



# Europe's fatal affair with VAT

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*As austerity drives Europe deeper into insolvency and loss of competitiveness, the political crisis is coming to a head. Economic stagnation is inextricably associated with the way governments raise revenue. One of the European Union's policies, the Value Added Tax, has inflicted a pernicious and persistent cost on 500 million Europeans. For as the VAT tax-take grew, banks and public exchequers grew mutually dependent, together building a house of cards based on future tax revenues – revenues that VAT does not and cannot provide, even as it chokes off productive commerce and industry and employment opportunities.*

*In 2014, the 28 members of the European Union used VAT to collect €975,900 million (equal to 7% of GDP). By the time the people of the United Kingdom voted in their Brexit referendum in June 2016, the tax-take was about €1 trillion.*

*This means that the losses stemming from VAT alone were €1 trillion: that is the sum on top of what was collected. It is the measure of what the nations of Europe could have produced and enjoyed if, instead, their governments had employed the one revenue raiser that does not distort economic behaviour. And yet, economists fail to highlight these distortions as breaches in the dikes guarding Europe from its encroaching sea of troubles.*

*As a customs union, the EU imposes tariffs which inflict further losses of wealth and welfare. Tariffs, like all taxes based on transactions in the marketplace ("taxable events") have effects similar to VAT, mutatis mutandis.*

*The excess burden of taxation is a worldwide problem. An ideological collective of economic scholars and statesmen stands idly by while the defences around their communities are systematically eroded. Worse, many rationalize and endorse VAT, supported by the cartel of international agencies and banks that promote 'harmony' in taxing, lending and collecting. Contrary to the stridently expressed views of libertarian commentators, Europe has not reached the limit of its taxable capacity; rather, it needs a better fiscal system and philosophy, with higher tax rates on narrower and less elastic and less dynamic revenue bases.*



# 1

## **What's the matter with sales taxation?**

**I**N AUGUST 2011 S&P Global Ratings lowered the credit rating of the U.S. Treasury. We held our breath, thinking this might be the tipping point before a flight from the dollar. Our Congress, deadlocked, quarrelsome and dysfunctional, seemed to deserve it. And yet mobile international capital saw something, spited S&P, and stayed with US Treasury securities. It seems that we must be doing something right, or at least less wrong than other nations. I would not breast-beat about “American Exceptionalism.” I deplore our nation’s faults, and failure to face them and reform them. I deplore it when some primitive calls it unpatriotic to spotlight our faults: how else can we see and cure them? At the same time it is foolish to preach that we must emulate Europe, when Europe is sliding downhill faster than we, and floundering as it slides.

I build a thesis around a simple, if partial answer: the USA is the only major nation lacking a national-level sales tax (or VAT or GST). At the same time we raise a higher fraction of our combined national, state and local revenues from taxes on property, and income from property, and from bequests of property. The fraction is not just a little higher, but plain to see even without the microscopes of modern theory and econometrics. True, our fraction of revenues raised from property has been trending downwards for half a century, but even so is still many times higher than in Europe, or in most nations of the world.

A major talking point among corporate spokesmen is to contrast the U.S. nominal corporate tax rate with those of other nations, which have recently become lower. Therefore, they say, we must lower ours, to make us “competitive” (today’s buzzword). They give the impression that the income tax base is gross income. I will show below that any income tax, personal or corporate, is less depressive, and has less excess burden, than any sales or excise tax or VAT, however “general.” That is partly because labour costs are deductible from taxable income. In addition, earlier economists like Musgrave and Domar and Commons and many others showed that deducting capital outlays may lower the effective income tax rate on investing in new capital goods, often to zero and even below. As Anne-Robert Jacques Turgot, an outstanding public servant,

economic philosopher and social reformer wrote, even longer ago, investing is “the beneficial and fruitful circulation that animates all the work of society...”

It is true that nominal corporate income-tax rates in the USA have moved recently to the #1 rank among major OPEC nations. That is not, however, because our rates have risen; rather, others have fallen. Italy’s rate, for example, has dropped from 52% in 1962 to 27% in 2012, a huge fall of 48%, while Italy replaced the revenues by raising its VAT. If Italy had prospered, it might prove the point urged by corporate lobbyists. However the well-known fact is that Italy has fallen to beggar status in the EU. It is the biggest beggar among the failing “PIIGS” nations.<sup>1</sup> This is the more remarkable considering that European VATs generally are of the “consumption type” that lets one expense investments.

Today, U.S. economists and politicians of left and right are moving toward a pessimal consensus: lowering tax rates on business and rentier incomes is acceptable so long as Congress also closes “loopholes.” Hardly anyone says what loopholes, hiding the vital truth that many loopholes, like fast write-off and expensing of investing in creating new capital goods – genuinely “income-creating” spending – are exactly what have made high rates of income taxation tolerable, and compatible with high rates of investing during the mid-20th Century.

Europe generally uses the “consumption-type VAT,” meaning that capital outlays are expensable. This may have the effect of exempting the income of capital from the tax, although it is hard to find a comprehensible definition of “capital,” and if it includes land it is extremely discriminatory, and in any case favours more durable over less durable capital, and fixed over circulating capital. This, which should be a major issue, is untouched, to my knowledge, in the literature – but will be touched herein.

James Buchanan has enjoyed great success with his new school of “Public Choice,” appearing in many texts as the trunk of a new, alternative economics.

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‘The Public Choice school argues that the best tax is one with the most excess burden. That is because the excess burden will dissuade voters from supporting any taxes at all.’

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One of its tenets, turning previous thinking upside down, is that the best tax is one with the most excess burden. That is because the excess burden will dissuade voters from supporting any taxes at all, and thus shrink government down to

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<sup>1</sup> PIIGS = Portugal, Ireland, Italy, Greece, and Spain. While these are mostly Mediterranean, we will see that many Baltic and central continental nations are nearly as troubled.

where it can be “drowned in a bathtub,” in Grover Norquist’s metaphor. Many deeply-funded new think-tanks undergird dozens of well-paid economists to orate on the same text.

Europe’s recent history seems to refute Buchanan’s thesis. Europe’s welfare states, or most of them, fast outgrow Norquist’s little bathtubs, even though financed by growing VATs with their excess burdens. VAT champions uphold it because of what they see as its high capacity to raise revenue, and yet Europe’s revenues keep falling as its nations substitute VATs more and more for narrower-based income taxes.

John Stuart Mill in 1848, citing an even earlier finding by John McCullough, showed that a seemingly “general” sales tax would tax capital for turning over, and thus induce investors to favour those capital goods that turn over slowly. In Austrian terms, the tax induces investors to lengthen the Austrian “period of production,” and thus distort the “structure of capital” in favour of “high order” capital goods. In Austrian cycle theory, this is a cardinal sin of public policy.

Modern Austrian writers, however, almost to a man, blame the problem entirely on low interest rates enabled by misguided central bankers. Something is missing there, and that something is tax policy.

Here is Mill’s proto-Austrian case against a general sales tax:

‘...if there were a tax on all commodities, exactly proportioned to their value, there would ...as Mr. M’Culloch has pointed out, be a ‘disturbance’ of values ...owing to ...the different durability of the capital employed in different occupations ...in two different occupations ...if a greater proportion of one than of the other is fixed capital, or if that fixed capital is more durable, there will be a less consumption of capital in the year, and less will be required to replace it, so that the profit, if absolutely the same, will form a greater proportion of the annual returns. To derive from a capital of £1,000 a profit of £100, the one producer may have to sell produce to the value of £1,100, the other only to the value of £500.’ [i.e., where capital is less durable, you must sell more gross to get the same net profit.]

‘If on these two branches of industry a tax be imposed ...the one commodity must rise in price, or the other must fall, or both: commodities made chiefly by immediate labour must rise in value, as compared with those which are chiefly made by machinery...’<sup>2</sup>

How memorable is Mill’s word “disturbance,” 150 years before Darth Vader in *Star Wars* sensed a “Disturbance in The Force.” In Mill’s and M’Culloch’s usage, “The Force” is value as determined in a market before or without taxes based on gross sales.

What Mill means by “capital” is clear from his insightful saying, “Capital is kept in existence from age to age not by preservation but by continual reproduction”.<sup>3</sup> Mill’s “capital” then obviously does not include land. Capital is not a specific concrete good, like a chair in the furniture shop. Rather, it is a quantum of value

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2 1848, Book V, Chapter IV, pp. 504-05.

3 1848, Book I, Chapter V, para. 18.

that we can, and normally do, keep existing by using the cash from sales to “meet the next payroll,” as they say, to replace the chair. It need not be an identical chair, or any chair at all, for capital in this transition is totally fungible in form and location.

Mill hid this light under a bushel, by offering just one example of a small difference, arithmetic only. It was easy to overlook in passing, which is what later standard-brand economists have done. Austrian-School writers, who should see Mill’s point so clearly, have mostly skirted tax policy. We should, rather, set this light in a tower on a hilltop as a beacon sending its gleam across the wave to save the foundering ship of state. This paper therefore returns to it below, as a prime example of the excess burden of any kind of sales tax, including VAT.

