The Value-Added Tax: Orthodoxy and New Thinking

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ACKNOWLEDGEMENTS

This volume was written to be a resource for the next serious public debate on the subject of value-added and other consumption-based taxes. It seeks to combine a discussion of theoretical issues with an analysis of practical problems such as tax incidence, trade implications and administrative difficulties.

The Center for the Study of American Business at Washington University has made analysis of major tax proposals a high priority research emphasis since its inception in 1975. As a result of a long association with Dr. David Raboy and Ernest Christian, the CSAB's director, Dr. Murray Weidenbaum, was approached with the idea for this volume. Messrs. Raboy, Christian, and Cliff Massa III had begun to research the pragmatic concerns associated with a consumption or value-added tax independently of the Center's own research on the theoretical economic issues. Joining forces to produce this volume seemed to be a logical way of making the results available to individuals interested in the various policy aspects of consumption taxes and especially value-added taxes.

The editors and authors bear the responsibility for the viewpoints presented in the material to follow, but they would like to acknowledge the debt of gratitude owed to a host of individuals. We have benefitted greatly from their comments and criticisms.

Each chapter was edited and helpful comments were offered by Kenneth Chilton, associate director, and Melinda Warren, writer/analyst, at the Center for the Study of American Business. In addition, valuable comments and criticism were received by Messrs. Raboy, Christian and Massa from senior executives of major corporations who reviewed the chapters examining the various aspects of a value-added tax. Despite their disparate views and experiences, these individuals have been unwaveringly dedicated to probing analysis and have, over an extended period, shared their insights. We express appreciation for the advice and counsel provided by: Michael Axt, Claude Burleson, Stephen Conafay, Kenneth Johnson, Ted Killhefer, John Loffredo, John Mendenhall, William Modahl, Sandy Navin, Patrick Nugent, C. P. Powell, James Pratt, Charles Rau, Robert Scott, Ira Siegel, Burton Smoliar, and

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Ernest Christian, Jr.

David Raboy

Murray Weidenbaum

INTRODUCTION

IF, WHEN YOU SAY "CONSUMPTION TAX," YOU MEAN . . .

by Ernest S. Christian, Jr. and
Cliff Massa III

Much has been said and written about consumption taxes in the United States, but mostly in a theoretical context. Dozens of scholarly treatises have been published, along with innumerable papers and speeches most of which were more argumentative than illuminating in nature. Audiences have sat through uncounted conferences on the merits or evils of consumption taxes, depending on the speakers' perspectives. There have been only three comprehensive legislative proposals to which these theories and arguments could be applied, no one of which was acted upon in the Congress.[1]

Purveyors of conventional wisdom have suggested that this theoretical context might be replaced within a year or two by actual consideration of a federal-level consumption tax. Some see enactment of such a tax as a desirable -- or at least a necessary -- means for reducing the federal deficit. The National Economic Commission, which was created by legislation in 1987 to recommend deficit reduction measures, was perceived by many skeptics and proponents alike to be the Trojan Horse which would carry a consumption tax

[1]The proposals were H.R. 7015, "The Tax Restructuring Act of 1980," introduced by Rep. Al Ullman; S. 1102, "The Business Transfer Tax Act of 1985," introduced by Senator William Roth; and H.R. 4598, introduced by Rep. Richard Schulze in 1986 to enact a "Business Alternative Minimum Tax."

proposal into the federal government's fiscal policy debate in 1989. Others see international developments which could pressure the U.S. into enacting a consumption tax with border adjustments for imports and exports as a trade policy initiative. These observers anticipate enactment of such tax systems by Canada and Japan, which would leave the U.S. alone among major industrialized democracies in our reluctance to make use of such a system. Both Canada and Japan, which account for about 40 percent of U.S. imports and about 35 percent of U.S. exports annually, could enact such border adjustable value-added taxes within a year.

