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America's Coming Tax Increase

With the deficit projected to hit 5% of GDP in only a decade, the choice is either spending cuts or tax hikes.

By Edward P. Lazear

In this bizarre U.S. election year, the leading candidates have failed to engage in a serious discussion of one of the top economic issues on Americans' minds—federal deficits and the national debt. Donald Trump suggested he'd wipe out the $14 trillion public debt in eight years. But even with the economic growth from his tax plan, this is highly unrealistic. Now he says he'd "rather not be so aggressive." Still, he has proposed an enormous tax cut and promised not to tamper with Social Security or Medicare, all of which points to massive revenue losses.

The debt held by the public has approximately doubled since President Obama took office and is now equal to 74% of gross domestic product. It's true that with the right policy mix, economic growth—stuck at just over 2% during the Obama "recovery"—will help close federal deficits and pay down the debt. At the end of World War II, for example, and shrank to a low of 23% by 1974. But letting growth or future belt-tightening close the gap is the exception, not the rule. More often, higher taxes are the result.

Democrats are explicit in wanting higher taxes, with Hillary Clinton pushing for a 4% surcharge on incomes over $5 million, higher capital-gains taxes and capped deductions. Bernie Sanders would raise the top marginal income-tax rate to 54.2%, tax capital gains and dividends as ordinary income and expand the estate tax.

On the Republican side, Mr. Trump, Ted Cruz and John Kasich have outlined plans that reduce taxes, at least for now. The Trump plan lowers personal and corporate rates, the latter to 15%. The Cruz plan taxes all personal income (above a minimum) at 10% and replaces business taxation with a 16% tax on net business sales. Mr. Kasich would lower personal and business taxes and allow full expensing of capital expenditures.

According to the Tax Foundation, the Republican plans produce positive and the Democratic plans produce negative economic growth. The Democratic plans produce additional revenue, but not lower deficits given their spending aspirations.

Under current law, the Congressional Budget Office has projected that the deficit will grow to more than 4% of GDP in six years and to 5% of GDP in 10 years. Deficits of this magnitude will rapidly increase federal debt. In an earlier CBO report's "alternative" scenario, the U.S. public debt will almost double again from its already high level in just over two decades.

If the CBO's projections are close to correct, there will be strong pressure to raise taxes in the future, regardless of whether a Democrat or Republican is in the White House. But it will be virtually impossible to squeeze this much blood out of the rich alone.

One likely long-run solution, absent spending cuts, will be to institute a national value-added tax, which operates much like a sales tax, specifically taxing the difference between a firm's revenues and costs at every stage of production.

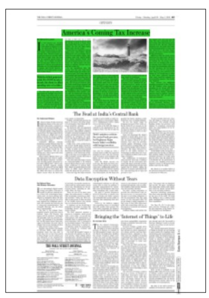
Mr. Cruz makes a VAT the centerpiece of his plan, although he prefers to market it as a "business flat tax." It substitutes for a variety of other taxes (payroll, corporate and some income) that are paid now. The Cruz plan is pro-growth and has many advantages over rival plans, but keeping a value-added tax low and substituting it for other more-regressive taxes has proved almost impossible.

All 34 countries in the Organization for Economic Cooperation and Development, except the U.S., have a VAT. As my analysis of OECD countries (posted on the Hoover Institution website) shows, 26 countries have higher VATs now than they did when they first instituted the tax. The average VAT today among these countries is 19%. The U.K., Italy and Denmark have all raised their VATs by 10 percentage points or more. The VAT, wherever it has been implemented, has been a money machine for big government.

Moreover, VATs are rarely a mere substitute for other taxes. Of the 15 countries with VATs that are above the median for the group, all but three have tax burdens that exceed the average across OECD countries. For every one percentage point that the VAT increases, the tax burden rises by about 0.8 of a percentage point. Were it a pure substitute tax, raising the VAT would have no effect on total taxes collected because other taxes would be reduced by a corresponding amount. That hardly ever happens.

Even without the additional spending proposed by Mrs. Clinton and Mr. Sanders, more projected spending in the future will likely lead to calls for ever-higher taxes. Without more budget discipline, America may be headed toward a European-style VAT tax and ever-larger government.

Mr. Lazear, chairman of the Council of Economic Advisers from 2006-09, is a professor at Stanford University's Graduate School of Business and a Hoover Institution fellow.



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