Racing to the Bottom?

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Racing to the Bottom?

Provincial Interdependence in the Canadian Federation

Edited by Kathryn Harrison

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Racing to the Bottom?

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1
Provincial Interdependence: Concepts and Theories

Kathryn Harrison

The image of a "race to the bottom" in which jurisdictions compete for footloose capital by reducing taxes and environmental and labour standards has gained increasing attention in recent years. Race-to-the-bottom imagery is prevalent in debates about economic globalization, particularly as enhanced capital mobility has pitted industrialized countries with relatively high environmental and labour standards against developing countries with much weaker standards (Tonelson 2000). Fears of a race to the bottom also arise within federal systems, as capital movement is even less constrained within a federation than between countries. Moreover, mobility of individuals is also unconstrained. Thus, in addition to the spectre of tax and regulatory competition, many fear that provinces or states within federations will race to the bottom with respect to welfare benefits lest they become "welfare magnets" for migration from their less generous neighbours (Peterson and Rom 1990).

The focus of this volume is competition among provinces within the Canadian federation. Do Canadian provinces engage in the proverbial race to the bottom and, if so, with what consequences? The question of whether provinces are constrained in their ability to pursue independent policies is hardly new (Scott 1977). However, the prospect of races to the bottom has become increasingly salient in recent years in response to several factors. The election of tax- and benefit-cutting neoconservative governments in Alberta and Ontario in the early to mid-1990s threatened to trigger a spiral of matching cuts by other provinces. At the same time, federal cuts to transfer payments to the provinces and the federal government's corresponding relaxation of conditions attached to the remaining transfers also threatened to undermine what seemed to be an increasingly fragile equilibrium among the provinces. Social activists, scholars, and even some provincial governments thus raised the spectre of interprovincial races to the bottom in a number of policy debates in the 1990s: concerning the Alberta government's high-profile tax cuts (Lee 2000); concerning the shift from cost-shared federal transfers under the Canada Assistance Plan to block funding under the Canada Health and Social Transfer (CHST) (Canadian Council on Social Development 1996[1]); concerning constraints on federal spending power posed by the Social Union Framework Agreement (Council of Canadians 1999); concerning trucking standards (*Crash Communicator* 1997[2]); and concerning the Canada-Wide Accord on Environmental Harmonization (Canadian Institute for Environmental Law and Policy n.d.; see also Harrison 1998), which environmentalists and some scholars depicted as a federal withdrawal from responsibility for national environmental standards.

While there has been no shortage of either political rhetoric or academic theorizing about races to the bottom, empirical studies have been in shorter supply. With respect to competition within federations, the US federal system offers an exception, not least because the presence of fifty states facilitates statistical analysis of the interactions among them. The "devolution revolution" launched by Ronald Reagan also prompted academic analysis of interstate competition in the United States a decade earlier than in Canada. However, within Canada, we know relatively little about the degree to which provinces respond to each other's policy initiatives and, to the extent that they do, whether the outcome is in fact a race to the bottom.[3] The purpose of this volume is to take a first step in filling that gap. The authors apply insights from economics and political science to several Canadian policy fields: Kenneth McKenzie on corporate income taxes, Kathryn Harrison on tobacco excise taxes, Gerard Boychuk on social assistance, Nancy Olewiler on environmental regulation, David Green and Kathryn Harrison on minimum wages, and Douglas Brown on industrial incentives. Mark Rom complements the Canadian case studies with analysis of US interstate dynamics with respect to welfare, education, and medicare.

We will return to the authors' findings in the concluding chapter. The purpose of this chapter is to introduce theories and concepts employed in the case studies that follow. In particular, the chapter draws a critical distinction between two forms of provincial interdependence. In the familiar race-to-the-bottom (or -top) dynamic, provinces engage in policy competition in response to mobility of individuals, goods, or investments. However, provinces may also react to each other's policies in a very different way in response to the transfer of norms and information across provincial borders, a dynamic that has been variously referred to as emulation, learning, and "benchmarking."

While the race to the bottom represents a troubling constraint on provinces' autonomy, emulation can be viewed as enhancing democratic accountability. Yet the hallmarks of provincial interdependence – provinces reacting to each other's policies – will tend to be much the same in both cases. This chapter reviews literature concerning each of these concepts before turning to the normative implications and methodological considerations.

Mobility-Induced Competition: The Race to the Bottom

While it is reasonable to assume that politicians devise policies primarily in response to political support and opposition within their own jurisdictions, their ability to gain political credit and avoid blame from their own voters may depend on what other jurisdictions do. If so, policy makers will be influenced by policies of other jurisdictions in formulating their own policies. Individual jurisdictions are interdependent by virtue of the permeability of borders, especially within a federation. However, the form that interdependence takes will depend on who or what is crossing borders – people, capital, and goods on the one hand and ideas on the other. This section and the one that follows contrast intergovernmental competition prompted by mobility of voters, firms, and goods, which could plausibly prompt a race to the bottom, with interdependence predicated on the flow of ideas, which will take the form of emulation, learning, or benchmarking.

Competing Models of Intergovernmental Competition

There is a substantial theoretical literature in both economics and political science on intergovernmental competition "in which the free movement of goods, services, people, and capital constrains the actions of the independent governments in a federal system" (Advisory Commission on Intergovernmental Relations 1991). However, within that literature there are two quite distinct camps: those who see interjurisdictional competition for mobile actors as a destructive or inefficient force that reduces citizens' welfare (McGuire 1991; Organization for Economic Cooperation and Development, Committee on Fiscal Affairs 1998) and those who view such competition as a desirable force that enhances democratic accountability and economic efficiency (Weingast 1995). Different authors' normative assessments clearly turn on the weight that they assign to various societal objectives, among them equality within jurisdictions, equity across jurisdictions, and economic efficiency. However, even if one resists imposing one's own preferences in favour of a relative standard that governments should be responsive to the preferences *of their own voters,* theoretical models of intergovernmental competition still offer very different assessments.

