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Taxing Our Way to Prosperity
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How did the United States go from having the strongest economy in the world to facing the most serious economic crisis since the Great Depression? What happened to an American economy that once was driven primarily by manufacturing companies, agriculture, small business entrepreneurs, and a thriving middle class, but now is dominated by Wall Street investment bankers and financial engineers? A country that once prided herself on her strong manufacturing base producing good-paying jobs for American workers has morphed into an economic system in which American jobs are "outsourced" overseas. Our manufacturing base has been hollowed out, and middle-class Americans are sliding downward economically.

Over the past decade, there has been *zero* private-sector job growth in the United States. The only growth in jobs has been in government (and in sectors—such as health care—in which government is heavily implicated). Government, of course, does not create jobs—if by jobs we mean employment that contributes to the overall production of an economy—only the private sector does that.

Manufacturing was particularly hard hit during the first decade of the twenty-first century. From 2000 through 2010, the United States lost one-third of its manufacturing sector: 5.6 million American jobs were shipped overseas or simply disappeared. As business economist David Hartman has pointed out, from 2000 through 2008 the U.S. manufacturing trade deficit subsequently amounted to $5.4 trillion.

A central reason for the loss of our manufacturing base, a no-growth private sector, and massive trade deficits is a business tax system that is among the most onerous in the world, with its 35 percent income tax rate and its 6.2 percent employer portion of the payroll tax (7.5 percent if you include Medicare taxes). Our current business tax system rewards debt—because interest on debt is deductible—while punitively taxing the engines of economic growth: capital investment, employment, and savings. The result has been predictable: we have been exporting American jobs overseas, and we have been exporting prosperity.

Adding insult to injury, U.S.-based businesses that have most of their plants and employees in the U.S. are (on average) at an 18 percent tax disadvantage to their trade competitors. That helps explain why we are now running trade deficits with more than ninety nations. Virtually every major trading country in the world—except for the United States—provides a tax advantage for its domestic manufacturers. As they have removed tariffs over the past four decades, most nations have put into place a value-added tax (VAT) that provides their companies with a significant economic advantage over foreign businesses. David Hartman has developed startling data on the effects of a border-adjusted VAT. Beginning with France in the mid-1960s, European countries adopted border-adjusted VATs that now average 20.7 percent. All Organisation for Economic Co-Operation and Development (OECD) countries, other than the United States, have since adopted VATs or their equivalents, averaging 18 percent. As a result, U.S. goods for export carry the full burden of U.S. federal, state, and local taxes—plus an added tax averaging 18 percent when they are shipped to foreign markets. Worse still, foreign goods that are imported into the United States enjoy, on average, an 18 percent VAT abatement, and yet are subject to none of the taxes imposed on U.S. manufacturers. Small wonder, then, that from 2004 to 2006, General Electric increased "its manufacturing base outside the U.S. by nearly half." [1]

Below are examples of the competitive tax disadvantage that the U.S. faces with nations that have adopted a border-adjusted VAT:

Country	**Current Rate on Goods**
UK	20%
France	19.6%
Germany	19%
EU 15 Average[2]	20.77%
Canada[3]	5% to 13%
China	17%
Mexico	16%
India	12.5%
Japan[4]	5%

Over time, this tax inequity has turned the trade surplus that America once enjoyed into an abysmal trade deficit—more than $500 billion per year. Lately, all eyes have focused on the federal government's budget deficit, which is certainly a serious concern. But the U.S. trade deficit is arguably a broader measure of the overall performance of the American economy, and it indicates that we Americans now consume too much and produce too little. We are mortgaging our children's futures for the sake of current consumption.

The restructuring of the American economy away from production over the past decade surely is also a major reason for the abject failure of the Obama administration's program of Keynesian stimulus: propping up U.S. "aggregate demand" has little impact on U.S. employment when so much of what Americans consume is produced overseas. Hence, we have our "jobless recovery," even as multinational corporate profits swell.

