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The Value-Added Tax

Sorting Through the Practical and Political Problems

Henry J. Aaron

CHAMPIONS OF THE VALUE-ADDED TAX have been touting its virtues for more than two decades. They have claimed at alternative times that replacing other taxes with a VAT would simplify taxation and improve economic efficiency, enhance international competitiveness of the United States, and increase private saving. Some of the supposed benefits are exaggerated or illusory. It is hard, for example, to understand how the addition of a VAT can simplify overall tax administration and compliance unless it entirely replaces one or more existing taxes. Other arguments are indisputably correct. Shifting the focus of taxation from income to consumption would clearly reduce the bias in the current system that favors current consumption over future consumption. Whatever one may think of these contentions, the mass of tax practitioners and of the general public remained unpersuaded that any potential advantages justified the trouble of introducing a new tax.

That enactment of a VAT is being widely discussed now is attributable to the huge current and projected federal deficits. Normal discussions of tax structure have been supplemented by a search for the politically least odious way to increase federal revenues.

The Congressional Budget Office currently projects that the comprehensive annual budget deficit will decline from about $157 billion in 1988 to roughly $134 billion in 1993. These estimates allow for the effects of the two-year deficit-reduction compromise to which Congress and the president agreed in late 1987. However, the projections greatly underestimate the actual deficit for two reasons.

First, they include as offsets to even larger deficits elsewhere in the federal budget the large Social Security surpluses that will result from the congressional decision to try to prepay part of the formidable cost of Social Security benefits that the baby-boom generation will impose when it retires next century. If these surpluses are to serve that long-run purpose, they must be used to expand national saving, not to finance current government consumption. For this reason, these surpluses should be excluded from estimates of the federal deficit. When this correction is made, projected deficits rise to $195 billion in 1988 and to $231 billion in 1993.

The fiscal problem is even more serious than these numbers suggest for a second reason. The same baby-boomers who will claim pensions on retirement will also demand costly hospital care and physician services. Thus, the same rationale that led Congress to provide for large Social Security surpluses — the impending cost of Social Security benefits for the baby-boom generation — implies that the Medicare program should also be running surpluses. Instead, the Medicare program, which currently is in rough balance, will soon begin to run large deficits that will exhaust accumulated reserves shortly after the turn of the century.

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To provide for the future costs of Medicare in a manner similar to that currently being used for Social Security would require an increase in taxes of about $50 billion in 1988. This estimate does not include any allowance for the prospective costs of long-term care. Prepaying some of the predictable long-term care costs, as well as those of acute care, would require tax increases well in excess of $50 billion in 1988 and of even larger amounts in future years. These numbers mean that at least $50 billion should be added to whatever deficit-reducing tax increases or spending cuts that budget deficits of $200 billion or more a year would justify.

Experts disagree on how far and how fast that deficit should be reduced. They also disagree about how much of the reduction should be achieved by spending cuts and how much by tax increases. But most recognize that the projected deficits are too large to be cut sufficiently by any combination of politically imaginable expenditure reductions.

Recent budget history suggests that Congress strongly endorses most current federal expenditures and is unwilling to cut them significantly. Forty billion dollars would be a generous — some would say absurdly high — estimate of the most that Congress is likely to cut spending. With heroic effort, Congress might increase excise taxes by perhaps $30 billion. In the exceedingly improbable event that Congress took both of these steps, additional revenues of about $75 billion would have to be found to achieve a deficit in 1988, adjusted for Social Security and Medicare, of $50 billion.

A more plausible estimate is that taxes, other than excises, will have to be increased *at least* $100 billion if the deficit, adjusted for the costs of Social Security and Medicare, is to be reduced to $50 billion. Increases of this size can be achieved in only two ways: by raising income tax collections — through base broadening or rate increases — or by introducing a new revenue source, such as a value-added tax or a national retail sales tax.

