

# WebMemo



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## Value-Added Tax: No Solution for Health Care or Fiscal Woes

*Curtis S. Dubay*

The value-added tax (VAT) is currently the topic of much conversation in Washington. With growing deficits and mounting government debt, many see it as the only viable alternative to restore fiscal order. It is also an option to fund government-run health care.

Congress should resist calls for a VAT on top of all the taxes Americans already pay. It should instead focus on reducing spending, including fundamental reforms to entitlements like Social Security and Medicare/Medicaid.

**What Is a VAT?** There are many kinds of VATs already in place around the world. The most commonly suggested form is similar to a national sales tax. Consumers would pay it on their purchases at the cash register in the same way they pay a sales tax. Businesses would also pay it.

Under the typical “credit-invoice” approach, a VAT is levied on the “value added” to goods and services as they pass through each stage of the production process. Businesses would collect the VAT on their sales to other businesses. They would then subtract the taxes they previously paid on the goods and services they bought to produce their product as recorded on their purchase invoices. They would then remit the difference to the government.

The credit-invoice VAT gets its name from the fact that businesses receive a credit for the taxes they pay as shown on their invoices. Retailers would remit the VAT collected from consumers purchasing finished products, after subtracting the tax they previously paid.

Another form of the VAT is the “subtraction method,” under which businesses would pay taxes on their annual receipts after subtracting the money they spent to make their product. This is similar to the current corporate income tax, except that businesses can immediately deduct the costs of their investments. But they would not subtract their labor costs such as wages, salary, and benefits.<sup>1</sup> A flat tax is a close cousin to a subtraction-method VAT.

If designed properly, a VAT could have certain *theoretical* advantages over America’s current tax system—but only if it replaced income and payroll taxes. A VAT levied in addition to all the existing taxes would be a huge and harmful tax increase, and it would do nothing to alleviate the damaging economic effects of the current tax code.

**Massive Tax Hike.** If Congress adopts a VAT without abolishing income and payroll taxes, it would amount to a massive tax increase. The total value added for all the goods and services produced by the U.S. economy in 2008 was \$6,300 billion.<sup>2</sup> Therefore, just a 1 percent VAT on all goods and services in the economy would raise \$63 billion for Congress to spend each year.

All current federal taxes raised \$2,524 billion combined in 2008.<sup>3</sup> Each percentage point of a VAT

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214 Massachusetts Avenue, NE  
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(202) 546-4400 • [heritage.org](http://heritage.org)

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would increase this amount by 2.5 percent, increasing each household's annual tax burden by \$534.

Some suggest the VAT rate should be set as high as 20 percent.<sup>4</sup> At that rate, a VAT that covers all goods and services in the economy—including food, clothing, housing, and health care—would collect an additional \$1,260 billion a year and cost every U.S. household \$10,680 annually.

Even if a VAT has a rate of just a few percentage points, it would likely lead to higher rates in the future. As evidence from the 29 Organization for Economic Cooperation and Development (OECD) countries that already have a VAT shows, once it is on the books the rate tends to rise over time.<sup>5</sup>

**Hidden Tax Increase and More Power to Washington.** A VAT piled on top of current income and payroll taxes would suffer from the following additional problems:

*Hidden Tax Increase.* Sound tax policy requires that taxes be transparent to taxpayers. But taxpayers will not see the portion of the VAT paid by businesses unless Congress requires that businesses show the full VAT paid on receipts. Even then, however, taxpayers could be unaware of the total amount they pay because they are unlikely to keep their receipts and add up the total annually.

*Economic Distortion.* Taxes impose a cost on society above their explicit price because they reduce economic efficiency. Economists generally agree that VATs are more efficient than most of the taxes currently imposed on U.S. taxpayers. But that is only if they apply to *all* goods and services in an economy.

Due to political considerations, a VAT in addition to current taxes would likely exempt politically sensitive items like food, clothing, health care, and housing. This would drive the tax rate higher to achieve the same amount of revenue and impose new economic distortions. Industries that get an exemption will be more profitable, compared to taxable industries, than they would have been without the tax. This means more capital will flow to these industries. This will lower economic well-being because capital will not flow to its most efficient market-determined use.

*More Economic Power to Washington.* A VAT not levied on all goods and services would give Congress even more power over the economy. Industries would lobby heavily for exemptions from the VAT for the economic benefits described above. This would give Congress an even larger roll in picking winners and losers in the marketplace. Success would depend less on ingenuity and hard work and more on the ability to gain political favor.

