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Value Added Tax: Does This Consumption Tax Have a Place in the Federal Tax System?

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VALUE ADDED TAX: DOES THIS CONSUMPTION TAX HAVE A PLACE IN THE FEDERAL TAX SYSTEM?*

*Alan Schenk***

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I. INTRODUCTION

When the people are weary of any one sort of Tax, presently some Projector propounds another, and gets himself Audience, by affirming he can propound a way how all the Publick charge may be born without the way that is.

Sir William Petty, *A Treatise of Taxes and Contributions* (1679)

Recent history has been marked by public discontent with the federal tax system and its allocation of the tax burden. This has prompted suggestions that Congress reduce its reliance on income and payroll taxes. One such suggestion is to shift some of the burden from an income tax to a consumption tax like a value added tax ("VAT").

In May, 1985, President Reagan submitted to Congress a Treasury proposal, in modified form, to broaden the bases and reduce the rates for the corporate and individual income taxes.¹ In this proposal, Treasury, restricted to revenue-neutral options,² declined to use this opportunity to replace part of the existing income tax with a VAT. Congress enacted a base broadening, rate reducing reform in the Tax Reform Act of 1986 (the "1986 Act"),³ but left the federal budget in a chronic deficit.⁴

This article will examine the philosophical support for a VAT, and the validity of its potential application to the American tax system. VAT is a multistage tax imposed on the "value added" to goods as they proceed through stages of production and distribution and to services as they are rendered. The prevalent view is that VAT is usually passed on to consumers in the form of increased prices, not borne by business. Thus, with a VAT, a govern-

¹ The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (1985) [hereinafter *The President's Proposal*]; see also U.S. Dep't of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President* (1984) (three volume report that provided the basis for the President's proposed tax reforms) [hereinafter *Treasury Proposal*].

² See *The President's Proposal*, supra note 1, at 5 (notes that reforms are revenue-neutral plus or minus 1.5% of total revenues).

³ In the 1986 Act, Congress capped the individual income tax rate at 28%, see *Tax Reform Act of 1986*, Pub. L. No. 99-514, § 101, 100 Stat. 2085, 2096-99 (codified at I.R.C. § 1), and the corporate income tax rate at 34%, see *Tax Reform Act of 1986*, Pub. L. No. 99-514, § 601, 100 Stat. at 2249 (codified at I.R.C. § 11).

⁴ The chronic nature of the deficit has generated serious concern among investors about the health of the American economy. See Murray, *Stock Market's Frenzy Puts Fed's Greenspan in a Crucial Position*, *Wall St. J.*, Oct. 21, 1987, at § 1, col. 6.

ment shifts its emphasis from taxing income, which represents the potential to consume, to taxing the actual consumption of goods and services.

The article concludes that although a VAT could provide the federal government with a powerful tool to raise additional revenue, including revenue from the charitable-governmental sectors of the economy and provide a more efficient means of taxing goods and services; a VAT would not fare well on equity, economic, and administrative grounds. Despite the 1986 reforms which significantly flattened the tax rates, the federal tax system still taxes individuals on an "ability to pay" principle. A VAT is regressive under this principle in that lower income taxpayers will bear the heaviest tax burden when such burden is measured as a percentage of income. Also, it is not clear that a VAT would have any positive long-term effect on the economy. Finally, the enactment of a VAT and its continued maintenance will impose significant administrative costs on the government and compliance costs on taxpayers. Thus, viewed under the parameters of the current tax system, a VAT is not appealing, but if there is a further shift in taxpayers' attitudes towards a progressive tax system, and what is fair, or there is a need for significantly more federal revenue than Congress could raise under existing taxes, Congress may enact a VAT.

In reaching this conclusion, the article will engage in an extensive analysis of consumption taxes and the existing federal tax system. Part II examines the current federal tax structure. Part III provides the basic ideology behind consumption taxes and prior governmental efforts to enact a VAT. Part IV describes the different variants of VATs and details their mechanics. Part V explains the structural reasons that justify a reexamination of the tax system and analyzes how the VAT fits into that system.

II. EXISTING FEDERAL TAX STRUCTURE

A. *National and International Perspective*

The tax burden may be allocated among income, consumption, and wealth.⁵ Taxes levied on any of these tax bases may be classified as: (1) direct personal taxes, or (2) indirect or ad rem taxes.

⁵ See Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 *Yale L.J.* 1081, 1084 (1980).

Direct taxes are imposed on the party expected to bear them. In contrast, indirect taxes generally are collected and remitted to the government by one not expected to bear the tax burden.⁶ For this purpose, the individual income tax, the employee's share of payroll taxes, and the wealth transfer (estate and gift) taxes are classified as direct personal taxes. The corporate income tax, the employer's share of payroll taxes, the sales and excise taxes, and the property taxes are classified as indirect or ad rem taxes.

Table 1 shows that the federal government relies much more heavily on direct personal taxes than state and local governments do. The federal government derived fifty-eight percent of its revenue from personal taxes, levied almost exclusively on an income base. In contrast, state and local governments derived only 11.6% of their revenue from direct taxes on income and wealth and over eighty-eight percent from ad rem taxes levied on income, consumption and wealth bases.⁷ Combining all levels of government, the United States raises about forty percent of its revenue from direct taxes and sixty percent from ad rem taxes.

⁶ See Kahn, *The Place of Consumption and Net Worth Taxation in the Federal Tax Structure*, in *Broad-Based Taxes: New Options and Sources* 133 (R. Musgrave ed. 1973).

⁷ Over a decade earlier, the relative reliance by these levels of government on personal and ad rem taxes was about the same. See Kahn, *supra* note 6, at 133-37.

TABLE 1*
Taxes by Type of Tax Base and Level of Government, 1981-1982**
 (in billions \$)

Tax Type	Federal			State & Local			All Levels		
	Personal	Ad Rem	Total	Personal	Ad Rem	Total	Personal	Ad Rem	Total
Income									
Indiv.	298.1			50.8			348.9		
Corp.		49.2			15.0			64.2	
Payroll***	94.9	94.9			56.1		94.9	151.0	
Total	393.0	144.1	537.1	50.8	71.1	121.9	443.8	215.2	659.0
Consump.									
Sales					60.6			60.6	
Others		140.7			192.1			332.8	
Total		140.7	140.7		252.7	252.7		393.4	393.4
Wealth									
Prop.					81.9			81.9	
Estate & Gift	8.0			2.4			10.4		
Total	8.0		8.0	2.4	81.9	84.3	10.4	81.9	92.3
TOTALS	401.0	284.8	685.8	53.2	405.7	458.9	454.2	690.5	1144.7
% of TOTALS									
(by group)	58.5	41.5	100.0	11.6	88.4	100.0	39.7	60.3	100.0

* The format for this table was taken from Kahn, *The Place of Consumption and Net Worth in the Federal Tax Structure*, in *Broad-Based Taxes: New Options and Sources* 133, Table 2 (R. Musgrave ed. 1973).

** Bureau of the Census, U.S. Dept. of Commerce, *Governmental Finances in 1981-82* 17, Table 2 & 19, Table 4 (1983).

*** The federal payroll taxes arbitrarily were divided equally between employees (personal) and employers (ad rem), though there is economic data indicating that, in the long term, the employer's share may be shifted back onto labor in the form of reduced wages. Assuming full backward shifting, the totals for all levels of government would be \$549.1 billion (48%) personal and \$595.6 billion (52%) ad rem.

Table 2 measures selected industrialized nations' tax burdens as a percentage of the nations' gross domestic products (GDP).⁸

⁸ The Organization for Economic Cooperation and Development (OECD) compares taxes of member nations based on GDP. The United States, on the other hand, relies on gross national product (GNP). GNP equals GDP "plus the Income accruing to domestic residents arising from Investment abroad less Income earned in the domestic market accruing to foreigners abroad." D. Auld, G. Bannock, D. Baxter & R. Rees, *The American Dictionary of Economics* G131 (1983).

TABLE 2
1982 TAXES (AS % OF GDP)
COMPARED WITH 1960 DATA

	1982 *	1960 Compared**	% Increase
	%	%	
Sweden	50.3	27.2	85
Netherlands	45.5	30.1	51
France	43.7	—	—
United Kingdom	39.6	28.5	39
Germany	37.3	31.3	19
Canada	34.9	24.2	44
United States	30.5	26.6	15
Japan	27.2	18.2	49

* Source: Organization for Economic Cooperation and Development, Revenue Statistics of (OECD) Member Countries 1965-1983 84, Table 1.

** Source: Organization for Economic Cooperation and Development, Long-term Trends in Tax Revenues of OECD Member Countries 1955-1980, OECD Studies in Taxation 11, Table 1 (1981). The French figures were not available.

Except for Japan, in 1982, the United States took a smaller percentage of its GDP in taxes than all of the compared countries. Also, of those compared, between 1960 and 1982, the public sector in the United States expanded the least.⁹

Table 3 below graphically presents the relative importance of each major form of tax in the nations' tax structures. Property taxes occupy a minimal role in most of the compared European countries, but are more important (although still modest) in England, Canada, the United States and Japan. Also, taxes on goods and services (consumption taxes) are much less important in the United States and Japan than they are in the other nations. Finally, France's individual income tax is startlingly low, Japan's corporate income tax is quite high, and Canada's payroll taxes account for a small proportion of its total taxes.

⁹ As a percentage of GNP, the growth in taxes has been concentrated in payroll taxes. See *infra* p. 216, Table 5.

TABLE 3
1982 TAXES AS PERCENTAGE OF TOTAL TAX*

	<u>Individual</u> <u>Income</u> (%)	<u>Corp.</u> <u>Income</u> (%)	<u>Payroll</u> (%)	<u>Property</u> (%)	<u>Goods &</u> <u>Services</u> (%)
Sweden	40.79	3.34	30.48	1.01	24.21
Netherlands	23.92	6.79	41.62	3.60	23.79
France	12.87	5.08	45.38	3.69	29.66
United Kingdom	28.40	9.56	20.26	12.72	28.97
Germany	29.89	5.11	36.18	3.26	26.52
Canada	35.02	6.01	11.27	9.02	34.60
United States	37.80	6.96	27.71	10.07	17.45
Japan	25.29	19.72	30.37	8.94	15.42

* Source: Organization for Economic Cooperation and Development, Revenue Statistics of OECD Member Countries 1965-1983 87, Table 7; 89, Table 11 & 90, Table 13 (1984). Due to miscellaneous items, the total percentage for each nation may not total 100%.

To generalize from Table 3, the United States and Japan place considerable emphasis on taxing income from labor and capital at its source (individual and corporate income taxes, as well as payroll and property taxes) and quite little on taxing the use of income and savings for consumption of goods and services. Japan relies more on corporate and less on the individual income tax than does the United States. France relies more heavily on payroll and consumption taxes than on income taxes. Sweden heavily taxes both individuals' income from labor (personal income and payroll taxes) and individuals' use of their income or capital on consumption (taxes on goods and services). While Sweden taxes returns on capital (dividends, rent and interest) under its individual income tax, it does not heavily tax capital under the corporate income tax or wealth under the property tax.

Viewed from an international perspective, it is not apparent that the United States should substantially alter its existing array of taxes. Our overall federal, state and local tax burden is not out of line in relation to other industrialized countries.

B. The Federal Tax System

1. Introduction

There currently are five general groupings into which federal

taxes can be placed—individual income tax, corporate income tax, payroll taxes (predominantly social security taxes), wealth transfer (estate and gift) taxes, and selective excise taxes and customs duties. The income and payroll tax liabilities depend upon the nature of the taxpayers' receipts. Thus, receipts from wages and returns on investments are included in the income base, but not receipts from gifts, inheritance, or government welfare and similar programs. Receipts from covered wages are subject to payroll taxes, but not returns on investments. In contrast, excise tax liability depends upon the use of funds for the acquisition of taxable goods and services, not the source of the funds. For example, air travel may be taxed, whether the ticket is purchased with funds from savings or from current wage income.

Since 1960, as Table 4 demonstrates, the federal government has maintained its traditional reliance on income-based taxes,¹⁰ but dramatically altered the balance among these taxes. It doubled the payroll taxes and cut corporate income tax from about twenty-three percent to eight percent of total revenue. In addition, starting in 1981, Congress moved the individual and corporate income taxes closer to consumption-based taxes. It encouraged savings by liberalizing deductions for individual contributions into retirement plans¹¹ and encouraged investment in capital goods with liberalized depreciation deductions provided by the Accelerated Cost Recovery System.¹² As part of the base-broadening, rate reducing reforms in 1986, Congress reversed some of the movement toward consumption-style income taxes.¹³

¹⁰ See Kahn, *supra* note 6, at 136, Table 3.

¹¹ Int. Rev. Code of 1954 § 219.

¹² Int. Rev. Code of 1954 § 168.

¹³ See *supra* note 3.

TABLE 4
TAXES AS A PERCENTAGE OF TOTAL BUDGET RECEIPTS*

	<u>1982</u> (%)	<u>1960</u> (%)
Individual income tax	48.2	44.0
Corporate income tax	8.0	23.2
Payroll taxes	32.6	15.9
Estate & gift taxes	1.3	1.7
Excise & other taxes	<u>9.9</u>	<u>15.2</u>
	<u>100.0</u>	<u>100.0</u>

*Office of Management and Budget, Historical Tables: Budget of the United States Government, Fiscal Year 1987, Tables 2.1 & 2.5.

While Table 4 illustrates the relative importance of each tax in the federal tax structure, it does not reflect the magnitude of the tax as a percentage of the standard measure of economic activity, the gross national product (GNP).¹⁴ Table 3 provides this perspective. It shows that total taxes, as a percentage of GNP, increased only two percent over this period. While personal income and payroll taxes increased from almost eleven percent to 16.3 % of GNP, this increase was offset by a decline in corporate taxes of 2.6 % of GNP.

TABLE 5*
FEDERAL TAXES AS A PERCENTAGE OF GNP¹⁵

	<u>1982</u> (%)	<u>1960</u> (%)
Individual income tax	9.7	8.0
Corporate income tax	1.6	4.2
Payroll taxes	6.6	2.9
Estate & gift taxes	.3	.3
Excise & other taxes	<u>2.0</u>	<u>2.8</u>
	<u>20.2</u>	<u>18.2</u>

*Office of Management and Budget, Historical Tables: Budget of the United States Government, Fiscal Year 1987, Table 1.2.

¹⁴ Over a period of time, measuring each tax by the standard GNP yardstick removes some of the distorting effect inflation may have on the total dollar revenue raised by each tax.

¹⁵ The GNP was \$507.7 billion in 1960 and \$3,141.5 billion in 1982. See Office of Management and Budget, Historical Tables, Budget of the United States Government: Fiscal Year

Thus, if the United States needs substantially more revenue than is within the tax base of existing federal taxes, the existing revenue could be raised from the existing income-based taxes or a new tax. The question is whether there are economic or other tax policy reasons for raising the revenue from a VAT rather than existing federal taxes.

2. Individual Income Tax

The individual income tax is the primary federal revenue source, accounting in 1982 for \$297.7 billion in revenue or 48.2% of federal budget receipts¹⁶ and 9.7% of GNP.¹⁷ Income from labor accounts for a dramatic 84.2% of the individual income tax base.¹⁸ As with most of the major federal taxes, the individual income tax is collected at the source of the income. For most individuals, the income tax on the eighty-four percent labor component of the base is withheld from wages and paid to the government by the taxpayer's employer. Self-employed individuals and those not within the withholding system pay their tax on income from labor through estimated tax payments or at the time their personal returns are filed. Tax on the remaining sixteen percent of the tax base is collected from the earners of the income (or, for estates and trusts, the entities) through estimated tax payments or payment accom-

1987, Table 1.2 (1986) [hereinafter Historical Tables].

¹⁶ Historical Tables, *supra* note 15, at Table 2.1.

¹⁷ See *supra* p. 216, Table 5.

