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TAX POLICY

Value-Added Tax Issues for U.S. Tax Policymakers

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The Honorable Dan Rostenkowski
Chairman, Joint Committee on Taxation

The Honorable Lloyd Bentsen
Vice Chairman, Joint Committee on Taxation
Congress of the United States

This briefing report provides information about the value-added tax, including how the tax would operate, its relative advantages and disadvantages, and the experience of European countries. It also discusses key issues that would face U.S. tax policymakers in deciding whether or not to enact this type of tax.

The report provides a series of charts and accompanying narrative. It is an adaptation of a slide presentation we developed to brief congressional and other parties interested in learning more about this form of taxation. Both the slide presentation and report were prepared pursuant to GAO's basic statutory authority, not at the Committee's request. We undertook the effort to assist Congress in its consideration of options to reduce the federal budget deficit. The report contains no recommendations.

Many European countries have adopted a value-added tax and rely upon it as a major source of tax revenue. From time to time the idea of initiating such a tax in the United States has appealed to U.S. tax policymakers, and thus the experience of Europe in designing and operating such a tax is valuable to the United States. One of the major value-added tax lessons learned from Europe and discussed in this report is that multiple rates can be used to offset the regressivity of the value-added tax, but the disadvantages of additional administrative complexity and compliance costs may be severe.

Information contained in the report was obtained from published sources and from discussions with tax policy experts and tax administration officials in the United States, Europe, and New Zealand.

We are sending copies of this report to the Secretary of the Treasury and the Director of the Office of Management and Budget, as well as appropriate congressional committees and Members of Congress. We will make copies available to others upon request.

Major contributors to the report are listed in appendix II. If you have any questions, please contact me on 275-6407.

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy and
Administration Issues

C O N T E N T S

ABBREVIATIONS

CBO	Congressional Budget Office
EEC	European Economic Community
IMF	International Monetary Fund
IRS	Internal Revenue Service
OECD	Organization for Economic Cooperation and Development

GAO What Is a Value-Added Tax?

Multistage Consumption Tax

Other Consumption Taxes
in the United States

- Retail Sales Taxes

- Excise Taxes

WHAT IS A VALUE-ADDED TAX?

Multistage tax

A value-added tax is a tax on the value added to a product or service at each stage of the production and distribution process. The tax is collected on the difference between a business' sales and purchases. For example, if a business buys $100 worth of material and equipment and produces a product or service that sells for $150, its value added is $50. The value-added tax is not designed as a tax on business; it is a tax on consumption[1] that is collected throughout the production and distribution process.

Consumption taxes in the United States

A value-added tax is similar to the retail sales and excise taxes used in the United States. The primary difference between a value-added tax and a retail sales tax is the collection point; a retail sales tax is collected only at the point of sale to the ultimate consumer. A value-added tax is levied at each stage of the production and distribution chain.

A value-added tax differs from excise taxes in terms of the tax base as well as the number of collection points. Excise taxes are targeted to specific products, whereas a value-added tax covers a full range of products and services. Excise taxes are also collected at only one point--generally at the point of manufacture. The federal government now levies numerous excise taxes on a wide assortment of products and services. The taxes on alcoholic beverages, cigarettes, and motor fuels raise the majority of federal excise tax revenues.

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[1]There are value-added tax systems that include investment goods in addition to consumption goods and services in the tax base. These value-added taxes are rarely used by industrialized countries. For the rest of this report, we will discuss only the consumption value-added tax. Other forms of consumption tax, in addition to the value-added tax, are retail sales and consumption expenditure taxes. For a detailed discussion of these alternatives, see Choosing Among Consumption Taxes (GAO/GGD-86-91, August 20, 1986).

