

EUROPE'S FATAL AFFAIR WITH VAT

(from page 8)

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. 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).

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" (continued on page 10)