
A Value Added Tax and Older Americans

Remarks to AARP Policy Council

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Topics

- Why is a VAT being Discussed?
- What do Other Countries Do?
- How would a VAT Work?
- Revenue and Distributional Effects
- What are the Alternatives?



Why is a VAT Being Discussed?

- CBO estimated baseline deficits are large
 - \$1414b and \$1349b in 2009 and 2010, 9.2% and 9.5 % of GDP
 - By 2020, down to 3.0 of GDP (\$687b)
 - Debt rises from 53.0% of GDP in 2009 to 66.7% of GDP by 2020
- But CBO baseline assumes:
 - Expiration of all Bush tax cuts and other expiring tax provisions
 - Failure to “patch” and index the AMT
- With these adjustments, deficits and debt up significantly
 - In 2020, deficit = 1714b (7.6% of GDP)
- After 2020, things get much worse!

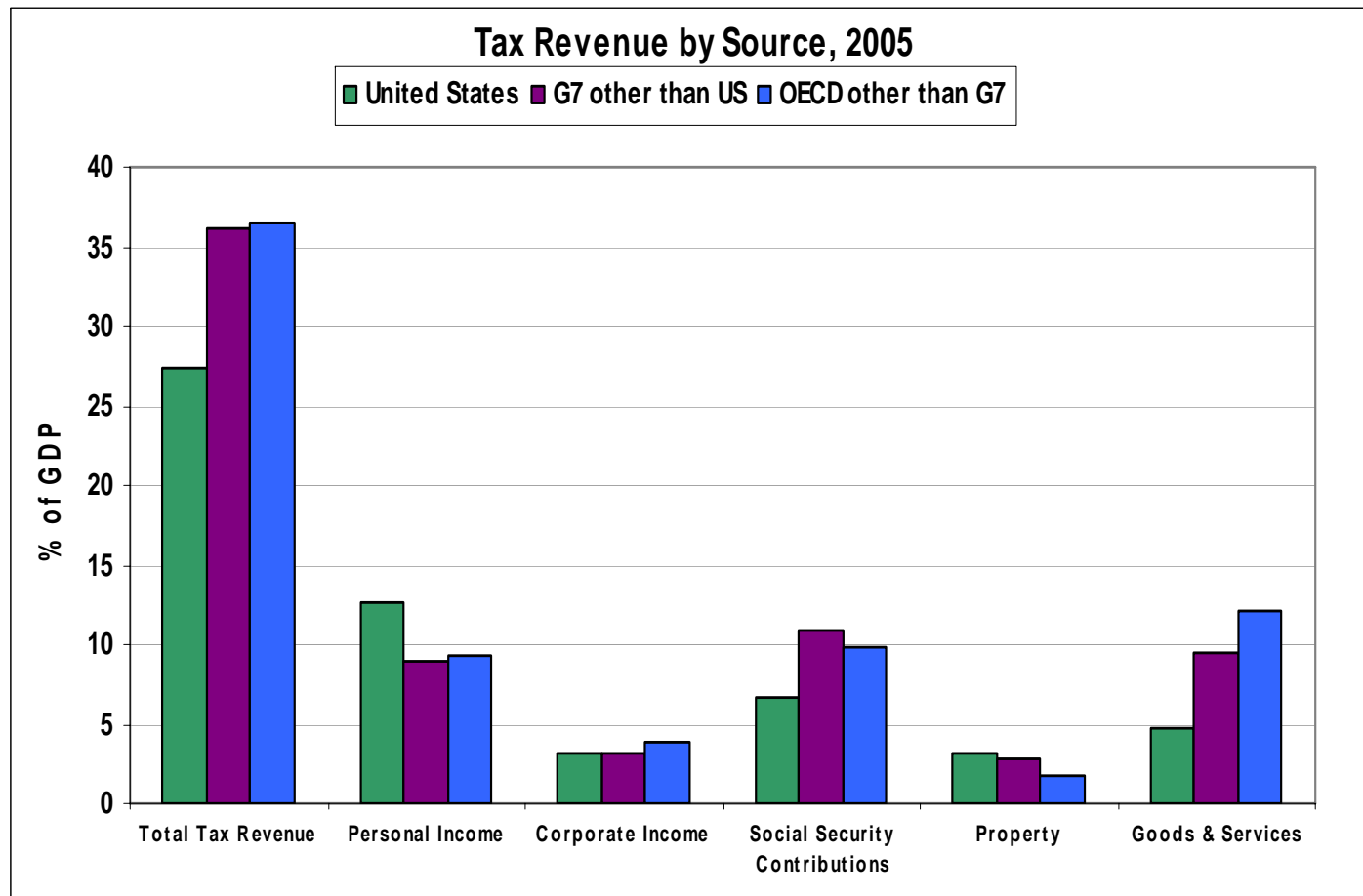


Why a VAT Instead of Other Taxes?

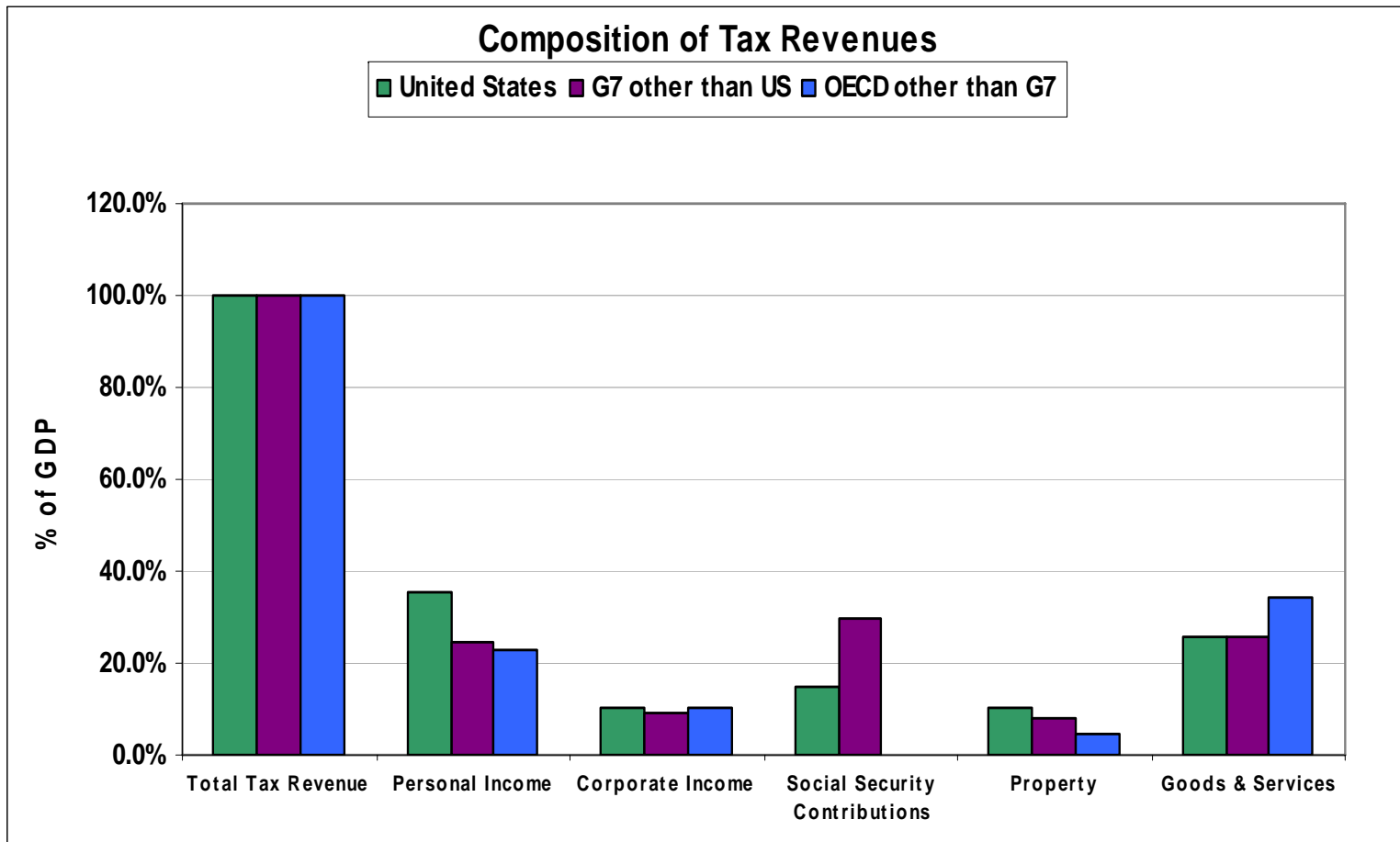
- Limits to raising income tax rates
 - Efficiency costs of income tax
 - Difficult to tax mobile capital and labor
 - US corporate tax rate near highest in OECD
- VAT is destination-based and exempts capital income (residence vs. source)
- VAT a proven revenue source that works
 - 130 countries use it
 - All other OECD countries