GAO Value-Added Tax as a Revenue Raiser

1992 Revenue Estimates of a 5% Value-Added Tax for the United States

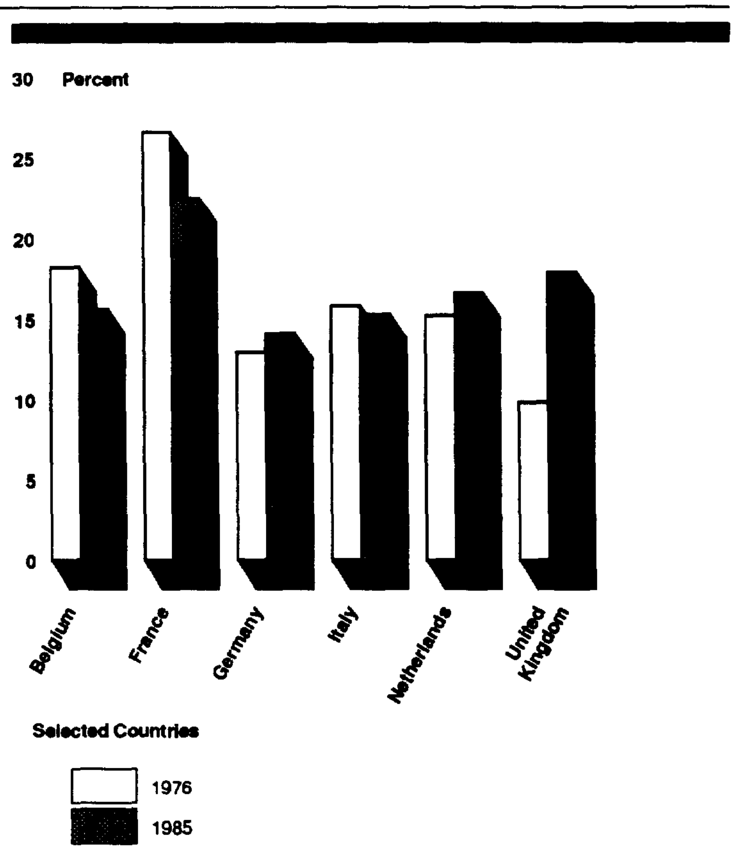
- Broad Base--$125 billion
- Narrow Base--$72 billion

VALUE-ADDED TAX AS A REVENUE RAISER

A federal value-added tax has tremendous potential for raising tax revenues. Its value base can be as large as the consumption component of the gross national product. The Congressional Budget Office (CBO) has estimated that a comprehensive 5-percent value-added tax could raise about $125 billion annually, while one that exempted food, housing, and medical care could yield about $72 billion. CBO estimates are based on the projected 1992 tax base.

From discussions with value-added tax experts and a review of the literature, it appears that many countries originally introduced a value-added tax on a revenue neutral basis, later transforming it through rate or base increases to produce additional revenue. However, according to a 1989 report on consumption taxation by the Organization for Economic Cooperation and Development (OECD), value-added tax revenues in most countries have not increased any faster than any other revenue source. For some examples, see Figure I.1.

Figure I.1: Value-Added Tax as Percentage of Total Tax Revenue, 1976 and 1985



Source: Value-Added Tax: International Practice and Problems, Alan Tait, International Monetary Fund, 1988.

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How a Value-Added Tax is Calculated

Methods for Calculating a Value-Added Tax:

- Tax-credit
- Subtraction

HOW A VALUE-ADDED TAX IS CALCULATED

There are two primary methods for calculating a value-added tax--the invoice or tax-credit method and the subtraction method.[2]

Tax-credit: This is the primary method used throughout the world. With this method, the value-added tax is calculated separately for each purchase or sale and included in the price at each stage of the production and distribution system. It is shown separately on all invoices. For the tax period, the taxpayer subtracts the total value-added tax paid on purchases from the value-added tax charged on sales. The difference is the net liability to the government.

The tax-credit method allows great flexibility in the design and use of a value-added tax, enhancing its ability to respond to a variety of tax policy goals. To the extent this flexibility is used, however, the tax would be more complex both in terms of administration and compliance. In the remainder of this report, we refer to a tax-credit method value-added tax, unless otherwise indicated.

Subtraction: For the subtraction method, the tax is calculated once during the reporting period on the total business activity of the taxpayer. It is simply the total value of sales minus the total value of purchases multiplied by the tax rate. The essential characteristic of the subtraction method is that a firm can calculate its value-added tax from its normal books of account. No additional records are required. On April 1, 1989, Japan introduced the only subtraction method value-added tax at a 3-percent rate.