But conventional wisdom is often wrong or contradicted by *other* conventional wisdom. As this book went to press in the fall of 1988, the two major parties' presidential nominees were vying for dominance as the *anti*-tax-increase champion; neither one was promoting a new system in order to increase taxes and reduce the deficit. Members of Congress also have been noticeably cool in their responses over the years to consumption tax proposals. Their skittishness is routinely explained in part by reference to the defeat in November 1980 of the late Rep. Al Ullman (D-OR), then Chairman of the House Ways and Means Committee, who had advocated a tax restructuring package which was based on a value-added tax. Now, their litany of political reasons for opposing such taxes includes the adverse reaction to former Arizona Governor Bruce Babbitt's call for a national consumption tax during his 1988 campaign for the Democratic presidential nomination. These latter bits of conventional wisdom suggest that debating federal consumption taxes may remain an academic exercise for the near term. Only time will tell who are the better prophets.

But the *possibility* that the new President and the 101st Congress will at least look into the subject has created a sense of urgency during the last year or two. More is being written on the subject, and more people are talking about it. The current flurry of activity may be only another false start, but if it is for real, the debate will shift from theories to hard realities in very short order.

This collection of 11 chapters seeks to contribute to the quality of the next serious public debate by linking the abundance of theoretical commentaries with practical questions and problems. These chapters represent a multi-disciplined effort to connect both the large body of economics literature on the subject and the prevailing popular view about "consumption taxes" with the numerous real-world questions which must be answered. All of these aspects should be considered if any such tax is ever to be intelligently debated in this country, much less properly structured and implemented. Just as the issues themselves are diverse, there is considerable diversity of opinion on nearly each one, as will be evident in the 11 separately authored chapters which follow.

For example, is it possible that the term "consumption tax" itself may be a misnomer which is no more properly applied to a sales tax or a tax on value added than to the present corporate tax on net income or to payroll taxes on wages and salaries? This conclusion would be so distinctively and substantively different from the popular view that, if correct, it could radically alter the decisions of policymakers. Even the *consideration* of this alternative view will affect the terms of the debate, no matter the level of support which it ultimately attains.

On what may be the eve of a watershed debate, the rhetoric on consumption taxes is still bouncing back and forth between genuine confusion and downright pettifoggery. The passionately expressed views are reminiscent of the contradictions so artfully presented in the following.[2]

> If, when you say whiskey, you mean that devil's brew, the poison spirit, the bloody monster that defiles innocence, dethrones reason, destroys the home and creates misery . . . then I am certainly against it with all my heart. But, if when you say whiskey, you mean the oil of conversation, the philosophic wine, the ale consumed when good fellows get together, . . . then certainly I am in favor of it.

The spectrum of perceptions and opinions about consumption taxes is just about as wide as that for John Barleycorn. It is as if people are talking about different subjects. To some extent, they are. Like the six blind men of Indostan describing an elephant, one's opinions about a consumption tax are likely to be shaped by what part of the beast one gets hold of first.

Much of the problem arises from the nomenclature itself. This is especially unfortunate, not because the "consumption tax" label is necessarily inaccurate when applied to certain tax systems, but because it tends to prejudice one's assessment of specific tax systems and to stifle an open-minded debate. The mere use of the label by proponents and opponents alike has substituted loose terminology and political biases for rigorous and thoughtful analysis.

The confused and emotional state of the current consumption tax

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[2] The original version of this exquisitely equivocating statement of opinion is generally thought to have been presented during congressional debates about temperance in the 1800s. A specific version is presented in *Alcohol Education in Oregon Schools: A Topic Outline and Resource Unit for Teachers* (State of Oregon: Alcohol and Drug Section, Mental Health Division, Board of Control, 1968), p. 77.

debate can soberly be portrayed by paraphrasing the Whiskey Speech.

> If, when you say consumption tax, you mean a tax on the bread for my table and the clothes on my back, a tax which raises all merchants' prices, a tax which bears most heavily on the poor, a tax which fuels the federal spending machine, then I am most certainly against it. But if, when you say consumption tax, you mean a small and equitable tax on all producers of goods and services, a tax which is measured by the "value added" by each, a tax which extracts a fair measure of revenues from foreign competitors in our markets, a tax which enables American-made goods to compete abroad, a tax which can lower the federal deficit and even reduce income and payroll taxes, then certainly I am in favor of it.

