IRET Byline

May 3, 1993 No. 118

Financing Government Health Services With A VAT Would Sicken America

On April 14, in a major shift from previous Administration pledges, prominent members of the Clinton Administration began suggesting that a value added tax (VAT) might be just the ticket for funding the health care plan that the task force headed by the President's wife is developing. Donna Shalala, Secretary of Health and Human Services, said "Certainly we're looking at a VAT." Alice Rivlin, deputy director of the Office of Management and Budget, concurred that the Clinton health-care plan would "take some more resources, and a VAT or a general sales tax has a good deal to recommend it." Under pointed questioning, White House communications director George Stephanopoulos admitted that a VAT "is being looked at at some level in the [health-care] task force [headed by Hillary Rodham Clinton]." Contrary to these trial balloons, it is difficult to imagine less appropriate circumstances for introducing a VAT or any other national sales tax.

Three weeks earlier, Mr. Stephanopoulos had categorically said that a VAT "will not be in the [health-care] proposal." And in February, President Clinton had given his assurance that a VAT, if it ever came, would be years down the road.

A VAT is a type of sales tax and can be compared in that respect to a retail sales tax. The difference is that a VAT is collected at every production stage on the value added at that stage. For example, if a firm buys $80 of inputs from other businesses and then uses the inputs to produce an output that it sells for $100, the firm's value added is $20. (Although a VAT is more complicated than a retail sales tax, they have approximately the same cumulative tax base, and much of what is said about a VAT would apply also to a national retail sales tax.)

Even without a VAT, President Clinton's budget plan would increase practically every major category of taxation in sight: higher individual income tax rates, a higher corporate income tax rate, higher estate and gift tax rates, new and higher excise taxes (notably the proposed Btu energy tax), and higher social security taxes. This wave of tax increases would, by itself, significantly raise tax burdens and marginal rates, thereby intensifying the tax distortions that hobble the economy's performance.

Even without a VAT, President Clinton's budget plan would increase practically every major category of taxation in sight ... Adding a VAT (or other national sales tax) to this brew would greatly worsen the strains.

Adding a VAT (or other national sales tax) to this brew would greatly worsen the strains. If the Clinton health plan were adopted and mostly funded with a VAT, the new tax would immediately increase people's tax liabilities by $30 to $90 billion annually (depending on the spending plan's price tag.)

A federal VAT would also impose on the American public billions of dollars of annual paperwork costs on top of the tax system's already massive administrative costs. Elevating the paperwork costs further, it is likely that in reaction to political pressures and Washington's penchant for micromanagement, any U.S. VAT now enacted would have multiple rates and numerous exceptions. (A guide here may be the Btu tax, which was complex

Institute for Research on the Economics of Taxation

IRET is a non-profit, tax exempt 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote economic growth and efficient operation of the free market economy.

1331 Pennsylvania Ave., N.W., Suite 515, Washington, D.C. 20004 Phone: (202) 347-9570

initially and has since gotten more convoluted.) In contrast, a lesson gleaned from experiences in countries with VATs is that the best way to hold down a VAT's administrative costs and avoid creating more confusion than necessary is to keep a VAT simple: one uniform rate and a relatively broad base not sprinkled with arcane exceptions.

Another severe disadvantage of a multiple rate VAT festooned with special cases is that it would generate significant tax biases among various goods and services. This would hurt the economy because, with differential tax rates pushing people towards some products and away from others, people would make many inefficient and wasteful decisions as both producers and consumers.

Because a national VAT or other sales tax would have an enormous tax base, it could finance the huge new program the Administration is likely to propose at a seemingly low tax rate, probably somewhere between 3 and 7 percent. No one should be lulled into believing that it would be a small tax, however. And given the usual political practice of introducing a tax at a low rate to assuage public opposition and then jacking up the rate shortly thereafter, no one should imagine that the tax rate would stay "low" for long. Each percentage point by which the rate was increased would bring a flood of new money into Washington at the expense of the private sector. Many countries with VATs have raised the rates over time. VAT rates of 15% to over 20% are common in Europe. A VAT at those rates would rival in size the payroll tax or the personal income tax.