The subtraction method is simple to calculate but may not be fully compatible with certain design features of the tax. For example, should policymakers decide to alleviate regressivity by using multiple tax rates, the subtraction method for calculating the tax will not work properly.

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[2]For additional information on the two methods and the ability to address key tax policy issues under each, see Tax-Credit and Subtraction Methods of Calculating a Value-Added Tax (GAO/GGD-89-87, June 20, 1989).

APPENDIX I

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Countries That Have Adopted or Considered the Tax

Number of Countries That Adopted
- 1960s--13
- 1970s--18
- 1980s--16

Countries That Have Considered
- Canada
- Iceland
- Poland
- South Africa
- Thailand

COUNTRIES THAT HAVE ADOPTED OR CONSIDERED THE TAX

Value-added taxes are widely used throughout the world. Forty-seven countries have introduced a value-added tax over the last 3 decades, including all 12 of the European Economic Community (EEC) member countries and 18 of the 24 OECD member countries. Japan is the most recent OECD member to adopt a value-added tax.

A number of countries, including Canada, South Africa, Poland, Thailand, and Iceland, have considered proposals for introducing a value-added tax. For example, Iceland has considered for 10 years the introduction of a value-added tax. It currently has a 25 percent retail sales tax. This rate of tax has apparently caused concern because the tax collection responsibilities lie entirely in the hands of retailers. Suspected tax evasion is one of the primary reasons for considering a value-added tax. Introduction of the tax has been delayed, in part due to concern about administering tax refunds under the system proposed to offset the regressivity of the tax.[3]

Canada has considered some form of a consumption tax since June 1987. Recently, the Canadian federal government outlined a multistage goods and services tax proposal that is similar to a value-added tax. The proposal was included in the government's budget for the 1989-90 fiscal year and will replace the current Canadian manufacturer's sales tax. The multistage tax will be set at 9 percent and will apply to a very broad base, including most goods and services sold throughout Canada. It is expected that legislation to implement the new tax will be introduced in the Canadian legislature before the end of 1989, with implementation scheduled for January 1, 1991.

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[3]Taxes are regressive if low-income families pay a larger proportion of their income in taxes than do high-income families. Taxes are progressive if the result is reversed.

GAO International Movement Toward Value-Added Taxes

The movement has been encouraged by:

- Tax Reform

- EEC Requirements

INTERNATIONAL MOVEMENT TOWARD VALUE-ADDED TAXES

Countries have introduced a value-added tax for different reasons, depending on their pre-existing tax system and on whether they were members of the EEC. Adoption of a value-added tax is a necessary condition for membership in the EEC. The EEC adopted the value-added tax to replace turnover taxes as a means of decreasing trade and other economic distortions among its members. The turnover tax is a tax on sales that does not allow an offset for taxes paid on purchases. The result is a tax on a tax.

As its first major step toward tax harmonization, in April 1967, the EEC instructed member states to replace their existing national consumption tax systems with a value-added tax. Since then the EEC has moved forward with a second stage of tax harmonization that is much more controversial. It is attempting to require member countries to standardize their value-added tax systems to two rates by 1992.

A broad tax reform movement was another major reason for governments adopting a value-added tax. A revenue-neutral approach was used by many countries, which often involved using a value-added tax to increase revenues from general consumption taxes in order to cut income taxes (Norway, New Zealand, Austria). Other countries recognized that a multiplicity of ad hoc sales taxes at different rates was inefficient both administratively and economically. They moved to a value-added tax to consolidate and modernize their tax structures (Chile, Haiti, Hungary, and Korea).

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Major Industrialized Countries Not Using a Value-Added Tax

United States

Australia

Switzerland

COUNTRIES NOT USING A VALUE-ADDED TAX

A few industrialized countries do not have a value-added tax system. These include the United States, Switzerland, and Australia. All but the United States have some type of broad-based national consumption tax.

Switzerland has a single-stage sales tax that is paid in most cases at the retail level. The government's proposals to replace the sales tax with a value-added tax were rejected by referendum in 1977 and 1979. Other reform proposals have since been made, but the government has not taken further actions.

