Chapter Eight
Value-Added Tax

"Thanks for my pocket money Dad. But you forgot to add 17.5% v.a.t."

The Panel developed and analyzed a proposal to adopt a value-added tax (VAT) that would replace a portion of both the individual and corporate income taxes. The VAT is a type of consumption tax that is similar to a retail sales tax but is collected in smaller increments throughout the production process.

The "Partial Replacement VAT" proposal studied by the Panel would combine a VAT and a lower-rate version of the Simplified Income Tax Plan described in Chapter Six. As shown in Table 8.1, a VAT imposed at a 15 percent rate would allow the top individual income tax rate in the Simplified Income Tax Plan to be reduced to 15 percent. The top corporate income tax rate would also be lowered to 15 percent. Both the income tax and VAT rates are presented on a tax-inclusive basis, as is the norm for income tax rates and the way they are presented throughout this report. The tax-exclusive rates would be 17.6 percent. A discussion of the difference between tax-exclusive and tax-inclusive rates is provided in Chapter Nine.

Table 8.1. Proposed Income Tax Rates for Married and Unmarried Taxpayers

Simplified Income Tax Individual Rates - Modified with a VAT		
Tax Rate	Married	Unmarried
5%	Up to $64,000	Up to $32,000
15%	Above $64,000	Above $32,000

Simplified Income Tax Individual Rates		
Tax Rate	Married	Unmarried
15%	Up to $78,000	Up to $39,000
25%	$78,001 - $150,000	$39,001 - $75,000
28%	$150,001 - $200,000	$75,001 - $100,000
33%	$200,001 or more	$100,001 or more

Panel members recognized that lower income tax rates made possible by VAT revenues could create a tax system that is more efficient and could reduce the economic distortions and disincentives created by our income tax. However, the Panel could not reach a consensus on whether to recommend a VAT option.

Some members of the Panel who supported introducing a consumption tax in general expressed concern about the compliance and administrative burdens that would be imposed by operating a VAT without eliminating the income tax or another major tax. Some members were also concerned that introducing a VAT would lead to higher total tax collections over time and facilitate the development of a larger federal government – in other words, that the VAT would be a "money machine." Other Panel members suggested that studies of the international experience and domestic political realities did not support the "money machine" argument. Some argued that adopting a VAT, whether to reduce income taxes or payroll taxes, would make it more likely that higher taxes would be used to solve the nation's long-term fiscal challenges, especially unfunded obligations for the Social Security, Medicare, and Medicaid programs. Others expressed the opposite view and regarded the VAT as a stable and efficient tool that could be used to reduce income taxes, fund entitlement programs, or serve as a possible replacement for payroll taxes. A proposal to use the VAT to replace payroll taxes was beyond the scope of the Panel's mandate, which focused only on income taxes.

Despite the lack of consensus to recommend a VAT option, the Panel views a Partial Replacement VAT as an option worthy of further discussion. This chapter will highlight issues that policymakers would need to consider in evaluating such a proposal. First, the chapter describes modifications to the Simplified Income Tax Plan that would be made possible by the VAT and the resulting distribution of the overall federal income tax and VAT tax burden. The chapter then discusses how businesses would compute their VAT liability and the advantages and disadvantages of a Partial Replacement VAT from a tax policy perspective. Finally, the chapter addresses arguments regarding whether the VAT would facilitate the growth of the federal government.

How it Would Work: Adjustments to the Simplified Income Tax Plan

The Partial Replacement VAT proposal studied by the Panel combined a VAT with a low-rate income tax modeled on the Simplified Income Tax Plan. This VAT would collect about 65 percent of the amount of revenue currently collected by our individual and corporate income taxes. As a result, tax rates under the income tax system could be substantially reduced.

The Simplified Income Tax Plan does not materially alter the current distribution of the federal tax burden. By contrast, a VAT absent other modifications would change the current distribution because the VAT is imposed directly on consumption, and therefore would tax all families equally on each dollar they spend on items subject to the VAT. Households with lower incomes generally spend a larger portion of their income than higher-income households, and therefore the VAT would generally impose a larger tax as a percentage of income on lower-income households. In considering the Partial Replacement VAT, the Panel sought to relieve the additional VAT burden through an appropriate income tax rate and credit structure. The Panel's goal was to maintain a distribution of the overall federal VAT and income tax burden that would be approximately distributionally neutral relative to current law.

