A VALUE-ADDED TAX FOR THE UNITED STATES?

Selected Viewpoints

A Special Tax Foundation Report
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The Tax Foundation is a publicly supported, nonprofit organization founded in 1937 to engage in nonpartisan research and public education on the fiscal and management aspects of government. Its purpose, characterized by the motto "Toward Better Government through Citizen Understanding," is to aid in the development of more efficient and economical government. It also serves as a national information agency for individuals and organizations concerned with problems of government expenditures, taxation, and debt.

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I. Background

The value-added tax (VAT) is a multi-stage levy based on the value added in each stage of the production and distribution of a commodity or service, from the earliest stage up through the final retail sale. Ignoring the question of how to deal with depreciation of capital equipment, value added is conceptually quite simple. For a given firm, it is equal to total sales receipts after the subtraction of payments to other firms for goods and services on which tax has been paid. The value that the firm adds is equivalent to the total of its payments in wages, in interest and rent paid to individuals, and the owner's profit.

While several technically differentiated types of VAT have been discussed in the literature, emphasis has focused on two types as classified by Professor Carl S. Shoup almost a quarter of a century ago. The two types—"consumption" and "income"—vary only as regards the method selected for the treatment of capital expenditures. Under the consumption type, the full cost of capital equipment is deducted from the tax base in the year of purchase. Under the income type, no deduction is allowed for current capital outlays in total, but rather depreciation deductions of the sort now allowed under the corporation income tax are made over the life of the capital equipment.

Thus, the main difference between the two types is that, under the consumption concept, the tax base is smaller the first year and slightly larger in the following years. The total base added over the full depreciation period is identical under both methods.

The consumption type of VAT is the standard approach followed in European countries, and is considered to be the one most suitable for adoption in the United States—if, as, and when this country seriously considers enacting such a levy.

In working out tax liabilities under the VAT, the usual method is to multiply a company's sales by the rate of the tax and then subtract credits equal to the tax on all goods and services that are purchased from other firms. In the consumption variety, tax credits on capital assets are deducted in full at time of purchase.

Among the European countries, a VAT-type tax was enacted in France in 1954; and in 1967, the European Economic Community (EEC) approved the system for enactment by its members. By 1968, both France and the Federal Republic of Germany had enacted a VAT, and the remaining EEC countries adopted it over the next several years. Today, such a tax is in effect in most of western Europe and many parts of South America.

2. A third type of VAT, called the gross product type, makes no allowance for capital purchases or depreciation.
3. In discussing the VAT the Special Committee of the American Bar Association on the Value-Added Tax devoted its attention to the consumption type.
The basic principles of VAT were developed in Germany and the United States shortly after World War I. Beginning in the 1930s, a VAT has been considered on several occasions for use at the state level. In 1953, a tax having some resemblance to a VAT was introduced in Michigan. Called a "Business Activities Tax" (BAT), it was described in the literature as "not a true VAT, conceived in haste as a temporary political expedient, made 'permanent' in 1955, and amended frequently until repeal in 1967." In 1975, Michigan adopted the Single Business Tax, which has some of the characteristics of a VAT.

In the early 1970s, the VAT was discussed as a device for reducing or totally eliminating the Federal corporate income tax. In September 1970, the President's Task Force on Business Taxation suggested that, if more Federal tax revenue were required, consideration should be given to enactment of an indirect tax such as the VAT. The majority of the task force, nevertheless, adopted the position that no additional Federal revenue source should be adopted at that time. In 1972, the Joint Economic Committee held four days of hearings on VAT as a source of "at least" $50 to $100 billion in new Federal revenues—the minimum amount needed by the mid-1970s, in the opinion of the Committee's Chairman, Senator William Proxmire.

In January 1972, the President requested the Advisory Commission on Intergovernmental Relations (ACIR) to examine the feasibility of a Federal VAT as a substitute for residential school property taxes. The Commission concluded that "...a massive new Federal program designed specifically to bring about property tax relief is neither necessary nor desirable." More recently the VAT has been under discussion as a means of alleviating the rising burden of social security payroll taxes. In 1978, the chairman of the House Ways and Means Committee and the Senate Finance Committee both expressed interest in considering a VAT to finance a portion of social security benefits. (See Section IV.)


6. There was discernible sentiment among corporate leaders for following this approach; see The Wall Street Journal, May 29, 1969.


9. A national bipartisan group composed of representatives of the executive and legislative branches of all levels of government in this country, as well as members selected from the general public.

II. Proponents versus Opponents of VAT

Arguments for and against enacting a broad-based, Federal value-added tax in the United States have been advanced by a number of individuals and institutions concerned with broad economic policy and with the Federal tax system, in particular.

