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The Political Pathway: When Will the U.S. Adopt a VAT?

By Reuven S. Avi-Yonah

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“Those who fear a VAT have little reason to worry — the votes aren’t there.” — Peter Orszag, speaking as director of the White House Office of Management and Budget, 2010¹

“There’s no way that a GST will ever be part of our policy. Never ever.” — John Howard, speaking as prime minister of Australia, 1996²

At the moment, as indicated by the quote from former OMB Director Peter Orszag, the political prospects for a VAT seem dim. After all, on April 15 the Senate passed by a 83-15 vote an amendment offered by Sen. John McCain, R-Ariz., stating, “It is the sense of the Senate that the Value Added Tax is a massive tax increase that will cripple families on fixed income and only further push back America’s economic recovery, and the Senate opposes a Value Added Tax.”³

And yet the very passage of that resolution indicates that the VAT is a live political option. Politicians don’t waste their time voting against unnecessary, dead-on-arrival policies.

The reason the VAT is on the table is also stated in the referenced article by Orszag: “Although hardly anyone wants to admit it, we’re not going to solve our budget deficit unless revenue is part of the equation.”⁴ And while in the short term it may be possible to address the deficit by raising income tax rates (Orszag suggests letting all the Bush tax cuts expire in 2013), in the long term it doesn’t seem plausible that we can raise

¹Peter Orszag, “One Nation, Two Deficits,” *The New York Times*, Sept. 6, 2010.

²Wayne Errington and Peter Van Onselen, *John Winston Howard* 219 (2007).

³156 *Congressional Record* S2351 (Apr. 15, 2010).

⁴Orszag, *Id.*

sufficient revenue that way to pay for Medicare, Medicaid, Social Security, interest on the national debt, and defense and some discretionary (but politically popular) spending. In fact, sometime around 2042, spending on the entitlement programs alone is projected to consume all federal revenues, leaving nothing for any other purposes.⁵

Nor do I believe it is politically possible to rein in the growth of the entitlement programs sufficiently to dispense with the need for a VAT. The best chance to do that was healthcare reform, but it was missed because the reform did nothing to address the core incentives of both patients and doctors to order more procedures, since the doctors are still paid by procedure and the patients do not bear anything like the full cost.

It seems to me that the question isn't whether the United States will adopt a VAT, but when and under what circumstances. There are two likely scenarios to consider.

The High Road: Presidential Leadership

The commonly told story about VAT is that every government that adopts it gets booted out of office in the next election — although the winners in the subsequent elections never repeal it. The most infamous instance is Canada, where Brian Mulroney's conservatives went down from a governing majority to two seats in Parliament. (The Conservative Party is back in power now, but that's no consolation to the politicians who lost their jobs a generation ago.)

But it doesn't have to be this way. Mulroney mismanaged the introduction of the VAT and had to appoint extra senators to get it through the legislature.⁶ A much better example is John Howard in Australia. After famously making his "never ever" statement, Howard campaigned on the need for VAT in 1998,

⁵Reuven S. Avi-Yonah, "Designing a Federal VAT: Summary and Conclusions," 63 *Tax Law Review* 285 (2010); Rudolph G. Penner, "Do We Need a VAT to Solve Our Long-Run Budget Problems?" 63 *Tax Law Review* 301 (2010); Alan J. Auerbach and William G. Gale, "Déjà vu All Over Again: On the Dismal Prospects for the Federal Budget," 63 *Nat'l Tax J.* 543 (2010).

⁶Richard Eccleston, *Taxing Reforms: The Politics of the Consumption Tax in Japan, the United States, Canada and Australia* 104-106 (2007); Neil Brooks, *The Canadian Goods and Services Tax: History, Policy, and Politics* (1992).

won narrowly, and was able to get the reform enacted by forging an unusual coalition of labor groups (concerned about cuts in welfare spending) and business groups (concerned about competitiveness). He was then reelected twice.

Can that happen here in America? It is hard to imagine President Obama, or any future U.S. presidential candidate, running for office on a platform that includes raising taxes. But suppose Obama was reelected in 2012. At that point, he could spend his new political capital on getting a VAT enacted without fear of having to run again.

The task would require leadership and skill in forging coalitions. Progressives would need to be persuaded that using a regressive tax to fund redistributive programs like Medicare, Medicaid, and Social Security is not a betrayal of their ideals. Rebating revenues to the poor will help. Conservatives would have to be persuaded that adopting a VAT will increase America's competitiveness, which can be achieved if the VAT revenue is used in part to cut other taxes (such as the corporate income tax). The states would have to be persuaded that a federal consumption tax will not cut into their revenue base. Perhaps some portion of federal VAT revenue must be allocated to the states.⁷

The task would be difficult, but not inconceivable. Nor would it be harder than, for example, passing healthcare reform.

The Low Road: Response to a Crisis

The more plausible option is a crisis. In 2012 the Treasury Department will need to sell 30-year bonds maturing in 2042. Yet by 2042, Medicare, Medicaid, and Social Security will consume all federal revenues, leaving nothing to pay the investors.

At some point — not necessarily in 2012, but certainly in this decade — I believe those investors may balk. Then, interest rates will go up, the dollar will go down (because investors fear the

⁷This was the solution in Australia. In Canada the provinces had the option to harmonize their retail sales taxes with the federal VAT, but few did so until recently. Nevertheless, the Canadian example proves that a federal VAT can coexist with states' retail sales taxes. See Avi-Yonah, *supra*.

Federal Reserve System will just print money to pay the high interest costs), and the U.S. will face a Greek- or Argentinean-style fiscal crisis.

At that point, Democrats and Republicans will unite in passing the VAT, just like they united to pass the equally unpopular bank bailout in 2008. There will be no more palatable choice, because it will be harder to sufficiently raise the income tax (which the Republicans will block) or cut entitlements (which is anathema to the Democrats).

The problem with this “crisis” scenario is that there will be no time to plan intelligently, and things will get messy. That is why Professor Charles McLure and I in 2009 organized the American Tax Policy Institute’s conference “Structuring a Federal VAT.” The idea was to bring the best expertise in ahead of time so that when the crisis hits, a blueprint will already be in place.⁸ This volume from Tax Analysts is another contribution to that effort.

Personally, I don’t like this crisis option and hope it won’t happen. But regardless of whether we take the high road or the low road, it is hard to see how the U.S. can avoid joining the other OECD countries — and almost every other country in the world — in adopting a VAT. The question is no longer whether, but when and how. ■

⁸See the papers from the conference in the *Tax Law Review* (2010).