Using the fact that for ordinary investments yielding income streams of present value \( R_1 \), \( G_1 \) tends to be equal to \( R_1 \), we may write:

\[
G_2(1 - 0.3 - 0.2t) = G_2(1 - t'),
\]

or

\[
\frac{G_2}{G_1} = \frac{(1 - t')}{(1 - 0.3 - 0.2t')}.
\]

It can be seen from a comparison of Table 12.3 with Table 12.2 that the incentive given to petroleum exploration by the capital gains provisions of our tax laws is almost as great, for any given tax rate, as that given by the percentage depletion provisions. Moreover, the differential incentive given by the capital gains provisions is like that given by percentage depletion in that it increases with the tax rate, from small values when the tax rate is in the neighborhood of 10 or 20 percent to high values when it is 50 percent and more. The conclusion appears inescapable that strong incentives for excessive investment in petroleum exploration really came into being in the last few decades, as income tax rates were raised toward their present high levels. To bring the relative incentives for petroleum exploration back to the level at which they were when percentage depletion was first enacted would entail, at present corporation tax rates, a very substantial reduction in the current 27 1/2 percent depletion rate, and a very substantial increase in the tax rate applicable to capital gains on oil properties.

Chapter 15, which appeared in *The Taxpayer's State in Tax Reform* published in 1968 by the Chamber of Commerce of the United States is essentially a straightforward exposition of the principles underlying the taxation of value added, together with a modest plea for its consideration as a permanent component of the United States tax system. This is a modest plea because the arguments for a value-added tax are much stronger when it is viewed (as was the case in the European countries, which have by now largely shifted to the value-added tax) as a substitute for a preexisting turnover tax than when it is viewed as a wholly new component of the system.

As Chapter 15 indicates, I place only small weight on the possible beneficial effects of a value-added tax on the balance of payments position of the United States. Its principal benefit, I believe, would be as a potential source of increases in revenues when these are needed in a hurry (as was the case, for example, in the Korean War) and as a highly responsive instrument of flexible fiscal policy in the short run.

I have encountered no arguments against the value-added tax in the above terms. Rather, its opponents seem to have concentrated their fire on the likely regressive incidence of the tax. On this matter no issues of economic analysis are involved, but only questions of values on the one hand and political judgment on the other. On the value side, I share with opponents of the value-added tax the belief that the tax system should be progressive. But I would argue that judgments concerning progressivity are more relevant when applied to the whole tax system (or even better, to the whole tax-expenditure system) than when applied to each component separately. A tax system can have some substantial regressive components, and still be quite, or even very, progressive overall. This does not argue in any sense that there should be
regressive components in a tax system, but only that where a particular tax (like the value-added tax) has very substantial advantages of its own (neutrality with respect to resource allocation, ease of administration, flexibility with respect to changing revenue needs), the fact that taken alone it is somewhat regressive in its incidence should not be taken as a decisive argument against it.

Here is where the issue of political judgment enters. If one views the ultimate incidence of the tax system as the product of a series of historical accidents — first one tax is imposed, then another, then a rate structure is changed, etc. — the addition of one new regressive component (in this case the value-added tax) will automatically make the system as a whole more regressive. This is the position taken by a number of opponents of the value-added tax.

On the other hand, it is possible to take the view that the political and social climate prevailing in any given period largely determines the degree of progressivity of the tax and expenditure systems, more or less independently of the particular components making up, say, the tax system. Thus the imposition of value-added tax could be accompanied, or reasonably shortly followed, by either an increase of the exemption level on the personal income tax, or by a closing of some tax loopholes that benefit mainly the higher brackets, or by a variety of other devices which would tend to preserve the progressivity of the overall structure, or to make it reflect changing political pressures and forces much as it would have done anyway, even in the absence of a value-added tax.

I do not have very firm feelings about which of these alternative sets of political judgments is more nearly correct or relevant, but my leaning is toward the view that the overall degree of progression is determined in a fashion that is largely independent of the presence or absence of any particular tax. Certainly I can say that when I more or less explicitly or consciously accept the approximate validity of this view of the political process that I feel most easy and comfortable in advocating a value-added tax for the United States.

