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Addressing the Long-Term Fiscal Imbalance with a Value-Added Tax

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Chairman Kelly, Ranking Member Thompson, and distinguished members of the Tax Subcommittee, thank you for this opportunity to testify on tax policy, economic growth, and prosperity.

I am Alan D. Viard, a Senior Fellow Emeritus at the American Enterprise Institute. I have written extensively on fundamental tax reform options, including the value-added tax. This testimony reflects my personal views and does not reflect the views of the American Enterprise Institute, which does not take institutional positions on any issues.[1]

The United States faces a large long-term fiscal imbalance that will burden future generations and that threatens long-term economic growth. A value-added tax (VAT) is an essential component of a well-designed response to this challenge.

Other policy options, including entitlement benefit cuts and high-income tax increases, could play a role in addressing the fiscal imbalance. However, they have serious limitations that prevent them from providing a full solution. Entitlement benefit cuts would be severely regressive, imposing much heavier burdens (relative to income) on lower-income households than on higher-income households. High-income tax increases would induce economic distortions that would impede long-term growth. Moreover, benefit cuts in the largest entitlement programs would likely face opposition from both major political parties and high-income tax increases would have limited revenue potential.

The United States should follow the lead of 170 other countries and territories by adding a VAT to the federal tax system. The VAT is economically similar, but administratively preferable, to a retail sales tax. The VAT is far less regressive than entitlement benefit cuts, although it cannot match the progressivity of high-income tax increases. The VAT also avoids most of the economic distortions induced by high-income tax increases, although it is not as economically efficient as entitlement benefit cuts. Because it occupies a middle ground between those two alternatives, it offers a plausible basis for bipartisan compromise, particularly once the limitations of the alternative options are understood.

Because the arithmetic of the long-term fiscal imbalance makes it likely that a VAT will eventually be adopted, the real question may simply be when to adopt it. We should act sooner rather than later to limit the debt buildup and ease the fiscal burden on future generations.

I. The Long-Term Fiscal Imbalance

Relentless Debt Buildup

The federal debt held by the public now stands at 98 percent of annual GDP, near the peak value of 106 percent reached in 1946. While the debt incurred during World War II was quickly reduced (relative to GDP) after the war ended, the current debt is on track to relentlessly rise

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[1] Portions of this testimony are drawn from Alan D. Viard, "Rethink Tax Policy to Address the Long-Term Fiscal Imbalance," in *Governing Priorities: Advice for America's President in 2021 and Beyond*, ed. Yuval Levin (American Enterprise Institute, 2020), pp. 59-69.

throughout the upcoming decades.

In its June 2023 long-term budget outlook, the Congressional Budget Office (CBO) projects that, under current policies, the federal debt will soar to 181 percent of annual GDP in 2053. Moreover, with the 2053 deficit projected to be 10 percent of GDP, the debt buildup will continue in subsequent years.

Debt is slated to accumulate as rising health care costs and population aging cause spending on health care programs and Social Security to grow more rapidly than federal revenue. The debt buildup will be even larger if Congress extends part or all the individual income tax cuts scheduled to expire at the end of 2025.[2]

CBO offers a forceful warning about the costs of allowing the impending debt buildup to occur. Higher debt would reduce long-term economic growth by crowding out private investment, and would push up interest payments to foreigners. It would also increase the risk of a crisis in which investors lost confidence in the US government and demanded higher interest rates to hold its debt. Furthermore, higher debt could lead to higher inflation expectations and reduce Congress' and the president's flexibility to respond to unforeseen events.[3]

The VAT is initially unappealing because it raises taxes on the middle class. Unfortunately, there is no viable way to fully address the fiscal imbalance without middle-class tax increases.

Little progress can be made by cutting spending on programs other than Social Security and the major health care entitlement programs (Medicare, Medicaid, and the refundable health insurance premium tax credits). CBO projects that other noninterest spending, which includes national defense, other annually appropriated spending, and the smaller entitlement benefit programs, will shrink from 10.7 percent of GDP in 2023 to 7.5 percent in 2053 under current policies, leaving limited space for additional reductions.[4]

Cuts in Social Security and the major health care entitlement programs and tax increases on high-income households may seem more promising. Although either or both of these options may have some role to play in addressing the fiscal imbalance, they have limitations that preclude them from providing a full solution.

