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WORKING PAPER SERIES

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July 2011

Working Paper 2008-03
http://www.frbsf.org/publications/economics/papers/2008/wp08-03bk.pdf

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Current draft: July 15, 2011

Acknowledgements:
We would like to acknowledge the excellent research assistance provided by Charles Notzon and the comments and suggestions from participants at the American Economic Association meetings, the CESifo Area Conference On Public Sector Economics, the Econometric Society World Congress, the Federal Reserve System Conference on Regional Analysis, the *Journées d'Économie Publique Louis-André Gérard-Varet*, the National Tax Association meetings, the Western Regional Science Association meetings, and from seminar participants at the Barcelona Institute of Economics (IEB), Baylor, Bergamo, Davis, Nevada-Reno, Oxford, and Pompeu Fabra. Very useful comments have also been provided by Don Andrews, Thiess Büttner, Raj Chetty, Kelly Edmiston, Don Fullerton, Andrew Haughwout, Ross Hickey, Jim Hines, Kai Konrad, Dan McMillen, Tom Mroz, Tom Neubig, Marko Koethenbuerger, Hashem Pesaran, Giovanni Urga, and Jay Wilson. Financial support from the Federal Reserve Bank of San Francisco and the IEB is gratefully acknowledged. Chirinko and Wilson thank the European University Institute and the IEB, respectively, for providing excellent environments in which to undertake this research. All errors and omissions remain the sole responsibility of the authors, and the conclusions do not necessarily reflect the views of the organizations with which they are associated.

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Abstract

Dramatic declines in capital tax rates among U.S. states and European countries have been linked by many commentators to tax competition and an inevitable "race to the bottom." This paper provides an empirical analysis of the reaction of capital tax policy in a given U.S. state to changes in capital tax policy by other states. The analysis is undertaken with a novel panel dataset covering the 48 contiguous U.S. states for the period 1965 to 2006 and is guided by the theory of strategic tax competition. The latter suggests that capital tax policy is a function of "foreign" (out-of-state) tax policy, home state and foreign state economic and demographic conditions and, perhaps most importantly, preferences for government services. We estimate this reaction function for the two primary business tax policies employed by states: the investment tax credit rate and the corporate income tax rate. The slope of the reaction function – the equilibrium response of home state to foreign state tax policy – is *negative*, contrary to many prior empirical studies of fiscal reaction functions. This seemingly paradoxical result is due to two critical elements – controlling for aggregate shocks and allowing for delayed responses to foreign tax changes. Omitting either of these elements leads to a misspecified model and a positively sloped reaction function. Our results suggest that the secular decline in capital tax rates, at least among U.S. states, reflects synchronous responses among states to common shocks rather than competitive responses to foreign state tax policy. While striking given prior findings in the literature, these results are not surprising. The negative sign is fully consistent with qualitative and quantitative implications of the theoretical model developed in this paper. Rather than "racing to the bottom," our findings suggest that states are "riding on a seesaw."

Keywords: Tax Competition, State Taxation, Reaction Functions, Capital Taxation

JEL Codes: H71, H77, H25

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> Wisconsin is open for business. In these challenging economic times while Illinois is raising taxes, we are lowering them.
>
> Governor Scott Walker of Wisconsin (January 12, 2011)

I. Introduction

This paper provides an empirical analysis of an important element in the theory of strategic tax competition, the reaction of capital tax policy in a given jurisdiction to changes in capital tax policy by neighboring jurisdictions. The analysis is motivated in part by the dramatic decline among industrialized countries in capital tax rates over the past few decades. There has been much debate over what factors are causing this decline and, in particular, how much of it is due to competition among jurisdictions. A number of cross-country empirical studies have attempted to identify the causes, but this research is hampered by the substantial heterogeneity across countries in institutions, regulations, and business environments that weigh heavily on tax policy and impede capital flows. U.S. states provide an ideal laboratory for investigating the determination of capital tax rates and the role of tax competition because, while states have much latitude for setting their own capital tax policies that, in fact, differ greatly among states, they share many important institutional and environmental factors in common. Moreover, the general downward trend in capital taxation observed among industrialized countries in recent decades has also been observed among U.S. states.

This trend among states can be seen in Figures 1 through 4, which show the major state capital tax policies in terms of national averages of tax variables from 1969 to 2006. In 1968, no state had an investment tax credit (ITC). Since then, as shown in Figure 1, ITC adoptions have grown steadily; by 2006, 24 states have or have had an ITC, and the average rate among states with an ITC has risen considerably to over 4%. Figure 2 displays the average ITC and corporate income tax (CIT) rates over all states. The national average ITC rate has increased in a nearly monotonic fashion and reaches nearly 2.0% by the end of the period. While the average CIT rate increased from the beginning of the period until 1991, it has fallen moderately since then. The impact of these two tax variables on the incentive to acquire capital can be measured by the tax wedge on capital (TWC), which is the tax component of the user cost of capital.[1] Figure 3 documents that the average TWC has fallen in recent years. This pattern is confirmed by two additional tax series displayed in Figure 4. The capital apportionment weight (CAW) is the weight on capital in a state's formula for apportioning national corporate income to the state; similar to a lower CIT rate, a lower CAW provides an incentive to locate capital in the state. The average CAW series has fallen sharply, declining by approximately 10 percentage points. An alternative perspective on capital tax policy is provided by the average corporate tax (ACT) rate, defined as the ratio of corporate tax revenues to corporate income. As shown in Figure 4, the average ACT peaked in 1980. Since then, this procyclical series has drifted downward. Viewed from a variety of perspectives, state capital taxation has changed dramatically in recent years and has become more "business friendly." These aggregate movements, buttressed with anecdotal observations and past empirical studies, suggest to many observers that states are engaged in a "race to the bottom."

The empirical results in this paper challenge that conclusion. We find that the slope of the reaction function – the equilibrium response of home state tax policy to foreign state tax policy – is *negative*. This result – consistent with the quotation above from the Governor of Wisconsin – runs contrary to the casual empirical evidence in Figures 1 through 4, the findings in many prior empirical results, and the implications of some theoretical models. We document that this seeming paradox is due to two critical elements omitted in most prior empirical studies. First, aggregate shocks affecting all states create common incentives that lead states to act synchronously. Absent proper conditioning for aggregate shocks, a positive slope of the reaction function is obtained with our data. Second, in theory, tax competition is driven by capital mobility among states, but the flow of capital is not instantaneous, instead occurring over several years. A properly specified model needs to allow for lagged responses. In our data, static models also generate a positively sloped reaction function. When we condition on aggregate shocks and allow for delayed responses, we find that the tax reaction function is negatively

[1] The TWC series equals [(1-ITC-CIT*TD) / (1-CIT)] – 1.0, where TD is the present value of tax depreciation allowances and ITC and CIT reflect only state taxes. See Appendix A for details.

sloped.

While this result is striking, it is not surprising and is fully consistent with the qualitative and quantitative implications of the theoretical model developed in this paper. Our findings suggest that the dramatic declines in state capital taxation in recent decades are not driven by tax competition among states, but rather from aggregate shocks (e.g., energy prices, U.S. macroeconomic conditions, tax rates and input costs abroad) impacting all states in more or less the same manner. Rather than states "racing to the bottom" (a competitive response of tax rates in the same direction), our results suggest that state tax competition is better characterized by states "riding on a seesaw" (a competitive response in the opposite direction).

Whether states are "racing to the bottom" or "riding on a seesaw" is important in current policy debates, both in the U.S. and abroad. Many analysts and policymakers point to the secular decline in marginal and average capital tax rates (documented in Figures 1 to 4) as proof that states are engaged in a harmful race to the bottom necessitating federal legislation or judicial action. For instance, a 2006 Supreme Court case, *Cuno v. DaimlerChrysler*, centered on whether state investment tax credits are a form of harmful tax competition and could run afoul of the Commerce Clause of the U.S. Constitution.[2] The U.S. Congress has considered several bills that would alter states' capacity to set various capital tax policies independently. In recent years, states have joined together to form multi-state tax commissions that have recommended various coordination/harmonization measures aimed at preventing tax competition, though lack of enforcement has hampered their effectiveness.

State business taxes and their implications for tax competition are also relevant for current policy debates in Europe.[3] As mentioned above, corporate tax rates among OECD countries also have declined sharply over the past two or three decades (Devereux, Rodoano, and Lockwood, 2008, Figure 1; U.S. Treasury, 2007, Chart 5.1). This has led to deliberations among

[2] The U.S. Commerce Clause states that "The Congress shall have Power … To regulate Commerce with foreign Nations, and among the several States, and with the Indian tribes; …" (United States Constitution, 1787, article I, section 8). See Enrich (1997) and Stark and Wilson (2006) for discussions of the Commerce Clause and its relation to tax policy.

[3] The restrictions in the U.S. Commerce Clause are echoed in the Treaty of Rome section on *Aids Granted by States*: "Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market" (Article 87).

European Union (EU) officials over whether to impose tax harmonization measures (McLure, 2008). As intra-union capital mobility rises toward levels approaching that among U.S. states, the U.S. experience may help inform the EU debate. Our results based on U.S. states suggest that policies aimed at restricting tax competition as a means of stemming the tide of declining capital taxation are likely to be ineffective. If aggregate shocks, and not tax competition, are driving the secular movements in capital taxation, the elimination of tax competition will do little to stop or reverse these trends.

Our paper proceeds as follows. Section II develops a theoretical model whose key element is the relative preference for private vs. public goods. We show that the sign of the slope of the reaction function of home state to foreign state tax policy depends on the income elasticity of private goods relative to public goods. To develop intuition for this important result, consider the case when the capital tax rate for a neighboring state rises. In turn, mobile capital (eventually) flows into the state, and the tax base rises. Depending on residents' preferences for public vs. private goods and how these preferences change with income, residents may prefer to use this "windfall" to finance a tax cut – a negative or "see-saw" tax reaction – allowing higher private good consumption while still maintaining current levels of public good provision. Alternatively, they may prefer to disproportionately use the windfall to increase public good consumption, necessitating a higher capital tax rate – a positive or "race to the bottom" tax reaction. Apart from the ambiguity of the sign of the slope, the theoretical model has an additional implication that the absolute value of the slope increases with the mobility of capital. Tax instruments that target new, highly-mobile capital (the ITC) should have larger reaction function slopes than do instruments targeting old, less mobile capital (the CIT).

Section III presents the estimating equation and introduces two econometric innovations into the tax competition literature. First, as we shall see below, the effects of aggregate shocks prove critical in evaluating the reaction function. We go beyond the standard time fixed effects estimator that constrains responses to an aggregate shock to be homogeneous across states. Instead, we employ the Common Correlated Effects (CCE) estimator, developed by Pesaran (2006), that allows for heterogeneous responses across states. Second, the theory of tax competition strongly implies that there will be an endogeneity problem with estimating the slope of the reaction function. We develop and implement a new procedure for selecting instruments that are both valid and relevant.

Section IV discusses our panel dataset for 48 U.S. states for the period 1965 to 2006. This dataset has the virtues of a substantial amount of cross-section and time-series variation for an economic environment that is relatively free of impediments to the flow of capital. We have data on five tax variables – the investment tax credit, the corporate income tax rate, the tax wedge on capital, the average corporate tax rate, and the capital apportionment weight – and a set of political, demographic, and economic variables to serve as controls and instruments.

Section V presents our empirical results that document the importance of controlling for aggregate shocks and delayed responses. When either of these elements is not controlled for in the econometric model, we obtain a positively sloped reaction function, as reported in most prior work. When both time fixed effects and time lags enter, the reaction function has a negative slope. These results are robust in several dimensions. Moreover, consistent with a prediction of our model, the slope is larger (in absolute value) for the ITC relative to the CIT.

Section VI offers a brief discussion of some of the relevant literature on reaction functions. Section VII summarizes and discusses how our "riding on a seesaw" finding informs policy discussions concerning tax competition and capital mobility.

II. The Tax Reaction Function: Theoretical Underpinnings And Empirical Implications

This section develops a model of strategic competition and extracts implications for the tax reaction function – the equilibrium response of tax policy in a home (in-state) jurisdiction to tax policy in a foreign (out-of-state) jurisdiction. We show that the slope of the reaction function can be positive ("racing to the bottom") or negative ("riding on a seesaw") and that the sign of this slope depends on the sign of one key parameter: the income elasticity of private goods relative to public goods. While the model developed in this section is not appropriate for welfare analysis, it is useful for identifying the determinants of the slope of the reaction function and motivating the linear model to be estimated and interpreted in the empirical section of this paper.

A. A Model Of Tax Competition

Our model of tax competition is based on six relations that describe the constraints faced by a government choosing business tax policy to maximize the utility of the representative domestic household. First, production in the home state is determined by a Cobb-Douglas function that depends on a mobile capital stock and a fixed factor of production, such as labor or a composite of land and labor. The capital stock available for home production (K) is the sum of the capital stocks owned by home residents (k) and, given the mobility of capital, the capital stock owned by foreign residents located in the home jurisdiction (k^f).[4] We write the production function ($F[K]$) in the following intensive form relative to the fixed factor of production,

$$y = F[K], \qquad K \equiv k + k^f, \tag{1}$$

Second, as a result of capital mobility, the capital stock in a given jurisdiction is sensitive to capital income tax rates prevailing in its and foreign jurisdictions. Consequently, the capital stock in the home jurisdiction depends negatively on the home tax rate (τ) and positively on the foreign tax rate (τ^f), as well as on a set of controls reflecting home and foreign demographic and economic variables (x_k and x_k^f, respectively),

$$K = K[\tau, \tau^f : x_k, x_k^f]. \qquad K_\tau[.] < 0, \;\; K_{\tau^f}[.] > 0. \tag{2}$$

This capital mobility function allows economic variables to affect home capital demand insofar as they impact production possibilities and the marginal product of capital. It proves convenient to assume that the derivatives with respect to the home and foreign tax rates are equal and opposite in sign ($K_\tau[.] = -K_{\tau^f}[.]$), though the qualitative results do not require this assumption.[5]

Equations (1) and (2) can be combined to generate a relation between production and the

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[4] If the state is a net capital exporter, $k^f < 0$. Without loss in generality, we analyze a capital importing state.

[5] While equation (2) is consistent with the standard constraint on net-of-tax return equalization across jurisdictions, it allows for the possibility that, owing to a variety of frictions, the net-of-tax returns on capital may differ. See Appendix A for analytic details.

home and foreign tax rates,

$$y = F[K] = F\Big[K[\tau,\tau^f : x_k, x_k^f]\Big] = G[\tau,\tau^f : x_k, x_k^f] \,, \qquad (3)$$

$$G_\tau[.] < 0, \;\; G_{\tau^f}[.] > 0.$$

The derivative, $G_{\tau^f}[.] > 0$, represents the incremental production from a tax-induced flow of capital from the foreign state to the home state.

Third, we link net income to expenditures by means of GDP accounting relations. Net income is measured by gross income (production) less the return on capital assets (r^f) owned by foreign residents but located in the home jurisdiction. Net income equals expenditures on public (g) and private (c) goods.

$$y - r^f = g + c \,. \qquad (4)$$

Fourth, the government's budget constraint (stated per unit of the fixed factor) equates public goods expenditure to an origin-based tax. This tax is defined as the product of the capital income tax rate (τ) and capital income, the latter defined as the marginal product of capital ($F'[K]$) multiplied by the capital stock located in the home state,

$$g = \tau \; F'[K] \, K = \tau \, \pi \, y \,.[6] \qquad (5)$$

Given the Cobb-Douglas production function, capital income in the home state is a fixed share (π) of output.

Fifth, capital imported from abroad is paid a return equal to the marginal product of

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[6] We focus on the capital income tax as the sole source of fiscal revenue for simplicity of exposition. The model can be expanded to include a wage tax (at rate τ_{wage}) or a sales tax (at rate τ_{sales}). In these cases, the $H[\tau]$ in equation (7) below is redefined as $H^{wage}[\tau_{wage}] \equiv \Big((1-\pi^f)/((1-\pi)\,\tau_{wage})\Big) - 1$ and $H^{sales}[\tau_{sales}] \equiv \Big((1-\pi^f)/\tau_{sales}\Big) - 1$, respectively.

capital multiplied by the amount of foreign capital located in the home state. The return on imported capital is a fixed share (π^f) of output,

$$r^f = F'[K]\,k^f = \pi^f y, \qquad (6)$$

$$\pi^f < \pi$$

Equations (4), (5), and (6) can be combined to generate a relation between the mix of private to public goods (c/g) and the tax rate. We multiply and divide the two terms on the right-side of equation (4) by g, use equations (5) and (6) to eliminate g and r^f, respectively, and rearrange the resulting equation to obtain the following equation,

$$c/g = \Pi/\tau - 1 \equiv H[\tau], \qquad (7)$$

$$\Pi \equiv \left((1-\pi^f)/\pi\right) > 1 \text{ (provided } \pi < 0.5\text{)},$$

$$H_\tau[.] < 0.$$

Based on (7), the tax rate must increase to raise the share of output devoted to public goods.

