

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**

September 19, 2006

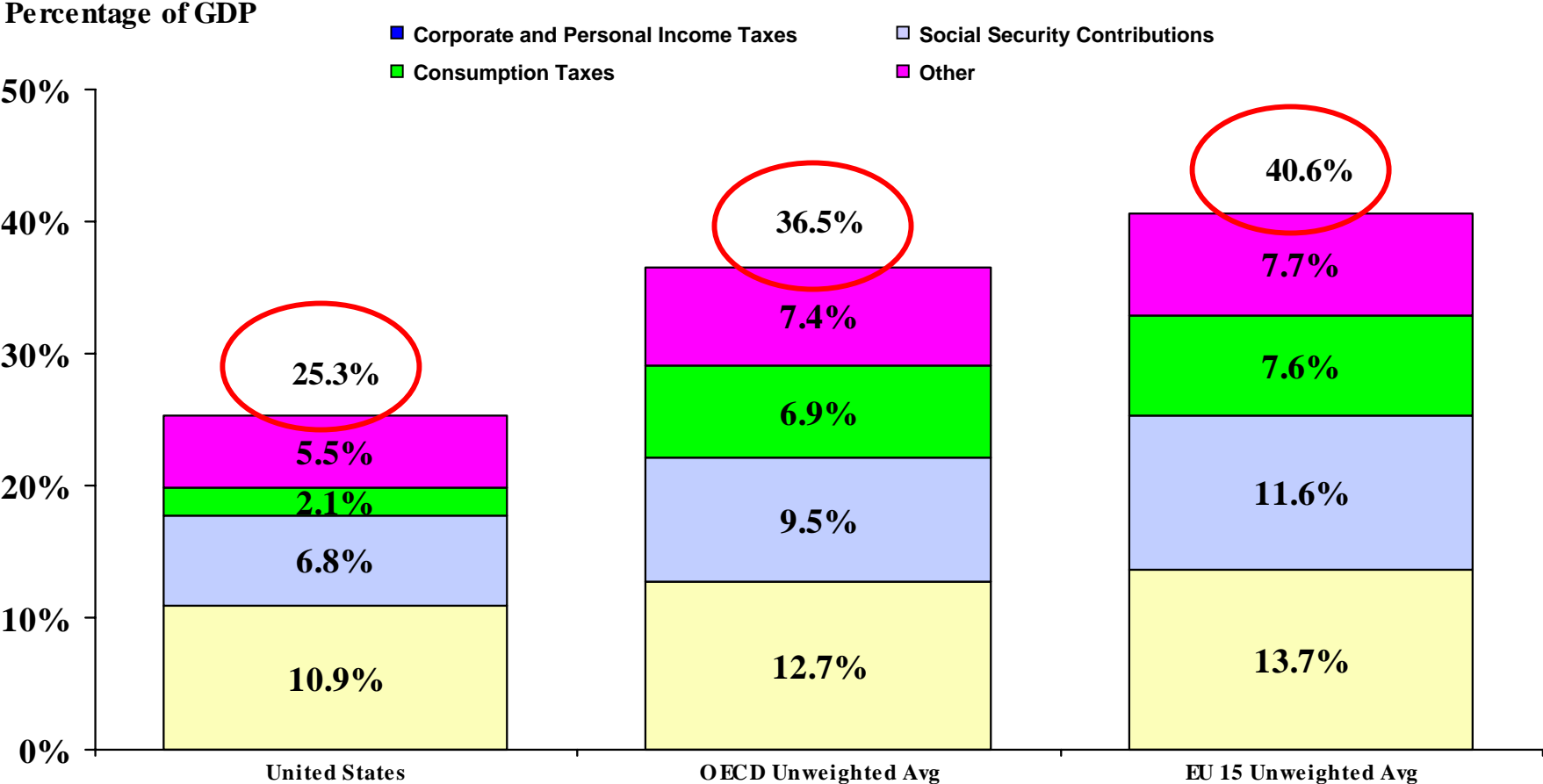
Itai Grinberg

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?

