid by all United States domestic airline companies who make three or more trips into or out of Minnesota during a calendar year. Payers of the Flight Property Tax typically have employees and equipment in Minnesota and lease airport facilities in Minnesota . . . .

A United States domestic airline must pay Flight Property Tax to escape sales tax on rentals of airflight equipment. In effect, an airline is forced to establish an economic presence in Minnesota to escape the tax. A United States domestic airline which does not establish an economic presence in Minnesota is placed at a competitive disadvantage because it is forced to pay the [lessor's] lease rate for use of flight training equipment and a sales tax.

*Id.* at 14,630 (emphasis in original).

each case, the taxpayer must engage in some in-state activity apart from the taxable transaction itself. Accordingly, the argument goes, the state in each case exerts its taxing power over the taxable transaction (i.e., the sale) by coercing the taxpayer to engage in some discrete in-state activity (use of the property in a new facility or use of the property in a facility that creates ten new jobs).

Although it is true that there are conditions imposed upon tax-favored in-state transactions that we have characterized as constitutional apart from the naked act of making an in-state purchase, we believe, as explained in the context of property tax incentives, that the distinction we have drawn between the two categories of incentives is meaningful. There is a significant difference between relieving a taxpayer of a tax obligation ordinarily due upon a sale when the taxpayer puts the property sold to a particular in-state use or employs it in a particular in-state location and relieving a taxpayer of a tax obligation ordinarily due upon a sale when the taxpayer engages in in-state activity that does not depend on the use or location of the property sold. In the former case, the taxpayer is not required to engage in any in-state activity that can be fairly characterized as independent of the acquisition and disposition of the property itself. In the latter case, the taxpayer is required to engage in in-state activity that it might undertake even if it had never purchased the property (e.g., creating a certain number of jobs in the state or making in-state investments of a certain magnitude).<sup>216</sup>

## II

### SUBSIDIES

We have seen that state tax breaks that provide business incentives run a serious risk of condemnation under the dormant commerce clause.<sup>217</sup> If, for example, a state entices a firm to build a new local plant by offering it a credit against its income tax, the Court might well invalidate the credit under authorities like *Westinghouse*

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<sup>216</sup> We recognize, as we did in the context of property tax incentives, *see supra* note 189, that the line we are drawing—between conditions that relate to the use or location of property and other conditions independent of the use or location of the property—may appear blurry in some contexts. Why, one may ask, is use of a property in a new facility any more a condition of use than use of property in a new facility that creates ten new jobs? Our response mirrors the response we offered in the context of property tax incentives: If the condition can in substance be fulfilled without regard to the physical acquisition or disposition of the property, it ought to be regarded as independent of use or location. In our judgment, although the question is close, the requirement of use in a new facility falls on one side of the line and the requirement of use in a new facility that creates ten new jobs falls on the other.

<sup>217</sup> *See supra* part I.

*Electric Corp. v. Tully*.<sup>218</sup> What if, however, the state provides not a tax break, but a monetary subsidy equal to the value of the credit?

Economists know that the real-world impact of such a subsidy mirrors the effect of the credit.<sup>219</sup> Thus, the firm that is relieved of paying \$10,000 in income taxes ends up with exactly as much cash in the till as the firm that pays the full tax levy, but then gets a \$10,000 subsidy check. This fact is of particular significance because the Supreme Court has often said that "constitutionality under the Commerce Clause . . . depends upon . . . practical effect"<sup>220</sup> and "economic realities."<sup>221</sup> Indeed, courts and commentators often characterize tax benefits—whether in the form of exemptions, deductions, or credits—as "subsidies."<sup>222</sup>

Do these realities mean that courts must treat cash bounties just like tax breaks for purposes of the dormant commerce clause? Until the Court's decision in *West Lynn Creamery, Inc. v. Healy*,<sup>223</sup> the answer to this question clearly was "no." In the wake of that decision, however, the answer has become more complex. Moreover, the issue has gained increasing importance because non-tax benefits "are the fastest growing type of development incentive."<sup>224</sup>

<sup>218</sup> 466 U.S. 388 (1984) (discussed *supra* notes 42-63 and accompanying text). See also *supra* note 32 (discussing *Maryland v. Louisiana*, 451 U.S. 725 (1981)).

<sup>219</sup> See ROBERT L. HEILBRONER & LESTER C. THURLOW, *ECONOMICS EXPLAINED* 173 (updated ed. 1987) (discussing tax reductions and subsidies as alternative means to influence the same activity); Michael J. Polelle, *A Critique of the Market Participation Exception*, 15 *WHITTIER L. REV.* 647, 685 (1994) (asserting "lack of economic justification" for the "Court's distinction between a tax credit and a subsidy" and lamenting the Court's failure to recognize the "obvious subsidizing effect of the tax credit"); see also *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988) (noting that Indiana's direct subsidy scheme was "no less effective in conferring a commercial advantage over out-of-state competitors" than an invalidated Ohio tax exemption); *Fireside Nissan, Inc. v. Fanning*, 30 F.3d 206, 216 (1st Cir. 1994) ("[W]e see no practical difference between the tax break offered to local liquor producers in *Bacchus* . . . and a 'direct' cash subsidy to those same industries . . .").

<sup>220</sup> *Department of Revenue v. Association of Wash. Stevedoring Cos.*, 435 U.S. 734, 750 (1978). Accord *West Lynn Creamery, Inc. v. Healy*, 114 S. Ct. 2205, 2213 (1994); *Hughes v. Oklahoma*, 441 U.S. 322, 336 (1979).

<sup>221</sup> *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

<sup>222</sup> See, e.g., *New Energy Co. v. Limbach*, 486 U.S. 269, 271, 277 (1988) ("[T]he emergence of ethanol production on a commercial scale dates from enactment of the first federal subsidy, in the form of an exemption from federal motor fuel excise taxes . . ."); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 272 (1984) (characterizing the Hawaiian liquor excise tax exemption as designed to "subsidize" local industry); *Regan v. Taxation With Representation*, 461 U.S. 540, 544 (1983) ("Both tax exemptions and tax-deductibility are a form of subsidy that is administered through the tax system."); Richard B. Collins, *Economic Union as a Constitutional Value*, 63 *N.Y.U. L. REV.* 43, 98-99 n.332 (1988) ("Tax exemptions . . . are sometimes called 'tax subsidies . . .'"); Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 *MICH. L. REV.* 1091, 1193 (1986).

<sup>223</sup> 114 S. Ct. 2205 (1994).

<sup>224</sup> SCHWEKE ET AL., *supra* note 6, at 19.



This Section of the Article explores the constitutionality of cash-subsidy and other non-tax-based financial incentives designed to spur business development. In Part II.A we ask whether *West Lynn Creamery* itself mandates equivalent constitutional treatment of state tax breaks and state subsidies. Having answered this question in the negative, we show in Part II.B that both precedent and policy support the constitutionality of state subsidies under the dormant commerce clause. In Part II.C we ask whether this presumption of constitutionality attaches when the state does not subsidize a general category of favored businesses, but instead channels benefits to a specifically targeted firm. After finding that this presumption applies regardless of *whom* the state favors, we ask in Part II.D whether constitutional results should hinge on *how* subsidy awards are packaged. We focus on eight forms of government benefits: (1) infrastructure improvements, (2) educational benefits, (3) below-market leases and land sales, (4) land giveaways, (5) one-shot cash grants, (6) per-unit subsidies, (7) loan forgiveness, and (8) user-fee waivers. We conclude that courts should assess all of these programs under a unitary "anti-tariff principle" that invalidates only close equivalents of the *de facto* tax-rebate program involved in *West Lynn Creamery* itself. In contrast to our position on tax incentives, we also conclude that courts, in applying this principle, should uphold almost all state subsidies.

#### A. *West Lynn Creamery* and Subsidies

*West Lynn Creamery* arose out of an effort by Massachusetts to aid its struggling dairy industry. To this end, the state imposed a tax on milk dealers for all in-state sales of milk, whether or not the milk had been produced in Massachusetts.<sup>225</sup> The state then placed all tax proceeds in a segregated fund and distributed the fund exclusively to operators of in-state dairy farms.<sup>226</sup> The Supreme Court struck down the program, rejecting Massachusetts's argument that it embodied nothing more than a constitutionally nondiscriminatory tax and a permissible expenditure of the state's own money.<sup>227</sup> According to Justice Stevens, who wrote for five Justices, the Massachusetts program effectively gave local producers an unlawful "tax rebate"<sup>228</sup> functionally in-

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<sup>225</sup> *West Lynn Creamery*, 114 S. Ct. at 2210.

<sup>226</sup> *Id.* Disbursements were based on each dairy farmer's percentage share of raw milk production, subject to two qualifications. First, each farmer who produced more than 200,000 pounds of milk was deemed to have produced only 200,000 pounds. Second, no farmer could collect subsidy payments that resulted in total payments beyond \$15 per hundred weight. *See id.* at 2210 & n.8.

<sup>227</sup> *Id.* at 2214-15.

<sup>228</sup> *Id.* at 2213.

distinguishable from the discriminatory tax exemption struck down in *Bacchus*.<sup>229</sup>

*West Lynn Creamery* provides a vehicle for attacking all business subsidy programs. Indeed, the two dissenters broadly read Justice Stevens's opinion as casting "doubt on the validity of state subsidies."<sup>230</sup> Justice Scalia, in a concurring opinion, went even further, declaring that "subsidies for in-state industry . . . would *clearly* be invalid under any formulation of the Court's guiding principle."<sup>231</sup> If Justice Scalia's reading of *West Lynn Creamery* were correct, that decision might well signal the end of all state efforts to induce business development with grants of cash or property. But Justice Scalia's reading is wrong.

As Justice Stevens framed his *West Lynn Creamery* opinion, he was well aware of Justice Scalia's concern that the Court was writing a new and bold chapter in the history of the dormant commerce clause. To Justice Scalia's protestations, Justice Stevens thus offered a blunt response: he declared explicitly that the Court was *not* ruling on the constitutionality of ordinary state subsidies.<sup>232</sup> Justice Scalia's rejoinder was that the Court's opinion *in effect* required invalidation of such subsidies because the only "guiding principle" fairly drawn from the decision was so "sweeping" that, under that principle, "every state law which obstructs a national market violates the Commerce Clause."<sup>233</sup> In actuality, Justice Stevens had suggested no such thing. Rather, he carefully explained that the constitutional defect in the Massachusetts program lay in its "coupling" of the in-state milk-producer subsidy with a specific and simultaneously enacted tax.<sup>234</sup> This close "conjoining" of "a tax and a subsidy"<sup>235</sup> mandated invalidation of "the entire program—not just the contributions to the fund or the distributions from that fund."<sup>236</sup> In other words, the milk subsidy transformed the Massachusetts milk program into a "tax rebate" scheme<sup>237</sup> "most similar to the law at issue in *Bacchus*."<sup>238</sup> The rebate-like character of the bounty, Justice Stevens explained, removed any

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<sup>229</sup> *Id.* Justice Stevens's opinion was joined by Justices O'Connor, Kennedy, Souter, and Ginsburg. *Bacchus* is discussed *supra* notes 33-41 and accompanying text.

<sup>230</sup> *Id.* at 2221 (Rehnquist, C.J., dissenting). Justice Blackmun joined Chief Justice Rehnquist's dissent.

<sup>231</sup> *Id.* at 2219 (Scalia, J., concurring) (emphasis in original). Justice Thomas joined Justice Scalia's concurrence.

<sup>232</sup> *Id.* at 2214 n.15.

<sup>233</sup> *Id.* at 2219 (Scalia, J., concurring).

<sup>234</sup> *Id.* at 2215.

<sup>235</sup> *Id.* at 2214.

<sup>236</sup> *Id.* at 2215.

<sup>237</sup> *Id.* at 2213.

<sup>238</sup> *Id.*

need to consider the constitutionality of subsidy programs "standing alone."<sup>239</sup>

As this brief review of *West Lynn Creamery* reveals, the Supreme Court invalidated the Massachusetts program on narrow grounds that do *not* require lower courts to treat run-of-the-mill subsidies like discriminatory tax breaks. Suggestions to the contrary reflect inattentiveness both to Justice Stevens's actual analysis and to the "maxim . . . that general expressions, in every opinion, are to be taken in connection with the case in which those expressions are used."<sup>240</sup>

## B. The Teachings of Precedent and Policy on the Constitutionality of Ordinary Subsidies

While Justice Stevens's opinion in *West Lynn Creamery* neither in terms nor in principle invalidated all freestanding state subsidies, it also did not declare their universal validity. Rather, Justice Stevens observed—again, with more accuracy than his objecting colleagues were willing to recognize<sup>241</sup>—that "[w]e have never squarely confronted the constitutionality of subsidies."<sup>242</sup> Justice Stevens then invited renewed reflection on the subject by adding that "we need not do so now."<sup>243</sup> His invitation was timely, given the recent explosion of the use of subsidies to encourage local business development.<sup>244</sup> Elaborating a coherent constitutional theory of subsidies, however, presents a formidable challenge, particularly because of the wide array of government programs any such theory must take into account.<sup>245</sup> Nonetheless, our own theory may be stated rather simply: In general, courts should *not* treat state subsidies afforded to local businesses the same as tax breaks that discriminate in their favor; rather, courts should strike down only those subsidies that operate, like the program in *West Lynn Creamery*, as discriminatory *de facto* rebates of an identifiable state tax. To be sure, it will sometimes prove difficult to decide whether a state program fits into the "de facto tax rebate" category.<sup>246</sup>

<sup>239</sup> *Id.* at 2214.

<sup>240</sup> *Cohens v. Virginia*, 19 U.S. (6 Wheat.) 264, 399 (1821).

<sup>241</sup> See *infra* notes 281-90 and accompanying text.

<sup>242</sup> *West Lynn Creamery*, 114 S. Ct. at 2214 n.15.

<sup>243</sup> *Id.*

<sup>244</sup> See SCHWEKE ET AL., *supra* note 6, at 20 (Between 1983 and 1989, "total state grants programs increased more than tenfold."); E.J. Dionne, Jr., *Tax Breaks For Jobs Just Another Form of Bribery*, PORTLAND OREGONIAN, Sept. 3, 1993, at D9 [hereinafter Dionne] ("State governments all over the United States are engaged in bribery on a massive scale."); Chris O'Malley & Kevin A. Drawbaugh, *The State Subsidy Wars, Political Pressures Push Government Into Give-away Game With Industry*, INDIANAPOLIS NEWS, Feb. 16, 1993, at 1 [hereinafter O'Malley] (reporting that state governments subsidized 394 private sector development projects with tax or cash packages in 1988).

<sup>245</sup> See *infra* part II.C.

<sup>246</sup> For an illustration of the difficulties involved in making the "is-it-really-a-rebate" inquiry, compare *Sheehy v. Public Employees Retirement Div.*, 864 P.2d 762 (Mont. 1993)

In general, however, courts should hesitate to apply this label in light of both Supreme Court precedent and the important functional differences between discriminatory tax breaks and most government subsidies.

### 1. *Supreme Court Precedent*

Supreme Court precedent firmly supports the constitutionality of state business subsidy programs as a general rule.<sup>247</sup> Indeed, three separate sources of authority underlie this conclusion: (1) *West Lynn Creamery* itself; (2) pre-*West Lynn Creamery* subsidy cases; and (3) the Court's decisions under the market-participant exception to the dormant commerce clause.

#### a. *West Lynn Creamery*

In *West Lynn Creamery*, Justice Stevens's dissenting colleagues charged him with wrongly "cast[ing] doubt" on state business subsidies by needlessly reopening the question of their validity.<sup>248</sup> A look at Justice Stevens's full (albeit abbreviated) treatment of the subject exonerates him from this charge. That treatment reads as follows: "We have never squarely confronted the constitutionality of subsidies, and we need not do so now. We have, however, noted that '[d]irect subsidization of domestic industry does not ordinarily run afoul' of the negative Commerce Clause."<sup>249</sup>

Justice Stevens's brief discussion sounds two themes: first, that the Court has never spelled out a full-scale theory of how subsidy programs interact with the Constitution (which is true); and second, that the Court's authorities nonetheless signal that "[d]irect subsidization of domestic industry" is "ordinarily" constitutional (which is also true). Read in this straightforward way, Justice Stevens's message is hardly as controversial as his critical colleagues suggested; indeed, it is not controversial at all. Rather, while Justice Stevens professed his unpreparedness to write chapter and verse on the constitutionality of state subsidies (an entirely appropriate choice given the judicial preference for not "formulat[ing] a rule of constitutional law broader

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(payments made to state retirees deemed rebates for purposes of intergovernmental tax immunity doctrine) with *Ragsdale v. Department of Revenue*, 895 P.2d 1348 (Or. 1995) (payments made to state retirees not deemed tax rebates), *cert. denied*, 116 S. Ct. 569 (1995).

