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Government Tax Competition Fosters Economic Growth

by Arlan DeBlieck

In "Fiscal Competition In A Federal System," Dr. Bruce Benson considers intergovernmental competition as part of the federalist process. Specifically, he considers the effects of interjurisdictional tax competition on economic growth, and details some of the trade-offs faced by politicians in making tax and policy decisions.

Government is under constant pressure to lower taxes while increasing expenditures. This pressure is compounded at the state and local levels of government because bad decisions can cause a loss in their tax base resulting in economic stagnation. The reason for this is "interjurisdictional competition." States compete with other states, municipalities against other municipalities, for their tax bases. These entities compete to lure businesses into their area in order to create economic activity that can ultimately increase tax revenues and expenditures that improve quality of life. If any of these governments get out of line with competitors, it can lose tax base.

During the 1960s, 1970s, and part of the 1980s, many believed that tax rates had little to do with business decisions, and ultimately, economic growth. However, further studies revealed that tax rates may not affect business location decisions to a large degree, but they do have a significant effect on the overall economic health of a jurisdiction. It was found that tax rates affected the flow of investment capital, income levels, and employment which determine the overall vigor of economic growth. Competition between governments ensures that tax rates and expenditures stay under control. New York and Massachusetts found out the hard way during the 1970s that failing to keep up with the competition can cause economic hardships.

Critics of interjurisdictional competition complain that while competition may be efficient in allocating resources, it creates a "zero-sum game." Critics believe that jurisdictions may be stealing businesses from each other and not really creating any economic growth overall. Also, when jurisdictions cut taxes, they reduce government revenues that could be redistributed to less advantaged members of society.

This argument is flawed because it ignores the effects that taxes have on economic growth and the creation of wealth. If wealth creation is stunted, what is left to redistribute? Not only does competition between jurisdictions ensure an efficient allocation of resources, but studies show that reducing tax rates can increase government revenues. Increasing taxes in the short run may increase short-run tax revenues, but studies show that higher tax rates slow economic growth, reducing what can be spent in the long run. Conversely, cutting tax rates can stimulate growth, allowing for increased spending in the future.

Politicians and bureaucrats hate competition. Studies show that politicians make decisions based on short-term factors. Politicians are rewarded with re-election at a higher rate when they call for tax increases to support current benefits, but pass the consequences off into the future. Politicians who support holding tax rates constant in order to facilitate economic growth,

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do not get re-elected at as high a rate. This indicates an incentive to sacrifice growth for short-run benefits. Competition inhibits politicians and bureaucrats from acting in their own self-interest.

Since government competition is similar to an oligopoly market, jurisdictions have tried to collude and form cartels in order to reduce competition. However, as with the private sector, these compacts rarely last and are not very effective. As a result, smaller governments have resorted to the federal government to seek protection from competitive forces. Because of the Constitution, there is very little the federal government can offer in direct protection.

What has developed into protection from competition is the deductibility of state and local income taxes from federal taxes. Competition is rendered useless because the effects of higher tax rates are hidden, making it seem as if all jurisdictional tax rates are the same. Additionally, the federal government has reduced expenditure competition by collecting more taxes at the federal level, then giving money back in the form of revenue sharing and block grants. This shields local politicians from having to increase local taxes to pay for increased spending. As a result of being able to deduct state and local taxes from federal tax liabilities and revenue sharing, politicians avoid the pains of interjurisdictional competition, while still being able to increase the redistribution of wealth.

Interjurisdicitonal competition is not totally avoided. Other forms of competition have replaced the competition in tax rates. Targeted benefits in the form of special tax breaks, special bonds, and facility improvements are now used to lure businesses into jurisdictions. However, jurisdictions have learned they do not have to cut all taxes to stimulate growth. Because benefits are targeted, rent-seeking activity at the local level has increased.

Dr. Benson concludes by discussing studies that looked at the most efficient size of government as it relates to Gross Domestic Product (GDP). Efficiency is considered the optimal size of government expenditures that also maximizes economic growth. Most of the studies placed the optimal size of total local, state, and federal government expenditures somewhere between 15 and 22 percent of GDP. Though this range is wide, all of the studies concluded that our current level of government spending exceeds this range and therefore that it is retarding economic growth.

This Institute Brief is one in a series on the chapters of a just published book, FEDERALIST GOVERNMENT IN PRINCIPLE AND PRACTICE, *edited by Dr. Don Racheter, President of Public Interest Institute, and Dr. Richard Wagner, Economics Professor at George Mason University and Chairman of the Institute's Academic Advisory Board.* FEDERALIST GOVERNMENT IN PRINCIPLE AND PRACTICE *looks at the relationship between federalism and liberty and explores the substantive practice of federalism, particularly the centralizing processes at work and the opportunities for decentralization.*

The author of this chapter of FEDERALIST GOVERNMENT IN PRINCIPLE AND PRACTICE *is Dr. Bruce L. Benson, Professor of Economics at Florida State University, Tallahassee, Florida, Research Fellow of the Public Research Institute, Advisory Board Member of the James Madison Institute, and an Associate of the Political Economy Research Center.*

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