STATE TAX COMPETITION AND CONGRESSIONAL COMMERCE POWER: THE ORIGINAL PRUDENCE OF CONCURRENT TAXING AUTHORITY*

James R. Rogers**

State and local governments employ fiscal incentives -- tax abatements and subsidies, among others fiscal tools -- in attempting to induce non-resident firms to locate business facilities within their jurisdictions or to keep resident businesses from moving elsewhere.[1] The literature on tax incentives spans law,[2] economics,[3] and public policy.[4] While a few analysts express skepticism regarding the

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** Assistant Professor, Department of Political Science, Texas A&M University. B.A. 1983, University of Nebraska; J.D. 1987, University of Nebraska Law School; M.A. (economics) 1989, Brown University; Ph.D. (political science) 1994, University of Iowa.

1. For a review of types of incentives, as well as a literature review of their effectiveness, *see* ROGER WILSON, STATE BUSINESS INCENTIVES AND ECONOMIC GROWTH: ARE THEY EFFECTIVE? A REVIEW OF THE LITERATURE (1989).

2. *See, e.g.*, Melvin L. Burstein and Arthur J. Rolnick, *Congress Should End the Economic War Among the States*, 9 THE REGION: SPECIAL ISSUE 2 (1995) (hereinafter Burstein and Rolnick); Mark Taylor, Note, *A Proposal to Prohibit Industrial Relocation Subsidies*, 72 TEX. L. REV. 669 (1994) (hereinafter Taylor); Charter Township of Ypsilanti v. General Motors Corp., No. 92-43075-CK, 1993 WL 132385 (Mich. Cir. Ct. Feb. 9, 1993) *rev'd*, 506 N.W.2d 556 (Mich. Ct. App. 1993).

3. *See, e.g.*, Thomas J. Holmes, *The Effects of Tax Discrimination When Local Governments Compete for a Tax Base*, Federal Reserve Bank of Minneapolis Research Department Working Paper 554 (1995) (hereinafter Holmes); David E. Wildasin, *Some Rudimentary 'Duopolity' Theory*, 21 REGIONAL SCI. & URB. ECON. 393 (1986); John D. Wilson, *Optimal Property Taxation in the Presence of Inter-regional Capital Mobility*, 17 J. URB. ECON. 73 (1985); John D. Wilson, *A Theory of Inter-regional Tax Competition*, 19 J. URB. ECON. 296 (1986).

4. *See, e.g.*, John Blair and Robert Premus, *Major Factors in Industrial Location: A Review*, 1 ECON. DEV. Q. 72 (1987); DeLysa Burnier, *Becoming Competitive: How Policymakers View Incentive-Based Development Policy*, 6 ECON. DEV. Q. 14 (1992); Dennis O. Grady, *State Economic Development Incentives: Why Do States Compete?* 1987 STATE & LOC. GOV'T REV. 86; Russell L. Hanson, *Bidding for Business: A Second War Between the States?* 7 ECON. DEV. Q. 183 (1993); BRYAN D. JONES & LYNN W. BACHELOR, THE SUSTAINING HAND: COMMUNITY LEADERSHIP AND CORPORATE POWER (2d ed., 1993); Charles E. McLure, *Tax Competition: Is What's Good for the Private Goose also Good for the Public Gander?*, 39 NAT. TAX J. 341 (1986); Paul Peretz, *The Market for Industry: Where Angels Fear to Tread?* 5 POL'Y STUD. REV. 624 (1986); Harold Wolman, *Local Economic*

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magnitude of the problem represented by tax competition between states for businesses,[5] many others argue that the rivalry between states for business is so cutthroat that there now exists a second "war between the states."[6] These latter analysts argue that the rivalry is so destructive and states are so unable to control it that congressional intervention is required under its extensive commerce authority to bring this competition to an end.[7] While seeming easily within the

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Development Policy: What Explains the Divergence Between Policy Analysis and Political Behavior? 10 J. URB. AFF. 19 (1988).

5. *See, e.g.*, Hanson, *supra* note 4.

6. *See, e.g.*, Burstein and Rolnick, *supra* note 2.

7. For example, Burstein and Rolnick, *supra* note 2, argue:

> [I]t is now time for Congress to exercise its Commerce Clause power to end another economic war among the states. . . . How can this war among the states be brought to an end? The states won't end this war, and the courts are not equipped to do so. Only federal legislation can prevent states from using subsidies and preferential taxes to attract and retain businesses. . . . Only Congress has the power to enact legislation to prohibit and prevent the states from using subsidies and preferential taxes to compete with one another for business. . . . The power of Congress under the Commerce Clause is so sweeping that to enact legislation to prohibit the states from using subsidies and preferential taxes to compete with one another, it need only make a finding, formal or informal, that such subsidies and taxes substantially affect interstate commerce. The Supreme Court will defer to such a congressional finding if there is any rational basis for the finding.

Id. at 3, 10, and 15. Holmes, who analyzes Burstein and Rolnick's proposal in a working paper for the research department of the Federal Reserve Bank of Minneapolis, writes:

> But if we assume that state officials actually do behave so as to maximize some measure of welfare of the residents of their state, then could a federal law that interferes with the ability of state officials to set state policies actually raise the overall welfare of U.S. residents? I think so, and the purpose of this article is to demonstrate why.

Holmes, *supra* note 3, at 2. Similarly, Taylor, *supra* note 2, writes:

> State legislatures are unable to restrict the subsidies because they must compete with other legislatures in establishing a pro-business climate. The judiciary is unable to restrain the granting of subsidies because the local governments have adapted their procedures to comply with existing legal constraints. The inadequacy

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domain of the national government's power to regulate commerce -- state economic rivalry under the Articles of Confederation was, after all, one of the important impetuses to expand national power under a new constitution -- this essay argues that the Commerce Clause[8] of the U.S. Constitution was not originally understood to provide the national government authority to regulate state fiscal policies of the type states employ to induce business location decisions. Indeed, it is argued that the important policy considerations underlying the Commerce Clause are not implicated in state tax competition for new business sites. Unlike traditional commerce litigation over attempts by states to export tax burdens by taxing interstate commerce, tax subsidies and abatements represent, at worst, forms of state tax *importation* that do not touch on commercial intercourse as traditionally understood, nor do these tax programs damage the economy as do tax impositions on interstate commerce.

To be sure, modern Commerce Clause jurisprudence grants Congress expansive powers.[9] So, too, the Supreme Court, in overruling *National League of Cities v. Usery*[10] in *Garcia v. San Antonio Metropolitan Transit Authority*,[11] eliminated judicially enforced barriers to congressional regulation touching even on essential attributes of "state sovereignty" such as state taxing powers. If Congress chooses directly to regulate state tax policies under its commerce power or under its taxing and spending authority, then it appears almost certain that it may constitutionally preempt contrary

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> of these alternatives points to federal legislation as the best means of addressing the dangers of relocation subsidies.

Id. at 671. Judge Shelton, a Michigan circuit court judge, wrote in his 1993 *Ypsilanti* decision that it is "perhaps for the federal government to finally intervene in this area on the basis that a national industrial policy regarding tax subsidies is needed." *Ypsilanti*, *supra* note 2, at 11.

8. U.S. CONST., art. I, § 8, cl. 3 ("[Congress shall have Power to] regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.").

9. *See, e.g.*, United States v. Lopez, 115 S. Ct. 1624 (1995).

10. 426 U.S. 833 (1976).

11. 469 U.S. 528 (1985).

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state policies under the Constitution's Supremacy Clause.[12] Nonetheless, the analysis advanced below is of more than historical interest for two reasons: First, the Constitution's drafters and proponents articulated a general understanding of the relationship of states to the national government and of the national government's authority to regulate state tax policies. Their understanding, even if not judicially enforceable, retains argumentative force relevant to policy considerations. While the Supreme Court may permit Congress constitutionally to exercise direct authority over state tax policies, Congress need not exercise that power if persuaded that it would represent unwise policy. The policy concerns of the Constitution's drafters may be relevant to the prudence of adopting such regulations. Second, in *United States v. Lopez*,[13] the Supreme Court recently asserted that the scope of the Commerce Clause is not infinitely expansive. It is too early to predict whether the decision simply represents an aberration in modern Commerce Clause jurisprudence or whether it represents a reinvigorated judicial commitment to federalism. If it represents the latter, then issues such as those discussed below will be relevant not only to the prudence of the proposed policies but to their constitutionality as well.

I. TAX IMPORTATION AND STATE TAX COMPETITION

Modern state tax competition bears only a superficial resemblance to the economic rivalry that spurred adoption of the Commerce Clause. Before turning to the historical background of the provision, we will briefly review the nature and effects of tax competition on business site decisions and how these effects differ from tax impositions on interstate commerce.

Beginning at least with Charles M. Tiebout's seminal article,[14] economists have shown that the state-level fiscal variety inherent in the

12. U.S. CONST. art. VI, cl. 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land . . . any Thing in the Constitution or Laws of any State to the Contrary not withstanding.").

13. 115 S. Ct. 1624 (1995).

14. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. OF POL. ECON. 416 (1956).

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federal separation of state and national governments generally contributes to economic efficiency. The basic argument is this: When people are permitted to move freely between states, individuals can choose the state with the combination of fiscal policies -- public goods and associated tax levels -- that they prefer. People who want a great highway system on which to commute to work every day or a terrific park system may choose a high tax/service state, whereas people who have a relative preference for private consumption may choose a low tax/service state. Given heterogeneous preferences regarding the consumption of state-provided goods and services, citizens distribute themselves among states consistent with those preferences and so maximize social welfare as compared to a system without state-level fiscal variation. The argument constitutes an efficiency rationale for federalism.

