Tax Reform and the Value-Added Tax: Context and Opportunities

National Academy of Social Insurance Seminar on Family Well-being, Public Policy, and Economic Growth

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Overview

- Comparing Tax Systems
  - How Much Revenue Do Countries Collect and How?
  - Infirmities of the Income Tax

- Federal Budget Woes: The Coming Crash
  - Sunsets and AMT
  - Medicare, Medicaid, and Social Security Spending

- Avoiding the Crash: a Value-Added Tax
  - How It Works
  - Advantages
  - Objections
  - Comparing an Add-on VAT System with the “Simplified Income Tax” Recommended by the President’s Advisory Panel on Federal Tax Reform
Comparing Tax Systems: How Much Revenue Do Countries Collect? How?

<table>
<thead>
<tr>
<th>Percentage of GDP</th>
<th>United States</th>
<th>OECD Unweighted Avg</th>
<th>EU 15 Unweighted Avg</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate and Personal Income Taxes</td>
<td>25.3%</td>
<td>36.5%</td>
<td>40.6%</td>
</tr>
<tr>
<td>Social Security Contributions</td>
<td>5.5%</td>
<td>7.4%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Consumption Taxes</td>
<td>2.1%</td>
<td>6.9%</td>
<td>7.6%</td>
</tr>
<tr>
<td>Other</td>
<td>6.8%</td>
<td>9.5%</td>
<td>11.6%</td>
</tr>
<tr>
<td></td>
<td>10.9%</td>
<td>12.7%</td>
<td>13.7%</td>
</tr>
</tbody>
</table>

Source: OECD Data (2005)
Although the U.S. has a Low Overall Tax Burden, Our Income Tax Burden is Relatively High…

Source: OECD Data (2005)
...and the United States has one of the Highest Statutory Corporate Income Tax Rates

Statutory Corporate Income Tax Rates in the OECD
(combined national and weighted average sub-national rate, 2005)

Source: OECD Data (2005)
Failings of the Current Income Tax

- Impedes Economic Growth
  - By some estimates economic waste from distortions imposed by current system reaches almost $1 trillion
  - Discourages savings and investment
  - Undermines competitiveness and may encourage off-shoring and expatriation
- Highly Complex and Difficult to Administer
  - Almost $150 billion spent each year on compliance and administration
- Breeds Cynicism and Noncompliance
  - Taxpayers increasingly uncertain whether they pay their fair share
  - “Tax Gap” of approximately $300 billion in 2001
A Crash is Coming (Part I):
Instability of Current Law

- Sunsets: Between now and 2011, the following provisions expire – individual, capital gains and dividend rate cuts; small business expensing; the $1,000 child credit and marriage penalty relief; estate tax repeal.

- AMT: In 2001 fewer than 2% paid the AMT, by 2010 more than 30% will pay the AMT (including more than 80% of those with family incomes between $100,000 and $200,000). Having 30% of Americans calculate their taxes twice and pay the higher of two amounts is a political train wreck.
By 2047, CBO projects Social Security, Medicare, and Medicaid will account for 18.3% of GDP – the 30-year average of federal tax revenue as a percent of GDP.

The aging of our population is unavoidable and is the major driving factor.

A serious long-term budget fix will require:
- Major entitlement reform
- Dramatic and unprecedented increases in tax revenues
- The elimination of other federal spending
- Some combination of the three
A Crash is Coming (Part II): The Explosion of Social Security, Medicare, and Medicaid Spending

Note: Reflects CBO’s intermediate-spending trajectory, which assumes that spending per Medicare enrollee grows 1 percentage point faster than per capita GDP (compared to 2.9% today); that defense spending gradually returns to its historical real level; and that non-defense discretionary spending and other mandatory spending remain at their historical levels as a share of GDP. Source: Congressional Budget Office (CBO), The Long-Term Budget Outlook (Dec. 2005).
The Comptroller General reports that:

- The federal government has committed itself to more than $43 trillion in current dollars IOUs – four times current GDP.
- Closing the current long-term fiscal gap would require 75 years of double digit real average annual economic growth.
- Absent earlier action, balancing the budget in 2040 would require draconian steps:
  - Cutting total federal spending by about 60 percent.
  - Raising taxes to about 2.5 times today's level.
Avoiding the Crash: A Value-added Tax

- A VAT could be used to raise revenue, support essential welfare programs, fund significant reform of the income tax and allow for lower rates, and promote savings.