In response to the Panel's request, the Treasury Department modified the Family and Work Credits described in Chapter Five to alleviate the additional burden of the VAT on lower-income families. This approach would be more effective than exempting food and other necessities from taxation because it could be targeted to lower and middle-income families alone, rather than all taxpayers.

The base credit amount of the Family Credit would be increased by $1,000 for married couples and $500 for all other taxpayers except dependent taxpayers. The additional Family Credit amount based on the number of children and other dependents would be increased by $500 for each child or other dependent. Like the Family Credit in the Panel's recommended options, this Family Credit would not phase-out; it would be available to all taxpayers.

The Work Credit would also be increased, so that the maximum credit amount in the first year would be: $1,832 for workers with no children, $6,820 for workers with one child, and $9,750 for workers with two children. The Work Credit would increase as the amount of work income increases, be refundable, and phase-out gradually above certain income levels. Further details regarding the modifications to the Family and Work Credits made by the Treasury Department in estimating the Partial Replacement VAT can be found in the Appendix.

Box 8.1. Reducing the Number of Individuals Who Pay Income Tax

If the Family Credit and Work Credit were expanded as described in this chapter, 101.1 million taxpayers would have no income tax liability, 51.1 million more than the 47.4 million taxpayers that would have no income tax liability under the Simplified Income Tax Plan. Some members of the Panel felt that it was inappropriate to increase the number of taxpayers who do not make a direct contribution to the cost of maintaining the federal government through income taxes. Others took the opposite position, commenting that taking additional lower and middle-income taxpayers off the income tax rolls would make the federal tax system simpler. Those taxpayers would continue to pay taxes, at the cash register through the VAT and through payroll taxes.

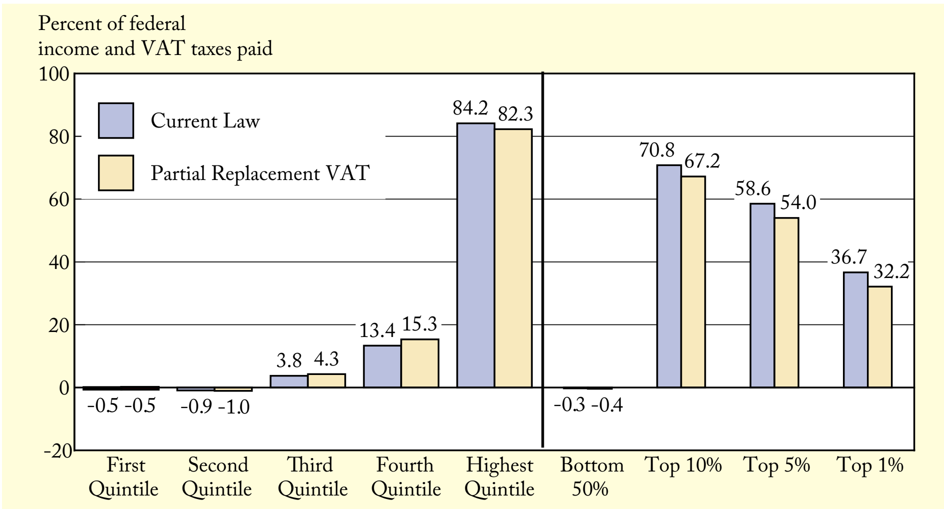
Who Pays the Tax?

As shown in Figures 8.1 through 8.4, the Family and Work Credits as modified by the Treasury Department would ensure that the tax system would be roughly as progressive as current law for families with incomes in the bottom two quintiles of the income distribution. However, for families in the third and fourth quintiles, the modified Work and Family Credits and rate structure presented here do not fully offset the increased burden of the VAT. Families in the highest quintile would bear less of the total tax burden.

