

# WebMemo



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## Value-Added Tax: No Easy Fix for the Deficit

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There is a growing call by backers of bigger government for Congress to impose a value-added tax (VAT) on top of all the other taxes Americans already pay. A VAT is similar to a national retail sales tax but is collected at every stage of business production until its entire burden ultimately falls on the consumer.

Among its suggested advantages, proponents argue a VAT would be an easy fix for the deficit because it would be difficult to evade relative to the income tax.<sup>1</sup> Evidence from countries with VATs suggests otherwise. If Congress implements a VAT as an additional tax, businesses and individuals would try to avoid it through fraud, severely limiting a VAT's ability to close budget gaps.

**Fraud Rampant.** VATs are common in other countries, especially in the European Union (EU).<sup>2</sup> Despite the perception that VATs are difficult to evade, data show that fraud to avoid the VAT is widespread in the EU. In fact, the fraud is causing revenue shortfalls large enough that many EU countries are scrambling to prevent the abuse.<sup>3</sup>

Under the most common form of the VAT—the credit-invoice method—businesses pay the tax on their purchases and collect it on their sales. After deducting the taxes they paid on purchases from the amounts they collected on sales, businesses remit the difference to the government.

This system is supposed to ensure that every business in the supply chain pays the correct amount of tax. For instance, if a business undercharges the VAT to the next company in the produc-

tion chain, the second company has to pay a higher VAT to the government. The total amount of tax collected by the government remains the same regardless of which company pays it. Therefore, each business has an incentive to make sure the other businesses it deals with are in compliance so they do not pay a bigger share of the tax than required.

Fraud persists with the VAT despite the theoretical advantages, mostly in four forms.

**1. False Claims of Taxes Paid.** Businesses create false invoices for the purchase of inputs they never bought and get bigger deductions for taxes paid than they are entitled to.

**2. Credit Claimed for Non-Creditable Purchases.** Typically, VATs have a variety of rates and exemptions. For example, basic needs such as food, medicine, and clothing often receive preferential VAT rates or outright exemptions from the tax, as do certain industries considered economically vital or politically sensitive.

Businesses that sell both VAT-exempt and non-exempt items have an incentive to allocate the purchase of supplies they use to produce exempt items toward the production of non-exempt items. This improper shifting increases the business's tax refund

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because it allows them to claim deductions on their tax returns for the taxes paid on inputs where there should be none. This fraud is common because it is difficult for authorities to prove which supplies the business used to produce the different products.

3. *Bogus Traders.* Businesses are set up exclusively to produce VAT invoices so other businesses can claim refunds on taxes they never paid.

4. *Hidden Sales.* Professional service providers, such as doctors and lawyers, often engage in this kind of fraud. They offer relatively high-value services, but their purchases from other businesses are relatively low cost. They charge their unknowing customers full price and collect the proper amount of VAT on the sale. But to the authorities, they show that they charged a lower price. The service provider forwards to the government less tax than it collected from its customers and pockets the difference.

It is always hard for tax authorities to determine the actual sales of an intangible good like a service. Many state and local governments in the United States often forego levying sales tax on most services because of this difficulty. Moreover, service providers and individuals can circumvent the tax by agreeing to use cash or barter transactions. This avoids a paper trail altogether and makes it nearly impossible for authorities to prove abuse.<sup>4</sup>

**Deficits Persist.** A recent study estimates that VAT fraud in the EU creates annual revenue shortfalls as high as 30 percent of potential tax collections in some countries. Shortfalls average 12 percent for all countries in the EU.<sup>5</sup> In comparison, the U.S. Department of Treasury estimated the net tax gap for all taxes in 2005 (the latest available data) stood just under 12 percent of potential receipts.<sup>6</sup>

The study also shows it takes years for countries to get up to speed enforcing the VAT. So the U.S. could reasonably expect shortfalls in this range—especially during the early stages of implementing a VAT.

