"General" sales taxes are not general, but partial and discriminatory (as of Sat. Sept. 3)

Mason Gaffney, November 2011

Standard textbooks say that a truly general retail sales tax is neutral as between "commodities", and locations as well, because one cannot escape it. It is the same in one town as another; and, unlike an excise tax, on one commodity as another. Those conditions are never achieved in practice, but to the champion that merely shows that reformers should strive to extend the reach and universality of the tax, as California is trying to do against Amazon today, to the applause of most economists, at least the most visible ones. Thus, Buchanan and Flowers write "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, *The Public Finances*, 4th Ed., Homewood, IL, Richard D. Irwin Inc., p. 399).

Sales taxes as we know them are not at all general, and not even intended to be. It is always worth repeating that nearly all state sales taxes, like California's, apply by law only to *personal* property, i.e. they exempt everything to do with real estate, whether sales, debt service, rentals, sales commissions, crop shares, royalties, bonus payments for leases, imputed consumption of owner-occupied grounds, gains, gifts, bequests … everything whatever. Standard texts ignore this gaping loophole entirely, thus silently telling students to accept it as fair and right. This seems to reflect the profession's blind spot on all matters pertaining to land, or worse, its tacit approval of raising taxes that "shoot anything that moves" in order to avoid taxing land.

John Due, one of the prevailing authorities, wrote in 1963 that the Feds have preempted the income tax base, so the States "are virtually compelled to turn to sales taxation" (p.296) - no mention that they might turn to property taxes, as they did from colonial days to 1932, along with severance taxes, franchise taxes, fees for using state property like water (falling, ground, and surface), carbon taxes, commercial fishing licenses, or other means of raising revenue from land and natural resources. Due also writes (p.295) that taxing rentals is unfair to tenants because there is no tax on the imputed rent that owners pay to themselves – no mention that we could balance taxes fairly by taxing the latter instead of continuing to exempt the former.

Sales taxes are said to fall on "consumption", and so to encourage "saving", but one searches in vain for any definition of "consume" or "consumption" in the sales tax literature. What does it mean to consume land, for example? Perhaps the unwritten assumption is that we cannot consume land because it does not wear out, but we certainly can consume time slots of it, and like the lawyer, time is its stock in trade. If we convert 160 acres from growing walnuts to golfing, or from pasturing cows to sheltering foxes to chase and birds to shoot, or riparian land from canneries to luxury yacht harbors, we are re-allocating the land from production to having its time consumed, right? So to make sense of sales taxation we must junk, or radically change, existing literature and its paradigms, which now lead us as by a ring in the nose down a primrose path to an end selected for us by prevailing authorities. We must think the matter through afresh, with our own minds.

In this paper I take the above as too obvious to labor further, and focus on a more subtle but profound and pervasive matter: how sales taxes penalize and slow down the turnover of capital, and the frequency with which a given capital is reinvested to make jobs. John Stuart Mill, with his philosophical bent and heritage from The Age of Reason, looked much deeper than modern writers on sales taxation, and pointed out a general non-uniformity or partiality that is inherent in the tax, and incurable (*Principles*, Book V, Chapter IV, "Of taxes on commodities", pp. 504-05). Here is Mill:

"… 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. … Now, equal capitals in two different occupations must have equal expectations of profit; but 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 of 5% *ad valorem*, the last will be charged only with £25, the first with £55, leaving to the one £75 profit, to the other only £45. To equalize, therefore, their expectation of profit, 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. … "

How prescient and memorable is the word "disturbance", 150 years before Darth Vader in *Star Wars* could intuit a "disturbance in The Force"! In Mill's and M'Culloch's usage, "The Force" is value as determined in a free market before or without taxes based on production or sales.

Mill shyly hid this light under a bushel, by offering examples of small differences, easy to overlook in passing, which is what later standard economists have done. We should, rather, make them more striking and memorable, for this is a point of utmost importance in guiding tax policy and other public policies.

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

Store	(I) Operating Capital	(II) Gross Sales	(III) Sales/Capital	(IV) Profit Before Tax	(V) Tax @ .5%	(VI) 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, which is based on Column (II), 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.[1]

Again, compare a parking lot and a cafeteria, supposing 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 services, at the other extreme, include no turnover of capital at all, unless perhaps a minuscule Capital Consumption Allowance (CCA) on the paving and striping.

The case is even clearer when we compare two uses competing for the same land. The one with more turnover pays more sales tax. The tax drives away capital that turns over fast, and reallocates the land to capital that turns slower, or to uses requiring less K, or no capital at all, like the parking lot. The lot itself never turns over. Its ownership may turn over, as often as you please, but that is an entirely different meaning of "turnover": it entails no income-creating, job-creating production of the lot, and no depreciation, and no routine recovery of the original purchase price.

Many economists manage to disregard such effects 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 views of Buchanan and Flowers that sales taxes are shifted backwards to factors of production; and many of us now hew to the Physiocratic doctrine that All Taxes Come Out of Rents (ATCOR).

What Mill means by "capital" is clear from his famous quotation, "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, or the sticks that went into it, or the logs that went into them, or the trees that made the logs. 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. Fred Foldvary, like some other "Austrian" thinkers, signalize this by describing specific concrete embodiments 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, a concept that most economists grasp and teach, even while many resist or ignore the idea of capital as a quantum of value – something more obvious to accountants, however.

Chemists also have appropriate vocabulary for it. Land in production is like a chemical "catalyst": it facilitates a process without ending up in the product. Working capital is, at the

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[1] The template of the table is borrowed from Harold Groves, 1946, *Financing Government*, NY: Henry Holt & Co., p.113. Groves himself uses this template to criticize the tax on personal property as falling heavier on "A". I have modified it to show the sales tax falling heavier on "B".

other extreme, like a "reactant": its corpus becomes embodied in the product and gets sales-taxed with each turnover, along with its net income.

"Fixed" (durable) capital is a mixed story. The corpus of fixed K as a catalyst does not get sales-taxed, only its income gets sales-taxed. 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.

A unit or quantum of fixed capital embodied and frozen into, say, Hoover Dam, or grading building sites, or land-fill in shallow water, or a tunnel, 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 subsidize them.

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) 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 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 being free of taxing turnover.[2]

[2] While they are at it, Buchanan and Flowers want to tax people for "consuming leisure". The idea goes back to Chicago's Henry Simons (1938), except he called leisure (mainly unemployment) a form of taxable income. Buchanan and Flowers do not call this a poll tax, for they disapprove of such "emotive terms", but they do not suggest taxing idle or underused land or capital for taking their leisure. The KKK would have approved, and one has to wonder what social philosophy imbues them and their disciples in the "Public Choice" school..