There are many variants of the race-to-the-bottom or "beggar-thy-neighbour" narrative. The most common is one in which jurisdictions' competition to attract or retain footloose capital prompts a downward spiral in policies that would impose costs on those actors. As a result, *all* jurisdictions end up adopting lower corporate taxes, less progressive income taxes, weaker environmental and labour standards, and lower minimum wages than they would have chosen acting independently. A similar dynamic can be envisioned with respect to social assistance, though competition in this case is to avoid the costs associated with the arrival of some migrants rather than to attract the benefits that accompany others. Provinces' reluctance to induce "immigration" by welfare recipients from other jurisdictions may prompt a downward spiral in welfare benefits.

Not all harmful interjurisdictional competition promises escalation downward, however. For instance, the flip side of a race to the bottom in corporate taxes is a race to the top with respect to subsidies and other incentives to attract investment. Interprovincial "bidding wars" or complaints of "job poaching" are by no means unknown in the Canadian federation (Andrews 2005; *Globe and Mail* 1995; Gram 1996; Roberts 1995; Seguin 1997). Indeed, the meanings of the terms "down" and "up" in this context are far from obvious. For instance, a *downward* spiral in environmental standards entails jurisdictions *raising* their discharge limits or resource allocations for polluters. Similarly, as Rom notes in this volume, provinces may *reduce* eligibility for welfare benefits by *increasing* the number of weeks that a claimant must have been resident in the jurisdiction before qualifying. While necessarily arbitrary, the chapters in this volume follow convention in defining downward competition as that which leads to reduced government spending or regulatory effort – in other words, lower taxes, weaker environmental regulations, and lower minimum wages.

It follows from the foregoing that downward competition is not necessarily bad, nor is upward competition necessarily good (Swire 1996). Whether competition is good or bad depends (among other things) on whether the resulting policies are more or less consistent with voters' preferences in the jurisdiction in question. Alas, formal models that predict both outcomes exist in the economic literature.

The political rhetoric concerning races to the bottom has a long theoretical lineage in the fiscal federalism literature. Oates (1972) offered a model of interstate competition with respect to social assistance, in which all states were prevented from delivering the level of benefits that their residents would have wanted as a result of in-migration of welfare recipients and out-migration of wealthy taxpayers. Oates posited that "attempts to tax the relatively wealthy more heavily than the poor will fail to some degree because of the departure of those on whom the tax places the largest liability" (1972, 138). Similarly, Zodrow and Mieszkowski (1986) and Wilson (1986) provided early formal models of inefficient tax competition in which all states set tax rates below their voters' preferences lest they lose mobile taxpayers. Markusen, Morey, and Olewiler (1993, 1995) modelled competition between two jurisdictions seeking to attract a job-creating plant in which both ended up with lower environmental standards than they would have had in a single-jurisdiction universe. The same authors also demonstrated that a very different, but equally troubling, race-to-the-top dynamic can emerge if jurisdictions compete to avoid hosting an undesirable facility with concentrated costs, such as a hazardous waste treatment facility or nuclear power plant, by raising their environmental standards.[4]

In contrast, other authors offer models of healthy competition for mobile actors that enhances governments' responsiveness to their voters' policy preferences. Just as competition among firms in private markets increases *consumers'* welfare, they argue, so too competition among jurisdictions can enhance *voters'* welfare. Tiebout's (1956) seminal article demonstrated that, if citizens were completely mobile, individual jurisdictions would compete to offer packages of goods and services with the result that like-minded citizens would individually and collectively maximize their welfare by clustering in communities that offered packages of policies that best satisfied their preferences at the lowest level of taxation. While this model offered important theoretical insights, no one suggested that the assumptions on which it was predicated – including costless mobility and irrelevance of employment prospects (Tiebout's citizens were all assumed to live on dividend income) – could ever approximate the real world.

While such a high level of mobility of individuals is implausible given resource constraints and familial and social ties, Tiebout's successors developed models of efficient interjurisdictional competition predicated on the more plausible scenario of firm mobility and citizen immobility. It is ironic that, although Oates's (1972) pathbreaking book *Fiscal Federalism* was one of the earliest and most-often cited theoretical arguments for a race to the bottom with respect to welfare, Oates is also one of the most-often cited critics of the notion of an environmental race to the bottom. Oates and Schwab (1988) offer a model predicting that interstate competition will prompt each jurisdiction to set taxes at the economically efficient point at which the marginal costs to the polluter just equal the marginal environmental benefits to the community. However, like Tiebout's, Oates and Schwab's model also relies on some rather implausible assumptions. The authors assume (as does Tiebout) that there is an infinite number of jurisdictions that are thus "price takers" in the market for business investment. In effect, the authors have defined away the prospect for strategic behaviour among jurisdictions that is central to concerns about races to the bottom. A critical distinction between Oates's pessimistic theorizing on welfare competition and his more optimistic model of interstate competition with respect to the environment lies in a second assumption, that the residents of each state all work for the regulated industry.[5] Oates and Schwab themselves demonstrate that the outcome of intergovernmental competition is no longer guaranteed to be efficient if voters are instead heterogeneous, with some fraction of the electorate preferring jobs in the regulated industry and the rest preferring environmental protection.