Proponents

In a 1966 policy statement, the Committee for Economic Development recommended that a value-added tax be considered as a way of raising the necessary revenue to finance the war in Vietnam and prevent inflation, and that the VAT be continued after the war as a permanent part of our tax structure, with the revenues to be used to reduce corporate income taxes:

The committee believes that a sound Federal fiscal policy for the future should place much more emphasis than our present policy does on measures to foster the growth of our capacity to produce.... An important step in this direction would be to reduce those taxes which impede the rise in private investment....The chief obstacle is the corporate profits tax.

In a study prepared for the National Association of Manufacturers, George Cline Smith's arguments included the question of the VAT's political feasibility:

...one is tempted to conclude the real advantage of the VAT lies in semantics: that it is ostensibly a tax on business activity and therefore is not subject to the usual attacks on sales taxes on grounds of being regressive or of invading the preserves of the states.... It is entirely possible that the real advantage of the VAT is that it is the only broad-based indirect tax that stands a chance of enactment by Congress. (Emphasis added.)

Among the prominent academicians who have supported the VAT concept are Professors Dan Throop Smith (Harvard University, emeritus), R. W. Lindholm (University of Oregon), C. Lowell Harriss (Columbia University), and Gerard M. Brannon (Georgetown University).

Professor Smith has emphasized the "neutrality" of the VAT as an argument in its favor, asserting that the tax is neutral in its treatment of both labor-intensive and capital-intensive industries, efficient and inefficient companies, partnerships and proprietorships, equity financing and debt financing. Thus, according to Professor Smith, the VAT permits tax factors to be minimized in making business decisions.

Professor Lindholm argues that the VAT "does not become another retail sales tax to be added on to sales price at the point of sale....Instead...VAT takes on the characteristics of a cost of doing business. VAT at the retail level is like property taxes and payroll taxes." 14

Professor Harriss has presented three arguments for a Federal tax on value added: (1) such a levy could provide revenue, which could help to prevent inflation by reducing budget deficits, (2) a VAT, by imposing a levy on consumption, would permit reductions in burdens on income and thus lead to a balance which could be considered more equitable and more favorable to capital formation, and (3) enactment of the value-added tax could be used to help phase out what is considered to be the seriously defective corporate income tax. On this last point, Professor Harriss finds persuasive reasons for replacing most of the corporate income tax—perhaps the top 30 or 35 rate percentage points—with a low-rate VAT.

Professor Brannon has focussed much of his discussion of the advantages of the VAT around its proposed role in partially replacing payroll taxes for financing the social security system (discussed below). In addition, Professor Brannon has developed a more generalized argument in favor of the VAT on the grounds that it taxes consumption rather than savings and thus encourages people to save, not only the affluent, but the ordinary citizen. Under the VAT, the tax law would in effect say to such persons, "If you save a bit more, your tax will be lower. If you save less than average people at your income level, your tax will be higher." If this is considered a worthwhile objective, then, in Brannon's opinion, the regressivity of the value-added tax can easily be dealt with. 15

Opponents

Professor Stanley S. Surrey, Harvard University and former Assistant Secretary of the Treasury, has criticized a proposed VAT on several counts. He questions the benefits which a value-added tax would provide for American export trade, and charges that the tax is really not "neutral." According to Surrey, it is neutral as to business only because it does not apply to business, being, so he claims, really a retail sales tax passed on to consumers. He characterizes the VAT as a "regressive tax" and "a distinct step backwards." Should there be the need for enacting some form of national sales tax, he prefers that it be a retail sales tax. As to the VAT, he asserts:

It is really nonsense for a country with an already functioning retail sales tax structure to add a value-added structure that collects in more complex and burdensome fashion the amounts that could be collected under the retail sales tax procedure.

In addition to the above alleged shortcomings, Surrey contends that those who advocate substituting a value-added tax for part of the existing corporate income tax should well ponder the experience of those European nations which, with the exception of Switzerland, raise much larger amounts of taxes in relation to Gross National Product than does the United States. According to Surrey, this is because they have added a national-level consumption tax to national-level income taxes. The deduction to be drawn is "that there is a type of Parkinson's law of taxation, to wit, for every type of taxation used by a Government the legislators will find expenditure needs that require raising the tax rates to the maximum politically tolerable level."\textsuperscript{18}

Dr. Richard E. Slitor, formerly with the U.S. Department of the Treasury, echoes this concern about the VAT all-too-easily opening the door to an expansion in the volume of both public revenues and expenditures. According to Slitor, "to spend is human; and...these human tendencies are given sustenance by new tax sources."\textsuperscript{19}

Among other negative voices raised concerning the VAT is the September 1970 report of the President's Task Force on Business Taxation, which, with but two dissenting votes, opposed enactment of a value-added tax as a substitute for any existing Federal levies on the grounds that such a new tax would be both inflationary and unnecessarily complex, and in addition, would involve the Federal government in an area of public finance previously preempted by the states.\textsuperscript{20}

