Europe's Fatal Affair with VAT

Mason Gaffney, January 2013

Abstract, Mason Gaffney, Europe's Fatal Affair with VAT

World lenders have dismissed warnings from credit rating firms and kept buying and holding U.S. Treasuries for security. The likely reason is that our tax system is stronger than Europe's. The major difference is that Europe has come to rely heavily on VATs, while the U.S. stands alone in not having any. VAT's broad tax base is not succeeding in maintaining revenues, even as tax rates climb. J.S. Mill faulted general sales taxes like VAT for taxing capital itself, not just its income, for turning over; Frank Ramsey and A.C. Pigou for ignoring different elasticities of supply and demand. Gaffney refutes the idea that such taxes foster capital formation.

VAT arose in 1954 France, and metastasized quickly worldwide. It reversed two centuries of progress in tax systems and turned Europe back towards the practices of l'ancien régime before 1800.

The next step is on how the U.S.A. came to adopt and develop tax systems more congenial to commerce and industry and high wages than did Europe. Credit is due to Turgot, and allied French économistes who bent the minds of our Founding Fathers. Credit is later due to leaders of The Progressive Movement who framed our early income-tax laws.

Step 3 explains how Germany's Currency Reform under Erhard quickly raised Germany back from the dead, and it how it demonstrated a fundamental principle of how taxes affect incentives positively, the wealth effect. Then, the original French VAT grew as the unseen protegé of European unity, while the U.S.A. fostered VAT everywhere around the world except at home.

Step 4 illustrates how Europe stagnated as VAT grew, and how banks and public exchequers grew mutually dependent, together building a house of cards based on future tax revenues – revenues that VAT cannot provide, even as it chokes off productive commerce and industry and employment.

Step 5 explains the theory of the excess burdens of VAT taxation, and faults economists, both conventional and Austrian, for failing to expound and highlight these, and relate them to Europe's unstanchable flood of troubles. Step 6 traces the role of a host of economic scholars and statesmen in rationalizing, endorsing and promoting VAT, from Thomas Hobbes to the Republican Platform of 2012.

Step 7 discusses the role of the cartel of international agencies and banks in promoting "harmony", in taxing, lending and collecting. It gives evidence that Europe has NOT reached the limit of its taxable capacity; rather, it needs a better tax system and philosophy, with higher rates on narrower and less elastic bases.

1. Introduction

In August, 2011, S&P 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 U.S.A. Treasury securities. It seems that we must be doing something right, or at least less wrong than other nations. I would not breastbeat about "American Exceptionalism". I deplore our nation's faults, and failure to face them and reform them. I deplore it when some primitives call 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 U.S.A. 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. These myopic tools, indeed, often divert analysts into straining at gnats while they "swallow a camel". 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 labor costs are deductible from taxable income. In addition, earlier economists like Musgrave and Domar and Commons and many others long ago 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 Turgot 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 U.S.A. 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% [(52-27)/52 = 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[1]. 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 pols of left and right are moving toward a pessimal consensus that lowering tax rates on business and *rentier* incomes is acceptable so long as Congress also closes "loopholes". Hardly anyone says <u>what</u> loopholes, hiding the vital truth that many loopholes, like fast writeoff 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.

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1 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.

Europe generally uses the "consumption-type VAT", meaning that capital outlays are expensible. 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 favors 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.

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. 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 where it can be "drowned in a bathtub", in Grover Norquist's metaphor. Many deeply-funded new thinktanks undergird dozens of well-paid economists who preach on the same text (James pp. 20-21, n.14). 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 favor kinds of 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 favor 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 labor must rise in value, as compared with those which are chiefly made by machinery. … " -- (1848, Book V, Chapter IV, pp. 504-05).

