Interjurisdictional Tax Competition: An Economic Perspective

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Comment

Interjurisdictional Tax Competition: An Economic Perspective

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I. INTRODUCTION

The migration of individuals and businesses as the result of high taxes often concerns local governmental officials. Consequently, they engage in programs designed to lower the tax costs of certain highly mobile residents. Local governmental officials tailor these programs to eliminate locational disincentives for current residents and, perhaps more importantly, for potential individual and business residents. Economists refer to this particular behavior on the part of local taxing
officials as tax competition.1

Tax competition involves competition among local taxing jurisdictions over mobile residents as sources of tax revenue. This competition is similar in many respects to the competition among firms in the private sector. The tax price an individual or business faces in relation to the basket of public goods provided by local government can be likened to the market price of a product in relation to the quantity and/or quality of the product provided by the market. If the individual or business does not like the terms of their bargain, then they are free to seek a better buy elsewhere. This freedom to contract lies at the heart of competition. Although the freedom to contract exists to a much greater extent in private markets, the freedom to move from one jurisdiction to another gives residents a quasi freedom of contract with local government.2 Concerned that residents will exercise this freedom in search of a better buy for their tax dollar, local governmental officials engage in tax competition to eliminate the locational disincentives of their present fiscal systems.

The Nebraska Legislature recently provided an illustrative example of tax competition in practice by reforming Nebraska's taxing scheme.3 Forced by competitive pressures to eliminate the locational disincentives of Nebraska's taxing scheme, the Nebraska Legislature reduced the progressivity of the individual income tax, and offered tax cuts favoring highly mobile business.

Nebraska is not alone in its attempts to improve its competitive taxing posture. Similar behavior by taxing officials of states throughout the nation has become commonplace. This recent increase in tax competition raises two interesting questions. First, why the sudden increase in tax competitive behavior? Are there factors promoting tax competition today that were not present in the past? Second, what are the consequences of this competitive behavior? Should it be viewed with the same favor with which we view competition in the marketplace, or are there hidden evils? Answers to these questions have important policy implications for both federal and state government. If the factors that lie behind the recent increase in tax competition are likely to persist, then it seems critically important that we have a thorough understanding of the economic and social ramifications of this governmental behavior. The major purpose of this Comment is to take a step forward in providing such an understanding.

This Comment begins, in Part II, with a cursory look at tax competition in the public sector. This part provides a theoretical development of tax competition and examines the role tax competition plays

1. See, e.g., W. OATES, FISCAL FEDERALISM 143 (1972).
2. As to this notion of a voluntary or social contract with local government, see J. OCHE, PUBLIC FINANCE 115-19 (1974).
3. Part III of this Comment discusses the details of this reform.
in the design of local fiscal systems. Moving from theory to practice, Part III of this Comment examines how tax competition recently influenced tax reform in Nebraska, pressuring local officials to reduce tax progressivity and to engage in tax discrimination against immobile business. Part IV is the focal point of the Comment, analyzing in some detail the economic ramifications of tax competition. This economic analysis focuses primarily on issues of efficiency and equity. Finally, Part V provides some concluding remarks and a plea for further understanding of the growing influence tax competition has on our local public economies.

II. TAX COMPETITION

A. A Theory of Tax Competition

At the heart of modern price or microeconomic theory is the assumption that the incentive to maximize utility motivates individual economic behavior, while the incentive to maximize profits motivates the economic behavior of the firm. The theoretical basis of competitive behavior among firms in private markets follows logically as a result of the behavioral interactions of these two market participants. Desiring to maximize utility, the individual seeks the best products his money can buy. Cognizant of this behavior, firms produce those products that the consumer desires at the lowest possible price, in an effort to maximize profits by attracting customers from competing firms. Since the days of Adam Smith, this competitive behavior among firms in the marketplace has been a cherished feature of our

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4. The British philosopher Jeremy Bentham first introduced the concept of utility. Bentham described the concept of utility as follows:

Nature has placed mankind under the governance of two sovereign masters, pain and pleasure. . . . The principle of utility recognizes this subjection. . . . By the principle of utility is meant that principle which approves or disapproves of every action whatsoever, according to the tendency which it appears to have to augment or diminish the happiness of the party whose interest is in question.


5. See, e.g., J. Hirshleifer, supra note 4, at 61.


7. For example, in perfectly competitive markets, "[w]hen each firm sets the price at which it sells its output, it will have to take into account not only the behavior of the consumers, but also the behavior of other producers." Id. at 82.

