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TO PREVENT CERTAIN DISCRIMINATORY TAXATION OF INTERSTATE NATURAL GAS PIPELINE PROPERTY

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

H.R. 1369

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CONTENTS

OCTOBER 6, 2005

OPENING STATEMENT

	Page
The Honorable Chris Cannon, a Representative in Congress from the State of Utah, and Chairman, Subcommittee on Commercial and Administrative Law	1
The Honorable Melvin L. Watt, a Representative in Congress from the State of North Carolina, and Ranking Member, Subcommittee on Commercial and Administrative Law	3

WITNESSES

Mr. Mark C. Schroeder, Vice President and General Counsel, CenterPoint Energy, Inc., Gas Pipeline Group	
Oral Testimony	4
Prepared Statement	5
Dr. Veronique de Rugy, Ph.D., Research Scholar, American Enterprise Institute for Public Policy Research	
Oral Testimony	11
Prepared Statement	12
Mr. Harley T. Duncan, Executive Director, Federation of Tax Administrators	
Oral Testimony	16
Prepared Statement	18
Mr. Laurence E. Garrett, Senior Counsel, El Paso Corporation, and on behalf of the Interstate Natural Gas Association of America	
Oral Testimony	28
Prepared Statement	29

APPENDIX

MATERIAL SUBMITTED FOR THE HEARING RECORD

Response to Post-Hearing Questions from Veronique de Rugy, Ph.D., Research Scholar, American Enterprise Institute for Public Policy Research	46
Response to Post-Hearing Questions from Harley T. Duncan, Executive Director, Federation of Tax Administrators	48
Response to Post-Hearing Questions from Laurence E. Garrett, Senior Counsel, El Paso Corporation, and on behalf of the Interstate Natural Gas Association of America	101

TO PREVENT CERTAIN DISCRIMINATORY TAXATION OF INTERSTATE NATURAL GAS PIPELINE PROPERTY

THURSDAY, OCTOBER 6, 2005

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:08 p.m., in Room 2141, Rayburn House Office Building, the Honorable Chris Cannon (Chairman of the Subcommittee) presiding.

Mr. CANNON. It looks like our witnesses are all here.

Good afternoon, ladies and gentlemen. This hearing of the Subcommittee on Commercial and Administrative Law will now come to order.

And before we start in with the substance of the hearing, I want to take a point of personal privilege, and recognize the counsel, the chief counsel, of the Commercial and Administrative Law Subcommittee, Ray Smietanka. My understanding is that today marks the 30th year of your service with this Committee.

Mr. SMIETANKA. That's correct, 30. October 6, 1975. [Applause.]

Mr. CANNON. We appreciate the wisdom that Ray brings to the Committee. I appreciate the fact, and particularly the fact, that he works well with minority counsel so we get things moving on issues that are important. So thank you, Ray. We appreciate that.

Today, we are going to consider H.R. 1369, a bill I introduced earlier this year, cosponsored by a great Texas delegation including Messrs. Carter, Smith, and Gohmert. This bill is intended to prevent certain discriminatory taxation of interstate natural gas pipeline property.

H.R. 1369 has two purposes: to prevent States from imposing a higher ad valorem tax burden on interstate natural gas pipeline property than that placed on local industrial and commercial property in the same assessment area; and to grant concurrent jurisdiction to the U.S. district court and State courts, to prevent imposition of taxes over this limit.

The issue of discriminatory taxation has been dealt with before by Congress when it enacted laws to prevent this type of discriminatory taxation against industries involved in other interstate commerce; specifically, the railroads, the airlines, the bus and trucking industries.

The natural gas pipeline industry has been the target of these discriminatory taxing practices by States for years, but the industry is not the only victim here. These taxes are a cost of doing business, therefore included in the pipeline's rate base, and are ultimately paid by consumers. States which impose such high taxes are in essence exporting their tax burden to people outside their State.

All consumers of natural gas, whether they are using it to heat their homes in the winter or for agricultural production, are victims. These taxes increase their gas bills to help pay for benefits in States where they do not live, and may not even visit.

It is not hard to determine who these people are. They are the citizens of—people in my State, as well as those in States like North Carolina, Maryland, Texas, and Michigan. But even residents of States that assess these discriminatory taxes are victims, because all consumers are paying higher prices for natural gas. This in turn increases the cost for products produced by natural gas, including electricity, plastics, nylon, and even insect repellents.

To provide relief, H.R. 1369 allows the United States district courts to determine whether certain States' taxes unreasonably burden and discriminate against interstate commerce. Currently, Federal courts cannot grant relief in such cases if the plaintiff can obtain a plain, speedy, and efficient remedy in the State courts. However, what is currently determined to be plain, speedy, and efficient when contesting an assessment can take years and require large amounts of resources.

I want to emphasize that H.R. 1369 would not relieve interstate natural gas pipelines of their obligation to pay their fair share of taxes. But it will allow them the opportunity to go to Federal court to challenge the practices of the States which single out gas pipelines for substantially higher tax assessments than are applied to comparable industrial and commercial properties.

Providing concurrent jurisdiction to the Federal courts, which Congress has the authority to do under section 5 of the 14th amendment, is essential; since efforts to obtain relief through State courts have historically, as the record will show, been a futile exercise.

We in Congress are required to balance our responsibility under the Constitution to protect interstate commerce from unwarranted interference, including unfair, burdensome and discriminatory taxation, while respecting the States' power to raise revenue to fund vital services in their States.

Last winter, the price for heating oils increased to an all-time high, and it's expected to continue to rise this winter. As fall advances, there is growing public anxiety over the cost of natural gas. All avenues of reducing the costs of natural gas should be reviewed.

I look forward to the testimony of the panel. I ask unanimous consent that Members have five legislative days to submit written statements for inclusion in today's record.

And I now yield to Mr. Watt, the Ranking Member of the Subcommittee, for an opening statement.

Mr. WATT. Thank you, Mr. Chairman. And I will be very brief. I want to just thank the witnesses for being here. To be honest with you, I don't know a lot about H.R. 1369, but the real benefit of having hearings is to allow us to hear the various aspects related to this bill, concerns if there are any, benefits, merits and demerits. So I'm always anxious to have a hearing about a bill, so I can learn something about it. So I appreciate your being here, and I appreciate your enlightening us.

Since I have to leave in about an hour for another appointment, I'll abbreviate my comments and get on with what we're here to do. And I yield back, Mr. Chairman.

Mr. CANNON. I thank the gentleman. Let me introduce our witnesses.

Our first witness is Mr. Mark Schroeder, the Division Vice President and General Counsel for CenterPoint Energy's pipeline and field services group. Mr. Schroeder served as Deputy General Counsel of the U.S. Department of Energy, where he was responsible for natural gas, environmental, and legislative matters, among others.

During his career, he has served as General Counsel for Northern Natural Gas, and as Vice President of Regulatory Affairs for two different energy companies. Mr. Schroeder has appeared before numerous congressional Committees presenting testimony on issues affecting the natural gas industry, energy regulation, and the environment.

Mr. Schroeder is a graduate of Louisiana State University, with degrees in accounting and law. He was the managing editor of the Louisiana Law Review. He is a member of the bars of Louisiana and the District of Columbia.

Mr. Schroeder, thank you for your appearance today, and we look forward to your testimony.

We have also with us Ms. Veronique de Rugy, our next witness. Dr. de Rugy is a Research Fellow at the American Enterprise Institute. She has served as a fiscal policy analyst at the Cato Institute, a post-doctoral fellow at George Mason University Department of Economics, and a research fellow with the Atlas Economic Research Foundation. She has also served on the board of directors of the Center for Freedom and Prosperity since 2000.

Ms. de Rugy has written extensively on the dangers of EU and OECD tax harmonization proposals, is the author of numerous op-eds and academic papers, and is the co-author of "Action ou Taxation" published in Switzerland in 1996. Presumably, Ms. de Rugy speaks French.

Ms. de Rugy earned her bachelor's degree and master's degree in economics from the University of Paris in Dauphine, and her doctorate in economics from the Sorbonne.

Ms. de Rugy, welcome, and thank you for coming today. We look forward to your testimony.

Our next witness is Harley Duncan, Executive Director of the Federation of Tax Administrators. Prior to his current position, Mr. Duncan served as the Secretary of the Kansas Department of Revenue, and the Assistant Director of the Kansas Division of the Budget.

Mr. Duncan is a member of the State Tax Notes Editorial Advisory Board, the Georgetown University State and Local Tax Conference Advisory Board, as well as many others.

Mr. Duncan earned his bachelor's degree from South Dakota State University, and his master's in public affairs from the University of Texas at Austin.

Mr. Duncan, welcome, and we appreciate your testimony.

Our final witness is Laurence Garrett, Senior Counsel for the El Paso Corporation Western Pipeline Group. Prior to working for El Paso, Mr. Garrett was the Senior General Tax Attorney for the Burlington Northern and Santa Fe Railway Company. He is admitted to practice in the courts of Kansas, Illinois, Colorado, and Texas.

Mr. Garrett earned a bachelor's degree in business administration and economics from Washburn University, where he also earned his law degree. He earned a master's of law in taxation from the University of Missouri School of Law, and a master's of law in natural resources and environmental law from the University of Denver.

Mr. Garrett, thank you for your appearance here today.

I extend to each of you my warm regards and appreciation for your willingness to participate in today's hearing. In light of the fact that your written statements will be included in the record, I request that you limit your remarks to 5 minutes. And we have a little light there that will go yellow when you have a minute remaining, and then red. You don't need to stop immediately, but given the constraints on time with Mr. Watt, and also mine and others, I may just have to give you some notice that you should wrap up.

And you should feel free to summarize your testimony, or highlight any salient points or portions. You'll note that we have the lighting system. We just talked about that.

After all the witnesses have presented their remarks, the Subcommittee Members, in the order that they arrive, will be permitted to ask questions of the witnesses, subject to the 5-minute limit.

And pursuant to the directive of the Chairman of the Judiciary Committee, I ask the witnesses, please stand and raise your right hand to take the oath.

[Witnesses sworn.]

Mr. CANNON. Let the record reflect that each of the witnesses has answered in the affirmative.

Mr. Schroeder, would you now proceed with your testimony. Thank you.

TESTIMONY OF MARK C. SCHROEDER, VICE PRESIDENT AND GENERAL COUNSEL, CENTERPOINT ENERGY, INC., GAS PIPELINE GROUP

Mr. SCHROEDER. Thank you, Mr. Chairman, Ranking Member, and Members of the Committee. Thank you for the opportunity to appear here before you today. My name is Mark Schroeder. I am the General Counsel for the Gas Pipeline Group for CenterPoint Energy, Incorporated.

CenterPoint Energy serves markets in the Middle West and South, including Texas, Louisiana, Arkansas, Oklahoma, Missouri, Tennessee, and Illinois, among others; as well as connecting significant mid-continent gas supplies to other pipelines destined for the Upper Midwest and the Northeast.

I have submitted written testimony, which I ask be made part of the record of this hearing. And I will keep my remarks now to just a few brief ones.

I appear here today to ask this Subcommittee's support for H.R. 1369. H.R. 1369 provides that interstate natural gas pipelines should not be subject to discriminatory taxation. The bill provides the bases upon which such taxes are to be evaluated, and provides a Federal forum for the adjudication of disputes regarding those taxes.

The bill affords the interstate natural gas pipeline industry essentially the same protections that Congress has already extended to other transportation industries operating in interstate commerce which are similarly characterized by large, immobile capital investments, including railroads, airlines, and trucking.

Let me be clear on this last point. The natural gas—interstate natural gas pipeline industry is a transportation business. Interstate pipelines do not own, or have an interest in, the commodity of natural gas. Therefore, we do not have a vested interest in seeing the price of the commodity increased. And we are particularly cost conscious in this environment in which we are competing to retain these markets.

As the prepared testimony of the pipeline industry witnesses amply demonstrates, the discrimination in taxation of natural gas pipelines is real and quantifiable, and the State judicial processes have not met the test of providing plain, speedy, and efficient relief.

In the testimony, there are some examples which are intended to be purely illustrative, and they are not directed at the behavior or regulatory scheme of any one State.

The discriminatory taxation of interstate pipelines burdens gas consumers, producers, and can alter the competitive landscape. The non-discriminatory assessment of taxes, with prompt resolution of questions regarding discrimination, is not asking too much.

In this period of high energy prices, H.R. 1369 is especially timely, and we urge its passage. Thank you.

[The prepared statement of Mr. Schroeder follows:]

PREPARED STATEMENT OF MARK C. SCHROEDER

INTRODUCTION

Mr. Chairman, Mr. Ranking Member and Members of the Committee:

My name is Mark C. Schroeder. I am the General Counsel for CenterPoint Energy, Inc.'s Gas Pipeline Group. CenterPoint Energy is based in Houston, Texas. Through two interstate pipeline company subsidiaries, CenterPoint Energy Gas Transmission Company and CenterPoint Energy—Mississippi River Transmission Corporation, the gas pipeline group transports natural gas in interstate commerce for delivery to local distribution companies, industrial end users, and power generation facilities in Arkansas, Illinois, Louisiana, Missouri, Oklahoma, Tennessee, and Texas.

Thank you for the opportunity to appear before you today to discuss an issue of great importance to the interstate natural gas pipeline industry and to consumers

of natural gas, particularly those consumers who receive their natural gas by interstate natural gas pipeline.

I appear here today in support of H. R. 1369. If enacted into law, H. R. 1369 would protect interstate natural gas pipelines from discriminatory tax treatment by states and other taxing jurisdictions. The imposition of discriminatory taxes on interstate natural gas pipelines adversely affects many natural gas consumers, who bear the cost of these additional tax burdens as part of the price paid for the transportation of natural gas.

The need for this legislation is illustrated by the historic discrimination against interstate commerce pursued by a number of states. CenterPoint's assets most affected by such discriminatory taxation are located in the State of Louisiana. For that reason, I offer our experience in Louisiana by way of example, to illustrate the problems faced by our industry. These problems are not exclusive to Louisiana; it is just one state that plays a pivotal role in the distribution of natural gas throughout the United States.

In *Maryland v. Louisiana,* 451 U.S. 725, 101 S.Ct. 2114, 68 L.Ed.2d 576 (1981) the United States Supreme Court determined that a "first use" tax imposed by the state of Louisiana on natural gas flowing through the state was unconstitutional because it specifically discriminated against interstate commerce. The first use tax was imposed on a variety of events, including events related to the transportation of natural gas through Louisiana before it was delivered to in-state and out-of-state consumers. In an effort to shield Louisiana consumers from the tax, the law provided various tax credits and exclusions to Louisiana taxpayers so that Louisiana consumers could effectively avoid the burden of the first use tax. In evaluating the validity of the First Use Tax, the United States Supreme Court stated:

> In this case, the Louisiana First-Use Tax unquestionably discriminates against interstate commerce in favor of local interests as the necessary result of various tax credits and exclusions. No further hearings are necessary to sustain this conclusion. Under the specific provision of the First-Use Tax, OCS gas used for certain purposes within Louisiana is exempted from the Tax. OCS gas consumed in Louisiana for (1) producing oil, natural gas, or sulphur; (2) processing natural gas for the extraction of liquefiable hydrocarbons; or (3) manufacturing fertilizer and anhydrous ammonia, is exempt from the First-Use Tax. § 1303 A. Competitive users in other States are burdened with the Tax. Other Louisiana statutes, enacted as part of the First-Use Tax package, provide important tax credits favoring local interests. Under the Severance Tax Credit, an owner paying the First-Use Tax on OCS gas receives an equivalent tax credit on any state severance tax owed in connection with production in Louisiana. § 47:647 (West Supp.1981). 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. Finally, under the Louisiana statutes, any utility producing electricity with OCS gas, any natural gas distributor dealing in OCS gas, or any direct purchaser of OCS gas for consumption by the purchaser in Louisiana may recoup any increase in the cost of gas attributable to the First-Use Tax through credits against various taxes or a combination of taxes otherwise owed to the State of Louisiana. § 47:11 B (West Supp.1981). Louisiana consumers of OCS gas are thus substantially protected against the impact of the First-Use Tax and have the benefit of untaxed OCS gas which because it is not subject to either a severance tax or the First-Use Tax may be cheaper than locally produced gas. OCS gas moving out of the State, however, is burdened with the First-Use Tax.
>
> * * *
>
> Accordingly, we grant plaintiffs' exception that the First-Use Tax is unconstitutional under the Commerce Clause because it unfairly discriminates against purchasers of gas moving through Louisiana in interstate commerce.

451 U.S. at 756, 101 S.C.t. at 2134 (footnotes omitted).

It seems odd that the industry must come to Congress to seek additional protection against interstate commerce discrimination. After all, one of the oldest settled principles of constitutional law is that the Commerce Clause of the United States Constitution prohibits the States from imposing discriminatory taxes or burdens on activities that are conducted in interstate commerce. That is, state taxes should not

exact a greater burden from interstate activities than the burden imposed on intrastate activities.

Unfortunately, having the constitutional protection from discrimination does not alleviate the procedural hurdles that block the timely resolution in state courts of challenges to the validity of state tax schemes. Attempts to address discrimination at the state level have been thwarted by the refusal of federal courts to consider the issues and by procedural road blocks in the state courts. Existing federal law discourages the federal courts from considering state tax challenges. In addition to banning the discriminatory taxation of interstate natural gas pipelines, H.R. 1369 provides for the resolution of disputes concerning discriminatory taxation of interstate natural gas pipeline properties by the federal courts, which will result in faster and more objective disposition of these cases.

THE CENTERPOINT COMPANIES' EXPERIENCE.

While other interstate gas pipelines are subject to discriminatory taxation elsewhere, the CenterPoint companies experience has been principally their involvement in litigation in the State of Louisiana since 2000 concerning an issue of discriminatory taxation in that state. Simply put, the scheme for the imposition of ad valorem property taxes in the state of Louisiana requires all interstate natural gas pipeline companies to pay property taxes to Louisiana's local governments based upon 25% of the fair market value of the pipeline company attributable to Louisiana while competing intrastate pipeline companies are allowed to pay property taxes to local governments based upon an assessed value of 15% of fair market value. This differential in assessed values results in the imposition of higher property taxes for interstate natural gas pipelines than for intrastate gas pipelines, resulting in higher costs for natural gas for consumers who must rely on interstate natural gas pipelines for the delivery of their natural gas.

CenterPoint made its decision to challenge the Louisiana scheme after reviewing Louisiana's prior efforts to impose discriminatory taxes on the natural gas industry and on consumers of natural gas. CenterPoint's involvement in the issue in Louisiana came after other interstate natural gas pipeline companies had taken steps to challenge the Louisiana system.

THE ANR SAGA/PROCEDURAL QUAGMIRES DELAY FINAL DISPOSITION OF INTERSTATE DISCRIMINATION ISSUES

In 1994, a group of interstate natural gas pipelines with operations in the State of Louisiana, including the ANR companies, initiated litigation in Louisiana challenging the discriminatory property taxes imposed on interstate natural gas pipelines. The ANR group's efforts have been difficult at best. A review of the reported decisions concerning the ANR group's efforts shows that a myriad of procedural roadblocks have been used to delay and effectively prevent the ultimate resolution of the interstate commerce issues.

When ANR initiated its proceedings, Louisiana statutes required such disputes to be initiated at the administrative level before the Louisiana Tax Commission. For tax years 1994 through 1999, ANR protested assessments determined by the Louisiana Tax Commission based upon 25% of the fair market value of the Louisiana portion of its pipeline. Additionally, ANR paid the taxes demanded by the Tax Collectors for the local taxing jurisdiction under protest. After lengthy procedural delays, the Louisiana Tax Commission dismissed ANR's protests. ANR appealed the actions of the Commission to Louisiana State district court and the district court determined that ANR's claims had prescribed (expired due to limitations imposed by statute) under Louisiana law. The Louisiana First Circuit Court of Appeal, in a case commonly referred to as "ANR 1" [*ANR Pipeline Co. v. Louisiana Tax Commission,* (La. App. 1 Cir. , 774 So.2d 1261(2000))], the Louisiana First Circuit Court of Appeal reversed the district court finding that ANR's claims did not prescribe while it exhausted its administrative remedies.

This was just the beginning for ANR, though. A review of the reported decisions reveal no less than five reported *ANR* decisions spanning over five years. The tortured history of the ANR cases tells a story of a quagmire of procedural issues and conflicting judicial determinations.

In the second ANR decision (*ANR Pipeline Co. v. Louisiana Tax Commission,* 2001 CA 2594 (and consolidated cases) (La. App. 1st Cir. 3/20/2005), *writ granted,* 2002–1479 (La. 3/21/03), 840 So.2d 527 (affirmed and remanded), the state appellate court addressed a district court decision dismissing ANR's claims. The district court had found that ANR's claims were premature and that ANR had failed to exhaust administrative remedies as a result of by-passing the Louisiana Tax Commission. In a decision handed down on March 20, 2002, the Louisiana First Circuit Court of Ap-

peal reversed and remanded the cases back to the district court for further proceedings. This decision was further reviewed by the Louisiana Supreme Court, which sustained the portion of the Louisiana First Circuit Court of Appeals' decision that ANR's proceedings were not premature and ordered the First Circuit to review the district courts granting of exceptions of no cause of action. In conformance with the Louisiana Supreme Court's directive, the Louisiana First Circuit of Appeal determined that ANR had stated a cause of action and remanded the case to the district court for further proceedings.

In the third ANR decision (*ANR Pipeline Co. v. Louisiana Tax Commission,* 2002—0576 (La. App. 1 Cir. 6/21/2002), the First Circuit Court of Appeal affirmed the district court's determination that the Louisiana Tax Commission should not conduct administrative hearings until the courts had ruled on the constitutionality of the Louisiana property tax scheme. The Louisiana Tax Commission was ordered to stay all administrative proceedings until a final ruling on the constitutional issues was determined by the courts. The need for this ruling resulted from an effort by the Louisiana Tax Commission to conduct proceedings and issue decisions concerning the imposition of property taxes on interstate natural gas pipelines prior to a determination by the courts concerning the validity of Louisiana's property tax system as it related to the imposition of property taxes on interstate natural gas pipelines.

After almost ten years of procedural battles, ANR's cases finally came to trial on January 10, 2005, which trial concluded on January 18, 2005. On March 10, 2005 the trial court issued its written reasons for judgment. The court found that the Louisiana Tax Commission had **intentionally** discriminated against the ANR taxpayers in violation of the Louisiana Constitution and the Equal Protection Clause of the United States Constitution because it had allowed other taxpayers that should have been assessed by the Louisiana Tax Commission at 25% of fair market value to be assessed by the local assessors at 15% of fair market value. The court did not reach the core issue of discrimination against interstate commerce, effectively putting the taxpayers' challenge based on discrimination against interstate commerce back to square one. Curiously, the court eschewed reaching a decision on the core constitutional Commerce Clause issue of discrimination against interstate commerce. The court determined that it would be inappropriate to reach the Commerce Clause issue because the Louisiana property tax scheme had been found to be infirm on other grounds. Nevertheless, the court did decide the case on U.S. Constitutional Equal Protection grounds and on uniformity grounds based on Louisiana Constitutional provisions, and found the Louisiana tax scheme flawed when examined under those constitutional provisions.

The district court further fashioned a remedy that required the ANR pipelines to be **locally** assessed at 15% of fair market value for the years of the intentional discrimination. The Louisiana Constitution requires that interstate pipeline properties be centrally assessed by the Louisiana Tax Commission. Contrary to the Louisiana Constitution, the court, seemingly without any basis in the text of Louisiana's State constitution or statutes, moved the assessment of ANR's property from central assessment by the Louisiana Tax Commission to individual assessments from multiple assessors at the parish level. This, of course, raises the likelihood of multiple disputes concerning the fair market values of the ANR assets in each parish for each of the years in dispute. The Louisiana First Circuit Court of Appeal affirmed the determination of the district court. Thus, after years of procedural battles ANR "won" on subsidiary issues that did not deal with the core issue of discrimination against interstate commerce, and ANR is now forced to deal with individual assessors in each parish for each year at issue to determine the fair market value of the pipeline segment in each parish and to take individual appeals from any adverse determinations of the assessors.

Like ANR, we believe that this "remedy" is not supported under Louisiana law and erects new roadblocks to the eventual determination that the Louisiana property tax system as it affects interstate pipelines is unconstitutional and impermissibly burdens the citizens of other states.

THE CENTERPOINT SAGA/A DIFFERENT APPROACH BUT STILL NO RELIEF

In an effort to avoid the procedural nightmare experienced by ANR, the CenterPoint companies chose to seek an administrative hearing before the Louisiana Tax Commission, subject to review by the Louisiana courts. At that hearing, CenterPoint and other interstate natural gas pipeline companies presented three days of testimony, including expert witness testimony, concerning (i) the large volumes of natural gas that flow through the state of Louisiana from production on the Outer-Continental shelf, (ii) the extreme competition related to the marketplace

for natural gas, and (iii) the impact of Louisiana's discriminatory tax scheme on the market place, the interstate natural gas companies, and non-Louisiana consumers of natural gas.

The Centerpoint companies showed that in 1999 alone, the United States generated 19.6 trillion cubic feet ("tcf") of marketed natural gas production. Fifty eight percent of that production originated from Texas (31%) and Louisiana (27%). Texas marketed production of natural gas in 1999 was 6.117 tcf, with roughly 23% (1.426 tcf) of the Texas production transported into and/or through Louisiana. Louisiana's 1999 production was 5.313 tcf, and 5.283 tcf was exported out of Louisiana into the interstate market. In 1999 about 19% of the national marketed production of natural gas in this country was transported from or through Louisiana before reaching end users. Thus, in 1999 Louisiana's discriminatory tax system affected approximately 19% of the national marketed production of the nation. I can provide the committee with more current numbers, but the reason I use the 1999 numbers is that is the evidence that the CenterPoint companies and others introduced during the litigation concerning Louisiana's property tax scheme.

The Louisiana Tax Commission and the other defendants in the case did not put on any expert testimony concerning the natural gas market place and the discrimination caused by the property tax scheme in Louisiana. Rather, a staff person for the Louisiana Tax Commission was called to testify concerning the various methodologies used to value interstate natural gas pipelines and intrastate natural gas pipelines. On December 10, 2001, the Louisiana Tax Commission issued a decision rejecting the contentions of the interstate natural gas pipelines that the Louisiana property tax scheme discriminated against interstate natural gas pipeline companies. The decision rendered by the Louisiana Tax Commission was allegedly supported by a study conducted by a staff member of the Louisiana Tax Commission. That study was apparently conducted after the trial and was never properly introduced into evidence or provided to the interstate natural gas pipeline companies for review, evaluation and cross-examination.

The CenterPoint companies appealed the decision of the Louisiana Tax Commission to the 19th Judicial District Court for the Parish of East Baton Rouge. Under Louisiana law, that appeal was on the record created before the Louisiana Tax Commission. The appeals were filed by the CenterPoint companies on January 8, 2002. In connection with the appeals, the CenterPoint Companies objected to the references to the staff report in the decision of the Louisiana Tax Commission. After numerous procedural delays, the district court judge reviewing the Louisiana Tax Commission decision ordered the Louisiana Tax Commission to reconsider its decision without reference to the staff report that had never been properly introduced into evidence in the case. The judge remanded the entire case back to the Louisiana Tax Commission for further consideration, which further delayed the resolution of the central issues raised in the litigation.

It was not until November and December of 2004 that the Louisiana Tax Commission dealt with the issues on remand. The Commission once again ruled against the interstate natural gas pipeline companies, without reference to the staff report. The CenterPoint companies and others were again required to file appeals to the 19th Judicial District Court. Almost three and one half years after the trial before the Louisiana Tax Commission and after filing for review by the 19th Judicial District Court, the CenterPoint companies have been successful in getting a briefing and oral argument schedule concerning the substantive issues before the 19th Judicial District Court. The 19th Judicial District Court is scheduled to hear oral argument on the CenterPoint cases on October 17. Notwithstanding the October 17th hearing, the attempt to get a final determination on the substantive legal issues may be undermined by additional procedural objections raised by the Louisiana Tax Commission. Lengthy delays and costly proceedings will occur once the 19th Judicial District Court Judge renders her decision. Appeals will be taken to the Louisiana First Circuit Court of Appeals and ultimate review will be requested by the Louisiana Supreme Court. CenterPoint's attorneys estimate that the additional delays before ultimate review by the Louisiana Supreme Court could be up to four years.

