VAT as the Key to Real Tax Reform

By Michael J. Graetz

Michael J. Graetz is the Isidor and Seville Sulzbacher Professor of Law and the Columbia Alumni Professor of Tax Law at Columbia Law School.

If the United States were to enact a VAT, how should its revenue be used? That is the question the editors of this volume asked me to answer. As many readers know, I have long advocated a VAT as the linchpin of reforming our nation’s tax system, most recently in the spring 2010 paperback edition of my book 100 Million Unnecessary Returns: A Simple, Fair and Competitive Tax System for the United States.1 For those unfamiliar with my plan, it has four key pieces:

■ First, enact a VAT, a broad-based tax on sales of goods and services now used by nearly 150 countries worldwide. The United States is the only OECD country that has no VAT or, as it is sometimes called, a goods and services tax.2

■ Second, use the revenue produced by that consumption tax to finance an income tax exemption of $100,000 of family income and to lower substantially the individual income tax rates on income above that amount.3

■ Third, lower the corporate income tax rate to 15 percent, or no more than 20 percent.4

■ Fourth, replace the earned income tax credit and provide low- and middle-income families with tax relief from the VAT burden through payroll tax offsets and debit cards.5

This plan has many significant advantages over current law and other tax reform alternatives:

1Yale University Press, April 2010. Much of this article has been adapted from the introduction to the paperback edition of my book.
2Id. at chapter 5.
3Id. at chapter 6.
4Id. at chapter 7.
5Id. at chapter 10.
It would encourage saving and investment in the United States, stimulating economic growth and creating additional opportunities for American workers.

It would eliminate more than 100 million of the 140 million income tax returns and would free 150 million Americans from having to deal with the IRS.

A corporate income tax rate of 15 to 20 percent would be among the lowest in the world and would solve most of the vexing problems of international tax policy.

The plan would avoid most of the difficult issues of transition to an entirely new system that have affected many other proposals to replace the income tax with consumption taxation.

With relatively few high-income Americans filing tax returns, there would be far less temptation for politicians to use income tax exclusions, deductions, and credits as if they offered adequate or appropriate solutions to the nation’s most pressing social and economic problems. They do not.

The plan would take advantage of our status as a low-tax country by making us a low-income-tax country.

Finally, by combining taxes commonly used throughout the world, this system would facilitate international coordination and fit well with existing tax and trade agreements — something that most other consumption tax proposals fail to do.

I designed this plan in a manner generally to change neither the progressivity of the tax system nor the amount of revenue produced under current law. This allows my proposal to be evaluated by comparing it directly with the current system, and it follows the important precedent of both distributional and revenue neutrality that facilitated enactment of the 1986 Tax Reform Act, our last major tax reform.

Since the first edition of my book was published, however, major changes have occurred in our nation’s economic, fiscal, and political circumstances. During the George W. Bush administration, the combination of large tax cuts, costly wars on two fronts, a new unfunded Medicare prescription drug entitlement, and other spending growth turned projected surpluses into substantial deficits. Then, as a result of the financial crisis, the
most significant recession since the Great Depression (with unemployment reaching a 25-year high), and a vast amount of government spending aimed at combating these problems, our short- and long-term financial condition deteriorated dramatically. Now the U.S. financial position is perilous.

We have never in modern times faced such a dangerous ongoing imbalance between the levels of federal spending and revenue. Our federal debt as a percentage of our economic output is greater than it has been since the end of World War II. And we had all the money then: Europe and Japan were in shambles, and China was entering into a dark communist era. Our economy was poised to grow for decades at an unprecedented pace. And our government owed Americans 98 percent of the money it had borrowed to finance that war. The Congressional Budget Office now projects that in a decade, our national debt will reach $20 trillion — 90 percent of our economic output (GDP) — with more than half owed to foreigners, many of whom we cannot count as friends. If we are able then to borrow at a 5 percent interest rate, interest on the federal debt will cost us a trillion dollars a year.

