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HOW A VALUE ADDED TAX WOULD HARM THE U.S. ECONOMY

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INTRODUCTION

In a desperate search for new revenues to finance its planned health care programs, the Clinton Administration apparently is giving consideration to a version of a national sales tax known as a Value Added Tax (VAT).[1] Alternatively, the Administration may urge a VAT as a source of revenue for deficit reduction. This is especially likely if Congress approves the Administration's proposed tax increase of more than $300 billion and the result is the same as with past tax hikes—more spending and higher deficits.

Adopting a VAT would be a serious mistake. If history is any guide, a VAT will:

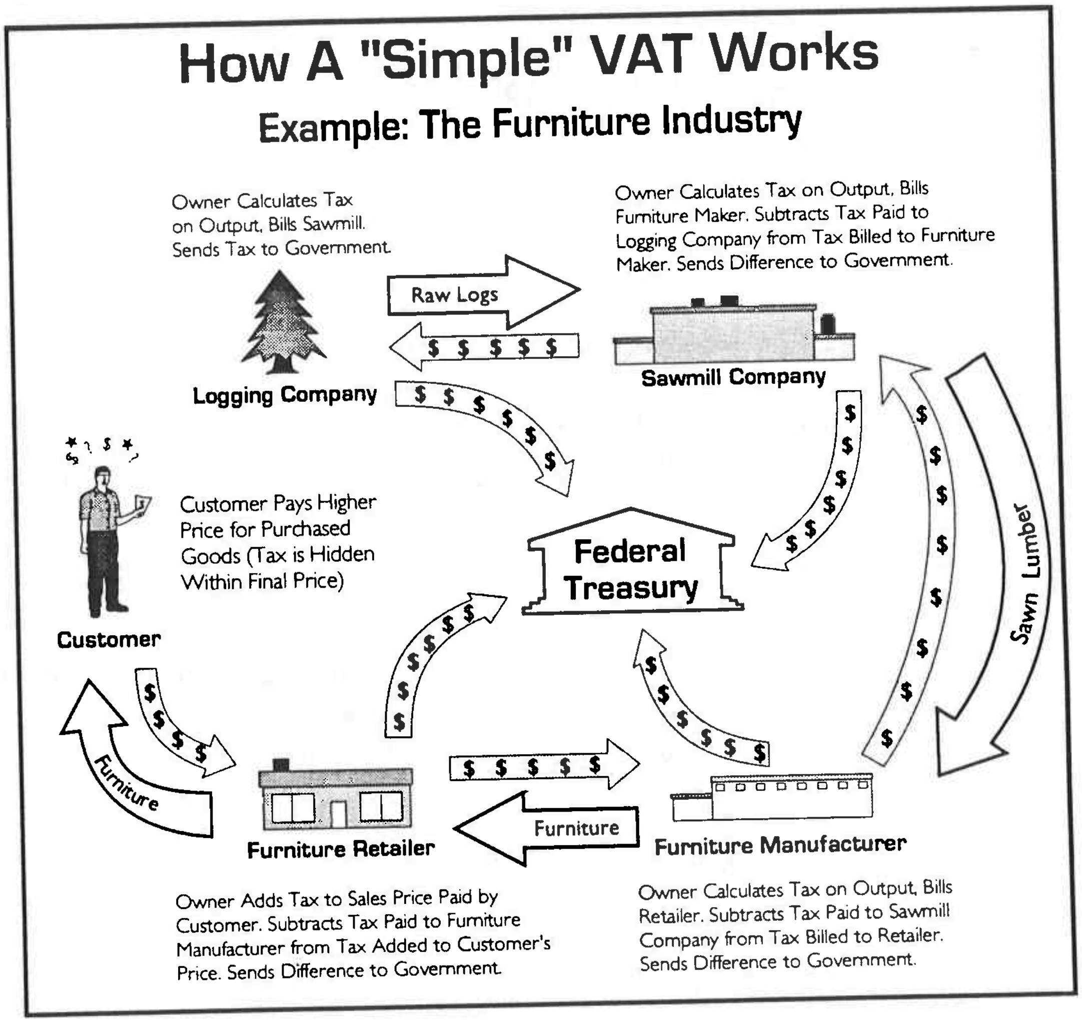
- ✘ **Expand the size and cost of government.** Countries with VATs have, on average, a 40 percent heavier total tax burden than those without VATs. Government spending in VAT countries consumes, on average, 42 percent more of national economic output than does government spending in non-VAT countries.
- ✘ **Slow economic growth and destroy jobs.** Adopting a VAT would, in just five years, destroy an estimated 2.1 million jobs and reduce the average family's annual income by $1,000.
- ✘ **Increase the budget deficit.** Every dollar of higher taxes since World War II has resulted in $1.59 of new spending, boosting federal borrowing rather than reducing it.