Chapter 13

A Federal Tax on Value Added

The idea of a value-added tax is still strange to most Americans, and it is only natural that this should lead to its being greeted with trepidation and suspicion. Our first task, therefore, is to set out the basic concept of the value-added tax, and to relate it to more familiar types of taxation. Then, as the second step in our analysis, we shall outline the principal arguments for and against the value-added tax, and attempt to assess their overall merits and weaknesses as well as any particular advantages or disadvantages that such a tax might have for the United States. Finally, we shall turn to issues related to the design and administration of a value-added tax.

THE NATURE OF VALUE-ADDED TAXATION

In its National Policy Statement, A Better Balance in Federal Taxes on Business (April, 1966), the Committee for Economic Development stated (p. 20):

We urge that serious consideration be given to the introduction of a flat rate tax on all the value added in business activity in the United States. To assure that the tax rate can be set at a low enough rate to minimize distortions, this tax should be as broadly based as is administratively feasible. By a tax on value added we mean an unduplicated tax on the increase in the value of products as they pass through successive firms in the production and distribution process.

The key element of value-added taxation is clearly stated by the CED: The base of such a tax is the increase in value of products as they pass through successive stages in the production and distribution process. The farmer pays tax on the difference between the value of the wheat he produces and the cost of the seeds, fertilizers, etc. used in producing the wheat. The Miller pays tax on the difference between the value of the flour he produces and the cost of the wheat and other materials consumed in making it. Finally, the retailer pays tax on the difference between the retail value of bread he sells and the cost to him (at wholesale) of acquiring the bread. Thus if the tax were levied at the rate of

From The Taxpayer's Stake in Tax Reform, copyright 1968, Chamber of Commerce of the United States. Reproduced by permission.
5 percent of value added at each stage of the process, it would end up having collected, in separate stages, 5 percent of the retail value of bread. It is an example of the principle of tax neutrality. In this context, the tax on bread is paid by the consumer, but not by the producer. The price of bread includes the tax, which is then passed on to the consumer. However, if the tax is not passed on, the producer will bear the tax burden. The principle applies to all goods and services, not just bread.

With respect to (b), under a general sales tax, export sales would presumably be exempt, while under a value-added tax, stripping all production done within the country, tax would automatically have been paid on the great bulk of the value of exports long before the item in question reached the export stage and became known to be headed for export. The border-tax adjustments permitted under the General Agreement on Tariffs and Trade are, however, all that is needed to bring about the same result under either value-added tax or the sales tax. These adjustments permit the rebating, at the point of export, of any indirect taxes that have been paid in the process of the production of any exported goods or services. They also permit the collection, at the point of import, of a corresponding tax (in our example, 5 percent) on any imported goods or services. In this way a tax which (like the value-added tax) is nominally levied upon production activity can be transformed in effect into a tax on acquisitions of final products by domestic consumers and business firms.

In sum, a general value-added tax of the product type, and incorporating the GATT border-tax adjustments, is for all practical purposes equivalent to a general sales tax on all final goods and services acquired by the private sector. Up to now we have considered the value-added tax as a levy on the difference between the value of production and the cost of acquisition of materials and intermediate products. We can now visualize an income statement for the firm, and ask ourselves what items does the above difference consist of. Basically, this reduces to an issue of deciding what we mean by value of production and what we mean by the costs of acquiring materials and intermediate products. However, we decide this issue, we must do so consistently; if an item is counted as part of production when sold to another firm, it must be counted as part of cost when bought from another firm. No serious issues arise here insofar as material goods or services (such as legal, accounting, and consulting services) are concerned. If they are bought from an individual or entity not covered by the value-added system, as in the case of the services of a lawyer directly employed by the firm, they are not deductible in the computation of value added.

If they are bought from a firm which is itself covered by the system, they are deductible to the purchasing firm but are treated as part of the value of product of the selling firm. Thus the services of a law firm contracted by a company would be deductible as far as that company was concerned, but the salary paid to the lawyers in question would not be deductible in the law firm's computation of its own tax liability. A similar issue arises in connection with the treatment of interest payments and rents. In both cases what is involved is the use within a firm of "hired" capital, and the question arises of whether to treat the payments to hired capital similarly to those to hired labor, i.e., to count interest and rent payments as part of value added, or whether to treat them similarly to the purchase and sale of goods and services, thus counting rental and interest income as part of the product of the firm and deducting rental and interest payments to other firms. The second of these approaches is clearly to be preferred, for the fact that the services in question are "hired" is not the relevant distinction. The relevant

