Backgrounder

Published by The Heritage Foundation

No. 2503
December 21, 2010

The Value-Added Tax Is Wrong for the United States

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Abstract: *In the context of unprecedented U.S. budget deficits, some proponents of the value-added tax (VAT) are calling for the U.S. to levy a VAT to close the federal deficit. They are seriously mistaken. While a VAT has some advantages to the current U.S. tax code, adding the VAT to current federal taxes—as proponents propose—would realize none of these benefits and would instead depress the economy. The real cause of the massive federal deficit is Congress's overspending, not a lack of taxation.*

The value-added tax (VAT) is a major source of tax revenue for every industrialized country in the world except the United States. The Domenici–Rivlin Debt Reduction Task Force has issued the latest call for the U.S. to adopt a VAT to solve its growing debt problem.[1] Some argue that a large tax increase is necessary because Congress cannot reduce spending enough to cut the deficit to more sustainable levels.[2] On this flawed line of reasoning, the VAT is the logical choice because it can raise large amounts of revenue and because the United States is the only developed country without a VAT.

Proponents often cite the economic virtues of the VAT as an additional reason for the United States to adopt it. While the VAT has some economic advantages compared to other tax systems, these theoretical advantages would apply only if it replaces all other federal taxes. If Congress simply added a VAT on top of other federal taxes, its comparative advantages would disappear. It would substantially raise taxes,

Talking Points

- The idea of levying a value-added tax (VAT) is receiving serious consideration in Washington.
- A VAT is similar to a nationwide sales tax, and every other industrialized country levies a VAT.
- Adding a VAT on top of the current U.S. tax code would impose a colossal tax increase and become an enormous drag on the economy.
- The VAT has some attractive features compared to the current tax code. If the VAT replaced the current system, it could be an improvement, but proponents see it as an add-on to the current system, not as a replacement.
- A VAT added on top of the current tax system would permanently increase the size of government, slow economic growth, and depress the U.S. standard of living.
- Americans are already overtaxed. Adding a VAT is unnecessary because the growing U.S. deficit is caused by overspending, not a lack of taxation.

This paper, in its entirety, can be found at: *http://report.heritage.org/bg2503*

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
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perpetuate the current tax system's many problems, and create a host of new complications. Even as a total replacement for the current tax code, a VAT would pose several challenges for the nation.

What Is the VAT?

The VAT is a consumption tax that taxes the value added by businesses at each point in the production chain. It can apply to both manufactured goods and services. This contrasts with the more familiar income tax, which taxes salaries, wages, and the returns to savings, but does not tax purchases. Because the VAT is a consumption tax, it would closely mirror the sales taxes that most Americans pay at the state and local levels. In fact, consumers would experience no difference between a national sales tax and a VAT. A sales tax and a VAT designed to raise equal amounts of revenue would raise the final price of purchases by roughly the same amount.

Credit-Invoice VAT. In the credit-invoice method, the most common form of the VAT, a business pays VAT on its purchase of inputs and collect it on its sales whether those sales are to another business or the final consumer. The business then submits the invoices that it receives from its suppliers to the government's revenue agency. The invoices detail the amount of VAT that the business paid to its suppliers. Once the revenue agency verifies that the business remitted the proper amount of tax on its sales and that the submitted invoices match the suppliers' filings, the agency refunds the business for VAT paid. The filings by businesses give the revenue agency a simple way to ensure that businesses pay the required amount of VAT.

As long as the business can pass the tax on to its customers, which is typically the case, the business ultimately pays no tax. It acts solely as a collection agent for the government, collecting VAT on its sales and remitting to the government the difference between the VAT it collects and the VAT it paid on inputs. The burden of the tax moves up the production chain until the consumer bears the full burden, just like under the sales tax. Chart 1 shows how a credit-invoice method VAT could apply in the production of a shirt.

A credit-invoice VAT is generally easier for revenue agencies to enforce than sales taxes and therefore enables more efficient revenue collection. The method of revenue collection makes it more efficient. A sales tax is collected only when the final user of the product makes a purchase. For instance, customers buying a new pair of shoes or a new television pay the price of the item plus the sales tax, which is an additional percentage of the sales prices, at the point of purchase. However, businesses do not pay sales taxes on the items they purchase so that the sales tax does not "pyramid" inside the cost of goods and raise their prices surreptitiously. In practice, businesses end up paying sales taxes in many cases, but they should be completely exempt from paying sales taxes according to sound tax policy.

Because a sales tax is collected at only one point in the production process, customers and sellers can work together more easily to evade it. The only check to make sure the seller collects the tax is an audit by a revenue authority. A credit-invoice VAT is more resistant to tax evasion because businesses collect and remit the tax at every stage of the production process.