This argument, however, is only true in general. There may be particular state policies, or interactions between state policies, that serve as exceptions to the general result. Indeed, critics of state tax competition argue that the implications of this competition between states serve to create just one such exception. Specifically, critics assert that two harmful outcomes result from this state tax competition: first, the competitive process results in state tax revenues that are lower than they would be in the absence of competition,[15] and, second, the tax programs states adopt result in incentives for socially inefficient resource misallocation on the part of firms.[16]

In brief, the arguments against these conclusions are, first, while it is correct that tax competition almost certainly reduces tax revenues relative to tax revenues that states would realize in the absence of such competition, we nonetheless cannot infer any conclusion about whether the loss of state tax revenues is good or bad for the economy at large. Second, critics who assert that tax competition results in incentives for firms to misallocate resources to inefficient production have fundamentally mischaracterized the political environment of tax

15. Burstein and Rolnick, *supra* note 2, at 7 ("Competition has simply led states to give away a portion of their tax revenue to local businesses . . . [and] in the aggregate, states will have less revenue."). *See* citations in notes 18 and 21, *infra*.

16. *See* citations in notes 28 and 32, *infra*.

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competition and the outcome that environment generates. In fact, it is the competitive dynamic between states that *prevents* resource misallocation. We now consider these arguments in greater detail.

A. State Tax Competition and Revenue Loss

State tax competition almost certainly means that states receive lower net tax revenues relative to a "collusive" outcome, where states overtly or tacitly agree not to compete against one another by offering special incentives to specific firms. Because such agreements generally cannot be enforced, non-cooperative game theory is an appropriate tool to analyze the behavior of states in this policy environment. The competitive interplay between states induces an environment similar, but not identical, to the incentive structure of the well-known "prisoners' dilemma" game.[17] The idea can be satisfactorily motivated using the simple 2 × 2 game described in Table 1.[18] Here there are two states and two firms. The states have similar cost structures and

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17. Note that the game reported in Table 1 is not identical to the prisoners' dilemma because the equilibrium strategy to engage in tax competition only weakly dominates the strategy to collude. The standard prisoners' dilemma realizes an equilibrium in (strictly) dominant strategies. ERIC RASMUSEN, GAMES AND INFORMATION 30 (2d ed. 1994). The equilibrium concept applied in the analysis here is that of Nash equilibrium, named after its innovator, a recent recipient of the Nobel prize in economics. An equilibrium is a Nash equilibrium if given the strategy of the other player(s), no player has an incentive to deviate to another strategy. This is the most popular equilibrium concept in economic and political analysis and is treated in any standard game theory text, as is the notion of an equilibrium in dominant strategies. *See, e.g.*, DREW FUDENBERG & JEAN TIROLE, GAME THEORY (1991). Note that every equilibrium in dominant strategies is a Nash equilibrium, but not every Nash equilibrium is an equilibrium in dominant strategies. Note also that the game described in Table 1 has three Nash equilibria: (compete, compete), (collude, compete), (compete, collude), where state 1's strategy is the first element of the ordered pair and state 2's strategy is the second element. Mutual collusion is not an equilibrium outcome to the game even though it maximizes net tax revenues over both states. This accounts for its prisoners' dilemma-*like* quality even though the games' incentive structures are not identical.

18. A more formal treatment, with n states and continuous strategy spaces, is provided in James R. Rogers, *The Futility of State Tax Competition for Business*, Paper presented at the 1996 Midwestern Political Science Association Meeting, April 14-16 (Chicago, IL) (hereinafter, Rogers).

the firms have similar cost and production functions.[19] If neither state competes, the collusive outcome is realized in which, on average, one firm locates in each state and each state realizes net taxes in the amount of $10. If just one state deviates from the mutually collusive outcome by offering the other state's firm a tax rebate or subsidy of $1, then both firms, being profit-maximizing, locate in the deviating state which is offering the lower net tax burden. Thus, the state defecting from the collusive strategy realizes tax revenues in the amount of $19,[20] and neither firm locates in the state offering the collusive tax rate, so tax revenue realized by that state is zero.

Table 1: Weakly Dominant Tax Competition

		State 2's Strategies	
		Collude	Compete
State 1's Strategies	Collude	10	19
		10	0
	Compete	0	0
		19	0

Note that in the game described in Table 1, if both states defect from the collusive outcome, then net tax revenue for both states is zero. The 2 × 2 game does not capture the story behind this revenue outcome as well as a game employing continuous strategy spaces,[21]

19. All this is to say that other variables -- which are certainly relevant in location decisions -- are held constant so that analysis can focus on the strategic interplay of competing tax policies.

20. Note that unilaterally defecting states engage in discriminatory intrastate taxation, offering the foreign firm a lower tax rate to induce relocation, $9, than it offers the resident firm, $10. Thus, net tax revenue, given unilateral defection, is $9 + $10 = $19.

21. Rogers, *supra* note 18, employs continuous strategy spaces. The problem is that given the basic story motivating the 2 × 2 prisoners' dilemma, one would expect the payoffs in the case of mutual defection (i.e., mutual competition) to be (9,9) not (0,0), although mutual defection is still an equilibrium outcome here. Modeling the strategy space as continuous in effect permits the competitive dynamic to drive expected revenues down to zero. To avoid the technical complication, the ultimate outcome is reproduced in Table 1 as the payoff given mutual defection.

but it is easy enough to motivate without the technical complication. In seeking to locate new business sites, states are involved in a competitive political dynamic with other states. Legislators want to induce firms to locate in their state because they believe new firms will expand the state's tax base.[22] They believe that, even if they must provide some costly financial inducements for a firm to locate in the state, *net* tax revenues will still increase. The problem with this belief is that legislators in other states are thinking the same thing and in order to induce a firm to choose one particular state, that state needs to equal or surpass the level of abatement that other states are offering. The outcome is that the locating firm will choose the state that offers it the best deal, and the best deal will be the one in which the benefits to the state generated by the locating firm just equal the

22. The literature holds that generating net tax revenue is the primary factor in decisions to offer tax benefits: "Both state and local governments have tried to compete in attracting business investment and households which yield tax revenues greater than or not less than the costs of government services demanded and used by them." OLIVER OLDMAN & FERDINAND P. SCHOETTLE, STATE AND LOCAL TAXES AND FINANCE 100 (1974) (hereinafter, Oldman and Schoettle). To be sure, legislators may seek to maximize goals other than tax revenues. They might seek to advance their state's general economic well-being, for example. Positing other legislative goals does not alter the basic analysis. Still, it appears the assumption of revenue-maximizing legislators is most reasonable. Unlike general economic well-being, legislators can direct revenues into government programs for which they may then take political credit. New firms that pay taxes hold out the prospect to legislators that they can spend more money without increasing the taxes their existing constituents pay. And, in fact, politicians assert that they are seeking to increase tax revenues by providing location incentives to firms. *See*, JONES AND BACHELOR, *supra* note 4, at 134 and BURNIER, *supra* note 4. *But cf.*, Holmes comment:

> The reason states compete for capital in my model is to enlarge their own tax base, that is, to increase the number of agents over which the fixed cost of the public good is spread. Another reason states might compete for capital is to acquire businesses that might provide some kind of externality to the state that is not internalized by the market prices for the factor. Suppose, for example, that high-tech industries or sport teams are thought to provide some sort of external benefit to a state. Then state governments might offer tax breaks or even subsidies to these industries but not to other industries like dry cleaning.

Holmes, *supra* note 3, at 27. I argue in Rogers, *supra* note 18, however, that anything a state or firm can measure can be traded for tax subsidy, not simply increased revenues for the state. Thus, firms might be able to demand subsidies for generating positive "externalities" if politicians actually recognize that the firms generate them.

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cost to the state in the form of tax revenues foregone or subsidies paid out.

This result is proven more rigorously elsewhere,[23] but the intuition is easy to understand. Let us say that a legislature believes that it can offer inducements to a firm that would leave some net tax benefit to the state given the firm's location decision. In that case, legislators expect to receive additional tax revenues, say, in the amount of R (revenue) dollars as a result of the firm choosing their state. They also expect that they must provide the firm financial inducements in the form of abatements and/or subsidies. Those inducements will cost the state I (inducement) dollars. So the net benefit to the state would be the amount that revenues exceed inducement costs, or R - I. In the case that legislators believe they can induce a firm to locate in their state and still derive net benefits, then they think that they can offer a package in which $R - I > 0$. But there is a problem with the legislators' belief that they can derive some net revenue advantage. Given that the firm will locate in whichever state offers it the largest inducement package, another state would have an incentive to offer a package slightly larger than that of the first state. It is in the firm's interest to accept the new offer, at which point other competing states must offer even better packages to the firm. Note that every time a state offers a better inducements package to the firm that the net revenues realized under the new package are lower than before. The conclusion to this competitive process is that the last inducement package offered by any state -- that is, the package that no other state can beat -- is the package in which the cost of the inducement package just equals the tax revenues the new firm is expected to generate. Furthermore, limiting tax benefits to firms offering high-wage jobs or engaged in high-tech industry will not alter the story or the outcome. Any firm that can potentially contribute more to a state's tax base is in a position to ask for and receive greater tax breaks from that state. That a firm offers a region high-wage jobs or high-tech industry does not alter the competitive dynamic of the basic game, all it means is that low-tech, low-wage firms will receive modest tax breaks and high-

23. Rogers, *supra* note 18.

tech, high-wage firms will receive large tax breaks. The net revenue effect implied by the basic model is still the same -- in equilibrium, a state will receive no net revenue benefit.[24]

Not offering any tax abatement on the part of the states is not an equilibrium outcome. This is somewhat difficult to motivate given the static 2 $\times$ 2 game portrayed in Table 1, given that the equilibrium strategies are only weakly dominant. But since states are indifferent in equilibrium between offering the tax abatement and not offering it, no state has an incentive to defect from offering the tax abatement, which satisfies the conditions necessary for Nash equilibrium.[25] More realistically, any time even a small benefit could be obtained by one state, another state has the incentive to offer a firm a "better" deal, with that state reaping an even smaller (non-zero) net tax benefit. Thus, the only equilibrium outcome is that in which states reap no net tax benefit, but nonetheless offer abatement programs in competition with other states. This is captured in Table 1, to some extent, in that all strategy combinations are equilibrium combinations *except* the strategy combination where both states are mutually collusive -- the outcome that maximizes joint tax revenues. This is the Tantulus-like irony of state tax competition in which states never realize the tax gains they hope for in offering the tax breaks.

