



# Issue Bulletin

No. 56

The Heritage Foundation · 214 Massachusetts Avenue, N.E. · Washington, D.C. 20002-4999 · (202)546-4400 · Telex:440235

December 4, 1979

## THE VALUE ADDED TAX

### INTRODUCTION

The recent enthusiasm for the value added tax (VAT) expressed by both Rep. Al Ullman (D-Oregon), chairman of the House Ways and Means Committee, and Senator Russell B. Long (D-La.), chairman of the Senate Finance Committee, is primarily a response to an approaching fiscal conflict. The current tax system has been widely criticized for its bias against savings, investments, and capital formation. Recommendations to improve U.S. productivity invariably include a tax cut proposal.

Pressure to repeal or reform the offending tax provisions is matched by the apparently intractable demand for additional federal outlays and consequently more tax revenues. Despite the greater tax revenues such cuts would produce, there is a great resistance to any short-term revenue reduction. The social security system, confronted with both a growing intolerance toward increased payroll taxes and the often automatic expansion of benefits and beneficiaries, is a precursor of the future crisis.

Theoretically, the VAT can satisfy both seemingly exclusive demands. Due to its neutral effect on economic decision-making the VAT, when substituted for distorting elements of our current system, will increase domestic economic activity and U.S. exports. At the same time, the new tax possesses powerful revenue capabilities. A 1 percent VAT may raise anywhere from \$10-14 billion.

Opposition to the VAT springs not from its theoretical promise, but from its political potential. The case for the VAT is based on a comparison of the ideal VAT with the existing tax structure. Proponents should recognize that the same forces which fashioned the allegedly inadequate current system will shape the legislated VAT.

A second source of concern is the VAT's effect on the size of government. It is feared the VAT rate will prove exceedingly easy to raise. Contrary to popular belief, the "hidden tax" threat of the VAT stems not from the tax itself but rather from the unindexed taxes for which it is substituted.

#### THE VALUE ADDED TAX

The value added tax is simply a tax assessed against the increase in the value of a good or service created during each step of production. The "consumption" version, the most common in Europe and often proposed for the U.S., would permit the entire cost of capital to be deducted from the value added in the year of purchase.

Ullman's VAT proposal, H.R. 5665, the Tax Restructuring Act of 1979 offers an illustration of how a VAT might function. The bill proposes to place a 10 percent tax on the sale of property or performance of a service within the United States. Imports would also be subject to the 10 percent assessment. Each month, the proposed tax period, total tax liability would be determined and paid. A credit for the value added tax assessed and paid during earlier stages of production would be subtracted from the 10 percent liability, resulting in the tax due. Should credits exceed liability, a refund would be forthcoming. It would be incumbent upon the seller to provide an invoice stating the value added tax already paid. This method encourages compliance through self-policing.

The mechanics of the VAT calculation are illustrated in Table 1. The value added during the 3rd stage of production is \$75. A tax of 10 percent should yield \$7.50. The price of the good after stage 3 is \$275. The 10 percent rate will yield a gross liability of \$27.50. That sum, however, is reduced by a \$20 credit for taxes previously paid. The net tax of \$7.50 is thus equivalent to 10 percent of the value added.

Table 1  
Mechanics of the Value Added Tax

Production Stage	Value Added	Selling Price	Tax	Credit	Net Tax
1.	100	100	10	0	10
2.	100	200	20	10	10
3.	75	275	27.50	20	7.5
4.	25	300	30	27.50	2.50

The Tax Restructuring Act further stipulates that a lower VAT, five percent, be assessed against retail food sales, purchase or rental of residential property for use by the transactor, and

medical care. A zero rating would be assessed against mass transit, the non-retail sales of farmers and fishermen, charitable, religious, and other 501 (c) (3) organizations, educational activities of government entities, interest, and exports.

Small businesses under \$10,000 in taxable transactions per year might choose to exempt themselves from the tax. An exemption however, unlike a zero rating, precludes a credit for the VAT paid on purchases.

H.R. 5665, following the widely accepted view that the VAT should be a substitute rather than a supplement, proposes completely offsetting tax cuts of \$130 billion. A 2.15 percent reduction in employee and employer social security rates would reduce federal revenues by \$52 billion. Individual income tax rate reductions, in combination with tax breaks on savings accounts and dividends, would total \$50 billion. Rate cuts, wider brackets, and liberalized depreciation would diminish corporate tax revenues by \$28 billion.

## ANALYSIS

The basic question of the VAT debate is quite simple. Are the expected economic returns of sufficient value to warrant the risk of increased federal revenues, and hence, more spending? The difficulty and disagreement arises in the assessment of the appropriate weights assigned to returns and risks. Congress' past behavior serves as an excellent guide for the latter exercise.

