Fiscal Competition or Harmonization? Some Reflections

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Abstract - Economic competition among governments, making use of both fiscal and regulatory policy instruments, is the subject of great concern on both sides of the Atlantic, for fear that it gives rise to a “race to the bottom” resulting in levels of public services that are too low. This paper explores the theoretical and empirical foundations for this claim. The literature is a large, rich, and complex one that, while perhaps inconclusive, provides some valuable insights into the nature of the issue. The case for harmonizing measures to restrain fiscal competition is not wholly compelling; there remains, in fact, a good case for the benefits from such competition.

INTRODUCTION

The issue of economic competition among governments is a contentious one on both sides of the Atlantic. In the U.S., there is an often-voiced concern that competition among state and local governments, making use both of fiscal and regulatory instruments, has resulted in a debilitating “race to the bottom.” Likewise in the emerging European Union, policy-makers decry the inhibiting effects on the public sector of such competition among the member nations. The response (among other things) is an explicit floor on Value Added Tax (VAT) rates in these countries.

Fiscal (and regulatory) competition is a complicated and quite intriguing issue. There is now an enormous literature in the economics journals and books that explores this topic. My purpose in this paper is simply to offer a brief recapitulation of the thrust of this literature along with some of my own reflections. Although this body of work, in my view at least, cannot provide a conclusive answer to the question posed in the title to the paper, it does lay out the issues in a useful way that helps us understand just where things may or may not go wrong.

At the outset, let me offer one observation. It seems a little strange on first glance to find economic competition cast in the role of the villain. With certain important qualifications of course, economists typically praise the workings of competition as a mechanism that encourages efficiency in production and in resource allocation more generally. In a setting of private markets with profit-maximizing agents, competition (working through Adam Smith’s famous invisible
hand) guides individual decisions in ways that promote socially beneficial outcomes. In the case of the public sector, however, we are told that competition undermines the adequate provision of public services. What’s going on here? Is there really a race to the bottom, or can competition among governments, in fact, be welfare-enhancing?

A REVIEW OF SOME LITERATURE

As I mentioned, there is a huge literature on this topic, and it is overwhelmingly theoretical in character. Public finance economists have set forth a lengthy series of theoretical models in which they explore the impact of competition among governments, where this competition makes use of not only fiscal instruments (tax and expenditure policies), but also various regulatory measures such as environmental restrictions on production.

The point of departure for this literature is the so-called theory of fiscal federalism [see Oates (1999) for a recent survey]. At the risk of some oversimplification, the gist of this conceptualization of multilevel government for the problem at hand is that a particular public service should be provided by the lowest level of government that encompasses the benefits and costs of its provision. The basic idea is simply that for matters of “local” interest, it is better to allow local government to tailor outputs to local circumstances (local preferences and costs), rather than to have a higher level of government provide more uniform levels of services across all jurisdictions. There are, in short, gains in economic welfare from fiscal decentralization for such goods—in the vernacular, this is the claim that “one size doesn’t fit all.” From this perspective, we can envision a federal structure in which a central government provides certain national public goods (like national defense) and decentralized governments provide the appropriate levels and mix of outputs that address the needs of their own constituencies (local roads, parks, police protection, etc.). Moreover, each level of government can draw (largely) on its own system of taxation to finance its budget.

Some of the new literature on fiscal competition provides a direct challenge to this vision. The argument, in brief, is that in their concern to attract new business investment and create new jobs, “local” officials (be they from state or local governments in the U.S. or member countries in the E.U.) tend to hold down tax rates (and perhaps also the stringency of environmental measures) that might discourage economic development. A competitive race relying heavily on low tax rates results in a public sector that is too small to provide adequate levels of public services.

On first inspection, this argument seems a little puzzling. If governments seek to promote the well-being of their citizenry, why would they provide too little in the way of public services? If the benefits of expanding public outputs exceed the taxes required to finance them, then we might expect an increase in the levels of these services.