A boost in personal and corporate income taxes of just over three percentage points in all brackets would generate sufficient revenue. In many ways, such a tax increase would be the simplest, fastest, and fairest way to raise the requisite revenues. In the end Congress may elect to pursue this course. To do so, however, it would have to reconsider questions that bedeviled the tax reform debates in 1985 and 1986 — whether to exclude some part of capital gains from tax or to index them and whether to provide investment incentives to hold down the user cost of capital, for example. Furthermore, members of Congress would face the allegation of bad faith from challengers who could charge that Congress was reneging on rate reduction, the quid pro quo for broadening the tax base in 1986.

To avoid such issues and charges, Congress is likely to consider a VAT, along with income tax increases, if it decides to raise taxes by a large amount. A value-added

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"Any large tax increase will be politically controversial, even with farsighted leadership from the White House and Congress."

tax falls on the increase in value of output at each stage of production. The type in most common use around the world falls on the difference between the value of output and the cost of goods and services purchased from other companies. In effect, the VAT falls on the sum of labor compensation and all income earned by owners of capital invested in the taxed company. Different countries employ a variety of administrative procedures to collect the tax.

Any large tax increase will be politically controversial, even with farsighted leadership from the White House and Congress. The need to narrow the great gap between government spending and revenue is sufficient to justify endorsement of whichever of these methods of raising taxes has the greater chance of being enacted. Because of our inexperience with and misgivings about a VAT, I shall examine the objections that have been and will be raised against such a tax, appraise their validity, and suggest ways those objections could be met. A similar exercise could be carried out for a major increase in the personal and corporate income taxes, as a large income tax increase poses some similar problems, and these problems also can be solved.

The Practical Problems

A value-added tax of 1 percent would yield between $13 billion and $22 billion dollars in 1989, depending on the breadth of the tax base. To raise $100 billion, therefore, would require a tax of at least 5 to 8 percent. For reasons set forth below, the rate necessary to raise *net* revenues by $100 billion would have to be higher to allow for concessions made to soften political opposition.

If the next administration and Congress decide to propose a value-added tax, a number of practical and political problems would have to be solved to secure its enactment and to implement it.

—Introducing a VAT would create inflationary pressures. How can they be minimized?

—A VAT, even one that excludes food and housing, will impose onerous, perhaps unfair, burdens on low-income and some elderly households. How can these burdens be minimized or offset?

—State and local governments are reported to oppose the VAT because it would represent federal intrusion on a tax base previously used predominantly by them. What can be done to soften that opposition?

—Administrative experts estimate that it would take 18 to 24 months to put a VAT into effect once it was enacted. Can and should this lag be shortened?

—Many conservatives fear that the addition of a major new revenue source, such as a VAT, would fuel the expansion of the public sector. Is this fear justified, and if so, what can be done to reduce opposition based on it?

Inflation

The introduction of a VAT yielding $100 billion in 1989 would boost the price of consumption relative to disposable personal income by approximately 3 percent. It is important to recognize that the aggregate size, if not the distribution, of this direct effect on the average taxpayer is the same as that of an increase in income taxes that would yield the same amount of revenues. One tax affects income; the other, expenditure. But the effect on the real aggregate disposable income is the same.

Under current rules, however, an increase in prices attributable to a VAT would directly boost the consumer price index (CPI), while the reduction in disposable income from an increase in income taxes would not. This statement is based on the presumption that a VAT will eventually be reflected fully in increased prices because monetary policy would largely accommodate a VAT-induced jump in prices. Such accommodation is likely because authorities would fear that aggressive use of monetary policy to prevent the introduction of a VAT from raising prices would increase unemployment excessively. To the extent that jumps in the CPI translate into higher wages, introduction of a VAT would cause further increases in prices, while an income tax increase might not.

Although fear of such a tax-price–wage-price spiral stands as a major objection to a VAT or national retail sales tax, this fear is overblown because a straightforward solution is available. The consumer price index could be redefined to remove value-added taxes. In that event, the introduction of a VAT would still cause an initial increase in prices. But this increase would not be propagated automatically through indexing formulas.

