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Issue Brief: A Non-Labor Value Added Tax

Problem: Two of the most serious and continuing challenges facing the US economy are unemployment (including under-employment and vast 'hidden' unemployment), and federal budget deficits. Lack of jobs yields immense economic and social costs, while large deficits crowd out private investments that could create more jobs.

Solution: New, effective, and mutually reinforcing tax policies that meet this dual challenge.

Current federal tax policy distorts and artificially elevates the price of labor relative to other factors of production. Most notably the 15.3 percent FICA payroll tax (employer and worker each paying half) adds to the cost of employing people; while substantial subsidies to energy and physical capital generate significant price distortions. Additionally, investment and long-run growth are constrained by our reliance on an income-based tax structure versus a consumption-based system. That reliance leads to reduced savings and to an insufficient pool of capital to support the investments required for sustained long-term economic growth and job creation. Our failure to adopt a consumption-based system has led in recent decades to a chronically low, and occasionally negative, savings rate. While the great recession temporarily boosted the US savings rate, it has fallen again.

FAST FACTS

- *US personal savings, down to -0.4% in 2005, climbing to 1.5% in 2007, 3.8% in 2008, to a high of 6.4% in 2010 fell below 4% in 2014. Many Euro-zone countries exceed 10%.*
- *The payroll tax share of federal revenues has grown from about 1/6 in 1960 to more than 1/3 today.*

How Do We Change the Situation?

Reduce taxes on labor, while diversifying our tax structure to incorporate more consumption-based taxes. Such a tax shift would create the conditions necessary for sustained job creation and revenue generation.

A Non-Labor Value Added Tax

A value-added tax (VAT) is a general tax on consumption of materials, energy and labor, collected in stages as goods and services are produced and marketed. Similar to a sales tax, the VAT is regressive.[1] However, if revenues were used to offset even more regressive payroll taxes (a tax shift), the effect would be progressive. Since the early 1950s, a general VAT has been widely adopted in both industrial and developing countries. More than 100 countries, including all members of the Organization for Economic Cooperation and Development (OECD) except the United States use a VAT. While it can be somewhat costly to administer, it is less subject to evasion than sales taxes. Rates in Europe range between 15 and 25 percent

[1] A regressive tax imposes a greater burden (relative to resources) on the poor than on the rich. Progressive taxes attempt to reduce the tax burden on people with a lower ability-to-pay, applying them to those with a higher ability-to-pay.

with exclusions or lower rates applying to expenditures on food, medical care, and certain other goods and services to moderate the regressive impact on low-income families.

An American non-labor VAT would work in much the same way as a VAT except that the wages and salaries of workers in private industry (where the tax applies) would be excluded. In 2010, wages and salaries of workers outside government amounted to nearly $5.2 trillion. Excluding this amount, along with food costs, from the comprehensive base of over $10 trillion, a 10% non-labor VAT would generate $432 billion. A rate of 15% (the low end of the European range) would bring in revenue of more than $648 billion. (*See* tables below.)

Basis of Non-Labor Value Added Tax

Item	2010 ($billion)
US Personal Consumption	$10,273.6
– less food costs	- 795.2
Broad Base for VAT	= 9,478.4
– less labor cost	- 5,161.6
Non-Labor VAT base	**= $ 4,316.8**

Source: Dept. of Commerce, Bureau of Economic Analysis, Tables 2.1 and 2.3.5.

Non-Labor VAT Potential US Revenues*

Low (5%)	Medium (10%)	High (15%)
$216 billion	**$432 billion**	**$648 billion**

*Estimate using a 2010 base of **$4,316.8** billion from the previous table.

By excluding labor from the tax, a non-labor value-added tax would have similar job-creating impacts as reducing the payroll tax – *i.e.*, strengthening the signal sent to employers about changed production-factor prices. The added tax on natural resources (and energy) would encourage conservation with a minimum of distortion between different natural resources. Using VAT revenues to offset payroll taxes would magnify the benefits.[2] A 15% VAT, used to offset PRT, could reduce these distortionary taxes by almost two-thirds.

Among all the factors of production, labor costs (those we should be encouraging most) receive the least beneficial tax treatment. Investment tax credits; rapid amortization (depreciation) of capital costs; low capital gains rates; depletion allowances; and other subsidies to fossil fuels and mined resources all are distortionary. (They also far exceed the relatively limited tax credits for renewable energy.) The result is an economy that favors resource and energy waste and discourages employment and hiring. At a time of record unemployment and global concerns about energy and resource conservation, our tax system is sending precisely the wrong price signals.

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A note on competitiveness. A VAT tax is removed at the border, thus lowering export costs. Countries with a VAT may apply it in-country to imports as a consumption tax. Conversely, current payroll taxes and employer-based health care costs are embedded in the cost of US goods and services, making them more expensive in global competition.

[2] In 2010, U.S government tax revenues were $2.6 trillion, of which payroll taxes (PRT) accounted for 36%, over $900 billion. (*See* Tax Policy Center, http://www.taxpolicycenter.org/briefing-book/background/numbers/revenue.cfm)