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1 The above statement is precisely true only for the so-called product type of value-added tax, but in the general principle that a fully general value-added tax is equivalent to a tax on some corresponding macroeconomic total applies also to value-added taxes of the income and consumption types. These are discussed in detail below.
which the government does or does not pay tax to itself, the analogy to a proportional income tax on income generated within the economy is quite close indeed. The consumption type of value-added tax differs from the income type in that instead of allowing the deduction of depreciation on capital assets it simply permits the cost of such assets to be deducted at the time of purchase. The analogy here is with a proportional tax on consumption, or with a retail sales tax on which investment goods acquired by business firms are exempt. This can be easily seen by proceeding from our earlier analysis of a value-added tax on the product type. We saw there that such a tax (with the GATT border tax adjustments) was equivalent to a general tax at a flat rate on all final goods and services acquired by the private sector of the economy. If, starting with such a tax, we exempt those goods acquired for investment purposes, we are naturally left with a tax striking only consumption goods.

The concept of a value-added tax, then, though it may be unfamiliar to many readers, has close analogies, in several variants, to (a) a fully general sales tax on final goods and services (product type), (b) a proportional tax on all income generated in the economy (income type), (c) a proportional tax on all consumption goods sold to consumers in the economy (consumption type). The equivalence is so close that it is difficult to conceive of any strong argument for a general value-added tax of one type or another, which is not equally weighty in favor of its non-value-added counterpart. Thus one rarely if ever hears arguments for substituting a value-added tax for an excise sales or income tax; its advocates instead tend to regard it as a substitute for other taxes, against which its superiority stands out more clearly, or as an additional tax in the system.

THE MAJOR ISSUES

The value-added tax clearly has its strongest appeal, and its firmest base of application, in continental Europe, where it has been in effect in France since 1954, is scheduled to be introduced in West Germany this year, and has been recommended for adoption by all Common Market countries. The reason is, I believe, not hard to find, for the continental European countries have traditionally relied heavily on sales taxes of the turnover type, in contrast to most other advanced economies. The overwhelmingly most important argument in favor of the introduction of value-added taxation on the Continent is that the value-added tax is a much more neutral, much more rational substitute for the prevailing (or previously prevailing) turnover tax system.

Under the turnover system, the farmer pays tax on the value of the wheat, the miller pays tax on the value of the flour, and the baker pays tax on the value of the bread. Thus, in effect, the wheat embodied in the bread is taxed three times, the value added in converting wheat into flour is taxed twice, and the value added in making flour into bread is taxed once. All the above assumes, however, that the farmer, the miller, and the baker are three separate business firms. If the miller and the baker merge, the new firm still only pays tax once on the value of the bread; the tax previously paid by the miller on the value of

\(^{1}\) Sales, and therefore profits, should in principle include goods "sold" by the firm to itself or its owners — e.g., inventory accumulation or withdrawal of part of the firm's product for consumption by owners.

\(^{2}\) Including payments in kind.

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the wheat simply disappears. And if the merged firm were to acquire the farmer’s enterprise, his tax too would disappear, leaving only the tax on the bread.

Not only does turnover taxation give obvious incentives to vertical integration, but since not every firm is in a position to become vertically integrated, the benefits of vertical integration do not accrue to all firms. The benefits of some firms are passed on to others, and the net effect is to increase the inequality of differential taxation of the same product. Moreover, in a world where there are no taxes, a bakery may want to integrate vertically to reduce costs. The tax on the bakery's output may be passed on to the consumer in the form of a higher price. In a world with taxes, a bakery may be forced to integrate vertically to reduce its costs. The tax on the bakery's output may be passed on to the consumer in the form of a higher price. In a world with taxes, a bakery may be forced to integrate vertically to reduce its costs. The tax on the bakery's output may be passed on to the consumer in the form of a higher price.

pay $1.05 for each dollar of cost. Once consumers have fully adjusted their consumption to this regime, the efficiency with which they use their income can no longer be improved by commodity-tax adjustments. Typically, selective excise tax systems do not have nearly the breadth of coverage of the European turnover tax systems, and it is likely that their economic costs are lower as well. On the first ground, self-interested opposition to the taxes is more likely to be confined to a small group of the electorate, and on the second it is harder to arouse strong opposition based simply on concern for public welfare. As a consequence, in spite of these having been considerable academic support and some business support for the substitution of a broad-based, low-rate tax for the selective excises that prevailed in the U.S. for more than a decade, this substitution never took place. When the selective excises were finally nearly eliminated in the tax law of 1964, the move came as part of a package of general tax reductions; no serious consideration was given to their replacement by tax of value-added or similar type.