A promising policy approach to our deep-seated economic problems begins with the recognition that whenever anything is taxed, there will be less of it. And conversely, when taxes on anything are reduced or eliminated, there will be more of it. The quickest way to reduce our unsustainable trade deficits and rebuild our American manufacturing base is therefore to reform our business tax system by replacing the corporate income tax and the employer portion of the payroll tax with an 8 percent, revenue neutral, border-adjusted business consumption tax (a particular form of value-added tax). This proposal was developed by David Hartman and so is known as the Hartman Plan—although a similar plan can also be found in Representative Paul Ryan's (R-Wisconsin) "Roadmap for America's Future." Domestically, the effect on the overall price level would in theory be close to nil—the 8 percent business VAT would raise from businesses the same tax levy currently raised by the business income tax et al. What would change are the tax incentives for business with respect to various components of domestic production. Further, tax incentives with respect to imports and exports would change. All goods and services coming into the U.S. would be taxed at the 8 percent rate, while all U.S.-based companies exporting overseas would receive a corresponding tax credit, or tax abatement, on their business consumption tax.

This change in tax policy would make the U.S. competitive by removing the advantage our trading partners now enjoy as a result of the border-adjusted VAT systems they have put in place to help their domestic companies. This revenue-neutral change would also be much less of a burden on the U.S. economy during a period of higher budget and trade deficits. In the long run, it would bring in more revenue than the taxes it would replace, because the U.S. economy would grow much faster. We would have a tax system that would encourage companies to create jobs in the United States and keep them here, while leveling the playing field with our trading competitors.

The United States' current business tax system also rewards financial engineers for loading up companies with debt and flipping them—because debt is deductible under the current system while capital investment, employment, and savings are punitively taxed. Replacing the current system with a business consumption tax would reverse those incentives, leading to healthier firms, less dependent on debt. In a recent article for *Tax Analysts*, former Reagan economic advisor Bruce Bartlett summarizes the conservative case for a business consumption tax in this way: "The VAT is probably the ideal tax from a conservative point of view. As a broad-based tax on consumption, it creates less economic distortion per dollar of revenue than any other tax—certainly much less than the income tax."[5] With a consumption tax, business leaders make their decisions based on real and undistorted economic opportunities rather than with an eye always fixed on tax implications—in other words, the free market is actually freer, and so, more productive.

One would think that conservative economists and conservative political leaders would be at the forefront of efforts to replace our corporate income tax system with a border-adjusted business consumption tax. Unfortunately, such is not the case. Leading opponents of a VAT include influential voices on the Right such as Larry Kudlow of CNBC and the editors of the *Wall Street Journal*. To understand why this is so, some distinctions must be made. First, there are *conservative objections* and then there are *objections made by conservatives*. Just because a self-identified conservative states an objection to the VAT does not mean that his objection is rooted in conservative principles. There are also *prudential objections* (we might call these *political objections*) and *objections on the merits*. There can be an overlap in these two, but prudential objections are focused on what shape a VAT might take given the tradeoffs that typically occur in the American political process. Keeping in mind these distinctions will be helpful in better understanding both the substance of the objections, and why I believe they ultimately should be rejected.

Most conservatives objecting to a business consumption tax typically do not argue that the VAT is itself at odds with conservative principles. Rather, their arguments against a VAT are arguments against how a value-added tax would likely be implemented. In many cases, these arguments are premised on the idea that the VAT would be a new form of taxation which would be added to all taxes already in existence. But that is not an argument against a VAT; it is an argument against increasing the tax burden. It would apply no less forcefully to a proposal that would increase income taxes, payroll taxes, or corporate taxes without proposing a reduction in other taxes. The key to the success of a business consumption tax's objectives—i.e., getting the private sector working again, rebuilding the U.S. manufacturing base, reducing the trade deficit, and bringing jobs home to America—is to completely replace the current corporate tax system with this new approach to taxation.

