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THE VALUE ADDED TAX: IMPACTS ON FLORIDA

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As the United States faces a record federal budget deficit forecast, policy makers are considering imposing a federal Value Added Tax (VAT).[1] Lawmakers, however, have overlooked the negative impact of the VAT on state governments. A VAT would lower overall economic growth, decreasing both federal and state tax revenue, and would compete for a tax base already tapped by existing state sales taxes. This would particularly harm states like Florida that rely disproportionately on state sales tax revenues.

BACKGROUND ON THE VALUE ADDED TAX

The VAT originated in France, which adopted it in 1954. Upon forming the European Economic Community (now the European Union, or EU) in 1957, member countries agreed to harmonize their tax structures as a part of their economic unification, including instituting a VAT.[2] Currently, the EU requires its members to maintain a standard VAT rate of at least 15 percent.[3] After its introduction into the EU, the VAT has spread to most developed economies, so it is natural for those in the United States who are looking for additional tax revenues to propose adopting a VAT, as so many other countries have done.

The VAT, as its name suggests, is a tax on value added at each stage of the production process. While the administration of the tax is complex, the concept behind it is simple. Every business calculates its VAT by subtracting its purchases on which the VAT has already been paid from its sales. The result is that firm's value added, on which the VAT is levied. Because the total value added of any good or service is equal to the sum of its value added at each stage of production, a VAT and a retail sales tax with the same rates would collect the same amount of revenues and have the same aggregate economic impact. In theory, the economic effects of a VAT and a national sales tax should be the same, except for factors affecting compliance on the part of taxpayers and administration on the part of the

government. While the merits of a VAT versus national sales tax have been debated, a key point is that the two taxes target the same tax base and have essentially the same aggregate economic impact.

LOWER ECONOMIC GROWTH

One way a VAT would negatively impact state finances is by reducing economic growth. In a longer Mercatus study, Holcombe estimates that a 3 percent VAT would slow the economic growth rate by about 0.17 percentage points, and a 5 percent VAT would slow the growth rate by about 0.27 percentage points.[4] If one considers a growth rate of 3 percent to be a healthy rate of economic growth—which was the rate of growth of U.S. GDP from 1999–2004—what appears to be a small impact on the economy ends up being substantial over the years.

A 3 percent VAT would result in a 2 percent reduction in GDP 10 years after its introduction and a 2.6 percent reduction in GDP after 20 years. A 5 percent VAT would result in a 3 percent reduction in GDP after 10 years and a 5.2 percent reduction after 20 years. During those two decades, a 3 percent VAT would reduce GDP by $982 billion, and a 5 percent VAT would reduce GDP by $1.5 trillion. The VAT might add to short-term federal government revenues, but the longer-term reductions in private-sector income would have a negative impact on federal income-tax revenues and on state government revenues.

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OVERLAPPING TAX BASES

Every tax creates a disincentive to engage in the taxed activity, because it makes that activity more costly.[5] State governments are already well aware of people's actions to avoid state sales taxes, sometimes by illegal tax evasion, by buying goods across state lines (and not remitting any taxes due), and by substituting purchase of non-taxable goods and services for those that are taxed. The higher the tax rate, the greater the disincentive to make sales-taxable purchases, and the disincentive effect increases more than in proportion to the tax rate.[6] The VAT taxes the same tax base as state sales taxes, so a federal VAT would have the effect of further lowering state sales-tax collections (beyond the growth effect explained in the previous section), because the VAT would be piggybacked on top of the already-existing state sales taxes.

If people spent the exact same amount on taxable items after the imposition of a federal VAT, a 5 percent VAT, for example, would raise the cost of those purchases by 5 percent, so they could buy 5 percent less with the same expenditure, and 5 percent less in purchases would lower state sales-tax collections by 5 percent. But because an increase in the tax would push people away from taxable purchases, state sales-tax collections from a 5 percent VAT would fall by more than 5 percent. A federal VAT would hit those states that rely heavily on sales-tax revenues the hardest, because the VAT would be tacked on to their sales tax.

FLORIDA WOULD BE AMONG THE HARDEST-HIT STATES

Florida is among a handful of states that do not levy state income taxes, and because of that, Florida would bear a heavier cost with a federal VAT than would other states. To get some idea of how Florida would fare relative to other states, table 1 lists those states that have the highest per capita sales-tax collections. The table shows that Florida ranks fourth, behind Hawaii, Wyoming, and Washington. Hawaii, which is at the top of the list, ranks high because of its tourism industry, which it has in common with Florida. Any reduction in tourism-fueled sales-tax revenues hits those states especially hard, because state residents do not pay those taxes. Hawaii has a state income tax, but Wyoming and Washington, like Florida, do not, so the sales tax is the major source of revenues for those states.[7] As table 1 shows, Florida's per capita sales-tax collections are 42 percent above the national average of $730. Because the impact on state sales-tax revenues would be in proportion to their reliance on that tax base, a VAT would force, Florida to bear a cost 42 percent above the national average.

