



## What If the U.S. Government Adopts a Value Added Tax?

TAX

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## Agenda

- **Nature of current discussions**
- **Long-term outlook for U.S. Government finances**
- **Approaches to coordinating state sales taxes and a federal VAT**
- **Opportunities, challenges and risks for states in a VAT environment**



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## Recent Musings/Writings

- **Michael Graetz, 100 Million Unnecessary Returns**
  - Tax simplification and rate reduction
- **Len Burman, Blueprint for Tax Relief and Health Reform**
  - Deal with short and long-term budget issues and resources for health care reform
- **Bruce Bartlett, Forbes**
  - Need to fund long-term entitlement spending
- **Robert Altman, Wall Street Journal**
  - Long-term finances



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## Other Musings/Writings

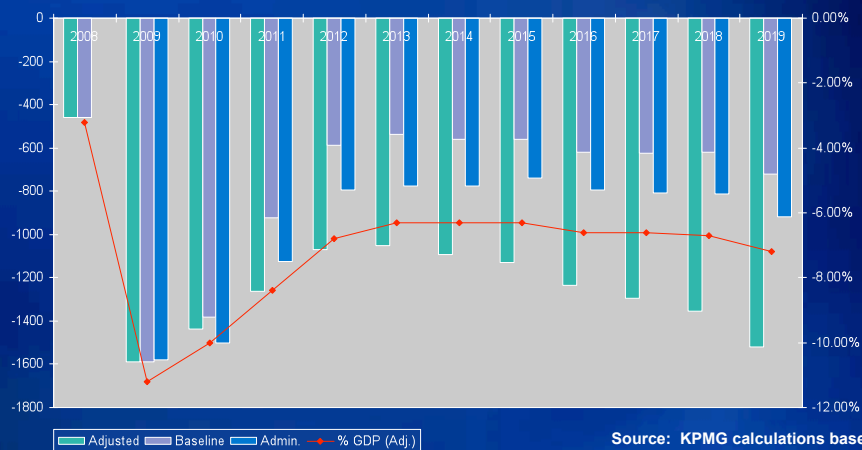
- **ATPI Conference, popular press articles**
- **Not necessarily a new discussion**
  - In 1972, President Nixon requested that ACIR examine issues involved in using a Federal VAT to replace property tax funding of elementary and secondary education
  - Treasury Blueprint for Tax Reform in 1986 had extensive discussion and considerable GAO and JCT work on the issue
- **States have enacted VAT variants**
  - Michigan SBT, Michigan MGRT, Texas Margin Tax and California Net Business Receipts proposal



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## Discussion Driver I – 10-Year Budget Outlook from CBO and OMB



Source: KPMG calculations based on CBO and OMB data..



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## Summary of Near-Term Outlook

- **Baseline forecast**

- Deficit declines to about \$560 billion in 2014 and 2015, but then grows to \$725 billion; deficit runs from 3.2 to 3.4 percent of GDP in later years; \$7 trillion in additional debt over 10 years

- **Administration policy**

- \$700-\$800 billion deficits from FY 2012 forward. Deficit runs about 4 percent of GDP from 2013 forward; \$9 trillion in added debt

- **Adjusted baseline**

- \$1 trillion deficits in each year with accelerating growth; deficit runs about 7 percent of GDP; \$12 trillion in added debt.

- **Debt held by the public**

- Under baseline reaches 60+ percent of GDP; under Administration, it reaches 75 percent of GDP; under alternative baseline, it reaches nearly 90 percent of GDP.



