Policy Brief: Value Added Tax

MPS – 541 Economic Foundations of Public Service
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Overview

Thomas Hobbes wrote, "It is fairer to tax people on what they extract from the economy, as roughly measured by their consumption, than to tax them on what they produce for the economy (Gruber, 2013)." Today, both conservative and liberal economists are pushing for a tax reform, which does just that. A tax reform that would enable increase tax compliance, simplify the tax code and improve tax efficiency can be accomplished by switching to consumption tax rather than an income tax.

Value-added tax (VAT), also known as a cascading consumption tax or a Good and Services tax, was created by Maurice Laure`, joint director of the France Tax Authority us credited as being the first to introduce VAT in 1954 (EconomyWatch, 2010). It is used in over 160 countries across the globe with 90% of the population living in countries that have VAT or GST (Royal Malaysian Customs Department, 2014). Many of the countries that have VAT are members of the Organization for Economic Co-operation and development (OECD). On average, these countries collect approximately 32% of their total revenue from VATs and only 27% from personal income tax. By contrast, the U.S. collects over 70% of revenue from income taxes (Lee, Kim, & Borcherding, 2013).

The Congressional Budget Office (CBO) conducted a detailed study in 1992 regarding the "Effects of Adopting a Value-Added Tax" in the U.S. Although there have been many reviews of VATs throughout the developed world, this study most directly links the outcomes of a VAT if implemented in the U.S.

What a VAT is

Unlike other consumption taxes such as the retail tax used in the U.S., VAT is collected in stages as the goods and services are produced and marketed. Taxes apply applied only to the value added by labor and capital at each stage, determining the amount of tax owed. Each business allows a credit for value-added tax paid on purchases of goods and services for business use. Traders must register as a VAT trader and be provided a number to provide to customers on invoices.

The most widely used form of VAT is the European-style and uses border tax adjustment to tax the entire value of goods in the country where they are consumed even if from abroad. The European-style VAT is preferred by many countries because it accommodates tax preference. However, there are countries that prefer the credit VAT method, the subtraction method VAT or the addition method.

Disadvantages of a VAT

Despite the assertion that a well-designed VAT enables the marginal tax rate to be low, some economists argue the tax burden is unfairly distributed. These economists point to the impact on low-income families and small businesses. In addition, some analyst purport VAT results in economic inefficiency through cascading taxes and excessive administrative cost.

One of the most consistent and common criticisms of VAT is it performs as a regressive tax. Under VAT low-income family tax rates – as a percentage of income – is greater than higher earning families. A few ways to correct the regressive nature of the VAT include exempting good and services lower income families spend large amounts of their budget on and allowing income tax credit for those families.

However, the CBO's 2011 study on reducing the deficit clearly illustrates these remedies can cause additional issues. In the study, the CBO argues exempting goods and services would substantially increase the costs of enforcement and compliance while reducing revenues. A narrow-based VAT with exemptions would distort economic decisions to a greater degree than would a VAT with a broader base. In addition, the report asserts a tax credit approach could be specifically targeted to lower- and middle-income families, but such provisions could add to the complexity of the individual income tax (Congressional Budget Office, 2011)

Similar to low income earners, some analyst believe small businesses disproportionately endure a tax burden under a VAT system. The cost of record keeping for a small business with VAT requirements could be excessive and detrimental to the viability of some small business. Business compliance costs are generally considered regressive with respect to tax revenue, which means that the firms, which must comply with VAT recordkeeping, are those most able to handle the additional costs (Brashares, Knittel, Silverstein, & Yuskavage, 2014). To combat this hardship an exemption similar to that for low-income families would need to be instituted.

In additional to these burdens some analysts argue VAT results in economic inefficiency. Taxing goods and services bought by businesses to produce other goods and services is economically inefficient because it imposes multiple taxes on some consumer goods and services. Cascading taxes create incentives for business to produce fewer goods or services, shift resources into tax-favored activities, or adopt tax-driven business structures. Cascading taxes also may have a negative impact on U.S. competitiveness because they impose some tax liability on exports and result in less tax being assessed on imports relative to competing domestically produced goods (McLaren & Bakale , 2008).