So, the problem which lies ahead is this. When we say "consumption tax," what are we talking about and do we really understand all that we think we know about the subject?

PRACTICAL DEFINITION OF A CONSUMPTION TAX

The currently popular, almost journalistic view is that a "consumption tax" is just what the label implies -- a tax paid by consumers on the prices of goods and services they purchase, thereby making consumption more costly than it otherwise would be. What most people have in mind is a retail sales tax and the accompanying line of reasoning which is as follows. Under such a tax, the total cost consumers pay is the price of the item plus the amount of the sales tax which is collected by the store at the cash register and printed on the receipt. This tax-induced increase in the total cost of consumer goods and services then creates a regressive economic effect on lower-income individuals who must spend a greater portion of their incomes, in general, and a substantially greater portion in purchasing necessities alone. In order to avoid regressivity, this line of argument goes, purchases of necessities must be exempted from tax, or arcane devices such as refundable income tax credits must be provided to lower-income families.

As in the case of any tax, economists question whether the consumer who "pays" the sales tax is the one who actually bears the real economic incidence or burden of that tax and whether the goods purchased are actually more costly than otherwise would be the case. The rest of us, politicians and plebians alike, usually adhere to the notion that the person who pays a tax is the one who bears the burden of that tax. After all, it is *our* bank accounts which are reduced when we pay a tax.

In the case of a sales tax, very few consumers would agree with any economic theory that the tax paid at the cash register is actually borne to some degree by the companies (or, more accurately, by their employees and/or shareholders) which produce and sell us the goods. It would be difficult to explain how companies have been forced to reduce the price of their goods by the amount of the tax in order to get us to buy the same quantities of those goods. Instead, most people consider that the price of the goods would be the same whether taxed or not and, if taxed, the cost would be the price *plus* tax.

Given this deeply-rooted and widely-accepted perception, points of view about the benefits and evils of consumption taxes are well defined and strongly held. If nothing else changes, a noisy dispute is certain to erupt among various businesses and other economic groups if or when a consumption tax debate is initiated in earnest in Washington. Assuming the previous flirtations with federal consumption taxes are reliable forecasters of the future, you will not need a program to identify the players; the rosters of opponents and supporters are predictable and the arguments can be recited by rote. The resulting "debate" will produce massive amounts of the proverbial heat and smoke, but there is not likely to be much light breaking through the haze.

But circumstances are changing. Business executives have taken a much stronger interest recently in understanding consumption taxes in general and value-added taxes in particular, primarily as a result of federal budget deficits, trade deficits and proposals for a generic or subtraction method value-added computation. The possibility that a federal value-added tax might actually be considered has disrupted the comfortable practice of pontificating on the subject without fear of having to convert theories into actual practice. Where speeches and commentaries previously could trot out the traditional virtues and vices of consumption taxes -- and the same attribute is a virtue to one speaker and a vice to another -- theories are being put to a more rigorous intellectual test by some who may have accepted the traditional views in earlier years, but largely without assessing what was being said.

WHAT THIS BOOK IS ABOUT

In this changing environment, the purpose of this book is to raise and consider questions about the features and effects of tax proposals which are commonly called "consumption taxes" and to do so in the context in which many policymakers and taxpayers probably would analyze tax proposals, given sufficient quiet time to do so.

Issues are presented from the perspective of the practical problems which would affect, or would arise from, the imposition of such taxes. No attempt has been made to produce one more scholarly treatise on the subject, although several such works are noted in the following chapters as sources of information and analysis. The intention instead is to discuss in some detail a range of economic, political, practical and technical questions which should be of interest to taxpayers and tax policymakers alike.

Chapter 1 sets the stage for Chapters 2 through 11 by explaining why the subject matter is current and relevant and by presenting some of the real political problems and opportunities associated with consumption taxes. It also establishes the context of the U.S. consumption tax debate and provides an overview of economic and political issues.

