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*Business and Financial Conditions 1*

*Toward a New Philosophy of Taxation*

*By Dr. Richard W. Lindholm 3*

*Economic Indicators 9*

*Monetary Indicators 10*

**Business and Financial  
Conditions**

THE anxious wait for confirmation of decisive quickening in the business tempo is still not over. A really big surge of Christmas sales, had that occurred, would have been an impressive signal. But that wasn't the way the old year ended. December retail sales—at least on the basis of preliminary figures—were just so-so, and there have been no hints of any real change in the early weeks of 1972.

Meanwhile, most nontrade indicators—aside from housing starts, which have been strong right along—continue to give off ambiguous readings. Industrial production, to be sure, recorded a hefty gain in December, but much of that was due to the poststrike rebound in coal output. And while personal income spurted as 1971 ended, that too was in part a quirk reflecting special influences, including a spate of pay increases that went into effect at the end of the freeze.

Perhaps the single most encouraging piece of recent news was the government's disclosure that survey data gathered in November and early December indicate that businessmen have targeted a 9.1% increase in capital expenditures for 1972. If realized, that, of course, would be very important in strengthening the general economy. One thing that makes this late autumn finding especially impressive is that some of the survey respondents turned in their reports at a time when there was still considerable uncertainty about the fate of 1971's major tax legislation (which included reinstatement of the 7% investment tax credit) and when it was far from certain that there would be an early resolution of international monetary differences.

The fact remains, however, that projections—

# Toward a New Philosophy of Taxation

*The following article was written by Dr. Richard W. Lindholm, Professor of Finance at the University of Oregon's College of Business Administration. Dr. Lindholm has written extensively on tax matters and is known as a forceful advocate of the value-added tax.*

**B**Y traditional standards of equity and efficiency, the system of taxation that exists in the United States—involving many different kinds of taxes levied in uncoordinated fashion by many different taxing jurisdictions—falls far short of the ideal. Few taxpayers have any sense of being treated fairly; few administrators are really satisfied that the system is nearly as economical or nondistorting as it ought to be.

Bad as the situation is now, it could get a lot worse the way things are going. Public revenue needs almost certainly will continue to mount rapidly in the years ahead, and as that occurs the distortions presently built into the system are bound to seem progressively more onerous to those they affect. And it is predictable that new distortions will be created, particularly since there is no end in sight to the helter-skelter quest by state and local governments for new revenue sources.

That some drastic reform of the tax system that exists in this country would be desirable is widely agreed on. The trouble in the past has been the difficulty of devising a remedial approach that was at once both sound and politically salable. For reasons that I shall set forth in this article, I believe that in the not-too-distant future the so-called value-added tax (VAT), which has begun to attract a great deal of attention, will be able to meet these twin tests. In my judgment, it has far more dramatic potential for bringing about radical improvement in the

nation's tax system than is as yet commonly realized, and, as its strengths come to be better understood, broad-based backing for it ought to develop.

Advocated by some people merely as a new revenue source and by others who want it just for the special help it could give to exporters, the value-added tax—properly understood—would actually be a first step toward altering the basic fundamentals of American taxation. VAT's adoption—under serious consideration for some time by Nixon Administration officials but apparently not to be recommended in this month's budget message—would signal nothing less than a new tax philosophy on this side of the Atlantic. VAT is already widely in use in Europe and is spreading there rapidly.

VAT is simply a flat percentage levy paid on the value added to a product or a service at each stage of production and distribution. A manufacturer adding \$100 to the value of something he processed would thus have a tax base of \$100 against which the tax rate would be applied. Actually, as the tax is typically administered in Europe—and presumably would be administered here—a seller does not make a calculation as such of the value added to goods or services in his particular operations. Rather, he figures his tax at the legally specified rate on the full amount of all sales to his customers and is allowed to credit against that liability all amounts of VAT which he himself has paid to suppliers. With VAT payable at each successive stage of the production of a good or service, its theoretical base is as large as a country's gross national product.

In order to put foreign-produced goods on the same tax footing as domestically produced goods, VAT systems provide that a border tax

even when they have a seemingly solid base—do not provide as much assurance as does actual performance. For the moment, the economy's over-all performance has to be assessed as mixed. This could change quickly, it is true, now that disposable personal income is benefiting from the federal tax legislation enacted late last year and from federal pay increases. On the basis of the data presently available, however, "mixed" is an appropriate descriptive term.

### *Scaling back the numbers*

The fact that a marked upswing in business is not apparent at this date—despite the strong expansive impulses that have come from the two-year old housing advance and from the post-August 15 bulge in auto sales—is clearly causing some analysts to have second thoughts about whether the consensus forecast of something like \$100 billion of growth in GNP in 1972 really makes sense. Moreover, skepticism about that forecast has certainly been accentuated by the sizable downward corrections which government statisticians have just made in GNP numbers for the second and third quarters of last year.

