ECONOMIC ANALYSIS

Getting to a VAT

By Martin A. Sullivan — martysullivan@comcast.net

Nobody wants to get a root canal. It is only when we consider the alternatives that we accept our fate. A value added tax is like a root canal for the nation's finances. We should have never let things get so out of hand. But like it or not, we have no other options.

Shortcomings of the Alternatives

Continue the status quo: spiraling government debt. By 2012 the federal debt as a percentage of GDP will be double its 2007 level. Without significant policy changes, debt as a percentage of GDP will reach 90 percent by 2020. Debt at this level will curtail long-term economic growth. Unprecedented in peacetime, it may threaten financial stability. And it leaves little "fiscal space" for fighting future recessions and financial crises. President Obama has asked his deficit reduction panel to reduce the deficit to 3 percent of GDP by 2015. This would stabilize the level of debt. A reasonable "current policy" baseline projects the federal deficit to be 5.9 percent of GDP in 2015. Because of the aging population and rising healthcare costs, deficits are expected to be even larger in later years.

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Spending cuts. To achieve the president's short-term goal by spending cuts alone would require either (1) cutting entitlements (Medicare, Medicaid, and Social Security) by 25 percent; (2) cutting discretionary spending by 40 percent; or (3) cutting all federal government spending by 13 percent. Despite a lot of tough talk, it is inconceivable that any more than a few elected officials would agree to cuts near this order of magnitude.

Individual income/payroll tax increases. The president's goal could be reached by raising income taxes by 30 percent. But the baseline already assumes the top rate increasing to 39.6 percent in 2011. Even if it were deemed desirable, raising taxes on America's wealthiest has limited potential because high-income households are nimble at keeping their taxable income down when rates get high. Frequently discussed proposals to raise the cap on earnings subject to payroll taxes have the same unattractive features as raising income tax rates.

Corporate tax reform. The U.S. corporation tax typically raises revenue equal to between 1 and 2 percent of GDP. To maintain competitiveness, the United States cannot buck the worldwide trend toward lower corporate tax rates. Some revenue can be raised by broadening the tax base. But in the face of mounting pressure to significantly reduce the 35 percent rate, there will be little opportunity to use revenue from base broadening for significant deficit reduction.

Energy tax. Taxes on "externalities" are the most economically beneficial of all taxes because they move business and consumers away from activities that incur costs that markets do not take into account. However, at levels calibrated to appropriately correct market failures, these "corrective" taxes can be only part of the solution to the deficit problem. A 50-cent-per-gallon increase in the gas tax would increase revenue by only about one-third of 1 percentage point of GDP. A carbon tax might raise about two-thirds of 1 percentage point of GDP.

Conclusion. There is nothing wonderful about any new tax — and a VAT is no exception to the rule. The case is made below that a VAT may be the least harmful of several unpleasant options. Opponents of VATs should be taken seriously only if they specify alternative programs for revenue increases or spending cuts.

Pros and Cons of a VAT

Revenue potential. A VAT with a rate of about 7 or 8 percent would raise sufficient revenue to reach the president's goal of reducing the budget deficit to 3 percent of GDP in 2015. A VAT of 4 or 5 percent could replace the revenue currently raised by the corporation tax.

Growth and competitiveness. Because a VAT is a consumption tax, it imposes far less burden on saving and capital formation than an income tax.

Stable source of revenue, part 1. Over the economic cycle, consumption is less volatile than income, so a VAT would provide a more stable source of revenue than the income tax.

Stable source of revenue, part 2. Because a VAT imposes a lower burden on domestic saving and investment than an income tax, it provides less of an incentive for out-migration of capital.

A superior sales tax. In concept, a VAT may be considered roughly equivalent to a sales tax. In practice, VATs have generally proved far superior. They have a broader base (for example, they tax services). And they ultimately only tax final consumption (by providing deductions or credits for intermediate inputs) and thereby avoid cascading double taxation common in state sales taxes.

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Regressivity. Consumption as a percentage of income generally declines as income rises. A tax on consumption would impose a larger tax burden (expressed as a percentage of current income) on the poor than on the rich. And unlike personal income taxes with progressive rate structures, VAT rates do not increase with income.

Money machine. Conservatives often oppose a VAT because it is a ''hidden tax'' that would allow the government to raise enormous amounts of new revenue relatively painlessly.

Addressing Objections

Liberal objections. There are several reasons to believe concerns about the regressivity of a VAT may be overstated:

- Most analysis of the distributional impact of a VAT uses annual income as the measure of economic well-being. But lifetime income is a better measure. When assessed as a percentage of lifetime income, the VAT is measured as generally having an equal (or proportional) impact across income classes.
- Most federal entitlement programs provide proportionately more benefits to low-income than high-income households. If revenues from a VAT are used to increase or maintain entitlement programs, any regressive effect of the tax burden may be offset by progressive spending.
- The VAT is almost universally described as a consumption tax. But to be precise, it is under some conditions equivalent to a consumption tax because the tax benefit of expensing purchases of capital expenditures is roughly equivalent to exempting the return to capital from tax. That equivalence does not hold for profits in excess of a normal rate of return (and it also does not hold for returns to existing capital that was not tax advantaged when purchased). So some returns to capital are in fact subject to tax under a VAT. These features make the tax more progressive than commonly perceived (and, conversely, less favorable to capital formation than commonly perceived).
- The tax itself can be made less regressive by exempting food and other necessities. But this approach complicates it and is not especially effective at alleviating the burden on the poor. The approach preferred by economists is an increase in transfer payments to low-income households concurrent with the imposition of a VAT.

