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Europe's VAT Lessons

Rates start low and increase, while income tax rates stay high.

As Americans rush to complete their annual tax returns today, there is still some consolation in knowing that it could be worse: Like Europeans, we could pay both income taxes and a value-added tax, or VAT. And maybe we soon will. Paul Volcker, Nancy Pelosi, John Podesta and other allies of the Obama Administration have already floated the idea of an American VAT, so we thought you might like to know how it has worked in Europe.

A VAT is essentially a national sales tax that is assessed at each stage of production, with the bill passed along to consumers at the cash register. In Europe the average rate is a little under 20%. (See the nearby chart.) In the U.S., a federal VAT would presumably be levied on top of state and local sales taxes that range as high as 10%. Some nations also exempt food, medicine and certain other goods from the tax.

The VAT Experience

Value-added tax rates when first enacted and under current law, as well as the top marginal income tax rate.

	Original Rate	Current Rate	Top Income Tax Rates*
Canada	7%	5%	46.4%
Denmark	9	25	59.7
France	13.6	19.6	45.8
Germany	10	19	47.5
Italy	12	20	44.9
Japan	3	5	50
Spain	12	16	43
Sweden	17.7	25	56.4
Switzerland	6.5	7.6	41.7
United Kingdom	8	17.5	50
United States	0	0	35**

*Tax Policy Center data as of 2008, save for U.K. and U.S.
**Federal rate, rising to 39.6% in 2011
Sources: OECD, Heritage Foundation, Tax Policy Center

VATs were sold in Europe as a way to tax consumption, which in principle does less economic harm than taxing income, savings or investment. This sounds good, but in practice the VAT has rarely replaced the income tax, or even resulted in a lower income-tax rate. The top individual income tax rate remains very high in Europe despite the VAT, with an average on the continent of about 46%.

Europe's individual income tax rates have fallen since the 1980s, following the U.S. lead in the Reagan era, and European corporate tax rates have come down even more sharply. But the drive of this decline has been global tax competition, not the offsetting burden of the VAT.

In the U.S., VAT proponents aren't calling for a repeal of the 16th Amendment that allowed the income tax—and, in fact, they want income tax rates to rise. The White House has promised to let the top individual rate increase in January to 39.6% from 35% as the Bush tax cuts expire, while the dividend rate will go to 39.6% from 15% and the capital gains rate to 20% next year and 23.8% in 2013 under the health bill, from 15% today. Even with these higher rates, or because of them, revenues won't come close to paying for the Obama Administration's new spending—which is why it is also eyeing a VAT.

One trait of European VATs is that while their rates often start low, they rarely stay that way. Of the 10 major OECD nations with VATs or national sales taxes, only Canada has lowered its rate. Denmark has gone to 25%

from 9%, Germany to 19% from 10%, and Italy to 20% from 12%. The nonpartisan Tax Foundation recently calculated that to balance the U.S. federal budget with a VAT would require a rate of at least 18%.

Proponents also argue that a VAT would result in less federal government borrowing. But that, too, has rarely been true in Europe. From the 1980s through 2005, deficits were by and large higher in Europe than in the U.S. By 2005, debt averaged 50% of GDP in Europe, according to OECD data, compared to under 40% in the U.S.

Thanks to the recession and the stimulus, U.S. federal debt held by the public has now reached about 63% of GDP and is headed higher, but the OECD forecasts that the 30 wealthiest nations will see debt burdens "exceed 100% of gross domestic product in 2011." Debt levels in France, Germany, Spain and Italy are expected to have increased by 30 percentage points of GDP from 2008 to 2011. Greece has a VAT rate of 21%, but its debt as a share of GDP is 113%.

The very efficiency of the VAT means that it throws off huge amounts of revenue that politicians eagerly spend. The VAT thus becomes an engine of even greater public spending. In Europe, average government spending was about 30.2% of GDP when VATs began to spread in the late 1960s. Today, those governments are more than 50% larger, with spending of 47.1% of GDP on average. By contrast, U.S. government spending (federal and state) rose to 35.3% from 28.3% as a share of GDP in the same period.

It is precisely this revenue-generating ability that makes the VAT so appealing to liberal intellectuals and politicians. Even liberals understand that at some point high income tax rates stop yielding much more revenue as the rich change their behavior or exploit loopholes. The middle-class is where the real money is, and the only way to get more of it with the least political pain is through a broad-based consumption tax such as a VAT.

And one more point: In Europe, this heavier spending and tax burden has also meant lower levels of income growth and job creation. From 1982 to 2007, the U.S. created 45 million new jobs, compared to fewer than 10 million in Europe, and U.S. economic growth was more than one-third faster over the last two decades, according to the Bureau of Labor Statistics.

In 2008, the average resident of West Virginia, one of the poorest American states, had an income $2,000 a year higher than the average resident of the European Union, according to economist Mark Perry of the University of Michigan, Flint. The price of a much higher tax burden to finance a cradle-to-grave entitlement state in Europe has been a lower standard of living. VAT supporters should explain why the same won't be true in America.