The point of the foregoing lengthy recitation of the ANR and CenterPoint cases in Louisiana is not to re-litigate the issues, which continue to wind their way through the Louisiana courts. Nor is it intended to suggest that these issues arise in Louisiana alone. Rather, the point is that state judicial processes have been used to thwart timely relief for taxpayers.

ABSENT STATUTORY GUIDANCE, THE FEDERAL COURTS ARE RELUCTANT TO INTERVENE

Concerned that it would have great difficulty getting a quick and proper decision from the Louisiana Tax Commission and the Louisiana courts, the CenterPoint com-

panies attempted in July of 2001 to get the federal district court in Baton Rouge, Louisiana to review the case. Federal law bars the federal courts from becoming involved in state and local tax cases unless state law does not provide a plain, speedy, and efficient remedy. When the CenterPoint companies filed in federal court CenterPoint knew that it would have to support its arguments that Louisiana did not provide a plain, speedy, and efficient remedy for dealing with U.S. Constitutional issues such as the interstate commerce discrimination issues raised by the companies.

In its petition, Centerpoint and other companies contended that Louisiana lacked a plain, speedy, and efficient remedy because of (i) uncertainty as to the procedure for appeals from the Louisiana Tax Commission in light of statutory changes adverse to the pipeline companies that had been supported by the Tax Commission, (ii) questions raised by ANR concerning the jurisdiction of the Commission to preside over constitutional challenges, (iii) bias inherent in the statutorily required procedure including: (a) the statutory requirement that the Louisiana Tax Commission act as both an adversary to Centerpoint and as a judge of the issues brought to it by Centerpoint, (b) the suggestion that the Commission would use it own attorneys (who were already engaged to oppose ANR on the issues) as quasi-judicial hearing officers, (c) the fact that at that time Louisiana law gave the Commission a financial stake in an outcome adverse to taxpayers under these circumstances, (d) the fact that the Commission was already involved in litigation adverse to the ANR group of companies in litigation raising the same issues.

On July 30, 2001, the Louisiana Tax Commission filed a motion to dismiss the federal proceeding. Notwithstanding requests to schedule the motion to dismiss filed by the Louisiana Tax Commission for hearing so that the CenterPoint companies could show that Louisiana lacked a plain, speedy, and efficient remedy, no hearing was ever scheduled by the federal court. After more than a year of waiting for the federal court to schedule a hearing so that a trial on the core issues could be scheduled, the CenterPoint companies gave up on pursuing the federal case and the case was dismissed so that the CenterPoint companies could focus on the case filed in the Louisiana district court.

Both the ANR group of pipelines and the CenterPoint group of pipelines continue to be years away from an ultimate determination that the Louisiana property tax system discriminates against interstate natural gas pipeline companies.

PRECEDENT FOR FEDERAL INTERVENTION IN STATE PROPERTY TAX MATTERS

Louisiana is but one of the states engaged in discrimination against interstate natural gas pipeline companies by imposing additional tax burdens on interstate pipeline companies that inflates the cost of natural gas to consumers in other states. With the escalating cost of natural gas on the one hand, and the procedural delays and vested interests of the states imposing discriminatory taxes on the other, it is imperative that a federal policy concerning such discrimination be enacted by Congress.

In 1979, Congress determined that there was a need to protect the railroads from discriminatory taxation. In recognition of that need among others, Congress enacted the Railroad Revitalization and Regulatory Reform Act, commonly referred to as the "4R Act". Under part of the 4R Act, states are prohibited from discriminating in the assessment of railroad property and in the imposition of taxes on railroads. Since the enactment of the 4R Act, the railroads have been able to successfully overcome discriminatory taxes imposed by the states and their political subdivisions. In fact, after the passage of the 4R Act, the Louisville & Nashville Railroad Company and others were successful in having the federal district court in Louisiana recognize that the Louisiana property tax scheme illegally discriminated against interstate railroads. *Louisville & Nashville Railroad Company, et al. v. Louisiana Tax Commission,* 498 F. Supp. 418 (M.D. La. 1980). Since that decision, the Louisiana Tax Commission has assessed railroads at 15% of fair market value. The 4R Act precluded the need for protracted litigation in state courts and provided for a rational remedy—central assessment by the Louisiana Tax Commission at 15% of fair market value.

In the Airport and Airway Improvement Act of 1982, Congress enacted similar protections for the airline industry. Because of that Act the Louisiana Tax Commission centrally assesses airline property at 15% of fair market value.

H.R. 1369 is modeled after the protections provided to the railroad and airline industries in order to keep states from imposing discriminatory tax burdens. Like those pieces of legislation, H.R. 1369 would protect the interstate natural gas pipeline industry and natural gas consumers from discriminatory taxes by preventing states and other taxing jurisdictions from discriminatory property tax assessments

and from the imposition of discriminatory taxes. H.R. 1369 would also promote the rapid disposition of disputes concerning discriminatory taxes by allowing the federal district courts to decide those cases.

It is an old axiom that "justice delayed is justice denied". Our industry, on behalf of our customers, seeks timely access to an impartial decision-maker. That is all H.R. 1369 provides. Accordingly, the CenterPoint companies urge this Committee to support H.R. 1369.

I am available to answer any questions the Committee Members may have, and thank you again for the opportunity to appear before you today.

Mr. CANNON. Thank you, Mr. Schroeder.

Dr. de Rugy? Is that correct, "de Rugy?"

Ms. DE RUGY. Yes. It's better than most people. [Laughter.]

Mr. CANNON. Well, that's very kind of you. We appreciate it, and we look forward to your testimony.

TESTIMONY OF VERONIQUE DE RUGY, PH.D., RESEARCH SCHOLAR, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

Ms. DE RUGY. Thank you, Mr. Chairman and Members of the Committee. I appreciate the opportunity to be here today to talk about discriminatory taxation of natural gas pipeline. My name is Veronique de Rugy. I am an economist, so I would like to focus on the consequences of the tax treatment received by pipeline.

To ensure that we do not get lost in the details of such a specific question, it is useful to ground our analysis in fundamental economic principles. Economists are notorious for their propensity to see all sides of an issue and never reach a definitive conclusion. President Harry Truman reportedly demanded a one-handed economist, because economists, he said, were always telling him, "On the one hand, this; on the other hand, this."

But on some fundamental ideas, economists are in absolute agreement. Among these principles we have—among these, we have the principle that taxes distort behavior. A tax raises the marginal costs of a product or activity, thereby discouraging people from choosing it.

The apple grower may decide that he may not be able to recoup the costs of taking care of an additional tree, so he won't plant it. And if the production of apple is taxed at a higher rate than that of the oranges, he may decide to stop producing apple altogether, and produce oranges instead.

The size of the distortion may vary, but it exists nonetheless. For instance, a tax on medicine would lead to few distortions; while a tax on movie tickets or a restaurant would lead to much distortion because there are more substitutes. Sick people often find themselves in a situation where they must get a given drug at any cost. But we find definitely easy way and different source of entertainment.

Natural gas pipelines are more similar to medicine. For instance, by their very nature they are very unresponsive to tax treatment. Once pipelines are built, their owner cannot easily move their operation to other States if they are unhappy with the tax treatment in a given State. The problem is exacerbated for interstate pipelines. Re-routing a pipeline to avoid an entire State would be exceedingly difficult.

From the State's perspective, imposing discriminatory taxes on natural gas pipelines and other immobile goods makes economic sense. To put it bluntly, the States can effectively hold the pipeline investment hostage and extract a high tax payment in return at a lower cost.

States also have an incentive to impose higher taxes on out-of-State companies than on their intrastate ones. However, this approach remains economically destructive. First, because some of the high taxes on pipelines can be passed through to consumers, natural gas consumers around the country will end up paying the bill, a higher bill. States that impose such high taxes are in a sense exporting their tax burden to consuming States.

Second, the higher cost of gas services, including those resulting from discriminatory taxes, falls on consumers without regard to their income.

Finally, the uncertainty of the tax treatment due to the absence of protection against discrimination, along with high taxes, will discourage investment in pipeline. This in turn will increase the price of gas.

In the aftermath of two hurricanes causing massive destruction, most of the country is focused on the price of gas at the pump. However, reports indicate that natural gas production has been slower to recover than that of crude oil. Lost production attributed to these storms has been reported to be 226.6 billion cubic feet. This been borne out by natural gas prices. While oil prices have begun to retreat, natural gas prices have continued to increase. They have doubled since June, and are now almost triple what they were a year ago.

As important as gas is to our economy—62 percent of American homes use natural gas—we cannot afford to burden our interstate pipelines with high taxes and risk weakening the pipeline infrastructure. If this legislation reduces the tax burden imposed on pipeline industry, it could go a very long way toward promoting new infrastructure investment. This would increase competition between pipeline operators and lead to low energy prices in the longer run. But ultimately, we should not forget who are the real beneficiary of this legislation: consumers.

Thank you, Mr. Chairman and Member of the Committee.

[The prepared statement of Ms. de Rugy follows:]

PREPARED STATEMENT OF VERONIQUE DE RUGY

INTRODUCTION

We are confronted today with a very specific question: should states be allowed to tax the property of interstate natural gas pipelines differently than other forms of property? To ensure that we do not get lost in the details of such a specific question, it is useful to ground our analysis in fundamental economic principles.

Economists are infamous for their propensity to see all sides of an issue and never reach a definitive conclusion—President Harry Truman reportedly demanded a one-handed economist because economists were always telling him, "On the one hand . . . on the other hand. . . ."—but on some fundamental ideas they are in absolute agreement. Among these is the principle that taxes distort behavior. The size of the distortion may vary, but it exists nonetheless. In the case of gas pipelines, the relative immobility of the capital may seem to make the distortionary effect small, but over the long run, high taxes will discourage investment in pipelines. This in turn will increase the price of gas. As important as natural gas is to our economy, we cannot afford to burden our interstate pipelines with high taxes and risk weakening the pipeline infrastructure.

If this legislation HR 1369 to prevent certain discriminatory taxation of natural gas pipeline property reduces taxes paid by the pipeline industry and reduces the uncertainty faced by pipeline owners then it could go a long way toward promoting new infrastructure investments. This would increase competition between pipeline operators and lead to low energy prices in the longer run.

1. THE ECONOMICS OF TAXATION

Economics tells us that people make decisions by comparing marginal costs and marginal benefits. A consumer will buy an apple if the enjoyment she'll get from it is greater than its price. An apple grower will plant another tree if he'll be able to sell its apples for more than it costs him to take care of the additional tree.

When the government imposes taxes, it distorts these decisions. A tax raises the marginal cost of a product or activity, thereby discouraging people from choosing it. The consumer may find that the apple is no longer worth the price she would have to pay for it—she may buy an orange instead. The apple grower may determine that he will not be able to recoup the cost of taking care of an additional tree—so he won't plant it. By choosing what and how much to tax, the government influences people's behavior; in effect, the government interferes with market decisions about the allocation of resources in the economy.

In a free market, individuals direct resources to their most highly valued uses. Consumers and producers spend their money on the products and activities that will give them the most "bang for their buck." Taxing these things pushes people away from the most highly valued products and activities and towards the next-best ones. In this way, the tax-induced distortions in behavior tend to make the market inefficient.

2. THE HOLD UP PROBLEM

However, some taxes distort less than others because they cause smaller changes in behavior. A tax on goods for which the supply is unresponsive to tax rates would induce fewer distortions than one on goods for which supply is highly responsive to tax rates. For instance, a tax on medicine or the air we breathe would lead to few distortions, while a tax on movie tickets or restaurants would lead to much distortion because there are more substitutes. Sick people often find themselves in a situation where they must get a given drug—at any cost—and we cannot easily switch to breathing a different gas, but we can easily find new sources of entertainment.

Natural gas pipelines are more similar to medicine and oxygen: by their nature, they are very unresponsive to tax treatment. Investment in a pipeline is irreversible. Once pipelines are built, their owners cannot easily move their operations to other states if they are unhappy with the tax rates in a given state. The problem is exacerbated for interstate pipelines—rerouting a pipeline to avoid an entire state would be exceedingly difficult.

As economists Benjamin Klein, Robert G. Crawford, and Armen A. Alchian explained in an influential paper, a party that contracts to make a relationship-specific or irreversible investment becomes susceptible to a "hold-up problem."[1] Say party A makes a specialized investment to fulfill a contract with party B. Once the investment has been made, A is stuck with the deal; he invested in such a specialized asset that it has little value in any use other than what he contracted with B. Knowing this, B can opportunistically renegotiate a lower payment to A.

Although Klein, Crawford, and Alchian focused on how firms vertically integrate or sign long-term contracts to avoid hold-up after investment occurs, an analogy can be drawn to pipelines. Once the natural gas pipelines have already been built across several states, the pipeline owner is locked in and the bargaining power is in the hands of the state. The state has the power to demand a larger share of the profits or to impose some form of discriminatory tax, since the pipeline owner is now deeply invested in the state. In theory, the state could even demand all of the profits, because the pipeline owner's alternative is to lose the investment entirely.

Their lack of mobility means that pipeline owners cannot easily react to an increase in their tax burden. To put it bluntly, the state can effectively hold the pipeline investments hostage and extract high tax payments in return. Considering that a state's objective is to maximize its tax revenues, imposing discriminatory taxes on natural gas pipelines and other immobile goods makes economic sense.

In addition, States legislators will try to impose taxes at the lowest cost for themselves. The best way to do that is to impose higher taxes on out-of-state companies

[1] Klein, Benjamin, Robert G. Crawford, and Armen A. Alchian (1978). "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," *Journal of Law and Economics* 21(2): 297–326.

rather than on intra-state enterprises. This approach exports the costs associated with higher taxation to outside jurisdictions, while allowing legislators to side step the political repercussions of taxing their own constituents. Given the interstate nature of pipelines, they are a prime target for this type of state taxation.

3. DISCRIMINATORY TREATMENT OF NATURAL GAS PIPELINE PROPERTY

In practice, this is exactly what states are doing. As explained in the previous section, pipeline property, by its very nature, is a target of choice for state legislators wanting to maximize tax revenues. Under the current federal law, there is no provision to prohibit discriminatory treatment of property belonging to interstate natural gas pipeline companies. As a result, states subject capital that cannot move—the pipelines—to a higher tax than other forms of capital.

According to experts in the industry, 17 states have tax laws that discriminate against natural gas pipelines. They do this in a variety of ways. For instance, some states distinguish pipelines from other businesses for the purpose of imposing a higher property tax rate on interstate companies. Other states manipulate their treatment of personal and real pipeline property, excluding personal property from taxation generally but including pipeline personal property. Still other states assess pipeline property at a different ratio than other commercial property. Industry experts estimate that the cumulative effect of these discriminatory tax policies is to increase the property tax bills of natural gas pipeline companies by more than 40 percent: in 2004, natural gas pipeline companies paid $445 million in property tax, while they would have paid only $256 million if state tax laws treated pipeline companies the same as they treat other businesses.

In the past, Congress has passed legislation prohibiting discriminatory treatment of property belonging to other industries operating in interstate commerce, such as rail, motor carrier, and air carrier transportation. These laws prohibit discriminatory tax treatment similar to what the interstate natural gas pipeline industry currently faces. In 1976, Congress passed the Railroad Revitalization and Regulatory Reform Act (later repealed by ICC Termination Act of 1995). A portion of the act relevant to the topic at hand provided that states may tax railroad property at a rate not exceeding the rate applicable to other property in the State. Also a state may not assess rail transportation property (49 U.S.C. § 11501), motor carrier transportation property (49 U.S.C. § 14502), or air carrier transportation property (49 U.S.C. § 40116) at a value that has a higher ratio to the true market value of the property than that of other commercial and industrial property in the same jurisdiction.

In other words, States can no longer discriminate against the commercial property of these protected interstate transporters as compared to how that State treats its own intrastate commercial and industrial property.

It should be noted that these policies were enacted over the states' strenuous objections.[2] States never find it in their short term interest to lose the power to extract a significant rent from captive capital.

Finally, the discrimination does not stop there. Under current law, pipelines also face a larger burden when it comes to challenging state tax discrimination. As it stands, interstate natural gas pipeline companies have no recourse in the federal court system to seek relief from discriminatory tax practices with respect to property assessments. Unlike other major interstate enterprises, such as rail, motor, and air carriers, interstate natural gas pipeline companies must typically pursue relief from discriminatory tax practices through state level appeal processes. This is an extremely difficult burden to carry.

4. THE NOT SO HIDDEN COST OF DISCRIMINATORY TAXES

On second look, however, tax discrimination remains a very poor calculation on the part of the state. Although it would be exceedingly costly for the companies to reroute their pipelines, taxation will alter their behavior in other ways. The higher cost of owning a pipeline means they will invest less in new pipelines and spend less on maintaining their existing equipment.

Furthermore, as Nobel Prize laureates Finn E. Kydland and Edward C. Prescott have demonstrated, if companies expect that states may raise their taxes in the future, they will invest less today.[3] As explained earlier, pipeline companies, unlike companies in other interstate industries, are not protected by federal guarantees

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[2] Michael S. Greve (2002), "Business, The States And Federalism's Political Economy," Harvard Journal of law and Public Policy, Summer, p. 895–929.

[3] Kydland, Finn E. and Edward C. Prescott (1977). "Rules Rather than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy* 85(3): 473–492.

against tax discrimination. The companies may reasonably fear that states will raise their taxes, and this uncertainty dampens their motivation to invest today.

Moreover, the work of MacDonald and Siegel suggests that when investments are irreversible, uncertainty concerning possible future tax changes may have massive disincentive effects on future investment.[4] Firms only chose to "nail down" large capital projects when they have confidence concerning the likely future paths of the key economic variables affecting their profitability. This suggests that a policy that reduces uncertainty surrounding future tax variables at the state level may have profound effects on investment.

The lack of new investments in the pipeline industry along with the lack of maintenance investment for already existing pipelines could have very costly consequences. According to a Republican Policy Committee paper published in November 2004, U.S. industry overall depends on natural gas for 27 percent of its primary energy consumption. Because of such a strong reliance on natural gas, U.S. consumption continues to rise despite escalating prices. The United States is expected to consume nearly 30 trillion cubic feet (Tcf) of natural gas per year by 2020—a 38 percent increase over current consumption levels.

To meet this strong demand, the industry estimates that $61 billion in natural gas infrastructure investment will be needed over the next 15 years. This includes investment in pipelines, storage facilities, and liquefied natural gas terminals. However, as mentioned earlier state discriminatory taxation of natural gas pipeline property discourages the pipeline industry from investing in infrastructure.

What happens if no new natural gas infrastructure is built? Quite simply, delays in pipeline and natural gas terminal construction will reduce the amount of natural gas available to consumers and thereby increase the price that they must pay. This likely will cause further job losses in industrial sectors that depend on affordable supplies of natural gas, such as chemical and fertilizer manufacturing. Because an increasing amount of electricity is generated by natural gas, electricity prices will be higher for virtually all consumers.

The Interstate Natural Gas Association of America Foundation completed an economic analysis that quantifies some of the consumer costs associated with delays in constructing new pipeline and natural gas import capacity.[5] The study published in July 2005 found startling results: a two-year delay in building natural gas infrastructure (both pipelines and LNG terminals) would cost U.S. natural gas consumers in excess of $200 billion by 2020.[6] The state of California, alone, would experience increased natural gas costs of almost $30 billion over that period. And, of course, should the end result be that certain facilities are never constructed, the economic effect would be even more severe.

The bottom line is that natural gas infrastructure delays and cancellations have consequences. Every consumer will pay higher prices for natural gas, electricity and the goods produced using natural gas if we do not act to ensure that natural gas industry has the appropriate incentives to increase adequate pipeline capacity in time to keep supplies affordable.

Of course other current government policies discourage the market from investing in infrastructure. According to the RSC, regulatory impediments to investment include jurisdictional confusion, which delays infrastructure construction; and "open access" and rate regulations, which distort rates of return on investment along to the tax impediments already mentioned.[7] Other tax issues include too-lengthy depreciation periods. Congress should allow the market to work. It should clarify administrative jurisdiction; it should terminate open access requirements and introduce market pricing of natural gas infrastructure services; and it should reduce depreciation periods or permit immediate expensing for tax purposes on capital investment.

CONCLUSION

In this area of higher energy prices exacerbated by hurricanes Katrina and Rita, it is all the more important to find a way to decrease energy prices. An important component of this bill is the provision of relief through the federal court system. It provides a statutory grant of jurisdiction which affords interstate natural gas pipeline companies the same relief avenues currently available to other major interstate

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[4] Robert MacDonald abd Daniel Siegel (1986), "The Value of Waiting to Invest," Quarterly Journal of Economics, Vol. 101, N. 4, November, p. 707–728.

[5] For more information see http://www.ingaa.org/Documents/Foundation%20Studies/F-2005-01%20(Avoiding%20and%20Resolving%20Conflicts).pdf

[6] Ibid, p. 1.

[7] Republican Study Committee (2004), "How Congress should help meet the Nation's Natural gas supply needs," November 16.

commerce industries. By giving a judicial avenue to pipelines to contest their tax treatment, it reduces significantly the hold up problem they faced for years and reduces their uncertainty.

If this legislation HR 1369 to prevent certain discriminatory taxation of natural gas pipeline property reduces taxes paid by the pipeline industry and reduces the uncertainty faced by pipeline owners then it could go a long way toward promoting new infrastructure investments. This would increase competition between pipeline operators and lead to low energy prices in the longer run.

Mr. CANNON. Thank you, Dr. de Rugy.

Mr. Duncan, you are now recognized for 5 minutes.

TESTIMONY OF HARLEY T. DUNCAN, HARLEY T. DUNCAN, EXECUTIVE DIRECTOR, FEDERATION OF TAX ADMINISTRATORS

Mr. DUNCAN. Thank you very much, Mr. Chairman, Mr. Watt, Members of the Subcommittee. Thank you for the opportunity to appear before you on H.R. 1369. My name is Harley Duncan, and I'm the Executive Director of the Federation of Tax Administrators, which is an association of the principal tax administration agencies in the 50 States, the District of Columbia, and New York City. I appear in opposition to H.R. 1369.

If H.R. 1369 is passed, it will disrupt the property tax systems in a number of States. In so doing, it will overturn the decisions made by voters and elected officials at the State and local level, reduce the revenues that are now flowing to localities and school districts in the affected States, or shift the tax burden to other taxpayers.

Moreover, the primary justification presented for H.R. 1369 is that Congress some 30 years ago established similar restrictions on the taxation of railroad property. That seems scant justification for an act as far-reaching as H.R. 1369. It should not, however, be unexpected that the pipeline industry would seek the intervention of Congress, given that the Congress has acted in the case of railroads.

There are three central points I'd like to make today. The first is that H.R. 1369 will disrupt the property tax systems in a number of States. The clearest and most immediate impact is going to be in approximately 9 or 10 States that use a classified property tax system in which pipeline property as well as certain other properties are included in a class that is assessed at a higher ratio to fair market value than other commercial and industrial property.

What is important to note in considering these classified property tax system States, however, is that the adoption of the system in each State has generally involved a vote of the electorate in that State to amend the constitution, as well as individual actions of State legislatures to establish the classified system. In other words, it's followed the duly established procedures under law for amending the constitution and establishing the system.

While you've heard that classified systems probably aren't held in great favor by the economists, some States use them as a tool to help balance out other features of their tax system, and to help control the incidence of the property tax burden across income groups and various types of property. And in others, the classification system has been used to prevent significant shifts in property

tax burden as there have been other changes enacted in the property tax system.

H.R. 1369 would insert the will of Congress over these decisions that have been made by the voters and the elected officials, and disrupt those property tax systems. It would also do so by only focusing on the property tax system and the assessment ratio. You'll probably hear some testimony about one State having a ratio for pipelines that's significantly higher from other commercial and industrial property.

What you also need to consider, however, is that in a number of States there are offsetting features in the property tax code. In one in particular with the higher assessment ratio on gas property, gas pipeline properties are not subject to the corporate franchise tax. So you've got offsetting features. And a bill that focuses only on property taxes and inserts Congress' will is going to miss the fabric of the system as a whole.

The second point I'd like to make is about the "any other tax" provision in section 1(b)(4). While it seems innocuous and straightforward, and in the 4-R Act context, it was described as a backstop to prevent States from enacting new taxes to replace the property tax practices that were prohibited, it hass proved to be anything but.

In my testimony, I outline about 15 cases where the "any other tax" provision was used to challenge any number of provisions in State tax law that treated railroads differently than other taxpayers. They range from taxes on the use of fuel by railroads, fees assessed for the maintenance of railroad crossings, the application of a corporate income tax to railroads vis-à-vis other types of property.

And the point is not that they won in each of those cases, but that the "any other tax" provision is not as innocuous as it might seem, and it needs to be examined. Proponents of the bill should, I would argue, be asked to identify what types of taxes, what particular taxes they feel fall under the provision, so that it can be examined. And it shouldn't be left out there as a sword that can then be used to attack taxes generally.

The final point, Mr. Chairman, is the Federal court jurisdiction. As you note, if there is a plain, speedy, and efficient remedy available at State law, the Federal courts demur. If you can prove there isn't a plain, speedy, and efficient remedy, you get to Federal court.

You will hear, and you have heard, that it's difficult to deal with State tax cases and State administrative appeals. I suspect any taxpayer and any State tax lawyer that has dealt with tax cases would agree with that. But those are the procedures that are there; they can be challenged; and they are the ones that face everybody, whether you're an in-State taxpayer or an interstate taxpayer.

And by establishing the Federal court jurisdiction, you provide a special place in the system and a separate avenue for the pipeline industry to challenge. And that is not going to result in equal justice for that.

So for these three reasons, Mr. Chairman, simply because it was done 30 years ago is not sufficient justification today. Thank you.

[The prepared statement of Mr. Duncan follows:]

PREPARED STATEMENT OF HARLEY T. DUNCAN

Statement of

Harley T. Duncan
Executive Director
Federation of Tax Administrators

Before the

Subcommittee on Commercial and Administrative Law
House Committee on the Judiciary
U.S. House of Representatives

On

H.R. 1369
Relating to State and Local Taxation of Interstate Natural Gas Pipelines

October 6, 2005

Chairman Cannon, Congressman Watt and Members of the Subcommittee:

Thank you for the opportunity to appear before the Subcommittee on H.R. 1369, a measure that would impose certain restrictions on state and local taxation of interstate natural gas pipelines. My name is Harley Duncan, and I am the Executive Director of the Federation of Tax Administrators. The Federation is an association of the principal tax administration agencies in the 50 states, the District of Columbia and New York City. I appear in opposition to H.R. 1369.

H.R. 1369 imposes several limitations on state and local taxation of natural gas pipelines. To a considerable extent, the limitations are fashioned along the lines of those contained in the Railroad Revitalization and Regulatory Reform Act (4-R Act) of 1976. The bill would prohibit states from assessing pipeline property at a higher ratio to true

market value than is the case for other commercial and industrial property in the same assessment jurisdiction or from imposing an ad valorem property tax on natural gas pipeline property at a higher tax rate than is applied to other commercial and industrial property in the jurisdiction. It would also prohibit states and localities from imposing "any other tax that discriminates" against a natural gas pipeline. Finally, the bill would grant the federal district courts jurisdiction over actions arising under the bill. It would provide that relief is to be granted if the assessment ratio of pipeline property exceeds that of other commercial and industrial property by more than 5 percent. It further provides that if the assessment ratio of commercial and industrial property cannot be ascertained through a valid sales-assessment ratio study, relief is to be granted if pipeline property is assessed or taxed at a rate greater than "all other property (excluding public utility property) subject to a property tax levy".