Conservative objections. These are mainly grounded in the argument that the tax is too efficient as a revenue generator — making it too easy for government to increase its size. This is a peculiar argument, as almost everybody seems to agree a tax system should be simple for taxpayers to comply with and help promote economic efficiency. Bad taxes certainly will help keep government small, but this strategy is not consistent with promoting simplification. If there are concerns that government is too large, there are more direct ways of addressing the issue. (Similarly, if we wish to promote fire prevention or fuel efficiency, there are better methods than outlawing stoves.) For example, different categories of government expenditure can simply be capped at any agreed-upon level. If lack of visibility is an issue, there can be a requirement that the tax be separately stated on receipts, signs, and wherever prices are published.

Political Pathway

Moderating the hard line. The biggest impediment to serious consideration of a VAT is the Republican Party's apparent refusal to consider any major tax increases. In recent years, the party's long-standing antitax position has become more strident. The party could become more moderate generally — and less resistant to tax increases in particular — if electoral results in 2010 and 2012 do not meet expectations.

Growing concern with deficits. As the federal debt continues to mount and politicians and the public realize the difficulty of cutting spending sufficiently to get the deficit under control, there will be an increasing willingness to raise taxes. Future financial crises would increase concerns about government debt levels and would likely reduce resistance to major tax increases. The reinstatement of statutory ''pay as you go'' rules will bring home the problem to Congress, which in practice has largely been able to ignore it since the late 1990s.

An Obama second term? Presidential leadership is a must. That is most likely to be forthcoming in the second term of a popular president.

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Business support. The corporate tax rate must be reduced, and the whole structure could use a top-to-bottom overhaul. A reasonable approach to this problem would be to use some revenue from a VAT to eliminate the corporate income tax. Japan — which, like the United States, has enormous government debt, an aging population, and a high corporate tax rate — may adopt this approach soon.

Radical Moderates Needed

While the need may be growing, current political conditions prevent serious consideration of a VAT before 2013 at the earliest. Both tried-and-true liberals and dyed-in-the-wool conservatives hate the idea. And as the U.S. political system has become increasingly polarized, these factions have become more influential. Hopefully, moderating influences will soon prevail and allow our nation's leaders to acknowledge that a VAT may be the most reasonable compromise solution to the nation's ever-deepening fiscal crisis. ■

NEWS ANALYSIS

The President's Tax Returns

By Lee A. Sheppard — lees@tax.org

At a recent question-and-answer session with workers at an advanced battery technology manufacturer in Charlotte, N.C., President Obama was asked whether Americans should be asked to pay more taxes to fund what passes for medical insurance reform. The questioner opined that Americans are ''overtaxed,'' and the president responded with a 17-minute lecture on fiscal and health policy (*The Washington Post*, Apr. 2, 2010).

The short answer is that Americans are hardly overtaxed. They don't even pay for the public services they get, let alone bank bailouts and foreign adventures. The tea partiers don't really want limited government. They just don't understand the composition of government spending, which mostly goes to functions like Medicare that they do not want to cut.

The U.S. government, as economist Paul Krugman is fond of saying, is an insurance company with an army. Medicare, Medicaid, Social Security, interest on the federal debt, and the armed services compose the vast bulk of the budget. The rest of federal spending is relatively inconsequential add-ons, and if they were eliminated tomorrow, the United States would still be in deficit. There's not much for tea partiers to cut.

The tea partiers want to continue the present level of spending on Medicare and Social Security. They supported the unfunded Medicare prescription drug plan. The Tea Party Contract From America calls for limiting tax increases to inflation and population growth and allowing opt-out from Social Security and Medicare taxes. But to the tea partiers' credit, they are opposed to bank bailouts and want to audit the Federal Reserve.

The New York Times polled tea partiers — or at least those disposed to talk to pollsters from the Gray Lady — and found that most of them responded that their tax burden is fair. Tea partiers tend to be older, wealthier, and better educated than the average citizen, the newspaper discovered, and more right-leaning than the average Republican. They generally cherish Medicare and Social Security (*The New York Times*, Apr. 15, 2010, p. A1).

It turns out the president's tax returns are as lengthy as his policy explanations. For 2009 the Obamas paid $1.8 million in regular income tax and self-employment tax on a taxable income of $4.9 million. They reported partial use of their unified credit on generation-skipping transfers made to their daughters. Vice President Joe Biden, who is