The Case Against VAT

By Douglas Holtz-Eakin

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The VAT has been used around the globe for decades. Its emergence in the U.S. fiscal policy debate is not, however, a tribute to this performance. Rather, it is simply a reflection of the devastating fiscal outlook facing the United States. The federal government ran a deficit of $1.4 trillion in fiscal 2009, about 10 percent of GDP. There is no relief in sight. Over the next 10 years, according to the Congressional Budget Office’s analysis of President Obama’s budget, the deficit will never fall below $700 billion. In 2020 the deficit will be 5.6 percent of GDP, roughly $1.2 trillion, of which over $900 billion will be devoted to servicing debt on previous borrowing.

Importantly, the budget outlook shows revenues that are adequate by historical standards. The CBO projects that over the next decade, the economy will fully recover and tax revenues will be 19.6 percent of GDP — over $300 billion more than the historic norm. The problem is spending. Federal outlays in 2020 are expected to be 25.2 percent of GDP — about $1.2 trillion higher than the 20 percent that has been typical in the post-World War II era. This leads to:

Reason #1 to oppose a VAT: It does nothing to solve the real deficit problem — excessive federal spending.

This fiscal outlook is no surprise. It has been outlined in successive versions of the CBO’s long-term budget outlook. In broad terms, over the next 30 years, the inexorable dynamics of current law will raise federal outlays from about 20 percent of GDP to anywhere from 30 to 40 percent of GDP. That’s well above any reasonable level of federal receipts. All this was well understood years ago. The only news is that the train wreck is worse than some anticipated and will happen sooner than previously thought.

This leads to another insight. It’s true that instituting a VAT in the near term would reduce deficits and could ameliorate any
financial market distress emerging from the budgetary outlook. Unfortunately, any such progress would be quickly undone because of rising federal spending. When that happens, Congress might well be tempted simply to raise the VAT rate. Indeed, the United Kingdom’s recent move to raise its VAT by 2 percentage points suggests behavior of this type. Unfortunately, Greece’s experience indicates that having access to a powerful revenue raiser like the VAT does not insulate a country from financial crisis.

Reason #2 to oppose a VAT: It may undercut incentives to rein in excessive federal spending.

Advocates of a VAT typically acquiesce to higher levels of federal spending rather than make the hard decisions required to rein in spending. There is no more toxic economic potion than the mixture of this acquiescence, the need for balanced budgets, and the adoption of a VAT.

As the preceding discussion highlights, reform of our public finances should begin with federal spending policy. In many cases, however, the discussion ignores the spending context and begins with the virtues of a VAT. Indeed, in principle the VAT has many desirable characteristics. As is well known, like the sales tax, a VAT is a tax on consumption. This places tax burdens on the amount that individuals take out of the economy. In contrast, an income tax places the tax burden on the amount of labor hours, effort, skills, capital, and risk-taking that individuals supply. To my eye at least, the former is ethically superior.

The VAT would be a genuinely broad-based tax, paid by essentially every part of the citizenry. In contrast, the individual income tax has evolved to the point that roughly one-half of taxpayers have no net liability. As is becoming increasingly well appreciated, it is a dangerous dynamic in a democracy to put a majority of voters in the position of being able to vote for benefits financed by a minority. A VAT has advantages from this political-economy perspective.

Also, a VAT (or at least the textbook version of the VAT) taxes all goods and services at the same rate, and hence does not distort decision-making. In contrast, the existing corporation and individual income taxes are rife with phaseouts, carve-outs, and other distortions. The corporation tax is high relative to many of
our competitors’, and the U.S. remains unique in its anticompetitive dedication to taxing the worldwide income of its multinationals. The individual income tax provides subsidies for the excessive consumption of debt-financed housing, gold-plated health insurance, and myriad other activities. Its combination of refundable tax credits and phaseouts imposes strikingly high effective marginal tax rates on working Americans who are not “rich” by any stretch of the imagination. The income tax system in the United States desperately needs fundamental reform.

Of course, a real-world VAT would have to pass through the same congressional taxwriting committees — the House Ways and Means and Senate Finance committees — that have made such a mess of the existing income taxes. One cannot predict the degree to which exclusions, zero rating, or other special features would undercut a VAT’s putative efficiency. But the case could be made that the VAT’s efficiency characteristics would be superior to those of the income tax systems.

But the efficiency effects of a free-standing VAT are quite different from the effects of a VAT that would be added onto the existing tax system. Indeed, because deadweight losses rise non-linearly, the total distortion associated with an add-on VAT would be worse than the sum of the two systems.