Writing in the January 22, 1979 issue of Tax Notes, Joseph A. Pechman, Director of Economic Studies for the Brookings Institution, specifically counters arguments presented by Gerard Brannon in support of a VAT. Stating that Brannon's defense of a value-added tax presented in prior issues of that publication is "slightly disingenuous," Pechman charges that Brannon is "obviously uncomfortable about the regressivity of the tax, but then rationalizes his position by proposing a credit for the estimated VAT paid by families with incomes below the income tax exemption levels."\textsuperscript{21}

\textsuperscript{18} Surrey, op. cit., p. 1-4.
Harriss, a VAT proponent, concedes that the revenue potential of a VAT "would invite increases in spending. How attractive to 'the spenders,' and they are legion, to be able to claim that 'only a small' VAT tax rate increase would be needed to pay for this expansion and for that new program." Harriss, op. cit., p. 5.
\textsuperscript{20} Business Taxation, op. cit.
III. Advantages versus Disadvantages of VAT

Examination of the extensive literature indicates widespread concurrence as to the possible advantages and disadvantages of a broad-based Federal levy on consumption such as the VAT. Claimed advantages for the VAT are that it would:

1. Be based on consumption, and thus provide a stable revenue base;
2. Be "neutral," since it would be imposed on all types of businesses;
3. Provide stronger incentives for businesses to control costs;
4. Encourage, or at least not discourage, savings;
5. Have the potential for raising large amounts of revenue at a low tax rate;
6. Be simple to administer;
7. Reduce obstacles to exports, under certain conditions;
8. Help bring about a better balanced tax system.

Set against these positive characteristics are the alleged drawbacks. It is contended that the VAT would:

1. Be regressive;
2. Lead to excessive spending;
3. Lack a countercyclical balance;
4. Be harmful to new and marginal business activities;
5. Create administrative complexities;
6. Set off inflationary tendencies;
7. Be a "hidden tax";
8. Conflict with the present pattern of state and local sales taxes;
9. Be unable, in many instances, to create meaningful incentives for exports.

In the following sections the more important of the above points will be discussed, with the arguments pro and con presented in greater detail.

A. Regressivity

A principal objection to the value-added tax is that it is said to be "regressive" with respect to income. Although a family with $25,000 income would pay more tax than one with $15,000, the burden as a percentage of income would be less on the former. The VAT is assumed to be essentially a tax on consumption. Amounts saved are not taxed. Thus to the extent that prices increase because the tax is shifted forward, consumers are burdened in proportion to their consumption. Since consumers at lower income levels spend proportionately more on goods and services and save less, their tax burdens, ceteris paribus, will be greater as a proportion of income than burdens for those higher in the income scale.

The VAT without special provisions is not a "progressive" tax. However, advocates of the VAT point out that upwards of 100 million Americans are already paying an "even more regressive social security payroll tax" and that, by making

22. With the 10% earned income credit, to modify the payroll tax, and with the extension of the taxable earnings base to higher ranges, the charge that the social security tax is regressive has lost much of its force. The tax is proportional over a range that includes a large and rising share of the population. Moreover, the benefit structure of the social security system favors those with lower earnings.
certain adjustments in the tax or effecting countervailing changes in other taxes, it is possible to modify the regressivity of a VAT. As Professor Dan Throop Smith has observed:

Viewed in perspective as part of a whole Federal system of taxation and payments for income maintenance, any equity problems that result for low-income families from a value-added tax can be handled readily. 23

One approach to mitigating the regressivity of the VAT would be to provide an exemption for or impose a lower rate on purchases of certain basic necessities such as rent, food and prescription drugs. 24 Exempting such items from the tax base is the approach utilized in many of the American states to modify the regressivity of the general sales tax. The imposition of multiple tax rates, with necessities taxed at a lower, and non-necessities at a higher rate, has been resorted to by some countries of the European Common Market.

Concerning the suggestion that the VAT's regressivity be offset by applying special low tax rates to items deemed to be necessities for their purchasers, some commentators have voiced the view that this would seriously enhance the difficulties in administering a new tax. Estimates have been made that the use of multiple rates would hike governmental administrative costs by 50 to 80 percent, and would also increase compliance costs of business firms. 25

Another method of reducing the burdens of a Federal value-added tax on persons with low incomes would be to adopt a kind of provision used in several state sales taxes. These grant taxpayers credits against the individual income tax for a portion of the amounts of general sales taxes which they pay in any given year. The report of the American Bar Association on the VAT concludes that the tax credit approach would tend to make the burden of the value-added tax more nearly proportional than regressive. 26

This type of modification was advocated by former President Richard M. Nixon in his January 1972 suggestion of consideration for a Federal-level value-added tax. Mr. Nixon suggested that families with incomes up to $20,000 be granted rebates against their Federal individual income tax for all or part of the burdens of a VAT which they might incur. Taxpayers with incomes so low that they were not liable for any Federal income tax payments were to be given cash refunds for their estimated VAT payments.

