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The Value Added Tax: Too Costly for the United States

Dr. Randall G. Holcombe
DeVoe Moore Professor of Economics
Florida State University

Most developed economies rely on a Value Added Tax (VAT) for a substantial share of their tax revenues, so it is natural that the United States would look toward the possibility of a VAT at a time when huge budget deficits are forecast as far out as the forecasts go. While one can debate the merits of a VAT in other countries, the tax is not a good fit for the United States. It taxes a base that has traditionally belonged to state governments, it has a cumbersome administrative structure that would impose large compliance and administrative costs, and it would slow economic growth. If a VAT were introduced in 2010, by 2030 the net effect on tax revenues would be small, because revenues collected by the VAT would be mostly offset by declines in revenues from other tax bases.

RESEARCH FINDINGS

- A VAT taxes the same tax base as state sales taxes. The VAT is a consumption tax that taxes the same tax base state sales taxes already tax. This raises the welfare cost of the tax. Every tax has a welfare cost because it discourages the taxed activity, and the welfare cost increases more than in proportion to the tax rate. So, a VAT placed on top of a sales tax will produce a larger welfare loss than a VAT without a sales tax (as it is applied in the EU). A second problem that would be produced by a VAT on top of state sales taxes is that without some coordination between the federal and state governments, both levels of government would have an incentive to set tax rates too high, because they would not account for the revenue loss their tax imposes on the other level of government. A VAT is not a good fit in the US, because states already tax the VAT tax base with their sales taxes.

- The VAT has high administrative and compliance costs. The VAT is a consumption tax that is, in theory, very similar in its effects to a sales tax. However, the accounting required to comply with and administer a VAT is much more complex. More record-keeping and more complex tax forms would be required of taxpayers, and the government would need a costly administrative structure to ensure compliance. This complexity of a VAT would produce a GDP penalty of about $63 billion a year, or about 0.44% of GDP.

- A VAT would slow economic growth. The VAT has a reputation as a big revenue generator, and it would generate substantial revenues initially, if imposed in the US. But if it was used to generate additional revenue to address the looming budget deficits, it would have a significant negative impact on economic growth, and slower revenue growth in other tax bases would offset the VAT's revenue. Looking out 20 years, a 3% VAT would reduce GDP by about 3.7%, a 5% VAT would reduce GDP by about 5.6%, and a 7% VAT would reduce GDP by about 7.5%. After two decades, a VAT at any tax rate would almost nothing to net tax revenues. State budgets would be especially hard-hit because VAT revenues would go to the federal government, while state revenues from income and sales taxes would be lower due to slower economic growth.

- Projections in this study are consistent with actual experience in countries that use a VAT. Big initial revenues promised by a VAT would disappear as other tax revenues grew more slowly. Government's share of GDP would rise, but because of slower GDP growth, not because of an increase in total government revenues. If this seems implausible, consider that US GDP growth has been consistently higher than EU GDP growth since the VAT's introduction there. In addition, US government spending per capita is about the same as it is in France, and is higher than in Germany and the UK, even though those countries have larger government as a share of GDP. These comparisons are not proof that the VAT causes slower economic growth, but do show that these projections are consistent with the experience of countries that use a VAT.

ABOUT THE AUTHOR

Randall G. Holcombe is DeVoe Moore Professor of Economics at Florida State University. He received his Ph.D. in economics from Virginia Tech, and taught at Texas A&M University and at Auburn University prior to going to Florida State in 1988. Dr. Holcombe is the author of twelve books and more than 100 articles published in academic and professional journals. His books include The Economic Foundations of Government (1994), Public Policy and the Quality of Life (1995), From Liberty to Democracy: The Transformation of American Government (2002), and Entrepreneurship and Economic Progress (2007). His primary areas of research are public finance and the economic analysis of public policy issues.

For more information or to meet with the scholars, contact
Kathleen O'Hearn at 703-993-8426 (office), or kohearn@gmu.edu (email).

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