The Treasury Department did not develop a modified credit and rate structure that would make the Partial Replacement VAT proposal approximately as progressive as current law. While the Partial Replacement VAT described in this chapter does not entirely alleviate distributional concerns, the Panel believes that with additional work, it would be possible to develop an approximately distributionally neutral tax credit and rate structure. Such a structure might, however, require somewhat higher income tax or VAT rates.

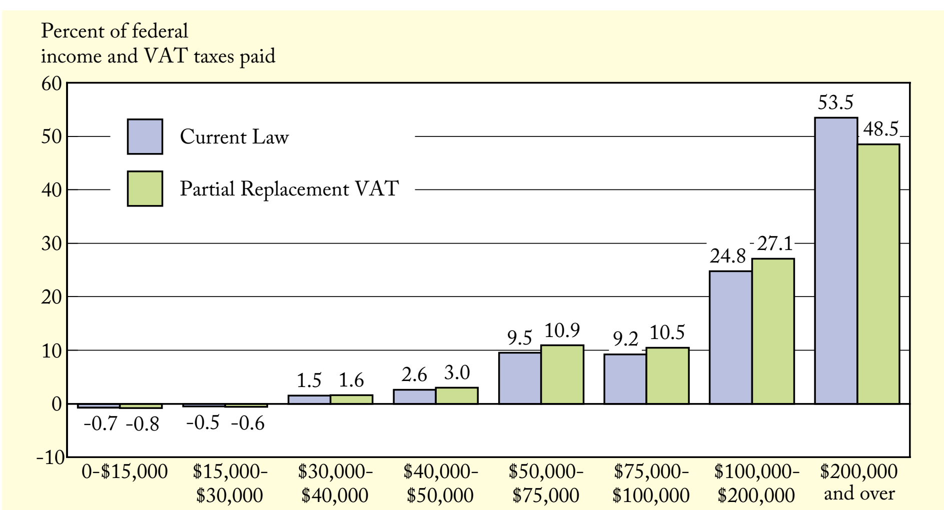
Figures 8.1 and 8.2 show how the distribution of the burden of the individual and corporate income taxes under current law for 2006 would compare to the distribution of the income and VAT taxes under the Partial Replacement VAT proposal.

Figure 8.1. Distribution of Federal Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $48,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907. Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

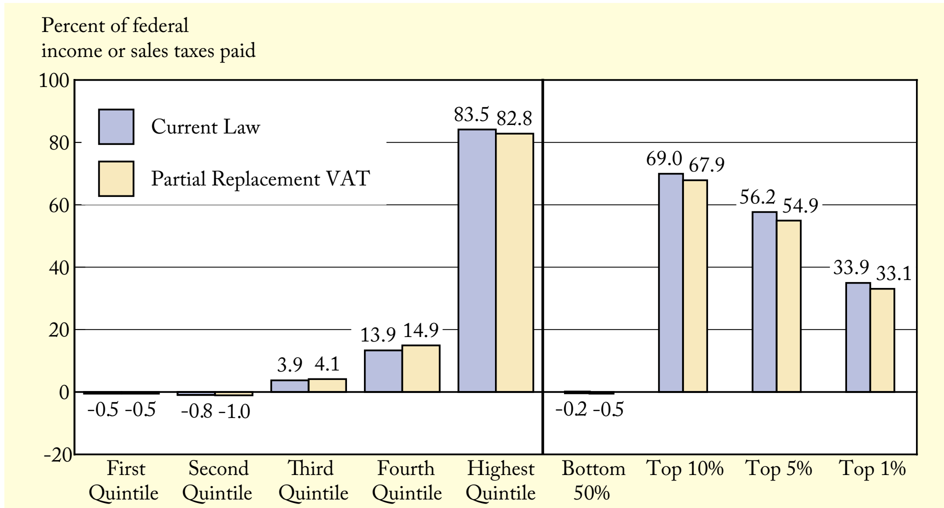
Figure 8.2. Distribution of Federal Income Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

