When California Had a Magnetic Tax System

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The OECD says a "harmful tax regime" is one that "attracts mobile activities." Many of us see that, rather, as a mark of a good system, but I'll return to that. First, let's follow them along a way. Right away we think of low taxes, and that is what the OECD means—on p. 27 they specify low *income* taxes. They, and allied international organizations like the EU, also have a history of jumping nations whose VAT is too low to suit them.

That view is too simple by far. Mexico, for example, has very 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 *structure* 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.

B. Magnetic tax structures

The United States is a great laboratory for testing tax structures. It contains fifty-one or more separate systems, with free migration of labor and capital guaranteed by the Constitution.

The extraordinary growth of California from about 1900 to 1978 shook and recast the economy of the United States, 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 twenty years or more. 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, schools and free public universities, health and mental health services, transportation, parks and recreation, and others. It held down utility rates by regulation, coupled with resisting the temptation to overtax utilities.

That all required tax revenues. California had oil, but did not tax severing it, and still doesn't. Its wine industry went virtually untaxed. There was and is hardly any tax on its magnificent redwood timber, either for cutting it or letting it stand. There was no charge for using falling water for power, or withdrawing water to irrigate its deserts. Most of those are 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 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?"

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. (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. Even the *braceros*, the Hispanic "guest-workers" who toil in the fields, send money home, relieving problems in their homelands. It would be better yet if they could become small landowners and work their own farms, but in this imperfect world we observe what is, without denying that it might and should be better. What is involved here, in spite of its well-publicized abuses, and glaring shortfalls, is turning useless and even criminal people into productive people.

As to capital, California offered a higher return on that, too. There emerged what people called "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 Shakespeare had Marc Antony say, "it were a grievous fault," worthy of suppression 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.

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 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," thus more than intimating that they are upholding the interests of labor, like good continental European social democrats. In this, I suggest they have misstated the issue, setting an agenda for a false and futile debate, fooling both their friends and their critics, and possibly even themselves (although I am cynical as to the last point). Their premise, at least the one they state, 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. The OECD treats land like one of those four-letter words that is unmentionable. So do its academic retainers, who are well-trained to believe that land is just as mobile as capital. This 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? Compare it with New Mexico, not far away. New Mexico has made itself 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 everything, 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 more federal spending per capita than almost any state, but that and scenery are about it. It is picturesque: its boosters call it "the Land of Enchantment," but the Enchanter has cast a sleeping spell on its local enterprise. It has the highest poverty rate in the United States, and, in its wide open spaces, nearly the highest rate of violent death in the United States—itself a violent nation.

D. Recent changes.

In 1978, California took a giant step backwards by enacting its Proposition 13, capping property tax rates at about one-third 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 has been the rapid "Alabamization" of California, as we have fallen to join Alabama with the worst school system in the nation. Inmigration has changed to outmigration, and of those who stay, California has by far the largest prison population of any state, so large that 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.

Today if we look for a new frontier we find it in, of all places, one of the original thirteen colonies, New Hampshire, with its poor soils, marshy peneplains, harsh climate, impassable mountains, and lack of natural urban confluences. What New Hampshire has now is the least repellent tax structure in the nation: it does not tax personal income or sales, while two-thirds of

all its state *and* local revenues come from the property tax. It has bucked the national trend toward taxing income and sales, and IT HAS PROSPERED! (Details are in a Chapter by Richard Noyes and the speaker in Fred Harrison (ed.), 1998, *The Losses of Nations*.)