8. In the long run, in perfectly competitive markets, prices would be driven down to levels where the economic profit of the firm is zero. See, e.g., J. Hirshleifer, supra note 4, at 216. It is important to distinguish between economic profits and accounting profits, as the former is revenue minus "all" costs, while the latter is apt to exclude certain costs such as the cost of shareholder capital.
market economy.\footnote{In his book The Wealth of Nations, Adam Smith described the benefits of competition as follows: But it is only for the sake of profit that any man employs his capital. . . . he will always, therefore, endeavour to employ it in the support of that industry of which the produce is likely to be of the greatest value, or to exchange for the greatest quantity either of money or of other goods. . . . he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. \textit{J. Hirschleifer, supra} note 4, at 13 (quoting A. Smith, \textit{Wealth of Nations} book IV, ch. 2 (1776)).}

In local public economies, the theoretical basis for competition breaks down as local not-for-profit government replaces the profit-maximizing firm. The profit and survival incentives that motivate private firms to respond to consumers' desires do not exist in the public sector. Yet, the fact that we do indeed witness tax competitive behavior among local governments\footnote{The Nebraska tax reform discussed in Part III is a case in point.} implies that there must be surrogate incentives that motivate local governments to act like profit maximizing firms in the provision of local public goods.

In a landmark article,\footnote{Tiebout, \textit{A Pure Theory of Local Expenditures}, 64 J. Pol. Econ. 416 (1956).} Charles Tiebout explained that the behavior of local governments is likely to simulate that of the profit-maximizing firm when consumer-taxpayers are able to "vote with their feet." The intuition of Tiebout's model is that when consumer-taxpayers are fully mobile (that is, when residents can move costlessly from jurisdiction to jurisdiction), there will be strong pressures for local government to respond to the wishes of the electorate, as expressed in the willingness of resident citizens to pay taxes to finance public services. Just as the consumers' freedom to purchase a product from a competing firm induces the profit-maximizing firm to satisfy its customers' desires, the residents' freedom to move to another jurisdiction in search of a better buy for their taxing dollar induces local government to do the same. Thus, in a Tiebout world, tax competition is nothing more than local government acting as a profit-maximizing firm, seeking to prevent the migration of its revenue base by providing those goods and services that its taxpayers desire at the lowest possible price.

\section*{B. Influence of Tax Competition on Design of Local Fiscal Systems}

If forced by the pressures of the mobile consumer-taxpayer to compete with other taxing jurisdictions, how might tax competition influence the design of local fiscal systems? To best answer this question, we may find it beneficial to begin by considering how tax competitive...
behavior might influence the design of local fiscal systems if every resident were fully mobile between taxing jurisdictions, and then to contrast this design with the design of local fiscal systems in the total absence of tax competitive behavior, as when residents are fully immobile—unable to move between taxing jurisdictions regardless of the level of taxes they face. While full resident mobility and immobility are obviously both unrealistic assumptions, the following analysis of local fiscal systems under each assumption will provide invaluable benchmarks by which to analyze the influence of tax competition on local fiscal design in the real world.

1. Local Fiscal Design Under Full Mobility Assumption

If every resident were fully mobile between taxing jurisdictions, the pressures of tax competition would ensure that local fiscal design would involve nothing more than a tax on every resident to the extent of the benefits of local governmental service received. Any attempt to do otherwise would involve the immediate migration of those residents facing tax levels in excess of benefits received. Eventually, local government would be forced to match resident tax levels with benefits received, or face inevitable insolvency.

Thus, in the presence of full resident mobility, the only workable local taxing scheme is one based on a benefit approach, in which tax levels correspond directly with benefits received. An ability-to-pay approach to taxation is simply unworkable when residents are fully mobile, for any attempt to assess taxes without regard to benefits received would imply immediate migration of those higher income residents facing tax levels in excess of benefits received. A similar pattern of "immigration" would be expected of those lower income

12. Our assumption of full mobility will be similar to that of Tiebout. That is, we will assume that residents can move costlessly from jurisdiction to jurisdiction. Id. at 419.

13. This result should not be hard to fathom, for if an individual faced no costs in moving, it only makes sense that he or she would move to take advantage of the potential tax savings. What is hard to overcome in reaching this result is the temptation to continue to consider such intangible variables as family, climate, and job opportunity. But, for our purposes, these too are costs of moving.

14. Once every resident whose tax levels exceeded benefits received had migrated, the only residents left would be those that received benefits in excess of taxes paid. This practice could obviously not continue for long before local government would become insolvent.


16. With an ability-to-pay approach to taxation, taxing officials characterize taxpayers according to ability-to-pay and then assess taxes accordingly. For a more in-depth discussion of this approach, see id. at 90-115.
residents standing to gain from the reverse. With full resident mobility, local governmental officials would be quick to realize that an ability-to-pay approach to taxation represents nothing more than a quick ticket into insolvency and quick ticket out of public office.

2. Local Fiscal Design Under Full Immobility Assumption

In contrast to the full resident mobility assumption under which tax competition forces local fiscal design to follow strictly a benefit approach to local taxation, the assumption of full resident immobility renders the forces of tax competition inoperable. No longer concerned that residents will migrate when faced with onerous levels of tax, local government can cast benefit principles of taxation aside in favor of an ability-to-pay approach to taxation.

An ability-to-pay approach to taxation is appealing to local officials because this approach embodies the widely accepted principles of horizontal and vertical equity. Horizontal equity is the notion that similarly situated taxpayers should face similar burdens of tax, and vertical equity is the notion that a taxpayer with greater resources should pay more taxes than a taxpayer with lesser resources. Under an ability-to-pay approach to taxation, the benefits of governmental services received are totally irrelevant. As a consequence, an ability-to-pay approach to taxation provides for a redistributional function of the taxing system, as those in higher income brackets invariably pay more in taxes than they receive in benefits. An ability-to-pay approach to taxation does not necessarily have to be progressive to be redistributive, but progressivity is often a characteristic of the ability-to-pay approach.