H.R. 1369 should be opposed for several reasons:

It will disrupt the property tax systems in a number of states where the voters have chosen to adopt a classified property tax system that taxes certain types of property differently from others. These classified systems have been approved by the voters in these states and have been found constitutionally valid where challenged. H.R. 1369 will also be used to challenge the property tax systems in states without such a classification system.

The "any other tax" provision of the bill is an insidious measure that is likely to be used (if experience is any guide) to challenge a number of features of the tax and regulatory systems involving natural gas pipelines.

The provision authorizing access to the federal court system to bring actions under the bill is unnecessary and will be disruptive to the tax administration system in many states.

> The bill will (once again, if experience is any guide) spawn a tremendous amount of litigation and consume immeasurable resources to determine its ultimate meaning and impact.

The bill is in many ways a solution in search of a problem. A rather exhaustive review of literature in the tax and public policy field failed to identify a single treatise on the property tax issues facing the interstate gas pipeline industry. The information that is available suggests that the primary "justification" for the bill is that Congress enacted similar legislation affecting the property taxation of railroads about 30 years ago when most U.S. railroads were in serious financial difficulty. On the basis that one group has it, the pipeline industry is now coming forward seeking similar treatment.

Classified Property Tax Systems

State property tax systems can be divided into two types: classified systems in which certain types of property (identified in either the state constitution or state law) are taxed differently (either assessed at a different proportion of fair market value or taxed at a different rate) from other types of property and non-classified systems in which all property is valued at the same ratio to fair market value and is taxed at the same rate (usually called a "uniform and equal" state.)[1] In each state with a classified property tax system, the system has been authorized by the state constitution by whatever procedure is specified for adopting constitutional provisions in that state, but usually involving approval by the voters in that state. The actual classifications and tax rates are contained in the Constitution or adopted in law through the normal legislative process. The ability to use a classified property tax system, at least as they have been implemented to date, has been upheld.

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[1] At least 18 states use a classified property tax system. It appears that in 9 of these states natural gas pipelines are in a class that is taxed at a higher rate than some other commercial and industrial property while in 9 others all commercial and industrial property is taxed in the same manner. Source: Survey of Railroad and Utility Taxation among the States: 2005 Update, New York State Office of Real Property Services. Available at http://www.orps.state.ny.us/ref/pubs/railroadutility/index.htm as of October 3, 2005.

Some states use a classified property tax system as a tool for calibrating the distribution of the property tax burden across income groups and the incidence of the state and local tax systems as a whole. In others, a classification system has been used to keep the relative shares of the property tax burden constant across property types as the state transitioned to an updated property tax system. Enactment of H.R. 1369 would disrupt these classification systems that have been adopted through the duly authorized procedures required in each state. It would, in effect, insert the will of Congress and overturn decisions made by voters and elected officials in the affected states. The end result will be a shift of some portion of the property tax burden to other property owners.

Undoubtedly, a considerable portion of the concern expressed by the pipeline industry is attributable to the fact that states have often had to exclude railroad property from the class into which other centrally assessed property (generally including pipelines) would be included because of the requirements of the 4-R Act. The result is to reduce property taxes on railroads relative to natural gas pipelines.

While one of the principles of tax policy is that taxes should be neutral across similar activities and should not distort economic decisions, differential taxation resulting here should not be laid exclusively at the feet of states and local governments. It is axiomatic that if Congress intervenes in state and local taxation in a manner that establishes a favored group of taxpayers, then other taxpayers that feel they are in the same position will come forward seeking the same favored treatment. Complaints about the differential impact of state classification systems on natural gas pipelines vis-à-vis railroads must be considered to be largely the result of previous Congressional intervention. Passage of H.R. 1369 to address the concerns of the pipeline industry will undoubtedly add to the list of those petitioning Congress for redress of perceived grievances and compound the problem created by the 4-R Act. It will also disrupt approved classification systems and shift the property tax burden among various property classes.[2]

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[2] Note that the issue of whether natural gas pipelines are entitled to the same treatment as railroads under the state constitution and the U.S. Constitution has been litigated and decided against the pipelines in one

Concerns about assessment rates will not be confined only to the states with classified property tax systems. Pipelines should be expected to generate actions challenging the actual assessment ratio for pipelines compared to other property in "uniform and equal" states as well. To the degree that they can achieve relief, it will shift the burden to other taxpayers.

"Any Other Tax" Provision

At first blush, the "any other tax" provision (Section 1(b)(4) of the bill) seems innocuous and straightforward. In the 4-R Act context, the counterpart provision was described as a backstop designed to prevent states from enacting new taxes to replace property tax practices that would be replaced. In reality, however, the provision was used to attack a number of state and local tax and fee arrangements that were pre-existing and would not be considered improper discrimination.

Among the challenges brought under the "any other tax" provision of the 4-R Act were:[3]

> The imposition of a personal property tax on a railroad company's rolling stock. *Burlington Northern and Santa Fe Railway Co. v. Missouri State Tax Commission*, No. 98-3544 (8th Cir. 1999).
>
> Ohio's excise tax imposed on the rolling stock of carlines levied in lieu of personal property (rolling stock and other personal property). *General American Transportation Corp. v. Limbach*, Civ. No. C2-285-1603 (S.D. Ohio, 1987).
>
> Louisiana's gross receipts license tax on railroads was struck down despite the fact that it applied to all utility industries and had been in existence since 1935. *Kansas City Southern Railway Co. v. McNamara*, No. 817 F.2d 368 (5th Cir. 1987).
>
> Imposition of an Iowa excise tax on intrastate consumption of fuel by railroads with funds earmarked for a special fund that was used to rehabilitate abandoned

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state. Colorado Interstate Gas Co. and ANR Pipeline Co. V. Beshears, No. 85,052, Kansas Supreme Court, June 1, 2001.

[3] This is not to suggest that all these challenges were successful. It does, however, demonstrate the breadth of measures that were attacked under the "any other tax" provision, and the types of litigation that should be expected if H.R. 1369 is approved.

rail lines for ultimate sale or lease back to the railroads. *Atchison, Topeka & Santa Fe Railway v. Bair*, 338 N.W.2d 338, cert. denied, 465 U.S. 1071 (1984).

Imposition of sales and use tax on purchases of fuel by railroads was challenged under section 306(1)(d) of the 4-R Act. *Burlington Northern R. Co. v. Commissioner of Revenue*, Nos. 6911, 6865 (Minn.Tax, 1999), reversed by: *Burlington Northern R. Co. v. Commissioner of Revenue*, 606 N.W.2d 54 (Minn. 2000).

Manner of applying the Virginia corporate net income tax to railroads. *Richmond, Fredericksburg & Potomac R. Co. v. Department of Taxation, Com. of Va.*, 762 F.2d 375 (4th Cir. 1985).

Alabama franchise tax on railroads measured by gross receipts from their Alabama intrastate business. *Alabama Great Southern R. Co. v. Eagerton*, 663 F.2d 1036 (11th Cir. 1981).

New Jersey railroad franchise tax in lieu of general corporate business tax challenged under 4-R Act. *CSX Transportation v. Director, Division of Taxation*, No. 004036-00 (N.J. T.C. 2005).

Collection of tax by state rather than local governments and possibility of a more accurate method of estimating tax base challenged under Section 301(6)(d) of 4-R Act. *Union Carbide Corp. v. Board of Tax Commissioners of the State of Indiana*, 69 F.3d 1356 (7th Cir. 1995).

Wyoming coal transportation tax. *Burlington Northern and Santa Fe R. Co. v. Atwood*, 271 F.Supp.2d 1359 (D. Wyo. 2003).

California assessment of its use tax on passenger rail cars purchased tax-free outside the state, and first used in California. *National Railroad Passenger Corp. v. California Board of Equalization*, 652 F.Supp. 923 (N.D. Cal. 1986).
Private car tax imposed by the state of Missouri on rentals derived from the leasing of railroad cars. *Trailer Train Co. v. State Tax Com'n*, 929 F.2d 1300, 1301 (8th Cir. 1991).

Imposition of a levy to recoup the costs of regulating railroad operations within the state. *Union Pacific R. Co. v. Public Utility Com'n of State of Or.*, 899 F.2d 854 (9th Cir. 1990).

Bridge construction and maintenance costs assessed against railroads. *Wheeling & Lake Erie Railway Co. v. Public Utility Commission of Pennsylvania*, 141 F.3d 88 (3rd Cir. 1998).

Costs of building culverts under railroad tracks assessed against railroads. *Chicago and Northwestern Transportation Co. v. Webster County Board of Supervisors*, 71 F.3d 265 (8th Cir. 1995).

Fee used to cover the costs of constructing and improving railroad grade crossings. *Burlington Northern and Santa Fe Railway Co. and Union Pacific Railroad Co. v. Atwood*, No. 00-CV-109-J (D. Wyo. 2003).

Imposing costs of drainage ditch on railroad. *Chicago and North Western Transportation Co. v. Webster County Board of Supervisors*, 71 F.3d 265 (8th Cir. 1995).

It is evident that in the 4-R Act context, the "any other tax" provision has been far more than a backstop to prevent states from offsetting changes in the property taxation of railroads by other means. It was used as a tool to try to reduce the costs imposed on the railroad industry by government, many of which were used to benefit the railroads directly through the maintenance of rights of way, crossings and the like.

It is important to note that challenges under the "any other tax" provision did not need to allege that the challenged taxes "discriminate" against railroads in a way that violated constitutional principles. Neither was it necessary to show that the impact of the state and local system as a whole was discriminatory against railroads or that it imposed a greater burden on railroads than it imposed on other industries or that the burden was out of proportion to the services provided by states and localities to the railroads. Instead, the judicial interpretation of the statutory language was based primarily on the fact that the imposition on railroads was different from that imposed on other businesses. In many cases, the levies were unique to railroads because they were used for purposes affecting only railroads. In short, the "any other tax" provision will, if history is a guide, be used to challenge a wide range of taxes and fees that may differ from the treatment accorded other taxpayers, but that would not be found to improperly discriminate under traditional constitutional principles.

So that you may be fully aware of the implications of Section 1(b)(4), proponents of H.R. 1369 should identify the particular tax arrangements that exist today that they believe would be subject to challenge under the "any other tax" provision. This seems

particularly important given that some states have deregulated portions of their energy industries and have altered their tax structures as a result. The result has been the adoption of certain excises on various segments of the industry to replace levies that became obsolete with the deregulation. With such a disclosure, the Subcommittee could evaluate the full impact of the "any other tax" provision as it moves forward.

Federal Court Jurisdiction

The grant of authority to the federal court system to hear cases arising under H.R. 1369 is an unnecessary and disruptive provision. The federal Tax Injunction Act (28 U.S.C. §1341) provides that the federal courts are to demur from hearing state tax cases where there is a "plain, speedy and efficient" remedy available at the state level. Each state does, in fact, provide avenues to challenge various aspects of the property tax administration system with which the pipelines are concerned through both administrative review bodies and the state judicial system. These venues can be used to challenge the appraised value, equalization with other properties, and whether the state is meeting all the requirements of its property tax law as well as bring constitutional claims regarding discriminatory treatment. Beyond this, the pipeline industry can, of course, and does avail itself of the state legislative process for resolution of its issues. In that setting, elected officials at the state level, viewing the issue in the context of the state's tax system overall can make a judgment regarding the merits of the pipelines' case. In short, there is no need for federal court jurisdiction in this area. The existing avenues of appeal are plenty.

Moreover, by affording direct access to federal courts in challenging state and local property tax assessments, Section 2(a) promotes discrimination by creating a privileged class of taxpayers that may avoid the traditional state or local judicial and administrative review process. Experience with similar legislation has shown that federal courts do not consider 4-R Act challenges to state taxation in the same context as state courts, which must weigh tax cases in the context of state constitutions, state laws and the state tax system as a whole. Further, federal courts have used a separate line of precedent and reasoning that results in special treatment for such property tax payers, which

inevitably leads to unfair results for those property tax payers without access to federal courts. In short, separate justice is not equal justice.

Finally, providing access to the federal court system will disrupt the financial condition and potentially threaten the financial integrity of affected local governments. Granting direct access to federal courts over a disputed assessment would allow taxpayers to withhold disputed taxes while the case moves forward, thereby making it difficult for local governments and school districts to determine their tax base or to receive even preliminary payment of taxes until years after the taxes are due. The normal procedure at the state level is that the taxes must be paid and the claim brought as a claim for a refund.

Spawning Litigation

If H.R. 1369 is passed, one thing is certain. It is likely to create a veritable tidal wave of litigation to ascertain the meaning of the Act and the manner in which it should be applied in individual states. As noted above, just the "any other tax" provision of the 4-R Act generated a number of challenges to state and local tax practices. In addition, there were a wide range of other cases brought to determine more fundamental matters about the Act. As outlined in the attached article by from the March 1991 Multistate Tax Commission Review (Attachment I), this litigation includes such matters as whether the 4-R Act was constitutional, whether it constituted an abrogation of the sovereign immunity of the states, the appropriate contours of the classes of property to which railroads should be compared, the techniques to determine the assessment ratio of various types of property, the proper treatment of various classes of exempt property and the like.

While the language of H.R. 1369 has been informed to a degree by the 4-R Act litigation, one should not assume that its meaning and application is intuitively obvious. In addition, there are likely to be actions in a number of states challenging the assessment ratio of commercial and industrial property even in states without a classification system.

These actions will consume large amounts of resources to gather the required information and defend.

Conclusion

H.R. 1369 represents an attempt by the interstate natural gas pipeline industry to use the power of Congress to carve out for it a special position in the state and local property tax system. H.R. 1369 would overturn the decisions of voters and state and local elected officials about the appropriate tax policy for the citizens in the state and the businesses operating in that state. In so doing, it would shift some portion of the property tax burden in affected states and localities to taxpayers that do not receive the preferential treatment. In addition, H.R. 1369 would allow the pipeline industry to pursue redress of their grievances in federal courts when there are avenues at the state and local level that are available to them to pursue their concerns. In fact, they have used those avenues, and do not like the answers they have received. It is for that reason that they turn to the Congress with their concerns.

Finally, H.R. 1369 is simply a case of "me too-ism." Congress at a different time and in different circumstances accorded similar relief to the railroad industry. Now the pipeline industry seeks the same treatment without a showing as to need or impact. Of one thing we can be sure, if H.R. 1369 is approved, they will not be the last industry coming before this body seeking special status.

Mr. CANNON. Thank you, Mr. Duncan. Let me just say that I appreciate your comments on this point and your written statements. And we are going to take a very close look at the "any other tax" provision, and undoubtedly limit it from where the bill stands today. So I appreciate your input on that. I'm sure there will be some questions on that point.

Mr. Garrett, you're recognized for 5 minutes.

TESTIMONY OF LAURENCE E. GARRETT, SENIOR COUNSEL, EL PASO CORPORATION, AND ON BEHALF OF THE INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

Mr. GARRETT. Thank you, Mr. Chairman, Ranking Member Watt. It is indeed an honor for me to appear before this esteemed Committee on behalf of the El Paso Corporation and the Interstate Natural Gas Association of America, which is the trade group for the natural gas pipeline industry.

I'd like to start out by first saying that this is a very, very important bill to the industry. The addition of discriminatory taxes that the pipelines currently bear, unfortunately, are borne also by those very citizens and consumers of natural gas that had nothing to do with the imposition of that discriminatory tax.

In other words, the discriminatory taxes imposed by the State of Kansas are borne by the consumers of natural gas in New York City and Maryland, as well as the District. So those States that do discriminate, in other words—and when I talk about discrimination, I think the Committee needs to understand what the pipeline industry is saying here. "Discrimination" means that you are taxing above what you tax other commercial and industrial property.

The pipeline industry is not asking to be relieved of their tax burden. They are only asking to remove the discrimination and be taxed in the general group of commercial and industrial taxpayers.

Now, there's a big reason for that. First of all, in that group there is a substantial amount of legislative clout. There are a lot of voters in that group. Pipelines don't vote. Pipelines are out of State. Pipelines are permanently fixed. They are high visibility targets for those States that think they can increase a tax and export it to their neighbor State.

That is what this bill is designed to address, simply the discriminatory tax. What it does not do, it does not limit the States from imposing or raising their taxes. What they have to do, though, is raise it on all the commercial and industrial property, and not simply single out the pipelines.

With regard to my esteemed colleague, Harley Duncan, I've known Harley for 25 years. He's probably the second guy I sued out of law school, I think. He was the secretary of revenue for the State of Kansas. My background is I litigated a lot of 4-R Act cases, which this statute is patterned after.

Mr. Duncan talked about the disruption in the tax systems. We didn't see that with the 4-R Act. I litigated that from 1980 up through 1999, when I left the industry. We didn't see the disruption in the tax systems. Was there a shift in taxes? Very small shift. And this pipeline shift would be even smaller. The property the pipelines own is less than what the railroads had.

With regard to the "any other tax" measure, I encourage this Committee to focus on this very carefully, because that's a very important provision. I would analogize that piece of this statute—and Harley is right, it's very, very critical. I would analogize that to the bottom of the sack: Without that piece in there, you have no bottom to the sack.

In other words, taxes tend to—State taxes tend to displace air like a balloon. So when you squeeze on one end, you get a puff out on the other. So that's what that "any other tax" is designed—and when Mr. Duncan cites all those cases, the Committee should ask themselves: Why are those cases there? Well, the reason they are there, because there was discrimination against the railroads.

With regard to the Federal jurisdiction, absolutely critical to this bill. Absolutely critical. I have litigated in Federal court with these 4-R Act cases. They are fast; they are clean; everybody gets a resolution, relatively speaking, quickly.

I have been involved in litigation in the State court system. What happens there is that if you are able to prevail—and I put a big "if" there—the cause of action is generally always a constitutional cause of action: a commerce clause violation, an equal protection violation. When the court does determine that there has been a violation, and if you're lucky to ever get that resolved in a matter of ten or 15 years, then the problem comes: where is the refund?

Two things happen. The counties spend that money. It's gone. It's not escrowed. And what is a company to do? Well, usually, they have to eat it, or take a credit going forward, or invoke some mechanism. They generally don't get their money back.

The other point here is, with a Federal court, they are more apt to apply Federal law. It's been my observation that State courts, while they say that they're bound by Federal law—and they are, and I think they try to follow Federal law—the most important thing is their State law. And you are going to have to have an extremely, extremely good case to win.

Now, in those instances where you do win, I promise you, the very next year the legislature will take that relief away. They will legislatively unwind what the court did.

So that's why you have to have the "any other tax." That's why you have to have the Federal jurisdiction. It's absolutely critical. And I'm open to any questions the Committee may have.

[The prepared statement of Mr. Garrett follows:]

PREPARED STATEMENT OF LAURENCE E. GARRETT

INTRODUCTION

The following testimony is submitted on behalf of the El Paso Corporation and the Interstate Natural Gas Association of America. El Paso Corporation provides natural gas and related energy products in a safe, efficient, dependable manner. El Paso owns North America's largest natural gas pipeline system and one of North America's largest independent natural gas producers.

The Interstate Natural Gas Association of America (INGAA) is a trade organization that advocates regulatory and legislative positions of importance to the natural gas pipeline industry in North America. INGAA represents virtually all of the interstate natural gas transmission pipeline companies operating in the U.S., as well as comparable companies in Canada and Mexico. Its members transport over 95 percent of the nation's natural gas through a network of 180,000 miles of pipelines. The interstate natural gas pipeline industry has two principal federal regulators: the Federal Energy Regulatory Commission (FERC) is responsible for the economic reg-

ulation of pipelines, while the U.S. Department of Transportation (DOT) Office of Pipeline Safety oversees the industry's safety efforts.

BACKGROUND

Thank you Chairman Cannon and Ranking Member Watt for the opportunity to testify today on HR 1369, legislation that, if enacted, would finally put an end to the unfair discriminatory taxation of interstate natural gas pipeline property that occurs in some States today. My name is Larry Garrett, and I serve as Senior Counsel for the El Paso Corporation Western Pipeline Group. I appreciate your interest in this important issue.

Our founding fathers and the original framers of the Constitution recognized that Congress should have the authority to ensure that entities engaged in interstate commerce are not unfairly discriminated against by individual States. With the robustness and fluid nature of our modern economy even more dependent today on interstate commerce, this protection is vital to ensure consumers in one State are not unfairly affected by the actions of regulators in another State.

A generation ago, Congress in its wisdom demonstrated its understanding of this fundamental principle. In 1976, Congress acted upon this understanding by passing legislation, the Railroad Revitalization and Regulatory Reform Act, to protect interstate rail carriers, in part, from discriminatory tax practices by the states. Moreover, Congress later enacted legislation granting motor carrier, and air carrier transportation property these same protections from taxes imposed by states in ways that unreasonably burden and discriminate against interstate commerce. As a result of this wise action, consumers of goods transported by rail, highway or the air in one State are protected from the harmful effects that discriminatory taxation in another State can have on the price and availability of those goods and services. Unfortunately, consumers of natural gas transported by interstate natural gas pipelines are not afforded this protection. In fact, interstate natural gas pipelines are the only major mode of interstate transportation that is not protected by federal law. El Paso and the membership of INGAA feel very strongly that now is the time for Congress to protect interstate natural gas pipelines in the same manner as provided to the other vital modes of interstate transportation.

Under current federal law, a State may not assess rail, motor or air carrier transportation property (49 U.S.C. §§ 11501, 14502 and 40116), respectively, at a value that has a higher ratio to the true market value of the property than the ratio that the assessed value of other commercial and industrial property in the same assessment jurisdiction has to the true market value of the other property. A State also may not levy an ad valorem property tax on the transportation property at a tax rate that exceeds the tax rate applicable to commercial and industrial property in the same assessment jurisdiction.

In other words, thanks to Congress acting, States can no longer discriminate against the commercial property of these protected interstate transporters as compared to how that State treats its own intrastate commercial and industrial property.

Unfortunately, interstate natural gas pipelines are a different matter altogether. Since pipelines do not receive the same federal protection given to other interstate transporters, some States have been aggressive in their discriminatory taxation of such property. Since local property taxes are calculated by multiplying tax assessments times the tax rates, discriminatory taxation of interstate pipelines usually arises in two ways:

- First, pipeline property may be assessed at a substantially higher proportion of true market value than the proportion of true market value at which other commercial and industrial property is assessed. An example being that a State may assess pipeline property for tax purposes at 100 percent of value, and other property at only 40 percent of such value.
- Second, pipeline property may be subjected to a higher tax rate than the tax rate that is applied for the same purpose against other taxable property. An example of this type of discrimination would be when a State subjects pipeline property at a rate of $1 per $1,000 of assessed valuation, and other property subject to the same tax purpose at a rate of $0.50 per $1,000 of assessed valuation.

Either way, a pipeline can be forced to pay higher discriminatory taxes than other taxpayers with similar property in the same taxing district.

Under current law, pipelines also face a tilted playing field when it comes to challenging state tax discrimination. Pipelines are limited to challenging discriminatory taxes through the state administrative and judicial systems. Resolution of these

cases takes years. The only avenue of challenge pipelines have is to prove that a State's discriminatory taxation violates either the Equal Protection Clause or the Commence Clause of the United States Constitution. This is an extremely difficult burden to carry.

In those rare instances where a pipeline can successfully demonstrate that a constitutional violation has occurred, state courts are reluctant to provide a meaningful remedy and state legislatures quickly eliminate any remedies that the courts may grant.

The problem is best illustrated by some actual cases. In 1994, an interstate natural gas pipeline filed a protest with a State's tax commission complaining that the personal property of interstate pipelines was assessed under state law at twenty-five percent (25%) of fair market value, while the personal property of intrastate natural gas pipelines, with whom they competed, was assessed at fifteen percent (15%) of fair market value. This resulted in an assessment of interstate natural gas pipelines at a rate 167% higher that the assessment of intrastate natural gas pipelines. Protests were filed each year from 1994 through 2005.

In January 2005, the cases were finally consolidated and set for trial before a state district court. The district court ultimately found that the state's assessment practices violated the pipeline's right to equal protection under the United States Constitution as well as its right to equal protection under the State's Constitution.

After finding these constitutional violations, the court then remanded the case back to the state tax commission to reassess the interstate pipelines by having the local assessors find "new" fair market values for the interstate pipelines and then assess the pipelines at 15% of the "new" fair market value. The court ordered the "new" fair market value to be calculated by a valuation methodology that undisputedly was not designed to find fair market value of a rate-regulated pipeline. The clear object was to give the assessor an opportunity to eliminate any refund of discriminatory taxes. The pipeline was relegated to litigating the fair market value of the pipeline in 520 separate valuation hearings in as many as 36 different local jurisdictions, even though the pipeline's fair market value was never an issue before the court. This can hardly be characterized as a plain, speedy and efficient remedy.

In another State, interstate pipelines challenged a discriminatory tax on their personal property. The pipelines prevailed in court only to have the legislature change the definition of the pipelines' property from personal to real. The purpose was to eliminate any relief the pipelines obtained in court.

In yet another State, pipelines challenged the practice of exempting the inventory of merchants and manufacturers, but taxing the inventories of pipelines. The State Supreme Court agreed that the inventories of pipelines should also be entitled to exemption. The next year the legislature moved swiftly to eliminate pipeline inventories from property tax exemption.

Plain and simple, the options available for interstate natural gas pipelines to protect their right to engage in interstate commerce without discrimination are toothless and hollow. They are the same toothless options Congress realized the air, highway and rail carriers had in the 70's and they are just as hollow today. It would be our preference to work with the states in solving this problem. However, some States, recognizing that interstate pipeline assets, by their nature, are not mobile, single out pipeline property for discriminatory tax treatment. Put another way: "interstate pipelines aren't going anywhere, so we might as well tax them". In these instances, the only remedy for interstate natural gas pipelines is for Congress to enact federal protections to protect their interests.

It is also important to realize this discriminatory taxation is not done in a vacuum. The consequences of each State's discrimination are felt far beyond the pipeline companies themselves. Ultimately, the pipeline and the consumer pay the bill for discriminatory taxation. Not only are such taxes reflected in the pipeline costs of transportation purchased by the consumer, but also the consumers of States which do not discriminate are forced to share the cost of these burdensome tolls. Furthermore, state tax policies that discriminate against interstate natural gas pipelines have the unintended consequence of determining where and if facilities are built. States that arbitrarily discriminate against pipelines are less likely to see the needed infrastructure built or expanded to provide energy services to sustain and grow the economy. Interstate natural gas pipelines, as a result of FERC Order 636, operate in a competitive marketplace with all of the associated market pressures faced by other businesses. If a pipeline project cannot be competitive in the market, such projects will not be built. State tax policies do enter into the decision making process in determining to proceed with major capital projects.

We strongly support the passage of H. R. 1369. We specifically would like to point out a couple of the bill's most critically needed aspects. First, Chairman Cannon's bill will eliminate the discriminatory tax practices that negatively affect our na-

tional pipeline system and burden the Nation's consumers of natural gas. It will finally declare these types of taxation activities to be an unreasonable and unjust discrimination against and an undue burden on interstate commerce. Second, the legislation also wisely gives the District Courts of the United States jurisdiction to grant mandatory or prohibitive injunctive relief, interim equitable relief, and declaratory judgments as may be necessary to remedy any acts in violation of this bill. The jurisdiction provided for by this bill is not made exclusive of the jurisdiction which any Federal or State court may have. It is important to point out this provision to show that the legislation will not infringe upon a State's right to adopt a flexible taxation policy towards interstate pipelines. The simple truth is that this bill will in no way alter the freedom of a State to tax its taxpayers so long as interstate natural gas pipelines are accorded equal tax treatment with other taxpayers.

In closing, the recent tragic events along the Gulf Coast have been a blunt reminder to us all how fragile life can be. Hurricanes Katrina and Rita have also reminded us all how these tragedies can interrupt our energy supply and, in turn, detrimentally affect people all across the country. This vulnerability is arguably most present in the natural gas market. Considering a majority of the natural gas consumed in this country is produced in only a few specific regions, the role of interstate natural gas pipelines to ensure that the natural gas found in those areas is accessible and reliably delivered to consumers in other areas is a foundation to our economy and livelihood. Whether it is used to generate electricity, heat our homes or serve as a feedstock in the production of many products we use daily, the dependable and affordable transportation of this fuel from one region to another is critical to this country. I would urge you to recognize the injustice we see today by affording the same protection to interstate natural gas pipelines that you have already given to the other interstate transporters of important products.

