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International Economic Competitiveness

ACIR Roundtable
on International Economic Competitiveness

American Competitiveness
in the World Economy
Robert D. Ebel and Laurence Marks

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A World Bank Perpsective
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Statement of Alice Rivlin

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State and Local Initiatives
on Productivity, Technology, and Innovation
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among State and Local Governments
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Advisory Commission on Intergovernmental Relations

A View from the Commission

The Tenth Amendment to the United States Constitution reads, "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

The 1980s was indisputably the decade of state governments. Those in doubt need only take a look at virtually any major domestic policymaking arena —welfare reform, early childhood care, education, environmental protection, homelessness, infrastructure, foreign trade promotion, and health-care cost containment. The states have become the dynamos of the federal system.

Across the nation, state constitutions are emerging from the shadow of the U.S. Constitution and becoming recognized as guaranteeing freedoms found nowhere in the federal document. These developments have been highlighted in two recent ACIR reports: *State Constitutional Law: Cases and Materials* and *State Constitutions in the Federal System*.

Why this outburst of state activism? For the most part, it happened because, by the end of the 1970s, the federal government was overpromising, overspending, and overstepping itself. But with the efforts started by President Ronald Reagan, the idea of New Federalism began, and states entered into an era of heroic policy experimentation. The states became the places where innovation and activism are found, which is something ACIR helped bring to the public's attention in its pioneering report on *The Question of State Government Capability*.

While this concept of New Federalism holds much promise, to make it work, a more orderly and reasonable division of responsibilities between the federal government and state and local governments must take shape in the 1990s. For the federal-state partnership to truly excel, intergovernmental cooperation is a must.

Unfortunately, there simply has been too little concern for the dissemination of information from Washington that could make this partnership work more smoothly. Far too often, federal departments that fund state and local government have not followed up with advice and assistance on how to take advantage of new ideas, research, and technology. Federalism must be sharpened by expertise if it is to realize its potential. One area in which ACIR has sought to facilitate sharing, for example, has been in its design of a national Clearinghouse for State and Local Initiatives on Productivity, Technology, and Innovation, to be operated by the U.S. Department of Commerce.

When we talk of the partnership between federal and state governments, I envision a business type of union more than a federal bureaucracy, namely, a partnership where the sharing of ideas and knowledge is encouraged. A few federal programs are taking shape along these lines. These programs send consultants into the field to educate people and share ideas.

An example of this information-sharing service is the National Institute of Corrections (NIC). Because of the nationwide problem of prison overcrowding, NIC has a program that sends consultants into the field to educate corrections officials in new management techniques to prevent prison violence and jailbreaks, and to raise staff morale.

The use of traveling experts, however, is an idea that could be spread much more widely, not only with federal programs but also with state and local agencies or programs that have created successful ideas. State and local governments, too, should have the opportunity to take their ideas on the road, establishing networks of knowledge among states. The possibilities are endless, and for this reason, ACIR has sought, for example, to assist the federal Office of Personnel Management to reinvigorate the IPA's intergovernmental mobility program.

It appears that the role of the states in federalism will continue to grow in the 1990s. For this concept to prosper, states will have to continue to be creative, and the federal government will have to increase its cooperation.

Ted Strickland
President
Colorado Senate

Intergovernmental

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On the ACIR Agenda

The last meeting of the Advisory Commission on Intergovernmental Relations was held in Washington, DC, on January 26. Following are highlights from the agenda and Commission actions.

International Competitiveness Roundtable

The issues of the nation's competitiveness in the world economy and intergovernmental policy formulation were discussed by the Commission during its review of the 1990-1993 research agenda. One outcome of this discussion was a roundtable on competitiveness, held in conjunction with the January 26 meeting of the Commission.

The panel was invited to make presentations on the topic of "U.S. Competitiveness in the World Economy." Participating in the roundtable were: Paul M. Meo, Chief of the International Trade Division of the International Bank for Reconstruction and Development (The World Bank); Lee O. Smith, Executive Director of the New York State Industrial Cooperation Council; Robert P. Strauss, Professor of Economics and Public Policy and Director of the Center for Public Financial Management at Carnegie-Mellon University, Pittsburgh; and Alice M. Rivlin, Senior Fellow in the Economic Studies Program at the Brookings Institution, Washington, DC. (See page 5 for the roundtable report.)

Clearinghouse Report

The Commission approved publication of the report *Scope and Design of the Clearinghouse for State and Local Initiatives on Productivity, Technology, and Innovation*, including findings and recommendations. The report will be published in April.

ACIR assisted the U.S. Department of Commerce in designing the Clearinghouse, which was authorized by Section 5122 of the *Omnibus Trade and Competitiveness Act of 1988* to assist state and local governments in their efforts to enhance business competitiveness by spreading the word about the many creative steps being taken by those governments.

National Conference on State Taxation and Regulation of Banking

Chairman Robert B. Hawkins, Jr., gave the welcoming remarks at the opening of this national conference on state taxation and regulation of banking, held in Washington, DC, on December 13, 1989. More than 160 people, representing 37 states, attended the conference, cosponsored by ACIR and the National Conference of State Legislatures, Multistate Tax Commission, and National Center for Policy Alternatives. Papers from the conference will be published this summer.

Governors Speak Out

Governor George A. Sinner of North Dakota was quoted in the *Washington Post* as asking House Speaker Thomas S. Foley on February 27 at the National Governors' Association Meeting, "Can't Congress please let us run the states?" Many governors also expressed concern about the accumulation of funds in the federal highway and airport trust funds. Governor John Ashcroft was quoted in the same story as saying, "There's no stomach on the part of Missourians to ante up again for highways when the federal government is hoarding dollars they've already paid." Governors Sinner and Ashcroft are members of the ACIR.

State Constitutions

Two of the country's most active state bicentennial commissions on the U.S. Constitution, New York and Virginia, have urged state groups to take action on ACIR's 1989 recommendations on state constitutional law. In a letter signed jointly by Stephen L. Schechter of New York and A.E. Dick Howard of Virginia, these commissions communicated ACIR's findings and recommendations to state chief justices, law school deans, state humanities councils, state social studies councils, and others.

ACIR's report *State Constitutional Law: Cases and Materials* will be reprinted this summer with a supplementary update in order to meet the needs of law schools that are now offering courses on state constitutional law.

Study of State-Local Fiscal Relations In Hawaii

ACIR staff and a group of consultants recently completed a comprehensive study of fiscal relations between the state and the four county governments in Hawaii. The study was performed under a contract with Hawaii's second Tax Review Commission.

The report on the study reviews the history of the Aloha State's fiscal system, estimates the relative revenue-raising abilities and public-service needs of each of the counties, and evaluates the vertical and horizontal balance of the system. The report also includes an appraisal of the property tax in Hawaii, a discussion of the potential for development fees and exactions in the state, and an analysis of a wide range of policy options for improving Hawaii's intergovernmental system.

ACIR Roundtable on International Economic Competitiveness

American Competitiveness in the World Economy

Robert D. Ebel and Laurence Marks

The United States currently enjoys the highest standard of living in its history. When all the economic factors are added up, Americans are among the world's most comfortably housed, safely and efficiently transported, and adequately fed people. We are able to afford billions of dollars of consumer goods and services. Moreover, for decades, each generation of Americans has been able to count on having a standard of living higher than that of the preceding generation.[1]

As we approach the 21st century, many fear that the nation will be unable to deliver on the promise of higher living standards for succeeding generations, and that even our present standard may be out of reach for a growing proportion of the population. This fear is linked directly to concern over the decline in America's position in the world economy and its global "competitiveness."[2]

The evidence of decline ranges from anecdotal statements relying on a kind of end-of-season football poll mentality (eight of the world's ten largest business firms are Japanese) to more systematic discussions regarding the United States' shift in the mid-1980s from a net foreign creditor to a net foreign debtor. Proposed policy solutions range from admonishing American business to pay more attention to the benefits of incremental advances in technology to a crisis call for overhauling many of the nation's institutions and policies in order to establish unified and/or managed national economic strategies.

ACIR is concerned about these issues for three reasons.

First, state and local governments are rapidly becoming involved in international economic affairs, especially in promoting exports and recruiting foreign investment.

Second, proposals to reform the federal system are emerging. Some proposals call for extensive federal preemption of state regulatory policies (e.g., in banking, telecommunications, and insurance) and/or increased federal management of traditional state and local spending responsibilities (e.g., K-12 education). Other proposals advocate outright federal prohibition of state political practices, such as setting economic and fiscal policies by initiative in California. Still other proposals are based on the argument that the diversity and creativity inherent in our noncentralized federal system has given and will continue to give the United States a long-run economic advantage in the global economy.

Third, although the underpinnings of the concern for competitiveness can be understood best from a *macroeconomic* perspective, many of the policies for dealing with the concern are *microeconomic* and, within the micro framework, highly intergovernmental.

The Threshold Issues

There are several key "threshold" issues related to the competitiveness debate, which give rise to some critical questions. Is there a problem? If so, why? What is the evidence of a decline in U.S. competitiveness or world economic power, and how is that related to living standards? What are the basic determinants of competitiveness? What are the overarching policy implications for federalism and intergovernmental relations?

The answer to the first question is "yes," there is a problem, if one defines it as a decline in the relative position of the United States as a world economic power and in terms of the economic statistics of trade relationships and the ability of U.S. firms to sell in world markets. But, even if there were no evidence of a decline in the United States world economic position, the issues would still be of paramount importance. The overriding goal of economic policy is—or ought to be—to improve people's living standards.

The evidence of the change in the economic position of the United States in the developed world is readily available: the United States share of world Gross Domestic Product (GDP) has fallen from 27 percent in 1950 to 18 percent in 1987.[3] Japan's GDP grew from only 9 percent of United States GDP in 1950 to 36 percent in 1987. West Germany grew from 11.1 percent to 18.3 percent. Similar, albeit smaller, changes were registered for France, Italy, and Canada. Among the six major industrialized nations, only the United Kingdom's GDP performance has declined relative to that of the United States.

Looking at the GDP data, there are two important elements worthy of note. First, the trends are nearly four decades old. In fact, except for Japan, during the 1980s, the U.S. position improved somewhat relative to that of the other countries.

Second, the biggest gainers, Japan and West Germany, are also the two clearest beneficiaries of post-World War II

United States foreign policy, which had as one of its cornerstones a rebuilding of the economies of its former military enemies. A success? Indeed.

Why, then, the sudden concern? In part, it is a superficial one, spurred by the power of the anecdote—Japanese investors buying Rockefeller Center, television specials on the "me decade," and high school achievement scores unadjusted for important structural changes in schooling.

Some of the reasons for concern have more systematic and persistent bases. Consider, for example, recent changes in key elements of the nation's economic profile:

- In terms of GNP per capita, the United States led the world's economies throughout the 1960s and early 1970s. Since 1973, however, the United States' rank has fallen from first to ninth place.[4]
- Each year since 1982, the United States has run a current account deficit—basically, the difference between exports and imports plus payments, such as interest and dividends.[5]
- Beginning in 1985, the United States shifted from net foreign creditor to net foreign debtor, a status that was typical of the United States until about 1920.[6]
- The national saving rate has declined by nearly a third since 1981, generating the need for a net capital inflow from foreigners well in excess of $100 billion a year for each year since 1984.[7]
- Between 1981 and 1987, the productivity of American business has grown only 1.5 percent a year. Although this is an improvement over the 1973-1981 period, it represents a rate well below that of the rest of the post-World War II period.[8]

Taken alone, none of these statistics is a particular cause for alarm. Taken together, their direction cannot be dismissed as unimportant. Indeed, when the economic linkages are understood, it is not unreasonable to conclude that if the economics are not reversed, there is a possibility that by the 21st century we will end up with a falling standard of living.

Role of Domestic Policy

As competitiveness has emerged as a major topic for national debate, different arguments have been put forth to explain the root causes of the problem. Some are meritorious, but too "micro" to be fully adequate to the task (e.g., we have uncompetitive costs of capital formation). Other arguments are the topic of considerable disagreement (e.g., American business managers concentrate too much on short-term profits; leveraged buyouts are bad; service workers make "second rate" contributions to output). Still other arguments are mostly myth (e.g., union wages price us out of markets; we have overemphasized basic research at the expense of market-driven research). And, finally, some arguments are just self-delusion (e.g., blaming the "other guy," such as "Japan bashing").

To understand the sources of concern about competitiveness, one must focus on two failings of the nation's domestic macroeconomy: inadequate national saving and falling productivity. Once these two elements are understood, some of the policy solutions, including the opportunities for intergovernmental actions, can be discussed more fruitfully.

Excessive Spending, Inadequate Saving

There is a direct link between the nation's domestic saving rate and its international trade imbalances and ability to sell its goods and services in the world's markets. How we define and address the policy options that emerge from this relationship will have an important bearing on the larger question of future living standards.

To understand this linkage, it is important first to understand a fundamental economic proposition: in order to pay for the sum of its expenditures for private investment goods (additions to the stock of productive capital), government activities (local, federal, state), and imports of foreign commodities, a nation must save—abstain from spending.[9]

Domestic Saving and World Trade. There are three sources of national saving—persons (e.g., savings accounts), businesses (retained earnings), and governments (budget surpluses).

If, as in the United States in recent years, the nation's spending exceeds its saving, the gap must be filled by some outside source. This is accomplished by having foreigners buy our currently produced domestic products (exports) and/or by borrowing from foreigners or selling assets to them.

The first strategy—exporting enough goods and services—has been inadequate. In fact, despite the 1988-89 export boom, the United States continues to import more than it exports. This fact, in turn, has been a major reason why our current account balance has been negative since 1982.

That leaves us with one other choice—relying on net capital inflows from abroad. This has been going on in sufficient magnitude so that the United States is now a net debtor. As a nation, we have sold more assets and borrowed more money from abroad than foreigners have from us.

Why We Need Foreign Capital: The 1980s. Of the three potential sources of saving, two account for most of the 1980s decline. Whereas the saving by business has been relatively stable since 1980 (falling only from 12.5 percent to 12.2 percent of GNP between 1980 and 1988), the personal saving rate, although remaining positive, has fallen by more than a third (5.0 percent of GNP to 3.0 percent).

The big dissaver has been the government sector in general (an average 2.6 percent of GNP) and the federal government in particular. For a variety of institutional as well as economic reasons, the state and local sector has been generating surpluses (i.e., taxes exceed spending). The federal government has run the largest deficits—has done its greatest net dissaving—in the nation's peacetime history. In short, the federal deficit and the international deficit, while perhaps not twins, are close relatives.

The Competitiveness Link. Does a persistent gap between the nation's total spending and total saving worsen the ability of firms to sell in world markets? The answer is a qualified "yes." The effect takes hold over the long run, and can happen in a couple of ways. One way has to do with the interaction between the nation's resulting net debtor position and the foreign exchange markets. In order for foreigners to buy U.S. output or assets, and/or loan us capi-

tal, they must use dollars. This has the effect of increasing the demand for the dollar in world markets. But, as the value of the dollar rises, so does the price of U.S. exports. This, in turn, reduces the competitiveness of our export industries. Other things being equal, the price of German automobiles falls relative to American models.[10]

A second and more important way that reduced national saving can lead to a decline in competitiveness is related to the use of the foreign capital inflow. If the capital inflow is used to finance the current level of consumption spending, including consumption spending by governments, then we may live well today, but we do so at the expense of accumulating a foreign debt that will have to be financed out of tomorrow's income. This produces a burden on future generations in the form of a standard of living lower than it otherwise would have been.

