

1980

## Replacing the Social Security Tax with a Value-Added Tax: Policy Perspectives

John F. Kelly

Joseph L. Lewis

William J. Irvin

Follow this and additional works at: <http://scholarship.richmond.edu/lawreview>

 Part of the [Tax Law Commons](#)

---

### Recommended Citation

John F. Kelly, Joseph L. Lewis & William J. Irvin, *Replacing the Social Security Tax with a Value-Added Tax: Policy Perspectives*, 15 U. Rich. L. Rev. 39 (1980).

Available at: <http://scholarship.richmond.edu/lawreview/vol15/iss1/3>

This Article is brought to you for free and open access by UR Scholarship Repository. It has been accepted for inclusion in University of Richmond Law Review by an authorized administrator of UR Scholarship Repository. For more information, please contact [scholarshiprepository@richmond.edu](mailto:scholarshiprepository@richmond.edu).

## REPLACING THE SOCIAL SECURITY TAX WITH A VALUE-ADDED TAX: POLICY PERSPECTIVES

*John F. Kelly\**

*Joseph L. Lewis\*\**

*William J. Irvin\*\*\**

On October 22, 1979, Representative Al Ullman (D-Ore.), then Chairman of the House Ways and Means Committee, introduced the Tax Restructuring Act of 1979,<sup>1</sup> which would have lowered the rates of the individual income, corporate income and social security taxes along with certain other tax benefits and would have replaced the lost revenues from such reductions with the revenues from a 10% value-added tax (VAT). The introduction of the bill followed a speech delivered by Sen. Russell B. Long (D-La.), then Chairman of the Senate Finance Committee, at the 1978 Tulane Tax Institute, in which he advocated an overhaul of the tax system similar to the proposals contained in Ullman's bill.<sup>2</sup> Although there was nothing particularly novel in the proposals of Long and Ullman, the mere fact that the two members of Congress with the most influence over tax legislation were advocating a major overhaul of the entire tax system was enough to spark a lively debate on the merits of substituting a value-added tax for part or all of the components making up the present federal tax system in the United States.

After less than a year of enlightened debate on the merits of the bill and of a VAT in general (and in the middle of a re-election campaign in which his opponent was attacking the bill), Ullman

---

\* Partner, Hirschler, Fleischer, Weinberg, Cox & Allen, Richmond, Virginia; B.A., 1951, and LL.B., 1956, University of Richmond; M.L.&T., The College of William and Mary, 1980.

\*\* Partner, Hirschler, Fleischer, Weinberg, Cox & Allen, Richmond, Virginia; B.S., 1961, and J.D., 1964, University of Richmond; M.L.&T., The College of William and Mary, 1980.

\*\*\* Associate, Hirschler, Fleischer, Weinberg, Cox & Allen, Richmond, Virginia; B.S., 1973, University of Virginia; J.D., 1976, University of Richmond; M.L.&T., The College of William and Mary, 1980.

1. H.R. REP. No. 5665, 96th Cong., 1st Sess. 1 (1979).

2. Long, *Remarks Before the Tulane Tax Institute*, 53 TULANE L. REV. 307 (1979).

withdrew his proposal and vowed never to reintroduce it, citing an oft-stated fear that the new tax would allow Congress to raise the total tax burden rather than supplant present tax burdens.<sup>3</sup> Senator Long also waffled, expressing contentment to let the public become educated about the tax and accept it without active prodding from his committee.<sup>4</sup> Ullman's subsequent defeat in his bid for reelection and Long's loss of the chairmanship of the Senate Finance Committee due to the shift to Republican control of the Senate further diminishes the possibility of resurrection of a VAT.

Although the Ullman bill is dead and the VAT concept has been placed on the back burner, it is the intent of this article to summarize arguments for and against such a tax, analyzing it from a standpoint of accepted tax policy, and to suggest where further debate should be focused if the VAT is ever resurrected. This article is not intended to present a scholarly analysis of economic or political consequences of enacting a VAT or resolve the theoretical controversies which have been debated, but merely to place the tax in perspective as it would affect the United States' existing federal tax system.

## I. BACKGROUND AND MECHANICS OF VAT

Apparently, the value-added tax was first proposed in Germany in 1918 to replace the newly established turnover tax (a sales tax which taxed the full sales price at each stage in the production and distribution process, without allowing a credit for tax paid on previous transactions).<sup>5</sup> The idea found its way to the United States in 1921,<sup>6</sup> where it sparked some interest among academicians. In 1940 a VAT bill was introduced in Congress and the VAT concept became the subject of an extensive analysis by the Division of Tax Research in the Treasury Department.<sup>7</sup> The first practical application of the VAT concept came in 1954 when France adopted a

---

3. 10 TAX. NOTES 392 (March 24, 1980).

4. *Id.*

5. *The Treasury Report on the Value-Added Tax*, 8 TAX NOTES 315 (March 19, 1979) (citing Due, *The Value-Added Tax*, 1965 W. ECON. J. 165).

6. *The Treasury Report on the Value-Added Tax*, 8 TAX NOTES 315 (March 19, 1979) [hereinafter cited as *Treasury Report*].

7. *Id.*

value-added tax to replace its manufacturer's sales tax.<sup>8</sup> In 1967 the Common Market countries approved the tax, and as of this writing, twenty-seven countries, most of them in Europe, Central America and South America, have adopted such a tax.<sup>9</sup> Substantial interest in the VAT system has arisen in the United States during the past ten years as a result of its popularity in western Europe. The European countries have found the VAT preferable to the "cumulative cascade turnover taxes" which were commonly used prior to adoption of the VAT system. The cascade tax is a form of sales tax which applies each time a product changes hands in the successive stages of its manufacture and sale; because of its cumulative nature, it results in a tax on a tax.<sup>10</sup>

European governments prefer the VAT to the retail sales tax (which has the same incidence and economic effect) because recalcitrant retailers made collection of the retail sales tax quite difficult.<sup>11</sup> In contrast, the VAT is self-policing since each business entity must report the tax collected on its purchases to insure credit upon resale to its own vendees.

Adoption of a VAT in the United States has been advocated by such groups as the United States Chamber of Commerce, The Committee for Economic Development, and The First National City Bank (New York);<sup>12</sup> one recent President of the United States even advocated its adoption.<sup>13</sup>

Although a detailed description of the mechanics of a value-added tax system is beyond the scope of this article and has been

---

8. *Id.*

9. For a table showing comparative rates of these countries as of 1979, see Tait, *The Value-Added Tax: A Worldwide Problem or Solution?*, 9 TAX NOTES 611 (Nov. 19, 1979).

10. Butler, *The Value-Added Tax: A New \$40 Billion Tax for the United States?*, 50 TEXAS L. REV. 267-71 (1972); American Bar Association, Section of Taxation, *Report of the Special Subcommittee of the Committee on General Tax Problems on the Value-Added Tax*, 24 TAX LAW. 419 (1971).

11. Krauss, *A U.S. Sales Tax Would Be Preferable to a Value-Added Tax*, 10 TAX NOTES 131 (Feb. 4, 1980).

12. *Treasury Report*, *supra* note 6, at 315.

13. Subcommittee of the Special Committee on Value-Added Tax, *Should the United States Adopt the Value-Added Tax?—A Survey of the Policy Considerations and the Data Base*, 26 TAX LAW. 45 (1972) [hereinafter cited as *Policy Considerations*]. President Nixon proposed a VAT in February, 1972 as an alternative to state residential and all local real estate taxes for the support of schools.

adequately covered elsewhere,<sup>14</sup> a general understanding of the mechanics is prerequisite to an assessment of the system from an economic and tax policy standpoint. There are several ways in which the tax base can be computed, but the system adopted by the European Common Market countries appears to be the simplest to compute and was the basis for the Ullman proposal. Under the Common Market value-added taxes,<sup>15</sup> the taxes paid by a business on its purchases (including purchases of capital equipment) are subtracted from the taxes it has collected on its sales and the difference is remitted to the government. Any credit created by more tax having been paid on purchases than collected on sales can either be carried to succeeding months or refunded. Since the ultimate consumer gets no credit for a later sale, the net tax base of the system is the equivalent of a tax on sales to individual consumers, which differs from a retail sales tax only in that the revenues are collected by the government at the earlier stages of production and distribution.