From the point of view of both government tax administrators and tax-complying businesses, the relief of value-added tax burdens on the poor would be less complicated if tax credits were used rather than multiple tax rates.

24. Congress might also opt for granting special treatment for such other necessity items as household utilities, public transportation, and clothing.
Critics counter, however, that this would also burden the Internal Revenue Service with the processing of many additional refund claims. According to these commentators, the tax credit approach is but a second-best method for reducing the regressivity of a VAT. The tax structure, they believe, should be tailored so that the least sophisticated taxpayers would be in a position to take advantage of the tax relief offered. It is held that this system would be effective only if income tax returns containing claims (or separate refund claims) are filed by those whose low-level incomes preclude them from having to do so for income tax purposes alone.

The Scandinavian countries have sought to offset the regressivity of a value-added tax, not through either special tax rates for necessities or income tax credits or refunds, but by means of their overall revenue-raising and public expenditure policies. Tax structures are among the most "progressive" in the world. With extensive programs of social insurance, medical care, and family benefits, these nations reportedly are convinced that they have more than offset any degree of regressivity resulting from the use of a single-rate value-added tax. 28

B. Neutrality

One of the strongest arguments put forth by proponents of a value-added tax is that such a levy would be "neutral" in its effects on different types of business decisions and activities. This contention commands widespread support in the literature.

Among those holding this view, the consensus is that the VAT is "neutral" in that, in marked contrast to the corporate income, payroll, or business property taxes, it minimizes the importance of tax factors in business decision-making. The burden of the tax, it is stated, falls equally on all types of business activities, irrespective of their organizational structure, efficiency or inefficiency, capital or labor intensity, or use of debt as opposed to equity financing—except in so far as the cost of financing is passed through in the sales price. Effects would be the same on partnerships and proprietorships, and conglomerates and integrated producers would not have any advantages as compared to small-size producers and specialty industries.

Among supporters of a VAT the caveat is added, however, that this tax will have these relatively favorable results—or avoid the undesirable effects of present taxes—only to the extent that public policymakers resist the temptation to provide large-scale exemptions and/or special low rates for special types of purchases. Excluding any important area of economic activity from a VAT would, it is held, seriously erode the base of the tax, require higher rates to raise a given amount of revenue, and distort the operations of the overall economy. Thus, it is argued, any steps taken to reduce the burden of a VAT on low-income groups should be provided directly, either through income tax credits or cash payments.

C. Inflationary Effects

Critics of the value-added tax contend that its introduction would set off an inflationary chain-reaction in the price and wage structure. Actual experience has varied, and the possibilities for this country are so complex that no unequivocal answer can be given as to the results most likely. Producers would try to pass any VAT additions to costs on to the consumer; to some extent, however, business enterprises might for a time have lower profits as they absorb the excess of VAT over any tax relief. The immediate results would depend on the stage of the business cycle at which the tax is introduced, other tax changes, the nature and efficiency of individual business firms, the elasticity of supply and demand for particular products (including both imports and exports), and other factors.

Those who argue that the VAT can set off a wage-price spiral argue that there is at least a "clear risk" that its adoption as a net addition to costs would lead to an immediate price increase equal to the total amount of the levy. Moreover, there could be what are referred to in the literature as "unwarranted increases" beyond the amount of the VAT "due to ignorance of the nature of the tax and/or opportunism." Finally, the VAT could directly affect wage levels, again depending on whether the tax were included in the cost-of-living index to which many wage contracts are keyed. This, in turn, could lead to demands for compensatory wage increases by other groups of workers. As Professor John F. Due puts it:

While virtually all taxes may have some effect in leading to demands for higher wages, a levy that directly increases the cost of living index is bound to have the greatest influence, per dollar of tax revenue.

Other commentators, however, point out that the exact effect of a VAT on the price and wage structure will depend on a variety of factors. One, of course, is whether there are offsetting reductions in other taxes. Fundamentally more important for the general price-level results will be monetary policy. Will the Federal Reserve provide for an expansion in the money supply to "validate" the forces for higher prices? If so, it seems clear the imposition of the tax can be expected to be followed by more inflation than would otherwise occur.

Attempting to estimate the effects of adopting a VAT in the United States by observing the consequences of such a tax enactment in other countries leads


30. The U.S. Treasury Department estimated that a 2% VAT would, if effects were shifted forward by equivalent price increases, hike the cost of living by approximately 1.7%. U.S. Department of the Treasury, op. cit., p.23.

31. The Value-Added Tax, Hearings...op. cit., p. 17.
to findings that will generally be termed "inconclusive." In Europe, the VAT was introduced as a replacement for the various turnover taxes which have no counterparts in this country. The response of the monetary authorities differed. Additional variables came into play, and their precise contributions to total effects are quite difficult to determine.