Australia has a wholesale sales tax. In 1985, the government proposed moving to a retail sales tax. According to a 1989 OECD report, the government took the view that administration and compliance costs of a retail sales tax would be lower than a value-added tax and that the advantage of a value-added tax in combating tax evasion was overstated. Further, the government had estimated that it would take 12 months longer to introduce a value-added tax than a retail sales tax. However, these retail sales tax proposals were dropped and reforms were made to the existing sales tax instead.

GAO Major Arguments For a Value-Added Tax

Economically Neutral

Large, Predictable Revenue Source

MAJOR ARGUMENTS FOR A VALUE-ADDED TAX

Economically neutral

A tax is said to be "neutral" if it does not change the relative prices of goods and services. If it is assumed that an economy operates most efficiently when all decisions are made on the basis of market prices, tax neutrality is a desirable attribute. A value-added tax preserves neutrality between capital and labor by taxing the value added by each factor equally; thus, it creates no incentive for businesses to substitute one factor for the other. A single-rate value-added tax also preserves neutrality among goods and services. However, a value-added tax containing exemptions and multiple rates is not neutral; lightly taxed or exempted goods and services are given a price advantage.

Large and predictable revenue source

A federal value-added tax has tremendous revenue potential. Its base can be as large as the consumption component of the gross national product. Even allowing exemptions for necessities and certain industries and groups, each percentage point of a value-added tax has been estimated to produce $14 to $15 billion, at least over the range of rates estimated by CBO. Since consumption spending does not fluctuate as much as income, a consumption tax would be a more stable source of revenue than an income tax.

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Major Arguments For a Value-Added Tax

Potentially Self-Enforcing

Not Biased Against Savings

MAJOR ARGUMENTS FOR A VALUE-ADDED TAX

Potentially self-enforcing

Much has been written about a value-added tax being "self-enforcing." This is predicated on the credit/invoice method of calculating the tax, in which taxpayers who buy goods or services for use as inputs in a business activity have an incentive to obtain an invoice that accurately documents the tax paid. Without an invoice, the taxpayer cannot claim a credit for taxes paid against total tax liability. Invoices allow tax administrators to track taxes owed the government.

Despite this administration advantage, the value-added tax has not been a perfectly self-policing tax among EEC countries. It has been reported that various forms of value-added tax evasion have occurred within the EEC. However, the full impact or significance of this evasion varies among the countries, depending upon their tax enforcement activities, rate structures, and the level of their value-added tax rate.

Not biased against saving

A value-added tax, incurred only when money is spent, is not biased against saving, while an income tax is said to have such a bias. Under an income tax, when a family saves more its tax burden increases, due to the tax on interest. A consumption tax, such as a value-added tax, has no such bias since the tax burden does not depend on when funds are spent, only if they are spent. Value-added tax advocates claim that by increasing saving the tax would stimulate economic growth. There is no clear consensus as to whether a value-added tax would increase the private sector savings rate in the United States, let alone by how much.

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Major Arguments Opposing a Value-Added Tax

Regressive

Money Machine

New Tax System for United States

Intrudes upon State Tax Base

MAJOR ARGUMENTS OPPOSING A VALUE-ADDED TAX

Regressive

Most economists regard the value-added tax as a regressive tax because lower income people use more of their incomes for consumption than higher income people do. The degree to which a value-added tax is regressive depends on the time period over which the regressivity is measured. The value-added tax always appears more regressive when taxes on annual consumption are compared with annual income. If we compare taxes on lifetime consumption with lifetime income, the degree of regressivity is reduced.

Money machine

Some claim that a value-added tax hands government an instrument for enlarging its role and scope. They cite Europe's experience in the 1970s and 1980s when value-added tax rates were increased. They point out that government revenue shortfalls can be met by simply increasing the value-added tax rate. The broad base of a value-added tax allows it to generate large amounts of revenue with small percentage rate increases. This could create a temptation to increase public expenditures.