There is now a large group of theoretical models that assess this claim that competition results in the underprovision of public services; the results depend largely on the setting for the models. It is, for example, straightforward to set out a standard kind of model in which interjurisdictional competition induces public officials to make the right choices—that is, to provide the economically efficient levels of public services (e.g., Oates and Schwab, 1988). I might add that these are quite rich models in which the local

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1 For a splendid and concise survey of the tax competition literature, see John Wilson’s fine paper (1999) in this journal. For a more extended treatment, Dietmar Wellisch (2000) has recently published an excellent book that covers the ground in a more formal and detailed manner.
public sector provides consumption goods to residents, public inputs for local firms that increase their productivity, environmental regulations, and taxes on both local firms and residents. These models, however, are admittedly restrictive: they assume that the governments are “small” in national capital markets, that they do not behave strategically relative to their neighbors, and that they have access to a full set of tax and regulatory instruments so that they can effectively engage in benefit taxation of both residents and firms. In such a world, competition among governments is a good thing—as they seek to attract new business and jobs, public officials do so in ways that promote an efficient allocation of resources. There is no race to the bottom here.

However, when one departs in quite realistic ways from this “pure” setting, other kinds of things can happen. An important line of work in the fiscal competition literature examines the case in which local governments do not have access to the full range of tax instruments (Zodrow and Mieszkowski, 1986; Wilson, 1986; Wildasin, 1989). In the simplest case, these models assume that local governments can only tax capital so that all local services (including those for residents) must be financed from taxes on mobile capital (local firms). In this setting, there arises a kind of fiscal externality in that local officials do not take into account the impact that their decisions have on the tax bases of other jurisdictions. This typically leads to decisions involving suboptimal tax rates with levels of public services that are too low. For this case, tax competition can indeed result in excessively low levels of public activity.

Distortions can also arise from other sources. They can occur, for example, where jurisdictions are not “small” so that local policy choices affect the equilibrium return to the stock of capital or where there are strategic interactions among neighboring communities or states. More generally, this literature reaches into a rich array of realistic fiscal institutions and settings that encompass multiple tax instruments, expenditure competition, and explicit bidding for mobile firms. The findings suggest that in many of these circumstances, competition can result in distorted outcomes—sometimes (but not always) with outputs of public services that are too low.

**TWO MORE OBSERVATIONS**

Let me offer two observations on the preceding synopsis of research on fiscal competition. First, the models I have described above are in the neoclassical tradition of public finance, where public officials are assumed to select policies that promote the well-being of their citizenry. In short, the objective of local public policy is taken to be the maximization of the economic welfare of local residents. In contrast, if we turn to another class of “public choice” models in which officials are assumed to have their own objectives, then the whole perspective on the problem changes radically.

Following the work of James Buchanan, William Niskanen, and others, suppose that we assume that public officials seek (for their own reasons) to maximize the size (budget) of the public sector. They thus have an interest in expanding the size of the tax base for their own purposes. In such a setting, there is a general tendency toward an excessively large public sector. As Brennan and Buchanan (1980) and others have argued, interjurisdictional competition in this case becomes quite appealing: competition prevents local officials from engaging in excessive taxation for fear of chasing away the local firms that generate much of the tax base. Competition, in short, provides a needed fiscal discipline that is absent at the central government level. Indeed, Brennan and Buchanan (1980) argue that fiscal decentralization is attractive for the very rea-
son that it constrains government from its expansionary tendencies: one way of corralling a monopolistically centralized public sector is to devolve its powers to lower levels of governments that compete with one another for firms and residents.

The basic point here is that whether or not fiscal competition is a good thing depends in important ways on one’s view of the public sector (Edwards and Keen, 1996; Frey and Eichenberger, 1996; Oates, 2001). In particular, if government has overly expansionary tendencies, then competition has real appeal. Even in the case of welfare–maximizing governments, however, the case is far from clear. Depending on the properties of the model, interjurisdictional competition can be welfare–enhancing and lead to efficient outputs of public services and private production—or it can introduce distortions, typically in the form of levels of public services that are too low.

This brings me to my second observation. If there are such distortions involving underprovision of local services, the important issue is one of magnitude. How large are the distortions that this literature describes? They may be quite small and hence of little consequence—or perhaps they are large and require some form of harmonizing measure. The fact is that we have little real evidence on this. The measurement of such welfare losses is a tough empirical task. We know that there is plenty of competition out there—states in the U.S., for example, have aggressive programs to attract business enterprise. However, we most emphatically cannot infer from this that competition is excessive or distorting (Courant, 1994). As I have noted, in many of the models, active competition encourages efficient outcomes.

