A Value-Added Tax Fuels Big Government

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President Obama is now talking about a "balanced approach" to deficit reduction that includes a "revenue component" achieved by "tax reform."

Among the tax reforms getting attention is a value-added tax, or VAT. Similar to a sales tax (more about this below), the value-added tax has become a significant part of the revenue systems of Europe and also has been adopted by over 100 other nations. The VAT is believed to be a magical device that can stuff government coffers with money without untoward economic political consequences. It is no such thing.

In the first place, increasing taxes will reduce economic growth. This is irrational and self-defeating policy. If the point of the current debt-ceiling exercise is to make the American people better off, the smart thing is to restore long-term fiscal integrity and economic growth with a balanced combination of spending reductions and tax cuts.

On the other hand, a VAT is the ideal choice for those whose goal is to refinance government sufficiently to allow it not only to continue "business as usual" but also to expand on a grand scale.

We estimate that each percentage point of a U.S. VAT would provide Washington over 10 years with approximately $981 billion with which to launch new spending. So even a small VAT might help reduce the debt-to-GDP ratio. But by making reforms to entitlement spending less likely, VAT revenues would also lead to a permanent increase in spending to 24% or more of GDP (compared to the historic average of 20%).

Total federal taxes would almost certainly increase to at least 24% of GDP (a 25% rise compared to the historic average). As a result of the drag of taxes on growth, we estimate that long-run output would permanently be nearly 3% lower than currently forecast. And, as has occurred in Europe, the VAT rate and revenues would over time inexorably increase-and so would the damage to private-sector jobs and incomes.

We estimate that each additional $1 trillion of revenue to the government from a VAT would cost the private economy at least $2 trillion, composed of $1 trillion of taxes and $1 trillion of lost GDP. This loss of GDP is less than what other economists (such as Martin Feldstein and Gregory Mankiw) have estimated would be the case for the income tax. A VAT thus appears less damaging at the outset, and some academics suggest that a small VAT be used to "buy" a reduction in the top income tax rate. But it is naïve to believe that the VAT rate would remain low, or that the income tax rate would not shoot back up.

In Europe, the VAT rate started out in the single digits in France in the 1950s. But because the VAT funds Europe's ever-expanding welfare state, the rates now range from a minimum of 15% to a high of 25%, and they are heading upward.

In Europe, the VAT on top of the income tax is a crushing burden. In France, where the VAT rate is 19.6%, total tax as a percentage of GDP is 46%, versus 30% in the United States. Britain now has a 20% VAT in addition to a 50% top rate on its personal income tax, a 26% corporate tax and a host of other taxes. Even if a U.S. VAT remained in the midrange of rates compared to Europe, it could easily push the total tax burden up to 40% of GDP.

In addition to its voracious appetite, the value-added tax is a master of disguise. Because it is levied on the sale of a product at each stage of production-whenever value is added-and at the final sale, the VAT is portrayed as a tax on consumption. The French once illustrated the VAT with an example: The farmer passes the tax to the miller, the miller passes it to the baker and the baker includes it in the price of bread. Ever since, the VAT has for political purposes been viewed as a burden on the consumer, thereby providing politicians with an excuse for "compensating" large numbers of favored voters with disproportionately large cash subsidies or exemptions.

Offsetting consumer subsidies would occur in spades in America, where the tax system has traditionally been preoccupied with "progressivity" and used to redistribute income.

The VAT isn't really a consumption tax, however. The truth is that the base of the VAT is the output of labor and capital-and, therefore, the economic burden of the VAT is, like that of the income tax, borne mostly by those who work, invest and produce the most output.

It is disturbing to consider a value-added tax sneaking into our current tax code disguised as tax reform. The outcome will be more spending, a higher combined income tax and VAT tax burden concentrated on a minority of voters, and a spate of special redistributional subsidies and exemptions that would mean higher rates. These higher rates would increase the economic output losses and continue the ongoing transfer of income and capital from the private sector to the government.

If Republicans get sucker-punched by a VAT, America will forever lose the opportunity to reduce spending, cut taxes, grow the private economy, and restore the country's long-term fiscal integrity.

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