Adoption of the VAT in the Federal Republic of Germany (replacing a turnover tax) and in Sweden (replacing a retail sales tax) came at a time when both countries were experiencing mild recessions. The new tax was not followed by any appreciable price rise in the short run. On the other hand, in the Netherlands and Denmark, enactment of a VAT was followed by price increases. In the Netherlands, the introduction of the VAT coincided with pay increases for government employees and led the government to institute a price freeze in order to curtail the ensuing spiraling price rise.

One European commentator was led to conclude that modern economic theory is rather undeveloped in this area and that most analyses of the effect of the VAT "vary in their assumptions and facts taken into account." The Tax Foundation, in its 1968 study of the VAT in Europe, put this another way:

...the arguments in favor of a particular view in the shifting of these taxes are abstract and verification of the facts is complicated, for it goes beyond the estimate of the effects of tax changes on the price of goods.

D. Effects of VAT on Federal-State Relations

Strong reservations have been expressed in some quarters as to possible adverse effects of a Federal-level value-added tax on the area of Federal-state relations. As of 1979, 45 states and a great number of local governmental units utilize the general sales tax as a major revenue source. State and local sales tax collections now amount to an estimated $46 billion (22 percent of total state and local tax revenues), and these levels of government are naturally reluctant to see the Federal government impose a levy on a tax base which up until now has been largely within their own exclusive fiscal purview.

Proponents of the VAT have sought to alleviate this concern by pointing out that the national government already levies excise taxes on certain consumer items ranging from alcoholic beverages, tobacco products, and gasoline, to the sale of bows and arrows and the making of local and toll telephone calls. Does the use of such consumption-based taxes by the Federal authorities interfere significantly with state (or local) sales tax collections? The states obtain significant revenues from their levies on liquor, tobacco, and gasoline.

Critics of the VAT suggest that enactment of a Federal VAT would bring undesirable changes in the traditional relationships between the levels of government in this country--i.e., could lead to a further, unwanted, erosion in the American federal system. Those who raise such questions feel that it is important for the national government to leave some forms of taxation--such as the general excise levy--to the states (and localities.) Otherwise, so they contend, decision making on taxation for state and local purposes will shift

further from local voters and taxpayers and state legislators toward the national Congress, and the nation will enter an era of greater resort to Federal grants-in-aid for and Federal control of lower-level government operations.

According to the report on the VAT of the American Bar Association, sides are chosen on this issue according to philosophical views:

Those who find virtue in eliminating pockets of substandard government services, even when they result from local options, will tend to see virtue in the Federal government moving into the field of consumer taxation, while those who find virtue in keeping decisions on levels of taxation close to the people...will doubt the wisdom of the move. 33

Whether the issue can be so starkly drawn in this fashion between proponents and opponents of a value-added tax, and further, whether enactment of such an impost would inevitably lead to the consequences which its opponents charge, involve questions beyond the scope of this report.

A more mundane consideration involves possible administrative difficulties for retail businesses in complying simultaneously with a Federal VAT and state sales and use taxes. Theoretically, it might be possible to alleviate such difficulties by coordinating administration of the two types of taxes by having the state tax "piggyback" on the Federal VAT. However, evidence indicates that efforts over the years to achieve similar joint handling of Federal and state income taxes—e.g., such as is done in the state of Rhode Island—have been only partially successful.

E. VAT and the Balance of Payments 34

One of the principal arguments used by proponents of a value-added tax is that adoption by the United States of such a levy would help immeasurably in alleviating the chronic balance-of-payments problems which have afflicted this nation during the past two decades. The VAT, so it is stated, would permit American exporters to reap advantages now enjoyed by the members of the European Economic Community, while escaping the drawbacks experienced by exporters from such countries as the United States, Canada, and Australia, which rely heavily on direct taxes.

Arguments that the U.S. balance-of-payments position could be significantly improved through enactment of a Federal-level VAT rest on the assumption that this would be accompanied by the removal, in whole or in part, of the Federal corporation income tax, or some other direct tax such as the payroll tax. A further assumption is that the burden of the tax which would be reduced

34. This section does not discuss the arguments relating to the significance of exchange rates of currencies. When they are free to float or adjust at regular intervals to balance-of-payments conditions, the adjustment process can appear quite complex.
or eliminated--the corporation income tax or the payroll tax on employers--is now shifted forward so as to enter into price.

The General Agreement on Tariffs and Trade (GATT)\(^{37}\) permits member nations (including the United States) to grant border tax adjustments, or tax rebates, for amounts paid for indirect taxes such as the VAT. Federal manufacturers' excise taxes and state sales taxes are not applied on exports. GATT, however, prohibits such rebates in the case of taxes classed as "direct," including the corporate income tax.

