# The OECD vs. "Harmful Tax Competition"

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The OECD tells us international tax competition is "harmful." Their official language is in Harmful Tax Competition, an Emerging Global Issue (OECD, May, 1998), and a less equivocal summary in my response of August, 1998, International Tax Competition: Harmful or Beneficial? (self-published).

## I. Precedents

The OECD ideal is tax "uniformity," which they also call "harmonization," an enchanting musical euphemism. This has a familiar ring in the argot of public finance. In 1960 or so, California sales-taxers noted that interurban competition kept cities from raising their sales taxes. They invoked the doctrine of "uniformity": if every city raised the sales tax, no seller or buyer could flee to a city without one. So they had the state impose one, collect it, and return it to each municipality of origin. Now, sales-taxers are campaigning to suppress interstate competition in the same way: a national sales tax, with revenues returned to each state of origin.

"Uniformity" sounds good, and sounds economically impartial—what economists call "neutral." 'Tain't so, however: 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. There, labor just makes wages; capital just makes enough to pay interest. Impose a uniform excise, GST, PAYE, or VAT and it makes economic life nonviable at these lean edges. The American "Whiskey Rebellion" of 1794, a frontier reaction to Hamilton's uniform national excise tax, should help us remember that principle.

A sales tax, to the extent it is shifted to sellers, falls heavier on operations of high volume and low markup, much heavier than on their opposite numbers. It is a tax on the gross volume of business, regardless of profits.

More generally, uniform taxation based on sales or income does not produce uniform economic results, even in theory. Fiscal economists acknowledge this as the “Ramsey Tax Rule." Having nodded to it in principle, however, the most visible policy wonks pass over it when counseling legislators, and preach "uniformity"—a maddening ambivalence I am loath to explain

in public, but will only deplore. It aids and comforts those who champion more centralized control of taxation.

## II. Internal contradictions of the OECD

Such centralized control is the aim of the OECD campaign against tax competition. It seems contradictory for those who preach for competition in the private sector—what they call "liberalization"—to suppress competition among governments. I will show that competition in the public sector has benefits, too.

It is also contradictory for the 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 real estate income in the United States, the largest member of the OECD.

## III. What is "harmful"?

The OECD says a "harmful tax regime" is one that "attracts mobile activities." Otherwise put, the OECD says it is harmful to promote economic growth. Merely to change the wording is to expose a flaw in the premise. However, the OECD evidently means by "harmful" that growth in country A can come only at the expense of country B—that growth is a zero-sum game. It is the old Mercantilist idea, recycled for modern times. The OECD also works from the premise that growth is the product of low taxes. Both those premises are wrong.

Mexico, for example, has low taxes, but repels both capital and labor anyway. A nation or state or province or city 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. The other is by a tax structure that favors mobile activities without stinting on public services. This may be done simply by targeting taxes on immobile resources. Let's inspect those points.

### 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. The whole province of Alberta is another such magnet, thanks to its monopoly of petroleum in Canada. The state of Alaska is another: its magnet takes the very direct form of an annual "social dividend," 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-à-vis those less favored by nature, by virtue of their occupying the best locations on the planet.

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; why not in the public sector, too?

## B. Magnetic tax structures

The other way is by adopting a magnetic tax structure. There are taxes that do not repel mobile factors, but positively attract them.

The extraordinary growth of California from about 1900 to 1978 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 provided expensive public services of many kinds: water supply, superior schools and free public universities, health services, transportation, parks and recreation, and others. That all required tax revenues. Its 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, 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 this tax competition "harmful"?

In a world of self-aggrandizing governments, intergovernmental competition is what 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 the 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, as there is to everything, to the migration of European and African people and capital to the New World, yet few people, on balance, would be better off in 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 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.

California attracted eastern workers; the competition drew up eastern wage rates. The damage to eastern employers was offset by an equal gain to their workers—both their incomes and their dignity—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. What is involved here is turning useless and even criminal 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 California's vigor seem too ambitious, so as to damage others? If so, as quoth Marc Antony when burying Caesar, "it was a grievous fault," worthy of suppression by an OECD. Most economists believe, however, that investing is the motor that drives the macro-economy, and investment opportunities are the key to the ignition.

California competition also pulled 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, and another bonus from increased aggregate demand from the multiplier effect of higher investing. We are conditioned these days to think of higher interest rates as suppressive, and so they may be when caused by restriction of supply. New investment opportunities, by contrast, are a rise of demand, with macro results that are mainly healthy. Keynes had many faults and many critics, including this writer, but he did a great service by selling this idea to the world.

Basically, California's remarkable 20th century growth extended the American and the Canadian 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.

Was California growth the product of southwestern pioneer vigor? Compare it with New Mexico, a Third World nation masquerading as an American state. An oligarchy of giant landowners, in the million-acre class, dominate politics and culture, and keep taxes off their latifundios. New Mexico raises a lower fraction of its state and local revenues from the property tax than any other state. Having two senators and few people, it gets more federal spending per capita than almost any state, but that and scenery are about it. It has the highest poverty rate in the United States, and nearly the highest rate of violent death.

## IV. Should tax regimes be the same everywhere?

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 five million, and a high per capita income by world standards. 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 flees; tax labor, and brains drain; tax commerce, and marts depart; but tax land and it stays. It's so simple—how could we have overlooked it? (If you really want to pursue that sordid question, I modestly refer you to my recent book, *The Corruption of Economics*.)

## 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 some desperate failing Asian nations are giving it another whirl (who learns from history, anyway?).

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. 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, so it demands nothing short of worldwide domination: a megalomaniac goal, indeed.

Does anyone actually nurture such a goal? Italian Treasury Minister Carlo Ciampi says that 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 (ROME, Dec 17 (AFP)). Baroness Elizabeth Symons of Vernham Dean, British Minister for the Overseas Territories, tells us that the 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." (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 and border taxation to purely intra-territorial taxation; away from in personam taxes towards in rem taxes; and away from a mobile tax base towards a more immobile tax base. They are not headed in those directions today, but if one or two nations can face them down, they will have no choice. Freedom anywhere foils tyranny everywhere. Tax tyranny is a balloon: seal every leak or it collapses.