It should be noted, however, that the prisoners' dilemma-like[26] incentive structure that states face in Table 1 situations is not sensitive to states realizing no net revenue in equilibrium. Even permitting that states realize some net tax revenue in the face of competitive pressures, it still establishes the obvious result that tax revenues across the states are lower with competition than they would be if states could enforce a collusive outcome. This is shown in Table 2, where the outcome of the competitive process is that states realize $1 of net tax revenue (a $10 tax and a rebate of $9 to the firms). This

24. This is proven more formally in Rogers, *supra* note 18.

25. FUDENBERG, *supra* note 17.

26. Recall that the game reported in Table 1 is not identical to the prisoners' dilemma because the equilibrium strategies to engage in tax competition only weakly dominates the strategy to collude. The standard prisoners' dilemma realizes an equilibrium in (strictly) dominant strategies.

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establishes an equilibrium outcome supported by dominant strategies, which is the traditional prisoners' dilemma incentive structure.

Table 2: Dominant Tax Competition

		State 2's Strategies	
		Collude	Compete
State 1's Strategies	Collude	10 10	19 0
	Compete	0 19	1 1

While it is true that state governments realize lower net tax revenues as a result of tax competition for business sites, this does not imply any unambiguous welfare conclusion that Congress ought to act to restrict states from competing and thus permit them to reach the collusive revenue outcome. After all, the money does not disappear if state governments do not collect it in the form of tax revenues; rather, it stays in private hands, potentially resulting in increased investment and higher incomes. Melvin Burstein and Arthur Rolnick are analytically careless to conclude that simply because state tax revenues are lower in the case of state tax competition relative to tax revenues realized in the collusive case that, therefore, states "have fewer resources to spend on public goods and the country as a whole has *too few* public goods."[27] Whether their welfare conclusion is correct rests upon more variables than simply lower tax receipts. Other commentators argue that limits to the ability of state governments to increase taxes may be beneficial as an effective limit on the growth of state government.[28]

27. Burnstein & Rolnick, *supra* note 2, at 7 (emphasis added).

28. *See, e.g.*, McLure, *supra* note 4.

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B. *Efficiency Losses Due to State Tax Competition for Business*

Thus far we have seen that state fiscal variation generally promotes economic efficiency and, even though no welfare implications can be assigned to the outcome, tax competition for businesses reduces state tax revenues relative to a non-competitive or collusive outcome. Critics also charge that by distorting market incentives for firms to engage in low cost production, state tax competition generates efficiency losses. According to the argument, this distortion occurs because incentive programs cause firms to ignore comparative state advantages. Thus, these programs induce firms to locate in regions with high resource costs, which means that production is not socially efficient. In Holmes' vivid image, "this type of state competition for businesses could result in anomalous situations like a banana plantation in Alaska."[29] If this argument were correct, then although the outcome would be individually rational for the profit-maximizing firm and the revenue-seeking state government, it would represent a net welfare loss to the entire economy; the nation would be poorer as a whole.

In making this conclusion, however, critics of tax competition ignore the important fact that they are not merely characterizing a

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29. Holmes, *supra* note 3, at 4. Burstein and Rolnick make the same argument: "[T]he overall economy becomes less efficient because output will be lost as businesses are enticed to move from their optimal locations." *Id.* at 7. Taylor's economic arguments in his Note, *supra* note 2, at 681-685, are something of a muddle, although he appears to suggest this general point. *Cf.*, DICK NETZER, STATE-LOCAL FINANCE AND INTERGOVERNMENTAL FISCAL RELATIONS (1969):

> On the assumption that factors of production have considerable geographic mobility and that markets are, in general, reasonably competitive, there is some likelihood that locational decisions will entail departures from allocative optimality. That is, businesses, and perhaps individuals, will locate in places which do not involve maximum efficiency in the use of resources, rather than in the places with lowest overall costs, ignoring state-local taxes.

Id. at 39. Posner advances the same claim: "[A] tax that discriminates in favor of out-of-state firms will cause the same distortion of comparative geographical advantages as a tax that discriminates against them." RICHARD POSNER, THE ECONOMIC ANALYSIS OF LAW 602 (3d ed. 1986).

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static economic outcome, but the economic outcome of a strategic political process. Precisely because abatement policies are the product of a strategic environment, the types of inefficient location choices that analysts warn against quite simply *never* represent equilibrium outcomes of the competitive political environment between states to attract capital. The "banana plantation in Alaska" argument would be correct only if Alaska did not face any potential or actual competitors in its offer of tax inducements for firms to locate there. Given tax competition, however, state tax policies will not overcome comparative state cost advantages in equilibrium nor induce firms to locate in states with high relative production costs: Any tax inducement that Alaska could offer a banana plantation, a state in a more temperate climate could mimic, thus offering the banana company a package in which it would pay the same amount in net taxes *and* realize increased profit due to lower production costs in the more temperate state. A banana plantation in Alaska, notwithstanding widespread assertions to the contrary, would never be an outcome resulting in equilibrium from state tax competition.

This is proven more formally elsewhere,[30] but the argument can be intuitively illustrated. Table 3 (see page 116) describes the non-competitive outcome between Alaska and Hawaii, in which resource costs to the firm per unit of output is $10 and $8, respectively; tax per unit of output is equal across the two states at $4; and, hence, cost per unit of output equals $14 in Alaska and $12 in Hawaii. Because profit-maximization always implies cost minimization,[31] it can be concluded that, given this cost and tax scenario, the firm will choose to locate in Hawaii. In this case, Hawaii will realize tax revenues in the amount of $4u, where u is the number of units of output the firm produces. Alaska, of course, realizes $0 of tax revenue because the firm does not locate there.

The scenario described in Table 4 (see page 116) is that which critics of state tax competition point to in arguing that tax incentives induce inefficient location decisions. Recall that Alaska realized no tax revenue in the collusive outcome from the banana company's decision

30. Rogers, *supra* note 18.

31. HAL R. VARIAN, MICROECONOMIC ANALYSIS, 74 , 336 (2d ed. 1984).

Table 3: Location, Production and Tax Revenue without Competition

	Resource Cost per Unit of Output	Tax Per Unit of Output	Tax Subsidy	Net Per Unit Tax Revenue	Net Per Unit Cost to Firm	Number of Units Produced	Total Tax Revenue Realized by State
	(1)	(2)	(3)	(2) - (3)	(1) + (2) - (3)		
Alaska	$10	$4	$0	$4	$14	0	$0
Hawaii	$8	$4	$0	$4	$12	u	$4u

Table 4: Location, Production and Tax Revenue With Out of Equilibrium Competition

	Resource Cost per Unit of Output	Tax Per Unit of Output	Tax Subsidy	Net Per Unit Tax Revenue	Net Per Unit Cost to Firm	Number of Units Produced	Total Tax Revenue Realized by State
	(1)	(2)	(3)	(2) - (3)	(1) + (2) - (3)		
Alaska	$10	$4	$3	$1	$11	v	$v
Hawaii	$8	$4	$0	$4	$12	0	$0

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to locate in Hawaii. So in order to induce the firm away from Hawaii and into its own tax jurisdiction, the Alaska state government offers the firm a subsidy of $3 per unit produced. This reduces the firm's net per unit cost of production to $9 in Alaska, which is lower than the $10 cost the firm pays if it locates in Hawaii. Therefore, the profit-maximizing firm will locate in Alaska. Note that Alaska's production subsidy maximizes the state's net tax revenue: When it did not engage in tax competition, net tax revenue was $0. Offering the subsidy induces the firm to locate in the state and generates $1v of tax revenue that it would not otherwise have realized. Thus, while rational for the state and for the firm to engage in this behavior, the fact that the resource cost of producing in Alaska rather than Hawaii is $10 rather than $8 means that there is economic waste in the economy in having production take place in Alaska rather than in Hawaii. Alaska's subsidy distorts the price signal of the market that it takes fewer resources to produce the same number of bananas in Hawaii relative to Alaska, or, in the alternative, that given the same quantity of resources, more bananas could be grown in Hawaii than could be grown in Alaska.

