

The 10 Percent Solution

How progressives can stop worrying and love a value-added tax.

The nation's fiscal situation is bleak. Although current deficits have garnered the most attention, of greater concern is the long-term mismatch between projected revenues and spending—gaps too great to plug with borrowing for fear of triggering a debt crisis. We all agree on the need to restore fiscal balance. But too much of the focus has been on the spending side, from Tea Partiers who rage about the size of government but have difficulty parting with their Social Security and Medicare checks, to more sober

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outlets like the National Academy of Sciences, whose *Choosing the Nation's Fiscal Future* report earlier this year also took an anti-spending tone. The fact is that we need to take a look at the tax side of the ledger as well.

The federal government desperately needs new revenue. To raise revenues, many progressives point to the corporate and individual income tax, urging the closing of loopholes on the corporate side and the raising of top marginal rates on the individual side. I would like nothing better myself. But the prospects for substantial new revenue from these sources are dim. Thirty years of successful conservative attacks have made the idea of raising the individual income tax politically toxic—since, after all, it's imposed most heavily on the most vocal and organized segment of society. Meanwhile, global competition constrains increases in the corporate income tax.

Instead, we need a new source of revenue, one that can finance a robust public sector for the twenty-first century. The place to get it is a carefully designed value-added tax (VAT). Much discussed in academic circles for decades, a VAT is now on the Washington agenda, the subject of many recent Beltway conferences. Most progressives reflexively oppose a VAT as regressive, and to be sure, it can be that. But properly structured, a VAT's regressivity *can* be mitigated. If a VAT is truly under consideration, it is crucial for progressives to engage the debate and bring to the table a VAT designed to achieve not just fiscal balance but progressive goals as well. The plan outlined here would capitalize on the VAT's attractive features—chiefly its ability to raise a significant amount of revenue with relative political and economic ease—while carefully blunting its regressivity. Linked to a set of strong protections for ordinary citizens, a VAT can be a key component of a progressive package benefiting lower- and middle-income Americans.

A VAT works by taxing the “value added” by each business in the chain of production; that is, the difference between the revenues that a business receives from the sale of goods and services it produces and the amount it pays for goods and services. Let's say we have a manufacturer who makes a good and sells it to a wholesaler for \$400 (for our purposes we'll assume the good was made without purchases from another firm). The wholesaler then sells the good to a retailer for \$900, who in turn sells it to a consumer for \$1,000. Under a 10 percent VAT system, the “value added” by the manufacturer is \$400, for a tax of \$40; the value added by the wholesaler is \$500, for a tax of \$50; and the value added by the retailer is \$100, for a tax of \$10. The total tax collected is \$100. Note that this is the same as a 10 percent retail sales tax on a \$1,000 item, but the tax is collected from businesses at each stage of the process. Businesses pass these taxes on to the consumer, who would pay \$1,100 instead of \$1,000, and still pay state and local sales taxes.

More than 145 countries have a VAT, the chief exceptions being the United States and some Persian Gulf and African countries. Economists regard the VAT as a steadier source of revenue than an income tax because consumption constitutes a more stable base than income, which tends to vary greatly from year to year for individuals and particularly for corporations. By taxing consumption, a VAT encourages investment and capital formation, which foster economic growth. In addition, evasion is more difficult and less likely than under an income tax, as each business has a financial interest in ensuring the VAT it pays on purchases is accurately recorded so that it gets credit against its VAT liability. At root, however, what makes a VAT attractive is its ability to raise a substantial amount of revenue with relative ease.

A VAT's regressivity can be mitigated. It is crucial for progressives to engage the debate and capitalize on the VAT's attractive features.

That ease derives from the VAT's design features. Both survey-based and experimental research show that taxes that are imposed a bit at a time rather than as a lump sum are far more popular with the public. Sales taxes, paid in small increments with each purchase without an annual tallying up, are regarded much more favorably than taxes extracted in a lump sum, such as the property tax, or taxes for which the annual total is known, such as the income tax. A VAT shares the advantageous features of the sales tax and is thus a way to fund government in manageable, incremental installments.