The sharp contrast in fiscal design under the full mobility and full immobility assumptions illustrates the tremendous impact resident

17. That is, tax levels that are below the fair market value of local governmental services received.
19. For a more in-depth discussion of these concepts, see id.
20. That this is so should be evident by considering that even with a flat rate of tax, a person with a higher level of income will pay more in taxes than a person with a lower level of income.
21. The widely held belief that equality of sacrifice requires not only that the rich pay more in taxes than the poor, but also that the rich pay a greater proportion of his income in taxes than the poor has long served to justify the use of progressive tax structures. J. Ochs, supra note 2, at 111-12. The basis for this widely held belief is the assumption that income is subject to diminishing marginal utility and that utility is commensurable among individuals. Even under these assumptions, however, it does not necessarily follow that equality of sacrifice requires a progressive tax structure. For a simple proof of this, see id. at 112-14. Instead, "assertions of the fairness of progressive tax rate structures seem to be more firmly rooted in a preference for an equal distribution of income than in equality of sacrifice in payment for public goods." Id. at 114.
mobility can have in shaping the forces of tax competition. When resi-
dents are fully mobile, tax competition operates in full force, requiring
strict adherence to a benefit approach to local taxation in order to
avoid mass migration and inevitable insolvency of local government.
However, when residents are fully immobile, tax competition has no
influence whatsoever on local fiscal design. Absent the competitive
pressures that require tax levels to correspond with benefits received,
local officials are free to adopt progressive, ability-to-pay approaches
to local taxation.

Given the dramatic influence resident mobility has on local fiscal
design, the importance of understanding the factors that influence res-
ident mobility cannot be underestimated. Thus, it is to this task we
now turn.

3. Factors Influencing Resident Mobility

Recall from our earlier discussion that modern price theory as-
sumes that the incentive to maximize utility motivates individual eco-
nomic behavior, and the incentive to maximize profits motivates the
economic behavior of the firm. From these assumptions, it follows
logically that local taxes will impact resident mobility only when the
tax savings from migrating exceed the costs of migrating. From this
description, resident mobility can be seen as an increasing function of
local tax levels and a decreasing function of resident migration costs.

The influence of migration costs on resident mobility cannot be un-
derestimated. Family, climate, and job opportunity, not to mention
actual moving costs, are just a few of the factors that make up an indi-
vidual's migration costs. The costs of building new plants, as well as
changes in transportation, labor, and capital costs, provide similar mi-
gration costs for the firm. When all things are considered, migration
costs can be fairly substantial and can reduce significantly resident
mobility.

The presence of migration costs provides the basis on which local
government can deviate from the benefit principles of taxation. As
migration costs increase relative to local taxes, residents become less
mobile and local officials are able to adopt more progressive, ability-to-
pay approaches to taxation.

By lowering migration costs, technological advance must be recog-
nized as a time-honored promoter of tax competition. Technological
advance, however, usually comes about rather slowly. As a conse-
quency, increased resident mobility from declining migration costs
would also be expected to proceed at a rather unhurried pace. But, if

22. See H. VARIAN, supra note 6, at 6, 82.
23. A good example is the increased mobility our nation has experienced as the result
of continued improvements in the means of transportation.
migration costs change so slowly, how then did we come to witness such a dramatic increase in tax competitive behavior among local jurisdictions over the last several years? The answer to this question lies in the fact that unlike migration costs, the influence of local taxes on resident mobility can change virtually overnight, with the swift stroke of the policymaker’s pen.

Ironically, it was federal policy revisions rather than those of the several states that were responsible for the recent increase in interjurisdictional tax competition. These federal shifts in policy include the “Fend-For-Yourself Fiscal Federalism” of the Reagan era and the trend toward lower federal rates of tax in the 1980s. With the “Fend-For-Yourself Fiscal Federalism,” local government suddenly became responsible for many governmental functions that had previously been the responsibility of federal government. This change, in turn, increased substantially the revenue states demanded out of their fiscal systems. Given that resident mobility is an increasing function of local tax levels, as these increased revenue demands forced states to raise local tax levels, more and more residents who had previously been immobile suddenly became mobile.

Just as the “Fend-For-Yourself Fiscal Federalism” increased resident mobility, so did the trend in the 1980s toward lower federal tax rates. Prior to the Economic Recovery Tax Act of 1981, the top federal individual tax rate was 70% and the top corporate tax rate was 46%. By 1988, these rates had fallen to 28% and 34%, respectively, as a result of the Tax Reform Act of 1986. Given that certain state and local taxes are deductible for federal tax purposes by individuals and businesses alike, with the decline in federal rates, the portion federal government subsidized of individual and business state tax bills had declined by 42% and 12%, respectively, in just a five-year period.

