Interjurisdictional Competition in the Federal System

A Roundtable Discussion

Advisory Commission on
Intergovernmental Relations

M-157
August 1988

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(August 1988)

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Preface

Since 1959, the Advisory Commission on Intergovernmental Relations has had as its primary mission responsibility for assessing the condition of American federalism and proposing ways to improve the federal system. Over the years, the ACIR has focused considerable attention on ways to improve intergovernmental cooperation. It may come as a surprise, therefore, to some ACIR watchers that the commission is giving attention to competition in the federal system. Part of ACIR's function, however, is to examine old ideas in a new light and new ideas in the light of prevailing wisdom. To do so, ACIR has sponsored conferences, roundtable discussions, and public hearings involving participants representing many different points of view.

Competition in the federal system has come into focus again primarily because of highly publicized examples of competition among states and among local governments for economic investment and large federally funded installations. Such competition, of course, is not new. It has occurred, with varying degrees of intensity, for two centuries. With regard to federally funded installations, a little noticed aspect of this competition is how much of it has taken place in the Congress. Nevertheless, the economic changes taking place in the United States, particularly the internationalization of the U.S. economy, have heightened the visibility of interjurisdictional competition and public concerns about it. What usually raises the most concern is the offering of tax abatements and other incentives by state and local governments to large, prospective investors.

One purpose of this symposium and of ACIR's research on competition is to broaden our view of competition beyond the normally publicized competition for particular facilities, and to examine the various forms that competition takes in the federal system. Competition may take different forms and intensities, for example, in different policy arenas and in different regions. Competition may drive down taxes and expenditures in some circumstances, but drive them up in other cases. Competition may also take different forms depending on the actors, that is, competition between local governments, be-

tween state governments, between local and state governments, or between state governments and the federal government.

More fundamentally, however, the evolution of cooperative federalism has raised certain issues that make it useful to take another look at competition. For one, there has been a subtle change over the years in our thinking about cooperation—from cooperation as a two-way street to that of a one-way street in which cooperation is viewed as the willingness of states to comply with federal rules. Furthermore, recent decisions by the U.S. Supreme Court, especially *Garcia* v. *San Antonio Metropolitan Transit Authority* (1985) and *South Carolina* v. *Baker* (1988), have changed the rules that initially guided the development of cooperative federalism. At the same time, there has been a remarkable resurgence of the states in recent decades, a resurgence that raises questions about just how much, and in what ways, the states need to be protected against competition. In fact, we now need to consider the degree to which federal rules and programs, established in part to shield states from competition, serve to inhibit innovation and to depress healthy competition.

ACIR has long pointed out the problems for federalism posed by the expansion of federal authority and the proliferation of federal rules, regulations, and programs. Along with that expansion has come a hyper-intergovernmentalization of the federal system. Interest in sorting out federal, state, and local responsibilities and interest in devolution have been prominent responses to these problems. Competition is another potential response, one that could help to loosen up the federal system and restore balance. In fact, any sorting out or devolution of responsibilities in the federal system could itself introduce elements of competition into intergovernmental relations.

Finally, there are growing concerns about efficiency in government. Good public management and accountability are often seen as important devices for improving efficiency. There are ways, however, in which healthy competition can improve efficiency directly, as well as indirectly by promoting good public management and enhancing accountability to the voters. Competition, like the separation of powers principle in government, can potentially link the interests of public officials to the interests of their positions—to paraphrase James Madison. Furthermore, if competition encourages state and local governments to improve the quality of public education, for example, in order to be more competitive on the economic development front, then we have a positive outcome.

The bottom line conclusion of the following symposium, perhaps, is that competition is neither wholly good nor bad for a federal system. The question is a bit more complicated and, therefore, requires and deserves more careful consideration.

Robert B. Hawkins, Jr.
Chairman

Acknowledgments

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John Kincaid
Executive DIrector

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Protecting Citizens against Cooperative Collusion

Albert Breton

I will focus on the question that is asked on the program: is competition good or bad for the federal system?

There is a tendency, especially among economists, when analyzing competition, to concentrate on questions of competition's efficiency and stability. This habit of thought comes from an historical preoccupation with the operation of markets. In that institutional context, it is reasonable to take competition as a given and to focus on the very important issues of efficiency and stability. An economist, emerging from the framework of market economics, will therefore tend to address the question of whether competition is good or bad in terms that have to do with the mechanics of resource allocation and with the capacity of competitive institutions to respond to outside shocks or perturbations with "excessive" gyrations or "controlled" movements.

However, if we want to examine a federal system in terms of competition and ask whether a competitive mode of organization is good or bad for it, we have to take one step backward, as it were. From the broader perspective of federalism, questions of efficiency and stability, though still important, look more like puzzles. The point can be illustrated by referring to Hicks' classic paper of a half-century ago on "The Theory of Monopoly." The paper, a survey of the relevant literature at that time, emphasizes the standard inefficiencies that exist when a market is supplied by only one seller or monopolist. Hicks pointed out that these standard inefficiencies, though important, may turn out to be small when it is acknowledged that the monopolist, not being in a competitive environment, may choose "the best of all monopoly profits," namely, a "quiet life."

The expression "quiet life" indicates that monopolists have the option of doing what they want. Monopolists, in other words, do not have to search for the best designs for their products, they do not have to be careful in production and distribution, they can market shoddy commodities, they can provide themselves with over-large offices and over-plush carpets, etc. In a word, they can take their profits in the form of higher cost operations, which more exer-

tion and diligence would reduce, or in lower revenue, which more care would increase.

Hicks' insight is very important, and has been used in the formulation of hypotheses for subsequent research, all of which has shown that monopolists do indeed tend to opt for the "quiet life" in the broad sense that I have given the expression. The main problem with monopoly, then, is that it lacks a mechanism that would induce it to serve its constituents. If that is granted, the question to be addressed becomes: Can competition play an effective regulatory role in intergovernmental relations? Can it serve to induce the relevant actors to serve their constituencies more effectively?