Those corrections give the economy a decidedly weaker look than was conveyed by GNP data as previously reported. The annual rate of growth in "real" GNP for the second quarter of 1971 now stands at 3.4% instead of 4.8%, while that for the third quarter stands at 2.7% instead of 3.9%. With real growth for those quarters now recorded at well below the rate at which the economy's potential output is believed to be expanding, it has become easier to understand why neither unemployment figures nor operating rates in manufacturing have shown any improvement during more than a year of cyclical expansion. Even though the growth rate

accelerated in the fourth quarter, results for the full year were decidedly unimpressive. Real GNP on a year-to-year basis was up less than 3%.

It is precisely this situation, of course, that the continuing stimulative nature of both fiscal and monetary policy is meant to change. That the Nixon Administration is now wholly committed intellectually to an activist budget policy is emphasized by the relative lack of concern it has come to show for red-ink financing. The large budget deficits in sight both this year and next have been justified as "job-producing." Clearly, no intent exists to scale them back sizably either by expenditure cuts or by tax hikes. And that the Federal Reserve is working in tandem is strikingly evident from the condition of ease that the System has fostered in short-term credit markets. The decline in the three-month Treasury bill yields to close to 3%—at a time when higher rates might well be appropriate for international reasons—is dramatic testimony to the determination of System officials to be counted on the side of fostering economic expansion.

The comparatively low level of interest rates in the United States has definitely been one reason why such a small flow of funds to this country has taken place since mid-December when Group of Ten conferees worked out their currency accord in Washington. Another reason—probably more important—is that the dollar tended to trade close to its new ceiling against most major currencies in the initial weeks after the accord—a fact that offered possibilities for further speculative profits to those people holding positions in foreign currencies. It is these things rather than any new evidence of weakness in the U.S. international position that seem to provide the basic explanation of why there has been no rush back into dollars.

must be paid on imports at the VAT rate. And on the theory that exported goods may be subject to other countries' border taxes and that taxes should be paid where the benefits of consumption are enjoyed, exporters receive rebates from their own government of VAT taxes they have paid to suppliers and, of course, pay no VAT on the value they themselves add to a product. This refunding to exporters is permitted under the rules of the General Agreement on Tariffs and Trade (GATT), as it is for all kinds of so-called indirect taxes. The refunding gives a competitive advantage internationally to countries that rely heavily on VAT systems in relation to those such as the U.S. that have tax systems oriented more to levies on income, which under GATT rules cannot be refunded.

Important as the benefits of a VAT system can be in aiding a nation's trade balance, I view the domestic advantages as of even greater significance. Most basic of all is the fact that VAT does not have nearly as many distorting impacts on economic decision-making as do a number of taxes now relied on heavily in the United States. VAT, therefore, could be of great potential help in preserving the vitality and productivity of the private sector of the economy.

Certainly there is good reason to think that the eventual substitution of VAT for some considerable portion of income taxes—particularly corporate income taxes—might very well yield substantial benefits. For one thing, the corporate income tax, at least at present high rates, creates a very strong inducement to minimize the legally definable tax base—that is, reported corporate profits. This encourages laxity in cost control (including tolerance in some instances of loose expense-account practices since the government picks up a substantial part of the tab). It also tends to discourage an emphasis on internal efficiency because all internal cost reduc-

### HOW VAT WOULD WORK

A manufacturer with total sales of \$1,000 and the other indicated transactions would be affected by a 10% VAT as follows:

	Transactions amounts	VAT liability, credit, or rebate
Total sales . . . . .	\$1,000	\$100 liability
Exports . . . . .	200	20 rebate
Imports . . . . .	100	10 border tax liability
Domestic purchases from VAT-paying suppliers . . . . .	200	20 credit
Domestic purchases from non-VAT-paying suppliers . . . . .	50	none
Net liability of VAT and border taxes . . . . .		\$ 70 liability

tions are reflected directly in the profits tally and hence become subject to the high corporate tax rates. Prevailing "double taxation" of corporate income, moreover—once at the firm level and once after stockholders receive dividends—encourages high profits retention by businesses. This, of course, tends to funnel savings automatically into established, conventional use patterns rather than having the allocation determined by capital-market competition. Additionally, high profits taxation—combined with the deductibility of interest paid and the nondeductibility of dividends—arbitrarily favors debt financing over equity financing, thus fostering a high fixed-debt structure for corporations.

The value-added tax, by contrast, is a much more neutral levy and consequently a much less distorting one. It does not, for instance, either encourage cost padding or discourage cost reductions because a firm's value-added tax is determined entirely by what can be thought of

as external factors—namely, by tax liability arising at the point of sale and by the value-added taxes a business pays its suppliers. Under a VAT system (assuming there were no corporate income tax at all), every dollar gained from internal cost reduction would get fully reflected in a firm's after-tax profits instead of being only partially reflected as is the case at present. This, of course, could generate a much greater drive for efficiency improvement in industry than now prevails.