1 "VAT Possibility is Reconsidered at White House," *The Wall Street Journal*, April 15, 1993, p. A16; "Sales tax back as 'possibility'," *The Washington Times*, April 15, 1993, p. A1; "White House Opens Door To New Tax," *The Washington Post*, April 15, 1993, p. A1.

✘ **Impose heavy administrative costs.** The Congressional Budget Office estimates a VAT would impose as much as $8 billion in compliance costs on the economy. Small business would be especially hard hit.[2]

✘ **Increase prices.** The Congressional Budget Office predicts that a 5 percent VAT would cause the Consumer Price Index (CPI) to jump by 3 percent. Because many government programs are tied to the CPI, federal spending would jump by more than $11 billion.[3]

A VAT would be a no-win proposition for America. Even to consider such a tax, especially at a time when politicians already are trying to impose a record tax increase of more than $300 billion, is a sign that policy makers have lost touch with the concerns of average citizens.



2 John Blundell, "Britain's Nightmare Value Added Tax," Heritage Foundation *International Briefing* No. 16, June 13, 1988, revised and updated May 10, 1993.

3 Office of Management and Budget, *Budget of the United States Government, FY 1994* (Washington, D.C.: U.S. Government Printing Office, 1993), p. 9.

WHAT IS A VAT?

A VAT, which effectively would impose a national sales tax on U.S. consumers, is levied on the "value added" to goods and services as they pass through each stage of the production process. While a VAT can operate several ways, according to the Congressional Budget Office: "It is typically administered by taxing the total value of sales of all businesses, but allowing businesses to claim a credit for taxes paid on their purchases of raw materials, intermediate materials, and capital goods from other businesses."[4] For a particular product, every time there is a transaction which adds value, that extra value is subject to the VAT.[5] Since businesses receive a credit for the taxes they have paid, the total tax, regardless of at which stage of production it was levied, ends up being added to the final sales price and paid by the consumer.

PROJECTED VAT REVENUES
5 PERCENT RATE
(in $billions)

	Comprehensive Base	Excluding Food, Housing, and Medical Care
1994	0*	0*
1995	68.2	35.7
1996	107.5	56.1
1997	116.3	60.4
1998	125.3	64.8

***Note:** Because of the heavy administrative and compliance costs of a VAT, it would take more than a year from enactment to actually begin collecting revenue.
Source: Congressional Budget Office

No matter how many steps there are in the production process, one or ten, a fixed percent of the final price of the product would represent the value added tax, just as a retail sales tax is a fixed percent of the final product price. Unlike a sales tax, however, the cost of the VAT to consumers would be hidden. Unless politicians took the unlikely step of requiring retailers to state explicitly the portion of the sales price due to the tax, consumers would not be aware of the tax.[6]

4 "Reducing the Deficit: Spending and Revenue Options," Congressional Budget Office, Washington, D.C., February, 1993, p. 395.

5 For example, if a timber company sold lumber to a sawmill for $500, and the VAT was 5 percent, the tax would equal $25. If the sawmill then turned the timber into finished lumber and sold it to a furniture manufacturer for $800, the 5 percent tax on the $300 of added value (the difference between the sawmill's $500 purchase price and $800 sales price) would garner an additional $15, for a total tax of $40. If the furniture manufacturer then sold a finished piece of furniture to a retailer for $1,000, the tax on the added value of $200 would be $10, pushing the total tax up to $50. Finally, if the retailer then sold the furniture to a consumer for $1,500, there would be an additional tax of $25 on the $500 of added value, for a grand total of $75.