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 memorable saying, "Capital is kept in existence from age to age not by preservation but by continual reproduction". 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 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 needn't 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 in Section 5, 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 adopt a VAT (James p.16). Sales-taxers in the U.S.A. keep pushing for ways to override the Commerce Clause in the U.S. Constitution and let each state 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 nontaxed employments. The shift in relative prices occasioned by the partial tax cannot occur under a truly general sales tax" (1975, p. 399). 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." (1939, p.254). Earl Rolph and George Break commit to this view (p.117). So does Harold Somers (pp. 17, 26). Bernard Herber (p.254) and David Hyman (2005 pp.617-26) chime in cautiously. Charles McLure, incautiously, damns "... the ridiculously unfair and distortionary de facto exemption of interstate sales …" (2005). Harold Somers' writes that a tax on gross sales is the same as a tax on net income (p.27).

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. The writer has addressed this issue elsewhere (2009, pp. 52-53), quoting A.C. Pigou (p.105):

"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."

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 favor 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" (Young, p.15). The notable exception is Joseph Stiglitz. Consistently, Stiglitz often writes sympathetically of taxing land values (2010).

Modern writers deplore the exemption of "services" from the sales tax base. These writers and teachers refer in their contexts only to labor 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 (Anderson, p.252).

Then there is the well-nourished doctrine that we should tax consumption in order to exempt saving. The writer has refuted this elsewhere (Gaffney, 2009) and will not repeat 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 public debts, equity withdrawal from appreciated lands, preferential tax treatment of imputed incomes from durable capital and lands, and the corporation

Europe before 1789

Before the Enlightenment ,and the Ages of Reason and Benevolent Despotism, Europe raised major revenues from excise taxes, and tariffs, and tolls. It built roads with drafted *corvée* and *robot* labor. In England, Thomas Hobbes, a leading influence on King James II, had pushed hard for taxes on what he called "consumption" (although neither he nor any later sales-taxer, to my knowledge, has defined "consumption" carefully enough to give the concept a clear meaning). Slavery, serfdom, peonage, and indentured labor were common. Prison labor was not unknown. Underpaid Religious staffed schools and hospitals, hospices and asylums.

French King Louis XVI, briefly playing the benevolent despot, in 1774 appointed Jacques Turgot his Finance Minister. Turgot was fresh from his triumphs as *Intendant of The Limousin* (Limoges), where his physiocratic reforms, intelligently conceived and conscientiously executed, 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 fulfill all*
>*the functions relating to education and religion and to aid the unfortunate*
>*through alms. The noble devotes his life to the defense 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, fulfills its*
>*obligation through taxes, industry and physical labor. . . .* "

The Physiocrats wrote and preached, and Turgot the statesman acted for untaxing commerce and industry, raising revenues from land taxation, and coining the slogan *laissez faire* for their philosophy which gradually advanced in France and throughout Europe. They schooled both Adam Smith and many of the American "Founding Fathers" in their thinking.

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* (Smith, p.850-51; Groves, p.307, n.14; Ustaritz; Rocker). 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 (Klein). 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 favoring domestic free trade even more than international trade. Here is one from WoN, (pp. 851-52), wherein he contrasts Great Britain with Spain and France, noting that the <u>interior</u> commerce of G.B. is relatively tax free[2].

> "*This freedom of interior commerce ... is perhaps one of the principle causes of the prosperity of G.B.; every country being necessarily the best and most extensive mkt for the greater part of the productions of its own industry.*" (WofN, pp. 851-52)

In the new U.S.A 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

2 "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.

ambitions, led Federal troops to put down this uprising. The voters, when they found him dominating the subsequent cabinet of John Adams3, 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 years4.

These Virginians knew their Physiocracy. Jefferson, Madison and Monroe had all represented the colonies or the U.S.A. in Paris, as had their friend Franklin, where they hobnobbed with philosophers and picked up their ideas (Bigelow IV:195; Sparks X:300, 345; Van Doren, p.372; Philip Foner pp.15, 24-39). They were pro-French, even as France shifted from monarchy to Directory to Empire to The Bourgeois King. It was Monroe who had led the fight for the Commerce Clause, freeing internal trade from excise taxes (Norton, p. 51); 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 (Medina). 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 (Eric Foner, p. 15). 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" (Brinkley, p.11; Williams, p.xii). 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 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, … " (Shoup and Haimoff, 1934, p.811; National Industrial Conference Board, 1929, pp. 163-66). Rulers in several nations, including the U.S.A., fostered *la petite propriété* (in Russia, "kulaks"5)

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3. Hamilton was not a formal member of Adams' Cabinet, but dominated it anyway.
4. 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 Tennesseeans who led Jefferson's old Party against the Whigs.