New tax system for United States

Most industrial countries that have a value-added tax had some earlier experience with a broad-based consumption tax. However, the United States has never had this type of tax at the federal level. To introduce a value-added tax in the United States would require time and start-up costs for new systems, regulations, forms, instructions, and taxpayer education. In addition, the value-added tax would add to the compliance burden of millions of businesses.

Intrudes upon state tax base

State and local jurisdictions that impose sales taxes have a natural opposition to a tax on consumption at the federal level. The federal government has made only limited use of taxes on commodities. States and localities use this tax base extensively. States are concerned that even a low-rate value-added tax could inhibit expanded state use of this tax base in the future.

GAO Key Value-Added Tax Policy Issues

Regressivity

International Trade

Compliance

Administration

Intrusion on State Tax Systems

KEY VALUE-ADDED TAX POLICY ISSUES

A set of key policy issues exists surrounding the design and operation of a value-added tax. These issues include how to deal with the tax's regressivity, the impact of the tax on a country's international trade position, the administration and business compliance aspects of the tax, and the impact of the tax upon state and local tax systems.

GAO Key Policy Issues: Regressivity

Methods for Dealing With Regressivity:

- Multiple Rates
- Exemptions
- Refundable Tax Credits
- Social Expenditures and Transfers

KEY POLICY ISSUES: REGRESSIVITY

The value-added tax is considered a regressive tax. Controversy exists, however, over the degree of regressivity and the best method of compensation. In practice, various alternatives have been selected by tax policymakers throughout the world to adjust the distributional impact of a value-added tax. We identified four techniques or alternatives:

1. Multiple tax rates tax necessities at a rate lower than the standard rate and/or luxuries at a higher than standard rate. Also included is the use of zero rating on certain goods and services. Under zero rating, no taxes are collected on sales, but taxes paid on purchases used in production can be claimed as a credit.

2. Exemptions from the value-added tax base include certain items that are considered necessities, such as food, shelter, and health care.

3. A tax credit that is based on estimates of value-added tax paid could be credited against consumption taxes or income taxes.

4. Government transfer payments, such as Social Security, food stamps, or other social benefit programs, could be increased to reflect the tax. Some governments use a portion of value-added tax receipts to increase social program benefits.

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Key Policy Issues: Regressivity Option 1: Multiple Rates

Six EEC countries employ higher rates for luxury goods, such as furs and jewelry.

Eleven EEC countries use reduced rates, and 2 use a zero rate for necessities, such as food and medicine.

Complicate administration and compliance.

KEY POLICY ISSUES: REGRESSIVITY

Option 1: Multiple rates

A recent International Monetary Fund (IMF) report indicates that most countries with a value-added tax use multiple rate systems. It says multiple rates arose in Europe out of a concern that value-added taxes would otherwise be too regressive. Many countries provide a reduced rate for necessities. Some also impose increased rates for luxury items. Table I.1 shows that 6 EEC countries use higher rates for luxuries, and 11 countries use reduced rates for necessities.

One of the drawbacks of using multiple rates is that the regressivity offset is not well targeted since a low tax rate on necessities benefits anyone who consumes the good, whether rich or poor. The use of multiple rates also causes administration and compliance problems. Multiple rates require complex regulations to classify goods for each rate. For example, is a chocolate-covered cookie a candy (luxury) or a food product (necessity)? Lastly, multiple rates raise the cost of keeping sales records, especially for small retailers who deal in goods covered by different rates.

Table I.1:

Value-Added Tax Rates for EEC Countries as of January 1987
(Rates in percent)

Country	Standard rate[a]	Rates lower than standard	Rates higher than standard
Belgium	19	1,6,17	25,33
Denmark	22	-	-
France	18.6	2.1,4,5.5,7	33.3
Germany	14	7	-
Greece	18	6	36
Ireland	25	0,2.4,10	-
Italy	18	2,9	38
Luxembourg	12	3,6	-
The Netherlands	20	6	-
Portugal	16	8	30
Spain	12	6	33
United Kingdom	15	0	-

[a] All country rate structures apply a zero rate for exports.

Source: OECD, "Consumption Taxation," January 1989.

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Key Policy Issues: Regressivity Option 2: Exemptions

Extends benefits to other than the poor.