<sup>247</sup> See Collins, *supra* note 222, at 98-100 (citing cases in which the Supreme Court upheld protectionist subsidies); Regan, *supra* note 222, at 1193-94 (listing examples of state actions that fall beyond the scope of the protectionist definition).

<sup>248</sup> 114 S. Ct. 2205, 2221 (Rehnquist, C.J., dissenting).

<sup>249</sup> *Id.* at 2214 n.15 (quoting *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988)).

than is required by the precise facts" presented<sup>250</sup>), he simultaneously acknowledged his impression that existing authorities generally support the validity of subsidies limited to in-state businesses. Given this acknowledgement, *West Lynn Creamery* itself bolsters—rather than undermines—the view that state subsidies "ordinarily" are constitutional.

b. *Pre-West Lynn Creamery Subsidy Cases*

The Court's earlier decisions offer even more potent aid to defenders of state subsidy programs. In the most telling of these decisions, *New Energy Co. of Indiana v. Limbach*,<sup>251</sup> the Court—while striking down as discriminatory an Ohio tax exemption afforded to sellers of ethanol produced in Ohio—saw fit to discuss Indiana's ethanol subsidy. The Court did not declare that subsidy constitutional; indeed, it made clear that the Ohio tax exemption would fall "even if the Indiana subsidy were invalid."<sup>252</sup> The Court did, however, offer its now often-cited utterance that "[d]irect subsidization of domestic industry does not ordinarily run afoul of [the Commerce Clause] prohibition."<sup>253</sup>

*New Energy* does not stand alone. In *Hughes v. Alexandria Scrap Corp.*,<sup>254</sup> the Court upheld Maryland's imposition of stricter documentation requirements on out-of-state auto demolishers, than on in-state demolishers, seeking to take advantage of the state's inoperable-car-processing subsidy program.<sup>255</sup> Although this modification drove almost all business in processing Maryland-titled "hulks" to local firms,<sup>256</sup> the Court found that this change of fortunes resulted solely from "market forces, including that exerted by money from the state,"<sup>257</sup> rather than from the sort of state action "with which the Commerce Clause is concerned."<sup>258</sup> Maryland, the Court explained, could have restricted its bounties "to domestic processors from the start."<sup>259</sup> It made no difference, in the Court's view, that the state first included out-of-staters in its program before adopting a new approach that effectively subsidized only in-state firms.<sup>260</sup>

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<sup>250</sup> *Ashwander v. Tennessee Valley Auth.*, 297 U.S. 288, 347 (1936) (Brandeis, J., concurring) (quoting *Liverpool, N.Y. & P.S.S. Co. v. Commissioners of Emigration*, 113 U.S. 33, 39 (1885)).

<sup>251</sup> 486 U.S. 269 (1988).

<sup>252</sup> *Id.* at 278.

<sup>253</sup> *Id.*

<sup>254</sup> 426 U.S. 794 (1976).

<sup>255</sup> It is interesting to note that the "state money initially was made available to licensed out-of-state processors as well as those located within Maryland." *Id.* at 809. An amendment in 1974 effectively "channeled" the benefits only "to domestic processors." *Id.*

<sup>256</sup> *Id.* at 803 n.13.

<sup>257</sup> *Id.* at 810.

<sup>258</sup> *Id.* at 805.

<sup>259</sup> *Id.* at 809.

<sup>260</sup> *Id.*

Justice Stevens, who wrote a concurring opinion in *Alexandria Scrap*, also saw no difference between the actual case and one in which a state offered subsidies exclusively to in-staters from day one. For Justice Stevens, Maryland's action was permissible because the Commerce Clause did not "inhibit a State's power to . . . encourag[e] local industry" with, among other things, "a cash subsidy."<sup>261</sup> In short, Justice Stevens—the author of *West Lynn Creamery*—believed a discriminatory "subsidy to operators of [in-state] plants" to be constitutionally unobjectionable.<sup>262</sup>

In *South-Central Timber Development, Inc. v. Wunnicke*,<sup>263</sup> six members of the Court again turned to the subject of subsidies. The issue was whether Alaska could condition sales of its timber on the buyer's agreement to process it in the state. A majority of the Court remanded for further review,<sup>264</sup> but two dissenting Justices (then-Justice Rehnquist and Justice O'Connor) would have upheld the rule under the market-participant principle first recognized in *Alexandria Scrap*.<sup>265</sup> The dissenters reasoned that Alaska was in effect channeling state resources to the local timber-processing industry by charging buyers of state-owned timber a below-market price to secure their agreement to hire local processors.<sup>266</sup> The Court should have upheld this effort, according to the dissent, because "the State could accomplish that same result in any number of ways"<sup>267</sup>—for example by "directly subsidiz[ing] the primary-processing industry within the State."<sup>268</sup> The four-Justice plurality (which included Justice Stevens) did not disagree. Instead the plurality found it "unimportant for present purposes that the State could support its processing industry . . . by direct subsidy."<sup>269</sup>

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<sup>261</sup> *Id.* at 816 (Stevens, J., concurring).

<sup>262</sup> *Id.* at 815 (Stevens, J., concurring).

<sup>263</sup> 467 U.S. 82 (1984).

<sup>264</sup> *Id.* Justices White, Brennan, Blackmun, and Stevens refused to apply the market-participant doctrine and were prepared to strike down the Alaska processing requirement. Justice Powell and Chief Justice Burger preferred to remand for a determination whether the Alaska requirement qualified for market-participant protection. Justices Rehnquist and O'Connor viewed the processing requirement as constitutional under the market-participant exception. Justice Marshall did not participate in the case.

<sup>265</sup> 467 U.S. at 103 (Rehnquist, J., dissenting). For a general treatment of the market-participant doctrine, see *infra* notes 291-305 and accompanying text.

<sup>266</sup> *Id.*

<sup>267</sup> *Id.*

<sup>268</sup> *Id.* In making this assertion, the dissenters relied on *Alexandria Scrap*. In a subsequent dissenting opinion, Chief Justice Rehnquist expressed a similar endorsement of state power to subsidize local industry. See *Chemical Waste Management, Inc. v. Hunt*, 112 S. Ct. 2009, 2019 (1992) (Rehnquist, C.J., dissenting) ("There seems to be nothing . . . that would prevent Alabama from providing subsidies . . . to domestic industries that generate hazardous wastes.").

<sup>269</sup> 467 U.S. at 99; see also Polelle, *supra* note 219, at 676 (reading *South-Central Timber* to teach that "Alaska could subsidize processing plants in Alaska").

Only a month before it decided *West Lynn Creamery*, the Court touched again on the matter of subsidies in *C & A Carbone, Inc. v. Town of Clarkstown*.<sup>270</sup> In an opinion penned by Justice Kennedy (and joined by four other Justices, including Justice Stevens), the Court struck down a rule that required delivery of all solid waste generated in the town to a newly built processing center.<sup>271</sup> The majority noted that the forced-use rule was in reality a "financing measure" that had been put in place to induce the construction and operation of a needed facility.<sup>272</sup> In rejecting the town's contention that it had "no other means to advance [this] interest,"<sup>273</sup> the majority cited *New Energy* in stating that: "[The town] maintains that special financing is necessary to ensure the long-term survival of the designated facility. If so, the town may subsidize the facility through general taxes or municipal bonds."<sup>274</sup> In a concurring opinion, Justice O'Connor fully agreed with the majority's assertion that "the town could finance the project by imposing taxes."<sup>275</sup> And in a dissent joined by Chief Justice Rehnquist and Justice Blackmun, Justice Souter did not question the town's ability to provide "financing through a subsidy derived from general tax revenues."<sup>276</sup> In short, every opinion written in *Carbone* seemed to accept the premise that state subsidization of a local business that was competing with out-of-state firms was entirely permissible.<sup>277</sup>

This review reveals that Justice Stevens—whose *West Lynn Creamery* opinion supposedly casts a cloud over most state subsidy programs<sup>278</sup>—wrote or joined opinions that endorse state subsidies in no fewer than four separate cases: *Alexandria Scrap*, *South-Central Timber*, *New Energy*, and *Carbone*. Even more important, nearly all of Justice Stevens's colleagues seem to have signed on to the same position. The Court's endorsement of subsidies in *New Energy* came in a unani-

<sup>270</sup> 114 S. Ct. 1677 (1994).

<sup>271</sup> *Id.* at 1680.

<sup>272</sup> *Id.* at 1684.

<sup>273</sup> *Id.* at 1683.

<sup>274</sup> *Id.* at 1684 (emphasis added).

<sup>275</sup> *Id.* at 1690 (O'Connor, J., concurring).

<sup>276</sup> *Id.* at 1701 (Souter, J., dissenting). In particular, Justice Souter found the town's flow control rule permissible because of the practical, rather than constitutional, "limits on any municipality's ability to incur debt or to finance facilities out of tax revenues." *Id.* More generally, Justice Souter was prepared to uphold the local processing requirement because it imposed costs only on local residents in the form of increased waste disposal charges, *id.* at 1699, so that those costs were borne by "the very citizens who passed [the law]." *Id.* This underlying sow-and-reap rationale applies no less strongly to justify the power to augment plant revenues with subsidies drawn from local taxes than to justify the power to fund the plant through forced use at stipulated fees. See generally Coenen, *supra* note 120, at 473-76 (discussing in-state subsidies in the context of legislative expenditures).

<sup>277</sup> See *National Solid Waste Management Assoc. v. Williams*, 877 F. Supp. 1367, 1380 (D. Minn. 1995) ("[T]he Supreme Court in *Carbone* identified general taxes as a less burden[some] alternative for subsidizing waste processing.").

<sup>278</sup> See *supra* notes 232-33 and accompanying text.

mous opinion, joined by five members of the current Court.<sup>279</sup> And eight Justices who sit on the Court today spoke approvingly of subsidies in *Carbone*.<sup>280</sup>

Even though this judicial nose-counting signals that a broad majority of the Court sees no problem with typical subsidies, Justice Stevens could fairly assert in *West Lynn Creamery* that the Court has not "squarely confronted [their] constitutionality."<sup>281</sup> The principal opinions in both *New Energy* and *South-Central Timber*, after all, spoke favorably of subsidies in only the briefest dicta.<sup>282</sup> The majority in *Alexandria Scrap* approved a subsidy, but only after characterizing the state in that case as "participating in the market"<sup>283</sup> as "a purchaser"<sup>284</sup> of junk cars.<sup>285</sup> Finally, the Court's endorsement of a power to subsidize in *Carbone* could be given a narrow reading (for example, as existing only when subsidization provides the least restrictive alternative for meeting a critical state financing need).<sup>286</sup> Moreover, it is hard to say that a controlling treatment of subsidies lurks in *Carbone's* single sentence on the subject, especially when the constitutionality of subsidies was not even at issue in the case.<sup>287</sup> Most importantly, *Carbone* does not say that the power to subsidize includes the power to discriminate; it would be consistent with *Carbone*, for example, for the Court to require the extension of any state subsidy presently awarded operators with in-state facilities to similarly situated out-of-state operators, at

<sup>279</sup> *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 270 (1988).

<sup>280</sup> 114 S. Ct. at 1679. Indeed, as in *New Energy*, the Court's endorsement of subsidies was unanimous. Only Justice Breyer, who replaced Justice Blackmun following the *Carbone* decision, has yet to write or join an opinion that supports the constitutionality of state subsidies.

<sup>281</sup> *West Lynn Creamery, Inc. v. Healy*, 114 S. Ct. 2205, 2214 n.15 (1994).

<sup>282</sup> *New Energy*, 486 U.S. at 278 ("Direct subsidization of domestic industry does not ordinarily run afoul of [the Commerce Clause] prohibition."); *South-Central Timber*, 467 U.S. at 99 ("[It is] unimportant for present purposes that the state could support its processing industry . . . by direct subsidy.").

<sup>283</sup> *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 810 (1976).

<sup>284</sup> *Id.* at 808.

<sup>285</sup> See Collins, *supra* note 222, at 103-04 & n.360 (viewing *Alexandria Scrap* as a "procurement" case and noting that "[p]assive subsidies may not enjoy the same immunity from dormant commerce power scrutiny"). See also *infra* note 291 and accompanying text (discussing possible characterization of subsidy cases unlike *Alexandria Scrap* as involving market "regulation" rather than "participation").

<sup>286</sup> Critics of subsidies might also read *Carbone* to distinguish between subsidies designed to "ensure the long-term survival of the designated facility," *C & A Carbone, Inc. v. Town of Clarkstown*, 114 S. Ct. 1677, 1684 (1994), and subsidies designed to increase already-successful firms' market share. But recognizing such a distinction would require the drawing of a most difficult line in the teeth of the Court's rejection of an essentially identical distinction in *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 270-71 (1984) (finding no difference between state efforts "to aid Hawaiian industry" and to encourage and promote the establishment of a new industry within the state).

<sup>287</sup> See *supra* notes 270-77 and accompanying text.



least if those out-of-staters pay state taxes.<sup>288</sup> In any event, none of the Supreme Court's authorities reveals a systematic effort to explain *why* business subsidies typically are permissible or *when* exceptions to the general rule approving them might come into play.<sup>289</sup>

In short, as Justice Stevens observed in *West Lynn Creamery*, the Court has neither decisively nor comprehensively addressed the subject of subsidies. At the same time, the Court has so often and unhesitatingly approved "subsidization of domestic industry" that a powerful body of Supreme Court precedent now suggests that courts "ordinarily" must find such state action constitutional.<sup>290</sup> The body of

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<sup>288</sup> The observation in the text raises the question of how far any constitutional state duty to subsidize extends. Out-of-state firms that compete with subsidized in-staters have a far stronger claim to equal treatment if they have, by paying taxes, helped to create the pool of funds out of which subsidy payments are made. See Coenen, *supra* note 120, at 425. In addition, payment by out-of-staters of state taxes indicates that such firms are in some measure susceptible to the state's regulatory authority, and thus have a claim to take the "sweet" with the "bitter." At the least, it should be clear that any prohibition on discriminatory subsidization would not impose a duty on the state to subsidize every comparable business in the nation. For example, a subsidy of Maine dairy farmers would not have to go to every dairy farmer in California; at the least out-of-state dairy farmers seeking the Maine subsidy would have to show that their product was being sold in Maine and thus in competition with the product of subsidized farmers in the state. One advantage of the "rebate-likeness" theory of subsidies we advance here is that it pretermits (essentially, if not altogether) "standing" problems of this kind.

<sup>289</sup> The lack of a "square confrontation" with subsidies also is revealed by the Court's twice-offered observation that ordinary subsidies might be deemed state regulations for dormant commerce clause purposes. See *infra* notes 294-95 and accompanying text (discussing *Reeves* and *New Energy* cases). In addition, even the Court's broad declaration in *New Energy* that subsidies "ordinarily are permissible" reveals the need to identify in some systematic way those "non-ordinary" subsidies that fall outside the Court's protective rule. Cf. *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 895 (1985) (O'Connor, J., dissenting) (citing Justice Brennan's dissent in *Alexandria Scrap* for the proposition that "the Court has divided on the circumstances in which the dormant [c]ommerce [c]lause allows [subsidies]").

<sup>290</sup> *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988). See also *Metropolitan Life*, 470 U.S. at 895 (O'Connor, J., dissenting) ("[A] State may provide subsidies or rebates to domestic but not to foreign enterprises if it rationally believes that the former contribute to the State's welfare in ways that the latter do not."); *White v. Massachusetts Council of Constr. Employers, Inc.*, 460 U.S. 204, 221 (1983) (Blackmun, J., concurring and dissenting) (citing "the power of the State to limit to state residents the direct benefits of subsidy programs supported with state funds" and "to prefer local businesses as providers of the goods it purchases in the marketplace, and to prefer local residents as direct purchasers or recipients of state-created bounty"); *Zobel v. Williams*, 457 U.S. 55, 67-68 (1982) (Brennan, J., concurring) ("[A] State may make residence within its boundaries more attractive by offering . . . direct distributions of its munificence"; "[t]hat is a healthy form of rivalry.").