It is precisely this inefficiency that critics of tax competition point to in arguing that state tax competition generates inefficient outcomes and that congressional intervention is necessary to discipline state governments in order to prevent this suboptimal, competitively induced outcome. This conclusion, however, is fundamentally flawed because the outcome reported in Table 4 is *not* an equilibrium outcome of tax competition between states. It should be obvious that given Alaska's offer and the response of a profit-maximizing firm to that offer, Hawaii, of course, would realize $0 tax revenue from the firm's location choice. But Hawaii can respond to Alaska's subsidy offer. In fact, it would be irrational for a revenue-maximizing Hawaiian state government not to respond. Given tax competition, low production-cost states seeking to maximize tax revenues will always be able to offer a cost and tax combination lower than any cost and tax combination a high production-cost state would be willing to offer.

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This is illustrated in Table 5 (see page 119). In response to Alaska's offer to subsidize production to the tune of $3 per unit produced, Hawaii responds with an offer to subsidize production in the amount of $2.50 per unit. Note that Hawaii's subsidy offer is still lower than Alaska's offer, but the firm will nonetheless locate in Hawaii because it faces lower per unit costs -- the sum of taxes and resource costs -- than it would face in Alaska. Thus, the firm would maximize profits by locating in Hawaii. Furthermore, Alaska would be unwilling to increase its subsidy offer to the point that the firm would once again be willing to locate in Alaska instead of Hawaii. In order to induce the firm to move to Alaska in response to Hawaii's most recent subsidy offer, Alaska would need to offer subsidies greater than $4.50 per unit. But that would mean that the state would be losing tax revenue on each unit produced by the firm in the state. Because the competitive behavior was created by the rational behavior of a revenue-maximizing state government,[32] Alaska would be unwilling or unable to outbid Hawaii. The conclusion is clear: tax competition does not result in equilibrium production inefficiencies, and it is precisely tax competition that guarantees that inefficiency is not an equilibrium outcome of the process.[33]

Critics of state tax competition have yet to make the case that the competition results in palpable economic damage. To be sure, state tax revenues are lower with competition between states than they

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32. *See* Rogers, *supra* note 18.

33. Holmes also asserts another reason that tax competition may induce economic inefficiency: "[t]o the extent that agents in the economy are similar in the way that their income-producing activities respond to tax rates, the deadweight loss of collecting a given amount of total tax is minimized by spreading the burden evenly." Holmes, *supra* note 3, at 4. Nonetheless, the amount of this deadweight loss is indeterminate, which he recognizes:

> [A]gents are identical in most respects, and the social pie is maximized by having all agents in the economy pay the same tax rate. This puts a uniform taxation rule on a good footing from the start. However, in a world with heterogeneous agents, a government may find some advantages to having different agents pay different taxes, apart from any effect this policy might have on competition across states for capital. In other words, a uniform taxation requirement may impede a government attempting to set up some optimal tax structure.

Id. at 26-27.

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Table 5: Location, Production and Tax Revenue with Competition

	Resource Cost per Unit of Output	Tax Per Unit of Output	Tax Subsidy	Net Per Unit Tax Revenue	Net Per Unit Cost to Firm	Number of Units Produced	Total Tax Revenue Realized by State
	(1)	(2)	(3)	(2) - (3)	(1) + (2) - (3)		
Alaska	$10	$4	$3	$1	$11	0	$0
Hawaii	$8	$4	$2.50	$1.50	$9.50	w	$2.50w

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would be given collusive behavior. But the case has yet to be made that lower state tax revenues as a result of this competition are necessarily bad. It is plausible that lower taxes stimulate the economy as much or more so than increased state expenditures paid for by those tax revenues. It is also plausible that consumers and resource owners could use the tax money they save more efficiently than the state government.

Furthermore, the most significant assertion of efficiency loss -- that competitively induced state tax regimes create incentives for firms to misallocate their resources to inefficient production -- turns out to be chimerical, a consequence of analysts ignoring the full import of rational behavior between states in a politically competitive environment. The inefficient outcome does not represent equilibrium political behavior on the part of state governments. Finally, recall that, as a general rule, state fiscal heterogeneity -- the sort of heterogeneity that results from a federal system in which different states can select differing levels of taxes and services -- is efficiency-maximizing. Federally mandated policies promoting fiscal uniformity among states risks dampening this state-level fiscal heterogeneity and thus risks introducing unique inefficiencies.

II. THE ORIGINAL UNDERSTANDING OF CONCURRENT STATE AND FEDERAL TAXING AUTHORITY

Contrary to a judicial tradition asserting extensive authority on the part of the national government to preempt state government taxation at variance with national policies, early constitutional commentators asserted an equally strong constitutional presumption that the national government could not constitutionally preempt most state tax policies, even if those state tax policies conflicted with national goals or policies. In a lengthy, explicit, and emphatic passage, Alexander Hamilton outlined the argument that the new Constitution did not grant Congress the authority to regulate state tax policies (with the exception of taxes on trade) even if those policies contravened national policies. His argument deserves to be quoted at some length:

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Although I am of opinion that there would be no real danger of the consequences which seem to be apprehended to the State governments from a power in the Union to control them in the levies of money, because I am persuaded that the sense of the people, the extreme hazard of provoking the resentments of the State governments, and a conviction of the utility and necessity of local administrations for local purposes, would be a complete barrier against the oppressive use of such a power; yet I am willing here to allow, in its full extent, the justness of the reasoning which requires that the individual States should possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants. And making this concession, I affirm that (with the sole exception of duties on imports and exports) they would, under the plan of the convention, retain that authority in the most absolute and unqualified sense; and that **an attempt on the part of the national government to abridge them in the exercise of it would be a violent assumption of power, unwarranted by any article or clause of its Constitution**.

. . . .

I mean the power of imposing taxes on all articles other than exports and imports. This, I contend, is manifestly a concurrent and coequal authority in the United States and in the individual States. There is plainly no expression in the granting clause which makes that power *exclusive* in the Union. . . . [I]t implies a further admission that as to all other taxes, the authority of the States remains undiminished. . . . The restriction in question amounts to what lawyers call a Negative Pregnant -- that is, a *negation* of the one thing, and an *affirmance* of another; a negation of the authority of the States to impose taxes on imports and exports, and an affirmance of their authority to impose them on all other articles. It would be mere sophistry to argue that it was meant to exclude them *absolutely* from the imposition of

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> taxes of the former kind, and to leave them at liberty to lay others *subject to the control* of the national legislature. . . .
>
> As to a supposition of repugnancy between the power of taxation in the States and in the Union, it cannot be supported in that sense which would be requisite to work an exclusion of the States. It is, indeed, possible that a tax might be laid on a particular article by a State which might render it *inexpedient* that a further tax should be laid on the same article by the Union; but it would not imply a constitutional inability to impose a further tax. The quantity of the imposition, the expediency or inexpediency of an increase on either side, would be mutually questions of prudence; but there would be involved no direct contradiction of power. The particular policy of the national and of the State systems of finance might now and then not exactly coincide, and might require reciprocal forbearances. It is not, however, a mere possibility of inconvenience in the exercise of powers, but an immediate constitutional repugnancy that can by implication alienate and extinguish a pre-existing right of sovereignty.[34]

There are several points worthy of note. First, Hamilton asserts a strong policy justification for his argument: the principle of local administration for local purposes is so compelling that there may be no real need for constitutional protection of state taxing authority. Nonetheless, he insists that state tax policy, but for one exception, remains beyond the scope of congressional authority. He asserts a textual argument for locating this policy in the Constitution's provisions: that the text of the Constitution specially addresses state taxes over imports and exports implies that all other subjects of state tax policies are not liable to congressional regulation or oversight. Hamilton explicitly considers the possibility in which the national and state governments attempt to tax the same articles, and the case in

34. THE FEDERALIST No. 32, at 197-201 (Alexander Hamilton) (Clinton Rossiter ed., 1961) (emphasis in bold added, emphasis in italics in original).

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which "national and State systems of finance" do not coincide in the "particular policy" each seeks to advance.[35] As to the latter point, Hamilton suggests that if the goals of congressional and state taxing policies are at odds, the Constitution, nonetheless, does not grant Congress the right to assert the supremacy of its policy goal over state policy.

Hamilton's argument does not deny the import or effect of the Supremacy Clause;[36] rather, his argument is that the text of the Constitution does not grant Congress the authority to regulate state tax policies (except with regard to exports and imports). Therefore, he concludes that any attempt of the Congress to do so would not be a law made pursuant to the Constitution and, hence, would not take supremacy relative to conflicting state tax policies.

In Hamilton's constitutional scheme, there is a strong presumption that states control their own tax policies free from congressional oversight or control. Even Hamilton would argue, however, that this presumption exists only in general, that is, that a state tax policy is free from congressional control insofar *as* it does not touch on another matter subject to congressional authority.[37] Consistent with Hamilton's argument is the case of a state's tax policy being preempted by a law Congress adopted under its authority to regulate commerce between the states (or as a result of other constitutionally granted powers). In such a case, the tax would lose to congressional authority under the Supremacy Clause. In order to consider whether state tax competition for business touches on constitutionally specified congressional interests -- particularly, the congressional power to regulate commerce between the states -- we need to discuss the origination of the Commerce Clause and its potential relation to state tax competition.

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35. Earlier, Hamilton distinguishes state policies "contrary" and "repugnant" to national policy from those cases in which "a concurrent jurisdiction might be productive of occasional interferences in the *policy* of any branch of administration . . . ." *Id.* at 198.