Subtraction-Method VAT. Another viable approach to levying VAT is the subtraction-method VAT, which is economically equivalent to the credit-invoice VAT. Each method has positives and negatives, but almost every country that levies a VAT has chosen the credit-invoice method as the best way to apply the VAT in practice. Of the approximately 150 countries that levy a VAT, only Japan uses the subtraction method.[3]

1. Congressional Budget Office, "Federal Debt and the Risk of a Financial Crisis," July 27, 2010, at *http://www.cbo.gov/ftpdocs/116xx/doc11659/07-27_Debt_FiscalCrisis_Brief.pdf* (July 30, 2010), and Debt Reduction Task Force, "Restoring America's Future," Bipartisan Policy Center, November 2010, at *http://bipartisanpolicy.org/sites/default/files/FINAL%20DRTF%20REPORT%2011.16.10.pdf* (December 9, 2010).
2. Catherine Rampell, "Many See the VAT Option as a Cure for Deficits," *The New York Times*, December 11, 2009, at *http://www.nytimes.com/2009/12/11/business/11vat.html* (June 1, 2010).

How the Value-Added Tax Works

Businesses collect the value-added tax (VAT) on their sales and pay it on their purchases from other businesses. This effectively turns them into tax-collecting agencies. The VAT moves up the production chain until consumers ultimately pay the entire cost of the VAT. Consumers are often unaware that a tax was levied at all because the VAT is often embedded in the price of goods. This is why the VAT is often referred to as a "hidden tax."

Source: The Heritage Foundation.

Chart 1 • B 2503 heritage.org

The subtraction-method VAT is similar in practice to the business income tax that the United States and most other countries levy. Businesses calculate their taxable base by subtracting their expenses from their sales (gross income). The major difference between the subtraction-method VAT and the business income tax is that the cost of labor is not deductible under the subtraction-method VAT. Labor's contribution to output is an integral part of the value added by the business. Among other key differences, all purchases from other businesses are deducted immediately under the subtraction-method VAT, including purchases of long-lived assets (no depreciation system), but interest expense is not deductible.

The most important difference between the credit-invoice VAT and the subtraction-method VAT is how they are collected. Instead of collecting the VAT each time a transaction occurs, under the subtraction-method VAT businesses would pay VAT on their taxable base, which is calculated by totaling their gross receipts and subtracting the cost of inputs purchased from other firms.

A subtraction-method VAT would have the same economic effects as a credit-invoice VAT because businesses still pay the tax on the difference between the sales of their goods and costs of their inputs. However, the subtraction-method VAT effectively prevents showing the tax embedded in the prices of goods and services. While most countries that levy a credit-invoice VAT do not require—

3. Harley Duncan and Jon Sedon, "How Different VATs Work," *Tax Notes: Views on VAT*, December 21, 2009, at *http://services.taxanalysts.com/taxbase/magdailypdfs.nsf/PDFs/125TN1367.pdf/$file/125TN1367.pdf* (June 2, 2010; subscription required).

and in some cases even prohibit—displaying the tax on sales receipts, displaying the tax in a subtraction-method VAT is impracticable, making the tax opaque to taxpayers.

That most countries' choose the credit-invoice method over the subtraction method reflects the economic circumstances and the consequences of past tax policy decisions. For example, because the subtraction-method VAT bears a strong resemblance to a traditional income tax, it could be a better, although still problematic, tax system than an income tax, but it would be a poor choice as an additional new tax. Many countries that have adopted a credit-invoice VAT already had some kind of national consumption tax. In searching for extra revenue, replacing a confusing array of minor sales taxes with a comprehensive, operational national retail sales tax in the form of a VAT would make good sense.

Further, all countries have problems with tax evasion. Tax evasion is still a problem under a credit-invoice VAT, but the tax is far less susceptible to evasion than most taxes because of the credit-invoice paper trail. The relative difficulty of evading a VAT is particularly important when governments impose high tax rates.

