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The Effect of State and Local Taxes on Industry

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Motivated in part by a desire to increase incomes and improve the living standards of the community, and in part by a desire to broaden and diversify the tax base, many state and local governments in the United States have, in recent years, devoted a good deal of energy to the problem of industrial attraction.

There are many policies which may be used by state and local governments to induce industries to locate within particular governmental jurisdictions. Whether the policies are selectively addressed to a number of highly desirable industries or whether they are indiscriminately addressed to all business enterprises, these policies are, at some point, concerned with the factual question of why businesses select particular sites for their operations.

This article is concerned only with the tax aspects of these locational decisions and represents an attempt to explore some of the policy implications of the business decision-making process.

In general, there are three methods by which state and local governments may attempt to grant tax concessions to potential industrial immigrants. By the first of these methods, the concessions are purely statutory in character and take the form of a more liberal construction of the tax laws in an attempt to create the appearance of tax burdens that are lighter than those of competing jurisdictions. An example of such a statutory lure, applied on a non-selective basis to many types of corporate enterpries, is the revision of the state income tax law to provide a less burdensome formula for the allocation of multi-state income.[1] A similar statutory device may be more selectively applied through a special classification of exemptions under the ad valorem property tax.

By the second method, the concessions are purely administrative in character and take the form of extra-legal negotiations between the tax administrator and the potential taxpayer. Such administrative concessions tend, of course, to be highly selective and depend upon the good faith and the good judgment of the administrator for the determination of what constitutes a desirable industrial activity and for the determination of

*The present article is based upon a study conducted by the author for the North Carolina Tax Study Commission in 1955-56.

**This article is not to be considered the official view of the company with which the author is associated.

1. The most recent example of such action is contained in the recommendations of the North Carolina Tax Study Commission, submitted to the Governor on November 15, 1956.

whether or not the concessions are truly necessary in each of the cases. Although tax determination by administrative decision is common in many areas of taxation, it is probably most importantly used in the administration of the ad valorem property tax, where the subjective processes of assessment provide abundant elbow room for the assessor who is unimpressed with his statutory responsibilities.

Finally, policies of industrial attraction might combine the statutory and the administrative methods. Such policies begin with a delineation by the legislative body of the broad outlines of the industrialization policy. The administrative authority is given wide discretionary powers within these policy boundaries, so that the final decisions, while justified by statute, are essentially administrative decisions. These policies, too, are most commonly associated with the income allocation provisions and with programs of temporary property tax exemption which a number of state and local governments have developed in recent years.

It is impossible to determine the extent to which the purely administrative concession is used as an instrument of industrial attraction. By its very nature, such a method is rarely available for public scrutiny. But a number of states have adopted constitutional or statutory provisions which grant a wide range of industrial exemptions from the ad valorem property tax. In some cases the exemptions apply to specific industries or specific products; in other cases they apply to all industries or to a variety of products. In some cases the exemptions are permanent; in other cases they are available for a specified number of years. In some cases the exemptions are available to all enterprises; in other cases they are available only to enterprices newly located in the state. In all cases the exemptions have as their purpose the creation of an atmosphere that will induce new industries to enter the state and that will persuade existing industries to remain.[2]

There are many grounds on which the use of a state and local tax structure as an instrument of industrial attraction might be criticized. But before any critical evaluation of such policies is possible it is necessary to reach some conclusion, however tentative, as to the *effectiveness* of a program of tax concessions in stimulating industrial immigration. Even if the policies are judged to be highly effective they may be found to involve disproportionately heavy social costs. Final judgment must clearly be based

2. The following states have adjusted constitutions or statutes to provide for the granting of industrial property tax exemptions at either the state level, the local level, or both: ALA. CODE ANN. tit 51, § 6 (1940); ARK. CONST., amend. xii; DEL. CODE ANN. tit. 9, § 8104 (1953); FLA. CONST. Art. IX § 12; KY. REV. STAT. § 132.200 (1953); LA. CONST. Art. X § 4; MD. ANN. CODE GEN. LAWS Art. 81, § 8 (23) (1951); MASS. ANN. LAWS c. 59, § 5 (1953); MICH. COMP LAWS § 211.24 (1918); MISS. CODE ANN. § 9703 (1953); N. H. REV. STAT. ANN. c. 72.12 (1955); OHIO CODE ANN. § 5711.16 (1953); OHIO CODE ANN. § 5711.22 (Cum. Supp. 1956); OKLA. CONST. Art. X, § 6; R. I. GEN. LAWS c. 29, § 4 (1938); TENN. CONST. Art. II, §§ 28, 30; VA. CODE ANN. Art. 58 § 412 (1950).

upon a consideration of both the benefits to be realized and the social costs associated with the tools in question.