For precisely that reason, conservatives are generally wary of the VAT as a tax that is "too good," a "money machine" that would fuel an unchecked expansion of government. According to Curtis Dubay of the Heritage Foundation, a VAT "would forever expand the size of government" and transfer billions "from productive private hands to the wasteful hand of government." Or, referring to the country that first instituted the tax, anti-tax crusader Grover Norquist quipped, "VAT is French for big government." That said, some conservatives have been open to a VAT, although only as a replacement for a portion or all of the individual income tax or corporate taxes. Chris Edwards of the libertarian Cato Institute has said that a VAT is "worth considering," but only as a substitute tax and only if listed separately on sales receipts so as to heighten its visibility and thwart future rate increases.

Among progressives, the revenue-raising promise of the VAT has been overshadowed by aversion toward its regressive nature. A regressive tax is, of course, one that falls more heavily on lower-income households. Progressives

view consumption taxes like the VAT as regressive because individuals and families at the bottom end of the income spectrum tend to spend everything they make, with the accompanying tax taking a greater share of their income than it would for the affluent, who spend only a portion of their income and save the rest. *American Prospect* co-editor Robert Kuttner calls the VAT “especially perverse” since it taxes consumers. In light of recent interest in the VAT, he warns Americans to “keep our hands on our wallets.”

But a VAT need not be regressive. When linked to a set of redistributive programs, a VAT becomes a substantial, steady source of revenue that provides the protections and investments for which Americans yearn. In other words, a properly designed VAT can be a tax program that matches progressives’ ambitions.

Plugging the Shortfall

In recent, non-recession years, federal government spending has been about 20 percent of GDP and receipts around 18 percent, for an annual budget deficit of 2 percent, which is generally regarded as sustainable. That situation is about to change dramatically. By 2035, the Congressional Budget Office (CBO) predicts that primary spending—federal government spending except for interest on the national debt—will reach 24 percent of GDP. The main drivers of increased spending are the three large entitlement programs, Social Security, Medicare, and Medicaid, with the health programs accounting for most of the increase due in part to the aging of the population, but mainly to growth in per capita health-care costs. And revenues will fail to keep up. If we assume that the Bush tax cuts are allowed to expire completely and that more and more households fall under the Alternative Minimum Tax (AMT), revenues would be 23 percent of GDP in 2035. But under the far more realistic assumption that most Bush tax cuts will stay in place, AMT relief continues, and the estate tax is pegged permanently at 2009 levels, then revenue in 2020 and thereafter will be just 19 percent of GDP.

Hence we have a long-term fiscal gap of 5 percent of GDP. Tea Partiers and many conservatives may wish to close this gap solely with spending cuts, but such reductions would have to be truly draconian, and both public opinion research and experience under Democratic and Republican administrations alike show that the public has little stomach for such reductions. For all their small-government talk, federal spending under Republican administrations has been no lower than under Democratic ones, and sometimes higher. The main difference under Republican presidencies has been lower taxes and higher deficits. If we are realistic about the size of government Americans truly desire, and if we wish to end the cycle of inadequate taxation and crippling deficits, it is time to look seriously at new sources of revenue.

To put the United States on a sustainable fiscal course, and to make new investments in much-needed areas, we need perhaps 7 percent of GDP in additional revenues. Part of that amount—2 to 3 percent of GDP—could be realized by increasing the income tax rates for the top two brackets. The rest could be achieved with a VAT. A 10 percent VAT would generate about \$570 billion per year, or 4 percent of GDP. Note that while some conservative VAT proponents wish to substitute the tax for all or part of the individual or corporate income tax system, thereby keeping total revenues steady, the whole purpose of a VAT in this plan is to generate the additional revenues we need to put the nation on a sustainable long-term trajectory.

A Better VAT

For a VAT to be truly progressive, it needs to be designed carefully, with its regressive edges smoothed out. There are four major design features that policy-makers should consider in creating a VAT.