Then there is The Ramsey Rule. Most standard textbooks and learned papers tell us that a truly general retail sales tax, unlike an excise tax, is neutral as between one commodity and another. A national tax is also neutral between locations, since it is the same in one region as another. Those conditions are never approached in practice, but in the sales-tax canon that merely means reformers should extend the reach of the tax, as the EU does with its push for tax “harmonization” among member nations, meaning in practice that all should follow-the-leader and adopt a VAT at about the same rate. Sales-taxers in the USA keep pushing for ways to override the Commerce Clause in the U.S. Constitution and allow each state to tax imports from other states.

Thus, Buchanan and Flowers wrote “If the tax is uniformly imposed on the sale of all commodities and services, there can be no real shifting of resources from taxed employments to non-taxed employments. The shift in relative prices occasioned by the partial tax cannot occur under a truly general sales tax”.<sup>4</sup> Even Harry G. Brown, no fan of sales taxes, wrote “if there is a tax on the production of all commodities and services...there is no advantage in leaving one taxed line for another line which is taxed to the same extent.”<sup>5</sup> Earl Rolph and George Break commit to this view.<sup>6</sup> So does Harold Somers, generalizing that a tax on gross sales is the same as a tax on net income.<sup>7</sup>

Bernard Herber<sup>8</sup> and David Hyman<sup>9</sup> chime in cautiously. Charles McLure throws out caution and boldly damns “...the ridiculously unfair and distortionary *de facto* exemption of interstate sales...”<sup>10 11</sup>

The Ramsey Rule says that sales tax rates, to be allocationally neutral, should not be uniform at all, but inversely proportional to elasticities of supply and demand. I have addressed this issue elsewhere,<sup>12</sup> quoting A.C. Pigou:

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4 Buchanan & Flowers (1975: 399).

5 Brown (1939: 254).

6 Rolph and Break (1949: 117).

7 Somers (1964: 17, 26, 27).

8 Herber (1967: 254).

9 Hyman (2005: 617-26).

10 McLure (2005).

11 Gaffney (2000 and 2000a) refutes this position.

12 Gaffney (2009: 52-53).

"If there is any commodity for which either the demand or 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."<sup>13</sup>

Pigou's reasoning leads straight as a guided missile to levying taxes *exclusively* on the value of land, because its supply is inelastic. Whether Pigou knew what he was saying we may never know, for he was guarded and cautious and indirect and often obscure and coded, like so many academics fearful of witch-hunters. He had reason to be concerned, since even today, long after his death, some are trying to discredit his ideas by alleging he was a Soviet secret agent. His Chapter XIV, "Taxes on the Public Value of Land," does favour such taxes, but is more hedged.

Richard Musgrave avoids the issue by leaving Ramsey completely out of his classic *Theory of Public Finance*. Many, indeed most modern academics square the circle by first citing and then misquoting the Rule. They apply it only to *demand* elasticities, omitting *supply* elasticities, even though these are the more important part of the original rule. Allyn Young started this ball rolling in reviewing Pigou in 1929: "I shall assume that costs are constant. It will be unnecessary, therefore, to take account of elasticity of supply as something apart from elasticity of demand."<sup>14</sup> The notable exception is Joseph Stiglitz. Consistently, Stiglitz often writes sympathetically of taxing land values.<sup>15</sup>

Modern writers deplore the exemption of "services" from the sales tax base. These writers and teachers refer in their contexts only to labour services, ignoring the service flows of land or capital. This is not from ignorance: they know that the "service-flow" of an owner's home has long been included in the National Income and Product Accounts (NIPA) as a form of income, income consumed by the owner-occupant as the real estate yields it. They just blank that out when it comes to taxing services to the "final" consumer.<sup>16</sup> Then there is the well-nourished doctrine that we should tax consumption in order to exempt saving. The writer has refuted this elsewhere,<sup>17</sup> and will only summarize the arguments here.

Basically they are that circulating capital is the life-blood of an economy, and there are four major vampires draining it away. These are

1. public debts
2. equity withdrawal from appreciated lands
3. preferential tax treatment of imputed incomes from durable capital and lands, and
4. the corporation.

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13 Pigou (1928: 105).

14 Young (1929: 15).

15 Stiglitz (2010).

16 Anderson (1913: 252).

17 Gaffney (2009).

## 2

## Origins of American exceptionalism

**B**EFORE THE ENLIGHTENMENT, and the Ages of Reason and Benevolent Despotism, Europe raised major revenues from excise taxes like the hated salt tax (*gabelle*), and tariffs, and tolls (like those exacted by the original Robber Barons straddling the Rhine). It built roads with drafted *corvée* and *robot* labour. In England, Thomas Hobbes, a leading influence on the Stuart line of monarchs, had pushed hard for taxes on what he called “consumption” (meaning in practice the products and commerce of the bourgeoisie).<sup>18</sup> Slavery, serfdom, peonage, and indentured labour were common. Prison labour and the galleys were not unknown, and lingered into the 19th Century, as dramatized in *Les Misérables*. Underpaid Religious staffed schools and hospitals, hospices and asylums. As recently as 1930 England used a salt tax as a tool of its imperialism in India, and beat down Gandhi’s passively resisting Indians with extreme cruelty that became notorious worldwide. At the same time it was forcing native Africans to labour like slaves by imposing poll taxes. Margaret Thatcher even tried to re-import the poll tax into England itself, which was her downfall.

French King Louis XVI, briefly playing the benevolent despot, in 1774 appointed Turgot his Finance Minister. Turgot was fresh from his triumphs as *Intendant of The Limousin* (Limoges), where he had converted a stagnant into a thriving province. The *Parlement de Paris*, composed of the First Estate (clergy) and the Second Estate (nobles) articulated dominant attitudes in its *Rémonstrance* to Turgot’s Six Edicts of 1774.

‘The personal responsibility of the clergy is to fulfil all the functions relating to education and religion and to aid the unfortunate through alms. The noble devotes his life to the defence of the state and assists the sovereign by providing council. The last class of the nation, which cannot render such distinguished service to the state, fulfils its obligation through taxes, industry and physical labour..’

The Physiocrats wrote and preached, and Turgot the statesman acted for un-taxing commerce and industry and labour, raising revenues from land

<sup>18</sup> Neither Hobbes nor any later sales-taxer, to my knowledge, has ever defined “consumption” to mean anything but trade in “personal” (movable) property, excluding real estate.

taxation, and coining the slogan *laissez faire* for their philosophy, which gradually advanced throughout Europe. They schooled both Adam Smith and many of the American “Founding Fathers” in their thinking. Obviously, “liberal” then meant something drastically different from “neo-liberal” today.

The students, in practice, got ahead of their teachers. Adam Smith asked why Spain, jump-started with gold pilfered from the New World, lagged in economic progress. He laid it on the Spanish *alcabala* and *cientos*.<sup>19</sup> These were heavy sales taxes, their nominal rates magnified by cascading, that spared the grandees from taxes on their lands while stifling Spanish commerce and industry.<sup>20</sup> They were “broad-based,” which modern sales-taxers tout as raising more revenues, but under Philip II with his broad-based *alcavala* and *cientos*, Spain declared national bankruptcy three times.

People today associate Adam Smith with international free trade, but Smith actually contains many passages favouring domestic free trade even more than international trade. Here is one wherein he contrasts Great Britain with Spain and France, noting that the *interior* commerce of G.B. is relatively tax free.<sup>21</sup>

‘This freedom of interior commerce ...is perhaps one of the principle causes of the prosperity of Great Britain, every great country being necessarily the best and most extensive market for the greater part of the productions of its own industry.’<sup>22</sup>

Today, neo-liberals tout “trade” as a basic social good, but they mean just international trade. Look up “commerce” in *The New Palgrave Dictionary of Economics*: it says “see International Trade.” States and cities speak of their export industries as their “economic base,” ignoring the findings of Jane Jacobs and others about the virtues of import substitution as key to economic development. Neo-liberal free traders like Charles McLure lead the charge to override the Commerce Clause of the U.S. Constitution and allow each American State to tax imports, to help them raise their State sales taxes. “Neo-” pundits hijack old words to mean the opposite of their originals.

In the new USA after 1789 the Federalists under Hamilton first took control, and began levying excise taxes. In 1794 farmers of western Pennsylvania rebelled against a tax on their maize, which they marketed as whisky to cut down on transportation costs. Hamilton, with his Napoleonic ambitions, led Federal troops to put down this uprising. The voters, when they found him dominating the subsequent cabinet of John Adams,<sup>23</sup> and leading the country into the depression of 1798, retired his party and installed Jefferson, whose Virginia dynasty shaped the nation for the next 36 years.<sup>24</sup>

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19 Smith (1776: 850-51); Groves (1946: 307, n.14).