Addition-Method VAT. The addition-method VAT is not used anywhere in the world. As its name implies, the addition method is the opposite of the subtraction method. Like the subtraction method, it is applied only once in the production process, and its cost is entirely hidden from individual taxpayers. Yet unlike the subtraction method, businesses add the costs of their inputs, instead of subtracting them from their sales to calculate their tax base subject to the VAT. Inputs could include labor costs, costs of goods and services purchased, and even profits in some cases.[4]

The addition method is more of a theoretical application of the VAT and is not used in practice. Even though it is no different in theory from the other types of VAT, when actually applied, the addition method creates problems that the other methods do not. Some businesses, such as businesses with labor-intensive production processes, would pay higher tax bills because their unique circumstances require them to add more to their taxable base. Unsurprisingly, such businesses would seek relief from the government in the form of carve-outs for their specific industry. However, when the government grants relief to one industry, the pressure to offer similar exemptions to other industries soon builds. Special treatment of particular industries quickly spreads and destroys the VAT's advantage of exerting minimal influence on the market. As a result of these exemptions, the addition-method VAT would create a substantial drag on the economy, unlike the other types of VAT.[5]

VAT Strengths

The VAT has some key meritorious features. The most important is that it excludes saving and investment from the tax base. Saving and investing are vital for economic growth because businesses use capital to expand their operations. Entrepreneurs use them to begin businesses. Both activities create jobs and grow the economy. Taxing savings and investment reduces their attractiveness to individuals and increases the cost of raising capital for businesses. This reduces the amount of saving and investing and therefore the number of jobs created. Because the VAT taxes only consumption, not returns from saving and investing, it is a better alternative than other taxes that tax saving and investing.

Another positive feature of the VAT is its "border adjustability." All countries that employ a VAT either exempt exports from the VAT or rebate the entire VAT paid on exports. Similarly, all countries that levy a VAT also levy the VAT on their imports. This has two positive effects. Domestically, all goods sold in a country with a border-adjusted VAT pay the

4. *Ibid.*

5. In 1976, Michigan enacted the Single Business Tax, a state addition-method VAT, to consolidate a variety of other state business taxes. The tax quickly became a serious drag on Michigan's economy, and the state was eventually forced to abolish the tax. See Chris Atkins and Jonathan Williams, "Tax Reform in Michigan: Replacing the Single Business Tax," Tax Foundation *Special Report* No. 149, January 2007, at *http://www.taxfoundation.org/files/sr149.pdf* (July 29, 2010).

same amount of tax regardless of country of origin. Second, in the global market, a border-adjusted VAT places exports on an equal footing with products from other countries because they will all face the same amount of tax regardless of where they are sold. In contrast, a business income tax raises the relative price of exported goods because it is not rebated like a VAT. Similarly, the individual income tax is rolled into the prices of goods produced by businesses that pay individual income tax instead of business income tax. There is no practical way to rebate the portion of the higher price due to either income tax from the good's total cost. When a business exports that product it must therefore sell at a higher price, making its product less competitive in global markets.

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All taxes create distortions in the market because all taxes change the behavior of individuals and businesses. The best taxes affect the behavior of individuals and businesses the least. A structurally sound VAT measures up well against other taxes because it exerts relatively little influence on the decisions of businesses and individuals. Yet this feature holds true only if it applies uniformly to all goods and services in an economy because it raises the prices of everything proportionally. In this way, no product or service gains an artificial comparative advantage over another. The moment one good or industry secures an exemption for its goods or services, this relative advantage of a VAT dissipates rapidly. Border adjustments support the neutrality of the VAT because it ensures that all goods face the same level of tax regardless of where they are manufactured.

The final strength of the VAT is its relatively low cost of enforcement. Because calculating the VAT is straightforward and businesses need to produce invoices to receive their refunds, enforcing the VAT costs revenue agencies less than enforcing other types of taxes.

VAT Flaws

While the VAT has some advantages over other taxes, it is far from trouble free. The VAT has several inherent problems.

Hidden Tax. The VAT's biggest flaw is that, unless mandated otherwise, the amount of VAT paid by taxpayers is hidden. (See Chart 1.) In this example, the consumer knows only that the price of the shirt is $22.00. Because the VAT is typically not printed on the sales receipt, the consumer does not know that the price includes a 10 percent ($2.00) VAT. One fundamental principle of sound taxation is transparency, and most nations' VATs flagrantly violate this principle.

State and local sales taxes are explicitly shown on sales receipts so consumers know the cost of the good before and after the tax. Even though a VAT would raise the final cost of goods and services in the same way, the VAT is typically not shown on sales receipts because politicians hide the steep price of the VAT and their policies from taxpayers.

Even if the VAT is shown on receipts, taxpayers are highly unlikely to keep their receipts and total their VAT for the year. Politicians especially like the VAT because it obscures the tax burden and the true cost of government services from taxpayers. This can lead taxpayers to demand more government services because they wrongly perceive that the prices of such services are lower than they are. In a democratic state, the cost of taxes and government should be as explicit as possible so that taxpayers and voters can make fully informed decisions about the size of government.

