

# How Could We Improve the Federal Tax System?

VALUE-ADDED TAX (VAT)

## What would and would not be taxed under a VAT?

**Q. What would and would not be taxed under a VAT?**

**A. Typically, a value-added tax covers all or most forms of consumption.**

In principle, the tax base of a value-added tax (VAT) is all consumption. Most VAT systems, however, exclude certain items from taxation. Some items (e.g., food and prescription drugs) are excluded to reduce the impact of the tax on low-income households. Others are excluded because defining their “value added” is difficult (e.g., financial services).

### BROAD VERSUS NARROW BASES

Eric Toder and Joseph Rosenberg (2010, 12) provide examples of broad- and narrow- based VATs. The broad-based VAT they examine includes “all domestic consumption, except for education, government-financed health care (Medicare and Medicaid), services of charitable organizations, and services performed by subnational governments,” capturing about 80 percent of consumption. Their narrow-based VAT excludes (in addition to the exemptions in the broad-based VAT) “housing consumption, food consumed at home, and private medical expenses (out-of-pocket expenses and insurance premiums),” capturing about 50 percent of consumption.

### REVENUE RATIOS

A revenue ratio is a formal measure of how broad a tax base is. For a VAT, the revenue ratio is calculated by dividing VAT revenue by the product of the standard VAT rate and all consumption. If the standard tax rate applied to all consumption and to nothing else, and if there were no evasion, the ratio would be one. Goods that are exempt, preferentially taxed, or zero rated (the inputs are eligible for credits though the goods are not taxed upon sale) reduce the revenue ratio, as does tax evasion.

The unweighted average VAT revenue ratio was 0.55 across all OECD countries in 2014, suggesting significant erosion in VAT revenues. The ratio ranged from 0.31 (Mexico) to 1.13 (Luxembourg). The combination of Luxembourg’s status as a center of financial services and e-commerce and the current tax treatment of those services may explain why its VAT revenue ratio is greater than 1.00.

The older VATs, mainly in European Union countries, have narrow tax bases, with many goods or services receiving preferential treatment. Newer VATs, such as in New Zealand and Japan, tend to apply a lower standard rate to a broader base of goods and services.

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### Further Reading

Organisation for Economic Co-operation and Development. 2014. "Measuring Performance of VAT." In [Consumption Tax Trends 2014: VAT/GST and Excise Rates, Trends and Policy Issues](#), 101–18. Paris: OECD Publishing.

Tax Analysts. 2011. [The VAT Reader: What a Federal Consumption Tax Would Mean for America](#). Falls Church, VA: Tax Analysts.

Toder, Eric, and Joseph Rosenberg. 2010. ["Effects of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes."](#) Washington, DC: Urban-Brookings Tax Policy Center.

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