Wilson's (1996) survey of the economic literature reports that competition again ceases to be so attractive as one introduces various other departures from an idealized model of intergovernmental competition.[6] For instance, models of tax competition typically generate efficient outcomes only if states employ "benefits taxes": that is, taxes that equal the value to the taxpayer of the goods and services provided by the state in exchange for tax revenue. Competition for business investment can thus be welfare enhancing if states impose corporate taxes just sufficient to cover public goods such as policing, fire protection, roads, and other infrastructure valued by investors. However, any effort by states to employ progressive ability-to-pay taxes or regulations designed to promote public goods on either firms or individuals will be hindered by interstate competition. Oates and Schwab (1991, 128) stress that interstate competition enhances public welfare only if "the federal government has fulfilled the redistributive function. Where this is not the case, the argument in favor of interjurisdictional competition is much less compelling." McGuire (1991) notes that in such a circumstance the greater mobility of wealthy as opposed to poor taxpayers will result in all states offering lower levels of public goods and services than desired by their voters, including the wealthy taxpayers. Again the models of healthy competition seem to have defined away the issues of central concern.

Models of healthy intergovernmental competition rest on a "laundry list" of demanding assumptions that are unlikely to be met in the Canadian or, for that matter, any other federation (Levinson 2003). On the other hand, models of inefficient competition that predict an inexorable race to the bottom also rely on highly stylized assumptions. Reality undoubtedly lies between these theoretical extremes. Firms are not infinitely mobile, nor are citizens completely immobile. Federations do not have an infinite number of jurisdictions, but neither do they have only two. Nonetheless, the theoretical literature on interstate competition suggests that some measure of inefficiency is quite plausible in the real world. The question is how significant interprovincial competition is and with what consequences.

The Politics of Races to the Bottom

Several propositions are suggested by theories of destructive interprovincial competition. First, and rather obviously, provinces can be vulnerable to interstate competition only to the extent that they have meaningful autonomy in a given policy field. Rom's chapter in this volume explores this factor by comparing US interstate dynamics in policy fields with and without constraining federal mandates. However, even when provinces have substantial discretion, the prospects of destructive policy competition, whether upward or downward, will depend on three factors: the credibility of an actor's threat of relocation, the impact of that actor's relocation, and the political opportunity costs of changing public policy to prevent the actor's relocation. Each of these will be considered in turn.

The credibility of the threat that an actor will relocate in response to provincial policy differences will depend on both the costs and the benefits of relocation to that actor. The benefits in turn will be a function of the magnitude of policy divergence (an issue examined in the tobacco tax chapter, where policy divergence increased over time) and the significance of that divergence for the actor in question. As Olewiler notes in this volume, the fact that pollution abatement costs typically represent only 1 to 5 percent of a firm's production costs (Nordström, Vaughan, and World Trade Organization 1999) means that the impact of even large differences in jurisdictions' environmental standards on firms' location choices can easily be dwarfed by other factors.

The costs of relocation, on the other hand, will depend on any legal impediments to relocation, distance, and the strength of an actor's ties to a particular community. The legality of relocation can be an issue, certainly with respect to individuals' mobility between countries, but also with respect to purchases of products at lower tax rates in other provinces within a federation. The stakes in moving can vary greatly. It is much easier to drive across a provincial border to purchase tax-free cigarettes (though the costs of doing so will of course depend on the distance that one must travel) than it is to relocate one's family to another province. In general, relocation will be less costly for capital than for individuals, who typically have familial and social ties to particular communities. However, firms are not equally footloose; those dependent on geographically unique natural resources will typically have less credibility with which to extract concessions from the state. Finally, even if the costs are low, one cannot move if one doesn't have the resources to do so. All else being equal, the poor will likely be less mobile than the wealthy (Osberg, Gordon, and Lin 1994).

The prospects of a race to the bottom also turn on the impact of any actor's leaving or arriving in a particular jurisdiction. Governments may look the other way when confronted with a few cross-border shoppers but take heed when tractor-trailers full of tax-free goods enter their jurisdictions. Closure of a small business may go unnoticed, but relocation of large or regionally significant important employers (e.g., those in single-industry towns) will not be taken lightly. Similarly, threats of relocation and opportunities to attract investment will carry greater weight during hard times than when the economy is booming.

Consideration of the opportunity cost of amending policy to preclude a relevant actor's mobility yields particularly important insights. It warrants emphasis that policy decisions are typically contested within jurisdictions, regardless of the influence of policies chosen by other jurisdictions. Even in an idealized "island state" there would still be pitched battles between those who pay for and those who receive welfare benefits, between those who place greater value on environmental protection and those who weigh heavily the potential loss of jobs, and between those who support higher minimum wages and the small businesses that must pay them. This observation has several implications for the study of provincial interdependence.

The first is that domestic factors still matter. Basinger and Hallerberg (2004, 261) argue that two domestic political factors mitigate against downward pressures from capital mobility: "constituency costs" generated by interest groups that oppose policy change, and "transaction costs" that depend on political institutions. Consistent with the former, even when US studies find interjurisdictional effects on US state welfare benefits, state policies are still primarily determined by factors within the state, such as economic conditions, level of poverty, and political competitiveness (Peterson and Rom 1989). Governments adopt policies primarily in response to local demands, and interjurisdictional concerns are likely to matter only at the margin (Chubb 1991). It follows that divergent "domestic" conditions could result in persistent differences among provinces, even in the face of downward or upward pressure from other jurisdictions. Rom, Peterson, and Scheve (1998, 37) stress that the existence of interstate competition with respect to welfare "does not mean that states will necessarily race to the bottom in any literal sense of the word, nor does it mean that all states will have identical welfare policies. Factors internal to a state can still be expected to influence its welfare policy offsetting the impact of interstate competition."

The question is thus what the *marginal* impact of interdependence is on provincial policies. A corollary observation is that, even if policy convergence is observed, it may be the result not of interjurisdictional competition but of parallel forces in different jurisdictions (e.g., changes in technology or economic conditions) (Banting, Hoberg, and Simeon 1997). It also follows that, if environmental standards are too weak, welfare benefits too low, or subsidies to industry too high in a province relative to one's own preferences, one cannot necessarily blame interjurisdictional competition – the problems may lie within the jurisdiction itself.