Taxing Services. The U.S. economy is becoming increasingly service-based, but the VAT has difficulty taxing services. In fact, all consumption taxes, including state and local sales taxes, struggle to tax services because tax authorities have difficulty determining actual sales when no physical property changes hands. Many state and local governments in the United States often forgo levying sales tax on most services because of this difficulty.

Compared to the cost of their services, service providers generally purchase low-cost inputs from suppliers. For example, doctors provide relatively high-cost services for patients, but have low input costs compared to automotive manufacturers. Auto manufacturers must purchase costly inputs such as steel to produce each car. Doctors need equip an office only once to provide their services. The same applies to other service providers, such as attorneys, accountants, and financial service providers. This means the value added (the price of the service minus the cost of inputs) is high for service providers and the VAT they owe as a share of gross receipts is also high compared to traditional manufacturing businesses. This creates a strong incentive for service providers and their customers to collude to evade the VAT by transacting in cash. Alternatively, the service provider can underreport sales to capture all the benefit of evading the tax. In both cases, authorities would have difficulty proving tax evasion without on-site monitoring and inspections.

Because services are a large and growing portion of the economy, exempting them from a VAT would necessitate raising the VAT rate considerably higher to collect the expected amount of revenue, another major problem of the VAT.

State Sales Taxes. Forty-six states levy a sales tax. A VAT at the federal level would be similar to state sales taxes. States would likely strongly resist any federal attempt to usurp their sales tax authority because they rely on sales tax revenue. A VAT at the federal level would likely force states to apply their sales taxes to a uniform set of goods and services. This would take from the states their ability to tailor their sales taxes to their desires and each state's unique economy. States would also be forced to keep their rates within a narrow range. Because the VAT rate would likely begin relatively high, it would leave states little room to lower their sales tax rate to increase their competitiveness compared to other states. Further, a federal VAT would increase sales tax evasion, thus reducing state tax receipts, possibly significantly.

Underground Economy. No tax is 100 percent enforceable, and the VAT is no exception. The VAT's ease of enforcement is not an absolute designation. The VAT is easier to enforce than other taxes that do not generate an easily auditable paper trail. Yet some would undoubtedly find ways to evade a VAT. In fact, a VAT would encourage development of a large underground economy. Saving up to 20 percent or more on every transaction would be a powerful incentive for consumers and businesses to work together to evade the VAT. They could evade the VAT by conducting transactions in cash or by bartering goods and services. Neither tactic would leave a paper trail, making it difficult for authorities to prove abuse.

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Europe's experience with the underground economy confirms this. Informal transactions and buying and selling on the black market are common in Europe. Avoiding the VAT is part of the culture. In many cases, citizens evading the VAT are not even aware that they are escaping taxation because their evasion methods have become part of their everyday lives.[6] Similar behavior would quickly become endemic in the United States if it adopts a VAT.

Fraud. A credit-invoice VAT has an inherent self-enforcement mechanism because of the trail of paperwork required, but even then fraud would still be prevalent. Fraud is different from the underground economy. It consists of businesses engaging in schemes to secure larger refunds than those to which they are entitled, rather than evading it outright like in an underground economy. No matter how well constructed, VATs are always susceptible to scams that allow businesses to claim larger refunds than they are entitled. VAT fraud can take the form of false claims of taxes paid, refunds claimed for nonrefundable purchases, businesses set up only to issue false invoices of taxes paid, and hidden sales.[7]

6. Amity Shlaes, "A VAT Will Make Us Eurotrash," *Tax Notes: Policy Perspectives*, January 11, 2010, at *http://services.taxanalysts.com/taxbase/magdailypdfs.nsf/PDFs/126TN0251.pdf/$file/126TN0251.pdf* (July 28, 2010; subscription required).

European countries have a long history of administering the VAT, but they still experience considerable VAT fraud. Countries in the European Union (EU) lose approximately $107 billion annually in uncollected VAT. This amounts to a tax gap—the percentage of tax revenues that a tax should collect—of 12 percent,[8] which is a high rate of noncompliance for a consumption tax.

Tax authorities will always struggle to gain the upper hand on criminals that game the VAT to their advantage. The monetary gains that the criminals can enjoy by abusing the VAT are a strong incentive to stay one step ahead of law enforcement. For instance, the EU is working to thwart VAT-related fraud and abuse in carbon dioxide emission permits, which are the staple of the EU's cap-and-trade program.

For example, in "carousel fraud," criminals set up a fake company that purchases the carbon-emitting permit from a company in another country. The fake company then quickly trades the permit to another company in its country, pockets the VAT that it collects from the company purchasing the permit, and quickly disappears with the VAT proceeds. This scheme can use any easily moved good.