20 Klein (1920).

21 “Relatively” is a necessary word. Godwin the idealist 20 years later deplored the growth of taxes on “consumption” (read retail trade). The glass that Smith saw as half full, Godwin saw as half empty.

22 Smith, *Wealth of Nations* (1776: 851-52).

23 Hamilton was not a formal member of Adams’ Cabinet, but dominated it anyway.

24 President J.Q. Adams, 1825-29, had left the Federalists in 1807, supported Madison for President, and been Monroe’s Sec. of State. Jackson and Polk were Tennesseans who led Jefferson’s old Party against the Whigs.

These Virginians knew their Physiocracy. Jefferson, Madison and Monroe had all represented the colonies or the USA in Paris, as had their friend Franklin, where they hobnobbed with philosophers and picked up their ideas.<sup>25</sup> They were pro-French, even as France shifted from monarchy to Directory to Empire to The Bourgeois King Louis Philippe, 1832-48. It was Monroe who had led the fight for the Commerce Clause, freeing internal trade from excise taxes;<sup>26</sup> Jefferson who wrote the Northwest Ordinance dividing public lands for privatization in small parcels, and bought Louisiana, and brought the Physiocrats Gallatin and DuPont into his circle, and welcomed Tom Paine back from France, and extended easy credit to small buyers of western lands. It was Madison, with all his faults, who masterminded the Constitution, and then, in the War of 1812, used the Federal power to tax property, a power he had so carefully circumscribed.<sup>27</sup> They got the new nation off to a flying start.

The Confederate states, even though fighting to survive, stood on their states' rights against their own C.S.A. government, and bucked an attempted C.S.A. property tax.<sup>28</sup> Jefferson Davis had to finance secession with excise taxes. So Davis put a 10% tax on all farm production, paid in kind – a crushing burden on marginal farmers. Winn Parish, LA, for example, home of Huey Long, in 1863 petitioned General Grant to save them from this “oppression”.<sup>29</sup> The C.S.A. repudiated its bonds and currency, and lost the war catastrophically. Following attempted Reconstruction, however, came Hayes, Reunion and Restoration of the old ruling class which ever since, first as Democrats and now as Republicans, has saddled the old Confederate States with the most regressive tax systems in the nation, featuring heavy reliance on sales taxes.

Through the complex turmoil of 19th century Europe the *bourgeoisie* joined the first two estates in the ruling class. In the transition, Louis Philippe of France, reigning between the revolts of 1830 and 1848, earned the title of “the bourgeois king,” indicating he did not view commerce and industry simply as geese to be plucked, as in the overworked phrase from Louis XIV’S finance minister Colbert. “The sales tax existed ...intermittently, in various European countries to about 1800, but in the 19th century it played no part in the fiscal development of the important nations”.<sup>30</sup> Rulers in several nations, including the USA, fostered *la petite propriété* (in Russia, “kulaks”<sup>31</sup>) as a political buffer for *la grande propriété*. (In Germany, *Grossgrundeigentum*.) Tax regimes evolved with shifting class voting power, in a complex history with details beyond the scope here.<sup>32</sup>

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25 Bigelow (1868: IV:195); Van Doren (1938: 372); Foner (1948: 15, 24-39).

26 Norton (1941: 51).

27 Medina (1960).

28 Foner (1988: 15).

29 Brinkley (1982: 11); T. Harry Williams (1969: xii).

30 Shoup and Haimoff (1934: 811); National Industrial Conference Board (1929: 163-66).

31 Originally “kulak” meant any peasant more acquisitive than average, following the Stolypin reforms. During the liquidation phase under Stalin it evolved to mean almost any peasant who opposed collectivization.

32 Wikipedia’s anonymous article on Turgot cites many sources on his being followed by many of the best-known economists of the 19th Century.

By the end of World War 2, tax structures in Europe were a *mélange*, short of anything ideal but not as regressive as under *l'ancien régime*. We will pick up the story later in 1954, when the first VAT began the march back to the fiscal ideals of *Le Rémonstrance*.

## Taxation in the colonies

American colonies had little need of taxes, by modern standards. There was no national government to support. French and Indian wars were a major expense, but Imperial Britain paid for much of that to fend off their French rivals. Armed settlers and hunters and vigilantes dealt with most kinds of local crime; volunteers fought fires. Church and extended families covered much of what today we call social welfare and education, such as they were. Companies chartered in England sought dividends in various ways, as from road tolls and by selling off or renting out lands granted them by the Crown. Plymouth Plantation meted out lands to each settler, “and him that had a better (location) allowed something to him that had a worse, as ye valuation wente”<sup>33</sup> – that is, in their crude way, they taxed land *ad valorem*, as many migrants did as they moved west.

Nationwide, when George III's treasury sought to charge the colonies for providing their common defence it was by an excise tax like that on tea. The new nation was born in revolt against The East India Company's monopoly and these kinds of taxes that accompanied it. Tax revolt and trust-busting were built into our very DNA, at birth.

Many of America's “Founding Fathers” visited France as diplomats, and learned from Turgot. Some noted American visitors included Franklin, Jefferson, Paine, Madison, Monroe, Adams, and others. America's revolution against England meant friendship with France and Frenchmen, including liberals like La Fayette, du Pont, and Gallatin. Turgot tried but failed to reform France in his day, but he was one of our Founding Fathers, in the mind. The Commerce Clause of the U.S. Constitution did for the new USA what Turgot had tried to do for France, it guaranteed free trade among the states.

Turgot first made his mark as Royally-appointed Intendant of Limoges (1761-74). There he abolished the mandatory *corvée* (roadwork in lieu of taxation). He improved roads by other means, like taxing the lands they served. He encouraged

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33 “Then they agreed that every person or share should have 20 acers of land devided unto them ... and they (who were) appoynted were to begin first on ye one side of ye towne, & how farr to goe; and then on ye other side in like manner; and so to devid it by lotte; and appointed sundrie by name to doe it, and tyed them to certainruls to proceed by; as that they should only lay out setttable or tillable land, at least such of it as should butt on ye water side ...and pass by ye reste as refuse or comune ...And they were first to agree of ye goodnes and fitnes of it before ye lott was drawne ...whose lottssoever should fall next ye towne ...or most convenient for nearness they should take to them a neighbor or tow ...and should suffer them to plant corne with them for 4 years ...ye rest were valued and equalized at an indifferent rate, and so every man kept his owne, and he that had a better allowed something to him that had a worse, as ye valuation wente” (emphasis mine). Wm. Bradford, 1627, *History of Plymouth Plantation*, from the original ms of Bradford's history *Of Plimoth Plantation*, Book II. Boston: Wright and Potter Printing Company, State Printers (1898: 258-61).

the now-famous porcelain industry, so that Limoges-Turgot is now a block phrase in that region of France. In 1774 the new King Louis XVI, impressed, made Turgot Comptroller-General for all France. Turgot set about removing interprovincial trade barriers, which he perceived as a major barrier to French prosperity. He coined the term *Laissez-faire*.<sup>34</sup> He also set about reforming the tax system, subjecting the previously exempt lands of the 1st and 2nd Estates<sup>35</sup> to forms of property taxation. This was in the spirit of the Age, the Age of Benevolent Despotism and Enlightenment. Enlightenment included Science and Philosophy, which included Physiocracy as taught by Quesnay at Versailles, and practiced by Turgot.

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While Intendant of Limoges he published his *Reflexionssur la Formation et la Distribution des Richesses* (1766). This short, compact work contains much of the essential wisdom that Adam Smith soon was to popularize and expand with *The Wealth of Nations* (1776). Turgot stressed the important roles of capital, and free markets. He favoured letting the market determine interest rates – not from dogma, but from observing the results of John Law’s ruination of French banking in 1720. He would combat poverty by relieving the poor of taxes, while raising revenues from taxes on the value of land – including lands traditionally exempt or under-taxed. He correctly observed that taxes based on land values are nearly the only kind that raises revenues without intervening in free markets, twisting and suppressing incentives to produce and invest. By “invest” he meant paying labour to produce new capital, or replace old capital. He emphatically did not mean the zero-sum casino games of buying land, or old capital, or trading shares in existing companies. Smith visited France in 1766 and consulted extensively with Turgot, a man whose practical turn of mind made him a congenial tutor for Smith.

The Commerce Clause, Turgot’s contribution to the U.S. Constitution, has preserved interstate tax competition. It created and has preserved our domestic market, the greatest free trade zone in the world, an essential ingredient of American productivity and prosperity. Like Turgot, our Founding Fathers aimed for domestic more than for international free trade. As the USA expanded the “domestic” market swelled to include many times the land area its founders dreamed of.

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<sup>34</sup> *Laissez faire, laissez passer, le monde va de lui-même*. It is French for an ancient Chinese concept from Lao-tse, and has now been hijacked and distorted by the very kinds of people Turgot meant to rebuke.

<sup>35</sup> The Clergy and the Hereditary Aristocracy, respectively.

