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Immobile Taxation in a World of Mobility

By

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I am concerned that the OECD (Organization for Economic Cooperation and Development) is campaigning to tax mobile capital wherever it may seek shelter (Harmful Tax Competition, April 27, 1998). It tells us that international tax competitition is "harmful," and should be stamped out. Is this just ceremonial, like so much politics? I fear not. It is more like a "smart bomb," with small nations' names on it. When a powerful international political organization officially brands a small nation as "harmful," trouble is brewing. Defamation anticipates oppression, conditioning suggestible minds to accept it. "The arts of Power and its minions are the same in all countries and in all ages. It marks its victim; denounces it; and excites the public odium and the public hatred, to conceal its own abuses and encroachments." -- Henry Clay, U.S. Senate, 14 March 1834.

OECD influence reaches deep into the scholarly world, and gets quick action. The National Tax Journal, a scholarly outlet that should be above political pressures, ran with the ball instantly. Joann Weiner of the U.S. Treasury's Office of Tax Analysis (OTA), and Hugh Ault of the OECD itself, and the Boston College Law School, rushed into print in the September, 1998, issue in a slavish rehash of the OECD report and recommendations. The journal review process is ordinarily so glacial that you could discover the meaning of life and take 5 years to get published, but Weiner and Ault picked up a Report published April 27, pondered, consulted, wrote their manuscript, had it "peer-reviewed" and jumped a long queue: the Journal published them just four months after the OECD Report itself.

In June, 1999, the same Journal published two articles, one of unprecedented length (37 pages), on international tax competition (Hines; Wilson). These are in the literature-reviewing academic style, with hemming and hawing, but John D. Wilson, the major author, concludes: "This assessment suggests a role for intervention by a central authority ... " - a strong avowal in the context of his overall tentative tone.

Quite a few academics, like myself, do not agree that interjurisdictional competition is "harmful" to the world. We do not teach that small nations are sneaky free riders. We may not think they shelter only plaster saints, either, but those who pioneer ways around foolish or tyrannical tax laws, however selfishly, may be doing a favor to those who passively submit to overweening authorities and wish others would do the same.

I. Precedents

So the OECD tells us international tax competition is "harmful." You may find their own words in their Harmful Tax Competition, 1998, issued as a "Recommendation to the Governments of Member Countries." Anyone who can stay awake through its deadly prose will recognize a very live assault on tax avoidance, which it slyly conflates with tax evasion, and an uncritical embrace of personal income taxation at high rates, imposed worldwide. You may find a readable summary in my response of August, 1998, "International Tax Competition: Harmful or Beneficial?"

The OECD ideal is tax "uniformity" among nations. This has a familiar ring to any economist who follows changing fashions in public finance. In 1955 California leaders told the voters that interurban tax competition is harmful, because it keeps cities from raising local sales taxes. The Legislature thenceforth encouraged every city and county to impose a sales tax (the Bradley-Burns Uniform Local Sales Tax Act, Revenue and Taxation Code Section 7200). The State collects it, piggyback style, and returns it to each municipality or county of origin (point-of-sale basis).

A "uniform" sales tax is NOT uniform in its effects. Retailers in rich locations can bear it and survive; those in marginal locations cannot. It drives a tax wedge between buyers and sellers, which only the rich locations have the cushion to absorb. The result is especially to penalize poorer neighborhoods and regions and communities. Thus, in the poor inland counties of Fresno, Tulare, Imperial, and Stanislaus, sales tax revenues are about 1.5% of assessed values of taxable property, while in rich coastal and suburban counties of Santa Barbara and Marin, sales tax revenues are about .75% of assessed values.

Bradley-Burns has unintended consequences. Interurban competition survives, but takes the new form of competing to attract retail trade (and hence sales tax revenues) by overzoning for it, and by subsidizing new retail outlets in various ways. Those best able to subsidize retailers are the cities already richer, adding to the bias against marginal locations. A byproduct of that is a retail vacancy rate approaching 33%, an enormous private and social cost. May we not assume that uniform worldwide tax rates, à la OECD, would likewise have unforeseen, perverse, inefficient consequences?

