The Conservative Case for a VAT

By Bruce Bartlett

The VAT is probably the ideal tax from a conservative point of view. As a broad-based tax on consumption, it creates less economic distortion per dollar of revenue than any other tax — certainly much less than the income tax. If conservatives are successful in defeating a VAT, the alternative inevitably will be significantly higher income tax rates, which will do far more damage to the economy than a VAT raising the same revenue.

The conservative preference for consumption taxes over income taxes has a long history dating back at least to Thomas Hobbes. In *Leviathan* (1651), he argued that consumption was what people took out of society, while saving added to society’s wealth. Therefore consumption was the best base for taxation, while saving should be exempt.¹ That view has been endorsed by every conservative tax theorist from David Hume and Alexander Hamilton in the 18th century, to John Stuart Mill and Alfred Marshall in the 19th century, to Irving Fisher and Nicholas Kaldor in the 20th century, and to Martin Feldstein and many others today.²

Hamilton also emphasized that taxing consumption was the method of taxation most consistent with freedom because people could more easily reduce their consumption than their income. As he wrote:

It is a signal advantage of taxes on articles of consumption, that they contain in their own nature a security against excess. They prescribe their own limit; which cannot be exceeded without defeating the end proposed, that is, an extension of the revenue. When applied to this object, the saying is as just as it is witty, that, “in political arithmetic, two and two do not always make four.” If duties are too high, they lessen the consumption; the collection is eluded; and the product to the treasury is not so great as when they are confined within proper and moderate bounds. This forms a complete barrier against any material oppression of the citizens by taxes of this class, and is itself a natural limitation of the power of imposing them.3

In the 1970s there was talk of a VAT for the United States. President Nixon was sympathetic to the idea.4 But eventually conservatives decided that the VAT’s greatest virtue — its efficiency (that is, its ability to raise revenue at a low deadweight cost) — was actually a defect. Their fear is that a VAT would raise too much revenue, too easily.5 Better to raise taxes as painfully

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3Hamilton’s witty saying originated with Jonathan Swift, who also influenced a long line of tax theorists. See Bruce Bartlett, “Jonathan Swift: Father of Supply-Side Economics?” History of Political Economy (Fall 1992), pp. 745-748.

4Privately, Nixon often expressed support for a VAT, but always rejected the idea on political grounds. See Nigel Bowles, Nixon’s Business (College Station, TX: Texas A&M University Press, 2005), pp. 47, 62, 67. On January 20, 1972, he wrote a letter to the Advisory Commission on Intergovernmental Relations asking it to study the possibility of replacing the local property tax with a federal VAT. The commission reported that a VAT was unnecessary to reduce local property taxes or improve equalization of school finance. See ACIR, “The Expenditure Tax: Concept, Administration and Possible Applications,” Report No. M-84 (March 1974).

and inefficiently as possible, they concluded, to limit the government’s tax take. At a press conference on February 21, 1985, President Reagan cemented conservative opposition to the VAT, saying the tax “gives government a chance to grow in stature and size.”

I myself long opposed the VAT on money-machine grounds. I changed my mind when I realized that there was no longer any realistic hope of controlling entitlement spending before the deluge hits when the baby boomers retire. The U.S. now needs a money machine.

Although some liberals have periodically been attracted by the VAT’s revenue potential, none have made a serious effort to enact one since House Ways and Means Committee Chair Al Ullman floated the idea in 1979 and was voted out of office the following year. The loss was widely attributed to his support for VAT. Ullman’s name has since been invoked as proof that a VAT is politically suicidal. As Sen. Byron L. Dorgan, D-N.D., said, “The last guy to push a VAT isn’t working here anymore.”

Politicians are also mindful that foreign leaders who impose VATs often suffer electoral defeat as a consequence. After enacting a VAT in Japan in 1986, Prime Minister Yasuhiro Nakasone was defeated the following year largely because of it. Canadian Prime Minister Brian Mulroney imposed a VAT in 1991, and it was considered a major factor in his 1993 defeat. Although Australian Prime Minister John Howard survived enactment of a VAT in 1998, his party suffered major losses as a consequence.