Proceeding with the argument, use of the VAT would permit rebates, which previously with the corporate income tax were disallowed. Therefore, the prices of American exports would fall; they could compete on more favorable terms in world markets. Conversely, VAT would be imposed on imports; any resulting rise in prices relative to those of domestically produced goods would cause the volume of imports to decline.

To this, some opponents of the VAT respond that the burden of the corporate income tax--the levy to be replaced by the VAT--is not shifted forward. Therefore, it is argued, its elimination and replacement by a VAT would, in the first instance, simply raise domestic prices. Consequently, any border tax adjustments for exports would not result in lowering their prices, but would simply offset the price rise due to VAT.

A refinement to this argument is that, even if one were to assume that the burden of the corporation income tax is shifted, its replacement by a VAT would not immediately lead to lower prices for domestically produced goods. Professor Dan Throop Smith, a leading proponent of the VAT, recognizes such a time lag. In his words: "Prices, like wages, may be sticky on the downside." Moreover, the corporate income tax, even if largely shifted into consumer prices, will rarely be more than a few percentage points of final price.

The 1970 report of the President's Task Force on Business Taxation (referred to above) questioned whether a VAT, at what it described as the "relatively low rate under discussion--2 to 5 percent" would ameliorate this nation's balance-of-payments difficulties, and said that, in any event, whatever benefits might be derived on that score do not justify introduction of the VAT in the domestic economy.\(^{40}\)

35. Professor Dan Throop Smith contends that "both businessmen and economists quite widely now accept the fact that the corporate income tax is largely shifted." Smith, op. cit., p. 83.
36. A third qualification is sometimes added, namely that business firms must be willing to pass on such tax savings in the form of cost reductions of exported goods. Otherwise, the adoption of a VAT in place of a direct tax will have no effects on the nation's balance-of-payments position. Arthur Andersen and Co., Perspectives on the Value-Added Tax, Chicago, 1970, p. 10.
37. The body of law that regulates international trade, originally established in 1947, and subsequently signed or adhered to by 112 nations.
38. Professor Stanley A. Surrey doubts that the burden of the corporation income tax is shifted forward so as to have a price effect. Surrey, op. cit., p. 167.
The American Bar Association's Committee on the Value-Added Tax examined at some length what it described as the claims of VAT proponents that the experience of those nations which had a tax of this type and also had balance-of-trade surpluses was not mere happenstance, but indicated a clear cause-and-effect relationship. The Committee's conclusions were that "the evidence to support the claim turn out to be shaky" and that, in any event, "it is difficult to quantify the impact of a nation's internal tax structure on its international trade."41

IV. VAT and Social Security Financing

As far back as 1935, suggestions were made to finance unemployment compensation insurance by means of a value-added tax. More recently, in 1970, the President's Task Force on Business Taxation considered substituting a VAT for some or all of the payroll taxes now used to finance the social security system. The 15-member Task Force, with one exception, expressed the view that "the contributory principle is so important in our social security system that it should not be abandoned or modified and that a value-added tax should not be substituted for payroll taxes."42

Since then, social security financing has become increasingly costly. Continuing enrichment of benefits has resulted in a sharp rise in the burden of payroll taxes. At the time of the 1970 Task Force Report, the combined maximum annual cost of social security taxes to the employer and employee was about $750; by 1978, the combined maximum came to over $2,100, and further increases were scheduled for future years.

Congress in 1977 enacted a series of additional increases in the social security tax rate and base, designed to shore up the financing of the system over the next 50 to 75 years. The bulk of additional tax revenues will not begin to come in until 1981. In that year, the employer and employee will each pay a tax of 6.65 percent on a maximum earnings base of $29,700 (now 6.13 percent on a base of $22,900), for a combined total tax of $3,950 (now $3,817). Overall, the scheduled tax increases will raise payroll tax payments by $14 or $15 billion a year in 1981, and more in later years.

Public reaction to the increases enacted in 1977 was perceived to be distinctly negative. Early in 1978, there was widespread speculation that Congress would either defer or curtail the payroll tax increases it had approved. Congress did not do so in 1978. While the intensity of public dissatisfaction is difficult to measure, there has been an apparent revival of interest in the possibility of curtailing all or some portion of the payroll tax increases by substituting another source of revenue.43 The renewed concern stems largely from statements by Senator Russell B. Long, Chairman of the Senate Finance Committee, and Representative Al Ullman, Chairman of the House Ways and Means Committee. Both have expressed interest in examining the feasibility of a value-added tax in financing social security.

