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Lisa Lim

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By: Lisa Lim, *MST Student*

Introduction

Value added tax (VAT), a consumption-based tax, is often considered as an alternative to reduce a government's reliance on the income tax. Globally, over 140 countries have adopted the VAT to generate revenue and serve as a border-adjustable tax (unlike the income tax).[32] The United States is the only OECD member nation without a VAT.[33]

This analysis examines a proposal to implement a broad-based, low, single-rate credit-invoice VAT in the United States. The introduction of a federal-level VAT would be supplemented by a simplified federal income tax with fewer tax brackets, lower income tax rates and a scaled-down tax preference regime. The intent of such a proposal is to improve the overall tax regime in the United States.

Principles of Good Tax Policy Evaluation

The following chart explains how the principles of good tax policy apply to the proposal to impose a VAT along with a greatly simplified income tax in the United States. The analysis uses the ten principles of good tax policy outlined in the AICPA Statement #1, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*.

Principles of Good Tax Policy Evaluation

Principle	Application	Rating
Equity and Fairness Similarly situated taxpayers treated similarly.	VAT is generally regarded as a regressive tax. Under this proposal, a broad-based single-rate VAT that applies to all goods and services, without any compensating measures is the most regressive form of VAT. Vertical equity and the ability-to-pay principle are adversely affected by a broad-based VAT. This is because the total VAT paid represents a higher tax burden as a percentage of current income of a lower-income taxpayer than a higher-income taxpayer. Further, low income taxpayers are thought to be the hardest hit because they tend to spend a larger proportion of their income on basic necessities than any other group.[34] However in an IMF publication, Ebrill et al. (2001), pointed out	**+/-**

[32] OECD, Consumption Tax, available at http://www.oecd.org/department/0,3355,en_2649_33739_1_1_1_1_1,00.html
[33] *Ibid.*
[34] Alain Charlet and Jeffrey Owens, "An International Perspective on VAT," *Tax Notes International*, September 2010, p 949; available at http://www.oecd.org/dataoecd/47/45/46073502.pdf.

	that the impact of VAT is highly regressive only when measured against current income, in isolation.[35] The alternative view suggested is to assess the wider impact of the overall tax system. Ebrill et al. (2001) conclude that a broad-based VAT is neither regressive nor progressive, if other compensating direct government spending programs and a progressive income tax regime are taken into account. Another alternative view considers ability-to-pay from a consumption standpoint, rather than from an income perspective. If one can afford to consume more goods, this directly indicates a higher ability-to-pay. Hence the VAT will impose a tax that is in *proportion* to a person's ability-to-pay, resulting in vertical equity. The 2005 Bush Tax Reform Panel report noted the regressive nature of VAT, but the Panel believed it was possible to achieve an "approximately distributionally neutral" VAT.[36] To achieve this, some adjustments to the VAT proposal would be required, including changing the VAT rate structure and providing a refundable tax credit. Although lacking vertical equity, a broad-base single-rate VAT is favored because it adheres to several other principles (as noted below) such as simplicity, neutrality and certainty. In practice, the regressive nature of VAT is usually addressed by governments through a multi-rate structure. Goods are categorized and taxed at different rates, similar to the current sales tax regime in the US. But, the administrative cost of providing a VAT rate differential must be examined against the benefits of improving the distributional fairness of a VAT.[37]	
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Generally, under the single-rate credit-invoice VAT, all businesses collect a uniform VAT calculated on the sales price. At the end of the reporting period, total VAT collected is reduced by total VAT paid on all purchases. Assuming a profitable business with receipts higher than input purchases, the excess VAT collected is then remitted to the authorities. If VAT paid is greater than what the business collected in VAT, a refund is issued. This is a relatively simple and straightforward procedure that aids certainty.	+

[35] Liam Ebrill, Michael Keen, Jean-Paul Bodin, and Victoria Summers, *The Modern VAT*, International Monetary Fund, 2001, ISBN: 1-58906-026-1, p 105.

[36] President's Advisory Panel on Federal Tax Reform, "Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System", November 2005, p 191; available at http://govinfo.library.unt.edu/taxreformpanel/.

[37] Vito Tanzi and Howell Zee, "Tax Policy for Developing Countries," International Monetary Fund, March 2001, available at http://www.imf.org/external/pubs/ft/issues/issues27/index.htm.