Collective or political bargaining might nevertheless lead to reactive increases in wages or transfers. Differences in the distribution of reductions in real incomes under a VAT from those that would result from an increase in income taxes might lead to different political bargains. But, as noted, the size of the overall impact on real disposable

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income from equal-yield taxes is identical.

I conclude that a VAT, while likely to cause a small addition to the price level — perhaps 3 percent for a $100 billion tax — need not add to subsequent inflation.

Burden on the Poor

Critics of the value-added tax point out that it is regressive, by which they mean that the ratio of a consumption-based value-added tax to income measured over a year, or some other similar period, declines as income increases. This observation is indisputable.

It is also highly misleading and oversimplified for several reasons. First, students of consumption have long noted that although the ratio of consumption to income declines with respect to *annual* income, it declines little with respect to *long-term average* income.

The explanation, which has also long been understood, is that annual income is a poor index of long-term economic status. Most households experience considerable income variability. In any given year, the ratio of consumption to income in the bottom income brackets is an average based on the behavior not only of households that are customarily in those brackets, but also of households with normally somewhat higher incomes. Consumption of the latter group is based on their normally higher income and raises the average consumption-income ratio for the entire bottom income bracket.

The top income groups have low ratios of consumption to income in large part for symmetric and opposite reasons. The ratio of consumption to income in the top brackets is dragged down by the consumption behavior of households experiencing abnormally high incomes, but whose consumption is based on their normally lower incomes. Thus, the fact that the ratio of value-added tax to consumption falls with annual income does not necessarily indicate that the tax is regressive based on long-term economic status.

It would be more nearly accurate to describe the value-added tax as proportional with respect to long-term income, because consumption of most households is roughly proportional to long-term income. This statement should be unsurprising, because the consumption of most households roughly equals their lifetime income — wages and salaries, plus interest and other income on savings. This statement holds even for the poor, since cash transfers are included in measures of money income. The one group for which it is untrue is the very rich, who consume less than their income by leaving bequests materially larger than any inheritances they may receive.

Whether or not a VAT falls proportionately on all income groups, it would unquestionably place greater burdens on the poor than would an equal-yield increase in income taxes. This burden is objectionable, but it can be offset for most low-income households by allocating a small part of the revenue from a value-added tax to increases in food stamps, Aid to Families with Dependent Children, Supplemental Security Income, other income-tested transfers, or the earned income tax credit. Virtually all low-income households could be fully protected against the effects of a $100 billion VAT if income-tested benefits were also raised by roughly $5 billion, the share of the bottom quintile in $100 billion of revenues.

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For example, a 10-percent increase in food stamp benefits would approximately offset the effect on households eligible for the full food stamp allotment of a VAT that raised $100 billion in revenue.[1] Total food stamp costs, projected at just over $12 billion in 1989, would rise more than 10 percent because additional families would be rendered eligible for assistance and because the percentage increase in benefits for families with outside resources would exceed 10 percent. Another option would be to increase the standard deduction by $500 a return at a cost of approximately $3 billion.

To ensure that high-income households that save do not avoid their fair share of the burden of reducing the deficit, the most direct and logical instrument would be an increase in estate and gift taxes. Alternatively, a variety of changes in the personal income tax base or increases in personal or corporate income tax rates could accomplish the same purpose with rough justice.