Currently, a powerful, or at least noisy, move is afoot to extend the spirit of Bradley-Burns (California's uniform statewide sales tax law) to the national level. This is partly in response to the rapid growth of interstate internet commerce, free of state sales taxes. The idea is to get Congress to override the Commerce Clause of the U.S. Constitution (Article I, Sects. 8 and 10) by imposing a Federal sales tax and returning it as a subvention to State governments by some allocation formula. The writer has criticized this elsewhere ("Why Sales Taxes," 2000).

II. Internal Contradictions of the OECD

It is incongruous for the OECD to fault what they tar as "tax havens" for distorting world investment patterns when their own internal systems distort investment on a grand scale. For example, their Report (p.31) brands a nation as "harmful" if it lets a person deduct costs when the corresponding income is not taxed. That sounds reasonable, and yet that is the standard treatment of much income property in the U.S.A., the largest member of the OECD. The costs of ownership - interest and property taxes - are fully deductible as current expenses. The cash flow is offset by overdepreciation until the property may be sold. The resulting nominal gain (inflated by loss of the remaining undepreciated "basis") then gets soft treatment as a "capital gain," resulting in a lower tax rate, at a deferred date, with total exemption at time of death. If it is an owner-occupied residence there is no tax-depreciation, but the greater benefit that there is no tax on the imputed income, however baronial the grounds, however prime the location.

III. What is "harmful"?

The OECD says a "harmful tax regime" is one that "attracts mobile activities." That is a strangely foreboding outlook, and inconsistent with the general belief that public policy should stimulate investing and jobs and housing and other good things. Even given the strange premise, though, they seem to have it wrong. OECD means that low taxes are harmful - on p.27 they specify low <u>income</u> taxes. They, and allied international organizations like the EU (European Union) also have a history of jumping nations whose VAT is too low to suit them.

That view is one-eyed. Good public services, paid by taxes, also attract mobile activities. Mexico, for example, has low taxes, but repels both capital and labor anyway. A nation may also attract mobile activities and factors in two other ways. One is by offering superior public services. That, for example, is how many of us became Californians, lured by the State University. The other is by a tax <u>structure</u> that favors mobile activities without stinting on public services. This may be done simply by targeting taxes on IM-mobile resources. Let's inspect those points closer.

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A. Richness of the tax base

A jurisdiction may enjoy both high public revenues and low tax rates if it be favored with a high tax base. Alfred Marshall, renowned Edwardian economist, warned about the excessive magnetism of London, and, within Greater London, of the richer suburbs. Vancouver, B.C. is another example of Marshall's principle. It is such a magnet for Canadians that the Provincial Government deliberately fosters developments elsewhere in the Province at the expense of Vancouver. The whole Province of Alberta is another such magnet, thanks to its monopoly of petroleum in Canada, and its effective system of raising Provincial revenues therefrom. The State of Alaska is another magnet. It has the highest taxes per capita of any U.S. state, but they are paid mainly by a handful of giant oil companies with favorable leases on State-owned lands. Its magnet takes the very direct form of an annual "social dividend" of over $1,000 per man, woman and child, in cash. More generally, though, the whole world is divided among tax jurisdictions with richer and leaner tax bases, ranging along a wide continuum.

In all those cases, the "distortion" caused by high public revenues is in attracting mobile factors, not repelling them. It is an advantage enjoyed by the major OECD nations, vis-a-vis those less favored by nature, by virtue of their occupying the best locations on the planet. It seems rather shabby of them to deny nations with poorer lands the best recourse available.

Poorer nations may replicate the magnetism given by natural advantages, and attract mobile activities, in two ways. One is by maintaining a more efficient and honest government: more service at lower cost. This is what competition is supposed to achieve in the private sector: why not in the public, too?

The other way is by adopting a magnetic tax <u>structure</u>. There are taxes and then there are taxes. The OECD authors are wearing blinders that keep their minds glued only on kinds of taxes that penalize and repel mobile activities. Let us liberate ourselves from that fixation. There are taxes in this real world - not just in theory - that do not repel mobile factors, but positively attract them. Now <u>that</u> is Tax Competition! The OECD ignores it, and apparently bids us ignore it, too, for it will embarrass nations with repellent tax structures. I will give you some examples.

