THE TOBACCO INSTITUTE

1875 I STREET, NORTHWEST
WASHINGTON, DC 20006
202 457-4800 • 800 424-9876

E. J. BATTISON, Ph.D.
Economist

October 1, 1984.

To: Fred Panzer

re: Consumption Taxes: Consumed Income, National Sales, and the V.A.T.

Consumption taxes could be more fair, more simple, and more efficient than the current income tax, but they could also promote a further surge in government spending. Clearly, a consumption tax would encourage savings and investments which would spur growth in employment, income, and productivity.

A consumed income tax can be based on income less savings, and it would be more efficient, simpler, and more equitable than the existing income tax with all its current loopholes. Relative prices would not be distorted, and an incentive to save would be established. The growth in investment in plant and equipment would spur employment and productivity increases. A consumption tax is neutral with regard to capital and labor, or saving vs consumption, and it is proportional with regard to each dollar of personal income taxed--not regressive.

Consumption taxes could help U.S. exports if tax rebates on exports were given and if the tax was imposed on imports, (the sales tax type).

A comprehensive consumption tax could be uniform at about 19 percent of income to generate the same revenues as the current income tax does. However, there would be some transitional costs, a shift in tax gainers and losers, and some tax aversion.

To implement such a tax, savings can be left tax free but later interest gains would be taxable, or the tax can be prepaid by taxing all earned income once up front, with future earnings on savings left tax free.

A consumption tax must be imposed across the board (broad based) at the same uniform rate if it is not to distort relative prices and the use of capital, and if it is to be proportional and equitable, unlike the current cigarette excise tax which targets one group of consumers for an excess tax burden.

Under a consumed income tax, no deductions would be allowed for depreciation or other capital consumption allowances, and capital gains and losses would be disregarded. At a rate higher than 19 percent, a consumed income tax could replace federal excises and corporate income taxes. The tax can also be made progressive by applying different marginal rates.

A national sales tax appears to be popular in public opinion surveys as simple and efficient, and fair if it is uniform and comprehensive. Although the tax is a direct percentage of retail price, many goods and most services are currently exempt in state and local sales taxes.

On the negative side, a nationally imposed retail sales tax would place a substantial collection burden on merchants. A rate too high in comparison to state and local tax rates would encourage aversion and black markets. A rate too low would raise insufficient revenues. A progressive sales tax would include "necessity" rates and higher "luxury" rates which would distort prices. Exemptions by rebates may be better to enable very low income persons to recoup the tax burden.

Competition with and opposition from state and local governments would limit the rates and the revenues available from a national sales tax, but such a tax could replace unfair excises or the corporate income tax. Consumer durables could have the tax prepaid up front on purchase or paid by installments.

A value added tax is assessed along the production chain as each sector adds value to a product or service for resale, so it has approximately the same tax base as a retail sales tax. It is consumption based if capital goods are taxed immediately on purchase, like other goods are.

Tax liability is usually calculated by the invoice credit method in which the tax rate is a percent of value added and applied to a firm's gross tax liability less the gross tax liabilities of suppliers, shown on the invoices collected from transactions with these suppliers. This method leaves a trail of information that facilitates compliance and enforcement.

A V.A.T. would not distort prices, would not favor consumption over investment, nor capital over labor, so it would be a generally neutral tax. It would be a proportional tax per dollar of income taxed at all levels and it is not regressive in reality. Neither is it inflationary, necessarily, but it could put upward pressure on prices. It is regressive in the sense that it taxes necessities for those with least ability to pay. The basics may have to be tax free, so as not to burden very low income persons, unless rebates are made available.

Besides the burden on low income earners, the V.A.T. requires substantial record keeping and numerous tax forms. Administration costs are incurred. Moreover, the V.A.T. has low visibility so there may be little resistence to raising its rates. The V.A.T. is not easily adaptable to progressive rates without distorting prices and losing efficiency.

A V.A.T. is less competitive with states and local governments than a retail sales tax but more threatening to them than a consumed income tax. A V.A.T. is one of the more enforceable consumption taxes, and it could be used to help combat the underground economy. It could substitute for existing taxes or add on revenues.

In theory, a V.A.T. encourages investment, productivity, employment, output, income, and consumption. It has substantial revenue generating capacity. However, additional tax revenues could encourage more government spending at even higher levels than at present by simply increasing the rate a notch. Eventually, private market activity could be pushed down to dangerously low levels. The advantages of the tax have to be weighed against the dangers of the increased taxing power potential of a V.A.T.

ccDuhaime Henderson Milway Sparber.

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