If someone wants to argue that competition is bad for the United States federal system or for any federal system, that person would have to suggest an alternative system capable of regulating the relevant actors—the politicians and the bureaucracy—more effectively than competition. Here, I mean regulate in the precise sense of providing inducements to search for and seek to address the preferences and interests of constituents. I put the matter this way to indicate that the choice of a "regulatory mechanism" is a choice between alternatives. We should surely choose the best mechanism, but the best will, in all likelihood, not be perfect.

As far as I know, the choice is between competition and cooperation. Do we want cooperative or competitive intergovernmental relations? Should any one of us confront the proverbial man (now person) on the street with that question, the answer would most surely be that cooperative intergovernmental relations are preferable. That is a normal response, even for a person who would not want cooperation between defending and prosecuting attorneys or between firms in a given market.

The reason why reflex responses to questions about cooperation and competition are usually answered in favor of the former in the case of intergovernmental relations and in favor of the latter in the case of courts and markets is simple. We know that courts and markets are there to serve third parties: the accused in the courts and consumers in the markets. At the same time, we forget that there are third parties in intergovernmental relations: the citizens.

Suppose there is no third party. Suppose that a large object has to be lifted, and that to do so requires, say, two persons. Should they cooperate or compete? Obviously, they should cooperate because, otherwise, the object would not be lifted. Furthermore, their cooperation is for lifting the object and nothing else. When there is a third party involved in the relationship, it may be advantageous for those who agree to cooperate to also collude against the third party. Collusion simply means that the "cooperating" agents stop serving third parties and instead exploit them. To put the matter differently, collusion is profitable to those who collude, while competition is profitable to third parties.

Because of this, there is an inherent tendency for cooperative arrangements to become collusive. I would even say that there is a tendency for coordination arrangements—as obviously essential to the functioning of federal

systems as to that of market systems—to also degenerate into collusion. We ensure competition in markets by antimonopolies and antitrust legislation efficiently enforced. I cannot address here the question of how we guarantee competition in intergovernmental relations, but assuming that it is done, we must conclude that competition is good for a federal system. It is the only mechanism that can ensure that a system operates to the benefit of citizens, not to that of governmental officials.

Protecting Citizens through Open Cooperation

Dan Bucks

Interjurisdictional tax competition undermines state tax systems that are otherwise fair, reasonable, and effective. In doing so, such competition undermines support for essential state and local services. There are five major points to be emphasized about competition:

First, interjurisdictional tax competition creates unjustified inequities in taxation.

Second, there is no empirical evidence that interstate tax competition makes government responsive to the general public.

Third, with respect to state taxes and economic growth, the studies claiming to show a relationship between them in fact contradict each other.

Fourth, interstate tax competition can have harmful economic effects, whereas cooperation among state and local governments can generate economic benefits.

Fifth, the "public choice" political/economic theories used to rationalize competition may lower the standards for public policies.

Interjurisdictional tax competition creates inequities by enabling some, usually large, businesses and wealthy individuals to shift their taxes to small businesses and ordinary citizens. Among the primary losers are those businesses and citizens that have long-term commitments to their communities and states.

The recent draft report prepared for ACIR points up the problem, albeit unintentionally. The report characterizes competition as making government responsive to "citizens," and the theory underlying much of the report is that every citizen competes on an equal footing. It is stated time and again, however, that states are competing not for ordinary citizens but for businesses and high-income persons. Thus, even while proclaiming its benefits, the report reveals that interstate competition is skewed in favor of certain groups.

In order to take advantage of interstate tax competition, a business or individual must be mobile and have the kind of visibility and status that translates into effective political power.

Mobility requires that a business or individual not be tied down by such practical matters as place of employment, market, or sources of supplies. One certainly must not be encumbered by sentimental ties to family, friends, or community. A business or individual must be footloose and fancy free to play the tax competition game.

In tax debates, visibility and status are qualities typically enjoyed by large businesses. Having significant amounts of discretionary capital, these businesses are likely to attract attention if they suggest that a state's tax policy might affect their investment decisions. An ordinary citizen who threatens to leave the state unless tax policies change is not likely to be noticed by public officials. Even existing businesses in a state are less likely to attract attention than are prospective new businesses.

To gain benefits by trading one state off against another requires both special freedom and mobility and a special position attainable by only a select group. Because only a select few can really play the tax competition game, the result will be distortions and inequities in the tax system.

The worldwide unitary taxation debate of recent years illustrates this point. The debate is over now, but the results contain important lessons for evaluating interstate tax competition. A handful of multinational corporations were able to convince legislators in nearly every state that used worldwide unitary taxation to change their tax policies with regard to worldwide combination by suggesting that the unitary system created a barrier to new investment. Now that worldwide unitary combination has been effectively eliminated, there is little evidence of significant economic benefits for the states that have abandoned it. The result has been simply to shift taxes from multinationals to smaller businesses or other taxpayers.

In 1967 ACIR concluded that efforts by states to attract businesses by competing through tax policies merely result in a self-defeating cycle of competitive tax undercutting and irrational discrimination among business firms. There is no reason to think that the effects are any different today.

The new draft ACIR report asserts that interstate tax competition makes government more responsive to the general public. However, there is little support for that conclusion in the empirical studies, as opposed to theoretical literature, that are reviewed in the report. To test the report's conclusion would require correlating complex opinion studies and migration patterns with trends in public policies, both those policies that are suspected of being affected by interstate competition and those that are not. To the best of my knowledge, no such studies exist. At the very best, the report's conclusion about responsiveness is premature and unsubstantiated.

