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Value Added Tax

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Introduction

This paper looks at the fundamental aspects of a Value Added Tax. There is a discussion and brief description of different types of Value Added Tax schemes. It will look at different ways to address inequity and the regressive nature of VAT. Lastly, there will be some observations and discussion of the impact it could have in the United States.

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Value Added Tax or VAT

In the coming months and years you will be hearing more about the Value Added Tax or VAT for short. It is no secret that policy makers and legislators are facing ever more challenging budgetary constraints, whether it is current funding or unfunded liabilities.

Robert Williamson at The Tax Policy Center says the top marginal rates could rise by 30 percent over the next 10 years, given the current deficit projections; if the choice was to lean on the top 5 percent of tax payers to foot the bill.

Choices will have to be made; either cut spending and programs, raise revenue or a combination of both. It is likely we will see some combination of the two. So how do we pay for it all? Simply raising income and corporate taxes is not the

answer. Overall, income taxes are already high and corporate rates are among the highest in the developed world.

This brings us to the VAT. In America we are not really familiar with what a VAT is and how it works. VAT has a number of different names. It can be called a consumption tax or goods and services tax.

What is VAT?

First, it is NOT a national sales tax. A sales tax is one that is levied on the entire amount of a purchase and is itemized for the consumer. The consumer pays the full amount of the tax due at purchase.

A Value Added tax is a tax levied at each stage of production of an item. The product chain begins at the raw material stage and ends at the finished product. The tax is assessed at each stage as “value” is added to the product at each stage of production. Value Added is simply the difference between the good or service sold and the value of the good or service

purchased. An example is a gallon of milk currently costing \$3.79 would go up to \$4.74, assuming a 25 percent VAT.

The VAT is a major part of the tax system in over 136 countries, raising about one-fourth of the world's tax revenue (Aizenman and Jinjark Aug. 2005).

Methods of imposing VAT

The first method would tax gross sales net of intermediate goods purchased at each stage of production. This is known as the subtraction method.

A second method imposes VAT on gross sales and allows a credit for the taxes paid by other firms at the earlier stages of production. This is known as the credit method.

The third method relies on general cash flow from the firm. It

uses a formula to distinguish between old capital and new capital to a firm. Old capital, in the form of debt or equity, is taxed as it is retired or as income is paid. New capital is excluded from the base and is not taxed.

VAT in Practice

The most common method used for VAT is the credit method. Firms are required to provide proof that VAT has been paid on purchases in order to take the credit. This requires a certain amount of self regulation.

The VAT can be somewhat efficient for a taxing authority to monitor. It is easy to compare reported sales and purchases along each stage of production. Enforcement requires a process to collect and analyze data along the production stream to ensure proper reporting and collection of taxes.

This process is not much different than our current income tax system, from an analysis and processing and manpower

standpoint. The paper trail to enforcement should be more transparent, with less “off the books” transactions. A clear trail up the production line would make identifying tax cheats much easier than the current income tax system.

Criticisms of VAT

The main criticism of a VAT is that it is regressive. People at the lower end of the income scale pay the same as those at the higher end because the VAT is passed along the production chain and is represented in the final price of goods and services.

An idea that has been proposed is a Progressive Value Added Tax. In this scheme tax rebates are linked to wages earned.

Implementing VAT in the U.S.

A VAT would be controversial and require a real change in our tax

system. One of the questions is what exactly could be paid for by implementing a VAT.

Like any tax, the amount of revenue generated in part is dependent on the rate.

A few have estimated what VAT, at certain rates, would pay for in the United States. Ezekiel Emmanuel has estimated a 10 percent VAT would pay for healthcare for every person not currently enrolled in Medicare or Medicaid. Yale law professor Michael J. Graetz estimates that a VAT of between 10 and 14 percent would raise enough money to exempt families earning less than \$100,000 a year from income taxes. This accounts for about 90 percent of all taxpayers. Finally, in a paper published by the Virginia Law Review, Leonard Burman of the Brookings Institute suggested that a VAT of 25 percent would pay for healthcare, exempt 90 percent of Americans from income taxes and could cut the top income tax rate to 25 percent.

Conclusions

A VAT could help reduce or eliminate current budget deficits and possibly provide the revenues necessary to provide healthcare for all. The assumption being that the estimated costs are realistic. But relying on a VAT to meet those costs has its pitfalls. Christian Weller points out in *The Benefits of Progressive Taxation in Economic Development*; countries with high VAT and a progressive tax system experience higher volatility in revenues. Just the opposite is true in countries with lower VAT and progressive tax systems. Volatility of revenue requires disciplined spending practices.

VAT is currently being discussed at the Treasury and the White House. Some are urging to push ahead. Others, like former

Federal Reserve Chairman Paul Volker, are open to the idea but with caution.

At some point overall tax reform is going to be needed to address deficits and unfunded obligations. The world appetite for US debt is likely to wane at some point. Policy makers will need to come up with a scheme that balances the need for revenue and fosters economic growth. Part of this balance may lead to tough choices about current programs.

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