What do Other Countries Do?



Shares of Tax Revenues



VAT Rates: Selected Countries

	1976	1992	2007
Australia	---	---	10.0%
Canada	---	7.0%	6.0%
France	20%	18.6%	19.6%
Germany	11.0%	14.0%	19.0%
Italy	12.0%	19.0%	20.0%
Japan	---	3.0%	5.0%
New Zealand	---	12.5%	12.5%
U.K.	8.0%	17.5%	17.5%

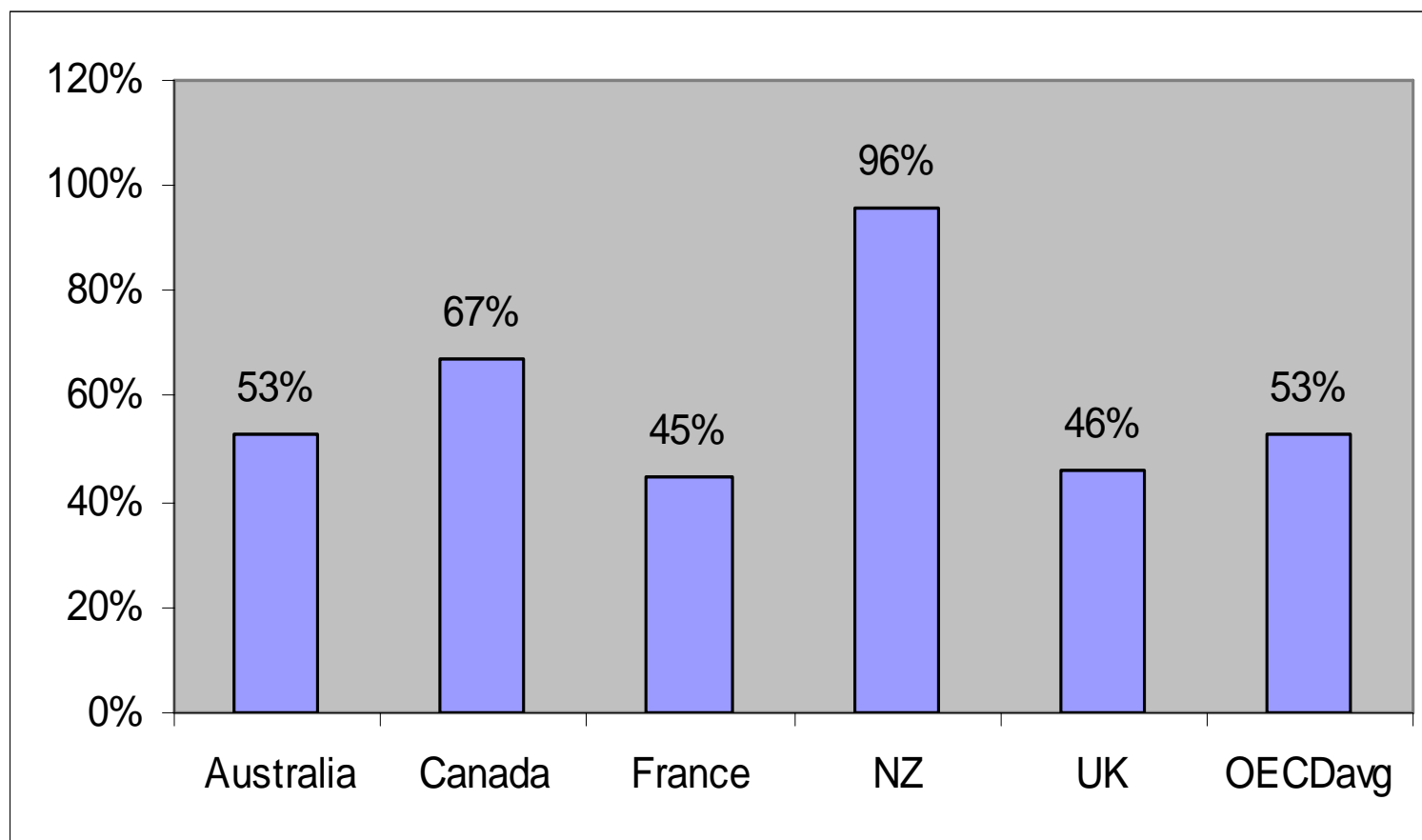


Spread of VAT

- 1980-88: Greece, Hungary, Korea, Mexico, New Zealand, Portugal, Spain, Turkey
- 1990-98: Canada, Czech Republic, Iceland, Japan, Poland, Slovak Republic, Switzerland
- 2000-2007: Australia
- 2010-2017: USA?



Ratio of VAT Base to Consumption: Selected Countries



How a Typical VAT Works

- All sales by all businesses taxable
 - Businesses pass on tax invoices to purchasers
- Registered VAT taxpayers claim credits for taxes paid on their purchases
- Exports are “zero-rated”
 - Exporters claim credits on purchases
- Imports are taxable
 - No credits on purchases from overseas
- Tax base equals domestic consumption



Differences between VAT and Income Tax

- Capital purchases deductible
 - No taxation on normal returns to capital
 - Makes it a consumption tax, exempts saving
- Collected from businesses
 - Tax burden can't vary with income level
 - But can offset burden on low-income taxpayers with credits if income tax retained
- Destination instead of origin-based
- No tax on financial transactions (R instead of R+F) – interest and dividends exempt



How Much Could a 5% VAT Raise in 2012?

<u>VAT Option</u>	<u>VAT revenues</u>	<u>Income and payroll tax offsets</u>	<u>Net revenues (% of GDP)</u>
Broad base (77% of consumption)	\$355.5b	\$96.7b	\$258.6b (1.6%)