However, several things have changed that could now make a U.S. VAT viable. First is the magnitude of the fiscal crisis that will have to be addressed soon. Spending for Social Security and

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Medicare alone will require a tax increase equivalent to 81 percent of current individual income tax revenue in today’s dollars over coming decades, according to the 2009 trustees’ reports of those systems.9

The recent explosion of stimulus spending has obviously made the problem worse. We are already seeing countries like the United Kingdom having trouble selling bonds and being warned of downgrades by credit-rating agencies. Greece’s fiscal problems nearly caused the European Union to implode in early 2010. The United States is not immune from such problems, which could cause inflation and interest rates to skyrocket, at which point a large tax increase will be inevitable. The only question would be how taxes will be raised.

A VAT would also address a common conservative concern about the growing percentage of the population that pays no federal income taxes. In 2010, 48 percent of all returns had no federal income tax liability, according to the Joint Committee on Taxation.10 A VAT would be a way of getting all Americans to pay for the federal government’s general operations. It’s unrealistic to think that income taxes will be imposed on such people once they have become exempt.

As economist Larry Summers once explained, the U.S. has no VAT because liberals think it’s regressive and conservatives think it’s a money machine. We’ll get a VAT, Summers said, when they reverse their positions.11

After Republicans — allegedly the party of fiscal responsibility — rammed Medicare Part D into law in 2003, I concluded that our looming fiscal problem was so enormous that higher taxes were unavoidable. And that was long before the recent financial crisis made matters far worse. I believed the tax increase would

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9In other words, the effective federal income tax rate would have to almost double. See Bruce Bartlett, “The 81% Tax Increase,” Forbes (May 15, 2009), available at http://www.forbes.com/2009/05/14/taxes-social-security-opinions-columnists-medicare.html.

10Joint Committee on Taxation, “Present Law and Background Data Related to the Individual Income and Social Insurance Taxes as in Effect for 2010 and 2011,” JCX-1-10 (Jan. 13, 2010), p. 23.

be so great that it would seriously cripple the economy if it were accomplished through higher rates on an already dysfunctional income tax system. I reluctantly concluded that a VAT would be the best way to raise the revenue.

When I first made this suggestion in a Los Angeles Times article in 2004, I was building on a large body of tax analysis showing that the VAT is the best known way of raising revenue. When I say “best,” I mean it raises large revenues from low rates and has minimal disincentive effects. In economist-speak, it has a very small deadweight or welfare cost.

Looking at the experience of other countries, I estimate that a U.S. VAT could realistically tax about a third of the gross domestic product, which would raise close to $50 billion per percentage point. If we adopted Europe’s average VAT rate of 20 percent, we could raise $1 trillion per year in 2009 dollars. Even if all this revenue were used to fund tax reform in a revenue-neutral manner, it would be worth doing. There are any number of glaring problems with the tax code, such as the alternative minimum tax, that will require significant revenue to fix permanently.

Back in the early 1980s, practically every leading conservative economist supported a VAT for the United States. Norman Ture, a godfather of supply-side economics, and Murray Weidenbaum, chair of the Council of Economic Advisers under Reagan, wrote many articles, books, and papers supporting the VAT. The conservative American Enterprise Institute published a book in 1987 saying that the VAT was the key to deficit reduction.

Perhaps the strongest evidence that the VAT was considered the conservative tax reform is that it is the foundation of the flat tax, which is still supported by practically every conservative tax

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13The data in Table 1 show that other countries tax about half of consumption, which is about two-thirds of GDP.
The flat tax, originally devised by Hoover Institution scholars Robert Hall and Alvin Rabushka, is a subtraction method VAT with one twist: Businesses are permitted to deduct cash wages paid from the base on which they calculate the VAT. Workers pay the same rate on their wages less only a personal exemption. The purpose of this adjustment is to create transparency so that people see the tax they are paying and to redress its regressivity.

In 1992, when then-California Gov. Jerry Brown proposed a VAT plus a flat-rate income tax, it was hailed by supply-side economists like Arthur Laffer and Gary Robbins. And conservatives have recently embraced a proposal that would replace California’s state income tax with a VAT.

House Budget Committee ranking minority member Paul Ryan, R-Wis., has received high praise from conservatives for his “Fiscal Roadmap” plan that would eliminate the national debt by slashing spending. But the plan would also replace the corporate income tax with what Ryan calls a business consumption tax. That is a type of VAT. Sen. Jim DeMint, R-S.C., generally considered to be the most conservative member of the Senate, has cosponsored the legislation.