It is proper to begin with the *a priori* assumption that tax concessions, whether calculated or not, are extremely dangerous. Unless they are strictly confined to *new* enterprises, tax concessions must have one of two effects upon the tax structure of any jurisdiction granting such concessions.[3] They must either reduce the total revenue of the jurisdiction, thereby limiting the ability of that jurisdiction to provide governmental services; or they must result in a shifting of the total tax burden to the shoulders of other taxpayers, thereby disturbing the equity relationships contained in the tax structure.

> Exemptions to particular property owners are demoralizing to those who continue to pay taxes. Tax exemption means a subsidy paid by the entire community and it is doubtful if all taxpayers have a proportionate stake in the benefits.[4]

And even if the concessions are effectively limited to new enterprises, the possibility exisits that the relatively static tax base will be insufficient to meet the new demands for governmental services which an expanding economy inevitably creates. If, in addition, the techniques of tax concession rely upon the use of administrative power, rather than the extension of statutory authority, the policies carry the somewhat more subtle but equally potent threat of subverting the democratic processes which are basic to the fiscal affairs of a system of representative government.

In the face of these demonstrable dangers, the burden rests squarely upon the proponents of any scheme of tax manipulation designed to stimulate industrial location to prove that the results will justify the costs. In other words, it is necessary to prove that a sufficient volume of new and desirable industrial activity will be stimulated to improve incomes and living conditions to such an extent that a net social benefit will be produced.

As an introductory warning, it may be pointed out that the policies in question are by no means the property of a single governmental unit. In declaring its intention to pursue a policy of industrialization through taxation, a government commits itself to a program of competition. In the problem under discussion, it is not the effect of the tax burden of a given jurisdiction upon the operations of a particular business enterprise that is important. Rather, the important consideration in locating or relocating a business enterprise is the effect of tax burden *differences* between competing jurisdictions. An extended combat between taxing jurisdictions may thus produce all of the fiscal costs and none of the economic benefits for any of the competing governmental units. In this respect, the dangers are com-

3. See YASEEN, PLANT LOCATION, 180. Yaseen also considers the possibility of adverse competitive effects of tax concessions on existing industry. These problems are also treated by Snell, *Tax Exemptions to Encourage Industry*, TAXES 383.
4. Seward B. Snell, *op. cit. supra* note 3 at 384.

parable to those associated with competitive price warfare among retail establishments.

THE ECONOMIC THEORY OF INDUSTRIAL LOCATION

The effect of taxes on industrial location has long been a controversial subject among economists and other specialists in the field of public finance. Even businessmen responsible for making the locational decisions are far from unanimous on why industries finally decide on a given location. However, there is substantial agreement at both extremes of the argument. It is agreed that geographical differences in tax burdens do play *some* part in the locational decision. Everyone is agreed that tax differences are not the *only* factors determining industrial location. But between these two extremes lies the practical question of just how *much* influence geographical differences in tax burdens exert in determining the location of industrial activity.

On the surface, the problem appears deceptively simple. It is part of our traditional reasoning as businessmen that, for any given output, a firm will attempt to minimize its total costs. Almost all of the taxes paid by corporations are considered to be costs of doing business. It follows, therefore, that taxes will be considered in the locational decision only to the extent that they affect the costs of doing business at various proposed sites.

All of the costs are in reality *expected* costs, for in determining a plant location an enterprise is more interested in its future than in its past. In theory, too, the relevant costs are not merely annual costs, but a schedule of costs over the expected future life of the property. Pure theory would thus require the location expert to calculate, for each of all possible sites, the present value of all expected future costs (taxes included) and to select the site yielding the lowest figure. Such calculations would have to be made for the entire company and not merely for that portion of the company represented by the new plant. The construction of the new plant may change the operating relationships of the remainder of the enterprise and markedly influence costs for other plants and for other corporate activities. This possibility is particularly important for the tax component because the construction of a new plant in one state will change the allocation ratios for the calculation of an income tax liability in all other states in which the corporation is subject to income taxation.

Up to this point, the theory has been constructed on the assumption that the type of product and the volume of ouput of the new plant are constant. In order to make the analysis fully realistic it is necessary to take account of the expectations of the cost effects of product changes and changes in the volume of output.