I have thus far not mentioned the method of reducing the regressivity of a VAT most commonly used in Europe and proposed in the United States — the exclusion from tax of food, housing, and perhaps some other "necessities." Although superficially appealing, exclusions are badly flawed instruments for dealing with regressivity. This approach cannot shield the poor from the burden of a VAT as fully as personal exemptions and the standard deduction shield them from the effects of an increase in the personal income tax. Furthermore, narrowing the value-added tax base means setting higher tax rates to gain the same amount of revenue that would be raised if these

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goods were taxed at a lower rate. The resulting higher rates apply to the remaining consumption of the poor and of all other groups as well. Exempting "necessities" can reduce regressivity but only at the price of seriously complicating administration by requiring sellers to make what are inevitably narrow and arbitrary distinctions.[2]

It is important to keep in mind that other solutions to the deficit also unduly burden the poor. Cuts in public spending invariably fall directly on beneficiaries of the programs that have been cut and indirectly on suppliers of those services. Across-the-board cuts in Social Security, for example, would directly reduce incomes of households with low-income elderly and disabled beneficiaries. Excise taxes suffer from the flaw of regressivity in a degree similar to that of the VAT.

Impact on the Elderly

The argument has been advanced that introduction of a new tax on consumption would burden retirees more than would an equal-yield increase in income taxes. This argument is based on the contention that retirees finance much of their consumption with savings from past income on which taxes have already been paid. Imposing a new tax on consumption from those savings would represent double taxation.

This argument has some substance, but not much. Most of the income that the elderly receive has not yet been subject to income tax *(see table 1)*. No significant problem of double taxation exists with respect to the first five of these items, which account for 69 percent of total income of the elderly, because personal income tax has not been paid before receipt of these classes of income.[3]

A problem of double taxation could arise with respect to the portion of income that comes from assets, if the assets were accumulated from previously taxed income. One should keep in mind, however, that asset income represents less than 10 percent of total income for the bottom half of the elderly income distribution. Furthermore, part of asset income consists of interest, dividends, or other income that has not been previously taxed, and part comes from tax-sheltered savings accounts, such as individual retirement accounts and Keogh plans, which likewise have not been previously taxed. Such payments would, and should, be subject to income tax and hence to any tax increase. Replacing an income tax increase with a tax on consumption could not be regarded as discriminatory.

In addition to cash income, the imputed value of owner-occupied housing would escape the effect both of an increase in income taxes and of a newly introduced VAT.

In short, the introduction of a VAT would subject only a small fraction of the income of the majority of the elderly to double taxation. The difference for the elderly between the burden imposed by a 5 percent VAT and that imposed by an income tax increase yielding the same revenue would be a small fraction of the 3 percent of consumption that either tax would yield. Assets provide a significant portion of income only for the elderly in the top one or two income quintiles, and even then not much of this asset income is subject to double taxation.

The claims that a VAT would excessively burden the poor, insufficiently burden the rich, and be unfair to retirees have limited merit. But these problems can be solved at the bottom of the income distribution by increases in transfer payments and at the top of the income distribution by selective increases in income or estate and gift taxes. The former would cost revenue, while the latter would gain it. Solutions to these problems may be politically difficult, but they are technically easy to design and would cost less than 10 percent of the revenue a VAT would generate.

Table 1. Sources of Income for the Elderly

Source	Percent of Total Income
Social Security, Railroad Retirement	39%
Private pensions	6
Government employee pensions	7
Earnings	16
Public assistance	1
Assets	28
Other	2

Source: Martynas A. Ycas and Susan Grad, "Income of Retirement-Aged Persons in the United States," *Social Security Bulletin*, vol. 50 (July 1987), table 4, p. 8.

Intrusion on State, Local Tax Bases

The federal government has made only limited use of specific taxes on commodities and no use at all of general commodity taxes. States and localities have used this tax base extensively and fear that introduction of a federal value-added tax would interfere with their ability to levy general and selective sales taxes *(see table 2)*.

The fact that states and localities have managed to make extensive use of income taxes despite far heavier use by the federal government of the income tax base than any VAT proposal now under discussion would make of the sales tax base suggests that this fear is exaggerated. Because the fear is real, however, it might prove expedient to couple any VAT proposal with provisions attractive to state and local governments.

