PROBLEMS OF THE VALUE-ADDED TAX

RICHARD A. MUSGRAVE

THE value-added tax, by some, is viewed as the ideal tax — a business tax which does not reduce profits, a consumer tax which is unseen by the consumer, a low rate tax with large yield, a tax with built-in self enforcement in collection, a tax which hardly falls on anyone and which, if only enacted, will ring in the millennium where all of us enjoy the benefits of public services without (really) knowing who pays for them. Rarely has a new tax been able to generate such a mystique and marshalled so convinced a set of proponents. It will be my purpose here to re-examine the case in a less starry-eyed, but, I hope unbiased, fashion.

Should We Follow Europe?

Proponents of the value-added tax like to point to the recent rush toward value-added taxation in European countries, the implication being that what is good for them must also be good for us. But this, I think, is misleading evidence. The background for the value-added tax in the U.S. is totally different from the European experience. There, the widespread move to VAT in recent years was made as replacement for prior reliance on turnover taxes, a move which everyone agrees was an improvement. Moreover, it was undertaken to harmonize the tax structure among Common Market countries. Looking forward to a uniform rate, this would obviate the need for border adjustments on exports and imports within the Market. Again, an improvement. But here neither consideration applies. Fortunately, we do not have a turnover tax to replace and we do not contemplate joining the Common Market, having had one of our own for some time. For the U.S., introduction of a VAT would involve a massive shift of the federal tax structure towards sales taxation and this is quite a different matter.

Similarity to Retail Sales Tax

Next, let it be recognized very clearly that the VAT is not a new form of taxation but merely a reincarnation of our old friend, the retail sales tax.[1] While there are significant administrative differences between the two, the more important point is their basic economic similarity. While the one taxes the final product at the retail stage, the other taxes it in slabs as additions to the value of the product are made at successive stages of production. The tax base in both cases equals consumption and the burden falls on the consumer. The real policy issue therefore, is whether the federal government should adopt a broad-based consumption tax. If the answer is yes, it is only a secondary question whether it should take the form of a value-added tax or a retail sales tax. As far as economic impact goes, this is a relatively minor point, especially if the VAT appears as an explicit part of retail price.

Which is Better?

The choice between the sales and value-added tax has to be made on administrative grounds. For countries with less developed business structures, tax administrations and levels of compliance, the VAT approach is preferable. Retailers are hard to catch and the invoice method of assessment assures some degree of self enforcement.[2] But for the U.S., these considerations are not of major importance and the retail approach is a viable option.

Its advantages are a smaller number of

[1]Reference throughout is to the consumption type value-added tax, where the tax base for any one firm equals sales minus purchase of intermediate goods and minus purchases of capital goods. The sum of these bases equals consumption. Under the income type value-added tax the base for each firm equals sales minus purchases of intermediate goods and minus depreciation. The sum of these bases equals national income. The tax here at issue and the one which is used generally in Europe is of the consumption type.

[2]Under this method, each firm pays tax on total sales and then credits taxes already paid by its supplier. The result is the same as with applying the tax to the net base (equal to sales minus purchases of intermediate goods and of capital goods) at each stage.

taxpayers, the possibility of integration with state sales taxes and (if you consider it such) greater clarity and visibility. For the VAT approach proponents claim that it facilitates exclusion of capital goods and (if you consider it advantageous) that the tax is less clearly identified and less visible. It is also argued that the VAT would have the advantage of leaving sales taxation to the states, but I find that a difficult point to accept since, in fact, the two taxes apply to the same base. In all, I tend to favor the retail option but I do not feel strongly about it; moreover, this is not my major concern here. The major concern is whether we should adopt a broad-based federal consumption tax.

Rates and Yield

At 1972 levels of G.N.P., the base for a truly broad-based VAT would be from $500 to $600 billion, while with a narrow base it may be as little as $300 billion. Using the broad base concept, a 1 percentage point tax would yield from $5 to $6 billion. By its nature the VAT or retail tax involves a large base and gives substantial yield at relatively low rates. This seems attractive, but does not remove the question of where the burden falls.