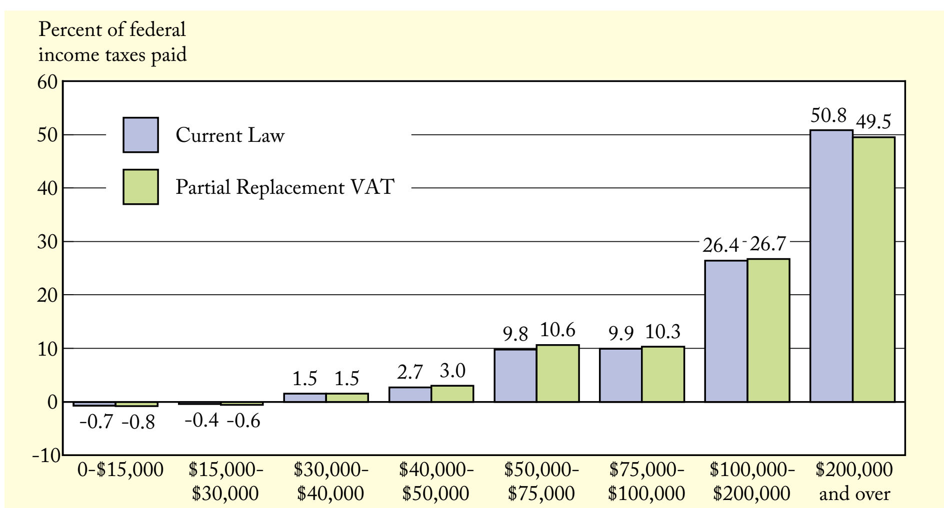
Figures 8.3 and 8.4 provide distributional estimates for 2015, the last year of the budget window.

Figure 8.3. Distribution of Federal Income Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Percentile (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $48,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907. Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 8.4. Distribution of Federal Income Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Level (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

How it Would Work: Implementing the VAT

The VAT can be thought of as a retail sales tax that is collected in stages, instead of all at once from the final consumer. The tax is collected by all entities providing taxable goods and services and is imposed on sales to all purchasers. A business calculates its VAT liability by taking the total value of its taxable sales and multiplying by the VAT rate. The business is then permitted to offset its VAT liability by the amount of VAT paid for its purchases of goods and services. The simple example first provided in Chapter Three provides an easy way to understand the process.

Imagine that a boot maker makes and sells custom-made cowboy boots. He buys leather and other supplies enough for one pair from a leather shop at a cost of $200 before taxes. The boot maker sells each pair of boots he makes for $500 before taxes.

If a 10 percent retail sales tax were in place, the boot maker would add the tax to the cost of the $500 pair of boots, and the consumer would pay $550 per pair. In the meantime, the leather shop would not impose a retail sales tax on its sale to the boot maker because such a business-to-business transaction would not be treated as a retail sale.

Under a VAT, the tax calculation works somewhat differently. The VAT, like a sales tax, is separately stated on invoices or receipts. However, because the VAT is charged on all sales of goods and services, and not just sales to consumers, the leather shop would collect a VAT of 10 percent, or $20 on the $200 of supplies purchased by the boot maker. The boot maker would pay the leather shop $220, and the leather shop would send the $20 to the government. When the boot maker sells the boots, he computes the VAT as $50, and charges the purchaser $550 for the boots.

Instead of sending $50 to the government, the boot maker would subtract the $20 of VAT already paid to the leather shop and remit $30 to the government. The government would receive $50 total — $20 from the leather shop and $30 from the boot maker. The $20 credit that the boot maker applies against his VAT liability is called an "input credit," and the invoice received from the leather shop showing $20 of VAT paid serves as proof that the boot maker can take the credit. The government receives the same revenue under a VAT as it would under a retail sales tax, and from the consumer's perspective the taxes look identical.

Design Assumptions

In studying the proposal, the Panel made certain decisions about the appropriate design for a VAT if it were ever adopted at the federal level.

- The VAT should be imposed on the broadest consumption base consistent with:
    - The structure of our federal system of government, and
    - The need to maintain neutrality between public and private sector provision of goods and services.

- The VAT should use the credit-invoice method.
- The VAT should be border adjusted.
- The VAT should be imposed at a single uniform rate.
- The VAT should be set at a rate that is high enough to raise sufficient revenue to accomplish substantial income tax reform, justify the administrative burden of the VAT on businesses and government, and discourage subsequent rate increases.