Limitations of Entitlement Benefit Cuts

CBO projects that spending on Social Security and the major health care entitlement programs will surge from 10.9 percent of GDP in 2023 to 14.8 percent in 2053. Restraining this rapid growth seems worthy of consideration. Also, scaling back entitlement programs could reduce economic distortions, such as incentives for early retirement. Also, reducing retirement benefits for current workers could prompt additional saving. Entitlement benefit cuts would therefore likely promote long-term economic growth.

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[2] Congressional Budget Office, "The 2023 Long-Term Budget Outlook," June 2023, pp. 7, 13-23, https://www.cbo.gov/publication/59014.
[3] Ibid., pp. 8–10.
[4] Ibid., p. 7.

However, entitlement benefit cuts would be severely regressive. Because only households with moderate incomes are eligible for Medicaid and health insurance premium tax credits, cuts in those programs would fall exclusively on economically disadvantaged households. Social Security and Medicare benefit cuts might burden all income levels, but lower-income households would bear vastly heavier burdens, relative to income, than higher-income households.[5] For example, a co-author and I found that across-the-board Social Security benefit cuts would impose a burden on households in the bottom 20 percent of the income distribution approximately 100 times larger, as a share of income, than the burdens on households in the top 1 percent.[6] Large entitlement benefit cuts could also impede access to health care and erode other social protections.

Moreover, benefit cuts in the major entitlement programs would face formidable political obstacles. Democrats have long opposed Social Security and Medicare cuts and generally support Social Security benefit increases and expanded health care assistance. Although Republicans have sometimes advocated entitlement cuts in the abstract, they have generally refrained from proposing significant specific cuts. Former president Donald Trump has expressly vowed not to cut Social Security, Medicare, and Medicaid. Well before Trump's presidency, Republicans often resisted entitlement benefit cuts, sometimes even promising to block benefit cuts allegedly supported by Democrats.[7] With each party pledging to prevent the other from cutting entitlement benefits, it seems clear that significant benefit cuts will not be adopted.

Limitations of High-Income Tax Increases

A variety of tax increases on high-income households have been proposed, including increases in top individual income tax rates on ordinary income, dividends, and capital gains, mark-to-market taxation of capital gains, increases in corporate income taxes and estate and gift taxes, and a new annual tax on wealth.

High-income tax increases place fiscal burdens on those with the greatest ability to pay and reduce economic inequality. However, they also induce economic distortions that threaten to impede long-term economic growth.

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[5] Social Security and Medicare means tests that reduce benefits for households with high annual incomes would be less regressive, but such means tests would induce economic distortions by discouraging recipients from increasing their incomes through work and saving. They would also not achieve large budgetary reductions.
[6] Sita N. Slavov and Alan D. Viard, "Taxes, Transfers, Progressivity, and Redistribution: Part 3," *Tax Notes*, November 26, 2018, pp. 1109–21, at p. 1115, https://www.aei.org/articles/taxes-transfers-progressivity-and-redistribution-part-3/.
[7] For example, Mitt Romney's 2012 presidential campaign attacked President Barack Obama for reducing Medicare provider reimbursements, as discussed by Alan D. Viard, "Both Parties Defend Medicare, None the Taxpayer," Real Clear Markets, October 24, 2012, https://www.realclearmarkets.com/articles/2012/10/24/both_parties_defend_medicare_none_the_taxpayer_99951.html. A list of talking points circulated in 2020 by Stephen Miller, then a White House senior adviser, falsely claimed that Joe Biden would "massively cut Medicare and Social Security" if elected president, Michael Scherer and Josh Dawsey, "From 'Sleepy Joe' to a Destroyer of the 'American Way of Life,'" *Washington Post*, July 18, 2020, https://www.washingtonpost.com/politics/from-sleepy-joe-to-the-dystopian-candidate-how-trump-has-recast-his-attacks-on-biden/2020/07/18/5a6a3e36-c830-11ea-b037-f9711f89ee46_story.html.

The individual income tax penalizes saving for future consumption by taxing the returns to such savings. Estate and gift taxes and annual wealth taxes have similar effects. The corporate income tax penalizes businesses that operate in corporate form rather than in non-corporate form and penalizes corporations that finance investment with equity rather than debt. In the global economy, the corporate income tax also penalizes corporations that invest and book profits in the United States and operate with corporate charters issued in the United States.