24. See Shannon, Interstate Tax Competition—The Need for a New Look, 39 NAT'L TAX J. 339 (1986). In addition to these two policy changes, the author of this article cited the growing vulnerability of our domestic manufacturers to foreign competition as a factor that quickens the search for a competitive location within the United States. Id. at 339.
25. For the 12-month period ending with June 1986, state tax collections were up 6.1%. See State and Local Tax Set Record Levels, 164 J. OF ACCT. 35 (Oct. 1987). The following year state tax collections were up again, this time by 8.3%. See Wall Street Journal, Apr. 27, 1988, at 1, col. 5. While there may be other factors at work behind these state tax collection increases, these increases are consistent with what we would expect as the result of the “Fend-For-Yourself Fiscal Federalism” of the Reagan era.
31. One of the hotly debated issues of the 1986 Tax Reform was whether or not individual deductibility of state and local taxes ought to be repealed. Had Congress re-
year period. Once again, many residents who had previously found it unprofitable to move would now be expected to reassess their positions as the reduction in federal rates increased substantially the burden of local taxes relative to resident migration costs.

With the increase in resident mobility resulting from the "Fend-For-Yourself Fiscal Federalism" of the Reagan era and the lower federal tax rates of the 1980s, there were renewed competitive pressures on states to legislate tax cuts in favor of the highly mobile. In 1987, Nebraska joined the list of its neighboring states who had been forced by competitive pressures to rethink their taxing posture. In Part III, this Comment analyzes the Nebraska Legislature's changes to Nebraska's individual and corporate taxing schemes in light of our theoretical development of tax competition's role in local fiscal design.

III. TAX COMPETITION AND NEBRASKA TAX REFORM

A. Individual Reform—Reductions in Progressivity

Individual migration costs vary inevitably from individual to individual. The different costs each individual assigns to an almost unlimited number of variables that affect migration account for these variances. The many different variables affecting migration include such things as job and family ties, income, and climate preferences, just to name a few. Given the wide variation in migration costs, it is safe to assume that resident mobility also varies widely from individual to individual. But, assuming migration costs on the whole are not significantly different from one income group to the next, in jurisdictions with progressive taxing schemes, higher income residents are likely to be significantly more mobile than lower income residents. This result follows logically from the fact that in progressive taxing
systems, higher income individuals face the greatest discrepancies between taxes paid and local governmental services received.

Under our assumption that individual economic behavior is motivated by the incentive to maximize utility, individual residents would be expected to become mobile when they can reduce discrepancies between taxes paid and local governmental services received by an amount that exceeds their particular migration costs. Since higher income individuals face the greatest discrepancies as a result of progressive taxing systems, absolute reductions in these discrepancies from migrating are likely to be much greater for the higher income individual.

The "Fend-For-Yourself Fiscal Federalism" of the Reagan era and the lower federal tax rates of the 1980s dramatically increased the mobility of the higher income resident by exacerbating the discrepancies between taxes paid and local governmental services received. As a consequence, many states were forced to legislate tax cuts in favor of higher income individuals to eliminate the locational disincentives of what had become overly progressive taxing schemes. The Nebraska response to the forces of tax competition was no exception.

Nebraska is somewhat unique in that by virtue of its ties with the federal taxing system, the progressivity of Nebraska's taxing scheme had already dramatically declined as a result of the Federal Tax Reform Act of 1986, from a top marginal rate prior to reform of 10.5% to a post-reform rate of 5.9%. In its reform of the individual income tax, however, the Nebraska Legislature left the top tax marginal rate unchanged at 5.9%, and replaced the revenue shortfall by dramatically increasing the share of revenue it collected on taxable incomes below $30,000. The Nebraska Legislature's conscious decision not to

34. See H. VARIAN, supra note 6.
35. Many states were tied to the federal tax system in the sense that many states' income tax computations began with federal adjusted gross income. What makes Nebraska's ties with the federal tax system unique is that Nebraska is one of only a few states that began its income tax computation with the amount of federal tax.
36. These two figures are based on a pre-1986 federal tax reform top marginal rate of 50%, and a post-reform top marginal rate of 28%, in conjunction with a 21% Nebraska tax rate on the resulting federal tax liability. Thus, 50% x 21% = 10.5% and 28% x 21% = 5.9%.
37. L.B. 773, Neb. Unicameral, 90th Leg., 1st Sess., 1987 Neb. Laws 1713 (codified as amended at NEB. REV. STAT. § 77-2701.01 (Supp. 1987)). This section sets forth what is known as a primary rate. For tax years beginning after December 31, 1986, the primary rate is 3.15%. Id. In addition, this section sets forth five individual tax brackets (A - E) that provide for another tax rate that is to be used in conjunction with the primary rate in computing an overall effective rate of tax. Bracket E, which is the top bracket, provides that individuals in this bracket compute their tax liability based on a rate that is 187% of the primary rate. Thus, the top marginal rate has remained unchanged at 5.9% (187% x 3.15% = 5.9%).
38. On this point, see Cederberg & Kuhn, supra note 32, at 494.
reverse the dramatic reduction in progressivity caused by federal tax
reform should come as no surprise, for this response is exactly what
we would expect from local officials under competitive pressure to al-
leviate the locational disincentives of an overly progressive individual
income tax.39