5 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..

as a political buffer for *la grande propriété*. (In Germany, *Grossgrundeigentum.*) Tax regimes evolved with shifting class voting power, in a complex history beyond the scope here6. By the end of W.W. II 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*.

2. American Exceptionalism

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 of 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 . Plimoth 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" (Bradford) 7 - 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 defense 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 Anne-Robert Jacques Turgot, an outstanding public servant , economic philosopher and social reformer. Some noted American visitors included Franklin, Jefferson, Paine, Madison, Monroe, Adams, and others. American's revolution against England meant friendship with France and Frenchmen, including liberals like LaFayette, du Pont, and Gallatin. Turgot tried but failed to reform France in his day, but this French thinker and leader was one of our Founding Fathers, in the mind. The Commerce Clause of the U.S. Constitution did for the new U.S.A. what Turgot had tried to do for France, it guaranteed free trade among the states.

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6 Wikipedia's anonymous article on Turgot cites many prominent economists on his being followed by many of the best-known economists of the 19th Century.

7 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 certainr ruls to proceed by; as that they should only lay out settable 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 lotts soever should fall next ye towne … or most convenint 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 ALOWED 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, pp. 258-61

He 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 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*8. He also set about reforming the tax system, subjecting the previously exempt lands of the 1st and 2nd Estates9 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.

While Intendant of Limoges he published his *Reflexions sur 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 favored 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 instead from taxes on the value of land – including lands traditionally exempt or undertaxed. He correctly observed that taxes based on land values are nearly the only kind that raise revenues without intervening in free markets, twisting and suppressing incentives to produce and invest. 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 U.S.A. expanded the "domestic" market swelled to include many times the land area its founders dreamed of.

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. W/o 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.

It was also, of course, 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

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8 *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.
9 The Clergy and the Hereditary Aristocracy, respectively.

work of society" – thus capturing the basic idea of modern macro-economics, in simpler language than used today.

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 lands clear to the Pacific, our "Manifest Destiny", as he called it. The U.S.A. 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 property income. 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 labor more and property less, and yet even so America is still taxes labor less, and property more, than most other nations. We stand alone as the nation with no national sales tax or facsimile thereof.

3. From Common Market to European Union and VAT

We pick up the story in 1948. W.W. II left Germany of course 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.10 They were "ruined", so it seemed. They didn't even have rationing tickets.

10 Heller, Walter W. "Tax and Monetary Reform in Occupied Germany." *National Tax Journal* 2, no. 3 (1949): 215–231.
Hirshleifer, 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.

Erhard observed that the only rationing tickets they needed now were 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:

Morgen, morgen, lacht uns wieder das Gluck
Gestern, gestern, liegt schon so weit zuruck,
war es auch eine schöne, schöne Zeit.

sind wir heut' auch arm und klein,
sind wir heut' auch ohne Sonnenschein,
sind wir heut' auch noch allein,
aber morgen, morgen, morgen, morgen, morgen.

Morgen, morgen, wird das alles vergehn,
morgen, morgen, wird das Leben endlich wieder schön.

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, then humiliated, 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 it 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 Freibourg 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. Germany's experience suggests that the

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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 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 U.S.A. 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 8 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.

Meantime, by 1954 the tide had turned back toward the attitudes of *l'ancien régime* with its taxes on merchants and their customers. Maurice Lauré, an engineer turned tax-man, got France to adopt VAT "to meet a fiscal crisis" (although that kind of 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. It was not general, but destined to become so. President René Coty, not a name to remember, was the last President of the fractionated 4th Republic, but Laurés VAT was declared a success. Charismatic Charles de Gaulle succeeded Coty, founded the 5th Republic, and presided from 1959-69. A fabled war hero, he 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. 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 spread quickly around Europe. The EC required member states to adopt VAT to enter the EU. Latin America also went along. In a second push around 1990, some industrial states like Canada[11], Australia,

11 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 (de Jong, 2012).

