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Get ready for Generation T

There's a huge global government tax bill waiting to be paid in the next decade

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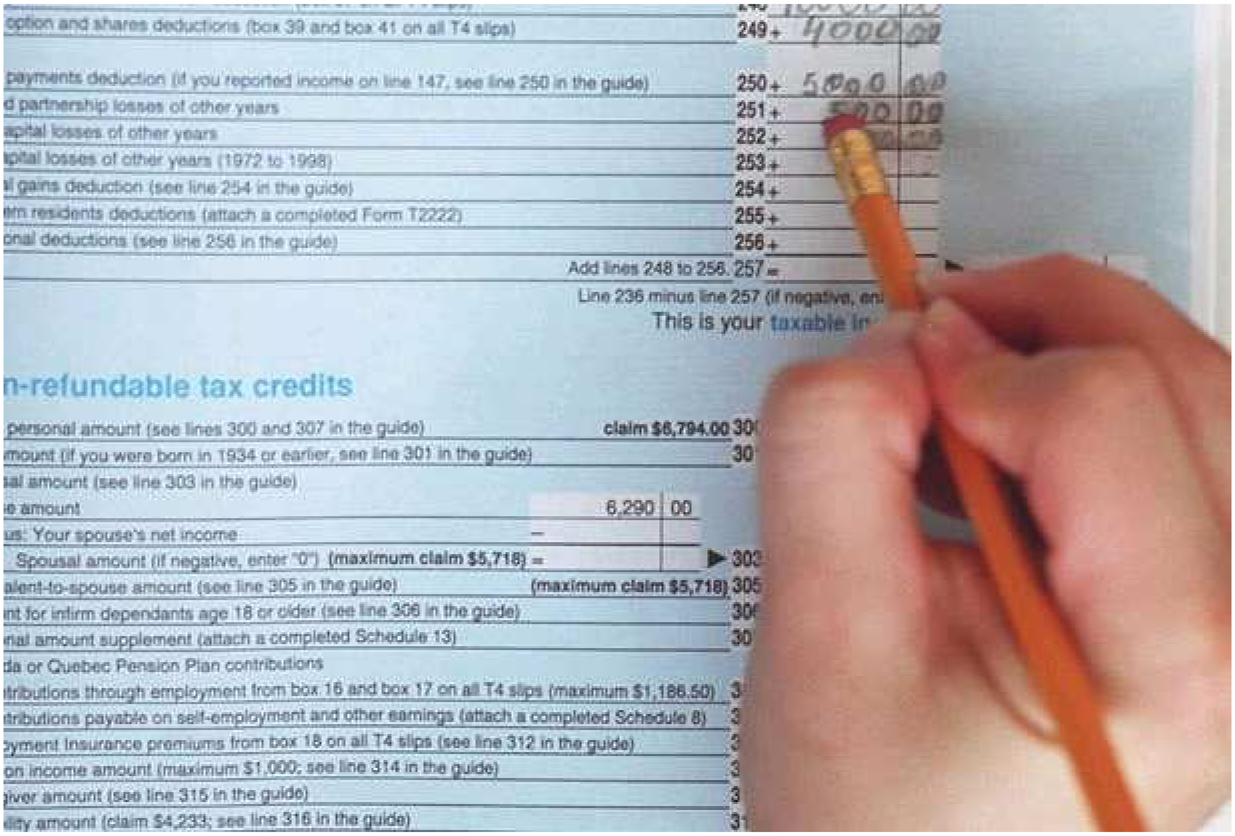

Governments will likely be forced to increase taxes in the coming years to pay for recent spending.

Photograph by: National Post, np

We're largely familiar with Generation X and Generation Y. But perhaps it is time to brace for the emergence of another generation in the United States-- Generation T, where T stands for tax.

This group can be described as young Americans, maybe aged 16 to 30, stuck with forking over higher taxes to pay off the debt legislators built up in the years leading up to the great recession, and then allowed to swell substantially in a bid to save the economy from disaster.

The American members of Generation T are likely to be hit with taxes their parents were lucky enough to avoid. Among the types they will get quite acquainted with is the VAT, or value-added tax. Think Canada's GST on a U.S. scale.

Nobody will like it, analysts warn, and protests are bound to bubble. But in the end investors will demand it in return for buying the bucket-loads of bonds Washington has to sell to finance the programs that legislators are reluctant to cut.

"The fiscal situation in the United States is not merely difficult, it is catastrophic," said Andrew Busch, global currency and public policy strategist with BMO Capital Markets. "The projections are just horrendous."

