INTERSTATE TAX COMPETITION: A COMMENT**

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CHARLES McLure has presented an interesting and stimulating discussion not only of tax competition but of several other related issues, including especially the federal income tax deductibility of state and local taxes. He reaches two main conclusions: first, tax competition is, on balance, a desirable feature of our federal system, and, second, state and local tax deductibility should be eliminated. In defending these views, McLure has explicitly recognized a number of qualifications and reservations that might suggest rather different conclusions. If in the end he does not find these qualifications to be of overriding significance, at least his audience has been properly alerted to the fact that there might be grounds for reasonable disagreement with his policy recommendations. His balanced appraisal of the issues is a valuable service for which we can all be grateful.

In my comments, I would like to elaborate, in an informal way, on some of the analytical problems that arise in the study of tax competition. My objective is neither to attack nor to defend McLure's conclusions per se. Indeed, some of my remarks will tend to strengthen his case in favor of tax competition, while others will tend to weaken it. Rather, I hope to sharpen the focus on some of the unsettled questions in this area, thereby identifying problems that require further research and perhaps also clarifying the underlying basis for conflicting viewpoints on policy recommendations. I will begin by reviewing McLure's discussion of the taxation of mobile capital and then turn to the question of whether or not tax competition may help to constrain revenue-maximizing bureaucracies. At the end, I will briefly comment on state/local tax deductibility. Mainly for reasons of space I will not attempt to discuss the benefit spillover issue.

In his discussion of tax competition and the migration of capital, McLure presents as an instructive example the case of a hypothetical tax on the Gloucester fishing fleet. He notes that this is a very fragile tax base for Gloucester: the imposition of such a tax, or an increase in its rate, would likely cause a considerable reduction in the size of the fleet. If this is the only tax available to support public spending in Gloucester, the level of spending is likely to be held down to low levels. He goes on to argue from this example that Gloucester ought to use a different tax, such as a tax on residential property.

Before I consider the possibility that Gloucester might use a different tax, let me discuss further the tax on fishing boats. In particular, let us ask why exactly the tax on fishing boats would lead to undesirably low levels of public spending.

First, note that almost any tax can reduce the equilibrium amount of the activity that it taxes. This can occur in the complete absence of tax base mobility. For example, a tax on labor income by the federal, state, or local governments can discourage labor effort. Suppose that it does. Then it is more costly to the taxing jurisdiction to raise an additional dollar of revenue from labor income taxes than would be true if labor were inelastically supplied—just as is true in the case of the tax on fishing boats. However, the efficiency implications of these two cases are quite different. A tax on elastically-supplied labor will discourage public spending—and, on efficiency grounds, it ought to. A tax on mobile fishing boats will discourage public spending—but, on efficiency grounds, it ought not to. Why do we reach different conclusions in these two apparently similar cases? Because the loss of tax base due to the labor income tax is a true *social* loss: the hours of labor that are no longer supplied in the face of higher taxes are simply lost to the economy. By contrast, McLure's fishing boats don't just disappear from Gloucester, they reappear somewhere else. That is, although this tax appears to the taxing jurisdiction to de-

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stroy part of its tax base, this loss of tax base is not a true loss to society. It is this difference that leads to the argument, not simply that tax competition discourages public spending, but that it *inefficiently* discourages public spending.

One way to think about the source of the inefficiency from taxation of mobile capital that I have found helpful is to consider it from the perspective of externality theory. In a recent paper, I analyze a model where capital is inelastically supplied to the economy as a whole. Any one jurisdiction's taxation of capital reduces its own tax base, but simultaneously increases the tax base, and tax revenues, in other jurisdictions. This is like an external benefit from state or local taxation. The classical remedy for such an externality is to subsidize the activity that generates external benefits. In this case, the remedy is to have a higher-level government subsidize the taxation of capital by lower-level governments, for example by providing grants equal to some percentage of lower-level government own-source revenue. In making some crude estimates of the possible subsidy rates to local governments that this externality might require, I come up with percentages as high as 40 percent—on the assumption, however, that local governments receive no other aid from the federal government and the states. With the existing high level of federal and state funding of local public spending, effective local property tax rates are considerably reduced. This greatly lowers the optimal subsidy rate since the underlying external benefit—that is, the extra tax revenue obtained by localities that receive migrant capital—depends on the prevailing rate of capital taxation.

In the world that I have been discussing, tax competition inefficiently lowers public expenditure. But I have been discussing a world with a fixed capital stock. If I wanted to strengthen McLure's argument that tax competition is desirable, I would challenge this assumption on two grounds. First, a substantial amount of research suggests that savings behavior is responsive to tax incentives or disincentives. If so, it may be highly desirable for states and localities to compete for capital by reducing their tax rates, because the effect of this in the aggregate may not be only to reshuffle the existing capital stock, but to increase the total capital stock. Second, even if a reduction in state/local capital taxation does not discourage national saving, it may still reduce the nation's capital stock by changing the international allocation of capital. If capital is internationally mobile, then reductions of state and local taxes can still increase the national capital stock, even if savings are unaffected. In this case, tax competition still restrains state and local spending, but it no longer restrains this spending *inefficiently*.

Thus, a case can be made that the existing literature on tax competition (including my own work), by arbitrarily assuming a fixed capital stock for the economy as a whole, has erroneously concluded that tax competition is inefficient. Some additional formal analysis of this issue ought to be done.

