



## The Dangers of a Value-Added Tax

***This European version of the sales tax could stealthily and dramatically grow the federal government.***

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On its way out of the recession, the economy may encounter a VAT blocking its way.

Last week on PBS's "Charlie Rose Show," House Speaker Nancy Pelosi said she thinks "it's fair to look at a value-added tax." And the Congressional Research Service just published a lengthy new paper on the value-added tax that tends to obscure the fact that the middle class will bear the majority of its burden.

Even Alan Greenspan is on board, albeit reluctantly, he says. Paul Volcker, chairman of Mr. Obama's tax reform panel, may not be far behind.

With the deficits at a historic high, these former heads of the Federal Reserve may prefer to pay for President Obama's spending spree with taxes instead of borrowed money. But tax and spend is no better than borrow and spend. Why not just stop spending so much?

For Mr. Obama, a VAT, which appears on the surface to simply tax goods and services at the cash register, is the ideal tax. At a 17% tax rate, for example, he can quickly increase taxes by \$1.5 trillion a year in a partially hidden way. A VAT is by its nature hidden, because no one files a tax return.

The VAT is so slippery that academics here and abroad do not agree on who pays this seemingly magical tax. Some economists still deceive themselves with the old notion that a VAT is simply a tax on consumers. This misperception comes from the European VAT, which uses a system of credits to create the illusion of pushing the tax forward from one business to another and finally to consumers.

Modern economists in the U.S. take the view that consumers bear only about 50% of the VAT, basically through higher prices and fewer product choices. Because of market forces, the rest of the tax ends up back on the owners and

the employees of the companies that produce and sell the goods and services subject to the VAT.

Our own simple general equilibrium model suggests that about 33% of the VAT tax is borne by people in proportion to their relative wage levels, about 17% in proportion to their capital, and about 50% in proportion to their consumption. Federal, state and municipal employees escape the implicit wage tax, but otherwise, the VAT is predominantly a tax on middle-class and upper-income earners and consumers.

The VAT also taxes imports, but excludes exports from taxation. But here again there is confusion. For instance, who really pays the import tax?

The old idea was that U.S. consumers would in all cases pony up the import tax in addition to the price of the imported product. In the case of most manufactured goods, however, the modern view is that market competition pushes all or part of the import tax back onto foreign sellers. There is no definitive answer as yet.

Amidst all this uncertainty, just imagine what a master political spin doctor like Mr. Obama could do with vast amounts of additional tax revenues drawn heavily from the wages and savings of the middle class, though widely misperceived to be paid disproportionately by lower-income consumers.

Proceeding from that misperception, he could create a vast new subsidy program that would offset by many multiples the VAT tax actually borne by these newly created welfare recipients. He could also increase the income tax on "the rich," saying that they and the middle class get a nearly free ride under the VAT compared to less affluent people who must spend everything on purchasing "taxable" essentials. Not so, but the VAT lends itself to spin.

Mr. Obama and Mrs. Pelosi might also use the VAT to fund "free" government-run medical care and hospitals for everyone, as well as "free" college education and "free" home mortgages.

How about a temporary VAT, solely to pay down the federal debt? When was the last time a tax ever went away? Or how about a smaller VAT of only 5%? Obviously, it could quickly grow. Any tax increase big enough to repay much of the huge federal debt would devastate the economy for years to come.

The one certainty about a VAT is its enormous revenue-producing potential. At a rate of 17% to 18%-about average for Europe-it could increase total federal taxes to 30% of GDP or more from 15% now, according to the Congressional Budget Office. In combination with higher federal spending, this could forever alter the balance between the public and private sectors.

America and its economy would be radically changed-and not for the better. The first priority in Washington should be to cut spending, not to add a powerful new weapon to the tax arsenal.

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