¹⁸ See Internal Revenue Service, 1982 Statistics of Income-Individual, Individual Income Tax Returns 2, Table A (1984). The breakdown of the individual income tax burden is presented in the following table:

panying the filing of the return.¹⁹ Whether initially withheld from wages or paid directly by the taxpayer, most of the individual income tax ultimately is borne by the individual earning the income.²⁰

3. Payroll Taxes

The dramatic increases in social security taxes and benefits since 1977 have made payroll taxes the second largest federal revenue

<u>Table A</u>		
	1982 Individual Income Tax Base	
	(in millions \$)	(%)
<u>Income from Labor</u>		
Salaries & wages	1,564,995	84.50
Pensions & annuities*	60,123	3.25
Statutory adjustments	<u>(64,887)</u>	<u>(3.50)</u>
Total income from labor	1,560,231	84.25
<u>Income from Capital</u>		
Professional & other businesses, including farms, estates & trusts	46,906	2.53**
Sale of assets	35,018	1.89
Interest & dividends in adjusted gross income	209,164	11.29
Rent	(8,478)	(0.46)
Royalty	<u>6,319</u>	<u>0.34</u>
Total income from capital	288,929	15.59
<u>Other (including unemployment compensation, alimony & state income tax refunds)</u>	<u>2,976</u>	<u>0.16</u>
Total Adjusted Gross Income (less Deficit)	<u>1,852,136</u>	<u>100.00</u>

* If annuity income represents the return on a capital investment, it properly should be classified as Income from Capital. To the extent that it represents payment of wages deferred to retirement, it should be classified as Income from Labor. The above statistical data does not separate pension and annuity income.

** Part of the income from professional and other businesses may constitute income from labor of the owners, but if it is not distributed as salary, it is classified as Income from Capital.

¹⁹ See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 302(a), 96 Stat. 324, 585-86 (as amended by Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 1361, 96 Stat. 1669, 1669 and Technical Corrections Act of 1982, Pub. L. No. 97-448, § 101, 96 Stat. 2365, 2365-67). However, Congress repealed the withholding requirement it imposed on interest and dividends before it became effective. See Interest and Dividend Tax Compliance Act of 1983, Pub. L. No. 98-67, § 102(a), 97 Stat. 369, 369.

²⁰ For an estate or trust, the tax is borne by the beneficiaries. In addition, sole proprietors and partners may, to some extent, try to shift part of their income tax to their customers in the form of higher prices for their products or services.

source. In 1982, payroll taxes totalled \$ 201.5 billion, which was 32.6% of federal budget receipts and 6.6% of GNP.²¹

Payroll taxes are imposed on only one factor of production, compensation. However, their bases are narrower than the eighty-four percent labor component in the individual income tax base. Some employers, such as some units of government, were excluded and later grandfathered out of the social security system.²² Some employers are not subject to the federal unemployment compensation tax on their workers' wages. Even for covered workers, the social security and unemployment compensation tax bases are capped at specified amounts of taxable wages per employee. Salary and wages above the statutory caps are exempt from these taxes.²³ Consequently, there is a significant gap between wages subject to payroll taxes and wages subject to the individual income tax.

The employees' contributions to the social security trust funds are withheld at the source of wage income. The employers' contributions for social security as well as their liability for federal unemployment taxes are imposed as wages are paid. Self-employed individuals use the self-assessment system to report and pay their social security tax liability. While in the short-term, the employers bear their share of the payroll taxes contributed into the social security trust fund, in the long term, it is likely that most or all of the employers' contributions are borne by labor in the form of reduced wages.²⁴

²¹ See Historical Tables, *supra* note 15, at Table 2.1.

²² Section 101 of the Social Security Amendments of 1983 provided that newly-hired federal employees would be covered by the social security system, not the government employees retirement program. See Social Security Amendments of 1983, Pub. L. No. 98-21, § 101, 97 Stat. 65, 65.

²³ See Treas. Reg. § 31.3121(a)(1)-1 (defining the method of calculating the statutory cap on payroll taxes); see also 1 Fed. Tax Guide Rep. (CCH) § 113 (listing the statutory cap at \$42,00 for 1986 and \$43,800 for 1987).

²⁴ See J.Pechman, *Federal Tax Policy* 215-17 (1983). There is some empirical work suggesting that the employer's share of the payroll tax may not be fully shifted back to the employees. See Hamermesh, *New Estimates of the Incidence of the Payroll Tax*, 45 *So. Econ. J.* 1208 (1979). But cf. Moore, *Self-Employment and the Incidence of the Payroll Tax*, 36 *Nat'l Tax J.* 491, 499 (1983) (maintaining that wage and salary workers earnings are reduced substantially due to the employer contribution of the payroll tax). If not borne by labor, the employer's share of social security taxes will be shifted forward and be borne by consumers. See P. Musgrave & R. Musgrave, *Public Finance in Theory and Practice* 412 (1976).

4. Corporate Income Tax

In 1982, the corporate income tax ranked third in importance as a federal revenue source.²⁵ It raised \$49.2 billion in revenue, accounting for eight percent of federal budget receipts and 1.6% of GNP.²⁶ To compute corporate taxable income, the Internal Revenue Code allows corporations to take deductions for reasonable compensation, interest and rent expenses, thus limiting the tax base to only one of the economic factors of production, profit.²⁷ The tax is imposed on and paid by the corporation and generally will be borne by its shareholders.²⁸ However, it is likely that some profitable corporations are able to shift this tax burden to consumers in the form of higher prices for their goods and services.²⁹

5. Excise Taxes

The federal government imposes (1) customs duties on imports, and (2) excise taxes on selected products and services.³⁰ In 1945, excise taxes accounted for 13.92% of total receipts.³¹ They remained in that general range through the mid-1950s. While highway user fees were instituted in 1957 and other trust funds were established in the 1970s, excise tax revenue remained fairly stable.³² Thus, as total revenue increased, excises declined as a per-

²⁵ As a group, excises and other miscellaneous taxes (not including estate and gift taxes) accounted for more revenue than the corporate income tax. However, excluding earnings by the Federal Reserve System from federal reserve deposits, excise and other taxes fell below the corporate income tax revenue.

²⁶ See *supra* p. 216, Table 4 & p. 216, Table 5; see also Historical Tables, *supra* note 15, at Tables 2.1 & 2.2.

²⁷ If depreciation for tax purposes exceeds the economic decline in the value of tangible productive assets, then corporate taxable income would not be equivalent to corporate economic profits.

²⁸ But see Brannon, *Fairness and Unfairness in the Tax System (Part II)*, 5 Tax Notes 23 (Nov. 28, 1977); Brannon, *Fairness and Unfairness in the Tax System (Part I)*, 5 Tax Notes 3 (Nov. 21, 1977) (both articles are reprints of chapters of an unpublished book by Gerard Brannon on tax reform. See G. Brannon, *Tax Reform: Justice, Efficiency and Politics* (unpublished manuscript)). Nevertheless, it is likely that in some industries, especially regulated industries, the corporation can shift at least part of the corporate tax forward into the price of its products or services.

²⁹ See *infra* text accompanying note 167.

³⁰ Congress imposed a windfall profits tax on selected producers that extract and sell domestically produced crude oil. See *Crude Oil Windfall Profit Tax Act of 1980*, Pub. L. No. 96-223, 94 Stat. 229. This tax is scheduled to be phased out by 1990. See I.R.C. § 4990.

³¹ Historical Tables, *supra* note 15, at Table 2.1.

³² *Id.*

centage of receipts. By 1979, they represented only four percent of total receipts. They rose to 6.8% in 1981, the peak revenue year for the crude oil windfall profits tax.³³

In 1982, custom duties were \$8.85 billion and excises and other miscellaneous taxes, not including estate and gift taxes, were \$52.47 billion. Combined, for 1982, they accounted for \$61.32 billion or 9.9% of federal budget receipts and two percent of GNP.³⁴

Most federal excise taxes are expected to be shifted to consumers as part of the prices for taxed goods and services.³⁵ To the extent that the windfall profits taxes are paid by business and other excises, such as airport and airway taxes on business travel, are paid on business purchases, they tend to be incorporated into the prices of those businesses' goods and services and ultimately are borne by the consumers of those items.³⁶

6. *Wealth Transfer (Estate and Gift) Taxes*

Estate and gift taxes are transactional taxes, not annual levies, imposed on the transfer of property (wealth) by gift, devise or bequest. In 1982, estate and gift tax receipts totaled \$8 billion, accounting for 1.3% of receipts (down slightly from 1.7% in 1960) and 0.3% of the GNP.³⁷

C. *Summary*

The burden of most federal taxes is on individuals directly. Taxes on income from labor—payroll taxes and most of the individual income tax base—is borne in whole or in substantial part by those performing the labor services.³⁸ Profits of unincorporated businesses are taxed under the individual income tax and, except

³³ Id.

³⁴ See supra p. 216, Tables 4 & p. 216, Table 5; see also Historical Tables, supra note 15, at Tables 2.1, 2.4, & 2.5.

³⁵ See J. Pechman, supra note 24, at 185-193. The major excise taxes include alcohol and tobacco taxes and the windfall profits tax. On the latter, see supra note 30. Other excise taxes include trust funds for highway, airport and airway, black lung disability, inland waterway, hazardous substances, and aquatic resources. See Historical Tables, supra note 15, at Table 2.4.

³⁶ See P. Musgrave & R. Musgrave, supra note 24, at 399.

³⁷ See supra p. 216, Table 4 & p. 216, Table 5; see also Historical Tables, supra note 15, at Tables 2.1 & 2.5.

³⁸ In the long term, even the employer's share of payroll taxes probably is borne by labor. See infra note 168 and accompanying text.

for those able to shift this income tax forward into the prices of proprietors' goods and services, tax on this profit likely is borne by the owners of such businesses.³⁹ Returns on capital owned by individuals, estates and trusts (dividends, rent and interest) are borne by the owners under the individual income tax. Estate and gift taxes are paid and borne by those who transfer wealth inter vivos or on death. Finally, corporate profits are subject to the corporation income tax. While economists debate whether the corporate tax is borne by shareholders, is shifted forward to consumers in the form of higher prices, or is absorbed by labor through reduced wage rates, it will be assumed, as most economists assume, that for purposes of making tax policy decisions, the tax is borne by shareholders.⁴⁰

Businesses collect and remit sales, excise or other taxes that are ultimately borne by consumers. In contrast to income and payroll taxes imposed at the point income is earned, these consumption taxes are imposed at the point the consumer uses income or savings to acquire taxed items.⁴¹ These indirect taxes represent a small portion of the federal tax system, but would increase significantly with the adoption of a broad-based consumption tax.

III. TRANSACTION FORMS OF CONSUMPTION TAX

Congress could increase revenue from consumption taxes by raising the rates or by expanding the base of federal excise taxes. For example, it could increase alcohol and tobacco tax rates, add more user fees for government services, or tax additional services. Rather than using the shotgun approach of excise taxes, Congress could adopt a broad-based tax on many or most goods and services acquired for personal consumption. As a tax imposed at a single stage, this broad-based tax could be imposed at the manufacturing⁴² or wholesale level, or like the state retail sales taxes, it could

³⁹ Business profits of estates and trusts are taxed under the Code. See I.R.C. § 1(e).

⁴⁰ See Break, *The Incidence and Economic Effects of Taxation*, in *The Economics of Public Finance* 138-54 (A. Binder ed. 1974) (presenting the different views as to who actually shares the cost of the corporate income tax).

⁴¹ Even if components, capital goods or finished goods or services are nominally taxed to manufacturers or intermediaries in the production-distribution chain, the tax likely will be considered part of the cost of providing the final goods or services and will be reflected in the prices charged final consumers.

⁴² For example, Congress proposed to fund the "Superfund" hazardous waste program

be limited to the retail stage.⁴³ Finally, Congress could enact a broad-based, multistage tax like the European-inspired VAT.⁴⁴

A. *The Philosophy Behind Consumption Taxes*

Some of the philosophical underpinnings of consumption taxes come from the writings of Thomas Hobbes, as expanded by Nicholas Kaldor. According to Hobbes, persons should pay tax based on what they withdraw from society's limited resources (measured by consumption) rather than what they contribute to such resources (measured by income).⁴⁵ Hobbes' philosophy was incorporated by Kaldor into a broader defense of the consumption base for progressive individual taxation.⁴⁶

A consumption based tax is particularly justified if there is such a scarcity of resources that excessive consumption will inhibit economic growth or will divert resources from more socially-desirable uses such as education.⁴⁷ With select excise taxes imposed on spe-

with a broad-based tax on corporations, a form of tax on value added by taxed corporations. See H.R. 2005, 99th Cong., 2d Sess., 131 Cong. Rec. H1941 (daily ed. April 4, 1985).

⁴³ Generally, it is assumed that a multistage VAT and a single stage retail sales tax raise the same amount of revenue, assuming that they have the same tax base. However, when Louisiana, over 20 years ago, extended its retail sales tax up to the wholesale level, making retailers subject to tax only on value they added, the sales tax revenue increased beyond the amount expected, based on economic growth. See J. Due & J. Mikesell, *Sales Taxation: State and Local Structure and Administration* 47 (1983). Apparently, by extending the retail tax up to the wholesale stage, the retailers were more diligent in reporting all of their retail sales and sales by wholesalers directly to consumers were taxed.

⁴⁴ Before converting to the VAT, European countries relied on a turnover tax imposed on taxable items as they turned over at each stage of production and distribution. See *infra* notes 86-87 and accompanying text. This tax had a cascade effect and encouraged the vertical integration of firms. *Id.* This article therefore eliminates turnover tax from consideration as a possible multistage form of sales tax.

⁴⁵ According to Hobbes, "What reason is there, that he which laboureth much, and sparing the fruits of his labor, consumeth little, should be charged more, than he that living idly, getteth little, and spendeth all he gets: Seeing that one hath no more protection from the commonwealth than the other?" T. Hobbes, *Leviathan* 184 (Dutton ed. 1914).

⁴⁶ See N. Kaldor, *An Expenditure Tax* 11, 53 (1965); see also Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 *Harv. L. Rev.* 1113 (1974) (arguing for a consumption tax) [hereinafter *Consumption-Type or Cash Flow*]. Professor Andrews' article, which relies on Kaldor, became the leading work in the academic debate over consumption taxes. See Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 *Harv. L. Rev.* 947 (1975), Graetz, *Implementing a Progressive Consumption-Tax*, 92 *Harv. L. Rev.* 1575 (1979) (both arguing for a consumption tax). But see Warren, Jr., *Fairness and a Consumption Type or Cash Flow Personal Income Tax*, 88 *Harv. L. Rev.* 931 (1975).

⁴⁷ See Kahn, *supra* note 6, at 137. According to Kaldor, "[i]t is only by spending, not by

cific items of consumption, and with income tax deductions granted for specific consumption expenditures such as medical care and charitable contributions, Congress already relies on the tax laws to allocate or control the level of consumption of various categories of goods and services.⁴⁸ Even if there is no scarcity, consumption advocates argue that the tax burden should be allocated among individuals on the basis of benefits that they derive from government services, and these benefits relate more directly to individuals' levels of consumption than their levels of income.⁴⁹

Income and consumption can be viewed merely as measures of different aspects of a broad concept of consumption, with income representing the potential power to consume and consumption representing the exercise of that power by actual purchases of goods and services. Indeed, a flat rate individual income tax could be constructed to resemble an income-style VAT base. Assuming that a comparable tax base could be constructed,⁵⁰ there would be some differences in the timing of tax liability. Under the individual income tax, income is taxed directly to those receiving factor incomes (wages, profit, interest, and rent). In contrast, under an invoice method, income-style VAT, the same factor incomes are taxed in increments as value is added to products and services,⁵¹ but the tax liability does not attach until the goods are sold or the services are rendered.

earning or saving, that an individual imposes a burden on the rest of the community in attaining his own ends." See N. Kaldor *supra* note 46, at 53.