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 (Ebrill et al.; Keen andLockwood) and the World Bank – probably not what their founders had in mind at Bretton Woods in 1944.

The U.S.A. has played an anomalous role. The Shoup Mission to Japan in 1949 had tried to pioneer VAT there, although in vain12. U.S.A.I.D. has spent huge sums promoting and subsidizing VAT in small nations. Only the U.S.A. itself has rejected VAT. Evidently there is a wide gap between our international representatives and the voters at home.

By now, all "developed" nations except the U.S.A. have national VATs. Many leading U.S. economists are urging the same for the U.S.A., chiding us for backwardness. Many prominent economists are pushing parallel proposals as well, under forms like “the flat tax”.

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, …

Meantime 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.

4. Europe after VAT: Troubles and Setbacks

Today in 2013 Europe is staggering. Many of its nations face bankruptcy. Its stronger members and institutions they dominate seek to impose "austerity" on the resentful weaker members. Its banks hold mostly its government's securities, crowding out small businesses that create most jobs. Its unemployment rates are breaking records. Its 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.

In September, 2012, the unemployment rate was 10.4% in the Euro area, and 23,3% for youths aged 15-25 Patterns diverge across nations, with the highest youth unemployment rates in Greece (55.6% in July), Spain (54.2%), Ireland (34.5%), Italy (35.1%) and Portugal (35.1%). Those are catastrophic numbers. Even in France, a pillar of European Union where VAT got started, the rate is 27.9%. Sturdy lowland and Baltic nations are not

12 Brownlee, Elliot,

immune: rates in Belgium are 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.

In Latvia wages are so low, and jobs so scarce, that she has lost about 10% of her labor force to emigration, even as Christine LaGarde, Olivier Blanchard and other faces of the establishment proclaim it a success story. Mexico, guided by the IMF into NAFTA and neo-liberalism, stagnates while its oil riches keep its taxes low, it houses the world's richest person (Carlos Slim), criminal gangs take over whole provinces, and desperate poor pound on the doors to the U.S.A., and slip through cracks in the fences of our country, which finances the world's military without having any VAT at all.

Debts, Public and Private

The debts of Greece, Italy and Spain are in the headlines, but many "stronger" nations also owe more than their revenues can well handle. Greece owes $315 b, but here are the debts of some "strong" nations, in billions of $: Finland, 101; Austria 230; Belgium 374; Netherlands 427; and France 1,835. Even Germany, supposedly the EU's economic bulwark, began showing signs of stagnation in the 1990s, leading to the sarcastic epithet "The German Disease". Its debts are highest of all, at 2,086. 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 trillions is rigged downwards by omitting huge pension obligations, estimated to add another $3 trillions to the total.

Some banks in greatest danger include Banco Santander (Spain), Credit Agricole (France), Commerzbank (Germany), Dexia S.A. (Belgium, and of course Bank Ireland. Germany's DeutscheBank, biggest in Europe, is not much stronger than Commerzbank.

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. In Greece, for example, public revenues have fallen 5% in the last year, while VAT revenues have fallen 15%. As credit ratings fall, required interest rates rise, so debt service rises, deficits rise, and debts keep growing, a disastrous vicious spiral. The resistless expansion of the EU stopped late in 2012 when Bulgaria refused to adopt the Euro for fear it would be called on to bail out even weaker nations.

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-fueled crash of 2008, but it keeps returning. 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 nations 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 for turning 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, however "general" or universal in their apparent coverage, tax capital for turning over. Turnover means replacement; and replacement sustains demand for labor. 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.

Sales taxes depress turnover heavily, and thus 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 other sales taxes that "shoot anything that moves". In the lingo of public finance, they are contingent on "taxable events".

