The Worldwide Benefits of International Tax Competition

by Mason Gaffney, Riverside, CA

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U.S. Treasury Secretary Robert Rubin tells us that economic conditions are "fundamentally sound." The light of history might have given him pause: that is what one of his predecessors, Andrew Mellon, told the public in October, 1929. However, it is only ceremonial, not to be taken literally, or as a guide. If public officials didn't say it, people would wonder why not, and worry.

We are gathered here tonight because the Organization of Economic Cooperation and Development tells us that international tax competition, on which your prosperity rests, is "harmful," and should be stamped out. Is this, too, just ceremonial? I fear not. When a powerful international political organization officially brands you as "harmful," look out. "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. Defamation anticipates oppression, conditioning suggestible minds to accept it. Current signals from Whitehall suggest that it may cooperate with OECD in the oppression.

I am an outsider here. Like the ardent lover in Lehar's Merry Widow, my destiny is just to "sing my serenade and part." My purpose is to begin building a stage on which you, the principal actors, may perform. Special conditions here have made many of your largest stakeholders and natural leaders reticent to speak out. I suggest the current OECD assault on your very being bids you change that habit, at least on this matter. My goal is simply to articulate what many of you are already thinking, and offer my back to serve as your floorboard. You are to be the leads in this drama.

I. Precedents

So the OECD tells us international tax competition is "harmful." You may find their own words in the Report of their Committee on Fiscal Affairs, Harmful Tax Competition, which the OECD Council approved on April 9, 1998, and issued as a "Recommendation to the Governments of Member Countries." Any Caymanian, citizen or expatriate, who can stay awake through its deadly prose will recognize a very live assault on your island nation and its economy. 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 fashions in the ideologies of public finance. For one example, closely analogous, in 1969 or so, Sacramento (California's State Capitol) told us that interurban tax competition was harmful, because it kept some cities from raising their sales taxes. To solve this problem, they invoked the doctrine of "uniformity": if only every city raised the sales tax, no retailer or buyer could escape it by fleeing to a city without one. Accordingly, Sacramento forced every city to impose a sales tax, piggybacking on the existing state sales tax. The State collects it, and returns it to each municipality of origin. A few years later California cut its local property tax rates to 1/3 of their former level, and replaced the funds with state subventions, financed by raising state sales taxes, subjecting its once-independent cities and schools to a high degree of state control.

A "uniform" sales tax is not uniform in its effects. Retailers in rich locations can bear it and survive; those in marginal locations cannot. The result is especially to penalize poorer neighborhoods and regions and communities.

It will not surprise any reasonably jaded and sceptical observer of dirigisme in practice that there were 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 by-product of that is a retail vacancy rate approaching 33%, an enormous private and social cost. "When will they ever learn?" Not soon, apparently: the next step will be for the State to preempt local zoning, centralizing more and more control in Sacramento. Such centralized control is clearly the aim of the OECD campaign against tax competition. It is anomalous that those who preach for competition in the private sector—what they call "liberalization" — should suppress competition among governments.

It is also anomalous for OECD to fault 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 most real estate income in the U.S.A., the largest member of OECD. The costs of ownership - interest and property taxes - are fully deductible. The cash flow is offset by overdepreciation until the property may be sold. The resulting nominal gain then gets special treatment as a "capital gain," often resulting in no tax at all, and at worst in a lower tax rate, at a deferred date. If it is an owner-occupied residence or country playground, there is not even a nominal tax on the imputed income.

Thus, OECD members might do well to review the Scriptural behest: "First pick the beam from thine own eye; then thou may see better to pick the mote from thy neighbor's eye."

II. What is "harmful"?

OECD says a "harmful tax regime" is one that "attracts mobile activities." Right away we think of low taxes, and

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that may be what OECD means - on p.27 they specify low income taxes. However, that is too simple by far. A nation may also attract mobile activities in two other ways: by offering superior public services; and by a tax structure that favors mobile activities without stinting on public services.

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, with the highest taxes per capita of any U.S. state. Its magnet is in the very direct form of an annual "social dividend" of over $1,000 per man, woman and child, in cash.

