Introduction: Getting Acquainted With VAT

By Martin A. Sullivan

Until recently, most talk about a value added tax in the United States was an academic exercise. Policy experts kept telling anyone who would listen that we could boost our competitiveness if some form of a VAT was used to replace all, or at least the worst parts, of our clunky income tax. But there was no pressing need for a VAT and no political incentive to undertake the arduous task of orchestrating a major tax reform.

But times are changing. Between the 2007 and 2010 fiscal years, the national debt increased from 36 percent to 62 percent of gross national product. And matters are only getting worse. America is relentlessly moving toward the edge of a fiscal abyss. In Washington, while our leaders may talk tough, they are not taking action. To avoid upsetting voters, they are careful not to even hint at spending cuts or tax increases of the size needed to make a real dent in the problem. With no limit on the national credit card, the daily push and pull of politics continues unhindered by the impending crisis.

Our system of checks and balances and the usual political gridlock are partly to blame. Also part of the mix is our national mental block about the federal debt. The tough choices that must be made are outside the scope of current political discourse. Our ungainly political system seems incapable of processing our giant financial problem. We require great leaps forward. We are getting baby steps. Nevertheless, time marches on. Our population is aging. The expense of our healthcare is soaring. Something must give.

There are three options. None are pleasant.

The first is to do nothing. This would send the finances of the federal government into uncharted territory. Figure 1 shows the trajectory of the federal debt as a percentage of GDP if current policies remain in place. (The trajectory is steeper if the Bush-era tax cuts do not expire.)
We are here
There are two concerns with this journey into the unknown. Unchecked federal deficits gradually weaken the economy as government debt absorbs private saving and crowds out capital formation. The other problem is the possibility of a sudden loss of investor confidence in the government’s ability to manage its finances, which could dramatically increase our cost of borrowing.

The second option is a large reduction in government spending. In the abstract, this is the approach favored by many, especially those from the political right. But the popular notion of shrinking the government loses much of its appeal when the discussion moves from the general to the specific. For example, few conservative politicians are willing to endorse cuts in Social Security and Medicare spending, the most obvious targets for reducing government expenditures. The size of the spending cuts needed to level the growth in government debt is startling — about $500 billion annually. That amount far exceeds what can be achieved by eliminating waste, fraud, and pork.

Figure 2 shows the composition of projected federal spending for 2020. To level off the debt would require cuts of about 3.6 percent of GDP. In 2020 that would equal about 14 percent of all federal spending. If cuts to Social Security, Medicare, Medicaid, defense, and interest payments are taken off the table, Congress would need to cut all other spending by 60 percent. The major components of “other spending” in Figure 2 include expenditures for veterans benefits and services; law enforcement; unemployment compensation; food and nutrition assistance; IRS administration; health and human services administration; Social Security administration; education; transportation; agricultural support; international affairs; general science; and space exploration.

Each of us has our views about what should be cut first, but all can probably agree that spending cuts of that magnitude would present momentous difficulties.

1For example, the Tea Party’s “Contract From America” calls for balancing the budget without tax increases.
Projected Federal Spending in 2020

- Social Security (22%)
- Other Spending (23%)
- Net Interest (14%)
- Medicaid (8%)
- Defense (15%)
- Medicare (17%)

Source: Congressional Budget Office.
This leads to the third option — raising taxes. It’s only the extreme political and economic fallout from the first two options that drives us to seriously consider a major tax increase in the face of the strong antitax sentiment in the United States.

Among the unpleasant possibilities, a VAT must be on the short list of options. For starters, a VAT is a consumption tax. Economists of all stripes agree that if there must be a new tax, a broad-based consumption tax will do the least economic damage. Further, all the world’s other leading economies have VAT regimes.

The amount of revenue a VAT would bring in depends critically on the details of its design, but a reasonable estimate is that it would take a VAT with a rate in the neighborhood of 10 percent to stabilize our country’s debt-to-GDP ratio. This ballpark figure is only a point of reference, not a prediction or a recommendation.

It’s unlikely a VAT would ever become law in America without major spending cuts also contributing to deficit reduction. Concurrent spending cuts would lower the VAT rate needed to restore fiscal sustainability. Conversely, there is a good chance that any new VAT would fund a reduction of other taxes. That is, there could be a tax reform and deficit reduction element to the adoption of a VAT. That would raise the VAT rate necessary to achieve fiscal sustainability.

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We usually quantify the activity of a business in terms of profits or revenues. Although you will never find it on a financial statement, another measure of business activity is the concept of value added — that is, the difference between revenue from sales to customers and purchases from other businesses. Collecting a tax on that value added requires that businesses compute this difference. Individuals have no responsibility in such a tax system (for instance, no returns to file) except to pay the sales price at the cash register at the time of purchase.

