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A U.S. VAT: IT'S PROBABLY INEVITABLE

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160 countries levy a national consumption tax and the U.S. (we) are the only country in the OECD that does not.1 The past 8 years of federal deficits plus the projected deficits over the next 25 years have raised concern about how long we can continue deficit spending and still avoid a fiscal crisis. Are we ready for a serious debate about a overhaul of our tax system before the window of opportunity closes?

Selling bonds to finance our deficit spending will eventually cause higher interest rates exacerbating annual deficits into a "debt or inflation spiral".[2] Congress is reluctant to curb spending and cannot agree on whose income tax to raise or how much. Economic growth seems to be stagnating around a 1.5% real (inflation adjusted) rate. What else must be considered?

Federal Debt Update

According to the Treasury, the total national debt is over $19 trillion.[3] Recent annual deficits have been approximately $600 billion and are projected to be $1 trillion per year starting in 2023. This is due to: i) entitlements to baby-boomers from both the Social Security Trust Fund and the Medicare Trust Fund; ii) last year's Bipartisan Budget Act which suspended sequestration, eliminated certain scheduled budgets cuts, and allowed a permanent extension of numerous tax breaks; and iii) more modest GDP growth projected over the next few years than had been hoped for. As a result, the CBO now projects $1.5 trillion more deficits than they thought just 18 months ago, and the 10-year cumulative deficits through 2026 will be $9 trillion, bringing our total federal debt close to $30 trillion![4]

To put this in perspective, by 2026, the portion of the federal debt held by the public is projected to be approximately 86% of our GDP, and the total gross debt would be about 110% of our GDP.[5] Economists point out that although the U.S. has experienced similar debt levels right after WWII, they caution that the circumstances that caused that debt and the underlying strength of our economy right after the war are not comparable to today. Furthermore, when countries historically reach over 100% debt to GDP ratios, they have generally faced a fiscal crisis of some form: substantial reductions in economic growth, crowding out of private investment, higher Treasury Bond interest rates and debt service burden on the federal government, higher consumer borrowing rates which would dampen economic growth causing a recession, currency devaluation, eroding purchasing power of wages and savings arising from inflation, and/or economic stagnation (as is happening in Japan). This results in substantial cuts in government

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[2] "*The Sustainability of the Federal Budget Deficit: Market Confidence and Economic Effects", Congressional Research Service, December 14, 2012.*

[3] Including $5 trillion owed to various federal agencies which also real obligations under current law.

[4] "*CBO: An Update to the Budget and Economic Outlook: 2016 to 2026*, Aug. 2016", p.27. https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51908-2016_Outlook_Update-2.pdf.

[5] "*CBO Aug. 2016", note 4*, p.4.

services and an overall reduced standard of living, especially to the poor, elderly, and middle class. It also puts the U.S. in a difficult funding position the next time a national crisis that requires a significant infusion of new spending arises.[6]

Some economists are concerned that the U.S. is *already* in excess of 100% debt to GDP when you consider the $5 trillion owed to other federal agencies such as for government pension and the amount owed to the Social Security Trust fund. We should also consider the present value of the unfunded entitlement programs, now estimated over a 75-year forecast period to be close to $50 trillion, and this is *after* considering projected payroll tax contributions. [7] As a result, the Congressional Research Service recently informed Congress that: i) "the CBO, GAO, and the Administration agree that the current set of fiscal policies will lead to an unsustainable debt burden if left unchanged in the long run"; ii) "if potential buyers of U.S. debt issuances lose confidence in the ability of the federal government to repay its debt, ensuing increases in the supply of money through debt financing (known as debt monetization) may lead to rising interest costs or price inflation"; and iii)"addressing the potential consequences of those projections will likely involve policy adjustments that reduce the occurrences and intensity of budget deficits, either through tax increases, further reductions in spending, or a combination of the two."[8]

How Much Would Personal Income Taxes Have To Be Raised to Stop Deficits?

According to the Treasury, personal income taxes in 2015 accounted for $1.5 trillion or 47% of $3.2 trillion in total tax receipts.[9] To raise about $600 billion more to cover of the annual deficit, the government would need to raise individual tax rates by 40% more. Additionally, rates would need to be even higher when you consider the projected future annual deficits reaching $1 trillion in 6 years.[10]

And of course, the idea of raising individual tax rates ignores: i) the likely impact that tax rate increases of that magnitude would have an adverse impact on growth and spending; and ii) the political reality that the wealthiest Americans will not support a rate increase of that magnitude.