Our long-term fiscal situation is even more dire. Our population is aging with fewer workers for each retiree, and we have no credible plan to control excessive and rapidly rising healthcare costs. So the financial picture is projected to get even gloomier in the longer term. If we fail to get control of the federal budget, rising interest costs will gobble up an ever-larger share of our nation’s resources. Public debt growing to such levels will also decrease the value of the dollar and challenge its role as the world’s reserve currency. Our growing national debt increases the risks of substantially higher interest rates, inflation, and another financial crisis. Over time it will threaten the living standards of the American people. These are facts, not forecasts.

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We are heading toward a cliff, risking the economic well-being of our children and grandchildren.

We simply cannot allow projected deficits and the additional borrowing they will produce to occur. Once our economy recovers and resumes real growth and job creation, both substantial reductions in anticipated government spending and tax increases will be necessary to address the looming disaster. We must curb our government’s spending. But we should not cut Social Security or health benefits for low- and middle-income families. Americans will have to work longer and retire older. High-income retirees will no doubt see their benefits cut or taxed away. And the first major tax policy challenge of the 21st century is the need to address the nation’s unsustainable fiscal condition fairly and in a manner most conducive to economic growth.

A great advantage of my plan is that by introducing a VAT on sales of goods and services and thereby decreasing our need to rely so heavily on the income tax to finance government spending, we can have a tax system that is fair and yet substantially more favorable to economic growth than our current system. With this plan in place, our ability to raise additional revenue would be increased without the economic costs that would arise if raising income and payroll taxes were our only options. We can no longer afford the luxury of a tax system that relegates the goal of economic growth to the back burner. And any tax reform must take care not to stifle our economic recovery.

A number of other analysts, recognizing that simply reforming our income tax is inadequate, have proposed that the U.S. enact a VAT to address the gap between our spending and our revenue. For example, both the conservative economist Bruce Bartlett and the liberal Bill Gale have proposed a VAT to reduce our debt and deficits. Others, such as Len Burman, have proposed using a VAT to fund specific spending programs such as health insurance.

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coverage. Burman regards using a VAT to fund progressive expenditures as the best way to address concerns about its potential regressivity. But despite the daunting challenges of our fiscal condition — challenges that a VAT can surely help ease — it would be a mistake to enact a VAT without using a substantial portion of its revenue to help finance a major reform and simplification of income taxes. That would be a wasted opportunity.

Let me begin with the corporate income tax. The statutory U.S. corporate rate has for many years been the second highest in the world, trailing only that of Japan, which has recently announced plans to reduce its rate, making ours the highest. This is a reversal of the situation immediately after the 1986 tax reform when we had the lowest rate in the OECD. As I describe in my book, the corporate income tax has long been popular politically — since everyone thinks it is paid by someone else — but makes little economic sense other than as a backstop to the individual income tax.

In today’s global economy, appropriately taxing multinational corporations has become extremely difficult. Recent disputes over the Obama administration’s international tax proposals illustrate the difficulties. (Consider, for example, the proposals dealing with cross-crediting of foreign taxes, the treatment of domestic expenditures that help produce foreign income, the treatment of U.S.-owned foreign entities, and transfer pricing, along with the recent trend of countries with foreign tax credit systems to move to dividend exemption systems.) But the problems are even more fundamental. As I have observed elsewhere, the basic building blocks of international taxation — the concepts of residence and source — are now built on quicksand. In today’s economy, both are easily manipulated.

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I have come to believe that, absent broad international agreement and cooperation eliminating tax competition, a low statutory rate is essential. I have therefore urged lowering the corporate rate to 15, or at most 20 percent. With a rate that low, companies would plan to locate income here and their deductions abroad. Transfer pricing decisions would operate in our favor; borrowing, with its attendant interest deductions, would be located abroad. A low corporate tax rate would also benefit purely domestic business and would encourage investments in the United States by foreigners. The costs of a 15 percent corporate rate could be funded by 2 or 3 percentage points of a broad-based VAT, perhaps less if accompanied by corporate base broadening.

