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Why the United States Needs a Value Added Tax

Charles E. McLure Jr.
Senior Fellow (Emeritus)
Hoover Institution, Stanford University

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Why the US needs a VAT

Need for federal revenue, *after recession*

- Deficits as far as the eye can see
- New initiatives: health care, education, energy independence

Simplification of the system: Graetz plan

- Tax threshold of about \$100,000 for couples
- Individual income tax rate of 20-25 percent
- Corporate income tax rate of 15-20 percent
- VAT of 10-15 percent

Why not raise income tax rates?

Giving voters a stake in their government

- 1961: no liability on about 20 percent of individual income tax returns
 - Marginal tax rates of 20-24% on 70 percent of returns
 - Less than 2 percent of tax returns paid marginal rates higher than 30 percent
- Now: 40% percent of households pay little or no income tax
 - On average, they pay negative amounts of income tax
 - 20% of households pay 87% of individual income taxes
 - Top 5% alone pays more than 60% of income tax

Why not raise income tax rates?

Giving voters a stake in government (continued)

- Obama proposals:
 - Tax cuts for 95 percent of wage earners
 - More households would pay no income tax
 - Raise top marginal rate to 39.6%
 - Raise tax on capital gains and dividends from 15 to 20%
- Query: Is this a healthy way to finance a democracy?

Effects on incentives to save, invest, and work

Effects on international competitiveness

- VAT would have no significant effects, except work

Three consumption tax options

Credit-method (European style) VAT

National retail sales tax (RST)

- “Fair Tax” would replace all federal taxes

Subtraction method Value Added Tax

- Treasury Department proposal for Business Activity Tax (BAT)
- Pushed by many non-tax experts

Mechanics of 3 Consumption Taxes An Illustration, assuming a 10% tax rate

Economic activity	Farmer	Miller	Baker	Total
Basic transactions				
1. Sales	\$ 300	\$ 700	\$ 1,000	
2. Purchases	\$ 0	\$ 300	\$ 700	
3. Value added (sales - purchases)	\$ 300	\$ 400	\$ 300	\$ 1,000
Subtraction-Method VAT (BAT)				
4. Business Transfer Tax (10% of line 3)	\$ 30	\$ 40	\$ 30	\$ 100
Credit-Method VAT (VAT)				
5. Tax on sales (10% of line 1)	\$ 30	\$ 70	\$ 100	
6. Less: input tax on purchases	\$ 0	\$ 30	\$ 70	
7. Net VAT liability	\$ 30	\$ 40	\$ 30	\$ 100
Retail Sales Tax (RST)				
8. Retail Sales Tax	Exempt	Exempt	\$ 100	\$ 100

Consumption tax options (cont.)

Observations

- In their pure forms, BAT, VAT and RST have identical effect: taxation of consumption
- VAT and RST are transactions-based taxes
 - They are levied on each sale
- BAT is an accounts-based tax
 - It is not levied on each sale
- BAT taxes slices of value added (sales minus purchases): politically important

Consumption tax options (cont.)

Credit-method VAT is by far the most common

- Approximately 150 countries worldwide
- All 27 members of the European Union (EU)

VAT has administrative and political advantages over Subtraction-Method VAT

- Japan is only OECD country to use Subtraction-Method VAT
- Japan modifies the tax to make it resemble a credit-method tax

Retail Sales Tax (RST)

- Levied by 46 U.S. states, including DC, and 9 Canadian provinces
- Not levied in any other major developed country
- Characterized by well-known defects

Ideal & Common Features of RSTs

Type of sales	Ideal RST	Common state RST
To consumers	Taxed	Many exempt
To business	Exempt	Many taxed
Exports	Tax-free	Tax on business purchases
Imports	Taxed like domestic products	Many tax-free (Quill) No tax on foreign business purchases

Operation of Credit-Method VAT

- Sales by registered traders are normally taxed
 - Most sales to households are taxed
- *Input credits* for VAT on purchases shown on invoices eliminates tax on business purchases
- “Destination” treatment of foreign trade, due to “*border tax adjustments*”
 - Imports are taxed like domestic production
 - Exports enter world markets tax-free
 - Exports are zero-rated, with input credits/refunds

Exempting and Zero-Rating of *Last Stage* under Credit-Method VAT

(Tax Rate = 10%)

Economic activity	Farmer	Miller	Baker	Total
Basic transactions				
1. Sales	\$ 300	\$ 700	\$ 1,000	
2. Purchases	\$ 0	\$ 300	\$ 700	
3. Value added (sales – purchases)	\$ 300	\$ 400	\$ 300	\$ 1,000
Exemption of Last Stage (Baker)				
4. Tax on sales (10% of line 1)	\$ 30	\$ 70	Exempt	
5. Less: input tax on purchases	\$ 0	\$ 30	\$ 0	
6. Net VAT liability	\$ 30	\$ 40	\$ 0	\$ 70
Zero-Rating of Last Stage				
7. Tax on sales (10% of line 1)	\$ 30	\$ 70	\$ 0	
8. Less: input tax on purchases	\$ 0	\$ 30	\$ 70	
9. Net VAT liability	\$ 30	\$ 40	-\$ 70	\$ 0

- Input credits are allowed for zero-rated sales, but not for exempt sales
- Exemption of last stage eliminates tax only on value added at that stage
- Zero-rating of last stage eliminates tax on entire value of sales at all stages through credits at last stage
- Zero-rating is common for exports

Exempting and Zero-Rating of *Intermediate Stage* under Credit-Method VAT

(Tax Rate = 10%)