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Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	The payment of a consumption tax, such as VAT is extremely straight forward and simple. From a consumer point of view, a VAT is no different from a sales tax. VAT is applied on the final purchase price and is paid at the point-of-sale. Under a broad-based VAT, most purchases of goods and services would have VAT added to the price. On the business front, payment of VAT is also relatively convenient. The excess VAT collected at the end of the reporting period is remitted to the tax authority. Again, this process does not differ from the existing procedure with the income tax.	**+**
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	In general, introducing a new VAT system in the US would increase the administrative burden and cost for the government. The main concern is the fixed cost to set up a new VAT administrative system within the IRS. These include training programs for IRS staff, implementation of a new IT system, issuance of forms, instructions and technical guidance, taxpayer awareness programs, and enforcement plans to ensure that all taxpayers can properly comply with the VAT. In a 1993 report, the US Government Accountability Office (GAO) estimated that the cost of administering a broad-based VAT in 1995 would be between $1.22 billion and $1.83 billion annually.[38] However, more recent studies showed that a broad-base single-rate VAT is in fact a more cost-efficient way to collect tax in the long run. The Bush Tax Reform Panel (2005) noted that in our current income tax system, the compliance cost is approximately 13 cents per dollar of tax paid, while the compliance cost of VAT in the EU countries range between 3 to 5 cents per dollar of tax paid.[39] Accordingly, VAT is known as an extremely efficient revenue generator and hence the name, "money machine". A 1% VAT in the US is estimated to generate approximately $37.8 billion in revenues.[40] Assuming that there is no marginal cost of compliance, increasing the VAT rate to 10% can effectively raise revenues without triggering additional compliance burdens.	**+/-**

[38] U.S General Accounting Office, "Report to the Joint Committee on Taxation, U.S. Congress, Value-Added Tax: Administrative Cost Vary With Complexity and Number of Business," May 1993, p 5; available at http://www.gao.gov/products/GGD-93-78.
[39] President's Advisory Panel on Federal Tax Reform, "Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System," November 2005, p 201; available at http://govinfo.library.unt.edu/taxreformpanel/.
[40] James M Bickley, "VAT as a New Revenue Source", CRS Issue Brief for Congress, Congressional Research Service," June 2005.

	In other words, VAT produces a high revenue *yield* and supports a cost effective collection process.	
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	In general, adding a VAT to the current income tax regime would not complicate matters for most individual taxpayers, who are consumers. There are no additional filing and reporting requirements for individuals who do not operate a business. And taxpayers stand to benefit from a simpler income tax regime that accompanies the proposal. However, adding on a VAT on top of the current corporate income tax regime could create another layer of complexity for businesses. But as mentioned under the principle of “certainty,” a broad-base single-rate credit-invoice VAT is relatively simple to administer. Businesses collect a uniform VAT on all their invoices and pay a uniform VAT on all purchases. Excess VAT collected is remitted to the authorities. Capital purchases qualify for input VAT refunds. And goods for export are not taxed. Without special exemptions and multiple rates, this form of single-rate VAT will be the easiest to comply with. Thus it is possible that VAT coupled with a simplified corporate tax regime could create a combined system that is potentially more business-friendly. The possibility of states replacing their sales tax systems with the federal VAT could yield further simplification.	**+/-**
Neutrality The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	Under the current income tax regime, tax is imposed twice. Once on income earned and later again when the income saved earns interest. This is said to discourage savings and encourage current spending. However, as a consumption tax, VAT does not tax interest earned on savings or capital gains. Also, a broad-based single-rate VAT ensures uniformity and neutrality. The consumer choice is not distorted among various goods and services. This applies to businesses as well. There will be no economic incentive or disincentive to purchase or produce any one item. Thus, the neutrality of the tax system is better preserved.	**+**
Economic Growth and Efficiency The tax system should not impede or reduce	Some analysts point to several negative effects on the broader US economy upon implementation of a VAT. One primary concern is the creation of an upward inflationary pressure causing an increase in consumer goods prices. In the 2005 CRS report by Bickley, it was noted that VAT would cause a “one-time” increase in consumer prices.[41] Unlike other European	**+**

[41] *Ibid*.

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the productive capacity of the economy.	countries which had an existing federal-level sales tax replaced with a VAT, the US does not currently have a federal-level sales tax. Thus a VAT introduction is expected to cause a one-time increase in prices. However, VAT cannot be said to cause sustained upward inflationary pressure. The second concern points to the efficiency of a VAT to generate enormous amounts of revenues that ultimately fuels government spending. However, studies show that there is no conclusive evidence to link the revenue potential from VAT to government expansion.[42] In fact, a case study of Canada shows that government spending gradually declined after the institution of a VAT in 1991. Subsequently, the Canadian VAT rate was reduced further shrinking government revenues and expenditures.[43] A third concern is the intrusion of VAT into the state's sales and use tax (SUT) base. Opponents argue that combining a federal level VAT on top of a state SUT will lead to an excessive rise in prices that will curb public consumption.[44] This concern was supported by a report prepared by Ernst & Young LLP for the National Retail Federation. The report found that introducing a VAT in the US will cause a significant decline in retail spending that will ultimately result in the loss of 850,000 jobs nationwide within the first year.[45] On the other hand, there is substantial support from commentators who believe that the state sales tax can be successfully integrated with the federal VAT. In the scenarios proposed, states could remove their existing SUT regime and "piggyback" on the federal VAT administration. States retain the autonomy to impose additional percentage points on top of the federal VAT, while a centralized administration program creates efficiency and economy in collection.[46] More importantly, the VAT is known to be administratively	

[42] Christina D. Romer and David H. Romer, "Do Tax Cuts Starve the Beast: The Effect of Tax Changes on Government Spending," National Bureau of of Economic Research, October 2007, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1024965.