A description of the technical details that would have to be considered if a value-added tax were instituted is unnecessary for the purposes of assessing basic economic and tax policy considerations. Nevertheless, a brief explanation of the workings of the Ullman VAT will contribute to a better understanding of some of the problem areas in a VAT system, which in turn will provide a basis for restructuring the tax before it is proposed again.

#### A. *Ullman's Bill: H.R. 5665*

Focusing only on the value-added tax aspects of The Tax Restructuring Act of 1979,<sup>16</sup> the bill would have imposed a value-ad-

---

14. The Section of Taxation of the American Bar Association established committees and subcommittees to explain and evaluate the value-added tax. For a detailed description of the mechanisms of a VAT, see *Evaluation of an Additive-Method Value-Added Tax for Use in the United States*, 30 TAX LAW. 565 (1977); *Report of the Special Subcommittee of the Committee on General Income Tax Problems on the Value-Added Tax*, 24 TAX LAW. 419 (1971) [hereinafter cited as *General Income Tax Problems*]; *Technical Problems in Designing a Broad-Based Value-Added Tax for the United States*, 28 TAX LAW. 193 (1975).

15. See generally, Carlson, *Value-Added Tax: European Lessons for the United States*, 11 TAX NOTES 811 (Oct. 27, 1980).

16. In addition to the value-added tax provisions, the Tax Restructuring Act of 1979 included the following provisions:

(1) Individual income tax reductions \$50 billion—\$42 billion, reduce taxes by reducing the

ded tax on sales of property and services in the United States at each stage of the production and distribution process (including the retail stage) and on imports.<sup>17</sup> The tax would generally have been 10% of the value of the property or services and the amount of tax would have been itemized separately on each invoice except an invoice to the ultimate consumer, where it would simply have been included in the price of the property or services.<sup>18</sup> Each business in the production and distribution chain would have received a credit for the value-added tax paid by it on purchases of property and services from other businesses.<sup>19</sup>

Instead of the 10% rate, certain items would have been subject to a 5% rate: (1) the retail sale of food and non-alcoholic beverages for human consumption, (2) the sale and rental of residential real property for use by the purchaser or tenant as a principal residence, and (3) medical care and prescription drugs. Additionally, a zero rate would have been imposed on charitable organizations, educational activities of governments and nonprofit institutions, mass transportation, exports, and interest.<sup>20</sup> Even though a zero

---

lowest rate from 14% to 10% and the highest rate from 70% to 50%, and the maximum capital gains rate to 20%; help for lower income taxpayers by expanding the earned income credit, making the credit for elderly refundable and adjusting payments to A.F.D.C. recipients; provide savings incentives by a deferred savings account, to which one could contribute \$1,000 each year and the interest would not be taxed until withdrawn, and a dividend reinvestment plan, by which one could defer tax on up to \$1,500 of dividends in any year if they were invested in a qualified dividend reinvestment plan; increase the maximum deductible contribution to an I.R.A. from \$1,500 to \$2,000, and allow persons covered by pension plans to establish an I.R.A. and make deductible contributions of up to \$1,000 per year.

(2) Business income tax reductions (\$28 billion)—reduce the maximum corporate tax rate from 46% to 36% and lower the existing graduated tax rates from 17, 20, 30, and 40% to 15, 20, 25, and 30%; widen the brackets from \$25,000 to \$40,000; reduce the corporate capital gains rate from 28% to 22%; liberalize the A.D.R. system of depreciation by allowing shorter useful lives without having to elect the rest of the A.D.R. system; provide a full investment credit for an asset with a useful life of five or more years and 60% of the credit for an asset with a useful life of three or four years.

(3) Social security (\$52 billion)—reduce both the employer and employee share of social security taxes to 4.5%, with comparable reductions for the self-employed. H.R. REP. NO. 5665, 96th Cong., 1st Sess. 1 (1979).

17. 125 CONG. REC. H 9,494 (daily ed. Oct. 22, 1979) (remarks of Rep. Ullman).

18. *Id.* at H 9,494-96.

19. *Id.* at H 9,494.

20. Several months prior to withdrawing the bill, Ullman, reacting to criticism, introduced the Tax Restructuring Act of 1980, H.R. REP. NO. 7015, 96th Cong., 2d Sess. 1 (1980), in an attempt to make the VAT more palatable by minimizing regressivity and restricting

rate applies, which in essence means the activity is exempt from the tax, the seller or supplier would still receive credits on purchases.

*B. Example: A Law Firm*

A simple example will illustrate the mechanics of compliance. Assume a medium-sized law firm collects \$1,000,000 from its clients during the second quarter of 1980 for legal services rendered. (It has made an election to file value-added tax returns on a quarterly basis, not monthly, and on a cash basis, not accrual). It also receives \$20,000 from the sale of a tax newsletter prepared by one of its partners regarding ways to take advantage of loopholes in the tax treaty between Germany and the United States, \$5,000 of which comes from United States customers and \$15,000 of which comes from German customers. Of the \$1,000,000 received for legal services, \$50,000 is attributable to a partner's negotiations conducted solely in Germany on behalf of a German corporation, on a deal that did not materialize; another \$75,000 is attributable to handling the acquisition of a Swiss corporation by a United States corporation, and it is reasonably estimated that one-third of the partner's time was spent negotiating in Switzerland and the other two-thirds negotiating, drafting documents, and closing the transaction in the United States. The only other income of the law firm during the second quarter was \$10,000 of interest earned on the "Partners' Buy-Out Fund."

During the same quarter, the law firm paid the following expenses: \$50,000 for the purchase of library acquisitions; \$125,000 in rent; \$80,000 for the purchase of a small computer having book-keeping and word-processing capabilities; \$25,000 for materials and supplies; and \$100,000 in salaries to employees. By the last day of July (the first month following the end of the second calendar quarter), the firm is required to file a value-added tax return and pay tax computed as follows: the value of services rendered

---

government spending to a percentage of the gross national product, originally 22.6%, and then gradually decreasing to and remaining at 20%. Under the new bill, food, shelter, medical expenses and sales to governments would have been exempted from the tax instead of taxed at the reduced 5% rate under the original bill and the revenue generated would have totaled \$115 billion instead of \$130 billion.

which is subject to the tax is \$950,000; the \$50,000 attributable to negotiations in Germany is excluded as an "export" service but the services regarding the Swiss acquisition are included since at least half of the service was performed inside the United States. Also excluded from the base is the \$10,000 in interest and the \$15,000 in revenues from the tax newsletter sold in Germany, but the \$5,000 from sales of the newsletter in the United States is included. Therefore, the firm owes, before credits, 10% of the \$955,000 earned from taxable sales and performance of services. It gets a credit, however, for 10% of all the expenditures listed above with the exception of employee salaries, even though the computer and library books would be considered capital assets for income tax purposes. The total credit, therefore, is \$28,000, leaving a net value-added tax liability of \$67,500.

Note that a business that is expanding or making large acquisitions of capital equipment or other property could build up credits that exceed the tax payable, and could thereby become entitled to a refund of the tax paid or carry over the credits to another period.

With this general understanding of a VAT system and Ullman's bill in particular, attention now can be focused on some of the advantages and disadvantages of such a system.

## II. TAX POLICY CONSIDERATIONS

Adam Smith espoused four criteria for a good tax system which have become generally accepted as dictating our federal tax policy: adequacy, simplicity and ease of compliance and administration, neutrality, and equity or fairness.<sup>21</sup> Using these criteria as guidelines, the United States' present system of federal taxation can be contrasted with a value-added tax.

### A. *Adequacy*

The ability of a tax to raise the amount of revenue necessary for the functioning of government at a desired level of expenditure is perhaps the single most important tax policy consideration, at least in a pragmatic sense. When adequacy is at loggerheads with another desirable objective, such as fairness or ease of administra-

---

21. A. SMITH, *THE WEALTH OF NATIONS* 777 (Mod. Lit. ed. 19\_\_\_).

tion, it is the other objective that is most often compromised.