Thank you once again for the opportunity to provide testimony on this important issue. I would be pleased to answer any questions you might have.

Mr. CANNON. Thank you. We appreciate your testimony. And now we're going to shift to questions. I'll take the first 5 minutes.

Dr. de Rugy, are these kinds of taxes, taxation of pipelines in particular, do they tend to be progressive, meaning that richer people pay more tax, or do they tend to be regressive, meaning that poorer people end up paying a larger burden?

Ms. DE RUGY. You mean the tax on property?

Mr. CANNON. The property tax on pipelines.

Ms. DE RUGY. Well, it actually depends on how it's assessed and whether it's a progressive rate or a proportionate rate. But as a general rule, the bigger the property, the more the tax you pay.

Mr. CANNON. No, what I mean is, ultimately consumers are going to pay. The taxes are going to be passed on.

Ms. DE RUGY. Oh, consumers—yes, well, consumers——

Mr. CANNON. So when consumers pay the taxes——

Ms. DE RUGY. It falls on every consumer, regardless of their income. So they tend to be regressive.

Mr. CANNON. So it's regressive——

Ms. DE RUGY. Yes.

Mr. CANNON. —and disproportionate——

Ms. DE RUGY. Yes.

Mr. CANNON. —on poorer people.

Ms. DE RUGY. Because the rate is proportional, you know, and falls on everyone.

Mr. CANNON. And since 62 percent of people in America heat their houses with gas——

Ms. DE RUGY. Homes.

Mr. CANNON. —their homes with gas, I suspect that that is across the board.

Ms. DE RUGY. Yes.

Mr. CANNON. I mean, you don't have any statistics——

Ms. DE RUGY. No, but I——

Mr. CANNON. —to suggest that poor people use electricity or something else?

Ms. DE RUGY. Well, I could try to look for it, if you would like.

Mr. CANNON. No, I suspect it's pretty——

Ms. DE RUGY. But I mean, it's regressive.

Mr. CANNON. I mean, typically, I think people are going to be across the board. The decision to heat with electricity or oil are different. And so I suspect that it really is quite a regressive tax.

Ms. DE RUGY. Yes.

Mr. CANNON. Mr. Schroeder, you explained the problems that you've had with regard to tax assessments in Louisiana in the testimony you submitted. With all the problems that State has had over the last month, are you saying that you don't want to pay taxes in the State?

Mr. SCHROEDER. No, sir. First, let me just say, you noted from my biography my longstanding personal ties to Louisiana. In fact, all my family, my siblings and my in-laws, are still in Louisiana. So there's probably nobody here more acutely aware of the problems in Louisiana.

Moreover, CenterPoint as a company and its employees have gone above and beyond in terms of devoting significant financial and human resources to the disaster in Louisiana, and more recently now the disaster in Texas with Hurricane Rita.

We've spent long hours rendering service and restoring service in New Orleans, with our employees devoting their time over there. We completely provisioned one of the evacuee centers in Houston—not the Astrodome, but the Houston Convention Center, which was completely staffed and supported by our company.

And more importantly, we have a very long-standing presence, and will continue to do so in Louisiana. We're a significant employer and a significant capital investor in that State. And we have done, and will continue to do, more than our share as a company to support Louisiana as it recovers from this.

However, and we believe as a company, Louisiana is certainly free to raise taxes: raise taxes on our company, raise taxes on property, generally. They're certainly free to petition Congress for funds to deal with the disaster. What we don't believe is appropriate, though, is to allow them to discriminate in the assessment of taxes and shift their tax burden onto consumers outside the State.

And I also think it's important that we all recognize that we ought not be making policy, longstanding policy, about who bears these tax burdens and whether or not discrimination against interstate commerce is or isn't appropriate, on the basis of this particular disaster, or in light of this particular disaster. It should be done in the context of what's good for the Nation, what's good for all the consumers of natural gas and all the rate payers that purchase our services across the country.

Mr. CANNON. Thank you, Mr. Schroeder. Mr. Duncan, thank you, in the first place, for your testimony, which I thought was very, very coherent and concise and interesting and insightful. And clearly, we have a situation of great complexity. And one of the reasons I personally prefer not to be mandating to States is because they have these complicated balances that you talked about.

So given that you've got 9 or 10 States that have this classified system of taxation, given that those balances are very different in each of those States, would it be fair to say that the effect, not of the general taxation policies within those States, but as it relates to just pipelines and taxation of gas pipelines, that the tendency in those States is to benefit their voters with taxation revenues that come from taxpayers in other States?

Mr. DUNCAN. I'm not sure that you can make a blanket statement that the effort is to use pipeline revenues to benefit voters in the State.

Mr. CANNON. Well, the point is not that that's the effort of the taxing State. But, isn't it the effect that when a State adds taxation to pipelines that go through the State, that people in other States end up paying into a system that brings revenue, taxation revenue, into the State that doesn't come from in-State voting taxpayers?

Mr. DUNCAN. I'm not going to deny your essential point, but it isn't as simple a matter as the tax on pipelines is all taken out of State. First of all, some of the gas is used in the State.

Second, there's a school of thought in the public finance literature—I haven't looked at it in a while—that says that the incidence of property taxes falls back, in part at least, on the owners of capital—that is, the owners of the pipeline and the shareholders—depending on the nature of the market conditions.

Mr. CANNON. Right.

Mr. DUNCAN. And I'd be glad to get that for your staff.

Mr. CANNON. We would love to have that. But my understanding from what you've just said is that you agree that there is a tendency to shift that taxation outside the State to other sources, either through the process you've just described, or just through the higher rates that people pay in other States. I mean, that's simple, but——

Mr. DUNCAN. Well, yet is it, but there's a lot of complex economics that goes with it sometimes; it depends. But the fact is that if one is taxing interstate activity, there are certain times that the ultimate incidence is going to shift out of State, and it may fall back, and it may fall onto others. Yes, sometimes taxes are exported. Nevada would be the classic example of trying to export tax.

Mr. CANNON. Thank you, Mr. Duncan.

Mr. Watt? The gentleman is recognized for 5 minutes.

Mr. WATT. Thank you, Mr. Chairman. I acknowledged at the outset that I don't know much about this bill, so I want to ask a couple of very, very, very basic questions, so I can make sure I understand what the bill does, or proposes to do.

I'm looking on page 3 of the bill, and it would make illegal four different kinds of things. And the fourth one is this "other tax" issue, which the Chairman says he's going to look at. And we could spend all day speculating about what those other taxes might be, so I'm not even going to deal with that aspect.

The other three seem to fall into two categories. Number one is levying or collecting a property tax at a rate, at a tax rate, that exceeds the tax rate applicable to commercial and industrial property in the same assessment jurisdiction. And the first two, num-

bers one and two, talk about making an assessment that is in some way discriminatory.

Basic question: Are there States that tax at a tax rate that is higher for property that has a pipeline running through it? The rate, itself; not the assessment. Are there States that are doing that? Mr. Garrett, Mr. Schroeder, you all operate in this business. Tell me what those States are, and if there are any such States.

Mr. GARRETT. You know, Ranking Member Watt, I am not aware of any State that has done that.

Mr. WATT. Mr. Schroeder?

Mr. SCHROEDER. Well, in Louisiana, in particular, our interstate natural gas pipeline property is taxed at a different percentage rate of fair market value than intrastate natural gas pipelines. That's the crux of our legal issue in Louisiana today, is we pay a tax based on 25 percent of our fair market value, as an interstate natural gas pipeline company; while the very intrastate pipeline companies with which we actually compete for business, in addition to taking our gas out of State, are taxed at a 15 percent rate. So we think that's a prima facie case——

Mr. WATT. Okay. So Louisiana actually taxes this property at a different rate.

Mr. SCHROEDER. Yes.

Mr. WATT. Are there any other States? Mr. Garrett seems to——

Mr. GARRETT. If I could follow up on your question, Congressman, are you asking about how much—the mill levy that is applied?

Mr. WATT. Yes.

Mr. GARRETT. Because usually, that's what we talk about when we talk about rate.

Mr. WATT. Right.

Mr. GARRETT. Not the level of assessment. The level of assessment, I think, is as Mr. Schroeder pointed out. There is difficulties there. They do charge at different levels of assessment. In other words, the pipelines in Louisiana are assessed interstate at 25 percent of fair market value. But to that value, to that assessed value, then they apply the tax rate.

Mr. WATT. All right. But the rate itself is an equal rate?

Mr. GARRETT. [Nods head.]

Mr. WATT. Okay. So the question that we are dealing with here is an assessment matter, by and large, except for Louisiana. Is that my understanding? Mr. Duncan, would you be able to enlighten me on that?

Mr. DUNCAN. I think, in terms of the tax rate of so many dollars per hundred dollars of assessed valuation, the distinction that—if there is one made in a State, it is generally between residential and non-residential property.

The issue here is the assessment rate. Once you find the value of the property, how much of it goes in the tax base? And the concern of the pipelines is that in some States 30 percent—in the case of Louisiana, for example, 25 percent of the total value of the pipeline constitutes the tax base for interstate pipelines, and 15 percent of the value—determined in a different manner, I might add—constitutes the tax base for the intrastate pipelines.

The issue is primarily one of assessment ratios. But if you didn't have the prohibition against assessment ratio and rate, you could get to the same end. And I would give them that.

Mr. WATT. All right. So this is not about the assessed value of a piece of property. I mean, how do you value a piece of property that has a pipeline under it?

Mr. SCHROEDER. Well—and Mr. Garrett can correct me if I'm wrong, because he's more of a specialist in this field than I am—but in Louisiana, the Louisiana Tax Commission publishes tables that provide for the uniform assessment of pipeline property. So there is some uniformity there in terms of how they value pipeline property on a statewide basis for interstate natural gas pipelines, if that answers your question.

So it's really—as Mr. Duncan and Mr. Garrett said, it's the percentage of the fair market value that is subject to the assessment that has been, in our experience, the most common or egregious example of the discrimination.

Mr. WATT. So the actual assessment itself, the valuation of a piece of property, is not the issue here?

Mr. SCHROEDER. It hasn't been our experience. It can be an issue. It's conceivable that an assessor would not follow the guidelines, I suppose. But that has not been our experience to date.

Mr. GARRETT. Sir, if I could give you an example, if you take—let me correct the record just for a moment on Louisiana. Louisiana like a lot of States assess and appraise interstate pipelines on a central assessment basis. That means the State does the actual appraisal. And how they do that is, they usually follow a cost, a market, and an income approach to value.

Mr. WATT. That's the way every piece of—isn't that the way most States do every piece of commercial real estate?

Mr. GARRETT. No, it isn't. And the prime example here is Louisiana. The intrastate pipelines are not appraised on an income basis. What they are appraised on is a replacement cost——

Mr. WATT. Oh, okay.

Mr. GARRETT. —less depreciation. In other words, their pipe is valued like per mile of just simple pipe. And probably, there's nothing wrong with that. They're not a regulated public utility. In other words, their earning capacity is not limited like a FERC-regulated interstate natural gas pipeline.

Mr. WATT. All right. I think I understand the issue a lot more. And Mr. Duncan has another response that will help me understand it more. But I won't ask another question. I'm just trying to understand what the issue is here.

Mr. DUNCAN. I don't know if this will help you understand or not. I'm glad to hear that the method of valuation is not an issue. It was often said that method of valuation was not an issue in the 4-R Act context, but there were cases brought challenging that method of valuation. So if the method of valuation is not an issue, that would be a good measure to set aside in the bill, as well.

Mr. GARRETT. I'd like to respond to that. The fair market value, or the valuation, is the denominator to this equation. The assessed value is the numerator. So if a State tampers with the assessed value and the numerator, they can discriminate. Or they can tamper with the fair market value in the denominator.

This is what the railroads went through in their litigation. What happened is the railroads, the first case they win is strictly on a discriminatory 20 percent of fair market value versus 30. Well, then the States take the position they can tinker and get that money back by raising the value.

And so fair market value, Ranking Member Watt, is a very, very important part of this bill. It was a very, very important part of the railroad bill.

Mr. WATT. Okay. Thank you.

Mr. CANNON. The gentleman yields back.

Mr. Chabot, I believe you were here next.

Mr. CHABOT. I thank the gentleman.

Mr. CANNON. The gentleman is recognized. The gentleman from Ohio is recognized for 5 minutes.

Mr. CHABOT. Thank you. Dr. de Rugy, I'll start with you, if I can. From what I gather, my home State of Ohio collects a large amount of taxes from the natural gas pipelines. In fact, if I'm understanding this chart correctly, I think we're the second-highest State, around 40 million in 2004, after Louisiana at about 46 million. And I think New York at 39 was next. But we're way up there.

Could you tell how, arguably, this impacts the State's economy and the consumers? And is it logical to assume that this tax causes Ohio consumers to pay more for natural gas in their heating bills, therefore, than they otherwise would?

Ms. DE RUGY. You're asking in the present state?

Mr. CHABOT. The way it is right now, yes.

Ms. DE RUGY. I guess there are a lot of things that go into the price of the tax. But it is possible, totally possible, that it means that the consumer in Ohio are going to pay much, much more for their gas than in other States.

I mean, there are different prices of gas, crude oil or natural gas, across States. And it's a mix of the cost of production and taxes, some of which can be transferred to other States, but most of it can't. And it's going to have to be paid by taxpayers in Ohio.

Mr. CHABOT. All right. Okay. Thank you. Mr. Duncan, if I could go to you next, Ohio has a large number of natural gas pipelines in the State, it's my understanding. And I understand the rate is high, as well. Could you tell us what burdens there might be in the State of having so many pipelines? What is the practical effects of that?

Mr. DUNCAN. Well, the State would provide a number of services to pipelines and to pipeline owners. Most particularly, you're going to have issues of safety, I suspect. So that there's a regulatory burden—a regulatory and a safety burden that would be most directly attributable to the pipeline property, would be my guess.

Mr. CHABOT. Okay.

Mr. DUNCAN. You also have the period—I mean, the disruption to any public rights-of-way, if they have to go into repair. You also have the issue of easements on the private rights—private lands, as well.

Mr. CHABOT. Okay. Mr. Garrett, and also Mr. Schroeder, what drawbacks are there for consumers when States charge discrimina-

tory taxes? And how could this affect the pipeline infrastructure, as well? Either one that would like to go first.

Mr. GARRETT. Well, with respect to the consumers, the property taxes of a pipeline are included in the rate base for the pipeline. So consequently, the consumers are paying a piece of that discrimination.

Now, unfortunately, every consumer that consumes gas through that pipeline that's been discriminated against, regardless of whether it's in the—Mr. Duncan was correct—regardless of whether it's in the state of discrimination or elsewhere, is paying a piece of that.

But also, the pipelines are paying a piece. And let me show you why. It is, unlike years ago where a cost of service could be passed down to the rate payer, that's not correct today. That isn't what really in reality happens. You have a policy at the FERC today that is encouraging competition.

And competition is a good thing. I mean, nobody denies that. The problem of it is when your rates are regulated the pipelines have to take a discount to ship gas, if you will. And when they do take a discount, they're not earning their rate. So in other words, that discriminatory piece of that tax, the pipelines are paying a share of that, also.

Now, that takes away from the ability to move capital into new areas. You want the gas out of the Rocky Mountain region to the East here. That takes a lot of money, and that money comes from pipelines.

And the difficulty here is when a pipeline makes a—when they're dealing with a discriminatory tax, and you're going into a State, you really have no brakes on. The risk skyrockets. Because once you put that pipe in the ground, it's hard to take it out. And when a State comes along and steps on your neck afterwards, it creates undesirable results.

Management—and I've sat in management meetings where this very issue has come up: "What about this State?", you know. "Well, we don't want to—" you know, "It's so uncertain, they don't have a tax-friendly policy, we have no Federal protection, it's a high risk." So, yes, it does. It has a terribly adverse effect at business.

Mr. CHABOT. Thank you. Mr. Chairman, my time has expired, but if Mr. Schroeder could respond very briefly?

Ms. DE RUGY. Can I just——

Mr. CHABOT. Yes.

Ms. DE RUGY. If you want, we could send you some—there's actually a large literature that shows that for investments that are irreversible the uncertainty can be disastrous, because then that will reduce the amount of investment that you make either to maintain or to build or to add to the investment.

Mr. CHABOT. I think all the Committee would probably like to receive that. Mr. Schroeder?

Mr. SCHROEDER. Just to agree first with Mr. Garrett and reinforce, when we design our rates, we don't design them to charge people in Louisiana, or just Arkansas, or just Oklahoma, based on the costs and expenses associated with that particular State's service. So you put all the property taxes in a bucket; essentially, spread them out uniformly across all of our consumers. And the re-

sult is that people in Arkansas and Missouri are carrying some of the tax-raising burden that Louisiana has imposed on our services.

There's also an important point that we haven't touched on here, and that is the effect that this can have on producers, as well. And today, in this high-price environment, certainly producers are not ones that are going to engender a great deal of sympathy, but these things go in cycles. And in periods when gas prices are lower and producers are competing over markets, they are all selling into a market at a largely uniform price. For example, at a hub, that hub price might be $6; it may be $10 today; a few years ago, it was $3.

If my pipeline traverses several States with higher property taxes, if my transportation rate to get into that marketplace where everybody is getting paid three or five or six dollars, if my transportation rate is higher than my competitors who are coming from other producing basins, the producers that I deliver gas from into these other pipes will receive a lower net-back. So there is also a penalty potentially being paid by producers, as well.

I realize that in today's environment that's not a particularly compelling argument. But we should remember that these things do go in cycles, and that there are times when producers feel the effect of that net-back, and it does run the risk of inhibiting investment on their part.

Mr. CHABOT. Thank you.

Mr. CANNON. The gentleman yields back.

Ms. Wasserman Schultz? The gentlelady is recognized for 5 minutes.

Ms. WASSERMAN SCHULTZ. Thank you, Mr. Chairman. Actually, I have two questions, and any of the panelists could choose to answer it. The need for this legislation has been—the citation that has been referred to in the need for this legislation has been the 4-R Act of 1976. And at the time, my familiarity with that act is that the U.S. railroads who benefitted from it were in bankruptcy. And certainly, the pipelines are not in any such situation.

So I'd like to understand why, when that act was adopted as a form of relief for U.S. railroads, when there doesn't appear to be any need for relief for pipelines, why it's necessary to move forward with legislation.

Ms. DE RUGY. Very quickly, I'll answer to that by saying that, actually, in my testimony, my written testimony, I never made any reference to that act, for that exact reason. The reason why it would be important to get rid of that discrimination has nothing—I mean, has nothing to do really with the fact that other companies benefitted from that.

It's from an economic point of view it would be a very important thing to do, independently of whether other companies have benefitted from it. So I think that's why, you know, comparing—saying, "Well, you know, we did it because this industry was in bankruptcy or was having problem," is just not the argument.

Ms. WASSERMAN SCHULTZ. Mr. Duncan, can you comment, please?

Mr. DUNCAN. I tend to—I mean, I agree with your point. It was adopted in 1976. It was part of a major package looking at regulations, some actual relief. It was the establishment of Conrail, and this was a piece that was included as a way of providing relief.

We hear today that it's discriminatory taxation. I have a feeling that if we didn't have the 4-R Act, we'd hear a lot less about the discriminatory taxation. Because the practice of the States would be to treat a broad group of property that we would traditionally call public utility, but that would include pipelines and the railroads and the motor carriers and the air carriers, in much the same fashion for property tax purposes. So it's the intervention of Congress in 1976 that leads to the discrimination that we're hearing about today.

Mr. GARRETT. And if I may follow up on that, I wasn't involved in the 4-R Act legislation, but I was involved in the 4-R Act litigation; so I had an opportunity to read a lot of the legislative history there. And you're absolutely correct; the railroads, certainly the eastern railroads, were in financial straits. The western railroads were not. But the objective was—is to eliminate this discrimination on interstate commerce.

I would encourage the Members of the Committee just to simply go back and look to see what their predecessors did. With the railroad bill, with the motor carriers, and with the airlines, there was a clear need to eliminate discrimination.

And I can refer the Committee Members to—S. 2289 is the Committee report on the discriminatory State taxation of interstate carriers. And it gives an excellent background of what they were looking at. And one of the quotes out of there is that ultimately the shipper and the consumer pay the bill for discriminatory taxation. That's true with the pipelines; that's true with the railroads; that's true with the airlines; and it was true with the trucks.

That's what Congress wanted to eliminate, this balkanization, this idea of a State imposing a discriminatory tax on a good—like a tariff, if you will.

Ms. WASSERMAN SCHULTZ. Yes, but my impression is not that that was the purpose of that act. The understanding that I have of the purpose of that act was for relief; not for relief from discrimination, for financial relief.

Mr. GARRETT. Well, it was relief from discrimination. And if I may continue here, not only are such taxes reflected in the transportation cost of goods purchased by the consumer—the same here with the pipelines today—but also, the consumers of States which do not discriminate are forced to share the costs of these burdensome tolls.

You know, you can look at a pipeline. A pipeline is a railroad underground. They do not own the cargo that they ship; the railroads don't own the cargo that they ship. Both of them are fixed assets that are very expensive, that are very important to our national infrastructure. You just simply can't pick them up and move when the taxing environment gets unbearable. That's what Congress stepped in to protect.

Ms. WASSERMAN SCHULTZ. Mr. Chairman, I have another question, but my time has expired.

Mr. CANNON. Without objection, the gentlelady is recognized for another minute.

Ms. WASSERMAN SCHULTZ. Thank you very much. The only other question I wanted to ask was on a different subject. I'm a former State legislator for 12 years, and so I jealously guard when we re-

move jurisdiction from the States and grant it to the Federal Government. Kind of a home rule thing.

And you know, I just don't really see in the research and the reading that I've done that there is an access to the courts issue. I mean, if there is a discriminatory issue, then the State and local courts seem available to pursue a remedy.

And I'm not sure why it needs to be—the jurisdiction needs to be moved to the Federal level. It doesn't make sense, unless there is some access to the courts issue that I'm not familiar with.

Mr. GARRETT. Well, there is an access to courts issue. One is in the State system. And I might add, too, take Kansas, for instance. Pipelines have a separate appeal procedure. They're not allowed to pay their taxes under protest, and sue. What they must do, if they have a complaint about their valuation or assessment, they must bring an action to the State board of tax appeals within 30 days of the assessment.

First of all, that time is very—you can hardly analyze your case in 30 days; let alone, bring a cogent defense. The system is extremely slow. I brought an action before the Kansas State Board of Tax Appeals, started in—the case started in 1998. The Kansas Supreme Court finally heard it this year; ruled in the—this was not a pipeline case, but it was a gathering lines case—ruled in the pipeline's favor; the companies still haven't received a refund. And Lord only knows when we're going to get to that.

Ms. WASSERMAN SCHULTZ. Mr. Chairman, would you let Mr. Duncan just give an alternative?

Mr. CANNON. Absolutely.

Ms. WASSERMAN SCHULTZ. Thank you so much.

Mr. DUNCAN. Thank you. You know, I hear these things about State procedures and State cases. I mean, I've had State tax attorneys that work for me make the same arguments: that it is cumbersome; it is difficult; you can't get the records, and the like.

I think the answer really is that we have a system that State and local tax cases are brought at the State and local level. There are procedures out there that affect everyone. If the Federal court, in reviewing that, sees that it's not plain, speedy, and efficient, they can take the case. And they have, in fact, on occasion, taken the case.

But everybody is treated by the same rules, and they all play by the same rules. I think, you know, is it cumbersome? Sometimes it is. Sometimes you don't get the answer you want, either. But we are all playing by the same rules. And the Federal court can assert itself, if they think the remedy is not there.

Mr. CANNON. The gentlelady yields back. And sometimes when the rules even work it's hard to get paid, according to Mr. Garrett. The gentlelady may be interested in a map of pipelines that we have, the Committee staff has. Because I suspect that you may want to support this bill, since I think the weight of the testimony here is that taxpayers in Florida are subsidizing revenues in Louisiana. And so from your historic perspective as a legislator, that may be interesting.

The gentleman from North Carolina, and senior Member of the Committee, is recognized for 5 minutes.

Mr. COBLE. Thank you, Mr. Chairman. Mr. Chairman, I have two meetings going on simultaneously. That's why I was late getting here.

Mr. Duncan, you earlier said that Nevada was an ideal example. I may be the only guy in the room who is not sure why Nevada is an ideal example.

Mr. DUNCAN. It's simple. Nevada—and I can understand that you wouldn't understand this. Nevada has most of its tax money come from gambling and liquor and other things that are imposed on tourists. So that's how it exports its tax burden. I'm sorry.

Mr. COBLE. Well, I figured it probably involved one of those "sinful" activities. Thank you, Mr. Duncan.

Mr. Garrett, you point out in your testimony—in fact, my colleagues may have touched on all these questions previously. But you point out, Mr. Garrett, that the interstate and natural gas pipelines are similar in nature to rail, air, and trucking modes of transportation. And I don't disagree with that.

Comment a little more in detail about the similarities and the differences that you see, A; and, B, why were the interstate natural gas pipelines not afforded the same protection that was extended to air, rail, and truck in the '70's?

Mr. GARRETT. Thank you, Congressman. First of all, the similarity is—specifically with the railroad, the railroads have an infrastructure; the differences being, of course, one is above ground; the pipelines are below ground, they're hidden. They both transport commodities in interstate commerce.

The difference between the railroad and the pipeline is, the pipeline simply transports natural gas; where the railroads transport all sorts of commodities. They are both captive. They both are capital intensive. They both cross States that discriminate.

The reason, I think, that it's—I can't give you an exact answer why the relief wasn't given to the pipelines back in the '70's, but here's probably at least my take on it. Back in the '70's, the pipelines were simply a small segment of the energy industry. In other words, the pipelines owned the interstate transportation; they owned the gathering systems; they owned the production; and sometimes they even owned the local distribution companies. They literally owned the whole, entire supply chain.

Today, since 1993, the Federal Energy Regulatory Commission ordered the unbundling of all of those entities. So today, when you have an interstate natural gas pipeline, that's all you have. They cannot own production; they cannot own the gas in the line, except that necessary to run the pipeline. That is somebody else's commodity. So today they are identical to a railroad.

Mr. COBLE. I got you. Dr. de Rugy, what is the proper balance, in your opinion, of whether this bill is an infringement of States' rights, on the one hand, or a protector of a State's right to protect its residents from higher or excessive prices due to another State?

Ms. DE RUGY. Thank you, Congressman. I think it's a very good question. It really seems to me that this bill is actually a good federalist policy. I'm a fervent defender of States' rights. And this bill doesn't mean that the Federal Government is going to impose on them how they should impose, which rate they should impose on companies within their States. This is not at all the point.

On the other hand, but this bill does—because this bill doesn't impose a national way of imposing taxes on pipelines. What it does, though, it protects all other States from a given State discriminating against a given industry, and this State exporting the costs on other States.

So actually, it is the perfect federalist solution, it seems. I mean, and I think it is. Because, as I said, it just balances those rights; without imposing a national policy which then would go against States' rights; yet protecting one State from suffering from the tax policy in another State. Actually, it does seem to me like a good federalist policy.

Mr. COBLE. We appreciate you all being with us. Mr. Chairman, I yield back.

Mr. CANNON. Thank you. You know, I had a person on my staff who loved to go to Las Vegas. And I could never understand why anyone would want to go subsidize somebody else's tax system, but he did. And it was his choice. The problem, of course, we're dealing with here is where you don't have choice.

And Dr. de Rugy, you mentioned earlier that you had some information on how uncertainty and exaggerating the risk leads to a huge distortion in investments. If you could get that to the Committee, I'd very much appreciate that, because that's a big, big part of the issue that we have here.

[The information referred to is available in the Appendix.]

Mr. CANNON. I want to thank the panel for the very thoughtful, insightful testimony. And we're going to work on this some more, and appreciate that. And at this point, the hearing is adjourned.