First, a progressive VAT could be designed to soften the blow on spending by the poor. This can be accomplished in several ways: a low or zero rate for necessities, such as food and prescription drugs; a reduction in the taxable amount of the item to a fraction of its actual value; or tax credits to the poor to offset the effect of the VAT. Canada introduced a tax credit with the institution of its good-and-services tax, and Canada and Australia implemented a tax credit for first-time home buyers to offset their VAT. Many countries have lower rates for food, medicines, and electricity and heating. For example, Switzerland has a 7.6 percent VAT rate, but reduced rates of 3.6 percent for lodging and 2.4 percent for food, medicine, newspapers, and water supply. The VAT in the Netherlands is 19 percent, but 6 percent for food and certain services. The British VAT of 17.5 percent is not imposed on food, books, and newspapers. Alternatively, all goods could be subject to taxation, but lower-income persons can be issued a debit card that would exempt certain dollar amounts from the VAT, as Michael Graetz of Columbia Law School has suggested. The “smart card” he proposes would be scanned by retailers and would reduce or eliminate the VAT on specific goods and services or on a portion of the cost. For ease of administration, the exemption amount could be based on the person’s income the previous year. Such cards could be given to the unemployed as well, an immediate form of relief to the individual. The advantage of a debit card or a tax credit offset of the VAT is that tax relief would be targeted to lower-income households, whereas under a system of low or zero rates for necessities, the affluent would not be taxed on those goods as well.

A second idea to mitigate regressivity would be to refund the VAT paid by lower-income households on larger purchases such as appliances and cars. Such

households would submit a form and receipt with their income tax form, much as they currently do with the earned-income tax credit, in order to qualify for a refund of the VAT on a sliding scale, perhaps a 75 percent rebate at the federal poverty level and a 50 percent rebate at 150 percent of the poverty level.

Third, progressivity can be introduced into a VAT system with higher rates on luxury goods such as high-performance autos, yachts, and furs. Finally, a VAT's progressivity can be enhanced by taxing services along with goods. The use of services—from home security to spa treatments—rises with income. Because the United States is now essentially a service economy and will only become more so in the coming years, including services in a VAT also keeps the tax base robust as overall spending shifts from goods to services over time. Most countries with a VAT include services, although some types of services that are difficult to value (such as medical, financial, or insurance services where the monetary value of the service may not be reflected in the amount paid) may be exempted or subject to a special tax.

As economist Henry J. Aaron noted in a Brookings volume on the VAT from 1981—on the agenda then as well—provisions like these that introduce a floor and some progressive elements make it possible to “convert a tax that in its simplest form is proportional with respect to consumption and regressive with respect to income into a tax that is progressive with respect to consumption and proportional or slightly progressive with respect to income.” In short, a tax that progressives could embrace.

What would this progressive VAT system look like in practice? First, let's assume a higher tax rate on luxury goods—say a 10 percent VAT for regular goods and a 15 percent rate on luxury goods. Hence, for a regular \$50 winter coat for her child, a consumer would pay a \$5 tax. But for a \$200 luxury coat, she would pay a \$30 tax. Similarly, a regular \$800 refrigerator would generate a tax of \$80, but a Sub-Zero at \$10,000 would generate a \$1,500 tax. The tax on an ordinary \$20,000 Chevrolet sedan would be \$2,000, while the owner of a new \$60,000 Lexus would pay a \$9,000 tax. Critics might object to the government setting different tax rates for different categories of goods and services, but some states already do just that: In Massachusetts, there is no sales tax on most clothing, but a 6.25 percent tax on the value of items over \$175. Moreover, the higher tax rate on luxury goods generates significantly more revenue than a single rate; our luxury coat, refrigerator, and car generate \$30, \$1,500, and \$9,000 respectively under the two-tier rate structure, but only \$20, \$1,000, and \$6,000 at a uniform 10 percent tax rate.