The greater the political support for a particular policy, the less vulnerable provinces will be to interjurisdictional competition. The race-to-the-bottom narrative assumes that jurisdictions actively seek to lure investment away from each other by lowering their standards. However, other scenarios are also conceivable. For instance, jurisdictions may be reluctant to set regulations or taxes more stringently than their neighbours lest they lose capital but not actively seek to undercut their neighbours in order to lure capital away (Harrison 1996b). Similarly, jurisdictions may be loath to set more generous welfare benefits lest they become welfare magnets but not inclined to gut welfare benefits in a conscious effort to "export" their poor residents.

The differences between these scenarios can be illustrated with simple game theoretical models. Assume that province A is considering increasing a tax or regulatory standard. The province faces four possible outcomes relative to its neighbour, province B: both could raise their standards (or taxes) equally, both could decline to raise their standards, A could raise its standards while B does not, or B could raise its standards while A does not. In game theoretical terms, these outcomes correspond respectively to cooperate-cooperate (CC), defect-defect (DD), cooperate-defect (CD), defect-cooperate (DC). How the two jurisdictions will relate to one another depends on the order of their preferences among these four outcomes. If both jurisdictions set equally stringent standards, there will be no movement of capital, taxpayers, or welfare recipients. If they are going to be equal anyway, both will presumably prefer higher standards to lower standards (CC>DD). After all, why forgo tax revenues or environmental benefits for no reason? Conversely, if a jurisdiction is going to achieve the same level of tax revenue or environmental benefit, it will presumably prefer the scenario in which it is the one that benefits from mobility (DC>DD and CC>CD).

Additional assumptions are necessary to fully specify each jurisdiction's preferences and thus the "game" in which the jurisdictions are engaged. The race to the bottom is often depicted as a prisoner's dilemma game (Harrison 1996b; Revesz 1992). If jurisdiction A places greater weight on attracting jobs than on protecting environmental quality or providing public goods with tax revenues, then its ideal outcome could be for B to regulate or tax unilaterally (DC>CC). Its worst-case scenario would be to regulate/tax unilaterally itself (DD>CD). If both jurisdictions share the same resulting preference ordering – DC>CC>DD>CD – then the result is the familiar prisoner's dilemma. Whether or not one jurisdiction is expected to regulate/tax, it is always in the other's interest to decline to do so, since both seek to lure jobs away from the other by declining to tax or regulate unilaterally. Paradoxically, the equilibrium result in which neither regulates/taxes (DD) is less desirable for both than if they had regulated/taxed with equal stringency (CC). This dynamic could degenerate in repeated play if individual jurisdictions compete for industry, not merely by declining to regulate/tax, but also by progressively relaxing their standards or taxes.

The picture is less discouraging, however, if one assumes that jurisdictions, while still reluctant to get "out of line" lest they export jobs or wealthy taxpayers, are not actively seeking to undercut each other. There may be sufficient political demand for environmental protection or other public goods that they prefer an outcome in which both jurisdictions tax or regulate to an opportunity to "beggar their neighbours" by undercutting them (CC>DC). The result is no longer a prisoner's dilemma but an "assurance game" in which there are two possible equilibria: CC and DD.[7] If a jurisdiction expects that its neighbour will regulate or tax, then it will do the same. If, however, it anticipates that its neighbour will decline to raise its standards, then it will also decline to do so. To the extent that jurisdictions are risk averse or misunderstand each other's incentives, a suboptimal outcome in which both jurisdictions decline to tax or regulate could still prevail. However, there is no incentive for a downward spiral. Two jurisdictions may be stuck at a suboptimal equilibrium, but they will have no reason to further reduce their standards in an effort to take advantage of each other. For the same reason, the assurance game presents a less formidable challenge to cooperation – harmonizing taxes or environmental standards at a higher level – than does the prisoner's dilemma, particularly in repeated play.

The prisoner's dilemma and assurance dynamics are both forms of mobility-induced competition, and consistent with usage in the literature both will be referred to here as variants of the race to the bottom. However, the implication of these two quite different variants is that the spiral to rock bottom envisioned by popular race-to-the-bottom rhetoric is far from inevitable. As Brueckner (2000, 507) notes, "a race to the bottom sometimes connotes a draconian tendency to slash welfare benefits to the bare minimum, mimicking the outcome in the least generous state. The theory, however, only points to a downward bias in benefits." Similarly, Oates (1998b, 8) observes that "the results from this literature are not downward spirals 'to the bottom'; they are suboptimal equilibria ... The real issue here is the magnitude of the deviations (if any) from the efficient outcomes." Short of an all-out race to rock bottom, jurisdictions may merely suffer from "regulatory chill" and thus remain stuck with suboptimal standards. Moreover, provinces may cooperate to overcome the latter scenario. At the limit, some provinces may place sufficient weight on public goods that their preference order is such that they will engage in neither the prisoner's dilemma nor an assurance game; rather, they will regulate or tax unilaterally, even if that entails a risk of prompting mobility by key actors (Harrison 1996b).

The discussion thus far has assumed only two jurisdictions with identical preferences. In the real world of Canadian federalism, of course, there are ten provinces and three territories with considerable variation among them. At any given time, some provinces will be more vulnerable to race-to-the-bottom pressures than others both because the impact of interprovincial policy divergence will vary among the provinces and because the provinces will have different political assessments of those impacts. The presence of one province that is seeking to poach jobs from its neighbours (i.e., one playing the prisoner's dilemma game) could unravel a fragile equilibrium among those who are merely seeking reassurance that they are not "out of line" (i.e., those playing the assurance game). On the other hand, the presence of a province with sufficient political support that is willing to tax or regulate unilaterally could provide the necessary reassurance to pull more anxious provinces up to the higher equilibrium in an assurance game.