6 Many consumers, of course, would recognize that the VAT existed, but it is still not likely that they would realize the magnitude of the levy. Gasoline consumers, for instance, generally understand that gas taxes exist. Because gas taxes are incorporated in the advertised retail price of gasoline, however, few are aware that taxes can total more than 50 percent of the retail price.

In theory, a VAT could be imposed on all economic transactions. Many VAT proposals, however, exclude necessities such as food, housing, and medical care. This reduces the tax burden on consumers buying these items, but such exemptions add to the accounting complexity and costs for businesses. Imagine, for instance, a firm having to categorize all purchases according to their tax status, and then having to submit numerous forms to receive the credit due on VAT paid. As the preceding table illustrates, the VAT's revenue-raising capacity varies depending on whether the tax is imposed on a "comprehensive base" or if major consumption items are excluded.

EFFECTS OF A VAT

Enacting a VAT would be a major setback for the American economy. Many countries already impose VATs on their consumers and the results have been dismal. Based upon historical evidence and economic research, it is clear that adoption of a VAT will have several adverse consequences.

EFFECT #1: A VAT triggers more government spending and higher tax burdens.

With its capacity to generate large amounts of tax revenue, a VAT likely would fuel higher government spending. Indeed, rather than their usual charade of claiming that the new revenues would be used for deficit reduction, many politicians openly are discussing ways to spend the money, with increased government spending on health care topping the list.

Even if lawmakers promised that the money would be used to reduce the budget deficit, more government spending almost certainly would be the result. This is confirmed by historical data. For every $1 that tax revenues grew between 1970 and 1980, federal spending increased by $1.22. Between 1980 and 1990, spending climbed by $1.29 for every $1 of additional tax revenue. And during the 1990s, the ratio has grown even worse, with spending climbing by $1.90 for every $1 of new revenue. A Joint Economic Committee study found that between 1947 and 1990 every $1 of higher taxes has associated with $1.59 of new spending.[7]

As the table on the following page illustrates, adopting a VAT is associated with larger levels of government spending and heavier total tax burdens. In fact, the average tax burden in OECD (Organization for Economic Cooperation and Development) countries with VATs is 44.3 percent of gross domestic product, some 12.7 percentage points higher than the average tax burden in OECD countries without VATs. Nations with VATs thus impose on their citizens a tax burden that is more than 40 percent heavier than those countries without VATs.

The higher tax burden in VAT nations is accompanied by an equally severe government spending burden. Governments in nations with VATs on average consume 51.1 percent of national economic output, 15.2 percentage points higher than the average burden

7 Richard Vedder, Lowell Galloway, and Christopher Frenze, "Taxes and Deficits: New Evidence," Joint Economic Committee, October 30, 1991.

VATs, Total Tax Burdens, and Total Government Spending 1988

Nations without VATs*	Tax Burden as a % of GDP	Total Spending as a % of GDP
Australia	30.5	34.3
Canada	34.5	44.4
Iceland	32.0	37.2
Japan	30.3	32.9
Switzerland	32.6	30.6
United States	29.4	36.1
Average	**31.6**	**35.9**

Nations with VATs*	Tax Burden as a % of GDP	Total Spending as a % of GDP
Austria	42.1	50.9
Belgium	46.3	50.4
Denmark	51.7	59.0
Finland	37.8	40.0
France	43.8	50.4
Germany	37.7	46.6
Ireland	40.6	53.2**
Italy	37.0	50.8
Luxembourg	49.7	51.0***
Netherlands	48.4	58.3
Norway	47.8	53.5
Sweden	55.5	59.5
United Kingdom	37.3	41.1
Average	**44.3**	**51.1**

*Since 1988, Japan, Iceland, and Canada have adopted Value Added Taxes.
**1987 latest figure available. ***1986 latest figure available.
Source: *Revenue Statistics of OECD Member Countries* (Paris: Organization for Economic Cooperation and Development, 1992).

of government in non-VAT countries. In other words, the burden of government spending as a percent of GDP is more than 42 percent higher in nations that have VATs.