Or take the idea of giving out refunds to lower-income households. Households at 100 percent of the federal poverty level might get a 75 percent refund on

the refrigerator purchase, for a final tax of \$20, rather than the \$80 that non-poor households pay (and less than the current sales tax rate in most states). Those at 150 percent of the poverty level could get a 50 percent refund, for a tax of \$40. Meanwhile, under a system of debit cards for necessities, a lower-income household would pay no tax on the winter coat, while other households would continue to pay \$5 on the regular coat or \$30 on the luxury version.

We can see how these design features make the VAT-based system progressive by looking at the value-added taxes paid as a percentage of total income under various scenarios. Let's compare two households, one with income of \$22,000, the poverty level for a family of four, and the other with income of \$200,000. If there were only a single VAT rate of 10 percent, and no refund to low-income households, then the \$80 tax on the regular refrigerator would constitute .36 percent of income for the poor household, but just .04 percent for the affluent household. But with a 75 percent VAT refund to the low-income household, the value-added tax paid (now \$20) drops to .09 percent of income. And if the affluent household buys a Sub-Zero instead, the \$1,500 tax would come to .75 percent of its income, yielding a progressive set of outcomes. Even if the affluent household instead chooses a \$2,000 LG that comes under the standard 10 percent VAT rate, the \$200 tax would constitute .10 percent of its income, still slightly higher than what the poor household pays after its refund. Moreover, by taxing services as well, the VAT would become even more progressive. The lower-income household uses only a few services while the affluent household likely pays for many: lawn care, house cleaning, accounting, private-college counseling, among others.

VAT and Spending

Beyond designing the VAT itself to blunt regressivity, the other crucial lever of redistribution is on the spending side. Many observers believe equity is better achieved through spending than taxation to begin with, and certainly the European welfare states have been explicit in coupling regressive value-added tax systems with progressive spending. The poverty rate produced by the market—that is, before taxes and social spending—is about the same in Sweden, France, the UK, and the United States, 27 to 30 percent, according to data from the Organization for Economic Cooperation and Development. But after social spending and taxes—including the VAT—the poverty rate drops to 8 percent in the UK, 7 percent in France, and just 5 percent in Sweden. In the United States, however, it stays at 17 percent. If the United States were to institute a VAT without dedicating the revenues to redistributive spending, then the objections of wary progressives would come to fruition. But coupled in a sustainable

way with a progressive set of programs, the VAT could become a crucial tool for alleviating inequality.

If in state sales taxes we have an existing model for the use of consumption taxes, so too do we have, in another tax, a familiar and popular model for pairing regressive taxation with redistributive benefits to create a net-progressive program: Social Security. Throughout its history, the payroll tax for Social Security has been one of the most popular taxes Americans pay. One reason for the tax's relative popularity is that it is earmarked; taxpayers know where the money is going. Large majorities of Americans—more than 85 percent in a 2009 Rockefeller Foundation poll—tell pollsters that they don't mind paying the tax both because they expect it to benefit themselves some day and because of the security it provides to retired Americans, the disabled, and the children and widowed spouses of deceased workers. No matter what happens with our individual retirement savings, Social Security provides a sure benefit whose value isn't dependent on the ups and downs of the stock market. Another reason the payroll tax has been relatively popular is that it is easy to pay. The tax is withheld from paychecks,

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taken out a bit at a time, making it possible for people living month-to-month to fund their retirement over a lifetime. Third, the payroll tax and the program it funds are universal, spreading the burden widely and giving all regular contributors a stake in the benefits. Universal participation confers legitimacy on the system—no group can be singled out for escaping taxation, as happens with the much-reviled income tax. Everyone has skin in the game because it is an earned benefit that all recipients have helped pay for—even if some pay more modestly than others. A VAT, too, would be paid incrementally and by all, making it financially manageable for households and legitimate in the eyes of the public.

The question is how to bake in progressive spending. Even a progressive VAT would raise the tax burden for middle-income families; the money must be returned to them in forms they would value. Earmarking is one tried and true formula. Before the Obama health-care reform passed, economist Leonard Burman, then of the Urban Institute (now of Syracuse University), sought to capitalize on earmarking's political attractiveness in proposing a VAT dedicated to health care. But I hesitate to earmark quite as narrowly, given the enormous number of societal needs that require more revenues.