Some tax included in exempt good or service.

KEY POLICY ISSUES: REGRESSIVITY

Option 2: Exemptions

Exemption is a method for removing firms or goods from the value-added tax system. If a firm is exempt, it does not have to collect any tax or turn over any revenue to the government. While it is not faced with any costs of complying with the tax, an exempt firm gets no rebate on any value-added taxes paid on its purchases from other firms. As a result, an exempt firm will be faced with paying the tax itself or passing it on to purchasers without an accompanying credit.

Countries can exempt goods or services because they are thought to have a particular value to society as a whole, or in an attempt to reduce the burden of the tax on low-income families. For example, 7 countries exempt original art; 12 countries exempt museums; and most countries exempt educational services, medical services, and rental housing. There are two problems with using exemptions to address regressivity: (1) since the exemption usually occurs at the retail level, all of the tax on previous stages remains; and (2) any tax relief that is granted goes to all purchasers of the good, rich or poor.

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Key Policy Issues: Regressivity Option 3: Refundable Credit

Better suited for targeting those in need.

Makes administration more complex.

KEY POLICY ISSUES: REGRESSIVITY

Option 3: Refundable tax credit

Some value-added tax experts believe that problems with the regressivity of a value-added tax can best be handled through the use of a refundable tax credit. The amount of the credit could be based upon the average amount of value-added tax paid by a low-income individual or household. Taxpayers may offset this credit against any income tax liability. Those who pay less income tax than the amount of the credit, including those whose income is so low that they do not currently file an income tax return, would receive a refund from the government. In this way, the regressive distribution of the value-added tax burden is offset. New Zealand uses the refundable credit approach. Also, as of October 1987, seven states in the United States used this approach to lessen the burden of state sales taxes upon the poor.

There are some operational drawbacks to the use of a refundable tax credit. These include concerns about designing a credit system that takes into account the personal circumstances of families and individuals, including family size, special medical circumstances, and regional cost of living differences. Also, a system of refundable tax credits would give rise to a large increase in the number of people who must file tax returns to claim the credit. This may cause a large number of people to file tax returns who otherwise would have no need to file.

GAO Key Policy Issues: Regressivity Option 4: Social Expenditures

Dedicate some tax revenues to indexing income transfer programs.

Increase social welfare expenditures.

Does not reach total targeted population.

KEY POLICY ISSUES: REGRESSIVITY

Option 4: Social expenditures

Some tax experts believe that it would be easier to compensate for the regressivity of a value-added tax by altering the country's social transfer programs. Low income benefit transfer payments such as Supplemental Security Income, Food Stamps, Aid to Families with Dependent Children, or other benefit transfer programs might be used. The countries of Sweden, Denmark, and Norway use social transfers to compensate for the distributional effects of a value-added tax.

One of the drawbacks to using this alternative is that not all low-income individuals and families receive social transfer payments; therefore, the use of social transfer payments would not completely alleviate the burden of the tax on low-income families and individuals. In addition, if all transfer payments, including Social Security, were adjusted, some families with incomes substantially above the poverty level would also benefit.

GAO Key Policy Issues: International Trade

Tax related price increases may adversely affect trade.

To offset price effects, countries

- refund tax on exports,
- impose tax on imports.

KEY POLICY ISSUES: INTERNATIONAL TRADE

There are value-added tax supporters who believe that adopting a value-added tax would improve the competitiveness of U.S. industry in international trade. The General Agreements on Tariffs and Trade allow countries using indirect taxes, such as a value-added tax, to rebate the tax on goods being exported and impose it on imports. Such adjustments cannot be made for direct taxes, such as corporate and individual income taxes. However, rebating the tax on exports is not equivalent to subsidizing exports, and imposing the tax on imports is not penalizing imports. The adjustment is needed so imports are not favored in competition with domestic products bearing the value-added tax and for exports to compete with foreign goods not bearing the tax. Without such adjustments, imports would have a price advantage over domestic goods, and exports would have a price disadvantage in foreign markets.