Why Can't Congress Cut Spending?

Congress tried. The Budget Control Act of 2011 (BCA) was intended to cut spending about $1.2 trillion over 10 years, by requiring Congress to find areas to cut. When Congress could not, the BCA required mandated cuts, known as "sequestration", and these cuts were scheduled to affect Defense, Medicare, and to all discretionary programs. However, because of political and societal pressures, and emergency funding measures, these planned cuts were either largely postponed, limited, or eliminated by subsequent legislation, especially through the Bipartisan Budget Acts (BBA) of 2013 and 2015.

Specifically, BBA 2015 canceled automatic spending reductions set to take effect in 2016 by at least $80 billion, and cancelled reductions for a few more years.[11]

Also in 2015, Congress permanently repealed a mandated 21% cut in Medicare reimbursements to physicians, which added another $140 billion to the debt over the next 10 years, and passed a largely unfunded Highway Trust Fund appropriation, which will add another $50 billion over the next 10 years. And lastly, at the end of 2015, Congress again passed an "extenders bill" for certain tax preferences

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[6] *"Public Debt Overhangs: Advanced-Economy Episodes Since 1800,"* Carmen M. Reinhart, Vincent R. Reinhart, and Kenneth S. Rogoff, Journal of Economic Perspectives, Vol. 26 No. 3 (Summer 2012), pp. 69–86, http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.26.3.69; and "*How the United States' High Debt Will Weaken the Economy and Hurt Americas",* Heritage Foundation, Feb. 12, 2013, http://www.heritage.org/research/reports/2013/02/how-the-united-states-high-debt-will-weaken-the-economy-and-hurt-americans#_ftn2.

[7] *"2016 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*" (page 215), and the *"Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds"* ; https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2016.pdf; and https://www.ssa.gov/OACT/TR/2016/tr2016.pdf.

[8] *"Deficits and Debt: Economic Effects and Other Issues",* Congressional Research Service, Feb.17, 2016, https://www.fas.org/sgp/crs/misc/R44383.pdf.

[9] *Monthly Treasury* Statement (September 2015), https://www.fiscal.treasury.gov/fsreports/rpt/mthtreasstmt/mts0915.pdf.

[10] "*CBO August 2016 Update", note 4, p.27.*

[11] *"Final Sequestration Report for Fiscal Year 2016"*, CBO, Dec. 2015, p.1,https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51038-Sequestration.pdf.

and subsidies, but this time made many of them permanent. These 2015 actions total another $1 trillion in debt over the next decade.[12] In summary, our needs are great and because Congress must campaign and lobby for our support, the system tends to "give us what we want", and our political system is incapable of stopping it.

How Much Would the Economy Have to Grow to Avoid Deficits?

Total tax receipts are $3.2 trillion, roughly 18% of annual GDP of $18 trillion.[13] Therefore, assuming tax receipts come in at the same rate of GDP, the Federal government would generate $180 billion for every $1 trillion of additional GDP growth. To cover this year's entire $600 billion deficit, the economy would have to grow another $3.3 trillion, or 18% all in one year. This is not likely possible.[14]

The Corporate Income Tax Code

In order to stimulate more economic growth, many in Congress have pointed to corporate tax reform. There are proposals to lower our rate from one of the highest in the world to be more competitive rate, encourage repatriation of foreign earnings, minimize base erosion, and serve to attract and retain businesses in the U.S. Although both sides have substantial common ground, they cannot agree on important details. There is tremendous pressure from lobbying groups to preserve the status quo for a multitude of corporate preferences, most of which would have to likely be eliminated in order to fund any meaningful reduction in the rate.

The only tax "reform" we have seen recently has come from Treasury issuing notices and regulations which effectively curtailed corporate inversions of U.S. companies, which of course is the symptom, not the disease. It did not do anything to encourage economic growth.