The real world of Canadian federalism is also not a one-shot strategic game but an ongoing process in which governments meet with some regularity and their first ministers develop relationships of trust (or distrust) over time. The possibility of repeated play in either the prisoner's dilemma or the assurance game offers some prospect that players will be able to coordinate their efforts to avoid outcomes that hurt all jurisdictions, though that will be considerably easier in an assurance dynamic than in a prisoner's dilemma. The authors in this volume thus look for evidence of provincial coordination to avoid races to the bottom.

Implications for the Cases

The foregoing discussion concerning credibility of relocation, impact of relocation, and countervailing domestic forces has several implications for the case studies in this volume. The prospect of unhealthy competition is arguably greatest with respect to corporate income taxation and business incentives, where the threat of mobility is often highly credible and the impact of relocation in terms of lost jobs can be significant. Moreover, since incentives or tax breaks typically have relatively low visibility and are funded by general revenues (without gutting any particular program), countervailing domestic pressures for higher corporate taxes or lower incentives tend to be weak. Indeed, when the prospect of investors' relocating does make the front page, public sympathy often rests with the firms, or at least with their employees, thus reinforcing a potential race to the bottom.

Environmental regulation also involves potentially mobile investors and a similarly large impact in terms of lost jobs. However, the prospects for a race to the bottom emerging in this case can be considered less than in the cases of corporate taxes and incentives for two reasons. First, the credibility of relocation is reduced given the relatively low costs associated with pollution abatement for most industries. And second, one can anticipate countervailing domestic support for maintaining environmental standards given both the popularity of environmental protection among voters at large and the existence of an organized environmental movement seeking to advance that interest.

Races to the bottom with respect to social assistance seem to be still less worrisome. Although differences in welfare benefits can make a big difference to recipients, those who require welfare have the least resources to relocate and are expected to be most dependent on social support networks in their home communities.[8] Moreover, the sheer size of Canadian provinces, particularly in comparison with US states, tends to deter welfare migration.

The significance of divergent excise taxes, such as those on tobacco and alcohol, is difficult to predict. Long distances between provinces tend to deter casual cross-border shopping, but, as US studies have shown, organized smuggling networks can emerge when price incentives are sufficiently large. As in the case of environmental regulation, it is noteworthy that there is political support for higher cigarette taxes from the antismoking movement.

The two remaining policy areas are unlikely to provoke mobility-driven competition among provinces or states. Education policy is discussed by Rom in the US context. While parents can and often do relocate within communities or between neighbouring municipalities in pursuit of better schools for their children, and may even do so among closely located US states, it seems highly unlikely that a family would relocate to another Canadian province for better schools alone given the substantial costs of finding new housing and employment. One could send one's children to private schools for considerably less.

Finally, despite Ross Perot's warning of a "giant sucking sound" as low-paying jobs migrate to jurisdictions with lower wages (*New York Times* 1992), there is little reason to anticipate migration of either workers or employers among Canadian provinces in response to divergent minimum wages. As with welfare recipients, minimum wage workers are hardly in a position to pull up stakes in pursuit of a few more cents per hour, particularly since their new wage would still fall short of a "living wage" in most provinces. More importantly, minimum wage jobs in Canada are disproportionately in the hospitality and service sectors (Battle 2003). By definition, fast food has to be sold where it is produced. Similarly, jobs in tourism are tied to the sites (and sights) of interest. With little threat of capital flight, one thus would not expect politicians to engage in a race to the bottom to retain or attract minimum wage employers. In effect, minimum wages represent a control case in which we do not expect provincial governments to engage in mobility-induced competition, despite their autonomy in setting wage standards.

Ideational Interdependence: Emulation, Learning, and Benchmarking

The discussion thus far has focused on competition induced by migration of mobile factors – capital, goods, wealthy taxpayers, and welfare recipients. However, people, goods, and cash are not the only things that cross borders. So do ideas, both as information and as norms or values. Just as citizens move easily within a federation, so too do ideas readily cross provincial borders through shared media networks and social ties of family and friendship.

The flow of ideas suggests a very different form of interdependence than the race to the bottom, one in which provincial governments are sensitive to the examples set by other jurisdictions, not because they fear that others' policies will undermine the efficacy of their own but because other jurisdictions offer examples for how to satisfy voters' preferences or, alternatively, benchmarks against which voters will evaluate them. In terms of Hirschman's (1970) analogy, the critical issue in mobility-induced competition or the race to the bottom is the threat of "exit," while the incentive for provinces to emulate or learn from each other's example lies instead in voters' "voice." In both cases, policy makers motivated by their own voters' preferences will bear other governments' policies in mind in formulating their own. However, interdependence prompted by the flow of information typically will not have the same zero-sum element.[9] A government can emulate another jurisdiction's example without consequence to the other government. In contrast, in the case of mobility-induced competition, each government's very *capacity* to satisfy its own voters will depend on what other jurisdictions do.

Three quite distinct literatures pertain to this idea-driven interdependence. Moreover, all three have historically had little interaction with the literature on races to the bottom. The first is the literature on policy innovation and diffusion launched by Walker's (1969) seminal article (see also Berry and Berry 1990, 1992; Gray 1973; Lutz 1989; and Poel 1976). US Supreme Court justice Brandeis (1932) likened state governments to laboratories of democracy that experiment, innovate, and learn from each other's experience. In Canada, Pierre Trudeau (1968) offered a similar argument for the spread of health insurance among Canadian provinces from its origins in Saskatchewan. More recently, the spread of smoking bans in public places and antipesticide ordinances among Canadian municipalities is indicative of policy diffusion at work. While the potential for policy diffusion among subnational governments is, at least in theory, broader than the diffusion of policy innovations, in practice the policy diffusion literature has focused almost exclusively on the spread of *new* ideas. The literature typically employs quantitative methods to examine patterns of diffusion, with little attention to the mechanisms by which policies spread from one jurisdiction to another.

