Europe's Fatal Affair with VAT (Part I)
By Dr. Mason Gaffney

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EUROPE'S FATAL AFFAIR WITH VAT

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Abstract

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 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. This is the more remarkable considering that European VATs generally are of the "consumption type" that lets one expense investments. (* Portugal, Ireland, Italy, Greece and Spain.)

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 what loopholes, hiding the vital truth that many loopholes, like fast writeoff and expensing of investing (continued on page 8)

EUROPE'S FATAL AFFAIR WITH VAT (from page 7)
in creating new capital goods – genuinely "income-creating" spending – are exactly what have made high rates of income taxation tolerable, and compatible with high rates of investing during the mid-20th Century.

Europe generally uses the "consumption-type VAT", meaning that capital outlays are 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). (continued on page 9)

EUROPE'S FATAL AFFAIR WITH VAT (from page 8)

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 interior commerce of G.B. is relatively tax free.

"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 market 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 ambitions, led Federal troops to put down this uprising. The voters, when they found him dominating the subsequent cabinet of John Adams, and leading the country into the depression of 1798, retired his party and installed Jefferson, whose Virginia dynasty shaped the nation for the next 36 years.

These Virginians knew their Physiocracy. Jefferson, Madison and Monroe had all represented (cont'd on p. 10)

EUROPE'S FATAL AFFAIR WITH VAT (from page 9)

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") 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 here. 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 off their French rivals. Armed settlers and hunters and vigilantes dealt with most kinds of local crime; volunteers fought fires. Church and extended families covered much of what today we call social welfare and education, such as they were. Companies chartered in England sought dividends in various ways, as from road tolls and by selling off or renting out lands granted them by the Crown. 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) - 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. America'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.

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. He also set about reforming the tax system, subjecting the previously exempt lands of the 1st and 2nd Estates 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 (continued on page 11)

EUROPE'S FATAL AFFAIR WITH VAT (from page 10)
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. Without it, it is likely that state sales taxes would rise to 20% or more in short order, as the wholesome fear of interstate competition was stifled.

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 work of society" – thus capturing the basic idea of modern macroeconomics, 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 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. They were "ruined", so it seemed. They didn't even have rationing tickets.

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 (continued on page 16)

EUROPE'S FATAL AFFAIR WITH VAT

from page 11)

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 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 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.

(Section 3, From Common Market to European Union and VAT, will be continued in the next issue of GroundSwell, along with Sections 4-7.)

(Economics Professor Dr. Mason Gaffney may be emailed at m.gaffney@dslextreme.com. GroundSwell does not have space for footnotes but they are available on request from Dr.Gaffney.)