In short, we still have one of the most anticompetitive, complex, corporate tax codes in the world, with one of the highest statutory rates. With respect to global earnings, the U.S. tax is in effect is an "optional" tax since multinationals have advisors that can help them legally avoid it, with no real incentive to repatriate their foreign earnings. Additionally, many of our trading partners have lowered their own corporate tax rates (e.g. Ireland is currently at 12.5%, and the U.K. lowered its rate from 28% in 2010 to a current rate of 19% which is moving to 17% rate in by 2020).[15] So if corporate tax reform stays deadlocked, or if legislation is enacted which does not close deficits, what else could we consider?

Abolish the Corporate Income Tax Completely?

As background, for fiscal year 2015, the corporate income tax only raised about $350 billion, out of approximately $3.2 trillion in total receipts, or about 11% of total tax receipts. We are all aware of its complexity and high costs to comply. Therefore, reforming it may substantially help economic growth. There have been some serious policy discussions around should we should consider *completely abolishing it*, and replace it with an integrated system whereby corporate profits and stock appreciation are taxed at the individual level. There are many good arguments for such a system, as summarized in a high profile position paper last year. [16]

However, time for a reality check here, most observers don't see completely abolishing the corporate income tax as politically possible for the foreseeable future. This gets us to consider another possibility, a national consumption tax.

How Would a National Consumption Tax Work?

A National Sales Tax

Let's first discuss the type we are all familiar with, the Pennsylvania sales tax, applied at a much higher rate at the national level. For example, the Fair Tax Act of 2015 would impose a rate of about 20% -23%, and would replace all other federal taxes.[17]

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[12] *"Committee for a Responsible Federal Budget",* 12-22-15 http://crfb.org/blogs/policymakers-dig-hole-12-trillion-deeper-2015.

[13] *"Monthly Treasury Statement (September 2015)", note 9.*

[14] "*CBO August 2016 Update", note 4, pp.* 12, 27 and 34.

[15] *"Fortune 500 Companies Hold a Record $2.4 Trillion Offshore",* Citizens for Tax Justice, March, 2016, Justicehttp://ctj.org/ctjreports/2016/03/fortune_500_companies_hold_a_record_24_trillion_offshore.php#.V9XA9vkrLIU.

[16] *"Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax"*, American Enterprise Institute and Tax Policy Center, Toder and Viard, April 2014, http://www.aei.org/wp-content/uploads/2014/04/-toder-viard-report_132524981261.pdf.

[17] *"Tax Reform in the 114th Congress: An Overview of Proposals",* Congressional Research Service,

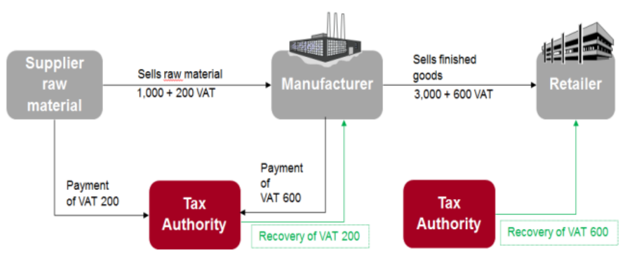
Proponents argue that such a system would capture taxes from illegal activity, would assess taxes on every person consuming at the retail level in the U.S., would encourage more productive earnings because income won't be taxed any more, and it would eliminate the complexity of our current income based systems. Critics argue that it would be regressive. However, rebates could be integrated for those near poverty level, with low income subsidies and exemptions for basic necessities.

However, a national sales tax has a major *noncompliance* disadvantage compared to our existing tax system. Specifically, since there is no cross reporting by prior or successor stages of a retail sale, the government would have no corroborating record of the sale and who is the end retailer responsible for the ultimate tax collection.[18] For this reason, plus the radical nature of such a high national rate, the replacement of all other federal taxes, and the ensuing disruptions and political pressures to maintain the status quo, the American public does not appear ready for something this dramatic. And, it could create unintended fallout in certain industries that is difficult to predict.[19] However, perhaps something like a VAT might be more acceptable.

A VAT

The VAT system differs from the national sales tax because a VAT is assessed at each stage of the supply chain through to the end consumer, on the difference between the seller's purchase price and the resale price of most products and services in our economy, whether online or not, except for legislated exemptions. It would also apply to rentals, sales of business assets, and commissions. How this is accomplished depends on the type of VAT system implemented.