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.

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 nontaxed employments. The shift in relative prices occasioned by the partial tax cannot occur under a truly general sales tax" (1975, p. 399). 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." (1939, p.254). Earl Rolph and George Break commit to this view (p.117). So does Harold Somers (pp.

17, 26). Bernard Herber (p.254) and David Hyman (2005 pp.617-26) chime in cautiously. Charles McLure wrote that proponents (he being one) expect VAT to "free the economy from distortions resulting from present taxes. … . "Neutrality is one of the chief advantages of the tax on value-added." He also damns "... the ridiculously unfair and distortionary de facto exemption of interstate sales …" (2005). Harold Somers' writes that a tax on gross sales is the same as a tax on net income (p.27). We return to this later, under "The Mill Effect".

All the above quotes refer only to taxes on simple "commodities", conceived and defined and illustrated in the most simple-minded ways. The writer has compiled a long list of loopholes, too simple and common to repeat here (Gaffney, xxxx). The greatest is the explicit exemption of all sales involving real estate. State sales tax laws in the U.S.A. all specify sales of PERSONAL property only, thus excluding from the start sales and rentals of homes, associated curtilages and demesnes, recreational and scenic holdings, etc. Unearned increments (aka capital gains) from most such lands are untaxed. Interest secured by mortgages is untaxed, and so on.

Capital proper, when affixed to land, becomes "real estate", hence exempt from sales taxes (and, I presume, most European VATs, although "no two VATs look exactly alike" (James, p.18)). The most durable forms of capital, the kinds that Austrians believe are oversupplied, are affixed to land, hence exempt from VATs.

Modern writers deplore the exemption of "services" from the sales tax base. These writers and teachers refer in their contexts only to labor 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 (Anderson, p.252).

John Stuart Mill in 1848 looked deeper, in a proto-Austrian way, and pointed out a systemic bias inherent in the tax. I repeat his quote here, for emphasis.

"… 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 labor must rise in value, as compared with those which are chiefly made by machinery. … " -- (1848, Book V, Chapter IV, pp. 504-05).

Mill hid this light under a bushel, by offering just one example of a small difference, arithmetic only. It is easy to overlook in passing, and standard-brand economists have done so. So, tragically, have most Austrian writers, few of whom analyze tax policy. Their strong tendency is to impute the malallocation of capital solely to misguided central bank policies, blanking out other factors like tax policy. We should, rather, set Mill's light in a tower on a hilltop as a beacon sending its gleam across the wave to save the foundering ship of state.

Harold Groves, a clearer expositor than Mill, makes the point in a simple table (p.113). "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".

	(I)	(II)	(III)	(IV)	(V)	(VI)
Store	Operating Capital	Gross Sales	Sales/Capital	Profit Before Tax	Tax @ .5%	Tax/Capital (%)
A	$30,000	$30,000	1	$300	$150	0.5
B	2,000	100,000	50	200	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 labor. The gross sales of parking lots, at the other extreme, include no turnover of capital at all, unless perhaps a minuscule Capital Consumption Allowance (CCA) on the paving and striping.

More generally, as Dan Sullivan points out, sales taxes penalize high-volume low-markup marketing strategies as against their opposite. Lest one turn up his nose at, say, Walmart, its low prices do not reflect low markup so much as low labor-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 markups, so sales taxation favors better locations over marginal ones. New businesses with high startup costs can deduct them from taxable income, but not from gross sales. Clifford Cobb notes that ghettos have many barber shops and beauty parlors but few shops carrying commodities.

What Mill means by "capital" is clear from his memorable saying, "Capital is kept in existence from age to age not by preservation but by continual reproduction". Capital is not a specific concrete good, like a chair in the furniture shop. Rather, it is a quantum of value 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 needn't be an identical chair, or any chair at all, for capital in this transition is totally fungible in form and location.

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 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, say, Georgia-Pacific or Weyerhaueser or Simpson or Ford's Roseburg timber corporations.

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.

