How I Learned to Stop Worrying and Love the VAT

BY JOEL SLEMROD

“Get ready for the VAT, or start fighting it.” So ended a recent column by the conservative commentator Charles Krauthammer in The Washington Post, in which he called the value-added tax (a sort of super sales tax, but we’ll get to that later) “the ultimate cash cow” and part of the Democratic Party’s strategy to “expand the beast and then feed it.”

Although Krauthammer’s views are shared by many, others argue that the United States will eventually be forced to face up to huge budget deficits that will persist after the economy recovers, and it is hard to imagine a fix that does not include raising a lot more revenue. From this perspective, a VAT looks very attractive compared with, say, squeezing more revenue out of the creaky old income tax.
How the VAT made a man out of Sam!

What an uncle!

And he used to be so broke!
THE VAT

Should we reject the VAT, then, or learn to love it? Since the Treasury’s default is not looming, our creditors don’t (yet) have the leverage to arrange a shotgun marriage. So we still have some time to get to know the VAT before deciding to set up housekeeping.

AN INTRODUCTION

First of all, feel free to refer to the VAT by its acronym, which rhymes with flat. But please don’t call it the VAT tax – that would be like waiting in line at an ATM machine. The VAT has been around the block more than once, making its debut in Europe in the 1960s; a half century later, a VAT is levied in every G-20 country except the United States. Indeed, Sijbren Cnossen of Maastricht University in the Netherlands called its spread “the most important event in the evolution of tax structure in the last half of the 20th century.”

While the United States has never had a federal VAT, 45 states do levy a very close relative – the retail sales tax. In the aggregate, the base of the VAT is exactly the same as that of the retail sales tax: total final sales from businesses to consumers. In principle, then, a VAT and an RST are both broad-based consumption taxes. So we can learn a lot about our potential love interest by observing this close relative.

In part, the VAT seems strange to us because of how it differs from the familiar RST in the way that the tax flows from the private sector to the government. With a retail sales tax, only retail businesses – not manufacturers or wholesalers – fork over money. With a VAT, all businesses remit. The basis for calculating the VAT is straightforward, at least in principle: businesses are taxed on total sales revenue, minus the cost of their inputs.

A simple example can help show why the base for a retail sales tax is equal to the sum of the bases for all the businesses that are covered by a VAT. Say you go to a bakery and buy a loaf of bread for $2. With a retail sales tax, the tax base is $2 (assuming, of course, you live in a state where food isn’t exempt). Suppose the process of getting bread to the consumer has just two steps. First, a farmer grows wheat, grinds it into flour and sells it to a baker for 50 cents. Then, the baker turns the flour into dough, transforms it to pumpernickel and sells it to you for $2. The value added by the baker is $1.50 – the price of the bread minus the cost of the flour. Under the VAT, the tax base is thus 50 cents for the farmer and $1.50 for the baker, adding up to the same $2.

The example could be complicated by adding the cost of other inputs at each stage, or adding more stages to the process of making and retailing bread. And, of course, in the real world, dozens of companies ranging from the manufacturers of the farmer’s tractor and seeds to the suppliers of the baker’s oven, electricity and cleaning supplies all contribute. But the sum of the tax bases would still be $2.

Because of the difference involving which businesses write the checks to the government, some might conclude that a retail sales tax is a tax “on” consumers, and the VAT is a tax “on” businesses, where “on” refers to who bears the burden of the tax. This is a mistake. All economists worthy of their Adam Smith neckties agree that the incidence is identical because the event that triggers tax liability – the creation and sale of a finished loaf of bread – is identical. (The same argument, in-

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ocidentally, applies to income taxes: economists don’t think it matters much, other than in terms of ease of administration, that employers withhold and remit a majority of taxes due on wages and salaries.)

If a VAT is just like a retail sales tax but involves more businesses in the collection process, why go to the extra trouble? Why is the VAT the tax success story of the last half century, almost totally replacing retail sales taxes everywhere but the United States? The short answer is that the retail sales tax suffers from important administrative and enforcement problems that are greatly magnified as the rate gets higher, while the VAT minimizes these problems in clever ways. Indeed, most tax experts believe that a retail sales tax above 10 percent would be exceedingly costly and intrusive to administer, but that a VAT of this magnitude could be managed (and is being managed in most other advanced economies) fairly smoothly.

