The Case against the Value-Added Tax

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Rapid increases in the burden of federal spending over the past decade have led to large budget deficits and rising levels of government debt. But this is just the tip of the iceberg. In the absence of reform, the combination of an aging population and entitlement programs will lead to even higher levels of government spending. And even though tax revenues are expected to climb above historical norms, the rise in receipts will be much smaller than the increase in outlays,

There is no magic point at which deficits and debt become too large, but Greece, Ireland, and Portugal are sobering examples of what happens when investors decide a government has reached a tipping point. To avoid a similar meltdown in the United States, policy makers almost certainly will be forced to take steps to staunch rising levels of red ink.

Unfortunately, even though more than 100 percent of the long-run fiscal imbalance is because of higher spending, it is quite likely that politicians will seek additional revenue, and a value-added tax will be one of the most tempting options. The VAT is a broad-based levy that has become ubiquitous elsewhere in the world. It is known as a consumption tax, but money is collected at the business level rather than at the cash register. This means the tax is built into the price of affected goods and services and largely hidden from taxpayers

Politicians are attracted to the VAT because it is capable of raising enormous amounts of revenue. Consumption is close to 70 percent of gross domestic product, or about $10 trillion. As such, even relatively modest tax rates would divert large amounts of money to Washington – even if lawmakers decide to include loopholes that shrink the tax base.

But this is why a VAT would be the wrong policy. America's fiscal problem is too much spending, not insufficient tax revenue. Imposing a new tax – particularly one capable of generating so much money – would be akin pouring gasoline on a fire and ensuring that America will become a European-style welfare state. In other words, bigger government and lower living standards.

Perversely, it is quite likely that a VAT would exacerbate rather than solve the problem of too much government borrowing. The nations in Europe that have been bailed out, as well as those teetering on the edge of fiscal collapse – including Greece, Spain, Portugal, Ireland, and Italy – all have VATs. Indeed, the average level of debt for all Western European nations is higher than the U.S. debt level. Imposing VATs, beginning in the 1960s, obviously didn't keep politicians from spending too much. For all intents and purposes, the experience in Europe confirms Milton Friedman's famous warning that, "In the long run government will spend whatever the tax system will raise, plus as much more as it can get away with."

What is a VAT?

There are a couple of ways of defining a VAT, but the easy shortcut method is to ask one simple question: Are businesses allowed to deduct labor costs? This is a blunt definition, but the non-deductibility of wages is a key characteristic of a VAT. Indeed, much of the revenue from a VAT is generated because it imposes, for all intents and purposes, a withholding tax on wages and salaries. But with the exception of a few tiny jurisdictions such as Monaco, this hidden tax on wages and salaries in all nations is in addition to the regular income tax.

In the language of public finance economists, the VAT is a consumption tax. But this term requires elaboration. A consumption (or consumption-base) tax does not mean a levy that is paid by consumers. Instead, it is the term applied to any revenue system that does not double tax income that is saved and invested. The Social Security payroll tax, for instance, is a consumption tax since it is not imposed on dividends, interest, and capital gains. Likewise, the flat tax popularized by former House Majority Leader Dick Armey and magazine publisher Steve Forbes is a consumption tax since dividends, interest, and capital gains are not subject to a second layer of tax.

In short, a consumption tax is a system where income is taxed only one time. That income might be taxed only one time when it is earned, as is the case with the flat tax. Or it might be taxed only one time when it is spent, as with a VAT or national retail sales tax. The current tax system, by contrast, is based on the “Haig-Simons” approach, which is sometimes referred to as a “comprehensive” tax base.

The Economics of a VAT

The VAT sometimes gets positive reviews from economists. This is not because it is pro-growth, but rather because the VAT – when compared to a comprehensive income tax – is a less-destructive way of raising revenue. This would be a compelling argument for the VAT, but only if politicians were considering a plan to completely eliminate the income tax:

Moreover, saying that VATs are not as destructive as the traditional income tax is damning with faint praise. It certainly does not mean that a VATs have a positive impact on economic performance. Indeed, the economic benefits of replacing the income tax with a VAT are completely attributable to getting rid of the current internal revenue code.