Considered solely from an adequacy perspective, the value-added tax clearly excels as a potent revenue source. At 1979 levels of consumption a value-added tax would yield perhaps fourteen billion dollars in revenue for each percentage point of tax,<sup>22</sup> although with exemptions and preferential rates the yield could be reduced to nine to ten billion dollars for each percentage point.<sup>23</sup> These are heady figures indeed when it is realized that a VAT of 14% to 21% (which is low for most countries with a VAT) could completely replace the corporate income tax (which raises a total of about 70 billion dollars in revenue) and the social security tax (which raises about 120 billion dollars).<sup>24</sup>

Importantly, the value-added tax is also seen as a politically acceptable method of raising such revenues. Perhaps because it is largely invisible, being lumped with the cost of goods and services, and because it is incurred on a "pay-as-you-go" basis without engendering an account for large accrued liabilities or returns to be filed by the consumer, it is probably the form of taxation most acceptable to the public. The closest thing to the value-added tax in the United States' existing tax structure is the state and local sales tax, which is usually identified in public opinion surveys as the least-hated tax.<sup>25</sup> One study concludes "the real advantage of VAT is that it is the only broad-based indirect tax that stands a chance of enactment by the Congress."<sup>26</sup>

It is this characteristic of the value-added tax that is perhaps most alarming to its opponents. The fear is that a "relatively painless source of revenue would simply be too attractive for the Con-

---

22. *Tax Restructuring Act of 1979: Hearings on H.R. 5665 Before the House Comm. on Ways and Means*, 96th Cong., 1st Sess. 134 (1980) (statement of Charles E. McLure) [hereinafter cited as *Hearings on H.R. 5665*].

23. *Id.* at 24 (statement of Treasury Secretary Miller); *Treasury Secretary Miller on the Value-Added Tax*, 9 TAX NOTES 656 (Nov. 12, 1979) [hereinafter cited as *Miller*].

24. *Id.*

25. Brannon, *Is the Regressivity of the Value-Added Tax an Important Issue?*, 9 TAX NOTES 879, 882 (Dec. 31, 1979) (citing ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, CHANGING PUBLIC ATTITUDES ON GOVERNMENT AND TAXES (1979)). See also Kingson, *Value Added Tax Versus Broader Income Bases: Tax Reform for the Rich or the Not So Rich*, 58 CORNELL L. REV. 340, 346 (1973).

26. *General Income Tax Problems*, *supra* note 14, at 432 (citing Smith, *A Study of Tax Policy and Capital Formation* 24 (prepared for the National Ass'n of Mfrs.)).

gress and President to resist," leading over time to increased rates or reinstatement of the taxes supplanted by the value-added tax, all to finance the expansion of government.<sup>27</sup> Ullman answered this concern with the suggestion that a rider be attached to the enacting bill limiting government spending to a percentage of the gross national product,<sup>28</sup> and Long went so far as to suggest a constitutional amendment having the same result.<sup>29</sup> While anything short of a constitutional amendment may not be acceptable to those with fears of excessive governmental spending, the practical difficulties of getting such an amendment must be considered. On the other hand, if pressures on Congress continue to increase with respect to reducing government spending to control inflation and enable a reduction in taxes, a constitutional amendment may become feasible in the near future. It is possible that the pressures of public opinion would be sufficient without a constitutional amendment to restrain Congress from tampering with the rates or recreating the supplanted taxes without overwhelming justification. Also, in the event of a real national emergency, it would be prudent to have a system on stand-by that could produce large amounts of revenue very quickly. In any event, the likelihood a VAT would not be used to increase the overall tax burden is greater if the VAT completely replaces an existing tax instead of merely reducing several existing taxes, because reinstatement of the eliminated tax would be much more likely to draw attention than a simple upward adjustment in the rates of an existing tax.

To pass the test of adequacy, a tax must not only raise sufficient revenues to finance the programs for which it is earmarked, but must do so without placing too heavy a burden on the taxpayers. A confiscatory tax may have the potential of raising sufficient revenues, but without the support of the people largely responsible for assessing the tax on themselves, it is a complete failure. Perhaps this is where the social security tax is today; if not, then it is rapidly approaching that point. For this and other reasons to be developed in this article, it will be suggested that, if there is merit to a VAT, it lies in the possibility of completely replacing the social

---

27. *Hearings on H.R. 5665, supra* note 22, at 134 (statement of McLure).

28. *See* note 20 *supra*.

29. Long, *supra* note 2, at 311.

security tax, which is not only the weakest tax from a policy standpoint, but also is under fire because of the question of adequacy. Because much of the following discussion will be focused on the social security tax, some background information should add perspective.

One of the earliest principles to be ingrained into the social security system was "pay-as-you-go." The theory was that current contributions should be enough to pay current benefits, with perhaps a year's cushion, and no more.<sup>30</sup> It was easy, from the very beginning of the system, to project increases in the tax rate as the system matured, but Congress was not willing to let its constituents pay a large tax that wasn't absolutely necessary for present benefits.<sup>31</sup> This, coupled with early benefits to individuals far in excess of their contributions, is perhaps responsible for much of the early popularity of the system. In fact, only one major attack on the system was made by a serious presidential contender. In the campaign of 1936, when the Social Security Act was only a year old and the social insurance provisions were not yet operative, Republican candidate Alf M. Landon attacked the law as "unjust, unworkable, stupidly drafted, and wastefully financed." He characterized the saving it forced on workers as "a cruel hoax."<sup>32</sup> Nevertheless, when the Ways and Means Committee rejected a "level premium" rate—a single rate that could maintain the system without ever being increased, estimated in 1949 to be about 6%—in favor of a 1.5% rate with minimal increases over the years necessary to barely keep up with increasing benefits, Robert Ball, later to become Commissioner of Social Security, wrote:

A pay-as-you-go system financed exclusively from payroll contributions makes little sense in an old age retirement program. . . . From the standpoint of persons who spend a working lifetime under the program, it seems somewhat absurd to charge first a combined employer-employee rate of only 1.0 or 1.5 percent and then gradually to increase the rate to perhaps as much as 11 percent. For social insurance just as for private annuities, it is much easier for both workers and employers to pay a more or less level rate over a working

---

30. M. DERTHICK, *POLICYMAKING FOR SOCIAL SECURITY* 237 (1979).

31. *Id.*

32. *Id.* at 185-86.

lifetime.<sup>33</sup>

M. A. Linton, a member of the 1939 Advisory Council, also warned of the difficulties in financing a system where the future burden was already being projected at close to 20%:

We of this generation . . . do not propose to pay out any such proportion of our earnings to provide current benefits under the Social Security Act, but we blithely assume that our children and grandchildren will be able to do so without serious disturbance to the economic life of the country. This whole philosophy needs to be reconsidered.<sup>34</sup>

Nevertheless, the 1% rate that went into effect in 1937, and which was scheduled to rise in steps of 0.5% every three years until it reached 3% in 1949, was not actually increased to 1.5% until 1950, and thereafter it was increased at rates just necessary to maintain the current levels of benefits.<sup>35</sup>

Actually, it was not until after 1972 that troubles began in earnest for the social security system. The non-controversial basic program of cash benefits for the aged was administered routinely, ad hoc benefit increases being enacted as needed. Then came the major expansion—first disability insurance, then medicare, then an enlargement of the underlying program. Beginning in 1973, official annual reports on the system's financial condition showed a projected long-run deficit (over seventy-five years), and the projected deficit kept increasing.<sup>36</sup> The tax rate that was scheduled to be eleven or twelve percent in the twenty-first century was now projected to be 20% or more. To make matters worse, beginning in 1975 the annual reports also showed a short-term deficit, and the forecasts proved accurate. Alarm spread that the system was near "bankruptcy" when expenditures exceeded income by \$1.5 billion in 1975 and \$3.2 billion in 1976.<sup>37</sup>

The rates which were burdensome for many taxpayers in 1973 at

---

33. *Id.* at 240.

34. *Id.* at 235.

35. *Id.* at 215, 245.

36. *Id.* at 381.

37. *Id.* at 382.

5.85% for both employer and employee appear frightening to many at a 7.65% rate, which is scheduled under current law to take effect in 1990 and all later years, with an ever-increasing wage base.<sup>38</sup> This has led to calls for reform from every direction; most are advocating financing part of the program from general revenues and perhaps lessening benefits.<sup>39</sup>

Reasons for the inadequacy of the projected tax rates are several. First, the baby boom generation will begin reaching retirement age about the year 2005, and if the current low fertility rate continues (women have an average of 1.8 children today compared to 2.4 in 1970 and 3.7 in the late 1950's), fewer workers will face this larger retirement population.<sup>40</sup> Further, increasing life expectancy will exacerbate the problem. Also, labor force trends indicate a shortened work life, due in part to later entry into the work force because of longer education and in part to the trend toward earlier retirement (two out of every three workers now elect to retire between the ages of sixty-two and sixty-four with reduced benefits, whereas only one out of ten wait until after age sixty-five to retire; this is to be contrasted to 1960, when half of all men and one-third of all women who retired waited until after age sixty-five).<sup>41</sup> The effect of these demographic changes is that the ratio of workers to beneficiaries will decrease from 3.3 in 1979 to approximately 2.0 in 2030.<sup>42</sup>

Another reason for the inadequacy of the social security tax rate structure is the benefit formula. In 1972 Congress adopted a formula tying benefits to the consumer price index, effective in 1975.<sup>43</sup> The indexed formula did not work properly, however, in the unanticipated periods of high inflation. Where inflation historically had been averaging around 2% a year, in 1974 it rose to

---

38. 42 U.S.C. § 430 (1977).