Furthermore, the conclusion is stated in impossible terms. It envisions the citizenry as a homogeneous group with a single, uniform set of preferences and interests for public policies. The reality is that there are many citizenries having diverse interests and views. Moreover, the ability to influence public policy is not equally distributed. In a pluralistic society in which resources are distributed unequally, interstate tax policy competition is unlikely to serve as a

vehicle for enhancing responsiveness to the citizenry. Competition might make government responsive to particular groups, but not necessarily to the public in general.

There has been a flurry of interest recently over a few studies suggesting that lower state and local taxes or more tax incentives can positively affect a state's economy. For years, there has been a consensus that state and local taxes, representing only a small fraction of overall business costs, have little effect on business location and investment decisions. The ACIR report points to the new studies as challenging the old consensus.

When examined closely, however, these new studies are largely contradictory. For example, one study claims to show that higher state corporate taxes have a negative influence on economic activity. At least two studies indicate that corporate taxes have no influence. One study contends that high property taxes have a negative effect on a state's economy. Another finds that property taxes have no effect, and still another discovers that higher property taxes have a positive effect on employment growth. If a state tried to implement state and local tax policies based on any alleged "new consensus" from these studies, their policies would run in every direction at once. If there is a new consensus that state and local taxes influence economic activity, then it is a strange consensus, comprised of studies which seem to cancel each other out.

Interstate tax cooperation can generate economic benefits, while competition can produce harmful economic results. Cooperation can reduce the costs to business of complying with state tax laws. For example, in recent years, the trucking industry has pressed for harmonizing fuel tax laws among the states. The states have responded, and the resulting increase in consistency has reduced compliance costs for the industry. The Multistate Tax Commission and its uniformity committee are constantly seeking ways to improve consistency with respect to general taxes on interstate business. In contrast, interstate tax competition can create disparate tax requirements and increased compliance costs for business.

Consistency among state tax systems also establishes the stability and certainty that make it possible for enterprises to plan successfully for their own futures. Businesses do not like surprises, whether they be in the form of tax increases for themselves or tax decreases for their competitors. They prefer certainty. Interstate tax competition increases uncertainty and the likelihood of such surprises. The tax benefit given to a business today can become the tax benefit given away tomorrow to another business that bargained for a better deal.

On a much larger scale, some observers have suggested that U.S. businesses focus too much on securing "paper profits" through tax breaks, mergers and acquisitions, and that they divert talents and resources away from creating real growth by improving productivity. Efforts to achieve paper profits primarily shift existing wealth from one hand to another in zero-sum games of

winners and losers. New wealth through greater productivity is not created through these activities.

In contrast, real growth based on gains in productivity comes through a variety of means, such as changing the organization and operation of the workplace, developing and applying new technologies, and improving the quality of the work force through effective education and training. As illustrated by the experience of other nations, these kinds of improvements can be made only through a high level of cooperation, including public-private sector cooperation. Such improvements are not supported by self-destructive cycles of conflict. While American businesses may expend great effort toward securing tax benefits and other paper gains, Japanese and German engineers, managers, workers, and government officials are working together to create real growth through improved productivity.

Indeed, the lesson to be learned from the international arena may be that cooperation, not competition, is a key to improved economic performance. Those societies that have outstripped the United States in productivity growth in recent decades are known for institutions that encourage and reinforce internal cooperation, which enables them to compete with the rest of the world. Those nations seem to believe that to compete effectively on a worldwide scale they must cooperate at home. Perhaps the lesson for the United States is that we should not be looking so much for new ways to compete internally by, for example, pitting one state against another, but instead should be discovering ways for greater cooperation among all those who have a stake in the future of this nation's economy.

Some advocates of interstate tax competition base their views on the public choice school of economics that applies models of free market competition to the arena of political decisions. The public choice models are characterized by elegant theoretical formulations based on limited assumptions. While one can admire their elegance, there are problems with applying these economic models to political life. In particular, the mode of thought embodied within these models may lower our standards of public policy. The models embody the values of the marketplace, in which everything is for sale and has its price. All that counts in such models is that individual actors be able to bargain for the most of what they want with the resources they have.

Inequalities in the distribution of resources and general standards of equity and fairness are ignored, and the impacts of such bargains on the rest of society are consigned to a narrow category of "spillover effects" for which no real guidance is offered for resolving those spillover problems. There is no room in these models, for example, for the principle that taxpayers equally situated should be taxed equally. The democratic ideal of one person, one vote gets lost somewhere in encouraging government by bargaining. There is no real recognition in public choice theories of the concept of the public interest, which the citizenry strives to develop and the government is bound to uphold and advance. We are left with the suspicion that governing is and should be a process in which every public policy and every public value is for sale.

Protecting Citizens through Appropriate Cooperation and Limited Competition

Parris Glendening

In 1959 the Congress created the Advisory Commission on Intergovernmental Relations to encourage greater cooperation among the federal, state, and local governments—in short, to make federalism work more efficiently. A good portion of that thrust was on cooperation, particularly vertical cooperation, and on the role of the federal government in stimulating greater cooperation and meeting needs throughout the vertical intergovernmental system.

During the past decade, the trend has been in the opposite direction, and there is no indication that this new trend will soon change. State and local governments increasingly have assumed the functions being given up by the federal government, while at the same time receiving significantly less federal aid. This has placed additional strain on state-local relations and, not surprisingly, often has led to additional interjurisdictional competition.

The changing relationships resulting from the withdrawal of the federal government from many areas of domestic policy and support are reflected by a new ACIR study to assess intergovernmental competition, and to judge whether competition is good or bad for the federal system. Until recently, a serious look at competition as possibly good for the federal system would not have been on ACIR's agenda.

The ACIR's draft report on interjurisdictional competition shows in some ways what I suggested years ago: Competition is inevitable, and can be good or bad depending on who is competing with whom and for what. Competition between states for economic development, whether for tourist dollars or business payrolls, is a fact of life. Competition between counties within a state to attract new residents and businesses is also a fact of life. Such competition can and often does lead to efforts to improve services essential to growth, such as better schools, more adequate transportation systems, better parks and more open space, and a potpourri of amenities. Competition between states or between counties is not necessarily bad, and can in fact stimulate efforts to improve services and the quality of life. On the other hand, competition between a state and its counties or a county and its municipalities is almost always coun-

terproductive. The way to improved public service and increased private development within a state is through cooperation, not competition.

