

Value-Added Tax

A **value-added tax** (VAT) is a consumption tax. It is a tax on the market value that is added to a product or material at each stage of its manufacture or distribution. The tax is passed on to the consumer because it increases the ultimate retail price of the product. Value-added taxes differ from sales taxes because sales taxes are applied only at the point of purchase.

As of the writing of this text, the United States does not have a value-added tax. It has been considered by Congress but has always been rejected. Several other countries, including Canada, do have value-added taxes.

Proponents of value-added taxes argue that they inhibit consumer spending less than sales taxes, because they are hidden in the final retail price of the product.

EXAMPLE 5 Comparing Sales Tax and Value-Added Tax

During the production of a sheepskin coat, value is added by the following.

- A farmer: \$10
- A leather tanning company: \$25
- A coat making company: \$150
- A retail clothing company: \$210

Compare the effect of (a) a sales tax of 10% and (b) a value-added tax of 10%.

SOLUTION

- a. A sales tax of 10% is straightforward and easy to calculate. No consumption taxes are paid until the coat is sold to the consumer.

$$\text{Sales tax} = (0.10)(10 + 25 + 150 + 210) = \$39.50$$

The consumer pays \$434.50, of which \$39.50 is sales tax.

- b. Following the trail of a value-added tax is more complicated. A spreadsheet helps keep track of the value-added tax at each stage.



The rules for collecting and paying a value-added tax vary. However, as you can see in Example 5, value-added taxes involve more paperwork.



	A	B	C	D
1	Current Value	Value Added	10% Value-Added Tax	New Value
2	\$0.00	\$10.00	\$1.00	\$11.00
3	\$11.00	\$25.00	\$2.50	\$38.50
4	\$38.50	\$150.00	\$15.00	\$203.50
5	\$203.50	\$210.00	\$21.00	\$434.50
6	Total	\$395.00	\$39.50	
7				

The total tax is the same: \$39.50.

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In the example above, compare the effects of (a) a sales tax of 8% and (b) a value-added tax of 8%.