39. See, e.g., Letter to the Editor, "Fundamental" Social Security Changes Versus "Tinkering," 10 TAX NOTES 467 (Mar. 31, 1980); Aaron, *Social Security: Proposals for Change by the Advisory Council on Social Security*, 10 TAX NOTES 243 (Feb. 25, 1980); Ross, *Social Security Today: The Need for Reform*, 10 TAX NOTES 171 (Feb. 11, 1980).

40. Ross, *Social Security Today: The Need for Reform*, 10 TAX NOTES 171-72 (Feb. 11, 1980).

41. *Id.*

42. *Id.*

43. M. DERTHICK, *supra* note 30, at 384.

12.2%, twice the rate in 1969, and to everyone's surprise price increases exceeded wage increases.<sup>44</sup> In 1977, Congress had to amend the automatic adjustment, leaving it tied to the consumer price index for persons already retired but tying the benefits promised to active workers to increases in the wage base.<sup>45</sup>

From the standpoint of "adequacy", how would a value-added tax be superior to the payroll tax? In terms of its capacity to produce revenues, the VAT is not superior. The actuarial future costs of the social security system are what they are irrespective of the source or sources of financing. Any superiority of the value-added tax over the social security tax on grounds of adequacy is instead rooted in a VAT's acceptability and stability. Whereas the payroll tax has already perhaps reached its saturation point, the 10% value-added tax that would replace it would still have room for acceptable growth.<sup>46</sup> In part, its invisibility is responsible for its acceptability, but for whatever reason, it is a politically feasible tax that can quickly rescue a floundering system. As for stability, the value-added tax would be more slowly affected by sudden changes in price or wage levels, since a substantial lag is generally found between such changes and consumers' habits.<sup>47</sup> Even if this hypothesis is incorrect, the value-added tax is at least as good as and is probably better than the social security tax on grounds of adequacy.

## B. Administration

To conform to sound tax policy, a tax should not be too expensive to collect nor too complex in its application. In its pristine form, the value-added tax is not only simple and easy to administer, it also is largely self-policing and actually encourages compliance through its unique system of credits for taxes previously paid. The credit for taxes paid on purchases is easily calculated from invoices that show the exact amount of the tax, and the added bur-

---

44. *Id.* at 391-93.

45. *Id.* at 392-408.

46. The rate would be well below that in most countries with a value-added tax. See note 9 *supra*.

47. Arthur Andersen & Co., *Perspectives on the Value-Added Tax 9* (1979) (Subject File TA 0820, Item 16).

den of keeping separate totals of taxes paid would be minimal. Since total receipts from sales and performance of services are figures that must be calculated for purposes of income taxation, the only burden added by a VAT would be to segregate exports and exempt products. For firms performing extensive services outside the United States, there might be interpretative problems which require extra bookkeeping (such as determining whether 50% or more of a service is performed inside the United States, as would have been required under Ullman's bill). If rate preferences and exemptions could be kept out of the bill, the cost and complexity of administration would be substantially reduced.

Former Secretary of the Treasury G. William Miller has estimated a value-added tax for the United States would involve from 10 to 15 million taxpayers, depending on the number of exemptions.<sup>48</sup> This would mean at least 30% more returns would be filed with the Internal Revenue Service, assuming quarterly returns are required and no existing tax would be completely replaced. If a simple value-added tax completely replaced either the corporate income tax or the social security tax, it is difficult to see how the cost of administration would be greater after some initial start-up costs. Multiple rates and exemptions could, however, create substantial administrative costs. A 1969 study by the National Economic Development Office of The United Kingdom of the multiple rate value-added tax in European countries found that at a 5% rate the government's cost of administration and compliance would probably approximate 2% of yield, which is significantly more than the 0.5% of yield that it presently costs the United States government to administer the federal tax structure.<sup>49</sup>

Costs of ensuring compliance may be reduced, since the natural pressure on businesses to stay "in the system" to obtain credits for the taxes they have already paid alleviates the underground economy problem. But there are still some ways to evade a VAT. For example, fictitious export documents can be created to generate value-added tax refunds for goods that in fact were never exported. Also, for service companies, the tax paid on purchases may be fairly small so only a small number of taxable transactions need to

---

48. Miller, *supra* note 23, at 655; *Hearings on H.R. 5665, supra* note 23, at 23.

49. *Policy Considerations, supra* note 13, at 71-72.

be reported in order to generate tax collections sufficient to offset credits for the value-added tax paid. After the credits are offset, services can be offered "underground," free of the tax, with no adverse tax consequences to the company but with a competitive advantage gained from the lower prices.<sup>50</sup> Even with these possible schemes of tax evasion, the "underground economy" problem should be only a fraction of the problem existing under an income tax system.

From an administrative standpoint, then, the additional costs of a value-added tax could be negligible if an existing tax is completely replaced, yet the benefits of improved compliance could be substantial both in terms of increased revenues and psychological concepts of fairness among taxpayers. On the other hand, if, as in Ullman's bill, no existing taxes were completely replaced, the additional costs would be substantial and the increased compliance and other benefits would have to be carefully measured to make sure they were not outweighed by such costs.

No current data has been found to indicate the actual costs of administering the social security tax, but if simplicity is any measure, the costs must equal or exceed the costs of administering a value-added tax (particularly one with few exemptions and preferential rates). One major complication under the social security tax has been in determining who is an "employee" subject to the tax and who is an "independent contractor" exempt from it. A controversy has raged between the IRS and taxpayers since the late 1960's, and the issue has been hotly contested and litigated.<sup>51</sup> Ordinarily, there are about 20 "tests" that must be applied to determine if one is a common-law employee for purposes of section 3121 of the Internal Revenue Code,<sup>52</sup> but in some cases, such as with physicians, the twenty tests are ignored and other enumerated tests are imposed.<sup>53</sup> In other cases, the Service has a difficult time making up its mind; it originally established guidelines for making

---

50. *Hearings on H.R. 5665, supra* note 22, at 159-60 (statement of Paul R. McDaniel).

51. S. REP. No. 95-1263, 95th Cong., 2nd Sess. 209 (1978), *reprinted in* Law and Committee Reports, 1978-3 C.B. 507.

52. *Id.*

53. *See, e.g.,* Special Ruling, March 2, 1961, 617 STAND. FED. TAX REP. (CCH) ¶ 6375.

employee designations for real estate sales persons in 1951,<sup>54</sup> issued revised guidelines in 1976,<sup>55</sup> and then revoked the new guidelines in September, 1978, reinstating the 1951 rules.<sup>56</sup> In the Revenue Act of 1978, Congress put a freeze on regulations and rulings on employment status until January 1, 1981 and provided taxpayers with certain "safe haven" tests.<sup>57</sup> It is difficult to recall an area that has generated more confusion and controversy, and it would be unlikely that a value-added tax would rival the complexities of the social security tax.

Taxpayer compliance can also be a problem in the social security tax. One common scheme of tax avoidance is the use of a "Subchapter S" corporation to enable the worker to withdraw funds from the corporation that would ordinarily be withdrawn as salary and thus be subject to the social security tax. Of course, the most pervasive compliance problem involves the cash transactions that are never reported.<sup>58</sup>

### C. *Neutrality*

To conform to sound principles of tax policy, a tax should have no effect on business decisions. If a value-added tax is enacted without exemptions or zero rates, it will achieve a relatively high degree of "neutrality". One writer has praised its neutral treatment of labor-intensive and capital-intensive methods of production, efficient and inefficient companies, partnerships and proprietorships, and equity financing and debt financing.<sup>59</sup> Arguably, a VAT would have no effect on the organization, efficiency of operation or financing arrangements of businesses. If this proved to be the case, business decisions could be made without undue consideration to tax factors which presently distort economic decisions. Under the existing system, tax considerations play a major role in corporate business decisions, particularly in the area of debt financing versus

---

54. *Mim.* 6566, 1951-1 C.B. 108.