This refinement may also have important tax implications. A state which is suitable for a plant of a certain size, producing a certain product, may, from the standpoint of taxes, be undesirable if the plant is later doubled in size or if the product is changed in some significant respect. The planned new installation must not be considered to be identical in all of its alternative locations. The architectural and engineering characteristics may have to be quite different in one location than in another. At one site it may be necessary for the company to construct its own sewage disposal system or to install devices to prevent stream pollution. All of these differences will be reflected in total costs. Similarly, it may be possible to minimize the tax costs by designing the plant operations to suit existing taxing districts or governmental authorities at each of the sites.

Thus, when the surface of the problem is penetrated, the theoretical model for a "rational" decision on industrial location is indeed complex. If only two alternative sites were considered, the application of the full theory would require a sweeping reappraisal of the future of the total enterprise. But the economic theory of plant location requires the consideration of *all* possible sites. Every site is a possible site until the proper cost calculations have been made. Of course, for the great majority of corporations it is possible to narrow the choices to a fairly small number of sites by simple observation. It does not require detailed calculations to eliminate the Black Rock Desert of Nevada or the Golden Isles of Georgia as potential sites for an automobile assembly plant. By simple observation such sites may be ruled out on the grounds of clearly prohibitive costs. The extent to which such subjective elimination is practiced in actual cases is extremely important in assessing the role of taxation in the locational decision.

Although the economic theory of plant location may appear to be more of a logical fantasy than a serious approach to a very practical problem, it does provide one important conclusion. From the point of view of the corporation considering a new location, the entire problem may be expressed in terms of a comparison of costs. The geographical relationship of the enterprise to its natural resources or to its market may always be expressed in terms of the costs of transportation to or from the point of production. Only when it is felt that the location of the plant may influence the market by the advertising effect of a large production unit, is it necessary to state the problem in other than cost terms.[5]

In the cost comparisons of the locational analysis the tax dollar clearly has the same authority as the transportation dollar, the labor dollar, or the rent dollar. If, in parading its advantages, a state offers an abundant market, the state is, in effect, offering low transportation costs to reach that market. This cost advantage may be offset in any number of ways.

5. Some corporations have, in recent years, given as one of the reasons for a preference for industrial dispersion a desire to affect markets through the location of plants by making people more aware of the company name and by adding, generally, to the company's good will.

One of these offsets may be a higher tax burden. Assuming that the tax advantage of one state is exactly offset by the costs of transporting the product from that state to the large market of a neighboring state, there is obviously no net advantage for either state if the tax burdens remain constant. The point is, of course, that there is nothing unique about the way in which taxes enter the corporate computation. If the dollar amounts are the same and if equal certainty attaches to each, a state's offer of low taxes is exactly as powerful as the state's offer of low wages, low transportation costs to the market, low transportation costs from the source of raw materials, low rental changes, or low interest rates.

From the point of view of these theoretical beginnings, the role of state and local taxes in determining the location of industrial enterprises is measured entirely by the magnitude of the differences between the tax bills at alternative sites. If labor cost differentials are greater than tax cost differentials, it is clear that labor costs are more important than tax costs in determining industrial location. If tax cost differentials are greater than transportation cost differentials, tax costs are more important than transportation costs. This argument does not disturb the conclusion that it is the *total* comparison that is significant, for the argument simply grades the component parts of the decision.

The conclusions, of course, will be different for each enterprise considered. For some types of enterprises transportation costs to the market are inherently large. For other types of enterprises transportation costs from the source of raw materials are inherently large. For other types of enterprises labor costs are inherently large. For other types of enterprises rental charges (actual or imputed) are inherently large. But in every case tax budens play the same "negative" role as every other cost element in the calculations.

The fact that this article is aimed at the significance of *tax* differentials makes it possible to conclude that a number of enterprises are, on theoretical grounds, likely to be relatively insensitive to tax lures or to tax hardships. The reasoning, of course, is simply that such enterprises are, by the nature of their operation, likely to be relatively more *sensitive* to other costs. For the most part, such enterprises are affected in greater degree by transportation costs. Thus, enterprises manufacturing perishable commodities feel obligated to locate close to the market because the costs of refrigerated or other preservative transportation are generally high. Similarly, enterprises concerned with transforming bulky raw materials into compact finished products feel obligated to locate close to the source of the raw materials, because the costs of transporting the raw materials are significantly greater than the costs of transporting the finished products. It is possible to construct a theoretical situation in which an enterprise normally attracted to the source of raw materials could be induced to move closer to the market by tax differentials, but in many such cases the tax differentials would have to be much larger than can reasonably be expected.