Burden Distribution

The burden distribution under a general consumption type VAT would be regressive. This is the case because such a tax falls on the consumer, and because consumption as a per cent of income falls when moving up the income scale. Its incidence thus differs sharply from that of a progressive income tax. This is illustrated in Columns I and II of the table, where we compare tax burdens under a 5% VAT yielding $25 billion with income tax liabilities yielding the same amount. It is assumed that the latter is obtained by a flat 25% increase in present income tax liabilities. The striking difference between the two taxes is obvious and needs no further comment.

Distribution with Credit

It would not be fair to the cause of the consumption tax, however, to let matters rest here. Devices may be developed which will go far to take out the regressive sting or — to be more precise — to do so for all but the upper tail of the income scale. To some extent (and more conveniently under the retail approach) this might be accomplished by excluding certain items of consumption (e.g. food and clothing, in addition to housing) from the tax base, items which weigh heavily in low income budgets. Preferably and more effectively, it could be done by using a broad-based tax but permitting an initial amount of tax-free consumption expenditure.

Thus, the taxpayer might be refunded for VAT paid on, say, the first $2,000 of consumption. With a 5% tax rate, the credit would equal $100 and to avoid excessive revenue loss, it might be made to vanish as income rises. Thus, the credit might shrink by $20 for each $1,000 of income in excess of $5,000, so as to disappear when an income of $10,000 is reached. The revenue cost of such a credit would be, say, $5 billion, thus calling for a 6% (rather than a 5%) rate if $25 billion was to be raised.

The administrative problems posed by this adjustment would be similar to that of the sales tax credit now applied in eight states. For households which are subject to income tax, the refund would simply be taken as a credit against income tax and the vanishing feature could be handled readily. For others, a cash refund would be needed. Since the bulk of households for whom the credit matters most will not pay income tax, effective implementation of the cash refund would be of crucial importance. As I understand, cash refunds now remain largely unclaimed at the state level; and if this were to be the case for the federal credit as well, its effects would be voided and the burden pattern would remain regressive. This is the more troublesome in view of past and prospective upward shifts in the income level at which federal income tax begins and the absence (for the foreseeable future) of a negative income tax. Possibly part of the problem might be met by a credit against payroll tax and a supplement to welfare, but the administrative cost will be substantial.

However this may be, suppose now that

an effective credit *can* be implemented. The burden distribution as shown in Column III would then be progressive up to an income of above $10,000, thus including as much as 80% of all taxpayers in the progressive range and making the burden distribution more or less similar to that of the income tax. The remaining difference could be narrowed down further by granting a higher credit. The consumption tax approach then could no longer be blamed for regressivity over the lower and middle range. But, by the same token, little would be gained by adding a new tax with all its compliance and administrative cost if the income tax does the same job. While it is true that the tax would favor savers as against consumers (relative to the income tax) this difference is hardly of sufficient importance over this income range to justify a new tax.

Moreover, Column III also tells us that a substantial difference between the two approaches would remain for the upper 30% of taxpayers. Here, progressive taxation of consumption could be implemented only via a personal expenditure tax. Though theoretically attractive, such a tax is not in the cards at this time. Now it may be argued that this is not too important, provided that upper bracket progression is implemented effectively via the income tax. If a VAT or retail tax were introduced and accompanied by removal of income tax preferences over the upper part of the income range, I would see no great objection to such a move on distributional grounds. But I doubt whether the result is worth the administrative effort involved. Improvement of and continued reliance on the income tax at the federal level would be preferable, combined if necessary with increased use of the sales tax base at the state level.

Substitution for Property Tax

Evaluation of the VAT, as of any other tax, has to be by comparison with its alternatives. Such is obvious if VAT revenue is to be used to finance the reduction of other taxes, but it also holds if additional revenue is needed and the VAT is compared with alternative new sources.