If, however, the capital inflow is used to finance new net investment that will provide a base for future United States economic growth, then our future standard of living may not be reduced. As a nation, we must still finance the accumulated debt, but this may be more than offset by the benefits gained from our increased stock of private capital.[11] To some extent, this is happening today. Data compiled at the Federal Reserve Bank of Philadelphia indicate that the news is not all bad. More than half (about 55 percent) of the 1980s net capital inflow was used to finance increased net investment.[12]

Finally, it is important to note that a key force for improvement is demographic. As this nation's population ages over the next 20 years, the U.S. saving rate is expected to rise. Historical evidence indicates that the bulk of personal saving is done by people in the 45 to 64 age group. According to Census Bureau projections, this age group will grow from about 18 percent of the current population to more than 23 percent after 2000.

Productivity

The second and more important of the two basic macroeconomic concerns is the nation's faltering productivity rate—the efficiency with which it produces goods and services. "Productivity" is defined as the ratio of the value of the nation's output and its input. Measuring it, however, is a crude exercise at best. Explaining the determinants of productivity is a puzzle.

Despite these problems, there is no doubt as to the importance of productivity. All else being equal, when a nation's productivity increases, so does its standard of living. Conversely, as productivity falters, so does the living standard. A simple exercise illustrates the effect.[13] If productivity had continued to grow throughout the postwar period at the rate recorded between 1948 and 1973, the Gross National Product in 1987 would have been about a third more than it is today. The median income of the American family—roughly $30,000 in 1987—would have been about $40,000. In fact, at that growth rate, the U.S. living standard would double every 35 to 40 years.

However, something happened around 1973—productivity growth slowed to a near halt. Although this slowdown was experienced throughout the world, it has been particularly evident in the United States. Thus, as one observer notes, during the next generation, the Japanese standard of living will double while the U.S. standard will move only a little ahead of where it is now.[14]

What has happened?

We don't know—at least we do not know enough. Some of the explanation is due to a measurement problem. How, for example, does one measure the productivity of a school teacher who introduces students to problem-solving skills? Also, part of the explanation of relative rates of productivity growth can be explained by the fact that some of our world neighbors are starting from a lower base. Thus, an element of catch-up shows up in the data.

Coming up with a clear set of economic explanations for what determines productivity growth has been even more elusive than getting the numbers right. Economists have not been able to devise a neat system of productivity accounts such as they have for the savings and spending equations. Studies that have sought to identify the total contribution of the factors associated with productivity gains have been able to account for only about half of the total of postwar productivity growth. A significant fraction of productivity growth remains ascribed to general "technological advance" that is not observed directly.[15]

Nonetheless, there is some consensus regarding the factors that have contributed to the slowing of productivity growth since the mid-1970s. These factors include the entry of a growing number of people into the labor force with little work experience, a lower level of research and development (R&D) expenditure than in the 1950s and 1960s, a proliferation of government regulations that divert the flow of capital to less productive assets, and two oil-price shocks.[16] At the same time, it has been possible to rule out some of the "usual suspects," such as the inability of American workers to compete against workers in low-wage countries, or that there is some sort of international trade conspiracy designed to limit American access to foreign markets.[17]

On the other side of the ledger, we do know that certain activities do, or at least are highly likely to, contribute to long-run productivity growth. To summarize:

- *Education.* The quality of the labor force is a critical factor in explaining U.S. economic growth. One estimate is that during 1929-1982, as much as two-fifths of the growth rate of national income can be attributed directly and indirectly to the education of the U.S. workforce. The direct component refers to the skill level of the people. The indirect contributions are attributable to innovation and advances in technologies, a spinoff of the education of the workforce.[18]

- *Private Capital.* The growth of the stock of nonresidential equipment and structures per person engaged in production has been a major element in the growth of the nation's productivity. It is also a significant variable in explaining the differential rates of productivity increase among industries. Not only does the substitution of capital for labor raise output per unit of labor, but fixed private capital also is a vehicle for cost-reducing technological change.[19]

- *Research and Development Activities (R&D)*. Technological progress is the chief force behind obsolescence and the force for increasing the demand for new capital that embodies cost-reducing innovations or capacity to create new products. As several studies have shown, R&D outlays are related directly to the pace of technological process and the ability of the nation to compete in world markets.[20]

- *Public Capital*. Not alone in its findings, a recent and especially thorough report to the President and the Congress on the status and economics of the nation's physical infrastructure found public infrastructure—e.g., roads, water and sewer systems, airports, bridges—to be highly complementary to the private capital base and an important contributor to the productivity of the private sector. At the same time, however, the report also concluded that there is a growing imbalance between public and private capital that "limits the growth of the economy and the [nation's] ability to compete in world markets."[21]

- *A Stable Economy*. Fluctuations in exchange rates and swings in the domestic business cycle make it difficult for businesses to be managed and production processes to be planned. Accordingly, a more stable economy would provide an environment for productivity gain. Stability is a yardstick against which the 1980s measures up quite well. Entering with double-digit inflation, the 1980s has been a period that has sustained the second longest economic expansion in U.S. history.

The Intergovernmental Dimension

As the United States approaches the 21st century, there can be little doubt that the present concern about the link between the nation's position in the world economy, the degree of its competitiveness, and the outlook for living standards is a legitimate one. This is especially true given the two major failings of the domestic economy: excessive consumption and faltering productivity.

Within this context, three key points must be mentioned. First, the international economy and the economic behavior of foreign competitors is not the real source of the problem. American productivity and living standards are not diminished by improvements abroad. The problem is at home, not in Japan, the European Community, or the developing nations of Southeast Asia. In fact, U.S. living standards will be enhanced if those economies grow and our trade with them increases. Economic competition is not a zero-sum game.

Second, many of the sources of the saving and productivity concerns are subject to policy manipulation. The range of these policies extends from such issues as the burden of governmental regulatory policies on American producers, the persistence of poverty, improving education, providing increased incentives for saving, and pursuing policies to promote capital formation, public as well as private.

Third, particularly when it comes to productivity, many of the solutions are inherently intergovernmental. A review of the fundamentals of the issue discussed above attests to this. Although the responsibility for providing for a stable economy and promoting national savings rests primarily with the federal government, actions needed with respect to nearly every other issue noted above are intergovernmental in nature. The solutions, therefore, must also be designed in the intergovernmental arena. Accordingly, one of the tasks of ACIR in coming years will be to participate in the design of that policy agenda.

Notes

[1] This discussion focuses on tradable goods and services. Concerns such as the distribution of income and wealth, infant mortality rates, and the quality of social services, while certainly important and replete with economic implications, are not addressed directly here. For this discussion, see Herbert Stein on "Economic Leadership," *American Enterprise*, January/February 1990.

[2] The term "competitiveness" has become a catchall phrase for a series of recent economic events relating to the U.S. position in the international economy. Despite its common use in the popular (as well as some academic and other policy) discussions, it is rarely clearly defined.

[3] France (11.8 to 15.9 percent), Italy (10.4 to 15.6) and Canada (6.4 to 10.4). For a discussion, see Barry P. Bosworth and Robert Z. Lawrence, "America in the World Economy," *The Brookings Review*, Winter 1988/89, pp. 39-48.

[4] Data provided by International Trade Division of the World Bank, February 1990.

[5] The data relating to the current account and the nation's net debtor status are from Stephen A. Meyer, "The U.S. as a Debtor Country: Causes, Prospects, and Policy Implications," *Business Review*, Federal Reserve Bank of Philadelphia, November/December 1989, pp. 19-31 and Table 1. Meyer also provides a glossary and a discussion of what it means to be a "net debtor" nation.

[6] *Economic Report of the President, 1988*. February 16, 1988.

[7] Meyer, p. 22, and Bosworth and Lawrence, pp. 39-40.

[8] *Economic Report of the President, 1988*, p. 67. The business productivity growth rate, which is measured in terms of output per hour for all persons, increased by an annual rate of 3.2 percent for 1948 IV to 1966 IV, 2.0 percent for 1966 IV through 1973 IV, and 0.7 percent from 1973 IV to 1981 III.

[9] By saving, or abstaining from spending, the nation as a whole frees up real resources of land, labor, and capital for investment spending. The higher a nation's income, the greater its ability to save and, thus, invest.

[10] Between 1980 and 1985, the value of the dollar increased by 50 percent. That rise, which was reversed between 1985 and mid-1988, fostered a significant drop in export prices. Since mid-1988, the dollar has appreciated. For a primer on this and other factors that determine the trade balance, see Ramon Moreno, "A Fading Export Boom?" *Weekly Letter*, Federal Reserve Bank of San Francisco, December 15, 1989.

[11] Which is what did occur in the early history of the nation. The nation's railroad system was developed in the 19th century largely as the result of foreign financing. For many states, the capital inflow is a critical part of development even today. A recent report by the Hawaii Office of State Planning (Foreign Investment in Hawaii, Office of Planning, Honolulu, 1989) is explicit in its conclusion that "investment in the economy is essential to the growth and diversification of our economic base." For further discussion, see *State Policy Reports*, Vol. 7, Issue 17, 1989, pp. 10-11.

[12] Meyer, p. 22, Table 2.

[13] This example is taken from Robert E. Litan, Robert Z. Lawrence, and Charles L. Schultze, "Improving American

Living Standards," *The Brookings Review*, Winter 1988/89, p. 28. See also Charles C. Mann, "The Man with All the Answers (Lester Thurow)," *Atlantic Monthly*, January 1990, pp. 45-62.

[14]See comments by Lester Thurow, *Atlantic Monthly*, p. 51.

[15]*Economic Report of the President, 1988*, p. 72.

[16]Alicia H. Munnell, "Why Has Productivity Growth Declined? Productivity and Public Investment," *New England Economic Review*, January/February 1990, pp. 3-22.

[17]Wage rates are productivity determined, not determining. As for trade, the United States now has a deficit with every major region of the world, and the increase in the deficit is roughly proportionate with the total volume of trade within each region. For a discussion, see Bosworth and Lawrence, pp. 41-42.

[18]This statement, while correct, should be used with caution. Included here is a component of the ability to use "advances in knowledge," whether generated here or abroad. Edward F. Denison, *Trends in American Economic Growth, 1929-1982* (Washington DC: The Brookings Institution, 1985), pp. 28-31.

[19]For a discussion, see John W. Kendrick, "The U.S. Business Economy: Productivity Trends and Prospects," *The AEI Economist*, August 1986.

[20]Kendrick, pp. 16-17.

[21]*Fragile Foundations: A Report on America's Public Works*, The Final Report to the President and Congress of the National Council on Public Works Improvement (Washington, DC: February 1988), p. 9, Executive Summary.

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National Productivity and Efficiency: A World Bank Perspective

Statement of Paul Meo

Unlike many other institutions, the World Bank uses the word "productivity." We are very much involved in handling development, and productivity is vital for that. The Bank looks at efficiency, the wise use of resources, from a policy orientation, which means that it looks at things a little differently from OECD countries.

First, we often examine infrastructure in great detail—the highways and the road systems, and, often, the intermodal systems. The reason we look at this is because developing countries spend from 20 percent to, in some cases, 45 percent of gross national product on investment. It's a very large share of their expenditures, and some countries spend it very inefficiently.

We also look at education systems, not only spending, which is a proclivity of OECD countries, but also at efficiency. The efficiency of education is probably one of the most important elements in enhancing the efficiency of the human factor.

We look, if *sub rosa*, at corruption. Corruption can be helpful, although usually it is not, and there is a corruption factor, possibly, in a substantial number of our clients.

We look at the rules of the game. Often, you can live with perverse rules, but when they are changed every time an administration changes, it makes things very inefficient. Productivity is very much affected.

Then we look at incentives systems and regulations. Too many regulations can ruin an investment climate. In Peru, there's a good saying: "For my friends, all I have. For my family, something. For my enemy, the law." The law is the enemy of development in many countries.

Then there is the environment. Environmental issues affect everybody. How you address environmental issues—in developing and developed economies—can have tremendous effects on productivity; you can give right or wrong signals, and the wrong ones can be very costly.

Other important issues are investment and consumption and relative national incomes. Those who say that investment is good and consumption is bad are not necessarily correct. Investment is sometimes perverse, and consumption can be very good. In one Caribbean country, what is called "investment" is really closer to consumption. An increase in consumption expenditures for education could have a greater productivity effect than other types of investment. That Caribbean country spends the lowest share of any developing economy on education—and it shows. In Chile, which has probably the most efficient economy in this hemisphere and, in Santiago, the most efficiently run subway system in the world, when they had to look at an additional subway line that they estimated to cost about $250 million, they declined to undertake the project. Over

five years, the investment would have increased their investment ratio by 2 to 3 percent of GNP and probably would have had zero effect on growth.

It has been said that the United States enjoys the highest standard of living in history. From a real consumption standpoint—looking at physical indicators and using a U.S.-weighted market basket for purchasing power comparisons—this may be an accurate statement. But when you look at productivity, when you look at the dollar values—that's what you trade and how you compete—on that basis—per capita GNP—the United States is well below most developed OECD countries.

In 1988, the per capita GNP of the United States was just below $20,000. Switzerland was much higher, over $29,000. Also quite high were Luxembourg, Japan (over $23,000), Finland, Denmark, and a few other economies. West Germany and the United States are about the same. The idea that the United States is the most affluent country and can determine its policies from that height is fallacious today.

Moreover, these income figures partly reflect productivity and wage variances. U.S. industrial wages in many areas are below those of West Germany and the EC countries, and, often, Japan. The productivity of the American worker as determined by the marketplace—especially in exporting industries—is below that of many of its OECD partners.

The situation could become relatively worse over the longer term. The average competitor for the United States is investing at least 20 percent, and usually 25 percent, of GNP, and their investment is quite efficient. Moreover, if there is any shift noticeable in foreign views, it is a wider acceptance of the importance of efficiency. Eastern Europe wants to become more efficient. EC in 1992 will enhance the efficiency of a pretty efficient outfit. The Bank is now expecting far higher growth rates in Europe than before.

The next point is research and development (R&D). The United States spends, as a percentage of GNP, about 2.5 percent on R&D—it's very high; it used to be the world standard. What is surprising is the tremendous increase of R&D outlays in some other countries. Everyone knows about the large increase of Japanese private R&D. Korea also is an interesting case; it went in five or six years from approximately 0.7 percent of GNP to over 2 percent. Moreover, it shifted drastically the percentage of the financing from about 80 percent by government to the reverse today.

There are some other points to remember when you think about the United States work force. One is the growth of out-sourcing. Japan survived the high yen by quickly out-sourcing a lot of low-value activities. Out-sourcing was virtually invented in the United States, with the maquilladora industries, the growth of export processing zones, and the shifting of assemblage and other low-value activities outside the United States. Yet the acceleration of these out-sourcing activities throughout the world, while it makes for a more dynamic global marketplace, means that the work force in the United States must be better trained, more efficient, and more productive if it is to compete with the higher technology and higher resource use of other similar economies that are now out-sourcing as well.

The final point is a technical issue involving what are called tradables and non-tradables. Some can argue that the size of the United States economy and its very large service sectors mean that we do not compete in the non-tradable, mostly service, area. We don't have to worry that much about them. If their wages go far higher than their productivity, it's not that bad.

Technologically, however, we are in a situation where economists have a hard time determining what is tradable and non-tradable. We are competing in many non-tradable areas, in many service areas. The Saturday morning cartoons that children see are made in Manila. Software is made in India and even Santiago, Chile. These services are becoming tradables. U.S. policy is to accelerate this shift. At the Uruguay round, the U.S. has virtually proposed that almost every item in the national accounts be treated legally as a tradable entity.

Paul Meo is chief of the International Trade Division of the World Bank.

