

**Eric Hanson 17th Memorial Lecture
Institute for Public Economics
University of Alberta**

THE VAT AS GAME CHANGING TAX POLICY IN THE U.S. AND ALBERTA CONTEXTS

By

Jack M. Mintz
James and Barbara Palmer Chair in Public Policy
School of Public Policy
University of Calgary

September 27, 2011

When I was invited to give this year's Eric J. Hanson memorial lecture, I was very pleased to do so. Back in 1973, I took a graduate course on fiscal federalism from Professor Hanson when I was completing my undergraduate honours degree at the University of Alberta. It was a course that allowed me to delve into Richard Musgrave's work, which provided substantial background on issues such as fiscal transfers and the allocation of taxing powers in a federal state.

So in choosing today's topic on VAT as a game-changing policy for the United States and Alberta, I was mindful of importance of fiscal federalism in North America. In the 21st century, the VAT is a highly important as a source of revenue given that 140 countries now have this form of taxation. The economic principle of allocating taxing powers in a federal state would suggest that commodity taxation is a relatively good taxing power for use by sub-national governments compared to income taxes that apply to mobile capital income. However, the VAT, being a multi-stage tax, is not that simple to operate at the sub-national level although it can be implemented relatively successfully at a regional level as seen with European, Brazilian and Canadian VATs.

Yet, out of the 140 jurisdictions with VATs, two interesting jurisdictions in North America shine in their reluctance to embrace this modern tax that started in France 57 years ago. The first is the United States of America with state and local level retail sales taxes and federal and state/local excise taxes. The other is Alberta, which has no general sales tax but selective excise taxes applied to alcohol, tobacco, pari-mutual betting and fuel. Clearly, commodity taxation is acceptable in these jurisdictions. However, a VAT is not one of them.

As most countries have found, the VAT is one of the most efficient and arguably fair taxes to levy in today's globally integrated world. VATs have been adopted often in face of strong political resistance. In six jurisdictions, including British Columbia, a VAT was introduced and then abolished but, in most cases, eventually returned as a tax.

In tax policy, nothing is certain. In 1900, who would have thought that income taxes would become one of the most significant sources of revenues for governments by 1950? In 1950, who would have predicted that the VAT would become so commonly used? At some point,

there is a tipping point whereby a government must introduce a politically difficult tax reform to respond to various fiscal and economic pressures. In my view, we are getting closer to those tipping points in reluctant jurisdictions such as United States and Alberta although it will still take time.

I shall elaborate upon these arguments by first discussing the economic reasons for the adoption of value-added taxation. I will then turn to United States to examine the case for a VAT that seemingly is impossible to enact. I then review how a VAT in Alberta could enhance its tax advantage.

The economic case for value-added taxation

The popularity of value-added taxation started with the unpopularity of many inferior taxes. With the VAT, a business charges all of its customers tax on sales but claims a refund for tax paid on its inputs. This approach to sales taxation avoids imposing taxes on business costs and leads to a more fair distribution of commodity taxes on goods and services by avoiding the cascading of taxes as products move through the production chain. Taxes on capital goods are also avoided thereby encouraging investment. Exports are typically exempt from VAT and imports are subject to VAT as the tax is levied on domestic consumption.

In France and other European countries, the VAT, with its refund of taxes on business inputs, replaced a turnover tax that resulted in high sales tax rates on some goods due to cascading taxes. New Zealand sharply reduced income taxes by introducing the Goods and Services Tax (GST) to encourage risk-taking, saving and investment. In Australia, the VAT replaced a single-stage wholesale tax and led to some reduction in income taxes. In Canada, the GST replaced the single-stage manufacturers' sales tax and the Harmonized Sales Tax (HST) and Quebec Sales Tax (QST) replaced provincial retail sales taxes, thereby reducing taxes on business intermediate good and capital costs and making companies more competitive in international markets. In some cases, like Ontario, the adoption of the HST also led to personal income tax reductions and corporate tax reform.