In recent months, the VAT has been seen increasingly in relation to the property tax. I am referring especially to the Administration's proposal — or what is said to be its coming proposal — that a federal VAT be introduced to support grants to states, to be passed on to local governments for school finance. This is to achieve the double objective of (1) eliminating dependence of educational facilities on the local tax base with resulting service differentials, and (2) of permitting property tax relief. The first objective is in line with several recent court decisions and altogether praiseworthy; but it is a non sequitur to suggest that property tax reduction is a necessary consequence. The obvious point to make is that to equalize service levels, it is merely necessary to place the property tax on a state-wide basis with equalized assessments and to redistribute proceeds back to localities in line with school needs. If a case is to be made for replacing property taxation with VAT revenue, it must therefore be made quite independent of the issue of school equalization.

I do not believe that there is a valid case for such a substitution. While the property tax need be improved — including above all state-wide administration and assessment — it is not a bad tax nor do I believe that, on the whole, it is excessively high. Homeowners, after all, not only pay property tax, but also derive favorable treatment under the individual income tax; and if the present situation imposes too heavy a burden on the little fellow, devices such as the Wisconsin circuit breaker might be applied and expanded to relieve him. If property tax reduction should prove the core of the new populism, so-called, William Jennings Bryan might indeed turn in his grave. Given the agenda of unmet public needs and the inadequacy of present revenue sources to provide for them, I find it unacceptable to introduce a major new tax such as the VAT only to serve as a substitute for the property tax. The property tax should be improved but it will continue to be needed as a major source of revenue at the state and local level. The key words are reform and state-wide revenue use, not repeal.

Moreover, federal assistance to state-local finance, whether drawn from the income tax or a value-added tax, should be given to help jurisdictions with low fiscal capacity and high need to enable them to meet minimum standards of public service; it should not be given as an invitation to tax reduction at the state-local level.

Substitution for Corporation Tax

Prior to bringing in the property tax, advocates of VAT thought of it mainly as a means to finance a reduction in corporation tax. This argument was based on three points.

The first involves balance of payments considerations. It was held that European countries have enjoyed a trade advantage because they have been able to apply an export credit under the turnover tax or VAT, whereas our exporters (not having such a tax to credit) have been at a disadvantage. This argument, at least in its crude form, is fallacious: introduction of VAT without an export credit bestows a disadvantage on the exporters; and granting the credit merely removes this disadvantage, leaving the net situation unchanged. But can the same be said for VAT-financed reduction in the corporation tax? For such a substitution to result in direct trade gains, it must be assumed that the corporation tax was shifted initially forward and that its removal resulted in reverse-shifting. It is doubtful that such would be the case. In addition, there may be indirect balance of payment gains — especially on capital account — but I do not consider these sufficient to be a major factor in the VAT issues. The recent devaluation, moreover, has rendered this aspect less important; and if tax adjustments were to be made to improve the balance of payment situation, there are other steps (e.g. reconsideration of tax deferral) which should come first.

The second point made in support of VAT substitution for the corporation tax is that the latter is partial (as it applies to the corporate sector only) and therefore imposes an excess burden caused by the resulting over-allocation of capital in the unincorporated sector. The VAT by being would it in fact be general? A realistic view general is said to have no such burden. But of the matter makes this highly unlikely. Chances are that the fraction of total consumption exempt from VAT would be no less (or more) than that of profits remaining outside the profits tax. Thus VAT would not be free of excess burden. While the distortion would be in consumption rather than production, relative costs in terms of excess burden are not readily assessed. It is not obvious which tax would win out.

Thirdly, the case for substituting the value added tax is based on the proposition that it is less detrimental to growth than are other taxes. This point has some validity, but I do not think that the difference is very great; and though I am not on the stop-growth bandwagon, I would not lightly substitute major losses in tax equity for minor gains in growth. Moreover, I believe there are other ways (including such devices as a flexible investment credit) which are better suited to secure growth with equity. Finally — and this should go without saying among people who are sincere about tax equity — use of VAT revenue to reduce corporation tax should be preceded by integration of retained earnings into the personal income tax.

Inflation Effects

A further difficulty with VAT or a retail tax is its impact on inflation. I would think it hardly worthwhile to introduce a federal consumption tax — with all the machinery which this would require — at a rate of less than say, 5 per cent. Such a move would undoubtedly be reflected in a corresponding increase in consumer good prices. In the absence of wage escalation, this would be a once for all and not very burdensome change — no more burdensome than a corresponding deduction in disposable income due to an increase in income tax. But given the behavior of wages and prices in our economy, it would surely result in further escalation of wages and prices, thus setting into motion a chain of adjustment which would greatly complicate the task of price stabilization. The success (or lack thereof) of stabilization being what it has been, such a handicap should not be added at this time.