Value-added tax proponents also believe that U.S. foreign competitiveness would improve if a value-added tax replaced part or all of a direct tax like the corporate income tax. Whether such a tax substitution would improve the economic position of U.S. industry abroad depends, in part, on whether the corporate income tax is reflected in prices paid by consumers. If removing part of the tax (through the substitution of a value-added tax) lowers the prices of goods produced by U.S. corporations, the U.S. trade balance might improve for a time. However, most economists, trade, and tax experts believe that any such improvement would be short term and, in the long run, negated by adjustments in exchange rates or the rate of inflation. In general, they do not believe that the U.S. balance of trade problems are affected by the composition (mix of direct and indirect taxes) of the U.S. tax system. Thus, they maintain that the value-added tax should not be enacted in the hope of improving the U.S. balance of trade.

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Key Policy Issues: Business Compliance

Multiple rates create higher compliance costs.

Burden more onerous for small firms.

Various methods used to reduce compliance burden.

KEY POLICY ISSUES: BUSINESS COMPLIANCE

One of the most important factors affecting costs to both the government and business is the complexity of the value-added tax. Depending upon how the tax is structured and what business a firm is engaged in, the accounting requirements to comply with a value-added tax can be complicated. With multiple rates and exemptions, a firm would have to record separately purchases and sales of items taxed at different rates or exempted. One published study reported that multiple tax rates have been estimated to increase the cost of administering the tax by, on average, 50 to 80 percent. Most of this increase would be due to increased business and government personnel costs.

Some studies have reported that for larger firms, the value-added tax does not appear to impose an unusual accounting burden and that it adds relatively little to a firm's costs (less than 1 percent of a firm's total sales). For smaller operations (for example, small retailers), the accounting and administration requirements may be more burdensome. One tax authority suggests that the accounting costs for smaller businesses may increase 20 percent under a value-added tax.

Some countries exempt businesses from the value-added tax on the basis of sales being less than a certain amount. This is the practice in most countries in the EEC and some countries in Latin America. The advantage of this system is that it reduces tax administration costs with little revenue loss by eliminating the smallest traders from the tax. A drawback is that larger firms may feel discriminated against, and this may influence their attitude toward voluntary compliance.

Another method for dealing with small businesses is called the "forfait," in which the small business and the government determine the amount of the business' sales. Once a sales level is agreed to, a value-added tax liability is established. In most circumstances it appears this type of system requires a large amount of administration resources for relatively little revenue.

GAO Key Policy Issues: Administration

Tasks Involved

- Identifying Taxpayers
- Processing Returns
- Controlling Collections
- Auditing Taxpayers

Organizational Choices

- By Income Tax Agency
- Independently

KEY POLICY ISSUES: ADMINISTRATION

Much of what is known about administering a value-added tax comes from the experience of EEC member countries. The main issues of value-added tax administration concern identifying taxpayers, processing returns, controlling collections, making refunds, auditing taxpayers, and levying penalties.

Before a value-added tax is enacted, authorities must decide which government agency ought to administer the value-added tax. Most EEC countries placed value-added tax administration responsibility in the agency handling the income tax. This was done for two primary reasons. First, the information collected while administering the value-added tax would assist income tax enforcement. Second, the personnel skills needed to administer the value-added tax closely resemble those needed to administer the income tax.

According to a 1989 OECD report, in only 3 of its 18 member countries are value-added taxes and income taxes managed by totally separate governmental entities. For example, in the United Kingdom, the customs department, not the income tax department, manages the value-added tax. In nine other OECD countries, the same tax inspector oversees both taxes, and in the remaining six the taxes are managed by the same department but within separate divisions. OECD reported further that two of the six countries with separate divisions currently are implementing changes to integrate value-added tax and income tax management.

An administration problem within most EEC value-added tax systems involves deciding what will be exempt. Because of valuation difficulties banking, financial services, and insurance are generally exempt from the value-added tax. In addition, and for a variety of reasons, many countries exempt cultural, educational, medical, and postal services, non-profit organizations, rental or leasing of real estate, and the purchase of buildings that are not newly constructed.

GAO Key Policy Issues: Administration Costs

Costs rise as system becomes more complex.