The diffusion literature is thus complemented by the literature on policy transfer or learning (Bennett 1991; Bennett and Howlett 1992; Dolowitz and Marsh 2000; Oates 1999a; Rose 1993), which focuses on the particular pathways through which governments learn from each other. Students of policy transfer typically employ qualitative methodologies, especially interviews with elite informants, to trace the spread of ideas. Most of the policy transfer literature focuses on idea transfer among politicians or bureaucratic elites from different jurisdictions. Thus, Rose (1993) examines "idea-mongering" among elites and Schneider and Ingram (1988) look at "systematic pinching of ideas" by policy makers in other jurisdictions. Indeed, Hall (1993, 28) is explicit in predicting that "first order learning" (i.e., setting of welfare benefits, taxes, or other standards) will take place through interactions among elites, "insulated from the kind of pluralist pressures we often associate with the broader political system."

Like the policy diffusion literature, studies of policy transfer tend to focus on novel policies.[10] In contrast, a smaller, third literature on "yardstick" competition hypothesizes that voters with limited information will look to other states' policy settings as benchmarks to evaluate their own incumbents (Advisory Commission on Intergovernmental Relations 1991; Besley and Case 1995; Breton 1991). Besley and Case argue that yardstick tax competition is a valuable means for voters to discipline rent-seeking politicians. Similarly, Breton (1991, 40) argues that, "if the citizens of a jurisdiction use information about the policies implemented in other jurisdictions to gauge and evaluate the performance of their own government, that process will increase electoral competition at home and thus incite their governing politicians to act to their benefit more than they otherwise would do." Voters' comparison of their government's policies with those of other jurisdictions can be facilitated by what Hoberg and colleagues (Hoberg 1991; Banting, Hoberg, and Simeon 1997) call "activist-driven emulation." An example of this strategy would be the "report cards" rating provincial governments issued by Canadian environmental groups in an effort to shame laggards into policy change.[11] Coverage of provincial policy making in national newspapers could also be sufficient to alert voters to the examples set by other provinces. As Shannon (1991, 119) has observed, "the forces of competitive emulation convert yesterday's expensive novelty (or public service 'frill') into today's standard budgetary fare." As wealthy, liberal, "pacesetter" provinces or states adopt new programs, even poor states or provinces may feel a "catch-up" imperative (Shannon 1991, 119).

The yardstick competition model is noteworthy in allowing that provinces or states may be interdependent when it comes to settings of well-established policy instruments, such as taxes, environmental standards, and minimum wages, not only the novel policies typically examined by students of policy diffusion and transfer. Mindful of their electorates, provinces may respond to each other's example in an ongoing process, beyond the one-off "pinching" of ideas. It is noteworthy that this form of emulation could contribute pressure either upward, as when environmental groups pressure provinces to match other jurisdictions' stricter environmental standards, or downward, as when the Fraser Institute helps voters to compare "tax freedom days" in different provinces.[12]

While the focuses of the literatures on policy diffusion, transfer, and benchmarking are somewhat different from each other, the central issue motivating all three is the policy implications of information flowing across borders. This ideational form of provincial interdependence is distinct from and will typically be less worrisome than is the interprovincial competition prompted by mobile capital and individuals discussed above. The chapters in this volume thus seek to distinguish between emulation or benchmark competition and mobility-induced competition.[13] Only the latter will be referred to as a race to the bottom.

It is noteworthy that emulation/benchmarking and race-to-the-bottom dynamics could coexist. For instance, a province could face upward pressure to emulate another province's environmental standards even while facing downward competition as a result of an industry's threats to relocate. Shannon (1991) depicts the combination of upward pressure to match the services of other jurisdictions as a desirable break on tax competition, with the two "unseen hands" guiding jurisdictions to desirable balance. However, there is no a priori reason to believe that the two pressures will be in balance. Indeed, it is conceivable that emulation could reinforce a race-to-the-bottom dynamic, for instance if activists pressed their government to match the lower taxes of another jurisdiction.

As in the case of a race to the bottom, upward or downward pressure on public policy resulting from emulation or benchmarking will also coexist with domestic political forces. Therefore, while information flowing across borders may bring provinces' policies closer together, there is no reason to expect complete convergence.

Normative Implications and Policy Prescriptions

The central focus of the chapters that follow is positive analysis. The authors ask whether jurisdictions engage in policy competition, of what sort, and with what consequences. It is, however, worth noting that, although mobility-induced competition and emulation or learning may look much the same, the normative implications and thus prescribed policy responses are very different. Because the flow of ideas and information within a democracy is highly desirable, emulation will normally be cause for celebration rather than concern. Voters' reliance on other jurisdictions as a benchmark provides an important mechanism for those voters to hold their governments accountable given the infrequency of elections and voters' constrained policy choices even then between a limited number of candidates and parties. In contrast, although there are theoretical models describing both beneficial and harmful mobility-induced competition, the former rest on highly idealized assumptions. The more plausible, harmful form of such competition, whether of the prisoner's dilemma or of the assurance variety, will tend to reduce responsiveness to the electorate.

The prospect of a race to the bottom typically elicits calls for harmonization of standards, whether through interprovincial cooperation or through intervention by the federal government. However, such harmonization will tend to dampen opportunities for emulation.[14] To the extent that desirable emulation and undesirable mobility-induced competition coexist, the cure for a race to the bottom could thus, in theory, be worse than the disease. National standards, while precluding downward competition, also constrain innovation, diversity, and cross-jurisdictional learning (Revesz 1992). A related line of argument sometimes offered is that even unhealthy competition can perform a useful function in counteracting other inefficiencies of the political system, such as rent seeking (Weingast 1995). As Kenneth McKenzie argues in this volume, "fiscal competition can reduce the power of Leviathan."

