The Coming VAT

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There was a time when Republicans advocated sizable income tax cuts as a means of inducing Democrats to cut government spending. Democrats eventually caught on to the ruse and of late have turned the strategy on its head. Fiscal stimulus, trillion dollar budgets, and a Pandora’s Box filled with tangled webs of healthcare ‘reforms’ are attempts to extract Republican approval for tax increases in light of the impending draconian federal deficits.

However desirable, in the current state of fiscal affairs, there is little hope of reducing bloated government spending sufficiently to significantly lower the annual federal deficit. Base line budgets have suddenly and deliberately ballooned meaning that future budgets will be commensurately higher. Eventual economic recovery will do much to reduce the relative size of the current and projected deficits. However, even the most optimistic projections for future economic growth are woefully inadequate to grow the economy out of unsustainably high budget deficits.

The real problem is what economists call the ‘structural’ deficit. The structural deficit is the federal deficit that occurs when the economy only experiences nominal unemployment (5 - 6 percent). The federal budget should be in balance when unemployment is that low. Unfortunately, it is currently nowhere near that point.

Enter the VAT (Value Added Tax). A value added tax is a type of sales tax that has the capability of raising large amounts of revenue with relatively low rates. Economists favor a VAT over an income tax because the latter taxes (discourages) what individuals contribute to society while the VAT taxes (discourages) what individuals take out of society. Ideally, an appropriately designed VAT would replace the income tax. Unfortunately, countries that have adopted some form of VAT still have an income tax.

Someone once said that the US would adopt a VAT once Democrats realize that it is a money machine and Republicans realize that it is regressive. Excluding certain goods and services such as unprepared food and medical services mitigates, to a great extent, the regressive nature of the tax. Economists prefer a VAT because it is economically neutral, that is, it does not interfere with market based decisions to allocate resources.

The US government has boxed itself into a corner, a corner where the VAT is the only reliable long-term solution to excessive government spending and the resultant deficits. Spending cuts of sufficient size are near impossible as are sufficiently high income tax rates. In fact, significantly higher income tax rates could be self-defeating, but that is a different story.

Republicans are not stupid. They backed out of a plan to form a Congressional deficit commission that would have the power to address federal budget deficits as it deems appropriate. Republicans were all for the commission as long as they thought the end result would be drastic cuts in government spending. It must be pointed out that not all Republicans/conservatives oppose a VAT. See Mike Huckabee’s FAIR TAX and TV host Glenn Beck .

At this stage with no meaningful alternative in sight, a VAT appears inevitable. Expect the Presidential Commission to recommend some form of VAT to address the looming deficits and bring them within the range recommended by the European Union (3% of GDP). Look for an initial recommended VAT rate in the 3 to 6 percent range. The rate could be significantly higher if the commission includes Medicare and Social Security in their recommendation.

One further point, the middle class will not be exempt.

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