The most common method, used by most VAT countries, is the "credit-invoice" method.[20] Under this method, at the end of a reporting period, the business calculates its VAT liability by subtracting the cumulative amount of VAT stated on its purchase invoices from the cumulative amount of VAT stated on its sales invoices. If done accurately, this ensures that the VAT will be neutral, except for the value added portion, regardless of how many transactions are involved. (See illustration below).



Advantages over an Income Based System

All serious U.S. consumption tax proposals would either eliminate or lower rates, and simplify many of our existing federal taxes to varying degrees depending on the consumption tax rate. The VAT itself is thought to be a much simpler system than income taxation system in that it involves assessing a tax on a *value added calculation*, which intuitively and theoretically is not as complex as defining taxable income. Additionally, it is thought that a consumption-based tax would be more neutral to decision making regarding what to invest in and how to finance it, as well as being economically more efficient to administer.[21]

To allow our goods and services to be more competitive around the world, the VAT could be "border adjustable" in that it would not apply to the export price, and allow a refund for the earlier production related VAT paid. Imports on the other hand would not be exempt since its earlier stage production had not been subject to the U.S. VAT. Proponents argue that moving away from an income based tax system would lead to more substantial economic growth and significantly more tax revenues than conventional income tax reform proposals. That is because a consumption based tax removes the disincentive to earn more and it would encourage investing. New revenue could be directed to deficit reduction, and substantial simplification of one or more of our existing tax systems.[22] A combination

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March 2016, https://www.fas.org/sgp/crs/misc/R43060.pdf.

[18] *"How Could We Improve the Federal Tax System"*, The Tax Policy Center, 2015, The Tax Policy Briefing Book, http://www.taxpolicycenter.org/briefing-book/why-vat-administratively-superior-retail-sales-tax.

[19] For example, many charities could become extinct because donations are no longer tax deductible.

[20] *"An Introduction to the Value Added Tax (VAT)"*, U.S. Chamber of Commerce, 2010, https://www.uschamber.com/sites/default/files/legacy/issues/econtax/files/vat_paper_4_25_2010.pdf.

[21] U.S. Chamber of Commerce, note 20.

[22] *"Should the U.S. Adopt a Value Added Tax?"*, WSJ, Feb.28, 2016, http://www.wsj.com/articles/should-the-u-s-adopt-a-value-added-tax-1456715703.

seems more viable. For example, if the corporate income tax could be reformed and rates lowered, the anti-competitive drivers would disappear, foreign earnings could be repatriated, U.S. businesses would have greater incentive to remain here, and more foreign capital would be attracted to the U.S., and compliance and planning costs would greatly diminish. The revenue cost of corporate tax reform could be augmented by introducing a VAT. Revenues that could be raised from a VAT depend on the rate to be used, the types of exemptions, and the subsidies granted to alleviate regressivity on the poor. VAT rates in the OECD currently range from a high of 27% to as a low as 5%, with the average rate around 17%. A recent Tax Policy Center analysis referred to a study which estimated that a 5% U.S. VAT rate could raise $200 billion to $350 billion annually (about as much as the corporate income tax) depending on how broad the taxable base would be.[23] Additionally, the Tax Foundation concluded on how much of the long-term gap in tax receipts could be neutralized by instituting a VAT. Assuming a VAT base of about 40% percent of GDP (the average of European-style VATs), they concluded that the government would need a 12% VAT each year to close the 25 year gap, a 17% VAT to close the 50 year gap, and a 21% VAT to close the 75 year gap.[24]

Conclusion

Trillion dollar deficits are inevitably coming. In summary, if structured properly, the VAT could be implemented in a manner that reflects European lessons learned, provides for substantial income tax reduction and tax simplification, stimulates economic growth, and provides additional funds for deficit reduction. *This debate will take years, but we think Congress will inevitably see there are probably no other viable options.*

As Tax Analyst wrote in their September 19, 2016 edition, Winston Churchill's oft-quoted remark is especially relevant here: "You can always count on Americans to do the right thing ---- after they've tried everything else."

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[23] *"How Could We Improve the Federal Tax System?",* The Tax Policy Center, note 20
[24] *"What VAT Rate Could Solve CBO's Long-Term Budget Outlook?"*, July, 2010, http://taxfoundation.org/blog/what-vat-rate-could-solve-cbos-long-term-budget-outlook.