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Value-Added Tax: Why the VAT Is Not Pro-Saving

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President Barack Obama's unsustainable near-term fiscal policies are now preamble to the massive and longstanding long-term fiscal problems highlighted in the Bowles–Simpson Commission report, the Domenici–Rivlin report, and elsewhere. As Europe in similar straits is now demonstrating that, in the immortal words of Herb Stein, "what cannot go on forever won't."

The preferred solution to excessive deficits for those favoring big government is to turn to a value-added tax (VAT) for additional revenues.[1] In making their case for a VAT, proponents often cite economic advantages of a VAT over an income tax as though the policy was to *substitute* the VAT for income tax rather than *add* the VAT. For example, one argument often raised in favor of the VAT is that it would improve the level of private saving. But given that the VAT is being proposed in addition to the income tax rather than as a substitute for it, this argument is flat-out false.

The Fiscal Problem Is Very Real. Federal budget deficits both near- and long-term are unsustainable, a point on which there is finally broad agreement. Something has to give. Either federal spending will be cranked down (as many new incoming Members of Congress are suggesting) from its now-bloated levels of around 25 percent of our economy to a more traditional 20 percent, or federal taxes must soar. For example, if the 2010 budget deficit were reduced entirely through tax increases to long-run sustainable levels, then even if the economy suffered no harm as a result, taxes would need to rise by about $750 billion a year.[2]

In fact, this magnitude of tax increase would be devastating to America's businesses and families. It is also almost surely beyond the revenue-raising capacity of our current tax system, which is why big government's defenders are focusing so heavily on the adoption of a European-style VAT as a new, additional revenue source. The Domenici–Rivlin plan, for example, includes a new European-style VAT, though in a bow to the opposition that such a tax has traditionally garnered in the United States, they tried to disguise it by quaintly calling it a Deficit Reduction Sales Tax. A rose by any other name …

The Income Tax, the VAT, and Saving. A longstanding criticism of the income tax is that it taxes saving more heavily than consumption. Indeed, one reason some favor an income tax despite its many flaws is that it imposes extra tax on savings, facilitating more progressive taxation.

An income tax generally levies tax on wage and salary income whether or not the income is saved or spent on consumption. If after-tax income is saved, then the income tax generally taxes the returns to saving, whether interest, dividends, or capital gains.[3] If the saving is invested in a business subject to the corporate income tax, then the returns are

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subject to another layer of tax at the corporation level. And if the individual accrues sufficient wealth to be subject to the death tax, then there is yet another level of tax on saving.

The European-style VAT, in contrast, imposes a single layer of tax on consumption. In the abstract, the VAT is equivalent to a national retail sales tax. It is levied when an individual buys a good or service for consumption, and the tax manifests as a higher purchase price.[4] Tax is levied either currently on consumption spending or later when today's saving is used for future consumption spending, and so the tax is neutral between savings and consumption.

Value-Added Tax Impact on a Family's Budget

Based on a family income of $63,000.

Current Tax Structure		With Impositon of a Value-Added Tax	
Saving	$3,000	Saving	$0
Consumption	$60,000	Consumption	$63,000
		Decline in purchasing power	*$3,000*

Source: Heritage Foundation calculations.

Table 1 • WM 3089 heritage.org

VAT as Alternative v. Add-On. Revenue-neutral tax reform involving a VAT *substituting* for income tax raises a number of concerns, but its one advantage might be that it would reduce or even eliminate the net bias against saving. Such a reform would quickly begin to raise the level of private savings and the private saving rate.

The same cannot be said of *adding* a VAT to the current tax system. Adding a VAT would not have the same beneficial effects as substituting a VAT because, obviously enough, the anti-savings biases of the current system would remain intact.

Even more telling, a massive VAT-based tax hike would slash the after-tax purchasing power of individuals and families. As they adjusted to the new tax, an early casualty would be private saving.

To illustrate, take a family earning $63,000 annually that saves $3,000 while spending $60,000. Suppose a 10 percent VAT were imposed in addition to the current income tax. As a result of the new VAT, what the family could once buy for $60,000 now costs $66,000. Initially and for a significant period, the family is almost certain to stop saving and would still need to cut its purchases by $3,000 to stay under budget.

The $3,000 loss of purchasing power would force the family to rethink its spending, saving, and retirement plans. Before the VAT hike, the family's savings rate was 4.8 percent of disposable income. The VAT has cut the family's purchasing power to $57,000 in terms of pre-VAT prices. If the family is able to cut its consumption sufficiently to restore its previous saving *rate* of 4.8 percent of after-tax income, then it would save about $2,714, a drop in saving of $286. The level of saving would decline.

On the other hand, if the family seeks to restore its previous *level* of saving, then it must increase its saving rate from 4.8 percent to 5.3 percent of disposable income. Facing a significant drop in disposable purchasing power, the family would have to increase its saving significantly out of fewer resources just to return to its previous level of saving.

Over time, the family would likely restructure its budget, reducing family purchases to return to some positive rate of saving. Eventually, the addi-

1. See Curtis Dubay, "The Value-Added Tax Is Wrong for the United States," Heritage Foundation *Backgrounder* No. 2503, December 21, 2010, at *http://www.heritage.org/Research/Reports/2010/12/The-Value-Added-Tax-Is-Wrong-for-the-United-States*.
2. This assumes spending at about 25 percent of GDP, a deficit of 2 percent, and income tax receipts of 18 percent (the modern average), leaving an excess deficit of 5 percent of GDP. GDP in 2010 is expected to be about $14.6 trillion, so closing the 5 percent excess deficit through taxes means about $750 billion in additional tax revenues.
3. Fortunately, Congress has enacted numerous provisions over the years to move the tax treatment of saving toward neutrality. These provisions include the deferral of tax through 401(k) and defined-benefit plans and the exclusion of the returns to saving through such programs as the Roth IRA.
4. Assuming the central bank accommodates the price movement through monetary policy.

tion of the VAT to the current tax system would raise the price of consumption relative to saving, and so the family would likely eventually return to its previous saving rate as savers adjusted to the new prices. In the meantime, and likely for a long time, the level of saving and the saving rate would drop significantly.

An Attack on Savings. VAT proponents who seek massive new sources of revenue—whether in the short run to pay for President Obama's spending surge or to address the nation's unsustainable long-term fiscal imbalance—sometimes misapply arguments that have some validity in the context of a revenue-neutral tax reform. A good example is the argument that a VAT would increase private saving.

However, as an add-on tax, the VAT would not improve saving incentives as some suggest but would instead hammer private savings for an extended period as individuals and families slash their saving rates to sustain current consumption in light of the VAT's higher prices.

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