Background

“You can always count on the Americans to do the right thing—after they’ve tried everything else.” Winston Churchill

“Liberals think it’s regressive and conservatives think it’s a money machine. If they reverse their positions, the VAT may happen.” Larry Summers
Why a Consumption Tax?

- Revenue
- Efficiency
- Conformity with the rest of the world
  - More than 160 countries have a national consumption tax
What is a Consumption Tax?

• I= C+S;  C=I-S

• A consumption tax explicitly excludes the normal rate of return on an investment from tax
  • Is more efficient (neutral) than an income tax
  • Immediate deduction/yield exemption equivalence
    • Assume a 20% tax rate and a 10% rate of return. X invests 100 in a machine. She deducts the cost and her after tax investment is 80. Her yield is 10, which is subject to a 20% tax of 2. Her after tax return is 8, which is 10% of her after tax investment of 80.
What Does a Consumption Tax Look Like?

- Retail Sales Tax
- Credit-Invoice Value Added Tax (VAT)
  - Preferred method
  - Compliance advantage
- Subtraction Method VAT (Business Cash Flow Tax)
  - Japan
  - Cruz
  - CBIT
  - “X-tax” (CBIT with wage deductibility)
- “Flat” tax where savings are deducted or yields from investment are excluded
- Addition method VAT
How Does a Credit-Invoice VAT Work?

• A sells raw material to B for 20 and collects a 10% tax of 2 and gives B an invoice evidencing the payment of 2 to the government.
• B sells product to retailer C for 40. B collects 4 in tax but remits 2 to government because of 2 credit from A’s sale.
• C sells product to consumer D for 50. C collects 5 in tax but remits 1 to government because of 4 credit from prior sales.
• Government collects a total of 5—the equivalent of a 10% retail sales tax. But it is collected along the supply chain, increasing compliance.
The Economics of a Consumption Tax

- Efficiency
- Price effects
  - Inflation
- Short/long term economic effects
  - Expected growth due to exemption of return from tax
- Trade
  - Border adjustability makes the tax “trade neutral”
- Incidence
  - Equity issues
    - Tax is nominally paid by labor income and dissaving (borrowers and retirees)
Design Issues

• Regressivity Relief
• Tax Inclusive v. Tax Exclusive
  • Transparency
• Exemption v. Zero Rating
• Financial institutions
• Small business
• Exempt organizations
• Interaction with state and local taxes
Implementation Issues

• Selling it to the Rotary Club
  • Principal challenge is to determine incidence of corporate tax
    • If used to reduce the corporate rate need to convince the public that you are replacing an implicit tax with an explicit one and there has been no change in the real tax burden
      • Incidence of corporate tax is on capital (75%) and labor (25%); incidence of VAT is on labor and capital but not in same proportions.
        • To keep incidence the same, need to increase tax on capital income as well as impose VAT
      • Tough to do when opponents say the corporate tax reduction is being financed by a tax on consumers
  • Need massive, coordinated education campaign
    • Business needs to take the lead
    • Highlight other changes that can accompany VAT enactment
      • Cardin Bill
  • Transition requires adequate time