In any event, high-income tax increases have limited revenue potential. Even commentators who strongly support high-income tax increases have long recognized that they would not raise enough revenue to fully address the fiscal imbalance and therefore would have to be accompanied by other measures.[8]

Turning to the VAT

In this testimony, I do not take a stand on whether high-income tax increases or entitlement benefit cuts should be adopted. Although those policies may play a role in rebalancing federal finances, they cannot provide a full solution.

When advocates of entitlement benefit cuts and advocates of high-income tax increases reach the limits of those approaches, they will be forced to look at other measures. Both groups should embrace the VAT as their second-preferred alternative. The VAT is much less distortionary than high-income tax increases and vastly less regressive than entitlement benefit cuts.

II. The VAT

History

German businessman Wilhelm von Siemens and American economist Thomas S. Adams developed the VAT in the early 20th century. France adopted the first VAT in 1954. Many countries in Europe and Latin America adopted VATs in the 1960s and 1970s, and many other countries followed in subsequent decades. The European Union, the International Monetary Fund, and the World Bank have promoted the VAT.[9]

As of October 1, 2022, the VAT was in place in 174 countries and territories, including every Organisation for Economic Co-operation and Development (OECD) country other than the United States. The 35 OECD VATs had standard tax rates ranging from 5 percent to 27 percent,

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[8] For example, see *New York Times*, "Once and Future Taxes," September 3, 2009, https://www.nytimes.com/2009/09/04/opinion/04fri1.html; *Washington Post*, "Who Pays Taxes," April 10, 2009, and Paul Krugman, "Climate of Change," *New York Times*, February 27, 2009, https://www.nytimes.com/2009/02/27/opinion/27krugman.html.

[9] Kathryn James, "Exploring the Origins and Global Rise of VAT," in *The VAT Reader: What a Federal Consumption Tax Would Mean for America* (Tax Analysts, 2011), pp. 15–22; William Gale, "Raising Revenue with a Progressive Value-Added Tax," in *Tackling the Tax Code: Efficient and Equitable Ways to Raise Revenue*, ed. Jay Shambaugh and Ryan Nunn (Brookings Institution, 2020), pp. 43–88, 53, https://www.brookings.edu/articles/raising-revenue-with-a-progressive-value-added-tax/..

with an unweighted average of 19.2 percent.[10] Most countries with VATs also have individual and corporate income taxes.

William Gale of the Brookings Institution has proposed a 10 percent VAT as part of a comprehensive deficit-reduction plan.[11] Professor Michael Graetz of Columbia Law School has proposed a 10 percent VAT as part of a deficit-neutral tax reform plan.[12]

Multistage Sales Tax

A simple example illustrates the VAT's economic similarity to the retail sales tax, as well as the administrative differences between the two taxes. Consider an economy with three businesses: a manufacturer, a wholesaler, and a retailer. The manufacturer makes no purchases from the other businesses and sells its output for $500 to a wholesaler. The wholesaler sells its output for $800 to a retailer, who sells a final product to consumers for $1,000. Of the $1,000 value of the final product, $500 is added at the manufacturing stage, $300 at the wholesale stage, and $200 at the retail stage.

A retail sales tax would apply to the $1,000 of final sales to consumers, and the retailer would remit the entire tax. At a 10 percent tax rate,[13] the tax would be $100.

Under a 10 percent credit-invoice VAT, the government would collect the same $100, but a portion of the tax would be remitted at each stage of production. The manufacturer would charge the wholesaler $550, the $500 before-tax price plus $50 tax, and remit the $50 to the government. The wholesaler would charge the retailer $880, the $800 before-tax price plus an $80 tax. However, the wholesaler would remit only $30 to the government because it would receive credit for the $50 tax that it was charged on its purchase from the manufacturer (as shown on the purchase invoice). The retailer would charge the consumer $1,100, the $1,000 before-tax price plus $100 tax. However, the retailer would remit only $20 tax to the government because it would receive credit for the $80 tax that it was charged by the wholesaler. In the end, the government would collect $100 of revenue, with the manufacturer remitting $50, the wholesaler $30, and the retailer $20. At each stage of production, tax equal to 10 percent of value added at that stage would be remitted.