One key advantage comes from the credit-invoice method that virtually every country with a VAT uses. Under this approach, tax liability is triggered by each transaction in which money changes hands. With a 12 percent VAT, for example, every sale a firm makes incurs a 12 percent liability, and every purchase it makes from other firms entitles it to a “credit” for the amount of tax that was remitted by the business it buys from. If a business is audited, it must have tax-paid invoices from its suppliers to back up the credits it has claimed. Note that this gives firms an incentive to purchase goods and services from tax-law-abiding suppliers. Otherwise, they stand to lose the tax credit they claimed on their purchased inputs.

Another advantage (or disadvantage) is that a VAT can bring in a lot of money. How much depends, of course, on the tax rate and the tax base.

Many types of consumption – for example, baby sitter services – are difficult to tax and almost certainly would not be included in the tax base. In addition, some types of consumption, like food, are typically exempted from the VAT in order to ease the tax burden on those with low incomes. The Congressional Budget Office has estimated that a compre-
 Comprehensive VAT that provided no special treatment for purchases of food or housing could raise about $81 billion for each percentage point of tax. Given the administrative and political realities, one might expect to collect more like $50 billion per point of a VAT. If that's correct, then enacting a 12 percent VAT would get us about halfway to eliminating the looming long-term fiscal imbalance that will largely be the product of increasing outlays for Social Security, Medicare and Medicaid.

Most countries “rebate” the VAT on stuff that is exported, so no tax is collected on the value of goods and services sold to other countries. Imports, on the other hand, are subject to the VAT because they are not treated as deductible inputs. Not surprisingly, then, some Americans view the VAT as an ingenious export promotion scheme that puts American exporters at a competitive disadvantage on foreign sales. They are, however, victims of a misunderstanding. A VAT with this treatment of exports and imports essentially levies a tax on all goods and services consumed within the country, whether imported or home-grown, exactly as a retail sales tax does. To put it another way, it offers no more competitive advantage than a retail sales tax—that is, none at all. Goods sold here, whether produced domestically or abroad, are subject to the tax. Not surprisingly, then, countries that rely more on a VAT to raise revenue have, on average, no bigger export sectors than those that do not.

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Several years ago, the conventional wisdom about the political prospects of the VAT in America was cleverly captured by Larry Summers, who remarked that the United States will get a VAT when liberals realize it is a money machine and conservatives realize it is regressive.

What worries conservatives about the VAT today? Many don’t accept the premise that tax increases must be part of how we deal with the long-term fiscal imbalance. They pursue a starve-the-beast strategy in which the end is shrinking government spending and the best means of getting from here to there is to deprive the government of money to spend. It hasn’t worked out as planned, thus far. The Bush tax cuts, after all, were followed by large increases in spending, some of it on war and home security but much on a major new program: the prescription drug benefit for Medicare recipients. Starve-the-beasters are against any tax increases, and especially against a whole new tax system that is—horror of horrors—simple and efficient.

There is irony here. Conservatives who castigate the government for being wasteful and labyrinthine are wary of the VAT because it isn’t wasteful or labyrinthine. This reminds me of the late British economist Joan Robinson’s scathing analogy of using tariffs to reduce imports by throwing rocks into the harbors of one’s own country. Throwing rocks in the tax collection system makes sense only if
there were no other way to achieve the desired size of government.

Stoking conservative fears is the notion that a VAT would be “invisible” to voters, causing them to underestimate the true cost of government. This is why the antitax zealot Grover Norquist has said that VAT “is French for big government.” But anyone who has been to Europe or Canada knows that a VAT need not be any less visible to consumers than a retail sales tax. For instance, in a country with a 12 percent VAT, cash register receipts can show the before-tax price and then tack on the 12 percent VAT, just as they do with retail sales taxes in most states.

Truth be told, though, the VAT is not quite as simple, efficient and self-enforcing as good-government types hope and starve-the-government types fear. Yes, experience abroad suggests that a broad-based single-rate VAT could involve considerably lower enforcement and compliance costs than the current income tax in the United States. But the VAT does pose some tricky implementation issues of its own, such as how to tax the sale of financial assets.

