DO WE NEED A VALUE-ADDED TAX TO SOLVE OUR LONG-RUN BUDGET PROBLEMS?

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Most people have heard that the United States faces a severe long-run budget problem. It is often called an "entitlement problem," but that is misleading. On the spending side, only three programs are to blame: Social Security, Medicare, and Medicaid. Before the recent run-up of spending related to the recession and stimulus program, the three constituted almost half of noninterest spending, and all three are growing faster than tax revenues. They are growing rapidly because a large portion of their benefits is devoted to the elderly and the elderly population is growing rapidly as a result of the aging of the baby boom and growing life expectancy. Baby boomers started receiving Social Security in 2008 and the first one will apply for Medicare in 2011.

In addition to serving a growing elderly clientele, Medicare and Medicaid face soaring health costs per beneficiary. Historically, per capita health costs have grown by somewhat more than 2 percent per year faster than incomes per capita. Over the long run, excess health cost growth presents more of a budget problem than the aging of the population, but there is an important aspect of aging that is not much discussed. The average age of the population is growing both because there are more old people *and* because there are relatively fewer young people. The baby boomers did not produce enough little potential taxpayers to support them well in their old age. If baby boomers had had as many children as their parents, tax revenues would be growing more rapidly and the long-run budget problem would be much less serious.

Given that the three large programs are growing considerably faster than tax revenues, the arithmetic of the long-run problem becomes pretty obvious. If the total tax burden remains constant at its 50-year average of slightly more than 18 percent of GDP and if we devote the same fraction of GDP to defense, nondefense spending, and other entitlements and if Social Security, Medicare and Medicaid are not reformed, deficits are bound to soar. Eventually, they explode because the national debt begins to rise so rapidly that the interest bill on that debt starts to dominate total spending. We begin to borrow to pay interest and we'll end up borrowing to pay interest on the interest. At that point, total spending, the deficit and the national debt begin to go straight up (Congressional Budget Office 2007).

Analysts make such long-run projections to show that they cannot happen. Obviously, foreign and domestic public and private investors will stop buying our debt long before deficits explode. Therefore, something has to give—hopefully before there is a crisis in international capital markets. The three rapidly growing programs must be reformed; all other activities of government must be cut to the bone; or tax burdens must rise.

Before the 2008–09 recession, the situation was already serious, but it seemed that we had a good amount of time to deal with it. Official projections then showed that spending growth would begin to accelerate toward the end of the next decade as more and more baby boomers entered Social Security and Medicare and that we would enter this difficult period with deficits around 3 percent of GDP and a debt to GDP ratio of about 40 percent. However, the recession has depressed tax revenues greatly and increased spending on safety net programs. The stimulus program passed in early 2009 cut tax burdens further and has added mightily to spending. The Congressional Budget Office (2009) has estimated that if President Obama's budget for 2010 is implemented in every detail, the deficit will be close to 6 percent of GDP by 2019 and the debt to GDP ratio will then exceed 80 percent. The long-run budget problem has become very much more urgent in a very short amount of time.

As one contemplates solutions to the problem, I believe that it becomes very clear, very fast that it cannot be entirely solved on either the tax or spending side of the budget. If one wanted to balance the budget without any increase in tax burdens, there would have to be draconian cuts in Social Security, Medicare and other programs. The required cuts are totally implausible politically. Balancing the budget solely by raising taxes is not only politically implausible, it is also theoretically impossible. As long as we let health costs rise faster than income, tax rates would have to be raised every year to restrain the deficit and taxes would eventually absorb 100 percent of the GDP.

But saying that the problem cannot be entirely solved on either the tax or spending side of the budget leaves wide latitude for an intense political battle over how much spending should be cut or taxes increased. And on both the spending and tax side of the budget, there will be an equally furious battle regarding the composition of required tax increases and spending cuts.

To the extent that taxes are raised, the options can be put in three categories. Tax rates can be raised within the current system; a fundamental tax reform might be used to broaden the tax base and lower rates some while still raising additional revenues; or we can impose a brand new tax such as a value-added tax (VAT).

Economists would complain that simply raising tax rates would have a highly negative effect on economic efficiency. The negative effects would be particularly serious if corporate and personal income tax rates were raised. Both tax systems are extremely complex and severely distort economic decisions. Besides, our marginal corporate rate is already one of the highest in the developed world. But economists only rarely have a significant impact on tax policy.