The sixth and final equation is the utility function that depends on private and public goods and that policymakers maximize by their choice of τ. We represent the utility of the representative home resident by the addilog utility function. Houthakker (1960) introduced this function and noted that it is most suitable when the arguments in the utility function are large distinct aggregates and when the primary force driving allocations is through changes in income. Both properties are satisfied in our tax competition setting, and we work with the following indirect utility function ($V[y]$),

$$V[y] = \xi_c\left((y(1-\pi^f))/p_c\right)^{\theta_c} + \xi_g\left((y(1-\pi^f))/p_g\right)^{\theta_g}, \qquad (8)$$

where θ_c, θ_g, ξ_c, and ξ_g are parameters (the latter two parameters may represent state specific characteristics such as political preferences) and p_c and p_g are the prices for c and g, respectively. Relying on Roy's identity to generate the demand functions for c and g and normalizing the prices to unity through an appropriate choice of units, we obtain after some additional manipulation the following equation for the ratio of the demands for c to g (Houthakker, 1960, equation (30)),

$$c/g \equiv \zeta[y(1-\pi^f) : x_\zeta] = \xi\left(y(1-\pi^f)\right)^{\eta_{\zeta,y}}, \tag{9}$$

$$\xi \equiv \xi_c\theta_c / \xi_g\theta_g,$$
$$\eta_{\zeta,y} \equiv \theta_c - \theta_g >=< 0.$$

In equation (9), the private and public goods mix depends on income and home state control variables (e.g., population and voter preferences) represented by x_ζ. A preference between private and public goods is a key element in this and other tax competition models (e.g., Bruecker and Saavadra (2001), Mintz and Tulkens (1986), Wilson and Janeba (2005), and Zodrow and Mieszkowski (1986)). In equation (9), this preference is represented by the θ_c and θ_g parameters whose difference defines the income elasticity of private goods relative to public goods, $\eta_{\zeta,y}$. This elasticity plays a major role in determining the sign of the slope of the reaction function.

The above model serves as a vehicle for studying the properties of the tax reaction function. The model is summarized by equations (3), (7), and (9). Substituting the first two equations into the third equation, we obtain the following relation between home and foreign tax rates,

$$c/g = \zeta[y], \tag{10}$$
$$0 = \zeta\left[G[\tau,\tau^f : x_k, x_k^f](1-\pi^f) : x_\zeta\right] - H[\tau],$$
$$0 = \Phi[\tau,\tau^f : x].$$
$$x \equiv \{x_k, x_k^f, x_\zeta\}$$

The existence of an equilibrium τ is verified in Appendix B.

B. Empirical Implications

Equation (10) implicitly defines a relation between home and foreign tax rates, and thus can be used to compute the reaction function for τ with respect to changes in τ^f. Adopting the standard Nash assumption used in the literature, we assume policymakers in the home state treat foreign tax policy as given. Differentiating equation (7) with respect to τ and τ^f with the chain rule and rearranging yields the following reaction function,

$$\frac{d\tau}{d\tau^f} = \frac{\eta_{\zeta,y} * \Gamma}{\left(\eta_{\zeta,y} * \Gamma - ((1+\zeta)/(\zeta(1-\pi^f)))\right)}, \tag{11a}$$

$$\Gamma \equiv \eta_{y,K} * (-\eta_{K,\tau}) \geq 0, \tag{11b}$$

where the η's are elasticities and $\eta_{y,K}$ and $-\eta_{K,\tau}$ are positive. These two parameters are represented by Γ, defined in equation (11b) and interpreted as the incremental output from a tax-induced flow of capital.

The first empirical implication of our model follows from the relation between the slope of the reaction function and $\eta_{\zeta,y}$ (the income elasticity of private goods relative to public goods) and is evaluated when this parameter is zero, negative, or positive. To develop the intuition for the slope of the reaction function under alternative values of $\eta_{\zeta,y}$, consider the situation where the foreign tax rate (τ^f) rises. Mobile capital (eventually) will flow into the home jurisdiction, and thus the tax base (capital income) will rise.[7] The allocation of this "windfall" to private vs. public goods and the subsequent impact on financing of public goods through taxation are the key elements determining the sign of the slope of the reaction function, as we will see in the subsequent three cases.

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[7] An additional benefit from the relatively lower tax rate (not modeled here) is that, if firms in the home state are non-competitive, the capital inflow will increase production and competitive pressures, possibly lower non-competitive profit margins, and increase welfare. This channel has been documented in the context of offshore financial centers by Rose and Spiegel (2007).

Case I: $\eta_{\zeta,y} = 0 \rightarrow d\tau / d\tau^f = 0$

The assumption that the relative division of resources between private and public goods remains unaltered ($\eta_{\zeta,y} = 0$) implies that there is no need to change the home tax rate to alter the mix. This case is consistent with homothetic utility in private and public goods. The reaction function is flat.

Case II: $\eta_{\zeta,y} < 0 \rightarrow d\tau / d\tau^f > 0$

Under this assumption, the one term in the numerator and the two terms in the denominator of equation (11) are each negative; hence the overall derivative is positive. The negative value for $\eta_{\zeta,y}$ represents a preference for diverting a disproportionate amount of the windfall toward the public good. Since public goods need to be financed by tax revenues, this preference dictates an increase in τ and thus a positive-sloping reaction function.

Case III: $\eta_{\zeta,y} > 0 \rightarrow d\tau / d\tau^f < 0$

Under this assumption, the numerator is unambiguously positive; the slope of the reaction function depends on the relative magnitudes of elasticities in the denominator. A sufficient condition for the denominator to be negative is $0 < \eta_{\zeta,y} < 3$.[8] Under this condition, the windfall is directed toward a relative increase in private goods. For instance, residents may view current levels of public services as satisfactory and would thus rather spend most or the entire windfall on private consumption. The windfall relaxes the budget constraint and allows the home jurisdiction to lower tax rates while maintaining public good consumption. Such a situation would result in a negative or "see-saw" tax reaction.

The above analysis highlights that the slope of the reaction function is indeterminate *a priori* and depends crucially on the income elasticity of private goods relative to public goods

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[8] This sufficient condition is based on the following computation. Upper bounds on $-\eta_{k,\tau}$ and $\eta_{y,k}$ (the two elasticities defining Γ) are 1.00 (from a Cobb-Douglas production function) and 0.33 (capital's share in production), respectively. If $\eta_{\zeta,y} < 3$, then $(\eta_{\zeta,y} * \Gamma) < 1$ and, since $((1+\zeta)/(\zeta(1-\pi^f)) > 1$, the denominator of equation (11) is negative.

($\eta_{\zeta,y}$).[9] This sensitivity is documented in Figure 5, which plots the slope of the reaction function (equation (11)) against values of $\eta_{\zeta,y}$ ranging from -2.0 to 2.0 in increments of 0.10.

The model developed in this Section has an additional testable implication – the slope should vary systematically depending on whether the tax instrument applies to highly mobile new capital or less mobile old capital.[10] Intuitively, the more responsive capital is to tax stimuli, the greater should be the response as measured by the slope of the reaction function; a positively sloped (negatively sloped) reaction function will be more positive (more negative) for the tax instrument targeting relatively mobile capital. Capital mobility is measured by the absolute value of the elasticity of capital with respect to the tax instrument, $-\eta_{K,\tau}$. Differentiating equation (11) with respect to this elasticity, we obtain the following result,

$$\frac{d\left(d\tau / d\tau^{f} \right)}{d(-\eta_{k,\tau})} = \left(\frac{-\eta_{\zeta,y} * \eta_{y,K} * ((1+\zeta)/(\zeta(1-\pi^{f}))}{\left(\eta_{\zeta,y} * \Gamma - ((1+\zeta)/(\zeta(1-\pi^{f})) \right)^{2}} \right) \begin{pmatrix} = 0 \text{ if } \eta_{\zeta,y} = 0 \\ > 0 \text{ if } \eta_{\zeta,y} < 0 \\ < 0 \text{ if } \eta_{\zeta,y} > 0 \end{pmatrix}. \qquad (12)$$

The testable implication depends on the slope of the reaction function and hence on the value of $\eta_{\zeta,y}$. In the empirical work, we expect that the slope of the reaction function will be greater in absolute value for the investment tax credit affecting new capital versus the corporate income tax rate that affects both new and old capital,

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[9] The possibility of a negatively sloped reaction function has been emphasized by Bruecker and Savaadra (2001, section on "Reaction Functions") and noted, though not usually highlighted, in several other tax competition studies: Mintz and Tulkens (1986, Section 3.2 and fn. 15), Wilson and Janeba (2005, p. 1218), and Zodrow and Mieszkowski (1986, Section III). Razin and Sadka (2011) show that a standard tax competition model augmented with an upward supply of immigrants does not lead to lower tax rates and a race to the bottom. Mendoza and Tesar (2005) establish that, in a model where government spending is held constant, the occurrence of a race to the bottom is sensitive to which tax instrument (labor vs. consumption tax rates) is used to balance the budget in the face of a decrease in the capital income tax rate.

[10] Wildasin (2007) makes an important point about the differential sensitivity of "new" and "old" capital to the ITC and CIT, respectively, and discusses the implications for tax policy and rent transfers.

$$\left|\frac{d\,ITC}{d\,ITC^{f}}\right| > \left|\frac{d\,CIT}{d\,CIT^{f}}\right| . \qquad (13)$$

To summarize, the model developed in this section guides the specification of the econometric model and the interpretation of the empirical results. In this framework, the sign of the reaction function is ambiguous and depends on the sign of the income elasticity of private goods relative to public goods for the representative household. Moreover, the absolute value of this slope increases with capital mobility. The latter is measured by the tax-price elasticity for capital $(-\eta_{k,\tau})$, and this elasticity is higher for the investment tax credit rate (targeting new capital) than for the corporate income tax rate (targeting both new and old capital).

III. Estimation Issues

A. The Estimating Equation

The objective of our empirical work is to identify the slope of the reaction function for state capital tax policies. We focus primarily on the investment tax credit rate (ITC) and the corporate income tax rate (CIT). As extensions to these results, we also estimate models for the other three tax variables displayed in Figures 3 and 4: the tax wedge of capital, the average corporate tax rate, and capital apportionment weight. The strategic tax competition model implies that the reaction function can be represented by a specification of the following form,

$$\tau_{i,t} = \alpha\tau_{i,t}^{f} + x_{i,t}\beta + u_{i,t}, \qquad (14)$$

where $\tau_{i,t}$ is a tax variable for state *i* at time *t*, $\tau_{i,t}^{f}$ is the tax variable for the foreign states, $x_{i,t}$ is a vector of control variables, $u_{i,t}$ is an error term, and the scalar α and vector β are parameters to be estimated. We measure $\tau_{i,t}^{f}$ by the 1st order spatial lag of the tax variable, $\tau_{i,t}$:

$$\tau_{i,t}^{f} \equiv S^{1}\left\{\tau_{i,t}\right\} = \sum_{j\neq i}^{J} \omega_{i,j}\tau_{j,t} \,, \tag{15a}$$

$$\sum_{j\neq i}^{J} \omega_{i,j} = 1 \,, \tag{15b}$$

where $S^{p}\{.\}$ is the spatial lag operator of order p, $\omega_{i,j}$ is a weight defining the "distance" between state *i* to the remaining *J-1* states indexed by *j*. Given the presence of a spatial lag of the dependent variable as an explanatory variable, equations of the above form are sometimes referred to as a spatial autoregressive model. An immediate implication of the strategic tax competition model is that $\tau_{i,t}^{f}$ will be endogenous; Section III.C addresses this endogeneity issue and discusses how we overcome the potential inconsistency problem.

We include five variables in the vector $x_{i,t}$ (which contains variables dated t and t-1). Three control variables are chosen to account for preferences for the mix of private and public goods ($x_{i,t-1}^{pref}$) and for economic ($x_{i,t-1}^{eco}$) and demographic ($x_{i,t}^{dem}$) effects. To avoid estimation problems arising from simultaneity, the preference and the economic variables are time lagged one period. As suggested by equation (10) in the theoretical model, 1^{st} order spatial lags of the economic and demographic control variables ($x_{i,t-1}^{eco,f}$ and $x_{i,t}^{dem,f}$, respectively) capture the impact of foreign variables on the setting of tax rates in a given state and by its competitors.

We extend the basic tax competition specification (equation (14)) in two important ways. First, we allow for the possibility that the impact of the key tax competition variable may be distributed over several time periods. The introduction of time lags of competitive states' tax policy, $\tau_{i,t}^{f}$, recognizes that the driving force behind a non-zero reaction function slope is the mobility of capital. This flow of capital may occur gradually over several years.

Second, our specification of the error term is new to the study of state tax policy (to the best of our knowledge) and has a generalized two-way error component structure that allows for heterogeneous cross-section dependence (CSD) among states,

$$u_{i,t} = \varphi_i + \gamma_i f_t + \varepsilon_{i,t} \,, \tag{16}$$

where φ_i is a state-specific shock, $\varepsilon_{i,t}$ is a state-specific shock that varies over time and is independent of $x_{i,t}$, f_t is an unobserved time-specific shock (f_t may represent a vector of shocks), and γ_i is a state-specific aggregate factor loading. The $\gamma_i f_t$ term allows for heterogeneous CSD among the states that may be important. All states are affected by common aggregate shocks such as energy prices, federal and foreign tax policies, globalization pressures, and U.S. macroeconomic conditions. These aggregate shocks are represented by f_t. However, the impact (direction and magnitude) of these aggregate shocks may vary by state. For instance, changes in energy prices may have different effects on New England states than on those states in the "oil patch" (e.g., Oklahoma and Texas). These differential responses are captured by the state-specific factor loadings, γ_i. The conventional time fixed effects (TFE) model is a special case of this framework and is obtained from equation (16) when $\gamma_i = \gamma$ for all *i*.

These two considerations lead to the following specification of our estimating equation,

$$\tau_{i,t} = \alpha_0 \tau^f_{i,t} + \sum_{n=1}^{N} \alpha_n \tau^f_{i,t-n} + x_{i,t}\beta + \varphi_i + \gamma_i f_t + \varepsilon_{i,t} \ . \quad (17)$$

For convenience, we will denote the sum of the coefficients on the current and lagged values of the competitive states' tax variable, which represents the long-run slope of the reaction function, by α,

$$\alpha \equiv \sum_{n=0}^{N} \alpha_n \ . \quad (18)$$

The strategic tax competition model necessarily implies that the three shocks – φ_i, $\varepsilon_{i,t}$, and $\gamma_i f_t$ – that affect state *i* are correlated with tax policy in the competitive states, $\tau^f_{i,t}$. We address the resulting estimation problem in the following three ways. First, φ_i is modeled as a state fixed effect. Second, $\gamma_i f_t$ is modeled using the Common Correlated Effects (CCE) estimator of Pesaran (2006) that will be discussed in Section III.B. Third, the correlation between $\varepsilon_{i,t}$ and $\tau^{f}_{i,t}$ is accounted for by projecting the latter variable on a set of instruments, $z_{i,t}$. Our implementation of the instrumental variables estimator is somewhat complicated by the CCE estimator, and we address this problem in Section III.C.

B. The Common Correlated Effects (CCE) Estimator

The CCE estimator is an important innovation for analyzing tax competition because it allows states to have heterogeneous responses to aggregate shocks. Such common shocks are usually controlled for in panel studies with time fixed effects. As discussed above with respect to energy prices, federal and foreign tax policies, globalization forces, and macroeconomic conditions, the assumption that all states are affected identically by aggregate shocks is restrictive and may bias all estimated coefficients. Of particular concern is the possibility that states' responses to aggregate shocks are correlated across space in a similar manner to the spatial pattern of capital mobility and hence tax competition. In other words, the state-specific factor loadings on the aggregate shock, γ_i, may be correlated with current and lagged values of $\tau^{f}_{i,t}$. Heterogeneous responses could be accounted for by Seemingly Unrelated Regression, but this framework is not feasible when the number of cross-section units exceeds 10. The CCE estimator, on the other hand, is feasible for panels with a large number of cross-section units and it accounts for the unobservable $\gamma_i f_t$ by including cross-section averages (CSA) of the dependent and independent variables as additional right-hand side variables,

$$\begin{aligned} \tau_{i,t} &= \alpha_0 \tau^{f}_{i,t} + \sum_{n=1}^{N} \alpha_n \tau^{f}_{i,t-n} + x_{i,t}\beta + \varphi_i + \varepsilon_{i,t} \\ &\quad + \gamma_i \left(\bar{\tau}_t - \alpha_0 \bar{\tau}^{f}_{t} - \sum_{n=1}^{N} \alpha_n \bar{\tau}^{f}_{t-n} - \bar{x}_t \beta \right), \end{aligned} \tag{19}$$

where the bar above a variables denotes its CSA. If the γ_i's in equation (19) are constrained to be 1 for all *i*, the specification would be equivalent to transforming the data by demeaning each variable with respect to its CSA, a standard way of controlling for time fixed effects with the least squares dummy variables (LSDV) estimator. In general, the CSA in the CCE estimator are formed with a set of state weights, v_j for j = 1,…,J, (note that these weights are unrelated to the $\omega_{i,j}$ state-pair weights used to construct the tax competition variable in Section IV.C), such that,

$$\bar{x}_t \equiv \sum_{j=1}^{J} v_j x_{j,t}, \tag{20}$$

$$\sum_{j=1}^{J} v_j = 1.$$

As shown by Pesaran (2006), the asymptotic properties of the CCE estimator are invariant to the choice of the v_j weights. The empirical work reported here is based on equal weighting ($v_j = 1/J$ for all j).