Economic activity	Farmer	Miller	Baker	Total
Basic transactions				
1. Sales	\$ 300	\$ 700	\$ 1,000	
2. Purchases	\$ 0	\$ 300	\$ 700	
3. Value added (sales – purchases)	\$ 300	\$ 400	\$ 300	\$ 1,000
Exemption of Intermediate Stage				
4. Tax on sales (10% of line 1)	\$ 30	Exempt	\$ 100	
5. Less: input tax	\$ 0	\$ 0	\$ 0	
6. Net VAT liability	\$ 30	\$ 0	\$ 100	\$ 130
Zero-Rating of Intermediate Stage				
7. Tax on sales (10% of line 1)	\$ 30	\$ 0	\$ 100	
8. Less: input tax	\$ 0	\$ 30	\$ 0	
9. Net VAT liability	\$ 30	-\$ 30	\$ 100	\$ 100

- Zero-rating intermediate stage has no effect on ultimate tax liability (Zero-rating produces lower input credits)
- Exempting intermediate stage breaks chain of credits and **increases** tax (Neither exempt seller nor its customer is allowed input credit for VAT paid by exempt seller)
- Exemption creates “cascading” of tax, incentives for self-supply, and other economic distortions; zero-rating does not
- Intermediate stage does not want to be exempt; this is politically important

Politics of credit- method VAT

Credit-method VAT minimizes incentives to seek lower rates and exemptions:

- Only exemption or lower rates at final stage reduces tax burden
- Exemption before the final stage increases tax burden
- Business making mostly B2B sales wants to be taxable

Problems with subtraction-method

Unlikely to be enacted in ideal form

- Taxing “slices of value added” creates incentives to seek exemptions and special rates
- Similarity to income tax makes it vulnerable to more fundamental base erosion
 - Pressure to allow interest deduction, as well as expensing

Exemptions and special rates make border tax adjustments inaccurate

- Exports may be subsidized
- Domestic production may bear lower effective rate than imports
- Trading partners might bring cases against the US in the WTO
 - It does not look like a sales tax
 - Export subsidy/import tax

Coordinating state sales taxes with a federal VAT: I

- Consider only credit-method federal VAT
- Canadian experience: credit-method state VATs and/or state RST could coexist with federal VAT

Coordinating state sales taxes with a federal VAT: II

- Conformity of state and federal tax bases
 - Would facilitate cooperation
 - Could improve state taxes
 - Reduced taxation of business inputs
 - Increased taxation of services
 - Politically difficult

Coordinating state sales taxes with a federal VAT: III

- **Administrative cooperation**
 - State utilization of federal registration
 - Exchange of information
- **State control of tax rates**
- **Issues created by local sales taxes in 30+ states**

State and Local Sales Tax Options, Assuming a Federal VAT

Option	1	2	3	4
State tax	RST	RST	VAT	VAT
Local tax	RST	VAT	RST	VAT
Feasible?	Yes	No	Yes	Yes

Dealing with interstate trade

- **Achieving destination-principle taxation of interstate trade**
 - Imports: taxed; Exports: tax-free
- **Automatic under an ideal RST**
- **Problematic under state VAT**
 - Exports are zero-rated in EU
 - B2B imports not taxed at state boundaries
 - Reverse charging or deferral

Problems of destination-based taxation under a state VAT: I

- **Massive refunds**
 - **Export refunds as % of gross VAT**
 - Canada: 50.3 percent
 - New Zealand: 35.5 percent
 - EU member States: 38.1 percent
 - Perhaps greater in US
 - **Not required under RST**

Problems of destination- based taxation under a state VAT: II

- Risk of carousel fraud
 - Special case of missing trader fraud
 - Based on credits/refunds for taxes not remitted
 - Cannot occur under RST

Dealing with interstate trade & carousel trade: Canada/Quebec “Dual VAT”

- An EU-style VAT with federal/state administrative cooperation
 - Quebec administers federal tax
 - Exports are zero-rated
 - Imports taxed via reverse charging or deferral
- No evidence on extent of refunds
- Does Canadian GST prevent carousel fraud under Quebec QST?
- Could be used at state level in US, but not local level

Dealing with interstate trade/carousel trade: “Integrated sales tax” I

- State registration based on federal registration
- All B2B sales zero-rated
 - Based on registration for federal VAT
- VAT at rate chosen by state on in-state B2C sales

Dealing with interstate trade/carousel trade: Integrated sales tax II

- May be best solution for US
 - Avoids refunds and carousel fraud
 - Consistent with state tradition of RSTs
 - Federal VAT protects administrative integrity of state tax
- Could be used at the local level, with either state VAT or integrated sales tax (state VAT & local IST)

Dealing with interstate trade: “Traditional” RST

- An RST that taxes many B2B sales and exempts many B2C services
- Difficulty of basing B2B exemptions on federal registration
- Difficulty of “piggybacking” on federal administration
 - Many services subject to federal VAT would be exempt from RST

Evaluation of “Fair Tax” Proposal

Key Components

- Eliminate federal income, payroll, and estate & gift taxes
- Eliminate the IRS “as we know it”
- Enact federal retail sales tax (RST)
- Provide “demogrants” to *all* households

“Fair Tax” Proposal (cont.)

Defects of Fair Tax Proposal

- Income-tax states would need to do what IRS now does
- RST rate – as high as 40% – would not be enforceable
 - Federal RST would be on top of State/local RST
 - If State/local income tax also were eliminated, combined RST rate would be even higher
 - Taxing State/local government purchases under federal RST holds down rate at expense of S&L government budgets
- “Demogrant” program would be largest expenditure program in the federal budget