Unfortunately, such a swap is not a real-world option. No political jurisdiction anywhere in the world has ever repealed an income tax and replaced it with a value-added tax. Moreover, no VAT proponent in the United States is proposing to eliminate the income tax.

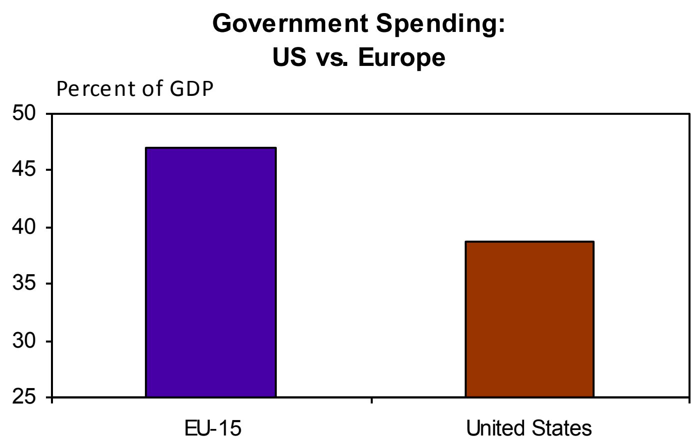
This means the only realistic way of assessing a VAT is to examine the economic impact of layering such a levy on top of the current system – what is generally referred to as an “add-on” VAT. In this scenario, the VAT is unambiguously harmful to economic performance. It reduces incentives for productive behavior by further increasing the wedge between pre-tax income and post-tax consumption. Simply stated, people have less incentive to earn income when there is less ability to enjoy the fruits of their labor.

As the OECD has acknowledged, “Because they lower the purchasing power of real after-tax wages, consumption taxes may curb labour supply in much the same way as a proportional income tax.”

VATs are associated with bigger government

Reviewing the experience of other developed nations is probably the best way to assess the likely impact of a VAT in the United States. Western European nations are especially useful case studies since the VAT was implemented in that late 1960s and early 1970s, thus providing about 40 years of evidence. Unfortunately, that data suggests a VAT means bigger government.

As seen in chart, the burden of government spending in “EU-15” nations is significantly larger than it is in the United States.



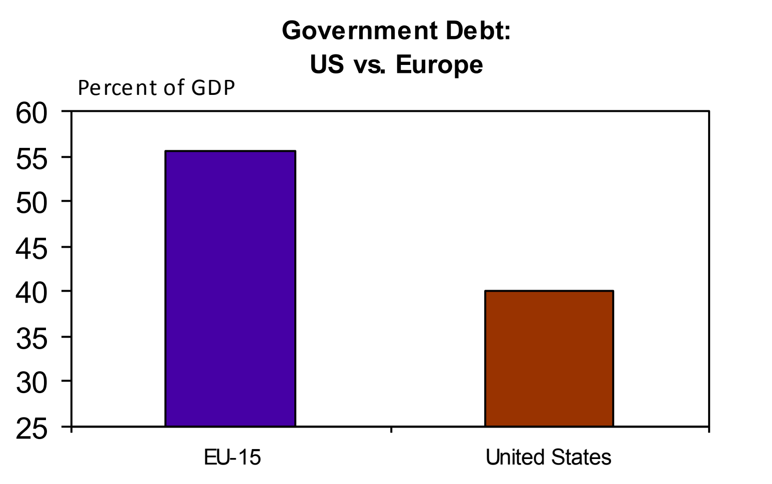
Source: Organization for Economic Co-operation and Development, *OECD in Figures, 2010* ed, at *www.oecd-library.org/economics/oecd-factbook-2010 factbook-2010-en* (Mav 25. 2010)

What makes this comparison especially revealing is that government spending in EU-15 nations was quite similar to U.S. spending levels back in the mid-1960s, shortly before VATs were implemented. The burden of government spending has increased in both the United States and Europe, but the increase in Europe has been larger (though government spending has jumped significantly in the Bush-Obama years, thus making the comparison less dramatic than it was 10 years ago).