For certain types of enterprises it is safe to assume that differences in transportation costs are likely to be greater than differences in all of the other costs combined. For such an enterprise it would be possible for a taxing jurisdiction to increase its tax burdens by large amounts without offsetting the transportation cost advantages. Indeed, it is likely that the tax costs could be increased to the point at which it would be impossible for the enterprise to continue in business. In spite of this, it may not pay the enterprise to change locations. Under these circumstances, the business would simply cease to exist. In cases of this sort, taxes may not be considered to have any locational effect, other than that of determining whether the business will operate at all.

The foregoing is a rough sketch of the theoretical arguments concerning industrial location. We conclude that differences in tax burdens are just as important as comparable dollar differences in any other cost factor. In theory, a particular site is selected only after an analysis of *total* costs, so that the ultimate importance of tax burdens is determined entirely by the relationship between the *size* of the tax differentials and the *size* of the differentials for other costs. On the assumption that businessmen behave with perfect rationality in their locational decisions, and on the assumption that they are able to collect enough information to transform the theoretical model into a practical decision, the theoretical conclusions are incontestable. Debate on the significance of taxes in the locational decision seems unnecessary.

Difficulties of Measurement

Although the theoretical argument provides some important insights into the practical problems of industrial location, the theory exists in too rarified an atmosphere to be useful as an explanation of the manner in which locational decisions are actually made. In the first place, businessmen are not always "perfectly rational" individuals. Partly because of intracorporate authority arrangements, and partly because of individual personality traits, businessmen sometimes are guided by emotional considerations, by untested prejudices, or by considerations of personal comfort or advantage. It must be remembered, too, that rationality itself can be a costly luxury. If all of the logical requirements of the theory were to be fulfilled in practice, it would be necessary for the firm to employ an army of expert "data-gatherers" and banks of electronic calculators. For all but the largest enterprises such attempts at rationality are likely to prove highly irrational.

The most serious limitations of the practical application of the theory of industrial location comes from the fact that detailed study of the data is virtually impossible, especially in the field of state and local taxation. The difficulty is not merely that of being unable to plan for a definite set of tax costs over a *long period of time.* The difficulty is that of being unable to determine, with reasonable certainty, the *first year's* tax costs. It is this difficulty that provides the most important distinction between the tax costs and the non-tax costs. It is generally possible to determine what the rental charge will be before the bills have to be paid. And it is generally possible to determine what the prevailing wage rate is and how this prevailing rate will be adjusted by the entry of a new enterprise. It is also possible to determine the architectural and engineering requirements in advance and to plan a definite set of operational costs for each of the potential sites. Transportation costs may be established without difficulty. Only in the case of tax burdens is it impossible to make a definite pre-determination. Such pre-determination may be possible for *some* of the sites on the lists, but a comparison of total costs is impossible unless there is a definite determination for *all* of the sites.

The difficulties faced by the location expert in determining the magnitude of the tax differential between a series of alternative sites are exactly the same as the difficulties faced by the tax analyst in attempting an objective measurement of the differences in interjurisdictional tax burdens.[6] Briefly, the difficulties come from the fact that it is not possible to assume that the tax burden implied by the law will be the same as the tax burden actually imposed. In many cases a good deal of discretion is permitted the tax administrator. In other cases the tax administrator assumes discretionary power without specific statutory authorization. In still other cases the law provides for tax relief if the taxpayer satisfies certain conditions. In some cases the law is precise and the administrator is inflexible. In very few cases is it possible to examine the tax laws and arrive at a tax cost figure in which great reliance may be placed, especially if the new plant is going to change the character of the community.

Although all types of taxes are subject to the same difficulties of interpretation, the income tax and the property tax are undoubtedly the chief sources of uncertainty. Through administrative adjustments to the formula by which taxable income is determined, and through arbitrary and inexpert appraisal practices, these taxes often give the lie to Adam Smith's familiar canon that taxes be "certain."[7]

In one other sense taxes tend to be less certain than do other types of costs. All costs are, of course, subject to variation through time, and all are, to a certain extent, unpredictable. But for the individual firm, tax costs are probably unique in the *degree* to which they may fluctuate and in the *extent* of their unpredictability. An apparently small change in the

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6. These difficulties are discussed at length in a forthcoming study, CARBERT, THE IMPACT OF STATE AND LOCAL TAXES IN NORTH CAROLINA AND THE SOUTHEASTERN STATES, to be published by the State of North Carolina, Chapters I, VI and VII.
7. ADAM SMITH, THE WEALTH OF NATIONS, Book V, chapter 2 (Canaan edition).