Consumption Tax Rates in the United States and Around the World – 2000
(unweighted averages)

- **EU**: 19.4%
- **OECD**: 17.7%
- **United States**: 4.6%

Source: Michael J. Graetz, May 11, 2005 presentation to the President’s Advisory Panel on Federal Tax Reform.
How Does a Credit-Method VAT Work?  
A Basic Example

Assume 10% VAT

Lumberjack sells wood for $100 + $10 VAT  
Net VAT = $10

Chairmaker buys wood for $100 + $10 VAT  
Sells chair for $250 + $25 VAT  
Net VAT = $15 ($25 - $10 input credit)

Store buys chair for $250 + $25 VAT   
Sells chair for $350 + $35 VAT  
Net VAT = $10 ($35 - $25 input credit)

Total VAT Paid = $10 + $15 + $10 = $35
Avoiding the Crash: Advantages of an Add-On VAT

Exploiting our Comparative Advantage as a Low-tax Country and Funding Future Obligations

- A broad-based 15%* VAT could collect about 65% of the revenue collected by the current income tax. That revenue would make it possible to:
  - Take 100 million people off the income tax rolls, reduce the top individual and corporate income tax rates to 15% - 25%, and repeal the AMT.
  - Could provide an exemption from income tax for families with $100,000 of income or less.
  - Help fund federal Social Security, Medicare, and other entitlement programs (or pre-fund liabilities through private accounts).
  - Balance the budget, reducing the Federal government’s long-term structural spending obligations.

* Tax-inclusive rate. Equivalent tax-exclusive rate would be 17.6%
Avoiding the Crash: Objections to an Add-On VAT

- **Regressivity**
  - Reducing income tax burdens by moving towards taxing consumption requires adjustments to protect against regressivity.

- **Political Economy Concerns**
  - Studies of the international experience suggest the VAT is not a "money machine."

- Debate over appropriate amount of redistribution and size of government should be largely distinct from debate about whether to use a VAT to help fund whatever level of transfers and size of government we choose.
Simplified Income Tax Rates vs. Simplification with a VAT

The limits of what can be achieved by radically broadening the income tax base.

How much more a VAT makes possible.

### Simplified Income Tax Rates

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Married</th>
<th>Unmarried</th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>Up to $78,000</td>
<td>Up to $39,000</td>
</tr>
<tr>
<td>25%</td>
<td>$78,001 - $150,000</td>
<td>$39,001 - $75,000</td>
</tr>
<tr>
<td>30%</td>
<td>$150,001 - $200,000</td>
<td>$75,001 - $100,000</td>
</tr>
<tr>
<td>33%</td>
<td>$200,001 or more</td>
<td>$100,001 or more</td>
</tr>
</tbody>
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### Simplified Income Tax Rates – Modified with a VAT

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Married</th>
<th>Unmarried</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>Up to $64,000</td>
<td>Up to $32,000</td>
</tr>
<tr>
<td>15%</td>
<td>Above $64,000</td>
<td>Above $32,000</td>
</tr>
</tbody>
</table>

Source: Report of the President’s Advisory Panel on Federal Tax Reform, Ch. 8 (2005).
Conclusion

The Current Income Tax System:

- Is inefficient, extraordinarily complex, and widely perceived to be unfair.
- Cannot raise enough revenue to fund expected entitlement spending and balance the budget without unacceptably high rates.

A VAT Can Help:

- Raise needed revenue.
- Improve economic efficiency, encourage savings, facilitate simplification and lower rates, and allow lower and middle income taxpayers to be taken off the income tax rolls.
- Finance other changes that ensure the overall system is as