

# How Could We Improve the Federal Tax System?

VALUE-ADDED TAX (VAT)

## How would small businesses be treated under a VAT?

**Q. How would small businesses be treated under a VAT?**

**A. Most countries exempt small businesses from value-added tax, although many small businesses choose to voluntarily register for the VAT.**

Most countries exempt small businesses from a value-added tax (VAT)—partly because small businesses are a powerful political constituency and partly because the administrative and compliance costs of taxing small businesses are high relative to the revenue raised.

The exemption is a mixed blessing, however. Many businesses prefer to buy their inputs from businesses in the VAT system so they can claim credits on the tax they pay. As a result, countries allow small businesses to register for the VAT even if they are not required to do so. For example, in Australia during the 2010–11 tax year, 37 percent of businesses had sales below the VAT threshold, yet 92 percent of all businesses registered for the VAT.

A higher exemption based on business sales saves on compliance costs but reduces revenue, with the revenue loss depending on the tax rate. A study by Treasury Department economists finds that if the United States had a 10 percent VAT, the optimal exemption based on sales would be about \$200,000 and would cover about 43 million businesses (Brashares et al. 2014). That exemption would be higher than in most other countries, but the 10 percent rate would be lower than in most other countries. At a 20 percent rate, close to the average for Organisation for Economic Co-operation and Development countries, the optimal exemption would be \$90,000, which is within the range of exemptions in other countries.

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### Works Cited and Further Reading

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