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U.S. Consumption Tax Is Tempting VAT of Poison: Caroline Baum

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Commentary by Caroline Baum

April 15 (Bloomberg) -- Congratulations! You've just finished working for the government. April 9 was Tax Freedom Day, the day on which Americans have earned enough to pay their federal, state and local taxes, as calculated by the Tax Foundation, a non-partisan tax research group in Washington.

Enjoy it while it lasts. As Americans awake to the 2009 tax-filing deadline today, they can look forward to working longer and harder for the government in the future -- at least the dwindling share that pays individual income taxes.

Enter the VAT, or value-added tax, a whole new source of revenue for the government. The VAT, a fixture in Europe for decades, is a broad-based consumption tax levied at each stage of production on the "value added," as the name implies.

Because government starts with a wish-list of new spending and entitlements and works backward to find a way to pay for them (when it's trying to look responsible), raising more revenue without sinking the economy is an issue right now.

"There is no way to finance all this new spending without an additional broad-based tax," says Dan Mitchell, senior fellow at the Libertarian Cato Institute in Washington.

Which is exactly why a VAT should be avoided, he says. "It's akin to giving the keys to the liquor store to a bunch of alcoholics."

Ultimate in Efficiency

Most economists agree the VAT is efficient: it raises lots of revenue. There are 140 countries with "successful VATs," says Robert Goulder, a tax attorney at Tax Analysts, a publisher in Falls Church, Virginia. Success is defined as "an ATM machine for the public sector," he says. "You have to cut spending as well."

The VAT is efficient for several reasons: It's well camouflaged in the price of the product; it's self-enforcing, with a built-in incentive for each cog in the supply chain to charge the tax in order to claim a credit on the tax paid; and it removes the double taxation of income. If the goal is to encourage saving and discourage consumption (except at times such as now, when spending is viewed as the route out of recession), the solution is for the U.S. to tax consumption.

Somehow I doubt the Obama administration or Congress would propose substituting a VAT for the income tax or lowering individual or corporate tax rates as an offset. The VAT would be an add-on. Marginal tax rates on the highest earners are set to rise next year when the Bush tax cuts expire. Congress is working to extend the cuts for families earning less than \$250,000 a year.

Regressive Tax

The main criticism of the VAT is that it's regressive. The poor spend a greater share of their income, so the burden of the tax falls on those least able to afford it.

In the age of Obama, a VAT would certainly have exemptions to address its regressive nature.

"A lobbyist's dream," says Tom Wright, former executive director of FairTax.org, a grassroots organization advocating the replacement of the income tax with a national sales tax. "They can lobby in singular exemptions and John Q. Consumer will never know."

The president promised not to raise taxes on individuals earning less than \$200,000 a year, and he's old enough to remember what happened to Poppy Bush for going back on his "no new taxes" pledge.

Some economists on the right have embraced the VAT as the least bad alternative in view of the gaping hole between government expenditures and revenue. Without it, marginal tax rates would have to double, according to the Tax Foundation, to address a deficit increasingly driven by spending to care for an aging population.

Perfect Poison

Before you conclude that a VAT is the answer to all our fiscal problems, consider some facts. "Greece collapsed in spite of a 19 percent VAT adopted in 2005," says Veronique de Rugy, a senior research fellow at the Mercatus Center at George Mason University in Arlington, Virginia. The additional revenue from the VAT did nothing to address Greece's indebtedness.

Does anyone think an out-of-control U.S. Congress would devote increased tax revenue to deficit reduction? (If you raised your hand, go back and reread this column from the beginning.)

Besides, "our problem is not a revenue problem," de Rugy says. "Our problem is a spending problem. There isn't enough (potential) tax revenue to address the spending coming our way."

If the administration were serious about reducing the deficit, you'd see credible proposals for spending cuts teed up along with the VAT, which is "not as toxic an idea" as it once was, according to White House economic adviser Paul Volcker.

Not in theory. As an either/or proposition, a VAT is preferable to an income tax.

In practice, a VAT is a perfect poison. It would give lawmakers the means to spend in ways they can only dream about.

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