C. Endogeneity and Instrumental Variables

The theory of tax competition has the strong implication that $\tau^f_{i,t}$ will be correlated with shocks to $\tau_{i,t}$ appearing in the error term. We address this endogeneity problem with instrumental variables (IV).[11] The endogenous $\tau^f_{i,t}$ variable is projected on a set of instruments $z_{j,t}$. The fitted value, $\hat{\tau}^f_{i,t}$, then replaces $\tau^f_{i,t}$ in equation (19).[12] A common challenge in the empirical tax competition literature is to identify a set of instruments that are both valid and

[11] Instrumental variables is one of two approaches typically used to estimate spatially autoregressive models. The other is maximum likelihood (e.g., Case, Hines, and Rosen, 1993), which is far more computationally intensive. See Brueckner (2003) for an extensive discussion of the econometric issues associated with identification of spatially autoregressive models in the context of tax competition and Pesaran (2006, Section 1) for a general review of estimation strategies.

[12] Since $\hat{\tau}^f_{i,t}$ is a generated regressor, we have investigated whether adjusting the standard errors with the procedure of Topel and Murphy (1985) has a notable impact on the standard errors. The adjustment turns out to have very little impact and hence we do include this adjustment in the results shown in this paper. Moreover, for testing the null hypothesis that the coefficient on $\hat{\tau}^f_{i,t}$ equals zero, no adjustment is necessary (Pagan, 1984).

relevant from the very large pool of feasible instruments. Tax competition theory, as well as spatial-econometric theory (e.g., Kapoor, Kelejian, and Prucha, 2007), typically suggest that spatial lags of the control variables should be valid instruments. However, there may be a large number of control variables and, for any given control variable, there may be 1st or higher-order spatial lag measures. Unfortunately, IV estimators is known to be biased in finite samples when a large number of instruments are used (Hansen, Hausman, and Newey, 2008). Thus, we adopt the following three-step search procedure to obtain an optimal instrument set for each of our tax variables. For the purposes of obtaining these optimal instrument sets, we focus on the standard two-way (state and time) fixed effects model.[13]

1) First, the potential set of instruments for a given tax variable – $z_{\tau,i,t}$ – is constructed from lists of included and excluded instruments. Included instruments are the five conditioning variables in $x_{i,t}$ and the state and year dummies.[14] Excluded instruments comprise a set of 16 voter preference variables for the competitive states: the 1st and 2nd order spatial lags of the eight voter preference variables defined in Section IV.D.

2) Second, we form sets corresponding to all possible combinations of the excluded instruments. For each instrument set and for a given tax variable, we estimate the two-way fixed effects IV model and store the minimum eigenvalue statistic (a multiple endogenous variable generalization of the 1st-Stage F-statistic) and the p-value of the Hansen-Sargan J test of overidentifying restrictions. A p-value greater than an arbitrary critical value implies that the null hypothesis is sustained and that the instruments are valid. Admissible instrument sets are identified as those whose p-values exceed a critical value of 0.10.

3) Third, from this admissible set of valid instruments, we then choose the instrument set that

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[13] Optimal instrument sets are identified separately for models without lags and with three lags of $\tau^f_{i,t}$

The optimal instrument set obtained for the three-lag model is used for all models containing lags of $\tau^f_{i,t}$.

[14] An interesting issue related to the proper choice of instruments for a panel model with two-way fixed effects is the potential "Nickell bias" (Nickell (1981)). As is well known in time-series models, the within IV estimator with predetermined variables (e.g., time lagged endogenous variables) is biased in finite-T samples because the predetermined variables are correlated with the within-transformed error term. In principle, this suggests that time lags of included instruments are invalid. However, what is not generally recognized is that there also is a parallel (or perhaps "perpendicular") finite-N bias coming from the spatial dimension. The two-way within estimator also transforms the error to sweep out time fixed effects that may be correlated with *spatial* lags of the included instruments, thus invalidating such spatial lags as instruments. It is important to keep in mind, however, that both biases vanish as T or N gets large and the rate of convergence is rather rapid. Thus, these potential problems do not arise in our dataset with T and N dimensions of 42 and 48, respectively.

is most relevant, as assessed by the minimum eigenvalue statistic. While we are not interested in formal hypothesis testing of instrument relevance, it is interesting to evaluate the null hypothesis of instrument irrelevance in terms of the 5% critical values presented in Table 1 of Stock and Yogo (2005); for seven or fewer excluded instruments and a bias greater than 10%, the critical value is 11.29. The instrument sets selected by our algorithm (one for each of the five tax policies we analyze) all exceed this critical value.

The optimal instrument set thus identified for a given tax variable is labeled $z^{*}_{\tau,i,t}$. While this procedure does not have a formal statistical basis nor is it based on an explicit metric, it has the virtues of generating a set of instruments that will yield consistent estimates and is based on a formal, non-discretionary algorithm. To the best of our knowledge, there are no formal statistical tests for choosing instruments (or moment conditions) that satisfy both the validity and relevance criteria. For example, the moment selection procedures of Andrews (1999) and Andrews and Biao (2001) focus on instrument validity and maintain instrument relevance. Conversely, Donald and Newey (2001) suggest a search criterion for selecting an optimal instrument set based on relevance, but they assume all potential sets are valid. Section V.B examines the robustness of our results to relaxing the validity restriction in step 2.

D. The General Specification and Implementation

The above considerations lead to the following general specification that is the basis of the estimates reported in Section V,

$$\begin{aligned}\tau_{i,t} &= \alpha_0 \hat{\tau}^{f}_{i,t} + \sum_{n=1}^{N} \alpha_j \tau^{f}_{i,t-n} + x_{i,t}\beta + \varphi_i + \varepsilon_{i,t} \\ &+ \gamma_i \left(\bar{\tau}_t - \alpha_0 \bar{\hat{\tau}}^{f}_{t} - \sum_{n=1}^{N} \alpha_j \bar{\tau}^{f}_{t-n} - \bar{x}_t \beta \right), \end{aligned} \qquad (21)$$

where, relative to equation (19), we have replaced the endogenous variable, $\tau^{f}_{i,t}$, with the fitted value, $\hat{\tau}^{f}_{i,t}$, in the first line and replaced the endogenous variable's CSA, $\bar{\tau}^{f}_{t}$, with the instrumental variable's CSA, $\bar{\hat{\tau}}^{f}_{t}$. When responses to aggregate shocks are constrained to be the same for all states, $\gamma_i = \gamma$, and this constrained estimator is equivalent to standard time fixed effects. We also will present estimates based on ignoring aggregate shocks; in this case, $\gamma_i = 0$.

The CCE model, as can be seen in equations (19) or (21), is nonlinear in parameters, which complicates its implementation. There are at least three ways to estimate this model. The first approach ignores the nonlinear restrictions imposed on the model by simply allowing each of the CSA terms (the terms on the second line of equation (21)) to have a separate, state-varying coefficient. This can be implemented by interacting state dummies with each of the CSA terms and including all of these interactions, along with the other variables of the model (those in the first line of equation (21)), in a linear OLS regression. For example, one would estimate a set of coefficients, $\theta_i = \gamma_i \alpha_0$, on the CSA of the contemporaneous tax competition variable, $\bar{\hat{\tau}}_t^f$. Such a regression is perfectly feasible, but it is quite inefficient given that it involves estimating a very large number of nuisance parameters. In our case, with 48 states, 5 control variables, and contemporaneous plus up to 4 lags of $\hat{\tau}_{i,t}^f$, we would have 586 parameters. We will refer to this estimator as the "unrestricted/inefficient CCE" estimator.

A second possible way of estimating this model is via a nonlinear estimator such as nonlinear least squares or maximum likelihood. However, even with the restrictions imposed, there are still a fairly large number of parameters to estimate, and nonlinear estimators may have difficulty converging.

A third approach, and our preferred one, is to first obtain consistent estimates of γ_i, insert these $\hat{\gamma}_i$'s into equation (21), and then estimate the resulting parsimonious model via linear least squares. Specifically, we implement the following three-step process:

- Step 1: Estimate the linear, unrestricted CCE estimator to obtain consistent (but inefficient) estimates of α_0, α_j's, and β. (Number of estimated parameters = 586.)
- Step 2: Use these as initial values for the α_0, α_j's, and β that pre-multiply the CSA terms (i.e., those on the second line of equation (21)). Obtain new estimates of the α_0, α_j's, and β from the main regressors (i.e., those on the first line of equation (21)) and use them as the α_0, α_j's, and β on the second line (the γ_i's are also estimated at each iteration). Iterate until α_0, α_j's, and β in 1^{st} and 2^{nd} lines converge (the convergence criterion is that each individual parameter estimate is within 1% in absolute value of its previous value). At

this point, the model yields consistent and efficient estimates of γ_i. (Number of estimated parameters = 106.)

– Step 3: Impose the $\hat{\gamma}_i$ from step 2. Estimate the resulting linear model via least squares to obtain consistent and efficient estimates of α_0, α_j's, and β (plus state fixed effects). (Number of estimated parameters = 58.)

We refer to this three-step estimator as the "efficient" or "restricted" CCE estimator. It should be emphasized that the purpose of imposing the CCE restrictions is for efficiency. Consistent estimates can also be obtained from the "unrestricted/inefficient" estimator in step 1. Thus, while most of the results we report below are obtained with the efficient CCE estimator, we also compare these results to those from the inefficient CCE estimator (see Table 4). As expected, the point estimates are similar between the two, but the efficient estimates are much more precise.

IV. U.S. State-Level Panel Data

Our estimates of the capital-tax reaction function are based on a U.S. state-level panel data for the period 1965 to 2006. The panel aspect of these data is crucial for understanding state tax policy for at least three reasons. First, state-specific fixed factors, such as natural amenities, affect a state's desire for government services and hence its tax and expenditure policies. Initial policies, stemming perhaps from historical policy choices persisting to the present era due to political economy forces (Coate and Morris (1999)) also determine current policies. The impact of these and other state-specific fixed factors (e.g., state industry mix) will be accounted for with state fixed effects. Second, state tax policy may be sensitive to aggregate shocks (e.g., energy prices) that vary over time, and these influences will be captured by time fixed effects or, more generally, by the CCE estimator that allows heterogeneous responses across states. Third, panel data long in the time dimension allow for the possibility that the response of state tax policy is distributed over several years. As we shall see in Section V, the latter two factors prove very important in the empirical analysis. We now turn to a discussion of the data underlying the variables used in our empirical analysis. Details about variable definitions and data sources are provided in Appendix A.

A. Capital Tax Policy (τ)

The model developed above, as well as the tax competition literature in general, analyzes the determination of a single tax on each unit of capital. Across the 48 states, the primary capital-tax policies are investment tax credits (ITC) and the corporate income tax (CIT). These policies target different types of capital, and hence their reaction functions should have different slopes that depend on the degree of mobility of the targeted capital. The reaction functions associated with these two tax variables form our baseline empirical results presented in Section V.A. We extend our analysis by estimating the reaction functions associated with three other tax variables – the tax wedge on capital, the average corporate tax rate, and the capital apportionment weight – in Section V.C.

B. Control Variables (x)

Recall that our model of strategic tax competition implies that variation in state capital tax policy is due to three control demographic, economic, and political preference variables that we measure by population (POPULATION), the investment/capital ratio (IK), and voter preferences (PREFERENCES), respectively. State population data come from the U.S. Census Bureau. We account for local economic conditions with the manufacturing investment rate (the ratio of investment to capital stock). The raw source data used to construct this variable is the Annual Survey of Manufacturers (ASM). The real manufacturing capital stocks are constructed according to the perpetual inventory method. Data outside of manufacturing for the years of our sample are unavailable.

Political preferences of state residents are, of course, unobserved. However, these preferences should, to a large extent, be revealed by electoral outcomes. Thus, the political party affiliations of the governor and state legislators should provide good proxies for preferences (Besley and Case (2003); Snyder and Groseclose (2000); Reed (2006)). Specifically, we measure the following two political outcomes as indicator variables:

(a) the governor is Republican (R). (The complementary class of politicians is Democrat (D) or Independent (I). An informal examination of the political landscape suggests that Independents tend to be more closely aligned with the Democratic Party. We thus treat D or I politicians as belonging to the same class, DI);

(b) the majority of both houses of the legislature are R.

The PREFERENCES variable takes on one of three values:

- 0 if the governor and the majority of both houses of the legislature are not R;
- 1/2 if the governor is R but the majority of both houses of the legislature are not R or if the governor is not R but the majority of both houses of the legislature are R;
- 1 if the governor and the majority of both houses of the legislature are R.

C. Foreign (Out-of-State) Variables (τ^f, x^f)

The two-state model developed in Section II is useful for understanding the intuition of strategic tax competition, but its focus on a single foreign jurisdiction is obviously highly stylized. In taking a tax competition model to data, however, one must confront the issue of evaluating the model when there are many foreign states competing for the capital tax base. It is generally infeasible to allow for a separate slope of the tax reaction function for each and every other foreign state. The approach taken in the literature, which we follow in this paper, is to measure foreign state variables (denoted by a superscript *f*) using spatial lags of the home state variable. A spatial lag is a weighted average of a variable over all foreign states.

In this paper, we focus on tax competition among the 48 contiguous U.S. states.[15] Equation (15) details the construction of the spatial lag and the weighting matrix, *W*, a 48x48 matrix with elements $\omega_{i,j}$ defining the "relatedness" of state *i* to the remaining 47 states indexed by *j*. The elements of the weighting matrix are chosen *a priori* and are meant to capture the degree of potential mobility of capital between the i^{th} state to each of the *j* foreign states.

The most natural weighting scheme and the one used most frequently in the literature is based on geographic proximity. We construct a *W* matrix with elements equal to the inverse-distance between state pairs, where distance is the number of miles between each state's population centroid. Each row of *W* is normalized so that the elements sum to one. A shortcoming of this geographic proximity measure is that it may not sufficiently discriminate among states. For example, while one might suspect that the economic interactions between California and Texas are greater than between California and Nebraska, the geographic proximity measure will give approximately equal weight to both pair of states. As an extension

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[15] We exclude Alaska, Hawaii, and the District of Columbia because of missing data for some of the weighting matrices and, for Alaska and Hawaii, because their great distance to other states strains the notion of "neighboring states."

presented in Section V.C, we construct a matrix based on commodity trade-flows in which element $\omega_{i,j}$ is the (row-normalized) value of commodity shipments from the i^{th} state to the j^{th} state, according to data from the 1997 Survey of Commodity Flows.

D. Candidate Instruments (z)

As discussed in Section III.C, we rely on eight voter preference variables defined over foreign states to form the candidate sets of instruments. Our instrument search algorithm considers all possible combinations of 1st order and 2nd order spatial lags of these eight variables as potential instrument sets, with the restriction that if the 2nd order spatial lag of a variable is included in a candidate set, its 1st order spatial lag must also be included. In addition to the two preference variables listed in Section IV.B for the governorship and legislature, we consider the following six political variables:

(c) the majority of both houses of the legislature are DI;
(d) the governorship changed last year from R to DI;
(e) the majority control of the legislature changed last year from D or split (between houses) to R;
(f) an interaction between the R governor and the R legislature indicator variables;
(g) an interaction between R governor and the D legislature indicator variables (note that the omitted interaction category is R governor and a split legislature dummy);
(h) the reelection of an incumbent governor last year.

Data for these political variables come from the Statistical Abstract of the United States (U.S. Census Bureau (Various Years)).

V. Empirical Results

A. Baseline Results

Tables 1 through 3 show the core results of the paper. Standard errors are robust to heteroskedasticity and clustered by year. The purpose of clustering by year is to account for any remaining contemporaneous correlation of the error terms across states in a very general manner. In particular, the common assumption in spatial econometrics of 1st order spatial autocorrelation is nested within this general clustering.

Table 1 presents the results of estimating equation (21) for the investment tax credit (ITC) with cross-section dependence accounted for by the CCE estimator and with various time lags. (Notes to the tables follow Table 7.) Column A contains estimates for a static model (i.e., number of lags of $\tau^f_{i,t}$ included is 0) and, as has occurred frequently in the literature, the slope of the reaction function is positive and statistically significant at conventional levels. In fact, the point estimate is quite large. A reaction function slope outside the unit circle would be unstable, suggesting a lack of convergence to a steady-state equilibrium set of tax rates across states.

The sign of the reaction function, however, flips to negative when time lags of the tax competition variable are introduced. Column B adds the first time lag, $\tau^f_{i,t-1}$, to the specification. The sum of the two coefficients on $\tau^f_{i,t}$ and $\tau^f_{i,t-1}$ is now negative and statistically significant at the 1% level. This sum of the contemporaneous and once-lagged tax competition variables, α, represents an estimate of the long-run slope of the reaction function. Adding additional lags of $\tau^f_{i,t}$ yields a very similar long-run slope estimate, as shown in Columns C to E.