tax laws, involving virtually no revenue change for the taxing authority, may have a very considerable effect upon the tax burdens of individual enterprises. Changes in the growth pattern of the state or of individual communities can bring unexpected problems of providing governmental services, and hence unexpected tax problems, especially those concerned with the many special purpose districts. Changes in the composition of the legislature or of an administration, and consequent changes in the philosophy or techniques of government, may impose tax burdens upon individual corporations totally different from those which were imposed before the changes. Changes in non-tax costs are related to changes in the economy as a whole. Changes in tax costs may be quite unrelated to general economic changes. A state with a low corporate income tax rate may find itself in fiscal straits and be forced to double the rate. A state may spend a decade reducing previously accumulated surpluses in a desperate effort to maintain its low tax rates. When the surplus is turned into a deficit the state may feel obligated to attempt "recovery" in one or two years with extraordinary high tax rates. Property tax assessments may deteriorate for fifty years. The final discovery that the situation is intolerable may result in a shocking revision. In a single year the ills of a long period might have to be corrected. The imminence of a radical departure from the status quo is rarely obvious on the surface and is never indicated by a simple examination of the existing statutes. Such changes are the source of the inherent and unique unpredictability of state and local tax burdens.

The fact that reasonably accurate tax differentials cannot generally be calculated by a corporation interested in industrial location does not, by any means, prove the unimportance of taxes in the locational decision. The difficulties of measurement force state and local taxes to play a secondary or a tertiary role. Thus, the corporation will typically esbtablish a set of minimum conditions which must be met by the new location. The probability is that taxes will not be on this minimum-requirement list.

Any number of factors may be considered to be of primary importance, but it is probable that there are very few enterprises that would include state and local tax differentials in the list of basic considerations. There can be only two reasons for this omission; either tax differentials between jurisdictions are small relative to differentials in other costs, or it is impossible to calculate tax differentials with any confidence. In view of the fact that some enterprises are known to exhibit sincere dissatisfaction with particular locations because of tax differentials discovered *after* location, it is here maintained that the only defensible argument for the omission of state and local taxes from the list of primary considerations for the majority of firms is the inability to discover the real differences in burdens between alternative sites.

The statement of the basic requirements will, of course, narrow the list of possible sites by eliminating those sites which are obviously unsatisfactory. Even in this primary consideration, however, it is too much to expect that management evaluate *every* site that could possibly satisfy the basic requirements, unless, of course, these requirements are so unique that they are met by a very small number of locations. As a result, many taxing jurisdictions will not have an opportunity to display their wares. Some will be eliminated because they do not offer the basic requirements. Others will be eliminated because of the prejudices of management, or because of the prejudices of the professional location experts. Others will be eliminated because of the fact that human beings have been known to overlook a good thing.

Once the list of possible sites has been narrowed to those which can fulfill the basic requirements, there is likely to be a consideration of those factors which are considered to be "desirable but not essential." The secondary consideration simply implies that these factors are known, perhaps intuitively, to involve smaller cost differentials than those involved with the primary factors. But still it is unlikely that taxes will be considered in any clear, quantitative way.

Some enterprises may consider that the differences in labor costs emphasize the desirability of the remaining locations in the Southeastern states. Other enterprises may consider that the differences in labor skills emphasize the desirability of the remaining locations in the Northeastern states. Still other enterprises may conclude that the costs involved in a location in the midst of industrial overcrowding are too great. In any event, a second process of elimination takes place. Once again, many taxing jurisdictions are eliminated before they have a chance to prove their low-tax status for the simple reason that other more easily calculated and more readily predictable elements are found to be undesirable.

By this argument, industrial location appears to be a process of elimination. Some sites are rejected because non-tax costs are known, *by common sense,* to be prohibitive. Other sites are rejected because non-tax costs are known, *by actual measurement,* to be relatively high. But it would seem that, until the final step, sites are not rejected because *tax* costs are *known* to be relatively high. This kind of knowledge simply does not fit the pattern of state and local taxation. When everything else has been decided, and when everything else has been found to produce equal advantages for those sites which have not been eliminated, taxes are considered to be the final deciding factor.[8]

The fact that tax differences are capable of only imperfect discovery

8. The conclusion that industrial location takes the form of a process of elimination rather than the form of a simultaneous solution of countless variables is suggested by McLaughlin and Robock, Why Industry Moves South, Chapter 3; and again by Robock, *Industrialization and Economic Progress in the Southeast,* The Southern Economic Journal, April, 1954, p. 317-319. See also Harold C. Berry, *Business Location As a Factor in Tax Liability,* Management and Taxes, 92.

