

How Could We Improve the Federal Tax System?

VALUE-ADDED TAX (VAT)

Why is the VAT administratively superior to a retail sales tax?

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A. Retail sales taxes suffer from several enforcement problems. Most notably, the government has no record of transactions with which to verify retailers' tax payments. In a value-added tax, the chain of crediting creates a natural audit trail, and the seller has more incentive to report the transaction and pay tax.

If the value-added tax (VAT) replicates the effect of a well-functioning sales tax, why not just enact a retail sales tax?

Retail sales taxes suffer from several enforcement problems. Most notably, there's no cross-reporting; the government has no record of the transaction and the retailer responsible for sending the check to the government for the tax it collects knows this. As a result, compliance rates can be low. Most countries have found that, as a practical matter, retail sales tax rates of 10 percent or higher aren't enforceable—buyers have greater incentive to avoid the tax and retailers have greater incentive to keep the revenues. Not coincidentally, all state sales tax rates are below 10 percent.

For any tax, cross-reporting is essential to compliance. In the income tax, evasion rates on wage income are low: firms withhold income and payroll taxes on workers' behalf and send the money to the government. (The exception is tips, which proves the point.) In the VAT, the chain of crediting creates a natural audit trail. In a transaction between two businesses, the seller knows the buyer is reporting the transaction to claim a credit, so the seller has more incentive to report the transaction and pay tax. There's no similar incentive under a retail sales tax.

Also with a sales tax, the retailer can't always tell whether the buyer is a consumer who should pay the tax or a business which should not—and has little incentive to find out. If the retailer doesn't impose a sales tax on consumer purchases, that's tax evasion. If the retailer does impose a tax on business purchases, the tax "cascades," building up over successive stages of production, which raises and distorts prices. By providing a credit for taxes paid, the VAT prevents cascading.

Last, when retailers evade sales taxes, revenues are lost entirely. With a VAT, revenue would only be lost at the "value-added" retail stage. All these differences help explain why numerous countries replaced their sales and turnover taxes with VATs.

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Further Reading

Gale, William G. 2020. [“Raising Revenue with a Progressive Value-Added Tax.”](#) In *Tackling the Tax Code: Efficient and Equitable Ways to Raise Revenue*, 43 – 88. Washington, DC: Brookings Hamilton Project.

Pomeranz, Dina. 2015. [“No Taxation without Information: Deterrence and Self-Enforcement in the Value Added Tax.”](#) *American Economic Review* 105 (8): 2539–69.

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

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