To consumers, a VAT can look identical to a retail sales tax if the amount of tax is separately stated from prices. The VAT, however, can put the tax out of view if retailers are allowed to bury it in the price with no separate mention of the tax.
Like a retail sales tax, a VAT is a tax on spending.\(^2\) That is the key to understanding the policy debate surrounding the VAT. A tax on consumption has distinctly different economic characteristics than an income tax. Income equals spending plus savings. The difference between the two taxes is the treatment of savings. Savings are exempt under a consumption tax, but taxed under an income tax. This difference has important implications for both economic growth and for fairness.

One of the surest methods of promoting competitiveness and long-term economic growth is to increase savings. Savings provides funds for capital formation. More capital leads to higher productivity and wages. Generally speaking, under an income tax people who save more are taxed more over their lifetimes than people who save less. In contrast, a consumption tax has no bias against saving. Under a consumption tax, people’s lifetime tax burden is unaffected by their savings rate.

In addition to its potential effect on growth, the other key feature of a consumption tax is its effect on the distribution of income. In general, low-income families save little or no money. And by borrowing, some families may even spend more than they earn (negative savings). Moving up the income scale, the proportion of income devoted to savings tends to increase. So a consumption tax, measured as a percentage of household income, is larger for low-income families than for high-income families. Most consumption taxes have a single standard rate, while most income taxes have a multitiered progressive rate structure, adding to the different distributional effects.

For many politicians, redistributing the tax burden from upper- to lower-income families is unacceptable. With the intent of alleviating the burden on the poor, most VAT systems now in

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\(^2\)Throughout this volume, authors adopt the widespread convention of assuming the value added tax is a consumption tax. This does not follow from its resemblance to a retail sales tax. It follows from its favorable treatment of capital purchases by businesses. Under all VATs in operation around the world, the purchases of property, plant, and equipment are deducted at the time of purchase (instead of written off over the useful life of the asset, as under an income tax). It is possible to design a VAT as an income tax by requiring businesses to depreciate capital purchases. In 1992 the Treasury Department proposed an income-based value added tax it called the comprehensive business income tax.
effect provide preferential treatments for various necessities. Those items typically include home-prepared food, medical care, and some types of clothing. Although it is widely adopted, tax experts consider this bifurcated approach a clumsy and complex solution to the fairness issue. (After all, rich people can purchase large amounts of “necessities” eligible for a reduced VAT rate.)

A preferred alternative among policy experts is to provide cash rebates to low-income households to offset the regressive aspects of the VAT. One novel approach made possible by modern technology would provide tax relief for necessities only to low-income families using “smart cards” to verify their identity.

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Most VAT systems around the world are of the credit invoice variety. Under this method, businesses pay gross tax on their business receipts and get offsetting tax credits for VAT previously paid by sellers of goods and services they purchase. The main alternative to the credit invoice method is the subtraction method, which uses a company’s accounting records to calculate value added (typically, sales minus purchases) and calculates the VAT burden as a percentage of that taxable amount. Because it lends itself more easily to preferential treatment of some items, politicians generally favor the credit invoice method. For the same reason, many economists prefer the subtraction method VAT.

Besides a VAT, there are several other proposed taxes that can be viewed as broad-based consumption taxes. They include:

- The FairTax. The FairTax is a national sales tax made famous through the efforts of House Ways and Means Committee member John Linder, R-Ga. Linder first proposed FairTax legislation in 1999. His latest version (H.R. 25) has over 60 cosponsors. Companion legislation (S. 296) introduced by Sen. Saxby Chambliss, R-Ga., has four cosponsors.

- The flat tax. The flat tax is a single-rate VAT divided into two parts: a business component and a household component. The business tax would operate like a subtraction method VAT except that it would allow businesses to deduct wages paid to employees. Individuals would be taxed only on their
wage income, at a single rate, and would be allowed generous personal exemptions.

- The X tax. Proposed by economist David Bradford more than two decades ago, the X tax is, like the flat tax, a two-part VAT. The essential difference is that the X tax would place more burden on upper-income households by imposing a progressive rate structure on wage income, while the flat tax relies on a single rate.

It’s critically important to note that each of these taxes has been proposed as a replacement to the current income tax. Most proponents of these plans would not support them as revenue-raising add-ons to the current tax system.

Of course, Congress does not need to create a new tax system to raise additional revenue. It can simply increase rates or broaden the base of existing taxes. Of those choices, base broadening seems the most likely option. The huge amounts of revenue necessary to stabilize the country’s finances can only come from cuts to some of America’s favorite tax breaks. They include the mortgage interest deduction, the deduction for state and local taxes, the exclusion to employer-provided health benefits, and various tax breaks for retirement savings. It took a monumental effort on the part of Congress and President Reagan to broaden the income tax base with the Tax Reform Act of 1986. That bill included large cuts in the individual and corporate tax rates and was revenue neutral. A revenue-raising income tax reform would encounter much greater political obstacles.

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Love it or hate it, the VAT will continue to be in the thick of the policy debate as long as our country’s fiscal policies push the national debt to unprecedented levels. Unfortunately, this trend will probably continue for many years. It does, however, make a thorough reading of Tax Analysts’ VAT Reader a prudent, long-term investment of one’s time.