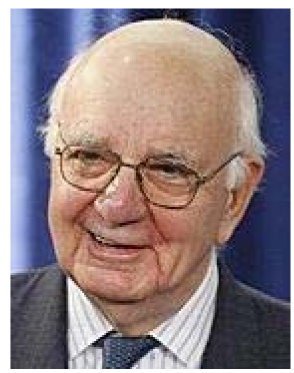
VAT: New Tax Coming Soon?

by Cait Murphy | Apr 7, 2010 | **0** Comments

- facebook
- twitter
- digg
- buzz



White House adviser Paul Volcker

The U.S. should consider using a European-style value added tax to help bring the deficit down, said White House adviser Paul Volcker in response to a question from CBS MoneyWatch.com at a panel discussion in New York City Tuesday night. “We have to think about really revamping the tax system,” said Volcker, who’s best known for successfully beating down inflation while serving as Ronald Reagan’s Federal Reserve chairman. The VAT, a levy on all the goods and services you consume, is not a “toxic idea,” he added.

Until recently, discussion of a U.S. VAT had been limited to the back rooms of think tanks and cocktail hours of high-minded conferences. But nearly every other industrialized nation has one, and the idea is beginning to spread. In addition to Volcker, the head of the Senate Budget Committee, Kent Conrad (D-N.D), has mused that a VAT has “got to be on the table,” and Speaker of the House Nancy Pelosi (D-Calif.) has murmured sweet nothings about it. In fact, interest in a VAT is cropping up all along the ideological spectrum (albeit more often along the leftish end).

The case for a VAT is simple: The U.S. government’s fiscal gap is widening by the hour. The deficit for 2009 alone was a cool $1.4 trillion, and it’s projected to hit $1.6 trillion this year. By the end of the year, the Office of Management and Budget says the gross federal debt will stand at $13.8 trillion. As Bruce Bartlett, a former Reagan economic advisor who supports a VAT, puts it, “The U.S. needs a money machine.” A VAT, because it touches every transaction, is just that: The Congressional Research Service estimates that each one percent of a value-added tax would raise $50 billion. That’s real money.

To be sure, no one expects a VAT to join the tax code this year or next. But what about by 2020? The odds narrow sharply. “There’s very little chance in the next few years,” says Brian Harris, a senior research associate at Brookings, a left-of-center think tank, “but a substantial chance in the next decade or so.” And Ryan Ellis, tax policy director at the right-of-center Americans for Tax Reform, who loathes the idea, says of the VAT, “I think it’s coming, in the next five to 10 years certainly."

What's to Love and Hate About a VAT?

About 150 countries have a VAT. It comes in different shapes and sizes, ranging from 5 percent in Japan to 25 percent in Sweden. It's easy to see why it's popular: As a broad-based tax that's easy to collect and hard to see, a VAT can rake in a lot of money.

A VAT can be assessed in several different ways. In the most common method, the VAT is assessed on a good at each stage of production and distribution — when the raw material is sold, when the product is manufactured, when a store stocks up, and when the consumer buys it. When a business calculates its VAT payment, it deducts the tax paid at the previous stage, based on records every company along the chain keeps. That's one reason the VAT is considered highly efficient — it's hard to dodge since each link in the VAT chain keeps an eye on the rest.

This process effectively hides the VAT from open view — unlike state sales taxes, the VAT is buried in the price of the good, not assessed at the cash register. But make no mistake: a 10 percent VAT would raise the cost of *everything* 10 percent. (High VAT taxes back home are one reason that Europeans love to shop in the U.S.) A VAT is also relatively simple to administer, so its "dead weight" — the distortion it imposes on the economy above and beyond the price of the tax itself — is minimal.

The VAT's efficiency in raising money is also why some oppose it. Even if a VAT started at a low level, say 5 percent, it's easy to increase the rate, as Europe has proved time and again. And its very simplicity and lack of visibility — no tax returns, no obvious hurt at the cash register — raises suspicions that a VAT is a stalking horse for higher spending. "I think America has prospered because the general level of taxation has been lower than Europe," says Chris Edwards of the libertarian Cato Institute, who prefers spending cuts to new taxes. "I don't think we should go in this direction."

The VAT also comes under attack for being regressive. Because lower income people spend a higher portion of their earnings, it may hit them particularly hard.

The Best of the Bad?

Despite long-standing political opposition, the VAT is starting to get attention for the simple reason that it may be the best among several bad options. A useful rule of economics is that if something cannot go on forever, it will stop. Current U.S. fiscal trends are unsustainable. At some point, even Congress will recognize this fact and be forced to act. It has three options.

- **Tax the rich:** Always a popular idea, but the math doesn't add up. Top tax rates are already likely to go up to almost 40 percent. An increase much above that is counterproductive, reducing incentives to work and invest while creating incentives to find tax shelters and other ways to avoid paying. And the income tax well is neither wide nor deep enough to fill more than a small piece of the $13.8 trillion hole. Ditto for taxing big business more heavily. The U.S. corporate tax rate (35 percent) is already among the highest in the world. Raising that is an excellent way to reduce competitiveness.

- **Cut spending:** If government spending were brought into line with revenues, new taxes wouldn't be needed. But that isn't happening. Ellis, of Americans for Tax Reform, points out that even if federal tax revenues return to their 40-year average of 18 to 20 percent of GDP (in 2009, it dipped to about 15 percent), the spending promises on the books for 2010 and beyond start at some 25 percent of GDP. That number is hard to knock down because the majority of federal spending is for Medicare, Medicaid, and Social Security, all of which are set to grow briskly as baby boomers retire. No one in either party seems interested in taming these leviathans. "It is almost literally impossible to close the gap on spending alone," says Michael Linden, associate director of Tax and Budget Policy for the left-leaning Center for American Progress.
- **Find new sources of revenues**: If more juice cannot be squeezed from the income and corporate tax code, the logical alternative is to tap a wider base. And the logical way to do that is to pass a VAT. Alan Greenspan, for one, considers the VAT "the least worst way" to narrow the budget gap.

Neither party shows enthusiasm for taxing you if you are not a plutocrat. President Obama has pledged no tax increases for 95 percent of the population, and most Republicans flinch at the "T" word in any form. (Interestingly, though, many GOP economists favored a VAT in the 1980s, and it was Margaret Thatcher who introduced one to the U.K.). But crisis can create opportunities for reform, and America's fiscal position is close to crisis. This may be the opportunity to take another real crack at our complicated and inefficient tax code, something last done in 1986.

A VAT could be a useful part of a larger reform. For example, in his book, *100 Million Unnecessary Returns*, Columbia law professor Michael Graetz proposes a 10 to 14 percent value-added tax, but earners making less than $100,000 would pay no income tax at all, and other income and corporate taxes would be reduced. That's just one idea. Press the buttons of almost any tax wonk in Washington and a different plan spits out; a VAT is part of most of them.

Americans as a whole did not squawk when spending rose during the Bush administration, and in electing Barack Obama, they voted for bigger government. At some point, the politics we have voted for have to be paid for. A VAT is likely to be part of the answer.

More on MoneyWatch:

- Be Prepared: Your Taxes Will Go Up
- What's Your Tax Bracket?
- Audit Red Flags: 8 Things Not to Do
- 10 Tax Deductions to Take Now
- CPA vs. Tax Software: The Best Way to Do Your Taxes