Nevertheless, whenever I suggest a VAT for the U.S., I am attacked by supply-siders and right-wingers. On CNBC, my friend Larry Kudlow accused me of wanting to “Europeanize the American economy.” They believe the VAT is a money machine that will lead to higher taxes and bigger government precisely because it is such a “good” tax.

It is an article of faith among conservatives that the VAT is a money machine that must be fought to the death. The Wall Street Journal continually rails against it on the grounds that if we were

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ever to adopt such an insidious form of taxation, we would quickly become just like Europe, as if that entire continent is one big gulag instead of someplace where, by and large, the people are just as free and prosperous as Americans.19

I want to make two points about the money-machine argument.20 First, it is often implied that the VAT trends continuously upward. That is wrong. According to the OECD, 7 of the 29 member states with a VAT have lower rates today than they had in the past: Canada, the Czech Republic, France, Hungary, Ireland, the Netherlands, and the Slovak Republic. And Australia, Finland, Korea, and Poland have never increased their VAT rates. Indeed, the average VAT rate in OECD countries is actually lower today than it was in 1984: 17.79 percent then versus 17.61 today.

The VAT rates commonly referred to are statutory rates that don’t necessarily tell us anything about the effective tax rate. Conservatives just assume that the VAT covers everything and has the same structure in every country. In fact, every country with a VAT exempts many items and usually imposes lower rates on some things and higher rates on others. The rates one tends to see discussed, such as those that appear below, are the basic rates that apply to most things that a VAT covers. But the share of consumption covered by the VAT varies enormously from one country to another, as shown in Table 1.

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19 See the following Wall Street Journal editorials: “The Abolitionist” (Aug. 6, 2004); “The Tax That France Built” (March 4, 2005); “The VAT Commission” (Feb. 19, 2010); “Europe’s VAT Lessons” (April 15, 2010). For evidence that Europeans are by and large as free and prosperous as Americans, see Peter Baldwin, The Narcissism of Minor Differences (New York: Oxford University Press, 2009). There is also a growing literature showing that American and European levels of taxation and spending are more similar than generally assumed. See Price Fishback, “Social Welfare Expenditures in the United States and the Nordic Countries, 1900-2003,” NBER Working Paper No. 15982 (May 2010); Willem Adema and Maxime Ladaique, “How Expensive Is the Welfare State?” OECD Social, Employment and Migration Working Paper No. 92 (Nov. 2009).

20 Previous research has emphasized that while countries with VATs tend to have higher tax/GDP ratios than those without them, countries with VATs also tended to have high tax ratios before introducing the VAT. Evidence that the VAT caused a rise in the tax ratio is weak. See Liam Ebrill et al., The Modern VAT (Washington: International Monetary Fund, 2001), pp. 25-39; Diana Furchtgott-Roth, OECD Countries and the VAT: The Historical Experience (Washington: American Petroleum Institute, 1990); J.A. Stockfish, “Value-Added Taxes and the Size of Government: Some Evidence,” National Tax Journal (Dec. 1985), pp. 547-552.
Another problem with the money-machine argument is that it ignores the critical role of inflation in fueling higher VAT rates in the 1970s. At that time, it was absurdly easy for governments to raise VAT rates because it was hardly noticed — what was another 1 percent rise in the inflation rate when the general price level was rising at double-digit rates? Further, to the extent that inflation was a function of budget deficits, higher taxes were a plausible means of reducing it. In the Keynesian model, higher taxes are inherently anti-inflationary because they reduce purchasing power.

It is critical that any money-machine analysis distinguish between those countries that adopted VATs before the great inflation of the 1970s and those adopting VATs in the era of relative price stability that we have seen since then. Tables 2 and 3 show that to the extent that there is a valid money-machine argument, it is only in the countries that could piggyback on inflation to ratchet up their rates in the 1970s. VAT rates show little evidence of a ratchet effect during the era of price stability.

In my opinion, opposing a VAT means implicitly supporting our current tax system, which imposes a deadweight cost equal to a third or more of revenue raised — at least 5 percent of GDP, according to various studies.21 This is insane. The idea that raising taxes in the most economically painful way possible will

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hold down the level of taxation, and the size of government, is obviously false. It just means that the total burden of taxation, including the deadweight cost, is far higher than it needs to be. If we raised the same revenue more sensibly, we could, in effect, give ourselves a tax cut by reducing the deadweight cost.