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 (1939, p. 254). 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.

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.

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 do not repeat 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. The writer has often spelled it out for students in class notes.

A unit or "quantum" of fixed capital embodied and frozen into, say, the Oroville Dam, or the long Honshu Tunnel, or grading building sites, or land-fill in shallow water,, or The Pyramids, or The Brooklyn 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 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 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 are beginning a new cycle of forgetting in 2013 as I write.

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 overtaxed 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 (Bk V, Chap 5, p.517), but the stronger recent statement is in Harry G. Brown (1939). Earl Rolph, crediting Brown, agrees (1952). Richard Musgrave, crediting both Brown and Rolph, endorses this approach in the main, too (1953, p. 318; 1959, p.379). 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 favorably 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.13 Thus they purge The Mill Effect, the "Disturbance in The Force", from modern fiscal economics.

Mark Skousen, presents a long valuable list of previous texts and learned writings supporting Austrian capital theory (Chap. 4, pp. 84-130 et passim). 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 favors sales taxes on the grounds that final consumers bear them, and this exempts saving and capital formation. The writer has refuted this belief elsewhere (2009), and will not repeat the reasoning here.

As to the structure of production, Skousen writes that "… a consumption tax … would be highly favorable toward the earlier stages of production," (p.345). 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 favorably, or at least NOT favorably. I will not labor 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 untaxing 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 favor of slow turnover, since the tax is deferred until sale (Gaffney, 1957, 1970-71, 2006; Vickrey, 1971). 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 arduous and obscure prose (pp. 392-99), Musgrave finally, grudgingly, finds a tax on "gross receipts "leads to a lengthening of the average period of investment" (pp. 396-97).

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13 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.

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. This quantum of value is relayed from one concrete capital good to another with each turnover (cycle of liquidation and replacement). 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 (1959). 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. The average transit time of a molecule of liquid through a reservoir is basically the flow/fund ratio: in economic terms, the sales/capital ratio (p.353 et passim). 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 saying "It is nice that this elaborate calculation is really unnecessary" (p.372).

Dorfman does not treat land separately, which is a fault. Neither does he analyze sales taxes and their effects. This writer has tried to supply the lack (1976, mathematical appendix). For now it is enough that we can measure turnover simply, and it varies hugely among sales-taxable items and firms.

Professor William Vickrey (1971) contributed a general mathematical model published as an Appendix to my "Tax-induced Slow Turnover of Capital", showing 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 math major (1971). 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 is 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 labor – both the number of jobs and their pay rates. 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 U.S.A., with all its faults, has no national VAT. We do not lack for crusading VATsters. They chide us for being behind Europe, where all nations in the EU depend heavily on VATs, the dependence rising fast ever since France introduced it in 1954. As the EU careens to financial crisis, and derivative political crises, while world capital flees for refuge in the U.S.A., 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.

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 (*QJE* , August *1921*). 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 (1918), 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 followup. 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 W.W. I in the U.S.A. led to a spate of proposals for a national sales tax in the U.S.A. including some from Andrew Mellon, W.R. Hearst, Ogden Mills, and his 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. The du Ponts, as major owners of GM, also had an interest in holding down gasoline taxes14.

The next tranche of advocates included scholars Irving Fisher, Kaldor, Meade, and Prest. Following W.W. II Professor Carl Shoup of Columbia joined the tranche. General Douglas MacArthur as head of SCAP15 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 S.P. R.R. and developer of upper class Los Altos in San Mateo County. Shoup came out strongly for a VAT 16. Shoup 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 U.S.A. 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 17, G.N. Hatsopolous, James Poterba, Steve Forbes, Rick Perry, Robert Hall and Alvin Rabushka backed by The Hoover Institution, Newt Gingrich, Milton Friedman, Richard Armey, 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.

7. International Enforcement Agencies for "Harmony", Lending, and Collections

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. The details are complex and interwoven, constantly discussed in media reportage and new books beyond our need to rake over here. Like most bureaucracies they tend to aggrandize and perpetuate themselves and freeze in place, as generations of libertarians preach. Perhaps the preachers and their exegetes overstate it. A major recent shift is evident. Control has shifted from Social Democrats to

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14 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.
15 Supreme Command, Allied Powers.