Recall that the VAT base is equal to sales revenue less the cost of inputs, and is thus not affected by the financial operations of a firm – its borrowing, lending, issuance of new shares and so on. Thus, for example, interest receipts are not part of taxable income and interest payments are not deductible from VAT liability. But for a financial institution, the financial operations are the real purpose of the business, and the pricing of the services offered is often implicit in the interest charges and payments. Thus, placing interest receipts and payments outside of the tax base may lead to serious mismeasurement of the true value added by a financial firm (or of a non-financial firm with financial operations) and consequent distortions to economic activity.
Nor do enforcement problems disappear under a VAT, in spite of the self-enforcement feature of the invoice-credit method of administration discussed above. Estimates of evasion range as high as 40 percent for the Italian VAT. Under a VAT, the tax authority must still monitor unregistered businesses, exaggerated refund claims, unrecorded cash purchases, underreported sales and false export claims.

One baroque type of noncompliance, known as “carousel fraud,” involves goods imported VAT-free that are then sold and resold multiple times in business-to-business transactions chains in the importing country. The first seller, whose identity is obscured by the layers of transactions, absconds with the initial VAT payment owed. Some estimates put the VAT revenue loss within the European Union from carousel fraud, often carried out by organized crime, as high as 60 billion euros annually.

WHO REALLY PAYS?
Just as the VAT is relatively simple and efficient (but not as efficient as conservatives fear), the VAT is relatively regressive (but not as regressive as liberals might fear). Over a lifetime, a uniform VAT collected on all sales would exact an amount from individuals that is approximately proportional to their lifetime incomes.

This means that, all told, a VAT of this sort would be significantly more regressive than an income tax like ours. For example, someone who spends an entire lifetime at the poverty level would never pay federal income tax under the current structure because tax-exempt levels of income are currently set above the poverty line. In fact, the working poor currently pay less than no income tax because they receive cash refunds under the earned income tax credit. In stark contrast, a 12 percent VAT would impose a tax burden equal to approximately 12 percent of that poor person’s lifetime income, while wealthy people (who presumably don’t spend all their income) would pay less than 12 percent.

The lifetime profile of the VAT is, however, significantly less regressive than one would expect from looking at a one-year snapshot of the relationship between household consumption and income, where low-income households typically spend considerably more than their incomes (by borrowing or digging into savings) while high-income households considerably less. This statistical pattern reflects the facts that in the face of short-term income shocks, households strive to stabilize their consumption, and that people save during their working years in order to consume during retirement. Thus, the very high ratio of consumption to income among households with low incomes largely reflects the numbers of retirees and those having a bad year or two; over a lifetime, these factors recede in importance.

Can the undesirable redistributional consequences of a VAT be offset? The answer is
yes, but at significant cost in terms of simplicity and economic efficiency. One way to soften the regressivity is to abandon the uniform tax rate and instead impose no tax on goods and services that figure more heavily in the expenditures of poorer families – food, shelter and health care. The European experience with the VAT, however, shows that multiple-rate VAT systems are significantly more complex and therefore more expensive to run. Preferential taxation of necessities also sharply reduces revenues, requiring an even higher tax rate on other goods.

The biggest problem here is that because in total most purchases of the preferentially taxed commodities (food, shelter, medical care) are made by middle- and high-income families, the approach is a very poorly targeted way to increase the progressivity of a VAT. Consider, too, that different VAT rates for different products also cause significant economic distortions by creating an incentive for people to consume more of the goods and services that are not taxed and less of the ones that are.

There are other ways, though, to make a VAT progressive. The tax could be paired with a tax credit or rebate paid to all households. So, for example, every good and service would carry a 15 percent VAT, but the distributional consequences would be offset by giving every individual an annual cash rebate – say, $1,000. More complicated income-related rebate schemes that adjusted the cash-back amount according to income could more finely tailor the distributional impact. But this would require the collection and verification of household-level information on income or consumption, defeating one of the main advantages of the VAT.