An argument occasionally advanced in favor of the VAT is its widespread use in Europe.<sup>1</sup> That Europe depends on the VAT, however, is an insufficient argument in favor of an American adoption. In nearly all European experiences the VAT replaced an existing tax on consumption. Furthermore, adoption of the VAT was hastened, if not compelled, by the creation of the Common Market. Thus, with regard to the crucial questions of savings, capital formation, and exports, the European taxes offer little guidance.

### Neutrality

The chief virtue of the VAT is its neutral impact on economic decision-making. Unlike the existing tax structure, the ideal VAT would not create an incentive, or disincentive, in favor of a certain economic activity. An excellent illustration of the current bias is the taxation of income derived from savings accounts. To save is to postpone consumption until the future. A cost of postponed consumption is the satisfaction foregone. To

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1. For a comprehensive country-by-country review of the VAT overseas, see Price Waterhouse's study, Value Added Tax (New York: Price Waterhouse & Co., 1979).

compensate for the lack of immediate satisfaction, and as an incentive to save, the market offers a positive return on savings: the interest rate. The tax on income from savings taxes income twice and effectively reduces the interest rate, thereby discouraging savings and encouraging consumption. In contrast, the value added tax does not discriminate between current and future consumption because it taxes consumption as it occurs. Thus, it does not distort or override the market's signal and incentive to save.

A similar bias occurs in the double taxation of dividends. The tax assessed before and after distribution reduces the effective yield of capital investment. Thus, corporate equity investment becomes relatively less attractive. The VAT avoids this pitfall and treats the returns to corporate equity in the same manner as returns to non-corporate capital or labor.

Removal of the present barriers to savings and investment should have significant economic rewards. Dr. Norman B. Ture, in The Value Added Tax: Fact and Fancies, estimated the economic impact of a VAT as a replacement for various components of the present tax system.<sup>2</sup> A VAT of 5.1 percent for instance, would generate thirty percent of the revenues currently raised by the individual income tax. Such a substitution would raise 1980 employment by 1.8 million, 1984 by 2.56 million, and 1989 by 3.2 million. (Table 2) Similar positive and striking results would occur in constant G.N.P., gross private domestic investment, consumption, and net exports. The increased economic activity would also boost federal tax revenues.

Table 2  
The VAT as a Substitute for 30 Percent of the Individual Income Tax  
(Dollar Amounts in Constant 1979 Dollars)

Increase or Decrease (-) in:	1980	1982	1984	1989
Employment (thousands of full-time equivalent employees)	1,810	2,170	2,560	3,230
Annual Wage Rate	\$ 350	520	730	980
Gross National Product (billions)				
Total	\$ 100	143	199	289
Business sector	\$ 88	120	161	23
Gross Private Domestic Investment (billions)				
Total	\$ 65	91	143	78
Nonresidential	\$ 44	55	83	51
Consumption (billions)	\$ 28	45	50	205

2. Norman B. Ture, The Value Added Tax: Facts And Fancies (Washington, D.C.: The Heritage Foundation, 1979).

Net Exports (billions)	\$	7	7	6	6
Exports	\$	17	21	26	35
Imports	\$	10	14	20	29
Federal Tax Revenues (billions)					
Initial impact	\$	0	0	2	(1)
Net of feedback	\$	21	24	27	48
VAT	\$	64	70	78	101

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year.

Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change.

Source: Norman B. Ture, The Value Added Tax: Fact and Fancies

When substituted for either the social security tax solely or the corporate income tax, however, the results are discouraging. In both cases, G.N.P., employment, investment and consumption decline.

Ture also evaluated the impact of the Long proposal, not yet introduced, to substitute a 12.5 percent VAT for 30 percent of the individual income tax, all of the employer payroll tax, and one-sixth of the corporate income tax. Such a substitution would have an impact similar to, but not as substantial as, the substitution for the individual income tax. (Table 3) An exception would be the greater increase in exports.

Table 3  
Substitution of the VAT for 30 Percent of the Individual Income Tax,  
Employers' Payroll Taxes, and One-Sixth of the Corporation Income Tax  
(Dollar Amounts in Constant 1979 Dollars)

Increase or Decrease (-) in:	1980	1982	1984	1989
Employment (thousands of full-time equivalent employees)	1,290	1,780	2,060	2,790
Annual Wage Rate	\$ 200	300	420	610
Gross National Product (billions)				
Total	\$ 63	95	128	200
Business sector	\$ 57	86	113	172
Gross Private Domestic In- vestment (billions)				
Total	\$ 61	52	77	42
Nonresidential	\$ 42	25	38	26
Consumption (billions)	\$ (17)	23	29	132

Net Exports (billions)	\$ 19	20	22	26
Exports	\$ 25	30	35	46
Imports	\$ 6	10	13	20
Federal Tax Revenues (billions)				
Initial impact	\$ 0	(9)	(5)	(20)
Net of feedback	\$ 16	14	21	27
VAT	\$ 151	170	192	242

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year.

Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change.

Source: Norman B. Ture, The Value Added Tax: Fact and Fancies

Although impressive, Ture's estimates are based on an ideal case. It is assumed that a single VAT rate is applied to all goods and services and assessed against all economic participants. Such a proposition is by no means certain.

Numerous exceptions or special VAT rates will diminish the neutrality of the VAT and thereby distort the allocation of resources. Since the VAT is ultimately a tax on the use of economic resources, i.e. labor and capital, a lower tax rate on one type of activity will increase the after-tax return on factors involved in that activity. Due to the higher rate of return, resources will flow into the favored activity. In this manner the VAT loses the sought-after neutrality and instead serves to allocate resources.

A uniform tax rate, while crucial to the economic success of the VAT may not necessarily coincide with Congress' social or political goals. The current tax system serves not only as a source of revenues but as a means of income redistribution. Thus far there has been little indication that Congress will readily abandon portions of the progressive tax system for the proportional VAT.

Ullman's Tax Restructuring Act of 1979 offers several illustrations of special treatments. Religious and non-profit activities, for instance, are given a zero tax rating. While perhaps constitutionally mandated or socially desirable, the favorable rate is economically undesirable.

Another conflict between social and economic goals is the disproportionate impact of the VAT on the budgets of lower income taxpayers. The Ullman bill addresses this question by taxing food, medical care and housing at half the proposed 10 percent rate. In addition, the income tax is used to offset the higher prices resulting from a VAT.

An as yet unaddressed inequity is the tax treatment of the retired. Throughout their working careers, these people paid taxes on their income and savings. Introduction of the VAT would tax savings or future consumption a third time, when spent. However, unlike those currently working, the retired would receive no compensatory reductions in income or social security taxes. The only apparent resolution of this dilemma would be to establish a special VAT status for the currently retired.

The VAT lends itself to legislative manipulation. The possibility of offering VAT exceptions to particular constituents or against certain types of consumption promises distinct benefits to elected officials. Since the economic costs of a non-neutral VAT can be spread out over all taxpayers, while benefits can be tailored for particular interests, legislators will be tempted to use the VAT for non-economic purposes.

In summary, it is impossible to anticipate the extent to which a VAT would be altered. However, it must be recognized that the VAT would be subjected to the same process which wrought our existing tax structure. It is quite likely that the neutrality of the VAT will be under constant assault from a variety of sources.

#### BALANCE OF PAYMENTS

Proponents of the VAT argue that when used as a substitute the new tax will significantly expand exports and improve the U.S. trade position. The extent of the effect of the VAT on foreign trade will depend upon which taxes are replaced by the new levy.

Under the General Agreement on Tariffs and Trade (GATT) indirect taxes, such as the VAT, may be remitted on exports and levied against imports. Direct taxes, e. g. corporate income and social security, are not subject to such border adjustments. To the extent that the value added tax reduces the price of U.S. exports relative to foreign goods and lowers U.S. domestic prices relative to imports, the U.S. balance of trade will be improved.

There are several factors which suggest that VAT would promote exports. One, substitution of the remittable VAT for an unremittable tax which is passed on in the price, such as social security, will create a relative U.S. export price advantage. Secondly, removal of the bias against domestic equity finance should spur capital investment, enhance efficiency and lower the relative price of U.S. goods.<sup>3</sup> Lower relative prices would expand exports and decrease imports.

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3. Ibid., pp. 41-47.

The balance of trade improvements achieved by the VAT's effect on costs might be mitigated by its impact on national income. As income rises the propensity to import also increases. It can be expected that a VAT which increases G.N.P. will also increase imports absolutely.

Ture has also calculated the balance of trade or net exports impact of a variety of tax proposals. The most impressive results occur when the VAT is substituted for the tax combination offered by Senator Long. Both net exports and exports are maximized. In 1982 for instance, exports would be increased by \$30 billion and imports by \$10 billion.