B. Corporate Tax Reform40—Tax Discrimination

With individuals, we assumed that migration costs did not vary sig-
ificantly from one income group to the next. With businesses, how-
ever, there are industries whose firms are inherently less mobile than
firms in other industries. There is no exhaustive list of industries
whose firms can be characterized as being inherently immobile, but as
a practical matter, we usually conceive of the firms within the retail,
construction, utility, and personal service industries as being inher-
ently immobile, because firms within these industries have no choice
but to locate where their market is.41 Similarly, there are industries
that by the nature of their operation are heavily operated toward the
source of their raw materials and thus, can also be characterized as
being inherently immobile.42

The presence of immobile business is significant in that it provides
incentives for local officials to bifurcate their business taxing schemes.
Cognizant that immobile business cannot escape onerous levels of tax,
local taxing officials are in a position to engage in a practice of tax
discrimination against immobile business. In reforming its corporate
business tax, the Nebraska Legislature did just that.

Through an assortment of tax incentives,43 the NebraskaLegisla-

39. The authors of the article on Nebraska Tax Reform noted that “[t]he Nebraska
individual income tax rates before 1987 were more progressive than the income
tax rates of any neighboring state.” Id. at 483.
40. This discussion focuses on the changes to the corporate income tax that the
Nebraska Legislature made in The Employment and Investment Growth Act of
1987)), and The Employment Expansion and Investment Incentive Act of 1987,
L.B. 270, Neb. Unicameral, 90th Leg., 1st Sess., 1987 Neb. Laws 646 (codified as
41. For a more detailed discussion of these particular businesses, see Papke & Papke,
Measuring Differential State-Local Tax Liabilities and their Implications for
42. Id. at 359.
43. For example, the Employment and Investment Growth Act of 1987, L.B. 775,
at NEB. REV. STAT. §§ 77-202, -2701, -2708, -2734.05 (Cum. Supp. 1987)), provided
qualifying businesses with investment tax credits, id. § 77-4105(4)(b), jobs tax
credits, id. § 77-4105(4)(a), sales tax refunds, id. § 77-4105(3), sales only allocation
factors, id. § 77-4105(1), and personal property tax relief, id. § 77-4105(2). For an
excellent discussion of the tax incentives provided by L.B. 775 as well as L.B. 270,
see Cederberg & Kuhn, supra note 32, at 490-502.
ture provided significant reductions in the effective tax costs of certain qualifying businesses. To be a qualifying business under L.B. 775, a business must be engaged in one of the following activities:

1. Research development or testing for scientific, agricultural, food product, or industrial purposes;
2. Data processing, telecommunications, insurance, or financial services;
3. Manufacturing, assembly, or fabrication of tangible personal property;
4. Administrative management or headquarter facilities;
5. Any combination of the above businesses;
6. Storage, warehousing, distribution, transportation, or sale of tangible personal property.\(^4\)

Similarly, the following is a list of qualifying businesses eligible for the credits under L.B. 270:

1. The assembly, fabrication, manufacture, or processing of tangible personal property;
2. The feeding or raising of livestock;
3. The storage, warehousing, distribution, transportation, or sale of tangible personal property;
4. The performance of data processing telecommunications, insurance, or financial services;
5. The administrative management of any of the above activities.\(^5\)

Noticeably absent from the list of qualifying business are those inherently immobile businesses such as the retail, construction, and utilities industries referred to above. Once again, though, the Nebraska response should come as no surprise, for tax competition provides local officials with no incentive to make tax cuts in favor of an immobile business population. That Iowa might tax its retail trade at a lower effective rate than Nebraska should be of no concern to Nebraska, for Nebraska retailers have no choice but to remain where their market is. Thus, the Nebraska response is exactly as we might expect, a bifurcated business tax, discriminating in favor of a highly mobile business base.

Until now, this Comment has focused on the theory of tax competition, and how tax competition influences local fiscal design, both in theory and in practice. In Part IV our emphasis shifts to an analysis of the economic consequences of the tax competitive behavior that has swept local government. This economic analysis focuses primarily on issues of equity and efficiency.

\(^5\) Id. § 77-27,189.
IV. ECONOMIC CONSEQUENCES OF TAX COMPETITION

To engage in any meaningful discussion of the economic consequences of tax competition, we must have standards by which to evaluate the tax competitive behavior we witness on the part of local government. For purposes of Part IV, the terms “efficiency” and “equity” will serve as these standards. “Efficiency” refers to the relationship between the aggregate benefits and the aggregate costs of a particular situation, and “equity” refers to the distribution of income among individuals.46 In simpler terms, efficiency corresponds to the size of the pie, and equity to how the pie is sliced.47