[Whereupon, at 3:15 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

RESPONSE TO POST-HEARING QUESTIONS FROM VERONIQUE DE RUGY, PH.D., RESEARCH SCHOLAR, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

CHRIS CANNON
Chairman
Subcommittee on Commercial and Administrative Law
B353 Rayburn HOB
Washington, D.C. 20515

Washington DC, December 1st 2005

Mr. Chairman,

Thank you for giving me the opportunity to testify before your Committee and for giving me the chance to answer the questions submitted from Members of the Committee.

First, I mentioned in my testimony that there is a large literature that shows that for capital investments that are irreversible, the uncertainty of whether a State will increase taxes once the investment is made is disastrous. The effect of uncertainty on the decision to invest has been the subject of a very robust economics literature. When firms make investments, they forgo waiting for more information that might otherwise affect their decision to invest.

This decision has a cost, beyond the expenditure on the investment itself, to the extent that future information might optimize the investment decision. Recent studies have shown that this opportunity cost can be quite large, and can be highly sensitive to the uncertainty of the return on the investment. Uncertain tax policy, with discriminatory tax policy particularly at point, can contribute to this opportunity cost and therefore significantly affect a firm's decision to invest. But the impact of the uncertainty is even more dramatic when the investment about to be made is irreversible—pipelines are a good example of irreversible investments.

Among other economic articles you can read:

Brennan, Michael J. and Edaurdo S. Schwartz, "Evaluating Natural Resource Investments," *Journal of Business*, April 1985, 58 (2), pp. 135-57

Majd, Saman and Robert S. Pindyck, "Time to Build, Option Value, and Investment Decisions," *Journal of Financial Economics*, March 1987, 18 (1), pp. 7-27

McDonald, Robert and Daniel R. Siegel, "The Value of Waiting to Invest," *Quarterly Journal of Economics*, November 1986, 101 (4), pp. 707-27

Pindyck, Robert S. "Irreversibility, Uncertainty, and Investment," *Journal of Economic*

Literature, September 1991, 29 (3), pp. 1110-1148

Also, during my testimony, I also mentioned that as this type of tax is assessed evenly through the price of natural gas to the consumer, it tends to be a regressive tax. I do not know whether natural gas is used in greater proportions by poorer households or what types of households use natural gas, oil or electricity to heat their homes as I am not an energy expert. However, the following information is posted at www.naturalgas.org "Natural gas is one of the most popular fuels for residential heating. According to the AGA, 51 percent of heated homes in the U.S. (or 49.1 million households), used natural gas heating in 2000. This popularity is also shown through the high proportion of new homes built with natural gas heating. According to the U.S. Census Bureau in their report Characteristics of New Housing, 2003, 70 percent of single family homes completed in 2003 use natural gas heating, followed by 27 percent that use electric heat, and 2 percent that use heating oil. This represents the sixth consecutive year that natural gas has heated 70 percent of new homes. This is compared with 47 percent of new homes using natural gas in 1986. The number of homes heated with natural gas increased 16 percent between 1990 and 2000; 52% of all U.S. homes today are heated and/or cooled with natural gas."

From that excerpt, one can conclude that a large number of lower income households are probably using natural gas. As such there is a case to made for the fact that this tax is likely to be somewhat regressive.

Please let me know if I can provide you with more information. And thank you again for giving me the opportunity to comment of this very important topic.
Your sincerely,

Veronique de Rugy
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RESPONSE TO POST-HEARING QUESTIONS FROM HARLEY T. DUNCAN, EXECUTIVE DIRECTOR, FEDERATION OF TAX ADMINISTRATORS

FEDERATION OF TAX ADMINISTRATORS

444 North Capitol St., NW, Washington, D.C. 20001 • (202) 624-5890

November 15, 2005

The Honorable Chris Cannon, Chairman
Subcommittee on Commercial and Administrative Law
House Committee on the Judiciary
B353 Rayburn HOB
Washington, DC 20515

Dear Mr. Chairman:

This letter responds to your request for further information on the various schools of thought regarding the incidence of property taxes and whether property taxes on natural gas pipeline property tend to be shifted forward to consumers or tend to fall back on the owners of capital, i.e., owners of natural gas pipeline property.

I have attached two articles, an excerpt from a public finance text, and an excerpt from a tax policy study done for the State of Ohio that review what have become known as the "three views" of property tax incidence – the traditional view, the benefits view and the 'new' or capital tax view. The traditional view holds that the property tax is shifted forward to consumers, or in the case of residential property, to homeowners in the form of higher prices because the national rate of return to capital is fixed and the property tax causes capital to migrate to lower taxed areas, thus resulting in a reduced amount of housing (and higher prices) in the higher tax areas.

The 'new' view or capital tax view tends to focus on the differential in property taxes across jurisdictions. Up to some average level of property taxes, the burden is borne by all owners of capital (i.e., it falls backwards) and it is only the differential that would be reflected by reduced capital being allocated to the higher taxed property, thus causing the tax to be shifted forward in the form of higher prices because. The economics of these various views becomes somewhat intricate. I think the excerpt from the Ohio study explains the difference between the traditional and capital tax view most clearly and simply.

Thus, I think it is fair to say that some, but not all, of the property tax burden on natural gas pipeline property will shift forward to consumers. The proportion shifted forward will depend on differentials in property taxes across states and the competitive conditions in the gas market. I do not have an estimate for that proportion.

I hope this information is helpful. Please feel free to contact me if you have questions or comments.

Sincerely,

Harley T. Duncan
Executive Director

Enclosures as stated

STATE AND LOCAL PUBLIC FINANCE

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CHAPTER

14

PROPERTY TAX: ECONOMIC ANALYSIS AND EFFECTS

The property tax system for the nation as a whole depresses the return on capital and changes the cost of capital to higher-tax communities and decreases the cost of capital to low-tax communities.

Peter Mieszkowski[1]

Headlines

Homeowners and businesses will stop paying local property taxes for schools next year, after historic legislation roared through the [Michigan] Legislature Wednesday.

How the state will pay for education instead is anybody's guess.

Throwing caution to the wind, the House and Senate overwhelmingly approved a $5.6 billion property tax cut without identifying replacement funds. Gov. John Engler promised to sign it.

School operating taxes make up 65 percent of an average homeowner's property tax bill.

"I think fundamentally we've got to change funding the way we pay for schools," said Sen. Debbie Stabenow, who proposed the cut in the Senate. "The first step is to get people to agree we should not use the property tax."

But critics called the action reckless and predicted it would create chaos in school funding.

[1] "The Property Tax: An Excise Tax or Profits Tax?" *Journal of Public Economics* 1 (1972), p. 94.

"We can't say, 'We're going to cut $6 billion from the budget, and kids, you're going to worry about where it comes from,' " said Rep. Lynn Jondahl, D-Okemos.

The legislative action was the startling climax to years of debate and failed attempts to cut property taxes.[2]

With an understanding of microeconomic analysis of taxes and the specific property tax institutions used by state–local governments, attention now turns to analyzing the economic effects of property taxes. As always, those effects include equity issues—that is, the effect on the distribution of the tax burden—and efficiency questions such as the effects of the tax on the amount, type, and location of property selected. The analysis has a number of important policy implications, particularly regarding proposals to provide property tax relief either to specific types of taxpayers or specific types of communities. This chapter begins with a theoretical analysis of property tax incidence, which is then used to consider the progressivity or regressivity of that tax. Finally, a number of different economic effects of property tax changes are considered.

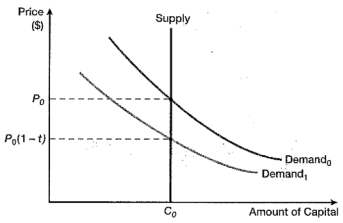
Property Taxes as Capital Taxes

The modern economic analysis of the property tax considers it as one of several taxes levied on the income from value of capital, which is one of the major inputs (with labor and materials) into the production of goods and services. Other capital taxes include the federal corporate income tax and state–local government corporate income or general business taxes. This characterization is important because it suggests thinking about property taxes as taxes on production, or specifically on a factor of production, rather than as a tax on consumption or consumer goods.

The characterization seems straightforward enough when thinking about commercial and industrial property—the tax is on the plant, land, and equipment, not the value of the product—but sometimes seems unusual when applied to housing, for people tend to think of a house as a consumer good. But the physical residential housing unit is only one input into the production of the consumer good "housing services," a fact most clearly seen for rental housing. The producer (the owner and landlord) combines land, labor, and a housing unit to provide housing service to the tenant or consumer. The only difference in the case of owner-occupied housing is that the producer and consumer are the same person. Therefore, the approach followed in this chapter is to first consider the effect of various property tax structures on the price and amount of capital and then to consider the effect of changes in the price and amount of capital on the prices and quantities of other inputs (such as labor) and consumer goods (particularly housing services).

[2]Chris Andrews and Greg Borowski. "State Slashes Taxes; No Plan for Schools." *Lansing State Journal,* July 22, 1993, p. 1A.

FIGURE 14–1
Incidence with perfectly inelastic supply



A Uniform National Property Tax

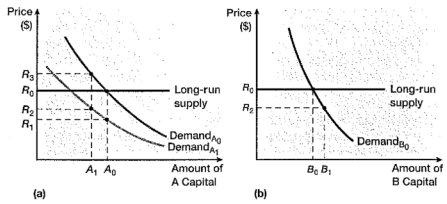
The first implication of this approach is that a uniform national tax on all property at a single rate would impose a burden, which cannot be shifted, at least in the short run, on all property owners. Remember the simple rule of tax analysis from Chapter 12: The only way to avoid or shift a tax is to change behavior. But if all property is taxed at the same rate in all jurisdictions, changes in the type of property owned by an investor or the location of the property will not reduce the tax liability. The only option to avoid the tax is to reduce the amount of property owned—that is, to reduce investment. Note that a property owner would not be able to avoid the tax by selling the property to another investor. Once the tax is imposed and known, any potential buyer would be willing to offer less for the property because the future after-tax return is lower than in the absence of a tax.

This situation is depicted in Figure 14–1, which shows a perfectly inelastic supply of capital at quantity C_0, which would be the case if the amount of capital investment is fixed in the long run. The property tax is represented by a shift down in the demand curve, and the net or after-tax return on capital falls from P_0 to $P_0(1 - t)$, where t is the property tax rate. The rate of return earned by property owners falls by the full amount of the tax simply because those owners at the time the tax is levied have no options to change behavior in ways to avoid the tax.

Differential Taxation of Different Types of Property

Obviously, the example of a uniform national property tax is not realistic, so adjustments to that case are necessary. Suppose, instead, that some types of property are exempt from taxation (or taxed at a zero rate) with all other property taxed everywhere at a uniform rate. In that instance, investors can avoid the tax by decreasing their investment in taxable property and increasing investment in exempt property. But that investor reaction itself will cause additional changes to the prices (and rate of return) of property. As investors reduce the amount (supply) of taxable property, the price of and investor return from that which remains will increase, offsetting the tax burden, while increases in the supply of exempt property would reduce the price and rate of

FIGURE 14–2
Effect of a property tax differential in the allocation of capital



return for those investments, mitigating the incentive to switch to nontaxable property. An equilibrium would be reached when the net-of-tax rates of return available from both types of property are equal.

This case is represented in Figure 14–2, showing an initial equilibrium at rate of return R_0 for two types of property (A and B) when there are no taxes (or both are taxed equally). Investors presumably are indifferent between the two types of investments because the (risk-adjusted) returns available from each are equal. If a property tax is imposed on type A only, the immediate effect is a reduction in the rate of return from type A property to R_1, as reflected by Demand$_{A1}$, which includes the tax. An investor in type A property earns a return of R_0, pays tax of (R_0 minus R_1), and retains a return of R_1. Because the tax has reduced the rate of return from type A property compared to that available from investing in type B property, investors are expected to switch from A to B, as noted above.

As the amount of type A property falls below A_0, the rates of return from type A property rise, and as the supply of type B property rises, the price of or rate of return from that property falls. From another perspective, potential investors in type B property need not be offered as high a return as previously, because the property tax on type A has made investment in B relatively more attractive. In Figure 14–2, equilibrium is reached at quantities A_1 and B_1, with a net-of-tax rate of return in both markets equal to R_2. Of course, owners of type A property still have to pay the tax; so to earn a net (after-tax) rate of return equal to R_2, they must receive a gross (before-tax) return of R_3. For instance, the income from investing in A property might provide a 10-percent return before taxes are considered but only, say, 7 percent after taxes are paid. In that case, an investor in type B property would receive a 7-percent return and pay no tax. In contrast, when there were no taxes, all investors received return R_0, perhaps 9 percent to continue the numerical example.

Another way to view this case is to consider the prices for each property type as those charged to rent those properties. Once the tax is imposed, the

price to the consumer to rent property A is higher than the price to rent property B (R_3 compared to R_2), so that the owners of both properties earn equal net-of-tax rent of R_2, which is, however, less than the rent received by the owners before taxes were imposed (R_0).

An important implication of this analysis is that *owners of both taxable and exempt property will bear an ultimate tax burden,* even though taxes are nominally collected only from owners of type A (taxable) property. Part of the tax levied on type A property is shifted to type B property through the market effects caused by the behavioral change of investors. Remember, the reason to change behavior (in this case, switch from investing in A to B property) is to avoid or shift the tax, in this instance to owners of exempt property.

The analysis in Figure 14–2 shows that the differential taxation of types of property creates economic inefficiency. The inefficiency arises because the tax differential creates an incentive for the economy to have more of the untaxed property, even though the productivity of B capital has not risen. If the initial long-run supply R_0 represents the marginal social cost for both types of capital and initial demand the marginal social benefit, the tax differential induces an increase in the amount of type B capital so that marginal cost is greater than marginal benefit. Similarly, the reduction in the amount of type A capital causes its marginal benefit to be greater than marginal cost. Because marginal social cost no longer equals marginal social benefit in each market, the change has reduced economic welfare or created an efficiency cost. The economy is supplying too much type B capital and too little type A.

Implicit in this discussion is an assumption that capital is perfectly mobile: profit-maximizing investors will always attempt to earn the highest possible return or profit, whereas consumers of these capital services are immobile, that is, unable to shift between the two types of properties. What happens if these assumptions are incorrect? If investors do not or are prevented from altering their investment types in response to the tax, then all of the tax burden falls on owners of taxed property. Essentially, the situation is again that represented in Figure 14–1.

If users of these types of capital can switch from one to the other, then the equilibrium we have identified is temporary. Because the consumer's price for type A property is now greater than that for type B property, the demand for type A property is expected to decrease and the demand for type B property to increase. As a result, the price charged for type A property will decline and the price charged for type B property will increase until the prices are equal again, meaning that investors in type A property will earn lower net returns than investors in type B property. Because of the differential tax on type A property, it is impossible for investors in both types of property to earn equal net returns *and* for users of both types to be charged the same price. Economists usually assume it is easier for investors to move investments among different types of capital than it is for users of capital to change demand. For instance, if capital owned by profit-making businesses is taxed while capital

used by nonprofit entities is exempt, the tax treatment of the property depends on its use, not any inherent characteristic of the property. To avoid the higher prices, profit-making firms would have to become nonprofit entities to consume type B property.

Differential Tax Rates by Location

In the above example, all taxed property was taxed at a uniform rate, which is also unrealistic. The next step, then, is to extend the analysis by considering taxation of identical property at different tax rates by different jurisdictions. This extension is easy, however, because it is analytically identical to the case just considered and represented in Figure 14–2, with type A capital now representing property in jurisdiction A and type B capital representing property in lower-tax jurisdiction B. Although the example reflects some tax in A and no tax in B, it is just as applicable to a situation where there is some tax in B, say $30 per thousand of assessed value, and a higher tax in A, perhaps $35 per thousand. Only the *differential in tax rates* will influence movement between the localities.

The initial effect of the higher tax in A is to lower the rate of return received by owners/investors in A compared to that available in B. If capital is mobile, investors are expected to shift their investments from jurisdiction A to jurisdiction B. The resulting reduction in the supply of property in A raises the value of or return from that which remains, while the increase in supply of property in B reduces the return from that property. Again, an equilibrium is reached when the net-of-tax returns available to investors in both jurisdictions are equal. For that to happen, the user's cost of capital must be greater in jurisdiction A than in B; users of capital face higher costs in A, the higher-tax jurisdiction. The effect of the differential in tax rates between the jurisdictions is therefore to reduce the amount of property and increase the user's price for property in the higher-tax jurisdiction, with just the opposite effects in lower-tax jurisdiction B.

As before, *some of the tax burden from the higher-tax jurisdiction is shifted to property owners in the lower-tax jurisdiction* through the decrease in the rate of return, which is caused by the increased supply. If users of capital also are mobile, the story continues. Because the price (rental charge) for capital is greater in A than in B, some users of capital might move their operations to B in an attempt to enjoy those lower prices. That shift of demand would reduce prices in A, the higher-tax jurisdiction, and raise them in B. The outcome of this chase depends on the relative mobility of suppliers compared to demanders. Remember that capital or property in this discussion is considered an input into production, so the users of capital are firms that produce goods and services and households who own their residences and are thus "producers" of their housing services. Therefore, one additional step is necessary to determine the effect of the differential capital (property) tax on prices of other goods and services. This step is to consider what happens to the return to supplies of other factors of production and to the prices of consumer goods.

Labor If capital is mobile, the higher tax rate in jurisdiction A causes less capital to be invested in that jurisdiction, which is expected to affect the demand for labor in jurisdiction A as well. If labor and capital are complementary, then the reduced amount of capital investment also will reduce the demand for labor, causing wages in jurisdiction A to fall. Just the opposite happens in jurisdiction B, where increased capital investment causes an increase in demand for labor and an increase in wages. If workers do not or cannot change jobs in response to these wage changes, the story stops; part of the differential property tax burden in A has been shifted to workers in A. But if workers are mobile and do respond to the change in relative wages, the supply of labor will fall in A (driving wages back up), and the supply in B will rise (driving wages down). In that case, the effect of the property tax differential in A is a reduction in employment in A rather than a change in wages.[3]

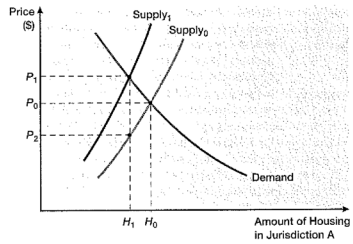
Local Consumer Goods (Housing) The changes in the user prices of capital in jurisdictions A and B, caused by the difference in property taxes, also are expected to affect the prices of goods produced and consumed locally that use capital in the production process. Because the user's price of capital (the rental rate) has increased in jurisdiction A, one expects that the prices of local goods that are capital intensive also will rise. Chief among these goods is housing. One expects that the price of housing service in A—that is, the consumer's cost of living in a house or apartment—will rise. In contrast, the decrease in the consumer's price of capital in jurisdiction B is expected to reduce the price of housing services in B.[4]

The changes in jurisdiction A are depicted in Figure 14–3, with the shift of the supply curve resulting from the increased cost of producing housing services due to the higher property tax. The tax differential causes the cost of living in a housing unit in jurisdiction A to rise from P_0 to P_1. Note also that if there is some elasticity to demand, the net return to the owner of the housing unit also falls, from P_0 to P_2, implying that this unit will now command a lower selling price. How can the cost of living in a house go up at the same time that its market price falls? Market price falls by less than the amount of the tax, so the total cost of the house plus tax rises. Of course, if this is an owner-occupied house the distinction is irrelevant because the owner and consumer are the same person.

[3]If labor and capital are substitutes for one another, then the story is reversed: the decreased capital investment increases the demand for labor.

[4]This analysis applies to locally produced and consumed goods. Goods that are sold on a national market presumably trade at a uniform price everywhere, except for differences caused by transportation cost and the consumer's cost of discovering any arbitrage opportunities. Even for local goods, the analysis is somewhat more complicated. For instance, the price of some labor-intensive local goods could even fall if the price of labor falls.

FIGURE 14–3
Effect of a capital tax on housing prices



Just as with labor, whether the story stops or continues depends on whether housing consumers respond to the change in the relative price of housing services between the two jurisdictions. If consumers are aware of the differences and are mobile, then more consumers are expected to seek housing in B, where the price has decreased, and less in A. But the increase in housing demand in B will increase housing prices again, while the decrease in housing demand in jurisdiction A will bring housing prices down. If consumers are perfectly mobile, the resulting effect of the property tax differential, then, is a decrease in the amount of housing in A and an increase in the amount in B, but no change in the relative prices.

Land Because of the positive property tax rate differential in jurisdiction A, the amount of capital investment in A is expected to fall, with the effect of decreasing the demand for the complementary input land. Further, if housing consumers react to the increased housing service price by leaving for other jurisdictions, the demand for land will decline further. These decreases in the demand for land will reduce the price (value) of land in A. But landowners do not have the option, available to owners of other types of capital, of moving their investment (land) to a lower-tax jurisdiction; the supply of land in jurisdiction A is fixed, as represented in Figure 14–1. If all other capital, other inputs, and consumers are all mobile, then the burden of the tax differential that remains is reflected in a decreased value of land. If land is the only immobile commodity or agent, then all of the burden of the tax differential is capitalized into land values in the higher-tax jurisdiction, A in the example. Those hurt by the tax differential are the landowners in jurisdiction A at the time the tax was increased (while landowners in B benefit).

Putting the Analysis Together

The actual property tax environment, with effective tax rates differing by location and sometimes by type of property, can be analyzed by combining the three different theoretical scenarios presented above. For instance, suppose that a third of all jurisdictions tax property at an effective rate of 2 percent, another third at 3 percent, and the final third at 4 percent (and all have equal amounts of property), so that the average effective rate is 3 percent. This is equivalent to a national tax at that 3-percent rate coupled with an additional 1-percent tax levied by one third of the subnational jurisdictions and a 1-percent subsidy (a negative tax) provided by another third. Analysis of the actual situation is equivalent to analysis of a national 3-percent tax coupled with analysis of the effects of the one percentage point differential from that average existing in some of the jurisdictions.

The effect of the average property tax rate, which can be thought of as a national tax at that rate, is a reduction in the return (income) from capital ownership and is thus a burden imposed on all owners of capital or property, as discussed above and depicted in Figure 14–1. Recall that this burden falls on owners of all types of property if capital is mobile, regardless of whether a particular type of property is taxed directly, and if taxed, whether at a high or low rate. This conclusion changes somewhat if the overall amount of capital in the society (that is, from savings and investment) is reduced by the fall in the rate of return from capital, which could raise goods prices or lower labor prices in the future. In that case, the average property tax rate imposes a burden on consumers and workers as well as capital owners in the long run.

The one percentage point property tax rate differential may cause changes in the prices of some consumer goods, of labor, and of land in the different jurisdictions. The nature and magnitude of these *excise effects* depends on the relative mobility of capital, labor, and consumers, as described above.

Consider one extreme set of assumptions first: Capital is perfectly mobile, whereas workers and consumers are perfectly immobile (workers and consumers do not move their economic activity across jurisdiction boundaries because of tax-induced price differences). Under these assumptions, the effect of the tax rate differential is to cause lower wages and land values and higher prices for locally-produced consumer goods (housing) in the higher-tax jurisdictions compared to the lower-tax ones. This set of assumptions, although precisely unrealistic, may in fact be an adequate approximation (or at least a good starting point) for analyzing *interstate* tax differentials. It is costly for individuals to become aware of price differences available in other states, and individuals sometimes face substantial costs to take advantage of those price differences. In many, though not all cases, individuals have to change both their work and consumer location if they want to change either.

In one recent study, Robert Wassmer (1993) analyzes the effect of differences in effective property tax rates compared to the national average rate on property values and the quantity of property for 62 large U.S. cities for the period 1966 to 1981. Wassmer reports that a 1-percent change in the difference between the city and national average tax rate is associated with a .13 percent

decline in the value of property units in the city. Similarly, there is evidence of a decline in the number of property units in the above-average rate cities. Thus, as suggested by the theory, the excise effects from property tax rate differences serve to impose burdens on immobile factors in the higher tax jurisdictions.

The opposite set of extreme assumptions, that workers and consumers as well as capital are perfectly mobile, leads to very different results. Because price differences cause and are ultimately removed by economic mobility, the remaining effect of the tax rate differential is to lower the value of land in the higher-tax jurisdictions compared to that in the lower-tax jurisdictions. This set of assumptions, although also unrealistic, is often applied to analyzing tax differentials *within* states or metropolitan areas. Because individuals often are aware of price differences within their area and because they can change their job or residential location without changing both, the costs of mobility are less than for interstate differences. In this case, the burden of any tax differential is likely to fall on landowners of the higher-tax jurisdictions (who may or may not be residents of those jurisdictions).

A recent study by Robert Carroll and John Yinger (1994) of rental housing in the Boston metropolitan area illustrates that exact point. The authors estimate the incidence on both landlords and tenants of a $1.00 increase in city property taxes used to provide an additional dollar of city services that go to tenants. On average, landlords bear $.91 of the $1.00 tax increase, with a range among the cities from $.98 to $.70. Thus, the greater relative mobility of tenants (consumers) compared to landlords (suppliers) prevents the landlords from shifting a large share of the property tax burden to renters.

One important policy implication of this view is that who will benefit from a property tax reduction depends on how that reduction is carried out. If a national program were used to reduce property taxes in all states and localities, the principal effect is a reduction in the average rate of tax, with little or no change in the tax differential between jurisdictions. A reduction in the national average rate of tax would increase the return to all capital owners and provide a benefit proportional to the amount of capital owned. On the other hand, if one (relatively small) state acted to reduce property taxes uniformly within that state, the effect on the national average rate of tax would be insignificant, and there would be no change in the tax differentials among localities within the state. But the relative position of that state compared to all the others would be altered, with the expected theoretical effect of raising wages and land values and lowering housing prices in that state.

Similarly, suppose that only one city were to lower property taxes (holding services constant). Now the changes to both the national and state average rates of tax would be insignificant, with only the differential between this city and others in its area being altered. If the extreme set of assumptions are applied as above, the expected result is an increase in land values in the city that lowered taxes. The new, more advantageous tax differential of this city is capitalized into higher land values, benefiting those who own land in the

city at the time the tax is reduced (or when the tax reduction is announced). Accordingly, from this viewpoint it is not wise to attempt to state *the* effect from lowering (or raising) property taxes, as the expected result depends both on what all jurisdictions are doing simultaneously and on how individuals respond.

Is the Property Tax Regressive?

In his classic analysis of the property tax, published in 1966, Dick Netzer (1966, pp. 23, 40) wrote:

> In the past forty years, there has been little theoretical controversy over the incidence of the American property tax. By and large, the "conventional wisdom" is accepted. . . . In general, the results [of Netzer's analysis with 1957 data] conform with the conventional wisdom: the property tax is on balance somewhat regressive when compared to current money income.

Writing just nine years later, Henry Aaron (1975, p. 19) offered a very different view:

> Economic analysis of differential tax incidence has undergone massive revision in the last decade. As a result, opinions among economists engaged in the study of tax incidence bear little resemblance to views generally held even a few years ago. The main contribution of recent research has been to show that the patterns of gains and losses generated when a single state or locality changes property taxes will differ markedly from that appearing after a change in the nationwide use of property taxes, and that none of these patterns resembles the profile of burdens from property taxes that economists formerly described.

The analysis to which Aaron refers is what you have read in the previous part of this chapter. And although the viewpoint articulated by Netzer was held by economists and policymakers for more than 50 years, the analysis in this chapter is now certainly the "new conventional wisdom" among economists and increasingly among policymakers as well.

The long-standing notion that property taxes are regressive (that is, impose a more-than-proportionate burden on lower-income families and individuals) arose from a simple theoretical proposition and two statistical observations. It was assumed that property taxes operated as excise taxes on commodities and increased the price of the taxed goods. Residential property taxes were therefore assumed to increase the price of housing services and thus impose a burden in proportion to the amount spent on housing consumption. Nonresidential property taxes were assumed to increase the prices of goods produced with that property, thereby imposing a burden in proportion to the amount spent on consumption of goods, excluding housing. Because it is known that both annual consumption and housing expenditures are a greater

TAXATION AND ECONOMIC DEVELOPMENT

A Blueprint for Tax Reform in Ohio

ROY BAHL
Editor

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tive of the owner, he or she can be thought of as paying a property tax of 50 mills with the state providing a transfer (credit) to the property owner equal to 5 mills on the assessed value. While the state does not actually make the payment to the individual, the outcome is the same whether the owner pays 50 mills to the local jurisdiction and gets a credit directly from the state, or pays 45 mills and the local government gets a payment from the state. Thus, the credit programs can be considered as either a grant to the local government or as a transfer to property owners.