The strongest organized voice favoring a value-added tax at the present time for the United States is the Committee for Economic Development. Their argument is three-pronged, as indicated in the following quotations:

The immediate consequences of rising military expenditures in Vietnam require taxes to be raised to prevent inflation. We recommend that a value-added tax on business activity be considered as the measure for raising the necessary revenue. As will become clear, this short-run solution to the immediate revenue requirements is a well-directed first step toward our longer-run plans for the structure of our tax system.

It is because of its relevance as part of our longer-run tax structure that we have suggested the value-added tax as the tax to meet our immediate revenue needs. . . . We [therefore] recommend that what is known as the international situation makes it possible for federal revenues to be reduced, the value-added tax kept as a permanent part of our tax structure and that the reduction in revenue should be brought about by corporate income tax reduction.

The corporate profits tax and the value-added tax also would differ in their effects on the balance of payments. Under present rules of the General Agreement on Tariffs and Trade (GATT), direct taxes such as the corporate income tax may neither be rebated on exports nor added to imports (it being assumed that such taxes are not passed on). Indirect taxes, such as the value-added tax, may be rebated on exports and added to imports (it being assumed that indirect taxes are passed on). A partial shift from the corporate tax to the value-added tax would be an advantage in the present international situation.5

5 This assertion must be qualified when distortions other than commodity taxes are present in the system, for then a differential tax or subsidy on specified commodities can work to offset existing distortions. I do not consider this qualification to be of major practical consequence in most cases, but it is conceivable that it might be in some. For further elaboration of this point see Arnold C. Harberger, “Taxation, Resource Allocation, and Welfare” in National Bureau of Economic Research, and The Brookings Institution, The Role of Direct and Indirect Taxes in the Federal Revenue System (Princeton: Princeton University Press, 1964), pp. 25-75, and “The Measurement of Waste,” American Economic Review, May, 1964, pp. 58-76. [This volume, Chapters 2 and 3].
income tax to a value-added tax offers the potential of stimulating exports and discouraging imports, and thus improving our balance-of-payments position.

Let us consider these arguments in turn. First, as an emergency measure to accommodate an unforeseen increase in government expenditures, the value-added tax served as an emergency measure during the Korean War. The selective excises that were imposed as an emergency measure during the Korean War were highly discriminatory, producing a highly unequal distribution of the extra tax burden that they entailed. Moreover, although successive steps of the excise tax legislation provided for the automatic expiration of the selective excises, subsequent steps led to the automatic postponement of their expiration, so that until the ultimate repeal of most of them in 1964, they seemed well on their way to becoming a permanent part of our tax structure. I believe that history demonstrates that there is more to the selective excises than the more worthy elements of the overall structure, the better. The value-added tax wins hands down against the Korean War excises on this criterion.

The disadvantage of the value-added tax as a temporary measure is that it would be an entirely new element in the tax system. The administrative problems of putting it into effect, and of reaching the great numbers of taxpayers that would be involved, seem quite formidable to pay. If the system is in any case not going to last, as strongly as I advocate the adoption of the value-added tax system in the United States, I doubt that I could favor its adoption at all.

If I had, as I believe I would have, a substantial probability of lasting longer, I would readily argue for its adoption to meet an apparently temporary emergency. I would argue for its adoption to meet an apparently temporary emergency. It is the most important point that the tax was once introduced but never maintained, and this is the permanent structure, it would be a natural vehicle for maintaining the into the permanent structure, it would be a natural vehicle for maintaining the revenue requirements of temporary emergencies through changes in rates. In revenue requirements of permanent structures through changes in rates. In this case, the administrative problems of putting the system in motion would be small increases in the rate of tax would dominate.