Until 1933, domestic free trade also prevented states from using sales taxes to raise revenue, for fear of interstate competition. It still tends to cap state sales tax rates. That forced states back on the property tax, just as Turgot recommended for France. Without it, it is likely that state sales taxes would rise to 20% or more in short order, as the wholesome fear of interstate competition was stifled.<sup>36</sup>

The U.S. Constitution was a product of The Age of Reason and Enlightenment. Science flowered. Turgot, like Quesnay, admired the work of William Harvey on how blood circulates, with flux and reflux. Turgot simply wrote that investing is “the beneficial and fruitful circulation that animates all the work of society” – thus capturing the basic idea of modern macro-economics, in simpler language than used today.

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‘America’s Founding Fathers aimed for domestic more than for international free trade.’

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The U.S. did impose national excise taxes, emphasizing sumptuary ones like Hamilton’s tax on whiskey, but the “Whiskey Rebellion” spoke to its unpopularity, and helped Jefferson displace the Federalists. Jefferson doubled our already vast area by buying Louisiana, accelerating a century of raising major revenues from land sales. Jackson even paid off the whole national debt, and went on to distribute surpluses to the States. Many States squandered the funds, but avoided paying the full price by stiffing their European creditors.

Before lands acquired in the Louisiana Purchase were sold out, President James K. Polk acquired more land clear to the Pacific, our “Manifest Destiny” as he called it. The USA became the biggest free trade zone in the world, perhaps in history, and prospered mightily, if erratically and prodigally, with giant-swinging cycles of boom and bust. We tied the parts together with ambitious long rails, but financed them with land grants that spared us from taxes. When the nation annexed lands from France and Spain and Mexico it left the private titles intact, but freed them from the repressive tax systems of those nations. Americans old and new grew accustomed to low domestic national tax rates, over a long period. State and local governments performed most public functions, and lived mainly on property taxes, a kind of tax with no taxable event in its base and thus little, if any, disincentive effects.

Not until 1909 did the U.S. turn to a corporation income tax, spurred by domestic demands for reform and naval and military ambitions. The personal income tax from 1913 was carefully focused by Progressive Congresses on

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<sup>36</sup> Gaffney (2000, 2000a).

property income. There were no state sales taxes of consequence until 1933.<sup>37</sup> Not until 1942 did Congress turn seriously to taxing wage and salary incomes, and withholding the taxes, and even then rates were graduated so steeply that property incomes, being in the top brackets, bore much of the brunt.

Since 1945 the tide has turned sharply back towards taxing labour more and property less, and yet even so America still taxes labour less, and property more, than most other nations. We stand alone as the nation with no national sales tax or facsimile thereof.

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'The USA became the biggest free trade zone in the world, perhaps in history, and prospered mightily, if erratically and prodigally, with giant-swinging cycles of boom and bust.'

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<sup>37</sup> Gaffney (2000, 2000a).

# 3

## From Wirtschaftswunder to Common Market to EU and VAT

WE PICK UP THE STORY IN 1948. World War 2 left Germany devastated, but not for lack of money demand or purchasing power. Wartime rationing and price controls, cum monetary stimulus – “suppressed inflation” – had left Germans with piles of cash in Reichsmarks. Ludwig Erhard, minister of finance under Konrad Adenauer, abolished rationing and price controls. He demonetized Hitler’s Reichsmarks and replaced them with Deutschemarks as the new legal tender, lowering the effective money supply by 93%. German families lost not just capital goods, but their life savings.<sup>38</sup> They were “ruined,” so it seemed. They didn’t even have rationing tickets.

To credit (or blame) Erhard alone would be to oversimplify. Kindleberger and Ostrander supply a raft of details - in fact, too many.<sup>39</sup> Squinting between the lines, though, they tell us that Military Governor General Lucius Clay supported an early report by Colm, Dodge and Goldsmith that called for high taxes on “unjust enrichment,” and on property and estates, but low taxes on current “taxable events,” to stimulate incentives to work and save.<sup>40</sup> It was in the spirit of V-Day, roughly comparable to the Reconstruction Era following our Civil War. Erhard was the German survivor who surfed this wave at its crest. For brevity here, I will simply refer to Erhard’s reforms.

Erhard observed that the only rationing tickets Germans needed after the currency reform were the new Deutschemarks, and they would work hard to get them. The same reasoning implies that they would also put their properties to work, if they owned any – and someone did own all the lands of Germany, and the surviving capital as well. A song of the times captured the spirit and attitude that emerged:

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38 Heller, Walter W. “Tax and Monetary Reform in Occupied Germany.” *National Tax Journal* 2, no. 3 (1949): 215– 231); Hirschleifer, Jack W. *Economic Behavior in Adversity*. Chicago: University of Chicago Press, 1987. Klopstock, Fred H.

“Monetary Reform in Western Germany.” *Journal of Political Economy* 57, no. 4 (1949): 277– 292; Lutz, F. A. “The German Currency Reform and the Revival of the German Economy.” *Economica* 16 (May 1949): 122–142; Mendershausen, Horst. “Prices, Money and the Distribution of Goods in Postwar Germany.” *American Economic Review* 39 (June 1949): 646–672; Wallich, Henry C. *Mainsprings of the German Revival*. New Haven: Yale University Press, 1955.

39 Kindleberger and Ostrander (2003).

40 Colm, Dodge and Goldsmith (1946: 185).

'Morgen, morgen, lacht uns wieder das Glück  
 Gestern, gestern, liegt schon so weit zurück,  
 war es auch eine schöne, schöne Zeit.'<sup>41</sup>

What followed is proclaimed as a *Wirtschaftswunder*, but let us not call it a *Wunder* (miracle) for that suggests a supernatural cause and stifles inquiry into real causes. It was unaccustomed *Armut* (poverty) that drove Germans to perform. The first cause of poverty was the obvious: paying taxes to prepare for war, the total war itself, losing it, being bombed, invaded, morally shamed, occupied and plundered. Second, less obvious, was Erhard's repudiating Hitler's Reichsmarks. Economists who sympathize both with Erhard and private property may cover up the contradiction by calling it "currency reform," a "wealth effect" (or income or liquidity effect), but the naked fact is that Erhard's State simply stiffed its creditors, the German people, thus confiscating their private property without compensation. It came from recognizing that incentives come from *Morgen* (tomorrow) and are only dulled by the security and comfort of holding property in the accumulations of *Gestern* (yesterday). Yes, Erhard believed in free markets and incentives; decartelization and Walter Eucken and the Freiburg School were in vogue. Yes, Social Democrats discredited themselves by opposing Erhard, and it is good press to mock them for their doctrinaire myopia. But generations of conservatives since then have spun the story to blank out the positive (*sic*) role of state confiscation of private property.

Few would deny today that the desperate circumstances of the times necessitated radical "currency reform." Now that Erhard's policy is a *fait accompli*, safely in the past, few would deny its spectacular success – it is an outstanding fact of history. But let us learn the economic lesson. Taxes have two opposite kinds of effects. There are the marginal effects, the kinds that Laffer and a thousand anti-taxers preach, the disincentive effects of diluting the rewards of work and enterprise. But there are also the wealth effects such as Erhard's "Miracle" demonstrated.

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'The secret of raising revenues without damping incentives is to select kinds of taxes with powerful wealth effects and weak marginal effects.'

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Germany's experience suggests that the wealth effects may even be stronger than the marginal effects. Certainly they are if we "play our cards right" and choose wisely among tax alternatives. The secret of raising revenues without damping incentives is to select kinds of taxes with powerful wealth effects and weak marginal effects. Property taxes come close to filling the bill, and even closer if we exempt capital improvements and movable capital (personal property) from

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<sup>41</sup> "Tomorrow, tomorrow, good fortune will laugh for us again/ yesterday, yesterday lies already so far behind/ it was a beautiful, beautiful time."

the tax base. VATs, at the other pole, fit the Laffer model like a glove: strong effects on marginal incentives, and minimal wealth effects.

With the Marshall Plan the USA undertook to help rebuild western Europe and Japan, with great success. “Social Democracy” was the slogan, to enlist proletarians in the common struggle against the Red Menace, which so quickly replaced the fascist menace of wartime. Former belligerents buried the dulled hatchets of nationalism. French leaders like Jean Monnet and Robert Schuman proposed a United States of Europe, to include the old Axis Powers, but not the USSR or its allies. France needed Germany to stop the USSR, and Germany was too big and robust for France to let go its own way again.

Initial steps like the European Coal and Steel Community and European Common Market grew to become the European Union. The 1957 Treaty of Rome created the European Community (EC), aka “The Common Market.” In 1990 a commission led by former French Finance Minister Jacques Delors broached a single currency, a step short of political union. French President Francois Mitterand forced the Euro on a reluctant Germany as the price for France’s support of German reunification after the Berlin Wall fell in 1989. The Maastricht Treaty of 1992 created the European Union (EU). The EU adopted the Euro. Soon the EU doubled in size, to 27 nations, including eight former members of the Soviet bloc. France as the leader rode high. Germany’s size and economic strength has now passed leadership partly to her, now under Chancellor Angela Merkel.

