Cato Scholar Urges US Tax Reformers To Resist VAT, by Mike Godfrey, Tax-News.com, Washington

Last updated 10 hours ago | Wednesday, June 10, 2009

A value-added tax system will not be the magic bullet that simplifies the US tax system while increasing revenues, as proponents of a federal consumption tax have suggested, according to a critique of the idea by Dan Mitchell of the Cato Institute.

Writing in the Wall Street Journal in response to renewed interest in consumption taxes in Washington as part of the wider debate on US tax reform, Mitchell argues that the evidence from Europe, where VAT systems have been in place for many decades, is not encouraging from the point of view of reducing both tax complexity and the overall tax burden.

“The classical argument in favor of a VAT says that it's desirable because it has a single rate and is based on consumption,” Mitchell writes. “It is true that single-rate systems (assuming a reasonable rate) are less harmful than discriminatory regimes with "progressive" rates. It's also true that a consumption-based tax would not inflict as much damage as our internal revenue code, with its multiple layers of tax on income that is saved and invested. But these arguments only apply if a VAT replaces the current tax system -- which is not the case here. And the evidence from Europe suggests it's not a good idea to add a somewhat-bad tax like the VAT on top of a really bad tax system.”

Mitchell notes that prior to the mid 1960s, before the advent of VAT in Europe, the average tax burden for the advanced European economies (commonly referred to as the ‘EU 15’) was just under 28% of gross domestic product (GDP) – a similar level to the US tax burden at the same time. By 2006, with VAT firmly entrenched across the European Union at rates of 15% or more (the legal minimum rate set down by the EU VAT Directive) the tax burden of the EU 15 had grown to a little under 40% of GDP. By contrast, the US tax burden had remained fairly static at 28%.

Mitchell also rejected the notion that VAT can increase the tax take without higher taxes on personal or corporate income, again pointing to Europe where taxes on income and profits consumed 8.8% of GDP in Europe in 1965 and 13.8% in 2006.

“The income tax system we have today is a nightmarish combination of class warfare and corrupt loopholes,” Mitchell writes. “Adding a VAT does not undo any of the damage it imposes. All that happens is that politicians get more money to spend and a chance to auction off a new set of tax breaks to interest groups. That's good for Washington, but bad for America."

The idea of a national consumption tax briefly formed part of the debate when President George W. Bush was putting together his bipartisan panel to study options for fundamental tax reform, but did not emerge as one of the final proposals.

The Bush panel came up with two broad plans for tax reform which would have reduced the number of income tax brackets, somewhat simplified corporate and investment taxes and abolished the alternative minimum tax, although the panel’s report was quietly shelved after the Democrats gained a majority in Congress in

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2006. However, for many tax reform advocates, the proposals did not go nearly far enough.

The last major round of tax reforms in the US was the Tax Reform Act of 1986 under President Ronald Reagan. But this work seems to have been largely undone by successive administrations and Congresses; there have been more than 3,250 changes to the tax code since 2001 alone - an average of more than one a day.

President Barack Obama has established his own tax reform panel which is due to report back by the end of 2009. Led by former Federal Reserve Chairman Paul Volcker, the only restriction placed on this panel's remit is to ensure that its proposals do not increase taxes on those earning less than USD250,000 per year. However, it is expected that the Obama panel's focus will be as much on efforts to close the 'tax gap' as on simplifying the tax code, although one of the President's pre-election pledges was to dramatically simplify the act of filing a tax return for the vast majority of individual taxpayers.

It is likely that a national consumption tax will be re-examined during the Obama panel's deliberations. Indeed Senate Budget Committee Chairman Kent Conrad recently told the Washington Post that VAT must be "on the table" as part of the latest tax reform debate.

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