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New York's Competition Experience

Statement of Lee O. Smith

New York State has been looking at the issue of competitiveness very closely for the past couple of years. In 1987, Governor Mario Cuomo appointed the Commission on Competitiveness and Trade, a group of business leaders, experts, labor leaders, and public representatives to try to deal with an inconsistency in the way the state economy was performing: We had record job growth during most of the 1980s, and the unemployment rate was coming down. At the same time, the state was losing manufacturing jobs, which was causing concern. Even though people tend to think of New York as having an economy powered by financial services in the metropolitan area, in fact there were well over a million manufacturing jobs in the state.

The first thing the commission did was try to analyze the relationship between New York's manufacturing job loss and the increasing national trade deficit. We discovered—we expected—a very high correlation between the growth of imports and the loss of jobs. We did not expect to find that the job loss was in the most profitable sectors of the economy. The five sectors that had the highest rates of growth and profits in the 1960s and early 1970s were the ones that suffered the greatest losses in the 1980s.

We also discovered a very strong correlation between the decline of exports and our manufacturing job loss, and we were reminded of the extent to which the state's economy was dependent on exports—much of which had to do with the decline of Latin America as an important market for our exporters.

The New York Commission spent a good deal of time coming to grips with those findings and trying to reach agreement on the meaning of "competitiveness." It was finally decided that the most sensible definition was the one used by the President's Commission on Competitiveness. That definition links the competition between businesses to the standard of living. In other words, competitiveness is the ability in an open global economy to produce goods and services that are successful and that can maintain the standard of living and create the wealth needed to meet social and investment needs.

The President's Commission reported a set of warning signs of America's—and New York State's—economic problems: The first warning sign was the unprecedented trade deficit.

The United States ran trade surpluses until about 1980; by 1987, the trade deficit hit $170 billion.

The second warning sign was the fact that the United States became a net debtor for the first time in this century. The debt is about $550 billion, and at the current rate we'll be a trillion dollars in debt to foreign lenders within the next four years.

The third warning sign was the fact that import penetration had occurred in almost every sector. The competitiveness issue used to be thought of as something that affected only the rust belt states—the steel industry, the automobile companies, etc. As the economy progressed in the 1980s, more sectors became exposed to competition and started to see loss of market share. That has continued, and, today, the big challenge is in financial services, where there have been tremendous in-roads by commercial investment firms and banks in the American financial market.

The fourth warning sign was our slippage in technology. Until the 1980s, the United States was the undisputed leader in technology, investment in R&D, and innovation. We began to lose that, and the decline has accelerated in the last several years. It was reported recently that United States corporations are spending less on R&D than ever before.

The fifth warning sign was increased levels of volatility in the markets and risk and business failure in the 1980s, during the period of economic expansion, than we had ever seen before. An historical perspective is necessary to see the extent to which volatility and risk have become endemic in the economy. That is the kind of thing that discourages planning and long-term investment and contributes to the great number of business failures and closings.

The last warning sign was the fact that for many Americans the standard of living basically stagnated in the 1980s and continues to do so.

All these warning signs added up to one conclusion, which is that we are losing ground. We are not doing as well in the global economy as we should be.

In some respects, the situation we face is the result of our success. The New York Commission tried to point this out. After World War II, the United States set out a clear policy to build up the economies of other countries. We wanted Japan, Germany, and the rest of Europe to recover; we wanted a global economy of growth, an open economy of trade. We have created the world we wanted. We wanted strong competitors and strong economic centers all around the world. Now we have to learn to live with the consequences.

Reviewing the warning signs two years after the President's Commission report was issued, the trade deficit is down about one-third, but it seems that the improvement has stopped and projections are for deficits of at least $120 billion over the next four or five years. The current account, which is the broader measure, is also going to remain in the negative range.

Debt has increased. Risk in the economy is about the same. Growth is about the same. In terms of technology, the slippage has been accelerating in the last two years. Imports have increased, but exports also have increased.

An encouraging sign in New York is the willingness of small and medium sized companies to explore the possibilities of exporting. We have a large number of qualified companies that can export, but in surveys and discussions with these companies, the Commission found that many of them have never tried it, know very little about it, and find very little assistance. New York was at fault in that regard. We thought that if we organized a few trade shows and had a few manufacturers' shows, that would be enough. But it

is much more difficult than that. As a result, the state is developing some new initiatives in that area.

Living standards have remained about the same during the past two years. One of the brightest spots in the last several years has been the growth of productivity in manufacturing. There has been a great deal of discussion about the weaknesses of overall productivity, but I think the problem is in the service sector of the economy, not in manufacturing. The fundamentals have not changed that much in the last couple of years; the United States is still losing ground in the global economy. This has been masked by the fact that unemployment has been relatively stable, inflation has been relatively stable, and competitiveness problems affect individual industries and individual communities in different ways. Competitiveness is not a generalized thing that everybody feels at once, like high unemployment. Therefore, competitiveness doesn't really generate the kind of concentrated political initiative that other kinds of economic problems produce.

The President's Commission tried to address in some detail how we were going to prosper in this open economy. Obviously, tariffs and quotas and protection are not going to be the long-term answer for the United States.

You have to get back to the basic fundamental strategy of our economy to understand the current situation. We discovered in the 1930s that if you were going to have the technology of mass production you had to have mass consumption. We set out to create a consumer society, and we did that very well. We created a mass consumer society with a broad middle class. In the process, however, we forgot about the production side of the economy, the fact that we need to have an economic system that can produce as much as we consume. Governmental policies were more concerned with regulating companies and trying to restrict actions that might have adverse effects on consumers. One of the major problems is that we are consuming much more than we produce.

In New York State, we do not advocate cutting consumption as the solution. The answer is to raise the level of production and the quality and skill of the productive sector of the economy. We think that the trade deficit and the loss of competitiveness have now become structural problems. We don't think dollar devaluation or cutting the budget deficit are adequate responses; the problems are too deeply embedded in the economy.

Just take one example, the electronics industry, which is a very big industry, American consumers have no choice but to buy foreign-made products. And the same is becoming true in other sectors. So long as people are consuming, they are going to be buying imported goods.

The question is, how are we going to increase our level of exports? How are we going to recapture markets so that we can balance off the inevitable flow of imports in our economy?

There is an important opportunity for the federal government to help the states in this regard. In the past decade, many states have taken initiatives to increase competitiveness, ranging from job training to support for R&D at universities, help in exporting, and some financing programs. The tradition of positive programs to help companies and communities increase their competitiveness is active and thriving in state and local governments.

The job for the federal government is to find a way to support state initiatives in a way that encourages the states to experiment, to adapt the best practices from other states, and to help finance new initiatives. We cannot run a national competitiveness strategy from Washington alone. It has to be decentralized, that's the nature of our economy and of decisionmaking. We should see, though, a real partnership between the federal government and the states. Such a partnership has tremendous promise, and probably will not be costly to do.

One of the first things that should be done is for the federal government to provide more support for education. It is fine for national goals to be articulated in Washington, but the resources are needed in the states. The United States does not spend enough on education. Contrary to some assertions, we are not the world's leader in per capita spending on education; we are way down compared to some other countries. The policies that need to be implemented to make us more competitive are really of two types. Some of the policies have to be industry-specific.

The United States has to make the 1990s the decade in which it regains its capacity to produce. The challenge is to produce more than we consume, not to cut the level of consumption, and the federal government has an important opportunity to build on what the states have started and to create a partnership that can be successful in restoring and strengthening the productive capacity of the economy.

The New York Commission studied five industries that were important in the state. The MIT Commission on Productivity studied ten industries. The point of industry studies is very important: general macroeconomic policies, whether dollar devaluation or cutting the budget deficit or lower interest rates, affect different industries in different ways. Some industries are not really affected by the level of the dollar. Other industries are very sensitive to it. Policies are needed to address the needs of those industries. At the same time, other policies must support improvements that help everybody, for example, in education.

Lee O. Smith is executive director of the New York State Industrial Cooperation Council.

The EC Challenge to State and Local Governments

Statement of
Robert P. Strauss

The effect of increasing world competition on the private U.S. economy is very important, but I want to shift the discussion to the impact of such competition on our state and local government institutions.

First, let me define competition, then deal with its implications. Competition means, quite simply, that companies do not have control over price. When they dominate a market, they can set a high price, and can earn extra profits or "economic rents." What has happened in the American economy in the 1980s—and for many companies in Pittsburgh in particular—is that many companies have less control over price than they did in the 1970s and 1960s. Instead, world markets are setting those prices.

The implications for government are very profound. When a company does not have control over its price and is trying to keep its shareholders happy, it must minimize its costs. Various taxes and, implicitly, the benefits one gets from those taxes in the way of services, become much more sensitive than when a firm has control over price and can share some of these economic rents with labor and government.

Increased world competition will have profound effects on pressures for lower taxes and improved services. The ACIR and state and local governments need to look into the next century to respond to this new type of pressure. European integration, or 1992, is the first place where this pressure is coming from. These pressures will come at a time when other aspects of our environment are changing.

The rate of change in technology is going to continue to be very fast. We are going to see breakthroughs in biological science that will make the recreation of life possible. The computer chip and all that it has implied for the last 30 years will continue to change the way we look at the world in terms of communications. For example, it is a technological fact that we could have direct representation through cable TV if we wanted to—something that may strike fear in the hearts of all elected representatives in our many governments—but we do have, with the technology of the 1980s and 1990s, ways to reshape the way we make public decisions.

For government in the next few years, however, I expect little to change. With respect to the federal setting, it is likely that trench warfare on the budget will continue. Some people call this the politics of blame, or "after you Alphonse" federal tax policy to see who's going to blink first, the legislative or executive branches of government. A best guess is that the fiscal impasse will continue.

In state government, reelection and reapportionment will be the dominant themes.

Such governmental stasis comes at a time when Western European integration will increase pressure on our institutions. It is clear that the EEC will move to a common monetary base and seek increased coordination of fiscal policy. The easy flow across national boundaries of capital and labor will occur. As a result, the EEC will regain two advantages that we have had for many, many years. Europe will become a mass consumer market that will attract American capital and ideas and become an easier place to do business than before. Companies are investing there in anticipation of 1992 in order to gain access to this mass consumer market. Unless we refashion our local institutions to eliminate some of the heterogeneity that makes doing business in the United States difficult, the shift of capital and ideas will be profound.

Also, the events in Eastern Europe have implications for the politics of the United States. People here have seen on television that there can be massive political and social change. If people become increasingly unhappy with the gridlock in the federal government, there could be some unusual behavior as people try to find ways to break some of the gridlocks on political, financial, and social issues in the federal, state and local sectors. This may have an effect on our willingness to take political risks in the U.S.

The issue into the next century that confronts our federal system is how to make the state and local sector more hospitable, and less heterogeneous, while still allowing diversity. That is the challenge of the new competition before the state and local sector. Some may look to federal leadership to solve this problem; however, federal leadership without federal funds will not be sufficient. It is a hard fact of life that moral suasion without dollars does not go very far. If there is going to be a meaningful response, it will come from increased cooperation from state and local governments.

There are two areas where the states and their localities must act to remain competitive. The first area involves regulation and the second involves fiscal institutions. The area of regulation involves the adoption of uniform postures toward historically regulated industries (e.g., telecommunications, transportation, and banking) and in such local areas as building codes.

We need to develop more rules across the country that will lead to more uniform regulations. To the extent the states can agree on common treatment of things—such as how big a truck should be, how low speed limits should be, and how roads should be built—there will be long-term, national benefits. This is going to have to come from what I like to call a "Bottoms-Up Federalism" rather than what John Shannon used to call "do-it-yourself federalism."

With respect to fiscal institutions (to remain competitive vis-a-vis the EEC), greater harmonization among the states must occur. A meaningful response by the states must include increasingly common definitions of taxable bases, with states allowed to choose different tax rates. Up until European integration, the concurrent taxing authority allowed by our federal Constitution, and the presence of significant economic rents, allowed for both substantial heterogeneity and 80,000+ local governments. An integrated Europe with uniform regulatory and fiscal institutions will make our situation an historical luxury we can no longer afford.

Beyond achieving greater uniformity in fiscal base definitions, state and local governments need to address some

other structural matters. The ACIR can provide leadership in these matters. One issue is to match financing methods with the nature of services that are provided by the state and local governments. This means at the local level: (1) financing municipal services by the property tax and user fees, and (2) financing the local share of education with a local income tax, and the state share with a state income or sales tax. For states it means, state aid for tax exempt property and either revenue sharing to address commuter problems or enabling local government to impose commuter taxes.

Second, there is a need to sort out state and local responsibilities. This means (1) state assumption of much of the costs of courts, (2) a more substantial state role in paying for the foundation costs of education, and (3) the phasing out of unfunded state mandates.

Third, there is a need to take up the old issue of how to consolidate governments. This is something that was permitted in Pennsylvania's 1967 Constitution, but for which the legislature has never authorized legislation.

Finally, we not only have to make our institutions more homogeneous at the state and local level, we also need to improve the quality of our public outputs. I have several suggestions here, which are perhaps unusual:

First, the public sector, including the federal government, needs to think in terms of an analogy to shareholder reports, so the people really know what they are getting for their taxes.

Second, since I expect there to be greater state aid to local government in the future to balance out disparities, at least in the area of education, there is going to be a great need to create political recognition for raising state funds and giving them to local government. I like to call this giving credit to the state elk hunters for bringing home the elk to their local, elk-eating officials.

Third, there is a need for state and local governments to reward public managers for success in risk-taking and to penalize them for failure. This involves a wholly new attitude toward public servants. In the area of education, if we expect our principals to be more productive managers and to take risks, then they need to be paid better for their successes and they need to be fired for their failures.

Finally, we need to improve campaign financing, the quality of our political leadership, and the ethical base of public service.

Maybe I am jaded, coming from western Pennsylvania, but when our local school board in Pittsburgh started handing out Visa cards to defray "administrative expenses" of board members, I felt that they had gone too far.

The problem of local corruption or questionable ethics is not just a problem of one part of the United States. It is a part of local government in many states. If we are going to improve the quantity and quality of public outputs, we must change the way we finance our elections, do something with salaries to make public servants better paid for the work they do, and then finally insist on a higher ethical standard.

In order to achieve greater homogeneity in our state and local institutions, we need to address periodically the areas in which states should cooperate, and build ways on a continuing basis for the states to do so. The states may have to contemplate sub-federal legislatures to deal with interstate spillovers of many programs, especially if federal leadership is limited to moral suasion. There is no constitutional impediment for this, and it may be the only way that groups of states can get the resources necessary to even out interstate spillovers of costs and benefits.

In sum, I envision significant pressures on state and local government in the 1990s resulting from European integration. Whether we can respond effectively to make our state-local regulatory and fiscal environment more uniform in order to meet this challenge is the question I hope the Commission revisits in this decade.

Robert P. Strauss is director of the Center for Public Financial Management, Carnegie Mellon University, Pittsburgh.

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The Challenge of Competition to Fiscal and Functional Responsibilities

Statement of Alice Rivlin

National economic policy—what we want for the economy and how to get it—and federalism—what should be the division of functions between the federal government and states and localities—are not new subjects. What is new, and very important, is bringing them together.

The economic situation facing the United States for the foreseeable future is very challenging. There are several new elements that we have not had to deal with before. One factor is the increasingly interlocked and competitive global economy; the other is that we are no longer dominant, and we are not going to be. We are just one of the major players, and we have to recognize that.

The first thing to think about is what we want for the U.S. economy as we look ahead. That can be summed up in a few words, namely, sustainable growth in which all groups share. That phrase carries a lot of freight, but the three elements, namely, growth, sustainability, and all groups sharing, are all important for both domestic and international reasons.

We all understand why we need growth—per capita growth, a rising standard of living. The definition of competitiveness as that which gets you a rising standard of living is as good as any. We need a rising living standard for obvious domestic reasons, but also to be the kind of world leader we want to be: to command respect and to have the resources to contribute to joint peacekeeping efforts and environmental efforts.