Meantime, by 1954 the tide had started to turn back toward the attitudes of l’ancien régime with its taxes on producers, merchants and buyers. Maurice Lauré, an engineer turned tax-man, got France to adopt VAT “to meet a fiscal crisis” (although such spin accompanies most political moves). VAT had political and administrative attractions, but economically speaking is only a variant form of sales tax. France introduced the first national VAT in 1954 (the same year it lost at Dien Bien Phu). It was not general, but destined to become so. René Coty was the last President of the fractionated 4th Republic, but Lauré’s VAT was declared a success.

Charismatic Charles de Gaulle succeeded Coty, founded the 5th Republic, and presided from 1959-69. A fabled hero of *la résistance*, *Le Grand Charlie* could get what he wanted, and was President in 1963 when a Common Market committee on tax “harmonization” issued the landmark (Fritz) Neumark Report that found the French VAT to be superior to Germany’s cascading turnover tax.<sup>42</sup> The Committee agreed to make VAT the basis of tax harmonization within the growing EU. In 1968 France changed its VAT from partial to general.

VAT quickly metastasized around Europe. The EC required member states to adopt VAT to enter the EU. Latin America also went along. In a second push

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42 Lindholm (1976: xxx).

around 1990, some industrial states like Canada,<sup>43</sup> Australia, Switzerland and Japan came on board too, along with many “developing” economies in Africa and Asia, until today some 140 nations use VAT. They were pushed along by newly empowered international organizations like OECD and the IMF and the World Bank – probably not what their founders had in mind at Bretton Woods in 1944.

The USA has played a schizoid role, worldwide. The Shoup Mission to Japan in 1949 had tried to pioneer VAT there, although in vain.<sup>44</sup> Harry Truman’s agent, Joseph Dodge, blocked it.

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‘USAID has spent huge sums promoting and subsidizing VAT in small nations. Only the USA itself has rejected VAT.’

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USAID has spent huge sums promoting and subsidizing VAT in small nations. Only the USA itself has rejected VAT. Evidently there is a chasm between our international representatives, “the best and the brightest,” and the voters at home.

By now, almost all nations except the USA have national VATs. Many leading American economists are urging the same for the USA, chiding us for backwardness. Many prominent economists are pushing parallel proposals as well, under names and euphemisms like “the flat tax,” “the fair tax,” “the people’s welfare tax,” and so on.

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‘I advance a thesis that our *lack* of a national VAT is a major source of U.S. fiscal strength vis-à-vis Europe.’

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A united Europe with a harmonized tax system and common currency would seem to have realized the fondest dreams of founding fathers Schuman and Monnet. And yet ...mobile international capital is seeking security in U.S. Treasuries, in spite of our notorious flirtation with national bankruptcy. Here I advance a thesis that our lack of a national VAT is a major source of U.S. fiscal strength vis-à-vis Europe; and that established standard-brand U.S. economists are seriously derelict in failing to point this out. Austrian-School economists are also derelict by failing to stress how VAT distorts the structure of capital, a topic in which they have special insight and interest.

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<sup>43</sup> Canada, which calls it a General Services Tax (GST), has only dipped a toe in the water, so far, with a national rate of 5%. Its Provinces, however, are huge. Ontario is bigger than many small nations, and Ontario’s rate is 8%, for a total of 13%. Ontario also includes services in its tax base.

<sup>44</sup> Brownlee (1985).

# 4

## Europe after VAT: troubles and setbacks

**T**ODAY EUROPE IS STAGGERING. Many of its nations face bankruptcy. Its stronger members and the institutions they dominate seek to impose “austerity” on the resentful weaker members. Banks hold mostly their government’s securities, crowding out small businesses that create most jobs. Unemployment rates are breaking records. Tax collections fall ever farther behind the needs, threatening both the governments and their bank-creditors with insolvency. Real estate manias in nations like Spain and Ireland, new to the perils of prosperity, have collapsed, bringing banks down with them.

### Unemployment

Unemployment rates across Europe reached catastrophic levels: 10.4% in the Euro area, and 23.3% for youths aged 15-25. Patterns diverged across nations, with the highest youth unemployment rates in Greece (55.6%), Spain (54.2%), Ireland (34.5%), Italy (35.1%) and Portugal (35.1%). Even in France, a pillar of EU, the rate was 27.9%. Sturdy lowland and Baltic nations were not immune: rates in Belgium reached 18.0%, Denmark 14.2%, Finland 18.9%, Luxembourg 18.6%, Sweden 23.4%. Central European Hungary, Poland, and the Czech Republic have high rates, too. Latvia, where wages were so low and jobs so scarce that she lost about 10% of her labour force to emigration, was proclaimed a success story by Christine LaGarde, Olivier Blanchard and other faces of the establishment.

### Debts, Public and Private

The debts of Greece, Italy and Spain made the headlines, but many “stronger” nations also owed more than their revenues could well handle. Greece owes \$315 bn. Even Germany, supposedly the EU’s economic bulwark, showed signs of stagnation in the 1990s, leading to the sarcastic epithet “The German Disease.” Germany’s “Miracle” seems slowly to be following an Olsonian pathway from

unity and strength-through-defeat to disunity and weakness-through-success. Germany's claimed debt of about \$2.1 trillion is rigged downwards by omitting huge pension obligations, estimated to add another \$3 trillion to the total. Some banks in greatest danger include Germany's DeutscheBank, biggest in Europe.

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'Governments' creditors are mostly banks,  
but these in turn are bailed out by the same  
governments to whom they lend.'

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Governments' creditors are mostly banks, but these in turn are bailed out by the same governments to whom they lend, a spiral winding only downwards until and unless European governments raise tax rates – and find a way to do so without stifling tax bases. The whole structure rests, finally, on tax revenues, lacking which it is just a house of cards. However, most tax bases fall when they are needed most, and the VAT base is falling fastest. As credit ratings fall, required interest rates rise, so debt service rises, deficits rise, and debts keep growing, a disastrous vicious spiral.

Pop Keynesians may see this as a virtue: deficit finance is the way to spend our way out of recessions. That idea from 1936 would seem to have died with the Stagflation of the 1970-79, and again with the deficit-fuelled crash of 2008, but it keeps rising from the ashes of its own self-immolation. The unanswered question now is, "Who will lend when both borrowers and lenders lack the will and the ability?"

How did Europe and its fellow VAT-sters reach this sorry state?

# 5

## Excess burdens from VAT

THE IDEA keeps resurfacing that a sales tax is made neutral by virtue of being “general.” Many great economists have refuted it, only to be inundated by floods of lesser voices in mass textbooks.

Retail sales taxes, however “general” or universal in their apparent coverage, tax capital as it turns over. Turnover is measured by the sales/capital ratio, which is highly variable among different firms, products, locations, stages of the cycle – and tax regimes, which economists influence. Sales taxes depress it heavily. This is not a mindless grouch at all taxes, for we need public revenues, and some taxes have positive effects. This is a rifle-shot at sales taxes, of which VAT is one.

To repeat for emphasis, retail sales taxes tax capital for turning over. Turnover means replacement; and replacement sustains demand for labour. Replacement does not just depend on sales, it anticipates them, and thereby generates the consumer incomes that finance them: turnover is the autonomous variable that takes the lead in the otherwise circular and now vicious circle of macro-economics in which employers wait for consumers, while consumers wait for employers to hire them. Turnover is measured by the sales/capital ratio, which is highly variable among different firms, products, locations, stages of the cycle – and tax regimes, which economists influence.

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‘Turnover is the autonomous variable that takes the lead in the otherwise circular and now vicious circle in which employers wait for consumers, while consumers wait for employers to hire them.’

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By taxing turnover, sales taxes shrink their own base. Arthur Laffer discredited this idea by letting his patrons apply it to *all* kinds of taxes; Murray Rothbard mistakenly applied it just to the property tax, the one major tax to which it does *not* apply because it taxes capital and land for standing still, not for turning over. These errors should not blind us to the truth in applying the idea to VAT and the

other sales taxes that “shoot anything that moves”. In the lingo of public finance, they are contingent on “taxable events.”

Many standard textbooks and learned papers tell us that a truly general retail sales tax, unlike an excise tax, is neutral as between one commodity and another. A national tax is also neutral between locations, since it is the same in one region as another. Those conditions are never approached in practice, but in the sales-tax canon that merely means reformers should extend the reach of the tax, as the EU does with its push for tax “harmonization” among member nations.

As already noted, Buchanan and Flowers wrote that “If the (sales) tax is uniformly imposed on the sale of all commodities and services, there can be no real shifting of resources from taxed employments to nontaxed employments. The shift in relative prices occasioned by the partial tax cannot occur under a truly general sales tax”.<sup>45</sup> We quoted and cited Harry G. Brown, Earl Rolph and George Break, Harold Somers, Bernard Herber, David Hyman, and Charles McLure to the same effect.