There is a debate in the academic literature about whether the VAT causes higher spending, or whether the relationship is the other way around. In other words, do higher taxes lead to higher spending or does higher spending lead to higher taxes? That is an interesting question, but largely irrelevant. A bigger burden of government spending is misguided, and that is true if politicians implement a VAT (or increase the rate) so they can spend more in the future. And it is true if politicians implement a VAT (or increase a rate) because they spent more in the past. In either case, the additional spending is made possible by the VAT.

Proponents of an add-on VAT often claim that their goal is to reduce deficits and debt. This presumably makes the idea of a new tax more politically palatable. This may be a clever strategy, but even a superficial look at the data shows that European nations with VATs heavily rely on borrowed money. Indeed, the sovereign debt crisis in Greece, Ireland and other European nations only exists because deficits and debt got out of control.

Deficits in Europe are much higher today than they were in the pre-VAT days. But one-year snapshots of red ink can generate unfair comparisons because most nations today have unusually high levels of government borrowing because of a weak global economy. Government debt figures are more appropriate since they represent accumulated fiscal balances, so they capture both good years and bad years. But this approach is even more damning for VAT advocates. Average government debt is much higher today in EU-15 nations than it was before VATs were adopted.



Source: Economist Intelligence Unit, at *www.eiu.com/public/* (2011)

Moreover, the chart shows that the average level of debt in EU-15 VAT nations is higher than it is in the United States. These numbers are especially significant given that the U.S. has just finished a 10-year period featuring record deficits. Yet even with all the additional red ink caused by the Bush-Obama spending binge, VAT nations in Western Europe still have more higher levels of debt.

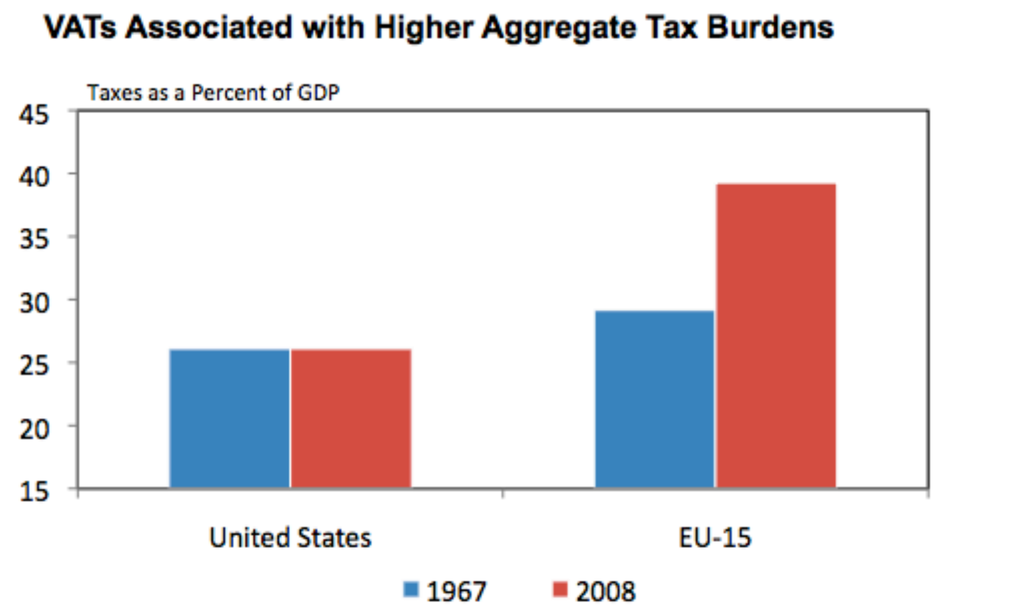
Some argue that this means that VATs cause higher deficits. That may be true, but it is difficult to prove or disprove such a hypothesis. Another plausible explanation is that VATs have no impact on red ink. According to this hypothesis, the propensity to use debt-financed spending varies across nations based on political and cultural tolerances for red ink. Southern European nations, for instance, almost always have higher levels of deficits and debt than Nordic nations. That was true before the VAT was implemented, and that is true now that all of the nations have a VAT.

This means that the real impact of a VAT is to allow governments to finance more spending, while still maintaining whatever level of red ink that they can get away with given varying national circumstances.

The VAT is associated with higher tax burdens.