16Shoup was overborne by the rival mission of Detroit banker Joseph Dodge, representing Truman, who preferred income taxes modified by fast writeoff.

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

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 capital18. Today in 2013 raising income taxes is off the table, unthinkable, unmentionable, a solecism. The prevailing dogma is that raising tax rates would only choke recovery and lower the tax base, as Laffer once warned. The focus is 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. 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 statewide19. 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, as shown earlier herein.

Why do lender groups 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 each needs the other. 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.

The idea that Europe has reached the limit of its taxable capacity is nonsense In the light of history. The Cold War wound down from 1989. Today the U.S.A., 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 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, as shown earlier, 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

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18 1998, Report of OECD Committee on Fiscal Affairs, *Harmful Tax Competition, an Emerging Global Issue*

19 Bradley-Burns Uniform Local Sales Tax Act, Revenue and Taxation Code Section 7200.

evidence of Europe's solvency and untapped taxable capacity is the high level of its land prices compared with ours. International buyers are paying record-smashing figures for homes in world-class neighborhoods 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 (LAT 1-29-13, p.B5).

The bottom line is that Europe is strangling itself with VAT, while the U.S.A., for all its many serious faults, is surviving better without one. 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 the "wretched refuse" kind to the most talented, both of whom 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.

Appendix I: How Gigantism in Banking Reinforces the Bias Against Turnover

The following is an excerpt from Stacy Mitchell, "How State Banks Bring the Money Home", *Nation of Change.org*, Sept 15 2011

One of the most significant, but least noticed, consequences of the rapid and dramatic consolidation of the banking industry over the last decade is how much it has hindered the U.S. economy's ability to create jobs.

To begin to understand this, take a look at each end of the banking spectrum. On one end are the nation's 6,900 small, locally owned, community banks. These institutions control $1.4 trillion in assets. That's 11 percent of all bank assets. They currently have $257 billion in loans to small businesses and farms on their books.

On the other end, four giant banks—JP Morgan Chase, Bank of America, Citibank, and Wells Fargo—now command $5.4 trillion in assets, or 40 percent of the total. Given that they are nearly four times as large as all local banks combined, one might expect that they would have made four times the small-business loans, or about $1 trillion. In fact, these banks have a mere $85 billion in small-business and farm loans on their balance sheets.

Why do giant banks make so few small-business loans? Automation is the short answer. The only way these sprawling institutions can function efficiently is by taking a mass production approach to lending: Plug credit score, income, and appraisal into the computer—out comes the loan. That's why the mortgage business was supposed to be so safe. The economic meltdown of 2007 shows that it's actually very risky.

Small-business loans are not so easily mechanized. Each is a custom job, requiring human judgment to evaluate the risk associated with a particular entrepreneur, a particular business plan, and a particular market. Community banks excel at this. Their lending decisions are made locally, informed by face-to-face relationships with borrowers and an intimate understanding of their hometown economies. Big banks, whose decision-making is long-distance and dictated more by computer models than judgment, are pretty bad at it. So they don't make many small-business loans.

It's no wonder, then, that unemployment has been so persistent. Our financial system is top-heavy with big banks that are scaled to meet the needs of large multinational corporations. The Commerce Department estimates that U.S.-based multinationals have eliminated 3 million American jobs over the last decade. Meanwhile, small businesses, historically responsible for about two-thirds of new jobs, have found it harder and harder to obtain credit.

In short, we have a financial system that is mismatched to the economic needs of American communities. This mismatch will become more acute as we attempt to transition to a carbon-efficient economy, which, by its very nature, will be the domain of small-scale enterprises: local food producers, community-owned wind and solar electricity, neighborhood stores that provide goods within walking distance of homes, and so on. To take root, these businesses will need a robust array of community-based financial institutions capable of meeting their capital and credit needs.

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