would seem to be sufficient reason for relegating state and local taxes to the role of final arbiter. But there is another reason which is embodied in the observation that *taxes are considered by many corporations to be* negotiable payments. There are few areas in the American economy in which haggling and bargaining may still be practiced. The modern marketplace, with fixed prices, has taken over the bazaar. But state and local taxes have fallen prey to the "fair trade" principle in a legalistic sense only. Outside the law (although sometimes permitted by law) bargaining is still possible. Furthermore, industrialization has been endowed with such an air of desirability that, when a corporation presents a dozen possible locations in various states, and when the choice is made to rest upon tax concessions beyond the law, the corporation often finds itself bargaining from a position of considerable strength. In this way at least part of the uncertainty of state and local taxes is removed in the final stages of the locational decision, however undesirable the results may be from the community's point of view.[9]

To the extent that tax considerations are introduced at earlier stages in the deliberations, they tend to take the form of a calculation of the obvious. In the same way that a site may be rejected because of an obviously inadequate water supply, a site may be rejected because of an apparently high tax levy. A high corporate income tax rate, an unfavorable allocation formula, a high franchise tax rate, and high property tax rates, will tend to prejudice the management against particular states or against particular sites within a state. The results of such an incomplete examination may be quite invalid. But they will permit the corporate officials to sift out those states whose tax burdens *appear* to be high.

Faced with the monumental task of persuading a large number of local tax assessors to disperse, for a moment, the clouds of mystery which surround local assessment practices, and faced with the equally monumental task of persuading a large number of state officials to generalize on the subject of special determinations, a corporation in the beginning stages of the exploration for a new location can hardly be expected to do more than examine the tax laws and related material, and, perhaps, to conduct a kind of hypothetical comparison.[10] In such considerations the state that conceals, however inadvertently, the low-tax elements of its tax structure is clearly at a disadvantage. Conversely, the state that conceals the high-tax elements of its tax structure has a clear advantage. The *real* tax advantage may, in fact, lie in the state that is rejected because its *apparent* tax burdens are excessive.

The role of state and local taxation in the locational decision thus appears to have at least two facets. If taxes are considered early in the ex-

9. This practice of tax determination through administrative processes is treated briefly in Berry, *op. cit. supra* note 8, at 94.

10. For a recent example, see Carbert, *op. cit. supra* note 6 , chapters VI and VII.

plorations, the calculations are likely to be of the obvious effects of the state and local tax structures. If taxes are considered late in the explorations, it is probable that they will serve as the final element in the choice between a number of sites which are otherwise comparable in their locational advantages. In this latter event, the tax calculations which form a part of the final decision may be concerned only with the apparent differences, or they may be the result of extended negotiations in which several taxing jurisdictions become competitive suitors.

Almost all state and local taxes levied upon corporate enterprises are permitted as deductions from gross income in the computation of federal income tax liability. With the present federal income tax rates, the absolute differences between alternative sites must be reduced approximately 48 per cent to provide a measure of the kind of tax differentials that influence tax location. Thus a difference of $1,000 in the state and local tax bills of two taxing jurisdictions would, in effect, be a difference of only $520 if federal income taxes were taken into account. The same thing is true, of course, of other types of costs which are allowed as deductions in the computation of the federal income tax base. The magnitude of the difference is further reduced by considering the effect of the new location upon the allocation ratios and the state income tax liabilities in other states in which the company operates. Although this feature of the problem is often neglected in locational problems, it can have extremely important implications for a company planning a large, new installation.

Effects of Tax Lures on Industrial Location

Mr. Philip Hammer has classified industrial development activities on the part of governments as "instructive, constructive, and seductive."[11] The "instructive" category covers informational and research services of all kinds. The "constructive" category covers programs of public expenditure of all kinds. The "seductive" category covers special incentives consciously developed to lure industry to a location in specific states or in specific localities. One of the most important of such lures is the tax exemption or the tax concession. And of these, the most important is the plan whereby new or expanding industry is granted a temporary property tax exemption (usually a *partial* exemption) for a specified number of years.