In December 1978, Senator Long urged repealing the social security tax, limiting income taxes to no more than one-third of a person's income, and replacing the lost revenues by a value-added tax, which he likened to a "hidden sales tax." According to the Finance Committee Chairman, such a development would "encourage work and investment."44

42. Business Taxation, op. cit., p. 70.
44. The Wall Street Journal, December 4, 1978. Senator Long's proposal to pay for social security with a value-added tax is "several years old," according to the Journal, but aides said the Senator would "push his ideas harder" this time.
Representative Ullman's support for adoption of a VAT is described as "qualified" in that, while he favors enactment of such a levy and intends to work closely with Senator Long, he nevertheless feels that the Louisiana lawmaker is going too far in that direction. Addressing the Tax Foundation in December 1978, Representative Ullman voiced the view that a value-added tax, in the form of a "uniform, low-level transaction tax" should be considered to supplement present social security financing. However, he emphasized that "payroll taxes should remain the principal source of revenue for Social Security, and income taxes must continue to support the major share of government." In Representative Ullman's view, such a tax as VAT could "conceivably be used to facilitate movement toward a more simplified system of business taxation including integration of corporate taxation and elimination of the double taxation of dividends." As a partial replacement for payroll taxes, it would, in Representative Ullman's words, "reduce the drag on new employment." In February 1979, Treasury Secretary W. Michael Blumenthal declared that he is not "unsympathetic" to a value-added tax, that Senator Long's proposal "deserved a thorough investigation"; and he added that, whenever the Congress is prepared to hold hearings on enacting such a levy, the Treasury Department is prepared to testify. While the Treasury head expressed this guarded receptivity to the idea of a VAT, the Assistant Secretary for Tax Policy, Donald C. Lubick, reportedly sought to downplay such an interpretation of the Secretary's remarks, at the same time repeating some of the standard criticisms usually employed by opponents of a VAT.

The existing literature on VAT provides little analysis relative to the question of social security financing. Some commentary, however, has recently been offered by Professor Gerard M. Brannon of Georgetown University.

Professor Brannon has suggested use of a VAT to fund any further increases which might be enacted in social security benefits. He asserts that financing social security by means of payroll taxes has come to have "bad political consequences," while replacing part of the burden with general revenue financing based largely on the income tax is viewed as "a very poor prospect." In Professor Brannon's view, there would be little overall difference in the effects on the U.S. economy, if a VAT were to be substituted for part of the social security payroll tax. The alleged "regressivity" of the VAT is, in his view, irrelevant, since existing payroll taxes are regressive, while the government, in any event, could offset any regressivity by making cash payments in the form of refundable credits to those who pay the tax.

Other opinions on the feasibility of substituting a VAT for all or part of the present social security payroll tax will no doubt come to light during forthcoming Congressional hearings. Representative Ullman has indicated that the Committee on Ways and Means will hold such hearings in the latter part of 1979.

47. Ibid.
V. Revenue Potential of VAT

Because it is a broad-based tax on consumption, the VAT is generally considered to have the potential to raise large amounts of revenue with a relatively low tax rate. As a consumption tax, the VAT is also held to be less elastic than taxes levied on either personal or corporate income. With yields less susceptible to economic fluctuations, a VAT would be more stable and could be expected to increase from year to year, according to a predictable pattern, as the result of economic growth and inflation. This in turn would permit government authorities to gauge more accurately their budgets and plan their cash expenditures.

The revenue potential of a Federal-level value-added tax in the United States would, of course, depend upon the definition of the tax base, and the rate chosen. Questions arise as to what exemptions, or reduced tax bases, are to be granted, and whether a single uniform tax rate, or multiple rates applied to different categories of transactions, are to be used.

There are varying exemption provisions among the nations which make use of the VAT. Medical and educational services are exempted in virtually all of these countries because of a belief in their social value. Banking, insurance, and brokerage activities are often exempt because of the difficulty of applying the value-added concept to these types of operations which serve both final consumers and businesses as producers. Housing is generally exempt from the VAT, although the tax is applied to construction and repair work, as well as to the sales of newly constructed buildings.

Some of the European countries exempt legal services, for substantially the same reasons that apply in the case of financial services. At times, very small business enterprises are exempt. In the United States the existence of state and local sales taxes might lead to exemption of the retailing sector from any Federal-level VAT. This would be done to avoid possible confusion at the retail level between the Federal VAT and state and local sales taxes, to reduce the number of taxpayers and thereby curtail costs of tax administration.

Most of the European states which use the VAT exempt medicines delivered by a hospital or a doctor, but not medications sold on the commercial market. In the case of a U.S. VAT, there would probably be considerable pressure to exempt food, although if this were done it would substantially reduce the base of the tax. While any such exemption would lower the alleged regressivity of the tax, it would at the same time have the disadvantage of distorting its economic neutrality.

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50. This aspect of the VAT has been criticized even by proponents of such a tax on the grounds that it would encourage greater public expenditures. Harriss, op. cit., p. 5.

51. For example, Germany exempts blind persons employing less than three employees while France grants this status to cooperatives providing artificial insemination services, something which has been described as "an unexplained departure from the value-added concept." American Bar Association, op. cit., p. 5.