Some suggest a VAT rate of 20 percent for the U.S. At this rate, it would have raised \$1.26 trillion based on the size of the economy in 2008,<sup>7</sup> a 50 percent tax increase for that year. Based on the data from EU countries and the size of the economy in 2008, the U.S. would likely have had a VAT receipts gap of between \$156 billion (if its enforcement efforts were exemplary and it limited the tax gap to the EU average) and \$390 billion (if they were not). This figure would grow in future years as the economy expands.

Annual shortfalls of these magnitudes would prevent a VAT from eliminating the deficit and lowering the debt. If it passed a VAT, Congress would

1. Catherine Rampell, "Many See the VAT Option as a Cure for Deficits," *The New York Times*, December 11, 2009, at <http://www.nytimes.com/2009/12/11/business/11vat.html?adxnml=1&adxnmlx=1261422110-CjN8PRWgk+Oa3ruX9r85Qg> (December 21, 2009).
2. OECD Tax Database, "VAT/GST Rates in OECD Member Countries," Table IV.1, January 1, 2009, at <http://www.oecd.org/dataoecd/12/13/34674429.xls> (December 21, 2009).
3. See Joe Kirwin, "EU Ministers Back VAT Reverse-Charging for Greenhouse Gas Emission Trade Sales," Bureau of National Affairs, December 3, 2009, at [http://news.bna.com/drln/DRLNWB/split\\_display.adp?fedfid=15794825&vname=dernotallissues&wsn=504956000&searchid=9968441&doctypeid=1&type=date&mode=doc&split=0&scm=DRLNWB&pg=0](http://news.bna.com/drln/DRLNWB/split_display.adp?fedfid=15794825&vname=dernotallissues&wsn=504956000&searchid=9968441&doctypeid=1&type=date&mode=doc&split=0&scm=DRLNWB&pg=0) (December 21, 2009); Bengt Ljung, "EU Addresses Tax Evasion Through VAT Grouping Schemes, Harmonized Practices," Bureau of National Affairs, July 6, 2009, at [http://news.bna.com/drln/DRLNWB/split\\_display.adp?fedfid=13741692&vname=dernotallissues&wsn=546124000&searchid=9968527&doctypeid=1&type=date&mode=doc&split=0&scm=DRLNWB&pg=0](http://news.bna.com/drln/DRLNWB/split_display.adp?fedfid=13741692&vname=dernotallissues&wsn=546124000&searchid=9968527&doctypeid=1&type=date&mode=doc&split=0&scm=DRLNWB&pg=0) (December 21, 2009).
4. Michael Keen and Stephen Smith, "VAT Fraud and Evasion: What Do We Know, and What Can Be Done?," International Monetary Fund, February 2007, pp. 9–10, at <http://www.imf.org/external/pubs/ft/wp/2007/wp0731.pdf> (December 14, 2009).
5. Reckon LLP, "Study to Quantify and Analyze the VAT Gap in the EU-25 Member States," September 21, 2009, p. 9, at [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/tax\\_cooperation/combating\\_tax\\_fraud/reckon\\_report\\_sep2009.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_cooperation/combating_tax_fraud/reckon_report_sep2009.pdf) (December 21, 2009).
6. See U.S. Department of the Treasury, "Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance," July 8, 2009, <http://finance.senate.gov/press/Bpress/2009press/prb070809b.pdf> (January 21, 2010).
7. See Curtis S. Dubay, "Value-Added Tax: No Solution for Health Care of Fiscal Woes," Heritage Foundation WebMemo No. 2532, July 9, 2009, at <http://www.heritage.org/Research/Taxes/wm2532.cfm>.

undoubtedly budget based on the expectation of receiving all the revenue it anticipates the tax raising. When the revenue comes in short, as it surely would, the deficit would increase by the amount of the gap, and a substantial deficit would persist.

**Never-Ending Tax Hikes.** A VAT would fail to close the exploding deficits forecast for future years as businesses would engage in all kinds of fraud to avoid paying the VAT. The deficits that remain year

after year would lead to continuous calls for even higher taxes, which would lead to more fraud and bigger deficits. Congress should end this cycle by simply restraining spending to historical levels and scrapping higher taxes, including the VAT.

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