And not only does VAT have advantages over income taxes, its evenhandedness makes it superior as well to many other types of taxes, including payroll taxes. Payroll taxes are especially burdensome for labor-intensive industries. They directly increase the cost of employing a worker and thus either discourage employment or exert downward pressure on wages. VAT would have no such impact. Indeed, under a VAT system an industry's tax liability would be totally unaffected by the way in which any of the principal factors of production (land, labor, capital, and entrepreneurial effort) are combined with other factors to produce outputs. Wholly nondiscriminatory, VAT neither penalizes nor rewards a firm for using more of one factor and less of another.

It is VAT's neutrality, and hence its potential for lessening tax-related distortions in our economy, that I believe to be its strongest selling point—weightier even than the help it would give to the country's foreign-trade position. Not to be overlooked, of course, is the fact that anything making for a healthier domestic economy in terms of such things as reduced inefficiencies and better capital allocation also contributes on its own to the strengthening of international competitiveness.

VAT also possesses two administrative qualities that add powerfully to its attractiveness.

The first of these is a built-in pressure for compliance. This stems from the requirement set forth in all VAT legislation that is in effect in Western Europe that only VAT amounts written down on sales invoices are deductible or refundable. This information is needed by all business purchasers in order to reduce VAT liability arising from sales. Thus, at almost every point in the production and distribution process, purchasers have a powerful vested interest in seeing that sellers record VAT amounts fully. Fraud is still distinctly possible under a VAT system (as the experience with false invoices in France shows), but evasion is at least less likely with VAT than with many other major taxes.

VAT also enjoys (at least as legislation typically is written in Europe) an inherent defense against pressures from those who plead for exemption or special treatment, action which whenever successful reduces the tax base. This deterrent arises (1) because firms in a non-VAT-taxed industry do not receive refunds of VAT amounts included in their purchases and (2) because firms that are subject to VAT receive no credits to use as an offset to their VAT liability if purchases are made from non-VAT-paying suppliers. In European countries, these deterrents to exemption and special treatment have acted to give VAT's base a predisposition to expand rather than contract, and a broad base is always a highly desirable feature of any tax, since the larger the base the lower the rate need be to raise a specified amount of revenue. And the lower the rate the smaller the danger that a given tax will seriously burden any given taxpaying unit.

In view of VAT's various strengths, both substantive and administrative, it certainly is not hard to understand why so many countries in Europe have turned to it. Initially introduced

by France in 1954, it now is a vital part of the tax systems of seven other countries as well: West Germany, The Netherlands, Belgium, Luxembourg, Denmark, Norway, and Sweden. And within the next 18 months, proposed VAT legislation is likely to become effective in Great Britain, Italy, Ireland, Austria, and Switzerland. Quite a record! The really extraordinary thing, however, is that the United States has been so slow to move and that it is still hesitating.

### *Ideal for revenue sharing*

One point in particular that should be appreciated about a national value-added tax for the United States—but which as yet is not—is that it would have considerable potential as an approach to revenue sharing. Specifically, it could in my judgment be a very useful device for getting rid of the infuriating complications and administrative costs associated with our great variety of state and local retail sales and use taxes—now in force in 47 states and in an additional large number of cities and counties. Once only bothersome—when rates were 1% or 2% and when coverage was limited—such taxes have now evolved to a point at which real burdens, often capriciously distributed among different classes of taxpayers, are involved.

A national, uniform VAT collected by the federal government and returned to state and local governmental bodies agreeing to abolish sales and use taxes would do several very good things. The waste, the inefficiency, and the flagrant evasion associated with the levying of sales and use taxes would end. In addition, very significant revenues would be available for revenue sharing—with VAT collections returnable (in instances where state officials so opted) to the very villages and counties from which they came. Precise feedback is readily possible administra-

tively under the value-added tax, something that is not true with the personal income tax or the corporate profits tax. This is a very significant plus which could help the revenue sharing idea—now bogged down in controversy—become reality. The difficulties revenue sharing has encountered are related in no small measure to the fact that virtually all of the specific proposals so far advanced identify federally collected income taxes as the revenue to be shared. The inability to allocate accurately taxable income back to its source has proved a major stumbling block.

VAT, of course, is not without detractors. Perhaps the charge most frequently hurled is that it is nothing but a national retail sales tax parading under another name. Labeling VAT an “unjust, regressive levy on consumption” has indeed become standard with those who do not like it.