The second point in the CED case for a value-added tax is the long-run economic argument that a substitution of a value-added tax for part of the corporation income tax would enhance the efficiency of the economy. The corporation income tax is an exceedingly discriminatory tax: it strikes the income from equity capital earned in the corporate sector of the economy, and thus discriminates against the corporate sector generally, while giving firms within that sector an advantage in the corporate sector generally, while giving firms within that sector an tax, and this is the most important point that the tax was once introduced but never maintained, and this is the permanent structure, it would be a natural vehicle for maintaining the into the permanent structure, it would be a natural vehicle for maintaining the revenue requirements of temporary emergencies through changes in rates. In revenue requirements of permanent structures through changes in rates. In this case, the administrative problems of putting the system in motion would be small increases in the rate of tax would dominate.

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* In the CED's words: "The present method of taxing corporate income tends to shield the inefficient and tax the efficient." (p. 27). The value-added tax would not entail this discrimination, but this does not mean that inefficient firms will not lobby forcefully against it.

Thus, though on the grounds of economic efficiency an explicit shift from corporation income to value-added taxation would be highly desirable, such a move is likely to face formidable political opposition.

The third string in the CED’s bow was the balance-of-payments argument, which had even greater currency today than it was in 1966 when the CED report was written. Indeed, there is a considerable impetus towards a balance-of-payments argument in government and business circles in the present. The effect that the U.S. is at a competitive disadvantage vis-a-vis Europe because Europe relies to a considerable extent on direct taxation as we do, and it is therefore able to target more heavily on indirect than on direct taxation, is undeniable. The GATT rules concerning border-tax adjustments, considered on the basis of the larger fraction of the internal value of export products. As much of this larger fraction is in general terms — not explicitly in terms of a trade-off between a domestic tax and the imposition of a value-added tax — I reduction in corporation taxes and the imposition of a value-added tax is not feasible. I shall first deal with the balance-of-payments implications of the introduction of a new value-added tax, and its substitution for a part of the personal income tax, and then turn to the case of a shift between corporation income and value-added taxation.

The reaction of the balance of payments to the introduction of a new value-added tax depends exclusively on the nature of the overall strategy of monetary policy which is pursued in the wake of the change, and on the economy’s reaction to that policy. The ultimate incidence of the tax, as has been indicated, will be broadly proportional across the economy. The question is whether the incidence will be reflected in a structure of costs which is roughly the same as it would be in the absence of the tax, with the tax being reflected in a rise in prices, or at the other extreme whether the structure of prices will be roughly the same as it would have been without the tax, with the tax being reflected in a reduction in the level of costs. In order for the former result to work out, the monetary authorities would have to expand the money supply by more than the normal amount so as to "finance" the consequent rise in prices. If the US. Federal Reserve were to simply provide for the normal secular expansion of the money supply, this would be in the presence of the new tax the definitionary pressure on money supply, and other costs. Now it is a well-known fact that the economy does not wage rates.

I doubt very much that the Federal Reserve authorities would opt for such a course. Maintaining the price level in the face of a 4 percent value-added tax would entail pushing wages and other costs down to a level 4 percent below the actual rate of inflation. We would have no ground to predict that it would do so under the circumstances here being considered. Our best prediction is that the Federal Reserve would as much eschew generating internal cost deflation as we have in general. This leads to the conclusion that the likely result of the imposition of a new value-added tax would be that the general price level would rise by the percentage of the tax, but that our export prices would remain essentially constant owing to the rebate of the tax at the border. Likewise, there would be no incentive to shift away from domestically produced goods and toward imports because imports would be subject to a countervailing surcharge of 4 percent at the border, and their prices would rise in step with those of U.S. products in our own national market. This is the case followed by our monetary authorities, then, the imposition of the new tax is unlikely to have any perceptible effect on our balance of payments.

Where the value-added tax is introduced as a substitute for a part of the personal income tax, more problematical issues arise. In principle, workers should be willing to accept a 4 percent reduction in their money wages (or, what amounts to essentially the same thing, a wage reduction of 4 percent in place of a normal 3 percent increase) in return for a reduction in income taxes of corresponding value to them. If this were the case, domestic prices could remain the same as a consequence of the simultaneous introduction of a value-added tax, and export prices could drop by 4 percent, with a corresponding improvement in our balance-of-payments position. But I doubt that this would happen. In the first place, organized labor is not likely to placidly accept such a trade-off. Perhaps the wage increases would be less than normal if income taxes were simultaneously reduced, but I find it highly implausible that there would be full reflection of income tax reductions in a reduced wage scale. In the second place, a fairly large segment of the labor force pays little or no income taxes. A policy of general wage reductions to reflect the reduction in income tax collections would leave this group clearly worse off, and give rise to a strong center of political opposition to the tax substitution scheme. I conclude, then, that the value-added versus personal income tax substitution might lead to some improvement in our balance-of-payments position, but that our exports are likely to have a significantly smaller price advantage than the percentage rate of the value-added tax.