Florida ranks even higher among states as a percentage of tax revenues raised through the sales tax. As table 2 shows, Florida ranks third by that metric. The absolute rankings are not as significant as noting how high Florida is above the national average. Florida relies on sales tax revenues for 60 percent of its total tax revenue, which is 94 percent higher than the national average of 31 percent. These numbers suggest the disproportionate price Florida would pay, in terms of a diminished sales tax base, compared with other states.

TABLE 1: SALES TAX REVENUE PER CAPITA, 2009

STATE AND RANK	SALES TAX REVENUE PER CAPITA	SALES TAX REVENUE PERCENTAGE ABOVE THE NATIONAL AVERAGE
1. Hawaii	$1,901	160%
2. Wyoming	$1,818	149%
3. Washington	$1,506	106%
4. Florida	$1,037	42%
5. Mississippi	$1,025	40%
National Average	$730	0%

Source: U.S. Census Bureau.

TABLE 2: SALES TAX REVENUE AS A PERCENTAGE OF TOTAL TAX REVENUE, 2009

STATE AND RANK	SALES TAX REVENUE PER CAPITA	SALES TAX REVENUE PERCENTAGE ABOVE THE NATIONAL AVERAGE
1. Tennessee	61%	96%
2. Washington	61%	96%
3. Florida	60%	94%
4. South Dakota	57%	84%
5. Hawaii	52%	68%
National Average	31%	0%

Sources: Sales Tax Revenue: U.S. Census Bureau; Total Tax Revenue: Statistical Abstract of the United States. Percentages calculated by the authors.

Tables 1 and 2 show that Florida is not alone in its heavy reliance on sales-tax revenues. Hawaii and Washington are in both "top five" tables. Hawaii shares with Florida its substantial tourist industry, and Washington shares with Florida its absence of a state income tax.[8] Table 2 shows that Tennessee and South Dakota also have no state income tax. Among other states with no personal income tax, Texas ranks 6th, Nevada ranks 8th, and Wyoming ranks 17th.[9] A federal VAT would hit these states the hardest.

CONCLUSION

If the federal government were to impose a VAT, states that rely heavily on sales-tax revenues would find their budgets impacted more severely than those that do not, because a VAT would tax the same tax base as state sales taxes. Whether reliance on sales-tax revenue is measured as a dollar amount per capita or as a percentage of total tax revenues, Florida would be particularly vulnerable to loss of revenue. Because the negative impact of taxes increases more than in proportion to the tax rate, layering a VAT on top of state sales taxes would be especially harmful to those states, like Florida, that get a majority of their revenues from a general sales tax. Though all state governments have a good reason to oppose a federal VAT, states like Florida have an especially good reason to be wary of any federal initiatives for this tax: a VAT directly competes for revenues from their own tax bases.

ENDNOTES

1. Most recently, Paul Volker suggested a VAT in the spring of 2010. See Robert J. Samuelson, "The VAT Masquerade: Why It's Not a Panacea for Deficits," *Newsweek*, April 26, 2010, 22, for a discussion of recent arguments for a VAT. Arguments for a VAT go back decades, however. See J.A. Stockfish, "Value-Added Taxes and the Size of Government: Some Evidence," *National Tax Journal* 38, no. 4 (December 1985): 547–552, who says, "Large government deficits raise the question of whether new taxes should be introduced. A value added tax (VAT) is one candidate." That argument, from 25 years ago, mirrors today's argument for a VAT.

2. See G.S.A. Wheatcroft, *Value Added Tax in the Enlarged Common Market* (New York: John Wiley & Sons, 1973) for a history.

3. See European Commission, Taxations and Customs Union, "VAT RATES," http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/rates/index_en.htm, for more background on the EU's VAT, including the minimum rate.

4. Randall G. Holcombe, "The Value Added Tax: Too Costly for the United States" (working paper, Mercatus Center at George Mason University, July 12, 2010).

5. See Randall G. Holcombe, *Public Sector Economics: The Role of Government in the American Economy* (Upper Saddle River, NJ: Prentice-Hall, 2006).

6. See Holcombe, *Public Sector Economics*, 215–217, for an explanation of this point.

7. Even in Hawaii, sales-tax revenues are about 85 percent higher than the state's personal income-tax revenues.

8. Tennessee taxes income from dividends and interest only.

9. Alaska and New Hampshire have no income or sales taxes. New Hampshire, like Tennessee, does tax income from dividends and interest.

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