A recurring theme in many of the following chapters is the presentation of alternative ways of looking at the fundamental nature and results of particular forms of consumption taxes. For example, Chapter 2 discusses the potential elements of a definition of "consumption tax." A sales tax and two value-added tax systems are assessed under such a definition, with the practical effects of differing formats being considered.

Chapters 3 and 4 present two views of the economic incidence of a multi-stage value-added tax and a single-stage sales tax. The first view is the traditional analysis, which concludes that the ultimate economic burden of the tax is borne by consumers (hence the "consumption tax" label). An alternative "shared incidence" analysis is also offered, which concludes that such a burden is shared among consumers, workers and owners of capital in proportions that are dictated by market forces. The varying implications of the two analyses are also reviewed.

This book is not intended to establish the correctness of any particular viewpoint. Rather, it is largely a means for organizing a discussion of issues which obviously are not yet fully developed in the literature or otherwise, and of focusing attention on certain critical choices upon which a whole series of other decisions depend.

For example, Chapter 5 reviews the basis for providing exemptions for certain goods or services and the consequences of doing so. The discussions note the relationship between exemptions and the fundamental analysis of whether the tax is considered to be primarily a tax on consumers or a tax which is dispersed among consumers, workers and owners of capital.

This same process of presenting alternative views in order to provide a more informed basis for decisions is to some degree carried forward through the remaining chapters. Chapter 6 considers potential problems of transition to a value-added tax and provides macroeconomic data about which sectors are most likely to encounter such problems. Again, one's perception about incidence affects one's conclusions about transition issues.

Chapter 7 discusses in some detail the international trade effects of a value-added tax and the relevance of substituting such a tax for existing U.S. taxes. Once again, the incidence analysis plays a critical role by influencing the terms of the debate over trade effects. The Appendix to Chapter 7 is a substantive presentation on the effects of monetary exchange rates in a border-adjustable value-added tax environment.

Chapter 8 describes the issues which affect how a value-added tax can readily be applied to financial services. This material is particularly provocative, given the European experience which suggests that such services generally should be ignored by value-added tax systems.

Chapters 9 and 10 provide some numerical analysis of sectoral impacts and macroeconomic effects of consumption taxes. Chapter 9, in particular, explores the potential, relative impact of a value-added tax on different business sectors of the economy in relation to existing federal taxes. Chapter 10 discusses macroeconomic effects of a consumption-based tax. Chapter 11 discusses issues of compliance and administration.

THE VALUE-ADDED TAX AS THE SUBJECT FOR DISCUSSION

While the roster of broadbased consumption taxes includes three general categories -- a national sales tax (imposed at the point of sale to ultimate consumers), a consumed income tax or expenditures tax (imposed on income which is available for consumption expenditures after removing savings), and value-added taxes (imposed at each stage of the production and distribution process for goods and services) -- the national sales tax and the consumed income tax do not appear to be high on any list of viable options.[3] Neither category has been the subject of a major legislative effort at the federal

[3]Other types of consumption taxes are much more limited in their application and do not fall within the realm of "broadbased" taxes. These include excise taxes on specific items, such as the federal taxes on gasoline, diesel fuel, tires, telephone services, alcoholic beverages, tobacco products, etc.

level in the United States or apparently in any other major trading nation. However, value-added taxes are already imposed in the European Common Market and other countries, and the governments of Canada and Japan have prepared major tax reform packages which are based on the implementation of a value-added tax.

Within the value-added category, the "invoice and credit" mechanism is the most widely known, since it is this format which is used in Europe. However, increased attention is being given to what is usually called the "subtraction method" of value-added taxation.[4] As Chapter 2 will more fully develop, the subtraction method is a generic method of value-added computation. The introduction of a Business Transfer Tax (the BTT) by Senator William Roth (R-DE) in 1985, the initial discussion drafts of the Canadian government's proposal and Rep. Richard Schulze's Business Alternative Minimum Tax (the BAMT) have generated a new look at the range of issues associated with consumption taxes.[5]

In addition to being a topic of current interest, the basic subtraction method also presents a format in which the alternative analysis of consumption taxes is more readily explained. For both reasons, the value-added tax is the principal subject for discussion in the succeeding chapters, with some emphasis on the generic or subtraction method as a current and topical example for analysis. However, the analyses and commentaries presented here can also be applied to other forms of consumption taxes. There does exist a widely-held view that the *form* of a consumption tax and even of a value-added tax can affect economic incidence and, thus, affect the conclusions which follow from that overriding analysis. Two approaches to this form versus substance debate are presented in Chapter 2 and Chapter 4.