Capital proper, when affixed to land, becomes “real estate,” hence exempt by law from sales taxes, for these apply, by law, only to sales of what we call “personal” property (Due, 1963: 287), and which Europeans, more realistically, call movable property. The most durable forms of capital, the kinds that Austrians believe are over-supplied, are affixed to land, hence exempt from sales taxes and VATs.

Many “Neo-con” or “Neo-liberal” writers deplore the exemption of “services” from the sales tax base. These writers and teachers refer in their contexts only to labour services, ignoring the service flows of land or capital. This is not from ignorance: they know that the “service-flow” of an owner’s home has long been included in NIPA as a form of income, income consumed by the owner-occupant as the real estate yields it. They just blank that out when it comes to taxing services to the “final” consumer.<sup>46</sup> John Stuart Mill in 1848 looked deeper, in a proto-Austrian way, and pointed out a systemic bias inherent in the tax. I have quoted him above.

Mill hid this light under a bushel, by offering just one example of a small difference, and only in the form of arithmetic. It is easy to overlook in passing, and standard-brand economists have done so. Tragically, so have most Austrian writers, few of whom analyse tax policy. Their strong tendency is to impute the misallocation of capital solely to misguided central bank policies, blanking out other factors like tax policy.

Harold Groves, a clearer expositor than Mill, makes the point in a simple table.<sup>47</sup> “Store A is engaged in a trade which has a very slow turnover, such as the furniture business; Store B is one with a rapid turnover, perhaps a meat shop.”

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45 Buchanan and Flowers (1975: 399).

46 Anderson (2003: 252).

47 Groves (1946: 113).

<b>Tax bias between slow and fast turnover businesses</b>						
	I	II	III	IV	V	VI
<b>STORE</b>	<b>Operating capital</b>	<b>Gross sales</b>	<b>Sales/ Capital</b>	<b>Sales/ Capital</b>	<b>Tax @ 0.5%</b>	<b>Tax/ Capital</b>
<b>A</b>	\$30,000	\$30,000	1	1	\$150	0.5%
<b>B</b>	\$2,000	\$100,000	50	50	\$500	25.0%

The sales tax is based on Column (II). It gathers much more from B, the meat shop, than from A, the furniture store, because of B's higher turnover and greater volume. B's little capital of

\$2,000 turns over 50 times and is taxed 50 times a year, while A's \$30,000 turns over and is taxed just once. (Groves uses this table for another purpose, but it serves to make Mill's point as well.)

Again, compare a parking lot with a cafeteria. Suppose both to be taxed on gross sales, including services. The inventory of fresh food in the cafeteria is taxed daily, as it sells out and turns over. The payrolls are taxed daily too, for they add to the gross value of sales. The value they add to the purchased stock of food is capital, too: "working capital." Or, if one prefers to ignore capital of life so brief and so small a claim on the final product, the sales tax is simply a tax on labour. The gross sales of parking lots, at the other extreme, include no turnover of capital at all.

More generally, as Dan Sullivan points out, sales taxes penalize high-volume low-mark-up marketing strategies as against their opposite. Lest one turn up his nose at, say, Walmart, its low prices do not reflect low mark-up so much as low labour-service per dollar of inventory. It also provides acres of free parking, a service of land, like other big-box stores. Sullivan also notes that sellers in better locations, say Rodeo Drive, can have higher mark-ups, so sales taxation favours better locations over marginal ones.<sup>48</sup> New businesses with high start-up costs can deduct them from taxable income, but not from gross sales. Clifford Cobb notes that ghettos have many barber shops and beauty parlours but few shops carrying commodities.<sup>49</sup> One could go on through all the Yellow Pages for thousands of more examples.

### **Illustrations and Analogies**

Within each business there are also differences among kinds of capital. In a retail bakery, for example, there are pies and pie-shelves. The pies come and go, perhaps

<sup>48</sup> Sullivan (n.d.).

<sup>49</sup> Cobb (2014).

several times a day; the shelves last for years; the ovens for decades; the buildings even longer; the sites forever. Many a needy widow with hardly any capital has earned her mite by baking, while renting the site, building and hardware. Her sales/capital ratio is high in contrast with that of the landlord, and orbital in contrast to timber-holding corporations like Georgia-Pacific, Weyerhaeuser, Simpson, or the Kenneth Ford family's Roseburg timber companies around Roseburg, OR.

Adam Smith, with his flair for metaphor, made the point by contrasting cargoes in foreign and domestic trade, in an age of wind-powered ocean vessels.

'[T]he quantity of that labour, which equal capitals are capable of putting in motion, varies extremely according to the diversity of their employment<sup>50</sup> ...A capital... employed in the home-trade will sometimes make twelve operations, or be sent out and returned twelve times, before a capital employed in the foreign trade of consumption has made one...the one will give four and twenty times more encouragement and support to the industry of the country than the other.'<sup>51</sup>

The case is even clearer when we compare two uses competing for the same land. The one with more turnover pays more sales tax per dollar of capital invested. The tax drives away capital that turns over fast, and reallocates the land to capital that turns slower, or to uses requiring less capital, or no capital at all, like the parking lot. As to the lot itself, it never turns over in the relevant sense of wearing out and being replaced. (Owner A may sell land to Owner B, but mere ownership turnover is a zero-sum transaction in the national accounts.)

Curiously, Harry G. Brown, a relentless critic of holding land idle, as well as of taxes with excess burdens, does not connect his two goals in one consistent system.<sup>52</sup> He does not recognize that sales taxes inhibit using land intensively, if at all. His mentor Irving Fisher may have misled him. In Fisher's tax theory, all taxes should fall on consumption, holding land is not consumption, and capital gains are not income at all.<sup>53</sup>

Chemists have a good vocabulary for it. Land in production is like a chemical "catalyst": it facilitates a process without disappearing into the product. Its "quantum of value" remains intact in the land. Working capital is, at the other extreme, like a "reactant": its corpus and its quantum of value go into the product. That means they get sales-taxed with each turnover – the basis of the Mill Effect. Physiologists have a name for it, too: what is metabolism but the turnover of protoplasm in cells? One could elaborate, and find analogies from other sciences, but the point is made, and will be made once more below with Dorfman's essay on hydraulic engineering.

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50 Smith, Book II Ch. 5, par 1.

51 Smith, Book II Ch. 5, par 27.

52 Brown (1939: 254).

53 Fisher (1937, 1942).

## Difficulties, solutions and measures

“Fixed” (durable) capital is a mixed, and therefore instructive story. The corpus of fixed capital as a catalyst does not get sales-taxed, only its income plus a little extra for depreciation get sales-taxed, as Mill wrote. Separating the catalyst from the reactant in fixed or durable capital is a trifle less simple than with working capital, but only marginally so. The basic mathematics of finance tells us exactly how to divide the product between interest, the net income of capital, and depreciation, which corresponds to the recovery or turnover of capital (and is labeled a “Capital Consumption Allowance” (CCA) in NIPA). We only repeat a sliver of the mathematics here, but lenders, mortgagors, bankers, and I.R.S. agents use it every day. So do millions of innumerate consumers who buy on the installment plan, taking the mathematics on faith. Innumerate readers may likewise take on faith the algebra below, but here it is for those who want it.

Let “a” be a level annual cash flow lasting for “n” years. “P” is its Present Value, found by taking the Discounted Cash Flow (DCF) using an interest rate, “i”.

$$P = a[1-(1+i)^{-n}]/i \quad (1)$$

The fraction of “a” that is interest on P is:

$$Pi/a = 1-(1+i)^{-n} \quad (2)$$

“1” is 100%. The second term as a function of “n” forms a curve of exponential decay (a ski-slope curve) starting from “1” when n=0 and falling to zero when n=∞.

Thus when n=0 the cash flow is all capital recovery – there is no interest income – and the sales tax is based entirely on turnover of pre-existing capital. At the other extreme, when n grows big,  $(1+i)^{-n} \rightarrow 0$  and there is little capital recovery, and that little is not taxed until after “n” years. So much for the algebra.

A unit or “quantum” of fixed capital embodied and frozen into, say, the Oroville Dam and the long aqueducts it feeds, or the English-French “Chunnel,” or the even longer tunnel from Sakhalin to Hokkaido, or grading steep building sites, or land-fill in shallow water, or The Pyramids, or The Mackinac Bridge, or the marble cladding of Nelson Rockefeller’s Parthenon in Albany, turns over so slowly that its net product or service after O&M (Operation and Maintenance) is mostly pure income. That product or service as a tax base, however we measure it, includes little recovery of capital. Too often, indeed, there is none at all, thanks to engineering megalomania coupled with the “irrational exuberance” of land speculators and “earmarking” politicians who trade subsidies for campaign contributions.