Influenced by the Supreme Court's pronouncements, lower courts have opined that subsidization of local business is constitutional. See *Fireside Nissan, Inc. v. Fanning*, 30 F.3d 206, 216 (1st Cir. 1994) (noting that "the Court has repeatedly affirmed the long-recognized proposition that states may directly subsidize local industry as long as they do so without burdening the ability of interstate competitors to sell their products in the state"); *W.C.M. Window Co. v. Bernardi*, 730 F.2d 486, 494-95 (7th Cir. 1984) (Illinois subsidy to local coal-burning plants, and even local plants that only burn Illinois coal, would be constitutional).

pre-*West Lynn Creamery* precedent becomes even more impressive when one considers the Court's post-*Alexandria Scrap* "market-participant" decisions.

c. *The Market-Participant Cases*

In a series of cases, the Court has deemed the Commerce Clause anti-discrimination principle inapplicable when a state chooses not to regulate commerce, but instead to enter the market to trade its own resources.<sup>291</sup> A state, for example, may freely favor its own residents when it engages in activities such as buying printing services,<sup>292</sup> hiring workers,<sup>293</sup> or selling state-made cement.<sup>294</sup> In these cases, the Court has neither embraced nor repudiated the view that the market-participant exception of its own force immunizes state subsidies from dormant commerce clause attack.<sup>295</sup> Yet even if the exception *per se* does not reach subsidies, its underlying rationale supports development of a principle that shelters subsidies as a general rule from constitutional challenge.

A central justification for the exception is that state citizens should be free to reap where they have sown;<sup>296</sup> thus, just as state revenues are principally derived from impositions placed by state residents upon themselves, state residents—in keeping with both "equity and

<sup>291</sup> For treatments of the market-participant exception, see Thomas K. Anson & P.M. Schenkkan, *Federalism, the Dormant Commerce Clause, and State-Owned Resources*, 59 TEX. L. REV. 71 (1980); Coenen, *supra* note 120, at 395; Collins, *supra* note 222, at 43; Mark P. Gergen, *The Selfish State and the Market*, 66 TEX. L. REV. 1097 (1988); Jonathan D. Varat, *State "Citizenship" and Interstate Equality*, 48 U. CHI. L. REV. 487 (1981).

<sup>292</sup> See *American Yearbook Co. v. Askew*, 409 U.S. 904 (1972), *aff'g mem.*, 339 F. Supp. 719, 722-24 (1972).

<sup>293</sup> See *White v. Massachusetts Council of Constr. Employers, Inc.*, 460 U.S. 204, 208 (1983). *But cf.* *United Bldg. & Constr. Trades Council v. Mayor and Council of Camden*, 465 U.S. 208, 221 (1984) (applying Privileges and Immunities Clause).

<sup>294</sup> See *Reeves, Inc. v. Stake*, 447 U.S. 429, 440 (1980).

<sup>295</sup> See *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 277 (1988) (noting that the Court has "observed that subsidy programs unlike that of *Alexandria Scrap* might not be characterized as proprietary" and emphasizing that the state in *Alexandria Scrap* was like "a private purchaser of the auto hulks"); *Reeves*, 447 U.S. at 440 n.14 ("We have no occasion here to inquire whether subsidy programs unlike that involved in *Alexandria Scrap* warrant characterization as proprietary, rather than regulatory, activity."); Collins, *supra* note 222, at 104 n.360 ("[T]he Court has consistently described the immunity to be for 'market participants,' rather than for subsidies. Thus, the Court could readily distinguish a new case involving passive subsidies.") (citation omitted); Polelle, *supra* note 219, at 684 n.112 (citing *Reeves* and *New Energy* for the proposition that "[l]ately . . . the Court appears to have doubts about . . . the subsidy version of the market participation exception"); see also *Alliance for Clean Coal v. Miller*, 44 F.3d 591, 597 (7th Cir. 1995) (Cudahy, J., concurring) (arguing that the exception forged in *Alexandria Scrap* "restricts permissible subsidies to situations where a state is 'acting in the more general capacity of a market participant'" and stating that "since first enunciated in *Hughes*, the market participant doctrine has been narrowed to exclude many state actions that appear to be 'subsidy equivalents'").

<sup>296</sup> See Coenen, *supra* note 120, at 421-26 (discussing rationale and collecting other sources).

accepted notions of the nature of property"<sup>297</sup>—should be permitted to direct the state's largesse to their own advantage. This "return of capital" rationale<sup>298</sup> applies no less strongly to outright cash subsidies than to resident-favoring disposals of state resources in more orthodox "marketplace" transactions.<sup>299</sup> Indeed, if a state's right to "limit[ ] benefits generated by a state program to those who fund the state treasury" authorizes the state to make below-market sales of cement solely to local residents,<sup>300</sup> it should authorize no less a restriction to local residents of cash payments made directly from "the state treasury" itself.<sup>301</sup>

In short, the view that our Constitution countenances state-made business subsidies finds support in *West Lynn Creamery* itself,<sup>302</sup> the Court's prior treatments of subsidies,<sup>303</sup> and an uninterrupted line of market-participant decisions.<sup>304</sup> Particularly when viewed as a whole, these authorities lend strong support to the conclusion that "[d]irect subsidization of domestic industry does not ordinarily run afoul of the negative Commerce Clause."<sup>305</sup>

## 2. Policy

The case for differential treatment of discriminatory tax breaks and subsidies finds support in more than Supreme Court precedent. A host of commentators have defended the distinction on the basis of history and policy,<sup>306</sup> and have offered three justifications of particular significance. First, the distinction reflects the "important eco-

<sup>297</sup> *Id.* at 423.

<sup>298</sup> Anson & Schenkkan, *supra* note 291, at 89.

<sup>299</sup> See Regan, *supra* note 222, at 1195-96.

<sup>300</sup> *Reeves, Inc. v. Stake*, 447 U.S. 429, 442 (1980).

<sup>301</sup> *Id.* It may be possible to distinguish resident-favoring subsidies from resident-favoring market-participant programs on the ground that the market-participant exception rests in part on "the long recognized right of a trader . . . [to choose the] parties with whom he will deal." *Id.* at 438-39 (quoting *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919) (emphasis added)). This rationale, the argument goes, fails to justify cash subsidies because, in such cases, no trade occurs at all. *But see infra* note 395 and accompanying text. However, another key rationale of the market-participant exception—that such programs are unlikely to over-proliferate in light of their inherent costliness—applies with even greater force to ordinary (and wholly uncompensated) cash subsidy payments. See Coenen, *supra* note 120, at 434-35; Regan, *supra* note 222, at 1194. Thus it may even be argued that the market-participant cases establish *a fortiori* the constitutionality of outright state subsidy programs.

<sup>302</sup> See *supra* part II.B.1.a.

<sup>303</sup> See *supra* part II.B.1.b.

<sup>304</sup> See *supra* part II.B.1.c.

<sup>305</sup> *West Lynn Creamery, Inc. v. Healy*, 114 S. Ct. 2205, 2214 n.15 (1994) (internal quotations omitted).

<sup>306</sup> See Coenen, *supra* note 120, at 487-88; Collins, *supra* note 222, at 126-29; Gergen, *supra* note 291, at 1152-53; Paul S. Kline, *Publicly-Owned Landfills and Local Preferences: A Study of the Market Participant Doctrine*, 96 DICK. L. REV. 331, 374 (1992); Regan, *supra* note 222, at 1110-25. *But see* Polelle, *supra* note 219, at 687-89 (questioning the distinction).

conomic reality"<sup>307</sup> that subsidy payments are inherently "expensive"<sup>308</sup> and signal a cost "directly borne internally" by the state.<sup>309</sup> In particular, because their "immediate expense is borne by the state treasury"<sup>310</sup>—and often caught up in the perennially controversial budgeting process—"[s]ubsidies do not distort local politics nearly as effectively as do protectionist . . . taxes . . . ."<sup>311</sup>

Second, concerns about discriminatory taxation—and especially taxation that targets political outsiders—resonate with deep themes in American law. Chief Justice Marshall noted in a celebrated passage that "the power to tax involves the power to destroy."<sup>312</sup> No similar champion has stepped forward to make the same claim about the power to subsidize. Likewise, no idea played a more potent role in the founding of our Republic than the notion that "[t]axation without representation is tyranny."<sup>313</sup> Proclamations about "nonsubsidization without representation" hardly strike the same chord. Thus, profound "historical and psychological" considerations bolster the distinction between resident-favoring tax breaks and resident-favoring subsidies.<sup>314</sup>

Finally, the distinction springs from the origins of the Commerce Clause itself, for the Clause grew out of concerns about abusive taxation—particularly the protective tariff.<sup>315</sup> Differing methods of financial "protection" afforded local industries may thus be placed on a continuum that moves progressively away from this manner of obstructing commerce. At the endpoint of the continuum lies the tariff itself, the quintessential form of state action that violates the Commerce Clause.<sup>316</sup> One step removed from the tariff is the tax exemption, deduction, or credit afforded only to resident payers of an

307 *West Lynn Creamery*, 114 S. Ct. at 2221 (Scalia, J., concurring).

308 Regan, *supra* note 222, at 1194.

309 Collins, *supra* note 222, at 102.

310 *Id.*

311 *Id.*; *accord* Kline, *supra* note 306, at 374 ("[State subsidies] are visible, direct, and recurring costs to the state checked through both the political process and the state budget.") (footnotes omitted); *see also* SCHWEKE ET AL., *supra* note 6, at 52 ("[W]hen policymakers use 'easy money,' like a . . . tax reduction, the more likely it is that the subsidy will be abused.").

312 *M'Culloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819) (Marshall, C.J.).

313 The phrase is generally attributed to James Otis. According to JOHN BARTLETT, *FAMILIAR QUOTATIONS* (Emily Morison Beck ed., 14th ed. 1968): "This maxim was the guide and watchword of all the friends of liberty. Otis actually said: No parts of His Majesty's dominions can be taxed without their consent." *Id.* at 446 n.4 (citation omitted).

314 Coenen, *supra* note 120, at 481.

315 *See, e.g.*, GERALD GUNTHER, *CONSTITUTIONAL LAW* 93 (12th ed. 1991) ("The national commerce power, it was hoped, would put an end to . . . protective tariffs on imports from other states.").

316 *West Lynn Creamery, Inc. v. Healy*, 114 U.S. 2205, 2211 (1994); *Guy v. Baltimore*, 100 U.S. 434, 439 (1879); *see also* *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 438-39 (1827) (Marshall, C.J.).

otherwise generally applicable tax. Such tax breaks may differ from tariffs, particularly if they disadvantage some resident taxpayers.<sup>317</sup> However, in cases like *Bacchus Imports*,<sup>318</sup> the Court held that discriminatory tax breaks are close enough to tariffs that they too violate the dormant commerce clause.<sup>319</sup> Another step removed from the tariff is the resident-favoring tax rebate. Tax rebates differ from protective tariffs and more common forms of discriminatory tax relief because rebates return to taxpayers cash already in the state's coffers. In *West Lynn Creamery*, however, the Court left no doubt that a tax rebate program favorable to local industry fell within the orbit of the anti-tariff principle.<sup>320</sup>

Beyond the tax rebate on the continuum lies the subsidy paid out of the general revenues to favored producers. This form of government program—involving neither tariff nor tax—appears to be shielded from Commerce Clause concerns.<sup>321</sup> Why? Because constitutional interpretation properly depends, in part, on the proximity of relation between a challenged practice and the practice at which the Constitution's Framers took actual aim.<sup>322</sup> The Framers' focused concerns about commerce-stifling *taxation* thus support the strong line past decisions have drawn between discriminatory tax breaks and discriminatory subsidies. Put differently, ordinary subsidies are sufficiently removed from the protective tariff on our constitutional continuum that they need not be afforded identical constitutional treatment.

### C. Subdividing Subsidies (I): Looking at Who Gets the Subsidy

To say that subsidies are ordinarily constitutional is not to say that they are always so. Subsidies, for example, may come with "downstream restraints" that create significant constitutional problems.<sup>323</sup>

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<sup>317</sup> For example, in *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984), the state exempted locally produced fruit wine, but not sake or other locally produced beverages, from the state's wholesale liquor tax. 468 U.S. at 265. Such a law is less problematic (both from an anti-protectionist and political-process perspective) than a straightforward tariff placed only on non-locally produced fruit wine.

<sup>318</sup> 468 U.S. 263 (1984).

<sup>319</sup> *Id.* at 271-73.

<sup>320</sup> *West Lynn Creamery*, 114 S. Ct. at 2213 (comparing the rebate scheme with the exemption scheme struck down in *Bacchus*).

<sup>321</sup> See Coenen, *supra* note 120, at 479-81.

<sup>322</sup> *Id.* at 438 n.264.

<sup>323</sup> This Article does not further pursue the subject of downstream restraints (except to the extent discussed in the context of tax relief, see *supra* text accompanying notes 187-93, 206-16) because one of the authors of this article already has written on the subject. Coenen, *supra* note 120, at 468-70, 476-78. The Court approached the subject of downstream restraints (albeit outside the subsidy context) in *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 98-99 (1984) (plurality opinion). See also *White v. Massachusetts Council of Constr. Employers, Inc.*, 460 U.S. 204, 221-22 (1983) (Blackmun, J., dissenting)

Subsidies may also become constitutionally suspect if they generate large market distortions for very little cost.<sup>324</sup> Finally, two other variables may affect the constitutionality of a subsidy award: First, *who* receives the subsidy; and second, *how* the subsidy is structured. This subpart considers the who-receives-the-subsidy question, leaving the “how” question for the next subpart.

### 1. *The “Ordinary” Business Subsidy*

If business subsidies for domestic firms “ordinarily” are constitutional, the question arises as to what comprises the “ordinary” business subsidy. The standard subsidy program, like the standard business-development tax incentive, is one that applies across the board to all business firms or activities that fall into some favored category.<sup>325</sup> This was the type of subsidy involved in *New Energy*,<sup>326</sup> as well as the type that would have been involved in *West Lynn Creamery* had the subsidy stood alone.<sup>327</sup> Thus, under the authorities collected above, subsidies that are *generally applicable* to a *category* of favored firms or activities are, except in extraordinary cases, constitutionally unobjectionable.

### 2. *The Targeted New-Business Subsidy*

With the growth of aggressive economic-development efforts, a new brand of business subsidy has proliferated: the subsidy designed to induce a targeted firm to operate within the subsidizing state. By way of such subsidies, states or localities afford cash payments or other non-tax incentives (or a mixture of cash and non-cash incentives) on a *single-shot basis* to a *particular* firm to generate *new* in-state business activity. Efforts to woo large projects built by Mercedes (in Alabama)<sup>328</sup> and BMW (in South Carolina)<sup>329</sup> exemplify this burgeoning form of business-development incentive.<sup>330</sup>

The relevant constitutional question raised by targeted new-business subsidies is whether courts should treat them less favorably than traditional, generally applicable subsidy programs. Targeted new-business subsidies do differ from more orthodox subsidies in signifi-

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(emphasizing downstream-restraint restriction); Kline, *supra* note 306, at 380-83 (describing effects of downstream regulation).

<sup>324</sup> See *infra* text accompanying note 460. This subject, like the subject of downstream restraints, is discussed in Coenen, *supra* note 120, at 478-79.

<sup>325</sup> See *supra* text accompanying notes 73-83, 86-87.

<sup>326</sup> See *supra* text accompanying notes 251-53.

<sup>327</sup> *West Lynn Creamery*, 114 S. Ct. at 2214.

<sup>328</sup> See, e.g., SCHWERE ET AL., *supra* note 6, at 43-44. See *supra* note 3 and accompanying text.

<sup>329</sup> See, e.g., O'Malley, *supra* note 244, at D1.

<sup>330</sup> See *supra* text accompanying notes 1-3.

cant respects. On balance, however, there is no good reason to treat targeted new-business subsidies less favorably than ordinary subsidies under the dormant commerce clause.<sup>331</sup> Indeed, there is a strong argument that the Court's receptiveness to orthodox subsidy programs supports *a fortiori* the constitutionality of the single-shot new-business bounty.