Narrow base (50% of consumption)	\$221.4b	\$59.7b	\$160.9b (1.0%)



Assumptions for Estimate

- Broad base exemptions (zero-rating):
 - Educational expenses
 - Government-funded health care
 - Charitable services
 - State and local government services
 - Financial services (exempt)
- Additional exemptions under narrow base:
 - Housing consumption
 - Food consumed at home
 - Private medical expenses (out of pocket and insurance)
- Non-compliance rate the same as under an income tax
- VAT revenues reduce income and payroll tax bases



What Could VAT Revenues Fund?

- Funding Universal Health Insurance
 - Burman estimates 18% VAT rate on broad base with 100% compliance
- Income Tax Relief (Graetz)
 - \$100,000 exemption from income tax
 - Top individual and corporate rates of 25%
 - Requires 10-15% VAT
- Alternative to Cuts in Social Security and Medicare
- Other (you name it!)



Comparing VAT to Income Tax: Sources of Income

<u>Income Source</u>	<u>Income Tax</u>	<u>VAT</u>
Wages	Taxable	Taxable
Returns to new saving	Taxable	Exempt
Interest paid	Deductible	Not deductible
Economic profits	Taxable	Taxable



Comparing VAT to Income Tax: Uses of Income

- Both Income Tax and VAT favor some current goods over others
 - Explicit exemptions from VAT base (food, medical expenses etc.)
 - Tax preferences under income tax (housing, health care, charitable giving, corporate vs. non-corporate goods)
- Different treatment of future saving. Compared with an income tax
 - VAT favors those will accumulate wealth in the future
 - VAT hurts those who will spend down wealth in future



