

Time to Consider a VAT?

By John Mauldin | December 23, 2023



Taxing Consumption

Enter a VAT

New Year's, New York, Washington, DC and Cape Town

First, let me wish you Merry Christmas, Happy Holidays or your favorite personal form of greetings for this time of year. I realize as you read this you are more focused on Christmas and the approaching New Year and family, so this will be a shorter letter than normal, but still a topic that is seminal in our discussions on taxes and debt.

But before we get into that, I want to respond to a few questions from readers. I have some readers who have evidently not been reading me for that long, and they are not very happy with me talking about raising taxes. They see my (very reluctant) willingness to consider raising taxes as just another tax and spend liberal/progressive, or a RINO. Whatever.

Longtime readers know that I have been dead against increasing taxes since the early 80s. Government spending and especially taxes distort the true economy. I viscerally understand, taking money from productive hands and putting it into the hands of government is not a pro-growth policy. It is not a free market policy. It is not something I was even willing to consider up until five, maybe seven, years ago.

The only reason I am willing to consider raising taxes is that we have painted ourselves into a corner on deficits and debt. Well over 20 years ago, I was writing that we would reach this point if we did not get a grip on spending. We didn't. Now here we are. The one thing that would be worse for the economy than raising taxes would be allowing the debt markets to overwhelm the economy and basically grind economic activity to a halt.

There are some hair shirt libertarians who would prefer everything collapse so we can rebuild with a “more principled approach,” assuming that *they* can come through the fire unscathed and not terribly concerned about those around them. I will admit to possibly, maybe, potentially, having lived in that dreamscape for a period of time in my life. Then kids and grandkids happened and I see the economy through their very challenged lives. We (you and me and our kids and families and friends) are all in this together.

The sad situation is that we can either watch our economic world crumble, or we can deal with reality and recognize that we are going to have to both cut spending *and* raise taxes. Hopefully, we can do it in a way that allows us to eventually dial back those taxes, or, as I am suggesting today, consider alternative tax revenue sources that are less destructive.

I’ve been writing this series on various cycle theories and lately have been writing on debt and deficits. I would suggest that you need to see my arguments in their totality, and not as an individual letter. At some point, I hope to put them all in one piece rather than a weekly series.

A number of readers have asked about why not propose a value added tax (VAT) like the rest of the world uses? I have been peripherally talking about VATs for some time now, and frankly think a VAT is probably our only real solution to raise the revenues needed along with some very serious and stringent spending restrictions/cuts.

For those who asked, I don’t see military spending as a sacred cow. For that matter, I don’t see Social Security or Medicare as they exist today as a sacred cow. Everything, and I mean everything, has to be on the table.

With that said, let’s talk about value added taxes.

Taxing Consumption

As I said earlier, tax policy will *always* distort the economy, often for the worse. When you take money from productive people and then try to social engineer an outcome, it’s not always a good use of money. Think Solyndra and a hundred other examples. Welfare has unintended consequences. Doesn’t mean we shouldn’t do it but recognize that it will create behavioral distortions. It’s one of those areas where we should just try to minimize harm.

The consensus of economists is that consumption taxes produce the fewest side effects. I think this is one thing that progressive economists, even Paul Krugman, can agree on. Not that they wouldn’t want to continue with income taxes and even raise them. That is where we part company. If we are going to raise taxes, we must reduce spending commensurately.

All that being said, the side effects of a VAT may actually be good if the tax encourages people to spend more carefully. And given how a VAT works, it would be good for our exported manufacturing sectors, creating new jobs. VATs are rebated at the border for exports, making US manufacturers more competitive versus the rest of the world. Seriously. Given that the US is generally at the forefront of technology revolutions, a VAT done right could enhance the US economy in marginal ways.

(Again, if the deficit was under the growth of nominal GDP, I would never even think about suggesting an increase in any tax, let alone a VAT. But, as us country boys would say, that horse is already out of the barn and well into the north 40.)

Americans are familiar with consumption taxes. Most states have a sales tax, sometimes with exemptions for necessities like food. Some have proposed national versions. The [FAIR Tax](#) is one idea that's been floating around awhile. It would impose a 23% national sales tax on all new goods and services, combined with a monthly "prebate" to every household that prevents an unfair burden on low-income families.

Advocates say the FAIR tax would fully replace the current income tax and payroll tax systems. I would note that this was true at one time, but I suspect the current level of deficits and debt have taken that 23% and increased it substantially. Oh, well.

Eliminating the IRS and all its intrusive requirements is certainly an appealing idea. The unknown part is whether a sales tax at that level – on top of current state sales taxes that can be 8% or more – would encourage cheating, and how much revenue it would yield. Personally, I think it is naive to think that a 30% plus sales tax (federal and local) would not move a large amount of transactions into the cash/black market arena.