As to land, this never turns over. Its ownership may turn over many times, but that is an entirely different meaning of “turnover”: it is a zero-sum game, macro-economically. It entails no depreciation and ultimate replacement of the lot, and no routine recovery of the original purchase price through a CCA (Capital Consumption Allowance). In a rational market, land is priced so high that its cash flow is just enough to cover interest on its price, with nothing left over for a CCA. In a rising but still rational market, indeed, interest on the price is greater than cash flow by an amount equal to annual appreciation. In a market with “irrational exuberance,” which comes along in a regular cycle of 18 years or so, interest often exceeds the sum of cash flow and appreciation, as we learned so well in 1990, promptly forgot, and went through again in 2008, and began a new cycle of forgetting in 2013.

Many economists disregard The Mill Effect by assuming, too blithely, that sales taxes are all shifted forward to “consumers”. Even if that were 100% true it would certainly depress demand for the over-taxed items. Most economists today share some, at least, of the paradigm of Buchanan and Flowers wherein sales taxes are shifted backwards to factors of production. There is a hint of this in Mill,<sup>54</sup> but the stronger recent statement is in Harry G. Brown.<sup>55</sup> Earl Rolph, crediting Brown, agrees.<sup>56</sup> Richard Musgrave, crediting both Brown and Rolph, endorses this approach in the main, too.<sup>57</sup> Many of us now hew to the Physiocratic doctrine that All Taxes Come Out of Rents (ATCOR). Either way, sales taxes create “A disturbance in The Force” – a massive and basic disturbance. To fuss over trivia, while missing the Mill Effect, would be to strain at gnats while swallowing a camel. For examples of such straining see Shoup and Haimoff, Somers, Rolph/Break, and almost any popular text on public finance.

Many texts on public finance compare a retail sales tax favourably with a “turnover tax,” since the latter taxes every transaction up to and including the retail stage. Thus they dispose of “turnover” by giving it an entirely different meaning than that used by Mill, and used here. They criticize a “turnover tax” (as sometimes used in Germany, and in the former Soviet Union, and now in Ohio) for taxing the same capital several times, “in cascade,” as it moves from owner to owner in successive transactions through the “stages” of production. They then criticize how firms may avoid it by integrating vertically. Fair enough, but then they dust off their hands as though done, leaving us the retail sales tax, imposed at only one “stage” of production, as though it were free of taxing turnover.<sup>58</sup> Thus they purge The Mill Effect, the “Disturbance in The Force,” from modern fiscal economics.

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54 (Bk V, Chap 5: 517).

55 Brown (1939).

56 Rolph (1952).

57 Musgrave (1953: 318; 1959: 379).

58 While they are at it, Buchanan and Flowers want to tax unemployed people for “consuming leisure.” The euphemism dates from Chicago’s Henry Simons (1938). Buchanan and Flowers do not call this a poll tax, for they disapprove of “emotive terms.” Yet they do not suggest taxing idle or underused land or capital for taking leisure.

Mark Skousen presents a long valuable list of previous texts and learned writings supporting Austrian capital theory.<sup>59</sup> He argues against policies that drive capital away from “lower order” capital goods that turn over quickly because they are near to the final consumer. You would therefore expect him to take the lead against retail sales taxes, with their bias against these lower order goods. Instead, Skousen switches to another paradigm and favours sales taxes on the grounds that final consumers bear them, and this exempts saving and capital formation. I have refuted this belief elsewhere,<sup>60</sup> and will not repeat the reasoning here.

As to the structure of production, Skousen writes that “a consumption tax... would be highly favourable toward the earlier stages of production...”<sup>61</sup> But “earlier stages of production” means unripe capital, at farthest remove from final consumers, capital that ripens and turns over slowly, the kind that Austrian theory tells us to treat less favourably, or at least *not* favourably. I will not labour the obvious contradiction, but simply express dismay that no Austrian economist, to my knowledge, has ever used Austrian-derived paradigms to criticize sales taxes. Skousen also gives priority to repealing the “capital gains tax,” evidently believing that it is a tax on capital, as its name misleadingly suggests. Actually, most unearned increments of value come from land. Taxing or un-taxing them has no direct effect on the structure of capital proper. Most real capital depreciates with time. There are some exceptions, like commercial timber and other biological capital that does add value with time. Here, a pure gains tax would indeed contain a small bias in favour of slow turnover, since the tax is deferred until sale.<sup>62</sup> The capital gains tax as we know it in practice, however, is structured to impose higher rates on faster turnovers.

Richard Musgrave does cite the “Swedish Austrian,” Wicksell, who published in German on tax policy, and with great insight. In laboured prose, Musgrave finally concludes that a tax on “gross receipts...leads to a lengthening of the average period of investment”.<sup>63</sup>

As to definitions and measurement, some economists see nothing but insoluble problems in measuring or even conceiving of the lifetime of a simple capital item, and even worse problems with the average lifetime of a collection of heterogeneous items. The matter may be made to seem hopelessly complex, and a battery of economists, following J.B. Clark and Frank Knight, ever stand too ready to oblige.

Fred Foldvary, an “Austrian” thinker, neatly solves the problem by distinguishing concrete items of capital as “capital goods,” while “capital” standing alone means the quantum of value.<sup>64</sup> This quantum of value is relayed from one concrete capital good to another with each turnover (cycle of liquidation and replacement).

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59 Skousen (1990, Chap. 4, pp. 84-130 et passim).

60 Gaffney (2009).

61 Skousen (1990: 345).

62 Gaffney (1957: 1970-71, 2006; Vickrey (1971).

63 Musgrave (1953: 392-99, 396-97).

64 Foldvary (2016).

In this relaying the capital becomes completely fungible in form and composition and location. Fungibility is a concept that most economists grasp and teach, although some resist the idea of capital as a quantum of value – something more obvious to accountants, however, and, as Dorfman showed, to hydraulic engineers.

Hydraulic physics and engineering provide a simple solution, ably expounded by Robert Dorfman in an article I cannot praise too highly.<sup>65</sup> Dorfman whimsically calls it “The Bathtub Theorem,” and properly acknowledges Knut Wicksell’s priority with his “grape-juice model,” although Dorfman’s model is more general. Dorfman’s bottom line is that the higher the sales/capital ratio, the faster a quantum of value will travel through a fund of capital. More briefly yet, the mean turnover of capital is the sales/capital ratio.<sup>66</sup> For the lady baking pies and selling out daily the annual ratio is 365. For the boreal forester the annual ratio is 1/70. Both figures may be modified slightly for elegant variations on the main point, but the difference of 26,000 times illustrates the Mill Effect so starkly, why bother with more? For doubters and masochists Dorfman provides many equations, but ends them delightfully by saying “It is nice that this elaborate calculation is really unnecessary”.<sup>67</sup>

Dorfman does not treat land separately, which is a fault. Neither does he analyse sales taxes and their effects. I have supplied the lack.<sup>68</sup> For now it is enough that we can measure turnover simply, and it varies hugely among sales-taxable items and firms.

Professor William Vickrey contributed a general mathematical model published as an Appendix to my “Tax-induced Slow Turnover of Capital”.<sup>69</sup> He showed how “Yield Taxes” (sales taxes on timber harvests) slow down average rotation periods. He equates average tree life with the sales/capital ratio simply by inverting the order of integration – a simple trick for him, a mathematician.<sup>70</sup> It was consistent with his lifelong efforts to tax capital gains as they accrue, following the Haig-Simons definition of income.

## Summary

We are left with this. Jobs depend on turnover. Turnover is measured by the sales/capital ratio, which varies hugely among different firms, products, locations, stages of the cycle – and tax regimes. Elected officials control the last, and we as economists try, at least, to influence elected officials. Sales taxes, rampant and rising in our times, depress turnover heavily, and so depress demand for labour – both the number of jobs and their pay rates.

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65 Dorfman (1959).

66 Dorfman (*ibid.* p.353).

67 Dorfman (*ibid.*, p. 372).

68 Gaffney (1976, mathematical appendix).

69 Gaffney (1971).

70 Vickrey (1971).

Property taxes have the opposite effect, and so may some aspects of income taxation. We do not here address how both property and income taxes may be modified for the better, although they may and should be. Our main point here is that sales taxes (and their twin, VAT) are among the worst possible choices when the objective is to make jobs and raise pay rates.

The USA, with all its faults, has no national VAT. We do not lack for crusading VATsters. They chide us for being behind Europe. As the EU careens to financial crisis, and derivative political crises, while world capital flees for refuge in the USA, the evidence of history is not speaking well for VAT. Forecasting is perilous, and some see doom ahead for the U.S. dollar, but as of this writing the evidence is against VAT. What Dien Bien Phu did for France's empire, VAT is doing for France's economy, and with it all of Europe's.