The fraud involving carbon emission permits alone cost EU countries $7.4 billion over a recent 18-month span.[9] The carbon emitting permits are the latest trend in VAT fraud, but certainly not be the last. Tax evaders will quickly move on to a new scheme once authorities clamp down on this type of fraud.

Economic Drag from Exemptions. Many wrongly claim that the VAT is regressive. They argue that the poor consume a higher percentage of their income and therefore would pay a larger portion of their income as VAT than the rich would pay. While measuring income tax paid relative to income is reasonable, measuring VAT tax paid relative to consumption is also reasonable because consumption is the base of a VAT. On this basis, a VAT is proportional because all taxpayers would pay the same amount of tax as a share of their consumption. This is an important distinction because, if lawmakers fall for the flawed regressivity argument, then any VAT law would likely exempt certain necessities, such as food and shelter, which often constitute a larger portion of a low-income person's consumption spending.

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One major advantage of the VAT in the abstract is that it exerts less influence on the decision making of individuals and businesses. However, once certain goods and services receive preferential treatment, the advantages of a VAT rapidly dissipate because some businesses—more accurately, the goods and services they produce—receive more favorable tax treatment than others.

Businesses that receive such exemptions can sell their goods at lower prices than their competitors' goods, which would be subject to the VAT. This would increase the profit margins of VAT-free businesses compared to businesses that must pay the VAT, attracting more investment to the VAT-free businesses. Thus, exemptions would distort investment, and this misallocation of resources would ultimately lead to less value produced from the nation's resources than would occur if there was no VAT.

More Power to Government and Lawmakers. The more government spends and uses tax and regulatory policies to micromanage economic affairs, the more power it amasses. Private citizens and

7. Curtis S. Dubay, "Value-Added Tax: No Easy Fix for the Deficit," Heritage Foundation *WebMemo* No. 2772, January 21, 2010, at *http://www.heritage.org/Research/Reports/2010/01/Value-Added-Tax-No-Easy-Fix-for-the-Deficit*.

8. Reckon LLP, "Study to Quantify and Analyze the VAT Gap in the EU-25 Member States," European Commission, September 21, 2009, p. 9, at *http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_cooperation/combating_tax_fraud/reckon_report_sep2009.pdf* (December 21, 2009).

9. Joe Kirwin, "EU Ministers Back VAT Reverse-Charging for Greenhouse Gas Emission Trade Sales," *Daily Report for Executives*, December 3, 2009.

businesses react to the government's accrual of power by seeking more access to decision makers. The large benefits that businesses can gain from receiving a VAT exemption for their product will cause them to seek VAT relief from the government. Carve-outs for businesses will give government more power to pick winners and losers in the marketplace and make business success more dependent on procuring government favors rather than providing a product demanded by the public. This concentrates more power in government and increases the power of businesses and industries with strong lobbies at the expense of those with less political sway. This will only increase the alienation that many feel from the government that is increasingly beholden to the powerful.

Government-Growing Tax

A VAT can collect a staggering amount of revenue. In the present budgetary context, some experts are calling for a VAT large enough to close massive current and future deficits.[10] For example, the Domenici–Rivlin Task Force report calls for a 6.5 percent "deficit reduction sales tax," which is in reality a VAT. The additional revenue needed to close the existing budget gap would require a VAT between 15 percent and 20 percent,[11] which would be in line with VAT rates in other economically developed countries. In fact, the EU requires its members to levy a VAT of at least 15 percent, and in some countries, the VAT is as high as 25 percent.[12]

At 15 percent, a VAT would collect about 6 percent of gross domestic product (GDP). In 2019, this would mean more than $1.2 trillion in higher taxes. If the rate was 20 percent, the VAT would raise 8 percent of GDP, just under $1.7 trillion in higher taxes in 2019.[13] A tax increase of this magnitude would raise the federal tax burden between 33 percent and 44 percent above its historical average.

Once a VAT is in place, Congress could easily increase the VAT any time it wants more taxpayer money to pay for new programs.

Once a VAT is in place, Congress could easily increase the VAT any time it wants more taxpayer money to pay for new programs. Continually increasing the size of government would become considerably less painful because small increases in the VAT rate could raise substantial sums of revenue. An increase of just 1 percent would raise more than $80 billion per year by the end of the decade.

The ability of the VAT to raise money will almost certainly prove irresistible to Members of Congress. The experience of other industrialized countries bears this out. As Table 1 shows, 29 of the 30 countries in the Organisation for Economic Co-operation and Development have implemented VATs. The United States remains the lone exception. In the years since they began their VATs, 20 of the 29 have increased their rate by at least 1 percentage point. Denmark leads the group with a 10 percentage point increase from 15 percent to 25 percent. On average, the 20 countries have raised their VAT rates by 4.5 percentage points.