A. Efficiency Gains from Tax Competition

1. More Optimal Provision of Local Public Goods

A traditional function of government is to provide those goods that people desire, but because of various defects in the market, are either not provided or are inadequately provided by the market.48 Economists refer to these particular goods as public goods. “[A] public good is one which should be produced, but for which there is no feasible method of charging the consumers.”49 Our system of national defense provides an illustrative example of a public good. Because of the unique nature of national defense, there is no feasible method for private enterprise to charge the consumer for this good. If an individual consumer bought this good in the market for himself, every other consumer would be able to enjoy the benefits of a system of national defense free of charge. With goods like national defense, consumers have the incentive to understate their true preferences for the good in the hope that they can get a free ride from the provision of the good by others.50 As a result of this strategic behavior, the market presumes that there is not a sufficient demand for these goods, and the market inadequately provides public goods like national defense. A traditional function of government, then, is to try and ascertain society’s true preferences for public goods that have been purposely understated in the market, and see that the provision of these public goods is consistent with society’s true preferences. But, in the absence of a

46. As to these definitions of “efficiency” and “equity,” see A. Polinsky, An Introduction to Law and Economics 7 (1983).
47. Id. at 7.
48. For a more in-depth discussion of this traditional function of government and the various defects giving rise to the need for such a function, see J. Ochs, supra note 2, at 1-31.
49. Tiebout, supra note 11, at 417.
50. When consumers are able to get a free ride from the provision of a good by others, economists refer to this as the free-rider problem. For a more in-depth discussion of the free-rider problem and the related problem of externalities, see J. Ochs, supra note 2, at 27-30.
properly functioning price system, how is the government to ascertain society's true preferences for public goods?

The genius of Tiebout's article is that when residents are fully mobile between taxing jurisdictions, tax competition forces local government to ascertain people's preferences for public goods, based on residents' willingness to pay taxes to finance local public services. Just as profit and survival incentives force private firms to monitor closely consumers' preferences for private goods, the threat of mass migration and inevitable bankruptcy forces local officials to similarly monitor the public's preferences for public goods and to provide those goods that the public desires at the lowest possible tax price.

Thus, one obvious benefit of tax competition is that it ensures a more efficient provision of local public goods. Just how far tax competition can push local jurisdictions towards the optimal provision of local public goods is obviously a function of resident mobility. The optimal provision of local public goods would undoubtedly never be reached, for it is inconceivable that residents could ever move costlessly between taxing jurisdictions. In addition, there are at least two strands of literature that suggest that even in the presence of full mobility, local government may not provide an optimal basket of local public goods. The fact that tax competition may not result in the optimal provision of local public goods, however, should not undermine the fact that tax competition can still move local government toward a "more optimal" provision of local public goods, albeit not "the optimal."

51. Tiebout, supra note 11, at 416.
52. The first strand of literature suggests that there will be an underprovision of those public goods whose benefits spill over to the residents of other taxing jurisdictions. The intuition of this argument is that these particular goods will be underprovided because local officials fail to account for the additional benefits that spill over to residents in other jurisdictions in ascertaining the optimal level that should be provided to the public. As to this strand of literature, see Brainard & Dolbear, The Possibility of Oversupply of Local Public Goods, 89 J. POL. ECON. 1197 (1981); Williams, The Optimal Provision of Public Goods in a System of Local Government, 74 J. POL. ECON. 18 (1966).

The second strand of literature suggests the provision of local public goods will be suboptimal because of the fiscal externality residents create in moving. This fiscal externality results because the migrating resident fails to take into account the effect of his moving on the tax price of local public goods in the region he leaves as well as in the region he enters. As to this strand of literature, see Buchanan & Goetz, Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model, 1 J. POL. ECON. 25 (1972); Flatters, Henderson & Mieszkowski, Public Goods, Efficiency, and Regions Fiscal Equalization, 3 J. POL. ECON. 99 (1974); Stiglitz, The Theory of Local Public Goods Twenty-Five Years after Tiebout: A Perspective, in LOCAL PROVISION OF PUBLIC SERVICES: THE TIEBOU MODEL AFTER TWENTY-FIVE YEARS 17 (G. Zodrow ed. 1983).
2. Elimination of the Leviathan Problem

In the theory of the firm, the assumption that the incentive to maximize profits motivates the economic behavior of the firm breaks down when the firm is operating in something less than a purely competitive market, and firm management and firm ownership are not vested in the same people. In these circumstances, firm managers, as maximizers of their own utility, have incentives to use firm resources to satisfy other more personal interests, instead using firm resources to maximize profits for some absentee group of owners.

In government, this type of behavior is referred to as the Leviathan problem. Government, if for the people, is inevitably not-for-profit, and to the extent there is no competition from governments in other jurisdictions, the environment in which most governments operate is ripe for exploitation. In this environment, "[m]aintenance of employment, salary, and 'perks' and freedom from the rigors of cost-minimizing efficiency may be a large part of the agenda, as in the case of employees in non-competitive parts of the private sector."

Another beneficial consequence of tax competition, then, is that it operates to remove one of the necessary conditions for the existence of the Leviathan problem, which is government operating in a noncompetitive environment. In competitive markets, the very survival of the firm and government hinge on pursuing profit-maximizing behavior. Anything less on the part of government would mean that residents could get a better bargain for their taxing dollar by migrating elsewhere. Thus, tax competition serves to ensure that government seeks to serve the people and not itself.