B. Magnetic tax structures

The U.S.A. with its Federal system is a great laboratory for testing tax structures. The extraordinary growth of California from about 1890 to 1978 shook and recast the economy of the U.S.A., and parts of the whole world. It was not done with low taxes and skimpy public services. It was in part the product of a tax structure that was Magnetic (compared with other states). California's natural advantages (a mixed bag) did not promote much growth after the 1849 Gold Rush and the Civil War, when California growth lagged badly for 20 years or more while migrants hastened to the plains states. Neither did the transcontinental rail connection, completed in 1867, promote much growth. Eventually, though, internal growth-oriented forces prevailed. California provided superior public services of many kinds: water supply and drainage, schools and free public universities, public sanitation and health services, public safety, mental health, transportation, parks and recreation, and others. It held down utility rates by regulation, coupled with resisting the temptation to overtax utilities.

The climate was attractive, yes, but it always had been. Growth now required tax revenues. California's main tax source was an immobile resource: ordinary real estate. Its tax valuers focused their attention on the most immobile part of that, the land, such that by 1918, land value comprised 72% of the property tax base - and on top of that there were special assessments on land. People and capital flooded in. California became the largest state, and a major or the largest producer of many things, from farm products up to the "tertiary" services of banking, finance and insurance.

C. Was this tax competition "harmful"?

On the contrary, in a world of self-aggrandizing governments, intergovernmental competition is all that makes life bearable. Competition from nations or cities with rich tax bases can distort the allocation of mobile factors, it is true, but that is not what OECD is targeting. Rather, they are targeting the magnetic tax structures of governments that are efficient and economical.

If California competition were harmful to the world as a whole, we would have to conclude by analogy that the discovery of the New World was, too: Columbus should have stayed home. There was a negative side to the migration of European and African people and capital to the New World, yet few would suggest that many people, on balance, would be better off today in a world shrunk to its eastern hemisphere.

California became the second-largest producer of cotton, for example, displacing a good deal of eastern cotton. The damage to eastern producers was offset by an equal gain to cotton processors and consumers, with a net gain from higher usage due to the lower price. Eastern cotton lands were released for other uses, like reforestation of lands marginal for cotton. (To the extent this was due to subsidies, and racing for cotton quotas during the Korean War, I do not vaunt it - but there are few pure examples of anything in this complex world.)

California attracted eastern workers, tending to draw up eastern wage rates. The damage to eastern employers was offset by an equal gain to their workers, with large net gains from two sources. One is a more equal distribution of wealth; the other is a drop in welfare costs and social problems like crime that would have ensued had the "Okies," for example, had to remain in the Dust Bowl instead of finding new lives in California. It would be better yet if they could have become small landowners working their own farms. Steinbeck was right to dramatize the abuses and shortfalls of the process, but in this imperfect world we observe what is, without denying that it might and should be better. What is involved here is turning useless and even criminal people into productive people.

California offered a higher return on capital, too. There emerged "the continental tilt of interest rates," higher in the west, to overcome the frictions of space and draw eastern capital to where it was more welcome. Note that higher wage rates and higher returns on capital occurred jointly - a result hardly possible in the imaginary "2-factor world" (labor and capital) of the neo-classical theory taught in most academies today. Over time, buildings that wore out in the east were replaced in California, by the reinvestment of cash from "Capital Consumption Allowances" yielded by old capital as it depreciates.

Did California's vigor seem too ambitious, so as to damage others? If so, as Shakespeare had Marc Antony say, such ambition "were a grievous fault," worthy of a knife in the ribs by an OECD. Most economists believe, however, that investing is the motor that drives prosperity, and raising investment opportunities is the key to the ignition. I certainly agree. OECD does not. Apparently any nation pursuing "harmful tax policies" to raise investment opportunities would upset some delicate balance or "grand eternal plan."

California competition did pull up interest rates back east, hurting some borrowers. These losses, however, were offset by equal gains to savers, with a net bonus from the rise of saving caused by higher interest rates. There are those who would intuitively assume that the distributive effects are regressive, but that is doubtful. In this case the truth is counter-intuitive. Equity earnings in stocks and real estate vary inversely with interest rates. Equity values are impacted even more, because higher interest rates translate into higher capitalization rates, which mean lower Price/earnings (P/e) ratios and lower capital gains.