Proponents often claim that a VAT is a form of tax reform rather than a tax increase. This certainly is a theoretical possibility, but there is no real-world evidence for this hypothesis. No political jurisdiction anywhere on the planet has ever adopted a VAT and eliminated an income tax. It has always been an "add-on" tax.

Not surprisingly, this is why VATs are associated with higher overall tax burdens. The chart shows what happened in EU-15 nations. Prior to the VAT's adoption, European nations had average tax burdens of less than 30 percent of GDP. Today, tax burdens consume nearly 40 percent of GDP.



Source: Organization for Economic Co-operation and Development, *Revenue Statistics*, 1965-2009 (Paris: OECD Publications, 2010).

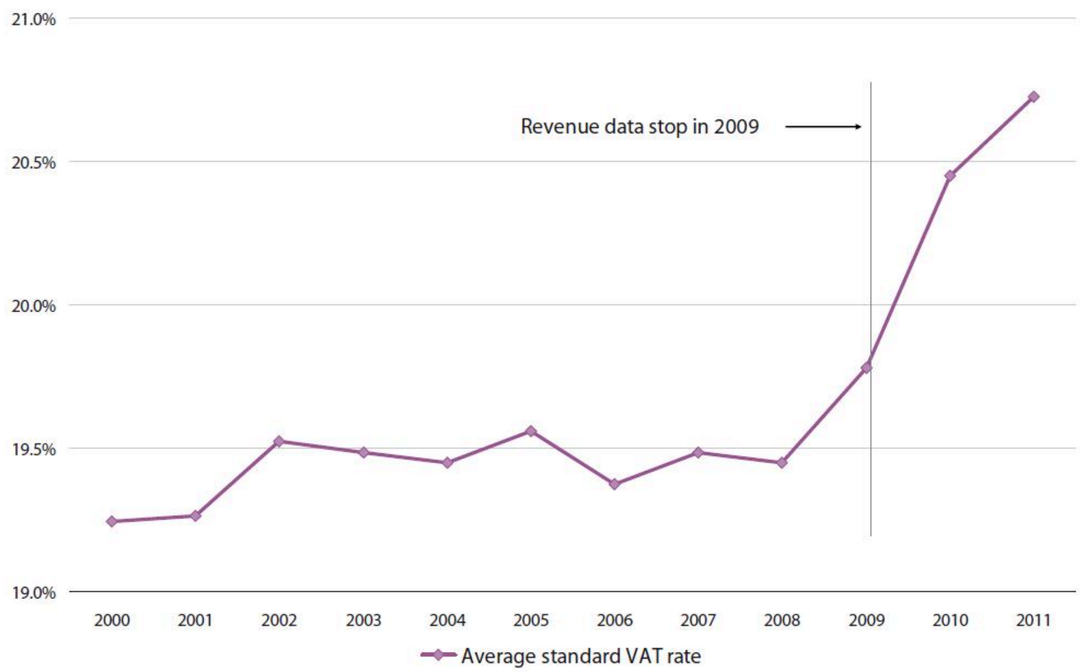
Note: EU-15 refers to the 15 member states of the European Union prior to enlargement in 2004.

The tax burden in non-VAT nations also has increased, but not nearly as much. The chart also compares the increase in the share of output taken by tax authorities in the United States and EU-15 nations. The chart shows that Western European nations in 1965 had slightly higher taxes, on average, than the United States. Following the enactment of the VAT, however, the gap widened dramatically.

It's possible, of course, that the overall tax burden in Europe would have climbed just as rapidly in the absences of a VAT. But it is difficult to see how this could have happened. Income tax rate already are very high, and may even be at or above the "revenue-maximizing" level, suggesting that higher tax rates could backfire because of reductions in taxable income. Payroll tax rates also are high, as are taxes on energy, alcohol, and tobacco.

The past couple of years certainly suggest that politicians view the VAT as a convenient tax to increase. The following chart, from a recent European Commission report, shows that the average VAT rate has jumped significantly since 2008. There's every reason to believe US lawmakers also would view the VAT as a money machine that would enable them to avoid much-needed belt tightening of the federal budget.

