Comments Prepared by Emil M. Sunley on Itai Grinberg's paper Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT

This is a wonderful paper. I define "wonderful paper" as a paper which I wish I had written. Itai's paper covers a lot of ground and builds a strong case for the US adopting a credit-invoice VAT and not a subtraction method VAT. The paper provides an excellent overview of many of the issues addressed in the various papers that will be presented at our conference.

As Itai explains in his paper, subtraction-method VATs come in two broad types. There is the simple subtraction method VAT under which the tax base is defined as sales less all purchases including purchases on which VAT was not charged. There is the sophisticated subtraction method under which the tax base is defined as sales less purchases on which VAT was paid. The sophisticated subtraction method VAT, with a few refinements, can be equivalent to a credit invoice VAT. Thus the difference between the sophisticated subtraction method VAT and the traditional credit-invoice VAT is largely one of form and not substance. A major portion of his paper deals with the various subtle issues relating to how a sophisticated subtraction method VAT and a credit-invoice VAT will deal with exemptions, multiple rates, services provided by the government and nonprofit organizations, real estate, and small business. Most of these issues are addressed in separate papers in this conference.

I agree with Itai that if the United States were to adopt a VAT, it should be a credit invoice VAT. However, Itai could have made the case against the simple subtraction method stronger, and therefore I would like to explore several issues relating to a simple subtraction method VAT.

The Simple Subtraction Method VAT

A point that Itai does not emphasize is that the simple subtraction method VAT is a *final* tax at each stage of production and distribution. The tax paid on one stage is not taken into account at the next stage. In contrast, under the credit-invoice method, the tax at each state of production and distribution is a *tentative* tax, as the purchaser *may* claim credit for the tax at the next stage of production and distribution.

Because simple subtraction method VAT is a final tax, there are three important implications.

Origin method

First, under the simple subtraction method, it is only possible to exempt exports, as the amount of tax paid at earlier stages is unknown. Therefore, a simple subtraction method VAT would, almost of necessity, be an origin-based – imports would not be taxed and exports would be taxed.

One advantage of an origin-based VAT is that it would eliminate the problem of VAT refunds to exporters, which has proved a fertile area for VAT fraud in many countries, as discussed in Cnossen's paper. However, there is a strong economic case for the United States adopting the destination-based VAT. If the United States wishes to mobilize revenue from taxing consumption, it is logical to have *domestic* consumption as the tax base – imports should be taxed and exports leave the country free of tax. A destination-based VAT would allow the United States to determine the rate or rates at which it wishes to tax domestic consumption.

As Keen and Hellerstain point out in their paper, a destination-based and an origin-based VAT can be said to be equivalent – in the sense that a switch from one regime to other will not alter resource allocation – under certain restrictive conditions, (i.e., VAT applies uniformly to all goods and services and there is exchange rate or domestic price flexibility).[1] These restrictions are unlikely to be met. In particular, the VAT will not apply uniformly to all goods and services. In an origin-based VAT, the various exemptions and lower rates will distort production, and therefore be of greater consequence than the consumption distortions resulting from exemptions and reduced rates in a destination-based VAT. It is because the simple subtraction method must be origin-based and would create distortions in production, most economists would favor a destination-based credit-invoice VAT.

Small business and breaking the chain

The second implication of the simple subtraction method VAT is that there is no over taxation when the VAT chain is broken, and this may explain why Japan adopted a version of the subtraction method VAT. Japan has many mom and pop stores which are outside the VAT but purchase VAT-paid goods. Under Japan's subtraction method VAT, mom and pop stores are favored and not penalized, as they would be under a credit-invoice VAT.

Financial sector

Third, a simple subtraction method VAT may be able to handle the financial sector better than a credit-invoice VAT. As Prof. Schenk points out, the problem of taxing the financial sector

---

[1] See, for example, S. Smith, 1993, "Subsidiarity and the Co-ordination of Indirect Taxes in te European Community, *Oxford Review of Economic Policy*, vol. 9 no. 1.

under a credit-invoice VAT is not measuring value-added but allocating the credit to depositors and borrowers, in the case of banks, and between policy holders and claimants in the case of insurance companies. Under a simple subtraction method VAT, it would be possible to impose a final tax on the financial institutions. Of course, at other stages of production and distribution, sales and purchases of financial services would have to be taken into account. For example, policy holders would treat insurance premiums as a purchase and any payments of insurance claims as a sale. To fully integrate the financial sector into a simple subtraction method, the VAT base would have to include real and financial transactions, which would transform the simple subtraction method VAT into what the Meade Committee called the R + F cash flow tax, which would not be simple but it would be a subtraction method tax.[2]

Potential Problems of a Subtraction Method VAT

Itai points out that a simple subtraction method VAT involves various fiscal risks. One risk is abusive transfer pricing, as the origin regime requires *valuation* of both imports and exports. In contrast, a destination regime does not require the valuation of exports – they are zero-rated – or the precise valuation of imports – any shortfall of tax due to undervaluation of imports (except in the case of imports for final consumption) is made up at the next taxable stage when the credit for tax on imports is correspondingly smaller.

A second risk is that there will be an incentive to exempt various intermediate goods. Congress might want to permit a deduction for 120 percent of certain capital goods or a deduction for a portion of wages paid to low-income workers. The history of Michigan's Single Business Tax should make one cautious when considering a subtraction method VAT.

A third risk outlined by Itai is the use of financial transactions – for example, offsetting long and short forward contracts for the delivery of goods – to eliminate the VAT liability. This abuse might be addressed by anti-abuse rules or possibly by adopting a subtraction method VAT that uses the R + F tax base.

Accounts Based vs. Transaction Based

It is often said that a credit-invoice VAT is a transaction-based tax and a subtraction method VAT is an accounts based VAT. This may be a distinction in the apparent form of the tax but not in substance. It is, of course, true that an inherent feature of the credit invoice VAT is the invoice – actually the *VAT invoice* that reports the amount of VAT paid and the VAT registration numbers of the buyer and seller. However, in a world without a VAT or in a world

---

[2] Institute for Fiscal Studies, 1978, *The Structure and Reform of Direct Taxation* (London: George Allen and Unwin).

with a simple subtraction method VAT, businesses will require invoices and receipts to substantiate their purchases for both financial and income tax reporting.

Whether we have a subtraction method or a credit-invoice VAT, tax audits will be accounts based. VAT audits begin with an examination of the taxpayer's financial books and records, checking, for example, gross margins to see if they are in line with industry norms, etc. The tax auditor may ask the taxpayer to substantiate certain purchases, and the taxpayers will have to produce supporting documentation – invoices and receipts. The tax auditor of a credit-invoice VAT in any industrial country does not start by asking the taxpayer to provide his box of invoices so he can audit the VAT return transaction by transaction.

Conclusion

Like most discussants I have raised some issues and that may suggest that the paper is not perfect. Let me conclude by saying the paper may not be perfect but it is wonderful.