Table 2 repeats this exercise with the ITC replaced by the corporate income tax (CIT) rate. The qualitative pattern found for the ITC – a positive slope flipping to a negative slope when time lags enter – also holds for the CIT. However, for the CIT, the point estimates of the slope are closer to zero (relative to Table 1) for all of the specifications, and they are insignificantly different from zero for those specifications containing lags.

The estimated coefficients on the control variables in Tables 1 and 2 for the lagged models, which we believe to be the most appropriate specification, also warrant a brief discussion. The coefficient on PREFERENCES suggests that states where voters tend to vote Republican have lower values for the ITC and CIT. This result could be consistent with a "liberatarian" or "tea party" type of Republicanism that favors both low investment subsidies and low corporate taxes (recognizing that the former need to be financed by the latter). The one-year-lagged investment rate ($IK_{i,t-1}$) has no significant effect on the ITC or CIT. The spatial lag of this variable has a negative and significant coefficient for ITC, perhaps suggesting that states view weak investment activity in competing states as an opportunity to attract capital to their own state by raising (or enacting) the ITC. Lastly, both home and foreign state populations negatively affect ITC and CIT rates.

Table 3 summarizes the variation in the estimated long-run slope of the reaction function, α, due to the tax policy instrument, the number of time lags included of the tax competition variable and controls for aggregate shocks. As discussed in Section III, the CCE estimator allows for heterogeneous responses to aggregate shocks across states, the time fixed effects (TFE) estimator allows only for homogeneous responses across states, and the estimator with no time fixed effects (NTFE, a one-way state fixed effects estimator) does not allow for any response to aggregate shocks.

Four key methodological findings emerge. First, the inclusion of time lags of the tax competition variable has a large and negative effect on the estimated slope of the reaction function. This finding holds regardless of whether and how one controls for aggregate shocks, and it holds for both tax policies.

Second, controlling for at least one time lag, we find that the slope estimate is not very sensitive to the number of time lags included for our preferred CCE model. For ITC, the slope estimate varies between -0.58 and -0.69 and is always statistically significant. For CIT, the slope varies between 0.00 and -0.14, and in no case is statistically different from zero. For the remainder of the paper, we will treat the three-lag model as our preferred specification.

Third, controlling for aggregate shocks also has a strong effect on the estimated slope of the reaction function. For ITC and for specifications allowing for lagged responses, controlling for aggregate shocks with standard time fixed effects and including time lags results in large negative slope estimates. Allowing for heterogeneous responses of states to aggregate shocks with the CCE estimator leads to more moderate and more plausible negative slope estimates for ITC. For CIT, adding standard time fixed effects has little impact on slope point estimates but increases standard errors substantially. However, allowing for heterogeneous responses to aggregate shocks with the CCE estimator has a strong effect on the slope estimate for CIT. The resulting CCE slope estimates for the CIT models with time lags are negative but close to zero.

Fourth, in unreported results, we find considerable variation in the estimated state-specific factor loadings on the aggregate shock, $\hat{\gamma}_i$. The null hypothesis of equality of the 48 $\hat{\gamma}_i$'s is easily rejected by a Wald test. The rejection of homogeneity suggests that the standard time fixed effects model is misspecified with respect to our data.

Aside from these methodological findings, the key economic result from Table 3 is that the slope of the reaction function for ITC is negative and significant, while the slope for CIT is insignificantly different from zero. The larger (in absolute value) slope for ITC confirms the second implications of the theoretical model. As shown in equations (12) and (13), the absolute value of the slope of the reaction function is expected to increase with capital mobility. For the CCE model with three time lags, the estimated slopes are −0.588 and −0.077 for the ITC and CIT models, respectively; only the slope for the ITC is statistically different from zero. This result is consistent with our theoretical model and the targeting of less mobile (new and old) capital by the CIT and more mobile (new) capital by the ITC.

In sum, our baseline results document that, when we account for time lags and aggregate shocks, the slope of the reaction function is negative. Allowing for both time lags in the tax competition variable and responses to aggregate shocks is crucial for obtaining an accurate estimate of the slope of the tax policy reaction function. In our data, misspecifying the empirical model in either of these dimensions leads to a positive slope estimate. Allowing for time lags is important because capital mobility among states is not instantaneous and occurs over more than one year. Allowing for aggregate shocks is important because they create common incentives that will lead states to act more-or-less synchronously. The positive slopes obtained when aggregate shocks are ignored accord with anecdotal evidence of positive reactions among states and the data in Figure 1. However, in order to properly assess the response of home state tax policy to foreign state tax policy, we must condition on aggregate shocks. With proper conditioning, the estimated slope of the reaction function is negative and more responsive for the ITC that targets new capital relative to the CIT that targets both new and old capital.

B. Robustness

In this subsection, we assess the robustness of our slope estimates to a variety of factors: (1) our method of implementing the CCE estimator; (2) the expansion of time lags to include all right-hand side variables, rather than just time lags of the tax competition variable; (3) the modeling of dynamics with a lagged dependent variable; and (4 and 5) controls for the endogeneity of the tax competition variable.

Our first robustness check evaluates whether our three-step restricted CCE estimator yields similar results to the simpler unrestricted CCE estimator described in Section III.D. Both estimators are consistent, but the latter is relatively less efficient. The results for α, the estimated long-run slope of the reaction function, from each estimator, for specifications with varying lag lengths, are shown in Table 4. For our preferred specification with three time lags, the two estimators yield very similar slope coefficients for ITC and CIT. However, as expected, the standard errors from the linear unrestricted CCE estimator are much larger.

Our second robustness check assesses the sensitivity of our main results to including time lags of all independent variables as opposed to just the tax competition variable. Our preferred specification omits these additional time lags to conserve degrees of freedom, as each extra right-hand side variable introduces another CSA term in the CCE estimator. Nonetheless, estimating this full specification is feasible with CCE, as well as the standard two-way and one-way fixed effects estimators. The results are shown in Table 5. Relative to the results reported in Table 3, the same qualitative patterns emerge across estimators and across the number of lags in these "full" specifications, though the standard errors are larger, as expected. The only notable difference is that the CIT reaction function slope from the CCE estimator with four lags is large and statistically significant. This instability in results in Table 5 moving from one, two, or three lags to four lags suggests that degrees of freedom are being exhausted.

Our third robustness check examines an alternative specification that captures dynamics with a lagged dependent variable (LDV). However, a major drawback of a dynamic model that includes one LDV and no lags of the independent variables is that the sign of the long-run effect on a given independent variable is restricted to be the same as the sign of the short-run effect. This restriction emerges because the long-run effect is calculated as the coefficient on the independent variable divided by one minus the coefficient on the LDV, which is typically between 0 and 1.[16] The LDV model is nested within the preferred model described above when

[16] The use of an LDV also creates some econometric difficulties with correlations between the LDV and the state fixed effect (the "Nickell bias;" Nickell (1981), Devereux, Lockwood, and Redoano (2007)) and the LDV and a serially correlated error term (Jacobs, Ligthart, and Vrijburg, 2010).

the latter has an infinite number of lags (see Appendix C). Of course, an infinite-lag model cannot be estimated, but a restricted version, in which the coefficients on the independent variables for the first *N* time lags are unrestricted and the effects of lags beyond the *N+1* period are captured parsimoniously by the dependent variable lagged *N+1* periods, can be estimated. (A complete set of results for this specification are available from the authors upon request.) For our preferred specification (N = 3), the results are qualitatively similar to the baseline results, with the implied long-run slope for the ITC being negative and statistically significant (though with a larger point estimate of -0.973) and the implied long-run slope for the CIT being negative and insignificant (with a point estimate of -0.172). The dependent variable lagged four periods is always highly statistically significant (0.313 and 0.424 for the ITC and CIT models,respectively).

Our fourth robustness check evaluates the impact of the endogeneity of foreign state tax policy on the reaction function slope estimates. Table 6 shows the α's when the tax competition variable is treated as exogenous by estimating with OLS. Two main findings emerge. First, in the static specifications in column A, the OLS slope estimates are negative and significant when aggregate shocks are controlled for (either via TFE or CCE). This result is in contrast to the IV results (Table 3) where the α's are positive and significant in the static specification. Second, for the specifications in Table 6 that allow for lagged effects and control for aggregate shocks, the α's are similar to those obtained by IV (Table 3) for both tax policies and all three estimators. In fact, to the extent there is a difference, the OLS results tend to be more negative than the IV results, suggesting that any OLS-bias on the slope estimate is negative.

Our fifth and final robustness check also examines endogeneity. As detailed in Section III.C, we use a three-step search procedure to obtain an optimal instrument set, $z^*_{\tau,i,t}$, for each of our tax variables. The instruments in $z^*_{\tau,i,t}$ are those with the highest first-stage fit, conditional on being valid at the 10% level. Here, we repeat the same search but drop the validity constraint. For CIT, it turns out the validity constraint does not bind (i.e., for the instrument set with the highest first-stage fit, the overidentifying restrictions are not rejected at the 10% level or below.) For ITC, the constraint does bind. Replacing $z^*_{\tau,i,t}$ in our baseline IV regressions with the instrument set with the highest first-stage fit (not conditioned on satisfying the validity constraint), we get similar results to those reported in Table 1. Specifically, the estimated α in our preferred three-lag specification is -0.407 (standard error of 0.141), compared with the estimate in Table 1 of -0.588 (standard error of 0.170). In sum, our key finding of a negatively sloped reaction function is not due to imposing the validity constraint in our instrument selection procedure.[17]

C. Extensions

This subsection extends the core analysis by considering three additional measures of capital tax policy and an alternative weighting scheme for constructing foreign state tax policy.

The first additional measure of capital tax policy we consider is the tax wedge on capital (TWC). All of the above analyses have measured $\tau_{i,t}$ using one of two statutory tax policies, the investment tax credit rate or the corporate income tax rate. The TWC allows us to examine their combined effects by focusing on that part of the user cost of capital that incorporates both of these policies (see fn. 1 and Appendix A for details). Estimates of the benchmark model but using TWC as the tax variable are presented in panel A of Table 7. The key patterns that we observed previously in Table 3 remain with TWC: models without aggregate effects or time lags of $\tau^f_{i,t}$ generate positive α's and the introduction of aggregate effects and time lags generates negative α's that are statistically different from zero at conventional levels.

The second additional tax policy measure is the average corporate tax rate ($ACT_{i,t}$). As we argue in more detail in Section VI below, statutory policies are the appropriate variables of interest in tax competition because they are the tax instruments that policymakers control directly. The average corporate tax rate, on the other hand, measures tax revenues divided by a tax base and are largely beyond the control of policymakers. Though policymakers' choices regarding statutory policies influence this average rate, current economic conditions and other exogenous factors, especially the firm's choice of organization form, also have a substantial influence.[18] Nonetheless, because average tax rate measures are often used in the empirical tax competition literature, we present results in panel B of Table 7 based a measure of $ACT_{i,t}$ in

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[17] Indeed, out of 1003 candidate instrument sets for the ITC model, 95.2% yield a negative and statistically significant α; none yields a positive and statistically significant α.

[18] Regarding the sensitivity of organization form to corporate taxation, see Goolsbee (2004), Mackie-Mason and Gordon (1997), and Mooij and Nicodème (2008) for evidence across U.S. states, U.S. industries, and EU firms, respectively.

order to draw comparisons with some of the previous literature. The $ACT_{i,t}$ is the ratio of state tax revenues from corporate taxes to total state business income, the latter measured by gross operating surplus.

The $ACT_{i,t}$ results are mixed relative to the estimates based on statutory tax rates. Focusing on the CCE results, we find that the estimated slope of the reaction function based on the $ACT_{i,t}$ is positive in a static model. Many prior studies have been based on average tax variables in static models, and the results in Table 7 may partly explain why positively sloped reaction functions have been found previously. As with the benchmark model, the addition of one or two lagged values of $\tau^{f}_{i,t}$ yields negative slopes. However, the results are fragile; the addition of a third or fourth lag leads to a sign reversal and much larger estimated slope. These results suggest that there can be a great deal of difference in estimated reaction function slopes when tax policy is measured by marginal and average tax rates, a finding consistent with the evaluation of statutory and average tax rates by Plesko (2003).

We next consider another important, but less well-known, capital tax policy used by U.S. states, the Capital Apportionment Weight. The CAW is the weight that a state assigns to capital (property) in its formula for allocating a portion of a corporation's national income to that state.[19] Unlike the ITC and CIT, changes in the CAW are somewhat difficult to interpret because an increase in the capital weight necessarily implies a decrease in the weights for the non-capital components in the apportionment formula; the net effect on incentives depends on the relative importance of capital and non-capital factors. With this caveat, the results for the capital apportionment weight are shown in Panel C of Table 7. Again, the introduction of time lags of the tax competition variable, combined with controlling for aggregate shocks, results in a sign

[19] In the United States, for the purposes of determining corporate income tax liability in a given state, corporations that do business in multiple states must apportion their national income to each state using formulary apportionment. The apportionment formula is always a weighted average of the company's sales, payroll, and property (with zero weights allowed). However, the weights in this formula vary by state, and there is no coordination among states. As shown in Figure 4, over the last forty years, states have increasingly moved toward increasing the weight on sales and decreasing the weights on payroll and property as a way to encourage job creation and investment in their state (and "export" the tax burden to foreign state business owners that sell goods and services in-state but employ workers and capital out-of-state). The capital (property) weight can be thought of as a capital tax instrument with similar effects as the corporate income tax, though it receives relatively much less attention by the public than the CIT.

flip of the long-run reaction function slope from positive to negative. The absolute values of the slope point estimates for CAW are much larger than those for ITC or CIT. These results strongly suggest that the slope of the reaction function for CAW is negative and that, as with ITC and CIT, including time lags of the tax competition variable and controlling for aggregate shocks are important elements in a properly specified econometric equation.

Lastly, we investigate whether our baseline results are sensitive to our definition of the foreign state tax policy by repeating our main regressions using an alternative weighting matrix (cf. equation (15)) to form the foreign state tax variable, $\tau^{f}_{i,t}$. How states react to tax policy changes in other states most likely depends on exactly what other states are considered to be competing for the same mobile capital tax base. In all of the above results, $\tau^{f}_{i,t}$ was constructed as a weighted average of other states' tax policies using geographic proximity weights (the inverse of the distance between population centroids). However, state capital tax policy may not be particularly sensitive to tax policies of other states that are geographically close, but may be more sensitive to policies of states that are "economically close." To measure economic closeness, we define the weighting matrix based on commodity trade flows; that is, state *j*'s weight in state *i*'s tax competition variable is proportional to the value of commodity shipments from state *i* to state *j*. The results discussed here are based on the three-lag specification and the efficient CCE estimator. For the ITC, the slope coefficient falls (in absolute value) from -0.588 (s.e. = 0.170) for the baseline results in Table 3 to -0.357 (s.e. = 0.081) but remains statistically significant. A negative slope is also obtained for CIT, as the coefficient estimate rises in absolute value from -0.077 (s.e. = 0.192) to -0.428 (s.e. = 0.172); the latter estimate based on trade flow weights is statistically significant at conventional levels.

VI. Comparison to Previous Empirical Studies

The empirical literature on fiscal competition has grown considerably in recent years, though the policy focus and methodologies used differ widely across studies. Among studies of "horizontal" (same level of government) competition, studies vary in whether they focus on expenditure policy or tax policy, and among tax policy studies, some focus on business taxes and some on consumer/personal taxes (see Brueckner (2003) and Zodrow (2010) for surveys). In terms of our policy focus on business taxes, the current paper is most closely related to Overesch and Rincke (2009), Devereux, Lockwood, and Redoano (2008) and, to a lesser extent, Altschuler and Goodspeed (2002) and Hayashi and Boadway (2001). All of these papers, except Overesch and Rincke, estimate a static model for some measure of corporate tax policy. All find that the slope of the reaction function is positive, as do we when we use the static model or omit controls for aggregate effects.[20]

Overesch and Rincke estimate a tax competition model using panel data on corporate income tax rates for EU countries. They control for time and country fixed effects, though they do not allow for common correlated effects. Similar to our results, they find that the estimated slope of the reaction function is positively biased if one omits time effects. However, while reduced, their estimated slope parameters remain positive after the addition of time fixed effects. A more significant difference in methodology between Overesch and Rincke and the current paper is the manner in which dynamics are modeled. Based on a partial adjustment model, Overesch and Rincke capture dynamics with a lagged dependent variable, which restricts the sign of the long-run effect to be the same as the sign of short-run effect.[21] Our more general estimator allows for sign flipping among the coefficients on the various time lags (including the

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[20] Empirically estimated reaction functions with negative slopes are rarely found in the economics literature. The only exception about which we are aware is the study by Büttner and Schwager (2004, equation (17) and Table 3) of higher education finance among German regions.

[21] This restriction can be seen by considering the formula for the long-run effect of a given variable in a lagged dependent variable model. The coefficient on any independent variable, call it α_0, represents the short-run effect of that variable. The long-run effect is given by $\alpha_0 / (1-\rho)$, where ρ is the coefficient on the lagged dependent variable and should be between 0.0 and 1.0. Thus, the long-run effect will always have the same sign as the short-run effect in a model that captures dynamics only with a lagged dependent variable. See Section V.B and Appendix C for further discussion.