So far, I have been focusing on the effect of tax competition on total public spending by states and localities. Another important question that deserves attention is the effect of tax competition on the structure of state and local taxation. Let us step back for a moment to the simple world of a fixed national capital stock. This fixed stock makes an excellent tax base: geographically uniform taxation of capital would cause no deadweight welfare losses. But states and localities may individually be loathe to tax capital, for fear of driving it away. They may therefore be induced to use socially less efficient taxes—perhaps taxes on labor, or on specific commodities. In this case, the problem with tax competition is not necessarily that it causes underspending in the public sector, but that it creates avoidable tax distortions. To the extent that this occurs, tax competition detracts from economic efficiency, and policies that encourage more efficient state/local taxation may be desirable. Note that a general federal subsidy to state and local government spending is not an appropriate corrective remedy for tax competition when it causes distortions of lower-level tax structures. What is needed, rather, is a specific incentive to tax mobile capital, as opposed to using other sources of tax revenue. Of course, this argument is again predicated on the assumption of a fixed aggregate capital stock, an assumption that, if relaxed, would change one's view of the efficiency implications of tax competition.

Actually, in McLure's view, reliance on a tax base other than mobile capital may be just what's wanted for lower-level governments. He feels that residential property taxes reflect the benefits of local public services much more accurately than taxes on commercial and industrial property, and that a move of the tax structure in this direction would be a satisfactory way of mitigating any ill effects of tax competition. At least on a priori grounds, however, I find this argument less than compelling. While in some average sense benefits may be linked more closely to residential than to industrial property, what really matters is whether the residential property tax drives out residential capital at the margin. One can imagine a world in which zoning constraints prevent property tax distortions of the residential housing market—a world that Hamilton, among others, has discussed on various occasions. Alternatively, it could be the case that property tax distortions of the residential housing market are just not very severe because the demand for housing is very inelastic. In either of these cases, residential property taxes might be highly desirable. Not only that, jurisdictions might even have incentives to adopt such taxes. But this is an empirical question, about which there is plenty of scope for disagreement.

Let me now turn to McLure's discussion of Leviathan models. To begin with, I see no reason to suppose that individuals employed in the pubic sector act, in general, with any more or less self-interest than those in the private sector. It is perfectly natural to expect that public sector unions will want higher wages for their members just as much as private sector ones. It is also natural to expect that they will argue for whatever policies will promote this objective, and use whatever rhetoric suits that purpose, just as industries argue for protective trade policies for all sorts of reasons (other than higher profits). The crucial question, I think, is whether tax competition effectively restrains public sector employees in a way that promotes lower-cost public production, and/or more efficient levels of public service provision. These are difficult questions.

One major reason why it is difficult to evaluate this "Leviathan" argument is that it is not easy to ascertain how much public spending is really justified on efficiency grounds. It is also not easy to ascertain the minimum cost of producing a given level of public services. Thus, there is little direct evidence to suggest that governments tend to overprovide public services, and/or to provide public services at excessive cost. One empirical analysis that has addressed this issue indirectly is that by Wallace Oates (1985), who investigates whether fiscal decentralization tends to be associated with greater or smaller levels of public spending. His finding that fiscal decentralization is not a very important determinant of the size of government casts some doubt on the basic Leviathan hypothesis.

I would note, further, that even if governments are always trying to expand beyond efficient levels, it is not totally clear that free mobility of capital and/or households will effectively constrain government spending, as McLure implies. For example, many of the stylized models used in the local public finance literature assume that households are costlessly mobile among jurisdictions. One implication of these models is that jurisdictions cannot extract any surplus or rents from these households, except insofar as they may own land or some other immobile factor. While this may limit the ability of governments to exploit these mobile households, a corollary to this proposition is that these mobile households have no incentive to participate in a costly political process to constrain their governments. In this world of costless mobility, a household's rational response to bureaucratic inefficiency is to migrate, not to expend effort on correcting the inefficiency. (In Hirschman's (1970), terminology, households will choose "exit" rather than "voice.")

Who, then will bear the cost of bureaucratic inefficiency? In models of the type I am describing, the owners of locationally-fixed resources—landowners, for example—are the ones who ultimately have the incentive to control these mini-Leviathans (if this is not a contradiction in terms). Whether they can effectively control the political process so as to constrain their budget-maximizing bureaucracies is then the crucial question. It is certainly possible to argue that mini-Leviathans would actually flourish in an environment where many of those who are enfranchised to vote on state and local budgets (or on the politicians who determine the budgets) feel that it's not worth their trouble to do so.[1]

Let me close by commenting on the state/local tax deductibility issue. For the most part, I am sympathetic to McLure's arguments against deductibility. It is true that deductibility may stimulate state and local public expenditure, and for various reasons, including tax competition considerations discussed earlier, this might be considered desirable. But deductibility is a very blunt and inefficient instrument for achieving a general increase in state and local spending. Moreover, deductibility provides no remedy for any distortions of state and local tax structures that may result from tax competition, since it does not differentially favor more efficient state and local taxes.

Of course, it is possible to take a second-best view of the political process that would favor continued deductibility. While there may be many better ways to stimulate state and local public spending—for example, some system of unrestricted matching grants—one might doubt that such programs will be forthcoming if deductibility is eliminated. While I profess no particular competence in making predictions about the political process, it is easy to understand why these sorts of considerations lead some to oppose the repeal of deductibility. I would simply note here that the basis for this argument is primarily political in nature rather than economic.

FOOTNOTES

**I thank Charles McLure for spotting some errors in the first draft of this paper.

[1]Of course, even if households were immobile, it still might be individually irrational to vote. See Ledyard (1984) for discussion of this issue.

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