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This is too big an issue to settle in a few words. If you find it counterintuitive, I can only ask you to think about my argument above. On balance, in my opinion, a rise of interest rates has an equalizing effect on the distribution of wealth, when the initiating cause is a rise of investment outlets.

The net "micro" or allocative effect of higher interest rates is to move capital into higher uses, as directors impose higher "hurdle" (or "cut-off") rates on their managers. Hurdle rates rose, not because there was less capital overall, but more opportunities to invest it productively.

Viewed historically, California's remarkable 20th Century growth extended the American and the Canadian tradition of the western frontier, in the spirit of Thomas Jefferson and Horace Greeley, as a "safety-valve" for mobile resources oppressed in the older states. It limited the power of the haves over the have-nots, with net gains all around.

Was California growth the product of untaxing wealth, and dumping taxes on poor workers and consumers? The OECD says competition is harmful because it limits the power of OECD nations to tax "wealth." OECD implies it is upholding the interests of labor, in league with European social democrats. The spokesmen thus misstate the issue, setting us up for a false and futile debate, fooling both their friends and their critics. Their premise is that "wealth" is more mobile than labor. Some wealth is, of course, but California relied on the property tax, and, to repeat, 70% of this tax base was land, pure land, totally immobile among taxing jurisdictions. The OECD treats land like one of those unmentionable four-letter words. So do its academic retainers, many of whom teach that land is just as mobile as capital. This dogma makes them completely useless to analyze the OECD allegation that a nation's tax regime is "harmful" if it attracts mobile resources.

Was California growth the product of southwestern pioneer vigor? That is another seductive hypothesis, but compare it with nearby New Mexico. New Mexico is little more than a Third World Nation masquerading as an American state. Since before statehood, an oligarchy of giant landowners, in the million-acre class, have dominated state policies and kept taxes off their vast lands. New Mexico raises a lower fraction of its state and local revenues from the property tax than any other state. Its economic base, such as it is, is mainly the product of what Senator Albert Beveridge of Indiana called "the free coinage of western Senators." New Mexico gets far more net federal dollars (spending less tax payments) per capita than any other state. In 1998 its "Federal Balance of Payments" was

+$3,697 per capita, compared to -$2,380 for Connecticut, a "donor" state (Wisconsin Taxpayer, p.10). That and God's gift of scenery are about it. In "The Land of Enchantment," The Enchanter has cast a sleeping spell on its local enterprise while its Treasury sups on the nations' taxpayers, and its cattle graze and breed at sweetheart rents on Federal lands. New Mexico bids fair to be the most parasitic state. It has the highest poverty rate and, in its wide open spaces, nearly the highest rate of violent death in the U.S. So much for southwestern pioneer vigor.

D. Recent changes.

In 1978, California took a giant step backwards by enacting its "Proposition 13," cutting property tax rates by about 2/3, and mandating underassessment of the tax base. The State has raised sales taxes to new high levels, leading the nation, as Bradley-Burns comes home with a vengeance, with combined state and local rates up to 8.25% in some counties. Personal income and business taxes also shot up. These are taxes that "shoot anything that moves," imposing severe "excess burdens," and that spare immobile resources that don't move - whose supplies are IN-elastic. The national ranking of its services began a steep fall; so did its per capita income. We have fallen to join Alabama with the worst school system in the nation. Inmigration even changed to outmigration for a time, and of those who stay, California has by far the largest prison population of any state; the union of prison guards is now our most powerful lobby, and building prisons is our fastest-growing construction industry. None of these people, prisoners or prison-builders or guards, are producing goods and services for others, but are not counted as unemployed, and our unemployment rate is above the national average even without them.

Frontiers are in the minds of men. Today there is a new frontier in old New Hampshire, with its poor soils, marshy peneplains, harsh climate, impassable mountains, and lack of natural urban confluences. What New Hampshire has is the least repellent tax structure in the nation: it does not tax personal income or sales. 2/3 of all its state and local revenues come from the property tax, while the U.S. mean has fallen below 1/3. Behind the times? Perhaps, but New Hampshire under this regimen is prospering like few other states (Noyes and Gaffney, 1998).