Finally, I come to the balance of payments effects of a shift to the value-added tax at the expense of a part of the corporation income tax. This tax switch would favor the corporate sector vis-a-vis the noncorporate sector. Noncorporate sector products would tend to rise in price, reflecting the newly-imposed value-added tax, while corporate sector products would tend to fall, because that sector would gain corporate tax relief equal to the full yield of the value-added tax, while it would be called upon to pay only its share of that yield under the value-added tax as such. It is not clear that corporate-sector prices would fall immediately, but the greater profits generated by the tax switch would give an incentive for corporations to expand output, and as output in fact expanded, the price fall would come about.

The substitution of the value-added tax for a part of the corporation income tax accordingly has favorable balance-of-payments consequences, if monetary policy is assumed to be unaffected. As import prices would rise by the full percentage of the value-added tax, consumers would shift some of their demand.
from imported goods to substitute commodities produced by the corporate
sector. On the export side, the prices of corporate-sector products — even
including the value-added tax — would tend to be lower than before, and the
relating of the value-added tax upon exportation would either make their
foreign prices fall still more or else give companies a strong profit incentive to
expand the quantity exported at the same price through sales promotion efforts
in foreign markets.

It is clear, therefore, that of the three alternatives we have explored which do
not entail reductions of wages and other costs, the present one is likely to have
the most favorable balance-of-payments consequences. But one must be careful
not to exaggerate these effects: even in this most favorable set of circumstances,
the balance-of-payments benefits to the United States would be significantly
smaller than those of a devaluation of the same percentage as the value-added
tax. That is to say, a value-added tax of 4 percent cannot yield as great balance-of-
payments effects as a 4 percent devaluation. I am afraid that many of the
proponents of a shift toward indirect taxation as a measure to improve our
balance of payments have greatly exaggerated the likely benefits that would
ensue. It is quite possible, as was indicated earlier, that internal prices would
rise to reflect a new value-added tax; in this case there would be no perceptible
balance-of-payments effects at all. Even in the favorable case just examined
the effects would be small unless the value-added tax carried a rate significantly
higher than 3 or 4 percent. It should also be noted that the higher the rate of
value-added tax, the stronger would be the political opposition, mentioned
earlier, to having its revenue consequences offset by a reduction in the cor-
poration income tax rate.

I come now to what I believe is the most important advantage of a value-
added tax: its potential as an instrument of flexible fiscal policy. Economists have
long been aware of the power of fiscal policy as a means of influencing the
general level of activity in the economy and of averting untoward movements
in the price level. Volumes have been written, and an untold number of speeches
made on this subject, yet precious little has been done. The source of the
difficulty is, I believe, plainly and painfully evident. It is now nearly a year
since the President called for a tax surcharge, and in spite of the pleadings
of Administration officials, the bulk of the economics profession, many enlightened
businessmen, and the Federal Reserve itself, nothing has been done. The last
great fiscal policy move made by the United States — the tax revision of 1964 —
came at the end of nearly two years of Congressional discussion and debate.
With this kind of Congressional delay, even the idea of a flexible fiscal policy
seems utopian.

Obviously, there are many reasons why Congress has been reluctant to accede
rapidly to Presidential requests in the fiscal field. The Constitution places fiscal
powers in Congress's hands, and our legislators have jealously guarded them.
The assessments of Congressmen and Senators of the need for tax changes may
differ within each body, giving rise to extended debate, and the majority view
of Congress may differ from that of the Administration, as may be the case at the
present time. These problems are obviously not going to be resolved by a new
tax gimmick, and it would be foolish to claim so. But I believe that having a
value-added tax in the system would greatly facilitate the flexible use of fiscal
policy, for two reasons.