It is also true that rate increases are unlikely to get the enthusiastic political support of ordinary voters, even if those rate increases are confined to those who are very rich. First, it is important to note that there is no way the long run budget problem can be solved solely by taxing the rich although it is not clear that the public knows that. The Obama administration's proposed income tax increases on those with incomes over $250,000 will raise only $56 billion in 2013 or about 0.3 percent of GDP. Moreover, the public is highly ambivalent toward the rich. They admire those who gained wealth through hard work, but think less of those with inherited wealth. (This seems to be inconsistent with generalized opposition to the estate tax, but that is based more on the notion that it is unfair to tax income twice.[1]) At the same time, the public is ambivalent toward those who succeeded because they made good choices like choosing to be educated in a lucrative field (Konow 2003), and they think that those who are rich because of special talents, like sports stars and entertainers, are overpaid (Ladd and Bowman 1998). They also think that Congressmen are overpaid, although they probably

[1] Slemrod (2006) cites a survey indicating that 82 percent of respondents favor eliminating the tax, but estimates that the number is inflated by 10 percent by a belief that most people pay the tax. However, a significant majority would still oppose the tax even in the absence of this misconception

do not believe that they have special talents. It would not be easy to design a tax system that satisfied these conflicting views.

When asked by a March 2007 Harris interactive poll, “If taxes had to be raised to increase revenue, how would you feel about raising the following types of federal taxes?”, 70 percent responded that sin taxes like those on tobacco and alcohol definitely or probably should be raised while 83 percent said that income taxes definitely or probably should not be raised.[2] Generally speaking, respondents to various polls declare that sales taxes are fairer than income taxes (Bowman 2009). I speculate that people reach this conclusion, because average income tax rates vary so widely within any income group and that is partly because of the proliferation of tax expenditures. For example, in 1999, there were roughly 20 million households in the third quintile, paying an average tax burden of $1,780, yet 4.6 million in the quintile paid more than $3,000 or almost 70 percent more than average while the top income in the quintile was only about 40 percent above the average. Fully 5.6 million in the fourth quintile paid less than $3,000. Over 3 million in the fourth quintile paid more than $7,500 while 4 million in the fifth quintile paid less (Joint Economic Committee 2003). Everyone seems to have an uncle or cousin that made more income but paid less in taxes than they did.

Would a tax reform that was perceived to make the income tax fairer make income tax revenue increases more acceptable? It would seem to be a propitious time for reform given that we should be providing permanent fixes for the alternative minimum tax and the estate tax, and deciding how to deal with the Bush income tax cuts. But there seems to be little interest in reform either in the Congress or in the Obama administration,

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[2] Unless otherwise stated, the polls cited in this paper are from a collection of polls on tax policy compiled by Bowman (2009).

even if the reform was to be revenue neutral. Passing a tax reform that actually raised revenue seems beyond the realm of political plausibility.

All this points to the likelihood that a new tax, such as a value-added tax, will be seriously considered when we finally admit to the need for new revenues. Such an admission seems more likely if we are confronted by a crisis in the market for our debt. Such a crisis makes it more likely that a higher portion of the budget problem will be satisfied by raising revenues as opposed to cutting back the growth in Social Security, Medicare, and Medicaid spending. The problem with the latter is that the retired population, especially the portion that is less affluent, heavily relies on these three programs. It is very difficult to cut them back abruptly and international capital markets may not have confidence that the United States would go through with restraints that are phased in over a long time period. Even though there are many design challenges, a new tax can be put in fairly quickly.

I certainly do not want to claim that a new VAT would be popular. In fact, it was highly unpopular when first introduced in Europe, Japan and in Canada. Countries have tended to introduce it as a last resort when faced with intense budget pressures. Western European countries have also tended to levy high tax rates on goods whose demand is relatively insensitive to price—very high sin taxes on alcohol and tobacco and very high gasoline taxes. Economists agree that that is a way to raise revenues very efficiently. Lindert (2003) has pointed out that these tendencies have left Europe with very much more efficient tax systems than we have in the United States. They are less progressive and more heavily burden consumption than income. This has enabled Western Europe to finance generous social welfare programs without greatly impeding economic growth. It as though they tax the poor in order to give benefits to the poor.

There is, of course, a danger that if the U.S. Congress invented a VAT, it would contain even more exemptions, multiple rates and zero rates than are prevalent in Europe. This would greatly reduce the efficiency gains from relying less heavily on income and more heavily on consumption taxation and also spur evasion.

