

How Could We Improve the Federal Tax System?

VALUE-ADDED TAX (VAT)

Is the VAT a money machine?

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A. A common criticism of the value-added tax is that it is simply a “money machine” that will enlarge a federal government by supplying a steady source of revenue. The empirical evidence has largely shown that this has not been the case.

Critics provide various reasons a value-added tax (VAT) would enlarge government. First, they say that any increase in government revenues will lead to more spending. If we want to control government spending, they say, we should cut revenues and “starve the beast.” Second, critics fear that because a VAT is a “hidden tax,” buried in the price of a good, policymakers can raise the tax with minimal economic disruption and without people noticing.

VATs’ accumulated track record, however, largely belies these concerns. For starters, VAT revenues and rates have not risen inexorably over time. In advanced countries, VATs were phased in during the 1960s and 1970s. But after that, as International Monetary Fund economist Michael Keen has shown, VAT revenues remained remarkably constant, hovering around 7 percent of gross domestic product (GDP) in the 1990s and 2000s (Keen 2013; Keen and Lockwood 2006). VAT revenue among high-income countries in 2015 was almost exactly the same share of GDP as in 1984.

Further, although revenues have risen significantly in European countries that have VATs, VATs don’t seem to be the reason. A study of 16 Western European countries from 1965 to 2015 found that VAT revenue rose by 5.6 percent of GDP, but excise and other sales taxes’ falling by 5.2 percent offset almost all of that change. Indeed policymakers in those countries often enacted a VAT with the explicit goal of replacing less efficient sales and other taxes. Total revenue in those countries rose substantially—by about 10 percent of GDP—so the 0.4 increase in revenue from VAT was a tiny fraction of the total tax increase. In addition, some evidence suggests that instead of a VAT fueling higher spending, the public’s demand for higher spending fuels demand for a VAT (Lee, Kim, and Borcharding 2013).

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Further Reading

Keen, Michael. 2013. [“The Anatomy of the VAT.”](#) *National Tax Journal* 66 (2): 423.

Keen, Michael, and Ben Lockwood. 2006. [“Is the VAT a Money Machine?”](#) *National Tax Journal* 54 (1): 157–73.

Lee, Dungeon, Dongil Kim, and Thomas E. Borchering. 2013. [“Tax Structure and Government Spending: Does the Value-Added Tax Increase the Size of Government?”](#) *National Tax Journal* 66 (3): 541–70.

Sullivan, Martin A. 2012. [“Was the VAT a Money Machine for Europe?”](#) *Tax Analysts* (blog), April 9.

Tax Analysts. 2011. [The VAT Reader: What a Federal Consumption Tax Would Mean for America](#). Falls Church, VA: Tax Analysts.

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