The OECD statistics are echoed by research conducted by the Tax Policy division of the U.S. Chamber of Commerce. The Chamber's study, which examined tax and spending growth between 1965 and 1982, found that government spending grew 45 percent faster in VAT nations than in non-VAT countries. Similarly, the study found that the tax burden grew nearly 34 percent faster in VAT countries.[8]

8 Terree Alverson, "Does the Value-Added Tax Contribute to Increased Government Spending and Taxation,"

EFFECT #2: A VAT slows the economy and destroys jobs.

By taking resources out of the productive sector of the economy and transferring them to the government, a VAT would slow economic growth and slow job creation. According to a study by Stotler Economics, a Chicago-based economic research firm, a VAT of only 3 percent would, by just the fifth year, reduce the typical family's income by $1,000 and destroy 2.1 million jobs.[9] The relatively weak performance of many European economies can be attributed, at least in part, to such effects of a VAT. The countries of the European Economic Community (EEC), all of whom impose VATs, averaged 10 percent unemployment in 1992 and expect the joblessness rate to climb to 11 percent this year.[10]

The VAT's impact on the annual economic growth could be enormous, depending if and how quickly lawmakers used the new revenue to boost government spending. Scholarly studies have found that every percentage point increase in government consumption spending as a percent of gross domestic product reduces the economy's potential rate of economic growth by as much as 0.3 percentage points.[11] Without knowing how much government spending in the U.S. would increase after enactment of a VAT, or how much of that spending would represent government consumption outlays, it is impossible to determine precisely how much economic damage a VAT would cause. But the impact could be especially severe if a VAT leads to the high levels of government spending found in those countries currently imposing a VAT.

EFFECT #3: A VAT increases budget deficits.

Although politicians almost always claim that higher taxes are imposed for the purpose of deficit reduction, history indicates that the deficit is more likely to rise than fall after taxes are raised. For example, tax increases were enacted in the U.S. in 1982, 1984, 1987, and 1990. In each case, politicians promised the money would be used for deficit reduction. Yet in every case the deficit rose the following year.

There is no reason to believe that higher taxes in the form of a VAT would work any differently. The reason is that tax increases cause higher budget deficits for two reasons. The first reason, explained above, is that politicians cannot resist the temptation to increase spending for favored interest groups.

The second—just as important as the propensity to spend—is the economic reality that higher taxes almost never result in the amount of new tax revenue politicians forecast. Simply stated, individuals will alter their behavior when the tax laws change. Investors scale back their activity, businesses hire fewer workers, and consumers reduce their spending. Wealthy individuals and businesses take money out of productive investments

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Chamber of Commerce of the United States, *Economic Outlook*, April/May 1986, pp. 12-16.

9 Robert J. Genetski, Debra J. Bredael, and Brian S. Wesbury, "The Impact of a Value-Added Tax on the U.S. Economy," Stotler Economics, Chicago, Ill., December 1988.

10 European Economic Community, *Annual Economic Report*, Brussels, February 3, 1993.

11 See, for instance, Daniel Landau, "Government Expenditures and Economic Growth: A Cross-Country Study," *Southern Economic Journal* 49 (1983), pp. 783-792; and Kevin B. Grier and Gordon Tullock, "An Empirical Analysis of Cross-National Economic Growth, 1951-1980," *Journal of Monetary Economics* 24 (1989), pp. 259-276.

and place it in tax shelters or take other steps to protect their earnings from government. The result: Workers without jobs do not pay taxes. Rich people with lower taxable incomes pay fewer taxes. Companies that are losing money do not pay taxes.

This does not mean that tax increases necessarily will result in less tax revenue, though some tax increases, such as the 1990 budget deal, did lead to lower revenue collections than were predicted before taxes were raised. It does mean, however, that because tax increases invariably are followed by lower-than-expected tax collections and higher-than-expected government spending, the budget deficit will increase rather than fall.