55. *Rev. Rul.* 76-136, 1976-1 C.B. 313; *Rev. Rul.* 76-137, 1976-1 C.B. 313.

56. IR-2034, September 8, 1978, 789 *STAND. FED. TAX REP.* (CCH) ¶ 6894; IR-2039, September 27, 1978, 789 *STAND. FED. TAX REP.* (CCH) ¶ 9624.

57. Revenue Act of 1978, Pub. L. No. 95-600, § 530(a)(2).

58. For the most recent I.R.S. underground economy report see 10 *TAX NOTES* 392-93 (Mar. 24, 1980).

59. Smith, *Value-Added Tax: The Case For*, 48 *HARV. BUS. REV.* 77, 79 (1970).

equity financing.<sup>60</sup>

It is true the VAT would be neutral if it were applied in the same manner to all types of businesses and business transactions. For this to occur, the VAT would have to be imposed upon all goods and services at the same rate. There is no single-rate VAT in Europe, and it is questionable whether a single-rate VAT would be enacted by Congress. All the VAT systems in Europe have two or three different rates applying to various types of commodities, and all have various exemptions. Some systems exempt food, others exempt a large variety of services, and favorable treatment is often given to small businesses. Separate rates, differentials, exclusions and discriminations are the norm, rather than the exception.<sup>61</sup> The difficulty in achieving simplicity and neutrality with a mass tax is evidenced by the experience of state governments with the retail sales tax.<sup>62</sup>

If the VAT has exemptions, there must be classifications and definitions of the items entitled to the exemptions. "Does a lower rate for food, for example, apply to such items as chewing gum, soda pop, candy or caviar? Experience with the income tax shows that even medical services and drugs are not easy to define."<sup>63</sup> Exemptions and exclusions would reduce economic efficiency by encouraging people to make expenditure choices that are less heavily taxed.<sup>64</sup>

The suspicion that these problems would occur if the VAT is enacted into law in the United States is probably accurate. One of the complicating aspects of the bill introduced by Ullman was it had a different rate for food, housing and medical care than it did for other goods and services, and it contained a small business exemption.<sup>65</sup> Ullman had even proposed a modification to his bill which would exempt various items. His position was apparently motivated by pressure from the public to modify the structure of

---

60. Brannon, *Is the Regressivity of the Value-Added Tax an Important Issue?*, 9 TAX NOTES 879, 881-82 (Dec. 31, 1979) [hereinafter cited as *Regressivity of the VAT*].

61. *Hearings on H.R. 5665*, *supra* note 50, at 155-56.

62. Kingson, *supra* note 25, at 366, citing Cohen, *Treasury Says European Experience with Value-Added Tax is Favorable*, 35 J. TAX. 316, 317 (1971).

63. *Hearings on H.R. 5665*, *supra* note 23, at 21; Miller, *supra* note 23, at 655.

64. *Hearings on H.R. 5665*, *supra* note 22, at 132.

65. *Id.* at 131.

the VAT to exempt such items as food and medicines. If Congress ever seriously considers the enactment of a VAT, there is no way of predicting how many modifications will be placed on the structure of the tax as pressure from consumer groups and lobbyists continues to mount.

The "neutrality" lost because of exemptions and differences in rates, however, is not the same neutrality that is missing in the present federal tax system. Neutrality that is lost in a VAT system might affect a decision to enter one industry versus another (though such a decision is generally based on skills and proclivities, not tax results), but, unlike the present federal system, decisions within the same industry relating to formation and operation should be free of tax-related considerations.

One VAT opponent admits a value-added tax is neutral, but rejoins that its neutrality emanates not from its fair and evenhanded application, but from its passage down to consumers.<sup>66</sup> But questioning the cause of the neutrality does not render the effects suspect. It can also be argued that a value-added tax is not neutral because it favors an efficient business over an inefficient business, since by keeping its indirect costs low an efficient business can lower its prices but maintain the same profit margin as the less efficient business. By lowering its prices, the efficient business incurs less of a value-added tax liability. It would take warped reasoning, however, to argue that this lack of "neutrality" in rewarding efficiency should be viewed as an objection to the tax.

Although the individual and corporate income taxes do not foster neutrality, the social security tax is generally viewed as neutral, although to some extent that depends on whether one believes the economists who say both the employee's and the employer's shares of social security taxes have the effect of reducing the take-home pay of employees, or the economists who say the employer's share, or some portion thereof, is absorbed by capital in varying degrees depending on the industry, firm and product. To the extent it is absorbed by capital, the payroll tax may affect production and investment decisions.<sup>67</sup>

---

66. Surrey, *Value-Added Tax, The Case Against*, 48 HARV. BUS. REV. 86, 88-89 (1980).

67. *Policy Considerations*, *supra* note 13, at 63.

In contrast, the personal income tax is probably the major distorter of economic decision making. Although in theory it could be neutral, a substantial number of activities get preferential treatment under the Internal Revenue Code.<sup>68</sup> The corporate income tax is also far from being neutral. It gives preferential treatment to many activities, and depending on the strength of the industry and firm, a portion of such tax may either be passed on in higher prices or borne by capital.<sup>69</sup>

In summary, introduction of a value-added tax to the tax system would increase neutrality most where the individual or corporate income taxes was reduced, and perhaps to a lesser degree where the social security tax was replaced.

#### D. *Equity*

The concept of fairness or equity in taxation is grounded in two precepts: first, that a tax system should provide equal treatment of equals ("horizontal" equity); and second, that people differently situated should bear a tax burden in proportion to their ability to pay ("vertical" equity).<sup>70</sup> Stated differently, horizontal equity means persons with equal income should bear approximately the same tax liabilities, and vertical equity means taxes should be levied in accordance with the taxpayer's ability to pay, ability being best measured by the taxpayer's income. Accordingly, it is generally accepted by taxpayers and theoreticians alike that the ideal tax system is built around a progressive income tax; however, this has not always been the case.<sup>71</sup>

In the nation's early history, the tax system was based on consumption taxes—customs duties and excise taxes on tobacco and alcohol. Louis Eisenstein describes the 1894 transition to the income tax system:

---

68. *Id.*

69. Schenk, *The Value-Added Tax as a Replacement for Part of the Corporate Income Tax*, 9 TAX NOTES 767, 769 (Dec. 10, 1979); Savage and Talley, *Value-Added Tax*, Issue Brief No. IB 79120, 4 (Nov. 13, 1979) (Cong. Research Serv., Major Issues System).

70. Boskin, *Consumption Taxation and Saving: A Debate*, 8 TAX NOTES 189, 190 (Feb. 12, 1979) [hereinafter cited as Boskin].

71. R. FREEMAN, *TAX LOOPHOLES: THE LEGEND AND THE REALITY* 6 (1973).

The [Founding] Fathers confidently assumed that for a long time to come the revenues would derive from imports, excises, "and, in general, all duties upon articles of consumption." What they expected they also deemed desirable. Hamilton had nothing but praise for taxes on consumption. "The amount to be contributed by each citizen," he explained to all who might be disturbed, "will in a degree be at his own option, and can be regulated by an attention to his resources. The rich may be extravagant, the poor can be frugal; and private oppression may always be avoided by a judicious selection of objects proper for such impositions." "It is a signal advantage of taxes on articles of consumption, that they contain in their own nature a security against excess." The poor can protect themselves by refusing to buy.