Graph 16: **Development of average standard VAT rate, EU-27**

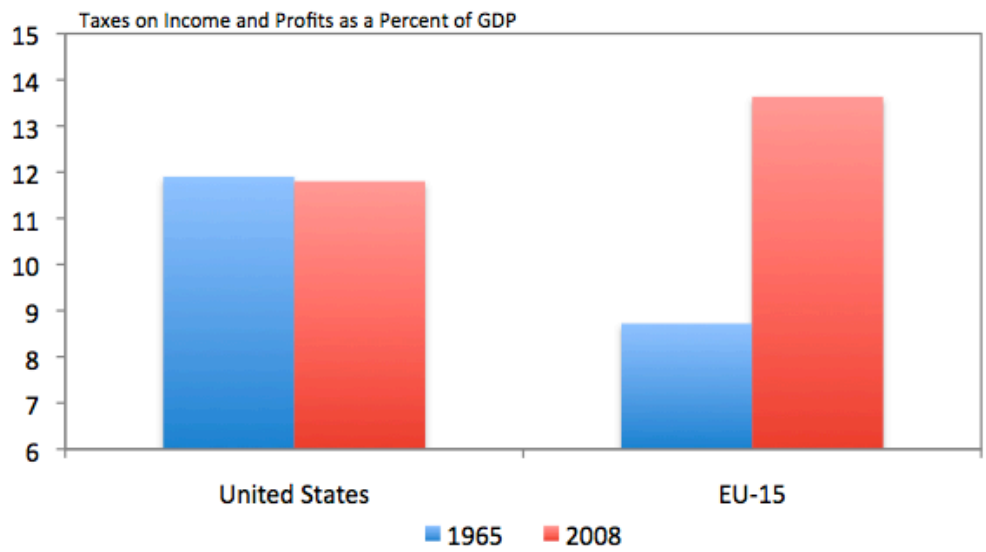


Source: Commission services

The VAT is associated with higher tax burdens on income and profits.

Proponents sometimes admit that a VAT increases the overall tax burden, but they claim that some of the new revenue is used to finance lower personal and/or business income taxes. This certainly is a potential result. Unfortunately, that's not what has happened in Europe. The chart shows that the tax burden on income and profits has climbed since the VAT was implemented.

VAT Does Not Lead to Lower Taxes on Income and Profits

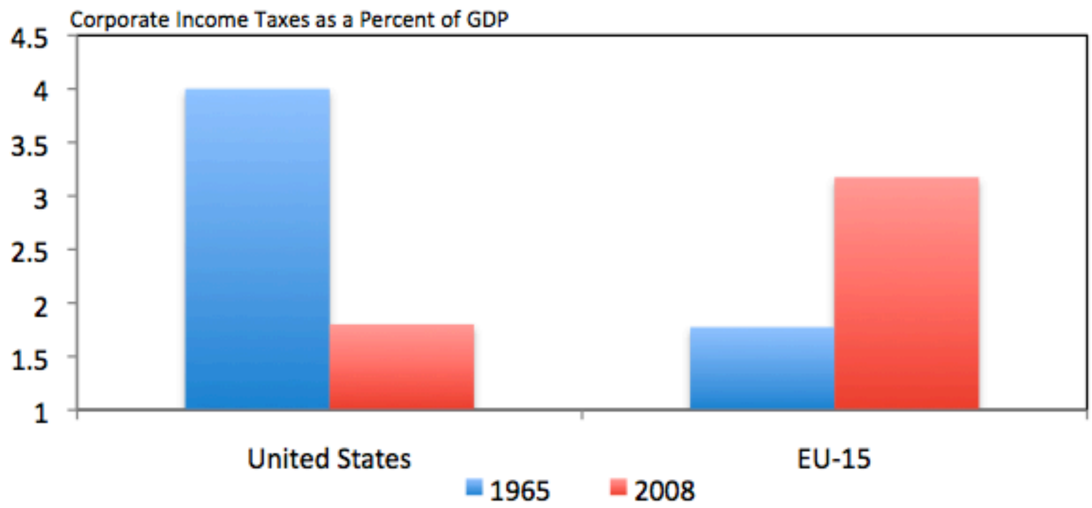


Source: Organization for Economic Co-operation and Development, *Revenue Statistics,* 1965-2009 (Paris: OECD Publications, 2010).