For the individual income tax, I have recommended a family exemption of $100,000 (indexed for inflation), and, in the first edition of my book, I suggested a flat 25 percent rate on income above that level. The exemption would remove 150 million Americans from the income tax altogether and create an opportunity for great simplification. Our need for additional revenue, coupled with a desire to increase progressivity at the very top of the income scale, might require a second income tax bracket, perhaps a 35 percent rate for income above some high threshold — say, $500,000 or even $1 million. But with a VAT as part of the tax mix, income tax rates could be much lower than would be possible relying on income taxes alone.11 In essence, my proposal would return the U.S. income tax to its pre-World War II form: a low-rate tax on a relatively thin slice of higher-income Americans.

Interestingly, the individual income tax changes I have proposed have proved the most controversial. Two criticisms have been offered most often. The first is that removing people from the income tax will diminish their connection to their government. The claim is that everyone needs to contribute taxes to

have a stake in government decisions about spending. Back in the day when my father took over our family’s dining room table for a couple of months every year to fill out his tax returns, the connection that income taxes forged between the government and its citizens was palpable. But for most Americans today, filling out their tax returns is simply another commercial exercise, often between them and their paid preparers or by answering a series of questions on their computers. When you ask people how much income tax they paid last year, all too often they answer, “I got a refund of $600,” or something like that. If the amount of VAT is separately stated, like a retail sales tax, at the cash register (and there is no reason it cannot be), then Americans will know how much they are paying the government every time they make a purchase. This objection is unavailing.

The second objection reflects a fundamental policy disagreement between me and my critics. Limiting the income tax to families earning more than $100,000 will transform the politics of tax expenditures. It will move the IRS away from serving as an agency providing benefits and return it to its tax collection mission. The income tax is riddled with incentives for unproductive expenditures. The number and size of tax expenditures have exploded since 1986. Tax expenditures are popular with both Republicans, who rarely see a tax cut they won’t embrace, and Democrats, who view tax exclusions, deductions, and credits as the only way to achieve their domestic policy goals without being tarred as big spenders. Typically, tax expenditures are unfairly distributed, benefiting most those least in need, and are poorly targeted, overly complex, and inadequate to meet their intended goals.

Consider two of the largest tax expenditures: the home mortgage interest deduction and the exclusion from income of employer-provided health insurance. The former distorts investments to benefit housing over other, often more productive, investments and encourages Americans to borrow excessively, putting up their homes as collateral. The latter contributes to making our healthcare costs the highest in the world, leaves millions uninsured, gobbles up the wage increases of workers, and makes American businesses and products less competitive in the world economy.
Or look at the income tax provisions that help finance higher education. There are 13 altogether: two tax credits, three deductions, and three exclusions from income for current-year expenses, and five other provisions to encourage saving for college expenses. Together they represent the greatest increase in federal funding for higher education since the GI Bill. But no one can tell you what they are, how they work, or how they interact. They have no doubt aided tuition increases so we now have higher education expenses growing at a rate exceeded only by healthcare. Planning to pay for college around these tax breaks is essentially impossible for middle-income families.

The largest tax expenditures are directed at the public, not narrow special interests. Very few work well. We have been unsuccessful at repealing these tax expenditures, so the only practical alternative is to repeal the income tax. That is precisely what I recommend for most Americans. Doing so would transform the politics of tax expenditures. Many would simply disappear. Repealing or cutting back on those that remain would become much easier politically. The temptation to enact new ones in the future would greatly diminish. All of these I regard as substantial advantages of my proposal.

A further issue remains. Repealing the income tax for all but higher-income families would eliminate the earned income tax credit, which provides a much-needed wage subsidy to low-income workers, and it would also eliminate refundable child credits for low-income families. In my book I devote a chapter to the question of how to maintain similar benefits and protect low- and moderate-income families from potentially excessive tax burdens under a VAT. Space does not permit me to repeat that analysis here.