The ACIR study divides competition into vertical and horizontal competition. It would appear, based on practical experience as much as on economic theory, that vertical competition is more likely to be harmful than not, while horizontal competition, when conducted in an atmosphere of comity, can lead to improved services and increased efficiency. That does not mean, however, that vertical cooperation is good and horizontal cooperation is bad. There are many practical reasons for horizontal cooperation as well. I am still firmly in the old school that believes intergovernmental cooperation, especially vertical cooperation, holds more promise than competition.

One of the assumptions in the ACIR report and elsewhere is that competition will automatically lead to lower taxes and will result in efforts to compete through lower taxation. In fact, the reverse usually occurs; competition in terms of life style and competition for amenities and very expensive government functions, such as education, means higher taxes, particularly if there is a regional leader.

That has occurred in Prince George's County, a major county immediately to the north of Washington, D.C. As county executive, I look at competition as primarily interlocal. Our competition becomes interstate as well, because we are in a metropolitan area that is made up of the northern Virginia suburbs, the District of Columbia, and the Maryland suburbs. Although Prince George's County is fairly wealthy, it is surrounded by two of the wealthiest jurisdictions in the country—Montgomery County, Maryland, and Fairfax County, Virginia. Montgomery and Fairfax counties also have superior school systems. For Prince George's County, competition meant bringing the school system up to par. In three years, we added over $100 million in new revenues, which meant several new taxes. The argument the county made to the state legislature for those taxes was that we were in competition with Fairfax and Montgomery counties—which had these same taxes—and we needed additional revenue sources as well.

Competition tends to produce business and citizen expectations about the quality of life in a metropolitan area, and there is no doubt that these expectations are a major consideration in a decision to move.

One of the functions of federal involvement in domestic policy has been to reduce disparities between state and local services caused by disparities in economic strength, and sometimes by differences in local or state priorities. In one sense, this is an example of vertical intergovernmental cooperation (i.e., cooperation between the federal government and state and local governments), that encourages horizontal intergovernmental competition by providing a more level playing field.

The steady withdrawal of federal support for local programs tends to increase disparities and make competition destructive of weaker or poorer governmental units. In a private marketplace, this kind of competition might be useful in reshaping the supply side to accommodate changes in the demand

side. In the public marketplace, however, the effects of such competition are very different. The public marketplace is, or ought to be, responsive to the needs of those who cannot pay the full market price for services. As federal policies change and states and local governments are more limited to their own resources for providing services, vertical cooperation within a state is more important than before. Vertical competition within a state would create even greater disparities among local governments.

Prince George's County suffered through the backlash of the taxpayers' revolt of 1978 and the subsequent systematic reduction in federal aid, yet it is stronger today. In no small measure, the county is stronger because it has successfully forged a cooperative relationship with its 28 municipalities, with the neighboring counties, and with the state.

For example, Prince George's, Montgomery, Anne Arundel, and Howard counties, and the City of Laurel are working together to solve regional transportation problems. Recently, the urbanized counties in the Washington-Baltimore region have joined with the governor of Maryland to begin developing a light rail transportation system to serve as a commuter link between the two metropolitan areas and to provide another option to meet the transit needs of each area and of each county within those areas. It did not matter that the proposed first stage of development would serve primarily the City of Baltimore and its immediate suburbs; the important factor was that a light rail system be started, so that it will eventually serve all of our jurisdictions. That concept has been hard to sell to state legislators.

An example of cooperation and competition combined is afforded by the invitation Governor William Donald Schaefer extended to all Maryland jurisdictions to offer sites for a proposed new state residential high-tech high school. A number of counties competed to provide the most attractive site possible; at the same time, we were cooperating with the state to establish a special educational facility that would benefit students from every part of the state. Each competing jurisdiction envisioned certain spinoff benefits, but all recognized the value of the school to the future economy of the state. Support was not conditioned on the school being situated in a particular jurisdiction.

Prince George's and Montgomery counties, with different histories of growth and development, different ethnic characteristics, and different economic structures, have long used bicounty agencies to provide water and sewer service, regional planning, park development, and public transportation.

Before *Brown* v. *Board of Education* (1954), Maryland maintained a dual school system for white and black students. Prince George's County experienced fantastic population growth in the 1950s and 1960s, including a significant influx of black students into the schools. The county had great difficulty building classrooms fast enough to meet the demand, and was not successful in achieving a satisfactory racial balance in individual schools. The problem was further exacerbated during the 1970s when total school enrollment declined while black enrollment increased, most of it concentrated in particular

areas of the county. As a result, the county is under a federal court order to take specific actions to reduce the racial imbalance in most schools and to provide enhanced opportunities in schools where racial balance is not a realistic goal.

The county has created magnet schools for racial balance and "Milliken II" schools for compensatory education. Because the school system had been segregated originally in compliance with state law, the county argued that the state had a responsibility to assist in implementing the desegregation plan. During the last three years, the state has provided special funding for the magnet and "Milliken II" schools, sharing approximately 50 percent of the added costs of these programs. This amounted to $11 million in new aid for FY 1989 for magnet schools in addition to a major expansion of statewide education assistance. In return, the improved perception—and reality—of the school system has been a major factor in attracting new industry to the county and, therefore, to the state. Prince George's County has pursued economic development aggressively, but the efforts have been directed toward attracting industry from outside the state, not from neighboring counties in Maryland.