Professor William D. Ross, of Louisiana State University, has commented, at the conclusion of his study of the effects of the Louisiana 10-year property tax exemption program, as follows:

> Theoretical analysis and empirical evidence presented in this study coincide to support the widely held belief that the industrial property tax exemption will, under special circumstances, serve as the deciding influence upon the decisions of management to

11. Address by Phillip Hammer, Carolina Symposium on Public Affairs, Chapel Hill, North Carolina, March 12, 1956.

> develop and to locate a new enterprise in Louisiana rather than in another state. In such a case, the added employment, income, business activity, and the new tax base thereby created in the community where the plant is located and in the state may well offset the direct and indirect costs of the exemption. Only in such a case, however, can an economic justification for the granting of the tax exemption be found. The results of this study indicate that such cases are very few in number, that exemptions cannot be so selectively employed, and that the cost in terms of lost revenue entailed in the granting of exemptions to all firms is great in proportion to results.[12]

Thus, as was to be expected from industrial location theory, temporary property tax exemptions may be instrumental in attracting some enterprises to the state granting such exemptions, but many enterprises that would have located in the same state without such exemptions accept the exemption as a gratuity. As a result, the technique "gives away" much more than it needs to give away in order to attract industry. This excessive beneficence can have only two results: (1) it can result in lower governmental expenditures, or (2) it can result in shifting the tax burden to other taxpayers. It may be argued that, to the extent that new industry is attracted, there will be no *loss* of revenue but only a *failure to gain* revenue. This argument is correct as far as it goes. But to the extent that the participating firms would have entered the state without the exempion, the exemption represents an unnecessary failure to gain revenue. Furthermore, while industry undoubtedly does not exhibit the same demands for direct governmental services as do retail establishments and homeowners, industrial growth nevertheless brings the need for greatly expanded governmental services of all kinds. If the revenue structure fails to keep pace with the need for governmental services, there must, of course, be a reduction in the level of such services.

If the level of services is maintained, the tax burdens that would have been borne by the new enterprises would have to be borne by other corporate and personal taxpayers in the exemption state. It is important to note that after the expiration of the exemption period the enterprise able to obtain the exemption will be forced to bear the relatively high tax burdens in order to permit the continuing exemption for other firms who enter later. The enterprise will, in effect, be helping to pay for its own exemption. This pattern would certainly be apparent if the granting of the property tax exemptions served, by fractionalizing the base, to increase the property tax rate. But adjustments to the exemption may take place entirely outside the property tax area. It may be that the corporate net income tax rate will have to be raised to help carry the burden of the new exemptions. In this case, the exempt firm will still receive a net advantage from the property tax exemptions as compared with other taxpayers in the

12. Ross, Louisiana's Industrial Tax Exemption Program, 47.

same state, but the interstate advantage will be greatly reduced or eliminated altogether.

There are some reasons for believing that a good many businessmen look with distrust upon temporary exemption schemes. The feeling is apparently strong that the level of governmental services will suffer or that the tax structure will contain hidden devices to assure the artificiality of the exemption. It is possible that the temporary exemption programs have actually dissuaded some enterprises from new location in favor of states with a declared policy of "fairness and equity and no free-rides."

Too little attention has been paid to the relationship between industrial location and governmental services, the relationship implied by Mr. Hammer's "constructive" activities. On the significance of these policies Mr. Hammer has this to say:

> The 'constructive' aspects of Southern industrial development are not usually recognized as part of the program. No state development agencies have responsibility for this type of activity—and yet I personally believe that it is by all odds the most important factor in industrial expansion.
>
> The South faces the need for a tremendous additional investment in its public facilities—its streets, schools, libraries, parks, water and sewer systems, and other physical improvements. It has already made substantial investments, but the task has just begun.[13]

In some cases the insufficiencies of governmental services will force the company to provide essential services for itself. Such basic requirements as fire protection, police protection, sewage facilities, water supply, and even employee transportation facilities may have to be provided privately if they are not provided publicly. In a community in which such services are missing, or in which they are inadequate for a large industry, the low tax bills imposed by the community may not be considered to be economic gravy. The substitute costs that would have to be borne by the company may, in fact, more than offset the low tax status in a given location.

In other cases the insufficiencies of governmental services cannot be remedied by private operation. Roads, highways, port and airport facilities are among the services which must be considered indispensable to industrial location and which are almost universally recognized to be governmental in character. But industrial enterprises are more and more recognizing the need for governmental services which do not directly influence the costs of business. Hospital facilities, parks, libraries, and other recreational and cultural facilities are often considered to be extremely important.

13. Hammer, *op. cit. supra* note. 12. These views are expressed by many economists and location experts as well as by many individual businessmen. The importance of such governmental services is stressed, for example, by Mabel Walker, *The Plant, The Office, and the City*, Tax Policy, August-September, 1955, p. 27. In an article in Fortune, July, 1956, by Richardson Wood, the *only* reference to the locational effect of taxes is in terms of the worry of the businessman that taxes might not "keep up with the requirements for schools and streets and sewers", p. 128.