EFFECT #4: A VAT means heavy administrative costs on business and taxpayers.

A VAT conscripts businesses to serve as tax collectors for the government. Every company and entrepreneur would be forced to keep records on every purchase and submit detailed forms to the IRS. The administrative burden of the VAT would be especially severe if policy makers chose, as most proponents of the new tax advocate, to exempt certain goods and services. The reason for this is that firms would have to segregate records according tax status and submit numerous separate forms to the tax authorities. The Congressional Budget Office notes that allowing exemptions would "substantially increase costs of enforcement and compliance."[12]

Compliance costs also would rise if politicians chose to apply different rates to different goods and services. Most nations with VATs not only exempt certain products altogether, but tax certain goods and services at different rates.[13] Depending on the country, the VAT rates differ for non-alcoholic drinks, candy, sugar, consumer electronics, clocks and watches, furs, jewelry, playing cards, cigarette lighters, matches, toiletries, drugs and medicines, books and newspapers, insurance, telephone service, advertising, entertainment, hotels, and restaurants. In some nations, there are as many as six separate rates of taxation.[14]

Thus, even though advocates of the VAT use theoretical models to assert that the tax is cheap to administer, the real world evidence suggests otherwise. The Congressional Budget Office estimates that the costs to the government would total as much as $1.5 billion and that the private sector would face an additional burden of as much as $7 billion.[15] The VAT would be especially painful for the segment of the economy which generates most new jobs—small businesses. Unlike larger firms, which generally have legal and accounting divisions that could be used to keep compliance costs relatively low, small businesses without such in-house expertise would face disproportionately high costs, totalling as much as two percent of sales.[16] In Canada, which adopted a VAT in January,

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12 "Reducing the Deficit: Spending and Revenue Options," Congressional Budget Office, Washington, D.C., February, 1993, p. 396.

13 "IMF Study Surveys Policy and Administrative Aspects of Value-Added Tax," *IMF Survey*, March 2, 1992, pp. 69-71.

14 *Taxation in OECD Countries* (Paris: Organization for Economic Development, 1993), p. 82.

15 "Effects of Adopting a Value-Added Tax," Congressional Budget Office, February 1992, pp. 67-74.

16 Graham Bannock, *VAT and Small Business: European Experience and Implications for North America*, Canadian Federation of Independent Business and National Federation of Independent Business Research and Education Foundation, 1986, p. 60.

1991, the complexity of the levy is estimated already to have driven one-fourth of small businesses into the underground economy.[17]

EFFECT #5: A VAT causes prices to rise.

While a VAT would not necessarily lead to a permanent increase in the rate of inflation, imposition of the tax would cause at least an initial increase in the price level. The Congressional Budget Office, for instance, projects that a 5 percent VAT would cause the Consumer Price Index to jump by 3 percent.[18] This price level increase, even if not sustained, would mean fiscal damage. More than $500 billion of federal government spending—programs such as Social Security—is tied to the consumer price index. The Office of Management and Budget estimates that a 3 percent increase in the price level would trigger more than $11 billion of new spending. Thus adoption of the VAT would obligate taxpayers to pay billions of dollars more to fund the higher spending caused by the increase in prices.

It also is possible that a VAT could lead indirectly to a sustained increase in prices. According to the outdated economic theories upon which the Clinton program is based, the economic cost of higher taxes may be offset by following an expansionary monetary policy. According to this theory, pumping extra money into the economy stimulates economic growth, thus offsetting the recessionary impact of tax increases. There is just one problem with this theory: It is wrong. In reality, a surge on the money supply may cause an illusory spurt in growth, but the final effect, after a year or so, is weakened economic growth and higher prices. The last time this high tax and easy money approach was used was during the Carter Administration. The result was "stagflation," a pernicious combination of rising prices and recession.