It is sometimes claimed incorrectly that a VAT would bolster saving. The germ of truth is that a VAT would not be as hostile to saving and investment as is the current income tax. The income tax has multiple biases against saving whereas a VAT would be neutral between saving and consumption. But that hardly means a VAT would encourage people to save more. On the contrary, an add-on VAT would deter people from working as much because the people would keep fewer after-tax rewards. With less production, both saving and consumption would decline relative to what they would be otherwise. To be sure, replacing an income tax with a VAT would induce people to save more – because the ***substitution*** would soften the net bias against saving, not because a VAT in itself would be good for saving. The Administration, of course, is talking of increasing all taxes, not exchanging one for another.

Another claim is that a U.S. VAT would improve the competitiveness of domestic producers relative to foreign rivals. A country with a VAT normally imposes an equivalent tax on imports and rebates the VAT on exports. Thus, goods and services sold in the U.S. would incorporate the VAT, whether produced domestically or abroad, and products exported from the U.S. would not carry the VAT with them into foreign markets. This would not aid domestic production, however, but merely force both domestic and foreign producers to carry the same added tax costs on their sales in the U.S. The added burden would discourage domestic production, as well as imports. If a VAT were substituted for another tax, the differential effect might indeed improve U.S. competitiveness, depending on the tax being replaced, but substituting one tax for another is hardly what the Clinton Administration has in mind. To be sure, a U.S. VAT might spur exports as businesses escaped the U.S. VAT by diverting products out of the U.S. and into foreign markets. But there would be a downside: the very real cost to U.S. consumers as products sold in the U.S. became fewer and more expensive.

If the Administration were willing to expose its claims about health care to greater scrutiny, it would propose an initial plan with ***no*** tax or spending increases. Supposedly, a prime reason for involving the government more deeply in the health-care system is to cut health care costs. However, this result would be directly contrary to most experiences with government programs. If the Administration believes what it says, it should begin with a plan that contains only those features it has identified as lowering costs without unduly compromising quality. Its insistence on a more sweeping plan suggests the Administration wants a national health system for other reasons and is skeptical enough about the supposed savings that it would prefer not to subject them to an explicit test.

If an expensive health care plan were funded with a VAT, it would divert from the rest of the economy resources that people would not otherwise choose to spend on health care. Washington officials and bureaucrats, in other words, would compel people to spend more for health services and less for everything else than the people would choose voluntarily. Beyond the resources directly taken from the rest of the economy to finance the government program, people would also pay through an across-the-board reduction in output and employment. A VAT is a tax on the creation of value, and when something is taxed more, less is produced.

It is understandable that people reacted angrily to the VAT proposal, causing a quick White House retreat. As taxpayers were struggling with last minute income tax filings and talk of myriad increases in existing taxes, what they wanted was tax relief, not an enormous new tax. Nevertheless, the Clinton Administration will find a VAT very alluring for several reasons and may return to the idea if the political heat abates. First, the Administration favors a hugely expansive health-care program and is in a bind about how to pay for it. Second, the Administration has promised to reduce the deficit, but its numbers are suspect because it failed to make solid cuts in any major spending category besides national defense and has overestimated how much its tax hikes will collect by assuming they will not weaken the economy. When deficit projections are raised in subsequent years, a VAT on tap would be awfully handy for the Administration and Congress. Third, the Administration has a long wish list of new, expensive government programs. A VAT could be the piggy-bank for financing them. It is suggestive in this regard that over the past 25 years government spending has increased much more rapidly in Europe, where most countries have VATs, than in the U.S.

The VAT proposal floated by the Clinton Administration would subject the American people to a large, immediate increase in their tax burdens and the economic distortions caused by higher taxes. To protect people from this, a national VAT (or any other major new tax) cannot be an ***additional tax*** but must be a ***replacement levy*** offset by sharp cutbacks in some existing taxes or their outright elimination. And to guard Americans from runaway increases in their tax burdens later, a national VAT (or similar tax) must not be adopted unless accompanied by a ***basic constitutional safeguard***: a constitutional amendment stipulating that any subsequent legislation to raise taxes would require supermajority approval in each House of Congress. Given the proclivity of elected officials to raise taxes and the ease with which they can get around any barrier short of a constitutional amendment (Washington officials have punched repeated holes, for example, in the supposedly airtight spending limits in the 1990 budget deal), nothing weaker will do.

Michael A. Schuyler
Senior Economist