To begin with, on our continuum of strengthening claims of constitutionality, the targeted subsidy falls even farther away from the protective tariff than does the generalized business subsidy.<sup>332</sup> The reason why is simple. The traditional protective tariff is not designed, at least primarily, to attract new business; instead, it seeks to *protect* the competitive positions of existing businesses from out-of-state competition.<sup>333</sup> Put another way, if the ordinary business subsidy is far removed from the paradigmatic protective tariff,<sup>334</sup> the single-shot new-business subsidy is *very* far removed. Indeed, by *requiring* the establishment of *new* business operations in the subsidizing state, such bounties may well serve to intensify the competitive environment in which existing in-state producers operate.<sup>335</sup>

Three additional functional considerations confirm that courts should be no less protective of targeted start-up subsidies than subsidies that apply across the board to a group of in-state operators. First, the act of exchanging a subsidy outlay for something that is discerni-

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<sup>331</sup> There is reason to believe that the Court agrees. See *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 879 (1985) (“[A] State’s goal of bringing in new business is legitimate and often admirable.”); *Zobel v. Williams*, 457 U.S. 55, 67-68 (1982) (Brennan, J., concurring) (“[A] State may make residence within its boundaries more attractive by offering direct benefits to its citizens in the form of public services . . . . Through these means, one State may attract citizens of other States to join the numbers of its citizenry.”). In *Reeves, Inc. v. Stake*, 447 U.S. 429 (1980), the Court noted that “business development programs”—no less than “police and fire protection”—can be “restrict[ed] to state residents” because “[s]uch policies, while perhaps ‘protectionist’ in a loose sense, reflect the essential and patently unobjectionable purpose of state government—to serve the citizens of the State.” *Id.* at 442 (footnote omitted). Justice Stevens, in his concurrence in *Alexandria Scrap*, approved of the ability of the states to “experiment with different methods of encouraging local industry,” including the use of a “cash subsidy.” *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 816 (1976) (Stevens, J., concurring). See generally JOHN E. NOWAK & RONALD D. ROTUNDA, *CONSTITUTIONAL LAW* § 8.9, at 299 (4th ed. 1991) (“[I]f a state offers a company a cash bonus or tax exemption in exchange for the company locating a factory in the state, its action can be upheld because the state is bearing the cost of producing some economic benefits for people in the state.”).

<sup>332</sup> See *supra* text accompanying notes 315-22.

<sup>333</sup> A leading law dictionary, for example, defines “protective tariff” as: “A law imposing duties on imports, with the purpose and the effect of discouraging the importation of competitive products of foreign origin, and consequently of stimulating and *protecting the home production of the same or equivalent articles.*” *BLACK’S LAW DICTIONARY* 1223 (6th ed. 1990) (emphasis added).

<sup>334</sup> See *supra* note 315 and accompanying text.

<sup>335</sup> See *Dionne*, *supra* note 244, at D9 (quoting Illinois Gov. Jim Edgar as saying that local business people “were infuriated with the state for giving special breaks to individual companies that were sometimes their fiercest competitors”).

bly new permits the state to claim that it has acted as "a purchaser, in effect" of a valuable asset.<sup>336</sup> The ability of the state thus to wrap itself in the market-participant mantle finds particularly strong support in *Alexandria Scrap*,<sup>337</sup> where the Court deemed the state a "purchaser" of wrecked cars that had no continuing value to the state or to anyone else.<sup>338</sup> If a state pays money for a firm's agreement to locate a new plant within its borders, is it not even more clearly a purchaser of a tangible, valuable asset? The reality is that the state, for all practical purposes,<sup>339</sup> acts just like the state in *Alexandria Scrap* in every new-business subsidy case: it encourages desired business activities, perceived to be in short supply, by "bid[ding] up their price."<sup>340</sup> These activities thus occur, as in *Alexandria Scrap*, "in response to market forces, including that exerted by money from the State."<sup>341</sup>

Second, any state effort to spawn entirely new business operations bolsters the claim that it has undertaken the sort of "experimentation in things social and economic" that our constitutional tradition of federalism celebrates.<sup>342</sup> The state simply behaves more like a "laboratory" of local inventiveness when it spurs *new* business ventures than when it acts to protect the old.<sup>343</sup> This is not to say that state efforts to channel subsidies in whole or in part to existing businesses trigger no concerns about state autonomy.<sup>344</sup> Those concerns, however, apply with added force when the state acts in focused fashion to expand its business base.

Finally, when a state considers the possibility of new business subsidies, ordinary political processes should provide greater safeguards against ill-advised and parochial decisionmaking than when a state enacts a subsidy of the ordinary sort. Clearly, this is true when an entirely new business locates in the state because the managers and workers of extant business operations will have influence in governmental decisionmaking councils that is not possessed by the new-

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<sup>336</sup> *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 808 (1976).

<sup>337</sup> See *supra* notes 254-69 and accompanying text.

<sup>338</sup> *Alexandria Scrap*, 426 U.S. at 808-10; see *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 277 (1988) (noting that the Court in *Alexandria Scrap* invoked "the analogy of the State to a private purchaser of the auto hulks").

<sup>339</sup> See *supra* text accompanying notes 220-21.

<sup>340</sup> *Alexandria Scrap*, 426 U.S. at 806.

<sup>341</sup> *Id.* at 810. Put somewhat differently, if *Alexandria Scrap* "can be taken to suggest that a straightforward production subsidy for local producers is constitutionally permissible," Regan, *supra* note 222, at 1196, it follows *a fortiori* that *new-business* subsidies are unobjectionable.

<sup>342</sup> *Reeves, Inc. v. Stake*, 447 U.S. 429, 441 (1980) (quoting *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting)).

<sup>343</sup> See, e.g., sources cited *supra* note 331.

<sup>344</sup> See *infra* text accompanying notes 354-63.



comer.<sup>345</sup> In addition, focused aid to new business operations may heighten competitive pressures on other in-state businesses, resulting in organized political opposition.<sup>346</sup>

There are arguments on the other side. For example, it may be that political checks on excessive spending diminish in the targeted-business subsidy setting because these “[i]ncentive packages are often put together in secret without appropriate discussion among lawmakers or the public.”<sup>347</sup> Targeted subsidies, moreover, may be the product of contracts that lock local governments into ongoing multi-year financial commitments, which consequently are neither reviewable nor revocable in the annual budget cycle.<sup>348</sup> And subsidies designed to attract a new plant may clash with deep constitutional commitments to long-term maximization of the public good,<sup>349</sup> especially if such subsidies typically result from the near-term “political return” that attends “attracting a large, high visibility project.”<sup>350</sup>

<sup>345</sup> See, e.g., Taylor, *supra* note 1, at 684 (noting that “political pressures to subsidize existing local industries may prevent the local government from properly evaluating such long-term effects as the positive externalities”) (footnotes omitted); see also *European Competition Policy: Banned Aid*, *ECONOMIST*, Nov. 19, 1994, at 75-76 (bemoaning “subsidy-sucking” local monopolies with the “political weight” to crowd out more efficient “small and medium-sized firms” that provide a “source of new employment”).

<sup>346</sup> See SCHWEKE ET AL., *supra* note 6, at 35-36 (“[E]lements of the business community are often among those opposed to aggressive inducements designed to attract industry . . . [B]usiness people become upset because special breaks given to certain companies produce an uneven playing field and, in effect, may penalize existing businesses.”); O’Malley, *supra* note 244, at D2 (“Subsidies increasingly are drawing complaints from existing businesses that want to know why newcomers should get help moving into town to compete with going concerns.”); see also Andrew Kolesar, Note, *Can State and Local Tax Incentives and Other Contributions Stimulate Economic Development?*, 44 *TAX LAW.* 285, 307 (1990) (suggesting that the “political backlash” resulting from the use of economic incentives may diminish their importance).

<sup>347</sup> SCHWEKE ET AL., *supra* note 6, at 4 (citing John Hood, *Ante Freeze: Stop the State Bidding Wars for Big Business*, 68 *HERITAGE FOUND. POL’Y REV.* 62, 66 (1994)). This dynamic is especially troubling if, in fact, “[t]he power of corporate lobbyists and collusion between state officials, legislators and businesses encourage the provision of subsidies.” *Id.* at 9.

<sup>348</sup> See *supra* text accompanying notes 307-11.

<sup>349</sup> See CASS R. SUNSTEIN, *THE PARTIAL CONSTITUTION* 311-12 (1993). See generally SCHWEKE ET AL., *supra* note 6, at 57 (“Although some states and localities can benefit even from wasteful incentives, the nation as a whole loses if no new jobs are being created and companies are moving from one place to another.”).

<sup>350</sup> SCHWEKE ET AL., *supra* note 6, at 34; see *id.* at 40 (“[T]he high visibility projects seem to draw the media’s attention.”) (quoting NATIONAL GOVERNOR’S ASS’N, *INVESTING IN AMERICA’S ECONOMIC FUTURE: STATES AND INDUSTRIAL ECONOMIC INCENTIVES* (1992)); *id.* at 82 (“[G]overnors must be prepared to withstand the political pressure that may result when they announce that their state will not engage in a bidding war for a high-visibility, high-impact project.”); Barrett, *supra* note 5, at 1028 (“State leaders, because of their political instincts, are usually guided by short-term considerations.”).

Recent experience gives some credence to an argument against new-business subsidies based on Commerce Clause concerns about interstate “retaliation.” See, e.g., *id.* at 1026 (“The competition for new business among the states has turned into a game of one-upmanship, resulting in a vicious circle “that encourages balkanization.”); see Taylor, *supra* note 1, at 670 (“[C]ities across the country engage in fierce bidding battles over prestigious

These arguments, however, do not justify adoption of a more restrictive Commerce Clause rule for the targeted new-business subsidy. Concerns about secret deal-making and multi-year commitments, for example, apply only to a limited class of cases. Even when applicable, moreover, these arguments do not undercut the core political-process and "it's-not-like-a-tariff" justifications for distinguishing subsidies from tax breaks.<sup>351</sup> The "public good" argument suffers from the vice of amorphousness and reliance on constitutional values at an unworkable level of generality.<sup>352</sup> On balance, the arguments for treating targeted new-business subsidies less favorably than generally-applicable subsidies undercut only modestly the very strong arguments for affording targeted subsidies even *more* judicial deference.<sup>353</sup> Such subsidies accordingly should not carry any diminished presumption of constitutionality.

### 3. *The Targeted "Stay at Home" Subsidy*

There is another sort of subsidy that the state can grant: the bounty designed to *retain* a specific business *already operating* in the state.<sup>354</sup> In some ways, this form of subsidy is more problematic than a new-business-attracting bounty. Recipients of "stay at home" subsidies, after all, have a toehold in the halls of local policymaking not enjoyed by courted outsiders.<sup>355</sup> Maintaining the status quo also smacks less of creative federalistic experimentation than does the retooling and expansion of the state's economic base.<sup>356</sup> Perhaps most important, fun-

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industrial projects in the hope of stimulating local growth and ensuring prosperity. In the heat of this competition, state and local governments face tremendous pressure to grant ever-increasing subsidies to corporations." (footnotes omitted); Phil Primack, *Study: Preferential Tax Treatment Hurts Overall Economy*, B. HERALD, Mar. 24, 1995, at 28 (quoting Arthur Rolnick, co-author of a report by the Federal Reserve Bank of Minneapolis, as saying that corporate posturing for subsidies and tax breaks "is part of the game we are seeing played across the country"); see also SCHWEKE ET AL., *supra* note 6, at 38 (noting copycatting of Kentucky industrial recruitment laws by other states in the region).

<sup>351</sup> In particular, when a project requiring multi-year commitments is proposed, its expense will likely induce close scrutiny by the public and local policymakers. See *supra* text accompanying notes 309-10. Moreover, while the use of secret negotiations may reduce political process checks to some degree, the public will eventually learn of deals negotiated behind closed doors and will hold the public officials who made and approved them accountable for their spending decisions.

<sup>352</sup> See *supra* text accompanying note 322. Moreover, even if many subsidies may be economically unwise and inefficient, "The Constitution does not require the States to subscribe to any particular economic theory." *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 92 (1987).

<sup>353</sup> See *supra* notes 332-46 and accompanying text.

<sup>354</sup> See, e.g., Kolesar, *supra* note 346, at 296-97 (discussing various "incentives [given] to an existing business which is threatening to leave," and specifically focusing on New York City's granting of incentives to maintain NBC's local operations); Taylor, *supra* note 1, at 682 (considering the efforts of Texas to retain General Motors plants).

<sup>355</sup> See *supra* text accompanying note 345.

<sup>356</sup> See *supra* text accompanying notes 342-43.

neling money to existing in-state firms already engaged in economic battle with out-of-state competitors involves, in a rather pure sense, the sort of "economic protectionism" at which the Commerce Clause takes aim.<sup>357</sup>

Even so, there are good reasons for including "stay at home" bounties in the rule that "ordinarily" shields subsidies from dormant commerce clause attack. To begin with, in the tax-relief context, the Court has pointedly refused to distinguish between incentives afforded new and existing business operations.<sup>358</sup> Considerations of authority and symmetry thus favor like treatment of business-creating and business-retaining subsidies.

Functional concerns also support applying a strong presumption of constitutionality to targeted "stay at home" subsidies. First, the risk that such subsidies will unduly proliferate if permitted is undercut by the built-in "costs of exit" that normally anchor established businesses in their current locations.<sup>359</sup> Second, permitting targeted business-creation subsidies,<sup>360</sup> while outlawing targeted business-retention subsidies, might well generate economically unjustified business relocations by forcing home states to compete on an uneven playing field. Finally, the unequal treatment of targeted business-attracting and business-retaining subsidies would open a judicial can of worms. Courts would find themselves in the position of having to distinguish between the two sorts of subsidies.<sup>361</sup> Courts would also have to distinguish between "targeted" and "generally applicable" subsidies.<sup>362</sup> On balance, the best rule is also the simplest: all subsidies should receive

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<sup>357</sup> See, e.g., *City of Philadelphia v. New Jersey*, 437 U.S. 617, 623-24 (1978) (differentiating between "economic isolation" and protectionism" and unavoidable "incidental burdens on interstate commerce"). Put somewhat differently, a subsidy aimed solely at benefiting an existing operation—without exacting from it any new business in the form of plant expansion, increased employment, or the like—lies close to the sort of state activity involved in the imposition of a true *protective* tariff. See *supra* note 333 and accompanying text.

<sup>358</sup> *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 406 (1984) (declining to draw any distinction between a discriminatory tax that "diverts new business into the State" and one that "merely prevents current business from being diverted elsewhere"); see *supra* text accompanying notes 59-60.

<sup>359</sup> See, e.g., *Western Oil & Gas Ass'n v. Cory*, 726 F.2d 1340, 1341 (9th Cir. 1984) (noting "the physical and practical immobility of plaintiffs' processing plants"), *aff'd by an equally divided Court*, 471 U.S. 81 (1985).

<sup>360</sup> See *supra* part II.C.2.

<sup>361</sup> What about, for example, cash payments made to a firm if it meets a certain number-of-employees goal? What if the state's intent in granting the subsidy is both to maintain and to increase employment by the subsidized firm? See Collins, *supra* note 222, at 102 ("It would . . . be difficult to separate subsidies that burden preexisting trade from those that stimulate new trade.")

<sup>362</sup> What about, for example, a subsidy afforded to an existing in-state plant pursuant to an established state program that envisions subsidy grants to participants in a particular business but also gives a governing board wide authority to deny subsidies to individual applicants? What if the board has only narrow authority? A middle range of authority?

the same high level of judicial acceptance that the Supreme Court has repeatedly signaled for "subsidization of domestic industry."<sup>363</sup>

#### D. Subdividing Subsidies (II): Looking at How the Subsidy is Structured

The preceding discussion supports the conclusion that business subsidies—whether afforded to targeted beneficiaries or to a class of favored firms—generally should survive constitutional attack. *West Lynn Creamery*, however, teaches that at least some business-supporting subsidies run afoul of the Commerce Clause.<sup>364</sup> As a result, it is necessary to look with particularity at the various *forms* that state subsidy structures can, and do, take. At least eight categories of benefits offered by states seem sufficiently important to merit individual examination: (1) infrastructure improvements; (2) educational benefits; (3) below-market leases and land sales; (4) land give-aways; (5) flat-amount cash subsidies; (6) per-unit subsidies; (7) loan forgiveness; and (8) user fee waivers. Although each of these forms of subsidy differs from the others, all are properly subject to review under the

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<sup>363</sup> *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988); accord *Collins*, *supra* note 222, at 104 ("On balance, the better rule is immunity for all subsidies. The rule is simple to apply . . ."). The case for uniform treatment of subsidies derives support, in part, from the wide agreement that many such subsidies—even if directed at already existing firms—are economically sound. In particular, many subsidies are approved for public-directed and profoundly important governmental goals, such as revitalization of poverty-stricken neighborhoods, Taylor, *supra* note 1, at 706 n.232, attacking serious unemployment, *id.* at 704, or aiding businesses in modernization programs. SCHWEKE ET AL., *supra* note 6, at 48-49 (noting Michigan's implementation of "a program for helping manufacturing companies select and apply new technologies in the workplace"); *id.* at 61 (describing and endorsing the Kansas "high performance incentive program" which encourages simultaneous technology and workforce upgrading).

