

NATIONAL
ACADEMY
OF SOCIAL
INSURANCE

**Family Well-Being, Public Policy and Economic Growth:
Lessons from History and Insights for the Future**

September 19, 2006

This policy seminar convened at 2:00 PM in the Ballroom of the National Press Club, 529 14th Street, NW, Washington, DC.

Value Added Tax: A Primer

Itai Grinberg, Attorney, Skadden, Arps, Slate, Meagher & Flom, LLP

ITAI GRINBERG: Thanks to NASI for organizing this event and to the earlier speakers for such insightful remarks. I'm just going to take a moment and want to do three things with you all in my segment.

I'll first elaborate a little bit about Peter's remarks on our tax system and comparing it with those of Western Europe. Then, I will say a little bit about the significantly increasing pressures on our income tax structure, a subject with which this audience will be really familiar. Finally, I will describe how value-added tax, a consumption tax used by every major developed economy except the United States, could fix the mess that our income tax system has become and avoid what otherwise could be a fiscal disaster.

This slide illustrates that the United States is in fact a very low-tax country. We collect only 25 percent of GDP at the national and state level. That compares to about 36 percent for the OECD, the organization of the major developed economies, and to about 40 percent for the EU 15, the countries of the European Union excluding the newer Eastern European members.

But, although we have a low overall tax burden, our income tax burden is relatively high. We collect a larger percentage of our total tax revenue from the income tax, as other speakers have mentioned. And our corporate income tax rates are particularly high, both on a statutory basis, as shown here, and in terms of marginal effective rates. In fact, the US has the second-highest corporate tax rate in the developed world.

Now, to illustrate why this matters, think about the fact that 12 of the 15 largest cross-border mergers and acquisition deals involving U.S. companies over the last 15 years ended with

the surviving parent company being foreign. That decision about the country of incorporation of the surviving parent is often made with tax factors in mind. And research suggests that the country of incorporation of multinational companies affects where it puts its research and development jobs, and management positions.

This question is important not just for shareholders, but also for U.S. workers. And similarly, startup companies that expect global revenues now often incorporate outside the United States in order to limit their exposure to the U.S. tax system, even when much of their workforce and much of their expected revenue is in the U.S. The corporate income tax rate is an important question, not just for people who own capital, but also for individuals generally.

More generally, relying excessively on income tax to fund government is sub-optimal, and by doing it, the U.S. fails to take advantage of our status as a low-tax country. The income tax impedes economic growth, creates confusion and unfairness, and is tremendously complex. Some estimates suggest that economic waste from distortions imposed by the income tax reach almost a trillion dollars a year.

The result of the complexity of the system is over a \$150 billion spent on compliance, and yet the tax gap, which is to say the difference between the amount that should be paid and the amount that is actually collected that is more than \$300 billion. Polling data suggest that everyone thinks the system is confusing and unmanageable, and in particular, young people no longer have compunction about cheating the system. Perhaps this is because with a set of rules as complex as our own, they worry that everyone else cheats, too.

That is just what is wrong now. Unfortunately, things are about to get much worse. The first looming problem is that we have no status quo. Between now and 2011, the most basic provisions of our income tax system are set to change or expire. The top rate will rise from 35 percent to 39.6 percent. The bottom rate will increase from 10 percent to 15 percent. The child tax credit falls from \$1,000 to \$500. Meanwhile, each year, Congress passes a patch to keep taxpayers out of the AMT, the Alternative Minimum Tax.

The first year that the AMT expires, more than 12 million taxpayers would pay the tax. Note that it is neither an alternative nor a minimum; rather, it is a mandatory maximum tax. It requires everyone to recalculate their tax a second time under a different set of rules and if that comes up with a higher amount, then they the higher number.

But allowing 20 to 50 million Americans to pay this gotcha tax is a political train wreck, which really means that it won't happen. The funny thing, though, is that our official budget estimates assume this is precisely what will happen. Since keeping 20 to 50 million Americans out of the AMT costs \$1.2 trillion just over the 10-year-budget window, what you are really talking about is the mother of all accounting fraud. This makes Enron look like small fries.

This won't be news to anyone here. We are at the National Academy of Social Insurance event, but the problem I just described isn't the worst of it; the biggest problem is our growing entitlement catastrophe. By 2047, the CBO projects Social Security, Medicare, and Medicaid will account for 18.3 percent of GDP. That's the 30-year average of federal tax revenue as a

percentage of GDP, which is to say that unless we increase taxes or change the programs, the entire federal budget will go to paying for these three programs.

This means that a serious fix requires major entitlement reform, dramatic and unprecedented increases in tax revenue or the elimination of a lot of other federal spending. This is just a graphical representation of that same point. The social insurance programs swamp out the rest of the government unless you increase revenues. We go from being a government that's an insurance company with an army to a government that's an insurance company without an army.

Some people tell you that we can grow our way of the problem. That's not true. The federal government currently has \$43 trillion in current dollar IOUs, and closing the fiscal gap without cutting spending or raising taxes requires double-digit, real-average-annual-economic growth for 75 years. No country on earth as ever done that.

If we do nothing to solve the problem, we either have to cut spending by 60 percent or increase taxes by 250 percent.