0-lag) of the foreign state tax variable. Such sign flipping occurs in our data and proves important for accurately estimating the reaction function slope.

An important contribution of our paper is to document the sensitivity of estimated reaction function slopes to the tax variable. Our preferred specification uses statutory tax variables because they are directly chosen by policymakers. Motivated by a tax competition model in which both capital and corporate income are mobile (the latter via transfer pricing), Devereux, Lockwood, and Redoano (2008) estimate a two-equation system with the statutory corporate income tax rate and the effective marginal tax rate (EMTR) on capital as dependent variables. For 21 OECD countries, they find a positive and significant slope for the statutory rate but a small and insignificant slope for the EMTR. These results are broadly consistent with our results for U.S. states when we estimate a similar static specification (cf. Table 3 (for ITC and CIT) and Panel A of Table 7 (for TWC)). Altschuler and Goodspeed (2002) and Hayashi and Boadway (2001) are somewhat less comparable to our study because they estimate reaction functions for the average effective corporate income tax rate – corporate income tax revenues divided by total corporate income (or GDP in Altschuler and Goodspeed) – rather than for statutory tax rates. Our results in Panel B of Table 7 suggest that there can be a great deal of difference in estimated reaction function slopes when tax policy is measured by marginal and average tax rates. The key distinction between these three papers and ours is that none of them allows for lagged responses to foreign state tax policies or for common aggregate time effects.

There are several papers that estimate models of other forms of fiscal competition as well. These also typically do not control for aggregate time effects or lagged responses. Egger, Pfaffermayr, and Winner (2005a, b), Besley and Case (1995), and Case, Rosen, and Hines (1993) use panel data to estimate static models, and all of these papers report a positively sloped reaction function. Among these papers, only Egger, Praffermayr, and Winner and Case, Rosen, and Hines include both jurisdictional and time fixed effects, but they do not allow for lagged responses. Revelli (2002), Brueckner and Savaadra (2001), and Heyndels and Vuchelen (1998) estimate cross-section models, and they too report reaction functions with positive slopes. The main methodological differences between our paper and the studies discussed in this paragraph are our inclusion of both time fixed effects and a distributed time lag of tax policy in foreign states. Though most of these studies look at different measures of fiscal policy then we do, our empirical findings suggest that the positive reaction function slopes found in these studies may be upwardly biased due to the omission of time fixed effects or the restriction to only contemporaneous responses.[22]

VII. Summary and Conclusions

This paper estimates a capital tax reaction function motivated by strategic tax competition theory. We estimate this model using state panel data from 1965-2006 for several measures of capital tax policy. Our key empirical findings are that the slope of the reaction function for the investment tax credit (ITC) is negative and statistically different from zero and the slope of the reaction function for the corporate income tax (CIT) is negative but not statistically different from zero. These findings are consistent with the implications of our theoretical model that 1) the slope of the reaction function can be positive, negative, or zero depending on a key elasticity and 2) tax policies targeting new, more mobile capital like the ITC should have a larger reaction function slope than policies targeting total (new and old) capital. We document that including time lags of foreign state tax policy and conditioning on aggregate shocks are vitally important in accurately estimating this slope. The results prove robust in several dimensions, including defining tax policy in terms of the capital apportionment weight (CAW) or the tax wedge on capital (TWC).

While these results are striking given prior findings in the literature and the casual observation that state capital tax rates, on the whole, have fallen over time, these results are not surprising. The negative sign is fully consistent with qualitative and quantitative implications of the theoretical model developed in this paper. The model illustrates how, if state residents prefer that positive state income shocks disproportionately be spent on private goods versus public goods, a state may react to a tax increase in a foreign state (or more precisely, to the income

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[22] All of the above papers are drawn from the economics literature. Tax competition and reaction functions have also been studied in the political science literature. Hanson (1993) concludes that "competition from neighboring states has little impact on development choices." Mooney (2001) argues that most prior empirical studies of the policy diffusion process among states are biased upward because they do not control for aggregate time effects. He then shows that the reaction function slope for states' decisions to adopt a personal income tax turns from positive and significant to either small and insignificant or negative, depending on the exact specification, when aggregate time effects enter the econometric equation.

windfall resulting from the tax-induced capital inflow from the foreign state) by reducing its own tax rate. The model highlights the crucial role played by the income elasticity of private goods relative to public goods. Suppose that this elasticity is positive. If a foreign state increases its tax rate, the resulting capital inflow and income windfall into the home state will increase the demand for private goods at the expense of public goods and lead to a reduction in the home state tax rate. This income windfall allows residents to reduce their tax rate and increase their private good consumption without sacrificing public services. The same logic applies in reverse for a decrease in the foreign state tax and the resulting capital outflow. Our empirical findings suggest that, while state capital taxation has eased dramatically in recent decades, the downward pressure is not coming from tax competition – i.e., how states respond to each other – but from aggregate shocks impacting all states in more or less the same way. Rather than states "racing to the bottom," which suggests a competition in which participants respond to each other's movements in the same direction, our findings suggest that state tax competition is better characterized by "riding on a seesaw."

An important implication of this result is that calls for legislative, judicial, or regulatory actions aimed at restricting tax competition as a means of stemming the fall in state capital tax revenue or the mobility of capital are likely misguided. In fact, similar calls in the European Union might also be inappropriate.[23] If aggregate shocks, and not tax competition, are driving the secular trends in capital taxation, both in the U.S. and Europe, attenuating tax competition will do little to stop or reverse these trends.[24]

The finding of a negative-sloping capital tax reaction function has several implications for the strategic tax competition models. First, the non-zero slope provides support for the empirical importance of strategic tax competition relative to other factors in tax setting behavior. The finding is a rejection of both the hypothesis that capital is immobile and the hypothesis that

[23] Sutter (2007, p. 124) argues that the Code of Conduct for business taxation was adopted by the EC Commission in 1997 in light of an "intense discussion about unfair tax competition among OECD and EC Member States in the late 1990s showing that national tax individualism ultimately leads to a harsh fiscal race to the bottom in attracting 'mobile' foreign industries and businesses."

[24] That is not to say that there are not other unrelated arguments for restricting tax competition. In particular, the canonical strategic tax competition models of Oates (1972), Zodrow and Mieszkowski (1986), and Wilson (1986) and others yield an equilibrium with sub-optimally low taxes and public services, irrespective of the slope of the reaction function.

the supply of capital to the nation is perfectly elastic; either hypothesis implies a zero slope to the reaction function. Second, multi-stage or Stackelberg models of tax competition rely on a positively sloped reaction function for several results (Konrad and Schjelderup, 1999). The negatively sloped reaction function documented in this paper raises concerns about the existence, stability, and uniqueness of equilibrium in these classes of models.

The negative slope also suggests that the theory of yardstick competition, a leading alternative theory of fiscal strategic interaction and one that predicts a positive-sloping reaction function, is either not an important force in the setting of capital tax policy or is dominated by the force of tax competition.[25] Future research in this field might well focus on whether similar methodological improvements as those employed in this paper could unearth evidence of negative sloping reaction functions in other areas of fiscal policy, such as personal taxation, in which yardstick competition is likely to be a stronger force.

[25] A negatively sloped reaction function allow us to avoid the observational equivalence problem between yardstick and tax competition noted by Revelli (2005).

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***** NOT FOR PUBLICATION *****

Appendix A: Variable Definitions and Data Sources[26]

This appendix describes the construction of and data sources for the variables used in this study:

1. ACT: Average Corporate Tax Rate.
2. CAW: Capital Apportionment Weight.
3. CIT: Corporate Income Tax Rate.
4. I/K: Investment/Capital Ratio.
5. ITC: Investment Tax Credit Rate.
6. PREFERENCES: Voter Preferences.
7. POPULATION: Population.
8. TD: Tax Depreciation.
9. TWC: Tax wedge on capital.
10. $\omega_{i,j}$: Spatial Lag Weights.

The series are for the 48 contiguous states (indexed by subscript s) for the period 1963 to 2006 (indexed by subscript *t*), unless otherwise noted.[27] Each of the above series is described in a separate section. The general organizing principle for each section is to first define each of the series mentioned above and then discuss its components. For each component, general issues concerning the construction of the series (if pertinent) and then data sources are discussed. Section 11 contains a Legend with abbreviations and sources.

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[26] In describing the raw data, we have taken some of the text in this data appendix directly from government publications.

[27] The most notable exception is that the Annual Survey of Manufacturers was not conducted from 1979 to 1981.

1. ACT: Average Corporate Tax Rate

The average corporate tax rate is measured as follows,

$$ACT_{i,t} = REV_{i,t}^{CIT} \Big/ GOS_{i,t} ,$$

where $GOS_{i,t}$ is state private gross operating surplus and $REV_{i,t}^{CIT}$ is state government revenues from the corporate income tax.

Gross operating surplus data come from REA, and state tax revenues data comes from STC.

2. CAW: Capital Apportionment Weight

The capital apportionment weight (CAW) is the weight that the state assigns to capital (property) in its formula apportioning income among the multiple states in which firms generate taxable income. The apportionment formula is always a weighted average of the company's sales, payroll, and property (with zero weights allowed). However, the weights vary by state. In practice, the payroll and property weights are always equal, at least for the states and years in our sample, so that knowing one of the three weights for a state reveals the other two.

We construct data from 1963 – 2006 on the factor apportionment weights for each of the 48 contiguous states. We use a number of different sources. OMER provides information on the year in which each state first deviated from the traditional three-factor, equal weighting formula. Kelly Edmiston kindly provided data on apportionment weights for years 1997 and 2001 used in CESW. John Deskins kindly provided data panel data for 1985-2003 used in BDF. Lastly, we were able to obtain weights for various years from STH.

3. CIT: Corporate Income Tax Rate

The effective corporate income tax rate at the state level ($\tau_{i,t}^{E,S}$) is lower than the legislated (or statutory) corporate income tax rate ($\tau_{t}^{L,S}$) due to the deductibility (in some states) against state taxable income of taxes paid to the federal government.[28] Some states allow full deductibility of federal corporate income taxes from state taxable income; Iowa and Missouri allow only 50% deductibility; and some states allow no deductibility at all. The deductibility provision in state tax codes is represented by $\upsilon_{i,t} = \{1.0, 0.5, 0.0\}$, and the provisional effective corporate income tax rate at the state level ($\tau_{i,t}^{\#,E,S}$) is as follows,

$$\tau_{i,t}^{\#,E,S} = \tau_{t}^{L,S}\left(1 - \upsilon_{i,t}\tau_{i,t}^{\#,E,F}\right).$$

The effect of federal income tax deducibility is represented by the provisional *effective* corporate income tax rate at the federal level ($\tau_{i,t}^{\#,E,F}$, defined below).

The $\tau_{i,t}^{L,S}$ and $\upsilon_{i,t}$ series are obtained from several sources. For recent years, data are obtained primarily from various issues of BOTS and STH, as well as actual state tax forms. Data for earlier years are obtained from various issues of BOTS and SFFF. Additional information has been provided by TAXFDN. Many states have multiple legislated tax rates that increase stepwise with taxable income; we measure $\tau_{i,t}^{L,S}$ with the marginal legislated tax rate for the highest income bracket.

The effective corporate income tax rate at the federal level is lower than the legislated corporate income tax rate ($\tau_{t}^{L,F}$) due to the deductibility against federal taxable income of taxes paid to the state. The provisional effective corporate income tax rate at the federal level is as follows,

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[28] In "corporate income" taxes we also include Texas' "franchise" tax, which has a very similar tax base as the traditional corporate income tax base.

$$\tau_{i,t}^{\#,E,F} = \tau_t^{L,F}\left(1-\tau_{i,t}^{\#,E,S}\right)$$

The effect of state income tax deducibility is represented by the *effective* corporate income tax rate at the state level. The $\tau_t^{L,F}$ series is obtained from GRAVELLE, Table 2.1. Our database presents $\tau_t^{L,F}$ in percentage points.

It has not generally been recognized that, owing to deductibility of taxes paid to another level of government, the effective corporate income tax rates at the state and federal levels are functionally related to each other. As shown in the above equations, these interrelationships yield two equations in two unknowns, and thus can be solved for the effective corporate income tax rates at the state and federal levels, respectively, as follows,

$$\tau_{i,t}^{E,S} = \tau_{i,t}^{L,S}\left[1-\upsilon_{i,t}\tau_t^{L,F}\right]\Big/\left[1-\upsilon_{i,t}\tau_{i,t}^{L,S}\tau_t^{L,F}\right],$$

$$\tau_{i,t}^{E,F} = \tau_t^{L,F}\left[1-\tau_{i,t}^{L,S}\right]\Big/\left[1-\upsilon_{i,t}\tau_{i,t}^{L,S}\tau_t^{L,F}\right].$$

The overall corporate income tax rate is the sum of $\tau_{i,t}^{E,S}$ and $\tau_{i,t}^{E,F}$. In the limiting case where federal corporate income taxes are not deductible against state taxable income ($\upsilon_{i,t} = 0$), this sum reduces to the more frequently used formula, $\tau_{i,t}^{L,S} + \left(1-\tau_{i,t}^{L,S}\right)\tau_t^{L,F}$.

4. I/K: Investment/Capital Ratio

As a measure of investment demand, as well as overall economic activity in a state, we use the state's investment-capital ratio. We extend data on this ratio used in Chirinko and Wilson (2008), which cover 1963 – 2004, through 2006. The primary raw source data is the Annual Survey of Manufacturers (ASM) conducted by the U.S. Census Bureau. State-level totals (which the Census Bureau refers to as "AS-3" data) are reported in the yearly volumes of the ASM publication. From 1994 onward, these data also can be found in the yearly ASM

Geographic Area Statistics (ASM-GAS) publications. Hereafter, we will refer to the ASM data on state-level totals for all years as the ASM-GAS data. The ASM data are collected from a large, representative sample of manufacturing establishments with one or more paid employees. The ASM manufacturing sector corresponds to NAICS sectors 31 to 33.

4.1 The Capital Stock -- $K_{i,t}$

The $K_{i,t}$ series is measured by the real (constant-cost) replacement value of equipment (excluding software) and structures, and this series is constructed from the following perpetual inventory formula,

$$K_{i,t} = K_{i,1981}(1-\delta_{mfg,t})^{t-1981} + I_{i,t} \qquad t = 1982,\dots,T ,$$

where $K_{i,1981}$ is the initial (1981) value of the real capital stock, $\delta_{mfg,t}$ is the geometric rate of economic depreciation (hence $(1-\delta_{mfg,t})$ is the survival rate), and $I_{i,t}$ is real total capital expenditure. The capital stock is dated end-of-period (EOP). Each component determining the capital stock is discussed in the following subsections.

4.2 The Initial Value Of The Capital Stock -- $K_{i,1981}$

The $K_{i,1981}$ series is measured by the book value of the capital stock adjusted for inflation,

$$K_{i,1981} = K^{BV}_{i,1981} * \left(K^{CoC}_{mfg,1981} / K^{HC}_{mfg,1981}\right),$$

where $K^{BV}_{i,1981}$ is the book value (historical-cost) of the capital stock for state *i*, $K^{CoC}_{mfg,1981}$ is the constant-cost value of the capital stock for the manufacturing sector, and $K^{HC}_{mfg,1981}$ is the historical-cost value of the capital stock for the manufacturing sector. All capital stock series are end-of-period. Inflation drives a wedge between book value capital stocks (based on the original purchase cost of investment) and real capital stocks useful in economic analyses. The $\left(K^{CoC}_{mfg,1981} / K^{HC}_{mfg,1981}\right)$ ratio provides an approximate adjustment for the inflation wedge based on national manufacturing industry data.

The $K^{BV}_{i,1981}$ series is obtained from ASM. The $K^{CoC}_{mfg,\tau}$ series is the product of a quantity index and a base year value that converts the index into a real stock,

$$K^{CoC}_{mfg,1981} = INDEXK^{CoC}_{mfg,1981} * K^{CuC}_{mfg,2000},$$

where $INDEXK^{CoC}_{mfg,1981}$ is the 1981 value of the chain-type quantity index for the real capital stock and $K^{CuC}_{mfg,2000}$ is the base year (2000) value for the current-cost value of the capital stock for the manufacturing sector. The $INDEXK^{CoC}_{mfg,1981}$ is obtained from FIXED, Table 4.2, line 7, and this series is divided by 100. The $K^{CuC}_{mfg,2000}$ datapoint is obtained from FIXED, Table 4.1, line 7. The $K^{HC}_{mfg,1981}$ series is obtained from FIXED, Table 4.3, line 7.

4.3. The Rate Of Economic Depreciation – $\delta_{mfg,t}$

The $\delta_{mfg,t}$ series is measured by the flow of annual depreciation divided by the capital stock existing at the beginning of the year,

$$\delta_{mfg,t} = \frac{D^{CuC}_{mfg,t}}{K^{CuC}_{mfg,t-1}},$$

where $D^{CuC}_{mfg,t}$ is the current-cost flow of depreciation in manufacturing industries and $K^{CuC}_{mfg,t-1}$ is the current-cost capital stock in manufacturing industries. The $D^{CuC}_{mfg,t}$ series is obtained from FIXED, Table 4.4, line 7. The $K^{CuC}_{mfg,t-1}$ series is obtained from FIXED, Table 4.1, line 7. See FRAUMENI for an excellent introduction to the theoretical and empirical literature on economic depreciation and JORGENSON-2 for an analysis showing that, even if capital depreciates according to a non-geometric pattern, long-run replacement requirements tend to a geometric pattern.