VATs also became popular in many developing and less developed economies because they were less subject to fraud and easier to collect compared to other potential taxes. A business charging VAT would want to register to be part of the system if a significant share of its sales is made to other businesses. It is far better to be registered so that other firms obtain refunds of VAT charged on their business inputs. Further, the VAT was an alternative way to collect tax compared to excise and income taxes that distort the economy or are difficult to administer especially in LDCs with large informal economies.

Overall, the case for the adoption of the VAT is based on various economic considerations:

- The VAT is simpler to apply compared to the retail sales tax and single-stage or turnover sales taxes since a vendor charges tax on all sales without having to identify whether the purchaser is a business (who claims a refund) or consumer (who does not). For example, under the retail sales tax, business-to-business purchases are exempt only if a certificate is shown. However, given the potential for abuse, many business-to-business sales under the retail sales tax are subject to tax.
- Given the refund of VAT on business-to-business sales, the VAT results in a fair and efficient levy on goods and services regardless of a consumer's purchasing habits. This is due to the avoidance of cascading taxes which results in some goods being more heavily taxed than others.
- Without being subject to international trade challenges, it is acceptable for a VAT to exempt exports and tax imports as a levy on domestic consumption. The VAT therefore has less impact on competitiveness compared to other sales taxes, including retail sales taxes with significant levies on business costs.

- With the refund mechanism, most VAT on capital goods is eliminated thereby encouraging capital investment and improved productivity by firms.
- As a replacement for income taxes, the VAT leads to less taxation of saving compared to income taxation. Under the income tax, saving is double taxed. Earnings are initially taxed whether consumed or saved. However, saved earnings are taxed a second time since income taxes are levied on investment returns (except in tax-assisted saving plans such as pensions, RRSPs and now Tax-Free Savings Accounts). In principle with a VAT, consumers and savers are equally treated. Given an aging society in many economies, the taxation of saving is an important concern since individuals need to accumulate wealth to support retirement and contingency needs.

Various economic studies have shown that consumption taxes are far better than corporate and personal income taxes in terms of economic costs. In a recent paper by Professor Beverley Dahlby and Ergete Ferede for the C. D. Howe Institute, the highest economic costs associated with federal and provincial taxation rests with the corporate income tax (on average over \$3 for each dollar raised), followed by personal income taxes (about \$2) and then general sales taxes (about \$1.13). Since the VAT eliminates most cascading of taxes by refunding VAT paid on business intermediate and capital goods, it is clearly a superior consumption tax in terms of its economic impact.

No VAT is perfect in terms of efficiency and fairness. Many countries have multiple rates and exemptions resulting in cascading and complexity. It can be difficult to tax some form of consumption under a VAT, especially financial services which are typically exempt. Also, saving tends to be accumulated most by upper-income households so a shift from annual income to consumption taxes is often viewed as unfair. Further, a VAT is applied at a single rate no matter how much a person consumes. Therefore, it is proportional rather than progressive on consumption.

Nonetheless, the VAT is typically made fair by exempting or assessing low rates of tax on necessities or by providing a refundable tax credit to low-income households to offset VAT charged on purchases. The VAT in principle does not apply to saving, except for some financial services, but income and wealth taxes are still possible to collect if it is desired to tax savings to some extent.

VATs have also been criticized as a “money machine” whereby governments find it easier to expand their size with more taxation. While many point to European countries with high tax to GDP ratios, it must be remembered many countries with VATs have relatively small governments such as Japan and Australia. In Canada, the adoption of the VAT at the federal level and provinces has been accompanied with falling tax to GDP ratios since 1991.

For these economic reasons, the VAT has become a critical part of public finances in most countries, with notable North American exceptions being the United States and Alberta.

A VAT for a fiscally challenged United States

At present, the United States has general retail sales taxes operating in 45 states with the highest rate in deficit-plagued California (8.25%). With multiple excise taxes and local sales taxes, the variation in rates across the United States is mind numbing, resulting in high economic and compliance costs for taxpayers. Internet and mail-order sales can be located in tax-free states enabling consumers to avoid paying home sales taxes as no state governments are required to collect sales taxes on goods and services on behalf of other states.