Those who oppose big government would do better to concentrate their efforts on cutting spending. The idea that we must hold down taxes or keep a ridiculously inefficient tax system because it will give us small government is juvenile. If people want small government, there are no shortcuts. Spending has to be cut. But if spending isn’t cut, we must pay our bills. It’s better to do so as painlessly and efficiently as possible.

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22A common conservative argument is that holding down taxes will somehow starve the beast and automatically lead to lower spending. Not only is there no evidence supporting that belief, but recent research argues that it is perverse. By reducing the tax cost of spending, the starve-the-beast theory has actually caused spending to rise. See Bruce Bartlett, “‘Starve the Beast’: Origins and Development of a Budgetary Metaphor,” Independent Review (Summer 2007), pp. 5-26; Christina D. Romer and David H. Romer, “Do Tax Cuts Starve the Beast? The Effect of Tax Changes on Government Spending,” Brookings Papers on Economic Activity (No. 1, 2009), pp. 139-200; William A. Niskanen, “Limiting Government: The Failure of ‘Starve the Beast,’” Cato Journal (Fall 2006), pp. 553-558; Michael J. New, “Starve the Beast: A Further Examination,” Cato Journal (Fall 2009), pp. 487-495.
Those who complain most about the VAT generally oppose all tax increases no matter how large the budget deficit is. They imagine that the fiscal crisis that their opposition to higher taxes will help create will lead to massive spending cuts that would be politically impossible otherwise. But that cannot happen, because Congress will never enact a large deficit reduction package that has no tax increases. Historically such packages have aimed for a 50-50 split between spending cuts and revenue increases. Moreover, when the crunch comes there will be a heavy premium on near-term budget savings, which tends to put entitlements off the table, since significant changes to these programs must be phased in. And given that defense and homeland security make up such a large percentage of discretionary spending, it’s impossible to achieve sufficient savings by cutting only domestic programs. Therefore, as a practical matter, higher revenues will have to be a major part of any budget deal drafted under crisis conditions.

Table 3. VAT Rates in OECD Countries Establishing VATs After 1975

<table>
<thead>
<tr>
<th>Country</th>
<th>Initial Rate</th>
<th>Year</th>
<th>2009 Rate</th>
<th>% Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>13 Korea</td>
<td>10</td>
<td>1977</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>14 Mexico</td>
<td>10</td>
<td>1980</td>
<td>15</td>
<td>50</td>
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<tr>
<td>15 Turkey</td>
<td>10</td>
<td>1985</td>
<td>18</td>
<td>80</td>
</tr>
<tr>
<td>16 New Zealand</td>
<td>10</td>
<td>1986</td>
<td>12.5</td>
<td>25</td>
</tr>
<tr>
<td>17 Portugal</td>
<td>17</td>
<td>1986</td>
<td>21</td>
<td>23.5</td>
</tr>
<tr>
<td>18 Spain</td>
<td>12</td>
<td>1986</td>
<td>16</td>
<td>33.3</td>
</tr>
<tr>
<td>19 Greece</td>
<td>16</td>
<td>1987</td>
<td>19</td>
<td>18.75</td>
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<tr>
<td>20 Hungary</td>
<td>25</td>
<td>1988</td>
<td>20</td>
<td>(20)</td>
</tr>
<tr>
<td>21 Iceland</td>
<td>22</td>
<td>1989</td>
<td>24.5</td>
<td>11.4</td>
</tr>
<tr>
<td>22 Japan</td>
<td>3</td>
<td>1989</td>
<td>5</td>
<td>66.7</td>
</tr>
<tr>
<td>23 Canada</td>
<td>7</td>
<td>1991</td>
<td>5</td>
<td>(28.6)</td>
</tr>
<tr>
<td>24 Czech Rep.</td>
<td>23</td>
<td>1993</td>
<td>19</td>
<td>(17.4)</td>
</tr>
<tr>
<td>25 Poland</td>
<td>22</td>
<td>1993</td>
<td>22</td>
<td>0</td>
</tr>
<tr>
<td>26 Slovak Rep.</td>
<td>25</td>
<td>1993</td>
<td>19</td>
<td>(24)</td>
</tr>
<tr>
<td>27 Finland</td>
<td>22</td>
<td>1994</td>
<td>22</td>
<td>0</td>
</tr>
<tr>
<td>28 Switzerland</td>
<td>6.5</td>
<td>1995</td>
<td>7.6</td>
<td>16.9</td>
</tr>
<tr>
<td>29 Australia</td>
<td>10</td>
<td>2000</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>14.7</strong></td>
<td></td>
<td><strong>15.6</strong></td>
<td><strong>6.1</strong></td>
</tr>
</tbody>
</table>

