THE WALL STREET JOURNAL.
WSJ.com

OPINION | JUNE 4, 2009

VATs Mean Big Government

The evidence from Europe shows that consumption taxes go hand-in-hand with rising income taxes.

By DANIEL J. MITCHELL

There is growing interest in Washington in a new national consumption tax, otherwise known as a value-added tax or VAT. Senate Budget Committee Chairman Kent Conrad (D., N.D.), for example, recently told the Washington Post that "a VAT" has "got to be on the table" as part of "fundamental tax reform."

President Barack Obama is already looking at a wide range of other potential tax increases, including higher income tax rates, restrictions on itemized deductions, an energy tax, and higher payroll tax rates. Even if they all became law, the revenues would not come close to satisfying his and Congress's appetite for bigger government, particularly a government-run health-care scheme.

At the same time, our aging population and unconstrained entitlement programs mean that a dramatic expansion in the size of government will occur automatically in coming decades unless Medicare, Medicaid and Social Security are reformed. Simply stated, there's no way to finance all this new spending without an additional, broad-based tax. That's exactly why a VAT -- which is like a national sales tax collected at each stage of the production process, rather than at the final point of sale -- should be resisted.

The classical argument in favor of a VAT says that it's desirable because it has a single rate and is based on consumption. 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.

VATs are associated with both higher overall tax burdens and more government spending. In 1965, before the VAT swept across Europe, the average tax burden for advanced European economies (the EU-15) was 27.7% of economic output, roughly comparable to the U.S., where taxes were 24.7% of GDP, according to data from the Organization for Economic Cooperation and Development OECD). European nations began to impose VATs in the late 1960s, and now the European Union requires all members to have a VAT of at least 15%.

Results? By 2006, the OECD reports that the average tax burden for EU-15 nations had climbed to 39.8% of GDP. The tax burden also has increased in the U.S., but at a much slower rate, rising to 28% for that year.

The spending side of the fiscal equation is equally dismal. In 1965, according to European Commission figures, government spending in EU-15 nations averaged 30.1% of GDP, not much higher than the 28.3% of economic output consumed by U.S. government spending. According to 2007 data, government spending now consumes 47.1% of GDP in the EU-15, significantly higher than the 35.3% burden of government in the U.S.

Another argument for the VAT concedes it will increase the overall tax burden but preclude higher taxes on personal income and corporate income. The evidence from Europe says otherwise. Taxes on income and profits consumed 8.8% of GDP in Europe in 1965, giving Europe a competitive advantage over the U.S., where they consumed 11.9%. By 2006, OECD data show that the tax burden on income and profits climbed to 13.8% of GDP in Europe, slightly higher than the 13.5% figure for the U.S.

Last but not least, some protectionists in the business community and on Capitol Hill are attracted by the VAT because it is "border adjusted." This means that there is no VAT on exports, but the VAT is imposed on imports. For people who obsess about trade deficits this is seen as a positive feature. But they do not understand how a VAT works.

Under current law, American goods sold in America do not pay a VAT -- but neither do German-produced goods that are sold in the U.S. Likewise, any American-produced goods sold in Germany today are hit by a VAT, as are, of course, German-made goods. In short, there already is a level playing field.

The income tax system we have today is a nightmarish combination of class warfare and corrupt loopholes. 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.

Mr. Mitchell is a senior fellow at the Cato Institute.

Please add your comments to the Opinion Journal forum.

Printed in The Wall Street Journal, page A15