4.4. Real Total Capital Expenditure – $I_{i,t}$

The $I_{i,t}$ series is defined as nominal capital expenditures deflated by a price index,

$$I_{i,t} = \frac{I\$_{i,t}}{P^{I}_{mfg,t}},$$

$$I\$_{i,t} = I\$^{NEW}_{i,t} + I\$^{USED}_{i,t},$$

where $I\$_{i,t}$, $I\$^{NEW}_{i,t}$, and $I\$^{USED}_{i,t}$ are total, new, and used nominal capital expenditures, respectively, and $P^{I}_{mfg,t}$ is the price deflator for investment for the manufacturing sector. The $I\$_{i,t}$ and $P^{I}_{mfg,t}$ series are discussed in the following subsections.

4.4.1. Total Nominal Capital Expenditure – $I\$_{i,t}$

The $I\$_{i,t}$ series represents nominal expenditures on equipment (excluding software) and structures. The series is obtained directly from ASM-GAS (e.g, in 2004, the data are published in Table 2, column I).[29]

4.4.2. Price Deflator For Investment – $P^{I}_{mfg,t}$

The price deflator for investment is constructed as an implicit deflator,

$$P^{I}_{mfg,t} = \frac{I\$_{mfg,t}}{I_{mfg,t}},$$

where $I\$_{mfg,t}$ and $I_{mfg,t}$ are nominal and real total capital expenditures, respectively, for the

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[29] We uncovered an obvious data error in the ASM regarding nominal capital expenditures in 1996 for Ohio and the sum-of-states national total. Ohio published value was over 400% of Ohio's typical levels and the resulting national total was inconsistent with the national total published in the alternative ASM publication, ASM-SIGI. We filled in the 1996 Ohio data point by simply taking national manufacturing capital expenditures from the alternative ASM publication, ASM-SIGI, and subtracting the sum of capital expenditures from all other states.

manufacturing sector.

The $I_{mfg,t}$ series is the product of a quantity index and a base year value that converts the index into real investment expenditures,

$$I_{mfg,t} = INDEXI_{mfg,t} * I\$_{mfg,t=2000},$$

where $INDEXI_{mfg,t}$ is the chain-type quantity index for real investment expenditures and $I\$_{mfg,t=2000}$ the base year value for current investment expenditures. The $INDEXI_{mfg,t}$ is obtained from FIXED, Table 4.8, line 7, and this series is divided by 100.

5. ITC: Investment tax credit rate

The state investment tax credit is a credit against state corporate income tax liabilities. In general, the effective amount of the investment tax credit is simply the legislated investment tax credit rate ($ITC_{i,t}^{L,S}$) multiplied by the value of capital expenditures put into place within the state in a tax year. The effective rate is lower than the legislated rate in a handful of states for two reasons. First, five states (Connecticut, Idaho, Maine, North Carolina, and Ohio) permit the state investment tax credit to be applied only to equipment. Since equipment investment is approximately 85% of ASM total national investment, we multiply $ITC_{i,t}^{L,S}$ by 0.85 for these five states. Second, states generally require basis adjustments deducting the amount of the credit from the asset basis for depreciation purposes; this adjustment is considered in the subsection on the Present Value of Tax Depreciation Allowances.

We extend the 1963-2004 state panel data on $ITC_{i,t}^{L,S}$ from Chirinko and Wilson (2008) through 2006. The original and extended data are obtained directly from states' online corporate tax forms and instructions. For most states with an investment tax credit, both current and historical credit rates are provided in the current year instructions (since companies applying for a credit based on some past year's investment apply that year's credit rate rather than the current rate). In those few cases where some or all historical rates were missing from the online forms and instructions, the missing rates are obtained via direct communication with the state's department of taxation. In some states, the legislated investment tax credit rate varies by the level of capital expenditures; we use the legislated credit rate for the highest tier of capital expenditures.

6. PREFERENCES: Voter Preferences

Voter preferences are measured by political outcomes. Specifically, we measure the following two political outcomes as indicator variables:

(a) the governor is Republican (R). (The complementary class of politicians is Democrat (D) or Independent (I). An informal examination of the political landscape suggests that Independents tend to be more closely aligned with the Democratic Party. We thus treat D or I politicians as belonging to the same class, DI);

(b) the majority of both houses of the legislature are R;

The PREFERENCES variable takes on one of three values:

0 if the governor and the majority of both houses of the legislature are not R;

1/2 if the governor is R but the majority of both houses of the legislature are not R or if the governor is not R but the majority of both houses of the legislature are R;

1 if the governor and the majority of both houses of the legislature are R.

Data for these political variables come from the Statistical Abstract of the United States (U.S. Census Bureau (Various Years)).

7. POPULATION: Population

Population data are obtained from CENSUS.

8. TD: Tax Depreciation

Tax depreciation allowances accrue over the useful life of the asset. We have assumed that the present value of tax depreciation allowances, $TD_{i,t}$, is 0.70 for all s and t. We assume a slightly lower value than the average across asset types and years reported in GRAVELLE to adjust for the basis reduction by the amount of investment tax credits taken.

9. TWC: Tax Wedge on Capital

The price of capital (tax-adjusted) is defined as the product of three objects reflecting the purchase price of the capital good, the opportunity costs of holding depreciating capital, and taxes. This latter term comprises tax credits, tax deductions, and the tax rate on income, and we refer to these tax terms (less 1.0) as the tax wedge on capital,

$$TWC_{i,t} = \frac{1.0 - ITC_{i,t} - CIT_{i,t} * TD}{1 - CIT_{i,t}} - 1.0 \ .$$

In this paper, we define $TWC_{i,t}$ only in terms of state tax variables.

Note that the user cost of capital, which was introduced by JORGENSON-1 in 1963 and extended by, among others, HALL-JORGENSON, GRAVELLE, JORGENSON-YUN, and KING-FULLERTON, equals the price of capital divided by the price of output.

10. $\omega_{i,j}$: Spatial Lag Weights

The spatial lag weights are measured by the distance between state population centroids (data are from CENSUS) and by commodity trade flows (data are from TRANSPORT).

11. Legend

ASM: CENSUS, *Annual Survey of Manufactures, Complete Volume* (Various Years).

ASM-GAS: CENSUS, *Annual Survey of Manufacturers, Geographic AreaStatistics* (Various Years). Publications for the years 1994 to 2004 (except 1997 and 2002) are available online. These data are published on an establishment basis. The data are obtained from electronic or paper documents depending on the time period: 2004 (Census website); 2003 to 1972 (CD's purchased from Census); 1971 to 1963 (paper copies). URL: http://www.census.gov/mcd/asm-as3.html.

ASM-SIGI: CENSUS, *Annual Survey of Manufacturers, Statistics for Industry Groups and Industries* (1996). URL: http://www.census.gov/mcd/asm-as1.html.

BDF: Bruce, Donald, Deskins, John, and Fox, William F., "On The Extent, Growth, and Efficiency Consequences of State Business Tax Planning," mimeo, University of Tennessee, 2005.

BOTS: The Council of State Governments, *The Book of the States* (The Council of State Governments : Lexington, Kentucky, Various Issues).

CBP: CENSUS, *County Business Patterns.* URL: http://www.census.gov/epcd/cbp/download/cbpdownload.html.

CENSUS: Bureau of the Census, U.S. Department of Commerce. URL: http://www.census.gov.

CESW: Cornia, Gary; Edmiston, Kelly; Sjoquist, David L.; and Wallace, Sally, "The Disappearing State Corporate Income Tax," *National Tax Journal* 58 (March 2005), 115-138.

FIXED: BEA, *Standard Fixed Asset Tables.* URL: http://www.bea.gov/bea/dn/FA2004/SelectTable.asp.

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JORGENSON-2: Jorgenson, Dale W., "The Economic Theory of Replacement and Depreciation," in Willi Sellakaerts (ed.), *Econometrics and Economic Theory: Essays in Honour of Jan Tinbergen* (London: MacMillan, 1974), 189-222.

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KING-FULLERTON: King, Mervyn A., and Fullerton, Don (eds.), *The Taxation of Income from Capital* (Chicago: University of Chicago Press (for the NBER), 1984).

OMER: Omer, Thomas C., and Shelley, Marjorie K., "Competitive, Political, and

Economic Factors Influencing State Tax Policy Changes," *Journal of the American Tax Association*, 26 (2004), 103-126.

REA: Bureau of Economic Analysis, *Regional Economic Accounts* URL: http://www.bea.gov/regional.

SFFF: American Council on Intergovernmental Affairs, *Significant Features of Fiscal Federalism* (Washington, DC: American Council on Intergovernmental Affairs, Various Issues). URL (e.g., 1987): http://www.library.unt.edu/gpo/ACIR/SFFF/SFFF-1988-Vol-1.pdf.

STC CENSUS, State Government Tax Collections report, various years. URL: http://www.census.gov/govs/www/statetax.html.

STH: Commerce Clearing House, *State Tax Handbook* (Chicago: Commerce Clearing House, Various Issues).

TAXFDN: Tax Foundation web site. URL: http://www.taxfoundation.org.

TRANSPORT: The U.S. Bureau of Transportation Statistics, *1997 Survey of Commodity Flows*.

***** NOT FOR PUBLICATION *****

Appendix B: Analytic Details – Properties Of The Capital Mobility Function And The Existence Of An Equilibrium Tax Rate, τ^*

This appendix provides some analytic details concerning the properties of the capital mobility function (equation (2)) and the existence of an equilibrium tax rate, τ^*.

A. Properties of the Capital Mobility Function

The capital mobility function used in this paper (equation (2)) allows for the possibility that, owing to a variety of frictions, the net-of-tax returns on capital may differ across jurisdictions. This sub-section demonstrates that the capital mobility function is consistent with the standard constraint on net-of-tax return equalization across jurisdictions. Equation (2) is reproduced here as follows,

$$K = K[\tau, \tau^f : x_k, x_k^f], \qquad \text{(B-1)}$$
$$K_\tau[.] = -K_{\tau^f}[.] < 0 .$$

The relation between the net-of tax returns in the home and foreign jurisdictions is as follows,

$$(1-\tau)\ F'[K]\ (1+\Delta) = (1-\tau^f)\ \Im'[K^f], \qquad \text{(B-2)}$$
$$\Delta > -1 ,$$

where Δ is a wedge that represents a variety of frictions that prevent equalization of net-of-tax returns across jurisdictions, $\Im'[K^f]$ is the production function for the foreign jurisdiction, and the production functions for both jurisdictions are subject to the Inada conditions (which guarantee that equation (B-2) will hold for some capital allocation). We assume that there is a fixed amount of capital ($\bar{K}$) that is allocated between the home and foreign jurisdictions,

$$\bar{K} = K + K^f . \qquad \text{(B-3)}$$

Substituting equation (B-3) into (B-2), differentiating the resulting expression by K, τ, and τ^f, and rearranging, we obtain the following derivatives,

$$K_\tau[.] \equiv \frac{dK}{d\tau} = \frac{F'[.]\,(1+\Delta)}{(1-\tau)\,F''[.]\,(1+\Delta) + (1-\tau^f)\,\Im''[.]} < 0\,, \tag{B-4a}$$

$$K_{\tau^f}[.] \equiv \frac{dK}{d\tau^f} = \frac{-\Im'[.]}{(1-\tau)\,F''[.]\,(1+\Delta) + (1-\tau^f)\,\Im''[.]} > 0\,, \tag{B-4b}$$

where we have assumed that the production functions exhibit diminishing marginal products ($F''[.] < 0, \Im''[.] < 0$).

B. The Existence Of An Equilibrium Tax Rate, τ^*

We analyze a symmetric equilibrium between home and foreign jurisdictions. We begin with the three relations that summarize the content of the theoretical model presented in Section II.A,

$$y = F[K] = F\left[K[\tau,\tau^f : x_k, x_k^f]\right] = G[\tau,\tau^f : x_k, x_k^f]\,, \tag{B-5}$$

$$G_\tau[.] < 0,\ \ G_{\tau^f}[.] > 0.$$

$$c/g = \Pi/\tau - 1 \equiv H[\tau]\,, \tag{B-6}$$

$$\Pi \equiv \left((1-\pi^f)/\pi\right) > 1 \text{ (provided } \pi < 0.5)\,,$$

$$H_\tau[.] < 0\,.$$

$$c/g \equiv \zeta[y(1-\pi^f) : x_\zeta] = \xi\left(y(1-\pi^f)\right)^{\eta_{\zeta,y}}\,, \tag{B-7}$$

$$\xi \equiv \xi_c\theta_c / \xi_g\theta_g\,,$$

$$\eta_{\zeta,y} \equiv \theta_c - \theta_g \ >=< 0.$$

where equation (B-5) is equation (3) representing the production function and the mobile capital stock, equation (B-6) is equation (7) representing the aggregate and government budget constraints, and equation (B-7) is equation (9) representing optimizing choices of private and public goods.

Under the symmetry assumption, no capital flows between jurisdictions (cf. equation (B-2) under symmetry and with $\Delta = 0$). Thus, equation (B-5) implies that the level of output in each country is constant, $y = \overline{y}$. Substituting this constant into equation (B-7) and eliminating c/g with equation (B-6), we obtain the following solution for the equilibrium tax rate, τ^*

$$\begin{aligned} &\Pi / \tau^* - 1 \;=\; \xi \left(\overline{y}(1-\pi^f)\right)^{\eta_{\zeta,y}}, \\ &\rightarrow \\ &\tau^* \;=\; \Pi \left(1+\xi \left(\overline{y}(1-\pi^f)\right)^{\eta_{\zeta,y}}\right)^{-1}. \end{aligned} \tag{B-8}$$

Appendix C: Notes on the Specification of Dynamic Models

This appendix provides the details supporting our discussion in Section V.B that (1) the standard lagged dependent variable (LDV) model is nested within a more general dynamic model that includes no LDV but an infinite number of time lags of the independent variables and (2) a restricted version of this latter model can be estimated by including *N* lags of the independent variables and the *N+1*[st] lag of the LDV.

An "expanded" specification of our preferred model includes lags of all independent variables and is written as follows,

$$\tau_t = \sum_{n=0}^{N} \left(x_{t-n} \beta_n \right) + \varepsilon_t \qquad \text{(C-1)}$$

where one of the variables in the x vector is the spatial lag of τ and *N* can go to infinity. (Note state subscripts have been omitted for expositional convenience.) Equation (C-1) is more general than our preferred specification (equations (17), (19), or (21)) because it contains additional lags. Equation (17) can be obtained from equation (C-1) by setting $\beta_n = 0$ for $n \geq 1$.

Now consider the lagged dependent variable (LDV) model:

$$\tau_t = \rho\tau_{t-1} + x_t\beta + \vartheta_t , \qquad \text{(C-2)}$$

where ϑ_t is an error term. The LDV can be eliminated by lagging this equation one period and substituting it into equation (C-2). The resulting equation contains the regressors x_t, x_{t-1}, and τ_{t-2}. The latter variable is eliminated by repeating the above procedure by lagging this transformed equation one period. If the procedure is repeated up to the *N+1*[st] period, we obtain the following equation,

$$\tau_t = \rho^{N+1}\tau_{t-N-1} + \sum_{n=0}^{N}\left(x_{t-n}\,\gamma_n\right) + \varepsilon_t\,, \tag{C-3a}$$

$$\gamma_n = \rho^n\,\beta\,, \tag{C-3b}$$

$$\varepsilon_t = \sum_{n=0}^{N}\rho^n\,\vartheta_{t-n}\,. \tag{C-3c}$$

The only important difference between our preferred model (equation (C-1)) and the LDV model (equation (C-3)) is the LDV term $\rho^{N+1}\,\tau_{t-N}$. (The less important differences involve redefining the coefficient vector on the x variables (equation (C-3b)) and the serial correlation in the error term (equation (C-3c).) The central point is that what we are omitting from our model is NOT last year's tax policy (τ_{t-1}), since the effects of this term are captured by the one-year lags of the x variables (and lagged error terms), but rather a term capturing the determinants of tax policy lagged more than *N* periods in the past. (The serial correlation in the error term does not pose any bias problems as long as the x variables are exogenous or instrumented.)

As *N* goes to infinity, ρ^{N+1} goes to zero, and the LDV term vanishes. It is in this sense that the LDV model is nested within a more general model with an infinite number of lags of x_{t-n}. In practice, the question of whether our omission of the LDV term from our estimating equation poses any problem depends on how far back lags of x_{t-n} could reasonably be expected to affect tax policy. The results presented in the paper for models without an LDV are based on a maximum lag of N=4. However, we also have estimated a model in which we set N=3 and then include the dependent variable lagged four periods (i.e., the term $\rho^{3+1}\tau_{t-3-1}$. These results are discussed briefly in Section V.B.