⁴⁸ For examples of excise taxation of items of consumption, see I.R.C. §§ 4071 (tires and tubes), 4661 (chemicals). The deductions for medical care and charitable contributions can be found in § 170 and § 213 of the Code. See I.R.C. §§ 170 (charitable contributions), 213 (medical care).

⁴⁹ Some commentators have suggested that governments should increase their reliance on the benefit principle by adding user fees for more government services. See R. Bird, *Charging for Public Services: A New Look at an Old Idea* (1976). But cf. Pechman, *Tax Policies for the 1980s*, 11 *Tax Notes* 1195, 1200 (Dec. 22, 1980) (arguing that income is preferable to consumption as a base for taxation, not only because it is a better measure of an individual's ability to pay taxes, but also because it is widely approved).

⁵⁰ It would be extremely unlikely that a comparable tax base could be constructed. With an invoice method, income-style VAT, payments of taxes and charitable contributions would be included in the tax base. In view of a history of exempting charities and units of government from income tax on returns from capital (dividends, rents and interest), except for the unrelated business income concept in § 511, see I.R.C. § 511, it would be very difficult to start taxing these sectors on income at this point.

⁵¹ McLure, Jr., *Economic Effects of Taxing Value Added*, in *Broad-Based Taxes: New Options and Sources*, *supra* note 6, at 157-58.

B. *Prior Federal Efforts to Enact a Consumption Tax*

There have been proposals to reduce federal reliance on income-based taxes and, in the process, increase consumption-based taxes. In 1977, the Treasury issued its "Blueprints for Basic Tax Reform,"⁵² analyzing a possible shift from our existing progressive individual income tax to a progressive consumption tax.

Congress has also toyed with proposals for a transactions form of federal consumption tax. In 1979, and again in a modified form in 1980, then House Ways and Means Chairman Al Ullman proposed a restructuring of our federal tax system by using revenue from a new European-inspired value added tax (national sales tax) to finance cuts in income and social security taxes.⁵³ Finally, in 1985, Senator Roth, a member of the Senate Finance Committee, proposed a VAT in the form of a Business Transfer Tax ("BTT"), designed to finance reductions in income and payroll taxes.⁵⁴ However, his proposal did not receive a full review in Congress.

Still, in the early 1980s, Congress moved the individual and corporate income taxes closer to consumption-based taxes by expanding tax preferences for individual savings and by granting liberal depreciation deductions for business acquisitions of capital goods. With the 1986 tax reforms, Congress reversed this trend. It curtailed both the deductions for payments into individual retirement accounts and the accelerated depreciation on capital goods,⁵⁵ and it repealed the investment tax credit available on purchases of capital goods.⁵⁶

IV. VALUE ADDED TAX

A. *In General*

A VAT is a multistage tax imposed on the "value added" to

⁵² U.S. Dep't. of the Treasury, *Blueprints for Basic Tax Reform* 9-12 (1977).

⁵³ See H.R. 7015, 96th Cong., 2d Sess., 126 Cong. Rec. 7481, 7483-85 (1980) (outlining the VAT portion of the bill) [hereinafter House Bill].

⁵⁴ See S. 1102, 99th Cong., 1st Sess., 131 Cong. Rec. S5675 (daily ed. May 8, 1985) [hereinafter Senate Bill]. On February 20, 1986, Senator Roth modified his proposed Business Transfer Tax (BTT). Except for Senator Roth's unusual provision providing a business with a credit against the employer's share of FICA taxes for its BTT liability, the proposed BTT resembles a sales- of cost-subtractive VAT. W. Roth, Jr., Remarks to the National Press Club (Feb. 20, 1986) (Copy on file).

⁵⁵ I.R.C. §§ 168 (capital goods), 219(g) (Individual Retirement Accounts).

⁵⁶ I.R.C. §49(a).

goods as they proceed through the stages of production and distribution and to services as they are rendered. The "value added" consists of the four economic factors of production—wages, profit, rent and interest.⁵⁷ Businesses usually pass on the cost of the VAT to consumers in the form of increased prices of goods and services.

A VAT may be viewed as a tax on consumption or a tax on business. The perception, if not the economic reality, may depend in part on whether the tax liability, at each stage, is based on tax charged on sales invoices (invoice method) or is based on periodic totals for annual business accounts. The latter is described as a sales- or cost-subtractive VAT if the base consists of sales and deductible costs, and is described as an additive method VAT if the base is the sum of wages, interest, rent, and a special computation of profit. One view is that the VAT serves as a mechanism to collect a tax on items of personal consumption included within the tax base. Providers of goods and services collect and remit the tax that they shift to consumers in the form of increased product or service prices. As such and with the same tax base, the VAT will raise the same revenue as an equivalent rate retail sales tax.⁵⁸ Another view is that VAT may be used as a "benefit principle" tax imposed on and borne by business as "a charge for the benefits of governmental services which directly benefit business enterprises. . . ."⁵⁹ However, in either case, unless there is in effect a system of administered prices or perfect competition, in the long term, it is likely that a VAT will be borne by final consumers.⁶⁰

While the term "value added tax" can be used to describe a tax imposed on the four economic factors of production, there are many different forms of taxation that can be included within the general concept of a VAT. The variations depend upon the method of calculating the tax, the jurisdictional reach of the tax, the inclusion or exclusion of the VAT itself from the tax base, and the

⁵⁷ See Shoup, *Theory and Background of Value-Added Tax*, 1955 Proc. of 48th Ann. Conf. on Tax'n 7.

⁵⁸ See *infra* p. 242 (diagram outlining the VAT burden on taxpayers).

⁵⁹ C. Sullivan, *The Tax on Value Added* 4 (1965). The benefit to business rationale is based, in part, on the premise that government services reduce business costs. *Id.* at 38.

⁶⁰ "The principles which assume nonshifted sales taxes other than a low-rate privilege tax either involve the unrealistic assumption of perfect competition or imply that the system is dominated by administered prices." *Id.* at 49. The incidence issue aside, the legislative decision to enact a VAT as a consumption versus a business benefit tax will affect rules providing for a transition to a VAT.

treatment of purchases of capital goods.

B. Elements of a Value Added Tax

1. Methods of Computing VAT Liability

There are two basic methods by which business may be required to compute its VAT base—the additive method or one of the subtractive methods, which include the sales- or cost-subtraction VAT and the invoice or credit method VAT. Theoretically, the same tax base can be created under each method, but it is likely that the choice of method will affect the ultimate tax base.

Under the additive method,⁶¹ the taxpayer, such as a wholesaler, totals the economic factors of production—wages, certain interest and rent expense, and profit⁶²—that add value to its taxable goods or services.⁶³ For each tax period, the wholesaler computes its tax liability by applying the tax rate to the total of these factors of production. For example, if the wholesaler incurred \$100,000 wage expense, \$10,000 in interest and rent expense, and earned a \$50,000 profit, the wholesaler's VAT base for the period would total \$160,000. Assuming a ten percent VAT rate, its VAT liability would be \$16,000, computed as follows:

Wages	\$100,000
Profit	\$ 50,000
Interest & Rent Expense	<u>\$ 10,000</u>
Tax Base	\$160,000
10% VAT Rate	<u>.10</u>
VAT Liability for Period	<u>\$ 16,000</u>

Under the additive method, the factors of production will be taxed, whether the taxpayer shifts these expenses forward into the

⁶¹ For an example of an additive VAT, see Michigan Single Business Tax Act, Mich. Comp. Laws §§ 208.1-145 (1979); see also Schenk, *The Michigan Single Business Tax: A State Value Added Tax?*, 8 Tax Notes 411 (April 9, 1979); Symposium on the Michigan Single Business Tax Act, 22 Wayne L. Rev. 1017-1213 (1976) (both critiquing the Michigan tax).

⁶² These four factors "reflect the activity of the employees of the firm, the services rendered by the individual creditors and lessors of the firm, and the reward to the firm's owners. . . ." Shoup, *supra* note 57, at 7.

⁶³ For a more detailed discussion of the additive method VAT, see Special Comm. on the Value-Added Tax of the Section of Taxation, ABA, *Evaluation of an Additive-Method Value-Added Tax for Use in the United States*, 30 Tax Law. 565 (1977).

price of taxed items or absorbs some of these expenses in the form of lower profit or reduced return on the owner's investment. Unlike the credit method VAT, the additive method tax liability is not deferred until the business sells its goods or services.

With the same tax base and tax rate, under a sales- or cost-subtraction method VAT,⁶⁴ assuming the wholesaler's sales were \$200,000 and its deductible purchases were \$40,000, the wholesaler's VAT liability for the period would be the same \$16,000, computed as follows:

Sales	\$ 200,000
Deductible purchases	<u>\$ (40,000)</u>
Tax Base	\$ 160,000
10% VAT Rate	<u>.10</u>
VAT Liability for Period	<u>\$ 16,000</u>

The sales-subtractive VAT taxes the costs and expenses incurred by business that are shifted forward in the prices of its goods and services, and provides a deduction for the cost of defined purchases. For example, to the extent that charitable contributions and taxes are shifted into the price of taxable items and thereby included as part of gross taxable receipts, these costs are included in the sales-subtractive base.⁶⁵

The second subtractive method VAT is the European-style invoice method (or credit method) VAT.⁶⁶ To make a valid comparison with the above examples, it again must be assumed that the wholesaler's sales were \$200,000 and its deductible purchases were \$40,000. The wholesaler's VAT liability for the period would total

⁶⁴ Taxes and contributions are included in the additive method base to the extent that they are shifted in prices of goods and services and therefore reflected in higher profit. For an example of the sales- or cost-subtractive method VAT, see the former Michigan Business Receipts Tax, 1955 Mich. Pub. Acts 738, repealed by 67 Mich. Pub. Acts 572-73. See also C. Sullivan, *supra* note 59, at 300-11 (reviewing the former Michigan tax law). The Michigan tax, known in the state as the Business Activities Tax ("BAT") was enacted as a specific tax on income. It was in effect in Michigan from 1955 to 1967. Since it was imposed on taxable gross receipts less allowable deductions and attempted to tax only value added at each stage of production and distribution, it loosely could be described as a sales- or cost-subtractive VAT. For a brief discussion of BAT and a comparison between the BAT and Senator Roth's BTT, see Schenk, *The Business Transfer Tax: The Value Added by Subtraction*, 30 Tax Notes 351 (Jan. 27, 1986).

⁶⁵ See Schenk, *supra* note 64, at 359-60.

⁶⁶ See C. Sullivan, *supra* note 59, at 17-19.

\$16,000, computed as follows:

Tax on Sales —	10% rate applied to sales of \$200,000	<u>\$20,000</u>
Tax on Purchases —	10% rate charged on purchases of \$40,000	<u>\$(4,000)</u>
VAT Liability for Period		<u>\$16,000</u>

Before the European nations enacted VATs, most of them relied on turnover taxes.⁶⁷ The turnover tax was levied on gross sales each time the goods turned over. It therefore encouraged vertical integration of operations to reduce the total tax burden on goods that proceeded through multiple stages of production and distribution.⁶⁸ In contrast, the additive and subtractive methods of calculating VAT provide tax neutrality between the nonintegrated and integrated firms by eliminating from the tax base the value added that already was taxed at previous stages.

There are cash flow differences between the additive and the invoice method VATs. Under the additive approach, a wholesaler must finance the VAT component in the price of its purchases. Thus, if the wholesaler purchased goods for \$100,000 plus \$10,000 VAT, its inventory cost would be \$110,000. The \$10,000 VAT would not be recovered until the wholesaler resold these goods. If it borrowed to finance the tax-inclusive \$110,000 inventory cost, it would bear the interest cost on the \$10,000 VAT until it resold the goods and repaid the loan. The VAT and the interest cost to finance the VAT would become part of the wholesaler's operating costs and therefore could be expected to influence the selling price for its goods. Under an invoice method VAT, assuming the wholesaler paid the same \$110,000 tax-inclusive price for inventory, in its first VAT return after the purchase the wholesaler would receive a \$10,000 credit against its VAT liability for the input tax on these purchases. Thus, under the invoice method, the wholesaler

⁶⁷ See *id.* at 6-16.

⁶⁸ Indeed, "[t]he competitive inequities and inefficiencies caused by the cumulative nature of the general turnover tax were responsible for the first proposal for value-added taxation, that of Dr. Wilhelm von Siemens, a German businessman and governmental consultant, who called his proposal the 'improved turnover tax' or the 'refined turnover tax.'" *Id.* at 12 (footnote omitted). On the deficiencies inherent in turnover taxes, see *id.* at 11-15.

would not have to finance the \$10,000 VAT⁶⁹ (except to the extent that it must pay its supplier the VAT before it can claim credit for the input tax), and the VAT therefore should not enter into the wholesaler's resale price for its goods.

2. *Jurisdictional Reach of the VAT*

Depending upon its jurisdictional reach, a VAT can be structured as an origin or destination principle tax. A tax designed to tax value added within the nation should be imposed on all value that is added to goods and services within the territorial boundaries of the taxing nation. An origin principle VAT, consistent with this economic notion of value added, imposes tax on the value added to goods and services within the taxing jurisdiction, whether the items are consumed domestically or are exported.⁷⁰ Consistently, value that is added to goods and services outside the taxing jurisdiction is beyond the scope of the tax, even if such items are imported and consumed domestically. For example, assuming a ten percent, origin principle VAT, if an importer imported goods for \$10,000 and added value of \$3,000, reselling them for \$13,000, the imports would be free of VAT and the importer would charge \$300 VAT on the \$3,000 value it adds to the goods.

A destination principle VAT imposes tax on goods or services consumed in the taxing jurisdiction, regardless of where the goods are produced or services are rendered. Imports are taxed and exports are tax-free.⁷¹ For example, the importer in the above example would add \$1,300 VAT to the tax-exclusive \$13,000 sales price for its goods. In effect, the import is taxed \$1,000 and the \$3,000 value added by the importer would be taxed \$300 for a total VAT of \$1,300. Likewise, if a manufacturer exported goods produced do-

⁶⁹ If the wholesaler did not receive the benefit from the input tax credit until after it paid VAT on its purchases, it would sustain some cash flow costs. This may occur if the tax periods were long, such as three months, or if the wholesaler could not obtain a refund for excess input tax credits.

⁷⁰ On the origin versus destination principle taxes, see C. Sullivan, *supra* note 59, at 40; Shibata, *A Theory of Fiscal Harmonization in Free Trade*, in *Capital Flows and International Policy Harmonization* 12-19 (H. English ed. 1979); Sullivan, *Indirect Tax Systems in the European Economic Community and the United Kingdom*, in *Fiscal Harmonization in Common Markets* 103 (C. Shoup ed. 1967).

⁷¹ Typically, nations that have adopted a destination principle VAT do not tax imported services and do not rebate VAT on all exported services. See, e.g., *Value Added Tax Act, 1983*, ch. 55, § 1, sched. 5, group 15 (the United Kingdom VAT).

mestically, under a destination principle VAT, the exporting country would rebate all VAT attributable to the exported products. For competitive reasons or because international trade is a significant element in the nation's economy, foreign VATs employ the destination principle.⁷² The destination principle VAT may be implemented under an additive or sales-subtractive method of calculating VAT liability. However, under these forms, it may be more difficult to identify the precise VAT component in exported goods.⁷³

3. *VAT-Exclusive or VAT-Inclusive Base*

A VAT is imposed on the value of taxable goods and services. For this purpose, the tax rate may be applied to the value of the items inclusive or exclusive of VAT.⁷⁴ With an invoice method, tax-inclusive base, assuming a 9.09% VAT and a \$100 before-tax price, the seller's tax-inclusive price would be \$110. With a tax-exclusive base, there is no computational reason to list separately the tax on sales invoices. With VAT hidden in the price of goods and services, it still is easy for sellers to calculate their tax liability, but more difficult for buyers to identify the tax paid.