Economic Outcomes of a VAT

Through the implementation of a Value Added Tax, the market failures of the current tax structures can be rectified to increase nation savings, national output and promote growth in capital-intensive industries in the U.S. As the U.S. continues to grow, by using this type of system, our capital-intensive markets such the communications, and technology industries would primary compose the exports market increasing competition in the market place while also increasing the import labor-intensive industries such as the textile, apparel and furniture industries (Congressional Budget Office, 1992).

By utilizing a broad-based VAT with a uniform tax rate, allocation of economic resources would become more efficient. Although a VAT would lower the purchasing power of the consumer, it would tax the consumer indirectly; preventing taxpayers from changing their behavior through either the income effect or the substitution effect to avoid the lump-sum tax placed the value of existing capital. Since the consumer is unable to change behavior to avoid this tax, the misallocation of resources is reduced and the social efficiency is gained.

Due to the effect a VAT would have on the international trading power of the U.S. and tax exportation, a VAT would have a negligible effect on international trade "because U.S. exports and imports appear to have nearly the same capital intensity on average (Congressional Budget Office, 1992, pp. 61). However, there would be a gain in exporting the tax burden of a VAT; however, a greater burden would be exported if the imports were more capital-intensive than exports.

As noted in the European VAT, Boarder Tax Adjustments (BAT) can be used to provide a trade advantage. By imposing a tax on imports and refunding the tax on exports, a cost advantage would be created for domestic industries. The efficiency gained with a BAT could be lost depending on trade composition and inflation, however by adopting a VAT would primary create an initial price spike in goods with little or no effect on inflation as seen in other countries who have adopted a VAT (Congressional Budget Office, 1992). Overall, a VAT will increase invest in domestic goods and services associated to capital-intensive industries.

Cost of VAT Implementation

The cost of VAT implantation will affect both the federal budget and private business. As cited by the CBO study, 1992, administrative and compliance costs of the VAT would be about five to eight billion per year. These costs would also be independent from the amount of revenue raised from the VAT. This is important to consider when judging the merits of the Value Added Tax, the benefits of increased savings and greater economic efficiency versus the cost in administration and compliance of the program.

Examples of the associated costs include the cost for the IRS to set up guidelines and regulations, and create a system to process payments. When the department of treasury undertook its tax reform study in 1984, it estimated that administering the VAT in the U.S. would require 20,000 additional IRS employees, to manage, enforce, and educate consumers about the tax (Congressional Budget Office, 1992). Without new employees to accomplish these tasks, other employees would be reassigned from revenue generating department to support the VAT.

Business would bear additional costs under a VAT as well. Although the specific costs of complying with the VAT are vague, they appear to be substantial. For example, small businesses would face a high compliance cost because of their lack of scale when complying with taxes. In order to relieve the value added tax burden on small business, European countries often times exempt them from registering. The government determines what the sales threshold is set at. After the threshold is set, all small businesses that are below the threshold are exempt.

Another way that countries have been trying to lessen both administrative and compliance costs are through a uniform tax rate. Most European VATs use two additional positive rates in addition to a zero rate. The higher rates are typically put on luxury goods and are used to shift the VAT's burden to high-income consumers. The zero rate is used on necessities so that it can reduce the VAT's burden on the poor. As cited in the CBO Study, 1992, European countries have been slowly moving towards having fewer rates as they begin to recognize the administrative and compliance costs associated with multiple rates.

An Alternative to a VAT

The principle advantage of a VAT over an income tax is the ability to raise revenue more efficiently. That does not mean that the VAT does not have its own problems. In order to address these problems an alternative to VAT is a direct consumption tax, this would tax consumption by directly taxing income from labor and existing capital. If a consumption tax were chosen in the U.S. over a VAT, it would be less regressive. This type of tax would also have fewer administrative and compliance issues.

Summary

Overall, the CBO study noted in regards to the economic effects of a VAT that “compared with a surtax, the VAT increased the long-run saving rate by slightly more than .5 percentage points. As a result, the capital stock is 7.9 percent larger, output (measured by net nation product) is 1.5 percent higher, and consumption is 1.2 percent higher, in the long run (Congressional Budget Office, 1992, pp.53).” Although there are many positive effect of implementing a VAT in the U.S., as noted above there are also many costs and scenarios associated with this type of consumer tax. The possibility exists to create a more socially efficient taxation system while mitigating the regressive nature of this type of tax, however this is dependent on the direction and composition of the U.S. economy in the future.

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