Table 1
Tax Policy (τ): Investment Tax Credit Rate ("New Capital")
Common Correlated Effects Pooled (CCE) IV Estimator and
Various Time Lags of Tax Competition Variable

	(A)	(B)	(C)	(D)	(E)
	Number of Time Lags of $\tau^{f}_{i,t}$:				
	0	1	2	3	4
A. Competitive States Tax Variable					
$\tau^{f}_{i,t}$	1.301 (0.059)	-1.309 (0.497)	-1.572 (0.502)	-1.473 (0.462)	-1.499 (0.469)
$\tau^{f}_{i,t-1}$	------	0.732 (0.474)	0.578 (0.551)	0.527 (0.507)	0.548 (0.515)
$\tau^{f}_{i,t-2}$	------	------	0.309 (0.189)	0.047 (0.266)	0.047 (0.269)
$\tau^{f}_{i,t-3}$	------	------	------	0.310 (0.261)	0.335 (0.376)
$\tau^{f}_{i,t-4}$	------	------	------	------	-0.028 (0.270)
α = Sum of Coefficients on the $\tau^{f}_{i,t}$'s	1.301 (0.059) [0.000]	-0.577 (0.146) [0.000]	-0.686 (0.159) [0.000]	-0.588 (0.170) [0.001]	-0.596 (0.175) [0.001]
B. Control Variables					
$PREFERENCES_{i,t-1}$	0.001 (0.001)	-0.002 (0.001)	-0.002 (0.001)	-0.002 (0.001)	-0.002 (0.001)
$IK_{i,t-1}$	0.005 (0.004)	-0.003 (0.004)	-0.003 (0.004)	-0.003 (0.004)	-0.003 (0.004)
$POPULATION_{i,t}$	-0.014 (0.002)	-0.014 (0.001)	-0.014 (0.001)	-0.014 (0.002)	-0.013 (0.002)
$IK^{f}_{i,t-1}$	0.006 (0.005)	-0.030 (0.011)	-0.038 (0.011)	-0.036 (0.011)	-0.037 (0.012)
$POPULATION^{f}_{i,t}$	0.019 (0.004)	-0.007 (0.007)	-0.012 (0.007)	-0.012 (0.007)	-0.014 (0.007)
Cross-Section Dependence	Yes	Yes	Yes	Yes	Yes
State Fixed Effects	Yes	Yes	Yes	Yes	Yes
C. Instrument Assessment					
p-value for test of overidentifying restrictions	0.644	0.820	0.872	0.855	0.801
Minimum eigenvalue statistic	18.902	15.008	16.884	17.491	16.393

Table Notes After Table 7

Table 2
Tax Policy (τ): Corporate Income Tax Rate ("Old and New Capital")
Common Correlated Effects Pooled (CCE) IV Estimator and
Various Time Lags of Tax Competition Variable

	(A)	(B)	(C)	(D)	(E)
	Number of Time Lags of $\tau^f_{i,t}$:				
	0	1	2	3	4
A. Competitive States Tax Variable					
$\tau^f_{i,t}$	0.512 (0.206)	0.378 (0.430)	0.569 (0.470)	0.575 (0.375)	0.693 (0.366)
$\tau^f_{i,t-1}$	------	-0.382 (0.431)	-0.836 (0.418)	-0.752 (0.389)	-0.843 (0.385)
$\tau^f_{i,t-2}$	------	------	0.130 (0.326)	0.392 (0.500)	0.415 (0.509)
$\tau^f_{i,t-3}$	------	------	------	-0.292 (0.293)	-0.022 (0.396)
$\tau^f_{i,t-4}$	------	------	------	------	-0.291 (0.192)
α = Sum of Coefficients on the $\tau^f_{i,t}$'s	0.512 (0.206) [0.013]	-0.004 (0.182) [0.981]	-0.138 (0.210) [0.513]	-0.077 (0.192) [0.690]	-0.048 (0.202) [0.813]
B. Control Variables					
$PREFERENCES_{i,t-1}$	-0.005 (0.001)	-0.002 (0.001)	-0.002 (0.001)	-0.002 (0.001)	-0.002 (0.001)
$IK_{i,t-1}$	-0.009 (0.009)	-0.001 (0.005)	-0.001 (0.005)	-0.001 (0.005)	-0.001 (0.005)
$POPULATION_{i,t}$	-0.007 (0.003)	-0.020 (0.003)	-0.018 (0.003)	-0.018 (0.003)	-0.018 (0.003)
$IK^f_{i,t-1}$	-0.135 (0.023)	0.014 (0.012)	0.011 (0.014)	0.011 (0.012)	0.015 (0.013)
$POPULATION^f_{i,t}$	-0.055 (0.007)	-0.031 (0.009)	-0.040 (0.010)	-0.033 (0.009)	-0.035 (0.009)
Cross-Section Dependence	Yes	Yes	Yes	Yes	Yes
State Fixed Effects	Yes	Yes	Yes	Yes	Yes
C. Instrument Assessment					
p-value for test of overidentifying restrictions	0.292	0.325	0.288	0.304	0.206
Minimum eigenvalue statistic	117.913	39.974	37.007	39.647	34.999

Table Notes After Table 7

Table 3
Estimated Slope of Reaction Function For Each Tax Policy
(α = Sum of Coefficients on the $\tau^{f}_{i,t}$'s)
Various IV Estimators and Time Lags of Tax Competition Variable

	(A)	(B)	(C)	(D)	(E)
	Number of Time Lags of $\tau^{f}_{i,t}$:				
	0	1	2	3	4
A. Investment Tax Credit Rate "New Capital"					
Common Correlated Effects Pooled (CCE)	1.301	-0.577	-0.686	-0.588	-0.596
	(0.059)	(0.146)	(0.159)	(0.170)	(0.175)
	[0.000]	[0.000]	[0.000]	[0.001]	[0.001]
Two-way Fixed Effects (TFE)	7.534	-1.425	-1.512	-1.584	-1.749
	(2.770)	(0.312)	(0.370)	(0.375)	(0.436)
	[0.007]	[0.000]	[0.000]	[0.000]	[0.000]
One-way (state) fixed effects (NTFE)	1.670	0.308	0.297	0.285	0.272
	(0.180)	(0.115)	(0.120)	(0.128)	(0.139)
	[0.000]	[0.007]	[0.013]	[0.026]	[0.050]
B. Corporate Income Tax Rate "Old and New Capital"					
Common Correlated Effects Pooled (CCE)	0.512	-0.004	-0.138	-0.077	-0.048
	(0.206)	(0.182)	(0.210)	(0.192)	(0.202)
	[0.013]	[0.981]	[0.513]	[0.690]	[0.813]
Two-way Fixed Effects (TFE)	1.418	0.760	0.778	0.781	0.817
	(0.173)	(0.809)	(0.832)	(0.817)	(0.818)
	[0.000]	[0.347]	[0.350]	[0.339]	[0.318]
One-way (state) fixed effects (NTFE)	1.030	0.767	0.689	0.646	0.566
	(0.133)	(0.163)	(0.165)	(0.170)	(0.177)
	[0.000]	[0.000]	[0.000]	[0.000]	[0.001]

Table Notes After Table 7

Table 4
Estimated Slope of Reaction Function For Each Tax Policy
(α = Sum of Coefficients on the $\tau^{f}_{i,t}$'s)
Two CCE IV Estimators and Various Time Lags of Tax Competition Variable

	(A)	(B)	(C)	(D)	(E)
	Number of Time Lags of $\tau^{f}_{i,t}$:				
	0	1	2	3	4
A. Investment Tax Credit Rate "New Capital"					
CCE-Unrestricted/Inefficient	0.493	-0.916	-0.834	-0.614	-0.428
	(0.812)	(0.320)	(0.361)	(0.353)	(0.397)
	[0.543]	[0.004]	[0.021]	[0.082]	[0.281]
CCE-Restricted/Efficient	1.301	-0.577	-0.686	-0.588	-0.596
	(0.059)	(0.146)	(0.159)	(0.170)	(0.175)
	[0.000]	[0.000]	[0.000]	[0.001]	[0.001]
B. Corporate Income Tax Rate "Old and New Capital"					
CCE-Unrestricted/Inefficient	0.951	-0.202	-0.142	-0.007	-0.090
	(0.338)	(0.324)	(0.387)	(0.404)	(0.410)
	[0.005]	[0.533]	[0.714]	[0.987]	[0.827]
CCE-Restricted/Efficient	0.512	-0.004	-0.138	-0.077	-0.048
	(0.206)	(0.182)	(0.210)	(0.192)	(0.202)
	[0.013]	[0.981]	[0.513]	[0.690]	[0.813]

Table Notes After Table 7

Table 5:
Estimated Slope of Reaction Function For Each Tax Policy
(α = Sum of Coefficients on the $\tau^{f}_{i,t}$'s)

Various IV Estimators and Time Lags of All Regressors

	(A)	(B)	(C)	(D)	(E)
	Number of Time Lags for all regressors:				
	0	1	2	3	4
A. Investment Tax Credit Rate "New Capital"					
Common Correlated Effects Pooled (CCE)	1.301	-1.271	-2.774	-1.779	-3.255
	(0.059)	(0.144)	(0.326)	(0.157)	(0.457)
	[0.000]	[0.000]	[0.000]	[0.000]	[0.000]
Two-way Fixed Effects (TFE)	7.534	-1.173	-1.280	-1.282	-0.651
	(2.770)	(0.452)	(0.585)	(0.588)	(2.392)
	[0.007]	[0.009]	[0.029]	[0.029]	[0.786]
One-way (state) fixed effects	1.670	0.527	0.513	0.591	0.400
	(0.180)	(0.394)	(0.378)	(3.082)	(0.429)
	[0.000]	[0.181]	[0.175]	[0.848]	[0.351]
B. Corporate Income Tax Rate "Old and New Capital"					
Common Correlated Effects Pooled (CCE)	0.512	-0.118	-0.308	-0.134	-2.195
	(0.206)	(0.274)	(0.317)	(0.290)	(0.349)
	[0.013]	[0.668]	[0.331]	[0.644]	[0.000]
Two-way Fixed Effects (TFE)	1.418	1.207	0.749	0.384	0.275
	(0.172)	(0.988)	(0.879)	(0.830)	(0.457)
	[0.000]	[0.222]	[0.395]	[0.643]	[0.000]
One-way (state) fixed effects	1.030	0.686	0.489	0.484	0.322
	(0.133)	(0.200)	(0.192)	(0.301)	(0.419)
	[0.000]	[0.001]	[0.011]	[0.107]	[0.443]

Table Notes After Table 7

Table 6
Estimated Slope of Reaction Function For Each Tax Policy
(α = Sum of Coefficients on the $\tau^{f}_{i,t}$'s)
Various OLS Estimators and Time Lags of Tax Competition Variable

	(A)	(B)	(C)	(D)	(E)
	Number of Time Lags of $\tau^{f}_{i,t}$:				
	0	1	2	3	4
A. Investment Tax Credit Rate					
"New Capital"					
Common Correlated Effects Pooled (CCE)	-0.807	-0.722	-0.695	-0.742	-0.737
	(0.070)	(0.070)	(0.072)	(0.077)	(0.082)
	[0.000]	[0.000]	[0.000]	[0.000]	[0.000]
Two-way Fixed Effects (TFE)	-1.344	-1.367	-1.474	-1.584	-1.709
	(0.250)	(0.233)	(0.236)	(0.238)	(0.252)
	[0.000]	[0.000]	[0.000]	[0.000]	[0.000]
One-way (state) fixed effects	0.266	0.259	0.240	0.222	0.204
	(0.113)	(0.114)	(0.124)	(0.134)	(0.146)
	[0.019]	[0.024]	[0.053]	[0.099]	[0.162]
B. Corporate Income Tax Rate					
"Old and New Capital"					
Common Correlated Effects Pooled (CCE)	-0.630	-0.502	-0.362	-0.249	-0.238
	(0.185)	(0.144)	(0.139)	(0.142)	(0.147)
	[0.001]	[0.001]	[0.009]	[0.079]	[0.106]
Two-way Fixed Effects (TFE)	-1.647	-1.608	-1.584	-1.604	-1.578
	(0.579)	(0.593)	(0.603)	(0.600)	(0.597)
	[0.005]	[0.007]	[0.009]	[0.008]	[0.008]
One-way (state) fixed effects	0.433	0.392	0.330	0.277	0.267
	(0.111)	(0.124)	(0.156)	(0.174)	(0.175)
	[0.000]	[0.002]	[0.034]	[0.112]	[0.128]

Table Notes After Table 7

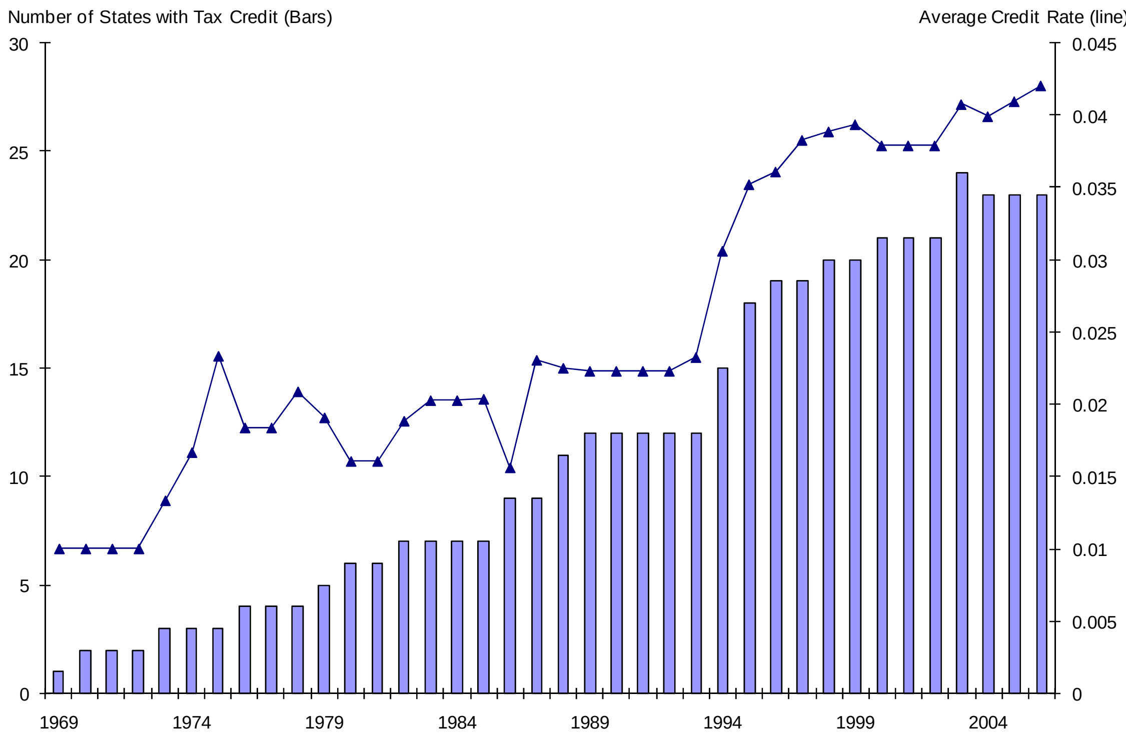
Table 7
Estimated Slope of Reaction Function For Alternative Tax Policy Measures
(α = Sum of Coefficients on the $\tau^{f}_{i,t}$'s)
Various IV Estimators and Time Lags of Tax Competition Variable

	Number of Time Lags of $\tau^{f}_{i,t}$:				
	0	1	2	3	4
A. Tax Wedge On Capital					
Common Correlated Effects Pooled (CCE)	1.062	-1.356	-1.352	-1.371	-1.430
	(0.064)	(0.156)	(0.160)	(0.164)	(0.161)
	[0.000]	[0.000]	[0.000]	[0.000]	[0.000]
Two-way Fixed Effects (TFE)	1.288	-1.274	-1.326	-1.448	-1.551
	(4.644)	(0.429)	(0.461)	(0.464)	(0.503)
	[0.782]	[0.003]	[0.004]	[0.002]	[0.002]
One-way (state) fixed effects	1.321	1.021	1.131	1.125	1.124
	(0.158)	(0.787)	(0.811)	(0.740)	(0.751)
	[0.000]	[0.195]	[0.163]	[0.129]	[0.135]
B. Average Corporate Tax Rate					
Common Correlated Effects Pooled (CCE)	1.103	-0.569	-0.440	2.267	2.287
	(0.039)	(0.196)	(0.243)	(0.144)	(0.122)
	[0.000]	[0.004]	[0.070]	[0.000]	[0.000]
Two-way Fixed Effects (TFE)	2.484	0.801	0.939	0.942	0.945
	(0.128)	(0.509)	(0.357)	(0.404)	(0.403)
	[0.000]	[0.116]	[0.009]	[0.020]	[0.019]
One-way (state) fixed effects	0.919	1.049	1.089	1.108	1.116
	(0.107)	(0.052)	(0.072)	(0.082)	(0.084)
	[0.000]	[0.000]	[0.000]	[0.000]	[0.000]
C. Capital Apportionment Weight					
Common Correlated Effects Pooled (CCE)	1.904	-2.045	-2.126	-2.209	-2.333
	(0.075)	(0.064)	(0.067)	(0.064)	(0.063)
	[0.000]	[0.000]	[0.000]	[0.000]	[0.000]
Two-way Fixed Effects (TFE)	2.089	-3.718	-3.825	-3.955	-4.131
	(1.239)	(0.250)	(0.263)	(0.294)	(0.282)
	[0.092]	[0.000]	[0.000]	[0.000]	[0.000]
One-way (state) fixed effects	0.942	0.297	0.317	0.337	0.359
	(0.209)	(0.077)	(0.077)	(0.074)	(0.071)
	[0.000]	[0.000]	[0.000]	[0.000]	[0.000]