Note: EU-15 refers to the 15 member states of the European Union prior to enlargement in 2004.

Some people in the business community are being lured to support the VAT by promises of better tax treatment of corporate income. Yet the data on corporate taxation shows that the adoption of a VAT was followed by a steeper burden on profits in EU-15 nations.

VAT Does Not Lead to Lower Taxes on Corporate Income



Source: Organization for Economic Co-operation and Development, *Revenue Statistics,* 1965-2009 (Paris OECD Publications, 2010).

Note: EU-15 refers to the 15 member states of the European Union prior to enlargement in 2004.

To be sure, corporate tax rates have dropped in recent decades, so it's possible that some of the added corporate tax revenue is a "Laffer Curve" response to better tax policy. But the lower tax rates are the result of tax competition beginning in the 1980s, whereas VATs were implemented starting in the 1960s.

The VAT is not good for trade

Some proponents claim that a VAT is good for trade because it is "border adjusted." This means that the VAT is imposed on imports and there is no VAT on exports (all previous VAT payments are rebated when products are sold to foreigners). For mercantilists worried about trade deficits, this is seen as a positive feature. But not only are they wrong on trade, they do not understand how a VAT works.

Protectionists seem to think a VAT is akin to a tariff. It is true that the VAT is imposed on imports, but this does not discriminate against foreign-produced goods because the VAT also is imposed on domestic-produced goods.

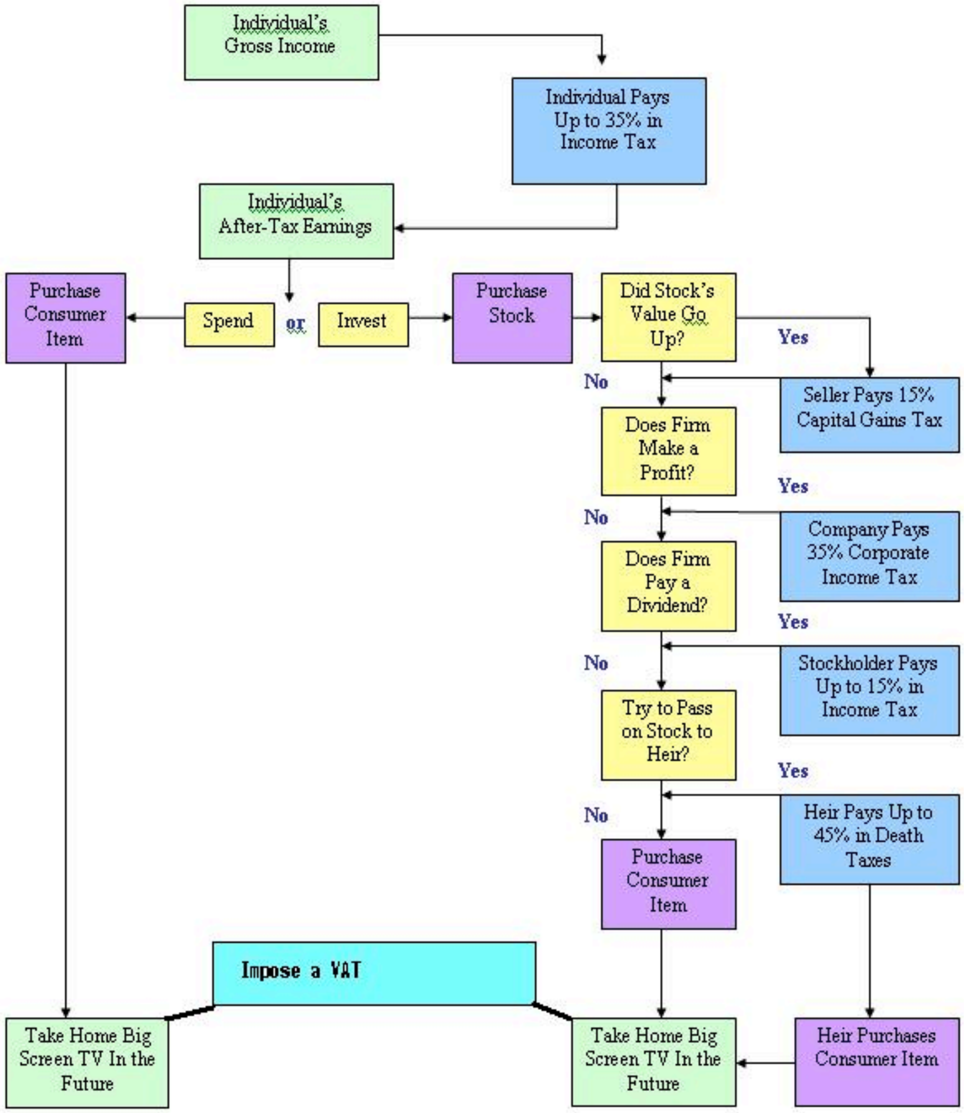
Under current law, American goods sold in America do not pay a VAT, but neither do German-produced goods that are sold in America. Likewise, any American-produced goods sold in Germany are hit be a VAT, but so are German-produced goods. There is a level playing field. The only difference is that German politicians seize a greater share of people's income, which helps explain why per-capita living standards are only about two-thirds of U.S. levels according to OECD data.