Tax Base

The Partial Replacement VAT base considered by the Panel would be broad in order to prevent economic distortions between taxed and non-taxed goods and services. The proposed VAT base would include all domestic consumption except for non-commercial government services, primary and secondary education, existing residential housing, and charitable and religious services. Special rules would apply to financial services and certain other goods and services that are difficult to tax. A more detailed discussion regarding the proposed VAT base and the mechanics of VAT exemptions are provided in the Appendix.

Government Services

Noncommercial services provided by federal, state, or local government would be outside the VAT base. However, commercial activities conducted by the government, such as electricity supplied by a government-owned power plant, would be taxed like any private sector business. The rationale for this treatment is to prevent federal, state, or local government from having an advantage over the private sector in areas where the two might compete to supply similar products. Rules would be necessary to distinguish between commercial and non-commercial government services. Further discussion of these issues appears in the Appendix.

Box 8.2. State and Local Government Services

Taxing the imputed value of noncommercial state and local government services would be technically feasible. New Zealand, for instance, does this by requiring local governments to pay a VAT on the total value of the salaries they disburse to their employees. However, if the federal government assessed a VAT on state and local government services in this way, those governments would need to raise taxes to pay the VAT on their purchases and on the imputed value of their services. The Panel concluded that it may be inappropriate for the federal government to directly assess an excise tax of this sort on state and local governments in the context of our federal system. Instead, state and local governments would pay a VAT on their purchases, but would receive refunds from the federal government for VAT paid.

Border Adjustments

Because the VAT is intended to tax domestic consumption, exports are outside the VAT tax base. However, because the VAT is assessed at every level of production and distribution, a "border adjustment" is necessary to exclude exports from the VAT. These adjustments are made by allowing businesses to claim input credits on exports while exempting their sales from the VAT. All of America's major trading partners remove the VAT from their exports in this way, and the World Trade Organization specifically defines a VAT as border-adjustable tax. Border adjustments are discussed in greater detail in Chapter Seven.

Small Business

Because the compliance costs associated with a VAT may be low overall but require a significant investment for some small businesses, it would be important to consider how to treat such businesses under a VAT. One advantage of the VAT is that it is possible to exempt many small businesses from collecting the tax without significant revenue loss. There are two reasons for this result. First, because the VAT is collected at every stage of production (rather than once at the retail level like a retail sales tax), and many small businesses buy many of their inputs from larger businesses, exempted small businesses would still pay tax on their inputs. As a result, much of the tax on any final good sold by a small business would still be collected. Second, exempted small businesses would be allowed to voluntarily register to collect the VAT. Some exempted businesses that sell primarily to other businesses would choose to collect VAT voluntarily in order for them and their customers to be able to claim input tax credits on their purchases.

The Partial Replacement VAT designed by the Panel would not require businesses with less than $100,000 in taxable annual gross receipts to collect the VAT. The Government Accountability Office estimated in 1993 that a VAT collection threshold at this level would reduce the number of businesses filing VAT returns from about 24 million to about 9 million. They further estimated that approximately 19 percent of small businesses qualifying for the exemption would nonetheless voluntarily collect the VAT. Preliminary estimates for 2003 suggest that only 1.8 percent of gross receipts are collected by businesses with less than $100,000 in annual gross receipts. Thus, a VAT collection threshold at this level likely would not lose significant revenue, particularly when voluntary collection is taken into account. Whether a higher VAT collection threshold would be feasible could be the subject of future study.

Tax Policy Considerations — Advantages and Disadvantages of Adopting a VAT

Economic Growth

A Partial Replacement VAT could achieve many of the advantages of moving to a consumption-based tax system discussed in Chapter Seven. Economic research shows that consumption taxes have a positive effect on economic growth compared with an income tax.

A broad-based VAT applied at a single rate is economically efficient because it generally does not distort consumers' choices among goods and services and does not discourage savings or distort the allocation of capital. Economists agree that a well-designed VAT imposes a lower excess burden than most other taxes for any given amount of revenue raised. Reducing the excess burden of taxation on the economy is an important way that the tax system can encourage economic growth.