Prince George's County has an office of intergovernmental affairs with eight full-time professional staff members specializing in different areas of cooperation—several in relations with the state and other counties, and others in county-municipal relations. The county is working with the municipalities in many ways to provide services, encourage economic development, and coordinate transportation projects. We are working with municipalities as diverse as Laurel, Bowie, Seat Pleasant, Greenbelt, Fairmount Heights, and Colmar Manor on city-county partnerships for new development and investment in the revitalization of older communities.

In Prince George's County, the full-time municipal liaison on the county executive's staff augments, not replaces, direct interaction between elected officials. Working with the Prince George's County Municipal Association, we have created a joint task force on improved county-municipal relations. This task force has explored numerous areas of coordination, including code enforcement, abandoned vehicles, and homelessness. The task force has opened a dialogue on planning strategies to provide better service to municipalities and to propose recommendations leading to cooperative programs. Through the most recent program, recommended by the municipal association, the county will, at the request of a municipality, issue a joint tax bill.

Prince George's was the first county in Maryland to provide a full, comprehensive tax differential program for all municipalities. It has become a model statewide and has attracted attention nationally as well. The county determines the property tax rate levied to support certain services, and if those services are provided by a municipality instead of the county, the county tax rate within the municipality is lowered. The municipal government may, if it chooses, increase its tax rate by the same amount without imposing an added burden on the residents. In most cases, because the municipal services were already being provided, the city taxes have not been increased at all, or have

been increased by less than the reduction in the county tax rate, resulting in a net tax reduction. A lower total tax burden improves the municipalities' and the county's competitiveness vis-a-vis neighboring jurisdictions, at least in the area of taxation.

To cite other examples of cooperation, the county is working with Takoma Park, a municipality located in Prince George's and Montgomery counties, to ease the problems of its bicounty status. The county is paying Takoma Park's debt service on storm-water bonds while a joint study is being conducted to find the best long-term solution to storm-water management in the city.

Economic development and revitalization are important for all of us. Prince George's County has instituted a Circuit Rider program to provide technical assistance to municipalities, as well as making available Community Development Block Grants for redevelopment projects. Community and neighborhood pride, which can be strengthened by community and ethnic festivals and other projects, is supported by a new office in the county government. We work together on community cleanup efforts and in many more areas of common interest.

This process must continue to be a two-way street, based on mutual respect and cooperation. The county is responsible for many services that municipal residents use—schools, libraries, the justice system, and mass transit, to mention some of the more costly ones. It is important to understand that the state, county, municipal and regional organizations are working together to meet the challenges resulting from the loss of significant federal funding.

The short-term and long-term result is a considerable expansion of intergovernmental cooperation within the state-local portion of the federal system. Contrary to some expectations, the diminishing federal presence has not led to fierce interjurisdictional competition. The situation is likely to be less cooperative, however, in areas where states and local governments do not or cannot pick up the loss of federal support. From the bottom view up, at least for one jurisdiction, federalism remains vigorously cooperative and healthy.

Protecting Citizens through Vigorous Competition and Limited Cooperation

William A. Niskanen

Coordination is certainly a desirable outcome of complex social systems. Competition and cooperation are among several processes through which coordination can be achieved. The issue here is whether the best way to foster coordination is through competition among state and local governments or by setting up some more formal structure of cooperation among these governments and with the federal government.

In my judgment, competition among state and local governments should be regarded as the desirable norm. Voluntary cooperation among adjacent governments is valuable for a few activities; but a top-down structuring of intergovernmental relations is seldom either necessary or appropriate.

Competition among local and state governments is valuable for the same reason that it is valuable in private markets. Such competition increases the range of choices available to citizens for the level, type and production of government services. Competition increases the responsiveness of each government to local residents, and it increases efficient service production.

Competition operates through different processes in the public sector and in private markets. Primarily because (1) governments are not organized to maximize net benefits, (2) entry into the public sector is severely limited, and (3) most government services are financed by taxes rather than by fees. The dominant processes by which competition operates in the public sector are voting and moving. Both of these processes operate better at the state and local levels than at the national level. Competition among state and local governments should be regarded, therefore, as desirable, notwithstanding the preferences of public officials, or for that matter private managers, for the more comfortable life associated with less competition.

As in private markets, there are special conditions for which competition among local and state governments is not sufficient to serve the public interest. The conditions most frequently suggested are economies of scale and external benefits or costs. Economies of scale are not important for local and state government services. The available evidence indicates that there are no economies of scale with respect to the populations served for almost all serv-

ices, other than possibly highways and wastewater treatment, beyond the smallest jurisdiction. Indeed, for most services, the unit costs appear to increase as a function of the level of population served by each government.

For certain state and local services, some benefits accrue to residents of other jurisdictions. For example, the benefits of university research accrue to residents of other states and, possibly, of other nations. Some of the benefits of reducing pollution are external to the state or local government. Even welfare benefits and services can generate external benefits to the extent that residents of other jurisdictions have some marginal concern about the recipients of these services.

There are also external costs associated with state and local decisions. For example, residents of other jurisdictions bear part of the taxes levied by local and state governments, such as taxes on property or businesses owned by nonresidents. Local and state officials are often quite aggressive in exploiting such taxes because the taxpayers do not vote in their jurisdictions. Some types of resource and environmental policies, such as drawing water from an interstate river or aquifer, or using tall stacks to dissipate power plant emissions, also generate external costs.

Some limited types of cooperation among local and state governments or with the federal government are appropriate. Such cooperation need not be structured by the higher level of government. For example, highways met at state borders, and ferries and bridges provided transportation across interstate rivers, long before there was a federal highway program. The Lakewood Plan of contracting for local services in the Los Angeles area evolved without any formal regional or state structure.

A substantial amount of intergovernmental cooperation will evolve in response to a recognition of mutual interests. Some federal or state structuring of these relations is necessary only when the net external costs or benefits are too broadly diffused to be resolved by cooperative arrangements among adjacent governments. There are substantial costs, in terms of loss of state and local control, to any top-down structuring of intergovernmental relations.