This basic error—criticizing ideas that are tangential to the VAT as though it were the VAT itself—is committed repeatedly by critics of the VAT. Writing thirty years ago in the libertarian *Cato Journal*, Charles W. Baird dealt with similar charges: "The nature of the value-added tax and the argument that it is superior to existing taxes stand apart from the danger that the government will merely add it on to present taxes. I don't believe we should refrain from identifying a superior tax plan merely because politicians might treat it as a supplement rather than an alternative."[6]

Douglas Holtz-Eakin is another conservative critic of a VAT. He is president of a newly created think tank called the American Action Forum and was a senior policy adviser to Senator John McCain's presidential campaign. In an article titled "The Case Against VAT," Holtz-Eakin provides six reasons for conservatives to oppose the tax. His number one objection: "It does nothing to solve the real deficit problem—excessive federal spending."[7] Of course, that is a specious argument. True conservatives, who believe in the principles of limited government, understand that federal spending is now out of control and must be reduced if we are to return to balanced budgets, which were the norm in our nation before 1940, other than in times of war and depression.[8] Supporting or opposing a business consumption tax to replace the corporate income tax, however, is an issue separate and apart from the necessity of reining in federal spending.

To be fair, there certainly are many on the Left who support a VAT precisely for the purpose of creating an additional revenue stream that could be used to address federal deficits without having to get federal spending under control.[9] It is primarily with these liberals in mind that Holtz-Eakin raises his first objection. Conservative proponents of the

VAT are in agreement with Holtz-Eakin on the need to reduce federal spending and oppose liberal efforts to implement a VAT in order to keep government spending levels high. But it is still odd for a self-proclaimed conservative to cite the failure of the VAT to reduce spending as an argument to actively oppose the VAT. After all, Holtz-Eakin's explicit opposition to the VAT would seem to imply that there is something intrinsically flawed with such a system of taxation. But there is nothing intrinsic to the VAT that requires higher levels of government spending.

Closely related to the objection that the VAT would distract from the task of cutting spending is the argument that once instituted, the federal government would treat the VAT as an ATM, always at the ready with cash for appropriators looking to fund new programs or expand old ones. We can call this the "feed the beast" argument. Jim Powell, a senior fellow at the Cato Institute, argues that the "VAT puts big spenders on steroids. It generates lots of revenue, and because this tax is substantially hidden from consumers, there's less political resistance to it."[10] In a paper published by the Heritage Foundation, Daniel J. Mitchell wrote that the "VAT triggers more government spending and higher tax burdens."[11] Both scholars cite the experience of Europe as evidence for their position.

Appeals to the anti-European sentiment of some American conservatives is a popular talking point for those opposed to the VAT. A *Wall Street Journal* editorial opposing the VAT was headlined, "The Tax That France Built."1[2] And the Cato Institute's blog, *Cato at Liberty*, warned: "The Value-Added Tax Must Be Stopped—Unless We Want America to Become Greece."[13] According to this argument, once European nations adopted a VAT there were significant increases in government spending as a share of those nations' GDP—increases that far outpaced those of the U.S. during the same period. But the merits of the VAT for the U.S. are no less real simply because many European nations began spending more money at the same time that they implemented the VAT. The fact that European governments are centralized and spend more on government services than we have traditionally done is not an argument for or against the business consumption tax per se.

While these conservative critics point out how European governments have increased spending since the introduction of the VAT, they entirely ignore the trading advantage these same nations have gained over the U.S. during the same period. With its 19 percent tax advantage over us, Germany has maintained a strong manufacturing sector and enjoys a trade surplus—even with very high labor costs—while the U.S. is running massive trade deficits.

Frequently, the "feed the beast" argument includes a claim that the VAT is hidden from consumers and will therefore be easier to raise than other taxes. Since the VAT is applied to the sale of goods at each stage of production, critics argue that consumers are not aware of its overall effect on the final price of goods. Thus, voters are less likely to resist an increase in this tax.

There are two problems with this argument. First, once again, this is an argument about political considerations, not an argument against the merits of a business consumption tax.