For those who are proponents of the Fair Tax, I would argue that you have much too high an opinion of your fellow man. I suggest you take a trip to Greece, Italy, Argentina or (pick a country) and see what lengths the locals go to in an attempt to avoid taxes. Many businesses in some countries have a price for credit cards and a price for cash. I have been to over 65 countries and catalogued dozens of ways that locals will work to overcome either taxes or local currency devaluation.

I suppose if someone could figure out a way to get their fellow man to cooperate in the taxation game, a sales tax would be as good as any other consumption tax. I've just seen too many creative ways that people go to, to avoid those taxes.

Enter a VAT

A more well-tested alternative, one that does not allow or create the possibility for an "underground economy," is the value-added tax – a kind of broader-based sales tax applied at all levels of production.

VATs are common. According to KPMG, more than 140 countries throughout the world have a value-added tax. Many are developed countries. The US is a bit unusual in *not* having a VAT. I like the idea of trying something where others have worked out the bugs.

The Congressional Budget Office has analyzed how a VAT might work in the US. This 2022 report considers two alternatives. Quoting the CBO:

“The first alternative would apply a 5 percent VAT to a broad base that would include most goods and services. Certain goods and services would be excluded from the base because their value is difficult to measure. Financial services without explicit fees and existing housing services would be exempted. (Existing housing services encompass both the monetary rents paid by tenants and rents imputed to owners who reside in their own homes. Although existing housing services would be excluded under this alternative, a tax on the purchase of new residential housing would cover all future consumption of housing services.) Primary and secondary education would be zero-rated, as would some other services provided by government agencies and nonprofit organizations for a small fee or at no cost. Expenditures for health care reimbursed by the government—primarily costs paid by Medicare and Medicaid—would also be zero-rated. After accounting for those exclusions, the tax base would encompass approximately 59 percent of household consumption in 2024.

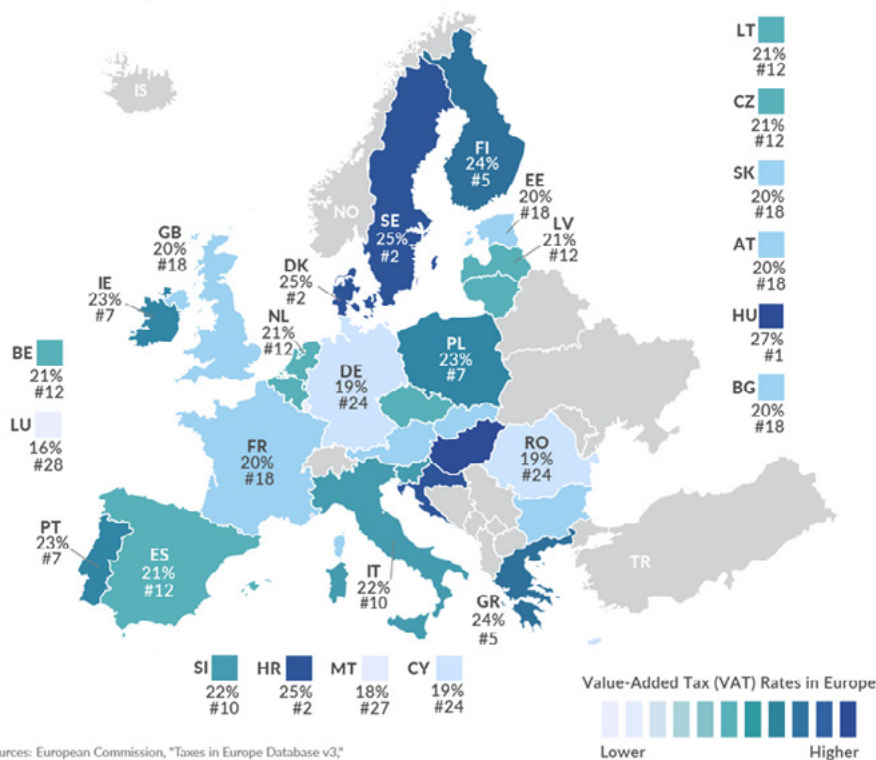
“The second alternative would apply a 5 percent VAT to a narrower base. In addition to the items excluded under the broad base, the narrow base would exclude certain goods and services that are considered necessary for subsistence or that provide broad social benefits. Specifically, new residential housing, food purchased for home consumption, health care, and postsecondary education would be zero-rated. After accounting for those exclusions, the tax base in this alternative would encompass about 37 percent of household consumption in 2024.”

The two alternatives would have the same 5% rate; the difference is in the base to which they would apply. The CBO, citing a Joint Committee on Taxation estimate, says the first alternative would reduce the deficit by \$3.05 trillion from 2024-2032 and the second would reduce the deficit by \$1.95 trillion over the same 9-year period.