36. The Supremacy Clause provides that the Constitution and all laws made "in Pursuance thereof . . . shall be the supreme Law of the Land." U.S. CONST. art. VI., cl. 2.

37. Thus, Hamilton distinguishes between *policy* differences resulting from concurrent authority and "direct contradiction or repugnancy in point of constitutional authority." Hamilton, *supra* note 34, at 198.

A. Initial Purposes of the Commerce Clause

The constitutional presumption, according to Hamilton, was that most state taxing decisions were not subject to a congressional override. Nonetheless, under the Articles of Confederation, states had been imposing taxes on exports to and imports from their fellow states, resulting in threatened trade wars and worse. These tax policies formed the basis for a vicious economic rivalry among the states. If the Constitution, as originally conceived, granted the national government authority to regulate tax competition between states for new businesses then it would most likely have come from the power to regulate commerce between the states. The arguments of this section, however, are twofold: first, that the Commerce Clause was not aimed at regulating this form of state economic rivalry, and that state tax competition did not touch on the policy concerns spurring adoption of the Commerce Clause; and second, that this form of tax competition is not an attempt by states to regulate commerce and, therefore, congressional attempts to suppress this form of behavior are not a regulation of "commerce" as originally conceived.

The argument distinguishing current state tax competition from the type the Commerce Clause was intended to regulate follows along two lines. First, this section surveys the role that state economic rivalry played in the development of the U.S. Constitution and American constitutional philosophy. It focuses on the form state economic rivalry took under the Articles of Confederation and the particular threat that this competitive dynamic constituted to the fragile union of the time. The policy goals of the Commerce Clause are discussed in this context and distinguished from the policy interests at stake in the current state tax competition for business. Second, the original distinctions between commerce and other forms of productive activity -- manufacturing and agriculture, most notably -- are examined, with the implication that state-funded subsidies for business location decisions are not attempts to regulate commerce between the states. Thus, Tiebout's general welfare result regarding federalism -- that heterogeneity among state fiscal regimes is efficiency-maximizing -- suggests that Congress should not risk imposing a uniform tax

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system across states and that it should refrain from asserting regulatory authority over state tax policies.

B. The Genesis of the New Constitution in Commerce Regulation

From its beginning, the weak national union organized by the Articles of Confederation threatened to dissolve into three or four separate, even hostile, geographical powers. Critical to the need for a new national authority and the development of the new Constitution was the recognition that economic rivalry between the states was a significant, if not primary, threat to union. Only a few years after the establishment of the American Confederation, commentators and statesmen alike lamented the critical oversight in the Articles regarding congressional power over commerce.[38] The lack of congressional authority meant that each state was free to set taxes on goods coming from and going in to other states. While modern Americans think of imports and exports only in the context of international trade, early American state politicians thought of trade with other American states in much the same way. Just as international trade today is a source of contention between trading partners, interstate trade under the Articles of Confederation was a similar source of contention between the states of the new union.

On this point there is a strong consensus of early commentators. For example, in 1824, Justice Johnson observed that from the power

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38. *E.g.*, speaking of the old Congress under the Articles of Confederation, as early as 1782, Alexander Hamilton warned of the consequences of the oversight: "The vesting Congress with the power of regulating trade ought to have been a principal object of the confederation for a variety of reasons. It is as necessary for the purposes of commerce as of revenue." Alexander Hamilton, *Continentalist, No. 5*, 3 PAPERS (1782), 75-82, *excerpted in* PHILLIP B. KURLAND & RALPH LERNER, THE FOUNDERS' CONSTITUTION at 477 (1987). In 1785, James Madison drafted a set of resolutions regarding foreign trade for the Virginia House of Delegates. The second proposed resolution held: "[Resolved], that the unrestrained exercise of the powers possessed by each State over its own commerce may be productive of discord among the parties to the Union; and that Congress ought to be vested with authority to regulate the same in certain cases." James Madison, *Draft of Resolutions on Foreign Trade, Virginia House of Delegates*, 12 Nov. 1785, *excerpted in* PHILLIP KURLAND & RALPH LERNER, THE FOUNDERS' CONSTITUTION at 482 (1987).

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of each state to regulate its commerce with the other American states "grew up a conflict of commercial regulations, destructive to the harmony of the States, and fatal to their commercial interests abroad."[39] Referring to the 1787 Constitutional Convention, Johnson concluded: "This was the immediate cause, that led to the forming of a convention."[40] Several years later, Chief Justice Marshall summarized the trend of commercial policies between the states under the Articles of Confederation and the subsequent sentiment that significant constitutional reforms were necessary:

> The oppressed and degraded state of commerce previous to the adoption of the constitution can scarcely be forgotten. It was regulated by foreign nations with a single view to their own interests; and our disunited efforts to counteract their restrictions were rendered impotent by want of combination. Congress, indeed, possessed the power of making treaties; but the inability of the federal government to enforce them had become so apparent as to render that power in a great degree useless. . . . *It may be doubted whether any of the evils proceeding from the feebleness of the federal government contributed more to that great revolution which introduced the present system, than the deep and general conviction that commerce ought to be regulated by Congress.*[41]

Nonetheless, while aimed at controlling economic rivalry, the Commerce Clause did not aim to nationalize state political authority. Rather, the Clause aimed to control a particularly virulent form of state economic rivalry, a form that is not at issue in the current state tax competition for business.

The new Constitution's defenders advanced at least three separate arguments in proposing that the national legislature exercise authority over interstate commerce: such authority was critical for raising

39. Gibbons v. Ogden, 22 U.S. (9 Wheat.) 224 (1824) (Johnson, J., concurring).
40. *Id.*
41. Brown v. Maryland, 25 U.S. (12 Wheat.) 419, 445-46 (1827) (emphasis added).

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national tax revenues, was necessary to effect national authority over international trade, and was necessary to end economically and politically debilitating attempts on the part of states to export their tax burdens. Each is addressed below.

Hamilton discussed the "tendency" of union "to promote the interests of revenue."[42] In it, Hamilton argued that commerce was the most suitable object for raising tax revenues and that duties on foreign imports would be the major source of revenue for the American national government for the foreseeable future.[43] The reason commerce would bear the brunt of the national government's tax burden was twofold. First, the amount of money in circulation is critical to an effective tax policy, and the instrument of commerce is money.[44] By referring to the circulation of money, Hamilton did not mean wealth or goods and services in general; the production of goods and services is different from Hamilton's definition of "commerce." Instead, Hamilton explained that an effective taxing power is assisted by a well developed cash economy. A nation's ability to raise tax revenue is enhanced as its commercial, money-based activity becomes increasingly developed and sophisticated; thus, as a critical incident to its taxing authority, the national government also needed authority to control and promote interstate commerce. Second, Hamilton considered alternative sources of taxation and found them all unsuitable as objects of taxation. He observed:

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42. THE FEDERALIST No. 12, at 91 (Alexander Hamilton) (Clinton Rossiter ed., 1961)

43. "In America it is evident that we must a long time depend for the means of revenue chiefly on such duties [on imported articles]." *Id.* at 93.

44. Hamilton wrote:

> The ability of a country to pay taxes must always be proportioned in a great degree to the quantity of money in circulation and to the celerity with which it circulates. Commerce, contributing to both these objects, must of necessity render the payment of taxes easier and facilitate the requisite supplies to the treasury.

Id. at 92.

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> In most parts of [America] excises must be confined within a narrow compass. The genius of the people will ill brook the inquisitive and peremptory spirit of excise laws. The pockets of the farmers, on the other hand, will reluctantly yield but scanty supplies in the unwelcome shape of impositions on their houses and lands; and personal property is too precarious and invisible a fund to be laid hold of in any other way than by the imperceptible agency of taxes on consumption.[45]

Because commercial intercourse must bear the brunt of the nation's taxing authority, Hamilton argued that a centralized power was critical to the future of the separate states and of the national government. Without a centralized commerce power, states or "partial confederacies" of states would be in competition with each other regarding commercial taxation. Importers could play each state against the others, or use the long, undefended borders of adjoining states to smuggle goods into high-tax states.[46] Furthermore, unified commercial regulation would lower the transaction and information costs to importers, thereby promoting commerce and higher tax revenues.[47] Hamilton thus concluded that a national authority over

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45. *Id.* at 93.

46. *Id.* at 93-94. Hamilton explained:

> The relative situation of these states; the number of rivers with which they are intersected and of bays that wash their shores; the facility of communication in every direction; the affinity of language and manners; the familiar habits of intercourse – all these are circumstances that would conspire to render an illicit trade between them a matter of little difficulty and would insure frequent evasions of the commercial regulations of each other.

Id.

47. Hamilton, *supra* note 42, at 93. Hamilton argued.

> [T]hat state of things which will best enable us to improve and extend so valuable a resource [as commerce] must be the best adapted to our political welfare. . . . As far as this would be conducive to the interests of commerce, so far it must tend to the extension of the revenue to be drawn from that source. As far as it would contribute to rendering regulations for

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commerce would draw revenue from trade far in excess of what states could draw separately or as members of partial confederacies.[48]

Duties on foreign imports, however, did not exhaust Hamilton's argument for the need of national authority over interstate commerce. In addition to the revenue to be raised from taxes on foreign trade, Hamilton argued in *Federalist 11* that authority over commerce must be removed from states and centralized in Congress to negotiate the best terms for trade with other nations.[49] States such as Virginia, Madison observed, had failed in attempts to use unilateral action to force Britain to end its monopoly of trade with the West Indies.[50] Madison argued that it failed and that other attempts would also fail

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> the collection of the duties more simple and efficacious, so far it must serve to answer the purposes of making the same rate of duties more productive and of putting it into the power of the government to increase the rate without prejudice to trade.

