

## VAT Choices

**Prepared by Neil Bruce**

The *main advantages* for considering any sort of VAT for the State of Washington are as follows:

- **Neutrality.** Uniform taxation of value added by all enterprises ensures that the tax does not favor or disfavor any particular enterprises, economic activities, or industries.
- **Adequacy.** The VAT is well suited for taxing economic activity broadly, which allows the maximum tax revenue at the lowest tax rate. (Long-run elasticity is close to unity.)
- **Stability.** Since the VAT tax base can be aligned closely with aggregate economic activity in the state (Gross State Product), fluctuations in tax revenue are commensurate with economic activity. (Short-run elasticity is close to unity.)
- **Horizontal Equity.** Tax rates for similarly situated taxpayers are equal because of uniform taxation.
- **Limited Number of Taxpayers.** The VAT is levied on enterprises who are required to register with the revenue authority. Registered taxpayers constitute the "VAT net". For all existing VATs, individuals are outside the VAT net (non-registered).
- **Experience.** The VAT is imposed on registered enterprises, rather than individuals. Washington has experience with multi-stage taxes in the B&O.

The *main difficulties* or problems associated with a VAT for the State of Washington are:

- **Novelty.** Although the VAT is ubiquitous in the world, there are few operating examples of VATs implemented by sub-national governments. In the U.S., Michigan and New Hampshire have addition-type VATs, states in Brazil have origin-based invoice method VATs, Quebec has a destination-based invoice method provincial VAT, and three Maritime Canadian provinces have provincial VATs harmonized with the Federal VAT.
- **Regressivity.** A uniform VAT is more regressive than a sales tax (or a VAT) that exempts necessities.
- **Complexity.** A VAT will involve more administrative and compliance costs than the B&O and retail sales taxes.
- **Harmonization.** Since nearly all states and the Federal government do NOT levy VATs, there are likely to be harmonization issues. It is not clear if all variants of the VAT would be deductible from the Federal corporate income tax for registered taxpayers and, for some variants, constitutional difficulties about interstate commerce may be encountered.

### **VAT variants and their pros and cons**

- A VAT can be levied on a **gross product, income, or consumption-type** base. The first measures value added as the whole difference between gross receipts and costs of intermediate goods and services. The second variant removes depreciation out of value added. The last variant removes the total cost of all investment expenditures from value added.
  - The gross product VAT base has the broadest base and is the simplest to measure.
  - The consumption-type VAT is the one used by national VATs.
  - The income VAT base requires capitalization rules like an income tax.
- The VAT may take an **accounts** or a **transactions** form.
  - The accounts method is best suited for a VAT that functions mainly as a business tax, such as the MI single business tax and the NH business enterprise tax. In each case, the amount to be taxed is reported by businesses based on their financial records.
  - The transactions method (commonly called the **invoice method**) is best suited for a VAT that functions as a goods and services tax. This is the form of the world's national VATs and the Canadian provincial VATs.
  - The transactions variant is more transparent than the accounts methods since the tax is "rung up" on an invoice.
- The tax base for the accounts method VAT can be calculated by the **addition** method or by the **subtraction** method. The latter is also called a **business transfer tax**.
  - A subtraction method would require the smallest adjustment away from the current gross receipts tax.
  - There is no existing subtraction method accounts based VAT. The MI and NH are both addition methods.
  - The addition method more easily permits different rates for different taxpayers.
- The VAT can be levied on an **origin** base or on a **destination** base. This appears to be a MAJOR issue for any state levied VAT.
- An **origin principle VAT** is levied on value added within the state for all goods and services regardless of whether they are sold within the state or exported out of the state. It excludes value added embodied in the goods and services that originated outside the state.
  - An origin principle VAT can impair competitiveness of domestic enterprises.
  - It also provides an incentive for interstate enterprises to shift value added out of the state by the means of transfer pricing.

- A ***destination principle*** VAT is levied on the value added to goods and services destined for the state regardless of whether that value added originates within or outside the state. Goods and services exported from the state are exempted from the tax. All transactions (invoice method) VATs in the world are levied on a destination basis by national governments.
  - A destination VAT poses difficulties for a sub-national government, because there are no border controls. There is no method of levying the tax on transactions between non-registered state residents (individuals) and out of state enterprises (except a use tax).
  - Exempting exports (typically done by "zero rating") could invite widespread tax evasion.
  - Methods proposed for avoiding these problems for sub-national VATs (the compensating VAT and the Variable Integrated VAT) require actions by institutions operating above the state level.
  - On the other hand, Quebec has an independent invoice-method, destination-based tax that reputedly operates well.
  - A subtraction-method, destination-principle tax could run into U.S. Constitutional problems because expenses for intermediate goods purchased within the state are subtracted but purchases of intermediate goods from out of state enterprises are not.
- ***Breadth and Scope.*** The main advantage of a VAT is its broad base. Typically, government and non-profit enterprises are excluded from the tax base. In addition, some industries such as finance, construction, residential, leasing, and re-trade pose the same difficulties for a VAT as for any other attempt to tax them.
- ***Integrated "Flat tax" Variant.*** The standard VAT is regressive like a retail sales tax, if not more so. In most cases, regressivity is offset by giving VAT tax credits under an accompanying income tax, or by exempting necessities (zero-rating them). An untried variant is the ***Hall-Rabushka (HR) flat tax***, which isolates the wage component of value added for special treatment.
  - The flat tax excludes wage compensation from enterprise value added but subjects wages and salaries above an exempt level to taxation at the VAT rate. While reducing regressivity, this vastly increases the number of taxpayers and could be construed as personal income tax.
  - An alternative is levy the VAT on the usual enterprise base, but allow employees to join the VAT net and pay taxes on salaries and wages (above the exemption) received from registered enterprises. Employees then receive a tax credit for the VAT paid on their compensation by the enterprise.
  - The HR flat tax reduces the regressivity of the standard VAT.
  - There is no operating version of the HR flat tax.
  - The HR flat tax poses inequities between employees of enterprises inside the VAT net and employees of enterprises outside the VAT net.