It has been suggested that a VAT may not only be useful as a revenue source. It could be used as a tool to discipline the spending side of the budget (Burman 2008). For example, a new VAT could be dedicated to finance a reformed health care system that provided wider coverage and be the only source of revenue for that program. The public would then become very much aware of the cost of the new policies and to the extent that health costs rose faster than total consumption, tax rates would have to be increased. Presumably, there would then be a strong political incentive to control health care costs.

That approach is somewhat inconsistent with the suggestion of others that a substantial VAT be imposed and used to eliminate the income tax for a large portion of the population (Graetz 2008). This approach could make a new VAT somewhat more acceptable politically, or perhaps more accurately, less politically objectionable. It is true that a fixed portion of a VAT could still be dedicated to a new health system and the rate raised when necessary. However, a VAT used for multiple purposes would not have the same close association with health policy in the minds of the voters.

There is a more serious problem. The Congress might promulgate a rule that the sole source of financing for the health system be a VAT, but then ignore the rule. The Congress is the true 500 pound gorilla. It can do anything it wants, including ignoring its own rules. It does that frequently. There was a long tradition that the gasoline tax be the main source of financing for the Federal highway program and that tended to discipline spending. The relationship between tax revenues and highway spending was weakened over the years as some of the money was diverted to mass transit and, for a time, to ethanol subsidies. But considerable discipline remained. That ended in 2008 when the Congress voted to use general revenues, that is, deficit spending, to fund a portion of highway spending (U.S. Senate, Committee on the Budget 2008).

Congress also recently reneged on a rule designed to bring some discipline to Medicare spending. The 2003 prescription drug bill contained what budget experts call a "soft trigger."[3] If the Medicare actuaries predicted that general revenues would be required to finance more than 45 percent of Medicare's costs over certain time periods, the president was required to recommend actions that either curbed cost growth or increased dedicated revenues. Congress was required to consider those proposals in an expedited manner. The actuaries made their forecast; President Bush made proposals; but Congress ignored them and quietly passed a new rule that relieved them of having to take any action. It can be argued that the Medicare trigger was poorly designed, but that issue was never seriously debated. The episode clearly shows that congressional respect for rules is not at a high point, especially when they involve budget discipline.

Arguing that using a dedicated VAT to discipline health cost growth may not work is very different from arguing that we should not have a VAT at all. There are two main barriers to adopting a VAT: Republicans and Democrats. Republicans are adamant in their opposition to any increase in the tax burden whether it comes from a new tax or

[3] A soft trigger automatically begins a budget process designed to provoke action once certain conditions are met. It does not, however, insure that action takes place. In contrast, a hard trigger automatically changes a program once certain conditions are met.

an increase in an old one. The only slim chance that they would accept a tax increase would be in return for the Democrats acquiescing in a significant slowdown in benefit cost growth. Although there are exceptions, the majority of congressional Democrats show very little interest in such a deal.

What might break the impasse over the long run budget problem? There are two possibilities—only one of them good. President Obama has mentioned the long-run problem from time to time, but has, so far, shown little inclination to put forward concrete proposals. Any savings from his health policy proposals will be long in coming and will be more than absorbed by his hoped for increase in insurance coverage. But he must know that his ability to take any new initiatives will be inhibited by the projections for never ending, very large and growing deficits in the long run. CBO projections of the implications of the president's budget for 2010 suggest that the deficit will never fall below one-half trillion dollars within the next ten years and will actually start rising after 2013. This is without any new initiatives.

Consequently, unless he pursues budget reform the president will be handcuffed if he wishes to increase spending on education, building infrastructure, research funding for health and energy or anything else. That is to say, it won't be much fun to be president. There is, therefore, a strong incentive to pursue budgetary reform. On the other hand, it must be admitted that if he does vigorously advocate budget discipline, he may be a one-term president. But at least he will have accomplished something important.

The other route to reform has already been mentioned. There may be a crisis in the international market for our debt that forces action. Economic and budget crises have played an important role in provoking fundamental Social Security reforms in a number of Western democracies (Penner 2007).

What would reform look like, if it was hastily designed in response to a crisis? It is reasonable to fear that the reform would be slap dash and somewhat irrational. But that has not been typical in other countries that have reformed under crisis conditions. One might complain about some of the characteristics of the reformed systems, but it cannot be said that they are irrational. It may well be that if a VAT is implemented during a crisis, the new tax may be less burdened by zero rates, multiple rates and exemptions than if it is designed under calmer conditions when lobbyists have more time to work over legislators. Whether designed in a crisis or in a calmer time, it is certainly the case that if we have a new VAT, it will look a lot better as a result of the work appearing in this conference volume.

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