Id.

48. *Id.* at 95. ("It is therefore evident that one national government would be able at much less expense to extend the duties on imports beyond comparison, further than would be practicable to the States separately, or to any partial confederacies.")

49. *Id.* at 86. Hamilton noted:

> By prohibitory regulations, extending at the same time throughout the States, we may oblige foreign countries to bid against each other for the privileges of our markets. . . . Would it not enable us to negotiate, with the fairest prospect of success for commercial privileges of the most valuable and extensive kind in the dominions of [Great Britain]?

Id.

50. JAMES MADISON, RECORDS OF THE FEDERAL CONVENTION (1787), in PHILLIP KURLAND & RALPH LERNER, THE FOUNDERS' CONSTITUTION 483 (1987). Madison also explained:

> Besides the vain attempts to supply their respective treasuries by imposts, which turned their commerce into the neighboring [sic] ports, and to coerce a relaxation of the British monopoly of the [West Indies] navigation, which was attempted by [Virginia] the States having ports for foreign commerce, taxed & irritated the adjoining States trading [through] them, as [New York, Pennsylvania, Virginia and South Carolina].

Id.

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because Britain did not anticipate coordinated retribution among the American states nor fear that American markets would be closed to it nationwide.[51] St. George Tucker made much the same point when he commented:

> The conduct of Great Britain in declining any commercial treaty with America, at that time, was unquestionably dictated at first by a knowledge of the inability of congress to extort terms of reciprocity from her; and of that want of unanimity among the states, which, under the existing confederation, was a perpetual bar to any restriction upon her commerce with the whole of the states; and any partial restriction would be sure to fail of effect.[52]

Only a united nation could wield sufficient economic power to extort better trading arrangements from the foreign nations that were its rival trading partners.

America's founding generation understood the benefits of specialization and trade. Consequently, they supported nationalization of the commerce power, not only granting Congress the right to regulate commerce, but also forbidding states from taxing imports that were in transit to other states or nations. Hence, the Commerce Clause aimed to end attempts by states to export their tax burdens to the residents of other states.[53] St. George Tucker described the

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51. *Id.* Madison explained:

> The want of [authority] in [Congress] to regulate Commerce had produced in Foreign nations particularly [Great Britain] a monopolizing policy injurious to the trade of the U.S. and destructive to their navigation; the imbecility and anticipated dissolution of the Confederacy [extinguishing] all apprehensions of a Countervailing policy on the part of [the United States].

Id.

52. ST. GEORGE TUCKER, 1 BLACKSTONE'S COMMENTARIES *app.* 248-54 (1803), *in* PHILLIP KURLAND & RALPH LERNER, THE FOUNDERS' CONSTITUTION 488 (1987).

53. *See* U.S. CONST. art. I, § 9, cl. 5, and art. I, § 10, cl. 2. Hamilton observed:

> An unrestrained intercourse between the States themselves will advance the trade of each by an interchange of their respective productions, not only for

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classic form of tax exportation then occurring between states by explaining the perceived need for congressional authority over interstate commerce:

> Thus a duty on salt imported into Virginia, or on tobacco exported from thence, might operate very extensively as a tax upon the citizens of the western parts of North Carolina and Tennessee, to the exclusive emolument of the state of Virginia. So unreasonable an advantage ought not to prevail among members of the same confederacy, and without a power to control it lodged somewhere, it would be impossible that it should not be exerted.[54]

> the supply of reciprocal wants at home, but for exportation to foreign markets. The veins of commerce in every part will be replenished and will acquire additional motion and vigor from a free circulation of the commodities of every part. Commercial enterprise will have much greater scope from the diversity in the productions of different States.

THE FEDERALIST No. 11, at 89 (Alexander Hamilton) (Clinton Rossiter ed., 1961). Explaining the concept of tax exportation, Oldman and Schoettle wrote: "The concept of tax exporting is simple enough. If a real property tax is thought to be borne by the owner of the property who lives in another jurisdiction . . . then the jurisdiction imposing the tax and receiving the revenue has exported its tax bill for the property." OLDMAN, *supra* note 22, at 100.

54. TUCKER, *supra* note 52. Tucker asserted that tax exportation was not simply a matter of economic fairness, but it imperiled the fragile union by inflaming existing state divisions:

> [T]he repetition of such exertions could scarcely fail to lay the foundation of irreconcilable jealousies, and animosities among the states. And it was evidently with a view to prevent these inconveniences, that the constitution provides that no state shall, without the consent of congress, lay any imposts, or duties on exports or imports, except what may be absolutely necessary for executing it's [sic] inspection laws.

Id. Hamilton developed a similar argument that commercial jealously would serve ultimately as a cause for open conflict between the states unless they united under the new Constitution. Hamilton asked rhetorically, "Has commerce hitherto done any thing more than change the objects of war?" THE FEDERALIST No. 6, at 57 (Alexander Hamilton) (Clinton Rossiter ed., 1961). Hamilton concluded that a "unity of commercial, as well as political, interests can only result from a unity of government." Hamilton, *supra* note 53, at 90.

In a similar vein, Madison wrote to Joseph C. Cabell that the actual aim of the Commerce Clause was to prevent states from exporting their tax burdens to other states and was not intended to work an additional grant of authority to the Congress:

> [The Commerce Clause] grew out of the abuse of the power by the importing States in taxing the non-importing, and was intended as a negative and preventive provision against injustice among the States themselves, rather than as a power to be used for the positive purposes of the General Government, in which alone, however, the remedial power could be lodged.[55]

The tax on "imports" that Tucker and Madison wrote of was not a tax on goods whose ending point was intended to be the taxing state. Rather, they were "imports" in the form of goods that would come into a state while simply passing through on the way to another state. For example, if Virginia were to tax goods en route from North Carolina to Maryland, then only North Carolina producers and Maryland consumers would pay the tax bill for Virginia. Even ignoring the fact that Virginia would face few incentives to tax the goods at rates any lower than the very maximum that the traffic would bear -- thus threatening to wreak havoc on other states' economies -- the Commerce Clause also served a political end in seeking to apply the American principle animating the late conflict with Great Britain, namely, the principle of "no taxation without representation." Tax exportation among the states constituted double taxation for citizens of states not fortunate to live between separated trading partners. Residents of states which bore the brunt of exported tax burdens clearly had no electoral say in choosing the policies of the taxing states.

Of these three rationales for the interstate Commerce power, the first two clearly do not apply to the current economic rivalry between

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55. Letter from James Madison to Joseph C. Cabell (Feb. 13, 1829), *in* PHILLIP B. KURLAND & RALPH LERNER, THE FOUNDERS' CONSTITUTION 521 (1987).

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states. No threat to either the national tax revenue or the national bargaining power with regard to international trading partners exists as a result of state tax competition for business sites. But one could not conclude that tax competition results in outcomes akin to state tax exportation. The citizens of one state do not bear the tax burden that funds government services provided to residents of another state. If anything, tax competition is a form of tax importation in which the residents of one state export lower prices and higher profits to citizens of other states as a result of the tax advantages provided to locating firms. Further, unlike taxes on interstate trade, tax competition does not threaten the ability of states -- and, hence, of the nation as a whole -- to realize gains of specialization and trade between states. As was illustrated previously, in political-economic equilibrium, state tax competition does not create production inefficiencies by inducing firms to locate in states with high resource costs. States enjoying comparative cost advantages can always offer attractive tax programs to locating firms. Thus, firms still locate where they would have otherwise, and trade continues unaffected between states.[56]

The one outcome that is realized, as discussed earlier, is that the competitive policy environment constrains state tax revenues relative to the non-competitive outcome. But, again, that states do not have revenue that they would otherwise have from business taxes does not have an unambiguous welfare implication. It simply means is that the money stays in private hands rather than being transferred to governmental coffers. Tax savings may be distributed to residents in other states in the form of lower prices and higher corporate earnings. However, even if the revenue benefits stay largely in the resident state -- as one might expect, say, if the benefiting firm were a sports franchise -- there is still no special fiscal burden placed on the citizens of other states. Residents of the state pay for their own government. Tax subsidies provided to the producers of goods and services do not affect the economy the same as, nor share in the inherent unfairness

56. Recall that the *telos* of a trade war is autarky -- no trade occurs between states (or nations). Thus, comparative geographical advantages are not realized and everyone is poorer. This has no analog in state tax competition for business. Specialization and trade still occur between states.

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of, attempts to tax commerce in order to export a state's tax burden to the residents of other states.[57]

The primary arguments that justified nationalizing the commerce power in the new Constitution did not revolve around a desire or perceived need for regulating the aggregate national economy, let alone any behavior indirectly affecting the national economy. Instead, all of the arguments for the Commerce Clause revolved around trade and the incidents of trade, both with foreign countries and among American states. Understanding these purposes is critical to understanding the initial goals of the Commerce Clause and the propriety of policies adopted under its authority.

