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As the fiscal crisis becomes more acute, expect new calls for a Europe-style VAT. Resist.

POLITICAL ECONOMICS

Beware the Coming Consumption-Tax Storm in America

Now that everyone notices America's n a t i o n a l - d e b t problem, expect wonks to be out in force offering "solutions." It isn't too soon to start batting away the bad ones. Today's installment: the value-added tax.

Note

The lack of a VAT is the most conspicuous difference between America's tax code and everyone else's. Most countries impose one. Europe has enthusiastically adopted this form of taxation over decades. VAT taxes furnish between 15% and 20% of government revenue in Britain, France and Germany. Countries with economies similar to the U.S., including Canada, Japan, the Netherlands and Switzerland, tend to bring in VAT revenue equal to around 5% of gross domestic product with a tax rate ranging upward to around 20%.

Note

The pitch for a VAT boils down to its simplicity. It's levied at every stage of production on the value added in that step. But unlike state sales taxes in America, under a VAT businesses can deduct or refund the VAT they've paid on their own purchases of raw materials. This is supposed to ensure that the end consumer pays the full consumption tax.

Advocates say importing the VAT to the U.S. would produce a revenue bonanza. Estimates churned out by the Congressional Budget Office usually start by assuming a 5% VAT rate. At that level, the math shows a VAT would produce $3.38 trillion over 10 years.

But lawmakers wouldn't stop at a 5% rate. No other developed country has. A VAT rate of 18% would churn out revenue of $12.2 trillion over 10 years, according to the green-eyeshade crew at the Peter G. Peterson Foundation. That might bridge the current deficit, or come close, over the next decade.

So if everyone else uses a VAT and it would solve the annual fiscal crisis (if not chip away at our $40 trillion debt mountain), what's not to like?

One problem is practical. Much of the convenience and simplicity are illusory. Businesses pay a refundable tax on raw materials, collect a tax from customers, subtract the refundable portion, then pay an adjusted VAT: What a pain. Estimates peg compliance costs at 1% to 2% of a company's revenue in the U.K.

An economist might think that's small, but an entrepreneur running a startup with narrow margins thinks otherwise. And while the smallest microbusinesses are exempt (those with annual revenue under £90,000 in Britain), this means those delicate startups and side hustles can't claim VAT refunds on inputs as larger competitors can. The VAT is pitched as a consumption tax, but in some cases it functions as a small-business tax.

The bigger problems are theoretical and philosophical. In a perfect world, yes, we'd have a VAT. But only

a VAT. Supply-side economists have long argued that, ideally, the tax system should tax consumption instead of work and investment. America's current tax code does the opposite. Note

By now it should be obvious to all what most of us have seen all along: The only likely option in the U.S. would be "a VAT and . . ." At current spending, the federal government can't afford to sacrifice the revenue from taxing labor income and investment returns (including corporate profits). If the logic of introducing a VAT is to fill a fiscal gap, we'll never see a push to reform those other taxes.

The consequence, and the whole point of a VAT, would be to increase government revenue as a share of GDP. Supply-siders constantly remind Washington that however lawmakers set tax rates, revenue in the U.S. always maxes out at around 18% of GDP. The purpose of a VAT would be to achieve a step-change toward the European level of nearly 30%.

It's easy to see why Democrats would enthuse about this. Europe's VATs have enabled the expansion of its welfare states even if revenue now proves inadequate.

Which, come to think of it, is an important point. Europe is experiencing a fiscal crisis in some ways worse than America's despite having the VAT. Since Congress can't match spending to current tax revenues, what reason is there to think lawmakers would be any more restrained once they've up-rated revenue collection with a new consumption tax?

This illustrates the coming political trap of the national debt. It's never a revenue problem, it's a spending problem. Republicans in particular should be wary lest they get gulled into bad bargains that trade permanent tax hikes for illusory budget stability.

By Joseph C. Sternberg