The current credit program is essentially an open-ended entitlement program; the more property tax revenue raised by the local jurisdiction, the more the state pays. As it currently operates, the annual cost to the state is not under the control of the state.

From the perspective of a program of grants to local governments, the program is designed such that the state government gives the local jurisdiction $1 for every $9 the local government raises locally. Thus, it rewards those jurisdictions that raise more property taxes, providing an incentive to use property taxes. This means that those jurisdictions that rely heavily on sales or income taxes are penalized.

As a grant program to local governments, no consideration is given to the fiscal condition of the local jurisdiction. Since the two rollback programs provide transfers, either to the local government or the owners, equal to a constant percent of taxes paid, and since wealthy districts raise more property taxes, the grants go to districts that are less in need. There are many alternative designs for a grant program to local governments that might be considered. A grant program could be designed in which the size of the grant depends inversely on available resources, measured, for example, by property wealth or income per capita, and directly on need, measured, for example, by the expenditures needed to provide some standard set of services with a certain level of quality. Much work has been done at trying to design such a system (see Ladd and Yinger 1989). Since nearly 70 percent of property taxes is raised by school districts, the funds for schools could be rolled into the school funding formula.

If the rollback program was eliminated, local governments would be expected to increase local taxes to make up for the loss in state funds. However, without the grant program, the cost to the local taxpayers for each $1.00 of expenditures will now cost $1.00 rather than $0.90.[68] Thus, the local government is not expected to increase taxes to make up fully for the loss of grants. It is also expected that local governments would attempt to adjust the current revenue mix away from property taxes to other revenue sources.

As relief programs to taxpayers, there are issues of equity and need inherent in the current rollback programs. First, the credit program provides property tax relief to all property owners, not just residential property owners, although only the 10 percent credit applies to nonresidential property. The issue of whether nonresidential property should receive the same reduction as residential property is a difficult one. It is not appropriate to talk about equity between individuals and businesses, and the notion of ability to pay does not apply to businesses.[69] On the other hand, taxing residential property at a lower rate than commercial and industrial property could lead to misallocation of resources.

Second, the current credit program provides the same percentage relief to individuals regardless of income except for the current homestead credit, which is similar to a circuit breaker program. The homestead credit program is rather modest both in terms of who is eligible and the amount of relief that is provided.

Table 7-14 presents estimates of how the magnitude of the three property tax credit programs vary across income classes for homeowners. For the 10 percent and 2.5 percent programs, the average credit across income classes is relatively constant up to the higher income classes. The credit is a smaller percent of income for higher income classes, but the bulk of the credits go to higher income individuals; over 60 percent goes to households with income over $30,000.

If the desire or intent is to provide property tax relief to individuals, i.e., to residential property, an alternative to the 10 percent and 2.5 percent credit programs now in place is to adopt a means tested relief program in the form of a circuit breaker.[70] This would essentially expand the current homestead exemption credit, which is a form of a circuit breaker. While the focus here is on residential circuit breakers, similar programs could be designed for businesses.

INCIDENCE OF THE PROPERTY TAX

With the exception of the corporate income tax, the incidence of the property tax is the most unsettled question in tax incidence analysis. The literature refers to the "old view" and the "new view" of property tax incidence.[71] Under both views, the property tax on land is borne by the owner of the land at the time the tax is imposed. Since the supply of land is perfectly inelastic, the owner can take no action to avoid the tax. An individual who purchases the land after the tax has been imposed will offer a lower price to compensate for the higher taxes he will now have to pay. In other words, the increase in the tax will be capitalized into the price of the land.

The two views differ on who bears the burden of the tax on improvements. The old view held that the property tax on structures increased the prices of goods and services and thus the tax was borne by consumers. Thus, in the case of the property tax on housing the occupant (either the owner in the case of owner occupied housing or the renter) bears the burden, while the tax on nonresidential property is born by consumers of the product produced in the facility, much like a sales tax. Since the value of housing as a

TABLE 7-14
Property Tax Rollbacks and Homestead Credits
(Homeowners Only)

Income Class (000s)	2.5% and 10% Rollback		Homestead Credit	
	Average Credit	Class As Percent Of Total	Average Credit	Class As Percent Of Total
0	$114.91	0.4	$318.80	3.6
< 1.0	93.10	0.2	144.40	1.3
1 - 2.5	108.17	0.4	217.35	3.9
2.5 - 5.0	112.81	1.4	342.95	21.6
5.0 - 7.5	104.41	2.4	269.43	31.8
7.5 - 10.0	89.51	2.4	138.74	18.4
10.0 - 12.5	87.83	2.6	82.16	12.3
12.5 - 15.0	85.72	2.5	29.25	4.2
15.0 - 17.5	87.04	2.8	16.07	2.6
17.5 - 20.0	87.20	2.8	-0-	
20.0 - 25.0	93.60	6.3	-0-	
25.0 - 30.0	98.08	6.7	-0-	
30.0 - 35.0	102.63	7.2	-0-	
35.0 - 40.0	109.23	7.3	-0-	
40.0 - 50.0	120.34	13.9	-0-	
50.0 - 75.0	146.22	22.7	-0-	
75.0 - 100.0	191.85	8.5	-0-	
100.0 - 150.0	248.27	5.4	-0-	
> 150.0	346.70	4.1		

Source: Author's estimates based on *1990 Census of Population and Housing, Public Use Micro Sample.*

share of income is smaller the greater the income, the property tax was considered highly regressive.

The new view is that the owners of capital bear the burden of the property tax on structures and equipment. If the stock of improvements and equipment is fixed, at least relative to the labor force, then if a uniform tax is imposed on the value of all capital throughout the economy, capital owners are unable to shift the tax burden unto either the consumer of goods and services or labor. Thus, the owners of capital bear the burden. However, property tax rates vary between jurisdictions. In response to the differential tax rates, capital will migrate from high tax jurisdictions to low tax jurisdictions. For example, consider rental units. If the tax rate is low in one jurisdiction, more rental units will be built there. This will lower the rent on units in that jurisdiction, and correspondingly, raise the rent in the higher tax jurisdictions. Thus, the new view holds that the return to capital falls as a result of the tax on capital, but consumers face differential prices across jurisdictions, some paying more and some less. On average, consumers bear no burden.

The basic theory inherent in the new view is generally accepted. However, the specific conclusion of the new view depends upon the value of

several parameters. The debate regarding the incidence centers on these value of these parameters.

The theory applies to the question, what is the incidence of a national property tax? The answer we get will be different if we ask, what is the incidence of an increase in the property tax rate within one jurisdiction? If the jurisdiction is small relative to the market for capital, then we can assume that the price of capital will not change. In response to the higher tax rate, capital will have an incentive to leave the jurisdiction. In order to retain the capital, the price of land or labor must decrease or the price of the product must increase. What happens depends upon the responsiveness of the various factors of productions and consumers to changes in taxes and prices. If labor is relatively mobile and if close substitutes are available to consumers, then the price of land will fall as demand for it decreases. But it is also possible to build a case for either the consumer or labor bearing part or all of the increase in the tax.[72] In all cases, however, the tax on owner occupied housing is born by the owner.

Despite this uncertainty regarding the incidence, the commonly adopted assumption is that an increase in property tax rates will be passed along in the form of higher prices. For owner occupied and rental housing, this means that the occupant will bear that part of the tax increase. For other goods and services, part of the tax is exported to consumers in other jurisdictions, while the remainder will be born by consumers in the form of a broad based sales tax.

We calculated the incidence of a statewide 5 mill property tax (effective rate) on housing, owner occupied and rental. The calculations were based on the *1990 Census of Population and Housing, Public Use Micro Sample*. The data provide information on income, property taxes paid by owners, and rent paid by renters. We had to make an assumption regarding the proportion of rent that is accounted for by property taxes which we took to be 12 percent of rent. We present results showing the effective tax rate (tax payments within the class divided by income within the class) both with and without the reduction in the tax payments for the 10 percent and 2.5 percent rollbacks, and homestead credit. Table 7-15 presents the results of the calculations. As can be seen, such an increase in the property tax is highly regressive, with or without the various credits.[73] The difference between the effective tax rate with and without the credits is somewhat larger for lower income households, due to the homestead credit, but for most income classes the difference in the effective rates is about the same. The effect of the credits is thus to slightly reduce the regressivity of the property tax.

There are few studies that have examined the incidence of the residential property tax in isolation, so there is no professional consensus as to the accuracy of these assumptions and calculations. Three studies which address the incidence of the residential property tax come to different conclusions. Setting aside the burden on the lowest income class due to data problems,

TABLE 7-15
Incidence of a 5-Mill Increase in the Property Tax Rate: Residential Only

Income Class	Effective Tax Rate	
	With Credit	Without Credits
1,001 - 2,500	5.27%	5.58%
2,501 - 5,000	1.97%	2.11%
5,001 - 7,500	1.31%	1.45%
7,501 - 10,000	0.99%	1.09%
10,001 - 12,500	0.81%	0.88%
12,501 - 15,000	0.70%	0.74%
15,001 - 17,500	0.63%	0.66%
17,501 - 20,000	0.54%	0.57%
10,001 - 15,000	0.47%	0.50%
25,001 - 30,000	0.39%	0.42%
30,001 - 35,000	0.33%	0.36%
35,001 - 40,000	0.29%	0.32%
40,001 - 50,000	0.25%	0.28%
50,001 - 75,000	0.21%	0.24%
75,001 - 100,000	0.19%	0.21%
100,001 - 150,000	0.18%	0.20%
150,001 and higher	0.15%	0.17%

Source: Author's calculations based on *1990 Census of Population and Housing, Public Use Micro Sample*

Netzer (1966) and Harmon (1989) find rough proportionality, ACIR (1973) and Folkman and MacDonald (1993) find fairly sharp regressivity. The studies are not strictly comparable due to differences in coverage, methodologies and definitions.

The Minnesota Department of Revenue (1993) recently published a detailed and extensive study of the incidence of Minnesota taxes. For the property tax on residential property, the study found that the property tax was relatively proportional, with a somewhat larger effective tax rate at the lowest income class and the middle income class. The results are driven by the assumption that landlords bear a large proportion of the tax on rental property. This result is consistent with other studies based on the new view that capital bears the burden of the property tax.

A further issue regarding the incidence is the use of annual income on which to compute effective tax rates. Since income varies from year-to-year, it is more appropriate to measure incidence on the basis of average income over several year, perhaps even one's lifetime. Fullerton and Rogers (1993) conducted such a study and found that for the property tax, the effective tax rate was U-shaped, i.e., decreasing over lower incomes and increasing over higher incomes, when income was measured on the basis of lifetime income. Metcalf (1994) also estimated the lifetime incidence of the property tax and concluded that it is regressive. Clearly, there is no consensus regarding the

incidence of the property tax. However, it does appear that the residential segment is regressive, while the entire property tax for a state is close to proportional.

CIRCUIT BREAKER PROGRAM[74]

INTRODUCTION

The presumed regressivity of the tax on residential property has been used to justify the institution of relief schemes designed to blunt the burden of that tax on lower income taxpayers. Most states have enacted some policy designed to provide progressive relief of property taxes imposed on households. This section presents several circuit breakers plans as an alternative to the current credit programs. The characteristics of circuit breaker plans in other states are summarized and the effects of several particular plans which could be implemented in Ohio are simulated. A summary of the features of the circuit breaker programs in other states is provided by the ACIR (1993). Ohio's homestead credit does qualify as a circuit breaker, but it is a very simple and minor program.

A property tax circuit breaker is a property tax relief program that reduces the tax burden, or effective tax rate, of the residential property tax. If the property tax burden for a household exceeds a certain threshold, a portion of the excess is relieved, usually by a refundable credit on the taxpayer's state income tax bill. Such a program is especially suited to providing relief to homeowners whose current income is low relative to their property wealth, as may happen with retirees. However, circuit breakers have been criticized for providing more relief to those with greater property wealth (holding income constant), and for providing forgiveness of tax liabilities when deferral may be more appropriate (such as in the case of those with temporarily depressed income or retirees).[75]

Circuit breaker programs offer policy-makers flexibility in terms of establishing a standard for excessive property tax burdens and the use of eligibility standards permit programs to be targeted to particular classes of taxpayers, in terms of income, age, ownership status, or particular classes of property, such as residential or agricultural. Finally, since the relief is usually provided through an income tax credit, circuit breaker programs can be, and are often designed to provide benefit to renters as well.[76]

In 1992, thirty-four states and the District of Columbia had some form of circuit breaker program. The specifics of these programs vary considerably across states, but to the extent information is available and comparable, some summary and comparison can be made. Of those states with programs, five limit eligibility to homeowners and twenty-eight make some provision for renters. The renters' eligibility is based on a presumption that some frac-

Reflections on the New View and the Benefit View of the Property Tax

by George R. Zodrow

In a special report, George R. Zodrow of Rice University analyzes the differences between the "new view" and the benefit view of the property tax.

Date: May 22, 2000

========== SUMMARY ==========

In a special report, George R. Zodrow of Rice University analyzes the differences between the "new view" and the benefit view of the property tax.

The new view concludes that the property tax is a tax on capital and is thus quite progressive, while the benefit view argues that the tax involves no redistribution.

========== FULL TEXT ==========

Introduction

[1] One of the more controversial -- and more interesting -- issues in state and local public finance is the incidence of the local property tax. There are two popular competing views of the effects of local use of the property tax. One is the "benefit view," which was developed initially by Hamilton (1975, 1976), Fischel (1975), and White (1975) and is articulated by Hamilton (1983) and by Fischel (1985, 1992) and in this report. [1] The benefit view, which is an extension of the well-known Tiebout (1956) model of local public expenditure determination, argues that consumer mobility and interjurisdictional competition, coupled with the appropriate voting behavior and zoning regulations and/or capitalization of local fiscal differentials into house prices [2] converts the local property tax into a benefit tax -- a payment for local public services received. Under this view, the property tax is a nondistortionary user charge that has no effect on either the allocation of capital (including housing capital) or the level of local public expenditures, and does not result in any interjurisdictional redistribution of income.

[2] In marked contrast, the so-called "new view" of the property tax, developed by Mieszkowski (1972) and extended by Zodrow and Mieszkowski (1983, 1986), argues that the property tax is a distortionary tax on the local use of capital. Under this view, property tax rates that exceed the national average reduce the amount of capital in a jurisdiction, with capital migrating to relatively low-tax jurisdictions; opposing effects occur in relatively low-tax jurisdictions. Property tax differentials thus result in an inefficient allocation of the national capital stock. In addition, as developed by Zodrow and Mieszkowski (1986), Wilson (1986), and numerous subsequent authors, concerns about the extent to which use of the property tax may drive capital out of a jurisdiction creates a tendency for local governments to choose an inefficiently low level of public services.

[3] With respect to incidence issues, the new view concludes that the "average burden" of all of the property taxes imposed across the nation is borne by capital owners generally -- the "profits tax" effect of the tax -- which implies that the tax is relatively progressive (with respect to annual income) and thus redistributive in its incidence. In addition, property tax differentials about the national average result in "excise tax effects" in the form of housing and commodity price increases and wage and land price declines in relatively high-tax jurisdictions that are accompanied by offsetting housing and commodity price declines and wage and land price increases in relatively low-tax jurisdictions. The distributive effects of these price changes tend to cancel, so that from a national perspective the profits tax effect is the primary factor affecting the distribution of the tax burden, and the new view implies that the property tax is a progressive tax. By comparison, the excise tax effects affect the national distribution of income in only a secondary way -- for example, there should be some increase (decrease) in the progressivity of the tax to the extent that high- income individuals tend to live in relatively high- (low-) tax jurisdictions. Thus, as stressed by Oates (1994, p. 142), the choice between the new and benefit views of the property tax "is an important matter (as) the two views have fundamentally different implications both for the efficient functioning of the local public sector and for the incidence of local property taxes." [3]

[4] This paper reviews the benefit view/new view debate. It begins with a discussion of three different ways of modeling the new view, each of which offers different insights into its operation, and then provides a brief overview of models of the benefit view. It then turns to a discussion of ways of choosing between the two views, including both theoretical arguments and relevant empirical evidence. The paper then provides a brief overview of the large literature that examines the potentially distortionary effects of use of property tax finance on the level of local public services. A short summary and some final thoughts on future research are offered in the conclusion.

The New View of the Property Tax

[5] Several different models of the new view of the property tax have been constructed, each of which offers different insights into its operation and implications. The basic intuition underlying the new view is most easily seen within the context of its initial exposition by Mieszkowski (1972). At the time of publication of that paper, the traditional analysis of the property tax was partial equilibrium in nature, focusing on the effects of the imposition of the tax by a single jurisdiction facing a perfectly elastic supply of capital. [4] Under these circumstances, the traditional view argued that capital bears none of the tax, and generally concluded that consumers -- of housing or of the output produced by taxed nonresidential capital -- bore the full burden of the tax.

[6] Mieszkowski argued that this partial equilibrium analysis ignored the general equilibrium effects of widespread use of the property tax by virtually all local jurisdictions in the economy. Adapting the Harberger (1962) general equilibrium model of tax incidence (which is characterized by two production sectors: a fixed national capital stock, and fixed government service levels) to the case of local use of the property tax, he modeled the economy as consisting of relatively high-tax and relatively low-tax jurisdictions. Given the assumption that the overall national supply of capital is perfectly inelastic, such an analysis

indicates that capital owners as a group bear the average burden of property taxation in the nation. [5] Mieszkowski termed this the "profits tax" component of the incidence of the property tax, and stressed that it implied that the incidence of the tax was highly progressive, as capital ownership is concentrated among the wealthy. This result was of course in marked contrast to the traditional view of the tax, which suggested that its incidence was roughly proportional to consumption and thus tended to be regressive or perhaps roughly proportional. Note that this average burden of the tax does not distort the allocation of capital in the economy, as capital bears the average burden of the tax regardless of its location.

[7] By comparison, capital escapes entirely the burden of tax differentials about the average level of property taxation in the economy in the Mieszkowski model. In relatively high-tax jurisdictions, the property tax drives out mobile capital, lowering the productivity of local factors of production (land and labor) and thus the competitive returns to these factors, and raising housing and commodity prices. Simultaneously, capital is attracted to relatively low-tax jurisdictions, where wages and land prices rise while housing and commodity prices fall. Mieszkowski termed these the "excise tax" effects of the property tax, and noted that they tended to cancel in the aggregate. Thus, as noted above, the profits tax component of the tax is the primary factor determining its incidence under the new view, with the excise tax effects playing a secondary role. In addition, the excise tax effects clearly distort the allocation of capital in the economy, with capital migrating away from high-tax jurisdictions to low-tax jurisdictions until after-tax returns to capital are equalized across all jurisdictions. Finally, note that a possible outcome under the new view is that consumers in a high-tax jurisdiction bear the full burden of their excise tax differential in the form of higher commodity prices. Thus, the traditional view of the property tax can be viewed as a special case of the new view, as applied to the tax differential in the jurisdiction, relative to the average rate of taxation in the economy.

[8] Although the Mieszkowski derivation of the new view provides the most transparent exposition of its basic tenets, it is incomplete because it is based on the Harberger general equilibrium model of national tax incidence and thus does not consider many of the aspects of local government use of the property tax stressed by proponents of the benefit view. In particular, local public services are fixed in the original Mieszkowski derivation and the interjurisdictional competition that is an important component of the benefit view is ignored. By comparison, the Zodrow-Mieszkowski (1986) reformulation of the new view of the property tax is designed to take such factors into account. [6]

[9] Specifically, the Zodrow-Mieszkowski reformulation differs from the original new view model in four critical respects. First, rather than specifying local public expenditure levels exogenously, local governments are assumed to compete along Cournot-Nash lines in the model (taking the fiscal policies of other jurisdictions and the return to capital as fixed) so that local taxes and expenditures are endogenous. Second, rather than ignoring the effect of local public services on individual utility levels, the model includes services explicitly in individual utility functions and allows individuals to differ in their tastes for public services. Third, the model allows for the segregation according to individual tastes for local public services stressed by Tiebout (1956) and proponents of the benefit view; indeed, as in most models of the benefit view, individuals in each community are homogeneous with respect

to their tastes for public services. Finally, the model includes a simple form of land use zoning.

[10] The mechanism by which property taxation is introduced into the model is as follows. The initial equilibrium is assumed to be characterized by head tax (benefit tax) finance, with individuals sorted into jurisdictions according to their relative demands for public services. Land use zoning is limited to fixing residential and nonresidential land use at their initial efficient levels. A restriction on the use of head tax finance is introduced, with the resulting revenue shortfall covered by introducing a property tax on both residential and nonresidential property.

[11] The results of this analysis demonstrate that adding all of these various "Tiebout-type" features to the new view model does not change its basic results. Explicit expressions are derived for the profits tax and excise tax components of the incidence of the property tax, which have precisely the effects described above. (In addition, interjurisdictional competition in the model leads to a tendency for local governments to under-provide public services, a point that is discussed further later in the paper.) Thus, the central message of the Zodrow-Mieszkowski reformulation is that adding a variety of Tiebout-type features to the standard general equilibrium model of the new view is not sufficient to reverse its general conclusions, as long as (1) capital is mobile across jurisdictions in response to interjurisdictional property tax differentials, and (2) capital is fixed in total supply at the national level.

[12] These two derivations of the new view focus on the incidence of a national system of property taxes. Although such results are of considerable importance from both a theoretical and a practical standpoint, the local character of the property tax implies that the effects of a single jurisdiction increasing its reliance on the property tax are of equal or greater interest. In addition, an understanding of the incidence of tax changes initiated by a single independent jurisdiction facilitates comparisons with derivations of the benefit view, which typically focus on the actions of independent local jurisdictions. At first glance, it might appear that the new view is largely irrelevant to the analysis of a tax increase by a single small jurisdiction, as models of the economic effects of tax changes by such a "small open economy" typically assume that it faces an infinitely elastic supply of capital; this in turn implies that the tax policies of a small jurisdiction cannot affect the after-tax return to capital. [7] Indeed, as noted above, this is the assumption underlying the development of the traditional view of the incidence of the property tax.

[13] However, Zodrow and Mieszkowski (1983), [8] following the work of Brown (1924) and Bradford (1978), demonstrate that such a view can be misleading; in particular, the new view can in fact be derived in such a context as well. The intuition behind this result is as follows. Consider an increase in the property tax on capital by a small local jurisdiction. Such a tax increase will drive mobile capital from the small taxing jurisdiction to all of the other jurisdictions in the economy, depressing the overall return to capital very slightly. Although it is reasonable from the perspective of the taxing jurisdiction to neglect this small effect and thus treat the return to capital as essentially fixed, this effect is important from a national perspective. Specifically, even though the reduction in the return to capital is very small, it naturally affects a very large capital stock. Moreover, the amount of revenue raised

by the small taxing jurisdiction is also small, relative to the size of the entire economy. Indeed, Mieszkowski and Zodrow show that under certain circumstances the overall reduction in national capital income precisely equals the amount of revenue raised by the taxing jurisdiction -- that is, capital bears the full burden of the tax. This of course is simply the profits tax effect of the new view, as applied to an increase in the property tax by a single small local jurisdiction.

[14] Most interestingly for the purposes of the analysis in this paper, this version of the new view in no way obviates the standard analysis of the incidence of a tax on capital by a small taxing jurisdiction, which concludes that the tax is borne by local factors of production or local consumers. [9] This effect occurs simultaneously, as the tax-induced outflow of capital from the taxing jurisdiction implies lower returns to relatively immobile factors such as local land and labor and/or higher prices to local consumers. Indeed, for a sufficiently small economy -- a condition that would describe virtually all local jurisdictions -- Kotlikoff and Summers (1987) show that the tax burden borne by local factors is roughly equal to the total burden of the tax. The case in which the entire tax burden is shifted forward to consumers of course corresponds to the "traditional view" of the incidence of the property tax. More generally, the local burden of the tax is shared between consumers and the owners of local factors.

[15] This analysis thus implies that under the new view -- just as under the benefit view -- there is a close link between local expenditures in a jurisdiction and the burden of the property tax; that is, the burden of financing local expenditures largely falls on local factor owners and local consumers in the taxing jurisdiction. Indeed, to the extent that local landowners (in particular, homeowners) reside in the taxing jurisdiction and increases in consumer prices are limited to goods (including especially housing) that are produced and consumed locally, [10] this derivation of the new view clearly has a striking benefit view flavor -- the burden of increases in local government expenditures financed with increases in the local property tax tends to be borne entirely by local residents. The primary difference between this "benefit view" version of the new view and the actual benefit view is that the mechanism for achieving this result under the former is different than under the latter, as the burden of the tax on local factors and consumers under the new view arises due to the outflow of capital in response to the imposition of the tax.

[16] Thus, as in the two previous derivations of the new view, the property tax distorts the allocations of capital (and tends to result in the underprovision of local public services). Nevertheless, for the equilibrium level of services that results, the new view implies that the residents of the jurisdiction who benefit from local public services bear the burden of the tax.

[17] Finally, Mieszkowski and Zodrow also show that the burden of the use of the property tax by a single taxing jurisdiction on local factors of production and local consumers is offset by opposing effects on the analogous factors of production and consumers in all of the nontaxing jurisdictions. That is, the outflow of capital from the taxing jurisdiction to all of the nontaxing jurisdictions raises returns to relatively immobile factors and reduces consumer prices in those jurisdictions. As in the standard new view derivation, all of these "excise tax" effects tend to cancel in the aggregate, so that from a national perspective the

main distributional effect of the use of the property tax by a single taxing jurisdiction is a reduction in the net return to capital -- even though the distributional effects of the tax increase are very different from the perspective of the local jurisdiction. [11] Thus, in an important sense there are two "burdens" of the use of the property tax by a single taxing jurisdiction -- (1) the national burden, which is primarily reflected in a reduction in the overall return to capital in the economy, and (2) the local burden, which is borne by local labor and landowners as well as the consumers of locally produced goods, and accompanied by offsetting effects on factors of production and consumers in all other jurisdictions. The existence of these two simultaneous tax burdens is the key factor giving rise to this benefit tax aspect of the new view.

The Benefit View of the Property Tax

[18] By comparison, property taxation is entirely nondistortionary under the benefit view of the tax, with efficiency achieved in both the allocation of capital and the level of public expenditures in each local jurisdiction. The benefit view is an extension of the Tiebout (1956) view of local public good provision. Under this view, the combination of interjurisdictional competition (with a sufficiently large number of jurisdictions so that each level of demand for public services can be satisfied) and perfectly mobile consumers "voting with their feet" ensures that local communities are homogeneous with respect to individual demands for local public services; in these Tiebout communities, local public services are provided at an efficient level.

[19] In the original version of the Tiebout model, the likelihood of obtaining an efficient equilibrium was enhanced by the assumption that all jurisdictions relied exclusively on head tax finance. In reality, the most important own source of revenue at the local level is the property tax. The Tiebout model was extended to accommodate property tax finance in important contributions by Hamilton (1975, 1976).

[20] Hamilton (1975) extends the Tiebout analysis in four ways. First, local public services are assumed to be publicly provided private goods, so that the per capita costs of providing public services is constant and community size is irrelevant to the efficient provision of public services. [12] Second, local services are financed with a residential property tax. Third, the housing market is modeled explicitly, and there are enough communities to satisfy all combinations of demands for housing and public services; as stressed by Ross and Yinger (forthcoming) this implies that the supply of housing associated with any desired tax and expenditure package is perfectly elastic. Finally, strict zoning ordinances, which specify the minimum value of housing in the community, are also assumed to be available to the local government.