Growth has to be sustainable—and it has not always been—and that again is important for U.S. leadership in the world. Growth cannot be at the price of degrading the environment. If we're going to tell the rest of the world to cooperate on reducing the threats to the global environment, we have to be doing a good job ourselves.

Growth cannot be only for the favored few or even for the favored many, if identifiable groups are being left out. Again, reversing the current trend to inequality is important for domestic stability and for having a voice in what happens in the rest of the world.

What is it going to take to make sure that we have growth in our standard of living? During the last couple of decades, we have grown in large part by putting more people to work. The influx of the baby-boom generation—and their mothers—into the labor force and the declining unemployment rates since the deep recession of the early 1980s have ensured that the U.S. had at least a modest rate of growth. We can no longer count on those sources. We cannot get unemployment down much more without risking inflation. We will experience slow growth in the labor force for the foreseeable future. The only way that we are going to get a rising standard of living in the future is by increasing the productivity of people who are at work.

We now realize that growth is going to take consuming less and investing more. Investment is not always efficient, but we really do not know any other ways to assure future growth except to take part of our current consumption and invest it to increase productivity. That means physical, human, particularly, and intellectual investment.

What is new in the last few years is the realization that all three kinds of investment are going to require the joint efforts of the private and public sectors. There is a new consensus in the business community that private investment isn't everything, that we have lagged in training, in education, in public infrastructure, and in the extent to which our public bodies are fostering intellectual investment in research and development.

Many questions arise about how we are going to do this. A big question is how we are going to get the savings that we need for this investment.

The realization that we need to improve our public investment over the new few years brings us to the federalism subject and to a major choice for the federal system: who takes the lead in this kind of public investment, the federal government or states and localities?

Not surprisingly, many people look to the federal government to take the lead, but that presents two big problems.

One problem is that the federal government is broke, there simply are no available resources for major new federal initiatives until we get the federal deficit under control (the budget deficit is a major use of our national savings). There is no apparent political interest in raising federal taxes to a level needed to do both of those things. Much more important is the fact that the federal government is not the right government to undertake most of these kinds of public investment expenditures. It may be a blessing that we have this fiscal situation, lest we launch into a new 1960s federal-government-does-everything approach.

It may be time to take a new look at governmental functions and at sorting out who does what best. Very briefly, there is a case for the federal government performing inherently national functions, such as defense and economic policy, trade policy, the interface between our country and others, and those functions for which uniformity is essential. The Social Security system is a good example of the need for uniformity; one would not want 50 different social security systems. We should expand the federal role in social insurance and in correcting problems, like air pollution, that produce major spillovers across borders.

There are other areas of public activity in which diversity and experimentation are desirable, and in which citizen participation and visible accountability are important. Those are the kinds of things that state and local governments ought to do—education, child development, training, most kinds of public infrastructure, and economic development.

The federal government probably would not be very good at industrial policy, but there has been quite a lot of success with state and local industrial policy. Local government working with local industry to improve the conditions for competitiveness of that industry or that area seems appropriate.

If one were to accept that division of responsibility, there remains the problem of funding. The state funding

problem has always been a difficult one, for two reasons: states compete with each other, and states have unequal resources. Although it has been possible for strong governors and mayors and legislatures to explain to the public why tax increases are necessary and to get them, it is always a difficult thing to do.

We need to think about how to mitigate the resource problem of state governments. That is probably more important than how to solve the resource problem of the federal government, at least with respect to this set of issues. We need to start thinking more about what I would call "common taxes"—taxes with a common rate for all states. Such taxes might be centrally collected and shared by the states.

For example, one could think of a value added tax at a common rate, say 5 percent, which would raise at least $100 billion, to be shared by the states on a population basis. One could think of that as a federally enacted collective tax put into a revenue sharing fund or as something that the states together decided was needed. The value added tax possibility is only an example of a generic approach to state taxation that ought to be considered for the future.

One could think of a common energy tax. We're going to need to tax energy so that we use it more efficiently. An energy tax that rose slowly and predictably over time would encourage investments in fuel conservation. The proceeds could be shared by the states. One could think of a common retail sales tax or even sharing a national retail sales tax between the federal government and the states. A gasoline tax could be handled that way. There are many possibilities.

The main point is that strengthening public investment is an important aspect of economic policy that ought to be done by the states and local governments. Hence, we need to think about moving states away from competing to have lower taxes and toward competing to hire better services. That takes a common tax base.

Where does that leave the federal government? Does it do anything for the federal deficit? Not directly. It would leave the federal government with the same problem, but with a new opportunity to resolve it: as the states became more clearly in charge of this range of investments and had more adequate funding to do so, it would be possible to devolve some of the remaining federal functions—and there aren't that many—back to the states. This would not solve the federal deficit problem, but it would take some of the pressure off. People would begin to realize that they should look not to the federal government for those things, but to states and local governments.

That doesn't leave the federal government with nothing to do. Foreign affairs, national economic policy, trade policy, and social insurance are all going to be important, and some of the investment that we need, as in basic research, should be done by the federal government. However, it does suggest that a new configuration of responsibilities and funding is needed between the states and the federal government as we move into this new period of economic development and competition.

Alice M. Rivlin is a senior fellow in the Economics Studies Program at The Brookings Institution.

The Discussion

Hawkins: Are there any questions?

Fraser: Just a minor point. Mr. Smith, will you repeat your seven warning signs?

Smith: The first warning sign was the growth of the trade deficit, which was unprecedented. The second was the growing indebtedness at all levels. The third sign was the high levels of risk and volatility in the markets. The fourth was relatively slow growth. The fifth was loss of our lead in technology and innovation. The sixth sign was the penetration of imports in every sector of the economy. And the seventh was lower standards of living.

Ruvin: What are the panelists' thoughts on how immigration—particularly illegal immigration—affects the competitive issue? Because that's one trade area we don't have a deficit in.

I think there was a comment that there wouldn't be future economic competitiveness—or that there wouldn't be future economic growth—as a result of the increase in labor force immigration. I would agree with that, but I'd like to hear some more reaction.

Rivlin: A moderate level of immigration is positive for our economy and gives us, in general, quite hard-working and energetic workers, as they have come for generations. I don't think illegal immigration is so much an economic question. We ought to decide what level of immigration we want for economic and other reasons, and then enforce the law.

Strauss: I have a simple attitude toward immigration. If people want to come, and they want to participate in our society and obey our laws, they should be welcome. We have set up quotas and severely restricted labor supply. If you believe in competition among companies, you ought to believe in competition among folks. We have benefited from immigration, and I don't agree with the current law restrictions that we have imposed. It would be a source of labor that would offset some of the demographics that are facing us.

Ruvin: I certainly am not suggesting that we raise barriers. The question simply is what the impact of immigration—particularly illegal immigration—might be on the competitiveness issue. Does this hamper our competitiveness? Does it enhance our competitiveness? Does it have any effect at all on our competitiveness in global economies? Particularly when you consider that we are sitting to the north of a region that has nearly 45 percent of its population under the age of 15, with virtually miniscule job futures, and a region from which the migration will continue to come.

Smith: I think that there is a relationship between immigration and competitiveness, which has to do with the fact that our traditional markets for exports in Latin America

have collapsed because of the third world debt problem, and many of the economies to the south of us have had severe problems. The immigration by those people hasn't been an act of free will, it's been an act of economic survival. It's not clear to me that the influx of millions of immigrants helps our competitiveness particularly. It encourages employers to follow low-wage strategies instead of increasing investment in equipment and R&D, and I don't think that we want to compete in the world economy based on wages.

The problem is to solve the third world debt issue so that the economies to the south of us can rebuild and strengthen themselves and people can find employment opportunities in their own homelands rather than being forced to come to the United States.

Meo: You asked us a demand question, a pull question, but there is a push question as well. Look at Mexico. The excellent changes in Mexico's economic policy are not fully understood. Mexico has essentially said it's determined to become a major economic actor in this hemisphere in the 21st century. I begin to have hope that they will be able to generate jobs and have a much more open economy in the future. A derivative and very important part of that will be United States openness to this highly competitive situation developing in Mexico.

Strauss: I'm sort of bemused by this discussion, living in Pittsburgh, and watching steel and auto decline because they were in part high-wage industries that ceased being price cutters. We are talking about fundamental economic forces. One of the economic benefits of having illegal immigrants—who I think ought to be legal—is that given their skills there's a broader supply of labor and it's kept wages in those industries relatively low, which has had a beneficial effect on prices. There are linkages among markets that are indisputable. If you say we should restrict immigration, we should bid up wages, we will find that we can't compete in certain areas in world markets.

Meo: I think this is the guts: Are they going to produce future automobiles in Puebla or Pittsburgh? If you bring the Pueblans into Pittsburgh, you can keep the wage rates down relatively and probably make Puebla less attractive for Honda, which is snooping around. If you do a sector deal with the Mexicans, and if you continue with the legal requirements for immigration, you'll make it more attractive for those jobs to be generated in Puebla. There are these trade-offs, if you will, everywhere.

Ruvin: Would you say that immigration is a topic that needs to be looked at in terms of its ramifications on our competitiveness, that our immigration policy is something that does affect our competitiveness and that we need to further evaluate the manner in which it affects competitiveness?

Meo: It is something that you should look at because not very widely known is the implication of the U.S. position in the Uruguay round. The U.S. wants a right of establishment in some service areas. They do not believe that a bank can have free service exchange unless it can open a branch office in, for example, India, and it has pushed this at the Uruguay round: the right of establishment would be negotiable. The Indians, of course, respond by seeking a similar right of establishment for construction, for example. If you take one establishment right, you must at least talk about the other one. Depending on results of the round in the future—I don't believe this issue will be resolved in the near future—how much of immigration is part of your trade or your competitive policy is going to be an issue.

Snyder: Several months ago, in Brussels, I went by a building that I was told holds 8,000 workers who are part of the European Economic Community, which everybody is excited about. And I suspect that most people in our country have never heard of it, let alone are excited about it. How does the World Bank see the impact of the EC on our economy?

Meo: I'm surprised that the vast majority of Americans don't realize how the European community, the 12, works, and, more importantly, the deals the EEC has with EFTA, for example, and the East Germans. For example, today an East German has a better trade relationship with the EEC than the United States, which is fascinating when you remember who belongs to whose pact. The EFTA economies, Scandinavia, Switzerland, and Austria, have free trade in all manufactured goods with the EEC.

The EEC is the world's largest exporter. It probably will soon have the world's largest GNP. It is slightly below the United States, at excessive exchange rates. If they go to a single monetary act as well, it will likely be a very strong competitor for the dollar, and the U.S. ability to borrow and influence financial markets will be strongly diminished.

There also are implications for the United States in the fact that the European Communities' Commissioner is the consulting chairman of the Eastern European aid groups, i.e., they have a strong interest and have accepted the leadership in undertaking the reconstruction of the economies of Eastern Europe. One would presume they would view with some sympathy further trade arrangements and deals in that area. This has a major impact on the United States. The authorities are fully aware of it, of course; the United States spends a lot of time looking at these things.

Snyder: It is amazing that those countries have accomplished what they have, in view of their history, that they have been able to come together to the point where the Japanese are more concerned about them than they are us.

Strickland: What is the prospect of coming to a common rate of exchange or a common dollar in the near future?

Meo: I suspect it may take a little longer. Some of the southern group of EEC countries have just entered the market, so it's going to be an interesting challenge. The EEC commissioned an econometric study of the impact on the EEC 12 of the single integrated market act. The estimate, which most people feel is probably conservative, is that it will give them a boost of about 3 to 5 percent of their GNP. Every year for the past three years, the bank has had to up its estimation of EEC growth rates. It's a very favorable economic expansion.

Fraser: Moving this into the social or public policy area, I've been watching the growing poverty in my community, and, as far as I can tell it's linked to the internationalization of our economy. We see industrial jobs moving to low-wage areas, some out of the country. In effect, our labor is having to compete with third world labor. As I reflected and thought of totally porous boundaries, I've assumed that over time we

would become a mirror image of the third world or of the other industrial countries, but that we lack some of the basic support systems that they provide to their people. My impression is that the internationalization of our economy is leading to growing inequity in the United States. Is that accurate?

There are other consequences as well. According to Julius Wilson, the loss of blue-collar jobs is contributing to the accelerating rate of single-parent families. That's having consequences in our cities: a very rapid growth in non-marriage families, and the growth of gangs. There's a whole spill-out of social pathology that seems to tie back somewhat to the internationalization of our economy.

Smith: We've had a tremendous loss of manufacturing jobs in the five boroughs of New York City. A lot of those jobs were held by members of the minority community. There is no doubt that the blue-collar sector of the economy has been hit hardest by international competition and that people who lack skills and education, the people for whom there hasn't been sufficient public investment made, are going to fall behind. The point that Alice Rivlin made about public sector investment is really essential. If we are going to have the people capable of producing high value goods able to create wealth, we have to give them more training, more education, more preparation. And I think that the internationalization of the economy has contributed directly to the growing inequality.

Rivlin: I think it's the wrong emphasis in the sense that it suggests that internationalization is basically bad for the economy. I think not; it's basically good. We do have a higher standard of living because we trade with the rest of the world, and if we cut ourselves off, it will be worse.

We are moving more and more toward a service economy, not just because of internationalization but for many reasons, and that's happening all over the world. We need to recognize that getting productivity up in the service industries is what our future standard of living really depends on.

Not that manufacturing doesn't matter, but we are actually doing quite well in manufacturing productivity, and that's part of the problem: fewer people are working to produce the same output in manufacturing. We need to turn our attention now to how to give the people who work in service industries the basis for higher productivity. That is not something that could be changed by closing our borders to either goods or people.

Strauss: Heavy industry—autos and steel, for example—was able to pay high wages because they dominated their domestic and, to some extent, international markets. That's gone. There's downward pressure on wages.

We need to create a safety net that works so that income security provides modest living with dignity. We also need to ensure that there are employment and retraining opportunities for adults, and that we invest in our young people.

The United States is going to prosper in the future by the quality of its ideas and its people. Without ideas and people and products, you cannot make profits, you cannot pay high wages. If you don't invest in people and in the creation of innovation in federal, state, and local governments, then you will not grow. There will not be as big a pie to divide up. That seems to be fundamental.

We have reduced what we're doing in public universities and in private universities. But that's not the only problem.

New York has done some very interesting things in the area of vocational education, trying to refashion it into science and technology education.

We have to invest in new ideas and recognize that ideas are transmitted now in a matter of months rather than years—some of our foreign competitors come to our markets and get our ideas before we take them to production. The issue is our people and our ideas, and that's how we'll grow.

Hawkins: Dr. Strauss, I see a contradiction between what you're saying now and in your statement. In one sense, you say we need less heterogeneity at the local level, we need metropolitan consolidation, but isn't that the management strategy of the 1950s rather than of the informational age of the 1980s?

Strauss: We could afford not to do it in the 1950s because we were in a different economic position. We dominated world markets then. The economic assumptions facing our economy are very different.

Hawkins: But what can we gain from metropolitan consolidation? Political leadership? More efficient public service delivery?

Strauss: Yes. And less harassment, corruption, and intermingling with the private sector so that it can go about its business. I wouldn't minimize this issue. Time is a fixed resource. When the private sector has to spend inordinate amounts of time understanding a zoning law or a tax structure, it will go to State Y instead of State X. We behave in our own private lives the same way. We look for convenience as well as quality. And with 82,000 local governments, we've got a ways to go.

Elazar: Isn't that an argument for more competition among local governments rather than less competition? If businesses are going to go where they can find a better deal, why would you want to consolidate and create the situation of local government monopoly?

Strauss: There's obviously going to be a trade-off between the number of people you want to do business with and the best price.