Two cost estimates of a value-added tax in the United States.

KEY POLICY ISSUES: ADMINISTRATION

Administration costs

Another lesson learned from Europe is that the difficulty of value-added tax administration increases with the complexity of the rate structure and the tax base, as well as with the number of taxpayers. Literature on administration costs indicates that the simpler the value-added tax system, the lower the administration costs.

OECD reported administration costs as a percent of revenues for 12 countries. These costs ranged from 0.32 percent to 1.09 percent, with the Scandinavian countries (Denmark, Finland, Norway, and Sweden) having the lowest ratios. The Scandinavian countries have simple, single-rate, broad-based systems. However, they also have some of the highest value-added tax rates, which should bring in more revenue and could explain some of the apparent efficiency.

U.S. value-added tax cost estimates

There have been two studies of the costs of administering a value-added tax in the United States: both are by IRS, one published by the Treasury Department in 1984 and an unofficial IRS staff study in 1986. Although the assumptions of the two studies differed, both reports arrived at an annual cost of administering a value-added tax of approximately $700 million. Both reports developed annual staffing and cost estimates for a single-rate value-added tax with 20 million taxpayers. Neither study incorporated the cost of the Customs Service, which would be a necessary component in dealing with the value-added taxation of goods and services crossing our borders.

Additional aspects limit the studies' usefulness in estimating the cost of introducing various designs of a value-added tax. The Treasury study appears to assume that a new infrastructure would be created to administer a value-added tax. The other study suggests that administration could be, in part, combined with the existing income tax system. There is insufficient detail in the studies to determine the basis for the estimates or to allow a comprehensive examination of how different assumptions affect the level of administration costs. If the value-added tax that is enacted differs substantially from what was assumed in the studies, there is little in these studies that would be helpful for estimating the administration costs.

GAO Key Policy Issues: State Concerns About the Tax

Intrusion on States' Revenue Source

Impact on States' Ability to Increase Retail Sales Revenues

Burden on Businesses

Taxpayer Confusion Between State and Federal Taxes

KEY POLICY ISSUES: STATE CONCERNS ABOUT A VALUE-ADDED TAX

State governments are concerned about the enactment of a federal value-added tax. Forty-five states now have a broad-based consumption tax in the form of a retail sales tax. Historically, states have received a significant portion of their tax revenues from sales taxes. If the federal government enacted a tax, it would add a second layer of consumption taxation that businesses in those states would have to calculate and collect.

State officials are concerned that the imposition of a value-added tax by the federal government would make it more difficult to increase state sales tax revenues. If the federal government adds taxes to the same items as the state taxes, state officials believe it will be more difficult to raise tax rates. They are concerned, further, that a federal consumption tax would pressure the states to alter their tax bases to conform with the federal tax base. There is also a concern expressed in the literature that evasion of state taxes will increase if sales are subject to a high combined federal/state rate.

Another concern of state officials is about the burdens that would be placed upon businesses that must charge two taxes on each sale they make. A second consumption tax would increase business compliance costs, but by incorporating certain administration features the federal government might be able to reduce these costs. One option would be to impose a single tax and divide the collections between the federal and state governments.

MAJOR CONTRIBUTORS TO THIS REPORT

GENERAL GOVERNMENT DIVISION, WASHINGTON, D.C.

Lynda D. Willis, Assistant Director, Tax Policy and Administration Issues
William Trancucci, Evaluator-in-Charge
Tom McCool, Economist
Mary Phillips, Evaluator

EUROPEAN OFFICE

Patricia Foley Hinnen, Evaluator

APPENDIX II

RELATED GAO PRODUCTS

GAO has issued a number of reports pertaining to value-added taxation. These reports are:

Tax-Credit and Subtraction Methods of Calculating a Value-Added Tax (GAO/GGD-89-87, June 20, 1989).

Choosing Among Consumption Taxes (GAO/GGD-86-91, August 20, 1986).

The Value-Added Tax--What Else Should We Know About It? (GAO/PAD-81-60, March 3, 1981).

The Value-Added Tax In The European Economic Community (GAO/ID-81-2, December 5, 1980).

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