Reason #3 to oppose a VAT: It will make the tax system less efficient, damaging economic performance at a time when rapid growth is especially valuable.

The case could be made that replacing the income tax system with a VAT would yield a more efficient way to raise the needed revenue. However, raising revenue efficiently is only one criterion for evaluating the desirability of a tax system. A second important aspect is the fairness with which tax revenues are raised. In this regard, the VAT might well be less desirable than the alternatives.

To see why, note that the base for a consumption-based VAT — the value of sales less the value of purchases from other businesses — includes wage and nonwage compensation to employees. Thus, one could imagine collecting a VAT in two separate filings. Businesses would remit taxes on a base that is the VAT base minus compensation to employees. Individuals would remit a tax — at the same rate — on the value of their
compensation. The revenues, economic incentives, and other fundamental characteristics are unchanged. Only the administration is altered.

Collecting part of the consumption tax from individuals permits three important improvements. The first is that the tax system can be tailored, at least in part, to the economic characteristics of households. For example, one could exempt the first, say, $30,000 of compensation (and thus consumption) from tax and thus improve the progressivity of the consumption tax. Also, one could imagine applying a schedule of graduated rates at the household level to further enhance the progressivity. (Notice that this taxes more heavily those who consume more, which has ethical merit.) That is essentially the “X tax” pioneered by the late David Bradford, a renowned expert on tax policy.¹

Besides improving the ethical foundations of the tax system, a two-part tax would also make easier the problem of taxing the value-added of subfederal governments, not-for-profits, and financial services companies. Although not the subject of this essay, taxing each of these entities poses significant policy challenges for the traditional VAT. Using a household-based collection minimizes these difficulties.

Finally, the two-part consumption tax could be implemented as a reform to the existing individual income and corporation income tax systems. That is, it would not require setting up an entirely new and separate administrative system. Instead it could be the outcome of pro-growth tax reform of our existing tax system.

Reason #4 to oppose a VAT: Even a replacement VAT is less fair than other pro-growth tax reforms.

It is also important to recognize that the VAT would have to coexist with state systems, especially state sales taxes. Because a VAT is conceptually a multistage retail sales tax, it raises tensions in the U.S. federalist system. States view the sales tax as their exclusive domain and will resist the federal intrusion. Moreover,

¹Some advocate a VAT with a rebate to low-income households for the same reasons. But in practice the rebate would be unrelated to actual tax payments, setting up a de facto entitlement subsidy for low-income households. The federal government does not need new entitlement programs.
to the extent they are unsuccessful, their systems will be pushed more toward income taxes that are potentially less efficient.

*Reason #5 to oppose a VAT: It competes with state-level sales taxes and pushes states to use income taxes.*

The final issues revolve around the fact that the VAT is a hidden tax whose cost is embedded in the price of goods and services. (Sales taxes raise the same transparency issues.) This feature, combined with the broad base, leads many commentators to fear the VAT as a money pump for larger government.² In the United States, each percentage point increase in a comprehensive VAT would yield roughly $40 billion to $50 billion annually. What should one think of these concerns?

Some have argued that there are cosmetic measures that counter the hidden nature of the tax, such as ensuring that the full value of the VAT appears on the receipt for every transaction. It is an open question whether this raises sufficient visibility, but it would clearly be a useful step.

That leads to the second point, which is that adoption of a VAT might be a reflection of a desire for bigger government. There is a strong, well-established correlation between having a VAT — or having a larger VAT — and having a larger government.³

Like any correlation, this relationship between the VAT and size of government can have multiple interpretations. Perhaps the countries that adopted a VAT did so to smooth the path to a larger public sector. But it could also be the case that a VAT fueled a growth in government that people otherwise did not anticipate or want.⁴ We simply can’t know which story is true, but one can’t expect those who are concerned about the growth of government to be sanguine about the VAT in light of the historical record.

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⁴Holtz-Eakin and Smith, 2010, find evidence of the VAT causing growth in government.
Reason #6 to oppose a VAT: The devil you know is better than the devil you don’t know. Adopting a VAT exposes the economy to policy risks about the size of government.

At this point in the discussion, I confess some disappointment. Six is not a compelling number of arguments against a VAT. Five has some appeal, as the author can always refer to a “handful” of arguments. Seven is a prime number and, with some stretching, allows the author to reference the seven deadly sins or the movie Seven. Getting Brad Pitt and Morgan Freeman into a tax policy piece is always a coup. But I am left with six.

But weak numeration should not disguise a strong truth: The United States should not have a VAT.