EUROPE'S FATAL AFFAIR WITH VAT

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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,

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 (continued on page 9)