Table 4  
The Value Added Tax and the Balance of Trade

VAT as a substitute for:	Year	Net Exports	Exports	Imports
Payroll Taxes	1980	9	3	-6
	1982	11	2	-9
	1984	13	0	-13
30% of Individual Income Tax	1980	7	17	10
	1982	7	21	14
	1984	6	26	20
One-Sixth of Corporate Income Tax	1980	2	3	1
	1982	1	3	2
	1984	1	4	3
Employers' Payroll Tax, 30% Individual Income Tax, and One-Sixth Corporate Income Tax	1980	19	25	6
	1982	20	30	10
	1984	26	46	20

Source: Norman B. Ture, The Value Added Tax: Facts and Fancies

## HIDDEN TAX

The insidious nature of the VAT is perceived by many as sufficient cause to reject it. Because the tax is assessed on a series of transactions, the taxpayer is never aware of the yearly VAT liability. Critics fear the taxpayers' ignorance will permit Congress to reap substantial additional revenues through slight changes in the tax rate. Although the danger of the VAT as a "hidden tax" is indeed real, its threat is perhaps exaggerated. Since all changes in the VAT rate must be accomplished through the legislative process, the taxpayer has the opportunity to affect the rate through elected representatives. Taxpayer acquiescence to unwanted rate increases is an abdication of the citizen's responsibility.



To assure sufficient taxpayer information, it might be desirable to require all retail sales to specify the total VAT included in the price. Such a mechanism would enlist the public's resistance to higher prices as a force to combat potential tax increases.

A characteristic of a "hidden tax" is a demonstrable link between increased tax revenues and unlegislated actions. Ironically, this phenomenon occurs not in relation to the VAT but rather with the taxes it is substituted for. Personal and corporate income taxes, including capital gains, are effectively increased as inflation distorts the relationship between real and nominal values. The danger of higher taxes lies not in the VAT, but rather in the remainder of the tax system. A VAT instituted as a substitute could quite easily become an additional tax as inflation drives the real tax rates upward.

A balanced budget or spending limitation proposal is often proposed as a remedy for the alleged hidden VAT. A more direct approach would be to index the tax system for inflation.<sup>4</sup> Unlike a balanced budget requirement or a spending limit, tax indexation might have the additional benefit of being incorporated within the VAT legislation.

An additional "hidden" cost is the VAT's effect on existing spending programs. The simultaneous and opposing pressures for lower tax rates and more spending would create a strong incentive for Congress and the bureaucracy to pursue the most efficient use of each dollar spent. The VAT and the unindexed tax system would spare Congress the budget crisis and, in effect, sanction the less efficient use of tax dollars.

#### Small Business and Inflation

In addition to doubts about its political uses, there are several questions regarding the VAT's effect on small business, consumer prices, and state revenues. It is unknown what the VAT paperwork burden, particularly that of the invoice method, would be on small business. A shift to the VAT might also endanger new businesses which are sheltered during the early non-profitable years by the light income tax burden.

Another unanswerable question is the VAT's effect on price levels. It must be stressed that a VAT is not in itself inflationary. Inflation is a continuous rise in the general price level. A VAT, assuming no change in Federal Reserve policy, will produce a one-time jump in the price level. The size of that jump will depend on the consumers' response to producers' efforts to pass

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4. For a thorough discussion of tax indexation see Donald J. Senese Indexing The Inflationary Impact Of Taxes (Washington, D.C.: The Heritage Foundation, 1978).

the VAT along in higher prices. Producers unable to pass the tax on will be forced to cut back production. The danger of the single jump in the price level is its possible ripple effects on cost of living adjustments and union contracts.

A final consideration is the proposed levy's effect on state revenues. For instance, if the VAT is passed on through higher prices, a state dependent upon a sales tax will benefit because the sales tax will be assessed against a portion of the value added tax. In contrast, if the VAT is not passed on, and production and incomes are reduced, a state which relies on the income tax might suffer.

#### CONCLUSION

Acceptance of the VAT requires a certain degree of faith. Implicit within approval is a confidence that Congress will place a greater value on the tax's economic potential than its social uses. Attempts to alter the uniform and neutral tax will reduce the promised economic benefits. Somewhat disconcerting is the realization that Congress did not always assign the highest priority to economic effects when shaping our current system. The recent calls for reform and the push for the VAT itself are a testament to Congress' shifting priorities.

Criticism of the VAT as a "hidden tax" is also illustrative. Proponents assume that the public will or at least should maintain a vigilance against slight but remunerative legislated changes in the rate. One can accept this assumption and yet reject VAT. The "hidden tax" is the remaining unindexed tax system. The inflation-reduced real tax rate increases of recent years demonstrate that the taxpayer is not or cannot be as vigilant against unlegislated increases as is apparently necessary. A VAT purportedly passed as a substitute can become an additional tax without any change in the VAT rate.

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