Hawkins: But isn't there an inherent contradiction? Economists extol the virtues of competition in the private sphere, but when it comes to the public sphere, they say we need a big public monopoly.

Strauss: My point is, for example, I come from a county with 132 municipal governments and 1.4 million people. That makes little sense.

Hawkins: We did economy-of-scale studies in California in 1973. Look at Los Angeles County. According to tried and true methods of your profession, they should have had diseconomies of scale in every public good they produced. But the county was right at the mean because it has to compete with 80 little cities.

(continued on page 23)

Intergovernmental Digest

President Bush Reaffirms Federalism Executive Order

President George Bush has reaffirmed his support for President Ronald Reagan's Federalism Executive Order No. 12612 (October 26, 1987). In a February 16, 1990, memorandum to the heads of all executive branch departments and agencies, the President stressed "that the principles of this order are central to my Administration." The order requires the federal departments and agencies to prepare federalism assessments of proposed legislation and regulations that would have major implications for state and local governments. This requirement is meant to minimize federal intrusion into areas of government for which the state and local governments have responsibility.

Anthony Commission Issues Final Report

After studying the impact of federal tax changes and mandates on the nation's cities and towns for the past two years, the "Anthony Commission" has released its final report, *Preserving the Federal-State-Local Partnership: The Role of Tax Exempt Financing*. The commission, which was headed by Representative Beryl Anthony, documents the burdens mandated on cities and towns over recent years as a result of changes in federal fiscal and tax policy and makes several recommendations to the Congress, including:

- A broadening of the definition of public purpose bonds to include facilities that are publicly owned and operated, or where the general public is the primary beneficiary of a privately owned facility and the private owner receives no other tax benefits.
- A halt to federal efforts to limit the market for tax exempt bonds further through such proposals as the alternative minimum tax.
- Congressional repeal of the current law requiring that a portion of general obligation and revenue bonds be under the volume caps.
- An increase in the current arbitrage rebate exemption for small issuers from $5 million annually to $25 million.
- Congressional action to halt the use of retroactive effective dates in tax legislation affecting municipal bonds.

Federal Court Reform Could Increase State Costs

Watch for the April 2 report of the Federal Courts Study Committee created by Congress in 1988. The committee sees a need for drastic federal court reform. In light of federal budget constraints, the committee is likely, among other things, to recommend ways to reduce the caseloads of federal courts by (1) narrowing access to federal courts, (2) channeling certain cases to administrative tribunals, and (3) diverting cases to state courts. The committee may recommend, for example, the elimination of most diversity jurisdiction cases (see *Intergovernmental Perspective*, Spring 1989), thus increasing state court caseloads. Major factors driving reform are the dramatic increases in appeals cases and drug prosecutions. Appeals from district court decisions, for instance, have increased from one in every 42 cases 40 years ago to about one in every eight cases today. Drug prosecutions now account for about 25 percent of the total federal criminal docket, 44 percent of all federal criminal trials, and 50 percent of all criminal appeals. Some federal judges now spend 70 percent of their time on drug cases. One result of federal court reform is likely to be more work and costs for state courts.

Federal Mandate Costs in Tennessee and Michigan

Governor Ned McWherter has issued a report on "The Impact of Federal Mandates on the State of Tennessee." The governor estimates that state costs incurred from existing federal mandates will increase from $11.6 million in FY 1987 to $127.8

million in FY 1995—an amount equivalent to a 1/4 cent sales tax increase or a 5-cent gas tax increase in the state. Michigan also has issued a report on the "Current Impact of Unfunded Federal Mandates and Reductions." The cost to the state of Michigan of current unfunded mandates is expected to increase from $45.7 million in FY 1990 to $89.7 million in FY 1991. When reductions of federal funding are added in, the costs increase to $64.0 million in FY 1990 and $124.7 million in FY 1991. The report notes that the FY 1990 cost of $64.0 million is larger than the FY 1990 general budget of 8 of the state's 19 departments.

Federal Aid Still Shifting from Places to Persons

The U.S. Department of Health and Human Services now accounts for 47 percent of all grant dollars disbursed by the federal government. Other federal departments and agencies are far behind: Transportation, 14 percent; Housing and Urban Development, 11 percent; Agriculture, 9 percent; Education, 9 percent; Labor, 5 percent; Environmental Protection Agency, 2 percent; and all others, 3 percent. This is a dramatic shift from 1960, when transportation represented 43 percent of the total and health represented only 3 percent.

Foreign Aid Coming to the U.S.?

At the request of the governors of Arkansas, Louisiana, and Mississippi, the Japanese Export-Import Bank is considering making low- interest loans to underdeveloped areas in those states. Generally, these loans are reserved for third world nations. The potential projects being considered—mostly industrial parks—have a total estimated value of $3 billion.

Federal Court Applies VRA to State Judicial Districts

Last December, a three-judge federal appeals court handed down a decision that applies the *Voting Rights Act* to judicial election districts. The court ruled that new district lines or the addition of judges must be precleared under Section 5 in those states where state legislative and local election districts are required to be cleared. This is the first time that the act has been applied to judicial districts.

Will States Limit Congressional Terms?

Proposals to limit congressional terms have sparked interest in some state capitols. Initial proposals have called for an amendment to the U.S. Constitution to limit the number of terms that can be served by members of Congress, but some states are considering whether an amendment is necessary. Article I of the U.S. Constitution specifies the length of House and Senate terms and certain other qualifications, but not numbers of terms. Consequently, states may be able to limit the number of terms served by members of Congress by statute or state constitutional amendment. Opponents of a limit argue that in a democracy the people should be free to elect whomever they wish as often as they wish, and that term limits will reduce the experience and expertise needed for an effective Congress.

Who Will Enforce Fair Housing?

Under the 1988 *Fair Housing Act*, HUD has written regulations that require state legislatures to reenact their fair housing laws to match the new federal act word for word, and to provide substantially more unreimbursed legal assistance than in the past if they want to retain their enforcement powers in this field. Currently, 38 states and 84 local governments are certified by HUD to handle housing discrimination cases. It appears that many of these governments will not be able or willing to be recertified under the new rules. If that happens, 3,500 cases per year could be shifted to HUD, the Justice Department, and the federal courts. ACIR has had informal contact with the U.S. Conference of Mayors and the National Association of Regional Councils, which have begun to look into this situation.

Reilly Seeks Omnibus Environment Law

EPA Administrator William K. Reilly, in a speech to the Natural Resources Defense Council on November 27, 1989, advocated a single new environmental law that would encompass the existing nine major statutes and emphasize pollution prevention and risk reduction. According to Reilly, "Under the existing environmental programs, each with its own statutory mandate, we have no mechanism—indeed we have no authority—to compare environmental risks across programs and to concentrate on those areas where we can realize the greatest benefits for human health and the integrity of natural systems."

Will Chemical Industry Seek Federal Preemption of State Environmental Innovation?

The chemical industry is monitoring environmental legislation in such trend-setting states as California, Florida, Georgia, Illinois, Massachusetts, New Jersey, New York, North Carolina, Pennsylvania, and Texas, where many environmental protection innovations are originating. The industry believes that such innovations increase the complexity and costs of doing business. Therefore, as the states seize more initiative on environmental matters, industry pressure for uniform federal standards may rise.

Slow Glow for Nuclear Waste Dump

The decision to build a nuclear waste repository in Nevada, which the Congress thought it had settled in 1987, appears to be stretching out to an indeterminate date. Nevada is resisting the federal move on environmental grounds, and the federal government is suing the state to allow the project to move ahead. The facility was originally scheduled to open in 1998, but even the most optimistic estimate now does not contemplate operation before 2010. The White House has agreed to appoint a civilian waste negotiator to work with Nevada under a provision of the 1987 act that has never been used.

Bloomingdale's Wins One on *Bellas Hess*

Legislation is under consideration to overturn the 1967 *Bellas Hess* decision, which held that mail order houses could not be required to collect state and local sales and use taxes on mail-order sales for states in which their only business presence is distributing catalogs and other ads. Congress has yet to act. In 1985, ACIR recommended that Congress enact legislation to negate *Bellas Hess*. ACIR estimates that in 1988 the total revenue loss to the states was $2.4 billion. This has spurred many states to pass laws to reduce the loss of tax revenues due to *Bellas Hess*. State legislative action has, in turn, generated court challenges. The most recent state court decision on the issue comes from Pennsylvania where, in 1985, the Department of Revenue ordered Bloomingdale's By Mail to register and begin collecting use tax on sales of merchandise in the state. On two separate occasions, Revenue Department employees who purchased merchandise from By Mail were able to return those items at an in-state Bloomingdale's store. The Department contended that such customer contacts went beyond those protected by *Bellas Hess*. The Pennsylvania court disagreed, reasoning that Bloomingdales' By Mail has insufficient nexus with Pennsylvanians because "Bloomingdale's stores in Pennsylvania do not solicit orders on By Mail's behalf nor act as its agents in any fashion and By Mail does not solicit orders for Bloomingdale's."

North Dakota Wins One on *Bellas Hess*

Chicago-based Spiegel, Inc., has agreed out of court to start collecting the 6 percent use tax on sales to North Dakota residents. With the support of the Multistate Tax Commission, the state had initiated a lawsuit to require Spiegel to collect the tax. Had the lawsuit been fully litigated, it could have been an important test of state laws enacted to bypass *Bellas Hess*. Spiegel indicated that the

costs of litigation would have been greater than the sales tax revenues to be paid. North Dakota accounts for less than 1 percent of Spiegel orders.

Southeastern Interstate Sales Tax Compact

The Southeastern Association of Tax Administrators has prompted 11 states to sign an interstate sales compact to exchange information on interstate sales and encourage businesses in their states to collect the sales tax voluntarily in states where they make regular sales. The states are Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, South Carolina, Tennessee, Virginia, and West Virginia.

State Taxation of Pensions Crosses State Lines

California has begun to tax the retirement incomes of former residents who earned their federal, state, local, and private pensions when they lived in the state. This so-called "source tax" could be especially attractive to other high-tax states, and could reach into low-tax states, where many retirees locate, as well as foreign countries. The National Association of Retired Federal Employees has warned its half-million members to watch for expansions of the source-tax concept. Nevada, where many Californians retire, has become so concerned about this new tax that it has passed a law prohibiting California tax collectors from placing liens against property in Nevada to enforce the source tax.

Court Says States Can Tax Sales of Religious Articles

On January 17, the U.S. Supreme Court ruled unanimously that states may apply their general sales taxes to religious organizations' sales of religious books and articles. The Court's ruling in *Swaggert Ministries* v. *California* was confined to whether the taxation of sales of religious articles violates the U.S. Constitution's First Amendment guarantee of freedom of religion. The Court said that it does not. Jimmy Swaggert Ministries, which challenged the California tax on nearly $2 million in sales during the 1970s, also had tried to challenge the state's tax on its mail-order sales, arguing that the organization's connection with California was too remote for the state to have constitutional authority to apply its tax (the *Bellas Hess* issue). However, because the California courts had refused on procedural grounds to rule on this aspect of the case, the Supreme Court said that it did not have the jurisdiction to rule on it.

Single Administrative Grants Forthcoming?

Since 1987, the National Governors' Association (NGA) and the National Association of State Budget Officers (NASBO) have worked to implement a pilot Single Administrative Grant (SAG) program. Under SAG, the federal government would award a single grant to states to administer AFDC, Food Stamps, and Medicaid. The pilot project, highlighted in the 1991 federal budget ("Advancing States as Laboratories"), is expected to begin in October 1990. Meetings will be held between NGA, NASBO, OMB, and other federal representatives to resolve basic issues in the federal version of the SAG Memorandum of Understanding (MOU). NASBO's 1988 MOU had proposed a SAG amount based on the historic ratio of federal administrative payments to benefit payments under the three programs. Under the federal proposal, the SAG amount would be fixed at a state's FY 1989 administrative expenditures, adjusted for changes in prices. Several other issues need to be resolved before negotiations with individual states can take place to begin the project.

The Discussion *(continued from page 18)*

Strauss: Let me talk about California in exactly that vein. There is a virtue in dealing with one unit that is levying taxes to provide public services rather than 47. And even though California has by most measures been a high-tax state, it has continued to prosper. One of the reasons is because the quality of the state and local public sector has been high. Consolidation of governments and getting them to a more efficient scale are separable issues, both of which make it easier for the private sector to survive.

Hawkins: I've been to many conferences in the last year listening to people talk to state and local officials about the imperatives of the new age. It always ends up that there has to be structural realignment. But you can achieve coordination in more than one way. One way is through the old industrial welfare state bureaucracy approach, which the private sector is getting rid of every day. Another way is to create—and this is one of the great challenges for federal and state officials—the policy structures that allow local governments to solve problems.

In California, you can say we need a regional transportation czar in the Bay Area because the local governments will not plan rationally. I say, as long as the state and feds say you can get in your car and get on the freeway at any time at zero cost, there is nothing local governments can do.

If we had a set of rational policies that created incentives for locals to do it, they could do it. Isn't that a more optimal solution than having a metropolitan government do it, impose it? Many times it is the incentives of the state and federal policies that are creating the problems in the first place.

Strauss: But it's also the case that local government exists, by its very definition, under state law. And that if the incentives were changed, you'd have to mandate or restrict what local governments can do. I see several areas where consolidation makes a lot of sense.

I am not saying we should go to county government for all general services, go to 3,000 general governments and eliminate the cities. But if you look around the country at 39,000 local governments, it's hard to understand why we have townships in urban areas. Because the political rationale for creating these organizations was based on economic and social and technological structures that are 100 to 200 years old. The states need to take another look.

Hawkins: I could make a very persuasive argument that we want more units of government rather than less, and here's the basis of the argument: We are creating a world in which the rate of change is growing almost geometrically. You have modern science combined with the incentives of a market-driven economy that is accelerating out of pace. The net effect of that is we're destroying institutions. What I see and hear is that people want community and they want control of their lives. They see themselves living in this tremendously competitive economic sphere in which we have less control. People want local governments as a form of community. Not everything is economics. There are social and political forces operating out there which I don't think we understand yet. In San Francisco, neighborhood groups are stopping more and more things, and business leaders are getting upset with that: we can't build a stadium, we can't do this, we can't do that. There are some pretty strong desires being expressed by a wide range of people. How are we going to sell them on the idea that they really shouldn't have the kind of control they have over zoning and housing and transportation, etc.?

Our political leaders are not going to say San Francisco is an irrational form of government and we need to consolidate it with all those little jurisdictions down the road.

Strauss: San Francisco is a metropolitan government in itself. People want control of their schools and what happens to their kids. They want safe streets and their garbage picked up, and I don't think they're particular whether it's done by a little town of 500 or a city of 50,000 or 250,000. I think you have to look at education versus all the other services, because education is what touches the core of every family. In the area of general government, and I'm not talking about consolidating school districts, there's an economic and administrative rationale for doing that. People also want to have honest police and good fire protection, and if that means a larger unit of government, then so be it.

Weiss: In New York people are concerned about more than just the control over schools. In my area, we have tremendous overdevelopment, to the extent that it could swamp communities, and people are up in arms about it.

We had, starting about 1949, the creation of community boards. There are 62 of them throughout the city. Nobody guessed that the City of New York rated 62 different small communities. But those boards have the capacity to allow input from the community, not to the total satisfaction of the people but sufficiently as they get resources, to be able to have an impact on what happens in their communities. It's not an easy choice.

Hawkins: In California we find that a lot of these small units are very rational economically; they contract with the county, they contract with private lawyers, they create joint powers agreements because people want the small communities.

The political dimensions of managing this new informational, highly competitive age is going to present our elected leaders with many challenges that are going to be different.

Snyder: I would just like to mention that Governor Mario Cuomo of New York, in his budget proposal, suggested consolidation among communities in the state.