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## Discussion Driver II – Long-Term

- **“Under current law, the federal budget is on an unsustainable path, meaning that federal debt will continue to grow much faster than the economy over the long run.”**

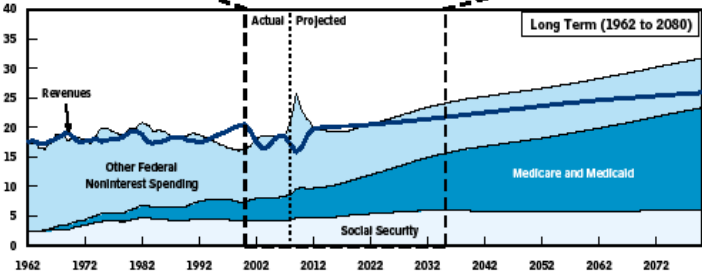
- **Congressional Budget Office**
- **The Long-Term Budget Outlook**
  - **June 2009**



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# Long-Term – Extended Baseline



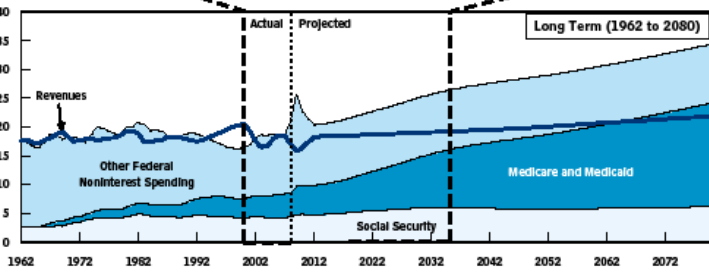
Source: Congressional Budget Office.  
 Notes: Spending in this figure excludes interest payments on the debt; hence, the gap between federal revenues and noninterest spending shown here does not equal the projected surplus or deficit.  
 The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections from 2009 to 2019 and then extending the baseline concept for the rest of the projection period.

Source: Congressional Budget Office



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# Long-Term – Alternative Baseline



Source: Congressional Budget Office.  
 Notes: Spending in this figure excludes interest payments on the debt; hence, the gap between federal revenues and noninterest spending shown here does not equal the projected surplus or deficit.  
 The alternative fiscal scenario deviates from CBO's baseline projections, beginning in 2010, by incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

Source: Congressional Budget Office



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## Long-Term Summary

- **Extended Baseline (Non-interest spending)**

- Primary spending reaches 24 percent of GDP by 2035 and 32 percent by 2080;
- Revenues would reach 20 percent of GDP by 2012, 22 percent by 2035 and 26 percent by 2080
- Debt held by public exceeds GDP by 2050

- **Alternative Scenario (Non-interest spending)**

- Spending exceeds baseline by about 2 percent of GDP
- Revenues would level off at about 22 percent of GDP
- Debt held by the public exceeds GDP by 2030



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## Long-Term Summary – Cont.

- **Fiscal gap is amount that government needs to immediately and permanently increase revenues or reduce expenditures to make the government's debt the same relative to GDP as it is at present**
- **Auerbach and Gale put long-term gap at about 4 - 8 percent of GDP, depending on scenario and timeframe**
- **Even with 'optimistic' CBO baseline, closing gap would require 25 percent reduction in all spending or 56 percent increase in income taxes**



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## State Interests in a Federal VAT

- Potential crowding out in the consumption tax space
- Potential calls to cede policy and administrative control to federal government
- Potential for improving structure and operation of retail sales taxes
- Potential for improving sales tax compliance
- Potential for reducing sales tax compliance burden



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## Policy Shortcomings in RSTs

- Base is primarily tangible goods; limited taxation of services
- Taxation of digital goods and related services is inconsistent and spotty
- Significant number of product exemptions, exempt entities, and use-based exemptions
- Significant taxation of intermediate business inputs [+40 percent of total based on COST Study]
- Significant complexity for multistate sellers



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## Primary RST Compliance Issues

- **Incoming cross-border transactions where seller does not have nexus**
- **Issues with exemptions**
  - Vagueness of some definitions for exempt products
  - Difficulty applying “use-based” exemptions
  - Potential for abuse by exempt purchasers
- **Dual use products**
- **Under-reporting of taxable transactions. RST gives only one shot at capturing tax**
- **Compliance burden – in particular in the case of multi-state businesses**



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## Coordination Issues

- **Achieve destination-based tax in multi-level system with multiple sub-national units and substantial interstate transactions**
- **Complicating Factors**
  - No border controls
  - Not all states have a sales tax or VAT
  - All states unlikely to adopt VAT
  - 9,000 local taxes add exponentially to complexity
  - Limited federal-state cooperative tax administration – primarily income tax data sharing
  - History of sub-national fiscal autonomy