I’m not sure why they estimate over 9 years instead of their usual 10 years. That means the yearly averages would be \$338 billion and \$216 billion, respectively. As with the other ideas I’ve described, that’s not enough to close the gap—but 5% is a relatively low rate. VAT taxes of 20% or more are common in Europe. They go as high as 27% in Hungary.

VAT Rates in Europe

Standard Value-Added Tax (VAT) Rates in European Union Countries and the United Kingdom, as of January 2023



Source: [Tax Foundation](#)

It should be noted that various countries in Europe tax different types of consumption differently. Some countries will have as little as a 5% VAT on, say groceries, then a much higher VAT on other less necessary consumption. It can get complicated quickly.

If a 5% VAT rate can really raise \$338 billion annually in the US, there's plenty of room to go higher and still have a lower rate than most EU countries. Could we get \$1 trillion a year from a VAT? Clearly we could. Combine that with serious spending cuts and income tax reforms, and a balanced budget comes within shouting distance.

Further, if the fair tax people are right and a 23% sales tax would allow for the elimination of income and Social Security taxes, what would a similar rate of a VAT allow us to do? Larry Lindsey wrote a book a little over a decade ago where he laid out, in detail, how a 20% VAT could eliminate both income and Social Security taxes. We have increased spending far beyond what it was when he wrote that book, but the principle is the same.

What if instead of a 20% VAT it was 22-23% but we eliminated Social Security taxes? That would certainly help those in the lower 60% of income in the country. Understand, I am not arguing for that position, but when you put a VAT on the table, a lot of options become available.

Ideally, the VAT revenue would enable major income tax cuts, too, making the net burden no higher for most households. Over time, maybe we could even eliminate income tax completely. Can we create a rebate for those of lower income to balance things out? Yes. Everything must be on the table.

This would be a giant change with thousands of important details. I can imagine many problems. I'm sure you can too. But no solution will be perfect. When we are forced to make necessary compromises, I can almost guarantee you that no one will be happy. Even contemplating it makes me very uncomfortable.

But when we are staring into the abyss of a bond market comprised of fully awakened, resurrected from the theoretical dead bond vigilantes, with no bottom to that abyss, compromises will be made. We saw that in 1998 and again in 2008. The next crisis will be significantly worse than the Great Recession.

This is a topic we will explore more, but I promised a shorter letter so I will cut to the chase here.

A final thought: I've been talking about various cycles and crises for the better part of five months. I know it all sounds rather doom-and-gloomish, but I'm still an optimist. First, we always get through it. Or better yet, we Muddle Through it. Second, ever improving technology will provide the wind for our sails. Artificial intelligence and biotechnology come to mind, but there are scores of other innovations in myriads of industries that will combine to improve our lifestyles, our health and our options. I believe the 2030s will be seen as the good old days when we're looking back from 2060. If I am right about biotechnology and the increasing and incredible improvements in aging and longevity breakthroughs, and I dearly hope I am, I will be there with you.

One thing that won't change? We will still be enjoying family and friends in the holidays. That is a universal constant.

New Year's, New York, Washington, DC and Cape Town

It appears that over 200 people will show up at our home on New Year's Day for Shane's black-eyed peas (the best I have ever had) and my Texas chili, mimosas, and vast amounts of side dishes. Shane is in full planning mode. Note that I did not say my chili is the best. Coming from Texas, chili is a subjective concept. You can make good and even great chili (like I do), but the best? I learned long ago that you never claim to have the best chili. For Yankees, I would note that real chili never has beans in it. EVER. If you put beans in it, then it is just a spicy soup. It may still be edible or even good, but it is not chili.

I will be going to Washington DC the weekend of January 20th for a private meeting with several senior biotech and medical research scientists where I will learn more about some amazing new discoveries in the longevity space. I am merely a fly on the wall, and grateful to be even allowed into the room. It's all under nondisclosures, but in a year or so you will begin to see what has so many senior scientists absolutely salivating.

From there I will take the train to New York for the week, doing some media and lots of meetings. Big changes are coming in my life and business. I am very excited. I know that a lot of people think that 74 is the time to start thinking about kicking back, but I am more energized than ever. Yes, we have a few bumps in the road but, hot damn, things going to be fun if we can stick around. I plan to.

Shane and I will be in Cape Town, South Africa in June and possibly somewhere in Europe or elsewhere in Africa. It seems the speaking world that I was so used to is finally coming back.

Shane and I wish you a very Merry Christmas. I am looking forward to New Year's as some of our kids are coming in plus the party. I am so grateful to have you as one of my friends, even if virtual. Have a great week and enjoy your friends and family.

Your always optimistic analyst,



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