Hawkins: What has been the evidence in the performance of consolidation of schools? Didn't the professional educators say that schools of 5,000 were the rational size to provide education? Wasn't that the dominant ideology?

Strauss: The argument for jointure is not just one of minimum cost. It's also to provide, in the case of education, electives, and so forth. Remember, I'm talking about two things: uniformity in revenue institutions so that the public sector can become easier to deal with, and consolidation where there's an economic and political rationale.

Remember, also, that my perspective is that of the Mononghahela River, where little communities sprang up like mushrooms, each with a mill and a wonderful revenue base. Now, the mills are gone, and they can't redevelop the river towns because they can't agree on a common development strategy. And that's true in other parts of the country.

Fraser: I see the tendency going in both directions. Policing is now going back to what was called community-based policing. The new police chief of New York City is talking the same way, and he came from Houston. On the other hand, it's clear that some functions have to be more adequately managed in broader geographical terms. It's the kind of argument that doesn't lend itself to generalization or simplicity; it becomes, rather, working out the function or the kind of context.

I wanted to go back to Dr. Rivlin's comment. When I stated my proposition about internationalization of the economy, I wasn't arguing against it, I was arguing for a recognition of its impact. I don't find that recognition being extended very broadly, particularly outside of Washington.

We talk about an educated work force, but we've got 40 percent of our black kids and 75 percent of our Native Americans not finishing high school. In Minneapolis, three years ago, we had 200 kids in gangs; now the police department estimates it's 2,000. I do not understand the visiting of a set of international policies on the American people without any effort to restore equity in the outcome.

Mr. Hawkins: In San Francisco, in the three lowest high schools, which are compensatory high schools, we spend almost $10,000 per year per student. They are the lowest high schools in the state and have been for years. You can send your kid to the best high school in San Francisco for about $8,000. But that's not the issue. The issue is incentives, and how you involve the parent and the student.

Education has been dominated by a demand and control structure philosophy for years, and we know now that what makes a productive school is the nexus in the classroom. The challenge to us in the public sphere is how we restructure the public sector to make the schools more productive.

Mr. Strauss: The educational issue is the one that the states and local school districts are going to focus on. The federal government will provide some moral encouragement but really no money, so there will be some confusion.

As a society, we let collective bargaining relations in the public sector, and especially in education, mirror industrial labor relations. And while industrial labor relations have changed in reaction to world economic forces, that hasn't happened in the public sector.

Today, in Pennsylvania, if the school district has a strike, they can still get their state aid as long as they do 180 days by the end of the fiscal year.

We have incentives built into the public sector in terms of education labor relations that put the kids last. And we have to figure out new ways to protect teachers' rights and deliver services to kids so that we address what Mayor Fraser was talking about, because we're wasting human resources in very large amounts.

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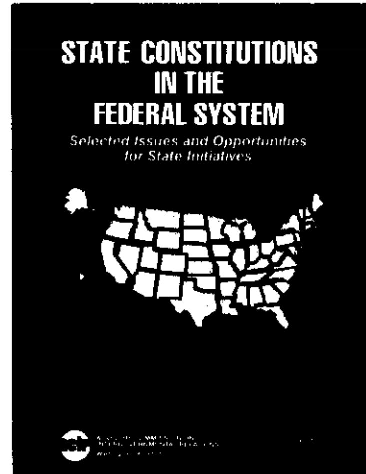

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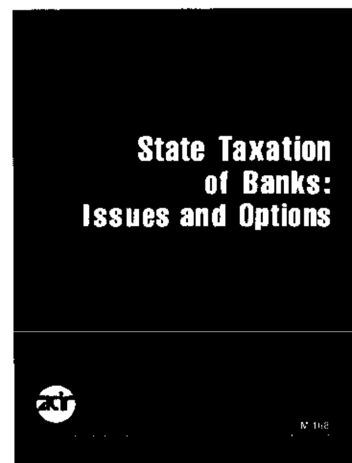

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State and Local Initiatives on Productivity, Technology, and Innovation

Bruce D. McDowell

Strengthening the competitive position of American businesses in the global economy has become a pervasive challenge for all governments in our federal system. As such, competitiveness has become a prominent motivator of innovations in state and local economic development programs.

The *Omnibus Trade and Competitiveness Act of 1988* included a provision to establish in the U.S. Department of Commerce a Clearinghouse for State and Local Initiatives on Productivity, Technology, and Innovation. In introducing this proposal, Senator Dale Bumpers of Arkansas noted that many state and local governments are "acting boldly and pragmatically" to address the competitiveness issue. His proposal was a modest one to assist state and local governments in their efforts to enhance business competitiveness by spreading the word about the creative steps being taken by those governments, as well as about related activities of the federal government.

The Department of Commerce asked the Advisory Commission on Intergovernmental Relations to help develop strong relationships with state and local governments and to assist in designing appropriate roles for the new Clearinghouse that would be of greatest support to state and local competitiveness initiatives. The Commission staff conducted a year of research and consultation with state and local governments, appropriate federal agencies, and a range of private-sector organizations. The Commission recommendations supporting the new enterprise were made to the Commerce Department on September 28, 1989, and the report is to be published this Spring.

The Commission's key finding is that many of the functions envisioned for the Clearinghouse by the Congress are being performed by a variety of state, local, and federal agencies, and some private sector units. It is essential therefore, that the Clearinghouse establish a nonduplicating niche, linking the other actors together into a readily accessible and highly utilized network and enhancing their operations.

Assisting Businesses to Compete

Internationally competitive businesses must be state-of-the-art, highly productive, farsighted, and wise to the ways of international markets. Many businesses achieve these characteristics by themselves, but others need help in doing so. They may need help to acquire new technologies, install flexible manufacturing processes that can be more responsive to quickly changing markets, obtain favorable financing (whether it be seed capital, venture capital, or permanent capitalization), develop adequate management capacity, understand export markets, have access to trained labor pools, obtain space to expand, and enjoy good labor-management cooperation, a favorable business climate, and adequate patent protection. Any given business may need only one or a few types of assistance, but, in the aggregate, the business community—especially the sector consisting of smaller businesses—is likely to need all of these forms of assistance if it is to achieve its full potential for succeeding in increasingly demanding domestic and international markets.

Many state and local governments offer business assistance programs such as business incubators, venture capital, seed capital, foreign investment, research parks, export marketing services, vocational and technical training, higher education, and joint industry/academic research and development resources. At the same time, the federal government offers assistance in (1) commercializing federal research findings, (2) disseminating published federal research results, (3) making federal laboratories available for testing and for joint research and development projects

State Technology Programs—Lessons

. . . it is clear that there are major flaws in the way many states are conducting their technology strategies.

The most serious problems appear to be the following:

Too few states have done their homework by performing serious strategic audits. Such audits are a necessary first step if strategic plans are to be developed on the basis of accurate, in-depth information about what is happening in state economies and where state innovation systems are failing.

Too few states have developed wholesaling strategies which give them leverage over investment decisions in the private sector.

Too many state technology dollars have gone into physical infrastructure—new buildings, new laboratories, and new research parks—rather than intellectual infrastructure.

States have focused too much of their attention on technology development, and too little on technology transfer and technology deployment. Serious commercialization strategies and technology transfer organizations are rare, as are active, comprehensive technology deployment programs. Even rarer are significant programs designed to encourage the new labor-management relations needed to get the most out of computer-driven production technologies.

Most state strategies consist of independent programs run at the state level rather than comprehensive programs run at the regional level.

Few state programs are aggressively measuring performance and outcomes, and even fewer are funding on that basis.

Few states are working with industrial sectors and regional clusters within their boundaries to improve their competitive edge.

Few states are working aggressively to change the culture of academia.

The most popular technology program model, the industry-university research center, appears seriously flawed. In most programs, academia is clearly in the driver's seat, and business is not intimately involved in defining the research agenda. As a result, too little technology transfer is taking place.

These problems are not overwhelming, and they should by no means call into question the validity of state efforts to stimulate technological innovation. They are simply the price we pay for experimenting. The important conclusion is not that our experiments have been flawed, but that if we are to truly take an experimental attitude, we must continue to learn from our mistakes and to refine our experiments. The lessons provided in this book are an attempt to help with that process. They should not be taken as final conclusions, but as the collected wisdom, at this point in time, of many of those who have been involved in this burst of experimentation over the past five years. They are not intended to offer conclusions about particular programs, but to suggest the right questions to ask as policymakers try to evaluate the effectiveness of their programs.

Reprinted from: David Osborne, *State Technology Programs: A Preliminary Analysis of Lessons Learned* (Washington, DC: The Council of State Policy & Planning Agencies, November 1989). Available for $10.00 per copy from CSPA, 400 North Capitol Street, Suite 285, Washington, DC 20001.

with industry and academic institutions, and (4) supporting small business development.

In addition, several national clearinghouses assist businesses in finding information about federal, state, and local initiatives for productivity and technology improvements. These include a repository of information on state technology extension services at the National Institute of Standards and Technology, the joint information program of the National League of Cities and Public Technologies, Incorporated, the NTIS Center for Utilization of Federal Technology, the Department of Commerce Productivity Center, the NASA technology utilization centers, the Federal Laboratories Consortium, the Small Business Development Centers, the Technology Applications Information System of the Strategic Defense Initiative Organization, and the Catalog of Federal Domestic Assistance.

One recent survey suggests that state governments have taken the lead in providing assistance to help U.S. manufacturers obtain and use technologies, modernize their manufacturing processes, and improve their productivity and profitability. Of the $620 million identified by the National Governors' Association and the National Institute of Standards and Technology as being spent on such programs in 1988, state governments provided 48 percent of the funding, the federal government provided 26 percent, and the remaining 26 percent came from a combination of industry, university, and local government sources.

Some sources of business productivity and technology assistance provide only passive information dissemination. Examples are program catalogs and directories, passive clearinghouses, newsletters, and articles.

Other sources of assistance provide brokering services; that is, they attempt to match businesses with information and assistance sources directly related to identified needs. Examples include interactive clearinghouses, public economic development agencies, and private technology and management improvement brokers.

Still other sources of business assistance provide hands-on help. Examples include federal laboratories, university research units, joint ventures among industries (including industry/federal and industry/university consortia), business assistance offices, job training and education units, and financial institutions.

Any given business may need only one type of assistance, but it is important to have all three types of assistance available for those businesses that may need them.

Gaps in Business Assistance

Despite the seeming surfeit of information sources on productivity and technology innovations, deficiencies exist

in serving business needs. Many businesses and the state, local, and federal officials attempting to serve them are unaware of the varied information sources and assistance resources available. Furthermore, it is not always easy to obtain this information.

For example, an evaluation of 19 directories of technology and productivity programs shows substantial information overlap, but also some gaps. In large part, these limitations reflect differences in objectives and targeted audiences. Some directories are designed primarily as "phone books." They list contact information for a broad array of programs, with little or no descriptive information. Other directories identify state programs within a particular category, such as capital assistance programs or university-based technology centers. Still other directories review initiatives for a selected number of states. Although the directories, taken as a whole, provide a good picture of the activities in the federal and state governments, few people have access to all of these sources, and they contain very little information about local government initiatives.

Another limitation of directories is that they get out-of-date quickly, as states create new programs and dismantle or restructure old ones. State and local officials frequently resist resurveys because of the administrative burdens involved in completing extensive questionnaires. Such resistance is strongest when the survey comes from a far-off federal agency with little promise of returning benefits to the respondent.

The other major deficiency in assisting businesses to become more competitive in international as well as domestic markets is that technology and productivity innovations have not been analyzed adequately. Most clearinghouses and directories are largely or completely descriptive. They give little guidance to a potential imitator as to what works best and the conditions under which success can be attained. Some of the best known programs have been evaluated, and the National Conference of State Legislatures maintains a computerized file of legislative audit evaluations, but there is relatively little agreement about how such evaluations should be performed or their validity. In addition, there has been little evaluation across groups of programs of similar types. Thus, it is difficult to advise the Congress, state legislatures, city and county governing bodies, and others about what works best, where, and under what conditions.

Although the *Omnibus Trade and Competitiveness Act of 1988* prohibits the Clearinghouse from evaluating individual state and local initiatives unless requested to do so by the program's sponsor, the law clearly anticipates the Clearinghouse providing policy analysis that could help elected officials to choose better programs for future support. This could be accomplished by peer reviews of groups of programs, focusing on the "lessons learned" rather than on comparisons and ratings of individual programs (see box on page 30). To assist others in evaluating their own programs, or programs under their official purview, the Clearinghouse should develop, through broad consultation processes, sound evaluation criteria to be applied sensitively by others who will assess productivity and technology innovations objectively.

Benefits of the New Clearinghouse

Experiences of earlier clearinghouses provide lessons for establishing the new clearinghouse in the most beneficial way. Some clearinghouses that have emphasized the accumulation of very large amounts of disparate information in a single data bank have become too difficult to maintain, too impersonal in their operations, and too remote from the sources of hands-on assistance that a business often needs to cope with specific problems. Often, requests for information are difficult to frame in terms that elicit an appropriate response from the system, and, frequently, the response produces an overwhelming flood of information, most of which turns out to be irrelevant. Cooperation from data suppliers usually wanes after the initial start up, and maintenance costs grow too high. In short, a series of smaller, decentralized, relatively specialized clearinghouses operating close to the information sources that they rely on have proved to be more successful than the larger, more diffuse efforts.

With this decentralized format, many constituents can benefit from the new Clearinghouse for State and Local Initiatives on Productivity, Technology, and Innovation. State and local governments want more timely information about each others' programs, as well as analytical guidance about which ones work best. In addition, they want more readily available information about sources of federal assistance. At the same time, federal agencies charged with responsibility for promoting the commercialization of federal research to assist the national economy could use this Clearinghouse to help market their inventions and research findings more effectively to a broader range of state and local governments and the businesses dealing with them. The Congress expects assistance from the Clearinghouse in helping it determine the best ways to reinforce state and local efforts to enhance the competitiveness of American businesses and stimulate the growth of the nation's economy.

Next Steps

To help move this effort along, ACIR adopted a series of recommendations at its January 1990 meeting urging the U.S. Department of Commerce to put the Clearinghouse into operation quickly, proposing that many existing clearinghouses affiliate with this new effort, suggesting that a variety of related federal agency efforts be focused on support of those affiliates, and urging the President and the Congress to consider a modest increase in the Clearinghouse budget.

These four recommendations reflect the Commission's conviction that it is in the national interest, and relatively inexpensive, for the federal government to encourage and reinforce state and local initiatives aimed at improving American businesses' capacity to compete successfully in world markets.

Bruce D. McDowell is director, Government Policy Research, ACIR. This article is drawn from a report adopted by the Commission on January 26, 1990.

Reassessing Competition among State and Local Governments

Daphne A. Kenyon

Almost a decade ago, the Advisory Commission on Intergovernmental Relations investigated the phenomenon of competition among state and local governments.[1] Specifically, interstate tax competition was the subject of one of a series of reports on disparities in regional growth. The major question raised by the Commission was "whether federal intervention is needed because interstate competition for industry has reached a point that is demonstrably adverse to the economic health of the states and the nation."[2] The 1981 report's general evaluation of tax competition was negative.