Notes To The Tables:

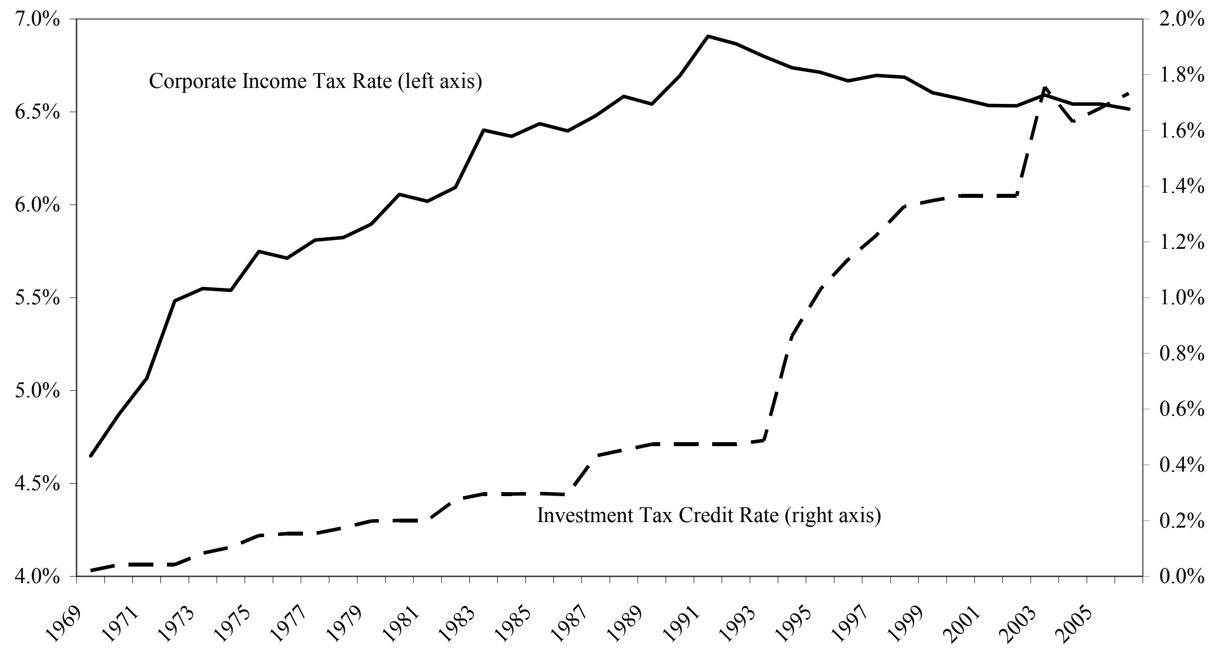
Instrumental variable (IV) estimates are based on equation (21) (except for the unrestricted/inefficient estimates in Table 4) and panel data for 48 states for the period 1965 to 2006. Given the maximum of four time lags, the effective sample is for the period 1969 to 2006. To enhance comparability across models, the 1969 to 2006 sample is used for all estimates. Some of the tables differ with respect to the tax variables appearing as dependent and independent variables. The foreign states tax variable ($\tau^{f}_{i,t-n}$, $n = 0,...,4$) is defined in equation (15) as the spatial lag of the home state tax variable, $\tau_{i,t}$. The competitive set of states is defined by all states other than state *i*, and the spatial lag weights are the inverse of the distance between the population centroids for state *i* and that of a foreign state, normalized to sum to unity. There are three control variables: $PREFERENCES_{i,t-1}$ captures the political preferences of the state. This variable is the average of three indicator variables, is lagged one period to avoid endogeneity issues, and ranges from 0.0 to 1.0. The three indicator variables are (a) the political party of the governor (1 if Republican; 0 otherwise), (b) the political party controlling both houses of the legislature (1 if Republican; 0 otherwise), and (c) an interaction between the indicator variables defined in (a) and (b). $IK_{i,t-1}$ is the investment to capital ratio, lagged one period to avoid endogeneity issues. $POPULATION_{i,t}$ is the state population as measured by the U.S. Census Bureau. The CCE estimator requires cross-section averages (CSA) of the dependent and independent variables as additional regressors; see Section III for details. To account for the endogeneity of $\tau^{f}_{i,t}$, we project this variable against a set of instruments (except for the OLS estimates in Table 6) whose selection is discussed in Section III.C. See Section IV and Appendix A for further details about definitions and data sources for the model variables. Instrument validity is assessed in terms of the Hansen J statistic based on the overidentifying restrictions. The null hypothesis of instrument validity is assessed in terms of the p-values presented in the table. A p-value greater than an arbitrary critical value (e.g., 0.10) implies that the null hypothesis is sustained and that the instruments are not invalid. Instrument relevance is assessed in terms of the minimum eigenvalue statistic (similar to a 1st-Stage F-statistic) assessing the joint significance of the excluded instruments from the projection of $\tau^{f}_{i,t}$ on the included (i.e., control variables) and excluded instruments. The α parameter measures the slope of the reaction function ($\tau_{i,t}$ vs. $\tau^{f}_{i,t-n}$, $n = 0,...,4$) and is the sum of the coefficients on the included $\tau^{f}_{i,t-n}$ variable(s). Standard errors for the CCE estimates are robust to heteroskedasticity and clustering by year.

**Figure 1. State Investment Tax Credit Rates
1969 To 2006**



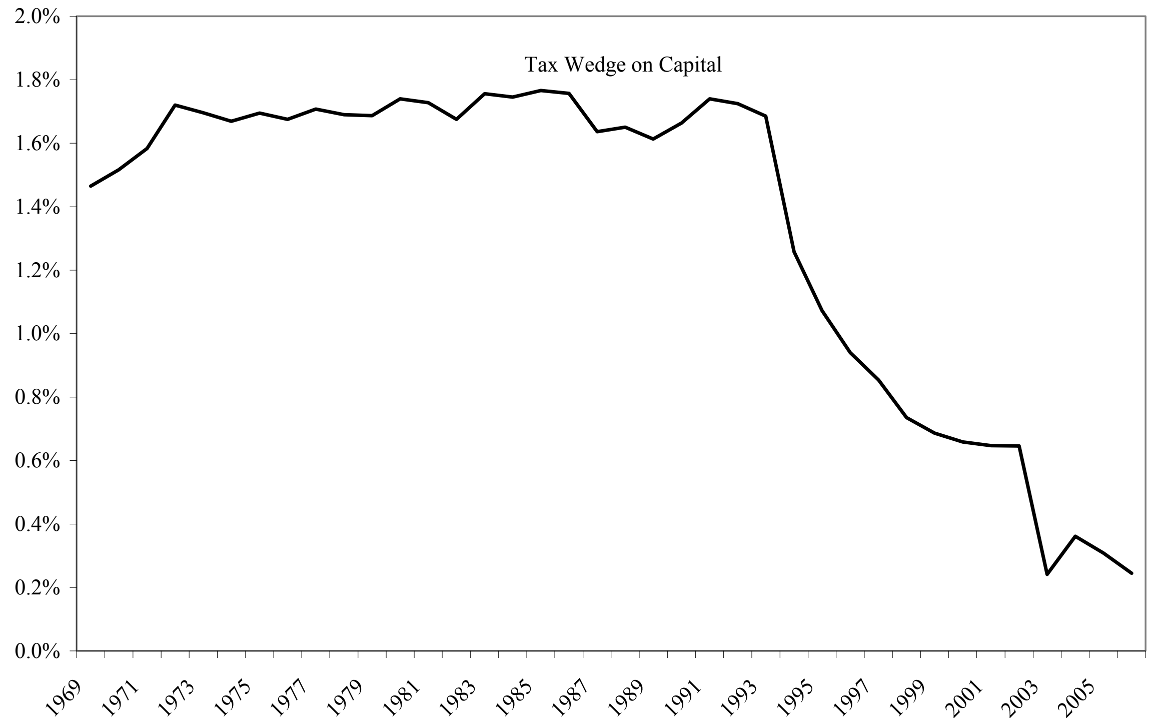
Notes to Figure 1: The number of states with an investment tax credit is indicated on the left vertical axis; the average credit rate (an unweighted average across only states with a credit) is indicated on the right vertical axis. The figure is drawn for all 50 states and excludes the District of Columbia. See Appendix B for details concerning the construction of the variables.

Figure 2. National Averages Of State Investment Tax Credit And Corporate Income Tax Rates 1969 To 2006



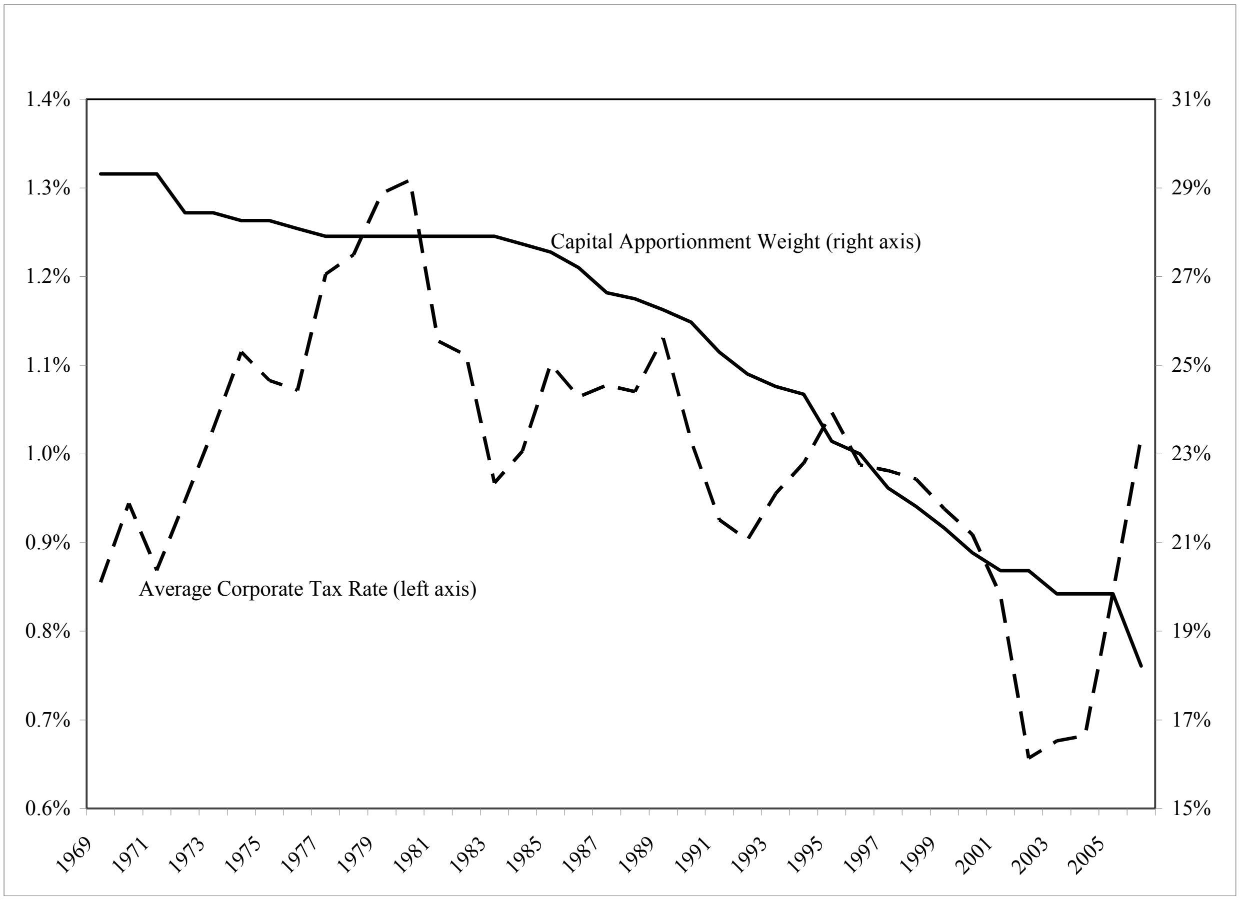
Notes to Figure 2: Averages are calculated over all 50 states (unweighted) and exclude the District of Columbia. Both rates are measured by the top marginal rate. See Appendix B for details concerning the construction of the variables.

Figure 3. National Average Of State Tax Wedge On Capital 1969 To 2006



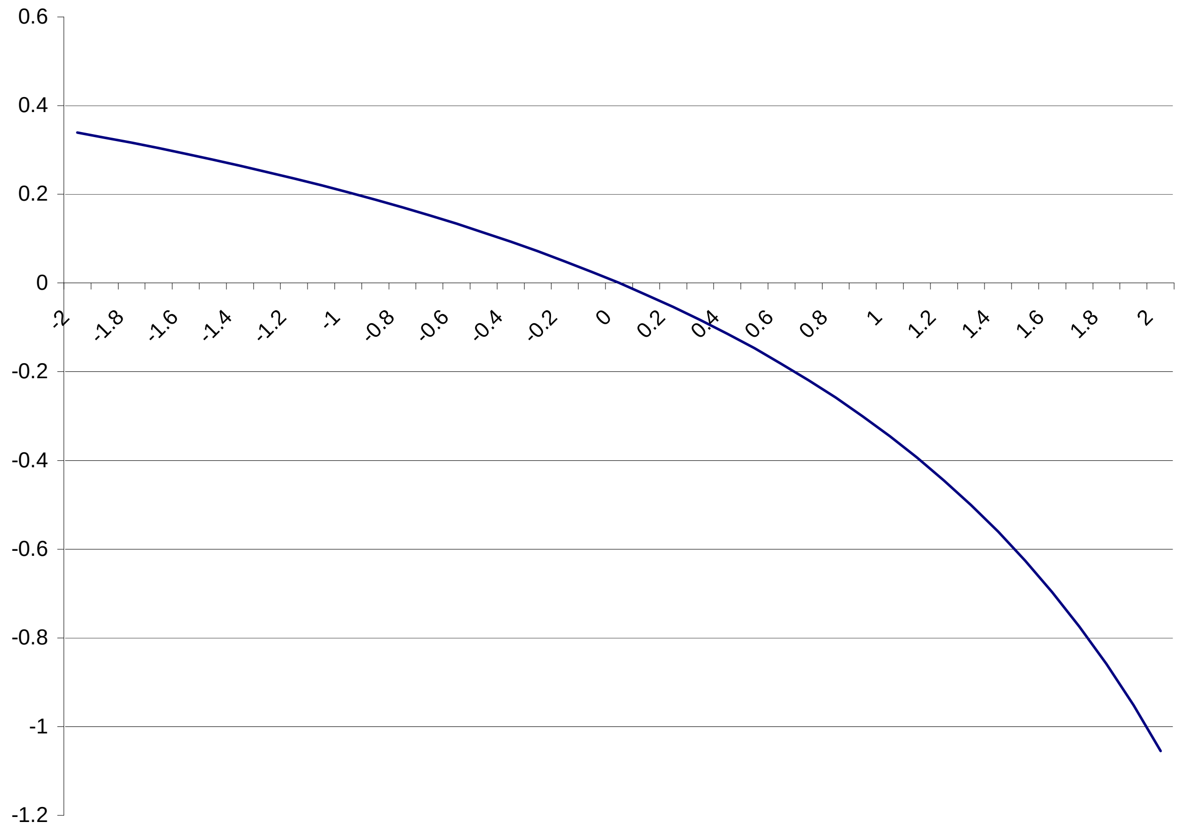
Notes to Figure 3: Averages are calculated over all 50 states (unweighted) and exclude the District of Columbia. See footnote 1 and Appendix B for details concerning the construction of the variable.

Figure 4. National Averages Of Capital Apportionment Weight And Average Corporate Tax Rate 1969 To 2006



Notes to Figure 4: Averages are calculated over all 50 states (unweighted) and exclude the District of Columbia. See Appendix B for details concerning the construction of the capital apportionment weight variable. The average corporate tax rate variable is the ratio of state tax revenues from corporate taxes, severance taxes, and license fees to total state business income, the latter measured by gross operating surplus.

Figure 5: Slope Of The Reaction Function



Notes to Figure 5: This figure plots the theoretical slope of the reaction function (equation (14)) on the vertical axis against values of $\eta_{\zeta,y}$ ranging from -2.00 to +2.00 in increments of 0.10 on the horizontal axis. These computations are based on the following assumptions: $\eta_{y,k} = 0.33$, $-\eta_{k,\tau} = 1.00$, and $\zeta = 3.5$ (the latter figure is the approximate ratio of consumption to total government spending (federal, state, and local) from the National Income and Product Accounts). Figure 5 is based on the assumption that $\pi^f = 0$. The shape of the figure is insensitive to variations in π^f and ζ.