In summary, most of what has happened to American federalism during the past half-century is undesirable. The consolidation of school districts, annexation by cities, centralization of public finances at the state and federal levels, and increased state and federal regulation of local and state activities have each reduced competition and voluntary cooperation among local and state governments. All of these changes have been promoted in the name of good causes—improving education, caring for the poor, solving environmental problems, and so forth. Over the same period, however, real tax burdens have increased enormously, student test scores have declined, crime has increased, the poverty rate has stopped declining, and the American federal system has been seriously weakened. American governments are not now serving us very well. Perhaps, therefore, we need to rethink the contemporary views that contributed to these conditions.

Protecting Citizens against Self-Defeating Tax Competition

Richard D. Pomp

Although state and local taxes may explain in some cases why a particular firm located in one area rather than another, research suggests that these situations are very few and that there is a high price to pay for trying to attract these so-called switchers. Yet states certainly seem willing to spend millions on tax incentives with little evidence that they are getting anything in return.

In 1981, ACIR published a report on interstate tax competition that was very critical of the use of tax incentives. Nothing has happened since then to change those conclusions. If anything, we have a very powerful statement from the Congress in the *Tax Reform Act of 1986* that using the tax system to engage in social engineering and to influence economic behavior is inefficient, wasteful, and leads to inequities. Instead, we are better off pruning the undergrowth and providing a level playing field.

At the time of the 1981 study, the issue was seen as Sunbelt vs. Frostbelt. It looks somewhat different today. What the 1981 study underscored was the fact that there are powerful economic forces at work in all countries that completely swamp the effect of state and local taxes. These economic forces cannot be predicted. When the textile mills left Massachusetts to go south, who could have predicted that the abandoned mills would become incubators for high-tech firms? Who could have predicted that the textile mills would eventually abandon the South and head overseas, again in search of cheaper labor? One thing that could have been predicted, however, was that no state and local tax system was going to counteract those forces.

There are several reasons why state and local taxes cannot influence and counteract these fundamental economic forces.

First, there are many important factors in a business location decision: plant or site availability, access to financing, cost of transportation, quantity and cost of labor, proximity to markets, quality of education, cost of housing, and a jurisdiction's general quality of life.

Second, taxes are just one of the many costs of doing business, and these other costs may completely overwhelm state and local tax systems.

Third, many state and local tax payments are deductible for federal income tax purposes. The effect of this so-called federal offset is to reduce the absolute burden of state and local taxes and to mitigate the differences in tax burdens among the states. The *Tax Reform Act of 1986* will lower the corporate rates to a maximum of 34 percent from a previous high of 46 percent. It has been suggested that lowering the federal rates has reduced the value of the state and local tax deduction. What this view fails to take into account is that many of the largest corporations—the corporations that states are competing for—paid no federal tax prior to the new law. They had a federal marginal tax rate of zero, which has now increased to 34 percent. This increases the value of the federal offset and makes state and local taxes less important than they were before tax reform.

Fourth, sometimes you get what you pay for in the public sector as well as in the private sector. If a corporation receives poor public services because of low taxes, that state is not necessarily attractive. A business may have to provide at its own cost what corporations in other jurisdictions receive through their tax dollars.

We have seen a move in many southern states to increase taxes and spend the money on education, which is viewed as a key to building a healthy economy. As we move into a more technologically oriented society, a trained work force must be available to attract the types of corporations the states are competing for.

The key to the development of Route 128 in Massachusetts and the Silicon Valley in California is obviously the presence of some of the finest universities in the world. Route 128 developed at a time when Massachusetts was known not so affectionately as Taxachusetts. Silicon Valley was developed before Proposition 13, when California also had a reputation as a high tax state.

Fifth, most relocating companies stay at their new sites longer than any group of elected officials is likely to be in office. Consequently, will a business make million-dollar decisions based on what one group of legislators may grant today and what another group, if financial conditions change, may take away tomorrow? Fiscal stability and predictability may be much more important than special concessions.

Sixth, state tax incentives contain the seeds of their own destruction. If incentives are effective at all, a state would gain at best a short-lived advantage. If an investment tax credit in one state is perceived as having a positive effect, neighboring states also will adopt an investment tax credit. If they all adopt the same investment tax credit, however, no state gains an edge on attracting business. All they have done is give up revenue needlessly.

New York adopted an investment tax credit in 1969 with very little debate and with no estimate of what it would cost. In 1983, the most recent year for which we have data, more than $650 million was spent on the credit. The benefits are highly skewed; two firms used 40 percent of the credits. Who made up the revenue? The other businesses in the state, by paying higher

taxes. Yet no study suggests that New York has benefited from its investment tax credit.

Competition between states may lead to a lack of competition within a state when measures are adopted that give one group of competitors an edge over another. The two firms that used 40 percent of the benefits of New York's investment tax credit obviously have an advantage over other firms that do not benefit from the credit yet pay higher taxes to make up the loss in revenue. There is always a "competitive equity" issue when you adopt measures to try to attract footloose corporations.

Because the evidence against the efficiency of using these tax incentives to attract business is persuasive, the argument has shifted in the last few years to the role that personal income taxes can play in creating a favorable business climate.

This issue is quite complicated, involving much more than nominal tax rates. Any effect that income taxes have on where people live should be seen in the greater New York area. People who live in New Jersey and Connecticut and work in New York City pay the same New York income tax, at least on their earned income, as residents pay. People who move to one of the neighboring states and continue to commute into New York do not achieve any significant tax savings unless they have substantial unearned income. Yet, if they do have such income and live in Connecticut, they will have to pay that state's high taxes on capital gains, interest and dividends.

People are not moving to Newark, New Jersey, to avoid New York taxes. They are moving because of the price of housing. Many of the firms moving from Massachusetts into New Hampshire are doing so because of the price of real estate. Businesses have moved out of California into Oregon for similar reasons. Part of this movement is just the natural cycle of economic development and growth, and there is probably very little that a state can do to counteract such movements by manipulating its tax system, other than by eliminating sources of waste, inefficiency, and slippage, which keep rates higher than they have to be.