ACIR argued that tax competition could lead to:

Inadequate state and local spending;

A shift away from taxes based on ability-to-pay;

An increase in the proportion of taxes paid by individuals rather than by businesses; and

Wasted resources as state efforts to attract mobile industry from other states result in a "zero-sum game."[3]

In 1987, ACIR commissioned another look at competition among governments entitled "Interjurisdictional Tax and Policy Competition: Good or Bad for the Federal System?" The prospectus for the project noted that some recent research had arrived at a favorable assessment of interjurisdictional competition. For example, Charles McLure argued that "the likely benefits of reducing tax competition are relatively slight.... On the other hand, the benefits of tax competition are potentially quite important."[4] Albert Breton, who has been developing a theory of competitive federalism, based in part on economic theories of competition, concluded:

> Markets, when they are well structured and competitive, do a good job over the longer term in allocating resources in ways that maximize the well being of the population. . . . What is less accepted, but an idea in which I nonetheless believe just as strongly, is that governments, when they are well structured and competitive, do as good a job as markets, and like them over the longer term, allocate resources in ways that maximize the well being of people.[5]

The Commission's prospectus raised three key questions:

What forms does interjurisdictional competition take?

Does the nature, character, or intensity of competition differ across different activities?

Under what circumstances, can competition be regarded as beneficial or detrimental?

The reassessment of interjurisdictional competition commissioned by ACIR was intended to be both a review of the theoretical and empirical literature on interjurisdictional competition and a conceptual exploration of the topic. This article summarizes some of the key findings of the Commission's research.[6] This summary focuses on ways in which the current findings differ from those in the 1981 report.

There is much more to interjurisdictional competition than competing for potentially mobile businesses through the use of negotiated tax packages.

State and local governments compete along several dimensions. In addition to tax competition, state and local governments are involved in service and regulatory competition. In the service area, one might consider interjurisdictional competition in the areas of education, public welfare and public works infrastructure. In the regulatory sphere, right-to-work laws and laws regulating workers' compensation insurance have been identified as potentially important to a state's business climate.

Furthermore, because taxes pay for services, tax competition cannot always be divorced from service competition. Thus, in many instances, it is better to speak of fiscal competition—which includes both tax and service competition. This view, taken to its extreme, has consumer-voters and business owners and managers shopping among communities for the best "package" of taxes and services.[7]

Even focusing on taxes alone, it is clear that tax competition is a broader concept than the crafting of special deals for identifiable business firms. Frederick Stocker has distinguished four kinds of tax competition:

1. Competition with respect to overall tax levels.
2. Competition with respect to the levels of specific taxes (e.g., corporate income tax, individual income tax).
3. Competition with respect to specific features of tax laws designed to attract certain industries (e.g., state efforts to design favorable apportionment formulas for their corporate income taxes).
4. Competition to attract specific firms through negotiated tax packages containing tax concessions or abatements.[8]

States or localities might use any one of these avenues in order to attract or retain business firms. Evaluation of the results of tax competition will differ depending on which avenue for competition is the focus. For example, state policies that try to maintain generally low overall tax levels might be viewed more favorably than policies that allow a governor to negotiate on an individual basis with particular chief executive officers. In the first instance, no business firm can claim that a tax "giveaway" has created an inequity between an existing and an incoming firm.

Finally, competition among state and local governments can take two forms: active rivalry or implicit competition. Active rivalry exists when state and local governments compete for industrial plants that will provide jobs for foreign investment, for high-income citizens, and for tourists. Implicit competition, which may be as pervasive as active rivalry, can be defined as the way in which the free movement of goods, services, people, and capital constrains the actions of independent governments in a federal system. An example is the constraint placed on a city's ability to aid the homeless that results from a belief that such aid will attract "undesirable" homeless people from other jurisdictions and encourage outmigration by "desirable" high-income families who would foot the bill.

Interjurisdictional competition serves as one regulator of our federal system.

Competition among governments places certain bounds on the actions of the 50 states and 83,237 local governments in our federal system. For example, what constraint prevents one state from levying a personal income tax at a 50 percent rate, or another from offering free college education to all state residents while another state abolishes its university system? These are extreme examples, but they make a point: interstate competition will tend to narrow, but certainly not eliminate, the diversity among the states.[9]

If one jurisdiction levies too high a tax burden relative to others with which it competes for jobs and residents, economic growth will be slowed.[10] Similarly, if a state did not meet minimal national standards in its university system, it would have a great deal of trouble attracting industry. The choice of locations that our competitive governmental structure presents to individuals and businesses constrains the range of policies government can adopt because, over time, individuals and businesses can "vote with their feet" and move to other jurisdictions.

Competition has been a key concept in economics ever since Adam Smith explained it in the *Wealth of Nations* (1776). According to Smith, competition is the force that turns individuals, each acting in his or her own self-interest, to benefit society as a whole. The interaction of self-interest and competition produces an economic system that appears to be regulated by a benign "invisible hand."

According to some economists, competition among governments may play a role parallel to that of competition in markets.[11] Just as market competition produces an economic system responsive to consumer needs, interjurisdictional competition can produce a government system responsive to voter desires. To some extent both systems appear to be regulated by Smith's "invisible hand."

There is, however, a set of important circumstances in which the "invisible hand" is not benign. These are the circumstances of "market failure," namely, the inability of markets to provide certain goods either at all or at the most efficient level. An important type of market failure arises when an economic activity causes incidental benefits or damages to others ("third parties") and for which no mechanism exists for compensating or penalizing those who initially generate the activity. Air or water pollution provides the classic example of such an "external" or "spillover" effect.[12]

Just as the analysis of private market competition has pointed to externalities as a major cause of market failure, the existence of spillovers between governments may negate the potential benefits of competition among governments. For example, competition among governments may have harmful effects when governments are allowed to "export" certain social costs (e.g., pollution or the burdens of providing welfare services) to residents of other jurisdictions.

Interjurisdictional competition does not necessarily depress state and local service or revenue levels.

In reviewing the history of state and local revenue systems, John Shannon argues that:

> The remarkable revenue performance of our 50 state-local systems since the end of World War II has knocked into a cocked hat the old conventional wisdom—that states and their localities were destined to have anemic revenue systems because they were "crippled by fears" of intergovernmental competition. . . . As a percent of gross national product, state-local own source revenue has risen from 6.6 percent to 12.1 percent [from 1949 to 1987.][13]

Perceptions of state and local officials also provide evidence that competition does not necessarily hold down state-local spending or revenues. Parris Glendening, county executive of Prince George's County, Maryland, has described how competition with surrounding counties

put pressure on his county to improve its school system. In order to pay for this, the county raised $100 million in additional revenues.[14]

Why did the previous literature maintain that interjurisdictional competition was bound to depress service levels of state and local governments? The old consensus focused almost totally on the tax side of the fiscal equation. This led to a confused analysis of the results of competition among governments. If high-income citizens and businesses cared only about the level of taxes they pay, competition would appear to lead to an ever lower level of taxation and, inevitably, to inadequate service levels.[15]

Some recent research, with an emphasis on a package of taxes and expenditures, brings a bit of balance to this discussion. By looking at both sides of the budget equation, support has been generated for the view that although high tax levels can reduce the attractiveness of a particular state or local government, high service levels (often measured by the proxy "expenditure level") increase the attractiveness of that same government. For example, empirical studies of mobility and the determinants of state economic growth have shown that spending on education tends to increase property values, draw immigrants, and increase the rate of state economic growth.[16]

It is important to note, though, that the effects of interjurisdictional competition on state and local spending vary by service area. It is possible for interjurisdictional competition to promote higher service levels in certain areas and to depress service levels in other areas. Even proponents of the new view of competitive federalism are concerned about the effects of interjurisdictional competition on the level of services in those areas that are likely to generate significant beneficial spillovers (e.g., care for the homeless).

Current research confirms the tendency for interjurisdictional competition to reduce reliance on ability-to-pay taxes.

Another traditional concern regarding interjurisdictional tax competition has been that it appeared to pressure state and local governments to turn away from ability-to-pay taxes and toward more regressive taxes. Wallace Oates and Robert Schwab recently reexamined the effects of interjurisdictional fiscal competition on the ability of governments to redistribute income.[17] They make two important points.

First, competition among governments produces a system in which all local government (and to a lesser extent, state government) taxes will tend to become benefit taxes. That is, in equilibrium, the taxes that individuals and businesses pay will tend to equal the respective values they place on public services received. Thus, in a competitive environment, business taxes are unlikely to be used for social programs, parks, or education. Business taxes will, however, be of sufficient magnitude to pay for such business-specific services as police protection, public utilities, and roadways.

The second major point is that any evaluation of this tendency for state and local governments to adopt benefit taxes depends crucially on the federal role in redistributive policy. If the federal government provides the right amount of support for low-income households, the state and local fiscal system that results from a competitive environment will be efficient and will not create inequities. If the federal government does not fulfill the redistributive role, however, one can be critical of interjurisdictional fiscal competition for making it impossible for state and local governments to fill that gap.

There is less concern about reduced state and local reliance on business taxes.

According to the past consensus on the effects of interjurisdictional competition, a related harmful effect of competition among states and localities was a shift from taxes levied directly on businesses to those levied directly on individuals.[18] The presumption was either that taxes on business had a more progressive incidence than taxes on individuals or that good public policy consisted of levying a substantial amount of taxes on businesses because they as well as individuals should bear their fair share of taxes.

The progressivity part of this argument is flawed. To see this, one must begin by recognizing that, ultimately, people, not institutions as such, pay taxes. A tax on the business enterprise is paid by owners of the firms' capital and property, its workers, and/or its consumers. To put it another way, although it is clear that the *impact* (site of the legal monetary obligation) is on the business entity, the *incidence* (the change in the distribution of income due to the tax) is always on individuals.

The key "gressivity" question is, then, which set of individuals—owners, workers, or consumers—bears the ultimate burden? If the tax falls on the owners of capital or property who tend to have relatively high incomes, the tax burden will be progressively distributed. If, however, the tax is shifted to workers (in the form of lower wages) or consumers (higher product prices), then the tax is probably regressive in effect.[19]

What is the net effect? That depends on a variety of market factors, which, in turn, vary by type of business activity. Suffice it to say that from the viewpoint of a single state, an increase in general business taxation will probably not be exported to nonresidents, but will be shared by the workers, consumers, and owners of immobile capital and land who reside in that state. Thus, there is most certainly a regressive element to business taxes. That leaves the state personal income tax as the primary tool for introducing progressivity into a state/local tax system.

Does this mean that "equity" requires that no state or local tax should be imposed on business? Not at all. There is also a "benefits received" element to the equity concern. Within this context, there are at least two justifications for state taxation of business, both of which are based on the "benefits received" principle of taxation. The first: since a state is an open economy, taxing income at its source is the only procedure available for assessing individuals, wherever they reside, for the benefit of public services that accrue to them indirectly through the business entity. The second rationale notes that since businesses receive business-specific benefits of government services (roads, sewage treatment, education for the workforce, police and fire protection), economic efficiency requires that the cost of these services (government operating as a factor of production) should be reflected in the overall cost structure of the firm.[20]

Thus, although the "gressivity" argument probably leads to less concern today regarding reduced state and local reliance on business taxation than at the time of the last ACIR report on interstate tax competition, there is, nonetheless, a good case to be made for state/local taxes on business. Ideally, the "fair share" amount of the tax would be related to the sum of the benefits received by business owners and factor suppliers.

Efforts to use tax incentives to attract mobile industry are still generally in disfavor. Current research on interjurisdictional competition is still generally critical of individually negotiated tax packages designed to lure new industry or to retain existing industry. Some of the standard criticisms apparently still hold, and, in some cases, these criticisms have been buttressed by additional research.

Dick Netzer's analysis of the explicit efforts by states and localities to influence location decisions of attracting business firms through tax incentives concludes that such activity is likely to have a negative-sum effect until all jurisdictions are offering equal incentive packages, at which time these efforts at economic development collectively have a zero-sum effect. He comes to this conclusion from the assumption that tax incentives merely shift economic activity around, and, in many cases, shift the activity from its most productive use to a less productive use.[21]

Larry Ledebur and William Hamilton take another tack in their criticism of state and local tax concessions to business. They have done cost-effectiveness studies for a variety of such incentives, where the benefits measured are those received by the firm in question, and the costs are the opportunity costs borne by the subsidizing government. Ledebur and Hamilton conclude that tax concessions are not cost-effective. State and local government revenues forgone through tax expenditures are greater than benefits derived from recipient firms. It is unlikely that any form of tax concession can be cost-effective.[22]

Ledebur and Hamilton's criticism of tax incentives used to attract mobile businesses is even more condemnatory than Netzer's. According to Netzer, tax incentives are a waste of resources from society's point of view; according to Ledebur and Hamilton, tax incentives are likely to be a waste of resources for the jurisdiction offering them, too.

A few analysts note instances in which special tax incentives can be sensible. For example, Nonna Noto describes the process a community must go through in an economic crisis. She points out the high economic and psychic costs incurred by households forced to uproot themselves in the search for new jobs. When all these costs are accounted for, the benefits of special tax concessions may exceed the costs. Noto points out further that rigorous analysis must be done to determine when, if ever, targeted tax concessions might be preferred to general tax cuts. The old consensus focused on the inequities of favoring a mobile firm over an immobile one. However, if firms differ in the benefits they can offer to communities in which they can potentially locate, it is not clear that their tax liabilities should not differ also.[23]

Concluding Note

Over the last decade, interest in the effects of competition among state and local government has remained intense. A wealth of theoretical and empirical research has added to our understanding of interjurisdictional competition. Compared to ten years ago, some conclusions about the effects of interjurisdictional competition have changed. Most significantly, some of the potential benefits of competition among state and local governments have been recognized.

Notes

[1] U.S. Advisory Commission on Intergovernmental Relations, *Interstate Tax Competition* (Washington, DC: March 1981).

[2] *Interstate Tax Competition*, p. 1.

[3] *Interstate Tax Competition*, pp. 9-12.

[4] Charles E. McLure, Jr., "Tax Competition: Is What's Good for the Private Goose Also Good for the Public Gander?" *National Tax Journal* 39 (September 1986): 346.

[5] Albert Breton, "Towards a Theory of Competitive Federalism," *European Journal of Political Economy* (Special Issue) 3 (1987): 322.

[6] See Daphne A. Kenyon, "Interjurisdictional Tax and Policy Competition: Good or Bad for the Federal System?" various drafts, and "Competitive Federalism: A New Look at Interjurisdictional Tax Competition," prepared for delivery at the 1988 annual meeting of the American Political Science Association, Washington, DC; and Daphne A. Kenyon and John Kincaid, "Rethinking Interjurisdictional Competition," *Multistate Tax Commission Review*, October 1988.

[7] Charles Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy* 64 (1956): 416-424. The Tiebout model stipulates an infinite variety of communities, each offering a different package of public services and taxes. On the assumption that all private goods are available at the same price, the individual selects his/her site in a manner that balances marginal site costs (e.g., housing costs plus taxes) with higher marginal evaluation of the public service package.

[8] Frederick D. Stocker, presentation at session on "Business Fiscal Incentives Problems and Issues" at Conference on Business Tax Incentives and State Economic Development, sponsored by the Midwestern Legislative Conference of the Council of State Governments and the National Tax Association, Chicago, Illinois, May 13-14, 1988.

[9] There are cases where federal intervention is called for. A state should not be allowed, for example, to establish a toxic waste dump on top of a neighboring jurisdiction's underground water supply. Similarly, the federal government must enforce civil rights laws, the commerce clause of the Constitution, antitrust statutes, and the like.

[10] See Michael Wasylenko and Therese McGuire, "Jobs and Taxes: The Effect of Business Climate on States' Employment Growth Rates," *National Tax Journal* (December 1985): 497-511.

[11] Breton. Others caution, however, that the extension of the individual preference approach used in analyzing the demand for private goods may be based on familiarity with the tools of microeconomics, and that it is difficult to demonstrate that in fact a relationship exists between the taxes whereby government services are financed and the demand of any one individual for public services. See Werner Z. Hirsch, *The Economics of State and Local Government* (New York: McGraw Hill, 1970). Chapter 2.