Tax Revenues by Tax Type as a Share of GDP

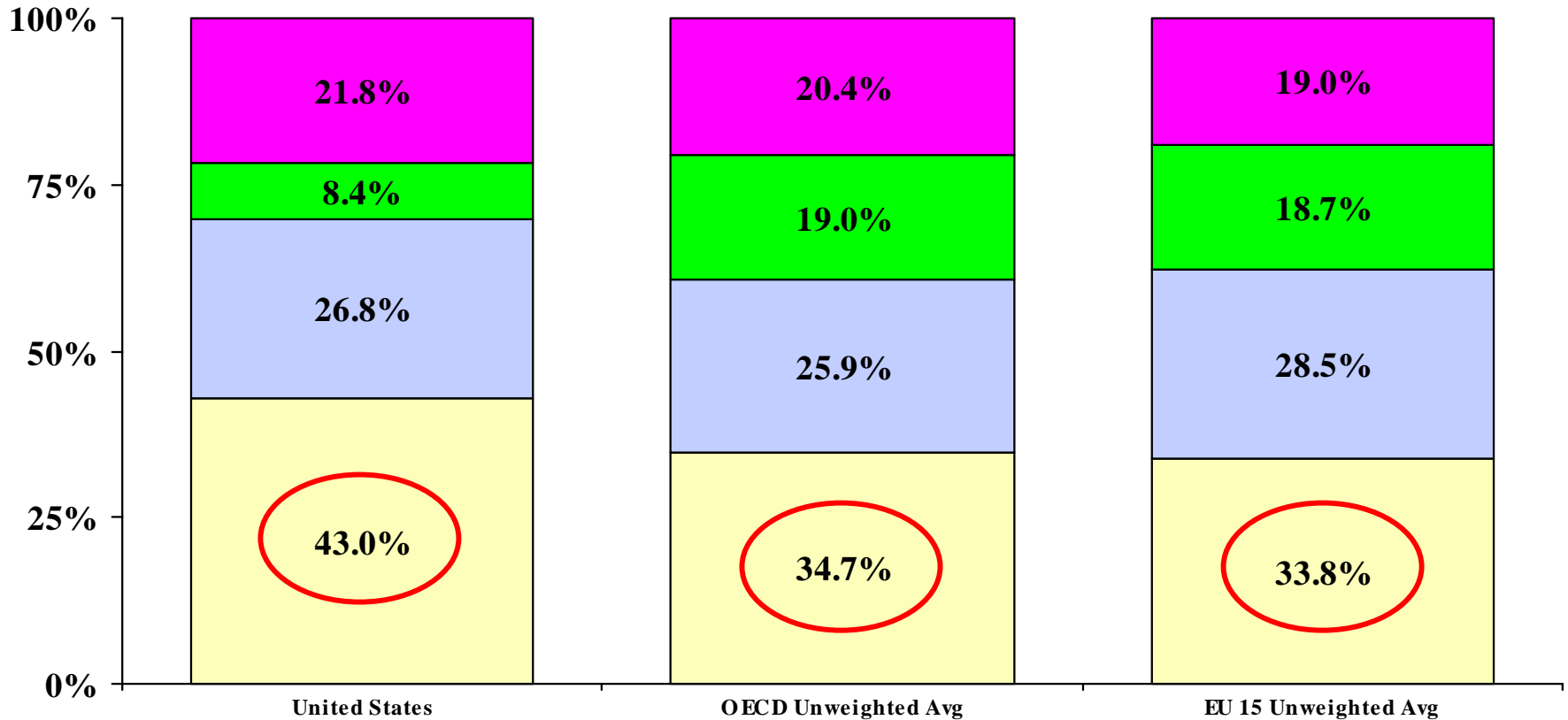


Source: OECD Data (2005)