Several important topics are discussed in this book, but no attempt has been made to present all of the issues and problems which a value-added tax proposal would raise in this country. For example, the treatment of governments, governmental agencies and traditionally tax exempt organizations is one major substantive area which is not addressed. Certain politically volatile matters such as the "money machine" argument are mentioned only briefly. The

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[4]The "subtraction method" label is one of three popular labels for specific mechanical rules under which a value-added tax is calculated. The "invoice and credit method" and "addition method" are the other two. Succeeding references to a generic value-added tax and a subtraction method value-added tax are interchangeable.

[5]A revised Canadian proposal which is likely to be submitted for consideration is a hybrid version of the invoice and credit and the subtraction method VAT systems.

quasi-legal/quasi-economic arguments about the General Agreement on Tariffs and Trade (GATT) legality of a subtraction method value-added tax which includes border tax adjustments is not analyzed here.

Each of these subjects is important, and thoughtful analysis of each will be essential to any serious public debate about a potential U.S. value-added tax system. The authors hope to address these and other matters at a later time. But as with any work on so large a subject, there comes a point at which one concludes that enough is enough. For now, "enough" is represented by the following 11 chapters.

A conscientious effort has been made to present information objectively and to describe alternative points of view, with restrained expressions of opinion and conclusions by the authors of individual chapters. The reader is urged to weigh the presentations, sift out any biases and come to the conclusions which seem appropriate.

Whatever the final conclusion, the reader should come away from this material with the following message. *Approach this subject with caution!* There is a great deal more involved than the simplistic picture brought to mind by the term "consumption tax."

The Value-Added Tax: Orthodoxy and New Thinking

1

SHIFTING TO CONSUMPTION AS A FEDERAL TAX BASE: AN OVERVIEW

by Murray L. Weidenbaum and
Ernest S. Christian, Jr.

For years, economists have debated the respective merits of income and consumption bases for taxation. The United States uses consumption-based taxes far less than most other developed Western nations. In 1985, the 23 members of the Organization for Economic Cooperation and Development obtained an average 30 percent of their revenue from taxes on consumption (see Table 1-1). For the United States, the ratio was 18 percent.

Many people believe that it is fairer to tax people on what they take from society, rather than on what they contribute by working and investing. In the nineteenth century, classical economist John Stuart Mill made this point in advocating the exemption of saving as part of a "just" income tax system. In the 1940s, American economist Irving Fisher argued that the income tax involved double taxation of saving and distorted the choice of individuals in favor of consumption. According to this view, not only is the income tax unjust, it encourages consumption and leisure at the expense of thrift and enterprise.

The U.S. Treasury actually proposed a "spendings tax" in 1942 as a temporary wartime measure to curb inflation. The proposal was quickly rejected by Congress. A major political argument against the expenditures tax -- then and now -- is that the exemption of saving would favor the rich who are better able to save large

Table 1-1

PERCENTAGE DISTRIBUTION OF TAX REVENUES IN SELECTED COUNTRIES BY MAJOR SOURCE, FISCAL YEAR 1985

Country	Income Taxes	Social Security Taxes	Taxes on Consumption	All Other
Austria	54%	0%	33%	13%
Australia	26	32	33	9
Belgium	41	33	24	2
Canada	44	13	32	11
Denmark	55	4	34	7
Finland	50	9	37	4
France	17	44	29	10
Germany	35	36	26	3
Greece	17	35	43	5
Ireland	34	15	45	6
Italy	36	35	25	4
Japan	46	30	14	10
Luxembourg	45	25	24	6
Netherlands	26	44	26	4
New Zealand	69	0	23	8
Norway	40	21	37	2
Portugal	29	26	43	2
Spain	28	42	26	4
Sweden	42	25	26	7
Switzerland	41	32	19	8
Turkey	45	5	44	6
United Kingdom	39	18	31	12
United States	43	29	18	10
AVERAGE	40%	26%	30%	4%

