

## **Much to Love, and Hate, in a VAT**

By N. GREGORY MANKIWI

THE policy world is abuzz with talk about whether a value-added tax should be part of the solution to our long-term fiscal problems. Most recently, Paul A. Volcker, head of President Obama's economic advisory board, said a VAT was "not as toxic an idea" as it used to be.

But is it actually a good idea? Regardless of whether your politics lean left or right, the VAT gives you some things to love and some to hate.

Let's start with the basics. Economists define a business's "value added" as the revenue it gets from the sale of goods and services, minus the amount it pays for goods and services. So, for example, if a farmer sells wheat to a miller for \$1, the miller sells flour to a baker for \$2, and the baker sells bread to a customer for \$3, each of the three producers has a value-added of \$1.

(For simplicity, I am assuming that the farmer does not buy anything to grow the wheat.)

Now let's invoke a piece of advanced mathematics:  $\$1 + \$1 + \$1 = \$3$ . That is, the value of the final product — the \$3 bread — is the sum of the value-added along the chain of production.

This leads to the first and most important insight about a value-added tax: It is essentially the same as a retail sales tax. The government could impose, say, a 10 percent retail sales tax, causing the baker to add 30 cents to the price of bread. Or it could impose a 10 percent tax on value-added. In this case, the farmer raises the price of wheat to \$1.10, the miller raises the price of flour to \$2.20 (reflecting both the tax and the higher price of wheat), and the baker raises the price of bread to \$3.30. Either way, the consumer pays 10 percent more for the final product.

Although a value-added tax is just another form of a retail sales tax, a VAT has the advantage of being harder to evade. Tax experts believe that

large retail sales taxes lead to compliance problems, which we can avoid by collecting the same tax along the chain of production.

So that's what a VAT is. What is there to love and hate about it?

For liberals, the main advantage of a VAT is that it would be a source of revenue to fund a robust, compassionate government. Over the past century in the United States, the federal government has expanded the social safety net, including programs like Social Security, Medicare, Medicaid and, most recently, the insurance subsidies in Mr. Obama's health care overhaul. Yet Congress has been more successful promising benefits than finding the revenue to pay for them. A VAT could solve that problem.

Yet liberals balk at the distributional impact of a VAT. The tax has the same effect on rich and poor, as gauged by a proportion of their spending. But because high-income households save a higher fraction of their income, they will pay a lower fraction of their income.

Whether this distribution of the tax burden is fair is open to debate. (What is indisputable is that adding it without subtracting something else would violate Mr. Obama's campaign pledge not to raise taxes on families making less than \$250,000 a year.)

CONSERVATIVES emphasize an altogether different set of concerns. For them, the main disadvantage of a VAT is that it would be a source of revenue to fund a large, intrusive government.

Western Europe is a case in point. Many nations there have large governments financed in part by value-added taxes. Europeans also typically work less than Americans and, as a result, have lower income per person. While sorting out cause-and-effect among these international differences is hard, many conservatives agree with Edward C. Prescott, a Nobel laureate in economics whose research suggests that Europe's lower income is largely attributable to its higher tax rates.

On the other hand, conservatives have long argued that the American tax system is grossly inefficient and impedes the economy's ability to reach

its full potential. They contend that taxing consumption is better than taxing income, and a value-added tax does exactly that.

Moreover, a VAT is the twin of the flat tax that conservatives sometimes advocate. To see why, imagine that we started with a VAT. Then we add a wrinkle: We allow businesses to deduct wages, in addition to the cost of goods and services. We also require households to pay a tax on their wage income.

Other than shifting the responsibility for the tax on wages from the business to the household, it might seem that we haven't done anything significant. Indeed, we haven't. But the new tax system would no longer be a VAT. It would be the flat tax that Robert E. Hall and Alvin Rabushka first proposed back in 1981.

So why, if these two tax systems are really the same, are conservatives attracted to the flat tax and repelled by the VAT? It is because the flat tax is usually proposed as a substitute for our current tax system, whereas the VAT is often suggested as an addition to it.

The bottom line, from both political perspectives, is that a VAT is neither blessed nor evil. It is a tool. We can use it to advance a larger government, a more efficient tax system or some combination of the two.

That will be the key issue in the coming debate.