C. *The Original Extent of the Commerce Power*

Readers of the Commerce Clause today are apt to suppose that it grants Congress authority over economic matters, the word "commerce" being thought synonymous with "business" or "economics." The modern use of commerce, however, is quite distinct from its use at our nation's founding. Around the time of the American founding, "commerce" was understood to be a particular economic pursuit, as separately identifiable as the pursuits of agriculture or manufacturing. Consequently, the *telos* of the Constitution's interstate commerce power initially sought only to control state-level commercial policies and did not seek to control state manufacturing or agricultural policies.[58] In itself, the use of a

57. Note also that if the prediction of the very simple game theoretic model portrayed in Table 1 is correct, then in the competitive equilibrium, "winning" states do not even indirectly deny tax revenues to states "losing" in the tax competition: Net tax revenues are zero in equilibrium. Thus, wherever the firm locates, the state realizes no net revenue gain and, for the losing state, what could not have been gained also could not have been lost. Citizens of "losing" states do not face a higher tax burden as a result of the firm locating in another state.

58. This does not mean that the U.S. Congress cannot constitutionally regulate commerce as a means to influence manufacturing or agriculture or other non-commercial ends. That the Congress can do so is judicially well established. *See, e.g.*, Gibbons v. Odgen, 22 U.S. (9 Wheat.) 1 (1824). Rather, the argument here is that the policy considerations supporting the Commerce Clause sought to exclude state-level manufacturing policies from national control. Thus, there may be a *prudential* argument for preferring

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state's fiscal policy as a component of that state's manufacturing or agricultural policy was not reckoned an attempt by that state to regulate commerce. Thus, such state-level policies would not impinge on the justification for granting Congress the right to regulate commerce between the states. There are any number of sources which serve to illustrate the common currency of the term "commerce" during the era in which the Constitution was written and initially interpreted. For example, Madison noted the omission from the Constitution of a grant to Congress of authority "'to establish public institutions, rewards, and immunities for the promotion of agriculture, commerce, and manufactures.'"[59] Similarly, Joseph Story argued that Congress may properly use "regulations of commerce" to protect and encourage domestic manufacturing, nonetheless granted that Congress did not have direct authority over manufacturing:

> The question comes to this, whether a power, exclusively for the regulation of commerce, is a power for the regulation of manufactures? The statement of such a question would seem to involve its own answer. Can a power, granted for one purpose, be transferred to another? If it can, where is the limitation in the constitution? Are not commerce and manufactures as distinct, as commerce and agriculture?[60]

At the time of the founding, "commerce" meant the movement of goods in trade, or "intercourse." Thus, Hamilton wrote in *Federalist*

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state-level policies to deal with manufacturing rivalry rather than immediately preferring a national solution.

59. Letter from James Madison to Professor Davis (1832) *in* PHILLIP B. KURLAND & RALPH LERNER, THE FOUNDERS' CONSTITUTION 523 (1987). Madison does argue, however, that this failure did *not* "exclude from the federal power over commerce regulations encouraging domestic manufactures," that is, Congress could "by the particular mode of duties or restrictions on rival imports" encourage "the particular object of manufactures." *Id.* *Cf.*, THE FEDERALIST NO. 42 (James Madison) (discussion of commercial vs. non-commercial states); Hamilton, *supra* note 42 (distinguishing agriculture from commerce); KURKLAND, *supra* note 50, at 485 (distinguishing among agriculture, commerce, and trade); and KURLAND, *supra* note 38, at 478.

60. JOSEPH STORY, 2 COMMENTARIES ON THE CONSTITUTION 1073-91 (1833), *in* PHILLIP B. KURLAND & RALPH LERNER, THE FOUNDERS' CONSTITUTION 523-24 (1987).

11 that "an unrestrained *intercourse* between the States themselves will advance the trade of each by an *interchange* of their respective productions . . . . The veins of *commerce* in every part will be replenished and will acquire additional motion and vigor from a free circulation of the commodities of every part."[61] Similarly, Chief Justice Marshall averred that "commerce is intercourse; one of its ordinary ingredients is traffic."[62] Reviewing similar material at length in his concurring opinion in *United States v. Lopez*,[63] Justice Thomas recently made the same point. He concluded that "[a]griculture and manufacturing involve the production of goods; commerce encompasses traffic in such articles."[64]

State tax policies aimed at business location decisions are not tax policies attempting to regulate "commerce" between the states as earlier American jurists understood the phrase. Trade comes *after* businesses locate and begin to produce in a particular state. We have seen that while such competition results in a general decrease in net tax revenues among states, the economic consequences of state tax competition are minimal in equilibrium. Furthermore, national economic welfare is promoted when state fiscal heterogeneity is preserved and promoted. The original understanding of the Commerce Clause gives little presumptive justification to attempts by Congress to regulate state tax policies. The Commerce power was not intended to provide Congress any direct power over the authority of states to set their own tax policies. On this point, Hamilton is clear. Indeed, Hamilton provides a lengthy argument in defense of the idea that state and national governments share a non-preemptable, concurrent power over tax policies and asserts that its rejection would represent a "violent assumption of power" on the part of the national government, "unwarranted by any article or clause" of the Constitution.[65] Even if Congress might prefer that state governments receive higher tax receipts than they do under the present competitive

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61. Hamilton, *supra* note 34, at 89 (emphasis added).
62. Brown, 25 U.S. (12 Wheat.) at 446.
63. 115 S. Ct. 1624 (1995).
64. *Id.* at 1643.
65. Hamilton, *supra* note 34, at 198.

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regime, important constitutional policy interests suggest that it not preempt state tax policies in this area. In sum, state tax competition to secure new manufacturing concerns for a state does not centrally involve the constitutional issues that motivated adoption of the Commerce Clause originally.[66]

III. STATE-LEVEL OR CONGRESSIONAL ACTION

The current literature on tax competition is replete with assertions that only Congress can end the "economic war between the states."[67] It is argued here, however, that it is premature to call for congressional intervention since critics of state tax competition have yet to demonstrate that the harm caused by tax competition outweighs the benefits. Additionally, the critical literature ignores already existing state-level tools by which states can end, and have ended, tax outcomes similar to those induced by the current competition, all without ceding control of their fiscal decisions to Washington. Fiscal variety is an important aspect of the states' role in America's federal system. The call for congressional action to exert direct authority over state tax regimes threatens what remains of the states' powers to pursue that role, a role, as we have seen, that is strongly rooted in the American political tradition as well as one that independently contributes to efficient economic outcomes.

Importantly, the current calls for national action to end state tax competition aim only to prevent states from adopting tax plans that create discriminatory intrastate tax regimes;[68] the plans would not end tax competition between states on the basis of average tax rates. Ironically, many states already have policies in place to prevent or end discriminatory intrastate taxation, which courts have long been willing

66. The Court's decision in *Lopez*, 115 S. Ct. 1624, may, however, signal the beginning of a less expansive judicial reading of congressional power under the Commerce Clause. If so, then the fact that the state tax laws under consideration do not seek to regulate interstate commerce may doom congressional attempts to control these state policies. The states themselves, of course, would still be permitted to regulate their own behavior.

67. *See supra* note 7.

68. *See infra* notes 69 and 70.

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to enforce, though not always consistently, and which legislatures have every political incentive to adopt or strengthen. Hence, state-level action can solve any problem that the national-level proposals aim at solving, and state-level action does not risk establishing an inefficiently homogeneous system of state tax regimes. Ultimately, states face only weak incentives to discriminate against resident businesses, so state-level attempts to control the effects of state tax competition may not be as futile as proponents of congressional action claim.

A. *Congressional Action*

The recent literature on state tax competition vigorously argues for congressional action to regulate state tax competition.[69] In none of these arguments, however, did the commentators attempt to think creatively about possible state-level solutions, nor did they discuss potential drawbacks to congressional action. Typically, the commentators noted some instance where two or three states "informally agreed to stop competing with each other,"[70] then dismissed state-level action from consideration given the failure of the half-hearted attempt. Furthermore, Burstein and Rolnick argue that state-level action cannot succeed because "it would be a practical impossibility to devise an arrangement that would both cover all the forms of subsidies and preferential taxes the states might devise and provide an effective method of enforcement."[71] This is no less true, however, of congressional regulation. States are perfectly capable of directly implementing -- and many states already have such provisions on their books -- the central requirement that Burstein, Rolnick, and others recommend for congressional implementation. Consequently, the same practical problem that Burstein and Rolnick observe with respect to state-level action -- the "practical impossibility" of covering all attempts to get around an agreement -- also inheres in congressional action. Congressional action would need the same sort of state cooperation as would action at the state-level.

69. *See supra* notes 2 and 3.
70. *See, e.g.*, Burstein and Rolnick, *supra* note 2, at 10.
71. *Id.* at 11.

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To be sure, given the Supreme Court's current position, Congress is not constitutionally prohibited from attempting to control state tax competition. But given the possibility of an effective state-level remedy, should Congress attempt to regulate it? Commentators urging congressional action to stem state tax competition neglect disadvantages to action at the national level, disadvantages that state-level action would not share. Recall that state tax competition, in fact, does not violate the spirit of the Constitution's Commerce Clause. States are not attempting to regulate commerce between the states, they are attempting to regulate manufacturing, that is, the production of goods and services, which, in the parlance of the Constitution's framers, preceded commerce.[72] This is not a distinction without a difference. Attention to the three causes of a national commerce power, discussed earlier, reveals that none obtains today. The primary evil that the Commerce Clause sought to remedy was the imposition of duties on the trade of other states such that the residents of one state were not paying the cost of another state's government. In the current rivalry other businesses and citizens of the same state bear the brunt of the tax and economic burden, and states are not burdening interstate commerce.