[43] William Gale and Benjamin Harris, "A Value Added Tax for the United States: Part of the Solution", Brookings Institution and Tax Policy Center, July 2010, p 11; available at http://www.taxpolicycenter.org/UploadedPDF/1001418_VAT_solution.pdf.

[44] Peter Roff, "Kansas Republican: VAT Tax Would Cripple U.S. Recovery," May 28, 2010; available at http://www.usnews.com/opinion/blogs/peter-roff/2010/05/28/kansas-republican-vat-tax-would-cripple-us-recovery.

[45] Robert Carroll, Robert Cline, Tom Neubig, John Diamond and George Zodrow, "The Macroeconomic Effects of an Add-on VAT," Ernst & Young LLP, prepared for the National Retail Federation, October 2010; available at http://bakerinstitute.org/publications/TEPP-pub-NRFValueAddedTax-100710.pdf.

[46] *Ibid.*

	superior over the SUT in many ways. VAT can help strengthen taxation of interstate e-commerce, resolve the sales tax pyramiding issues and create a stronger audit trail to support enforcement efforts that ultimately reduces the state tax gap.	
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	VAT is highly transparent and visible. This is contrary to many public myths that VAT will be hidden between the convoluted production and distribution chain. In reality, under the current income taxation regime, many taxpayers are not fully aware of their *effective* tax rates. They are also unaware of how other taxes such as property tax and SUT interact to affect their overall tax burden. On the other hand, VAT is extremely visible. VAT can be printed on every invoice and receipt upon purchase. Taxpayers will know exactly how much VAT is paid on every transaction, at the checkout counter. The elimination of pyramiding under a VAT also helps transparency. For example, today, while food is exempt from sales tax in many states, there may indeed be some sales tax hidden in the price of food due to the sales tax grocery stores pay on equipment and other purchases. The other contention is that taxpayers would not know their total annual VAT liability, unless receipts are saved and tallied annually. But this is true of the current state sales tax regime as well. To be sure, the newly implemented VAT should be added on top of the prices of goods, instead of having the VAT imputed within the prices. This will ensure that the overall visibility of the VAT is not compromised.	**+**
Minimum Tax Gap A tax should be structured to minimize non-compliance.	VAT has been praised for its superior administrative features. Key among them is the creation of a strong audit trail in the invoices between businesses and taxpayers. Under the credit invoice approach, every business in the supply chain imposes and collects a portion of the VAT on every sale made. There is an inherent incentive for businesses to collect VAT in order to report and offset the VAT paid from their purchases. Thus, VAT mitigates situations whereby end-retailers and customers collude to evade the sales tax completely. However, VAT is not an airtight process that is "evasion-free." In the EU, several VAT fraud schemes have been identified.[47] Among the most proliferated fraud techniques are the use of cash transaction in a "black economy," non-reporting of VAT	**+/-**

[47] International VAT Association, "Combating VAT Fraud in the EU, The Way Forward," March 2007, p 6 to 10; available at www.iva-online.org/documents/IVA_Paper_FINAL.pdf.

	by insolvent companies, and the missing trader fraud also commonly known as the "carousel type fraud."	
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	According to the Tax Policy Center, a 5% broad-based VAT would have generated approximately $200 billion in revenue in 2010. The aggregate revenue potential in a 10-year span beginning 2010 to 2019, is expected to reach $3.2 trillion.[48] Further, a broad-based VAT promotes a more stable and durable revenue stream. There will be a baseline spending on necessities and basic services, which will maintain a certain amount of revenue. However, as with all consumption taxes, VAT revenues may eventually suffer from tightening wallets in the event of a prolonged economic downturn.	+

Conclusion

A broad-based single rate VAT meets six principles of good tax policy. However, it did not fully meet the requirements for equity, simplicity, economy in collection and minimum tax gap. Therefore, the timing for implementation of a VAT (if considered) is crucial. Introducing a VAT in a fragile economic environment could cause unintended consequences beyond those examined in the Principles of Good Tax Policy framework.

Possible Improvements: To address the equity issue, the solution typically applied is to provide some type of annual credit relief that reduces the regressive impact of a VAT. Simplicity can be preserved by ensuring that the VAT system will not be fraught with special exemptions and multiple rates. The administration must be committed to a single VAT rate to avoid confusing taxpayers. Also, the current corporate income taxation regime must be truly simplified to account for the additional VAT burden. To address the economy in collection concern, the fixed start-up cost of establishing the VAT system cannot be underestimated. The start-up cost must be balanced with the long run expected efficiency of VAT collection. To address the minimum tax gap concern, the US must look to the experience of its counterparts in the OECD. The US stands to benefit from the various lessons derived from other governments that can improve VAT operations.

[48] Tax Policy Center, Table T09-0442; available at http://www.taxpolicycenter.org/numbers/Content/pdf/T09-0442.pdf