Some business-retaining subsidies can enhance public well-being by helping businesses that are in financial trouble, *see, e.g., European Union: Mad Bull Disease*, *ECONOMIST*, Oct. 15, 1994, at 68 (advocating a subsidy, in an amount less than the state's liquidation costs, likely to revitalize an imminently bankrupt business). Subsidies also can be used to increase employment in underdeveloped areas—or at least to help ensure that conditions of high unemployment do not get worse. *See* NATIONAL GOVERNORS' ASSOCIATION, *Economic Growth and Development Incentives*, in *NGA PRINCIPLES OF MUTUAL COOPERATION* § 3.2.3 (1993) [hereinafter *PRINCIPLES*], reprinted in SCHWEKE ET AL., *supra* note 6, app. A ("Using subsidies to encourage investment in distressed areas of the state or to increase employment opportunities that bring the underclass into the economic mainstream are viewed as legitimate development objectives."); Barrett, *supra* note 5, at 1034 ("Most would agree that a government program that diverts industry from wealthy to poor states and thus improves the economy of a depressed region or state is desirable."). In short, "it is constitutionally and politically impossible to completely eliminate the use of development incentives. It is also not advisable on other grounds, since some incentives may serve the public interest." SCHWEKE ET AL., *supra* note 6, at 16. At the very least, this laundry-listing of a variety of potentially "good" subsidies suggests why "[o]utright prohibition of the worst types of [subsidies] . . . may be . . . administratively unworkable . . ." *Id.* at 49. *See* Gergen, *supra* note 291, at 1137 ("[F]ormulating a simple rule that can distinguish wealth-creating subsidies from those that are inefficient is virtually impossible.").

<sup>364</sup> *See supra* part II.A.

same constitutional criteria. In particular, courts must ask whether the distinctive features of each subsidy's structure render it sufficiently "tariff-like" to fall victim to the dormant-commerce-clause prohibition.<sup>365</sup> More specifically, courts should inquire whether the particular benefit so resembles a discriminatory tax rebate as to bring it within the disqualifying principle of the *West Lynn Creamery* case.<sup>366</sup>

### 1. *Infrastructure Improvements*

Business-development subsidies do not always come in cash, and one important form of non-cash aid is the provision of needed infrastructure for a planned business facility.<sup>367</sup> As a carrot to attract a manufacturing plant, for example, the state may offer to expand roads, to improve a nearby waterway, or to install needed sewer pipes or wastewater treatment facilities. Do these forms of "subsidization" run afoul of the dormant commerce clause? Almost certainly not.

The construction of publicly-owned facilities to spur private business investment seems far removed from the tariff-centered concern that gave rise to the Commerce Clause.<sup>368</sup> Building such improvements is a quintessential form of government activity that creates assets owned by the citizenry as a whole.<sup>369</sup> States, moreover, choose their capital projects for a rich variety of reasons that courts are ill-prepared to evaluate, prioritize, and second-guess.<sup>370</sup> History offers little aid to challengers of these projects: Hamilton and other commercial expansionists of the constitutional period might well have welcomed the synergistic development of roads and comparable public improvements along with private production facilities.<sup>371</sup> The Court

<sup>365</sup> See *supra* notes 315-22 and accompanying text.

<sup>366</sup> See *supra* notes 227-32, 239, and accompanying text.

<sup>367</sup> See Dionne, *supra* note 244, at D9 (reporting that in effort to keep the headquarters of Sears, Roebuck & Co. in-state, Illinois officials spent \$61 million to "build highways and improve the prospective site").

<sup>368</sup> See *supra* notes 332-35 and accompanying text.

<sup>369</sup> See PRINCIPLES, *supra* note 363, at 81 (in which the National Governors' Association advocates subsidies in the form of "physical and social infrastructures," and urges that "such investments may be tied to the location or expansion of an individual company . . . [but] should be viewed as assets for other businesses that locate in the community"); Barrett, *supra* note 5, at 1020 n.3 (noting that an infrastructure "expenditure, unlike a bribe, is not objectionable as it leads to real improvements in state resources"); O'Malley, *supra* note 244, at D2 (quoting Lt. Gov. Frank O'Bannon, who holds the view that "infrastructure improvements . . . help everyone").

<sup>370</sup> See Collins, *supra* note 222, at 101-02.

<sup>371</sup> See SCHWEKE ET AL., *supra* note 6, at 47-48 ("State spending on . . . transportation infrastructure . . . [has] traditionally been understood as helping to improve private sector performance."). Cf. *Evansville-Vanderburgh Airport Auth. Dist. v. Delta Airlines, Inc.*, 405 U.S. 707, 714 (1972) (noting that a "facility provided at public expense" can aid the "right to travel" in keeping with constitutional purposes). Of course, "Hamilton believed that the future of the United States depended on a large-scale expansion of industry and commerce." JOHN M. BLUM ET AL., *THE NATIONAL EXPERIENCE* 141 (1963). See Alexander Ham-

has recognized that “[s]tates may try to attract business by creating an environment conducive to economic activity, as by maintaining good roads.”<sup>372</sup> If that is so, it seems logical that states should be able to lay out road systems in the way that most successfully stimulates commercial and industrial activity. In other words, states should be able to use good roads to lure good firms. And if states may use good roads for this purpose, they should be permitted to use good sewers and other state-owned capital improvements as well.

## 2. *Educational Benefits*

States sometimes lure new businesses with pledges to provide or pay for specialized worker training.<sup>373</sup> This form of aid differs from the provision of infrastructure, because workers’ skills—unlike new roads or sewer pipes—are not government-owned.<sup>374</sup> By providing state-of-the-art worker training, however, the local government implements its historic role as educator<sup>375</sup> and does so in a way tailored to produce concretely valuable and potentially lasting benefits to members of the local community.<sup>376</sup> Worker training subsidies—perhaps even more so than many infrastructure improvements—provide the sort of “individual and collective good”<sup>377</sup> that neutralizes the most potent objections to “handout” subsidies that directly benefit only a favored business recipient.<sup>378</sup> For this reason, even staunch critics of business development programs have expressed few qualms about worker-training incentives.<sup>379</sup> Courts should follow suit by finding this form of subsidy constitutionally unobjectionable.

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ilton, *The Continentalist No. V. April 18, 1782*, in *SELECTED WRITINGS AND SPEECHES OF ALEXANDER HAMILTON* 55 (Morton J. Frisch ed., 1985) (arguing that “every man acquainted with commercial history” recognizes that trade cannot properly regulate itself without the “encouragements, or restraints of government.”).

<sup>372</sup> West Lynn Creamery, Inc. v. Healy, 114 S. Ct. 2205, 2214 n.15 (1994).

<sup>373</sup> See, e.g., Kolesar, *supra* note 346, at 287; SCHWEKE ET AL., *supra* note 6, at 7 (“Non-tax incentives, a growing form of inducement, include . . . customized work training.”).

<sup>374</sup> See *supra* text accompanying note 369.

<sup>375</sup> See *United States v. Lopez*, 115 S. Ct. 1624, 1632 (1995) (noting the historical sovereignty of states “in areas such as . . . education”); *id.* at 1640 (Kennedy, J., concurring) (“[I]t is well established that education is a traditional concern of the States.”).

<sup>376</sup> See *supra* text accompanying note 349.

<sup>377</sup> SUNSTEIN, *supra* note 349, at 312.

<sup>378</sup> See *PRINCIPLES*, *supra* note 363, at 81; SCHWEKE ET AL., *supra* note 6, app. B at 83 (“[I]ncentives . . . should be investments that accrue to the state and its citizens as well as the business and that will remain if the business leaves. This means education, training, and infrastructure as opposed to tax breaks and financing subsidies . . . .”) (quoting Andrew Grose, Former Nev. Dev. Dir.).

<sup>379</sup> See *PRINCIPLES*, *supra* note 363, at 81; SCHWEKE ET AL., *supra* note 6, app. B. at 83.

### 3. *Below-Market Leases and Land Sales*

Governments are often landowners. Indeed, they may hold real property for the sole purpose of later transferring it to private entrepreneurs for expanded business development. What if a local government sells or leases realty at a below-market cost in return for the grantee's commitment to use it to launch a new business venture?<sup>380</sup> Is this form of subsidy constitutionally permissible?

The argument in favor of the constitutionality of below-market land transfers begins with the Court's decision in *Reeves, Inc. v. Stake*.<sup>381</sup> In that case, the Court relied on the market-participant exception to the dormant commerce clause to reject a challenge to a state's preference for its own residents in the sale of state-made cement. If a state "as a seller of cement, unquestionably fits the 'market participant' label,"<sup>382</sup> so too should the state as a seller of buildings and land.<sup>383</sup> Because the market-participant moniker applies so aptly to this setting (and no exception to the exception appears to apply<sup>384</sup>), the state simply "is not subject to the restraints of the Commerce Clause."<sup>385</sup>

Indeed, *Reeves* should control *a fortiori* in the below-market-land-transfer cases. Why? Because in *Reeves* the Court was willing to countenance even outright discrimination between residents and non-residents in the making of cement-sale contracts.<sup>386</sup> Ordinary land-transfer subsidies do not involve any comparable "residents only" policy.<sup>387</sup> Indeed, because state land-transfer preferences typically are open to both erstwhile out-of-staters and established in-staters, it is difficult to say that they involve any discrimination against interstate commerce at all.<sup>388</sup> Moreover, in *Reeves* the state was hoarding a re-

<sup>380</sup> See, e.g., Taylor, *supra* note 1, at 675 n.41 (citing the use of "subsidized rent" as a business incentive).

<sup>381</sup> 447 U.S. 429 (1980).

<sup>382</sup> *Id.* at 440.

<sup>383</sup> Kolesar, *supra* note 346, at 287 (noting that many states offer subsidized leasing, among other creative "economic incentives outside the tax realm").

<sup>384</sup> The Court, for example, has signaled that an exception to the market-participant principle may apply when the state transfers natural resources or puts "downstream" conditions on the buyer of state-sold property. See *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82 (1984); see generally Coenen, *supra* note 120, at 453-60 (natural resources), 463-73 (downstream restraints). These exceptions, however, have no application to most business development subsidies, including ordinary below-market realty transfers. See *id.* at 461 & n.384 (noting the inapplicability of any "natural resources" exception to typical land transfers because all states include land). Nonetheless, if a land-transfer or other subsidy were structured to require continued and future dealing with private in-state firms, it would raise significant constitutional problems. See *id.* at 476-78.

<sup>385</sup> *White v. Massachusetts Council of Constr. Employers*, 460 U.S. 204, 208 (1983).

<sup>386</sup> See *Reeves*, 447 U.S. at 442.

<sup>387</sup> *Id.* at 441.

<sup>388</sup> In particular, this is not a case in which the state's action "leav[es] no room for investment from outside." *C & A Carbone, Inc. v. Clarkstown*, 114 S. Ct. 1677, 1683 (1994).

source it could have made readily available for out-of-state use.<sup>389</sup> Land, in contrast, cannot be shipped away.<sup>390</sup> Because the Court in *Reeves* countenanced even outright hoarding of a readily transportable resource by way of state-made trades, it surely should countenance state-made land transfers that cannot, and do not, involve hoarding at all. For this reason, the constitutionality of bargain-price leases and land sales seems uncontroversial.<sup>391</sup>

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Consider as well the “non-discriminatory” alternative to the ordinary below-market lease or sale: the lessee, in exchange for the favorable terms of transfer, would promise merely to initiate a business expansion somewhere in the United States. Is it really appropriate to say that the failure to offer such terms constitutes “discrimination against interstate commerce”? To be sure, discrimination would be present if a state were to blatantly favor, in its awards of favorable property transfers, businesses already incorporated or operating in the state. But such a case is far-removed from the ordinary program of this kind, which generally involves leasing or selling realty to *any* firm or person in return for the mere promise to use the transferred property for business operations.

<sup>389</sup> *Reeves*, 447 U.S. at 433, 443-44.

<sup>390</sup> See *United States v. Pappadopoulos*, 64 F.3d 522, 526-27 (9th Cir. 1995) (emphasizing this fact in defining scope of Congress’s power to act under the Commerce Clause).

<sup>391</sup> There is, as usual, a counter-argument. In *Reeves*, the Court noted that South Dakota had not “cut off access to its own cement altogether, for the policy does not bar resale of South Dakota cement to out-of-state purchasers.” *Reeves*, 447 U.S. at 444 n.17. Arguably, this ability-to-resell feature helped interstate commerce enough (particularly when compared with the option of having South Dakota cease all cement-producing operations) that the Court was willing to tolerate South Dakota’s favoritism of local businesses in its initial sale of cement. The out-of-state resale option applicable to state-made cement, however, cannot apply to state-made realty transfers precisely because land cannot be transported and used outside the state. See *supra* note 390 and accompanying text. Critics of below-market realty transfers thus may argue that *Reeves* does not constitutionalize below-market land transfers on the ground that an important basis for the Court’s decision in *Reeves* is inapplicable in the land-transfer context. See also *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 96 (1984) (explaining that the Court in *Reeves* noted that “South Dakota did not bar resale of South Dakota cement to out-of-state purchasers”).

We find this argument unpersuasive. The discussion in *Reeves* of the resale option (which was limited to a footnote) was not offered as an important justification for applying the market-participant rule. The footnote instead was offered merely to bolster the Court’s explanation why it chose not to apply any exception to “the general rule of *Alexandria Scrap*,” *Reeves*, 447 U.S. at 447, based on the “hoarding” of resources which “by happenstance” are found in the state. *Id.* at 444. The Court’s concern about a state’s placing conditions on a buyer’s selection of its own trading partners is particularly understandable given the Court’s celebration in *Reeves* itself of “the long recognized right of trader or manufacturer, engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal.” *Id.* at 438-39 (quoting *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919)). Conditioning a land transfer on a promise to use the land to operate a new business, however, involves no such restriction. And it certainly does not involve the sort of “embargo” involved in restricting all resales of a transportable state-made product to local residents. See, e.g., *Hughes v. Oklahoma*, 441 U.S. 322 (1979) (striking down a statute prohibiting the out-of-state sale of Oklahoma minnows). Put differently, the sort of activity at issue in *Reeves* involved a risk of undue hoarding; thus, in such a case, even if the state is a market-participant, courts may look at the *degree* to which the state has constricted the outflow of goods. Standing alone, however, below-market realty transfers do not, and cannot, involve hoarding, because land necessarily is not subject to cross-border transfer. In short, because land transfers cannot involve hoarding, *Reeves*’s expression of concern about too much hoarding is beside the point in the



The local government's claim to autonomy in this setting finds support in an assortment of additional public policy concerns. There is, for example, a judicial and social interest in avoiding problematic inquiries into what is, and what is not, a "below-market" price. The claim of autonomy is strengthened by each state's especially keen interest in being able to define itself by controlling the use of lands physically situated within its borders.<sup>392</sup> And deployment of below-market realty transfers (particularly as part of implementing industrial-park, enterprise-zone, or comprehensive land-use plans) comports with the Court's rooting of the market-participant exception in the goal of encouraging "effective and creative programs for solving local problems."<sup>393</sup>

#### 4. *Land Giveaways*

What if the state—instead of selling land at a submarket price—transfers land free of charge in return for the grantee's commitment to place a facility on it?<sup>394</sup> This gratuitous grant bears such an obvious resemblance to the below-market sale that the cases seem indistinguishable. In particular, if a state may sell land for much less than its market value, why should it not be able to make such a sale for a "below-market price" of zero? A possible response to this question is that application of the market-participant exception hinges in part on the state's "*appearance* of 'participating in' . . . the market."<sup>395</sup> When the government acts as a seller or lessor of property, it bears "similarities" to "private businesses . . . in the marketplace."<sup>396</sup> Not so, the argument goes, when the government collects no payments whatsoever for the transfer of its property. In such circumstances, the argument concludes, the government cannot be viewed as a market participant.

Courts should reject this would-be distinction, for it is as thin as a shadow. First, the state's likeness in appearance to a private trader is only one—and not the most pertinent—factor considered when ap-

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land-transfer context. See *Fireside Nissan, Inc. v. Fanning*, 30 F.3d 206, 215 (1st Cir. 1994) (rejecting Commerce Clause challenge to law that permitted any existing dealer within 20 miles to object to a new car dealership, but only if the existing dealer was located in the state "because Rhode Island's new car dealership law does not facially apply to interstate commerce . . .").