The good news, though, is that we can avoid all of this. There is a way to save ourselves from all of those terrible consequences. Again, The U.S. is a low-tax country overall, which gives us breathing room. Average U.S. sales taxes are well below the consumption tax rates among our major trading partners. That suggests there is substantial room to impose a value-added tax without exceeding global norms. And the VAT can raise enough revenue to make income tax reform possible, by which I mean lower-income tax rates and a more sensible system that's less complex, and bring in revenues that can help us deal with our growing entitlements. People are getting older and we are going to have to help support them in one way or another.

So before going any further, I just want to slow down for a couple of minutes and explain how a VAT works. A VAT is just like a sales tax but it is assessed in smaller pieces and collected at every level of production and distribution. Imagine that you buy a \$350 chair at a store and you pay \$35 of tax in a sales tax. That is pretty straightforward, a 10 percent rate.

The problem, though, is if you are a consumer: you are not supposed to pay the tax if you are a small business, but it is really hard to tell whether a guy coming into store is buying a chair for his house or a chair for his office. Sales taxes are notoriously prone to one of two problems: they either double tax stuff by taxing the chair and then when the company sells the product, it is effectively being taxed again, or they don't tax the chair at all because they are trying to avoid the double tax. The VAT helps solve that problem and also has some other administration and enforcement advantages.

For example, imagine you are a lumberjack and you sell a \$100 piece of lumber. In a retail sales tax system, you would not assess tax since you are selling the wood to a chair maker and the chair maker is not a consumer. By contract, in a system with a VAT, you charge 10% or \$10. The chair maker then makes a chair, which he or she sells to a store for \$250 with a 10% tax as well, which is \$25. But instead of remitting the \$25 to the government, the chair maker

says, hey, government, I am sending you \$15 and this receipt, which says I already paid the lumberjack \$10

Once you get to the level of the store, they are going to charge you \$35 in tax for the \$350 chair. The store says, hey, government, I paid the chair maker \$25. The tax is collected at exactly the same rate; it is a 10 percent tax, you pay \$35 at the store, but each of the companies has just told the government how much tax they paid the other guy, and in the process they have just helped the government collect the tax. It is hard for businesses to admit to all of their tax revenue, particularly when they are smaller, but it is easy to get someone to say, don't look at me for taxes; go to the guy I bought something from. That is the genius of the VAT.

I want to just make one comment. In some European countries the VAT is not on the receipt when you buy stuff at the store but it doesn't have to be that way. You can make the VAT every bit as visible as a sales tax is in the United States, as they do in Canada.

Why would we want this tax? Well, it allows us to exploit our competitive advantages of a low-tax country, and a broad based 15 percent VAT could collect 65 percent of the revenue of the income tax, around \$750 billion per year. Now, that's enough to take 100 million people off the income tax rolls, reduce the top individual and corporate income tax rates to 15 to 25 percent, and repeal the AMT. You could provide an exemption from income tax for families with \$100,000 of income or less. You could also help fund Social Security, Medicare, and other entitlement programs, and you could balance the budget. The U.S. could and should have one of the lowest income taxes in the world without reducing government services or making our overall system less progressive. By keeping our income taxes high and our consumption taxes low, we basically fritter away our competitive advantage.

What are the main objections to the VAT? Well, from the left, the objection has historically been that the tax is regressive. That may be true, but the appropriate thing to do is to make other adjustments to guard against regressivity, especially if shifting from an income tax to a VAT. Now, in contrast, the VAT is actually more progressive than the payroll tax and that is worth keeping in mind. A payroll tax taxes work earnings below an income cap, or at least ours does, and only work earnings are taxed. A VAT, on the other hand, taxes only spending and it taxes all spending. If you make a million dollars a year, you are taxed on the \$900,000 to a million dollars when you spend it. It also taxes capital income, so when you earn money on investments, you are also taxed. Given the choice between encouraging savings, which a VAT does by not taxing them, and taxing working, I find it hard to see why we would choose higher payroll taxes over a VAT to pay for needed revenue.

The main objection from the right to the VAT, on the other hand, is that it is a money machine. People think it is invisible and therefore will allow government to grow. The basic idea here is that it is a really efficient good tax so we shouldn't do it. (Laughter.) The data don't support that analysis. The best studies suggest that there is no clear connection between imposing a VAT and government getting larger. That said, if we wait too long and then try to address our entitlement crisis in sort of the final days with the VAT, we might find that this particular criticism is a self-fulfilling prophecy.

The debate over appropriate amounts of redistribution and size of government, to my mind, should be largely distinct from the debate about whether to use a VAT to help fund whatever level of transfers and size of government we choose. My own preference is for lean but also progressive government that spends more on the young or more economically displaced, or the poor, and less on the middle-class old. But the decision about implementing a VAT does not in anyway require that similar preference. It is just a source of revenue from which you can then make the decisions you want about how big a government you want to have and how you want to spend the money that it raises.

The final slide is just another way of showing the magnitude of a difference the VAT makes. It compares the rates that the president's advisory panel on federal tax reform, a panel that existed last year to propose reforms for the income tax, was able to reach, in revenue-neutral reform in other words reform that doesn't raise money, with and without a VAT. What you see is that when they really simplify the income tax, they could only get down to a 33-percent rate; when they put the VAT in place, they got down to 15. It just illustrates how much more a VAT makes possible.

So in conclusion, the current system is extraordinary complex, inefficient, unfair, and cannot raise enough money. The VAT can do all those things, encourage savings, facilitate simplification, lower rates, allow lower- and middle-income taxpayers to treat April 15th as just another spring day and finance other changes that ensure the overall system is as or more progressive than the status quo.

(Applause.)