To obtain the same revenue with a tax-exclusive as with a tax-inclusive base, it is necessary to set the rate under the tax-exclusive base at a higher level. For example, to raise the revenue obtained with the above 9.09% rate applied to a tax-inclusive base, the legislature must impose a ten percent rate to a tax-exclusive base. Applying the ten percent rate to the \$100 before-tax price

⁷² As part of the harmonization of value added taxes within the Common Market, the European Economic Community has proposed that member nations work toward the adoption of the origin principle for commerce within the Community and the destination principle for trade with outsiders. See Sixth Council Directive of May 17, 1977 on the Harmonization of the Laws Relating to Turnover Taxes—Common System of Value Added Tax: Uniform Basis of Assessment, 20 J. O. Comm. Eur. (No. L145) 1-2 (1977).

⁷³ See R. Lindholm, *The Economics of VAT 167-75* (1980). For example, under the additive or sales-subtractive VAT, if an intermediate seller is exempt from VAT under a small trader exemption, this loss of tax revenue is not recouped (as it is under an invoice VAT) at a subsequent stage. The exporter who exports goods that include a component or a service that was acquired from an exempt supplier cannot identify the precise VAT component in the price of these exported goods. In these cases, it may be necessary to estimate the VAT component, or to make some statutory assumption about the rebatable VAT element in exports.

⁷⁴ For a general discussion of a VAT levied on tax-inclusive or tax-exclusive prices, see A. Tait, *Value Added Tax 11-13* (1972).

would result in the same ten dollar VAT and \$110 tax-inclusive price. According to one commentator, "the tax on a price exclusive of tax is clearer, more honest, and less complicated than that levied on the tax inclusive base."⁷⁵ While the tax-exclusive base may have some of the attributes just quoted above, it may not be less complicated for retailers selling to final consumers. In particular, small retailers without computerized cash registers may find it easier to apply the VAT rate to the total tax-inclusive prices for sales than to convert sales totals to tax-exclusive amounts and then add VAT to these figures.⁷⁶ Indeed, some countries that employ a tax-exclusive, invoice method tax have adopted simplified VAT procedures that, in effect, give retailers the option to calculate their VAT liability based on their tax-inclusive sales figures.

To calculate VAT under the additive method, the taxpayer must total the factors of production for the tax period—wages, profit, interest, and rent expense. Since the additive method does not base tax liability on the sales price of taxable items, it would be difficult to construct a tax-inclusive, additive method base.

The sales-subtractive VAT is based on gross taxable receipts less allowable deductions. To the extent that this "period" tax is considered a business cost and is shifted into the price of the taxable items (gross taxable receipts), the VAT will be imposed on the tax-inclusive prices. Administratively, it would be difficult to impose a sales-subtractive VAT on a tax exclusive base. To do so would require the identification of the VAT component in gross taxable receipts as well as in the cost of allowable deductions. Since it would not be separately stated on purchase invoices, at best, the tax could only be estimated.

4. *Taxation of Capital Goods*

Conceptually, under a VAT designed to be shifted to consumers, the final consumers of taxed goods and services bear the VAT component in the price of those items. Since business generally is the final consumer of capital goods that it uses in its operations, the legislature must decide if the business should bear VAT on capital goods. If capital goods are included in the tax base, then

⁷⁵ Id. at 13.

⁷⁶ See H.M. Customs & Excise Notice No. 727, Gross Takings, British Value Added Tax Rep. (CCH) 10 (Oct. 1987).

the VAT is described as a gross national product (GNP)-style VAT.⁷⁷ Under a GNP-style tax, the VAT borne by business presumably will be shifted, as any other operating cost, into the prices of that business' goods or services. For example, under an invoice method VAT,⁷⁸ the manufacturer calculates its output tax liability based on the sales prices of its goods. These prices presumably include an allocable part of the cost of capital goods used to produce the goods, including the VAT paid on such capital goods. Since the manufacturer charges VAT on the sales price that includes some VAT on capital goods, this VAT will have a tax-on-a-tax, or cascade effect.⁷⁹

With a national income (NI)-style VAT,⁸⁰ a business purchasing capital goods can recover the VAT charged on such purchases through a depreciation-like input tax credit over the estimated life of the capital goods. For example, if a manufacturer purchases ten year life machinery for \$100,000 plus \$10,000 VAT, then under an invoice method VAT,⁸¹ over the machinery's ten year life, the manufacturer obtains a \$10,000 input tax credit against its VAT liability.⁸² With a NI-style VAT, if the manufacturer must finance the \$10,000 VAT charge, it must bear the interest cost on the loan as part of its cost of operations.

The European VATs, as well as those enacted in most other

⁷⁷ See C. Sullivan, *supra* note 59, at 188-90.

⁷⁸ A GNP-style VAT can be created under an additive or a sales-subtractive VAT as well. Under the additive method, in computing profit, the taxpayer would be denied a deduction both for the cost of capital goods purchased and for depreciation taken for income tax purposes. The same treatment would be provided under a sales-subtractive VAT.

⁷⁹ One reason VAT was viewed as an improvement over the prior European turnover taxes is that the VAT could be designed to avoid the cascade effect that occurred under the turnover taxes. Businesses in countries with turnover taxes found it tax advantageous to vertically integrate their operations in order to reduce the number of taxable turnovers from production to retail sale.

⁸⁰ See C. Sullivan, *supra* note 59, at 185-87.

⁸¹ The same treatment may be provided under an additive or sales-subtractive VAT. Under the additive method, the taxpayer would recover the VAT charged on capital goods by reducing profit through a depreciation deduction for the cost of such goods. Under the sales-subtractive VAT, the taxpayer would reduce gross taxable receipts each year by an amount equal to depreciation of the cost of the acquired capital goods.

⁸² The VAT could be recoverable at a rate of \$1,000 per year over the 10-year life. The \$1,000 credit is based on the assumption that the VAT is creditable on a straight-line basis over the estimated useful life of the capital goods. The legislature could provide other formulas for the recovery of the VAT. For example, it may provide a shorter recovery period or provide for the accelerated recovery of the credit, such as on a declining balance method.

countries, are consumption (C)-style VATs.⁸³ Under an invoice method,⁸⁴ C-style VAT, business purchasers of capital goods generally obtain an immediate input tax credit for VAT charged on such goods. In the above example, the \$10,000 VAT would be recovered when the machine is acquired.⁸⁵ Even with a C-style VAT, some capital goods still remain in the VAT base because purchasers cannot obtain an input tax credit for VAT charged on these goods. For example, some units of government or other entities exempt from VAT are not eligible for input tax credits. Likewise, taxable traders that produce or sell exempt goods cannot obtain input tax credits for VAT charged on purchases allocable to their exempt supplies. Also, private individuals who are final consumers of capital goods cannot recover VAT charged on such purchases.

The European preference for a C-style VAT may be traceable to those countries' experiences with their turnover taxes that preceded VAT.⁸⁶ The turnover tax was imposed on the sales price of goods every time that the goods turned over in the process of production and distribution. It therefore had a tax-on-a-tax, or cascade effect. France and others switched to VAT to remove the cascade effect.⁸⁷ It therefore is not surprising that they chose the C-style VAT which does not have the cascade effect of a GNP-style

⁸³ See, e.g., Aaron, Introduction and Summary, in *Value Added Tax: Lessons from Europe 3* (H. Aaron ed. 1981). If the United States were to adopt a federal VAT, it likely would be a C-style VAT. The Ullman proposal for a federal VAT was a C-style VAT. See House Bill, *supra* note 53, at 7483-85.

⁸⁴ The same consumption base can be created under an additive or sales-subtractive VAT. Under an additive method VAT, the cost of capital goods (but not depreciation) would be deductible in arriving at profit included in the tax base. Under a sales-subtractive VAT, the cost of capital goods (but not depreciation) would be fully deductible against gross taxable receipts.

⁸⁵ Under some VAT schemes, the credit for VAT paid on capital goods may be used to reduce the business' VAT liability, and excess credits can be carried over to subsequent tax periods, but it is not refundable if the business does not have any VAT liability for the tax period. Consider, for example, the French VAT, under which traders can use input tax credits to offset output tax liability, but before the 1972 reforms, any excess had to be carried over to subsequent tax periods. See 4 *Guides to European Taxation, Value Added Taxation in Europe, France*, § 8.2. (1973). With the 1972 reforms, excess credits arising in 1972 and subsequent years are fully refundable. *Id.* at § 9.3. Under the former French approach, taxpayers with excess credits for VAT paid on purchases had to bear the interest cost to carry that VAT element until it received a VAT benefit from the credit in a future tax period.

⁸⁶ See C. Sullivan, *supra* note 59, at 11-15.

⁸⁷ See Advisory Comm. on Intergovernmental Relations, *Value Added Tax and Alternative Sources of Revenue 5* (1973).

VAT.

For a totally unrelated reason, it was predictable that the European nations would adopt C-style VATs. Their national economic policies tend to encourage investment in capital goods in order to make local industry competitive in the international marketplace and thereby stimulate export trade, a significant component of their GNP.⁸⁸ A C-style VAT treats capital goods purchases more favorably.

Debate over the taxation of capital goods under an American VAT may focus on a comparison between the taxation of labor and capital under a C-style and GNP-style VAT. For this purpose, assume that an invoice method VAT that is charged on taxable items is shifted forward to consumers. If the per unit cost of labor and capital are identical,⁸⁹ a producer would have no incentive to replace labor with capital, or vice versa. If a GNP-style VAT were added to existing federal taxes, capital would become more expensive than labor. The output tax on sales includes the cost of labor and capital shifted in the prices of the seller's goods and services, thus taxing both alike. However, because the business bears the VAT imposed on the purchase of capital goods and does not bear VAT on the purchase of labor (hiring employees), the cost of capital is higher. A C-style VAT would maintain the prior equality between the cost of capital and labor because purchasers of capital goods would receive an immediate rebate of VAT charged on such capital goods, treating the purchase of capital and labor alike.⁹⁰

C. *Scope of the Tax Base*

If the United States enacted an invoice method, C-style VAT imposed on the tax-exclusive price of taxable items and based its jurisdictional reach on the destination principle, it would have a VAT similar to those enacted in most other countries. However, it

⁸⁸ See C. Sullivan, *supra* note 59, at 178.

⁸⁹ The labor cost would include all payroll and other taxes imposed on the employment of labor. The capital cost would include the interest cost attributable to the financing of the capital goods purchases.

⁹⁰ Some proponents of the C-style VAT carry this argument further and maintain that a C-style VAT would encourage domestic industry to modernize, and thereby expand their export trade. See Aaron, *supra* note 83, at 4-5. However, it is not clear that raising revenue from a VAT rather than income taxes, and relying on a C-style, rather than a GNP- or NI-style, VAT will have any significant impact on the balance of trade.

still would have to resolve the most difficult problem in designing a VAT system; that is, it would have to define the scope of the tax base.

To construct a VAT with a consumption base, it is reasonable to begin with personal consumption expenditures (PCEs), the major component of the gross national product. Table 6 lists the elements of the American GNP for 1982.

Table 6
U.S. Gross National Product—1982*
(in billions \$)

Personal Consumption Expenditures (PCEs)		
Durable goods	252.7	
Nondurable goods	771.0	
Services	<u>1027.0</u>	
Total		2,050.7
Gross Private Domestic Investment		447.3
Net of Exports over Imports		
Exports	361.9	
Imports	<u>335.6</u>	
Total		26.3
Government Purchases		
Federal	272.7	
State and Local	<u>369.0</u>	
Total		<u>641.7</u>
GNP		<u>3,166.0</u>

* Bureau of Economic Analysis, U.S. Dep't. of Commerce, 66 Survey of Current Business 26, Table 1.1 (July, 1986).

If a federal VAT were imposed on all PCEs, using the 1982 figures, the \$2,050.7 billion base would have represented sixty-five percent of our GNP. To provide some perspective on this figure, for 1982, taxable income reported on individual income tax returns was \$1,473 billion⁹¹ and corporate income subject to the corporate income tax was \$205.2 billion,⁹² a combined income tax base of

⁹¹ Internal Revenue Service, *supra* note 18, at 39-42, Table 1.2.

⁹² Internal Revenue Service, 1982 Statistics of Income, Corporation Income Tax Returns 18, Table 1 (1985).

\$1,678.2 billion. Moreover, the consumption base could be expanded beyond the above PCEs by taxing some government purchases.⁹³

A tax levied on PCEs generally would be imposed on all goods sold and services rendered in the private exchange economy—that is, sales for value.⁹⁴ Congress may construct a broad-based VAT and then reduce the VAT burden on specific goods and services by providing a lower or even a zero rate for the preferred items. Even with a zero rate, the supplies technically remain in the tax base. In contrast, Congress can reduce the VAT burden on traders and purchasers by exempting from VAT sales by certain sellers or sales of specific goods and services. Both tax rate reductions and tax exemptions are considered tax preferences.⁹⁵

A VAT preference may be based on the nature of the seller. These preferences generally are limited to items provided by charities or governmental bodies, although many VAT schemes exempt sales by small businesses. More commonly, VAT preferences depend upon the nature of the goods sold or services rendered. These item preferences typically apply to sales at all stages within the production-distribution chain. However, in some cases, the preferences may be limited to sales made at only one stage, such as retail. For example, a standard ten percent rate may apply to all taxable goods and services, but a reduced five percent rate may apply to the sale of newspapers to final consumers. A higher twenty-five percent rate might apply to the sale of gold jewelry at retail.⁹⁶

As discussed above, under an invoice method VAT, the grant of an item-by-item VAT preference either reduces the tax base by exempting specific goods or services from tax or maintains the base but reduces revenue by providing a lower or even zero rate.⁹⁷ A

⁹³ See *infra* notes 149-52 and accompanying text.

⁹⁴ To prevent potential tax avoidance, the tax may extend to goods and services transferred without adequate consideration. See *The Value Added Tax Act, 1983*, ch. 55, § 3, sched. 2, group 5 (the United Kingdom VAT).

⁹⁵ The introduction of multiple rates or various forms of tax preferences complicates the tax and significantly increases the cost to the government to administer and to the taxpayers to comply with the tax. When the United Kingdom added a multiple rate to its VAT system, it increased its customs and excise staff by 10%. See 890 *Parl. Deb., H.C. (5th ser.)* 303 (1975).

⁹⁶ For example, Senator Roth's bill provided a single stage exemption for some food, housing, medical care, and land. See *Senate Bill*, *supra* note 54, at S5675.

⁹⁷ It is easier to administer a tax rate preference than an exemption, because the rate

reduced or zero rate preference alters the output tax charged on sales, while an exemption alters both the output tax on sales and the input tax credit on purchases. The following example illustrates these three methods of providing transaction-based preferences under an invoice method VAT. Assume that a firm sells food to final consumers. In a given tax period, the firm sells food for \$100,000 and pays \$6,000 VAT on \$60,000 purchases of inventory and other items attributable to these taxable sales. The standard VAT rate is ten percent.

1. If food sold to final consumers is taxed at a reduced five percent rate, the seller charges the five percent rate on its sales and obtains a full input tax credit for the ten percent VAT paid on purchases allocable to these sales. The seller thus is entitled to a \$1,000 VAT refund for this tax period, computed as follows:

Output Tax on Sales		
5% x \$100,000		\$ 5,000
Input Tax on Purchases		
10% x \$60,000		\$ 6,000
Net VAT liability		<u>\$(1,000)</u>

2. If food sold to final consumers is zero-rated, the seller does not charge VAT on its sales and obtains an input tax credit for VAT paid on purchases allocable to these sales. The seller can recover the entire \$6,000 VAT charged on its purchases, computed as follows:

Output Tax on Sales		
0% x \$100,000		\$ 0
Input Tax on Purchases		
10% x \$60,000		\$ 6,000
Net VAT liability		<u>\$(6,000)</u>

preferences can be traced to sales. The exemption must be checked by reference both to sales and to the input tax attributable to such exempt sales.