A good system of schools for the children of company personnel stands high on the list of primary requirements of many companies. It is commonly recognized, too, that the values of a good school system extend beyond the needs of company personnel. These values are, from the company's point of view, the intangibles of community stability and social health. If taxes are reduced at the expense of these services, or if the reduction in taxes serves to delay the necessary expansion of these services, the result may very well be a diminished interest in the community as a possible industrial location. To this extent, low taxes (at least, extremely low taxes) may have exactly the opposite effect on the locators. They may, in fact, drive industry away.[14]

CONCLUSIONS

There is thus no clear answer to the old question of whether state and local taxes significantly affect industrial location. At the first level, the answer depends upon the magnitude of the differences between the tax bills of the sites in question. Even after the differences between state and local tax bills are reduced by the proper consideration of the federal income tax, it is apparent, by even a superficial examination, that fairly large differences in state and local tax bills do exist.

These differences must be interpreted differently for different enterprises. For some types of businesses the tax differentials will be insignificant as compared with the differentials in transportation costs, labor costs or building costs. For other types of businesses the tax differentials will not only be significant, but, in all probability, constitute a determining factor. In any event, the tax differentials that are used in any but the final calculations are almost certain to be hypothetical and superficial.

It is in the nature of state and local taxation that, without collusion between the taxpayer and the authorities, certainty in the imposition is virtually unknown. In the final stages of the decision-making process, it

14. It is possible to draw this interpretation from an extension of the findings of a very interesting study by BLOOM, STATE AND LOCAL TAX DIFFERENTIALS AND THE LOCATION OF MANUFACTURING. The author makes use of a correlation technique to test a number of postulates regarding manufacturing location and state and local tax burdens. The author shows that "there is only a rather unimportant relationship between state tax collection levels and increases in manufacturing employment. But it indicates that *manufacturing employment increased most where per capita taxes are highest.*" (p. 26) The probability that higher per capita taxes are related to higher service levels may indicate the favorable attitude with which businesses approach areas in which governmental services are adequate. In addition, the author found that "there is no discernible tendency for growth in manufacturing employment to be depressed where *corporate net income and license tax collections* are high." (p. 34, italics added) Unfortunately, the evidence does not seem fully to support the conclusion that "state and local tax collection differences from state to state *as they presently exist* are not important to the mass of industrial location decisions" (p. 40). This may be true when *aggregate* collections are considered, but it may or may not be true when *corporate* tax burdens are considered. The author's concern with "business taxes" does not remove this difficulty, for he has included only those taxes which are exclusively corporate taxes. He has not considered, for example, the effect of corporate property taxes upon the corporate decision. See Carbert, *op. cit. supra* note 6, chapters VI and VII.

may very well be that many enterprises acquire certainty through the bargaining process. But even this apparent certainty must be tempered by the possibility of a change in the law itself. State and local tax bills thus present a greater problem of uncertainty to the corporate official than almost any other cost. It is this uncertainty that forces a consideration of the *apparent* tax differentials. But even in this case, tax differentials must be compared with the differentials in other costs before the locational analysis makes any sense.

Thus, the *theory* of industrial location is quite clear. It gives the state and local tax burden exactly the same importance in the locational decision as other costs, to the extent that the differentials between alternaive locations are of the same magnitude. But in practice the answers are less clear. Experience suggests that state and local taxes are, for the majority of business enterprises, of secondary importance at best. Unfortunately, however, state and local governments have tended to formulate policy on the basis of the theoretical rather than the practical conclusions. If the tax structure of a particular jurisdiction is shown to impose heavy corporate burdens, as compared with those imposed by a competing jurisdiction, policymakers tend to assume that a substantial tax reduction will automatically provide the necessary attraction.

It is probable that much of this policy reasoning is based upon contentions advanced by enterprises already located in the state in question. The contentions may take the form of an implied threat by such enterprises to leave the state unless the tax burdens are reduced to levels comparable with those which seem to be imposed by other states with "equal locational advantages." Or the contentions may take the occasionally more forceful form of a suggestion that other enterprises not now located in the state but urgently needed in the industrial community will not seek location unless the tax burdens are reduced to levels comparable with those which seem to be imposed by other states. In either case, the arguments are likely to be extremely effective in a state that is searching desperately for new industry and seeking to retain the industry it now has.

Such arguments are, of course, a natural product of the desire of business institutions to reduce total costs wherever possible. Once a business has located in a particular state the business has a clear economic motive to attempt a reduction in its state and local tax bill, whether the expectation of this tax bill played a major role, a minor role, or no role at all in the locational decision.