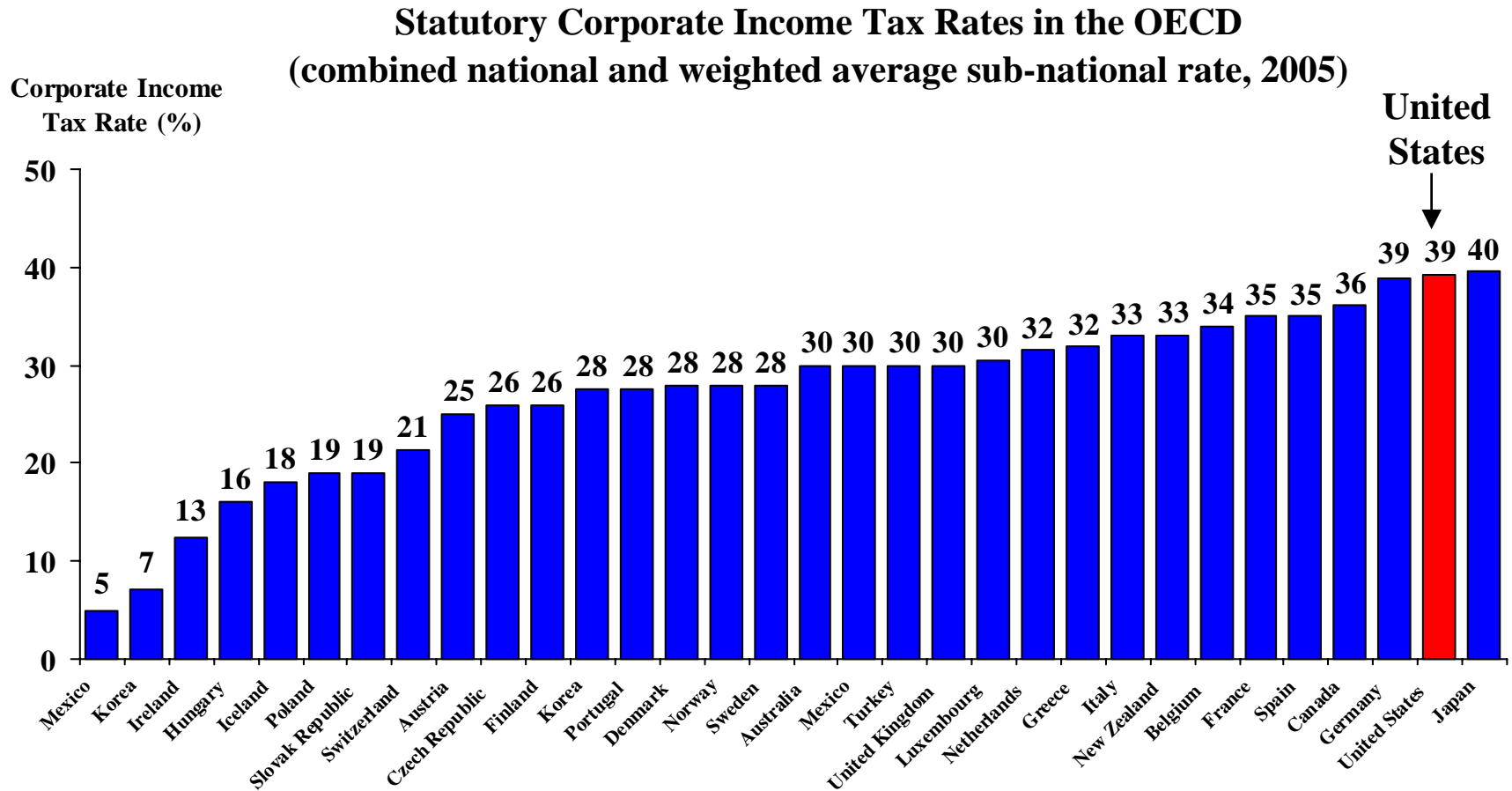
Although the U.S. has a Low Overall Tax Burden, Our Income Tax Burden is Relatively High...

Composition of Tax Revenue as a Share of Total Tax Revenue

- Corporate and Personal Income Taxes
- Social Security Contributions
- Consumption Taxes
- Other



...and the United States has one of the Highest Statutory Corporate Income Tax Rates



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 offshoring 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