3. If food sold to final consumers is exempt from VAT, the seller does not charge VAT on sales and is not entitled to an input tax credit for VAT charged on purchases allocable to VAT-exempt sales. The seller does not have any output tax liability and must absorb the \$6,000 input tax on its purchases.

Output Tax on Sales		
0% x \$100,000	\$	0
Input Tax on Purchases		
10% x \$60,000		
(cannot be claimed as credit since sales were VAT-exempt)	\$	<u>0</u>
Net VAT liability	\$	<u>0</u>

The input tax credit (commonly referred to as the input tax deduction) mechanism is unique to the invoice method VAT. As illustrated above, it facilitates the use of item-by-item preferences or the use of preferred (lower) rates to selected items at the retail stage without disrupting the system at earlier stages of production and distribution. Also, unlike the state sales tax structure, where sellers must determine whether the buyer is exempt from tax, the sellers in an invoice method VAT system generally charge VAT based on the nature of the item sold, not on the status of the buyer or the use to which the buyer will put the item.⁹⁸ The buyer can be relieved of tax on purchases by receiving credit for input tax on purchases.

The gross tax base calculated under a sales-subtractive method VAT includes the selling price (or value) of taxable items. As it can do with an invoice method VAT, the legislature can narrow the sales-subtractive VAT base by exempting entities or specific items. The difference is that under the invoice method, revenue lost through an entity or item exemption at an intermediate stage can be recouped upon taxable sale at a subsequent stage. Under the invoice method, this revenue recoupment is accomplished by not

⁹⁸ Some VAT systems deviate from this model and require sellers to determine the nature of the buyer or the use to which the buyer will put the item supplied. See, for example, the VAT in the Republic of China, Business Tax Law, Art. 7(4), (6)-(7), 26-28 (H. Liu & M. Olson trans. 1987) (copy on file).

granting an input tax credit for any VAT component in the price of goods or services purchased from exempt entities or any VAT component in purchases that were exempt from VAT. The revenue is permanently lost under the sales-subtractive VAT.

Still, a sales-subtractive base can be narrowed in a manner not used under the invoice method. Taxpayers can be allowed deductions for costs or expenses that usually are included in a VAT base. For example, taxpayers may be allowed deductions for employee fringe benefits, even though compensation generally does not reduce a VAT base.

The additive method VAT is not a transactional tax and is not linked to the sales price of taxable items. Under an additive method VAT, it is feasible to exempt entities from the tax, but it is difficult to grant preferences based on the nature of the goods sold or the services rendered. For example, unless the statute is quite complex, it would not be feasible to zero-rate or exempt from VAT the sale of canned soup because the seller of the can and the provider of legal and other services to the canning company would have to identify and zero-rate these sales and services. Alternatively, the canning company would have to estimate and claim refund for the VAT component in purchases attributable to sales of the canned soup. If the wholesaler and retailer sold taxable items as well as the soup, it also would be necessary for them to segregate the factors of production that were attributable to the soup and eliminate these amounts from their tax bases. That it is difficult to grant item preferences under an additive method VAT may be viewed as an advantage of relying on this method of calculating VAT liability. However, in its place, the additive method provides the opportunity to reduce the base in other ways. By altering the definition of profit, the legislature can permit deductions for costs or expenses that typically are considered part of a VAT base. For example, as illustrated in the above discussion of the sales-subtractive VAT, the legislature could allow taxpayers to deduct fringe benefits in arriving at profit includable in the additive method base, even though compensation is a major element in this VAT base.

D. Mechanics of a Consumption-Style VAT

The following example illustrates the mechanical aspects of a C-style VAT. It is based on an invoice method, destination principle

tax imposed at a standard ten percent rate and applied to the tax-exclusive price of taxable supplies.

Assume that a manufacturer purchases aluminum, other raw materials, and components for \$30,000 (exclusive of VAT). Suppliers to the manufacturer add a ten percent VAT of \$3,000, charging a total price of \$33,000. The manufacturer then produces computers and sells them to a retailer for \$70,000 and adds \$7,000 VAT, charging a \$77,000 tax-inclusive price. In computing its net VAT liability for the value that it has added, the manufacturer reduces its \$7,000 output tax on sales by the \$3,000 input tax on its purchases and remits to the government the \$4,000 net. When the retailer sells the computers to final consumers for \$100,000 (exclusive of tax), it adds \$10,000 VAT and thus charges the consumers \$110,000. The retailer pays its net VAT liability of \$3,000, represented by the difference between the \$10,000 output tax on sales and the \$7,000 input tax on purchases. To the extent that the \$10,000 is shifted to buyers in the form of higher prices for the computers and the consumers are not allowed any refund for VAT paid, the final consumers bear the \$10,000 VAT. Assuming the VAT is shifted forward, with the same tax base and tax rate, a VAT raises the same total revenue and has the same tax impact on final consumers as a single-stage retail sales tax.

	<u>Tax paid to the Government at each level</u>	
<u>Manufacturer</u>		
Output tax on sales		
\$70,000 x 10% rate	\$ 7,000	
Input tax on purchases		
\$30,000 x 10% rate	<u>\$ 3,000</u>	\$ 3,000 paid by suppliers
Net VAT liability	<u>\$ 4,000</u>	\$ 4,000 paid by manufacturer
<u>Retailer</u>		
Output tax on sales		
\$100,000 x 10% rate	\$10,000	
Input tax on purchases		
\$70,000 x 10% rate	<u>\$ 7,000</u>	
Net VAT liability	<u>\$ 3,000</u>	\$ 3,000 paid by retailer
<u>Final Consumers</u>		
VAT on purchases		
\$100,000 x 10% rate	\$10,000	
No input tax credit	\$ 0	
VAT borne by consumers	<u>\$10,000</u>	<u>\$10,000</u> Total tax paid

V. STRUCTURAL REASONS TO REEXAMINE THE TAX SYSTEM

Adam Smith's four canons of taxation influenced tax policy for almost a century. According to Smith, a tax (1) should foster national concepts of equity, (2) should be certain, not arbitrary, (3) should be easy for taxpayers to pay, and (4) should be economical for the government to collect.⁹⁹ Recent United States tax reform goals include Smith's first, third, and fourth canons promoting tax equity and simplification, and add a canon that the tax reform should promote economic growth.¹⁰⁰ More broadly, federal taxes should be imposed at acceptable rates, meet the desired short- and long-term revenue needs, distribute the tax burden in an equitable manner, facilitate both taxpayer compliance and efficient government collection, and not inhibit economic growth. The 1986 tax reform broadened the base and reduced the rates under the individual and corporate income taxes. Future reforms of the income taxes likely will focus on simplification of the corporate income tax or adjustment of income tax rates to increase revenue. Congress still may be pressed to consider the possible enactment of a new broad-based federal tax on consumption to raise revenue or finance future income tax reforms. The debate over the desirability of adding a federal tax on consumption should include the following policy-relevant factors: the scope of the federal public sector, federal tax base issues, economic considerations (including our concept of vertical equity and the growing importance of international commerce on our economy), concerns about taxpayer compliance, and federal-state fiscal relations.

A. *Scope of The Federal Public Sector*

The federal budget reflects Congress' judgment on the extent to which private resources should be diverted from saving or consumption to public purposes. The 1986 revenue-neutral income tax reforms left the federal budget with large deficits. Despite both budget-cutting initiatives in Congress since the early 1980s and the Gramm-Rudman Act, designed to help balance the federal

⁹⁹ A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* 777-79 (Mod. Lib. Ed. 1937).

¹⁰⁰ See President's Proposal, *supra* note 1, at 2; 1 Treasury Proposal, *supra* note 1, at 8.

budget,¹⁰¹ Congress has not dramatically curtailed federal spending. The decision to reduce the deficit by reducing federal programs or increasing taxes is a political decision and will not be discussed here. Nevertheless, as mentioned above, it is likely that in future major tax legislative debates, Congress will consider the possibility of increasing revenue.¹⁰²

B. Federal Tax Base

1. Introduction

One reason Congress might consider enacting a tax on consumption, such as a VAT, is to reduce federal reliance on direct taxes measured by income. Traditionally, the United States has relied heavily on direct taxes (income and payroll) imposed at the source of income for the bulk of federal revenue. In 1982, they accounted for 80.8% of federal budget receipts.¹⁰³ Indirect taxes, accounting for the remaining 11.2%, have played a more modest role in federal fiscal policy.

Federal taxes on consumption, indirect taxes generally imposed on the sale of taxable goods or services, accounted for less than ten percent of 1982 budget receipts.¹⁰⁴ They include customs duties on imported goods, windfall profits tax on crude oil,¹⁰⁵ excises on consumer goods, such as alcohol, tobacco, gasoline and other fuels, and excises on consumer services, such as telephone and air transport.¹⁰⁶

State and local governments rely more heavily on indirect taxes on consumption; most notably, the retail sales tax imposed on sales to final consumers.¹⁰⁷ Under their sales tax regimes, states tax con-

¹⁰¹ See Balanced Budget and Emergency Deficit Control Act of 1985, Pub. L. No. 99-177, 99 Stat. 1037.

¹⁰² For example, see ex-Senator Howard Baker's suggestion that Congress consider the adoption of a new tax to repay the deficit. *Wall St. J.*, Aug. 1, 1985, at 40, col. 2.

¹⁰³ See *supra* p. 216, Table 4.

¹⁰⁴ *Id.*

¹⁰⁵ The crude oil may be used in the production of plastics or other components in consumer goods, or may be refined into transportation or household fuel.

¹⁰⁶ See 1984 Commissioner & Chief Counsel, Internal Revenue Service Ann. Rep. 2, Table 2.

¹⁰⁷ As of 1986, only Delaware, Montana, New Hampshire, and Oregon did not levy a retail sales tax. See Chart of State Taxes, 1 State Tax Guide (CCH) at 662-63; J. Due & J. Mike-sell, *supra* note 43, at 4-5. In Alaska, there is a local, not state level sales tax. See Alaska Stat. § 29.45.650 (1986).

sumer goods, although some exempt necessities such as food and medicine.¹⁰⁸ States vary significantly in their tax treatment of services. About forty percent of the states do not tax services other than utilities, admissions, and transient accommodations.¹⁰⁹ At the other extreme, only a few states impose sales tax on a broad range of services.¹¹⁰ Thus, there is little consistency in the taxation of consumer goods and services under federal, state and local taxes. The tax burden on PCEs is distributed unevenly,¹¹¹ distorting consumption patterns by encouraging consumers to purchase untaxed or low taxed items and discouraging them from purchasing heavily taxed goods and services. The addition of a federal VAT, coupled with repeal of some excises, would provide more consistency in the federal taxation of consumption items. However, disparities would remain among consumers in different states because of variations in state sales tax bases, unless the states were to replace their sales tax regimes with a VAT that mirrored the federal system.

2. Comparison of The Tax Base of Income and Payroll Taxes and a Potential VAT

The federal individual income tax is imposed on labor income and returns on capital, on sales of capital goods and other property, and on other income that is not excludable by statute. It taxes the wages of employees in the private sector as well as employees of income tax-exempt organizations and units of government.¹¹²

Labor costs account for about seventy-five percent of the value

¹⁰⁸ See J. Due & J. Mikesell, *supra* note 43, at 65-70.

¹⁰⁹ See *id.* at 90, Table 4.1.

¹¹⁰ See *id.*

¹¹¹ The 1986 guidelines for tax reform in Canada stress the need to have "similar products . . . bear the same rate of sales tax." Can. Dep't of Fin., *Guidelines for Tax Reform in Canada 3* (1986). In addition, according to Finance Minister Michael H. Wilson's statement, "[t]he sales tax burden should be shared more equally than it now is among goods and services and the sectors that produce them." *Id.* at 2. Under the federal sales tax, similar products are treated differently, and "different rates of tax apply to various goods and services. . . ." *Id.* As a result, "an important part of the overall tax burden is very unevenly distributed across the economy." *Id.* at 5.

¹¹² It does not tax excludable receipts like gifts, life insurance proceeds, municipal bond interest, some social security benefits, and other government transfer payments, such as welfare.

of PCEs.¹¹³ The existing federal system taxes American workers on the value they add to goods and services, whether such goods and services are consumed domestically or exported. Except for the excises and customs duties, Congress does not tax consumers on the value of purchased goods and services, whether the purchases are produced domestically or imported. Therefore, one essential difference between an income tax increase and a destination principle VAT is that an income tax increase would tax all of the value added by domestic labor; while the VAT would tax the foreign labor component in imports and would not tax the value added by domestic labor to exported goods or exempt sales by the charitable-governmental sectors.

The corporate income tax is levied on business profits, on sales of capital goods and other property, and on returns on passive investments. It does not tax the charitable-governmental sectors on most of the gain they derive from sales of goods or rendition of services.¹¹⁴ Assuming the corporate income tax on business profits is borne by the owners (shareholders), the domestic consumers of the corporation's goods or services do not bear a federal tax on the profit component in the prices of these items.

The individual and corporate income taxes basically tax profits from export sales by American companies, but not profits on imports to the United States if earned abroad by foreign corporations.¹¹⁵

Payroll taxes are levied only on labor income of covered employees and self-employed individuals, and then only up to the wage cap. Payroll taxes are imposed, whether the covered persons work in the private or public sector or for charities, and whether their labor adds value to exports or to goods sold or services rendered domestically. They do not apply to the foreign labor component of

¹¹³ See, e.g., Taxation & Economic Policy Office, Mich. Dep't of the Treasury, Analysis of the Michigan Single Business Tax 26 (1985) (stating that "[f]or all businesses, compensation [for 1981] represents 76.7 percent of the Michigan tax base or value added." If it is assumed that one-half of the income from professional and other businesses, including farms, estates and trusts, is personal service income, labor accounts for 85.5 percent of the tax base.).

¹¹⁴ Income tax-exempt organizations as well as state colleges and universities may be subject to income tax on unrelated business taxable income under § 511(a). See I.R.C. § 511(a).

¹¹⁵ See I.R.C. §§ 881 (mainly taxing passive United States source income of a foreign corporation), 882 (taxing income of a foreign corporation only if it is "effectively connected with the conduct of a trade or business within the United States"). But see I.R.C. §§ 951-70 (taxing American shareholders of a controlled foreign corporation on Subpart F income).

imported goods or services. In the short term, the employer bears its share of payroll taxes and therefore may shift this tax to consumers of their goods or services. In the long term, however, it is likely that labor bears the full payroll tax burden.¹¹⁶ Consequently, payroll taxes likely will have the same impact as the individual income tax on consumers of the employer's goods or services; that is, consumers of these goods or services would not bear the federal tax imposed on the labor component of goods or services.

The payroll tax has a narrower base than the broad-based VAT, because the VAT base includes returns on capital (profit, rent, and interest) as well as the labor component in the prices of taxed goods and services. Indeed, the labor component of a VAT base generally may be broader than the base of payroll taxes such as our social security taxes for two reasons. First, wages of covered workers are taxed only up to the wage cap. Second, payroll taxes are not imposed on the labor performed on goods imported for sale in the United States,¹¹⁷ while foreign labor costs included in the selling price of goods imported for sale in the United States are included in the VAT base. In some respects, the payroll tax base is larger than the likely labor component of a VAT base. Services provided by employees of governmental entities, income tax-exempt organizations, and other entities making exempt supplies may be subject to payroll taxes but not VAT. On balance, VAT probably would have a broader base and would be borne by a larger number of individuals.

A broad-based, C-style VAT is levied on sales of taxable goods and services. VAT may be viewed as a mechanism to tax the four factors of production¹¹⁸—labor, profit,¹¹⁹ rent, and interest—that add value at each stage of production and distribution. However,

¹¹⁶ See *infra* note 168 and accompanying text.

¹¹⁷ See Brannon, *Does VAT Provide a Balance of Trade Advantage?*, 30 *Tax Notes* 1387 (March 31, 1986). Foreign labor also does not benefit directly from the government programs financed with the payroll tax revenue. *Id.* at 1390.