Eventually this fiscal attitude provoked a good deal of unkind criticism. As individual income rises, relatively less is spent and more is saved. Therefore, in terms of income, the taxes of the well-to-do were much lower than the taxes of the not-so-well-to-do. Those who found it difficult to make ends meet were unable to understand why income spent should be taxed while income saved is exempt. The solution proposed was a tax on income, whether it was spent or saved. Many who were dissatisfied came to a more daring conclusion. Laborers in the East and farmers in the West ominously proposed that glaring inequalities in wealth should be reduced by heavier taxes on higher incomes. It was not enough to impose a tax on income as distinguished from consumption. The tax, they argued, should also be progressive; the rates should increase as incomes increase. With malice aforethought they sought to reverse the existing situation, so that the more prosperous would pay a relatively larger tax than the less prosperous. In the language of today, they requested a redistribution of income.<sup>72</sup>

While the present federal tax system is progressive, the state and local systems, *e.g.*, retail sales, property and income taxes, are not progressive. As a whole the tax system in the United States is either proportional to income or slightly progressive, depending on whether stockholders or consumers are viewed as in fact bearing the burden of the tax on corporate income and the employer's portion of the social security tax.<sup>73</sup>

---

72. L. EISENSTEIN, *THE IDEOLOGIES OF TAXATION* 17-18 (1961).

73. J. PECHMAN, *FEDERAL TAX POLICY* 5 (3d ed. 1977).

At least one economist believes both horizontal and vertical equity are best served by a consumption tax rather than an income tax.<sup>74</sup> As for horizontal equity, he argues that under the current tax system two individuals with the same potential lifetime earnings are taxed very differently depending on their choices regarding consumption or savings.<sup>75</sup> A consumption tax, however, would treat these two individuals identically on a lifetime basis and "would yield the same present value of taxes independent of when, over their lifetime, they consumed the present value of their earnings."<sup>76</sup> To the extent that his argument is dependent on the assumption that all individuals will consume the present value of their earnings over their lifetime, it appears flawed.

As for vertical equity, the same economist states that "it is certainly clear that many economists think that consumption is a much better measure of ability to pay than is income."<sup>77</sup> But even if they are wrong and income is the appropriate measure of the ability to pay, he says, "an enormous amount of research in economics reveals that current consumption is a much better measure of the average income over a long period of time (or what economists call permanent income) than is current income."<sup>78</sup> Therefore, he concludes that a tax on consumption upholds the principle of total equity better than a tax on income. The substantial weight of commentary, however, holds that the value-added tax violates the principle of vertical equity because it is regressive.<sup>79</sup>

The most forceful presentation of the effect of the VAT on progressivity is contained in the testimony of Treasury Secretary G. William Miller on November 8, 1979 before the House Ways and Means Committee.<sup>80</sup> He presented a graphic chart illustrating the resulting distribution of tax burdens if the VAT were to completely replace the individual income tax and the employee portion of social security taxes. That chart demonstrates that combined in-

---

74. Boskin, *supra* note 70.

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.*

79. See, e.g., *Hearings on H.R. 5665, supra* note 23 at 21; *Miller, supra* note 23, at 655; *Hearings on H.R. 5665, supra* note 22, at 132-33.

80. *Hearings on H.R. 5665, supra* note 23, at 14; *Miller, supra* note 23, at 651.

dividual income and employee social security taxes are progressive, but a VAT, even if necessities are exempt, is regressive. As a share of income, combined individual income and employee social security taxes are only two percent for families with incomes of less than \$5,000. The percentage increases to 33 percent for families with more than \$100,000 of income. In contrast, under a VAT without exemptions and at a 23.2 percent rate (the rate required to equal the 1978 revenue raised by the individual income and employee social security taxes), the percentage share of income would be 35 percent for families with incomes of less than \$5,000, but only 6 percent for families with more than \$100,000 of income. The chart also demonstrates what would happen should individual income and employee social security be reduced by \$100 billion, retaining the same degree of progressivity for these taxes as under the present structure, and offsetting the revenue loss with a \$100 billion VAT without exemptions. The resulting distribution of tax burdens would be regressive at the lowest income levels and mildly progressive elsewhere. As a share of income, families with less than \$5,000 of income would pay 17 percent in taxes, families with incomes between \$5,000 and \$10,000 would pay 14 percent, and the percentage would then increase through the greater income ranges, so that families with over \$100,000 of income would pay only 21 percent of their incomes in taxes. Secretary Miller concluded that the overall distribution would be "significantly less progressive than the present combination of income and employee social security taxes."<sup>81</sup>

Many commentators believe, however, that a VAT's regressivity can be mitigated to a large extent by using exemptions within the value-added system and credits within the income tax system.<sup>82</sup> The credits would be preferable because exemptions create administrative problems and erode the value-added tax base and its revenue potential. A refundable income tax credit for tax paid on a necessary amount of consumption avoids the administrative problems and can be phased out at increased income levels so that,

---

81. *Hearings on H.R. 5665*, *supra* note 23, at 21; *Miller*, *supra* note 23, at 654.

82. For specific proposals on how to use income tax credits, see Brannon, *The Value-Added Tax Again—and Again*, 7 *TAX NOTES* 691 (Dec. 18, 1978); *Regressivity of the VAT*, *supra* note 60, at 879. See also *Miller*, *supra* note 23, at 654-55; *Hearings on H.R. 5665*, *supra* note 23, at 21.

in effect, middle and upper-income groups would still pay tax on purchases of food and other necessary items.<sup>83</sup> The issue that causes the most emotion and debate is whether a refundable credit would be effective because of the difficulties in passing it through to the roughly 25 million individuals who do not file an income tax return.<sup>84</sup> Experience with credits in the income tax system would indicate that the poor may not be effectively reached,<sup>85</sup> but more persuasive is the argument that with publicity, special outreach programs, and perhaps even adjustments in direct expenditure programs to the poor, the tax credit system within the income tax structure could be effective in eliminating the regressivity of a value-added tax.<sup>86</sup> This has been the experience in Scandinavian countries where broad social benefit programs and adjustments to personal income tax are believed to "more than offset" any element of regressivity in the value-added tax of more than 15%.<sup>87</sup> Senator Long recognized that the means exist to eliminate regressivity in a value-added tax that can be "every bit as progressive as the American people want it to be."<sup>88</sup>

Proponents of a VAT might even defend some regressivity on the ground that the degree of progression in the present individual income tax system cannot be justified in terms of equity. As Roswell Magill observes, the effect of the high degree to which the rate schedule rises increases

the incentives of the taxpayer to find ways of avoiding the full impact of the ordinary rates, and . . . the pressures on Congress to accept provisions in the tax law which mitigate the impact of the high rates in special circumstances where particular groups of taxpayers can plead undue burdens. Lower rates would reduce these pressures on the tax system as well as be more in accord with general notions of relative equity.<sup>89</sup>

---

83. *Hearings on H.R. 5665, supra* note 23, at 21; *Miller, supra* note 23, at 655.

84. *Id.*

85. Murray, *Value-Added Credits: Will They Work?*, 8 *Tax Notes* 139 (Feb. 5, 1979).

86. *Regressivity of the VAT, supra* note 60, at 381-82.

87. Kingson, *supra* note 25, at 366, citing Cohen, *supra* note 62, at 316-17.

88. Long, *supra* note 2, at 312.

89. Magill, *Federal Income Tax Revision 90* (1959) (House Ways and Means Comm., 86th Cong., 1st Sess., *Tax Revision Compendium of Papers on Broadening the Tax Base*).

Some say a VAT actually would increase tax equity by taxing expenditures for consumption in addition to income.

Income represents the worth of what families and their property contribute to the flow of output—the inputs which make goods and services available. Income results from what is done for others, what is *put into* the economy. Is it not inequitable to discriminate against the family that produces more because it provides more for others? Although 'fairness' in taxation will always be debatable, is it not unfair to discriminate the most against those who contribute the largest amounts to the stream of output?

A family's expenditure for consumption represents what it gets from the economy. The goods and services which it *takes out* of the total of production provide the benefits it receives. Some of us enjoy far larger consumption benefits than do others. Tax discrimination among families on the basis of what they get in consumption, it is said, is more equitable than discrimination according to what they contribute to production.<sup>90</sup>

Ullman's claims that the proposed VAT is "virtually without loopholes" and that everyone will pay, including those engaged in the "underground economy,"<sup>91</sup> refer to the principle of horizontal equity—people with equal incomes should bear equal tax burdens.

Whether the proposed VAT would be "virtually without loopholes" or not remains to be seen. With effective lobbying, the oil industry has demonstrated that what some members of Congress consider a loophole, is to others a means of achieving fairness. A type of VAT adopted by Michigan was excessively complicated by concessions made in response to lobbying pressures,<sup>92</sup> and there is no reason to expect that Congress would not respond similarly to such pressures. As recently observed by Senator Harry F. Byrd, Jr. (I-Va.), "Lack of discipline resulting in total fiscal irresponsibility has been the hallmark of the Congress for several decades. Congress has no means to discipline itself except its own restraint—of

---

90. Harriss, *Value-Added Taxation: Thoughts for 1977*, 4 TAX NOTES 4 (May 30, 1977).

91. House Committee on Ways and Means, *Hearing Announcement on the "Tax Restructuring Act of 1979 (H.R. 5665)"* 7 (Oct. 23, 1979) (Committee Print #96-38).