<sup>392</sup> See generally *Village of Euclid v. Ambler Realty Co.*, 272 U.S. 365, 389-90 (1926) (asserting that local governments have inherent power to control the use of land through zoning).

<sup>393</sup> *Reeves*, 447 U.S. at 441.

<sup>394</sup> See, e.g., *O'Malley*, *supra* note 244, at D2 (reporting that officials in Illinois gave \$10 million worth of free land subsidy to an automotive company).

<sup>395</sup> Coenen, *supra* note 120, at 441 (emphasis added).

<sup>396</sup> *Reeves*, 447 U.S. at 439 n.12.

plying the market-participant principle.<sup>397</sup> Second, there is a resemblance between the “land-giving” government and a private trader. The government, after all, does not simply give its land away; instead, like a private trader, it transfers its property—often by way of formal contract—in return for the desired benefits that flow from securing a productive business neighbor.<sup>398</sup>

Any force that remains in the “it doesn’t look like a private trader” argument is more than offset by a countervailing consideration. The market-participant exception springs in part from the realization that such programs will not over-proliferate because of their inherent costliness.<sup>399</sup> It follows from this premise that land giveaway programs provide an even *stronger* case for market-participant protection than below-market land transfers. Why? Because outright giveaways are necessarily more costly—and thus less likely to be undertaken—than those land transfers “for which state governments receive some value in return.”<sup>400</sup>

For all of these reasons, courts should not distinguish land giveaways from below-market land transfers when applying the dormant commerce clause. As discussed above, the inherently in-state character of land makes it difficult to say that any land-transfer program involves discrimination against interstate commerce.<sup>401</sup> But even if courts detect a discrimination problem, they should apply the market-participant exception to repel the dormant commerce clause attack.

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<sup>397</sup> See Coenen, *supra* note 120, at 443.

<sup>398</sup> See Note, *Legal Limitations on Public Inducements to Industrial Location*, 59 COLUM. L. REV. 618, 623 (1959) [hereinafter *Limitations*] (“Typically, these transactions [involving land or cash grants] purport to be contracts whereunder the industry promises to locate in the community, to remain for a stated number of years, and to employ a minimum number of workers.”); cf. *J.F. Shea Co. v. City of Chicago*, 992 F.2d 745, 748 (7th Cir. 1993) (stating that the city in *White* “was a market participant because it used its own funds” and “was a party to the contract”); SCHWEKE ET AL., *supra* note 6, at 16 (“Incentives should take the form of legally enforceable contracts between the government and the beneficiary company.”). It may be argued that “buying” a favorable business location is not an activity that occurs in the private “market” at all, so that the market-participant exception cannot apply to it. The argument is strained, however, because private businesses *do* compete for business locations seen to be in their best interest (for example, when shopping centers or office buildings battle for high-profile or “anchor” tenants). In addition, in subsidizing business decisions, the state is properly seen as “weighing in” with private market participants (such as local land sellers, construction firms, and the like) to generate local business activity. This form of “participating in the market” by “bidding up the price” is exactly the sort of activity that was authorized by the Supreme Court in *Alexandria Scrap*. See *supra* text accompanying notes 254-62.

<sup>399</sup> See Regan, *supra* note 222, at 1194 (“The very fact that spending programs involve spending and are therefore relatively expensive as a way of securing local benefit makes them less likely to proliferate than measures like tariffs.”); see also *supra* text accompanying notes 254-62.

<sup>400</sup> Coenen, *supra* note 120, at 475.

<sup>401</sup> See *supra* note 388 and accompanying text.

### 5. *Flat-Amount Cash Subsidies*

If the Constitution countenances land grants conditioned upon establishing local business operations, it should also tolerate the practice of awarding flat cash bounties offered to achieve the same end.<sup>402</sup> The only difference between the two incentives lies, after all, in the nature of the government asset bestowed. In one case, the state conveys a parcel of land; in the other, it delivers a package of dollar bills. Some might argue that this distinction matters, because the cash subsidy looks enough like a tax rebate to trigger the Commerce Clause anti-tariff principle.<sup>403</sup> According to this argument, tariffs and tax rebates have to do with *money*; because cash subsidies directed at local businesses also involve money, they should be treated like discriminatory tax breaks even if grants of land and other property are not.

Three reasons undermine the argument that monetary subsidies are more problematic than land grants. First, the logic that underlies this argument would require the rejection of *all* business-supporting cash subsidies. We already have seen, however, that the invalidation of all such subsidies would offend Supreme Court precedent<sup>404</sup> and hamstring salutary state experiments that pose no real threat to Commerce Clause values.<sup>405</sup>

Second, political process considerations suggest that courts should view cash grants at least as favorably as land grants. Local governments that have an interest in expanding the local property tax base (as all local governments do) have a strong built-in incentive to move publicly owned "industrial park" land (which is not taxable) into private hands (where it is taxable). Because the same is not true of publicly owned cash, localities may well be less inclined to dole out

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<sup>402</sup> In fact, several states and localities have granted such bounties. See Taegan D. Goddard, *Job-buying Becomes Economic Civil War*, PLAIN DEALER, Feb. 12, 1994, at 11B ("Fighting for jobs, state governments are waging an increasingly fierce battle to attract corporate investment. Their weapons include . . . even direct subsidies."); see also Barrett, *supra* note 5, at 1019 & 1023 n.20 (citing use of "direct grants" and "outright grants"); Taylor, *supra* note 1, at 675 n.41 (citing "outright cash" award). Probably the most dramatic cash giveaway program has been developed by Amarillo, Texas. In September, 1995, the city sent out—in Publisher's Clearinghouse-like fashion—\$8 million "checks" to 1,350 corporations in an attempt to stir up interest in siting operations in Amarillo. Under the Amarillo program, firms will receive \$10,000 for each local job they create up to a maximum of \$8 million. See *All Things Considered* (National Public Radio, Sept. 20, 1995) (transcript on file with authors).

It bears emphasis that cash subsidies (as well as other forms of subsidies) may run afoul of *state* constitutional constraints even if permissible under the federal Constitution. See, e.g., *Maready v. City of Winston-Salem*, 467 S.E.2d 615, 626 (N.C. 1996) (reversing trial court ruling invalidating, on state constitutional grounds, cash incentive awards made to new or expanding businesses pursuant to statutory authority).

<sup>403</sup> See *supra* notes 315-22 and accompanying text.

<sup>404</sup> See *supra* part II.B.1.

<sup>405</sup> See *supra* part II.B.2.

cash on improvident projects than to transfer realty. As a result, from a political-process perspective, the case for the constitutionality of cash giveaways seems even stronger than for land grants.

Finally, the attempted distinction between land and cash misses the point of the tariff prohibition the Commerce Clause imposes. This prohibition bars *any* form of tariff, whether the importer must pay it in money, widgets, or constructed homes.<sup>406</sup> In other words, the anti-tariff principle applies equally to cash and non-cash customs duties. It follows that subsidies should fall outside (or inside) the orbit of this principle in equal measure whether awarded in cash or other forms of property. In short, one-shot cash subsidies, no less than one-shot land grants, should in general escape dormant commerce clause attack.

#### 6. *The Per-Unit Subsidy*

States sometimes grant a flat-amount cash subsidy on a single-shot basis in exchange for construction of a plant in the state. The per-unit subsidy—as that term is used here—is a horse of a different color. Assume, for example, that a state offers a five-year, one-penny-per-filled-container subsidy to a soft drink company in return for its building of a bottling plant in the state. The per-unit subsidy differs from the flat-amount cash payment because it has an ongoing, contingent character. The subsidy may trigger the building of a local plant, but it *also* encourages the plant's continued and expanding operation. This feature of the per-unit subsidy renders it more akin to the protective tariff than the one-shot payment because the continuing subsidy—like the protective tariff—aims at retaining and supporting a business that has established its operations in the state.<sup>407</sup>

Even more important, per-unit subsidies will in many cases resemble tax breaks already held unconstitutional by the Court. Assume, for example, that State A charges a 1% tax on all goods sold at wholesale within its borders. Assume also that State A provides a 1%-of-wholesale-price cash subsidy for goods produced within the state by an in-state company. It could be argued that the practical effect of the subsidy is to relieve the in-state company, in discriminatory fashion, of its entire wholesale tax burden in violation of the dormant commerce clause.<sup>408</sup> Support for this argument comes from *West Lynn Creamery*, in which the Supreme Court struck down a state subsidy precisely be-

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<sup>406</sup> See *West Lynn Creamery, Inc. v. Healy*, 114 S. Ct. 2205, 2212 (1994) (citing a variety of laws struck down because they had the "same effect as a tariff or customs duty—neutralizing the advantage possessed by lower cost out-of-state producers").

<sup>407</sup> See *supra* text accompanying note 354.

<sup>408</sup> See *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984).

cause it operated as a "tax rebate."<sup>409</sup> To be sure, the State A subsidy does not simply offset the wholesale tax, because the subsidy is paid even on goods sold at wholesale outside the state, which are not subject to the State A wholesale tax at all. The subsidy's challenger will argue, however, that this just makes the subsidy more objectionable because it promotes local industry, at the expense of out-of-staters, to an even greater degree than if the subsidy merely neutralized the effect of the State A wholesale tax.<sup>410</sup>

Is the State A subsidy unconstitutional under the principle of *West Lynn Creamery*? Perhaps not. For example, unlike Massachusetts, State A did not enact the tax and subsidy simultaneously as part of a unitary program.<sup>411</sup> Also, in contrast to the situation in *West Lynn Creamery*, the State A subsidy does not come from an account carefully segregated from the general revenues for the very purpose of effectively refunding to domestic producers all taxes paid on sales of their goods.<sup>412</sup> Indeed, the hypothetical State A tax and State A subsidy are not related at all except in that the subsidy is based on the same wholesale-price value that the state uses to compute the tax.

The State A hypothetical, however, may come close enough to *West Lynn Creamery* to raise some judicial eyebrows. Consequently, state policymakers should avoid this type of subsidy, and they should have little difficulty doing so. Why? Because the only problem with the hypothetical wholesale price subsidy is that it "lines up" so closely with the wholesale revenues tax. To avoid this problem, the state need only disconnect its mode of computing subsidy payments from its mode of calculating its taxes. Instead of basing subsidies on wholesale prices, for example, State A might pay the in-state company \$10,000 for each month it turns out more than 60,000 units of product. In making such refinements to its subsidy structure, the state must avoid jumping from the frying pan into the fire. If, for example, State A substituted for its wholesale-price subsidy a subsidy based on a firm's total revenues, a court might deem that subsidy an unconstitutional "rebate" of gross-receipts, or even income, tax payments.

Per-unit subsidies will raise many problems of this kind. To avoid those problems, state lawmakers must take three precautionary steps. First, they must appreciate that the Court found and condemned a discriminatory *de facto* rebate in the *West Lynn Creamery* case. Second, they must recognize that the contours of this anti-rebate principle re-

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<sup>409</sup> *West Lynn Creamery*, 114 S. Ct. at 2213.

<sup>410</sup> *See id.* at 2215.

<sup>411</sup> *See supra* text accompanying notes 234-39.

<sup>412</sup> In the view of Justice Scalia, placement of the milk tax proceeds into a segregated account was critical in rendering the tax-and-subsidy program unconstitutional. *West Lynn Creamery*, 114 S. Ct. at 2220-21 (Scalia, J., concurring).

main undefined. Finally, in light of these realities, state lawmakers must give wide berth to the anti-rebate restriction. They can do so by carefully disassociating calculation of "per unit" subsidies from any existing tax base or mode of tax computation.

### 7. *Loan Forgiveness*

If a state can give a cash bounty to a firm for locating a new business within its borders, the state also should be able to favor the same business with a repayable loan. And if the state can seek to attract new businesses with favorable lease or land-sale contracts, then surely the state may also offer loans on favorable terms.<sup>413</sup> And if a state may make favorable loans to new businesses, then surely it may excuse in part or in whole loan payments upon the occurrence of such stipulated conditions as maintaining local operations for a specified period of time.

But wait!

There are special problems with loan forgiveness packages. These problems begin with state constitutions, which may well restrict this form of business development subsidy.<sup>414</sup> Loan-forgiveness incentives also face a potential problem under the dormant commerce clause because courts may view loan forgiveness as akin to constitutionally suspect *tax* forgiveness.<sup>415</sup> Both loan-repayment waivers and tax-payment waivers, after all, operate to excuse the local business from meeting a monetary obligation otherwise owed to the government. Critics also might paint the loan forgiveness tool as especially objectionable on the ground that it is more easily hidden from potential objectors than such "high-visibility" subsidies as outright grants of land or cash.<sup>416</sup>

These arguments, however, fall short of bringing loan forgiveness plans within the sweep of the anti-tariff principle. To begin with, the making of loans involves market participation in the purest sense,<sup>417</sup>

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<sup>413</sup> See, e.g., Barrett, *supra* note 5, at 1019 & 1023 n.20 (citing use of "low-interest" loans); Taylor, *supra* note 1, at 675 n.41 (same); see also SCHWEKE ET AL., *supra* note 6, at 19 (noting that "49 states use [industrial development bonds] to enable local governments to offer low-interest loans to firms").

<sup>414</sup> See, e.g., Op. Ga. Att'y Gen., No. 95-22, at 4 (Apr. 28, 1995) ("[I]t is beyond the power of [the state agency] to create forgivable loans as it has in the incentive loan program."). For a general treatment of state and local authority to encourage business development with government financing, see David E. Pinsky, *State Constitutional Limitations on Public Industrial Financing: An Historical and Economic Approach*, 111 U. PA. L. REV. 265, 277 (1963).

<sup>415</sup> See *supra* part I.B.

<sup>416</sup> See SCHWEKE ET AL., *supra* note 6, at 52 (noting that, because a "soft loan" is "easy money," it is "more likely . . . that the subsidy will be abused"); see generally *supra* text accompanying notes 311-13 (relating high-visibility subsidies to political accountability).

<sup>417</sup> See *supra* text accompanying notes 290-301.

and affording relief from paying a loan made by way of contract is simply not the same thing as granting an abatement of a tax. Arguments against loan forgiveness based on reduced political visibility also seem overdrawn. Government officials have to appropriate money to make loans in the first place, and they must do so with the recognition that such loans may never be repaid. It is also unlikely that forgivable loans will slide by the watchful eyes of potential objectors more easily than outright subsidies. The making of loans, after all, requires substantial outlays of taxpayers' monies, and the concept of a forgivable loan is hardly difficult for local politicians—or those who vote for them—to grasp. In short, forgivable loans seem no less costly to state and local governments than outright cash subsidies. As a result, such loans should receive comparable treatment under the dormant commerce clause.

### 8. *User Fee Exemptions*

It is a hornbook principle of dormant commerce clause case law that a "user fee is valid only to the extent it 'does not discriminate against interstate commerce.'"<sup>418</sup> In other words, the Court historically has treated user fees much like state taxes, by subjecting them to a rigorous anti-discrimination principle.<sup>419</sup> A serious question thus arises as to whether user fee abatements—for example, from electrical, sewage, or water charges—can pass constitutional muster when used to attract new business development.<sup>420</sup>

In answering this question, one must recognize that local governments usually, and quite properly, provide water, sewer, and similar services only within their own geographic confines.<sup>421</sup> As a result, in the typical case, when a local government gives a fee break to one service user, it is hard to say that it is discriminating against interstate commerce at all; it seems more accurate to say it is discriminating only against other residents of the same locale.<sup>422</sup>

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<sup>418</sup> *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 114 S. Ct. 1345, 1352 n.6 (1994) (quoting *Northwest Airlines, Inc. v. County of Kent*, 114 S. Ct. 855, 858 (1994)).

<sup>419</sup> Indeed, there is reason to believe that the Court has subjected user fees to even stricter constitutional scrutiny than taxes under the dormant commerce clause. See *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 621-22 (1981) (suggesting that taxes are subject to less intense review than user fees under the fourth, "fair relation," prong of the *Complete Auto Transit* test).

<sup>420</sup> See generally Taylor, *supra* note 1, at 675 n.41 (citing use of "reduced energy costs" as an incentive to attract new businesses).

<sup>421</sup> See, e.g., *Swin Resource Sys., Inc. v. Lycoming County*, 883 F.2d 245, 251 & n.2 (3d Cir. 1989) ("No court, to our knowledge, has ever suggested that the commerce clause requires city-operated garbage trucks to cross state lines in order to pick up the garbage generated by residents of other states.").

<sup>422</sup> See *supra* text accompanying notes 388, 401.