Exacerbating the U.S. scenario is the need to fund the three major entitlement programs -- Medicare, Medicaid and Social Security. Federal spending on these three big-ticket items is set to rise from 8.4% of GDP, at present, to roughly 14.5% by 2030, the Congressional Budget Office has estimated. Meanwhile, revenue will rise only modestly from its present 18.8% level.

Americans won't be the only ones singled out with new widespread taxes. The debt-to-GDP ratios in key developed economies, including Canada's, are set to swell in the coming years. But in the U.S. case, it is projected to reach triple digits -- over 100% in 2012 -- joining the ranks of Japan and Italy.

These growing debts in advanced countries will also put pressure on government imbalances as interest charges to service budget shortfalls will almost double from 1.9% of GDP in 2007 to 3.6% of GDP in 2014.

That has triggered alarm bells among the chattering classes and has prompted some prominent economists, led by Nobel Prize winner Paul Krugman, to predict that a U.S. VAT isn't just probable but inevitable.

"The reality is if you jacked up the corporate rate to the level that Washington needs, all the corporations would leave the U.S.," said Gary Clyde Hufbauer, senior fellow at the Peterson Institute for International Economics. "As for jacking up personal rates, you can't do it on the back of just millionaires -- you need to draw deep into the terrain of people, or folks that President Obama said he would never tax."

According to Mr. Hufbauer, the U.S. tax burden will have to climb significantly, from its present level of 18% to 20% of GDP to the mid-20% range.

Tax experts say a VAT is among the least-damaging taxes a government can deploy because it does not tax savings, thereby providing an incentive for people to work harder.

Other tax experts say the VAT's introduction could help fix myriad flaws in the present U.S. tax regime. Leonard Burman, director of the Washington-based Tax Policy Centre and public finance expert with the Urban Institute, said that a large fraction of households -- up to 40% -- do not pay income tax because they don't generate enough in wages or use credits to offset earned income.

"The concern is that households who do not owe income tax perceive government to be free and thus will always support new programs, even if they have very little value. Put differently, they have no stake in reducing [government] spending," Mr. Burman said in a paper for the Virginia Tax Review.

Mr. Burman has recommended introducing a VAT, whose proceeds would help finance surging health-care costs. But to soothe public fears of overtaxation, the VAT would need to be accompanied by other reforms, he suggested, such as cuts to personal and corporate income tax rates and a "credible process" to curb program spending.

Alas, some analysts wonder if this is at all possible.

Mr. Busch said the U.S. Congress appears to be "oblivious" to the need to curb spending, noting the Senate just approved a US$1.1-trillion omnibus bill that will see spending at a number of government departments climb by a staggering 10%, well ahead of inflation.

"This gives drunken sailors a bad name. At least with drunken sailors they pass out or run out of money. Congress does neither," he said.

Chris Edwards, director of tax policy studies at the Cato Institute, said the public would likely reject, in droves, a new consumption tax, regardless of its potential benefits. It will be seen as giving legislators more reason to spend, he said, adding the VAT's European origins will also anger Americans.

However, he noted there is a movement afoot in Washington to establish a special bipartisan task force to draft a deficit-reduction plan, co-led by Sen. Kent Conrad of North Dakota -- among the most high-profile VAT advocates.

"From my point of view, this appears to be a nefarious plot to implement the VAT," he said, acknowledging it could well materialize.

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DEBT WILL DRIVE TAXES

A rebound in the global economy is set to kick off the beginning of the next decade. But this return to growth will be accompanied by a surge of another sort -- in the amount you, the taxpayer, are about to pay to government.

The great global recession exacerbated the state of budget balances in much of the developed world. The debt burden among Group of 20 nations is expected to rise to over 120% of GDP, up from roughly 80% before the onset of the recession.

Legislators have to restore fiscal order or risk credit downgrades, such as Greece has sustained in recent weeks. Spending restraint is an option, but history dictates politicians find this hard to do -- especially with an aging population that's expecting social security and health care.

"Countries like Japan, Britain and the U.S. with large public deficits and growing debt are painting themselves into a corner whereby tax increases will be a necessity in order to stabilize debt burdens," says Jack Mintz, a leading tax expert and a professor at the University of Calgary's school of public policy.

"While governments will look to raise taxes in the most politically acceptable way, which often means imposing higher levies on the rich and corporations, there is little room for manoeuvre."

Source: Paul Vieira, Financial Post