A SELECTION OF VAT MYTHS

In their campaign to impose a new tax on American consumers, proponents of VAT claim that the tax would have several desirable effects. In most cases, these claims are flatly wrong or grossly inaccurate. In other instances, the claim may be true, but the result is not desirable. For instance:

Assertion: A VAT would increase savings by reducing the overtaxation of savings and investment.

Reality: Raising taxes on consumption does not solve the problem of excessive taxation of savings and investment. Taking more money out of consumers' pockets, as a VAT clearly would do, necessarily would result in less total savings in the economy. Indeed, a cross-country study of 23 nations in *Business Economics*, the Journal of the National Association of Business Economists, found that "savings rates are not higher in countries that rely more heavily on a VAT for revenue."[19]

17 *Value-Added Taxation in Canada and Japan* National Retail Institute, Washington, D.C., January 1993, p. ES-2.
18 "Effects of Adopting a Value Added Tax" Congressional Budget Office, February 1992, p. 64.

VATs AND INCOME-BASED TAXES
1988

Nations without VATs*	Income and Profit Taxes as % of GDP	Income and Profit Taxes as % of GDP, including SS Taxes
Australia	17.2	17.2
Canada	15.9	20.6
Iceland	8.4	9.2
Japan	14.5	23.0
Switzerland	13.3	23.7
United States	12.7	21.4
Average	**12.0**	**19.2**

Nations with VATs*	Income and Profit Taxes as % of GDP	Income and Profit Taxes as % of GDP, including SS Taxes
Austria	10.8	24.6
Belgium	18.0	33.8
Denmark	30.2	31.5
Finland	19.0	22.1
France	7.6	26.6
Germany	12.9	27.0
Ireland	15.6	21.3
Italy	13.2	25.5
Luxembourg	20.1	33.8
Netherlands	13.5	34.0
Norway	16.0	28.2
Sweden	24.4	38.3
United Kingdom	13.9	20.8
Average	**17.8**	28.3

*Since 1988, Japan, Iceland, and Canada have adopted Value Added Taxes.
Source: *Revenue Statistics of OECD Member Countries* (Paris: Organization for Economic Cooperation and Development, 1992).

Whenever taxes are raised—even if it is consumption that is being taxed—the effect is to lower individual savings, since consumer spending patterns are unlikely to quickly change. So the savings rate tends to fall. Therefore, a VAT actually would exacerbate the tax code's negative effect on savings. Moreover, since imposition of a

19 Ken Militzer and Ilona Ontscherenki, "The Value Added Tax: Its Impact on Saving," *Business Economics*, Vol. XXV, No. 2, April 1990, pp. 32-37.

VAT would reduce economic growth, the incentives to invest would be lower than they would be in the absence of a VAT.

Many VAT proponents admit that if a VAT were added to existing taxes, it would reduce total savings. But then they argue that revenues from the tax could be used to lower or eliminate other taxes with more damaging effects on savings and investment. While this is fine in theory, the evidence from Europe indicates that this simply does not happen. As the preceding table demonstrates, countries with VATs tax income at heavier rates than do countries without the VAT. The tax, in other words, is added to other taxes. It is not a substitute for them.

As the preceding table indicates, income and profit taxes in nations with VATs average 17.8 percent of gross domestic product, 5.8 percentage points higher than they are in nations without VATs, representing a 48 percent *higher* tax burden. If Social Security taxes are included (which operate the same way as income taxes), income and profit taxes in countries with VATs average 28.3 percent of gross domestic product, or 9.1 percentage points higher than they are in non-VAT countries. Using this more comprehensive measure, the tax burden on income and profits is more than 47 percent higher in VAT countries.

Assertion: America is one of the few industrialized nations without a VAT.

Reality: Fortunately for American consumers and workers, the assertion is true. Many VAT proponents imply that America somehow is backward because it lacks a VAT. According to the Organization for Economic Cooperation and Development, however, the two wealthiest countries in the industrialized world are the United States and Switzerland—neither of which has a VAT.