So what happens if America adopts a VAT? There is no change in Germany. The government continues to tax American-produced goods in Germany, just as it taxes German-produced goods sold in Germany. There is no reason to expect a VAT to cause any change in the level of imports or exports from a German perspective. In the United States, there is a similar story. There is now a tax on imports, including imports from Germany. But there is an identical tax on domestically-produced goods. And since the playing field remains level, protectionists will be disappointed. Politicians in Washington, by contrast, will be delighted since they get more money whenever any products are sold.

Notwithstanding this analysis, some people doggedly assert that a VAT must be good for trade and competitiveness because the rebate ensures that there is no tax built into the price of America exports. It is true that the corporate income tax undermines competitiveness and makes America a less-attractive location for producing goods and services, particularly since the United States has one of the world's highest tax rates on business income. This is an argument for lowering or repealing the corporate income tax, not an argument for a VAT.

The VAT is anti-saving, not pro-saving

Advocates of the value-added tax commonly claim that the levy would boost saving. The superficially compelling argument for this assertion is that the VAT is a tax on consumption, so the imposition of such a tax will make saving relatively more attractive. But this simple analysis overlooks the fact that saving is simply deferred consumption. The tax is simply postponed until the point when consumption occurs. There is no avoiding the tax.



People who save usually earn some sort of return (such as interest, dividends, or capital gains). This means they will be able to enjoy more consumption in the future. But that does not change the calculation. The above chart compares a consumption-base tax system (on the left side) and a comprehensive-type tax regime such as the current internal revenue code (on the right side). In either case, the imposition of a VAT does not alter incentives to consume today or consume in the future.

To be sure, incentives to save would be boosted if all of the double taxation on the right side was eliminated. But that's because anti-savings provisions embedded in the current tax system would e repealed. Imposing a VAT would have no impact. Simply stated, the VAT is not pro-saving.

But this is not the end of the story. A VAT, like an income tax or payroll tax, drives a wedge between pre-tax income and post-tax income. This means, of course, that a VAT also drives a wedge between pre-tax income and post-tax consumption – and this is true for current consumption and future consumption. This tax wedge means less incentive to earn income, and if there is less total income, this reduces both total saving and total consumption.

Honest VAT proponents often admit that the levy will not boost the savings rate or the total level of savings, but they say that other potential tax increases will have a much worse impact on incentives to save. This is true, at least if the other tax options are higher income tax rates, higher corporate taxes, higher capital gains taxes, and other options that would exacerbate the double taxation in the current tax code.

But this is not an argument for a VAT. It's an argument against raising other taxes.

Conclusion

Enacting a value-added tax would be a costly mistake for American consumers and workers. Once adopted, the VAT would prove irresistible to politicians eagerly looking for money to pay for new programs. The VAT would also undermine entitlement reform because politicians could gradually increase the tax to finance promised benefits.
The tax rate would doubtlessly climb, financing a surge of new federal spending. The result would be a stagnating economy, higher budget deficits, and fewer jobs for American workers. The value-added tax may have some attractive theoretical qualities compared to taxes on income and production, but in the real world, it would simply be another burden on an already overtaxed economy.