It is well recognized that the sales tax system in the United States is almost a ‘basket case’ with multiple distortions and a lack of enforceability for inter-state sales. With the current fiscal stress in the United States, sales taxes that are roughly 18 percent of total tax revenues are not going to be a reliable source of revenue for state governments in the future.

Since the financial crisis, the United States is currently faced with an annual \$1.4 trillion deficit and climbing debt burdens at all levels of government. With the need to stabilize its net debt to GDP ratio as well as deal with massive unfunded liabilities for social security and health, there is no shortage of experts who have argued for the adoption of a federal VAT in the United States.

Stephen Richardson, Executive Fellow at The School of Public Policy, suggested in his paper for the The School of Public Policy, aptly called “PIIGS R’ US”, (www.policyschool.ca/publications) the following: a 10 percent federal VAT, styled similarly to the Canadian VAT, would annually raise \$500 billion, helping close the fiscal gap. Otherwise, the US will need to raise income taxes (with almost 45 percent of the population currently not owing federal income tax in 2010) or massively cut spending by 30 percent to stabilize their fiscal problem.

Despite all the strong economic arguments made for adopting a VAT in the United States, there is little political constituency to support it. On this fiscal issue, both Republicans and Democrats agree. The Republicans are strongly opposed to a VAT since they view it as “money machine” leading to larger government. The Democrats view the VAT is unfair hitting too heavily those with low or modest incomes.

Other political opposition to a US VAT has come from the state governments who are concerned that the federal VAT would force them to adopt a similar tax at the state level. And the usual political interest groups who have been exempt from state sales taxes would also oppose the VAT.

With current Republican and Tea Party opposition to any tax increases, it is clear that a VAT in the United States will not come anytime soon. Nonetheless, there are good reasons why eventually the US will be boxed into a corner whereby something must be done to deal with its fiscal crisis as well as to encourage economic growth.

Assuming some tax increases will be needed in the future, a VAT appears the best of all difficult choices. It would also be a remarkable shift in the United States towards a more efficient tax system, especially if some of the revenues are used to replace income taxes. One could rely more on income and payroll taxes to close the deficit but with an aging population and slow growing economy, the tax burden to fund public services is better focused on consumption-related levies.

Consumption levies include new or higher excise taxes (such as fuel or carbon) or user fees to pay for public services. Or it could be a VAT that is a broad-based tax garnering large revenues at reasonably low rates. Such revenues can fund public services or reduce income or other taxes that impose high economic costs. Or both could be done.

A US VAT could immeasurably improve states finances as well. The federal government will be in better position to transfer revenues to the many state governments that are currently cutting spending due to balanced-budget requirements. More importantly, in my view, the state governments could opt into a federal VAT system by eliminating their antiquated retail sales taxes. As the Canadian experience has shown, a sub-national government could maintain its retail sales tax with a federal VAT or harmonize its sales tax with federal VAT. If a state elects to adopt a VAT, it would have a more reliable sales tax to fund education and social services.

All in all, the dire fiscal circumstances in the United States may be the eventual tipping point for a federal VAT. In the case of Alberta, another VAT-reluctant jurisdiction, other considerations prevail.

VAT and the Alberta tax advantage

While the US is fiscally in deep trouble, Alberta has substantial resource wealth to fund public resources. The Province does have a deficit at the present time but it currently holds \$14.7 billion in net financial assets forecasted for March 31, 2012 (although this is now only 40 percent of its 2008 level of net assets).

Alberta, though, worries about maintaining its standard living in the coming years. With a relatively small population and a cold climate, Alberta is not a natural draw for businesses to locate in the province except to exploit its non-renewable natural resources.

Historically, the Province has looked for that magic bullet that will diversify the economy since non-renewable resources have a finite life.

Non-renewable revenues are capital revenues in the sense that once a royalty is collected after the extraction of oil, gas or coal the revenue cannot be replaced. Peter Lougheed, Premier of Alberta in the 1970s, understood that it would be important to save royalties to ensure that future generations can enjoy the same level of public services as the current generation once the non-renewable resources are no longer available. However, if the Province were to save more and use less royalty revenue for current spending, it would need to increase taxes or cut spending to achieve more financial saving, a policy recommended by a large number of commissions including one that I chaired.

