



# IS THE U.S. FINALLY READY FOR VALUE ADDED TAX?

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## INTRODUCTION

Has the time come for VAT in the U.S? It is unclear, but one thing is clear. In health care and tax reform, the conditions have never been more appropriate to consider emulating the successful experience of VAT seen in so many other nations. Bi-partisan support for a U.S. VAT system is building in the face of runaway deficits and impending healthcare reform. This whitepaper explores why VAT may soon happen in the U.S.

**This article explores why VAT may soon happen in the U.S. and discusses:**

- Reasons liberals and conservatives have traditionally opposed the idea
- How federal budget deficits are driving the conversation around VAT
- How VAT might impact tax distribution in the U.S.

Bi-partisan support for a U.S. VAT system is building in the face of runaway deficits and impending healthcare reform. Here's why VAT may soon happen here.

Several times in past decades, officials in Washington have considered the creation of a value-added tax system for the United States, but such plans never received enough support. The most serious attempt was in the 1970's, when President Richard Nixon was said to be sympathetic to the idea. But the main champion of the proposal at the time, the chairman of the House Ways and Means Committee, Al Ullman, D-OR, was widely believed to have been defeated in his re-election attempt due to his support for VAT. Since then, support for VAT in the U.S. has been seen as political suicide.

So when news began to circulate earlier this year that the Obama administration is studying the creation of a VAT in the US, many people reacted with skepticism. The idea has strong advocates in economists close to the administration, such as Ezekiel Emanuel, brother of White House chief of staff Rahm Emanuel. But, as the Washington Post noted in its widely noticed article, VAT "is popular with academics but highly controversial with policymakers"<sup>1</sup>.

Liberals and conservatives alike have been traditionally opposed to the idea, but for different reasons. Liberals oppose it because VAT is seen as a regressive tax, disproportionately taxing the poor. Conservatives, on the other hand, dislike VAT because it is seen as a 'money machine' – a system that can raise too much revenue, too easily. Under this point of view, VAT's notorious efficiency is seen as a defect, feared by those who would prefer to limit the size of government.

But now, two factors may be making the prospect of a VAT more appealing than before. One is the dramatically growing federal budget deficit, and the other is the possible passage of health care reform that could expand coverage to millions of uninsured families.

<sup>1</sup>Montgomery, Lori. Once Considered Unthinkable, U.S. Sales Tax Gets Fresh Look, Wash. Post, May 27, 2009.



The federal budget deficit for this year is forecast to exceed \$1.8 trillion dollars, with the federal government borrowing almost half of every dollar it spends<sup>2</sup>. Bruce Bartlett, former Treasury Department economist projects that “spending for Social Security and Medicare alone will require a tax increase equivalent to 81% of individual tax revenue over coming generations”<sup>3</sup>. The magnitude of the fiscal crisis makes the prospect of tax increases a distinct possibility. The question now is simply one of deciding which method is more appropriate to raise the necessary revenue. Compared to other potential revenue sources, a VAT may not be any harder to achieve politically. In fact, because of health care reform, it may be the ideal option.

In a 2009 study published in the *Virginia Tax Review*<sup>4</sup>, economist Leonard Burman, from the Tax Policy Center of the Urban Institute and Brookings Institution, argues that by financing health care reform, the key drawback of VAT, its regressivity, is effectively addressed. As with any form of consumption tax, VAT takes more in percentage terms from poor families than rich ones. However, low-income families constitute the overwhelming majority of the uninsured. Among those that currently have health insurance, the proportion of cost to income is much higher for low to middle-income households than for higher income households. Hence, for lower income groups, a VAT to pay for health care may seem like a reasonable trade-off. In addition, a VAT can be made progressive by exempting essential items, such as food, utilities or other goods and services disproportionately consumed by the poor.

In addition, as economist Bartlett notes, “VAT is probably the ideal tax from a conservative point of view.”<sup>5</sup> A common concern of conservatives is the economic distortion brought about by any tax system. Another common complaint is that a large percentage of households do not pay income tax. According to the Tax Policy Center of the Urban Institute, an estimated 40% of families owe no income tax. Both of these concerns would be addressed by a VAT system: as a consumption tax, it creates less economic distortion than income tax and it forces every consumer, regardless of the income bracket, to finance the federal government expenses.

Some authorities, such as Yale law professor Michael J. Graetz, argue that VAT could actually allow 90% of households to be exempted from income tax altogether, in contrast to the estimated 40% of families that are currently exempt. He argues that a VAT would simplify the tax system, dispensing with millions of tax returns, by returning income tax to its origins as a tax on those with high income only (above \$100,000 for couples, or \$50,000 for singles) by introducing a VAT.

<sup>2</sup> Montgomery, Lori. Idem

<sup>3</sup> Bartlett, Bruce. VAT Time? A money machine that conservatives shouldn't oppose, *Forbes*, June 5, 2009.

<sup>4</sup> Burman, Leonard E., A Blueprint For Tax Reform And Health Reform, *Virginia Tax Review*, Mar. 19, 2009. <http://www.taxpolicycenter.org/publications/url.cfm?ID=1001262>

<sup>5</sup> Bartlett, Bruce. VAT Time? A money machine that conservatives shouldn't oppose, *Forbes*, June 5, 2009.

<sup>6</sup> Graetz, Michael J., 100 Million Unnecessary Returns: A Simple, Fair, And Competitive Tax Plan For The United States (2008), at 201.



But just how much government spending a VAT would be able to fund would depend on the rate of tax. VAT advocate Emanuel estimates that a 15% rate would be needed to finance health care. Burman estimates that a universal health care system and the income tax cuts that would accompany a VAT would require a VAT rate of at least 18%, assuming a very broad tax base and 100% compliance. Such assumptions, however, are unrealistic since a degree of non-compliance must be accounted for and the required tax base would be an estimated 71% of the GDP – well above the average of about 41% for European value-added taxes. Realistically, says Burman, the rate would have to be 25% or more – the same as the highest rates found in the European Union in countries such as Sweden and Denmark.

VAT is already in place in 130 countries. It remains to be seen whether the time has really come for VAT in the United States. But one thing is clear: in health care and tax reform, the conditions have never been more appropriate to consider emulating the successful experience of VAT seen in so many other nations.

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