92. Schenk, *The Michigan Single Business Tax: A State Value Added Tax?*, 8 TAX NOTES 411, 412-13 (Apr. 9, 1979).

which there is none."<sup>93</sup>

When determining how VAT would effect equity in the existing federal tax system, the taxes it replaces must be examined. Although the individual income tax is progressive, the payroll income tax is regressive. First, the amount of earnings that is taxed is limited; second, the payroll tax has no exemptions or deductions; third, its rate is constant rather than increasing at higher income levels; and fourth, income from interest, rents, and profits is not subject to the payroll tax at all, and persons in the higher income tax brackets receive most of this kind of income.<sup>94</sup> Four members of the Advisory Council on Social Security took the position that from an overall economic viewpoint, the social security program is not regressive since the lowest-paid worker receives roughly three times as much benefit for his tax dollar as does the highest paid and since many low-paid workers have the tax refunded to them under the earned income credit provision.<sup>95</sup> However, as one member of the Council pointed out, the question is not whether the program as a whole is regressive, but whether the payroll tax as such is regressive, and there can be no question that it is.<sup>96</sup>

It is not enough to say that a value-added tax with income tax credits and rebates would be progressive or at least not as regressive as the social security tax. The truth is that by removing the limits on the wage base and implementing a similar system of credits in the income tax structure as advocated for a value-added tax, the social security tax can be made much less regressive. From a practical standpoint, however, it is unlikely that the payroll tax can be manipulated to increase progressivity; it is simply too firmly entrenched in the tax system in its present form. On the other hand, when replacing it with a brand new tax, the chances for enhancing progressivity in the entire tax system are much greater.

---

93. Letter from Harry F. Byrd, Jr. to the Editor of the N.Y. Times, Mar. 3, 1979, reprinted in *The Richmond News Leader*, Mar. 20, 1980, at 10, col. \_\_\_\_.

94. ADVISORY COUNCIL ON SOCIAL SECURITY, SOCIAL SECURITY FINANCING AND BENEFITS 37 (1979) [hereinafter cited as ADVISORY COUNCIL].

95. *Id.* at 213.

96. *Id.* The regressivity has also been excused by calling the tax an "insurance premium," and, as such, "the least regressive of the insurance premiums in America." M. DERTHICK, *supra* note 30, at 232.

### E. *Conclusion Based on Tax Policy Considerations*

A value-added tax, while not a perfect method of taxation, has the potential to make a significant contribution toward the development of a tax system in line with what is considered good tax policy. Whether this could be achieved as a practical matter in a politically-charged environment is a matter for speculation, but consideration of a tax that has the potential to enhance our overall tax system should not be precluded by skepticism of the political process. A value-added tax, properly structured, could significantly improve the existing federal tax system if the social security tax were eliminated.

## III. OTHER CONSIDERATIONS

Tax policy considerations should not by themselves, however, determine the acceptability of a new type of tax. Any impact the tax might have on elements of the national economy other than the source and amount of revenues should be assessed. The impact of a VAT in such areas as incentives for savings and capital formation, the balance of trade, stability and predictability of revenues, and inflation may well overshadow pure tax policy considerations.

### A. *Savings and Capital Formation*

Taxes on income, both individual and corporate, penalize saving and encourage consumption. The corporate income tax not only reduces incentives to save by taxing earnings, but tends to discourage saving by taking income away from those who are most inclined to save.<sup>97</sup> It is also reasonable to assume that a corporation with more disposable cash as a result of a reduction in corporate income taxes would use some of that cash to expand or update its facilities and equipment. Therefore, substitution of a value-added tax for part of the corporate income tax could have a significant positive effect on capital formation.

Since neither the social security tax nor a value-added tax applies directly to the return from saving, substituting one for the other would be unlikely to affect savings decisions.<sup>98</sup> One commen-

---

97. *Hearings on H.R. 5665, supra note 22, at 131.*

98. *Miller, supra note 23, at 652; Hearings on H.R. 5665, supra note 23, at 15.*

tator points out that income derived from invested capital is exempt under the payroll tax while under a VAT the tax is merely deferred until the income used for saving or capital formation is spent; any minor effect of such a substitution would be short-lived and insignificant.<sup>99</sup>

### B. *Balance of Trade*

Based on the assumption that the corporate tax is borne by investors and not shifted to consumers in the form of higher prices, Treasury Secretary Miller concluded that the trade balance would not improve significantly upon substituting a value-added tax for the corporate income tax.<sup>100</sup> To the extent a corporate tax cut reduces export prices, exports would be aided in the short-term, but it is unlikely the effect would be significant because of the time lag between the corporate tax cut and the export price cut. Additionally, a value-added tax that replaced a corporate income tax would likely create inflationary pressures and cause labor to negotiate compensatory wage increases, which in turn would cause price increases more than offsetting any reductions inspired by corporate tax cuts.<sup>101</sup> If there were an improvement in the balance of trade, it would be because the substitution led to an improved investment climate and a more productive and competitive domestic economy, and thus, enhanced capital formation.<sup>102</sup>

If the social security tax were replaced by a value-added tax, the reduction in the employer portion might be passed along to consumers, at least in part, in lower prices. Secretary Miller therefore concluded that “[a] modest trade balance improvement might result. . . .”<sup>103</sup>

### C. *Stability*

A value-added tax is generally expected to produce more stable flows of revenue than income taxes, which are dependent on over-

---

99. *Hearings on H.R. 5665, supra note 22, at 131.*

100. *Miller, supra note 23, at 653; Hearings on H.R. 5665, supra note 23, at 16.*

101. *Schenk, The Value-Added Tax as a Replacement for Part of the Corporate Income Tax, 9 TAX NOTES 767, 770 (Dec. 10, 1979).*

102. *Id. at 771; Miller, supra note 23, at 653; Hearings on H.R. 5665, supra note 23, at 16.*

103. *Hearings on H.R. 5665, supra note 23, at 16; Miller, supra note 23, at 653.*

all economic swings. This stability is not absolute, however, for value-added tax revenues from consumer purchases of luxury items would still be influenced by a country's economic stability.<sup>104</sup> In any event, a more stable flow of revenue would enable the government to more accurately forecast its budget and plan its cash expenditures, and might result in a savings on interest costs on temporary borrowings.

#### D. *Inflation*

It is generally accepted that a value-added tax by itself would cause a one-time increase in the price level, with a possible ripple effect due to adjustments in wage contracts, social security payments, and other indexed items over time.<sup>105</sup> This price increase would be offset by the amount of any price reductions passed on to consumers because of a decrease in the corporate income tax or the employer's portion of the social security tax.

Other forces might be triggered which would have an effect on inflation. For example, some price increases caused by a value-added tax would undoubtedly run into consumer price resistance and be self-regulated by the mechanism of supply and demand. Additionally, if the value-added tax revenues are used by the government to balance the budget in lieu of deficit spending, they could have a salutary effect on the rate of inflation.

The expected impact of a value-added tax on inflation, according to Professor Smith, "gives it a false and unreal contrast to income taxes."<sup>106</sup> If there is an income tax increase, real incomes are reduced and there is less to spend privately even though prices may not rise. The net effect of a tax which raises revenue through price increases is the same as a tax which reduces income directly since they both reduce real disposable incomes.<sup>107</sup> Professor Smith would prefer the tax be itemized on retail sales and not included in the cost-of-living index.<sup>108</sup>

---

104. *Hearings on H.R. 5665, supra* note 22, at 142-43 (statement of Richard A. Hoefs).

105. *See, e.g., Miller, supra* note 23, at 652; *Hearings on H.R. 5665, supra* note 23, at 15-16.

106. *Hearings on H.R. 5665, supra* note 22, at 96 (statement of Dan T. Smith).

107. *Hearings on H.R. 5665, supra* note 22, at 140 (statement of Richard A. Hoefs).

108. *Hearings on H.R. 5665, supra* note 22, at 96 (statement of Dan T. Smith).