**Bigger Government and VATs.** Opponents of a VAT often point to Europe and their bloated government sectors as evidence that VATs cause government spending to grow. They argue that VATs are hidden and less economically damaging than a corporate income tax, for example. So governments are able to raise more revenue at less political risk with a VAT. But the causal direction is unclear: It is just as likely that European nations chose to spend more and relied on VATs to fund their largess.

If so, then this pattern would parallel the pattern President Obama is seeking to establish in the U.S. now with government spending soaring, greatly

1. Daniel J. Mitchell, "Beware the Value-Added Tax," Heritage Foundation *Backgrounder* No. 1852, May 16, 2005, at <http://www.heritage.org/Research/Taxes/bg1852.cfm>.
2. Bureau of Economic Analysis, "National Income and Product Accounts," table 1.4, May 29, 2009, at <http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=55&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Year&FirstYear=2007&LastYear=2009&3Place=N&Update=Update&JavaBox=no> (June 23, 2009).
3. U.S. Office of Management and Budget, "The President's 2010 Budget: Historical Tables," May 2009, table 1.1, at <http://www.whitehouse.gov/omb/budget/fy2010/assets/hist02z1.xls> (June 23, 2009).
4. Alan J. Auerbach and William G. Gale, "The Economic Crisis and the Fiscal Crisis: 2009 and Beyond: An Update," Brookings Institution, June 2009, p. 3, at [http://www.brookings.edu/~media/Files/rc/papers/2009/06\\_fiscal\\_crisis\\_gale/06\\_fiscal\\_crisis\\_gale.pdf](http://www.brookings.edu/~media/Files/rc/papers/2009/06_fiscal_crisis_gale/06_fiscal_crisis_gale.pdf) (June 24, 2009).
5. See Organization for Economic Cooperation and Development, "VAT/GST Rates in OECD Member Countries," at <http://www.oecd.org/dataoecd/12/13/34674429.xls> (July 9, 2009).

ratcheting up the pressure for tax hikes. Congress and President Obama have recently increased spending by trillions of dollars. First they passed the ineffective stimulus that cost \$787 billion. They then passed an irresponsible budget that increases the debt by \$7,500 billion over 10 years. Now they are working to spend trillions more to fund government-run health care and an even more expensive cap-and-tax environmental regulation regime.

**Cut Spending and Taxes.** Adding a costly VAT on top of all the taxes Americans already pay would be unnecessary and harmful. Instead, President Obama and Congress should:

- Stop expanding existing government programs and creating new ones;
- Abandon their plans for a costly takeover of the health care system;
- Institute a hard spending freeze during this severe recession;

- Fundamentally reform existing entitlements, including Social Security and Medicare/Medicaid, to make them more efficient and affordable;<sup>6</sup> and
- Cut spending on programs that are clearly not working or are subject to rampant waste, fraud, and abuse.<sup>7</sup>

**Tax and Spend.** Raising taxes is the wrong answer to a growing *spending* problem, especially during a recession that is claiming almost half a million jobs each month.<sup>8</sup> And President Obama and Congress have demonstrated what many taxpayers fear: Tax hikes will be used not to solve the existing deficit problem but to pay for expensive new programs.<sup>9</sup>

—Curtis S. Dubay is Senior Analyst in Tax Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

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6. Brian M. Riedl and Alison Acosta Fraser, "How to Reform Entitlement Spending: A Memo to President-elect Obama," Heritage Foundation *Special Report* No. 43, January 13, 2009, at <http://www.heritage.org/Research/Budget/sr0043.cfm>.
  7. Brian M. Riedl, "President's Budget Cuts Should Go Towards Deficit Reduction," Heritage Foundation *WebMemo* No. 2427, May 7, 2009, at <http://www.heritage.org/Research/Budget/wm2427.cfm>.
  8. Rea S. Hederman, Jr., and James Sherk, "Heritage Employment Report: June Job Market Continues Downward Slide," Heritage Foundation *WebMemo* No. 2521, July 2, 2009, at <http://www.heritage.org/Research/Labor/wm2521.cfm>.
  9. Stuart M. Butler, "CBO's Warning on Raising Taxes to Pay for Medicare, Medicaid, and Social Security," Heritage Foundation *Background* No. 2153, June 27, 2008, at <http://www.heritage.org/Research/Budget/bg2153.cfm>.