*Note: There are 30 nations in the OECD and 29 have VATs, only the U.S. does not.*

*Sources: EU, IMF, OECD, PricewaterhouseCoopers, and national sources.*
Unless an alternative to existing taxes is in place, Congress will have no choice but to raise income tax rates. Since those who oppose a VAT also tend to be obsessive about holding down tax rates, especially the top rate, they must ask themselves which is worse — a broad-based consumption tax or confiscatory income tax rates? When that day comes, I think they will choose the former. But that option may not exist unless we act soon to adopt a VAT, because it takes two to three years to put it in place. Because revenue is needed immediately in a crisis, a VAT will effectively be off the table.

Finally, conservative opponents of a VAT must ask themselves what their true goal is. Is it to increase growth and economic prosperity, because low taxes generally support those objectives, or is it to keep taxes from being raised regardless of the circumstances? Unless one believes that budget deficits have no effect on growth and prosperity, one has to accept that there are times when higher taxes are the lesser of evils and can actually stimulate growth. Conservatives like to pretend that the 1982 and 1993 tax increases never happened, but the fact is that growth was stimulated in both cases because the increases led to lower interest rates, lower expectations of inflation, and less crowding-out in financial markets.

Unfortunately, ideological dogmatism, rather than serious analysis, seems to underlie most of the opposition to a VAT among conservatives. When, economic conditions eventually force them to live in the real world — instead of a fantasy world where the budget can be balanced by abolishing Medicare — I think they will support a VAT just as European conservatives did. The longer they wait to do so, the greater the economic pain we will have to go through before they bow to reality and support a VAT.

Even though I think we should enact a VAT as soon as possible, I am under no illusion that it is feasible under current

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political and economic conditions. But those conditions will inevitably change if projections of future federal deficits are even close to correct, and if economists’ beliefs about the impact of deficits are remotely true. The projections mean that sometime in the not-too-distant future we will see significantly higher inflation and interest rates. At some point — I don’t know when — we will pass a political threshold, and politicians can start to talk honestly about the sorts of fiscal actions that will be necessary to bring inflation and interest rates down to tolerable levels.

I don’t anticipate that even then a VAT will be among the first options considered. When there is the inevitable flare-up in financial markets as bond prices crash, the dollar takes an unexpected dip, and the price of oil shoots up, Congress and the White House will solemnly vow to cut the deficit because it will be the one thing that everyone will be able to agree on that might help and at least won’t hurt. Everyone will go out to Andrews Air Force Base and, after weeks of intense negotiations, announce that a deal has been struck to deal with the crisis.

Republicans will inevitably agree to some modest tax increases, Democrats will agree to trim Medicare and Medicaid, and both sides will promise that discretionary spending will be slashed. But after the low-hanging fruit has been picked and deficits continue to rise and financial markets once again suffer turmoil, we will, after perhaps 10 years of unsuccessful efforts to get our finances under control, eventually reach a point where a VAT is politically viable. Republicans will finally be brought around by using the revenue to offset many of the ad hoc tax increases that will have already been enacted, with a little left over for deficit reduction. That way they can rationalize that their surrender to the inevitable is a tax reform rather than a tax increase. But in fact it will simply be a retroactive tax increase.

As David Ignatius wrote in The Washington Post, “By ruling out a VAT when it could keep the federal deficit in check, politicians have all but guaranteed that the debt crisis, when it comes, will be more damaging. But by then, everyone will be clamoring for a VAT, so it will be safe to endorse it.”

It’s stupid to put up with a decade of unnecessary pain and suffering before we finally bite the bullet and do what must be done to stabilize our public finances. But I see no other path that will get us there. The right-wing fantasy that our fiscal problems can be solved by only cutting spending must be enacted and proven a failure before rational people can finally put real solutions like a VAT on the table without being accused by Larry Kudlow and The Wall Street Journal of trying to turn every American into a tax slave.