[21] The implications of the Hamilton (1975) model are striking. Most importantly, all communities are homogeneous not only with respect to public service demands (as in the Tiebout model) but also with respect to housing consumption. The rationale underlying the result of community homogeneity with respect to house values proceeds in two steps. First, strict zoning establishes a minimum house value for a community. As a result, it is impossible for households to purchase a home with a value below the minimum and thus enjoy the public services provided by the community while paying property taxes lower

than those assessed on the minimum-value home. Second, households that wish to purchase a home of greater value than the minimum value in a given community will never choose to reside in such a community because they would be subsidizing -- through their payment of relatively high property taxes -- the public good consumption of the rest of the community. Instead, such households would simply choose to move to a more affluent homogeneous community where their desired level of housing consumption equaled the minimum house value specified by zoning ordinances (and such a community is always available by assumption).

[22] Under these circumstances, individuals cannot adjust their housing consumption in response to the imposition of -- or an increase in -- the property tax. As a result, the property tax is effectively converted into a head tax. Individuals are sorted according to both tastes for housing and tastes for public services and, as in the original Tiebout model, the allocation of resources to the public sector is efficient as the property tax is effectively a lump sum tax assessed as payment for local public services provided. [13] In addition, the allocation of capital to housing is efficient, and no redistribution of income across households occurs through the local public sector.

[23] An obvious problem with the Hamilton (1975) model is that homogeneity with respect to house values is seldom if ever observed even in suburban communities. Hamilton (1976) addresses this issue in a model that includes communities that are heterogeneous with respect to house values (although still homogeneous with respect to public service demands). [14] Two additional assumptions are required for the "heterogeneous communities" version of the Hamilton model. First, all communities are fully developed. As noted by Mieszkowski and Zodrow (1989), this assumption imposes a type of "heterogeneous zoning" constraint on the model in the sense that housing consumption is fixed regardless of any changes in the level of property taxation. In particular, the reduction in housing capital in response to an increase in the property tax that would occur under the new view is precluded by assumption. Second, even though Hamilton assumes that the communities that are the focus of his analysis are heterogeneous, he also assumes that homogeneous communities are still available to all of the different types of households as well. This assumption implies that no high-income household would be willing to pay any property tax in excess of benefits received, because it always has the option of moving to a homogeneous high-income community. Under these conditions, a relatively expensive home in a heterogeneous community sells at a discount, equal to its "fiscal differential" -- the present value of all future property taxes in excess of benefits received. Moreover, because the only option facing low-income households who wish to reside in a heterogeneous community is a homogeneous community with relatively low housing values and public services, such households are willing to pay a premium to live in the heterogeneous community; the amount of the premium is the present value of all future benefits received in excess of property taxes paid. Thus, the Hamilton model is characterized by perfect capitalization of any fiscal differentials, and the property tax is again effectively converted into a head tax or a benefit tax, once variations in housing prices are considered along with explicit property taxes paid.

[24] Finally, the view of the property tax as a benefit tax in the presence of the appropriate zoning ordinances has been extended by Fischel (1992, 1993, 1995). Focusing primarily

on the Hamilton (1975) model, Fischel argues that zoning ordinances, defined comprehensively to include a wide variety of land use regulations, are sufficiently restrictive to convert the property tax into a benefit tax. He stresses that zoning ordinances are not limited to specifying minimum lot sizes (and one home per lot), but can encompass a wide variety of other regulations, including restrictions on setbacks, height limits, differential building standards, requirements for off-street parking, restrictions to single family use, and minimum square footage, as well as designation of certain areas as off limits for environmental or other reasons and requirements for the provision of infrastructure at the expense of the developer.

[25] Fischel (1992, p. 171) argues that this wide range of zoning tools is sufficiently flexible to imply that local governments have a great deal of control over the capital stock, and in general he concludes that the benefit view approximates reality, as zoning imposes strict limits on housing consumption. Although he concedes that such "regulations do not always ensure that the last dollar paid in taxes equals the taxpayer's marginal willingness to pay for local services"; he stresses that they are sufficient to prevent "wholesale free riding on local public goods."

[26] In addition, Fischel (1992, p. 174) emphasizes that the property tax will be a benefit tax as long as "local politics insists that development pay its own way" in the sense that aggregate taxes paid by a new development cover the costs of providing it with public services. He argues that such a result is very likely to obtain in the relatively homogeneous suburban areas that are most likely to avail themselves of zoning tools.

[27] Finally, in his article, Fischel stresses that a wide variety of empirical studies, especially the comprehensive work of Yinger, Bloom, Boersch-Supan, and Ladd (1988), have found evidence that property taxes and local public service expenditures are capitalized into house values. He argues that fiscal "capitalization is everywhere" and that the existence of such capitalization -- in the context of a model in which local governments are analogous to "municipal corporations" that act to maximize the house values of their vigilant homeowner/voter "shareholders" who strive to protect the value of their housing investments -- is sufficient to make the property tax a benefit tax at the local level. [15]

Choosing Between the Two Views

Validity of the Underlying Theoretical Models

[28] Both the benefit and new views of the property tax are based on standard economic models that have a long history in the public finance literature. Nevertheless, each of these models -- the Harberger (1962) general equilibrium model of tax incidence in the case of the new view and the Tiebout (1956) model of local public expenditure determination in the case of the benefit view -- are based on some fairly strong assumptions. Accordingly, each view is suspect to the extent that these assumptions are unrealistic. The main potential problems for each of the two models are considered in turn below.

The New View

[29] Consider first the new view and the Harberger model of tax incidence on which it is

based. The assumption that the national capital stock is fixed in total supply (even though capital is perfectly mobile within the nation) is essential to the new view result that capital bears the average burden of the tax is the assumption, as completely inelastic supply implies that capital owners cannot escape the average burden of the tax. However, this assumption is questionable on two grounds.

[30] First, in the context of a closed national economy, the reduction in the after-tax rate of return implied under the new view may induce a reduction in domestic saving and investment. This would in turn imply a reduction in the national capital stock and thus lower productivity and factor returns for labor and land; that is, the average burden of the tax would be partially shifted from capital to labor and land. The extent to which saving is responsive to changes in after-tax rates of return is of course a controversial issue. Although a few empirical studies and most current life-cycle general equilibrium simulation models suggest a large degree of responsiveness, most empirical studies suggest fairly modest responses. [16] Moreover, even standard life cycle simulation models are characterized by small savings responses when a precautionary motive for saving is included. [17] Thus, the importance of this caveat is unclear.

[31] Second, the U.S. economy is certainly not closed, as international capital flows are becoming increasingly important. If the United States were a small open economy, the standard analysis noted above implies that the after-tax rate of return to capital would be very nearly fixed by external market forces and domestic capital would bear relatively little of the tax, which would instead be borne almost entirely by relatively immobile land and labor. As stressed by Gravelle and Smetters (1998), this strong result must be qualified because (1) the United States is not a small open economy but rather accounts for roughly 30 percent of the world capital stock, (2) U.S. goods and international goods are not perfect substitutes (as assumed in the standard analysis), and (3) capital is less than perfectly mobile across nations. As a result, Gravelle and Smetters argue that capital in the United States bears roughly 30-90 percent of the burden of a general national tax on capital (rather than none as predicted by the small open economy model). Although the Gravelle-Smetters analysis tempers the basic point considerably (depending on the parameter values utilized in their analysis), it is still the case that international capital mobility implies that, in the context of the new view, capital is able to shift some of the average burden of the property tax to labor and land.

[32] A separate issue is that the analysis underlying the new view is clearly long run in the sense that it requires full adjustment across jurisdictions of the (fixed) national capital stock to any tax change. In the short run, capital is immobile, and a property tax increase will be borne by local capital and land owners as it is capitalized into local property values. It is only in the longer run, when the capital stock adjusts through depreciation or reductions in planned new construction and/or maintenance (as well as reallocation of the population across houses and across jurisdictions) that the new view becomes fully operative. Given the relatively low depreciation rate of housing, as well as the employment and community ties and transaction costs that limit residential mobility, it may take a considerable amount of time to reach a long run equilibrium in response to a significant increase in the level of property taxation. /18/, [19]

The Benefit View

[33] The benefit view of the property tax is an extension of the Tiebout (1956) model of local expenditure determination. As noted by many observers, the assumptions underlying the Tiebout model are fairly strong. Specifically -- see, for example, Rubinfeld (1987) -- the Tiebout model assumes (1) perfect information on the part of all individuals, (2) perfect mobility, with individuals moving only in response to fiscal factors, (3) communities that are able to attain and maintain optimal size (balancing the advantages of economies of scale against congestion effects), with each migrant paying the marginal (equal to average) cost of services, (4) no interjurisdictional externalities, (5) sufficient community choice to accommodate all tastes for local government services, (6) communities that are homogeneous with respect to tastes for public services so that public choice problems are nonexistent, (7) income that comes solely from dividends (or at least income that is generated independent of location), (8) public goods that are financed with lump sum taxes, and (9) no land or housing. As discussed at length by Rubinfeld and elsewhere, [20] all of these assumptions are strong and, even though many have been relaxed in the subsequent literature, the conditions for the existence of a Tiebout equilibrium are nevertheless quite stringent. The realism of these conditions is naturally subject to debate. For example, Rubinfeld characterizes the Tiebout view of the world as "extreme" and "narrow," while Fischel (1995) argues that "Tiebout's Model, amended to include more realistic assumptions about voting, taxation, and zoning, is a reasonably accurate representation of the economic role of American local governments." To the extent that the assumptions underlying modern versions of the Tiebout model are suspect, its basic result of efficiency in local public service provision is also questionable.

[34] Although these issues are of considerable interest, most of the debate surrounding the choice between the new and benefit views of the property tax has assumed the general validity of the underlying models and focused instead on other aspects of the choice between the two views. This approach will be adopted for the balance of the paper.

Other Dimensions of the Choice Between the New and Benefit Views

[35] As demonstrated by the three different ways of constructing the new view outlined above, there are several ways of thinking about this view of the property tax; each of these models offers different insights, and the appropriate model to consider under any particular circumstances depends upon precisely what question about the incidence of the property tax is being asked. Accordingly, the following discussion of the new and benefit views will draw at various times on all three derivations. As stressed above, a careful examination of the various derivations of the new view -- although clearly highlighting the fundamental differences between the new and benefit views -- also demonstrates that the implications for the effects of property tax of the new view are not as different from those of the benefit view as might be expected. Although this implies some convergence on the economic effects of the property tax, it also implies that it is much more difficult than one might think to distinguish between the two views, especially in terms of empirical tests of the competing views. The remainder of this section is devoted to exploring a number of such issues.

Evidence Supporting The Tiebout Sorting Mechanism

[36] As noted above, the benefit view is appropriately viewed as an extension of the Tiebout model. Accordingly, one could argue that the fact that the Tiebout "sorting" mechanism -- under which households tend to be grouped in jurisdictions that are homogeneous with respect to demands for public services -- appears to be operative, especially in suburban communities, provides some support for the benefit view. For example, Hamilton, Mills, and Puryear (1975), Pack and Pack (1977), Eberts and Gronberg (1981), Munley (1982), Gramlich and Rubinfeld (1982), and Heikkeila (1996) provide empirical evidence that the variation in variables that might be taken as proxies for (unobservable) demands for local public services, such as income and housing consumption, is significantly less within communities than across communities. The degree of intrajurisdiction and homogeneity varies in these studies; in particular, Pack and Pack (1977) find relatively little homogeneity within jurisdictions.

[37] In any case, these studies provide little information on the choice between the benefit and new views. For example, Oates (1994) notes that tendencies toward homogeneity are not a very strong test of the Tiebout model, as such tendencies are consistent with other models of locational behavior. Similarly, Ross and Yinger (forthcoming) stress that the bidding and sorting model developed by Ellickson (1971) and Henderson (1977) and extended by many others [21] implies that the local jurisdictions in which households are ordered would be far more homogeneous than under a random allocation. More fundamentally, the "Tiebout version" of the new view, constructed by Zodrow and Mieszkowski (1986) and described above, derives the new view results within the context of a model that is characterized by Tiebout sorting of individuals by taste for public services, with all desired public service/housing demand packages satisfied perfectly and all communities homogeneous with respect to both housing and public service demands. Thus, evidence that supports the general operation of the Tiebout sorting mechanism does not provide compelling evidence for either the benefit view or the new view.

The Elasticity of Supply of Communities

[38] The Hamilton (1975) model assumes the existence of a sufficient number of communities to satisfy all combinations of demands for housing and public services. Unless the number of desired taste combinations is fairly limited in practice, this is a relatively strong assumption. In particular, the mechanisms for creating new communities in response to demands for particular housing, tax, and services packages are costly. As stressed by Rubinfeld (1987), the creation of new jurisdictions is limited by the availability of land near established employment centers. Moreover, changes in jurisdictional boundaries do not appear to be related to differences in demands for particular service and tax packages. [22] Thus, the benefit view is likely to obtain only if the existing distribution of communities is sufficiently diverse to accommodate at least roughly the diversity of tastes for public services (and housing, in the Hamilton (1975) version of the benefit view). Fischel (1995, p. 255), drawing on earlier work (Fischel 1981) that indicated that 80 percent of the urban population lives in areas that are highly fragmented, concludes that the "choice of locality is especially wide" as most individuals live in metropolitan areas that have "scores if not hundreds of local governments." However, some observers are still skeptical. For example, Rubinfeld (1987, p. 584) stresses that in a Tiebout-Hamilton world,

"The necessary number of such communities is likely to be extremely large." In any case, as above, Zodrow and Mieszkowski (1986) show that new view results can still be obtained in models that are perfectly homogeneous with respect to both housing demands and tastes for public services, so such homogeneity does not distinguish between the two views.

Zoning Requirements

[39] To a large extent, the choice between the benefit and new views hinges on whether zoning ordinances are sufficiently restrictive to set the minimum housing level in a community, and whether such restrictions preclude the long run tax-induced changes in the capital stock predicted by the new view. Fischel (1992) provides an extensive list of the various types of zoning restrictions that might be encountered -- and substituted for one another, depending on the circumstances. As noted earlier, these include minimum lot sizes (and one home per lot), setbacks, height restrictions, requirements for off-street parking, restrictions to single family use, minimum square footage, and differential building code requirements, as well as designation of certain areas as off limits for environmental or other reasons and requirements for the provision of infrastructure at the expense of the developer. In addition, Fischel provides a variety of data on the quantitative significance of zoning ordinances, arguing that the practice of zoning is widespread. For example, he notes that the number of general purpose governments that could in principle enact zoning ordinances exceeds 25,000. Moreover, as detailed in Fischel (1985), there is no question that a great deal of time and effort are devoted to zoning, and that the practice of zoning has attracted a great deal of attention in the legal community. Finally, he notes (Fischel 1995, pp. 262-4) that several empirical studies have demonstrated that fiscal factors are important determinants of the nature of zoning decisions.

[40] The admittedly widespread prevalence of zoning restrictions of various types, however, does not by itself demonstrate the validity of the benefit view. As stressed by Mieszkowski and Zodrow (1989), the Hamilton (1975) version of the benefit view obtains only if the zoning requirements are binding -- it is in this sense that "perfect" zoning is required for the benefit view to be operative. Of course, as noted by Ladd (1998, p. 34) in her recent insightful review of the debate, perfect zoning in all cases would never be expected; rather the issue is whether zoning under the benefit view "sufficiently approximates reality that it becomes useful for making predictions and drawing conclusions." Unfortunately, evidence on the extent to which zoning constraints are binding is extremely difficult to obtain. Ladd notes that "no one would disagree that the property tax would distort decisions about minor expansions and repair that are beyond the purview of the zoning authority but not the tax assessor" -- that is, one would not expect the benefit view to be operative at the margin for such changes in the housing capital stock. Similarly, even the most ardent proponents of the benefit view do not assert that it is operative in large and highly heterogeneous urban areas. [23] But the extent to which zoning constraints are binding in the suburban communities that are the focus of the Tiebout-Hamilton analysis is difficult to determine. Mieszkowski and Zodrow (1989) and Fischel (1982) note the prevalence of communities that are subject to zoning that specifies minimum lot size and/or minimum square footage, but are quite heterogeneous in terms of house value -- with many homes considerably larger than that specified by the zoning restrictions. Ross

and Yinger (forthcoming) cite a number of studies that demonstrate considerable income heterogeneity in suburban jurisdictions; [24] they argue that such evidence suggests that zoning constraints are typically not binding. They also argue that "zoning tools, such as lot size restrictions and set-back rules, appear far too blunt to control H (housing) precisely." [25] Similarly, Rubinfeld (1987, p. 591) concludes that "there is reason to believe that actual zoning policies deviate substantially from the one which transforms a property tax into a head tax."

[41] In marked contrast, Fischel argues that zoning, when defined comprehensively to include all of its many facets listed above -- rather than only readily quantifiable restriction such as minimum lot size -- is in fact a binding constraint in many instances. He notes that local regulators have considerable flexibility in defining and enforcing zoning regulations, and are limited to only a relatively small extent by the legal restrictions associated with various court decisions regarding fiscal zoning.

[42] Unfortunately, all of the arguments on the specific issue of whether zoning constraints are binding (rather than on the simpler but much less informative issue of whether a huge number of zoning restrictions exists), are quite speculative in that they are based largely on anecdotal evidence. More compelling evidence, however, will be difficult to come by, as it would literally require a detailed property-by-property study to determine the extent to which the combination of various zoning requirements in a jurisdiction, including variances and re-zonings in response to homeowner requests, results in binding constraints on its housing stock. [26]

[43] Finally, Ross and Yinger also stressed that, it is important to note that the existence of zoning is consistent not only with the benefit view, but also with several alternative models of housing and local public goods determination. Most importantly, zoning restrictions may simply ratify the nature of development that would occur in any case as a result of market forces, within the context of bidding/sorting models of community development. [27] Thus, the existence of zoning does not prove the validity of the benefit view. [28]

Aggregate Budget Balance

[44] Another point often made in support of the benefit view is that there are powerful forces that act to prevent, in the words of Fischel (1992, p. 171) "wholesale free riding on local public goods." This point is an entirely reasonable one. It seems clear that fiscal zoning (broadly defined) can have an important influence on the nature of community development, especially in the form of precluding entry by low-income households that would place high demands on local public services while providing little in the way of property tax base. [29] Similarly, Fischel is correct when he argues that the current residents of a political jurisdiction have a clear and strong incentive to insist that new developments "pay their own way" in the form of paying enough taxes to cover the costs of their public services, so as not to impose an additional property tax burden (and thus lower property values) on existing residents.

[45] However, once again, these phenomena are not inconsistent with the new view of the property tax. Although fiscal zoning may very well change the character of the composition

of a community, all that is required for the new view to be operative is that the resulting communities not be zoned so precisely as to preclude the reductions in housing consumption predicted by the increase in the cost of capital attributable to the existence of, or increases in, the property tax. Moreover, new view models are characterized by local government budget balance; thus, the new view naturally does not imply any cross-subsidization across jurisdictions. Rather, local taxes and expenditures are equal -- but at a lower than efficient level because local governments underspend on local public services in anticipation of tax-induced reduction in their property tax bases due to capital out-migration.

[46] A similar phenomenon operates under the new view for new development within an existing jurisdiction. Recall that the Tiebout- Hamilton models assume that local public services are publicly provided private goods. Facing the same property tax rate and thus the same cost of capital as existing properties, new developments will be characterized by the same less-than- efficient level of housing and public expenditures; however, the property taxes paid will be sufficient to cover the cost of providing services to the new development. Under the new view, the new development is basically a replica of the existing community -- characterized by the same suboptimal levels of housing consumption and public service levels, but also by "budget balance" in the sense that the increase in taxes attributable to the development equals the costs of providing it with public services.

[47] In addition, as described above, under the "single taxing jurisdiction" version of the new view, not only are statutory payments of the property tax equal to expenditures but more importantly, the economic incidence of the tax also tends to be borne by local households. That is, although an increase in property taxation by a single jurisdiction -- and, by extension, a new development in an existing jurisdiction -- is borne by all capital owners in the nation, the economic effects of the tax-induced outflow of capital imply that local factors and consumers bear a burden equal to the full amount of the tax as well. In this sense, as stressed above, the new view of the property tax includes an important "benefit" component (even though the tax is not a nondistortionary benefit tax as viewed by Hamilton and Fischel) and new developments "pay their own way."

Interjurisdictional Capitalization

[48] Ever since the path-breaking article by Oates (1969), a substantial literature has examined the capitalization of interjurisdictional differences in property tax burdens and local expenditure levels. Definitive evidence of such capitalization is difficult to establish, as empirical estimation of the extent of capitalization is plagued by a number of difficult problems, including determining the appropriate discount rate, devising accurate controls for housing characteristics, and dealing with a number of troublesome econometric issues. Nevertheless, the consensus -- for example, see Yinger, Bloom, Borsch-Supan, and Ladd (1988) -- is that full capitalization occurs to a first approximation, with the increases in house values associated with increases in public services roughly offset by the decreases in house values associated with increases in property taxes.

[49] There is considerable dispute in the literature, however, about the implications of this evidence. Oates initially argued that capitalization was evidence for the Tiebout model and the benefit view. Similarly, as noted earlier, Fischel argues that fiscal "capitalization is

everywhere" and that capitalization -- in the context of a model in which local governments are analogous to "municipal corporations" that act to maximize the house values of their homeowner/voter "shareholders" -- is sufficient to make the property tax a benefit tax at the local level. There is general agreement that capitalization indicates that households value a relatively attractive combination of taxes and public services and will have greater demands for housing in communities in which they can obtain such a combination. However, as emphasized initially by Edel and Sclar (1974) and Hamilton (1976b) and more recently by Ross and Yinger (forthcoming), this argument does not necessarily imply the validity of the Tiebout model and the benefit view, as it does not adequately consider the supply side of the Tiebout model. Specifically, these authors argue that if the supply of communities is elastic in the sense that there are possibilities for new community formation (or changes in the boundaries of existing communities) or changes in the fiscal policies of existing communities, then the Tiebout model should in the long run imply zero capitalization. That is, in the context of the Hamilton (1975) model of homogeneous communities, housing prices should reflect only construction costs; property taxes paid are just equal to benefits received and thus have no independent effect on housing prices, just as housing prices are not affected by differences in expenditures on private goods. [30] As stressed by Ross and Yinger, this implies that a regression that examines housing prices across jurisdictions should not pick up any capitalization effects whatsoever if the economy is in a Tiebout-Hamilton type of equilibrium. (This does not imply that residents do not value local services or prefer lower taxes, but simply that housing prices do not vary with services or taxes when such an equilibrium is attained, and thus an econometric analysis will not pick up a correlation between these variables.) They stress (p. 13) that rather than providing support for the benefit view, "Statistically significant capital- ization of S (services) or T (taxes) therefore serves as a rejection of the Hamilton model." Similarly, Edel and Sclar argue that decreases over time in the extent to which capitalization is observed are indicative of a movement toward a Tiebout equilibrium, rather than declining importance of the Tiebout mechanism, and Rubinfeld (1987, p. 593) argues that "in the long run...capitalization is likely not to occur."

[50] The implications of the existence of fiscal capitalization for the validity of the benefit view are thus unclear, and are still a subject of debate in the literature. The conditions for the zero capitalization result (and thus a full Tiebout equilibrium) are stringent and unlikely to be met in practice; in particular (as noted above), the supply of communities to a metropolitan area is not highly elastic, jurisdictional boundaries are not flexible [31] and, as argued by Hamilton (1983), the expansion of fiscally advantaged housing will always be opposed by existing residents who fear its negative effect on the values of existing properties. Hamilton concludes that capitalization thus provides evidence of the validity of the Tiebout mechanism and that the property tax is a benefit tax.

[51] However, this interpretation has been challenged by a variety of researchers. For example, Epple (1980) argues that the typical capitalization equation can also be interpreted as a demand equation, in which a negative coefficient on the property tax variable merely reflects the effect of an increase in the price of housing on demand. Wales and Wiens (1974) note that budget balance within a local jurisdiction implies that tax rates must be higher in communities with relatively low house values and, holding tax rates fixed, communities with expensive homes will have higher expenditures; accordingly, they

argue that in the absence of perfect controls for housing quality, capitalization equations that identify negative relationships between property values and taxes and positive relationships between property values and local public expenditures may simply be picking up spurious relationships attributable to the budget identity. Similarly, Brueckner (1979) and Epple, Zelenitz, and Visscher (1978) argue that capitalization tests are unlikely to provide definitive evidence for or against the benefit view.

[52] More fundamentally, the implications of fiscal capitalization for the choice between the benefit and new views are ambiguous -- even if one accepts the idea that the benefit view implies capitalization -- because some capitalization is also consistent with the new view. Specifically, note that the "single jurisdiction" derivation of the new view implies that any increase in local property taxes will not only be borne by capital owners nationwide, but that the burden of the tax will also be borne by local factors of production and consumers. Thus, to the extent that this burden falls on local land owners, the new view implies that some of the burden of a local property tax increase will be capitalized into lower land prices. Similarly, the average burden of high property taxes in a jurisdiction, relative to the average national level of property taxation, may be capitalized into lower land prices. Thus, the existence of capitalization does not by itself distinguish between the benefit and new views. One potential area for future research would be to construct models of the different capitalization processes and amounts capitalized under both views and then attempt to identify econometrically which view is more consistent with the resulting estimates. However, given the problems associated with estimating capitalization accurately, such an approach would be rather difficult to implement.

Intrajurisdictional Capitalization

[53] While the extent of interjurisdictional capitalization, if any, under the homogeneous jurisdiction version of the Hamilton (1975) model is a subject of some debate, capitalization of fiscal differentials -- the present value of the differences between benefits received and taxes paid -- is the driving force underlying the heterogeneous version of the benefit view derived in Hamilton (1976, 1983). As noted above, this view also rests on some fairly strong assumptions. In particular, communities are fully developed, so that reductions in housing consumption are precluded by assumption. In addition, mobile households of all types are assumed to have as a locational alternative a community that is homogeneous with respect to housing consumption and provides its desired level of public services. Thus, the supply of housing at each price is effectively assumed to be perfectly elastic. Moreover, as stressed by Rubinfeld (1987) and by Ross and Yinger (forthcoming), Hamilton's perfect capitalization result obtains only if all individuals have identical demands for public services, which in turn implies, contrary to existing empirical evidence, that the income and price elasticities of demand for public services are zero.

[54] Under these circumstances, fiscal differentials are fully capitalized into property values. And, although there is much less empirical evidence on the extent of intrajurisdictional capitalization, Yinger, Bloom, Borsch-Supan, and Ladd (1988) conclude that the available studies suggest a fair degree of capitalization. Once again, the relevant question is whether full capitalization allows one to distinguish between the new and benefit views. And once again, the answer is negative.

[55] The new view analysis focuses on interjurisdictional tax differentials, and concludes, for example, that a relatively high property tax rate in a jurisdiction will lead to an outflow of capital and lower land prices; it does not address explicitly the issue of intrajurisdictional heterogeneity. However, in the context of heterogeneous communities, the tax-induced decline in land values would apply only to average land values within the jurisdiction -- which are in fact independent of the extent of housing heterogeneity in the Hamilton (1976) heterogeneous communities model. Given this reduction in average land values attributable to the outflow of capital induced by a relatively high property tax rate, capitalization of intrajurisdictional fiscal differentials would be consistent with the new view, and would indeed be expected as long as households were perfectly mobile and homogeneous communities were available, as assumed in the Hamilton derivation. That is, as argued by Mieszkowski and Zodrow (1989), under these circumstances, the "excise tax" effects of the property tax would be expected to be capitalized into property values. For example, high-income housing in a heterogeneous community, which would face a high-tax rate for a given level of services relative to that in a homogeneous high-income housing community, would sell at a discount. Similarly, low-income housing in a heterogeneous community, which would face a low-tax rate for a given level of services, relative to the homogeneous low-income community, would sell at a discount. These effects are analogous to those occurring under the heterogeneous community version of the benefit view (although the level of the capital stock and the quantity of public services provided would be lower if the new view were valid). Thus, evidence supporting intrajurisdictional capitalization does not help distinguish between the new and benefit views either.