There is a unique risk to national regulation should Congress decide to attempt it. The tendency of national regulation is that, once asserted, it tends to grow and dominate an area. Because variation in state-level fiscal regimes enhances economic efficiency, national regulation risks losing this efficiency if Congress overextends its regulation and effectively standardizes significant sections of state fiscal regimes. Even assuming that additional regulation is necessary, Congress could always choose to regulate the policy area in the future should states fail to arrive at a coordinated solution to tax competition. On the other hand, if Congress regulates without waiting for any serious state attempt to solve the problem, then states will most likely never again have a chance to tailor their own remedy. Congressional

72. "Raising echoes of the discussions of the Framers regarding the intimate relationship between commerce and manufacturing, the Court declared that '[c]ommerce succeeds to manufacture, and is not a part of it.'" *Lopez*, 115 S. Ct. at 1649 (quoting United States v. E.C. Knight Co., 156 U.S. 1, 12 (1895)).

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regulation risks future fiscal uniformity in a way that state-level action does not.

B. A Suggested State-Level Policy

All of the current proposals for congressional intervention in state fiscal design share the feature that Congress simply provides state governments with a stimulus to tax all intrastate businesses uniformly. To wit, Holmes' proposal, which is explicitly the same as Burstein and Rolnick's, suggests this requirement to decrease much of the incentive for state tax competition for business: "[W]hen a state government offers a low tax rate in order to attract capital, it must offer the same low rate to all businesses that locate within the state and not discriminate by offering the low rate to just a few."[73] So, too, Taylor's proposed statute would impose precisely the same requirement: "Prohibited incentives shall include the creation, payment, or offer of payment by any state or political subdivision of a state of relocation incentives where: (a) such relocation incentives are not equally available to private commercial enterprises already operating within the boundaries of the state or political subdivision . . . ."[74]

The irony is that there already exists at the state level robust and accepted constitutional or legal bases for uniform or equal taxation. Almost all state constitutions "embody some provisions for uniform or equal taxes,"[75] which may account for the reason that many states have yet to enact *any* tax abatement legislation in favor of relocating firms in the face of the competitive policies pursued by other states. While generally reviewed under the relatively lax "rational relationship"

73. Holmes, *supra* note 3, at 4.

74. Taylor, *supra* note 2, at 711.

75. JEROME R. HELLERSTEIN, STATE AND LOCAL TAXATION 36 (1969) (hereinafter HELLERSTEIN). *Cf.*, M. DAVID GELFAND & PETER W. SALSICH, STATE AND LOCAL TAXATION AND FINANCE 7-8 (1985) (hereinafter GELFAND AND SALSICH): "The 'uniformity' provisions are closely related to the equal protection concept and generally require that similarly situated persons or objects subject to taxation be treated in a like manner." A number of state courts have struck down discriminatory tax exemptions under their state constitutions' uniformity and equality clauses. *See* HELLERSTEIN at 51 - 52.

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standard,[76] state courts, most recently in North Carolina,[77] have proven willing to find discriminatory tax provisions unconstitutional,[78] as the U.S. Supreme Court also has.[79]

Additionally, given that national proposals do not aim to end all state tax competition but only aim to end the adoption of discriminatory intrastate taxes, states not only can easily implement such proposals themselves, but they also have natural constituencies for them. Given some political impetus -- which would not necessarily be greater than that required for legislation enacted by Congress -- state legislators and already existing businesses and other taxpayers have great incentives to support such legislation.[80] As was shown

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76. Gelfand and Salsich observe:

> In general, the courts answer uniformity questions by analyzing the classification scheme that the challenged tax utilizes. Unless a suspect class, such as race, or a fundamental interest, such as the right to vote, is involved, the courts will apply the so-called "rational basis test" of equal protection jurisprudence to determine the validity of the classification. . . . If a legitimate governmental interest can be identified, and the particular classification can be said to bear a rational relationship to that interest, the test is satisfied even though the classification may not be the "most precise possible means of accomplishing [the] legislative purpose."

GELFAND & SALSICH at 8 (brackets in original).

77. For example, there is this recently reported case:

> "A Winston-Salem [North Carolina] judge agreed with local attorney Bill Maready that North Carolina's incentives did not serve a public purpose and therefore were unconstitutional. . . . The decision has caused state officials to back off of some recruitment offers. That state's attorney general has joined in a State Supreme Court appeal of the judge's ruling."

Tax Breaks As Incentives Under Attack, OMAHA WORLD HERALD, October 1, 1995, at 1, 11.

78. *See, generally*, HELLERSTEIN, *supra* note 75, at 36-69.

79. In Allegheny Pittsburgh Coal v. Webster County, 488 U.S. 336 (1989), a unanimous Court, applying a rational relationship standard, struck down parts of West Virginia's property tax system for significant intrastate tax disparities. *Cf.*, Nordlinger v. Hahn, 505 U.S. 1 (1992).

80. Many state constitutions grant responsibility for equal taxation to their state legislatures. Hellerstein, for example, cites the Indiana Constitution as providing that "The General Assembly shall provide, by law, for a uniform and equal rate of assessment and taxation . . .", and the Michigan Constitution as providing that "[t]he legislature shall provide a uniform rule of taxation." HELLERSTEIN, *supra* note 75, at 36. In states with similar provisions, it would seem that legislatures could require state courts to review

earlier, the competitive process results in no net revenue advantage for states. Legislators, in essence, waste their time participating in the process, although, as we have seen, they have no choice but to do so absent a coordinated effort among states. So, too, already existing businesses and taxpayers in states have an incentive not to permit free-riding on their tax burden. At worst, lower prices due to lowered tax burdens are exported from such states. Thus, both resident businesses and resident taxpayers are natural constituencies for any remedial legislation that legislatures might need to pursue.[81]

Furthermore, states face relatively weak incentives to engage in tax competition with other states. The 2 × 2 game in Table 1 motivates the idea. Recall that the game portrayed there was distinct from the standard prisoners' dilemma in that competitive strategies only weakly dominated the collusive strategies. Thus, while mutual competition was an equilibrium outcome, given the discrete strategies portrayed in the game in Table 1, no state had an incentive to deviate from strategies in which one state plays the collusive strategy and the other plays the competitive strategy.[82] To be sure, this is a product of the discrete strategy space and does not exist in the associated game with continuous strategies.[83] Nonetheless, it captures enough of the picture to illustrate just how thin the incentive structure is that induces tax competition among states. Consistent with Table 1 and with the

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discriminatory tax legislation under a higher standard of review without running afoul of constitutional separation of powers doctrine.

81. Note, additionally, that if state policy makers value goals other than tax revenues – goals such as intrastate economic efficiency – then Holmes' analysis of the "deadweight loss" due to discriminatory intrastate tax burdens (*see supra* note 33) would provide state legislators internal incentives to eliminate such provisions. There is little reason to believe that national legislators are more concerned with such *intra*state efficiency losses than are state legislators.

82. Naturally the "competing" state has no incentive to defect and play a collusive strategy, but note the other state realizes no net tax revenues as against the competing state, nor does it realize net tax revenue when it deviates from its collusive strategy and engages in a competitive strategy. Being indifferent between the two outcomes, the state has no incentive to deviate and that establishes that the strategy pair is a Nash equilibrium.

83. Rogers, *supra* note 18. Although in that game there are multiple equilibria in which many or most states do not engage in tax competition for new business sites. A central result holds only that at least one state makes an offer to the firm and realizes no net tax revenue for its effort.

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associated game in continuous strategies is that a large number of states may choose to opt out of the competitive process, conceivably leaving only a few states to compete with one another. If true, this would hardly represent a policy problem of national dimensions or of critical proportion.[84]

IV. CONCLUSION

For all of the insistence that only Congress can end tax competition between states for new business firms, the policies that have been advanced in the literature do not require action at the national level. State policies have failed in the past because they were informal and, therefore, enjoyed little credibility and political commitment. Potentially interested constituencies were not motivated to secure adoption of legislation that would remedy any pernicious effects of tax competition. In the policies advanced so far, the national government provides nothing more than a stimulus to states to implement tax policies requiring that all intrastate businesses be taxed uniformly. Yet there would seem to be natural constituencies for such proposals already existing at the state level.

Furthermore, congressional action on this issue has its own risks: it would risk an unprecedented intrusion into the heart of the powers that the Constitution originally reserved to the states. The American founders were emphatic when writing of the dangers of an exertion of national control over state tax policies. Furthermore, a national policy would risk losing the variation in state fiscal policies that economists have shown actually increases economic efficiency. Finally, state tax and manufacturing policies do not in fact violate the spirit of the Commerce Clause. The policy behind the constitutional provisions are unaffected by the current tax competition between states. For the time being, a congressionally imposed end to state tax competition enjoys no unique advantages relative to a state-level solution and labors under

84. Critics of tax competition more often assert than prove that the implications of the problem are national in scope. Several scholars are quite skeptical whether state tax rivalry comes even close to representing a "second war between the states." *See, e.g.*, Hanson, *supra* note 4.

several unique disadvantages. Furthermore, Congress may always choose to regulate in the future should attempts at a state-level solution fail. Prior to any congressional regulation of state tax competition, it would be prudent for states to be afforded greater opportunity to determine the need for a remedy. Then, should it be necessary, states should be permitted to secure a remedy at the state level. For Congress to act without more evidence of a compelling need risks permanently losing a critical foundation for the political and economic advantages provided by American federalism.

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