For at least two reasons, however, this non-discrimination analysis cannot end the discussion. First, the analysis may miss a key point. In particular, given the doctrinal kinship of user fees and taxes,<sup>423</sup> the Court might insist that states are duty-bound to facilitate “user-fee neutral decisionmaking” just as much as they must ensure “tax-neutral decisionmaking.”<sup>424</sup>

Second, even if our no-discrimination analysis *generally* safeguards water-and-sewer-type user fee waivers, this analysis will not apply when a state or locality voluntarily makes a service available across state lines. Assume, for example, that a New Jersey governmental authority that picks up solid waste agrees for a price to handle waste generated in New York by metal fabricators. Assume further that, as part of an inducement package offered to a competing fabricator to locate in New Jersey, the authority for three years waives 50% of its ordinary waste pick-up charges. Does the user-fee reduction for the in-state operator—which now clearly discriminates against its out-of-state competitors—violate the dormant commerce clause?

This case reveals the tectonic tension between the Court’s states-can’t-discriminate user-fee jurisprudence and its states-can-discriminate market-participant decisions.<sup>425</sup> The complex questions that result from these competing principles warrant—and have received—extended treatment in a separate article.<sup>426</sup>

That Article—which was written by one of the authors of this piece and hereby is endorsed as essentially sound by the other—concludes that the Court’s user-fee anti-discrimination principle properly reaches only state charges for access to roads, airports, and other “channels of interstate movement.”<sup>427</sup> User-fee abatements used to spur business development typically do not involve benefits of this ilk, but instead involve charges for such items as power and waste services. Affording access to these sorts of benefits—in contrast to affording access to highways and waterways—does not involve the “essential avenues of interstate trade.”<sup>428</sup> Thus the fixing of user fees for such non-transportation-related benefits ordinarily should escape Commerce Clause challenge under the protective umbrella of the market-participant principle.

<sup>423</sup> See *supra* note 419 and accompanying text.

<sup>424</sup> See *supra* text accompanying notes 68-70.

<sup>425</sup> Compare *supra* notes 418-19 and accompanying text with *supra* part II.B.1.c. See also *Oregon Waste Sys., Inc. v. Department of Envl. Quality*, 114 S. Ct. 1345, 1356 (1994) (Rehnquist, C.J., dissenting).

<sup>426</sup> See Dan T. Coenen, *State User Fees and the Dormant Commerce Clause* (1995) (manuscript on file with authors).

<sup>427</sup> *Id.* (manuscript at 4).

<sup>428</sup> *Id.*



## III

## TAX BREAKS, SUBSIDIES, AND LEGAL THEORY

Our discussion of tax and subsidy incentives raises fundamental questions of symmetry and coherence in the law. We have recognized, after all, that the economic consequences of tax breaks and subsidies are often indistinguishable.<sup>429</sup> Yet if our own analysis reaches any overarching conclusion, it is that courts applying the dormant commerce clause should approach tax breaks and subsidies very differently.<sup>430</sup>

Much ink has been spilled on why this distinction comports with sound dormant commerce clause policy.<sup>431</sup> But it may be fair to add that the distinction flows from the very deepest wellsprings of the law. Rudolph von Jhering wrote that "form is the 'innermost' matter of law."<sup>432</sup> And so the law is rife with rules centered on considerations of form. Lon Fuller perceived the centrality of form in private law. He explained, in particular, that law often works like language by calling upon persons to channel their undertakings into particular forms to render them legally efficacious.<sup>433</sup> If a woman wishes to leave property to the Community Chest upon her death, she must execute a properly drafted and witnessed will. If she wants to transfer a candelabra *inter vivos*, she must either effect a suitable documentary transfer or wield the formal tool of physical delivery. Only through use of these modes of "expression" can the donor's intentions take hold and have effect.

If form is central to the law of private transactions, why should it not also be of significance when public bodies act? And if it is, why should it seem strange that the public body that wishes to channel financial benefits to in-state industry must channel its actions into particular forms? The answer is that this result should not seem strange at all.<sup>434</sup>

The question that remains is why courts should prefer the form of the cash or non-cash subsidy to that of the tax exemption, deduction, or credit in applying the dormant commerce clause. Rules of form typically serve some function,<sup>435</sup> and private law principles again help show why this is so with the subsidy form. The law of property,

<sup>429</sup> See *supra* notes 216-19 and accompanying text.

<sup>430</sup> See *supra* text accompanying notes 241-46.

<sup>431</sup> See, e.g., Coenen, *supra* note 120, at 479-84; Kline, *supra* note 306, at 370-79; Regan, *supra* note 222, at 1193-94; *supra* part I.B.2.

<sup>432</sup> 2 *Geist des Römischen Rechts* 478-79 (Scientia Verlag Aalen 1993) (1894). The translation comes from Robert S. Summers, Notes for Faculty Session on "The Formal Character of Law" (Apr. 11, 1995) (on file with *Cornell Law Review*).

<sup>433</sup> Fuller, *supra* note 15, at 801-03.

<sup>434</sup> See *infra* note 444 and accompanying text.

<sup>435</sup> See Fuller, *supra* note 15, at 800-03 (discussing functions served by legal formalities).

for example, generally requires the formality of delivery to effectuate a gift.<sup>436</sup> And the law of contracts requires that the most important of consensual exchanges be committed to the formal medium of the signed, written page.<sup>437</sup> As Fuller perceived, these requirements of form exist in large measure to serve a "cautionary function."<sup>438</sup> The underlying thought is that use of these formal devices will force the mind to reflect upon the terms of the undertaking with seriousness and specificity—and that that is a good thing for both intrinsic and instrumentalist reasons.<sup>439</sup>

So it is with subsidies. Commentators have explained that subsidies differ from tax breaks for a variety of reasons. A *central* reason, however, revolves around political-process based concerns of focused, intelligible, and deliberative decisionmaking.<sup>440</sup> Just as surely as use of the will or the deed impresses upon the individual mind the significance of its contemplated act, consideration of a subsidy forces the mind of the public body to consider most pointedly the cost and consequences of moving forward.<sup>441</sup>

The significance of form should not be understated. Formal categories permeate public, no less than private, law.<sup>442</sup> Indeed, in its most recent term, the Supreme Court emphasized that "economic equivalence alone has . . . not been (and should not be) the touchstone of Commerce Clause jurisprudence."<sup>443</sup> Thus, in the dormant commerce clause field—as in other realms of law—the *form* in which gov-

<sup>436</sup> RESTATEMENT (SECOND) OF PROPERTY, Donative Transfers § 31.1 (1992).

<sup>437</sup> See generally 2 CORBIN ON CONTRACTS §§ 275-300 (1950 & Supp. 1994) (discussing history and operation of Statute of Frauds).

<sup>438</sup> Fuller, *supra* note 15, at 800. Of course, the Statute of Frauds serves the cautionary function imperfectly because (for example) even a post-contractual memorandum may satisfy the writing requirement. Still, in the vast majority of cases governed by the Statute of Frauds, the writing will serve a cautionary purpose. See *id.* (noting that "any requirement of a writing" serves to caution "one pledging his future").

<sup>439</sup> See *id.*

<sup>440</sup> See, e.g., Kline, *supra* note 306, at 371, 374 (noting that "[w]hat distinguishes state spending programs from protectionist regulation is the form . . . by which local residents are preferred," and subsidies are "visible, direct and recurring costs to the state checked through both the political process and the state budget").

<sup>441</sup> This theme is pursued at length in Dan T. Coenen, *Business Subsidies and the Dormant Commerce Clause* (work in progress, manuscript on file with the authors). In particular, the author explains why these values properly inform the formation of constitutional rules and rules derived from the dormant commerce clause in particular.

<sup>442</sup> Consider, by way of illustration, the differing precedential significance of holding and dictum in judicial writing, and of published and unpublished judicial opinions. Of course, the Constitution of the United States requires public bodies to act through certain pre-established forms, such as bicameral action, precisely to avoid adoption of "oppressive, improvident, or ill-considered measures." *Immigration and Naturalization Service v. Chadha*, 462 U.S. 919, 947-48 (1983).

<sup>443</sup> *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 115 S. Ct. 1331, 1344 n.7 (1995). This point is explored in depth in Walter Hellerstein et al., *Commerce Clause Restraints on State Taxation After Jefferson Lines* (1995) (manuscript on file with the authors).

ernment pursues its objectives may well have critical significance. The strong distinction drawn here between subsidies and tax breaks resonates with this palpable, but often overlooked, truth at the root of all law.

#### CONCLUSION

All major issues of government policy ultimately seem to become questions of constitutional law. The burgeoning use of local business incentives ensures that constitutional challenges to these programs will increasingly find their way into the courts. Indeed, the onslaught already has begun.

The most promising avenue for attacking these programs under the Federal Constitution lies in the dormant commerce clause. In this Article we have offered an overarching theory of how the Commerce Clause interacts with both state-tax and state-subsidy incentives. Although our approach is not above criticism, we believe it is superior to proposed alternatives. First, our synthesis does not jettison Supreme Court precedent. Indeed, better than any previously identified alternative, our approach tracks both the letter and spirit of the Court's business-incentive decisions.

Second, our synthesis avoids extremes. State business incentives will neither stand nor fall *en masse* under our analysis. In particular, we embrace a middle-ground position on the constitutionality of state *tax* incentives, which rests on the sensible difference between tax structures that effectively coerce in-state activity and those that merely encourage new investment in the state. Other proposed approaches either denude the Court's precedents by essentially giving states *carte blanche* to construct discriminatory tax incentives or wipe off the books virtually all tax incentives in contravention of deeply rooted assumptions. Either result presents grave difficulties, and our approach steers clear of both of them.

Finally, our synthesis recognizes and reflects the Court's long-standing insistence that tax breaks and subsidies are constitutionally different. Under our approach, states will channel business incentives into the form of subsidies. They should. The use of subsidies, as we have explained, serves the salutary end of focusing state decisionmakers—and the voters to whom they are accountable—on the costs and inequities that business development incentives can engender.

In assessing state business incentives in future cases, the Court will have to deal—as it often must—with judgments about imponderables. We presume neither to predict the direction the Court will take in future cases nor to declare that we have solved every problem business incentives will present. We have, however, constructed for the

Court's consideration a coherent and comprehensive structure for analyzing these issues built firmly upon the Court's own past pronouncements.<sup>444</sup>

APPENDIX: PROCEDURAL ISSUES RAISED BY CHALLENGES TO TAX  
INCENTIVES AND SUBSIDIES

We have seen that business-development tax incentives are often open to constitutional challenge.<sup>445</sup> Similarly, attacks on subsidies will sometimes succeed.<sup>446</sup> Prospective challengers of business-incentive programs do, however, face a range of procedural and remedial difficulties. In this Appendix, we introduce some major problems.

A. Tax Incentives

In light of the apparent vulnerability of state tax incentives to successful constitutional attack, the question arises as to why more of these incentives have not been challenged.<sup>447</sup> The answer may lie in potential litigants' perceptions that their victories in this arena are likely to be Pyrrhic. In other words, a successful attack on a state tax incentive may result in elimination of the tax incentive for those previously favored by the legislature rather than extension of tax benefits

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<sup>444</sup> After this Article was drafted, we became aware that Peter D. Enrich of Northeastern University School of Law had drafted another article on the same topic. Peter D. Enrich, *Saving the States From Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, HARV. L. REV. (forthcoming Dec. 1996). Both our article and Professor Enrich's article are in quite close agreement on the center points. We both conclude that there is a substantial class of tax incentives, of which income tax credits constitute typical instances, which cannot withstand Commerce Clause scrutiny. And we both recognize that there is another substantial class of tax incentives, of which property tax abatements and sales tax exemptions constitute typical instances, which can be distinguished from the first class in ways that make the precedential arguments for unconstitutionality less compelling.

The principal differences between the two articles involve their focus. Our Article is addressed largely to the substantive criteria that govern—or ought to govern—the constitutionality of state business development incentives, and it explores the implications of those criteria for particular types of business development incentives, including subsidies. Professor Enrich's article devotes more attention to the normative question whether such incentives are desirable and to standing and related questions as to who will and who can raise the challenge to these incentives. The differences in focus of the two articles do lead to some divergences in Professor Enrich's and our conclusions about which types of incentives will—or should—survive Commerce Clause scrutiny.

Professor Enrich and we are in full accord on two points, however: first, the articles generally reinforce and complement one another; second, both articles should be read by anyone seeking a fuller understanding of the constitutional restraints on state business development incentives.

<sup>445</sup> See *supra* part I.B.

<sup>446</sup> See *supra* part II.

<sup>447</sup> Although there have been some challenges to state tax incentives, see cases cited *supra* note 139, taxpayers have barely scratched the surface of the vast array of tax incentives that appear to be susceptible to constitutional attack. See, e.g., *supra* text accompanying notes 73-83, 207-13 (listing a number of state tax incentive provisions).

to all similarly situated taxpayers.<sup>448</sup> It is certainly difficult, for example, to imagine a court extending the benefit of an unconstitutionally discriminatory sales or property tax exemption to *all* taxpayers, thereby eliminating the tax altogether from the state's tax structure, rather than abolishing the exemption for the favored class of taxpayers. It is worth bearing in mind, however, that the remedies for unconstitutionally discriminatory tax incentives need not always, if ever, be that draconian. There are, in any event, fruits of victory apart from obtaining the particular tax benefit on a prospective basis.

With regard to some tax incentives, such as income or sales tax credits confined to those who have engaged in a particular type of in-state activity, the credit or deduction could be extended to all taxpayers who engage in that activity, regardless of whether they engaged in the activity in the state. This result would not substantially erode the income or sales tax base. In fact, courts in several cases have fashioned remedies in just this way—that is, by extending the favorable tax treatment to all taxpayers engaged in the favored form of activity, whether they pursue it inside or outside the state.<sup>449</sup>

Even if a taxpayer is not successful in obtaining the advantage of the tax incentive in question, its invalidation may well inure to its economic benefit by creating a level playing field between the taxpayer and its in-state competitors that enjoyed the tax benefit in the past. Indeed, it is this consequence of invalidating the tax incentive that provides the essential justification for judicial intervention under the dormant commerce clause, namely, to safeguard the “free trade” purposes underlying the clause by prohibiting statutes that “provid[e] a direct commercial advantage to local business.”<sup>450</sup>

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<sup>448</sup> See, e.g., *Delta Air Lines, Inc. v. Department of Revenue*, 455 So. 2d 317 (Fla. 1984) (striking discriminatory corporate income tax credit provided to Florida-based air carriers rather than extending credit to all carriers), *appeal dismissed sub nom.*, *Delta Air Lines, Inc. v. Florida Dep't of Revenue*, 474 U.S. 892 (1985); *Archer Daniels Midland Co. v. State ex rel. Allen*, 315 N.W.2d 597 (Minn. 1982) (striking tax reduction for gasohol produced in state rather than extending reduction to all gasohol); *Giant Indus. Arizona, Inc. v. Taxation and Revenue Dep't*, 796 P.2d 1138 (N.M. Ct. App. 1990) (striking gasoline tax deduction for ethanol-blended fuel manufactured in state rather than extending deduction for all ethanol-blended fuel).

<sup>449</sup> For example, the New York Court of Appeals on remand from the United States Supreme Court in *Westinghouse* held that the appropriate remedy was to extend the tax credit to income generated by DISC shipments regardless of the state from which the exports were shipped. *Westinghouse Elec. Corp. v. Tully*, 470 N.E.2d 853 (N.Y. 1984). See also *Comptroller of the Treasury v. Armco, Inc.*, 521 A.2d 785, 791-92 (Md. Ct. Spec. App. 1987) (extending favored treatment of DISC dividends to all DISCs, where statute unconstitutionally limited favored treatment to DISCs with 50 percent or more of their taxable income in state); *Northwest Aerospace Training Corp. v. Commissioner of Revenue*, 1995 WL 431134 (Minn. T.C. July 18, 1995) (extending exemption for sales tax on receipts from lease of flight equipment to all leases, where statute limited favored treatment to leases made to lessees with economic presence in state).

<sup>450</sup> *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959).