Multistage collection would make the VAT easier to enforce than the sales tax, under which the entire revenue would be lost if the retailer evaded tax on the sale. To be sure, the retail sales tax

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[10] Organisation for Economic Co-operation and Development, *Consumption Tax Trends 2022: VAT/GST and Excise, Core Design Features and Trends*, section 2.2 and Annex A, https://www.oecd.org/tax/consumption-tax-trends-19990979.htm.
[11] Gale, "Raising Revenue," and William Gale, *Fiscal Therapy: Curing America's Debt Addiction and Investing in the Future* (Oxford University Press, 2019), pp. 241–253.
[12] For a description and analysis of a recent version of the Graetz plan, see James R. Nunns and Joseph Rosenberg, "An Analysis of the Updated Graetz Proposal to Enact a Broad Reform of the Federal Tax System," Urban-Brookings Tax Policy Center, May 2022, https://www.taxpolicycenter.org/publications/analysis-updated-graetz-proposal-enact-broad-reform-federal-tax-system.
[13] The example assumes a 10 percent tax-exclusive rate for the retail sales tax and VAT. The tax-exclusive rate expresses the $100 tax as a fraction of the $1,000 before-tax sale price. The tax-inclusive rate is 9.09 percent because the $100 tax is 9.09 percent of the $1,100 after-tax sale price. Retail sales tax and VAT rates are usually expressed in tax-exclusive form.

might be administratively preferable at low tax rates (such as current state and local sales tax rates), because it would spare the manufacturer and the wholesaler from the obligation to compute and remit tax. However, the VAT's superior enforcement capacity is needed at higher tax rates, which increase the incentive to evade tax.

Economic Properties

A comprehensive VAT (or retail sales tax) is a tax on all consumption occurring after the tax is introduced. The tax burden ultimately falls on the three sources from which that consumption is financed: wages earned after the tax is introduced, wealth on hand when the tax is introduced, and abnormally high returns on investments made after the tax is introduced. The VAT imposes no tax burden on, and raises no net revenue (in present discounted value) from, normal-return investments made after the tax is introduced, because the revenue collected when the investment payoff is consumed is offset (in present discounted value) by the revenue lost when consumption was reduced to make the investment.

The Federal Reserve should, and almost certainly would, accommodate the tax by increasing the consumer price level to reflect a new VAT (or retail sales tax). If the Federal Reserve did not take that step, nominal wages would need to fall, which might be difficult due to the downward rigidity of nominal wages.[14]

III. A Middle Ground on Efficiency and Distribution

Economic Efficiency

The VAT has strong efficiency advantages over high-income tax increases. Like other consumption taxes, the VAT does not penalize saving. Those who consume today and those who save to consume tomorrow both pay the same tax rate on their consumption when it occurs, with no net tax burden on new normal-return investments. Unlike the corporate income tax, the VAT is neutral between corporate and non-corporate businesses and between debt and equity. The VAT, which applies to consumption of both domestic and imported goods, is also neutral in the global economy. It does not penalize investing or booking profits in the United States or operating with a corporate charter issued in the United States.

To be sure, the VAT is not as economically efficient as entitlement benefit cuts. Notably, a VAT (or a retail sales tax) creates work disincentives similar to those created by income taxes. Nevertheless, the VAT should be an acceptable second choice for supporters of entitlement benefit cuts.

Distribution

The VAT is vastly less regressive than entitlement benefit cuts. In 2012, the Urban-Brookings

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[14] For discussion of the need to increase the consumer price level in response to a VAT or retail sales tax, see Gale, "Raising Revenue," p. 67, and Alan D. Viard, "Tax Increases and the Price Level," *Tax Notes*, January 6, 2014, pp. 115-126.

Tax Policy Center (TPC) estimated that a 5 percent broad-based VAT would reduce after-tax income by 3.9 percent for households in the bottom 20 percent of the income distribution, 3.6 percent for households in the middle 20 percent, and 2.5 percent for households in the top 1 percent.[15] Under the VAT, households in the bottom 20 percent would face a burden, relative to income, somewhat less than double the burden on households in the top 1 percent. In contrast, under entitlement cuts, households in the bottom 20 percent could face a burden, relative to income, 100 times larger than households in the top 1 percent, as discussed above. Although the VAT and entitlement benefit cuts are both regressive, the extent of the regressivity is completely different.