There are two broad options for responding to a potential race to the bottom. The first is harmonization among the provinces. This is most promising in the case of an assurance dynamic, especially so in Canada, where with only thirteen provinces and territories the first ministers can meet face to face on a regular basis. There is, however, reason for skepticism about provincial collaboration to resolve a prisoner's dilemma in which provinces have incentives to undercut each other. In that case, the very incentives for competition that prompt collaboration also encourage defection from agreed-upon standards. Gibbins (1996, 10) thus argues that "decentralization is incompatible with national standards which are anything more than window-dressing. Interprovincial agreements as an effective substitute for Parliamentary action are a mirage."

While the prospects for interjurisdictional cooperation may be limited, a critical difference between competition in an international setting and competition among provinces within a federation is the existence of a federal government that may have authority to intervene. Such intervention could take various forms. In the case of competition with respect to excise taxes, the federal government can employ its authority with respect to interprovincial commerce to prohibit smuggling and other forms of interprovincial sales. In the case of regulatory competition, the federal government may have sufficient overlapping jurisdiction to set its own standards to establish a floor for downward regulatory competition. With respect to welfare competition, Oates (1972) first made the theoretical case that shared-cost or conditional grants to subnational governments would be more effective than unconditional transfers. Conditional grants can also be an effective, albeit controversial, means of promoting harmonization of regulatory standards. For instance, the US federal government employed a threat to withhold highway construction grants to the states as a means of coercing states into adopting federal air quality and emissions standards.

In contrast, equalization transfers are justified primarily on grounds of horizontal equity among provinces rather than as a response to a potential race to the bottom. Equalization could have an indirect effect on interprovincial competition by mitigating, at least to some degree, poorer jurisdictions' presumably greater temptation to engage in a race to the bottom to attract jobs. However, by the same token, if provinces don't have to raise tax revenues themselves, they may be even more generous in engaging in a race to the top with respect to industry incentives.

While the spectre of federal government involvement is often invoked as a panacea by those who fear a race to the bottom, there is certainly no guarantee that the federal government will intervene. Indeed, the same public choice problems that prompt provinces to compete in a race to the bottom may also prompt the federal government to decline to set national standards (Harrison 1996b). After all, industries that oppose taxes or regulations at the provincial level employ many of the same strategies, including the threat of capital flight, at the national level. As Noël (1999) has observed, "there is little reason to believe that what Charles Lindblom has called 'the privileged position of business' plays less at the centre than within the units [of a federation], especially now that mobility appears less circumscribed by national borders." Moreover, federal intervention in ostensibly provincial matters is invariably nested in a larger constitutional game in which many provinces oppose national standards as a matter of principle.

Finally, when the federal government does intervene, there is also no guarantee that its intervention will be helpful. The US Advisory Commission Intergovernmental Relations (1991) observed that the US federal government not only regulates and impedes interstate and interlocal competition but also stimulates it. Federal intervention in one field may simply prompt provinces to compete on other grounds (Revesz 1992, 106, 123), while other national rules can actually have perverse effects. For instance, the US Supreme Court's 1969 decision disallowing state minimum residency requirements for welfare benefits and the subsequent 1999 decision overturning two-tier state schemes (in which states paid newcomers benefits at the rate that they would have received in their state of origin for some period) both had the effect of rendering state governments more sensitive to the potential costs of maintaining more generous welfare benefits than their neighbours (Brueckner 2000; Rom, Peterson, and Scheve 1998). Similarly, the US Supreme Court's disallowance of differential hazardous waste disposal fees for waste generated in state and waste imported from other states prompted states to engage in a race to the top with respect to waste taxes (Levinson 2003).

Standards of Evidence

The theoretical landscape is clearly complex, thus posing considerable challenges for empirical analysis. Documenting a race to the bottom is no simple matter. While the term evokes an image of provincial standards in free fall, a downward policy trend is neither necessary nor sufficient evidence of provincial competition for mobile actors. If provinces are already "stuck at the bottom," or at least at some suboptimal equilibrium in an assurance dynamic, one would not see a downward trend. Moreover, even if a downward trend in standards is evident, it could be prompted by an external force influencing all provinces or, alternatively, an emulation dynamic.

Nor is convergence an appropriate test for a race to the bottom, contrary to Noël's (1999, 200) assertion. As long as "domestic" factors continue to matter, one would expect to see some measure of persistent diversity even if provinces are interdependent. Moreover, not all provinces will necessarily be "in the game" (Harrison 1996b) or playing the same game (Rom and Garand

2001). If convergence does occur, again it could be the result of provincial governments' facing similar domestic pressures, emulating each other or, for that matter, cooperating to avoid a race to the bottom.

Those studying interprovincial competition are thus well advised to consider alternative explanations for observed trends. The prospect of two very different intergovernmental dynamics raises particular methodological challenges since the symptoms of either one – governments adapting their policies in response to other jurisdictions' policies – will be very much the same. Given the very different normative implications of these two dynamics, the risk of misinterpreting evidence is significant indeed. Counterfactuals, process tracing, and natural experiments (as when the federal government relaxes restrictions on provincial autonomy or one province makes a dramatic change in its policies for domestic reasons) are thus invaluable tools.

The authors in this volume have addressed these challenges in several ways. McKenzie, Olewiler, Rom, Boychuk, and Brown marshal an impressive array of measures to track policy outputs and outcomes over time. Diverse measures are important for a number of reasons. First, overlapping policies can have reinforcing or contradictory effects. As McKenzie discusses, an apparent decline in taxes may not be cause for concern if it is compensated for by increases in another tax on the same actor. Second, governments may compete along different dimensions of a particular policy. For instance, Rom finds that US states can be more or less sensitive to each other's policies with respect to welfare access or benefit levels depending on which is more politically salient. Boychuk also reports different trends in Canadian provinces' social assistance rates with respect to different recipient groups. Finally, policies simply may not be as influential as they seem. In other words, even if there is a decline in standards over time, it may not have a very significant effect. Olewiler examines not only trends in environmental standards but also resulting environmental quality and shifts in industry composition in search of a response.