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## Working Assumptions

- **“Normal” credit-invoice VAT unlikely to work in U.S. at the state-local level**
  - Volume of interstate trade makes refund of input VAT on exports problematic and susceptible to fraud
  - Thousands of local taxes make border adjustment impractical
- **Compensating VAT (CVAT) and Virtual Integrated VAT (VIVAT) options call for an infrastructure to redistribute funds to achieve destination basis seems unlikely**
- **Revenue sharing or harmonization approaches seem unlikely to be adopted given autonomy**



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## McLure’s “Integrated Sales Tax”

- **All sales to registered traders regardless of location would be zero-rated – no tax collected**
- **All sales to others would be taxed at a rate of the state’s choosing**
- **Base nearly identical to federal VAT**
- **IST could also apply at the local level if adopted at the state level**
- **State-level administration is maintained**
- **States and localities could maintain a retail sales tax if so desired**



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## Advantages of an IST

- Tax base more closely resembles the ideal consumption tax, presuming same is true with federal base
- Accommodates state and local setting of rates
- May accommodate state-specific exemptions
- Does not require universal adoption
- Mitigates refund fraud exposure
- Reduced compliance burden possible
- Opportunities for coordination with federal government



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## Risks/Challenges for States

- Zero-rated sales to traders present compliance issues
  - No fractional collection; must insure collection on end-stage sale
  - Potential fraud in obtaining and using trader registration
- Remote sales to consumers remain an issue
- Must retain significant control/influence over registration
- Crowding into the consumption tax field
- Concerns about fiscal autonomy/sovereignty



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# Administrative Prerequisites

- **Central or coordinated taxpayer registration**
  - Must be able to match or track from federal to state
  - Critical to identifying and controlling eligibility for exemption or zero-rating
  - Key to subsequent data sharing, real-time B2B data base, refund/debt offsets, enforcement and the like
- **Issues to be resolved**
  - Desire/need for different thresholds, particularly if states maintain RST
  - Revocation/suspension for recalcitrant traders
  - Dealing with related entities
  - Voluntary registration and non-nexus sellers



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# Administrative Prerequisites – Cont.

- **Data base on interstate shipments**
  - Information on origin state, destination state, seller, purchaser, items sold
  - For B2B and (possibly) B2C
- **Used to track cross-border sales, profile risk and enforcement strategies, aid in collection**
- **Some (modest) effect on seller burden – uniform report**
- **Issues to be resolved**
  - Most benefits arise from universal reporting which may require a federal reporting requirement
  - Requires attention to information of limited value to federal tax administration
  - Financing



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## Other Federal Assistance

- **Dealing with remote/distance selling**
  - Overturn Quill based on some level of conformity
  - Possible EU-style distance selling rules
  - Potential disruption/competition with Streamlined
- **Cooperative Enforcement**
  - Work to use information in the interstate data base
  - Cooperative audit selection development
  - Sharing/stratifying audit workload
  - Aggressive information exchange under 6103



## Other Federal Assistance

- **Federal administration of state GST at U.S. border**
- **Mutual set-off of refunds among jurisdictions**
- **Criminalize multistate fraud; active investigation program**
- **Sponsorship/enforcement of the interstate sales data base**



## Main Themes

- **Enactment of a federal VAT will not interfere with most choices for a sub-national consumption tax**
- **States unlikely to conform to federal VAT in short run**
- **Federal VAT may contribute to improved state consumption tax if state adopts VAT or retains status quo**
- **International experience is not dispositive as to the 'best way,' but shows possibilities and issues**
- **There are incentives that may help move to VAT**
- **Coordination needs to be considered at the outset**



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## Conclusion

- **Substantial near and long-term fiscal pressures facing the federal government**
- **May occasion new federal revenue source**
- **Creates significant opportunities and challenges for states**
- **Change will require substantial cooperation with federal government**
- **Substantial issues of sovereignty**
- **Retail sales taxes can continue to exist**



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