### E. *Miscellaneous Disadvantages*

Opponents of a value-added tax claim that since it is a tax on consumption, it would fall relatively more heavily on the aged. They point out this is particularly unfair since the aged have paid substantial amounts of payroll taxes during their working lives.<sup>109</sup> However, social security payments are automatically indexed to the consumer price index, so even if the social security tax is replaced by a value-added tax, which causes prices to rise, there should be no detrimental effect on the aged.<sup>110</sup>

Another objection raised by opponents is that the forty-five states (not including the District of Columbia) which impose general sales taxes would object to federal encroachment into a tax arena previously held exclusively by states.<sup>111</sup> A value-added tax might make it more difficult for them to raise their sales taxes. This argument was rejected by Secretary Miller on two grounds: (1) all levels of government impose certain taxes, such as income taxes; and (2) total federal, state, and local sales tax collections are lower in the United States than in most developed countries.<sup>112</sup>

Another reason to consider replacing the social security tax with a VAT is the effect of the social security tax on the poor. Not only is the social security tax regressive, but when it reduces the take-home pay of a person near the poverty level, the gap is narrowed between the lowest paying jobs and welfare and unemployment compensation. It can thus be said to discourage unskilled persons from seeking employment, thereby contributing to unemployment. In addition, when viewed as part of a tax structure that includes the investment tax credit, the social security tax contributes 12.26 percentage points to a 22.26 percent bias against workers at the lower end of the pay scale whose jobs are most easily automated.<sup>113</sup> On the other hand, by taxing consumption more than saving, a value-added tax "would encourage capital formation and thereby contribute to economic growth—the only method ever demon-

---

109. *Hearings on H.R. 5665, supra note 23, at 16; Miller, supra note 23, at 653; McLure, note 110 infra.*

110. McLure, *Thoughts on a Value-Added Tax*, 9 TAX NOTES 539, 542 (Oct. 22, 1979).

111. *Miller, supra note 23, at 655; Hearings on H.R. 5665, supra note 23, at 23.*

112. *Id.*

113. Nasuti, *The Value-Added Tax and the Poor*, 9 TAX NOTES 383, 384 (Sept. 17, 1979).

strated to be both efficient and effective in reducing poverty."<sup>114</sup>

#### IV. ONE OBSTACLE TO SUBSTITUTING A VAT FOR THE SOCIAL SECURITY TAX

Thus far, the scorecard is marked decidedly in favor of giving serious consideration to the replacement of the entire social security tax with a progressively structured value-added tax. Yet the 1979 Advisory Council on Social Security considered such a proposal and unanimously rejected it.<sup>115</sup> An analysis of the Council's reasoning indicates most of its arguments have been dealt with in this article and should not present insurmountable obstacles—the aggravation of inflation, federal intrusion into a revenue source customarily reserved for states and localities, and regressivity. However, one reason advanced by the Council warrants further analysis:

[A]s compared to the value-added tax [the payroll tax] has some important advantages. The payroll tax is levied on the same base used to compute social security cash benefits and thus helps sustain the principle that social security benefits are an earned right. Because the payroll tax is a tax on the earnings that determine the amount of a person's benefits, it has a compelling logic that the value-added tax does not have.<sup>116</sup>

This creation of the appearance of an earned right can be traced to the genesis of the social security tax. Enacted by Congress in 1935 as part of President Roosevelt's New Deal, a payroll tax of 1% each for employer and employee was to be collected beginning in 1937 to finance monthly benefits to retired workers starting in 1942.<sup>117</sup> Originally, there was to have been a direct relationship between benefits and total tax payments,<sup>118</sup> but before the payment of monthly benefits actually began, this relationship was weakened by changes enacted in 1939.<sup>119</sup> Payments were to be based on aver-

---

114. *Id.*

115. ADVISORY COUNCIL, *supra* note 94, at 41-42.

116. *Id.* at 41.

117. M. DERTHICK, *supra* note 30, at 213-15.

118. *Id.* at 214.

119. *Id.*

age monthly wages instead of the total amount of wages, dependents of the beneficiary were made eligible, and the progressivity of the benefit formula was increased. Another round of amendments weakened the relationship even further in 1950,<sup>120</sup> when current beneficiaries received increases to compensate for increases in the cost of living, independently of their tax payments. In addition, 10 million new workers, including many self-employed and farm and domestic workers, were brought into the system and were made eligible for benefits after a covered employment period of only six calendar quarters.<sup>121</sup> Through the years liberalized programs, including the addition of disability benefits and old-age health insurance, further eroded the relationship between taxes paid and benefits received.<sup>122</sup> Nevertheless, as the benefits increased the burden of taxation grew from a 1% tax on both employee and employer in 1937 on a wage base of \$3,000, to a 6.13% tax in 1980 on a wage base of \$25,900, with further increases scheduled.<sup>123</sup> Because of the growing tax burden and predictions of even higher rates caused by demographic changes, with rates perhaps as high as 25% within the next 25 years,<sup>124</sup> the program increasingly has come under attack. One Commissioner of Social Security has stated the belief that millions of people feel threatened today because of "[l]ack of credibility of government in general and the particular financial crises of social security in the past several years. . . ."<sup>125</sup>

President Roosevelt once explained his preference for a contributory system to a visitor who complained of the regressive nature of the tax:

I guess you're right on the economics, but those taxes were never a problem of economics. They are politics all the way through. We put those payroll contributions there so as to give the contributors a legal, moral and political right to collect their pensions. . . . With those taxes in there no damn politician can ever scrap my social se-

---

120. *Id.*

121. *Id.* at 214-15.

122. *Id.*

123. *Id.* at 429-32 (chronology of changes in the social security laws).

124. Ross, *Social Security Today: The Need for Reform*, 10 TAX NOTES 171, 172 (Feb. 11, 1980).

125. *Id.* at 173.

curity program.<sup>126</sup>

Labor supported the regressive tax because it felt benefits would be higher under the contributory plan and that its political influence would be greater.<sup>127</sup> Tied in closely was the psychological argument for payroll taxes: a person told that he is getting a return from his own "savings" is not going to feel guilty accepting government aid; human dignity and self-respect are retained. Finally, the link between wages and benefits was thought to discipline the demand for expanded benefits.<sup>128</sup>

The suggestion is that, although the notion of earned rights was once necessary to insure wide acceptability of the system, the desired programs have now been "graft[ed] . . . into the social fabric"<sup>129</sup> and there should be no longer any fear they could be repealed. Moreover, today there is a very weak link between taxes paid and benefits received, leading to charges that the American people are being deceived. In the House of Representatives, John W. Byrnes of Wisconsin "did not object to raising the benefits, . . . 'But, I do complain when you try to make the American people and everybody else feel that they have paid for what they are getting. It just is not honest and it is playing politics with the old people of this country.'"<sup>130</sup>

The "earned right" notion is basically a myth that has been perpetuated for political reasons. Because the social security system has become an institution in our society, the need for those political justifications no longer exists. The social security tax should be exposed for what it is—a very regressive tax on some people so others may get government assistance. The people who pay social security taxes all their lives but never receive benefits because they never retire, become disabled, or leave dependent survivors should not be misled into thinking they are accruing some "earned right".

Stanford G. Ross, former Commissioner of Social Security, believes people can accept the concept of financing social security

---

126. M. DERTNICK, *supra* note 30, at 230.

127. *Id.*

128. *Id.* at 239.

129. *Id.* at 247.

130. *Id.* at 225.

with general revenues through a process of education and reassurance:

We have to reassure people that the government will never renege on its commitment to provide comprehensive and viable social protection that effectively meets human needs. Today, that is a problem. While the government has an undeniable moral obligation, there is no legal obligation to pay benefits under any and all circumstances. Lack of credibility of government in general and the particular financial crises of social security in the past several years have left millions of people feeling threatened.

It is time to develop mechanisms that could reassure the public that mandated benefits will always be paid by the government. One way of doing this is to consider, for example, a general appropriations statute stipulating that social security benefits will be paid from time to time from general revenues as needed. This would be the same kind of statute as that which presently guarantees that interest on the national debt will be paid.<sup>131</sup>

## V. CONCLUSION

The "earned right" concept and possible psychological factors present the only real obstacles to eliminating the social security tax and financing the social security system with the revenues from a value-added tax. That such factors should be considered, and considered thoroughly, is unquestionable. That such factors automatically preclude the consideration of a value-added tax as a replacement for the social security tax is no longer a viable argument. Social programs are here to stay, and the public can be educated to see the realities of the social security system and the social security tax, and the benefits of a progressively structured value-added tax. If more analysis and debate are necessary, they should begin now, before the chance for meaningful tax reform is lost.

---

131. Ross, *supra* note 124, at 173.