In the first place, there are many ways of changing the income tax law; thus,
when a proposal is made for a specific set of changes, there usually emerge, in
Congress, groups that feel that a change ought to be made, but of a different
— changing exemption levels rather than rates, making the changes more
progressive or less progressive, etc. Moreover, when an adjustment of the
personal income tax is contemplated, political considerations usually dictate
that a change in the corporation tax rate also be made, giving rise to debate as
to how the benefits of the tax cut should be distributed between corporations
and individuals. Small wonder, then, that when it examines possible income tax
changes, Congress takes a long time! In contrast to this situation, a change in
the value-added tax would in principle only entail varying the rate of tax. The
Pandora's box of alternative possibilities that emerges when the income tax is at
issue is totally avoided, and it is only reasonable to suppose that Congress would
be able to act with much greater dispatch. As a general tax at a low rate, shared
broadly by the whole community, the value-added tax is therefore a prime
candidate as the preferred fiscal instrument for countercyclical manipulation.
Moreover, the insulation from politics provided by its generality and neutrality
makes it again the obvious vehicle for Congress' granting to the President
limited discretionary power to change the rate of tax for countercyclical
purposes.

The second ground for preferring the value-added tax as an instrument of
flexible fiscal policy is the administrative simplicity with which its rate could
be changed. Taxpayers could simply be instructed to change the rate of tax
which they applied to the value added calculated on their tax returns. Espe-
cially if the tax were of the consumption type, thus requiring no depreciation
accounting, it would not be a serious burden on businesses to file, say, quarterly
tax returns, and in this event a decision made within any quarter to change
the rate of tax could already have its effect by the end of that quarter.

From this analysis of the issues involved in a federal tax on value added, I
find no reason to modify the conclusions I drew in an earlier paper on the
subject:

In sum, the value-added tax has considerable merit as a revenue-
raising device. It is admirably suited as an instrument for achieving
emergency increases in tax revenue, and it is also an excellent tool in
framing a flexible and countercyclical fiscal policy. A low-rate tax
on value added, preferably of the consumption type, could therefore
be an important addition to our federal tax system. (Challenge, Nov./
Dec., 1966, p. 46)

THE DESIGN AND ADMINISTRATION OF
A VALUE-ADDED TAX

The first major issue concerning design and administration is whether a
value-added tax should be of the product, income, or consumption type. I feel
that the overwhelming weight of the arguments on this issue favor the con-
sumption type of tax. Under a product type of tax, purchases of materials and
intermediate products are deductible, but investment goods acquisitions are not. Therefore, a distinction must be made between investment goods and other inputs; such a distinction is necessarily arbitrary, and can give rise to litigation and other enforcement difficulties. Also, the "natural" treatment of inventories under a product-type tax is to consider as inputs those materials actually used up in the production process during the tax period, and to treat increments to inventory as investments by the firm. This embroils the tax authority in all the knotty problems of inventory accounting, and places corresponding burdens on the companies in connection with the preparation of their tax declarations.

The income-type tax is even worse. Not only does it require the distinction to be drawn between investment goods and other inputs, but it also requires the depreciation of past investments. The tax authority here becomes involved with all the issues with respect to admissible depreciation rates and patterns that we have become familiar with in connection with the income tax. And as with the product-type tax, the natural treatment of inventories would require inventory accounting to support a firm's tax declarations.

By way of contrast, the consumption-type tax is the model of administrative simplicity. All purchases by a firm from other firms covered by the value-added tax are deductible at the time of acquisition, regardless of whether they are investment goods or direct inputs into production. Since both investment goods and other inputs are deductible, there is no need to distinguish the part of the purchases made during a period that went to increase inventories from the part that fed the production line; hence no inventory accounting is necessary at an underpinning of the tax calculation. Strict cash accounting of all purchases from other firms is all that is necessary. It is this simplicity which makes it reasonable to think of quarterly collections under a consumption type of value-added tax; thus enhancing its usefulness as a countercyclical weapon.

The second issue of design and administration is that of coverage. While a fully general tax has great theoretical appeal, the burdens of administration and compliance can be substantially reduced, with only a minor sacrifice of yield, by exempting farmers and retailers. The exemption of farmers would not reduce the yield, because since farmers would not be in the system, purchases by food processors and other firms from farmers would not need to be treated as allowable deductions by those firms in calculating their own tax liability. In effect, the food processors and other firms buying from farmers would get their farm products more cheaply, but then would be required to pay the tax not only on their own value added but on that of the farmer. A definite loss in revenue would, on the other hand, be involved in the exemption of retailers, but it might be deemed worthwhile in the light of the substantial savings of administrative effort that would be involved. Clearly, if

SELECTED BIBLIOGRAPHY