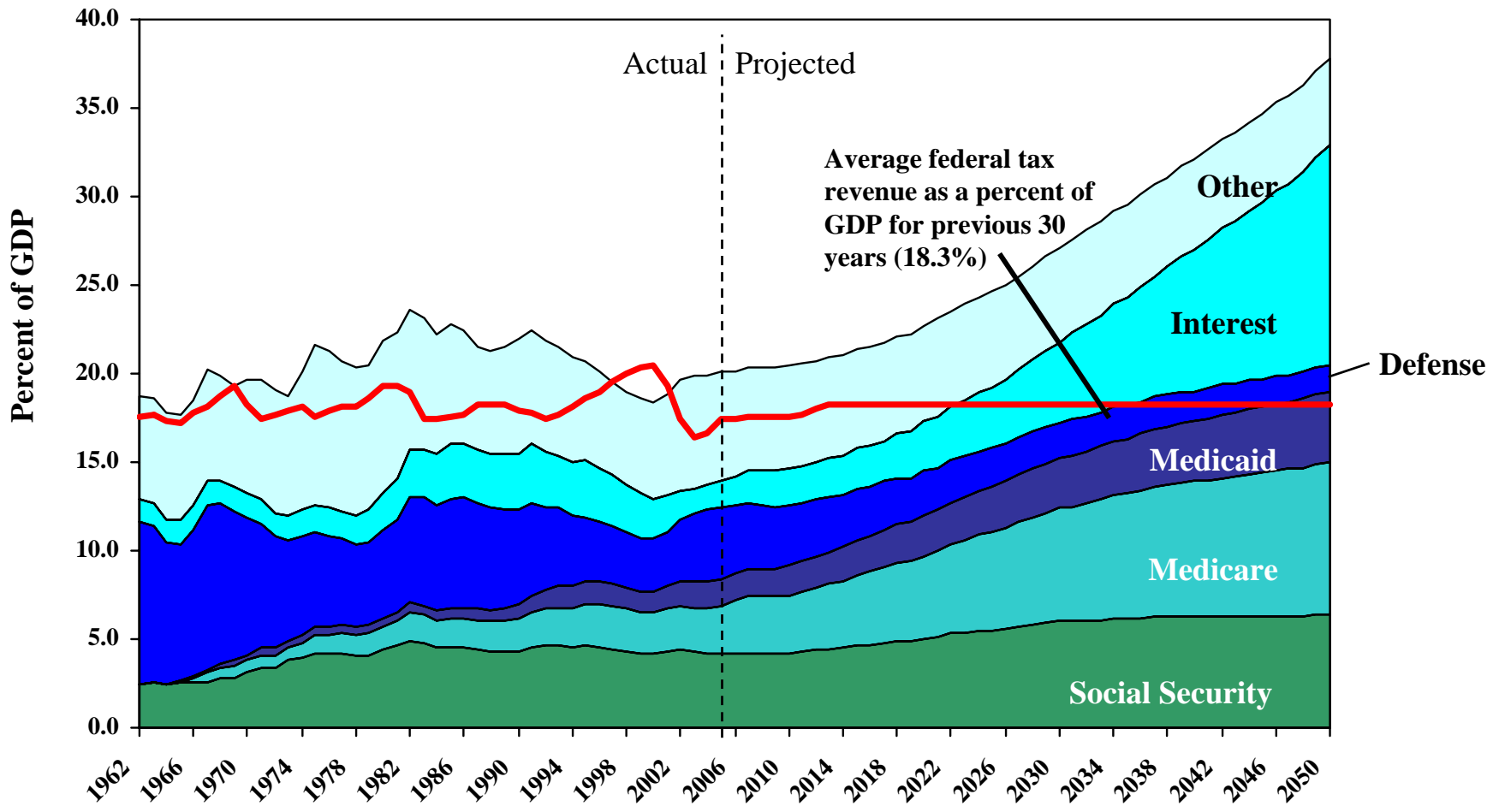
A Crash is Coming (Part I): Instability of Current Law

- 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.

A Crash is Coming (Part II): The Entitlement Crisis

- 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).

