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# Beware of a VAT Attack on the American Economy

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American liberals have pined over a European-style value-added tax (VAT) ever since the VAT spigot first gushed in the 1960s. The VAT's popularity in the United States is due to its ability to raise vast new sums to finance a huge expansion of government, to do so with less damage to the economy than hiking the income tax, and all the while keeping the taxpayer almost completely in the dark. Despite its popularity in Europe especially, Americans' widespread, enduring, and well-grounded antipathy toward the VAT has kept it appropriately at bay all these years.

Washington's irresponsible spending splurge may change this dynamic. Unless American policymakers force federal spending to retrench, Obama and friends may finally slake their Euro-VAT envy. Central to this debate is whether a VAT is necessary (it is not) and whether it is wise, the latter issue hanging on a handful of arguments about the VAT's economic effects.

**Neither a Budget Crisis Nor a VAT Are Inevitable.** President Obama and his congressional allies have driven federal spending and the national debt ever higher. Consequently, the U.S. may soon face budget and financial crises similar to those threatening much of Europe. Financial markets will not long tolerate the federal government's projected and ongoing trillion-dollar budget deficits, especially as these deficits build a bridge of debt toward America's long-term fiscal morass centered on entitlement spending.

The U.S. faces the certainty of a fundamental course correction: Either reverse Obama's spending surge and restore entitlement spending to sustainable levels or the federal government will be forced to turn to massive new tax sources, and the VAT is the top contender. The simple reality is that the current tax system likely cannot generate the necessary revenues to sustain this level of spending.

One argument sure to be raised is "inevitability," which starts from the premise that a budget crisis will force a policy change. In the face of a budget crisis, Congress and the President would then be compelled to slash the budget deficit dramatically and permanently to stabilize credit markets. Big government advocates would then argue that the spending surge and entitlement promises giving rise to the deficits are essential, inevitable, uncontrollable—anything but an irresponsible and reversible policy.

If one accepts that spending cannot be reduced materially, then the choice becomes a VAT or ongoing financial crisis, making the VAT appear inevitable. However, there is nothing about current or projected bloated federal spending levels that is inevitable or irreversible.

Spending levels are a policy choice that always appear difficult to cut in the abstract. But as European governments as well as state and local governments across the nation have rediscovered, it can be done.

This paper, in its entirety, can be found at:
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**VAT Would Weaken the Economy, Just Like a Higher Payroll Tax.** In this debate about higher taxes, VAT proponents often speak of its economic effects as though the VAT were to replace the income tax. In the abstract at least, such a policy could benefit the economy by reducing economic distortions. But adding a VAT to the current tax system—the intended policy—just layers another set of distortions on top of the existing problems. As an add-on tax, the VAT would clearly and materially weaken the economy in both the short run and the long run. The easiest way to understand how is to consider the effects of a different sort of tax—a payroll tax.

A payroll tax (such as the tax funding Social Security) is levied on workers' wages and salaries. The immediate effect of levying a payroll tax is to reduce the return to work or, alternatively, to reduce the price of leisure. Every hour of leisure is an hour less of work. An increase in the tax on work reduces the price of an hour of leisure and so reduces the incentives to work.

Most workers have little ability to adjust their working conditions quickly in response to an increase in the payroll tax. However, over time workers have substantial latitude to change the conditions of their employment. They can negotiate new work options with their current employers or new employers. They can adjust their budgets, consuming more leisure and fewer goods, and at some point they can choose to retire earlier.

For workers, a higher payroll tax rate means less take-home pay, less lifetime earnings, and a heightened tax bias against work. For the economy overall, a higher payroll tax rate means a decline in the long-run size of the workforce and therefore a decline in national output, a decline in incomes earned, and a decline in tax receipts from all sources, including the individual income tax, the corporate income tax, and existing payroll taxes.

To understand the link between the payroll tax and the VAT, consider the worker and his or her family as an economic unit earning income, consuming, and saving. Workers work to earn cash wages that they can use to spend on goods and services now or in the future. Rather than expressing wages in terms of dollars, one can just as easily express them in terms of a bundle of goods and services. A worker earning $1,000 per 40-hour workweek can buy a bundle of goods of size X costing $1,000. One could then say that the worker's wages for the week was an X-sized bundle of goods.

A 10 percent VAT would raise the price of those goods and services to $1,100, so the worker's wages can no longer buy the same quantity as before the tax was levied.[1] The worker must now work 44 hours to buy that same bundle. Equivalently, one could instead levy a 9 percent payroll tax, and then the worker would need to work 44 hours to buy the same bundle of goods at $1,000.[2]

With either the 9 percent payroll tax or the 10 percent VAT, the effect is to reduce the worker's after-tax purchasing power so that he must now work 44 hours to be able to buy the same bundle that he previously bought with just 40 hours of work. The government, of course, obtains the value of the worker's extra four hours of work as $100 in new tax revenues.

The immediate economic effects of a VAT, therefore, are higher prices of goods and services facing consumers. However, the anti-growth effects of a VAT become apparent when one examines how the VAT reduces the amount a worker can buy with a week's wages. The growth effects arise from the decrease in purchasing power per hour worked. Thus the economic effects of the VAT are identical to those of a new payroll tax—fewer hours worked, lower output and incomes, and a decline in federal receipts that offset in part the revenues expected from the VAT.

1. This assumes, as is typically done, that the central bank would accommodate the one-time price increase through monetary policy.
2. A 9 percent payroll tax levied on $1,100 of income yields almost $100 in tax, while a 10 percent sales tax levied on $1,000 of goods yields $100 in tax revenue. For perfect equivalence, the payroll tax would have to be just slightly higher than 9 percent.

**VAT Is Wrong for America.** A widely anticipated federal budget crisis could provide an opportunity for big government proponents to slip the nation a tax-hike mickey in the form of a new VAT layered on top of the existing tax system. Enacting a VAT would permanently reduce the size of the labor force because, economically, it is equivalent to a new or higher payroll tax rate, reducing the after-tax value of work, permanently reducing the supply of labor, and thus permanently reducing the size of the economy.

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