10. See Alan J. Auerbach and William G. Gale, "The Economic Crisis and the Fiscal Crisis: 2009 and Beyond—An Update," Brookings Institution, September 2009, p. 3, at *http://www.brookings.edu/~/media/Files/rc/papers/2009/06_fiscal_crisis_gale/06_fiscal_crisis_gale_update.pdf* (June 1, 2010); Lori Montgomery, "Once Considered Unthinkable, U.S. Sales Tax Gets Fresh Look," *The Washington Post*, May 27, 2009, at *http://www.washingtonpost.com/wp-dyn/content/article/2009/05/26/AR2009052602909.html* (June 1, 2010); and Henry J. Aaron and Isabel V. Sawhill, "Bend the Revenue Curve," *The Washington Post*, October 12, 2009, at *http://www.washingtonpost.com/wp-dyn/content/article/2009/10/12/AR2009101202389.html* (June 1, 2010).
11. Auerbach and Gale, "The Economic Crisis and the Fiscal Crisis," p. 3.
12. Council of the European Union, "Council Directive 2006/112/EC of 28 November 2006 on the Commons System of Value Added Tax," *Official Journal of the European Union*, December 11, 2006, p. 3, at *http://eurlex.europa.eu/LexUriServ/site/en/oj/2006/l_347/l_34720061211en00010118.pdf* (June 1, 2010).
13. Author's calculations based on Tax Policy Center, Revenue Tables: 2009, Table T09-0442, at *http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2517* (June 1, 2010). The VAT base excludes education expenditures, rent, housing, and religious and charitable services.

VAT Rates Typically Rise After Implementation

Of the 29 countries in the OECD with a value-added tax (VAT), 20 increased the tax rate after the tax was implemented.

Increased VAT rate
Decreased VAT rate

Country	Year VAT Implemented	VAT Rate in First Year	Current VAT Rate*	Change, in Percentage Points
Denmark	1967	15%	25%	+10.0
Italy	1973	12%	20%	+8.0
Germany	1968	11%	19%	+8.0
Turkey	1985	10%	18%	+8.0
Sweden	1969	17.7%	25%	+7.3
United Kingdom	1973	8%	15%	+7.0
Luxembourg	1970	10%	15%	+5.0
Mexico	1980	10%	15%	+5.0
Norway	1970	20%	25%	+5.0
Spain	1986	12%	16%	+4.0
Portugal	1986	17%	21%	+4.0
Belgium	1971	18%	21%	+3.0
Greece	1987	16%	19%	+3.0
Iceland	1989	22%	25%	+2.5
New Zealand	1986	10%	12.5%	+2.5
Austria	1973	18%	20%	+2.0
Japan	1989	3%	5%	+2.0
Ireland	1972	20%	21.5%	+1.5
Switzerland	1995	6.5%	7.6%	+1.1
Netherlands	1969	18%	19%	+1.0
Australia	2000	10%	10%	0.0
Finland	1994	22%	22%	0.0
Korea	1977	10%	10%	0.0
Poland	1993	22%	22%	0.0
France	1968	20%	19.6%	–0.4
Canada	1991	7%	5%	–2.0
Czech Republic	1993	23%	19%	–4.0
Hungary	1988	25%	20%	–5.0
Slovak Republic	1993	25%	19%	–6.0

* As of 2009.

Sources: Organisation for Economic Co-operation and Development, VAT/GST rates in OECD member countries, Table IV.1, at *http://www.oecd.org/dataoecd/12/13/34674429.xls* (June 7, 2010).

Table 1 • B 2503 heritage.org

Permanently Slower Economic Growth

Adding a VAT to the taxes currently in place would permanently slow U.S. economic growth for several reasons.

First, the VAT would transfer trillions of dollars per year from productive private hands to the less efficient public sector. Over the long term, fewer resources in the private sector would produce a lower standard of living for succeeding generations than they would have enjoyed without a VAT. This lower standard of living results from the government allocating the VAT revenue for political reasons. On the other hand, if the private sector is allowed to keep these resources, it would allocate them based on market considerations. A politicized allocation is generally less efficient than market-based allocation because political decisions do not consider the highest-value use of resources, while the market considers such issues and therefore does a better job of assigning resources where they will contribute the most to economic growth.

Second, the VAT would weaken the economy by weakening the incentives to work. VAT proponents often highlight that the VAT, unlike the income tax, is neutral between saving and consumption. However, they downplay that fact that the VAT, like the income tax, discourages work. This long-established fact may not be immediately obvious, but it is evident after analyzing why people work.