Financing the Seventies

I conclude that there is no good case for introducing a federal retail or value-added tax as a substitute for revenue from present taxes, be it the property, income or corporation tax. Rather, I would support income tax and property tax reform. At the same time, the topic of this seminar is not tax reform but *Financing the Seventies*. In this respect, it is my view that revenue available from present taxes will not suffice to meet our public needs during the coming decade. It is by now recognized that the massive bonanza of excess revenue, due to built-in revenue growth and declining defense needs will not materialize. This mirage having vanished, we should recognize that substantial amounts of additional revenue — say, $50 billion or more — will be needed by the mid-70's if we are to mean business in meeting our social needs, including income maintenance, schools, health, environment, housing and other public services. While I see none of our plentiful presidential candidates so advise the public, this revenue will not be obtained entirely or even primarily from budget cuts or the closing of income tax preferences. New taxes or substantial rate increases under the income tax will be needed to meet the bill.

Viewed in this context, I am not prepared to rule out the use of a federal consumption tax, assuming that an adequate and effective credit can be provided and that the move is accompanied by income tax reform in the upper brackets. An equitable burden distribution can be obtained and need not differ greatly from that of raising income tax. If Congress is willing to finance overdue public needs in this way, while rejecting the income tax route, the net result may well be a gain. But this, I repeat, is a different matter from viewing the new tax as a replacement for present and in most cases superior, revenue sources.

This qualified endorsement is, however, given with some hesitation. Having spent the better part of my life arguing that taxes should be personal and visible — the former to secure equity and the latter to secure an effective democratic process — I do not feel at ease in advocating an invisible tax to secure public services which (though I hold them desirable) people might not be willing to vote for if properly assessed. Moreover, the gambit may fail. Tax legislation in recent years has resulted in a substantial slippage in income tax revenue.[3] Making a major new revenue source such as VAT available may well lead to further income tax slippage; and though VAT may not be introduced as a substitute in the first place, it may have a hidden long-run effect of this sort. Given this danger, it may be the better part of political wisdom to forego the VAT to begin with. Perhaps a solution might be found by linking the new consumption tax revenue to a specific social program such as expanded income maintenance (moving towards a negative income tax) or to the provision for health

BURDEN IMPACT OF RAISING $25 BILLION IN ALTERNATIVE WAYS

(tax as per cent of AGI)

Adjusted Gross Income	Income Tax[1] I	Value-Added Tax, 5%[2] II	Value-Added Tax, 6% with Credit[3] III
2,000	—	5.0	—
4,300	—	4.5	2.7
5,000	0.49	4.4	2.9
10,000	2.26	4.0	4.8
15,000	3.03	3.7	4.4
50,000	5.96	2.5	3.0
100,000	8.63	2.0	2.4

[1]Joint returns, four exemptions. Above $15,000 assumes 10% as deduction. All income fully taxable. Assuming the yield from present rates at $100 billion, the above equals one quarter of present liabilities to yield $25 billion.

[2]Ratios estimated with reference to *Tax Burden and Benefit of Government Expenditures by Income Classes 1961 to 1965*, Tax Foundation, 1967. These estimates, especially for higher incomes, should be taken as illustrative.

[3]$2,000 of consumption is tax-free. Credit of $120 to vanish by$24 for each $1,000 of income in excess of $5,000.

[3]While there has also been a substantial increase in the weight of payroll taxes in the federal tax structure, this poses a somewhat different problem as it should be seen not only as a change in tax structure but also in relation to increased transfer payments.

insurance. Even though earmarking (under ideal conditions) is a bad budget practice, it might be useful in this context. However this may be, the circumstances under which I would visualize the introduction of a VAT are not those which most of its proponents have in mind. And given the circumstances which they usually visualize (i.e. reduction of other taxes) I would not favor its introduction.