¹¹⁸ To the extent other expenses, such as charitable contributions and taxes, are shifted into the price of the taxable goods and services, such payments also would be included in the VAT base. The seller would not obtain an input tax credit attributable to these costs, because charities and units of government cannot issue tax invoices for these receipts.

¹¹⁹ Operating losses constitute a reduction in the tax base to the extent that the losses are reflected in a lower price of goods or services. Operating losses also reduce the income tax bases to the extent that they can offset profits from other activities or profits from the same activity in past or future years.

unlike the income and payroll taxes that tax factor incomes to those earning the income, the VAT typically is borne by the consumers of goods and services, not by the business that employs these factors of production to add value to the taxed items. Also, unlike the income and payroll taxes that are imposed as the taxpayers earn income, the invoice method VAT is not levied until the sale of the taxable goods and services created with the factor incomes.

The VAT base can be illustrated with the following example involving a ten percent tax. For purposes of this example, it is assumed that all sales during the tax period consist of inventory purchased in that period, all labor costs are included in the prices of the goods sold in that period, and all goods are sold domestically.

<u>Elements of Profit for Period</u>		
Sales		\$100,000
Cost of goods sold (excluding \$6,000 VAT)		<u>\$ 60,000</u>
Gross Income from Sales		\$ 40,000
 <u>Expenses</u>		
Labor	\$10,000	
Rent	\$ 1,000	
Interest	\$ 500	
Depreciation	\$ 1,000 *	
Taxes	\$ 700	
Charitable Contributions	\$ 300	
Other purchases (such as utilities on which the sellers charged \$300 VAT)	<u>\$ 3,000</u>	
Total expenses		<u>\$16,500</u>
Profit for period		<u>\$23,500</u>

* Depreciation is attributable to \$5,000 (exclusive of VAT) in capital goods purchased this period. For purposes of this analysis, it is assumed that such goods have a useful life of five years and the taxpayer utilizes straight-line depreciation.

With the above elements of profit and sales for the period, the trader would have a \$3,200 net VAT liability, whether VAT was calculated under the European-style invoice method or the additive method.

VAT Base Under Above Invoice Method

Sales		\$100,000
<u>Less</u>		
Inventory purchases	\$60,000	
Other purchases	\$ 3,000	
Capital goods purchased	<u>\$ 5,000</u>	
Total		<u>\$ 68,000</u>
Tax Base		<u>\$ 32,000</u>

VAT Liability for Tax Period—Invoice Method

<u>Output Tax</u>		
Sales \$100,000 x 10% VAT rate		\$ 10,000
<u>Less</u>		
<u>Input Tax</u>		
Inventory purchases	\$60,000 x 10%	\$6,000
Other purchases	\$3,000 x 10%	\$ 300
Capital goods purchased	\$5,000 x 10%	<u>\$ 500</u>
Total		<u>\$ 6,800</u>
Net VAT due		<u>\$ 3,200</u>

Components of VAT Base and Tax LiabilityAdditive Method

Profit (adding back in depreciation)	\$24,500
Labor	\$10,000
Rent	\$ 1,000
Interest	\$ 500
Taxes	\$ 700
Charitable contributions	<u>\$ 300</u>
Total	\$37,000
Less capital goods purchased	<u>\$ 5,000</u>
Total base	\$32,000
10% VAT rate	<u>.10</u>
Net VAT due	<u>\$ 3,200</u>

Thus, the additive VAT base includes the four factors of production as well as payments of taxes and charitable contributions (the latter are not taxed to the payee) to the extent that all of these costs are shifted by the payor into the prices of its taxable products or services. The invoice method VAT base also includes pay-

ments of taxes and contributions that are shifted into the selling price of taxable goods and services. Thus, these VAT bases do not include payments by individuals of their personal tax liabilities or their personal charitable contributions, nor payments of taxes and contributions by VAT-exempt entities. Ultimately, consumers of taxable goods and services bear VAT on shifted taxes and contributions made by sellers in the production-distribution chain. Depending upon the scope of the VAT base, however, consumers may not bear VAT on the services the charities and units of government provide with the tax revenue and contributions.

Viewed from the perspective of the final consumers who bear the tax burden, a VAT is imposed on taxable goods and services, whether the purchase price is paid out of income already subjected to income and payroll taxes, receipts exempt from these taxes, or funds from accumulated wealth.

3. *VAT as a Tax on Business or on Consumers*

a. *Introduction*

In this article, it is assumed that any American VAT will be a C-style tax that eliminates producer or capital goods from the tax base. A C-style VAT may be imposed as a tax on business or as a tax on final consumers. If the VAT is designed as a tax on business, the tax burden may be allocated among traders in relation to the value each adds to taxable goods and services and the value of its taxable imports. If VAT is designed as a tax on final consumers of taxable goods and services, the tax burden may be allocated among consumers in relation to the amount of taxable goods and services they purchase. Whether the legislature describes the VAT as a tax to be borne by business or by consumers, the tax likely will be shifted by business in most instances and will be borne by consumers. Nevertheless, the legislative intent to tax business or consumers may affect the design of the tax base.

If the VAT is intended to tax business, then the legislature logically may grant tax preferences based on the nature of the seller. Congress could decide, for administrative reasons, to remove from the tax rolls traders making sales of taxable goods and services below a minimum amount for a specified period, such as a quarter or

a year.¹²⁰ For constitutional reasons, the legislature also may exempt units of government, at least to the extent that they supply goods or services in the exercise of their essential governmental functions.¹²¹ For political reasons, the legislature also may exempt other supplies by units of government or supplies by some or all income tax-exempt organizations. If the legislature intends to use VAT in order to allocate part of the cost of government among businesses in relation to the value they add to goods and services, then it is difficult to justify VAT exemptions based on the nature of the item sold, such as sales by farmers and construction companies, or services by medical practitioners and financial intermediaries.¹²²

If, instead, the legislature intends to impose VAT on consumers, then it should define the scope of the tax by reference to the nature of the supply. The legislature may grant item-by-item preferences for social, economic, or administrative reasons. For example, to reduce the regressive effects of a tax borne by consumers, the legislature may remove VAT from the cost of necessities such as food, housing, and medical care.¹²³ While, from a policy perspec-

¹²⁰ For example, under the British VAT, a person is a taxable person subject to VAT if he is, or is required to be, registered. Registration is required if a person makes taxable supplies exceeding 6,000 pounds sterling in a quarter or exceeding 18,000 pounds sterling for four quarters. The Value Added Tax Act, 1983, ch. 55, §§ 2(1)-(2), sched. 1(1).

¹²¹ See Special Comm. on the Value-Added Tax of the Section of Tax'n, ABA, Technical Problems in Designing a Broad-Based Value-Added Tax for the United States, 28 Tax Law. 193, 201-05 (1975).

¹²² Common Market and other countries with VATs imposed on consumers typically grant preferences for food, housing, medical care and some services of financial intermediaries. For example, the United Kingdom grants zero rating for food, buildings and certain fuel, and exemptions for land, health services, and certain financial services. The Value Added Tax Act, 1983, ch. 55, § 12, sched. 5 & 6.

¹²³ This goal can be accomplished in two different ways. The legislature may tailor such exemptions to the targeted low income consumers by granting them a credit against their income tax liability for all or a portion of the VAT they must pay on their purchases. To provide the benefit of the credit to individuals who are not on the individual income tax rolls, the legislature would have to make the credit refundable. While the refundable nature of the credit would increase the effectiveness of the credit in reaching intended beneficiaries, it would also result in the submission of some kind of return by those otherwise not on the income tax rolls, countering the recent trend to reduce the number of taxpayers on the rolls. See The President's Proposal, *supra* note 1, at 5. In addition, the legislature may have to provide a definition of income that is more consistent with the economic rather than the Code concept of income. In the alternative, the legislature may exempt these necessities, whether purchased by low or high income consumers. This exemption-by-product approach reduces the tax base more than the tax credit option.

tive, the base of a VAT levied on consumers should depend upon the nature of the items purchased, it is inevitable that the legislature would grant at least some VAT exemptions based on the nature of the seller.¹²⁴ For administrative reasons, Congress may remove small traders from the VAT rolls.¹²⁵ Other supplier exemptions may be prompted by political rather than administrative or equity considerations. For example, subject to an unrelated business concept,¹²⁶ Congress may exempt sales by section 501(c)(3) charitable organizations¹²⁷ or units of government.

In defining the base of a VAT imposed on consumers, the legislature could start with the Commerce Department's list of PCEs, and then reduce this potential tax base by granting preferences for some items on this list and/or for some suppliers of these items. Alternatively, the legislature could start with a base consisting of a combination of PCEs and value added by the charitable-governmental sectors of the economy and then narrow this potential base by removing goods and services from either or both group(s). In the following material, these two sources for a comprehensive VAT base will be considered separately.¹²⁸

b. Personal Consumption Expenditures

If the legislative intent is to impose VAT on personal consump-

¹²⁴ If the exempt supplier is selling goods or rendering services to a taxable trader, the loss of revenue resulting from this "supplier" exemption is recouped at the next taxable stage. This revenue recoupment occurs under an invoice method VAT because the buyer charges VAT on the sales price of its goods or services and does not reduce this output tax liability by any portion of the cost of the items purchased from the exempt supplier.

¹²⁵ See, e.g., The Value Added Tax Act, 1983, ch. 55, § 12, sched. 1(1) (providing for a small trader exemption from the United Kingdom VAT).

¹²⁶ See I.R.C. §§ 511-15 (pertaining to income tax-exempt organizations and the unrelated business concept).

¹²⁷ Section 501(c)(3) charities include organizations operated for religious, charitable, scientific, literary or educational purposes, or for the prevention of cruelty to children or animals. I.R.C. § 501(c)(3).

¹²⁸ There are other tax base issues that should be considered, but they are beyond the scope of this article. For example, should a VAT base include the sale by businesses of assets other than in the ordinary course of business? Such sales include bulk sales of inventory and sales of depreciable and intangible property by a business in the process of liquidation or sale of all or a portion of its operating assets. The businesses typically have obtained an input tax credit for VAT charged on the purchase of these assets. It therefore would be appropriate to charge VAT on the resales. If taxable traders purchased the assets, they could take an input tax credit on such purchases. If nontaxable persons, such as final consumers, acquired the assets, they should bear VAT on such purchases.

tion of goods and services, Congress could construct the base by reference to the Commerce Department's report of PCEs. Some commentators have constructed possible VAT bases, using this data. For example, using the 1970 data on PCEs, Professor McLure projected a VAT base equal to 75.5% of PCEs, if Congress granted limited preferences, and a base of 46.6% of PCEs, if Congress granted more liberal preferences.¹²⁹ Using Professor McLure's assumptions and updating the data to 1986 levels, the estimated tax base with his list of limited preferences would be 74.9% of PCEs and, with his list of more liberal preferences, 49.6% of PCEs, as follows:

¹²⁹ See McLure, Jr., *supra* note 51, at 165, Table 2.

Table 7

	<u>PCEs</u> ¹³⁰	<u>Limited Exemptions</u>	<u>Liberal Exemptions</u>
		(in billions \$)	
Food & tobacco ¹³¹	532.0	522.6	333.2
Clothing, accessories & jewelry ¹³²	209.1	209.0	209.0
Personal care ¹³³	41.4	41.4	41.4
Housing	436.9	—	—
Household operation ¹³⁴	343.0	333.3	212.2
Medical care expenses ¹³⁵	357.8	357.8	—
Personal business ¹³⁶	195.1	84.6	46.9
Transportation ¹³⁷	365.3	360.1	360.1
Recreation ¹³⁸	198.0	186.9	186.9
Private education & research	46.9	—	—
Religious & welfare activities	62.4	—	—
Foreign travel & other, net	11.9	—	—
Total	<u>2,799.8</u>	<u>2,095.7</u>	<u>1,389.7</u>
% of PCEs	<u>100</u>	<u>74.9</u>	<u>49.6</u>

¹³⁰ See Bureau of Economic Analysis, U.S. Dep't of Commerce, 67 Survey of Current Business 32, Table 2.4 (July, 1986) [hereinafter Commerce Survey].

¹³¹ Limited exemptions remove food furnished to employees (including military) and food produced and consumed on farms. Liberal exemptions also remove purchased meals, beverages and tobacco products.

¹³² Whether the base has limited or liberal exemptions, it removes only standard clothing issued to military personnel.

¹³³ There are no exemptions in this category, whether the base is constructed with limited or liberal exemptions.

¹³⁴ With limited exemptions, domestic services are removed from the tax base. With liberal exemptions, household utilities also are removed.

¹³⁵ With limited exemptions, all medical care expenses remain in the tax base, but with liberal exemptions, all medical care is removed from the base.

¹³⁶ With limited exemptions, two categories are removed—expenses of handling life insurance, and services furnished without payment by financial intermediaries except life insurance carriers and private pension plans that are not insured. With liberal exemptions, legal services and funeral, and burial expenses also are removed.

¹³⁷ With limited and liberal exemptions, bridge, tunnel, ferry, and road tolls, as well as local transit systems are removed from the tax base.

¹³⁸ With limited or liberal exemptions, the following items are removed from the tax base: admissions to legitimate theaters and opera, entertainments of nonprofit institutions (except athletics); clubs and fraternal organizations except insurance; and parimutual net receipts.

With a VAT base containing the above limited exemptions of PCEs, the tax in 1986 would have raised about \$21 billion per one percent rate VAT, and with more liberal exemptions, it would have raised about \$14 billion per one percent rate VAT. In contrast, Chairman Ullman estimated that his proposed VAT would have raised, in 1981 about \$11.5 billion per one percent rate VAT.¹³⁹

The federal, state and local governments tax consumers of services in a very haphazard fashion, with some services taxed at more than one level of government and other services not taxed at all. Services, in 1986, accounted for approximately 34.4% of the GNP and fifty-two percent of PCEs.¹⁴⁰ It is likely that the service sector will continue to grow. Indeed, with the technological obsolescence of the work force in the production section, one mathematician estimated that by the year 2000, the United States will need only two percent of the labor force to produce all American-made goods.¹⁴¹

Though consumption taxes in the United States are relatively modest by Western standards,¹⁴² these taxes are imposed predominantly on goods. Services tend to increase with individual or family income. A federal VAT imposed on a broad range of consumer services, as well as on consumer goods, would expand the subject of American taxes.

There have been two major bills proposing a federal VAT. The preferences proposed under each of these bills are different. Representative Ullman's 1980 proposal for a invoice method VAT¹⁴³ included preferences for some PCEs. It zero-rated retail sales of food and sales by farmers and fishermen, housing, medical care, mass transportation in urban areas, exports, interest,¹⁴⁴ and supplies by section 501(c)(3) organizations other than as part of an unrelated

¹³⁹ See Staff of House Comm. on Ways and Means, 96th Cong., 2d Sess., Explanation of the "Tax Restructuring Act of 1980" 1-2 (Comm. Print 1980) [hereinafter *Tax Restructuring*].

¹⁴⁰ See Commerce Survey, *supra* note 130, at 20, Table 1.1. This percentage depends upon the standard used in classifying economic activities as goods or services. This figure is based on National Income and Product Accounts.

¹⁴¹ See R. Barnet & R. Muller, *Global Reach: The Power of the Multinational Corporations* 325-26 (1974) (citing Rand mathematician Richard Bellmann's prediction of this two percent figure).

¹⁴² See *supra* p. 214, Table 3.

¹⁴³ See House Bill, *supra* note 53, at 7484.