IV. Should tax regimes be the same everywhere?

A more efficient government would offer superior public services without higher taxes; or the same services with lower taxes. Is this harmful? OECD, and allied international organizations, make a great point of commending free markets and competition - what they call "liberalization" - to borrowing nations. They should, by similar reasoning, endorse competition among governments to attract people and capital. Such competition is a major defense against the tyranny that a monopoly government can exercise.

What about tax "uniformity"? Even if we hold public services constant, uniform sales or income taxation does not produce uniform results. Tax-economists acknowledge that in their theorizing as "The Ramsey Rule." Having nodded to it in theory, many of them then pass over it in prescribing actual tax policy. They would improve their policy prescriptions if they read and heeded Ramsey.

A.C. Pigou (1928, pp.105-08), Ramsey's patron and a cautious writer, explained it without hedging:

> "When one source of production yields an absolutely inelastic supply, ... A given revenue can be raised with less sacrifice by concentrating taxation upon this use than by imposing uniform rates of tax on all uses."
>
> "... if there is any commodity for which ... the supply is absolutely inelastic, the formula implies that the rate of tax imposed on every other commodity must be nil, i.e. that the whole of the revenue wanted must be raised on that commodity." (See also Young, 1929, and Stiglitz, 1986, pp.161, 404.)

In some disfavored regions, or "lean territory," at the edges of settlement, the land generates little or no surplus above the opportunity cost of the mobile factors. Labor just makes wages; capital just makes enough to pay interest. Impose a uniform GST, PAYE or VAT and it makes economic life non-viable at these lean edges, because there is no taxable surplus there: you can't squeeze blood out of a stone. The giants of classical political economy like Smith, Ricardo, or Mill saw this clearly; so had their mentors, the French Physiocrats like Quesnay and Turgot. Thomas Jefferson, a student of the Physiocrats, also saw it clearly, which is why he opposed the excise taxes favored by Hamilton, which bore heaviest on the frontiersmen whom Jefferson represented so well. His brilliant Treasury Secretary, Albert Gallatin, was an educated French-Swiss immigrant who also knew his Physiocracy, and had represented the very region of western Pennsylvania that spawned the "Whiskey Rebellion" against Hamilton.

A modern example is "the <u>Backveld</u>" of South Africa. South Africa imposed a VAT with the very purpose of extracting taxes from poor blacks there on the poor land. The result was to sterilize the <u>Backveld</u> economically, to scorch the earth and drive its people away to squat in extra-legal shacktowns like Soweto, near Johannesburg, and

The Crossroads near Cape Town. It forced them to survive by hawking in gray markets on the streets and roadsides, turning also to drugs, prostitution, and crime. What else were they to do?

A rich place like, say, Vancouver might impose a VAT and survive, but it is not clear that it should, even so. Hong Kong is the sparkling paragon of a rich territory that embraced magnetic tax policies. As a Crown colony, it redoubled its natural magnetism by shunning repellent taxes of most kinds. Its public coffers overflowed, nonetheless, because the Crown owned all the land there, and did a tolerable job - not excellent, but better-than-average - of collecting much of the rent for public purposes. With a tiny land area, it became a world center of both secondary and tertiary industry, with a population of 5 millions, and a high per capita income. Those who have eyes to see, let them see.

National governments not owning their own land can replicate the Hong Kong effect simply by emulating California of yesterday, and New Hampshire of today, basing most of their taxes on the immobile factor, land. Tax capital, and capital flight is a hazard, but land never flies nor flees. Tax labor, and brain-drains are a menace, but land stays home.

V. Choices for the OECD nations

If the OECD nations are concerned about tax competition, they have at least three choices.

A. They could impose exchange controls to prevent capital export, as attempted by various authoritarian states before world war II, and some welfare states afterwards. This approach had its day, and is now a proven failure, although that is not stopping some desperate failing Asian nations now from giving it another whirl.

B. They can try muscling small nations into copying, and helping them enforce, their own repressive tax systems. This means and requires extending their sovereignty worldwide, as envisioned in the OECD Report we are discussing. It is in the spirit of the times, in this age of world cartels, MNCs, the International Telecommunications Union, world radio and TV networks, the IMF, the World Bank, the WTO, the MAI (another OECD boon), the Trilateral Commission, Interpol, the world war on drugs, the U.S. as world policeman, etc. It is something like the Holy Alliance that undertook to police each aberrant nation of post-Napoleonic Europe, only more ambitious: its turf is the whole world, with no exceptions or refuges, not even any speck of coral in the wide oceans.

