

VAT Tax?

[Kenneth Anderson](#) • September 2, 2010 11:08 am

Daniel J. Mitchell at the [Cato blog has a new post](#) up, continuing an argument against the imposition of a VAT tax in the United States. His argument in that piece is fundamentally that a VAT tax does not really solve the fiscal problem, but instead merely invites government to grow with the revenue stream, and to leverage the increased revenue stream to increase deficits. He cites new studies suggesting that VAT taxes lead to increased government spending, adds Milton Friedman's remark that government will grow to match the size of the revenues available to it.

I am often struck, however, by how friendly economists, even those worried about deficits, are to a VAT tax. Greg Mankiw, for example, [noted in 2009 that many economists love the VAT](#) on "purely" economic grounds:

From a strictly economic standpoint, a VAT is great. It is essentially a flat consumption tax, like the so-called FairTax, but implemented in a way to reduce compliance problems. Because it is collected in stages along the chain of production, rather than all at the retail level, tax evasion is more difficult.

If you look at the economic effects, a VAT is similar to the Hall-Rabushka Flat Tax, which many economists love. Essentially, the main difference between a VAT and the flat tax as developed by Hall and Rabushka is that firms get to deduct wages as a cost under a flat tax, but then those wages are taxed at the household level. Other than this minor change of shifting the responsibility for the tax on wage income from the firm to the household, the Hall-Rabushka flat tax and VAT have identical economic effects. (There is also an exclusion for the first X thousands of dollars of wage income under Hall-Rabushka, making it progressive in average tax rates, but the same result can be accomplished with a VAT as well by rebating some of the revenue via a demogrant.)

My bottom line: If I could replace our current tax system (including the personal income tax, corporate income tax, payroll tax, and estate tax) with a VAT, I would gladly do it.

The gigantic caveat (as Mankiw emphasizes later) is replacing the *rest* of the tax system with a VAT. Proposals in the real world are about the VAT as a supplemental source of revenue, not a replacement.

The fundamental problem with the VAT is political — or more precisely, a public choice problem rather than a fiscal economics one. The hidden nature of the VAT makes it a politically feasible way to creep up tax revenues, because of the fact of rational political ignorance on the part of voters, and public choice incentives on the part of politicians to increase government and the concomitant revenues to fund it. This is a slightly different point than Mitchell makes in his piece; Mitchell focuses on more revenue streams available eventually equals government to match, as Friedman argued. But the specific argument against the VAT is the politically hidden nature of the tax, because it is

imposed at each stage of value-added, but then is no longer visible to the end user as a tax, but merely as part of the “cost.” If you’re a voter, that should be a bug, not a feature. If you’re a member of the political class, so to speak, it is much more likely to be regarded the other way around.

Since that public choice fact of exploiting rational ignorance is the feature that makes the VAT particularly special among tax mechanisms, however, I am always a little leery of purely technocratic evaluations of the VAT that emphasize that, in a politically purer world than ours, it is the equivalent of a form of flat tax. That equivalence is a great political selling point — but it is not what drives the politicians looking to introduce it in the United States.