¹⁴⁴ See *Tax Restructuring*, *supra* note 139, at 16-17.

business.¹⁴⁵ Senator Roth's proposed Business Transfer Tax included single-stage exemptions for some food, housing, medical care, and land.¹⁴⁶

Typically, items acquired for investment, such as stocks, bonds, and futures contracts, are not deemed items of personal consumption and therefore should not be included in the VAT base. However, there are many items that possess elements of both investment and personal consumption, such as paintings and other art objects, land, and collectors' items. The last category includes antiques, coins and stamps, and military relics. These mixed investment-consumption goods generally are not used-up by the final consumer, but may be stored or placed on display in the owner's residence or place of business and, ultimately, resold. Theoretically, the VAT-ability of the mixed investment-consumption item should depend upon the use to which the goods are put. If the goods are displayed at home, their use may be viewed as predominantly consumption and thereby taxable, but the same painting stored in a vault may be held predominantly for investment and therefore should not be subject to VAT. An administrative advantage of VAT over the way retail taxes have developed in the United States is that under the VAT, the seller charges VAT based on the nature of the supply, not the nature of the buyer or the reported purpose to which the buyer intends to put the item. For this reason, and for administrative simplicity, the legislature may arbitrarily tax these mixed purpose purchases, notwithstanding the investment quality of the purchase to some buyers.

Congress could use a VAT base to offset the distortions in consumption created by some income tax exemptions, such as those exemptions for in-kind services. The individual income tax system, for example, encourages employees to bargain for part of their wage package in the form of health and accident insurance rather than in cash because the insurance benefits are not subject to income tax.¹⁴⁷ The grant of these income tax preferences distorts in-

¹⁴⁵ See *id.* at 17. Supplies by other income tax-exempt organizations are taxable only if a charge or fee is made for such supplies. *Id.*

¹⁴⁶ See Senate Bill, *supra* note 54, at S5676-77.

¹⁴⁷ The system also encourages taxpayers to bargain for other nontaxable fringe benefits, such as free parking at work, meals provided on the business premises, free flights for airline employees, group legal services, and educational assistance benefits.

dividual consumption choices.¹⁴⁸ Congress could tax these benefits under a VAT by providing that a business may serve as surrogate taxpayer for the final consumer. Thus, under an invoice method VAT, a business can be denied an input tax credit for VAT charged on business travel and entertainment expenses as well as on automobiles purchased for the personal use of employees or owners.¹⁴⁹ Likewise, the input tax credit may be denied for VAT charged on business purchases of inventory, such as food or clothing, that are applied for the personal use of such individuals.

c. Sales and Services by Charitable-Governmental Sectors

A taxable trader's payments of taxes and charitable contributions are included in its VAT base to the extent that such payments are included in the trader's prices or fees charged for its goods and services. In effect, under an invoice method VAT, the taxable trader serves as surrogate tax collector on the portion of the services provided by the payee unit of government or charity with the taxes and charitable contributions made by such trader. The trader does not obtain an input tax credit for the payments because VAT is not charged on such payments. Such tax ultimately is paid by the final consumers of the goods and services acquired from such taxable traders. For example, assume businesses in City A pay \$10 million of the \$20 million local property taxes used to finance education. Assume further that these businesses shift the \$10 million cost into the prices of their taxable products, collecting a ten percent VAT on this \$10 million. The \$1

¹⁴⁸ This distortion was more prevalent before Congress' decision, effective in 1985, to curtail the scope of nontaxable fringe benefits, see I.R.C. § 132, and its decision in 1986 to disallow 20% of business expenses for certain meals and entertainment, the latter a form of consumption by employees receiving these items without charge. See I.R.C. § 274(n). This same 20% disallowance rule applies to business payments for meals excludable from the employee's income under § 119 of the Code.

¹⁴⁹ Unless Congress combined the enactment of a VAT with the repeal of the remaining income tax preferences for certain services, the federal tax system still would distort consumers' choices by encouraging taxpayers to receive some of their income in services not subject to income tax. If Congress subjected health and accident insurance to VAT, see I.R.C. § 106(a) (excluding the value of such employer-provided coverage), it might reconsider the rationale for the income tax preference for the nonprofit organizations providing this kind of service to final consumers, especially since income represents one of the four economic factors of production included in the VAT base. A study of possible VAT preferences may trigger a reexamination of the rationale for the above described kind of income tax preferences.

million VAT attributable to these taxes will be borne by final consumers of these products. Indirectly, final consumers pay VAT on the \$10 million of educational services provided by City A. The local residents of City A pay the other \$10 million in local property taxes. No VAT is paid on this \$10 million in educational services that they finance.

Any American VAT would undoubtedly include preferences for some supplies by the charitable-governmental sectors. For example, under the Ullman bill, both sales to units of government¹⁵⁰ and educational services provided by governmental entities were zero rated.¹⁵¹ Under Senator Roth's proposed Business Transfer Tax, units of government and income tax-exempt organizations were not taxed, except that the latter were taxed on receipts allocable to unrelated business income.¹⁵²

It is beyond the scope of this article to debate the justification for potential VAT preferences for the charitable-governmental sectors, based on the nature of the supply or the nature of the supplier. However, such preferences may significantly reduce the potential tax base and increase the complexity of the tax, detracting from some of the professed advantages of adding a broad-based VAT to the federal tax system.

4. *Demographic Aspects of the Tax Base*

A VAT may be an attractive new revenue source if current and anticipated demographic changes reduce the existing income and payroll tax bases. A federal VAT would provide a desirable offset to this tax base cut. The following discussion focuses on two demographic changes that may influence the future federal income and payroll tax bases—the aging population and the increase in the proportion of two-job couples. As our population ages, we experience a reduction in the ratio of workers to retirees.¹⁵³ Ultimately, this shift may alter the balance between payroll tax receipts and the cost of social security and medicare programs financed with

¹⁵⁰ See Tax Restructuring, *supra* note 139, at 17. This is an unusual form of VAT preference because it places on the seller the responsibility to identify the preference by reference to the nature of the buyer.

¹⁵¹ See *id.* Other sales by governmental entities are taxable only if the entities make a separate charge or fee for such supplies. *Id.*

¹⁵² Senate Bill, *supra* note 54, at S5662.

¹⁵³ See J. Pechman, *supra* note 24, at 1204.

these taxes. There are other tax base ramifications associated with our aging population. Past and some current incentives to defer income through contributions to pension and profit-sharing plans, Individual Retirement Accounts, or other retirement programs have created a reservoir of deferred income that will become taxable as the retirees withdraw these savings for post-retirement consumption. However, this built-in tax base merely offsets retirees' typically lower taxable income. Since retirees typically are replaced by lower paid workers, it is likely that, on balance, the individual income tax base will decline unless the number of workers or their per capita income increases.

If a reduction in the number of workers to retirees creates a need for additional revenue, should Congress raise this revenue from the existing individual income or payroll taxes, or should it enact a new VAT? The individual income tax would raise revenue from retirees as well as workers. Payroll taxes would increase the tax burden on workers, not retirees. In effect, Congress would increase the payroll tax burden on the children of retirees in order to finance the programs benefitting their retired parents. If, instead, Congress adopted a new VAT, the tax would be borne by retirees as well as workers in proportion to the amount of taxable consumer goods and services purchased by each group. Retirees that bore income and payroll taxes during their working years now would bear VAT on purchases financed with their after-income tax savings. A new VAT creates an inevitable transitional problem resulting from a switch from a federal system relying heavily on taxes imposed on income at its source to a system relying on taxes imposed in part at the source of income and in part at the point of use of income for consumption. However, if such a tax is otherwise desirable, this transitional problem should not form the basis for rejecting a federal tax on consumption. To provide relief for the retirees, the legislature could adjust the retirees' income tax burden or their social security benefits.

The increase in the number of two-job couples has produced a change in the demography of the American work force. With the cut in the top individual tax rate, it is predictable that this trend will continue.¹⁵⁴ The resulting increase in the number of workers

¹⁵⁴ For a discussion of some of the policy issues relating to the choice of the taxable unit as an individual or a family, see McIntyre, *Fairness to Family Members Under Current Tax*

ultimately may reduce wage rates. Yet, both husband and wife will contribute fully to payroll tax revenue. They also combine their incomes for purposes of the individual income tax. In some cases, their combined income may be taxed at a higher effective tax rate than if they were unmarried.¹⁵⁵ In contrast, VAT liability is based on the level of taxable consumption, not on the consumer's marital or family status.

Anticipated demographic changes in the work force resulting in increased taxable wages subject to income and payroll taxes, should offset some of the negative aspects of our aging population. On balance, alterations in the tax base resulting from the above demographic changes should not influence the composition of the federal tax structure.

5. Summary

The enactment of a VAT may expand the federal tax base by imposing tax on economic activity that is beyond the scope of the income tax bases. For example, to the extent that taxpayers use savings or untaxed income for taxable consumption items, the government would obtain revenue from sources not covered by existing income and payroll taxes. In addition, taxable traders' contributions to charities and taxes paid to units of government are included in an invoice method VAT base to the extent that such payments are included in the prices of the traders' taxable goods sold or services rendered. To the extent that these contributions or taxes are deductible for income tax purposes, they are not included in the income tax bases.

Reform Proposals, 4 Am. J. Tax Pol'y 155 (1985); see also Munnell, *The Couple Versus the Individual Under Federal Personal Income Tax*, in *The Economics of Taxation* 247-78 (H. Aaron & M. Boskin ed. 1980) (outlining family income tax planning).

¹⁵⁵ This marriage penalty, ameliorated prior to 1987 by the special deduction for the two job couple, still remains for some couples after tax reform, despite the fact that there are only two rate brackets. For example, assume that after 1987, W earns \$22,000 and H earns \$20,000 income. If they were married, filing separate returns, then after taking the \$3,000 standard deduction, see I.R.C. § 63(c)(2), and the \$1,950 personal exemption, see I.R.C. § 151(d) W would have taxable income of \$17,050 and H would have taxable income of \$15,050. At the 15% rate, see I.R.C. § 1(a), W's tax would be \$2,577.50 and H's tax would be \$2,257.50, for a total of \$4,835. If they were married, filing a joint return, after taking a \$5,000 standard deduction and \$3,900 for two exemptions, their taxable income would be \$33,100 and their tax would be \$5,400.50, \$565.50 more than if they were unmarried.

C. *Economic Considerations*

Many of the policy-relevant considerations listed above have economic implications. In addition, VAT advocates frequently claim that there are economic advantages of adding this national sales tax to our federal tax system.¹⁵⁶ The analysis in this subsection covers the impact of taxes on inflation, capital formation and savings, equity or fairness, and economic efficiency. For purposes of this discussion, it is assumed that federal revenue must be increased. Thus, for each economic issue, the impact of a new VAT will be compared with increases in existing federal taxes. Finally, this subsection concludes with a discussion of the desirability and feasibility of adopting a VAT as a fiscal tool to promote national economic goals.

1. *Inflation and Price Stability*

Inflation is recognized as a complex process influenced by many cost-push factors.¹⁵⁷ In the past, inflation significantly affected federal tax revenue. As price increases prompted increases in money incomes, wage inflation pushed taxpayers into higher tax rate brackets.¹⁵⁸ Indeed, due to the progressive rate structure, individual income tax collections increased by more than the inflation rate, producing a "fiscal dividend." Beginning in 1985, Congress curtailed this inflation dividend by adjusting the individual income tax rate brackets for inflation.¹⁵⁹ With the two rate individual income tax enacted as part of the 1986 tax reforms, Congress has precluded an inflation dividend from the taxpayers already in the top rate bracket.¹⁶⁰ Inflation in wages and prices still increases

¹⁵⁶ See, e.g., R. Lindholm, *A New Federal Tax System* 127-40 (1984).

¹⁵⁷ See R. Goode, *The Individual Income Tax* 291 (1976).

¹⁵⁸ See J. Pechman, *supra* note 24, at 16. According to Pechman, at 1984 income levels and tax rates, 10% inflation would increase federal receipts about "\$105 billion a year, or 2.6 percent of potential GNP." *Id.* For decades, Congress used part of this fiscal dividend to cut individual income taxes in the biennial congressional election years and used the remainder to finance the expansion of federal programs. See E. Tuyle, *Political Control of the Economy* 137 (1978). This automatic inflation-induced boost in personal income tax revenues ("bracket creep") occurred without congressional action. See J. Pechman, *supra* note 24, at 109.

¹⁵⁹ See Int. Rev. Code of 1954 § 1(f).

¹⁶⁰ Taxpayers in the 28% rate bracket still may be affected by inflation if their inflated income pushes them into the five percent surtax range. See I.R.C. § 1(g). Even with this two rate system, Congress provided inflation adjustments by providing for the indexing of the

payroll tax revenues tied to wages, and inflation in prices automatically increases excise taxes that are measured by the selling price for taxed goods and services, but inflation does not change the effective payroll or excise tax rates.¹⁶¹

It is unlikely that VAT would perform better than existing taxes as a tool to stabilize the economy during periods of full employment. Indeed, there is scant evidence that taxes, per se, influence inflation by significantly affecting consumer demand, wage rates, or the money supply.¹⁶² Changes in taxes act as stabilizers if they offset "the effects on income and output that would otherwise be associated with autonomous fluctuations in demand."¹⁶³ Changes in individuals' income and payroll tax burdens alter after-tax spendable funds (usually measured by disposable personal income) and thereby may influence the level of potential consumer demand for goods and services. However, the impact of these taxes on consumer demand and on inflation probably is less than other factors, such as "the composition of income, wealth, liquidity, previous and expected future levels of income and consumption, and demographic variables."¹⁶⁴

A progressive individual income tax, without inflation adjustments, provides some automatic stabilizing effect on prices,¹⁶⁵ but not necessarily on wages.¹⁶⁶ Traditionally, during periods of inflation, the effective individual income tax rates increase and spendable income decreases. With the indexation of the tax rate brackets and the planned reduction to two tax brackets, Congress has reduced the stabilizing effect of the individual income tax. A switch

tax rate brackets and the standard deduction for tax years after 1988, and the indexing of personal exemptions for tax years after 1989. See I.R.C. §§ 1(f), 63(b)(4), 151(d)(3).

¹⁶¹ As flat rate taxes, most excise taxes do not have the bracket creep effect of the progressive individual income tax. Inflation also does not affect excises based on the number or volume of the items sold, such as alcohol, tobacco and gasoline taxes.

¹⁶² Brown, Reflections on Fiscal Policy, in *The Economics of Taxation*, supra note 154, at 349, 354.

¹⁶³ R. Goode, supra note 157, at 272.

¹⁶⁴ Id. at 280.

¹⁶⁵ If inflation occurs during periods of high unemployment, the built-in increases in personal income tax may precipitate further declines in production and employment. See Bailey, Inflationary Distortions and Taxes, in *Inflation and the Income Tax* 291, 313 (H. Aaron ed. 1976). A direct tax on consumption, such as a progressive expenditure tax, would have less built-in flexibility than the individual income tax simply because consumption is more stable than income. R. Goode, supra note 157, at 278.

¹⁶⁶ See R. Goode, supra note 157, at 289.

from individual income tax to VAT therefore may not reduce the stabilizing effect of federal taxes on prices.

The corporate income tax generally does not influence inflation, but its impact depends, in part, upon who bears this tax. If the corporate tax is shifted into product prices, then it increases prices and therefore the inflation rate. For corporations able to shift part of the corporate tax back to labor in the form of reduced wages, corporate tax increases should not alter product prices. More likely, with the exception of corporations in regulated industries or those enjoying monopoly or similar economic power to set prices, the corporate tax is borne, at least in large part, by shareholders, not shifted forward in product prices. In this situation, a corporate tax rise should not increase product prices. The overall stabilizing effect of the corporate income tax is difficult to evaluate but assuming that it is absorbed by shareholders, it probably is substantially below that of the individual income tax, even with the current two rate brackets.¹⁶⁷

Payroll taxes have mixed effects on product prices. The employee's share of social security taxes can be expected to reduce his take-home pay and, depending upon the monetary policy, may tend to stabilize or reduce prices. In the short term, an increase in the employer's share of social security taxes will increase business costs and therefore product prices. However, in the long term, the employer likely will shift this cost back to labor¹⁶⁸ and reduce the product prices. Thus, increases in both the employer and employee's share of payroll taxes can be expected to have some stabilizing effect on the economy. Nevertheless, it is unlikely that Congress would increase the taxable wage base or rate under the

¹⁶⁷ Dividend policy does not respond quickly to changes in the level of after-tax profits. To the extent that a reduction in after-tax profits eventually will reduce dividend distributions, a corporate tax increase may reduce shareholders' disposable income, but probably not enough to affect overall consumer demand and, consequently, consumer prices. Thus, the corporate tax would not produce as quick a stabilizing effect on personal consumption expenditures as the individual income tax, even if dividend cuts would affect product prices. See R. Goode, *supra* note 157, at 277-280.