The dramatic distributional difference between a VAT and entitlement benefit cuts is sometimes overlooked due to a puzzling misconception about the distributional assessment of spending cuts. It is well understood that a tax is progressive only if it imposes larger burdens *relative to income* on higher-income households. However, some commentators mistakenly view a spending cut as progressive if it merely imposes larger *dollar* burdens on higher-income households, even if the burdens are a far smaller fraction of those households' incomes.[16] A consistent comparison makes clear that the VAT is far less regressive than entitlement benefit cuts.

It is also important to note that the VAT's regressivity can, and should, be addressed by providing relief to low-income households. TPC estimated that a 7.7 percent VAT accompanied by rebates to low-wage workers and increases in certain benefit payments would raise the same revenue as a 5 percent VAT without those provisions. With the rebates and benefit increases, the VAT would generally be progressive, reducing after-tax income by 0.6 percent for households in the bottom 20 percent of the income distribution, 2.9 percent for those in the middle 20 percent, and 3.6 percent for those in the top 1 percent.

Furthermore, the VAT would be only one component of the federal tax system, which would continue to include the progressive individual and corporate income taxes.

The VAT should therefore be an acceptable second choice for supporters of high-income tax increases.

Middle Ground

When supporters of entitlement benefit cuts seek to avoid economic distortions, they should recognize that the VAT is far less distortionary than high-income tax increases. When supporters of high-income tax increases seek to avoid regressivity, they should recognize that the VAT does not pose the same regressivity challenge as entitlement benefit cuts, particularly if relief is provided to low-income households.

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[15] Eric Toder, Jim Nunns, and Joseph Rosenberg, "Implications of Different Bases for a VAT," Urban-Brookings Tax Policy Center, February 2012, p. 23, https://www.taxpolicycenter.org/publications/implications-different-bases-vat. These estimates overstate the VAT's regressivity because they do not include the burden imposed on wealth held when the VAT is introduced.

[16] For discussion of the inconsistency, see C. Eugene Steuerle, ''Progressivity and Government Downsizing,'' *Tax Notes*, January 15, 1996, pp. 319–320, and Sita N. Slavov and Alan D. Viard, "Taxes, Transfers, Progressivity, and Redistribution: Part 2," *Tax Notes*, September 26, 2016, pp.1879-1889, at p. 1888.

The VAT occupies a middle ground between the approaches to deficit reduction generally preferred by the right and left. As a result, the VAT is well positioned to be part of a bipartisan compromise, which is the only type of legislation that can realistically address the long-term fiscal imbalance.

In isolation, a VAT is clearly unpopular. On April 15, 2010, the Senate voted 85 to 13 to adopt a nonbinding resolution condemning the VAT. History suggests, however, that this resolution offers little guidance about the VAT's ultimate prospects. On July 14, 1981, the Senate voted 98 to 0 to adopt a nonbinding resolution stating that Social Security benefits should not be subject to income taxes. Yet, partial income taxation of benefits was included in the bipartisan Social Security reform package adopted in April 1983, less than two years later. Overwhelming support for symbolic resolutions that condemn measures in isolation need not preclude their subsequent inclusion in a bipartisan compromise.

IV. VAT Design

Any VAT legislation would need to address various design issues. Solutions to the design issues can be found by drawing on the experience of the 170 other jurisdictions that have adopted VATs. I briefly offer recommendations on a few major issues.

Ensure Transparency

In a democratic society, citizens should know what taxes they are paying. To ensure that the VAT is visible to taxpayers, the full tax charged to the consumer should be listed as a separate item on customer receipts, as is normally done for state and local retail sales taxes. The Graetz and Gale plans would require that the VAT be listed on receipts.[17]

Under that arrangement, the VAT would likely be at least as transparent as employee payroll taxes and individual income tax withholding, which are displayed as line items on paycheck stubs. The VAT would be far more transparent than corporate income taxes and employer payroll taxes, which are largely invisible to the general public.