And this particular problem can be easily overcome. For example, as mentioned previously, Paul Ryan has proposed replacing the corporate income tax with an 8.5 percent business consumption tax in his "Roadmap for America's Future."[14] In the bill filed by Ryan, this tax rate cannot be raised without the approval of three-fifths of Congress. It is highly unlikely that such a vote would go unnoticed by the American people. Members of Congress opposed to such a tax increase, trade associations representing industries that would be harmed by an increase, and the numerous watchdog organizations that advocate against tax increases would make sure that any vote would receive substantial public attention. Representative Ryan's proposal shows that there is a simple fix to the potential threat of secret tax hikes. Second, arguing against the VAT for being a "hidden" tax ignores the fact that many of our existing taxes are just as hidden. Are most American workers conscious of the effect that the payroll tax has on their take-home income? Are most American consumers aware of how much of the cost for their goods and services is the result of the 35 percent corporate income tax rate and the employer portion of the payroll tax?

Finally, some conservative critics of a border-adjusted business consumption tax argue that an 8 percent tax on all goods and services coming into the U.S. will increase prices for American consumers. Yet what do U.S.-based businesses do now with their existing array of income and payroll taxes? They pass those costs on in the prices charged consumers. That is why C. Larry Pope, chief executive officer of Smithfield Foods, Inc., the largest pork processor and hog producer in the world, advocates tax reform: "I fundamentally don't understand the logic of corporate income taxes. If I have a 35 percent tax, all I do is take that 35 percent tax and I transfer it into the price of bacon and the price of pork chops," said Pope, who has more than thirty years of experience in the industry.[15]

In summary, most of the criticisms of a business consumption tax from the Right are prudential and political; they are not matters of conservative principle. On the whole, the objections are directed at a VAT that would be added to existing taxes, not one used in a revenue-neutral fashion to replace our existing corporate tax system. Of course, if the Hartman Plan works, then the private sector can be expected to grow, which in turn would result in increased government revenues. The choice then would be between reducing budget deficits or increasing spending, but that is an issue separate and apart from the question of the optimal business tax system.

It is true that all taxes, of whatever kind, inhibit private-sector economic growth. Nevertheless, since governments require revenue to operate, some form of taxation is necessary. Thus, the question becomes: which system of taxation is the least harmful to economic growth and job creation? Policies which incentivize consumption while discouraging capital investment, employment, and savings are a recipe for a no-growth economy—which is what we have in America under the existing business tax structure. The prominent investment guru Mark Faber made a similar point recently in an interview in *Barron's*: "The government [has] continuously implemented policies to boost consumption, when everyone should know that an economy will grow in a sustainable way only through the implementation of policies that foster capital formation."[16]

It is particularly noteworthy that many of the conservative critics of a VAT openly admit that, in the abstract at least, a business consumption tax is superior to current methods of taxation. Holtz-Eakin acknowledges that "in principle the VAT has many desirable characteristics." He compares the effects of a business consumption tax to those of the income tax, with the consumption tax coming out on top:

As is well known, like the sales tax, a VAT is a tax on consumption. This places tax burdens on the amount that individuals take out of the economy. In contrast, an income tax places the tax burden on the amount of labor hours, effort, skills, capital, and risk-taking that individuals supply. To my eye at least, *the former is ethically superior*. . . .

Also, a VAT (or at least the textbook version of the VAT) taxes all goods and services at the same rate, and hence does not distort decision-making. In contrast, the existing corporation and individual income taxes are rife with phaseouts, carve-outs, and other distortions. The corporation tax is high relative to many of our competitors', and the U.S. remains unique in its anticompetitive dedication to taxing the worldwide income of its multinationals. . . . The income tax system in the United States desperately needs fundamental reform.[17]

Writing for the Heritage Foundation, Daniel J. Mitchell says that it is true that "taxes on consumption do less damage to the economy than taxes on income and production." But Mitchell waves away this point by claiming it "would be relevant only if policymakers were considering wholesale elimination of income taxes and seeking an alternative source of revenue."[18] Mitchell makes a similar point in a column he wrote for the *New York Post* that was also published on the Cato Institute's website. "The VAT has its virtues: As a single-rate, consumption-based system, much like the flat tax or national sales tax, it would introduce far fewer economic distortions than today's income tax—and a heckuva lot less paperwork. That would be a persuasive argument—if proponents wanted a VAT to replace the Internal Revenue Code."[19] What Mitchell suggests is precisely what is being advocated here. When it comes to tax reform, it would be a tragic mistake for conservatives to allow liberals to shape the rhetorical arguments for such a tax. We must be clear that an American business VAT will be an alternative to the existing tax system, not an addition.