People work for many reasons, but economically, the primary reason is to earn income to purchase food, clothing, housing, health care, and all of the other goods and services of modern living. Given an individual's skills and capabilities and the available market opportunities, each individual can command a wage commensurate with the economic value that they can create. Given that wage, the individual then knows how much he or she can earn by giving up a certain amount of free time or leisure and can choose what work to perform, how long to work, and how much leisure to take. This is the essence of the labor–leisure tradeoff in the absence of taxation. Of course, it is also a broad abstraction and simplification of complex market processes, but is nevertheless a reliable portrait of the issues in this argument.

In addition to damaging the economy, levying a VAT on top of all of the other federal taxes that Americans already pay would overwhelm all of the VAT's theoretical advantages.

When government taxes wages, such as with a payroll tax, the tax reduces a worker's after-tax wages and therefore reduces the return to work or, equivalently, reduces the "price of leisure." Such a tax predictably reduces the number of hours that workers desire to work. Consequently, workers have less after-tax income to consume or save, limiting their ability to buy goods and services.

If the government imposed a VAT in lieu of a payroll tax, the worker's after-tax income would be unchanged, but the VAT would cause prices to increase, reducing the worker's ability to purchase goods and services. In this case, the true value of the worker's wages has declined because their purchasing power has declined. From the worker's perspective, what matters is what he or she can buy in exchange for a certain amount of work. Whether through a payroll tax reducing after-tax wages or a VAT raising consumer prices, both taxes disadvantage the worker equally, reducing the worker's incentive to work. Economically, the VAT is equivalent to a payroll tax. Both reduce work effort and therefore output and incomes.

Six VAT Myths

In addition to damaging the economy, levying a VAT on top of all of the other federal taxes that Americans already pay would overwhelm all of the VAT's theoretical advantages. While the economy could conceivably be stronger if the VAT completely replaced the entire income tax code,[14] fundamental tax reform is not a high priority in Congress in the current budget environment. If Congress considers a VAT, it would most likely be as a method to raise more revenue to close the deficit. The inefficiencies of the income tax would remain and the inefficiencies unique to a VAT would be added on top to create an even heavier drag on the economy and burden on taxpayers.

Six myths are commonly submitted in defense of the VAT. Most result from a misunderstanding of the difference between a VAT as a replacement for all current income taxes and a VAT as an addition to the current taxes.

Myth #1: A VAT would increase the savings rate.

Some argue that a VAT would encourage saving because it would raise the prices of everything we buy. In this line of thinking, Americans would buy fewer goods and services and therefore save money that they formerly spent.

A VAT would undoubtedly raise the prices of everything that consumers buy, but this would not increase the savings rate. The low savings rate is not the result of low prices, but of the current tax code that discourages savings by taxing returns of investment through taxes on capital gains, dividends, and interest. Adding a VAT would not change this. As long as the income tax continues to tax capital income and capital gains, the tax code will continue to discourage saving.

In fact, adding a VAT to the current tax code would reduce savings for an extended period and result in a permanent loss in wealth and growth. A VAT would potentially raise the prices of consumer goods and services between 15 percent and 20 percent. To sustain as much of their current consumption as possible, families would need to save less and even dip into previous savings to purchase the same amount of goods and services that they consumed before the VAT.

14. This should include the repeal of the 16th Amendment to ensure that the income tax stays repealed and that taxpayers are not forced to pay both an income tax and a VAT.

Myth #2: A VAT would increase investment.

Since some argue the VAT would increase savings, they subsequently argue that it would also increase investment. Once again, they confuse the effects of a VAT as a replacement for the current tax code with the effects of adding a VAT to the current tax code. Investment would likely decrease if Congress added a VAT to the current tax system, especially in the short term, because households would need to cut back on savings and withdraw previous savings to maintain current levels of consumption.

Myth #3: A VAT would encourage economic growth.

Few economists argue that tax hikes encourage economic growth. Yet some argue that a VAT would improve economic growth because it would tax consumption instead of income. The income tax's highly progressive structure[15] and the double taxation of capital income and capital gains strongly discourage working, saving, and investing, which are essential to economic growth.

If Congress added a VAT on top of the current system, the disincentives to work, save, and invest would persist. In fact, the disincentives to work and save would actually increase further. The VAT would likely reduce the savings rate for an extended period. In terms of growth effects, the VAT is economically equivalent to a tax on labor and so it would discourage work even more.

Myth #4: VAT promotes exports.