Any independent force threatens the whole structure, which then demands nothing short of worldwide domination: a megalomaniac goal, indeed. The IMF's interim committee must become "the embryo" of an economic government for the world, backing recent calls by Michel Camdessus for the interim council to become a body producing binding directives rather than recommendations (Italian Treasury Minister Carlo Ciampi, ROME, Dec 17, 1998 (AFP)). New OECD guidelines are intended not just for members and their territories, but "non-members as well. It is, therefore, an ambitious attempt to create a new international standard to apply equally to all jurisdictions." (Baroness Elizabeth Symons of Vernham Dean, Minister for the Overseas Territories, Address to the British Virgin Islands Financial Services Seminar, September 1998.)

C. They could reform their own domestic tax systems along the lines demonstrated by California before 1978, by Hong Kong before 1997, and by New Hampshire today. They could lead us to a world of benign tax competition. They could move away from extra-territorial taxation to purely intra-territorial taxation; away from mobile tax bases to immobile tax bases. They are not headed in those directions today, but if one or two nations can face them down, they will have no other option. Freedom anywhere foils tyranny everywhere. Tax tyranny is a balloon: seal every leak, or it collapses.

VI. Tax intelligence

A cognate concern of the OECD is extending the sovereign powers of its members to pry into private dealings in other nations. Income-tax agents are necessarily _voyeurs_. They are frustrated and offended by privacy provisions in other nations and, as the OECD Report makes clear, they believe they have the moral authority to pierce those veils, and to invoke political force for the purpose.

Must it be so? Is taxation always at war with personal privacy and national sovereignty? The OECD Report tacitly premises that all taxes must be on a personal (or corporate) basis: what the lawyers call _in personam_. Some other taxes, however, are levied on a thing, or _in rem_. A pure case of _in rem_ taxation is the tax on real estate. This is a lien on the specific parcel of land, not the owner's other assets or income. The land, not the living _corpus_ of the owner, is the gage. Sovereignty over land is unambiguous. Each parcel of land is either inside or outside the taxing jurisdiction, regardless of who owns it, or where he or she resides, or what other assets he or she may own, or other income he or she may receive, here or elsewhere. No international tax treaties are needed in order for a nation or smaller jurisdiction to tax its own land. No information need be demanded of any other nation or its institutions.

Adam Smith wrote in 1776 that if you tax movable capital ("stock") it will be concealed or removed. Worse, some forms of capital are more concealable and removable than others, so a tax on capital, even on ALL capital, is necessarily nonuniform. Knowing the quantity of mobile capital requires a deep inquisition "as no people could support" (Smith, p. 800). Today, with instant electronic encrypted international fund transfers, the ability to avoid and evade taxes on mobile capital has outrun even Smith's vivid insights.

The OECD's response is to call for more enforcement, and to scapegoat small tax havens. To enforce an income tax today calls for nothing less than a worldwide intelligence network with vast powers of search and seizure.

It also calls for worldwide thought-control to give it moral authority and general support. The end of this thought-control is to criminalize income. Since that is too absurd to proclaim in so many words, the OECD nations have added a step: it is not criminal to earn income, but it is criminal to do so and not "admit" it and pay a fine. People's minds have been conditioned to tar that as "cheating," as though it were a kind of moral lapse. The OECD Report is the latest move in a longtime thought-control campaign to universalize that attitude toward earning income. One earns income mainly by producing goods and services, so that mindset is stiflingly, massively counterproductive. More: to impose a false, self-serving "morality" on others is itself immoral, in the worst way.

We have come far downhill since Adam Smith gave people credit for not supporting deep inquisitions into private affairs. How he would boggle at the inquisitions "supported" or tolerated today! However, now it has become clear that income taxation cannot endure without a worldwide intelligence network: a worldwide inquisition by the revenue agents of every nation into the records of every other nation. Here, I submit, is where to draw the line. Here is where a determined small community, jealous and precious of its sovereignty, can defy, puncture and collapse a bloated world tyranny. It's been done before.

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