3. Redistribution Function Confined to Federal Government

In the theory of public finance, the most efficient assignment of the redistributive function of government is at the highest level of govern-

53. See supra note 8.
54. In their famous book, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932), Adolf A. Berle and Gardiner C. Means first recognized that as stock ownership became increasingly diffused, corporate managers would become less subject to the control of corporate shareholders and more free to manage the corporation in their own self-interests. For some empirical evidence in support of Berle's and Mean's proposition, see Williamson, Managerial Discretion and Business Behavior, 53 AM. ECON. REV. 1032 (1963).
57. George Break described the beneficial consequences of tax competition as follows: "[i]t replaces sloth and inertia with an active search for better and more varied public services and for more efficient ways of providing them." G. BREAK, INTERGOVERNMENTAL FISCAL RELATIONS IN THE UNITED STATES 178 (1967).
Musgrave reasons that if both state and central government insist on a particular distribution of income, a final solution would never be feasible.

It would lead to a continuous set of adjustments and readjustment without a final equilibrium being reached. Since one or the other level of government must be given priority, there is much to be said, in the federal system, for permitting this adjustment to be made at the central level. Unless this is done, distributional adjustments at the state level may come to be nullified by interstate movement, and serious barriers to an optimal location of economic activity may be imposed.59

Nevertheless, a progressive, ability-to-pay approach to taxation is appealing to local officials because this approach allows local officials to achieve both horizontal and vertical equity in their taxing schemes.60 As pressures from tax competition increase, however, local officials become more and more cognizant of residents migrating to escape the onerous levels of tax that often characterize this approach to local taxation. As a result, sources of revenue for many of local government's redistributive services begin to dry up. Ultimately, if the forces of tax competition are sufficiently strong, local government will be forced to abandon its efforts to effectuate a redistributive function of local government, and the responsibility for this function of government will fall solely on the shoulders of federal government. The irony of the fact that the forces of tax competition require the redistributive function to be confined to the federal level of government is that this is just as the theory of public finance would have it, given the efficiencies of having the highest level of government redistribute wealth. Thus, a collateral benefit of tax competition is that it serves to ensure an efficient assignment of the redistributive function of government.

B. Detrimental Consequences of Tax Competition

1. Underprovision of Local Public Goods

Many economists argue that a detrimental side effect of tax competition is that it results in "a tendency toward less than efficient levels of output of local public services. In an attempt to keep tax rates low to attract business investment, local officials may hold spending below those levels for which marginal benefits equal marginal costs."61 In other words, tax competition in the eyes of many is nothing more than

59. Id.
60. Id. at 160.
61. W. Oates, supra note 1, at 143. David Wildasin also subscribes to this view and advocates federal subsidies to states of up to 40% to offset this tendency for an underprovision of public goods at the local level. See Wildasin, supra note 31, at 354.
a "zero sum game" or a "beggar thy neighbor" type activity.\textsuperscript{62} In response to these criticisms, Charles McClure states that "if benefits for residents of the taxing jurisdiction must be financed by taxes on capital that is mobile between jurisdictions . . . , [t]hat spending should be suboptimal under these circumstances is hardly surprising."\textsuperscript{63}

In an illuminating example, McClure asks "whether spending on school lunches in Gloucester, Massachusetts would be optimal if financed entirely by a property tax on the fishing fleet docked there."\textsuperscript{64} He submits that:

\begin{quote}
[M]ost of us would agree that competition from neighboring harbors (in the markets for both fish and dock facilities) would prevent the cost of school lunches from being borne by either consumers of fish or . . . owners of boats. Rather, one would expect that boats would be docked elsewhere, little revenue would be collected by Gloucester, the burden of the tax would be borne by owners of the least mobile factors in Gloucester, and school lunches would be supplied at sub-optimal levels in Gloucester.\textsuperscript{65}
\end{quote}

McClure’s example illustrates that often the underprovision of local public goods is more the result of second-best approaches to the financing of these goods than the consequence of tax competition.\textsuperscript{66}

2. Efficiency Distortions of Tax Competition

While the problem with tax competition is that it does not necessarily cause underspending in the public sector, it can potentially result in tax distortions that detract from economic efficiency. Because states and localities are hesitant to tax mobile residents for fear of driving them away, "they may . . . be induced to use socially less efficient taxes—perhaps taxes on labor, or on specific commodities."\textsuperscript{67}

The efficiency of any tax is measured by considering the extent to which that tax distorts economic activity. If a residential property tax, for example, drives out residential capital at the margin, then it is an inefficient tax. While it is impossible to design a taxing scheme that does not distort economic activity to some extent, the most efficient taxing scheme would be one that raised the desired level of revenue with the least distortion of economic activity. If, for example, our residential property tax drove out more residential capital at the margin than say a tax on business capital, then a taxing scheme that relied more heavily on a business capital tax would be more efficient than a

\textsuperscript{62} John Shannon states that until quite recently this rather dim view of intergovernmental tax competition was widely held by students of public policy. See Shannon, \textit{supra} note 24.