[12] These circumstances are discussed in any standard public finance textbook. See, for example, Vincent Ostrom, Robert Bish, and Elinor Ostrom, *Local Government in the United States* (San Francisco: Institute for Contemporary Studies, 1988), Chapter 5.

[13] John Shannon, "Intergovernmental Competition: Where There Is an Expenditure Will, There Is a Revenue Way," prepared for the U.S. Advisory Commission on Intergovernmental Relations-Urban Institute Conference on Interjurisdictional Tax and Policy Competition, March 23-24, 1988.

[14] Parris Glendening, "Protecting Citizens through Appropriate Cooperation and Limited Competition," U.S. Advisory Commission on Intergovernmental Relations, *Interjurisdictional*

Competition in the Federal System: A Roundtable Discussion (Washington, DC: August 1988), p. 9.

[15]For example, the 1981 ACIR report argues, "Although some tax concessions are self-limiting, the general concept of business tax relief is not. The pressure for an extension of tax concessions to business and individuals need never abate when proponents argue that the "tax breaks" do not shift taxes because they promote prosperity for everyone" (*Interstate Tax Competition*, p. 10).

[16]Wasylenko and McGuire conclude that spending on K-12 education is a strong determinant of employment growth rates in a state's retail trade and finance sectors. They also conclude, however, that tax and spending variables are not the most important factors likely to determine differential growth rates across states; nonfiscal policy factors (e.g., wage levels, energy prices, weather, income) are more important.

[17]Wallace E. Oates and Robert M. Schwab, "The Allocative and Distributive Implications of Local Fiscal Competition," prepared for the U.S. Advisory Commission on Intergovernmental Relations/Urban Institute Conference on Interjurisdictional Tax and Policy Competition, March 23-24, 1988; revised draft, June 1988.

[18]*Interstate Tax Competition*, page 10.

[19]Because a uniform national tax on business income (e.g., as approximated by an average burden of state income taxes) represents a decrease in the return to owners of capital, its incidence would be progressive.

[20]Charles E. McLure, Jr., "The Elusive Incidence of the Corporate Income Tax: The State Case," *Public Finance Quarterly* 9 (October 1981): 395-413. For a discussion of this article and related research, see Ronald C. Fisher, *State and Local Public Finance* (Glenview, Illinois: Scott, Foresman and Company, 1988), pp. 226-228.

[21]Dick Netzer, "An Evaluation of Interjurisdictional Competition through Economic Development Incentives," prepared for the U.S. Advisory Commission on Intergovernmental Relations/ Urban Institute Conference on Interjurisdictional Tax and Policy Competition, March 23-24, 1988.

[22]Larry C. Ledebur and William W. Hamilton, "The Failure of Tax Concessions as Economic Development Incentives," in Steven D. Gold, *Reforming State Tax Systems* (Denver: National Conference of State Legislatures, 1986), pp. 112-113.

[23]Nonna A. Noto, "Trying to Understand the Economic Development Official's Dilemma," comment on Dick Netzer's paper "Economic Development" prepared for the U.S. Advisory Commission on Intergovernmental Relations/Urban Institute Conference on Interjurisdictional Tax and Policy Competition, March 23-24, 1988.

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Books, etc.

Aging

AGING IN AMERICA: *The Federal Government's Role.* Congressional Quarterly, Inc., 1414 22nd Street, NW, Washington, DC 20037, 1989. 102 pp. $11.95.

This CQ "current affairs" book deals with the elderly, Social Security, Medicare and Medicaid, catastrophic illness costs, and long-term care. The U.S. population is growing older. In 2011, the first of the baby boom generation—those born between 1946 and 1964—will turn 65. By 2030, at least one in five Americans will be elderly. Because of the tremendous changes that will occur in American society, attention is now being focused on issues of importance to the elderly and to the shrinking younger population that will have to support a much larger class of aged citizens.

Drugs

THE BUSINESS OF DRUGS. By Mary H. Cooper. CQ Press, 1414 22nd Street, NW, Washington, DC 20037, 1990. xiii, 165 pp. $15.95.

This book presents a comprehensive overview of the international business of drugs, concentrating on the economic forces that drive the drug market. Separate chapters on cocaine and crack, heroin, and marijuana trace the drugs from cultivation to refinement to their distribution routes, usually in the United States. Other chapters address the influence of drugs on society and the attempts of federal, state, and local governments to disrupt the industry.

Economic Development

ECONOMIC DEVELOPMENT IN THE STATES. Council of State Governments, Box 11910, Iron Works Pike, Lexington, KY 40578, 1989. $20 each.

The past few years have seen a tremendous increase in state programs to stimulate economic growth. State officials are discovering that many voters cast their ballots as much in review of the economy as in judgment of the office-holder. Policymakers face a fundamental challenge as they decide whether and how to tailor incentives to attract specific firms or to offer incentives as part of more comprehensive economic development strategies. To help officials make more informed decisions, in 1988, the CSG Policy Analysis Service undertook a study related to state business tax and financial incentives. The study is in three volumes: *State Business Incentives and Economic Growth: Are They Effective? A Review of the Literature; The Changing Arena: State Strategic Economic Development,* and *The States and Business Incentives: An Inventory of Tax and Financial Incentive Programs.*

Environment

ENVIRONMENTAL POLICY IN THE 1990s. Edited by Norman J. Vig and Michael E. Kraft. CQ Press, 1414 22nd Street, NW, Washington, DC 20037, 1990. xiv, 418 pp. $18.95.

When the first "environmental decade" was launched 20 years ago, protection of natural resources seemed a relatively simple proposition. Great progress has been made, but the task has become far larger, involving change in human behavior. This book seeks to explain the most important developments in policy and politics and to analyze the central issues for all governments in the next decade. Organized in five parts, the book provides a framework for analyzing policy changes, details policy dilemmas that need to be resolved, discusses alternative coordinating mechanisms, addresses the new global environmental agenda, and raises the issue of whether democratic political institutions are capable of resolving the ethical and value conflicts that underlie environmental politics.

Federalism

THE MIDWEST RESPONSE TO THE NEW FEDERALISM. Edited by Peter K. Eisinger and William Gormley. University of Wisconsin Press, 114 North Murray Street, Madison, WI 53715, 1988. xiii, 319 pp. $37.50 (cloth). $15.75 (paper).

This collection of papers focuses on Indiana, Illinois, Michigan, Minnesota, Ohio, and Wisconsin. These states represent a wide spectrum of political cultures, from the progressive traditions of Minnesota to the machine remnants found in Indiana and Illinois. The contributors examine how these states adapted to block grants, how local governments have dealt with the new fiscal stringency, and how state and local governments have responded to inconsistencies and contradictory messages concerning federal regulations in welfare, transportation, civil rights, and environmental policy.

RESTORING BALANCE IN THE FEDERAL SYSTEM. *A Report of the Intergovernmental Affairs Committee.* Council of State Governments, Box 11910, Iron Works Pike, Lexington, KY 40578, 1989. 64 pp. $30.

No issue has raised more concern among states in recent years than the need to restore balance between the responsibilities of the states and the federal government. There is no one solution. Proposals for change have included public education, lawsuits, reapportionment, political pressure, and statutory and constitutional changes. In 1989, CSG's Intergovernmental Affairs Committee undertook to analyze the options and seek consensus on action. A report setting out tentative conclusions was sent to the state legislatures, hearings were held jointly with ACIR throughout the country, and other organizations were consulted. This report contains selected testimony from the CSG-ACIR hearings and a statement of the Intergovernmental Partnership Task Force, a coalition formed to examine constitutional reform.

Finance

FINAL REPORT OF THE ANTHONY COMMISSION ON PUBLIC FINANCE. Government Finance Officers Association, 180 North Michigan Avenue, Suite 800, Chicago, IL 60601, 1989. 58 pp. $6.00.

After a two-year study of the impact of recent federal tax law changes on state-local finance, the Anthony Commission recommended specific improvements in the law that would allow state and local governments to provide revenues for infrastructure and would strengthen the federal-state-local partnership. Citing the reality that the era of substantial federal support for many state and local projects has ended while state and local governments' access to the tax-exempt bond market has been reduced and made more costly, the commission encourages the Congress to reexamine a number of provisions in the Internal Revenue Code that go beyond their stated purpose of preventing abuses.

STATE-LOCAL FISCAL INDICATORS. By Steven D. Gold and Judy A. Zelio. National Conference of State Legislatures, 1050 17th Street, Suite 2100, Denver, CO 80265, 1990. vii, 103 pp. $25.

This compendium demonstrates the diversity in spending and taxing patterns among the states and attempts to place that diversity in perspective. The authors selected a limited number of indicators of key relationships and analyzed them in terms of population, personal income, and other demographic or economic measures. This volume is a companion to *Reforming State Local Relations: A Practical Guide*.

Immigration

OPENING AND CLOSING THE DOORS: *Evaluating Immigration Reform and Control.* By Frank D. Bean, Georges Vernez, and Charles B. Keeley. Urban Institute Press, 2100 M Street, NW, Washington, DC 20037, 1989. xiv, 138 pp.

In 1988, the Rand Corporation and the Urban Institute established the Program for Research on Immigration Policy to follow the five-year implementation process of the 1986 *Immigration Reform and Control Act* and to investigate continuing policy issues. The first in a series of annual overviews, this volume outlines general immigration trends and policy proposals, focusing on major historical features; provisions, implementation, and effects of the reform act; and recent trends in legal immigration and refugee admissions.

Infrastructure

CAPITAL PROJECTS: *New Strategies for Planning, Management, and Finance.* Edited by John Matzer, Jr. International City Management Association, 777 North Capitol Street, NE, Washington, DC 20002, 1989. 228 pp.

This book brings together material that can help local managers and public works directors solve infrastructure problems. It shows what some local governments have done to implement sound planning and priority setting processes, monitor and assess the condition of existing facilities, and implement systematic maintenance programs. The book includes case studies, charts, checklists, forms, and other practical tools that can be incorporated into local capital improvements programs.

Intergovernmental Relations

REFORMING STATE-LOCAL RELATIONS: *A Practical Guide.* By Steven D. Gold. National Conference of State Legislatures, 1050 17th Street, Suite 2100, Denver, CO 80265, 1989. xxiv, 159 pp. $20.

This book is intended to provide state officials and others with a concise discussion of policies that can be adopted to improve state measures affecting local governments. It takes its direction from the recommendations of the NCSL Task Force on State-Local Relations. The philosophy underlying the recommendations is that states ought to reconsider their policies toward local governments because of fundamental changes taking place in the federal system. The task force recognized that no "grand design" for state-local relations can be developed to apply to all states. The guide attempts to identify the major issues that the states may consider.

Local Government

ADMINISTRATION AND FINANCE OF ILLINOIS TOWNSHIPS. By Norman Walzer and Nancy Baird. Illinois Institute for Rural Affairs, Western Illinois University, Macomb, IL 61455, 1989. 98 pp.

This report is based on a survey of more than 1,400 township supervisors. It calls attention to the needs of rural governments and illustrates ways that public officials have worked to find solutions. The authors point out that public services in rural areas are threatened by property tax base declines and poor local economic performance. Population losses, increasing age of residents, and low local income compound the fiscal issues.

Mandates

COPING WITH MANDATES: *What Are The Alternatives?* Edited by Michael Fix and Daphne A. Kenyon. Urban Institute Press, 2100 M Street, NW, Washington, DC 20037, 1990. xiv, 110 pp. $22.75 (cloth). $11.50 (paper).

The issue of mandates—regulations that one government imposes on another—is complex. Mandates are a federal-state issue, but they also affect state-local relations. Mandating has become an important concern to policymakers. This volume examines mandates in terms of their history and recent federal and state experience in responding to complaints from local jurisdictions. The contributors place the mandate issue within three larger contexts: policy goals of intergovernmental regulation, the inevitable tensions in the federal system, and the evolving assessment of regulation as a policy tool. The volume also describes and assesses the effectiveness of cost estimates and mandate reimbursement, and includes case studies.

The Presidency

INVENTING THE AMERICAN PRESIDENCY. Edited by Thomas E. Cronin. University Press of Kansas, Lawrence, KS 66045, 1989. xiii, 404 pp.

The framers of the Constitution wanted a more authoritative and decisive national government, yet they were keenly aware that the American people were not about to accept too much centralized power vested in one person. The challenge was to invent an executive office that would be strong enough to provide effective gover-

nance without threatening the new republican forms of government. This book, through 14 interpretive essays, tells the story of the invention of the Presidency, treating the structure and design of the office, the powers and roles granted to the presidents, and early precedents.

Privatization

THE PRIVATIZATION DECISION: *Public Ends, Private Means.* By John D. Donohue. Basic Books, 10 East 53rd Street, New York, NY 10022, 1989. viii, 264 pp. $22.95.

Today, federal, state, and local governments are in a bind, pulled by citizen demands for more and better services and constrained by the public's reluctance to pay for those services with higher taxes. Is the private delivery of public services the way out of this dilemma? This book looks at the ideologically charged privatization debate and assesses when privatization works and when it does not. Comparing the performance of private contractors and government employees in functions as diverse as national defense and garbage collection, the author concludes that privatization pays off only under very special circumstances.

State Government

STATE POLICY CHOICES: *The Wisconsin Experience.* Edited by Sheldon Danziger and John F. Witte. University of Wisconsin Press, 114 North Murray Street, Madison, WI 53715, 1988. xviii, 294 pp.

With one foot in the rustbelt and the other in the depressed farm economy, Wisconsin, like other states, has plenty of problems. Balancing revenues and expenditures, expanding economic development, containing medical costs, distributing resources to the needy, reducing financial distress on farmers, and responsibly exploiting natural resources are discussed in this volume by experts in a broad range of disciplines. The book is divided into three major sections which deal with budgets, finances, and conditions for economic development; human need and human services; and agricultural and natural resources policy.

Taxation

TAXING CHOICES: *The Politics of Tax Reform.* By Timothy J. Conlan, Margaret T. Wrightson, and David R. Beam. CQ Press, 1414 22nd Street, NW, Washington, DC 20037, 1990. xiii, 275 pp. $14.95.

This volume presents a case study of how the *1986 Tax Reform Act* became law. Drawing on interviews with more than 50 high-ranking participants, the authors examine the history of the federal income tax and the political environment for tax reform in the 1980s. They compare the tax reform process with other recent policy reforms and offer a new model of the contemporary policymaking system.

Telecommunications

TELECOMMUNICATIONS POLICY AND ECONOMIC DEVELOPMENT: *The New State Role.* Edited by Jurgen Schmandt, Frederick Williams, and Robert H. Wilson. Praeger Publishers, 1 Madison Avenue, New York, NY 10010, 1989.

This study of changes in telecommunications policy focuses on nine states: California, Florida, Illinois, Nebraska, New York, Texas, Vermont, Virginia, and Washington. Data came from industry literature, government documents, and interviews with state officials and private sector groups. Each chapter examines a single state, generally describing the socioeconomic characteristics, the telecommunications industry, and the political culture and policymaking environment. Each chapter also explores the link between telecommunications and economic development, and state governments' role as users of telecommunications.

Urban Affairs

THE FUTURE OF NATIONAL URBAN POLICY. Edited by Marshall Kaplan and Franklin James. Duke University Press, 6697 College Station, Durham, NC 27708, 1990. vii, 405 pp.

Can we forge a comprehensive urban policy? This book is structured to respond to questions of urban need, to issues related to the effect of past and current policies on urban areas, and to the definition of possible future federal initiatives to help cities. The book is divided into five sections, examining broad indicators of urban need and distress; evaluating problems in education, infrastructure, housing, and poverty; evaluating past efforts at creating federal urban policies and giving a current status report; evaluating HUD, city hall, citizen, and nonprofit group actions in response to urban ills; and analyzing the attitudes of Americans toward helping the poor. The book contains a set of recommendations for future policies.

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