The Partial Replacement VAT also would make it possible to substantially reduce income tax rates for all individual and corporate taxpayers. Lower marginal income tax rates on individuals and businesses would strengthen incentives to save, invest, work, and innovate while making our tax system more efficient.

U.S. Competitiveness

Reducing the corporate income tax rate should improve incentives for investment of capital in the United States by both U.S. residents and foreigners. U.S.-based multinational corporations and multinationals based in countries with territorial tax systems would have incentives to shift investment and operations to the United States to take advantage of the lower income tax rates relative to other countries. These incentives would be similar to those discussed in Chapter Seven, although the incentives would not be as strong as those discussed with respect to the Progressive Consumption Tax Plan because an income tax would be retained, albeit at lower rates.

The Partial Replacement VAT also would be compatible with existing bilateral tax agreements with our major trading partners because it would retain a corporate income tax. These agreements facilitate cross-border investment and ensure that U.S. multinationals operating in foreign markets receive tax treatment comparable to the tax treatment of companies based in the country in which the U.S. multinational is operating.

Box 8.3. Border Adjustments and Competitiveness

Border adjustability has been a longstanding priority for many American businesses with substantial export sales. All our major trading partners border adjust their VATs, and exporters of goods and services imported into the United States receive VAT rebates.

American businesses sometimes argue that the lack of border adjustability of the U.S. income tax system puts U.S. exports at a competitive disadvantage in global markets. However, economists generally believe that exchange rate adjustments or other price level changes offset border tax adjustments in the long term and eliminate any advantage or disadvantage border adjustments might otherwise create. Regardless, a border-adjustable VAT that reduces corporate income tax rates could positively affect the competitiveness of U.S. goods and services in the global marketplace. Further discussion of border adjustments and the advantages of destination-based taxes appears in Chapter Seven.

Benefiting from International Administrative Experience

In implementing the VAT, the United States would be able to take advantage of the wealth of worldwide experience in administering and complying with the tax. The VAT has been adopted by every major developed economy except the United States. Thus, the Treasury Department and IRS could study and apply best practices from around the world. Moreover, U.S. multinational corporations already have extensive experience in complying with the VAT, as they currently collect and remit VAT taxes in most countries in which they operate outside the United States.

Compliance and Administration Costs

One significant benefit of the Simplified Income Tax Plan is that it would reduce administration and compliance costs for the government and taxpayers. In contrast, having to collect and pay both VAT and a business income tax might increase total compliance costs for businesses. It would also create an additional set of administrative responsibilities and costs for the IRS.

On the other hand, the Panel heard testimony that taxpayers' compliance costs for the current income tax amount to approximately 13 cents per dollar of tax receipts, whereas compliance costs for European VATs ranges from 3 to 5 cents per dollar of tax receipts. Further, compliance costs per dollar of income tax revenue could fall as a result of reduced incentives for income tax evasion due to the lower income tax rates accompanying the introduction of a VAT. Thus, it is not clear whether the overall compliance and administration cost savings from introducing a Partial Replacement VAT and lowering income tax rates would be larger or smaller than the cost to businesses of complying with the VAT.

Noncompliance

Some evasion is inevitable in any tax system. For 2001, the IRS estimates that the evasion rate for the income tax was between 18 and 20 percent of taxes due. Some analysts suggest that evasion rates for a Partial Replacement VAT could be somewhat lower. One reason is that invoices used to claim input credits under a VAT create a paper trail based on third-party information reporting that facilitates audits and may induce businesses to comply more fully with both the VAT and the corporate income tax. Under the current income tax, compliance rates are highest where there is third-party information reporting or withholding.

Further, business-level tax evasion is often concentrated in smaller businesses, and the VAT exempts many of these businesses from the collection process. To the extent that tax avoidance and evasion are motivated by high income tax rates, lowering income tax rates with a Partial Replacement VAT might also reduce incentives to avoid or evade the remaining income tax.