The notion that America should mimic the tax policies of European nations is especially bizarre since the European Economic Community (EEC) is mired in economic stagnation. Economic growth in the EEC averaged only one percent in 1992 and is expected to be even lower this year. Similarly, unemployment in the EEC averaged 10 percent last year and is expected to reach 11 percent this year. Nor is this a short-term phenomenon. During the 1980s, the U.S. created more jobs than all of the EEC combined.

Assertion: A VAT would make American products more competitive in world markets.

Reality: A VAT would have no effect on the balance of trade. Since a VAT is rebated on exports and imposed on imports, some believe that the tax would help sell more American-made products. This belief is not true. Adding a VAT to imports means that consumers would have to pay more, regardless of where the product originated. A 5 percent VAT, for instance, would not change the relative costs of a Nissan Maxima and Ford Taurus. All that would happen is that they would both be 5 percent more expensive thanks to the tax. Similarly, even though a VAT is rebated on exports, if the country importing the product has a VAT, the American export will be subject to the levy just as foreign goods would be treated in America. And if the other country does not have a VAT, American exports still would not gain a competitive advantage since both the American products and the host country products would be free of the tax.

Supporters of the VAT point out that most other taxes, particularly income taxes and payroll taxes, are not rebated on exported goods and that this policy makes American products more costly and less competitive. While true, the problem is not solved by adopting a VAT. The only way to address the damaging impact of income and production taxes is to reduce income and production taxes.

Assertion: A VAT could generate substantial new revenue for the federal government.

Reality: The assertion is true. A VAT would be a huge new source of taxes for the government. But this is a reason to reject the tax. The American people already are overtaxed. Tax revenues have soared from $517 billion in 1980 to more than $1.14 trillion today. Even after adjusting for inflation, this represents an increase of 26 percent. The deficit exists because spending has grown even faster. Indeed, after adjusting for inflation, the federal budget has increased by 42 percent since 1980.

Not only have tax revenues grown faster than inflation since 1980, they are expected to continue growing. According to both the Congressional Budget Office and the Office of Management and Budget, tax revenues are expected to grow by some $70 billion each year between now and 1998—without any legislated increase in tax rates or imposition of new taxes. Reducing the budget deficit simply requires politicians to limit spending growth to less than this naturally occurring stream of new revenue.

Discussion of a VAT is even more disconcerting because politicians already are considering the tax-heavy Clinton budget package. The Clinton budget, with its more than $300 billion proposed tax hike, will slow the U.S. economy. Adding a giant new tax on top of this record increase could be a disaster.

Assertion: Taxes on consumption do less damage to the economy than taxes on income and production.

Reality: The assertion is true, but simply because a VAT is less damaging than certain other taxes hardly qualifies as a reason to impose the tax. This argument would only be relevant if policy makers were considering wholesale elimination of income taxes and were seeking an alternative source of revenue.[20] But since politicians view the VAT strictly as an additional source of revenue, adoption of the tax simply would compound the damage caused by the current tax code.

It is also worth noting that not one of the countries with a VAT has used the tax to eliminate taxes on income, profits, or production. Indeed, as shown earlier, the tax burden on productive economic activity is higher in countries with VATs.

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20 For explanations of why a VAT would be acceptable, if used to completely replace all income taxes, see Norman B. Ture, *The Value-Added Tax: Facts and Fancies* (Washington, D.C.: The Heritage Foundation, 1979) and Murray Weidenbaum, "The Case for Taxing Consumption," *Contemporary Issues Series 54*, Center for the Study of American Business, July 1992. This strategy would necessitate repeal of the 16th amendment to the U.S. Constitution (which allowed the government to levy income taxes) because of the danger that politicians would simply re-impose income taxes at a later date.

CONCLUSION

Enacting a Value Added Tax would be a costly disaster for American consumers and workers. Once adopted, the VAT would prove irresistible to politicians anxiously looking for funds to pay for new programs. The tax rate doubtless would climb, financing a surge of new federal spending. The result: a stagnating economy, higher budget deficits, and fewer jobs for American workers. The Value Added Tax may have some attractive theoretical qualities compared to taxes on income and production. But in the real world it simply would be another burden on an already overtaxed economy.

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