

The Value Added Tax as An Alternative to the Corporation Profits Tax

by JOHN R. FERGUSON

A GROWING interest in benefits taxes in general could result in a more careful examination of land value taxation as a means of improving the municipal tax structure and eliminating the inequities of ability-to-pay taxes which are presently concentrated on improvements rather than land.

It is frequently suggested, for instance, that taxes should not be levied on corporations for they are merely passed on in higher prices or reduced earnings. Much has been written on this but the controversy continues as to whether corporation taxes are in the long run paid wholly by consumers or to a large extent by shareholders.

The question arises principally because of the acceptance of the ability-to-pay approach to taxation—with ability to pay, in case of corporations, being measured by their profits. If corporations were required to pay taxes to the federal government in accordance with the benefits approach to taxation, as compensation for services rendered to them by the government, then such taxes would be more clearly considered a legitimate cost of doing business and, like all other costs of production, they would be passed on in the prices of the goods and services.

The corporation profits tax is far from being an equitable tax for business enterprises. For one thing it penalizes the most efficient companies by requiring them to pay more than their fair share of the costs of government services. To the extent that such profits taxes are passed on to consumers they have an inflationary impact. On the other hand the corporation profits tax subsidizes inefficient or marginal companies, for if they are not profitable

they are not required to pay taxes and so receive without cost the services of the government.

An alternative to the corporation profits tax that is attracting attention and being extensively employed in the European Common Market countries is the value added tax. This tax is applied to business enterprises on the basis of the value that each contributes to the total of the national wealth produced. The tax takes the form of a relatively low rate applied to the total value of the goods and services produced by a business enterprise, after deducting the value of goods and services purchased from other business enterprises. It can be considered a "benefits" doctrine tax rather than an ability-to-pay tax, for in principle it provides that all businesses pay their fair share of the cost of government services.

The value added by business enterprises will provide a much broader tax base than corporate profits and thus will permit a low rather than a high rate of tax. It is capable of producing a substantial amount of revenue for the government but it will also permit a more accurate calculation of the cost of goods and services produced. This should be of importance in determining the allocation of resources in the economy through the medium of the market place.

Unfortunately in the application of the value added tax in Europe it is considered appropriate to remove the tax from exports and apply it to imports. This follows from the fact that the levy is considered a sales tax rather than a cost of production. If the tax were recognized as a legitimate cost of production, then the exemption of export goods and the applica-

tion of the tax to imports would be recognized as forms of government subsidy—in the first case to export industries, in the second as a tariff on imports.

A useful refinement of the value added tax that would permit it to be viewed realistically as a benefits doctrine tax would be to apply the tax to the cost of the value added by a business enterprise, rather than to its market price. This would exempt profits from taxation and would permit profits to be more fully an incentive for productive efforts. It could be made clear to any business enterprise that the most effective way of reducing its federal tax liabilities would be to reduce its costs of production. This method of making goods more competitive in both international and domestic markets would interfere less with the workings of the market place than do the government's subsidies.

In an address to the Tax Foundation in New York in December, 1968, Professor Dan Throop Smith of Harvard University said of the inequities

of the corporation profits tax:

"The two most useful changes in our tax structure from the standpoint of economic efficiency and growth would be a substitution of a value added tax for a substantial part of the corporation income tax and a reduction in the rapid progression and excessive marginal rates in the individual income tax."

The most significant feature of Professor Smith's proposal for corporations is that it would lead away from the ability-to-pay approach and toward a benefits approach. In the realm of personal income taxation, a reduction in the progressiveness of the tax would also have the effect of turning it in the direction of benefits and away from ability to pay. This should be of particular interest to those who realize the importance of a tax on land value, for it is a prime example of a benefits doctrine tax. The taxation of land values and exemption of improvements would result in taxes being paid to a municipality in direct relation to the benefits provided.

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VAT — A Common Market Tool

Europe is the source of much interest in value added tax. One reason is that Europeans are in the habit of paying only a minimal income tax. They employ various evasion devices available to them. In the U.S. the Internal Revenue Service is aided by income reporting systems which make evasion difficult, and penalties can be severe.

Europe notes that the U.S. market for equipment such as that for power generation and transmission is bigger than that of all Japan, Britain, Sweden, France, Holland, Belgium and Italy, together. They look on value

added rebates on their exports as a way of beating their GATT (General Agreement for Trade and Tariff) assessments against subsidies. These VAT rebates are not yet prohibited. This puts U.S. makers at a disadvantage in many products for the home market, without considering whether foreign competition at lower prices benefits the whole economy.

Protectionists believe a country is better off when not being paid for its exports, calling this a favorable balance of trade. Many companies are

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