The Discussion

Hawkins: I thank all of you for your presentations. Are there any questions from the Commissioners? Mr. Dwight?

Dwight: I would like to make sure that what I heard is correct. First, it seems to have been asserted and not rebutted that tax concessions are not a major factor in business decisionmaking and, therefore, ought not be a major consideration for the Commission. Is that correct?

Second, public policy has to be concerned with excesses in any direction. Very large tax concessions or any extreme governmental decisions regarding competition to attract a business base would probably be counterproductive and harmful.

Glendening: That is correct. Obviously, if one jurisdiction has an 8 percent sales tax and another jurisdiction has either no sales tax or a very low one, people will tend to cross the line, especially to buy large products.

The District of Columbia experienced this last year when its gasoline tax went up considerably. The result was that many commuters waited until they were in Virginia or Maryland to buy gas. The actual revenues in D.C. went down. The problem was not that the District increased its gasoline tax—so did Maryland and Virginia—but that D.C. increased it dramatically beyond the regional margin.

With regard to tax breaks, Prince George's County jurisdictions use them quite extensively. They have played a role in the county's fiscal turnaround. We now have almost $9 billion worth of private investment coming on line.

There is one point on which I think nearly all the panelists would agree. Competition must be evaluated partially in terms of efficiency and effectiveness of service delivery. The competition between jurisdictions in how well they provide a service, whether it is education, environmental protection, or transportation, is very real. For example, there was the decision of the American Automobile Association (AAA) to leave Fairfax, Virginia, and move to Florida. The association's explanation was that the traffic was too bad. That was kind of humorous, but the point is that the AAA's decision was influenced

not by high taxes but by the fact that Fairfax did not provide an adequate transportation system.

These types of decisions are made all the time. To give just a couple of examples, Fairchild Industries left Maryland not because of taxes but because of displeasure with certain state actions. Now Fairchild is thinking of moving back into Maryland. There was no consideration of taxes in either of the decisions. Litton Industries' Amacon Division, with 2,000 employees, was talking about a major move from Prince George's County. Not once in discussions with company officials was there any mention of taxes or economic competition. They kept asking what we were going to do about education. They wanted to bring in highly trained technicians who demand a quality education system. The discussion was all about service competition.

Hawkins: Mr. Isaac?

Isaac: Economic consultants tell city officials that without the necessary incentives, they are not in a good competitive position. The lack of tax incentives will be considered a drawback. Yet, as city officials, we know that what we are really doing with the incentives is sacrificing either the future or another segment of the taxpayers, who will have to take care of those taxes. In many cases, after all these benefits have been offered to the switchers, they may switch again after a few years if they get a better deal elsewhere. How do you stop that? By cooperation?

Niskanen: I fail to understand the case for a cartel of local finance officials coming to an agreement on tax provisions and tax rates. I understand why they might feel that their interests are served by such a cartel, but I don't understand why anybody should endorse that arrangement.

Bucks: The case for tax cooperation and against competition is based in part on the principle that people who are equally situated should pay equal taxes. Interstate tax competition tends to work systematically to undermine the basic principle that businesses equally situated should pay equal taxes. In terms of the accusations concerning collusion and cartels, such effects are generally not possible in state policy decisions because of open-meeting and right-to-know laws. Arriving at cooperative agreements at the state and local levels merely involves openly and honestly deciding what constitutes good public policy. There is also an alternative to competition in the normal electoral and separation of powers processes that keep government responsive to the citizenry. We don't need this kind of competition.

A recent survey of the problem of interstate tax and incentive competition concluded—just as ACIR did in 1967—that competition is self-defeating and destructive, and that states should enter openly and honestly into compacts that offer only certain incentives. This makes more sense than getting into bidding wars that subvert sound public policy in terms of designing the tax system.

Hudnut: But that is not going to happen.

Hawkins: Mr. Bragg?

Bragg: In Gasoline Alley, the first guy who gave out Green Stamps did a great business until everybody had Green Stamps. Then they all quit issuing Green Stamps. I think state and local governments are finding out that we may have all the Green Stamps that are going to be put out. There have been many examples in recent years of billions of dollars in incentives being offered and turned down because they didn't mean that much in the long run.

Hawkins: Professor Breton?

Breton: The point that must be emphasized very strongly is that if state governments, or provincial governments in my country, were successful in suppressing tax competition, that competition would show its head somewhere else. Suppressing tax competition altogether could very well result in more competition on the service side. It is possible for some forms of tax competition to be unstable, but there are some taxes for which competition has to be efficient, not in the sense of driving the rates up or down, but of driving benefits and taxes closer together. There is no presumption that all states will have the same tax rates. In a way, it is fallacious to think of tax competition independently of other forms of intergovernmental competition.

Pomp: There is "good" competition and "bad" competition, but it is hard to talk about them in the abstract. If bad competition is suppressed, there is nothing wrong with states competing in other areas when it is efficient.

With regard to the relationship between benefits and taxes, the problem is that some corporations are able to reduce their taxes to nominal amounts yet still receive the same benefits as other taxpayers. State corporate income taxes are not benefit taxes or user charges. The latter may be a more efficient way of pricing some government services, depending on your view of the appropriate functions of government.

The sales tax offers an interesting example of how cooperation can work. If one state has a high sales tax and people are making major purchases in a neighboring low- or no-sales tax state, a bistate agreement can ensure collection of the use tax due when the merchandise is shipped to the high-tax state. This kind of cooperation can lead to a more efficient, more equitable tax system. Collecting use taxes from out-of-state mail order sales would be another example of how to improve state-local tax systems. Legislation on this issue is being considered by the Congress.