Such "sweeteners" could take a variety of forms. Among the least costly to the federal government would be to let states exchange their current retail sales taxes and some or all selective commodity taxes for add-on taxes, imposed in addition to the federal VAT, and collected by the federal government, with proceeds returned to the states. States and localities could be accorded wide discretion to set add-on taxes as they wished, provided they accepted the VAT base. Major advantages for states and localities would include improved collections on the rapidly rising value of mail-order sales and the ability to tax many services now effectively outside the range of sales taxes.

Other sweeteners would reduce net federal revenues

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Table 2. State and Local Use of Sales and Commodity Taxes

Type of Tax	Percent of Personal Income in FY 1985
General sales and gross receipts	2.79%
Selective sales	1.39
Motor fuels	0.45
Public utilities	0.33
Insurance premiums	0.15
Tobacco	0.15
Alcoholic beverages	0.11

Source: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, 1987 Edition* (Washington, D.C., June 1987), tables R-3, R-4, and R-5, pp. 132–34.

from a VAT but might prove more attractive to states and localities. The federal government could allocate a fixed percentage of VAT revenues to a revenue-sharing pool. The recent sacrifice of general revenue sharing on the altar of reduced federal spending might dampen state and local faith in the durability of such a commitment, however. Alternatively, the federal government could increase matching for Medicaid or Aid to Families with Dependent Children, introduce formula grants for elementary and secondary education, or propose other devices for transferring some part of VAT revenues to state and local treasuries.

Each of these approaches adds politically controversial issues to those raised by the introduction of a VAT. But each can compensate state and local governments for federal infringement on a tax base that states and localities use extensively.

Slow Implementation

A VAT is likely to take 12 to 18 months longer to implement than would an increase in income taxes. Even if a new president decides to propose a value-added tax, he is unlikely to do so before late 1989 or early 1990. In the unlikely event that Congress speedily enacted the new tax, the Internal Revenue Service would need 18 months to two years to hire and train new administrators, design rules and forms, and carry out the public education necessary before revenues could actually be collected. No revenues from a VAT could be expected before 1992 or, quite possibly, 1993. If reducing the deficit is sufficiently important to justify a major new tax, is such a delay supportable?

Most of that delay is unavoidable whatever form a proposed tax increase may take, if one assumes that President Reagan will not propose a major tax increase and that Congress will not enact one without White House leadership. Unless an emergency compels immediate action, the next president is likely to spend much of his first year in office deciding how best to deal with the deficit and shaping a political consensus on the chosen course. No

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proposal for a large tax increase of any kind is likely to go to Congress before late 1989, and action there is unlikely at least until 1990. Large increases in revenues, therefore, are unlikely before 1991.

Whether the additional delay for a VAT will then be seen as an advantage or a disadvantage clearly depends on the state of the economy. For example, if a VAT were enacted during a recession, the inducement to spend in advance of a new VAT and the delay in the onset of collections could easily be seen as an advantage. When any major tax increase is at least three years away, it is hard to know what to make of the argument that a VAT should not be considered because implementation would be slow.

Spur to Big Government

The VAT became a major revenue source in the European Economic Community during the 1960s and 1970s. At the same time, the size and scope of government spending increased dramatically. Even if one understands fully the fallacy in *post hoc, ergo propter hoc* reasoning, the coincidence of the new tax and government expansion is bound to suggest some relationship. Either the availability of abundant revenues from the new tax created opportunities for public spending, or officials interested in expanding public spending embraced the value-added tax as the best way to make their fiscal wishes come true.[4] It is not clear how one who accepts this connection comes to terms with the contraction of the public sector, but not of the VAT, during the 1980s.

Whatever relevance this argument may have had for Europe (or the United States) of the 1960s, the United States of the 1980s and 1990s is altogether different. While policymakers of the 1960s spent many nights devising uses for fiscal dividends spawned by the interaction of rapid economic growth and inflation with an unindexed income tax, their counterparts today and tomorrow must devise ways to prevent current government deficits from absorbing half of national saving and undermining economic growth. Furthermore, the contention that a VAT, once enacted, would be far easier to increase than income taxes are is asserted as if it were self-evident, when in fact there is no current basis for it.