VAT Pros and Cons

- Pros:
 - No additional burden on capital income
 - Internationally compatible
 - Self-enforcement mechanisms
 - Can exempt small businesses
- Cons:
 - Distribution of tax burden
 - Additional administration and compliance costs
 - Tax avoidance issues
 - Hard to tax sectors (financial institutions)



Effect of 5% VAT on After-tax Income

<u>Income quintile</u>	<u>5% broad base</u>	<u>5% narrow base</u>	<u>Broad w rebate</u>
Bottom quintile	-2.8%	-1.2%	+1.7%
Middle quintile	-2.9%	-1.6%	-1.5%
Top quintile	-2.6%	-1.8%	-2.2%
Top 1%	-2.1%	-1.5%	-2.1%
All taxpayers	-2.7%	-1.7%	-1.7%



Effect of 5% Broad-Base VAT by Age (Incomplete)

<u>% Change in ATI</u>	<u>Under 65</u>	<u>65 and Over</u>
Bottom quintile	-3.7%	-0.9%
Middle quintile	-3.4%	-0.8%
Top quintile	-2.9%	-1.3%
Top 1%	-2.4%	-1.5%
<u>All taxpayers</u>	-3.1%	-1.1%



VAT vs. Income Tax for Older Taxpayers?

- Both tax earnings and payouts from tax-deferred accounts (non-Roth)
- VAT exempts indexed transfer payments (helps low-income older taxpayers)
- VAT exempts saving and taxes withdrawals from saving
 - Helps those ages 50-64 in high accrual years
 - Hurts those ages 65+ who are spending down wealth



How do Older Households Spend down non-pension Financial assets?

<u>52-56 in 1998</u>	<u>1998 Assets</u>	<u>2006 Assets</u>	<u>% Change</u>
Bottom fifth	10,503	4,631	-55.9%
Middle fifth	85,923	123,113	+43.3%
Top fifth	422,581	1,074,833	+154.3%
<u>62-66 in 1998</u>	<u>1998 Assets</u>	<u>2006 Assets</u>	<u>% Change</u>
Bottom fifth	39,924	18,222	-54.4%
Middle fifth	198,613	180,166	-9.3%
Top fifth	615,173	864,251	40.5%



Why not instead raise Income Tax?

- TPC Simulated Ways of raising 2% of GDP relative to President's baseline
 - Boost all rates by almost 50% (top rate 52%)
 - More than double only top 3 rates (top rate 76%)
 - Raise taxes only on those making over \$200k/\$250k (top rate up to 91%)
 - Eliminate itemized deductions (closes only 38% of gap)
 - Limit itemized deductions to 15% (only 20% of gap)
- These estimates don't account for behavior
- Bottom line – hard to get there with income tax alone



Notes for Politicians

- Defeat of Chairman Ullman (1980)
- New VATs in 1980s and 1990s
 - Canadian and Japanese premiers defeated after introduction.
 - Australian candidate proposed and lost
 - NZ govt. re-elected, but lost 3 years later
- Contrary Stories
 - Thatcher elected twice after doubling rate
 - No country has repealed its VAT



Political Objections in U.S.

- Tax is regressive (liberals)
- Tax is a money machine (conservatives)
- “VAT will be enacted when conservatives discover it is regressive and liberals discover it is a money machine” – Larry Summers



Prospects for Enactment

- Zero to None in Short Run
 - Many economists, tax experts, and senior public servants (ex- Paul Volcker) favor it
 - But no explicit political support
 - Republican opposition to raising tax burden
 - Obama: no tax increase at incomes less than \$250k
- Very high in the long run
 - Funding health care, infrastructure, defense etc.
 - Aging of the baby boomers
 - Can't keep borrowing overseas forever
 - What are the options?



Conclusions

- Something needs to be done to address growing deficits
- VAT may be preferable to alternatives
 - Adverse economic effects of higher income taxes
 - Draconian spending cuts
- Older Americans would pay more, but not all of them
 - Special concerns about middle-income people spending from accumulated assets
 - But VAT increases may be better than alternatives