Hawkins: Mr. Bucks' remarks indicate that one of the roles of a multistate tax commission is to try to create a level playing field. Some years ago, ACIR was intimately involved with the unitary taxation issue. If I remember the arguments correctly, large corporations were asking for the level playing field. The states and the Multistate Tax Commission said that the states should have the absolute right to determine how they wish to tax multinational corporations. In that case, we clearly did not want a level playing field, and states

clearly were competing with one another. Several states consciously got rid of unitary taxation in an attempt to attract business.

Regardless of whether that argument is right or wrong, the point is that there are 50 states, each with independent sovereignty over tax policy. Are we ever going to be able to get this so-called level playing field over all taxes? Won't some states always compete aggressively?

Bucks: My remarks did not address the questions of tax rates or the level of services citizens want. There will be variances in those matters. When applied to the shape and character of the tax base, interstate tax competition tends systematically to distort the effort.

In fact, in every instance that I was able to study, the unitary tax involved creating a level playing field between the in-state businesses and the multinational corporations. In a study that I supervised in Montana, for example, where there was direct competition between a multinational retailer and a group of in-state retailers, we found that with worldwide unitary taxation, the small businesses paid taxes that were only—yes, only—two to three times as high as the taxes of the multinational. That was still acceptable. After the repeal of the unitary tax, the disparity grew, with the small businesses paying taxes (measured either by presence or sales) that ranged from 70 to 363 times as much as the multinational corporation.

Worldwide unitary taxation ensured a level playing field. Interstate tax competition ensured a shift of the tax base from the multinational corporations to the small in-state businesses. This is a precise example of the kinds of distortions and inequities that competition creates in the tax system.

Breton: We should not confuse the issues of equity and efficiency. It could be very efficient for a state or a jurisdiction to forgive all taxes for a corporation. Imagine a jurisdiction in which the population, for one reason or another, is absolutely immobile, shows a strong preference for that particular jurisdiction, and is willing to sacrifice a number of other amenities for the benefit of having jobs. It may be rational for that jurisdiction to cut taxes to zero—or institute a negative tax—to be able to attract the capital to provide those jobs. Of course, opposition from other jurisdictions may make it difficult to adopt such a tax policy. There is nothing in principle that says that all tax rates have to be equal to make a system efficient. Equity is a different problem, and there are many roads to equity.

Hawkins: Mayor Maier?

Maier: What function or variable do the panelists think most influences local taxation, particularly in middle-sized and large cities?

Glendening: The voters can have a significant, immediate, and effective reaction to particular types of taxes, especially if you start skewing the tax picture so much that the property taxes go up.

Maier: What about the total magnitude of local taxation?

Glendening: The biggest influence then is service demand.

Breton: Two major factors are what people get in exchange for their taxes and what people in other jurisdictions get for their taxes.

Hawkins: Do you think the state and federal governments have any impact?

Maier: Local governments in many states are operating under mandated labor laws and arbitration. The public sector is trying to follow private patterns, but the private patterns are not the same. For example, one of Milwaukee's biggest costs is fire protection; the other is police. Throughout the country, those two services constantly fight for parity. Milwaukee is the only large city in the United States that stripped the fire fighters of parity. As a result, we were compelled to go to arbitration, and the ruling, based on decisions made in the East, was that fire fighters are entitled to parity with police. The city had to give up a hard-fought gain.

The conditions under which local governments operate in general, certainly in the Midwest, are dictated by the standards of the state legislature and, now, the public service unions. This is the biggest factor in our costs. Bargaining is a rough situation when you have no effective means of control. The market is not dictating our costs. This may not be true throughout the nation, but it is generally true in many middle-sized cities.

Hawkins: A response?

Glendening: Mandated costs are clearly a problem, and it is not just labor. All the costs are mandated costs. The Maryland legislature is passing three bills that, by our estimate, will cost the county approximately $8 million in up-front costs. The county probably would have undertaken only one of the additional programs.

Hawkins: That is a form of destructive competition. It is the favorite old game—the state legislature, the upstream government, passes beautiful legislation and imposes the burden of implementing and paying for it to the downstream governments. Many people would argue that Proposition 13 was passed precisely because the state's mandates forced local governments to raise their property taxes.

Hawkins: Mayor Isaac?

Isaac: Local governments see the states competing, and putting together massive incentive packages to attract tax-exempt facilities that are then placed in local jurisdictions. Yet, there is no assistance from the state to help the localities provide the necessary services. As a result of the tax exemptions, the local jurisdictions are faced with high service demands but low revenues.

Glendening: There is a general recognition that competition is not just taxes but also quality of life and services—especially very expensive ones like

education—and the amenities offered. That clearly is one motivating force. The other one is that there is no such thing as a free lunch. When you put the two together, what often happens with competition is that the costs get passed on to someone else.

For example, the whole debate on industrial development bonds was whether local jurisdictions could get the federal government to help subsidize local development. It was easy for state and local officials to say that this is fine, that it is only going to cost the federal government. But it goes beyond that. For example, when a local government says it is going to maintain low taxes and service competitiveness, some of the costs and functions of government are picked up by the state or the federal government through aid programs, or the local government tries to shift the costs from one type of tax to another.

If a local jurisdiction does not have an income tax or a sales tax, property taxes will go sky high. When that happens, you will have a taxpayers' revolt. If property taxes are then reduced, something else will have to be increased. Someone has to pay the bill, and competition often becomes a search for someone else to do so.

Hawkins: Thank you. What we have heard from the panelists is that there is a great deal of competition in the federal system. Competition is inherent in our intergovernmental structure, and it has both positive and negative effects.

ACIR's new report on interjurisdictional tax and policy competition will be the first in series of studies on competition issues. Future studies will look at vertical as well as horizontal competition, and try to come to grips with what many of us think are negative constraints—either through unfunded mandates or cuts in aid—on the ability of local governments to deliver services.

On behalf of the Commission, I would like to thank the panelists.

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