Rom in the US context and Green and Harrison in the Canadian context utilize multivariate analysis to assess the degree to which provinces respond to each other after controlling for factors within each province that might influence policy choice. However, this strategy is difficult to employ in a country with only ten provinces unless one has a long time series of data. As noted by Olewiler, data can be in short supply even for shorter periods.

Moreover, as noted above, finding a correlation among provincial governments' policies does not tell us why the correlation exists. Does it reflect parallel movement, emulation, or mobility-induced competition? Authors seek to unpack this question in a number of ways. Boychuk compares provincial social assistance trends before and after the critical juncture at which the federal government moved from cost-shared to unconditional block grants. He also employs counterfactual analysis to assess alternative explanations for declining welfare generosity in the 1990s, including the impact of shared ideas and economic trends. Harrison and Green and Harrison employ process tracing via documentary analysis and interviews with interest group representatives, politicians, and senior bureaucrats to explore rationales for policy changes with respect to tobacco taxes and minimum wages.

Finally, we are able to compare findings among policy areas in which mobility is a plausible threat (corporate taxation, industrial policy, environmental regulation, and social assistance) and those where it is not (minimum wages, education). Without further ado, we turn to the case studies, which ask, collectively, are Canadian provinces engaged in a race to the bottom?

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NOTES

1 The council notes that "dramatic reductions in [social assessment benefits in] some jurisdictions will put pressure on others to match those reductions in order to avoid an influx of people, thereby precipitating a 'race to the bottom' or alternatively, to maintain higher rates while erecting barriers as in the recent case of British Columbia." Similarly, the BC government stated, "how can desirable national standards of social benefits and services be maintained in a world of declining federal influence? Such standards are essential if Canada is not to witness, in the name of competitiveness, an interprovincial 'race to the bottom' in providing social benefits" (Province of British Columbia 1995).

2 "The fundamental problem working against national safety standards is the temptation by individual provinces to gain competitive economic advantage by relaxing standards. Unless the Federal Government sets national minimum standards, the race to the bottom by the provinces will only get worse."

3 An important exception is Noël (1999). Noël is attentive to the empirical question of whether Canadian provincial governments engage in a race to the bottom, but he relies primarily on US studies, many of which are now dated.

4 The outcome is troubling not because communities should be forced to accept hazardous waste facilities or nuclear plants but because the standards that competitive jurisdictions would adopt in such a scenario would be higher than justified by their own residents' preferences.

5 Levinson (2003, 248) succinctly explains the difference. Even in his early work, Oates theorized that interstate competition would be efficient if states employed only benefits taxes equal to the value of public services supplied by the state to each taxpayer. The problem with social assistance, recognized by Oates, is that by necessity it relies on redistributive taxes. However, environmental regulation is typically also redistributive in that firms, their customers, and workers who pay a price to comply with regulation are a smaller group than the broader population that benefits from a cleaner environment. However, in assuming that all residents of each competitive state were also employed in the regulated industry, Oates and Schwab's model effectively assumed that environmental regulations were a form of nonredistributive benefits tax. When Oates and Schwab relaxed that assumption, allowing for a heterogeneous population of employees and nonemployees, the model no longer predicted that competition would be welfare enhancing.

6 Besides those discussed below, Wilson (1996) discussed inefficiencies that can follow from "lumpy" investments, the existence of opportunities for tax evasion, unemployment, and monopoly power in capital markets, all of which have plausibility.

7 The astute reader will realize that I have not fully specified the jurisdictions' preference orderings in this case. There are several variants of the assurance game, but the critical feature of each, in addition to the assumptions already laid out, is that each jurisdiction prefers to cooperate if the other does and defect if the other does. In other words, CC>DC and DD>CD.

8 Osberg, Gordon, and Lin (1994) demonstrate a positive correlation between income and interregional mobility.

9 If voters pressure their governments to set the "lowest" taxes or the "most stringent" environmental standards, zero-sum competition could result, even in an emulation dynamic. One would expect such a dynamic to be short-lived, however. The real costs of outdoing other provinces simply for the sake of being "the best" would soon become apparent and, presumably, unpopular with an electorate that had not fully considered the implications of being "the best." It is more problematic if politicians are driven to outdo or undercut the example of other jurisdictions not by popular opinion but by powerful interests. However, such a group's disproportionate influence likely lies with a threat of mobility. If so, we are back to the race-to-the-bottom dynamic.

10 Berry and Berry (1994) and Hall's (1993) "first order learning" are exceptions.

11 See, for example, Canadian Nature Federation (2001).

12 See <http://www.fraserinstitute.ca/shared/taxcalc.asp>.

13 It is somewhat ironic, however, that some of those writing about yardstick competition themselves do not distinguish between the two, apparently because they view both forms of competition as healthy. See Besley and Case (1995) and Breton (1991). Others acknowledge the distinction but do not explore it further (Brueckner 2003; Rom, Peterson, and Scheve 1998). For instance, in a major report on intergovernmental competition by the US Advisory Committee on Intergovernmental Relations (1991), the possibility of "yardsticking" as a distinct intergovernmental dynamic warranted only a footnote. Exceptions are Bailey and Rom (2004) and Shannon (1991).

14 Oates (1999b) has noted that, in theory, national governments are not prohibited from employing different approaches in different regions. Indeed, given the public goods character of the knowledge gained from policy innovation, provinces have incentives to free-ride on each other's policy experimentation, thus undermining the benefits of decentralization. However, in practice it is difficult for a federal government to justify treating citizens in some regions differently from those in other regions, particularly given the popularity of "national standards."