Moreover, the government would be writing a check for several thousand dollars every year to every household, and it is not clear that voters could be convinced of the logic (and equity) of taxing with one hand and returning some of the money with the other. Note, too, that a rebate would require that a whole new administrative apparatus be set up in addition to the one needed to run the VAT. Tracking low-income people to ensure that they
T H E  V A T

receive their allotted share could prove difficult; the IRS already has difficulty dealing with this population, as evidenced by the high rate of fraudulent claims for the earned income tax credit.

WHAT'S LOVE GOT TO DO WITH IT?

Would a VAT make us better off? America certainly needs to address the long-term fiscal imbalance that saps savings, forces us to collectively borrow abroad to maintain consumption, and even puts the Treasury at risk of default on its debt. So if a VAT were part of a package that put our fiscal house in order, it would be good for the economy. But the task of finding the right balance between tax increases and expenditure cuts is beyond the scope of this article. I’ll stick with the question of how a VAT compares with other ways of raising revenue.

The defining characteristic of all taxes on consumption, including the VAT, is that – unlike income taxes – they do not reduce the return (and thus the incentive) from saving and investing. Supporters argue that, compared with a pure income tax, minimizing taxation’s negative impact on the incentive to save would lead to more saving, more saving would lead to more investment, and more investment would make workers more productive and improve Americans’ standard of living in the long run. Compared with raising rates in our current income tax, which is riddled with preferences and ambiguities, enacting a VAT would minimize capricious variation in tax rates on different types of investments, leading to a more efficient allocation of both capital and risk-bearing.

Moreover, raising revenue with a clean broad-based VAT would avoid exacerbating the myriad distortions in what we consume that are caused by the income tax. Some VAT supporters are particularly enamored of the fact that it would effectively levy a one-time tax on existing wealth holders because it would reduce the amount of goods and services their nest eggs could purchase. This, some argue, is a good thing because (a) it would raise revenue while causing minimal economic distortion since it is typically too late for the core holders of wealth, the elderly, to alter their key economic choices, and (b) it would recapture a portion of the inordinately large entitlement benefits (namely Social Security and Medicare) that have been handed out by myopic American politicians over the last few decades.

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Setting Up Housekeeping

As I’ve suggested, Larry Summers’s quip about the political prospects for a VAT needs updating. The VAT is not as regressive as liberals fear, nor quite the money machine that conservatives abhor. Before 2008, savvy observers often concluded that the United States would face up to its fiscal imbalance – possibly with a VAT – if and when an economic crisis occurred. Well, we’ve been hammered by the worst economic crisis since the Great
Depression, yet the country seems no closer to addressing what is now an even bigger structural deficit.

Perhaps the observers’ conclusion should be amended; maybe we’ll find the collective will to face up to the fiscal imbalance (and consider a VAT) when we get an economic or financial crisis whose cause is clearly related to the deficit. That, after all, is what’s forcing wrenching expenditure and tax reform in Greece, Britain and Ireland.

Maybe, maybe not. There is no consensus among folks whose jobs may depend on the way taxes are levied. But many take the possibility seriously. In a survey by KPMG done in 2009, some 57 percent of senior business executives said they believe the United States would get a VAT within five years, and 75 percent said it would happen within 10. In light of the subsequent hardening of political positions, these numbers would now be lower.

To be sure, the VAT has supporters across the political spectrum. Len Burman of the Tax Policy Center, whose politics are probably best characterized as center-left, argued for a VAT to finance health care reform, saying that the regressivity of the tax would be a counterweight to the progressivity of subsidies built into the reform. Representative Paul Ryan, one of the conservative Republican “young guns,” includes an 8.5 percent VAT (disguised with another name) in his “Roadmap for America’s Future” – although his goal is to replace other taxes, not to supplement them.

The next signpost of the political future is the report by the president’s deficit commission, which is slated to be released before this article is published. The committee did devote a good portion of one hearing to the VAT. As of today, though, prospects seem dim that the commission, two-thirds of whose members are in Congress, will begin a serious courtship with the VAT. After all, on April 15, 2010 (tax day), the Senate went on record as opposing a VAT, approving by an 85-13 margin a resolution declaring the alien levy a “massive tax increase that will cripple families on fixed income.” All six of the senators who are on the deficit commission voted for the resolution condemning the VAT.

But some day, some way, America may have to raise a lot of revenue to take care of the nation’s business. And given the alternatives, the VAT is going to look pretty good.