Finally, it is now established that when a taxpayer is required to pay a tax that is subsequently held to discriminate against interstate commerce under settled principles of Commerce Clause adjudication, the Due Process Clause guarantees the taxpayer “meaningful backward-looking relief to rectify any unconstitutional deprivation”<sup>451</sup> of property. Thus in many—although not all—cases, the taxpayer will receive a refund of the discriminatory taxes it has paid in the past, whatever remedy the court, and ultimately the legislature, may fashion for the future. As the Court has observed, “[t]he State may . . . choose to erase the property deprivation itself by providing [the taxpayer] with a full refund of its tax payments.”<sup>452</sup>

The state may also “reformulate and enforce the . . . [t]ax during the contested tax period in any way that treats [the taxpayer] and its competitors in a manner consistent with the dictates of the Commerce Clause.”<sup>453</sup> Thus the state might require payment of back taxes by those who received favored tax treatment under the unconstitutional tax incentive, thereby retroactively eliminating the discrimination. In the real world, however, the practical and political difficulties of fashioning any retroactive remedy other than a refund (as well as legal difficulties presented by federal and state strictures regarding retroactive legislation) make solutions that require back-tax collections unlikely. Accordingly, taxpayers who successfully challenge state tax incentives under the Commerce Clause are likely, at a minimum, to be rewarded for their efforts with tax refunds, assuming they have involuntarily paid taxes under the unconstitutional regime and do not run afoul of enforceable procedural limits on obtaining such recoveries.

## B. Subsidies

Subsidy cases, like tax-break cases, will raise a range of remedial issues. Perhaps the most interesting set of issues emanates from the “*de facto* tax rebate” approach to subsidies that we have identified as an organizing principle in this area of law.<sup>454</sup> The problem arises because specialized procedural rules apply to cases involving the constitutionality of state *tax* laws. In particular, the federal Tax Injunction Act<sup>455</sup> generally channels into state court any suit to “enjoin, suspend or restrain the assessment, levy or collection of any tax under State

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<sup>451</sup> *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 31 (1990).

<sup>452</sup> *Id.* at 39.

<sup>453</sup> *Id.* at 40.

<sup>454</sup> See *supra* notes 238-39 and accompanying text.

<sup>455</sup> 28 U.S.C. § 1341 (1994).

law."<sup>456</sup> Similarly, in *Fair Assessment in Real Estate Ass'n v. McNary*,<sup>457</sup> the Supreme Court relied on considerations of "comity" to require claimants who seek damages for state-tax-related constitutional violations to press their cases before state tribunals.<sup>458</sup>

The question that presents itself is whether these restrictive doctrines applicable to state *tax* cases will carry over to state *subsidy* cases in which relief is sought on the ground that the subsidy operates as a discriminatory *de facto* "tax rebate." Providing an answer to this question presents a challenge that will call for statutory and case law analysis more probing than the few words we offer here. Those who consider subsidy-related litigation should recognize, however, that the applicability of these limiting "tax" doctrines to their cases will turn in large measure on two key variables.

First, whether the subsidy is challenged on "rebate-likeness" grounds may well affect the outcome. Other lines of attack may be launched: that the subsidy is improperly coupled with a downstream restraint;<sup>459</sup> that the particular subsidy creates so much market distortion for so little cost that the rule that generally safeguards discriminatory subsidies should be deemed inapplicable;<sup>460</sup> or even that our entire theory is wrong, so that out-of-staters may challenge all local subsidies—regardless of their linkage with any tax—on the ground that they "discriminate[ ] against interstate commerce."<sup>461</sup> In all of these cases, the challenge to the subsidy is unrelated to any tax; thus the limiting rules applicable to constitutional tax cases should not and will not apply.

If the case rests on the claimed tax-rebate-likeness of a challenged subsidy, however, the applicability of the Court's tax doctrines may turn upon a second variable: the *relief* the challenger seeks. In *West Lynn Creamery*, for example, the Court struck down the tax-and-subsidy program "as a whole."<sup>462</sup> In such a case, procedural rules applicable in state tax cases apply because the tax itself is at issue.

What if the challenged subsidy is severable from the tax it allegedly offsets and the sole relief sought is a prospective injunction of

<sup>456</sup> *Id.* See also 2 STEVEN H. STEINGLASS, SECTION 1983 LITIGATION IN STATE COURTS § 18.3(a) (1990); 17 CHARLES A. WRIGHT ET AL., FEDERAL PRACTICE & PROCEDURE § 4237 (2d ed. 1988 & Supp. 1996); William L. Taylor, *Section 1983 in State Court: A Remedy for Unconstitutional State Taxation*, 95 YALE L.J. 414, 417-18 (1985).

<sup>457</sup> 454 U.S. 100 (1981).

<sup>458</sup> *Id.* at 116.

<sup>459</sup> See *supra* text accompanying note 323.

<sup>460</sup> See Benjamin C. Bair, *The Dormant Commerce Clause and State-Mandated Preference Laws in Public Contracting: Developing a More Substantive Application of the Market-Participant Exception*, 93 MICH. L. REV. 2408, 2423 (1995); Regan, *supra* note 222, at 1196. But see Coenen, *supra* note 120, at 478-79.

<sup>461</sup> *C & A Carbone, Inc. v. Town of Clarkstown*, 114 S. Ct. 1677, 1682 (1994).

<sup>462</sup> *West Lynn Creamery, Inc. v. Healy*, 114 S. Ct. 2205, 2215 (1994).

subsidy payments? The Court might say that such a suit is indistinguishable from one challenging a state tax law so that the Tax Injunction Act applies. The policies underlying the Act, however, cut in the other direction. This is so because, when litigants seek to enjoin future payments of a subsidy, they in no way endanger the state's "collection of revenue . . . with consequent damage to the State's budget."<sup>463</sup> To the contrary, if the litigant is successful, funds in the state treasury will be augmented because the state must *not* make future subsidy outlays.<sup>464</sup> It has been said that the Tax Injunction Act is inapplicable when "the suit does not seek to enjoin the collection of taxes [but] challenges only the unequal distribution of state funds."<sup>465</sup> This description fits an action brought solely to enjoin further subsidy payments.

Serious risks to the revenue-protecting goals of the Tax Injunction Act will arise, however, if the litigant sues not to enjoin future payments of a subsidy, but to require *extension* of the subsidy to out-of-state businesses. Here, a grant of the requested relief *will* deplete funds in the state treasury. Thus, the state will argue that tax doctrines built on safeguarding state fiscal autonomy should operate to channel these suits into state courts.<sup>466</sup>

This argument probably should fail. To begin with, many constitutional challenges to state programs threaten state fiscal autonomy without triggering the Tax Injunction Act or the "comity" exceptions to the general rule of federal-court jurisdiction over constitutional cases.<sup>467</sup> School-desegregation and prison-condition cases provide striking examples.<sup>468</sup> States may argue that school and prison cases are fundamentally different from cases in which litigants seek the benefit of a "*de facto* tax rebate"<sup>469</sup> they assert they have been discriminatorily denied. Such rebate cases, the states may say, fall comfortably

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<sup>463</sup> *California v. Grace Brethren Church*, 457 U.S. 393, 410 (1982) (quoting *Perez v. Ledesma*, 401 U.S. 82, 128 n. 17 (1971) (Brennan, J., concurring and dissenting)).

<sup>464</sup> See, e.g., *WRIGHT ET AL.*, *supra* note 456, § 4237 n.19 (citing cases for rule that Tax Injunction Act does not block federal actions that allow, rather than prevent, collection of a tax).

<sup>465</sup> *Levy v. Parker*, 346 F. Supp. 897, 904 (E.D. La. 1972), *aff'd mem.*, 411 U.S. 978 (1973).

<sup>466</sup> See *Wright et al.*, *supra* note 456, § 4237 n.18 (citing cases that apply the Tax Injunction Act to suits in which litigants want to effectively expand the group benefitting from tax exemption or credit, thus reducing tax collections).

<sup>467</sup> See 28 U.S.C. §§ 1331, 1343 (1994). Section 1331 gives federal district courts original jurisdiction when federal questions are presented. Section 1343 gives federal district courts original jurisdiction over civil rights cases.

<sup>468</sup> See, e.g., *Milliken v. Bradley*, 433 U.S. 267, 289 (1977) ("*Ex parte Young*, 209 U.S. 123 (1908), permits federal courts to enjoin state officials to conform their conduct to requirements of federal law, notwithstanding a direct and substantial impact on the state treasury.").

<sup>469</sup> See *supra* note 246 and accompanying text.



within the special rules applicable to tax cases (and are indistinguishable, in particular, from cases involving claimed entitlements to tax exemptions or credits<sup>470</sup>) because the whole theory of the challenger is that the subsidy operates in effect as a *tax* break.<sup>471</sup>

The difficulty with this line of reasoning is that it tends to equate a tax rebate that really *is* a tax rebate (because, for example, it is characterized as a rebate by state law and administered by and through state tax officials) with a subsidy said to be unconstitutional on the ground that it operates *like* a tax rebate. In *Baldwin v. G.A.F. Seelig, Inc.*,<sup>472</sup> for example, the Court struck down a minimum milk price law made applicable to nonresident producers because it operated as the "equivalent to a rampart of customs duties" by denying out-of-state products a price advantage earned by way of more efficient operations.<sup>473</sup> In other words, a state's non-tax law was deemed invalid because of its *practical* kinship to an unlawfully discriminatory tax. No one would suggest, however, that the Tax Injunction Act applied in *Baldwin*. The same principle, we suspect, should cover a challenge directed at a subsidy, even if the challenge rests in whole or part on rebate-*likeness* grounds.

Consider a present-day challenge by an out-of-state hulk processor to a subsidy like the one involved in *Alexandria Scrap*.<sup>474</sup> In such a case, the challenger might well rely on a variety of arguments: that the market-participant exception should be overruled and the hulk-processing incentive struck down as impermissibly discriminatory;<sup>475</sup> that the subsidy diverts so much business to in-staters at so little cost that an exception to the market-participant rule should apply; and (perhaps) that the subsidy operates as a *de facto* tax rebate of a license, gross-receipts or income tax. This challenge to what is in essence a state *subsidy* ought not to be forced into state courts by exceptional doctrines designed to deal with state *taxing* programs.

Even if federal courts find the Tax Injunction Act and the *McNary* "comity" principle inapplicable in subsidy cases, the practical problems that confront the challenger of a subsidy are not at an end. The successful challenge of a state subsidy, for example, may well entitle a proper plaintiff to "meaningful backward-looking relief."<sup>476</sup> As

<sup>470</sup> See *supra* note 466 and accompanying text.

<sup>471</sup> See WRIGHT ET AL., *supra* note 456, § 4237 nn.17-18 and accompanying text (noting that "the Tax Injunction Act applies even when the effect of the suit will relieve the taxpayer's burden only indirectly").

<sup>472</sup> 294 U.S. 511 (1935).

<sup>473</sup> *Id.* at 527.

<sup>474</sup> See *supra* notes 254-62 and accompanying text.

<sup>475</sup> See Bair, *supra* note 460, at 2419 n.61 (collecting authorities critical of the market-participant exception).

<sup>476</sup> *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 31 (1990); see also SHELDON H. NAHMOT ET AL., CONSTITUTIONAL TORTS 375-76 (1995) (discuss-

we have seen, such relief will almost always take the form of money-damage payments.<sup>477</sup> If such relief is sought from the state itself, however, it almost certainly is not obtainable in federal court because of the Eleventh Amendment.<sup>478</sup> The effect of this rule will be to channel virtually all subsidy actions that involve requests for retrospective relief from the state itself into the state courts.<sup>479</sup>

If the plaintiff successfully prosecutes a "backward looking relief" case against the state, must the court award attorneys fees under 42 U.S.C. § 1988?<sup>480</sup> The answer is no if the *only* relief obtained is backward-looking money damages. This is so because section 1988 fees are not recoverable unless the plaintiff prevails under section 1983, and section 1983 does not support a claim for money damages against a state.<sup>481</sup> In the ordinary case, however, the plaintiff will not seek only retrospective monetary relief; rather, the plaintiff will couple the claim for money damages, brought directly under the Fourteenth Amendment, with a section 1983 claim for declaratory and prospective injunctive relief against state officials under the principle of *Ex parte Young*.<sup>482</sup> These remedies are ordinarily available under section

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ing impact of *McKesson*). Note, however, that states may argue that subsidy cases are different from tax cases for purposes of this principle, given the Court's derivation of due-process rules in *McKesson* from the notion that an "exaction of a tax constitutes a deprivation of property." 496 U.S. at 36. Of course, the subsidy challenger may respond to the state's argument, in part, by saying that the *de facto* rebate nature of the challenged subsidy establishes that the challenger has been subjected to the discriminatory "exaction of a tax" within the meaning of *McKesson*.

<sup>477</sup> See *supra* note 452 and accompanying text.

<sup>478</sup> See, e.g., *Edelman v. Jordan*, 415 U.S. 651 (1974) (generally barring suits in federal court designed to recover money damages from the state); see also *Taylor*, *supra* note 456, at 418 ("The Eleventh Amendment bars federal district courts from entertaining actions seeking retroactive relief against a state."). A possible counterargument is that, because the later-adopted Due Process Clause *itself* is the source of law that "obligates the state to provide meaningful backward-looking relief," the Eleventh Amendment principle of *Edelman* somehow is trumped in such a case. Cf. *Fitzpatrick v. Bitzer*, 427 U.S. 445, 456 (1976) (finding that Congress can abrogate Eleventh Amendment immunity through exercise of Fourteenth Amendment enforcement power).

<sup>479</sup> Notably, these considerations are not present if the taxing authority is a *local* government because such units are not immune from suit in federal court under the Eleventh Amendment. See generally PAUL M. BATOR ET AL., HART AND WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM 1172-73 (3d ed. 1988) (discussing the different treatment of state agencies as opposed to local or municipal governments under the Eleventh Amendment). Moreover, even if the Eleventh Amendment does require *initiation* of the suit in state court, the Amendment does not preclude *review* of the final state court judgment by the United States Supreme Court. *McKesson*, 496 U.S. at 26-31.

<sup>480</sup> See generally NAHMED ET AL., *supra* note 476, at 391-431 (discussing fee awards under § 1988).

<sup>481</sup> *National Private Truck Council, Inc. v. Oklahoma Tax Comm'n*, 115 S. Ct. 2351, 2355 n.5 (1995); *Will v. Michigan Dep't of State Police*, 491 U.S. 58, 68-69 (1989). Again the rule is different if the defendant is a local government. See *Monell v. Department of Social Servs.*, 436 U.S. 658 (1978) (deeming local governments "persons" within the meaning of § 1983).

<sup>482</sup> 209 U.S. 123 (1908).

1983, and obtaining them entitles the plaintiff, as a general rule, to attorneys fees recoverable from the state treasury under section 1988.<sup>483</sup>

Does some exception to this general rule apply in subsidy cases involving tax-rebate-likeness challenges? The state will say yes, relying on *National Private Truck Council v. Oklahoma Tax Commission*<sup>484</sup> for the proposition that state courts need not award section 1988 fees in *tax* cases if state law affords an adequate remedy for the underlying constitutional violation without reference to section 1983. This principle should control, the state will say, because the challenger's essential claim is that the subsidy is an unconstitutionally discriminatory *de facto* tax rebate.

This argument brings us full circle. The special exception to fee recoveries in constitutional tax suits derives from the special protections afforded state tax programs by the principles underlying the Tax Injunction Act and *McNary*.<sup>485</sup> We have already suggested that those *tax*-related principles should not extend to suits involving challenges to state *subsidies*.<sup>486</sup> If we are right on that point, it should follow easily that the principle of *National Private Truck Council* does not apply in subsidy cases either.

The remedial questions we have considered hardly exhaust the range of practical problems litigants will confront in mounting constitutional attacks on state subsidies. State-specific procedural and limitations rules, for example, may block otherwise available recoveries.<sup>487</sup> States may even be able to limit recoveries—particularly of attorneys fees—by declining altogether to open their courts to section 1983 claims.<sup>488</sup> A full examination of these issues is left to others. Enough has been said to alert practitioners to the many procedural pitfalls that await any challenge to state subsidization on dormant commerce clause grounds.

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<sup>483</sup> See *Hutto v. Finney*, 437 U.S. 678, 690, 693-700 (1978).

<sup>484</sup> 115 S. Ct. 2351 (1995).

<sup>485</sup> See *id.* at 2354-55 (discussing *McNary*'s holding that "Congress never authorized federal courts to entertain damages actions under section 1983 against state taxes when state law furnishes an adequate legal remedy").

<sup>486</sup> See *supra* text accompanying notes 455-64.

<sup>487</sup> See, e.g., *Wilson v. Garcia*, 471 U.S. 261 (1985).

<sup>488</sup> See *National Private Truck Council*, 115 S. Ct. at 2355 n.4. See generally Bator et al., *supra* note 479, at 495-500 (discussing obligations of state courts to enforce federal claims).