Actually, VAT in essence is really a procedure for including the cost of maintaining government in the total cost of producing GNP. It is thus more accurately called a production tax than anything else. If VAT were the exclusive source of government revenue and if it were applied at a single rate against a very broad base, it would simply make the full cost of government an identifiable and explicitly stated cost of producing a nation's goods and services.

A production tax of such nature does not, of course, have as one of its objectives the creation of any particular pattern of income distribution. In conventional terms, it is neither regressive nor progressive. A government wishing to pursue a particular target with regard to income distribution could not, as a practical matter, do so by means of VAT. That function has to be left to other taxes and other government measures, including expenditures policy.

Objecting to the value-added tax because it is

passed on to the final consumer is not very meaningful. All business costs (whether for the use of labor, the use of capital, or for anything else) must ultimately be covered by prices charged for goods and services. VAT's burden thus turns out to be about the same as any other cost that is marbled uniformly throughout the production process. VAT, to repeat, is economically neutral.

Those who recognize VAT's potential for helping this country's trade position but who object to it for other reasons often argue that U.S. officials—instead of considering enactment of the levy—should concentrate on getting GATT rules renegotiated to permit the rebate to exporters of direct as well as indirect taxes. However, accomplishing such a change—even assuming a cooperative attitude on the part of our trading partners—is extremely hard to imagine.

That is because the treatment provided for in GATT rules is grounded in the characteristics of tax differences rather than being simply a matter of arbitrary edict. It is one thing to devise an equitable scheme for rebate to exporters of amounts representing excises or value-added taxes and quite another to figure out a way to do so in the case, say, of income taxes. One exporter may be a very profitable company paying considerable corporate income taxes while another may be losing money and thus paying no income taxes. Refunding corporate income taxes that have been paid on goods moving into export channels simply is not feasible, nor is the establishment of a border tax based on foreign profit levels. Similar difficulties—in fact somewhat more complicated—would arise in trying to develop a method for refunding payroll taxes to exporters or in establishing a compensatory border tax for foreign payroll taxes. GATT's prohibition on the rebate

of direct taxes traces to these difficulties. If we are going to get help with our trade position comparable to that now enjoyed by nations using the VAT system, there really is no practical way to do so except by adopting VAT.

### *Opening VAT's spigot*

I would favor the introduction of VAT in the United States at a 10% rate, somewhat below typical European levels but high enough to generate a very sizable amount of revenue. A rate of 10% on a very broad base ought to provide at least \$60 billion to the Treasury. It is my belief that half of this amount would best be used under a revenue-sharing program that would eliminate all state and local sales and use taxes. Under these circumstances, the upward pressure on prices caused by the introduction of VAT would be substantially lessened. Significantly, the substitution of a 10% VAT for existing sales and use taxes combined with the return of half of all VAT collections to states (with the Treasury doing the allocation on the basis of retail sales totals by states) would result in a substantial net increase of funds available for state and local use. The State of New York, for instance, would receive about 403% of its current state and local sales tax collections; and New Jersey about 410%. In Massachusetts and Pennsylvania, the revenue shared would be equivalent to about 560% and 190%, respectively, of the revenue now derived from sales and use taxes.

The other half of the Treasury's VAT receipts, or something over \$30 billion, could very sensibly be used to initiate a dual-rate system for corporate profits taxation (with distributed profits made subject to a lower rate than undistributed profits) and to eliminate all federal excise taxes except those on tobacco, alcohol,

and petroleum. This would be similar to actions aimed at reform and simplification that the British are proposing to take when VAT goes on the books in Britain.

Any funds remaining after these allocations would go into the Treasury to support budget programs generally. If the residual proved to be of any real size (or if at some future date the VAT rate were increased), further improvement of the tax system could be achieved. Lifting some or all of the burden that local property taxation carries in supporting education is one obvious possibility. Stabilizing payroll taxes is another.

Collections from the 10% border tax that would be introduced simultaneously with the introduction of VAT should just about finance the 10% VAT rebate paid to exporters. The border tax combined with the rebate would stimulate U.S. manufacturing and exports, give jobs to American workers, and increase domestic investment of savings. This is just what VAT apparently has been doing for EEC member-

state economies during the past several years. Again, the approach is provided for under GATT rules and hence its adoption would in no way open the U.S. to charges of pursuing a restrictive "beggar thy neighbor" policy. The United States would only be doing what its trading partners consider to be right, at least when *they* do it.

In order for the United States to move in the direction outlined above, a new philosophy of government finance, at least for most Americans, is required. Taxation must be seen as a necessary cost of production wherever production takes place and whatever is produced. There must be a perception also of the fact that inefficiencies and distortions can be minimized if a substantial portion of the necessary taxes is collected at each point in the production and distributive process at which value is added to goods or services. Finally, the harmonizing of our tax system with that of other nations must be seen as one of the adjustments necessary for preserving the benefits of an unfettered international movement of goods, services, and capital.