Making the VAT visible to taxpayer would ensure that the tax does not become a "money machine" that the government can surreptitiously hike to finance additional spending. In Canada, where the VAT is listed on customer receipts, the VAT rate has not risen over time.[18]

Provide Relief to Low-Income Households

As discussed above, relief to low-income households is a vital tool to address the VAT's regressivity. Such relief should be included in the VAT legislation. Also, Social Security and other government benefits should be adjusted so that they are not automatically reduced by the

[17] Michael J. Graetz, "The Tax Reform Road Not Taken – Yet," *National Tax Journal*, June 2014, 67 (2), pp. 419-440, at p. 425; Gale, "Raising Revenue," p. 72.
[18] For discussion of the Canadian experience, see Martin Sullivan, "VAT Lessons from Canada," in *The VAT Reader*, pp. 283-290, and Gale, "Raising Revenue," pp. 76-77.

price increase and real wage reduction caused by the VAT. The Graetz and Gale plans include such provisions.[19]

Adopt a Broad Base

The VAT should be applied to a broad tax base that includes as many consumer goods and services as possible. Food, medical care, and housing should be subject to the tax. The low-income relief discussed above, and federal health care programs, are the best way to protect households in need. The Graetz and Gale plans adopt broad tax bases.[20]

VAT should be imposed on wage (and other employee compensation) payments by state, local, and tribal governments, and nonprofit institutions. Without such a measure, goods and services produced in-house by employees of governments and nonprofits would be tax-advantaged, relative to other goods and services, including goods and services purchased by governments and nonprofits from outside suppliers. The Graetz and Gale plans include such a tax.[21]

Offer Exemption for Small Businesses

An optional exemption could be provided to small businesses that wish to avoid the compliance burdens of the VAT. The Graetz and Gale plans include an optional exemption for small businesses.[22]

An exempt business would not remit VAT. However, its business customers would not be able to claim any tax credit on their purchases, which means that VAT payments remitted upstream of the exempt business would not be credited to anyone. Small businesses that are in the middle of the production chain may forego the optional exemption and thereby offer their business customers the opportunity to claim credit for upstream tax remittances.[23]

V. The Way Forward

In view of the size of the long-term fiscal imbalance, it is likely that a VAT will eventually be adopted. The real issue may not be whether to adopt a VAT, but when to do so. Earlier adoption would allow government debt to stabilize at a lower level, which would promote long-term economic growth. Earlier adoption would also reduce the necessary tax rate, as there would be

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[19] Tax Policy Center, "Updated Graetz Proposal," pp. 5-6; Gale, "Raising Revenue," pp. 60-61.
[20] Tax Policy Center, "Updated Graetz Proposal," pp. 10-12; Gale, "Raising Revenue," pp. 54-60.
[21] Tax Policy Center, "Updated Graetz Proposal," pp. 13-14; Gale, "Raising Revenue," p. 58.
[22] Tax Policy Center, "Updated Graetz Proposal," p. 11; Gale, "Raising Revenue," pp. 59-60.
[23] Consider the example in the text above, in which the manufacturer remits $50 tax, the wholesaler remits $30 tax, and the retailer remits $20 tax. If the wholesaler is exempt and remits no tax, the manufacturer still remits $50 tax, but the retailer now remits $100 tax because the retailer cannot claim credit for any VAT payments when purchasing from the wholesaler, which is not in the VAT system. The $50 remitted by the manufacturer is not credited to anyone because the VAT chain is broken at the wholesale stage. The exemption therefore increases the total tax from $100 to $150. If, instead, the wholesaler remains in the VAT system and remits $30 tax, its product is more attractive to the retailer, even if the price rises by $30, because the product carries an $80 tax credit that the retailer may claim.

less debt to service. Earlier enactment would also allow the tax to be phased in gradually, if desired.

To be sure, early adoption of a VAT would diminish the pressure to address the fiscal imbalance through other means. With the VAT in place, there would be less pressure for entitlement benefit cuts and high-income tax increases. Strong supporters of those options may be tempted to delay or head off the VAT to ensure greater use of their preferred approaches. They should recognize the limits of those options, however, and weigh any possible gains against the costs of delay.

When addressing the fiscal imbalance, time is not on our side. To promote long-term economic growth and ease the fiscal burden on future generations, we should adopt a VAT sooner rather than later.