Because the VAT is rebated on exports and imposed on imports (the border tax-adjustment system), some contend that the VAT would make American products more competitive in the global market. This is false. A VAT would have no effect on the competitiveness of United States exports. Once again, proponents are confusing the potential advantages of a VAT as a replacement for the income tax with the realities of a VAT as an add-on tax. Even if the VAT itself is internationally neutral because of border tax adjustments, adding a VAT does not reduce the disadvantages imposed by the income tax, which lacks these border tax adjustments and is therefore detrimental to U.S. competitiveness.

Myth #5: VAT allows for lower income taxes.

Some proponents tout the VAT as a solution to massive deficits. Without cutting spending to lower the deficit, Congress will have little room to reduce income taxes because all the income tax revenue plus the VAT revenue will be needed to bring the deficit under control. Nevertheless, if Congress were to pass a VAT, it would likely include some minimal and temporary reductions of the income tax to buy support from the American people and certain lawmakers. However, as long as Congress retains the power to levy an income tax under the 16th Amendment, future Congresses could always raise it back to its previous levels or even higher.

The only way the VAT or any other national consumption tax could be acceptable is if the 16th Amendment were simultaneously repealed.

This has been the experience in Europe. Income taxes have actually increased after the countries implemented VATs, despite promises to the contrary.[16] The combination of a VAT and the income tax in the United States would likely lead to similar income tax increases as successive Congresses look for more revenue to spend. This would lead to further increases in the tax burden and the slower rates of economic growth from higher taxation.

The only way the VAT or any other national consumption tax could be acceptable is if the 16th Amendment were simultaneously repealed.

Myth #6: VAT would close the deficit.

Congress spends every dollar of tax revenue plus as much as it can borrow from credit markets.[17] It is on track to push the limits of credit markets. There

15. Curtis S. Dubay, "Income Tax Will Become More Progressive Under Obama Tax Plan," Heritage Foundation *Backgrounder* No. 2280, June 1, 2009, at *http://www.heritage.org/Research/Taxes/bg2280.cfm*.
16. Daniel J. Mitchell, "Beware the Value-Added Tax," Heritage Foundation *Backgrounder* No. 1852, May 16, 2005, at *http://www.heritage.org/Research/Reports/2005/05/Beware-the-Value-Added-Tax*.

is little reason to believe that Congress would suddenly discover fiscal discipline after levying a VAT. More likely, it would spend the VAT revenue on new programs and continue borrowing as much as possible. Giving Congress more taxpayer money to spend would likely worsen the current fiscal crisis until credit markets decide to stop lending to the United States because they no longer are confident that it can repay its debts.

Greece is a good example of how this could happen. Despite its 19 percent VAT, credit markets have stopped lending to it at reasonable rates because of its chronic and unsustainable overspending. The credit market may soon stop lending to other similarly fiscally troubled countries that levy substantial VATs, including Portugal (21 percent), Italy (20 percent), and Ireland (21.5 percent). Given the political realities, the only way to close a budget deficit is to reduce spending. Higher taxes consistently lead to higher spending.

An Unnecessary Tax

The current and future deficits are threatening the stability of the U.S. economy and have prompted some camps to consider the VAT as a way to eliminate the deficit. Congress's overspending has caused the threatening deficits, not a lack of tax revenue. If Congress permanently extends the 2001 and 2003 tax relief for all taxpayers and patches the alternative minimum tax (AMT) so it does not affect middle-income families, federal tax revenues will still exceed their historical level of 18 percent of GDP in the coming years. On the other hand, under President Barack Obama's budget, spending will rise to 24 percent of GDP by the end of this decade—a considerably higher level than the historical average of 20 percent of GDP. Unchecked entitlement spending will push this level even higher in the coming decades. Unless Congress restrains spending, ever-higher tax levels will be required to close the deficits. Yet as European nations are discovering, even the VAT cannot solve their problems. They need to fundamentally restructure their entitlement and welfare spending.

Congress should ignore misguided siren calls for a VAT and instead immediately address its spending problems. Tax increases will never reduce the gap. Instead, Congress must cut spending to 20 percent of GDP or lower. This would reduce the annual budget deficit to a more manageable level. The national debt would stabilize as a percentage of GDP and the threat that credit markets will stop lending or raise interest rates would abate. None of these necessary steps requires a VAT.

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17. J. D. Foster, "Tax Hikes, Economic Clouds, and Silver Linings: A Review of Deficits and the Economy," Heritage Foundation *Backgrounder* No. 2095, February 25, 2008, at *http://www.heritage.org/Research/Reports/2008/02/Tax-Hikes-Economic-Clouds-and-Silver-Linings-A-Review-of-Deficits-and-the-Economy.*