Source: American Council for Capital Formation.

portions of their incomes. Proponents of an expenditures tax respond that it can be made as steeply progressive as desired. Moreover, the recent trend in income taxation in the United States has been away from progressivity and toward a flatter, more proportional revenue structure. The 1981 and 1986 tax acts are striking cases in point. Another objection to the consumption base is that it would favor the miser over the spendthrift, even when both have similar spending power or ability to pay. The response offered to this argument is that consumption uses up the resources available to the nation, while work and saving add to these resources.

In practice, much of the impact of shifting to a consumption base would depend on how the tax is structured. The two major alternatives are an expenditures tax levied on total purchases within an accounting period and a value-added tax collected on each purchase. In theory, the base of the two taxes is the same -- the value of goods and services purchased. The yields could be similar.

AN EXPENDITURES TAX

An expenditures tax would be collected in much the same manner as the income tax. The annual taxpayer return would continue to be the heart of the collection system. Only one major change would be made; the portion of income that is saved would, in effect, be exempt from taxation.

For a while, the United States was moving toward an expenditures tax, albeit indirectly and in modest steps. The establishment of Individual Retirement Accounts (IRAs) enabled many federal taxpayers to defer paying taxes on amounts saved and invested in an IRA (up to $2,000 a year). Also, the first $100 of dividends received by a taxpayer was excluded from gross income. The Tax Reform Act of 1986, however, greatly reduced the incentives for investing in IRAs and eliminated the dividend exclusion. Having so recently curtailed deductions for saving, it is unlikely that Congress will in the near future reverse course and effectively exempt all saving by shifting to an expenditures tax.

A VALUE-ADDED TAX

Attention has shifted to forms of national sales taxes, notably a value-added tax. Such a consumption-based tax could be levied in addition to the currently collected taxes (although substitutions are possible). After having lain dormant for nearly a decade, interest in a value-added tax in the U.S. has reemerged primarily because of the conjunction of two economic factors -- budget and trade deficits.

Sources of Revenue For Deficit Reduction

There are political and economic proponents of additional federal tax revenues who want to use such revenues for two *inconsistent* policy objectives -- reducing the federal budget deficit and satisfying pent-up demand for new or increased domestic spending programs. Both pressures are well understood, although the latter is not spoken of in public very often.

Although less clearly understood, it is also likely the case that we are near the end of the era in which the income tax can provide major new revenues to the federal government. As the result of recent tax reforms, primarily in 1986, the base of the income tax has been broadened just about as much as is politically possible.

Income tax rates were drastically reduced in 1986 primarily as the direct result of a strong political force which is still at work. High marginal rates of tax, which were born in a war-time era and designed to apply to the rich, were being applied to a broad range of people in the newly affluent middle class who certainly do not consider themselves to be "rich." Having substantially reduced tax rates twice in the 1980s, it will be exceedingly painful for the Congress to reverse course and reimpose high rates of tax on income. The appetite for low tax rates was whetted, not satisfied, when the old idea of steeply "progressive" rates was effectively discarded almost without comment.

As a potential revenue raiser, the sheer *size* of a value-added tax base is unequaled by the current income tax base or payroll tax base, each of which has been severely limited by political judgments over several decades. The value-added tax base roughly corresponds to the total output of goods and services in the economy plus imports and minus exports. For example, a comprehensive value-added tax base in 1987 might have amounted to approximately $2.5 trillion.[1] That year a value-added tax of 3.5 percent on the comprehensive base could have raised approximately the same revenue as the present corporate income tax with its generally applicable rate of 34 percent. A value-added tax of about 16 percent could have raised

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[1]For this general purpose, the comprehensive base is computed as the total amount of personal expenditures ($2,966 billion) less the values of all housing services ($469 billion), which totals $2,497 billion. Sources: *Economic Report of the President* (February 1988), Tables B14 and B104.