A Crash is Coming (Part III): We Cannot Grow Our Way Out of the Fiscal Gap

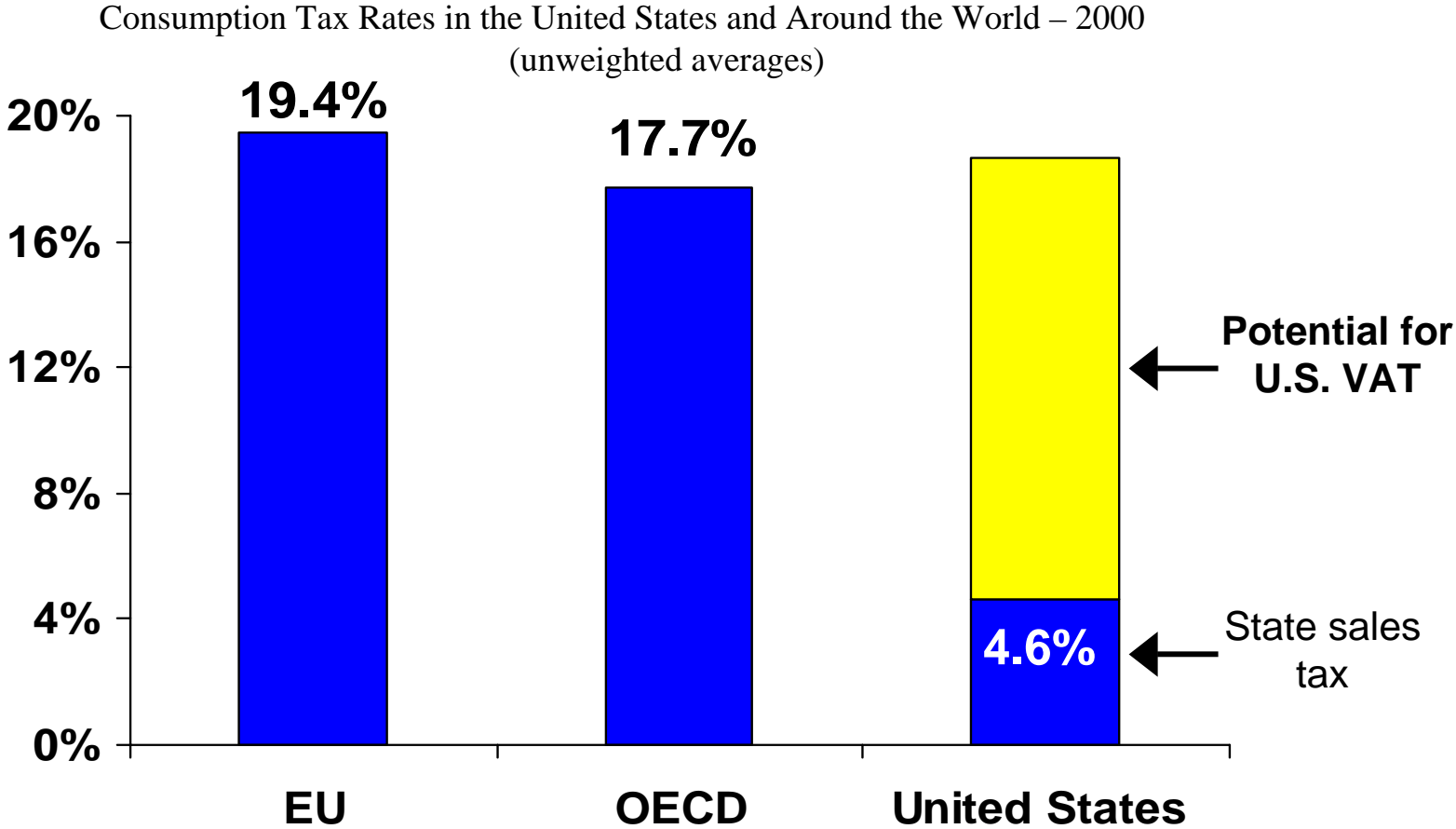
The Comptroller General reports that:

- 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



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.

President's Advisory Panel on Federal Tax Reform: Simplified Income Tax vs. Simplification with a VAT

Simplified Income Tax Rates

| Tax Rate | Married | Unmarried |
|----------|-----------------------|----------------------|
| 15% | Up to \$78,000 | Up to \$39,000 |
| 25% | \$78,001 - \$150,000 | \$39,001 - \$75,000 |
| 30% | \$150,001 - \$200,000 | \$75,001 - \$100,000 |
| 33% | \$200,001 or more | \$100,001 or more |

Simplified Income Tax Rates –
Modified with a VAT

| Tax Rate | Married | Unmarried |
|----------|----------------|----------------|
| 5% | Up to \$64,000 | Up to \$32,000 |
| 15% | Above \$64,000 | Above \$32,000 |

Comparing the rates in the President's Advisory Panel's revenue-neutral "Simplified Income Tax" to the rates the Panel found possible with an add-on VAT illustrates:

- The limits of what can be achieved by radically broadening the income tax base.
- How much more a VAT makes possible.

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