However, the VAT would not put an end to tax evasion. Evasion in a VAT can range from simple non-filing and non-payment of tax by businesses to complex schemes in which goods pass through a series of transactions designed to generate counterfeit input tax refunds. The Organization for Economic Cooperation and Development (OECD) reports noncompliance rates of 4 percent to 17.5 percent in major developed economies with VAT systems. United Kingdom Revenue and Customs, which employs one of the most sophisticated approaches to estimating VAT evasion, found VAT evasion of 12.9 percent in the U.K. as of April 2004. One should note, however, that the U.K. VAT base is substantially narrower than the Partial Replacement VAT base studied by the Panel and includes more than one VAT rate. VATs are more prone to evasion when they exclude more categories of goods and services and utilize multiple rates. In its revenue estimates, the Treasury Department assumed a noncompliance rate of 15 percent for the VAT.

Coordination of State Sales Taxes and the VAT

Coordinating between states' retail sales taxes and the VAT would be a major challenge. States likely would view a VAT as an intrusion on their traditional sales tax base. Differing federal and state consumption tax bases, with different forms and administrative requirements, would be complex for business. In states that continued to apply their pre-existing sales taxes, the weighted average combined tax-exclusive state and federal tax rate would be approximately 24 percent.

If states were to bring their sales tax bases into conformity with the broad federal base and coordinate their sales tax collection systems with the federal regime, the economic efficiency of state sales taxes would be improved. Compliance burdens for multistate businesses and administrative costs for states could be reduced. Even greater gains in terms of simplicity and lower compliance burdens might be achieved if the states moved to impose state level VATs.

However, the result of a similar harmonization effort in Canada is not encouraging. Canada considered adopting a unified federal and provincial VAT base in 1987, but intergovernmental discussions failed to produce an agreement to standardize the existing provincial sales tax bases with the base for Canada's federal goods and services tax. The United States has many more sales tax jurisdictions than does Canada, and so it is quite likely that the U.S. experience could be fraught with even greater difficulties.

Macroeconomic Effects of Transition

Some observers have worried about potential macroeconomic disruptions associated with moving from an income tax to a VAT. Although there may be some such consequences, those considerations were secondary in the Panel's decision not to recommend the Partial Replacement VAT. Any consequences associated with price level adjustments under a Partial Replacement VAT would be less severe than those under a full replacement retail sales tax or a full replacement VAT, because the tax rate would be lower and therefore any required adjustments would be less extensive.

Political Economy Concerns

The Partial Replacement VAT proposal would add a major new federal tax without eliminating any existing taxes from the federal system. One important factor in the Panel's decision not to recommend the Partial Replacement VAT proposal was several Panel members' concern about how introducing a supplemental VAT might affect the size of the federal government in the medium or long run. These Panel members were concerned that adding a VAT on to the current income tax structure could, over time, lead to growth of federal outlays as a share of GDP — as the tax rate for the Partial Replacement VAT could rise, or corporate and individual income tax rates could return to their present levels. The Panel members who were concerned about this possibility viewed growth in the government's share of the economy as undesirable. Other Panel members were not concerned about this possibility, either because they were more confident that Congress would use the VAT only to offset existing taxes, or because they believed that allowing some growth in tax revenues as a share of GDP would offer a means to finance the growing cost of entitlement programs.

There are relatively few empirical studies on the relationship between the adoption of a VAT and the growth of government spending. None of these studies resolve the fundamental difficulty of determining the direction of causality between the tax structure and the size of government. Simple country comparisons suggest that countries without VATs, like the United States, have a smaller government sector than countries with a VAT. However, more sophisticated statistical studies that control for other factors that may affect the relationship between the size of government and the presence of a VAT yield mixed results. The evidence neither conclusively proves, nor conclusively disproves, the view that supplemental VATs facilitate the growth of government.

Even if the findings were conclusive, studies of VATs in other nations may not provide much guidance on the effect of adopting a VAT in the United States. Most developed countries initially used a VAT to reduce or eliminate other consumption taxes, such as existing sales or excise taxes. The VAT proposal studied by the Panel would replace part of the income tax with a VAT. The United States has no broad-based pre-existing federal consumption tax to replace. Thus, whether adopting a VAT would fuel the growth of U.S. federal spending remains an open question.

