

Raising Revenue with a Progressive Value-Added Tax

In a new book titled *Tackling the Tax Code: Efficient and Equitable Ways to Raise Revenue*, The Hamilton Project offers a range of detailed proposals by leading economists and other experts for better tax policies that can raise revenue in a progressive and growth-friendly manner. In one chapter, William Gale of the Brookings Institution and the Urban–Brookings Tax Policy Center proposes a progressive value-added tax (VAT).

Specifically, Gale’s proposal would implement a VAT with:

- **A broad base**, including essentially all consumption that is associated with explicit payments.
- **A standard rate** that applies to all taxable purchases.
- **An exemption for small businesses** with gross annual revenue below \$200,000.
- **A refundable credit available to all households** to make the tax progressive.

Issue Overview

- **The government eventually needs to raise revenues to meet existing and future federal commitments.** Retirement and health-care commitments necessitate steadily rising spending at a time when the federal government is already missing other opportunities to make valuable public investments.
- **Consumption taxes can be very efficient.** Well-designed VATs provide an impressive combination of revenue, progressivity, and efficiency. A VAT is difficult to avoid and generates limited economic distortions.
- **The VAT is advantageous relative to alternative consumption taxes.** Retail sales taxes tend to produce widespread evasion when implemented at higher rates. A VAT comes with built-in compliance advantages because firms must obtain receipts from their suppliers in order to minimize their own tax liability.

The Challenge

The future fiscal and economic health of the United States depends on the federal government’s ability to increase revenues above the current, historically low rate. Revenues in the U.S. are low both by comparison with previous periods in U.S. history and with other advanced economies.

Tax policies used today by the U.S. federal government have advantages and disadvantages, but few can match the efficiency of a well-designed VAT. A VAT does not distort savings decisions and is very difficult to avoid or evade. However, consumption taxes (of which the VAT is one kind) have been criticized for being excessively burdensome for low earners, given that consumption is a higher share of income for people of limited means and consumption taxes are typically applied at a flat rate.

The Path Forward

To seize the opportunity presented by consumption taxation, Gale proposes a broad-based, credit-invoice VAT—sometimes referred to as a “goods and services” tax. This VAT would include a rebate to households that renders the tax progressive as well as efficient. By lowering the real value of existing assets, it would also function as an implicit one-time tax on accumulated wealth.

- **The VAT would have as broad a base as possible**, including essentially all consumption that is associated with explicit payments. This avoids costly disputes over the appropriate classification of different forms of consumption and makes avoiding the tax much more difficult. The VAT would be applied to food, education, non-profit activities, and government purchases of goods and services. States and localities would have their payments rebated.
- **A refundable credit would be available to all households**. Each family would receive a rebate equal to twice the poverty level times the VAT rate. Thus, a family with consumption equal to twice the poverty line would have their VAT burden entirely offset. Those consuming less than twice the poverty line would pay less in tax than their rebate. A per-family allowance dramatically enhances the progressivity of the VAT.
- **A single rate would apply to all taxable purchases**. Taxing different goods at different rates creates opportunities for avoidance, raises administrative costs, and would create an endless stream of arguments in favor of preferences for specific goods and services. In contrast, taxing everything at the same rate will prove fairer and simpler and will reduce avoidance.
- **The VAT would include an exemption for small businesses with gross annual revenue below \$200,000**. These businesses would have the option to opt into the VAT because while the exemption reduces firms’ compliance costs and taxes owed on sales, it also eliminates their ability to claim the VAT they pay on input purchases (and receive accompanying rebates from the government).
- **A VAT would tax imports and rebate payments to exporters**, consistent with how VATs operate in other countries, in order to make the tax fall on consumption and not production.

Gale argues that the VAT can raise revenue in an efficient, progressive, and administrable manner. Given the long-term fiscal shortfalls facing the country and the need for more government investment in crucial social priorities, his proposal concludes that policymakers should implement a well-designed VAT.

About the Author

William Gale is the Arjay and Frances Fearing Miller Chair in Federal Economic Policy and a Senior Fellow in the Economic Studies Program at the Brookings Institution, as well as the Co-Director of the Urban-Brookings Tax Policy Center.