IS THERE A RACE TO THE BOTTOM?

Is fiscal competition a serious distorting force in the industrialized world? The evidence in support of an affirmative answer to this question is, to my knowledge, largely anecdotal. We certainly have heard of cases where intense competition by several state governments for a large new manufacturing plant seems to have resulted in an outcome that at least some see as unfavorable to the “winner.” The real issue, though, aside from these dramatic cases, concerns the impact of the widespread programs of state and local governments for economic development. I know of no systematic evidence that provides a compelling case in this context for the existence of a race to the bottom.

There is some limited evidence supporting a negative answer. In a recent piece on environmental federalism (Oates, 2000), I offer my own reading of the U.S. experience and report on some recent econometric studies of the impact of devolution of environmental measures from the federal to state and local governments. If there were fierce and distorting economic competition, one would expect to find that states are reluctant to enact measures that are more stringent that the centrally determined standards. Yet there are plenty of instances where U.S. states have introduced regulations for the control, for example, of pesticides and hazardous wastes that go well beyond federal requirements. The one area where we don’t see this taking place is for the national ambient air quality standards under the Clean Air Act. But my reading of this case is that the legislation calls for such stringent measures (standards so tough that there are no adverse health effects from air pollution irrespective of the costs of control) that few would want anything any tougher.

Moreover, Goklany (1999) provides a provocative account of the history of air quality management in the U.S. in which he documents the sometimes quite extensive and effective measures introduced by state and local governments prior to the Clean Air Act Amendments of 1970.
Taking another tack, three recent empirical studies examine the record on environmental management during the Reagan years when substantial responsibility for environmental protection was shifted from the federal government to the states. Although this is admittedly a brief time span, none of the studies finds any evidence of a race to the bottom. John List and Shelby Gerking (2000), using state level data, estimate a fixed–effects model that examines both levels of environmental quality and abatement expenditures. They find no evidence of deterioration and some of improved environmental quality, leading them to conclude that “... in this instance, the race to the bottom did not appear to materialize.” In another assessment of the Reagan experience, Daniel Millimet (2000) has studied airborne emissions of sulfur dioxide and of industry spending on pollution abatement. He finds that actual emissions were lower and abatement spending higher than forecast by his model, suggesting a race to the top rather than the reverse. Likewise, Per Fredriksson and Millimet (forthcoming) find little impact of the Reagan decentralization of environmental policy; what they do find is evidence of a strategic race to the top among U.S. states. While I don’t know of comparable empirical work on fiscal competition, the few studies we have on environmental management do not provide any systematic support for the existence of a race to the bottom.

Finally, I want to cite some preliminary findings from an ongoing study by Ian Parry (2001). Parry has taken another approach to this issue by using a basic numerical model to try to get some sense of the magnitude of likely distortions from fiscal competition. Making use of an interregional model and some plausible estimates of key parameters taken from the literature, Parry finds that the likely distortions from fiscal competition are quite modest. These results emerge for the case of welfare–maximizing governments. Moreover, where there are traces of Leviathan (budget–maximizing) behavior by public officials, the negative welfare effects of fiscal competition quickly become smaller and can change their sign from negative to positive.

**CONCLUSION**

The literature on fiscal competition thus takes us some distance in understanding the kinds of circumstances under which we might expect such competition to impair the functioning of the public sector, but it is far from conclusive. As we have seen, there are clearly settings in which economic competition among governments can undermine the adequate provision of public services. However, the extent and magnitude of such distortions are not well understood.

Moreover, in certain other settings, fiscal competition can have a beneficial impact: it provides the right sorts of incentives for decisions on taxes and public expenditure. Especially if there are tendencies toward excessive budgets, fiscal competition may play an important role in constraining the public sector. From this perspective, Gary Becker (1998) has argued that “Competition among nations tends to produce a race to the top rather than to the bottom by limiting the ability of powerful and voracious groups and politicians in each nation to impose their will at the expense of the interests of the vast majority of their populations” (p. 22). But even aside from such a jaundiced view of the public sector, there remains much to be said for the traditional case for fiscal decentralization both in terms of encouraging efficient resource use and in promoting democratic participation.

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