One option would be to link the VAT to a broad package of social protections and investments, such as augmenting federal student aid, child-care assistance, unemployment benefits, job training, infrastructure spending, and so on. These are areas where we need investment to increase future productivity (education, infrastructure) or in which large costs tend to fall on households just at the moment they are least able to afford them (child care, unemployment, job training).

Perhaps even better would be to dedicate a portion of federal VAT revenues to aid to states. Even before the current economic downturn, many states had growing needs and looming fiscal shortfalls. The outlook now is far grimmer. The current K-12 funding system is inadequate in many areas already; we can't even think about financing much-discussed reforms like longer school days. State support for higher education has fallen precipitously, as has funding for infrastructure projects. The states will need more money to implement the recent health-care reform, as the new law puts the onus on them to expand their Medicaid and S-CHIP programs (for which federal help declines over time), to enforce many of the new insurance industry regulations, and to run the new health-insurance exchanges from which some individuals and small businesses will buy their insurance. The list of needs is long. Earmarking a portion of new VAT revenue for state aid would not only help pay for these pressing needs (and help offset the value-added taxes that states would now be paying with their purchases), but also might win over governors and other actors who might otherwise oppose a national VAT as interfering with their state sales-tax systems. The layering of one tax system over another is not an insurmountable barrier; other countries have managed to coordinate a new national VAT with existing sub-national sales taxes. But sharing the revenue explicitly might go a long way in developing allies.

Why It's the Right Time for a VAT

VATs have been considered before. During the 1920s, tax economist Thomas S. Adams discussed a VAT as a substitute for the even-then complicated system of corporate taxation. In response to concerns over the inequity and level of the property tax, Richard Nixon floated the idea of a VAT to help fund public schools in the early 1970s. In partial reaction to deep cuts in income taxes proposed by New York Congressman Jack Kemp in 1977 and endorsed by Ronald Reagan, some Democrats cast about for ways to reform the tax system, and House Ways and Means Chairman Al Ullman introduced a bill creating a 10 percent VAT in 1979. His subsequent defeat at the polls in 1980 put a chill on the VAT idea for years. These earlier efforts typically viewed the VAT as an element in a broader reform in which it replaced an existing tax that was viewed as either inadequate in producing revenues or overly complicated.

Introducing a new type of tax to the American people is a big lift politically. It has been done before, under special circumstances. The rarer case is a new tax introduced in response to a social movement railing against income inequality (the income tax, introduced in 1894, was deemed unconstitutional, then enabled by constitutional amendment in 1913). More common has been the introduction of new taxes in the face of war (the income tax became widespread during World War II) or profound economic distress with accompanying new roles for government (the payroll tax for Social Security and many state sales taxes introduced during the Great Depression).

This sense of urgency was missing in earlier considerations of a VAT. But now may be the time. The budget deficit has a new salience. At the same time, the recession has laid bare holes in the safety net and great needs at the state level. Public support for the major entitlement programs continues unabated. To maintain popular programs like Social Security and Medicare without catastrophic benefit cuts, and to put in place other protections for the middle class, we should aim for revenues that are 25 percent of GDP. But our low taxes present a problem: Where will we get the money to fund the protections and fuel the investments Americans need and desire? In a country with astonishing income inequality, where the top 1 percent have become separated from the rest of their fellow Americans, many progressives understandably would like to see multiple income tax brackets aimed at the very top slices of the income distribution, so that a CEO making \$20 million is no longer paying the same marginal tax rate as his dentist who makes \$250,000, a travesty that observers are now fond of pointing out.

But such changes are likely not in the offing. Conservatives have achieved their dream of eroding the income tax both fiscally and politically. Progressives should move to adopt a new tax that will provide the revenues needed to promote their agenda. A properly designed VAT can do just that. **■**