However, a significant part of Alberta's strategy to grow and diversify the economy has been to maintain a tax advantage with low income taxes and the absence of a sales tax. With resources revenues, now about 25 percent of spending, the Province in the past used its low-tax regime to attract people and employers to reside here.

Alberta, though, does have a tax structure problem.

As I have shown with my colleague Duanjie Chen, Alberta has a "marginal effective tax rate on capital" of 18 percent on non-resource investments that is no different than most of Canada, less than that in the United States and mid-range in the world. Factor in resource investments, Alberta has a slight tax disadvantage compared to most other Canadian and global jurisdictions. It is not that Alberta has excessively high taxes on capital. It is just that it has no advantage.

Where Alberta does have an advantage is with respect to the taxation of labour at least compared to other Canadian provinces. Taking into account income, payroll and sales taxes, the marginal tax rate on labour income, averaged across the working population, is about 6 percentage points less than the rest of Canada.

Alberta is proud that it does not have a sales tax but it is hard to understand the source of the pride. The sales tax is economically better for the province compared to income tax so a shift from income to sales taxation would clearly add to Alberta's tax advantage. For example, I have calculated in the past that an 8 percent HST would enable the province to drop personal and corporate taxes by half from 10 to 5 percent.

In contrast to Alberta, Rick Perry's Texas has no income tax but does have a sales tax. Texas also seems to do a better job in diversifying its economy by attracting hi-tech and non-resource companies to the State. In part, this is due to warm weather, less costly regulation and heavy public expenditures on post-secondary education. However, it is also due to having the lowest income and capital gains tax rate in the United States that attracts entrepreneurs. How much Texan growth is due to its tax policies would require some careful study. However, this contrast between Texas and Alberta hits one between the eyes.

Of course, Alberta need not adopt a VAT similar to the federal GST. It could adopt other types of consumption-based taxes that would enable it to have a significant reduction in income taxes. One example is business value tax, which is an accounts-based value-added tax. Similar to the corporate income tax, a business would pay tax on its revenue net of purchases of goods and services from other businesses. This type of tax is being used in some countries like Italy and Hungary at the sub-national level. The incidence of the tax generally falls on consumers like a sales tax but it appears more like a business tax.

Another proposal for sales taxation in Alberta is to allow municipalities collect the tax on an optional basis to fund infrastructure. One approach would be a retail sales tax at a modest rate but this inefficient tax would require a new administration. Some have argued

for a one percent municipal sales tax piggybacked on the GST base but this is a completely unrealistic proposal. It would be very difficult for a municipal GST to be levied on transactions without increasing substantially compliance and administrative costs associated with the tracking of transactions and invoices. Further, unless the federal government collects and audits the tax, it would be subject to significant tax evasion as businesses would be able to route sales through neighbouring tax-free jurisdictions (similar to the “carousel problem” in Europe). Even if the federal government collected the tax, it would resort to some sort of allocation formula to measure consumption given the small size of municipalities (this approach is used in the three Atlantic Provinces).

Nonetheless, the fact that some politicians are entertaining the idea of a VAT of some form in Alberta is a major shift. The political opposition to a sales tax is rooted in history but it does not mean that historical preferences can never change. Turning points can happen.

Conclusion

The VAT has become one of the world’s most common taxes today. It is economically less costly to raise and superior to other forms of single-stage or multi-stage sales taxes. It is a good alternative to income taxation since the latter falls on mobile capital income that is not easy to tax in today’s world economy.

The United States and Alberta are reluctant states in adopting VATs. In the case of United States, its severe fiscal stress may eventually push the federal government to adopt a VAT. For Alberta, its desire to grow and diversify the economy with its tax advantage is better achieved by a reliance on consumption-based rather than income-based taxation to achieve its economic aims. Both reluctant states may eventually join the rest of the world in adopting some form of VAT. But it will take some time before inevitability hits.