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'Sales taxes, rampant and rising in our times,  
depress turnover heavily, and so depress demand  
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## 6

## Scholarly origins of and support for VAT

**WE** HAVE SEEN how Maurice Lauré pioneered VAT in France in 1954, whence it grew with the idea of European Union, before going viral around the world. Lauré was not the first to broach the idea, however. Others had been tilling the seedbed before. Of course, everyone touting a retail sales tax had been conditioning minds for years before, but there were only few who limned out the specific form of VAT.

One was the American economist Thomas S. Adams.<sup>71</sup> Adams was disturbed by the growth of income taxes, especially on “business” (property) incomes, and proposed substituting a national tax on gross sales. His prose was muddy and equivocal, and anyway, Andrew Mellon soon led Congress to lower surtax rates on high incomes, relieving much of rich families’ grievances and Adams’ case against income taxes.

Another was Wilhelm von Siemens,<sup>72</sup> who saw VAT as a technical improvement to avoid cascading in the German sales tax. Siemens could cite some earlier pamphlets as supports, but they and he were only on the margins of power and there was no follow-up. Soon German governments, saddled with debts and reparations, turned from collecting taxes to printing money, causing one of history’s worst hyperinflations.

The high income-tax rates of World War 1 in the USA led to a spate of proposals for a national sales tax, including some from Andrew Mellon, W.R. Hearst, Ogden Mills, and his allegedly liberal friend R.T. Ely. While they never prevailed nationally, their views reinforced a climate of opinion that influenced the many states that rushed in a horde to substitute retail sales taxes for property taxes in the 1930s. Another less obvious factor was the 18th Amendment (Prohibition) which cut deeply into Federal revenues from sumptuary excise taxes on alcohol, forcing more reliance on income taxes, both corporate and personal. The du Pont family subsidized the campaign to repeal the 18th Amendment, a less extreme but more successful move to relieve themselves and their class from income taxes.

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<sup>71</sup> Adams QJE (August 1921).

<sup>72</sup> Von Siemens (1918).

The du Ponts, as major owners of GM, also had an interest in holding down gasoline taxes.<sup>73</sup>

The next tranche of advocates included scholars Irving Fisher, Kaldor, Meade, and Prest. Following World War 2, Carl Shoup of Columbia joined the tranche. General Douglas MacArthur as head of SCAP<sup>74</sup> was in a position to dictate many policies to occupied Japan, and he picked Shoup to head an advisory group on tax policy. Shoup, of professorial and objective mien, was the scion of Paul Shoup, President of the Southern Pacific Railroad and developer of upper class Los Altos in San Mateo County. Shoup came out strongly for a VAT.<sup>75</sup> He was one of the first American economists to push VAT abroad. Like MacArthur, he hoped that his policies applied first in a foreign nation would set an example to be followed in the USA itself, but it did not work out that way, either for him or later Americans working for the IMF, World Bank, OECD, and other international bureaucracies.

More recent champions are Pete Peterson, Harold Somers, Michael Dukakis and his advisor Larry Summers, Cary Brown, James Buchanan, Paul Krugman,<sup>76</sup> G.N. Hatsopolous, James Poterba, Steve Forbes, Rick Perry, Robert Hall and Alvin Rabushka backed by The Hoover Institution, Newt Gingrich, Milton Friedman, Richard Arme, Henry Aaron, Charles McLure, Richard Lindholm, John Due, Raymond Mikesell, Arnold Harberger and many others. The Republican platform of 2012 even included a plank to repeal the 16th Amendment and adopt a national VAT. Centrists scoffed at the extremism, but in our times we have seen how fast, sometimes, extreme becomes mainstream.

## The EU as Enforcement Cartel

The European Union has required and spawned its own governing legislatures and bureaucracies in bewildering array, layered on top of existing national bureaucracies. These new agencies take on powers and lives and agenda and academic satrapies of their own, like our own Federal Reserve System. Like most bureaucracies they tend to aggrandize and perpetuate themselves and freeze in place. A major recent shift is evident. Control has shifted from Social Democrats to Conservatives representing bankers and other lenders. A critic describes them as the “giant Goldman-Sachs squid.” The metaphor is exaggerated, but a useful mnemonic of where power now lies.

In 1998 the OECD was pressuring errant nations to raise tax rates. It campaigned against tax regimes it stigmatized as “harmful” because they might attract mobile capital.<sup>77</sup> By 2013, raising income taxes was off the table, unthinkable,

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73 More recently Pierre (Pete) Samuel du Pont IV, ex-Governor of Delaware, has come out against state sales taxes. Times and families change, or perhaps “Pete” is cycling back to his ancestor and namesake, P.S. du Pont the Physiocrat. Otherwise, however, he is prominent in ultra-conservative causes and politics.

74 Supreme Command, Allied Powers.

75 Shoup was overborne by the rival mission of Detroit banker Joseph Dodge, representing Truman, who preferred income taxes modified by fast write-off.

76 It is hard to understand how Krugman, today's leading champion of deficits, in 1989 co-authored *Overconsumption*, a criticism of spending.

77 Report of OECD Committee on Fiscal Affairs (1998), *Harmful Tax Competition, an Emerging Global Issue*

unmentionable, a solecism. The prevailing dogma was that raising tax rates would choke recovery and lower the tax base, as Laffer once warned. The focus was on “austerity,” meaning to lower spending on social programs and force down wage rates. Protesters in debtor nations see The Troika and its *appanages* as a hydra-headed cartel of bankers and Germans to reduce them to debt slavery. Conspiracy theory and paranoia? More likely what we see is just the unconscious or semi-conscious comity of people with common interests working in harmony. Either way the results are much the same.

One thing the old and the new EU agencies share in common is making an ideal of tax “uniformity” among nations. Sales-taxers have long seen their need for the same ideal within nations or even big states. California is our biggest State in all but area, and also the most isolated by topography, so it most resembles a nation. Accordingly, it has led the march to state sales taxes. For example, in 1955, California sales-taxers 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, our Legislature encouraged local sales taxes state-wide.<sup>78</sup> The State collects it, and returns it to each municipality of origin. A central power can overcome interjurisdictional tax competition, as Europe’s Troika agencies are attempting now. Thus, EU was the necessary pre-condition for VAT. The two have grown together.

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‘Europe now enjoys a colossal Peace Dividend, one of the biggest and longest in history. The idea that this should lead to national bankruptcies is absurd and ridiculous.’

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Why do lender groups like Europe’s Troika come to the aid of debtors approaching peonage?

It is a survival mechanism found in nature. Most parasites stop short of destroying their hosts because they need them for the future. Most predator populations leave behind a saving remnant of their prey to supply the next generation of their food supply. Mankind most consciously saves both the seed corn and the breeding stock for future generations. Thus lender groups have an interest in keeping borrowers solvent enough to repay the principal of debts, while also risky enough to have low credit ratings calling for high interest rates. Lenders also want to discourage debtors from seeking other lenders, and maintain a united front to discipline debtors who default.

Has Europe reached the limit of its taxable capacity? The thought is nonsense in the light of history. The Cold War wound down from 1989. Today the USA,

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<sup>78</sup> Bradley-Burns Uniform Local Sales Tax Act, Revenue and Taxation Code Section 7200.

the only nation with no VAT, bears the cost of policing and defending Europe, and most of the world too. Europe for centuries before now poured its treasures into a series of internecine wars from which the EU has rescued it. Europe now

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‘The bottom line is that Europe is strangling itself with VAT, while the USA, for all its many serious faults, is surviving better without one.’

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enjoys a colossal Peace Dividend, one of the biggest and longest in history. The idea that this should lead to national bankruptcies is absurd and ridiculous on its face. The alternative hypothesis is that Europe's woes are endogenous. A major cause is heavy reliance on VAT – the main tax to which Laffer's warnings might apply – and the lack of substantial taxes on property or its income, the taxes to which Laffer's strictures least apply. The evidence of Europe's solvency and untapped taxable capacity is the high level of its land prices compared with America's. International buyers are paying record-smashing figures for homes in world-class neighbourhoods like Woodside and Los Alto Hills, San Mateo County, for example, because our prices, steep as they look to us, are still cheaper and the quality of life may be better than in counterpart regions of Europe.<sup>79</sup>

The bottom line is that Europe is strangling itself with VAT, while the USA, for all its many serious faults, is surviving better without one. Well may we chant, “*Vive la différence!*” We still cling to the remnants of a property tax system inherited from earlier times when we led the world in real production and real *per capita* income, making us a magnet for immigrants from the world – from

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‘Let us pray that the python of VAT never wraps us in its coils; let us work to make that prayer come true.’

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the “wretched refuse” kind to the most talented kind, both of which strengthen us when we offer them chances to work and invest productively. We have an income tax system that, while riddled now with counterproductive loopholes, still prohibits the tax-depreciation of land and occasionally succeeds in taxing the unearned increment of land values. We still find some investment “loopholes” that were designed constructively to reward real income-creating investing in new capital. Let us pray that the python of VAT never wraps us in its coils; let us work to make that prayer come true.

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79 LAT 1-29-13, p.B5.

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