52. For this reason a number of economists would prefer to include food in the tax base of a VAT, while compensating low-income consumers for the VAT paid on food purchases by means of income tax refunds and cash rebates.
One important category of exempt transactions under any value-added tax is the export of goods and services.

Another approach which may be taken to limit the impact of a value-added tax on certain types of activities is to grant what is termed a reduced taxable base. An example of this variation occurs in Sweden, where new buildings are accorded a taxable base equivalent to 60 percent of actual value.

Certain countries make use of multiple tax rates, levying different rates on different types of transactions. There is well-grounded belief, however, that a VAT will operate most effectively, not only with as few exemptions as possible, but with a single rate structure. According to Professor Dan Throop Smith, "The universal recommendation regarding a value-added tax is to avoid exemptions and differential rates."

The table on the following page indicates the size of the taxable base for a consumption-type VAT. This base represents an updating of one suggested by the Treasury Department in 1969. The items listed are those which the Treasury study considered "candidates for exclusion from the total GNP." The total tax base shown, $954.7 billion in 1977, represents personal consumption expenditures minus the items listed in the table, plus purchases of owner-occupied housing. The adjustments shown reduce the personal consumption expenditures total by $315 billion, or 26 percent. Addition of $64 billion for owner-occupied housing purchases brings the base for a VAT of this type to just over 50 percent of total GNP.

Thus, at 1977 income levels, a consumption-type VAT as defined here had a potential revenue yield of over $9.5 billion per percentage point of the rate.

In 1978, gross national product rose 11.6 percent over 1977. Assuming that the major components included in this VAT tax base performed similarly, the revenue potential of a VAT in 1978 would have been more than $11 billion for every one percentage point of the rate.

53. Among the member states of the European Economic Community, France and Belgium opted for four rates; Italy for three; The Federal Republic of Germany and the Netherlands for two; and the United Kingdom for one.
54. Smith, op. cit., p. 79.
### Value-Added Tax Base
**Calendar Year 1977**

(\textit{In millions})

<table>
<thead>
<tr>
<th>Major GNP Category</th>
<th>Amount</th>
<th>Deductions from GNP</th>
<th>Amount</th>
<th>Included in tax base</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Total</td>
<td>$1,887,177</td>
<td>$932,473</td>
<td>$954,704</td>
<td></td>
</tr>
<tr>
<td>2. Personal consumption expenditures</td>
<td>1,206,507</td>
<td>315,451</td>
<td>891,056</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal remittances in kind to foreigners</td>
<td>255b</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditures in U.S. by foreigners (addition)</td>
<td>6,699b</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rental value of owner-occupied homes</td>
<td>107,317</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rental value of farm homes</td>
<td>5,926</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Food produced and consumed on farms</td>
<td>1,245</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic service</td>
<td>7,141</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditures abroad by U.S. residents</td>
<td>1,524</td>
<td></td>
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</tr>
<tr>
<td>Foreign travel by U.S. residents</td>
<td>10,493</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Food furnished employees (including military)</td>
<td>3,798</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>G.I. clothing issue</td>
<td>83</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bridge, road tolls</td>
<td>879</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utility services provided by governments, including transportation</td>
<td>N.A.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medical care, drugs</td>
<td>117,977</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private education and research</td>
<td>18,800</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Religious and welfare activities</td>
<td>15,384</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fraternal net receipts</td>
<td>2,032</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonprofit entertainment and sports</td>
<td>1,078</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Services furnished without cost by financial intermediaries, except life insurance</td>
<td>23,295</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenses of handling life insurance</td>
<td>12,132</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Net exports of goods and services</td>
<td>-11,143</td>
<td>All</td>
<td>-11,143</td>
<td>0</td>
</tr>
<tr>
<td>4. Government purchases of goods and services</td>
<td>393,975</td>
<td>All</td>
<td>393,975</td>
<td>0</td>
</tr>
<tr>
<td>5. Changes in business inventories</td>
<td>15,571</td>
<td>All</td>
<td>15,571</td>
<td>0</td>
</tr>
<tr>
<td>6. Gross private fixed investment</td>
<td>282,267</td>
<td>218,619</td>
<td>63,648c</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Producers durable equipment</td>
<td>127,922</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonresidential structures</td>
<td>63,886</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Residential structures for rental purposes</td>
<td>26,761</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Footnotes to Table:

a. This table is an updated version of the tax base depicted in Table 1 from "Report on Value Added Tax," Treasury Department Study, September 10, 1969 (unpublished, but released to the public in draft form in February 1979).

b. Personal remittances in kind to foreigners and expenditures in U.S. by foreigners are deducted by the Bureau of Economic Analysis in computing the total of U.S. consumption expenditures. This computation therefore ignores the $255 million in the former category (already excluded) and adds twice the latter category.

c. Represents purchases of owner-occupied housing.