Box 8.4. Visibility of the VAT

Some critics of the VAT express concerns about its visibility to taxpayers, because in some countries VAT is included in marked prices and no reference is made to the tax on receipts. However, the Panel assumed the VAT would be separately stated on all sales, so consumers would know the amount of VAT paid with each purchase.

Some members of the Panel suggested that even a separately stated VAT would be less visible to taxpayers than the burden of the income tax. These members pointed out that taxpayers would not know their total VAT liability for any given year unless they kept all their receipts and added together all VAT paid. Others noted that a similar observation could be made about the income tax, which many taxpayers pay over time through withholding from their compensation, and about payroll taxes, where the employer-paid portion is "invisible" to most workers. These members stated that taxpayers are much more likely to know the amount of the refund check they received as a result of excess tax withholding than the amount of their overall tax liability. Others responded that if true, these observations were an argument against tax withholding, not an argument for a Partial Replacement VAT.

Some members of the Panel who opposed a Partial Replacement VAT suggested that once a VAT was enacted, it would never be repealed. International experience suggests that few countries retreat from a VAT, and that VAT rates generally do not decline. These Panel members were unwilling to support the Partial Replacement VAT proposal given the lack of conclusive empirical evidence on the impact of a VAT on the growth of government. Others were more confident that voters could be relied upon to understand the amount of tax being paid through a VAT, in part because the proposal studied by the Panel would require the VAT to be separately stated on each sales receipt provided to consumers. These members of the Panel envisioned that voters would appropriately control growth in the size of the federal government through the electoral process.

Box 8.5. Comparing the Enforcement of a VAT and a Retail Sales Tax

Because the VAT is similar to a retail sales tax, one might ask why the Panel chose to study a VAT rather than a retail sales tax as a partial replacement to the income tax. Although they are similar taxes, there are four principal reasons for concluding that a VAT may be more enforceable than a retail sales tax.

First, VAT taxpayers – especially intermediate producers – have an incentive to demand VAT invoices from suppliers because they are needed to claim the VAT credits that reduce the buyer's VAT liability. The invoices used to claim a tax credit create a paper trail that may induce businesses to comply more fully with the law. Most taxable transactions will appear on two tax returns – the buyer's and the seller's – so that tax authorities will have two opportunities to detect evasion. Further, because sellers provide the tax administration a record of their purchases by claiming input credits, tax administrators are more able to estimate what sales and therefore VAT due should be and thereby can detect evasion more easily in a VAT than in a retail sales tax.

Second, the credit-invoice system eliminates the need for business exemption certificates. Under the credit-invoice system, every taxpayer pays tax on its purchases, and then taxpayers show proof to the government that they are entitled to input tax credits, rather than presenting an exemption certificate to a supplier. As described in Chapter Nine, the business exemption system requires retailers to play an enforcement role and is fraught with evasion opportunities.

Third, under the VAT the amount of tax liability at risk in most transactions is only a fraction of the total tax assessed on the sale of the good or service to a consumer. This is because the VAT is collected in smaller pieces at each stage of production, while the entire retail sales tax is collected on a final consumer sale. The lower effective tax rate on each transaction may reduce the incentive to evade the VAT.

Finally, in contrast to a VAT, the proper administration of a retail sales tax would require all small retailers to collect tax. With a tax collected solely at the retail level, a small business exemption would be unworkable from enforcement, efficiency, and revenue perspectives. Because the compliance costs associated with a retail sales tax or a VAT may be low overall, but significant for small retailers, the need to require small retailers to act as collecting agents in a retail sales tax is a significant disadvantage.

The VAT's advantages over the retail sales tax in minimizing evasion should not be overstated. Because large firms are less likely to cheat, evasion problems in either system are likely concentrated in smaller firms. When those firms are retailers, the incentive to cheat at the margin under the VAT and the retail sales tax is roughly equal, assuming the same tax rate applies.

Further, more transactions are subject to a VAT than to a retail sales tax, creating additional opportunities for evasion. Under a VAT, firms could fabricate invoices to claim input credits, even if such purchases were never made. Claiming excess input credits in a VAT also can produce a tax refund for a business. This temptation does not exist under the retail sales tax.