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Home

Don't Let Semantics Distort Tax Reform

Real Clear Markets
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The VAT syndrome began bending American minds in 1971, when Richard Nixon briefly considered importing this European tax into the United States. At the Treasury Department, I was tasked with drafting the prototype VAT statute. Forensic examination of the VAT revealed a tricked-up national sales tax with a misleading name. It was rejected by President Nixon and has since had no political viability, although the "VAT" word has clung to life in the related realms of semantics and sophistry.

With topflight young statesmen like Speaker Paul Ryan, Senator Ted Cruz and Senator Marco Rubio taking a lead, the prospects for tax reform in 2017 are bright.

It's not necessary to invent the tax reform wheel. The circa 1998-2005 "Five Easy Pieces" approach to tax reform shows that all the current brand-name tax reform proposals are packages of long-sought, familiar, "regular order" amendments to the current federal income tax arranged and rearranged in different ways.

Those components of income tax reform as originally articulated by the late Jack Kemp and myself are: (a) lowering marginal rates (including capital gains tax rates); (b) eliminating the double tax on corporate earnings; (c) accelerating depreciation, ultimately to the point of 100 percent first-year expensing for business capital investment; (d) expanding the Roth IRA to all personal saving; and (e) excluding export and other foreign trade income of American companies from tax in much the same way that other countries already do in the world marketplace.

Whether enacted in the ordinary course of tax reform or as part of the Cruz, Rubio or Carson proposals, the "Five Easy Pieces" create a high level of tax efficiency, economic growth and bang for the buck.

Senator Cruz proposed a variation on a classic that, according to Tax Foundation data, adds $23 to GDP over a ten-year period for every $1 of dynamically computed ten-year revenue cost. Dr. Carson has adopted another one with a benefit/cost ratio of $8 to $1. Senator Rubio has substantially modified another classic. His proposal has a benefit/cost ration of $8 to $1. All three proposals are imperfect and all are likely subject to change - but all are far better than the current tax code.

The barrier to tax reform is one of communication. In Washington, and especially in the politics and economics of taxation, semantics becomes substance. Misunderstanding quickly morphs into disinformation. For example, although he was careful to say that the Cruz tax plan is not a sales tax, a Tax Foundation analyst innocently strayed off into the semantical minefield and referred to it as a tax on value added. Predictably, the VAT bomb exploded. Facts to the contrary, the Cruz proposal was immediately pilloried in the media as a VAT "form of sales tax" or worse.

The VAT word is strictly a red herring. Neither Senator Cruz nor anyone else is proposing a VAT (crypto or otherwise) - and no one is ever likely to do so. It is time to excise the VAT word from the tax lexicon or at least to stop using it incorrectly. The damage to tax reform can be dire. To 99.9% of people, the term value-added tax and its lingua franca VAT acronym mean a sales tax paid by consumers. And they are right. Using the VAT word to describe a tax reform plan that is not a sales tax misleads the press and the voters. A VAT is so inimical to tax reform that the mere mention of it word has recently scared some of my fellow conservatives nearly out of their wits, to the point of seeing VAT taxes lurking where none exist.

Senator Cruz, Senator Rubio and Dr. Carson propose to tax income from work (expressed as wages and salaries) and income from capital (generally expressed as profits, dividends, interest and gains).

Because the income from work plus the income from capital equals the amount of value added in the economy, each of these income tax reform proposals could be said to tax value added. But, so what? The base of the current federal income tax is also equal to value added. A base equal to value added does not a sales tax make.

The determination of "value added" is a bookkeeping transaction in the European retail sales tax. A tax is "collected" from each upstream company (the miller, the baker, etc.) based on the amount of value it added. However, because of statutory reimbursements and refundable tax credits between businesses, the only "real" taxpayer under the VAT-type sales tax is the retail customer. He is the last one in the chain and receives no reimbursement and no tax credit. Some people have confused themselves into thinking that merely because a tax has a base equal to value added, taxes paid by businesses get passed on to consumers -- but that is not true. In the VAT system, it is the reimbursement and credit system that moves the tax forward, not the tax base. Whether the tax base is value added or net income, it is obvious that businesses can pass forward their tax costs (in the form of a higher price) only to the extent market forces allow.

The term "value-added tax" is relevant to an abstruse provision in the World Trade Organization (WTO) treaty. In 1996 and 2004, the pre-eminent expert Dr. Gary C. Hufbauer and I advanced the thesis (here oversimplified) that a tax similar to the current Cruz and Carson proposals that taxed wage income and capital income at the same flat rate could qualify under the WTO and correctly exclude export sales from U.S. income tax - in the same way that European VATs exclude exports from sales taxes. (In my zeal, I may have helped propagate the horrible "subtraction-method value-added tax" appellation -- and for that I contritely apologize.)

The Cruz proposal pushes the envelope with an exclusion for export income - but that does not mean he has proposed a sales tax; just the opposite. He is apparently trying to break through a WTO barrier and establish that the U.S. does not have to adopt a VAT-type sales tax in order to level the international tax playing field for made-in-America exports.
Tax reformers should focus on creating a high-growth, job-boosting tax code for America -- and leave semantic confusion to others.

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