[56] The discussion thus far suggests that it is rather difficult from an empirical standpoint to distinguish between the new and benefit views of the property tax, and that several arguments often made in support of the benefit view do not provide compelling evidence in its favor. This result is not terribly surprising, given the general point stressed above that the differences between the "benefit tax" aspects of the two views are not as great as one might think. Nevertheless, as discussed below, several empirical tests are able to distinguish between the two views.

The Effects of Property Tax Differentials On Capital Intensity

[57] As stressed throughout the analysis, the essential difference between the new and benefit views of the property tax is that the new view implies that relatively high levels of property taxation should drive mobile capital out of a jurisdiction, resulting in lower capital intensity. By comparison, under the benefit view, the property tax functions as a user charge for services received and a relatively high property tax rate should not affect capital intensity. In addition, under the new view, capital outflow from a relatively high-tax jurisdiction results in lower land and property values. In contrast, under the benefit view, a relatively high property tax rate in a community should not affect aggregate land and property values as it merely reflects a relatively high level of local public services. [32]

[58] In an intriguing contribution to the literature, Wassmer (1993) draws on these different implications of the new and benefit views to conduct an empirical test of the validity of the new view. Specifically, he examines a sample of 62 cities to see whether the effects of

property tax differentials, relative to the average level of taxation for the sample, are consistent with the new view in that a relatively high property tax rate in a city (1) depresses its property values, and (2) reduces its capital intensity. Wassmer finds evidence that supports the new view; however, the effects are fairly modest as a 1 percent tax differential reduces property values by 0.13 percent and causes a very slight outflow of capital over a five- year period. He concludes (p. 154) that his results "provide evidence that local property taxes affect local property values in the manner predicted by the New View and are not possible under a pure Benefit View of property taxation." At the same time, the results -- which are consistent with the conjectures of Mieszkowski (1972) -- suggest significant forward shifting of property tax differentials into higher housing prices rather than reduced property values (which decline fairly little). However, they also indicate rather little in the way of the reallocation of housing capital that is essential to the operation of the new view in the long run.

[59] Wassmer's results thus provide some support for the new view, but are far from definitive. One problem with his analysis is that his measure of the capital stock in a jurisdiction -- the number of homes, with some fairly imprecise controls (e.g., the number of rooms and the extent of plumbing) for the amount of capital utilized in the homes -- is sufficiently imprecise that his estimates are difficult to interpret. Moreover, as stressed by Fischel (1998), proponents of the benefit view typically argue that it applies primarily in suburban jurisdictions -- not the sample of central cities analyzed by Wassmer. Thus, a fruitful line for future research would be to extend Wassmer's work to a sample of suburban jurisdictions using more accurate measures of the capital stock in each jurisdiction.

The Effects of Property Tax Differentials On Housing Rents

[60] The new and benefit views of the property tax also have potentially different and thus testable implications for rental housing. In general, under the benefit view, one would expect an increase in property taxes to be reflected in an increase in housing rents, as long as the benefits received by renters equal the cost of the services being financed, as should occur in a Tiebout-Hamilton equilibrium. By comparison, under the new view, the effect of property tax finance of local expenditures received by renters is unclear. As described above, an increase in property taxes on rental properties by a single jurisdiction can be reflected in either higher rents or lower returns to landlords, depending on the relative elasticities of demand and supply of rental housing. Thus, forward shifting of the tax into higher rents is consistent with both views and would be inconclusive in terms of choosing between the new and benefit views, but backward shifting to landlords should occur only under the new view.

[61] In an excellent recent contribution to the literature, Carroll and Yinger (1994) use this strategy to analyze the effects of the property tax for a sample of 147 towns and cities in the Boston metropolitan area. They first review the earlier literature on the extent of forward shifting of the property tax. They argue that the results presented in this literature are inconclusive with several studies indicating no shifting or only partial shifting but some suggesting full shifting; [33] they argue that these results are suspect in any case as the studies suffer from a variety of methodological problems. [34]

[62] Carroll and Yinger argue that two conditions must be met for the benefit view to be valid. First, any increase in property taxes should be fully shifted forward as higher rents, with no declines in the value of rental housing. Second, at the margin, the net benefit of an increase in expenditures enjoyed by renters and the associated increase in property taxes should be zero. They consider a number of cases in their analysis, including the case of perfectly mobile renters, which is most favorable to the benefit view. (Renter mobility ensures that the condition of a zero marginal net benefit to renters will be satisfied; however, if the marginal benefits received -- and marginal costs paid -- by renters are low relative to the marginal costs of providing public services, landlords will bear a significant portion of the burden of the property tax).

[63] The empirical results of this study are consistent with the new view in that landlords bear a large fraction of a property tax increase. This result obtains in all of the various cases studied by Carroll and Yinger (with different assumptions regarding the supply and demand elasticities of rental housing), with the average burden on landlords varying from 84-91 cents per dollar of increased taxes and a minimum burden over all cases and all communities of 67 cents per dollar. In addition, the authors simulate the average burden of the property tax in their initial equilibrium and find that on average landlords bear 45 percent of existing tax differentials. Carroll and Yinger (1994, p. 311) conclude that, for their sample, "the property tax on rental housing is far short of being a benefit tax."

[64] As the most recent and most careful study of the extent of shifting of property taxes into higher rents, the Carroll and Yinger study provides strong support of the validity of the new view, at least as it applies to rental housing. Note, however, that it does not preclude an equilibrium where the benefit view applies for suburban homeowners even if it is invalid for renters.

[65] More generally, although the two studies described above provide limited support for the new view, considerable differences still exist regarding the extent to which the empirical literature distinguishes between the two views of the incidence of the property tax. For example, Ross and Yinger (forthcoming, p. 43) argue that "the evidence against the benefits view is overwhelming." By comparison, Oates (1994, p. 142) concludes that, "As things stand, it is impossible to reject either the new view or the benefits view in favor of the other." A similar lack of consensus appears in the theoretical and simulation literatures, as some researchers assume the validity of the new view and treat the property tax as a tax on capital, while others argue that benefit view considerations suggest that some or all of the property tax should be ignored in calculating the total tax burden on capital. [35] However, one large body of literature can be taken as at least indirect support for the new view. Specifically, the voluminous "tax competition" literature examines the idea, discussed previously, that local jurisdictions, concerned about the outflow of capital to other jurisdictions associated with the use of a tax on mobile capital, will tend to reduce their reliance on the property tax and underprovide public services. Thus, one could argue that the mere size of the tax competition literature provides indirect support for the new view; that is, if most observers subscribed to the benefit view of the property tax, the concerns of the tax competition literature regarding underprovision of services financed with property taxes on mobile capital would be largely irrelevant. In any case, the following section provides a brief overview of the literature on the effects of such "tax competition" among

local jurisdictions. It draws heavily on the excellent and much more comprehensive recent survey by Wilson (1999). [36]

Tax Competition, the Property Tax, And Local Services

The Basic Model

[66] The idea that property tax competition may lead to the underprovision of local public services dates back to Break (1967) and Oates (1972), who stressed that the reluctance of local officials to impose taxes on mobile capital may cause them to hold spending at inefficiently low levels. This idea was initially formalized in papers by Zodrow and Mieszkowski (1986) and Wilson (1986). For example, Zodrow and Mieszkowski construct a model with many identical jurisdictions with fixed land and perfectly mobile capital. Each local government provides local public services, which are modeled as publicly provided private goods, and chooses its expenditure levels to maximize the welfare of a representative resident. When a head tax is available, the property tax is set at zero and the head tax finances an efficient level of local public services. However, when an exogenous constraint limits use of the head tax, property tax finance implies that the level of public services chosen is suboptimally low, as the government cuts back on use of the capital tax because it fears an outflow of mobile capital to neighboring jurisdictions. /37, 38

[67] Moreover, the magnitude of the distortion of public service levels associated with tax competition may be large. For example, Wildasin (1989) evaluates the size of the federal subsidy required to induce local jurisdictions to provide an efficient level of services and finds that it is significant -- as high as 40 percent in the absence of other intergovernmental grants and 10 percent when such grants are considered. [39] Similarly, Yinger (1982, 1985) finds that the underprovision of public services that may result from use of the property tax in a median voter model may be quite substantial. [40]

Extensions to the Basic Model

[68] The fairly simple model of tax competition constructed by Zodrow and Mieszkowski has been extended in many ways. Brueckner (1999) adds labor that is mobile across local jurisdictions and is sorted across jurisdictions according to relative preferences for public services (which are modeled as publicly provided private goods). Although tax rates differ across jurisdictions in Brueckner's model, tax competition implies that all jurisdictions are still characterized by inefficiently low-tax rates and public service levels. [41] Matters are more complicated if housing is added to the basic model. In this case, the property tax distorts both local expenditure decisions and housing purchases. If housing and public services are substitutes, then inefficient underprovision still occurs. However, if housing and public services are complementary, underprovision of local public services may be desirable (efficiency- enhancing) because the property tax reduces housing consumption. [42] More generally, Wilson (1986) shows that, even in the context of models with much more complex production structures than in the basic model, underprovision results as long as use of the property tax reduces the size of the local capital stock; he argues that this result obtains for plausible values of the key parameters in his model. [43]

[69] Matters are also more complicated when local jurisdictions are large or differ in size. Wilson (1999) notes that the tendency toward underprovision is mitigated (but not eliminated) if the taxing jurisdiction is large, as a large jurisdiction is relatively less concerned about capital outmigration because it faces a less than perfectly elastic supply of capital. In the same vein, Bucovetsky (1991) and Wilson (1991) show that relatively large jurisdictions will underprovide less at the margin than smaller jurisdictions; however, relatively small jurisdictions may actually overprovide public services because their capital stock is large due to the relatively high-tax rates in large jurisdictions.

[70] Wilson (1987) extends the basic tax competition model to include trade factors, with production of two goods, one labor intensive and one capital intensive. In this model, the imposition of the property tax induces trade specialization, as the high-tax, high- service region specializes in labor intensive goods (because its relatively intensive use of the property tax drives out capital) while the low- tax, low-service region specializes in capital intensive goods. In this context, underprovision of local public services cannot be established unambiguously.

[71] All of the models described above make the fairly conventional assumption that local public services do not exhibit population economies of scale -- they are essentially publicly provided private goods. Wilson (1995) shows that the underprovision result does not necessarily extend to the case in which local public goods are characterized by scale economies. In his model, local governments use a mix of head taxes and property taxes which, if set properly, result in an efficient level of public services. Wilson, however, does not consider the case in which the degree of head tax finance is limited exogenously (as in the basic tax competition model).

[72] This brief review of the tax competition literature as it applies to local use of the property tax suggests that local taxation of mobile capital creates a tendency for underprovision of local public services. However, even within the context of the fairly narrow range of models discussed above, the effect of property tax finance on the level of local expenditures is theoretically ambiguous in certain cases.

[73] In addition, a wide variety of other factors affect the extent to which interjurisdictional competition -- as tax competition or in other forms -- decreases or increases the efficiency of the local public sector. Several factors that might lead to overprovision or underprovision of local services have already been cited above -- underprovision as applied to environmental quality, welfare support, and interjurisdictional spillovers, and overprovision as applied to vertical externalities between local and national governments, and opportunities for tax exporting. More generally, a variety of models of local government suggest that interjurisdictional competition is likely to result in an efficient equilibrium, similar to the efficiency result obtained in private commodity and factor markets in a perfectly competitive environment. The most obvious example is the Tiebout (1956) model, discussed at length above. Moreover, Tiebout- type results have also been obtained in more general models; in particular, Oates and Schwab (1988, 1991, 1996) obtain efficient local public equilibria in models that include environmental factors in firm production functions and individual utility functions and account for the provision of local public services to businesses (but require that local revenues be raised through benefit taxes on

individuals and firms). In yet another strand of the literature, public choice scholars such as Brennan and Buchanan (1980) argue that interjurisdictional competition is efficiency-enhancing because it limits the budget-maximizing tendencies of local government officials. [44] Thus, despite the huge literature on these issues, the net efficiency implications of decentralized local provision of public services are far from resolved. As stressed by Wilson (1999, p. 271), what is needed is more research on "the potentially important trade-offs between the good and bad aspects of intergovernmental competition"; similarly, Oates (1996, p. 29) emphasizes that a great deal of empirical work must be done before one can assess whether interjurisdictional competition "in practice, improves or worsens the performance of the local public sector in terms of standard welfare economics." [45]

Conclusion

[74] This paper has reviewed the ongoing debate regarding the validity of the new view and the benefit view of the local property tax. At one level, the differences between the two views are substantial. For example, the new view concludes that the property tax distorts both the allocation of capital (including housing capital) and the determination of the level of local public services, while the benefit view argues that the property tax is an efficient head tax that distorts neither of these two decisions. From a national perspective, the new view concludes that the property tax is a tax on capital and is thus quite progressive, while the benefit view argues that the tax involves no redistribution. On the other hand, from a local perspective, the new view has an important benefit view component in the sense that it predicts -- given the distortions in housing consumption and the level of public services noted above - - that local residents will tend to bear the full burden of an increase in the property tax (as predicted under the benefit view). This similarity between the two views makes it difficult to distinguish between them empirically. In particular, tests that provide evidence of Tiebout sorting and of interjurisdictional and intrajurisdictional capitalization, as well as the widespread prevalence of zoning ordinances, are not sufficient to establish the validity of the benefit view. The results of several recent innovative empirical studies provide grounds for cautious optimism that progress can be made in conducting empirical tests that will distinguish between the two views. In particular, tests of the extent to which property taxes affect capital intensity in the suburbs would be particularly informative, as would further testing of the extent to which property taxes are shifted forward as higher rents, as predicted by the benefit view. In addition, studies of the extent to which the combination of zoning tools available in a community results in binding constraints on the level of housing consumption would be very useful in establishing one of the underlying premises of the benefit view. Several recent studies provide some limited support for the new view. However, much further empirical investigation must be done before the validity of either view can be established.

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FOOTNOTES

[1] See also Fischel (1995, 1998).

[2] Fiscal differentials are defined as the differences between the present values of the benefits of local public services received and property taxes paid.

[3] The quantitative magnitudes of the efficiency and distributional differences between the benefit and new views are likely to be large as well; see Mieszkowski and Zodrow (1989) for a discussion of such estimates, and Nechyba (1998) for a recent examination of the efficiency and distributional effects of the property tax when modeled as a tax on capital as implied under the new view (as compared to the effects of a tax on land).

[4] The following analysis considers only the capital portion of the tax; there is general agreement that land bears most if not all of the burden of the land portion of the tax. However, note that landowners may be able to shift some of the tax burden if the supply of land to the taxing jurisdiction is elastic; see Hobson (1986) for a thorough analysis of this issue.

[5] Note, however, that the average burden of the tax may be difficult to define precisely, especially in the presence of existing taxes; see Courant (1977).

[6] This paper was thus partially a response to Aaron (1975, p. 42), who argued in his often-cited survey of the property tax literature that "the theoretical foundations of the new view are incomplete."

[7] See Mieszkowski and Zodrow (1989) for a discussion of a number of such partial equilibrium "metropolitan models"; that is, models that analyze the effects the use of the property tax by a single metropolitan area, rather than a system of metropolitan areas.

[8] See also the excellent analysis by Lin (1986) and, in the context of state corporate tax on capital, Mieszkowski and Zodrow (1986).

[9] This is a standard "open economy" result; for example, see Kotlikoff and Summers (1987) and Slemrod (1988).

[10] Note that in the standard small open economy model, the possibilities for forward shifting of taxes on exported goods are severely limited by national and international competition, so that local consumers tend to bear almost all of the burden of the tax that is shifted forward in the form of higher consumer prices.

[11] Thus, as stressed by Ladd (1998, p. 36), "from the perspective of the mayor of an individual city, the property tax is reasonably viewed as regressive" to the extent that the mayor focuses only on the effects of the tax in his or her jurisdiction (and consumption of housing declines with income) and ignores the effects of the use of the property tax by other jurisdictions. However, under the new view, the latter factor implies that the tax is progressive from a national perspective.

[12] See Hamilton (1983) for a justification of this assumption, which is common in the state and local public finance literature.

[13] The Hamilton benefit view model has been extended to the case of the nonresidential property tax by White (1975) and Fischel (1975). In these models, perfect mobility of firms coupled with the appropriate binding zoning ordinances, ensures that the property taxes paid by firms exactly offset the costs of providing them with public services plus the cost of any environmental damages they impose on the community.

[14] See also Hamilton (1983).

[15] See also Netzer, Lincoln Institute conference, who similarly concludes that "perhaps close to 80 percent of all local property tax revenues conceivably might be viewed as benefit taxes, in a loose sense"; by comparison, in his commentary on the Netzer paper, Musgrave, Lincoln Institute conference, is generally supportive of the new view.

[16] For a recent review of this voluminous literature, see Engen, Gravelle and Smetters (1997).

/17 See Engen and Gale (1996).

[18] Note, however, that employment and community ties primarily limit individual mobility across jurisdictions; mobility within jurisdictions -- e.g., moving to a smaller home in response to an increase in property tax rates -- is presumably considerably greater than interjurisdictional mobility, although the former is impeded by relatively high search and real estate transaction costs.

[19] In addition, several studies have shown that all of the results of the new view do not necessarily obtain within the context of the standard general equilibrium model if some of its assumptions are relaxed. For example, Hobson (1986) shows that if the supply of land to taxing jurisdiction is variable the land component of the tax is not necessarily borne by landowners, and Wilson (1984) and Brueckner (1981) construct models in which the excise tax effects of property tax differentials differ from those predicted by the new view. See Mieszkowski and Zodrow (1989) for further discussion.

[20] For articles on the debate, see the surveys by Rubinfeld (1987), Ross and Yinger (forthcoming), and Fischel (1995), as well as the articles in Zodrow (1983).

[21] See Ross and Yinger (forthcoming) for a survey of these articles; among the many

contributions to this literature are Rose- Ackerman (1989), Bucovetsky (1981), and Yinger (1982).

[22] See Epple and Romer (1989).

[23] For example, Ladd (1998, p. 34-35) notes that the benefit view is also not likely to obtain in exurban or rural areas, so that under any circumstances for a "significant proportion of the U.S. population, the property tax is not appropriately viewed as a benefit tax." Fischel (1995) agrees with this assessment and describes empirical evidence that demonstrates a variety of differences across suburban and central city communities which suggests that the assumptions underlying the benefit view are satisfied only in the suburbs.

[24] For example, see Pack and Pack (1977), Goldstein and Pauly (1981), Epple, Filimon, and Romer (1983, 1984, 1993), and Epple and Platt (forthcoming). This literature suggests that while there is more homogeneity within than across suburban communities, such communities are still relatively heterogeneous.

[25] In addition, Ross and Yinger note that voters would have to have extremely good foresight to set zoning restrictions at the optimal long run level of house size.

[26] Two other tests of the benefit view are suggested by Ross and Yinger, who argue that the Hamilton model implies that zoning ordinances should be determined solely by the tastes of local residents (and should thus be independent of the zoning policies of nearby communities) and that house prices should be independent of zoning restrictions. They argue that the results of most empirical studies do not support these predictions of the benefit view.

[27] For example, see Henderson (1977) and Wheaton (1993).

[28] In addition, Fischel (1992) argues that studies that demonstrate that zoning tends to increase the prices of existing homes are consistent with the notion of binding fiscal zoning (although he notes that other explanations could be offered as well). In any case, as stressed by Ross and Yinger (forthcoming), the theoretical implications of zoning for existing house prices are unclear, as is the empirical evidence on this issue.

[29] Note again, however, that other models -- especially the bidding and sorting models noted above -- also imply income segregation.

[30] Hamilton (1976b) notes that this argument must be qualified by any fiscal advantages of industrial capital, differences in state or federal aid, and differential costs of providing local public services due either to differences in input costs or differences in the costs of providing services of a given quality attributable to differences in population characteristics across communities.

[31] See Epple and Romer (1986).

[32] Recall that this is the case even in the heterogeneous community version of the benefit view developed in Hamilton (1976a); in this model, intrajurisdictional fiscal differentials are capitalized into land values, but these capitalization effects cancel for the community as a whole, leaving aggregate land values unchanged.

[33] For example, Dusansky, Ingberand, and Karatjas (1981) find full forward shifting; while Wheaton (1984) found no shifting for commerical rents.

[34] These problems include incomplete descriptions of housing attributes, the use of expenditures as a measure of public service quality without adjusting for differences in the cost of providing services of a given quality, omission of services other than education, as well as simultaneity bias and the use of restrictive functional forms in the estimating equations. All of these problems are addressed in their study.

[35] See Mieszkowski and Zodrow (1989) for some examples and further discussion.

[36] In particular, the following discussion focuses on tax competition models in which local governments use property tax finance. See Wilson (1999) for a discussion of models that include commodity taxes and taxes on labor income, as well as other forms of interjurisdictional competition involving underprovision of environmental quality or welfare support.

[37] The basic model assumes away three other factors that would also affect the efficiency of local public service provision. First, interjurisdictional spillovers of the benefits of public services are ignored. Considering such spillovers would increase the tendency for underprovision; see Williams (1966), Brainard and Dolbear (1967), and Oates (1972). Second, all land is assumed to be owned locally. If enough land were owned by nonresidents, the opportunity to "export" some of the burden of the property tax could lead to overprovision; see McLure (1967, 1981) and Lee (1998). Third, no account is taken of "vertical externalities" between levels of government. For example, local governments will ignore any negative effect of their use of capital taxes on the federal income tax base (through reduced saving); for a discussion of these issues, see Wilson (1999).

[38] Zodrow and Mieszkowski also show that underprovision of public services tends to result when the property tax is used to finance services that are provided to businesses.

[39] DePater and Myers (1994) and Bucovetsky, Marchand, and Pestieau (1998) also analyze the use of intergovernmental grants to offset the tendency for underprovision of local public goods in the presence of tax competition.

[40] Yinger also shows that fiscal capitalization may work with or against the distortionary effects of a residential property tax on the demand for housing.

[41] Similar results -- for the case of publicly provided private goods -- are obtained by Wilson (1995).

[42] See Henderson (1985) and Bucovetsky (1985).

[43] Wilson also shows that the capital-labor ratios in public production are significantly higher than those in private production.

[44] See also Rauscher (1996, 1998), Edwards and Keen (1996), and Gordon and Wilson (1998).

[45] See Oates (1996, pp. 29-30) for a suggested research agenda; Bartik (1994) and Courant (1994) also suggest a variety of directions for future research.

END OF FOOTNOTES

Comment on this story

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RESPONSE TO POST-HEARING QUESTIONS FROM LAURENCE E. GARRETT, SENIOR COUNSEL, EL PASO CORPORATION, AND ON BEHALF OF THE INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

November 14, 2005

The Honorable Chris Cannon
Committee on the Judiciary
Chairman, Subcommittee on Commercial and Administrative Law
United States House of Representatives
2138 Rayburn House Office Building
Washington, D.C. 20515-6216

Dear Chairman Cannon:

Thank you for the opportunity to appear before your Committee on October 6, to testify in favor on HR 1369. As you know, this issue is very important not only for the entire interstate natural gas pipeline industry, but also for the nation's natural gas consumers. Speaking for El Paso, we commend you for your leadership on this critical issue and stand ready to assist you in any way.

In your letter dated October 31, 2005, you requested that I respond to the following questions: "Could you explain why it is important to grant jurisdiction to review cases under this law to the federal courts? Are there any specific benefits or disadvantages to granting jurisdiction?"

The grant of jurisdiction to federal courts to hear cases of discrimination is crucial to the successful implementation and enforcement of the anti-discrimination provisions of H.R. 1369. There are several reasons why a grant of jurisdiction to federal courts is necessary.

1) H.R.1369 is an expression of federal policy. Federal policy should be applied uniformly in each state. If state courts are permitted to apply their own interpretation to a federal statute, there is a substantial risk that the meaning and application of federal law could vary from state to state. Federal courts are in a better position to interpret and discern Congressional intent and enforce federal law. First, there is a greater likelihood that the interpretation and application of federal law by federal courts will be uniform and not vary from state to state. Second, federal courts do not face the same political pressures as state courts. Federal judges do not have to stand for re-election. Federal courts have no political interest in perpetuating and furthering the exportation of a discriminatory state tax.

2) The procedure for bringing an action in federal court under H.R.1369 will be the same in every state. Without jurisdiction in federal court, a pipeline will be subjected to the varied appeal procedures of each state. In most states this means that a pipeline will have a very short period within which to challenge a discriminatory state tax. In most states, a protest or petition must be filed within 30 days of the notice of assessment. This is generally not a sufficient amount of time for the pipelines to analyze their assessments for discriminatory practices.

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3) Without federal court jurisdiction, pipelines will be forced to bring violations of a federal statute to state administrative agencies. Most states require pipelines to file petitions alleging violations of law with the state tax commission or boards of tax appeals. These actions are brought under each state's administrative procedures act. The trial record is made before the administrative agency. Seldom are there any formal rules of evidence. The state judiciary serves as a court of review. If there is any evidence in the record to support the agency's findings of fact, the courts will not disturb that finding. When there are no formal rules of evidence, and the agency's findings of fact will not be disturbed if there is any basis in the record to support the finding, all of the ingredients are present to permit official mischief. With federal court jurisdiction, the rules of evidence are formal and uniform in each state. Additionally, the federal court does not sit as a reviewing court, but instead sits as a trial court with original jurisdiction. With federal court jurisdiction, there simply is no question of fairness for all the parties.

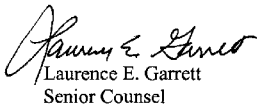
4) Time is another important factor. Cases in the state systems can take years to resolve. For example, pipelines in one state filed a protest in 1994 and the case was not set for trial until 2005. By the time all appeals are exhausted, the case will not be resolved for potentially another three years. Unfortunately, this example is not the exception, it is the rule. It can hardly be said that this represents a plain, speedy and efficient remedy for the taxpayer. This problem is also compounded by the fact that when a pipeline prevails, it may not receive any interest on the refund, or if interest is paid, it is often at below market rates. Where a taxing authority does not have to pay interest on refunds, there is an imbedded incentive for a state to lengthen the appeal process in order to use the unlawful taxes without paying the full cost of borrowing. With federal court jurisdiction, the court would simply enjoin the assessment, levy or collection of any discriminatory tax the court may find. Even with federal court jurisdiction, the pipelines would be required to carry the burden of proof and establish discrimination in violation of the federal statute. Federal courts have no incentive to delay resolution of the issues in a federal discrimination case. The concept of unlawful discrimination in other areas of federal law is not new to Federal courts. Federal judges are experienced in hearing and deciding all sorts of discrimination cases under other federal statutes.

5) Congress in considering legislation similar to H.R.1369, prohibiting state tax discrimination against interstate rail carriers concluded that a federal court remedy was required in order to ensure a plain, speedy and efficient remedy for the rail carriers. In a Senate Committee Report, the Committee noted that "The committee is convinced of the need for a Federal court procedural remedy as provided in S.2289. Section 1341, United States Code, prohibits district courts from enjoining, suspending, or restraining the assessment, levy, or collection of any tax under State law where a plain, speedy, and efficient remedy may be had in the courts of such States. The effect of this statute has been to close the doors of the Federal courts to carriers affected by discriminatory taxation. It has not, however, insured that the State courts provide carriers with a plain, speedy, and efficient remedy." Senate Report on S.2289, Report No. 91-630, P.6-7. This report was issued December 20, 1969. The committee's rationale and conclusion with respect to the need for a federal court remedy is as cogent today as it was in 1969.

The benefits to granting jurisdiction to the federal courts to enforce the provisions of H.R.1369 are: consistency and certainty in the application of federal law from state to state; consistency and certainty in procedure and rules of evidence; much shorter time required to resolve issues; cases are before the court under the court's original jurisdiction, not under its jurisdiction to review administrative proceedings; removal of political pressures; and greater incentive to enforce federal law.

Chairman Cannon, if I can be of further assistance or provide additional information, please feel free to call upon me at anytime.

Very best regards,



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