Curbing the regressivity of the VAT is actually straightforward — even though many VAT regimes around the world have used poorly targeted and overly expensive exclusions (such as for food) or complex multiple rate structures — options I do not recommend. At the outset, it is important to recognize that the VAT is not nearly as regressive as is often claimed. It is well known that a VAT burdens spending from both current income
and existing wealth, so it is more progressive than a payroll tax.\textsuperscript{12} The elderly would be largely protected from the one-time price increases attributable to a VAT through the indexing of Social Security benefits and government payments for healthcare costs.

Also, the corporate income tax is not nearly as progressive as the official estimates (which tend to allocate its burdens entirely to owners of capital) suggest. In today’s global economy, there is considerable evidence that a substantial share of corporate income taxes is a burden on labor, which is much less mobile than capital.\textsuperscript{13}

Finally, if enacting a VAT enables greater spending than would otherwise be possible, the distribution of the spending must also be taken into account. We should concern ourselves with the overall progressivity of the government’s taxing and spending and not worry excessively about the progressivity of a single aspect of that system. This was, of course, the political genius of Franklin Roosevelt’s decision to fund progressive Social Security benefits with a regressive payroll tax — one of our nation’s most successful public policies.

I propose two ways for offsetting the regressivity of a VAT and delivering benefits that could replace the EITC and refundable child credits: (1) wage increases funded through payroll tax rebates for employees and employers, and (2) a “smart” or “debit” card that could be swiped at the checkout counter to relieve families from paying VAT on a specified amount or purchases.\textsuperscript{14} The information requirements to deliver those benefits will depend on how targeted versus how simple one wants to be.

For example, exempting $10,000 of spending per person with a 10 percent VAT would simply require providing everyone with


\textsuperscript{14}See chapter 10 of 100 Million Unnecessary Returns, supra note 1.
a debit card worth $1,000. Under my plan, including the amount of the debit card in income would be a relatively simple way to claw back its benefits for families with incomes above $100,000. If more targeting was desired, more information would be required about wage or income levels and the number of children. And obviously, if one wanted to replicate the EITC of current law, information similar to that now provided through tax returns might be required. But that is neither necessary nor appropriate. The British have demonstrated that refundable credits can be delivered through increased paychecks without the need for workers to file annual returns, and both the national taxpayer advocate and President Bush’s advisory panel on federal tax reform have urged radical simplification of the EITC.\textsuperscript{15}

The details of regressivity offsets such as these will depend on the VAT base and its rate, along with several other variables, but the essential point is this: Benefits can be provided to low- and moderate-income families, and the regressivity of a VAT can be reduced without either narrowing the VAT base or insisting that annual income tax returns be filed.

Combining a VAT with major reform of corporate and individual income taxes would permit us to achieve whatever revenue and distributional targets our political process determines to be appropriate. Reforming our income taxes does not preclude Congress from dedicating an amount of VAT revenue to funding specific expenditures, such as healthcare. And changes like these can be phased in on a timetable appropriate to our economic circumstances at the time of enactment. In contrast, simply adding a VAT to our existing tax system to address the need for more revenue would waste a once-in-a-lifetime opportunity for real and lasting income tax reform.

The plan I have advocated here (and more fully in my book) could help our economy and sharply reduce the wasteful costs of tax compliance and enforcement by using a well-known and time-tested tax — the VAT — to return the U.S. income tax to its

\textsuperscript{15}\textsuperscript{15}See 100 Million Unnecessary Returns, supra note 1, at 175. For the simplified form recommended by the President’s Advisory Panel on Federal Tax Reform, see id. at 222-223 and Appendix 2.
original function as a tax on higher-income individuals and to
dramatically lower our corporate income tax rate. The time for
tax policy tinkering has passed. We owe it to ourselves and to
future generations to put our fiscal house in order and to do so
fairly, simply, and in a manner most favorable to economic
growth. Our nation’s tax system is badly broken. We need to fix
it and fix it right.