



Insight

Tax Reform, Yes! VAT, No!

DOUGLAS HOLTZ-EAKIN | AUGUST 30, 2010

From Politico By Doug Holtz-Eakin and Cameron Smith

The federal budget is in worse shape than Roger Clemens's reputation.

It ran a deficit of \$1.4 trillion in fiscal 2009 and is on track to nearly match this red ink in 2010. Going forward, there is no relief in sight.

This stark reality has fueled calls for a federal value-added tax.

House Speaker Nancy Pelosi (D-Calif.) has asserted that a VAT is "on the table." The debt commission Co-chairman Erskine Bowles said, "There are many good arguments that you can make for a value-added tax." Even conservative wunderkind Rep. Paul Ryan's comprehensive fiscal reform "road map" contains a VAT.

Not so fast. If Congress continually resorts to tax increases, the result will be a growth-killing cycle of spend and tax. Congress should forget the VAT, control spending and get on with the task of pro-growth tax reform.

The deficit problem is excessive spending — not inadequate revenues. In 2010, outlays are projected to be 25.2 percent of gross domestic product — about \$1.2 trillion higher than the typical 20 percent of GDP in the postwar era. Coincidentally, that's about the size of the projected deficit in 2020.

Adopting a VAT could add insult to injury and exacerbate the spending problem. Raising taxes of any sort might relieve Congress of financial market pressure to get its house in order. Unfortunately, this would quickly be undone because of rising federal spending.

Worse, a VAT is an especially dangerous tax. As its many opponents point out, the VAT is a "hidden" tax, whose cost is embedded in the price of goods and services.

When combined with a broad base, this feature yields a potential money pump for larger government. In the United States, each percentage point increase in a comprehensive VAT would yield roughly \$40 billion to \$50 billion annually.

While proponents scoff at these concerns, there is a well-established correlation between having a VAT — or having a larger VAT — and having a larger government.

In "[Leviathan Unbound: The VAT?](#)" we used sophisticated statistical techniques and data from the Organization for Economic Co-operation and Development to discern whether this means that countries that have installed a VAT did so to smooth the path to a larger public sector. Or whether the VAT fueled a growth in government that people did not anticipate or want. The result: Adopting a VAT caused a growth in government.

We are the first to admit that no single study is conclusive. But there is no reason to aggravate the spending

problem. Especially when a VAT is not the only route to consumption taxation.

Placing the tax burden based on the amount that individuals take out of the economy is ethically preferable to an income tax that places the tax burden on the amount of labor hours, effort, skills, capital and risk-taking that individuals supply to society. Tax reform can achieve the same ethical objective and improve on a VAT in three ways.

First, by continuing to collect part of the consumption tax from individuals, the tax system can be partly tailored to the economic characteristics of households. For example, one could exempt the first, say, \$30,000 of compensation (and thus consumption) from tax, and so improve the progressivity of the consumption tax.

In addition, one could apply a schedule of graduated rates at the household level, to further enhance the progressivity.

Second, consumption-based reform of business taxation would be pro-growth and pro-competitiveness. A consumption-based business tax would not distort the allocation of capital among sectors (residential real estate, commercial real estate, manufacturing, services and so forth), types of investments (equipment, structures, research, workers skills) or business models (C-corporation, S-corporation, partnership, etc.). Incentives for investments of all kinds and efficient use of those investment dollars are at the heart of pro-growth policies.

Moreover, a pure VAT is levied on imports but rebated on exports. Washington could lobby for comparable global treatment of a two-part VAT.

Finally, a new VAT would have to co-exist with existing state systems — especially state sales taxes. Because a VAT is conceptually a multistage retail sales tax, it raises tensions in the U.S. federalist system. States view the sales tax as “theirs” and are likely to resist the federal intrusion.

The dire fiscal outlook may well provoke a strong effort to carve back the excessive size of government. Washington should not fool with a new VAT that threatens to undo any progress on spending — especially when pro-growth tax reform supports the need for robust growth and supplies any residual revenue needs.

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