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 lands on the planet. It seems rather mean of them to deny to nations occupying less favored lands the only compensatory measures 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 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 structure. There are taxes and then there are taxes. The OECD Report was written by people wearing blinders that keep their eyes and minds fixated only on kinds of taxes that penalize and repel mobile activities. Let us liberate ourselves from that fixation. There are taxes that do not repel mobile factors, but positively attract them. The OECD does not like them. I will give you some examples.

B. Magnetic tax structures

The spectacular growth of California from about 1900 to 1976 was in part the product of a magnetic tax structure. California's natural advantages, such as they are, did not promote much growth during the latter 19th Century. Eventually, though, growth-oriented forces prevailed. Taxes (of a certain kind) rose, and California provided superior public services of many kinds: water supply, schools and free public universities, health services, transportation, parks and recreation, and others. It held down utility rates by regulation, coupled with resisting the temptation to overtax utilities to hold down property tax rates.

California had oil, but did not tax it, and still doesn't. Its wine industry went virtually untaxed. There was and is hardly any tax on its magnificent redwood timber. There was no charge for using falling water for power, or withdrawing water to irrigate its deserts. All those would have been good ideas, but they are not what California did.

Its main tax source was another kind of immobile resource: ordinary real estate. Its tax valuers focused their attention on the most immobile part of that, the land, such that at one point, 1920, land value comprised 70% of the "real estate" tax base.

People and capital flooded in, for they are mobile in response to opportunities. 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 tax competition "harmful"?

If California competition was 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 at home. While it is politically correct today to stress the negative side of the migration of European people and capital to the New World, I doubt if many people, on balance, would prefer a world shrunk to its eastern hemisphere.

California became the 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 buyers, 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.

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. Even the braceros, the Hispanic "guest-workers" who toil in the fields, send money home, relieving problems in their homelands. What is involved here, in spite of its well-publicized abuses, is turning useless people into productive people.

As to capital, California offered a higher return on that, 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. Over time, buildings that wore out in the east were replaced in California.

Did this in California seem ambitious in any way damaging to others? It did tend to pull up interest rates back east, hurting 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

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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 P/e ratios and lower capital gains. This is too big an issue to settle here, but on balance, in my opinion, a rise of interest rates has an equalizing effect on the distribution of wealth.

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

Basically, California's remarkable 20th Century growth extended the American tradition of the western frontier, in the spirit of Thomas Jefferson, 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.

D. Recent changes.

In 1978, California took a giant step backwards by enacting its "Proposition 13," capping property tax rates at about 1/3 of their previous level. The national ranking of its services began a precipitous fall; so did its per capita income. Struggling to maintain itself, the State has raised sales and income and business taxes to unprecedented levels. These are taxes that "shoot anything that moves," and spare immobile resources that don't. The result is the rapid "Alabamization" of California, as we descend to join Alabama with the worst school system in the nation.

Today if we look for a new frontier we find it in, of all places, one of the original 13 colonies, New Hampshire, with its poor soils, 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 income, while 2/3 of all its state and local revenues come from the property tax. Richard Noyes and I have spelled out the details in our chapter in The Losses of Nations, Fred Harrison (ed.), 1998.

IV. Is Competition Beneficial?

A more efficient government would offer superior public services without higher taxes; or the same services with lower taxes. Is this harmful? Those who sanction competition to regulate private enterprise to attract suppliers and customers, and undercut monopolies, should by the same reasoning also endorse competition among governments to attract people and capital. Such competition is a major line of defense against the tyranny that a monopoly government could exercise.

Every government has some latent monopoly power by its nature - a monopoly of power over certain lands. The behavior of OPEC during the 1970s, and the threat posed by Saddam Hussein more recently, illustrate the point, but by no means exhaust it. Governments try especially to attract industries that are clean, safe, and generative of fiscal surpluses. Tertiary industries like yours are what they cherish most. Through OECD, they will fight to keep them from migrating elsewhere.

The benefits of intergovernmental competition are exemplified in European history. The 16th Century, the age of nation-building, also saw a worsening in the returns to the mobile factor, labor. Before that, during the anarchic Wars of the Roses, dozens of petty tyrants competed to hold onto their retainers and archers, making the 14th and 15th Centuries a golden age for English labor. Economic historians have shown that the material living standards of labor in this golden age were higher than in the 19th Century, for all its technical progress. The Church used its vast landholdings to provide the welfare system of the period. The Tudor monarchs then put an end to such wasteful competition among tyrants. They let their favorites enclose the commons, and replace people with sheep. They let thousands be cast loose to roam as "sturdy beggars," and then whipped them back, bereft of bargaining power, to serve their masters on the masters' terms. Thus was the modern age born in agony, an agony brought on by ending competition among governments.