\textsuperscript{63} McClure, \textit{supra} note 31, at 341-42.

\textsuperscript{64} \textit{Id.} at 342.

\textsuperscript{65} \textit{Id.}

\textsuperscript{66} McClure adds that in this case "[t]he first-best solution from an allocative point of view would be to charge market price for the lunches, rather than trying to cover their cost through the taxation of an entirely different and mobile activity." \textit{Id.}

\textsuperscript{67} Wildasin, \textit{supra} note 31, at 353-54.
taxing scheme that relied more heavily on a residential capital tax, for there would be less distortion of economic activity with the former. Thus, the optimal taxation scheme, at least from an efficiency standpoint, would be to tax most heavily those classes of property with the most inelastic demand.68

With tax competition, a tax on mobile residents does not necessarily drive out economic activity at the margin, it just drives it elsewhere. Thus, in McClure's example, the property tax on the fishing fleet in Gloucester, Massachusetts does not necessarily drive out capital for fishing fleets, the fishing fleets just show up in another harbor. The problem with tax competition is that if a tax on capital for fishing fleets distorts economic activity less than a tax on retail capital, then the fact that tax competition prevents local officials from taxing the mobile fishing fleet capital more heavily than immobile retail capital means that tax competition can cause local officials to rely on inefficient schemes of local taxation.

While in theory tax competition may prevent local officials from adopting efficient schemes of local taxation, an interesting sidelight in practice is that even in the absence of tax competition, equitable and not necessarily efficient schemes of local taxation are often the most popular choice.69

3. Inequitable Schemes of Local Taxation

That local officials would choose to promote equity over efficiency in the absence of competition implies that another detrimental consequence of tax competition may be that it results in potentially inequitable schemes of local taxation. As noted, equity manifests itself in local schemes of taxation in approaches that levy taxes according to ability to pay.70 By taxing similarly situated taxpayers similarly, an ability-to-pay approach promotes horizontal equity, and by levying greater burdens on those with a greater ability to pay, an ability-to-pay approach promotes vertical equity as well.

In the presence of tax competition, local officials can be forced to abandon these equitable ability-to-pay approaches to taxation in favor of a benefit approach that ties tax levels more closely with benefits received. Of course, how far tax competition forces local officials to deviate from an ability-to-pay approach depends on resident mobility.

68. As to this optimal approach to taxation, see Beck, Tax Competition, Uniform Assessment, and the Benefit Principle, 13 J. Urb. Econ. 127 (1983).
69. See supra notes 4-32 and accompanying text. In the absence of competitive pressures that force local officials to tie tax levels with benefit received, local officials opt for more progressive, ability-to-pay approaches to taxation in an attempt to promote both horizontal and vertical equity. For a more in-depth discussion of this situation, see R. Musgrave, supra note 15, at 160.
70. R. Musgrave, supra note 15, at 160.
In the extreme case of full resident mobility, tax levels would have to correspond exactly with benefits received. In this situation, a very, very wealthy individual could conceivably pay the same or even less in taxes than the very poor individual. The more realistic case, however, might be as in Nebraska where immobile business is taxed more heavily than mobile business. But, just the same, tax competition has caused a breakdown in the ability-to-pay approach at the local level, and two similarly situated Nebraska corporations may well face different burdens of tax.\textsuperscript{71}

V. CONCLUSION

Whether the equity loss from tax competition outweighs the efficiency gain is a normative issue whose resolution lies beyond the scope of this Comment.\textsuperscript{72} Nevertheless, the fact that this Comment does not attempt to resolve this normative issue should not detract from the thrust of this Comment, which was to provide a positive economic analysis of tax competition. We laid the foundation for this analysis by examining the theoretical underpinnings of tax competition, and expanded on this examination with an in-depth look at how tax competition influences local fiscal design, in theory as well as in practice. From there, we developed a framework by which to analyze the positive economic consequences of tax competition. In that development, we saw that tax competition serves to promote economic efficiency by driving local government toward a more optimal provision of public goods, by eliminating the Leviathan problem, and by ensuring that the redistributive function of government is assigned at the highest level of government. However, we also saw that tax competition was potentially inefficient in that it induces local officials to adopt less than efficient schemes of local taxation. And, finally, we saw that tax competition could potentially result in economic inequities by forcing states to abandon their progressive, ability-to-pay approaches to taxation.

Given the size of present day government, the importance of understanding the interdependencies of local government cannot be underestimated. In response to these concerns, this Comment was written in an attempt to provide a higher level of understanding of the intricacies of interjurisdictional tax competition. In so doing, hope-

\textsuperscript{71} The most popular response to the objection to tax competition on distributional grounds is that redistributive policies should be confined to the federal government in the first place since that is where these policies can be most efficiently carried out. On this point, see supra Part IV, section three of this Comment, and McClure, \textit{supra} note 31, at 346.

\textsuperscript{72} McClure concluded that this normative issue balances out and that "the benefits of tax competition are potentially quite important" and "that tax competition is, on balance, good." McClure, \textit{supra} note 31, at 346.
fully this Comment will stimulate further research and a broader understanding of this important phenomena of our local public economies.

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