Whatever the reality, the fear that a VAT breeds big government is real, and it is unlikely to be dislodged by argument. Furthermore, it pushes to the foreground a question of great importance — the proper scope of government.

Accordingly, proponents of a VAT have two options. First, they can try to design sweeteners that compensate those who fear large government with something else that appeals to them. For example, some business opposition to a VAT might weaken if a VAT were linked to a reduction in taxes on corporate income or to renewed investment incentives, however hard it may be to justify such incentives on the basis of economics or tax structure.[5]

Second, proponents of a VAT might try to make a virtue of what some see as a flaw, by linking a VAT to a popular government initiative, such as some form of insurance against the costs of long-term care. Either of these courses would prove quite expensive but might soften or override opposition based on the fear that a VAT would lead to an expanded government.

The Political Problem

Much of the debate about the virtues and flaws of the value-added tax turns on whether it would be a good idea to raise the current amount of revenue with a tax system that relies to a greater extent than the current system does on consumption taxes. At various times and places, this debate is worth having. The issue today is quite different. Given the size of the federal deficit, its pernicious long-run effects, and the evident unwillingness of the political system to eliminate the deficit through spending reductions, is there a method of raising taxes that will be politically and economically acceptable?

Any large increase in taxes will have some general undesirable economic side-effects. In this sense, the VAT and an equal-yield increase in income taxes have much in common. Most of the specific objections to a VAT have some basis. Even if one prefers an increase in income taxes to the introduction of a VAT — as I do — one should recognize that all of these objections can be answered by companion proposals. Most of these proposals carry a price and would cut into the net revenues that could be raised by a VAT. On balance, it seems likely that a broad-based VAT of 7– 8 percent with accompanying sweeteners would be necessary to net as much revenue as an unadorned 5 percent VAT would generate.

This line of reasoning suggests that the major task in designing an enactable VAT is not the details of the tax itself. This problem is technically undemanding, and the solutions are widely understood. The subtle and difficult problem is designing the companion legislation to mold a political coalition at reasonable cost.

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1. This estimate is based on the fact that $100 billion will be approximately 3 percent of consumption in 1989 and that food is estimated to absorb about 30 percent of the budget in estimates of poverty thresholds.

2. The French experience with a VAT that has a normal rate, a higher rate, and a lower rate illustrates the problems that cannot be avoided once a VAT is imposed at more than a single rate. "The . . . reduced rate is applicable to foods (except beverages other than water and milk), including candy, margarine, and vegetable fat; products used in agriculture; passenger transportation; nonpornographic entertainment; books; residential rents; and meals served on the job. The increased rate is applied to cameras, radios, recording equipment, automobiles and motorcycles, furs, jewelry, perfume, tobacco, and pornographic entertainment. . . . To illustrate the anomalies, books are taxed at reduced rates, records at the increased rate; pastry is taxed at the reduced rate, fruit juice at the normal rate; radios are taxed at the increased rate, television sets at the normal rate; alcoholic beverages are taxed at the normal rate, tobacco at the increased rate." Jean-Pierre Balladur and Antoine Coutière, "France," in Henry J. Aaron, ed., *The Value-Added Tax: Lessons from Europe* (Brookings, 1981), pp. 20, 21.

3. A small portion of Social Security benefits represents the return of the employees' payroll taxes on which personal income tax has already been paid. For no retiree does this component of Social Security exceed 15 percent of the actuarial value of benefits.

4. Actually, the VAT in most European countries replaced older turnover, wage, or sales taxes and was not so much a new revenue source as it was a reformed or rationalized revenue source.

5. The Committee for Economic Development first proposed such a linkage more than 20 years ago.

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