Given our massive budget and trade deficits, the case for a VAT will grow. Because some liberals support a VAT is not a sound reason to be against this approach to taxation as such. Rather, conservatives should see this as an opportunity to gather a consensus behind a long overdue reform of our job-killing corporate tax system. Most Americans are concerned about the loss of good-paying American jobs to other nations and the hollowing out of our manufacturing base. Implemented the right way, the shift to a business consumption tax would be a huge boost to the American economy. A system of taxation which rewards capital investment and savings is just the right medicine for an ailing and stagnant private sector.

Our country needs an economic policy aimed at putting Americans back to work. We need to produce more and consume less. Replacing our onerous corporate tax system with a border adjusted business consumption tax will bring jobs home to America and get our economy moving again. That would be the real "stimulus" program.

Notes

1. **Francesco Guerrera, "GE to Shift Output from US," *Financial Times*, July 27, 2006.**
2. **The EU 15 are the original fifteen nations belonging to the European Union: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.**
3. **Canada's rate varies by province.**
4. **Japan also employs a number of mercantilist policies to give its businesses a competitive advantage. Such measures include strongly encouraging Japanese government and industry to purchase domestically manufactured hardware and software, large subsidies of the IT industry, and regulatory requirements that force foreign firms to turn over propriety information.**
5. **Bruce Bartlett, "The Conservative Case for a VAT," in *The VAT Reader: What a Federal Consumption Tax Would Mean for America* (Falls Church, VA: *Tax Analysts*, 2011), 83.**
6. **Charles W. Baird, "Proportionality, Justice, and the Value-Added Tax," *CATO Journal* 1 (1981): 405.**
7. **Douglas Holtz-Eakin, "The Case Against VAT," in *The VAT Reader*, 96.**
8. **John F. Cogan, "Federal Budget," in *The Concise Encyclopedia of Economics*, ed. David R. Henderson, originally published as *The Fortune Encyclopedia of Economics* (New York: Warner Books, 1993).**
9. **Lori Montgomery, "Once Considered Unthinkable, U.S. Sales Tax Gets Fresh Look: Levy Viewed as Way to Reduce Deficits, Fund Health Reform," *Washington Post*, May 27, 2009.**
10. **Jim Powell, "If VAT Is Rx for Deficits and Debt, Why Are VAT Users on the Brink?" *Investor's Business Daily*, August 31, 2010, http://www.cato.org/pub_display.php?pub_id=12109 (accessed April 26, 2011).**
11. **Daniel J. Mitchell, "Beware the Value-Added Tax," *Heritage Backgrounder*, no. 1852 (2005): 3.**
12. **"The Tax That France Built," *Wall Street Journal*, March 4, 2005, A14.**
13. **Daniel J. Mitchell, "The Value-Added Tax Must Be Stopped—Unless We Want America to Become Greece," *Cato @ Liberty*, February 28, 2011, http://www.cato-at-liberty.org/the-value-added-tax-must-be-stopped-unless-we-want-america-to-become-greece/ (accessed April 26, 2011).**
14. **Paul D. Ryan, "A Roadmap for America's Future," January 2010, 69, http://www.roadmap.republicans.budget.house.gov/UploadedFiles/Roadmap2Final2.pdf (accessed May 3, 2011).**
15. **Mary Kissel, "It's Getting Harder to Bring Home the Bacon," *Wall Street Journal*, April 30, 2011.**
16. **Marc Faber, "Barron's Roundtable," *Barron's*, January 31, 2011.**

17. Holtz-Eakin, "The Case Against VAT," 97–98 (emphasis added).
18. Mitchell, "Beware the Value-Added Tax," 10.
19. Mitchell, "The Value-Added Tax Must Be Stopped."