V. Should tax regimes be the same everywhere?

Uniform taxation does not produce uniform results, a phenomenon that tax-economists acknowledge 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 - a strange ambivalence that I will not try to explain here, but only deplore. They would improve their policy prescriptions if they gave more weight to the Ramsey Rule. 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 Goods and Services Tax, Pay As You Earn, or Value Added Tax and it makes economic life nonviable at these lean edges, because there is no taxable surplus.

An example is "the bush" of South Africa. South Africa imposed a VAT with the very purpose of extracting taxes from poor blacks in the bush. The result was to sterilize the bush economically, to scorch the earth and drive its people away to squat in extralegal shacktowns like Soweto, near Johannesburg, and The Crossroads near Cape Town. It forced them to survive doing business 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.

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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 land area about the same as the Cayman Islands, it became a world center of both secondary and tertiary industry, with a large population, and a high per capita income by world standards. Those who have eyes to see, let them see.

Nations 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, real property.

VI. Choices for OECD nations

If 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 less authoritarian welfare states afterwards. This approach had its day, and is now a proven failure, although that is not stopping several 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, 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 this speck of coral amid a great Sea. Any independent force threatens the whole structure, so it demands nothing short of worldwide domination: a megalomaniac goal, indeed.

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 are not headed this way today, obviously, but if the little Cayman Islands can face them down, they will have no other choice. Freedom anywhere foils tyranny everywhere. Tax tyranny must seal every leak, or it collapses.

VII. Tax intelligence

A cognate concern of the OECD is extending the sovereign powers of its members to pry into private dealings in other nations. The French verb percevoir has two meanings: one, of course, is "to perceive"; the other is "to tax." How very perceptive of the French to see that connection. To tax it you must first see it and understand it. Income-tax agents are necessarily insatiable 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? Fortunately, no. The OECD Report makes the unfortunate tacit premise that all taxes must or should 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. Import duties, for example, are levied on the simple act of bringing in dutiable goods, regardless of who does it, or where they come from (although sometimes this is considered). No deep inquisition is required into all the personal affairs of the importer. They are enforceable simply by refusing admission until the duty is paid or, in extreme cases, seizing the goods. Only in criminal cases are persons as such penalized or jailed.

There are upper limits on feasible tariff rates. Many national borders, unlike those here, are long and penetrable. Many nations are lowering or avoiding import duties in the interests of freer world trade, the strong trend of the times. Many groups, as here, are rebelling against high domestic consumer prices. The weight of opinion is that import duties, and all such consumer taxes, are regressive, and socially undesirable.

A purer case of in rem taxation is the tax on real estate. Such taxes are a lien on the land, not the person who owns it. Sovereignty over land is unambiguous. It 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 stock (movable capital) it will be concealed or removed. Worse, some forms of capital are more concealable and removable than others, so a tax is necessarily nonuniform. Knowing the quantity of mobile capital requires a deep inquisition "as no people could support" (Wealth of Nations, p. 800). Capital is never uniformly taxed, and never can be, even within one nation. In today's world economy, with instant electronic encrypted international fund transfers, the ability to avoid and evade taxes on mobile capital has outrun even Smith's keen insights.

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 crimi-

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nal to do so and then fail to admit it. People's minds have been conditioned to accept tarring that as "cheating," as though it were a kind of moral lapse. It is roughly parallel with Kenneth Starr's approach to President Clinton: what you did was not criminal, nor public business; but failing to report it was both, and impeachable. The OECD Report is the latest move in a longtime thought-control campaign to universalize that attitude toward earning income. Considering that one earns income mainly by producing goods and services, that mindset is stiflingly counterproductive.

We have come a long way since Adam Smith gave people credit for not supporting deep inquisitions into their 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 nation, jealous and precious of its sovereignty, can defy, puncture and collapse a puffed-up world tyranny. It's been done before.

(Editor's note: Dr. Mason Gaffney is Professor of Economics at U.Cal.-Riverside. He is the author of dozens of scholarly papers. He is also the editor of several books which are available from the Schalkenbach Foundation.