¹⁶⁸ See Break, *supra* note 40, at 119, 168-175. According to Break, "[i]f the aggregate supply of labor is insensitive to wage rate changes, economists typically conclude that an employers' payroll tax will be completely shifted, and even for implausibly high labor supply elasticities the unshifted portion is unlikely to exceed 20-25 percent." *Id.* at 174; see also De Wulf, *Taxation and Income Distribution*, in *Comparative Tax Studies: Essays in Honor of Richard Goode* 345, 354-355 (S. Cnossen ed. 1983).

benefit-linked social security taxes in order to control inflation.

Increasing existing selective excise taxes may not serve to stabilize prices. Most of these excise taxes are imposed on the selling prices of taxed items, so that increases in excise taxes likely will increase the prices of the taxed products and thereby may trigger some reduction in overall consumer demand by consumers of those taxed products.¹⁶⁹ Excise tax increases may have other salutary effects. For example, an increase in the rates of existing excise taxes (particularly on a temporary basis) may affect the timing of the demand for those items and therefore may discourage attempts to increase prices.¹⁷⁰ Ironically, if Congress were to consider a possible increase in excise rates, due to the time lag between proposal and effective date of the increase, the proposal actually may trigger additional consumer demand before the rate hike takes effect.¹⁷¹

Enactment of a broad-based VAT can be expected to cause a one-time increase in product prices¹⁷² for the taxed items by the rate of the new tax.¹⁷³ In 1979 the United Kingdom shifted from income taxation to VAT. As a result of this tax shift, the retail price index substantially increased.¹⁷⁴ As with excise taxes, a time lag between enactment and effective date of a new VAT may increase consumer demand for the period before the tax becomes effective.

In summary, if Congress decides to increase revenue and wants

¹⁶⁹ See Bailey, *supra* note 165, at 313.

¹⁷⁰ See R. Goode, *supra* note 157, at 291.

¹⁷¹ See Munnell, *supra* note 154, at 359. A proposal to reduce rates may precipitate a drop in the demand until the rate declines.

¹⁷² A broad-based tax imposed equally on all units of production is more likely to be shifted into product prices than taxes imposed only on selected items or only on one factor of production such as profits. Kaldor states that "[a] general tax on sales of 10 per cent. will always raise prices in relation to wages 10 per cent. . . ." 1 N. Kaldor, *A Memorandum on the Value-Added Tax*, in *Essays on Economic Policy* 279 (1964).

¹⁷³ Product prices also may be influenced by monetary growth attendant to the enactment of a broad-based sales or value added tax. However, the inflationary impact of the monetary policy must be divorced from the impact of the tax policy. The former will not be considered in detail in this article. See *The President's Task Force on Business Taxation, Business Taxation: The Report of the President's Task Force on Business Taxation* 80 (1970) (minority views of Norman B. Ture) [hereinafter *Business Taxation*].

¹⁷⁴ See A. Prest, *Value Added Taxation: the Experience of the United Kingdom* 11 (1980). However, there were reports that some stores were absorbing part of the VAT increase. "One econometric study suggests that only three-quarters of the VAT increase was likely to be passed forward to consumers." Beenstock, *Taxation and Incentives*, 134 *Lloyds Bank Review* 35, 35 (1979).

the tax increase to serve to stabilize prices and control inflation (or at least not create an inflationary effect), then it should not increase revenue with a new VAT. Quite the contrary, a new VAT likely will increase product prices more than increases in income or payroll taxes, especially a progressive income tax.

2. *Capital Formation and Savings (Economic Growth)*

Increased individual savings and increased after-tax business profits can promote economic growth by generating higher levels of business investment and thus creating more jobs.¹⁷⁵ In part, it is assumed that an increase in the rate of return on savings or investment will produce the economic growth. Conversely, it is claimed that since a tax on savings or investment reduces the after-tax rate of return, such a tax adversely affects economic growth. It is unclear if these assumptions remain valid today.¹⁷⁶

A VAT ultimately is borne by consumers of taxed items.¹⁷⁷ For individuals choosing between current consumption and saving, the enactment (or increase in rate) of a tax on consumption should provide an incentive to defer consumption—in other words, it should encourage savings.¹⁷⁸

Taxes imposed at the source of income and borne by individuals reduce personal disposable income and therefore reduce funds available either for savings or consumption. Tax changes or tax incentives that increase the rate of return on savings may not actually lead to increased savings for two reasons.¹⁷⁹ First, an abrupt

¹⁷⁵ See J. Pechman, *supra* note 24, at 36.

¹⁷⁶ See Sunley & Brannon, *Direct Consumption Taxes: Value Added and Retail Sales*, in *Tax Policy: New Directions and Possibilities* 42 (Center for National Policy 1984); see also *Consumption-Type or Cash Flow*, *supra* note 46, at 1173 (discussing a consumption tax's effect on savings).

¹⁷⁷ Excise taxes also are borne by final consumers and would affect economic growth much like a VAT.

¹⁷⁸ R. Goode, *supra* note 157, at 74. For some income groups, an increase in excise or other consumption taxes will alter savings, but not the level of consumption.

¹⁷⁹ For example, the 1981 individual income tax reductions, including incentives for certain forms of savings, "were apparently allocated by households to consumption and saving approximately in the proportions they had allocated their disposable income before." J. Pechman, *supra* note 24, at 116; see also Pechman, *supra* note 49, at 1197 (arguing that the decline in investments may be the result of uncertainty in payoff of investments rather than a shortage of savings). Two economists have persuasively argued that income tax incentives for savings under our previously highly progressive individual rate system would not have been effective. See Galper & Steuerle, *Tax Incentives for Saving*, 2 *Brookings Rev.* 16

increase in the level of savings may precipitate a drop in consumer spending. The resulting decline in the domestic demand for goods and services actually may reduce capital formation because it may produce excess productive capacity. Second, individuals with low income typically use all of their disposable income for consumption. Tax reductions on returns on capital or tax incentives for savings would probably not affect the savings rate for this income group. As disposable incomes rise above the level needed to purchase necessities, individuals have discretionary income available for additional consumption or for savings. Before the 1986 reforms, the progressive individual income tax took an increasing share of discretionary income from higher income individuals.¹⁸⁰ Thus, individuals more likely to save a larger proportion of their incomes would have reduced levels of discretionary income available for savings.

An increase in the corporate income tax may adversely affect savings and economic growth. New investment in physical capital comes mainly from individual and business savings or from borrowing. Indeed, existing corporations finance a large proportion of new investment with after-tax corporate profits.¹⁸¹ Since tax borne by business reduces after-tax profits, a corporate tax rise reduces funds available for distribution to owners or for reinvestment in business expansion.

Since the two-tier system of taxing corporations on their taxable income and taxing shareholders on dividend income actually reduces the rate of return on corporate investments, the corporate tax may divert investment funds away from corporations to investment opportunities in the noncorporate sector that earn a higher after-tax return. However, even if Congress integrated the corporate and individual income taxes or took other action to increase the rate of return on corporate investments, these measures may not promote business expansion or increase investment in the corporate sector.¹⁸² With high rate corporate and individual income taxes in effect before the 1986 reforms, Congress effectively used

(1983).

¹⁸⁰ See *supra* note 3.

¹⁸¹ See Subcomm. of the Special Comm. on Value Added Tax, ABA, *Should The United States Adopt The Value-Added Tax?—A Survey Of The Policy Considerations And The Data Base*, 26 *Tax Lawyer* 45, 64-65 (1972) [hereinafter *Policy Considerations*].

¹⁸² See Pechman, *supra* note 49, at 1197.

tax incentives to divert economic resources into socially or economically desirable investments. Like Joan of Flanders, who in 1224 encouraged migration of fifty weavers to Courtrai by exempting them from the universal *taille* (property tax),¹⁸³ Congress encouraged capital formation with tax preferences such as the investment tax credit and accelerated depreciation for capital goods and encouraged investment in social projects such as low-income housing with liberal depreciation deductions and other preferences. Notwithstanding these incentives, management generally will reinvest business profits only if such internal expansion will provide a better return than alternative investment opportunities.¹⁸⁴ In addition, with the 1986 tax reform that broadened the bases,¹⁸⁵ reduced the rates under the income taxes,¹⁸⁶ and restricted the use of certain tax exemptions and deductions,¹⁸⁷ Congress substantially reduced its ability to use tax preferences under the individual and corporate income taxes to divert economic resources to investments that would promote economic growth.

Payroll tax increases are not likely to affect savings and capital formation. Payroll taxes¹⁸⁸ are imposed at the source of income from labor and, for the employees' share, are withheld from wages. In the long term, both the employer and employee's share of the social security taxes probably will be borne by labor in the form of reduced wages. They thus reduce funds available to the worker for savings or consumption and therefore do not encourage either. Social security taxes are proportional as to income, up to the wage cap. The effective tax rate then declines as income exceeds the cap. Since these taxes burden lower income taxpayers (not as likely to

¹⁸³ See R. Cave & H. Coulson, *A Source Book for Medieval Economic History* 374 (1936).

¹⁸⁴ *Id.*

¹⁸⁵ For example, the 1986 Act repealed the investment tax credit available under the 1954 Code. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 211(a), 100 Stat. at 2166 (amending I.R.C. § 49(a)).

¹⁸⁶ See I.R.C. § 1.

¹⁸⁷ In the 1986 Act, Congress eliminated several tax incentives for savings. It eliminated the capital gains preference applicable to gain on the sale of investments. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 301, 100 Stat. at 2216-17 (repealing I.R.C. § 1202). Congress also restricted the deductions for payments into Individual Retirement Accounts. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1101, 100 Stat. at 2411-14 (amending I.R.C. § 219).

¹⁸⁸ For this purpose, the analysis is limited to the Federal Insurance Contributions Act (FICA) taxes which encompass the social security and hospital insurance that account for most of the federal payroll taxes.

save) more than higher income taxpayers (more likely to save), the savings rate is not likely to change if the social security tax rate or possibly even the base is increased.¹⁸⁹

A VAT is preferable to existing federal taxes as a fiscal device to encourage savings. Income taxes withdraw funds individuals would otherwise use for consumption or savings. An income tax increase therefore does not encourage savings. Since payroll taxes do not directly burden income from savings or the use of savings for consumption, they do not encourage either. On the other hand, if Congress increased the cost to consume with a VAT (or to a lesser extent selective excise taxes), in effect, it may encourage taxpayers to save rather than consume.

3. *Equity or Fairness*

One significant criterion used to measure the quality of a tax system or a particular tax within the system is tax equity or fairness.¹⁹⁰ Explaining the mission's recommended changes in the Japanese tax system following World War II, Carl Shoup, head of the American Tax Mission, noted that a nation's "tax system must satisfy the deep, widespread feelings of the people as to what is fair."¹⁹¹ He added that "no one remains in the tax field for long without realizing that nothing he recommends will stand up unless it meets the test of fairness in the distribution of the tax burden."¹⁹²

Two economic concepts traditionally have influenced our view of

¹⁸⁹ If Congress retained existing rates, but completely removed the cap on payroll taxes, then such action would reduce funds available to higher income individuals possibly resulting in a reduction of personal savings.

¹⁹⁰ Distributional equity has been described as the method by which "economic resources ought to be distributed in a fair society." Warren, *supra* note 5, at 1081-82. Distributional equity of a tax may be tested either by the distribution of the tax burden or by the distribution of the benefits from the programs financed by the tax. According to Henry Aaron, "[t]he most important question about a value-added tax concerns what its revenues are used for." Aaron, *The Value Added Tax: Some Lessons and Issues*, 1 *Brookings Review* 4, 5 (1982). This article considers only the former.

¹⁹¹ See Gen. Headquarters, Supreme Commander for Allied Powers, Tokyo, 1 Report on Japanese Taxation 17 (1949) (four volume report) [hereinafter Report of the Shoup Mission]. According to Richard and Peggy Musgrave, in their classic treatise on public finance, one of the requirements for a "good" tax structure is that "[t]he distribution of the tax burden should be equitable. Everyone should be made to pay his 'fair share'." P. Musgrave & R. Musgrave, *supra* note 24, at 210.

¹⁹² See 1 Report Of The Shoup Mission, *supra* note 191, at 16.

distributive justice—the “benefit” and the “ability to pay” principles. Based on the benefit principle, each taxpayer should contribute to the revenue “in line with the benefits which he receives from public services.”¹⁹³ A tax based on the benefit principle may link revenue to government expenditure policy; for example, highway user taxes and tolls to fund the maintenance of roads, and to some extent social security taxes to fund retirement and disability programs are taxes levied on the benefit principle. Taxes that fund general government services such as defense cannot be explained under the benefit principle.¹⁹⁴ Congress could levy a VAT to finance specific programs. For example, Congress considered the possible adoption of a form of VAT to finance the Superfund to clean up hazardous waste. However this article assumes that a broad-based VAT will be enacted only if substantial revenue is needed either to reduce the budget deficit or to finance general government services. It therefore is more appropriate to judge VAT by the ability to pay principle.

Three broad gauges may be used to measure individual ability to pay taxes—income, consumption, or wealth¹⁹⁵ of a taxpayer or a taxable unit. Since economic income equals the sum of consumption, savings, and taxes, the basic difference between a tax based on income and a tax based in consumption is that under the latter, income not used for consumption is not taxed.¹⁹⁶ Wealth taxes have been viewed as a possible supplementary index of ability to pay, since income does not adequately take account of the fact that wealth represents command over resources.¹⁹⁷ This article does not compare VAT with a possible annual wealth tax.

In the United States, where the economic system distributes income unequally and family responsibilities may affect ability to pay taxes, the income tax tailored to individual differences may

¹⁹³ P. Musgrave & R. Musgrave, *supra* note 24, at 211. “[B]enefit taxation, even at its best, can relate only to the financing of public services and not to the redistributive function of the tax-transfer process.” *Id.* at 215.

¹⁹⁴ See *id.* at 212-15.

¹⁹⁵ Several European countries impose annual wealth taxes as well as estate or inheritance taxes. The wealth tax typically is based on the value of assets, less liabilities, of the taxable individual or taxable unit (household). See J. Pechman, *supra* note 24, at 245. Exemptions remove all but the wealthy from the tax base. *Id.*

¹⁹⁶ See Shoven & Taubman, *Savings, Capital Income and Taxation*, in *The Economics of Taxation*, *supra* note 154, at 203, 206.

¹⁹⁷ See R. Goode, *supra* note 157, at 21.

effectively distribute the tax burden in accordance with ability to pay concepts.¹⁹⁸ A graduated consumption tax like an annual expenditure tax also may distribute tax burdens in accordance with taxpayers' ability to pay tax.¹⁹⁹

The "ability to pay" principle is subdivided into two elements of distributive justice—horizontal and vertical equity.²⁰⁰ To achieve horizontal equity, taxpayers situated equally should be taxed equally.²⁰¹ If income (what a taxpayer adds to community resources) is viewed as an appropriate measure of ability to pay tax, then taxpayers with equal incomes should be taxed equally. If consumption (what the taxpayer withdraws from community resources for personal use) is deemed an appropriate measure of ability to pay, then taxpayers with equal levels of consumption should be taxed equally.²⁰² For this purpose, equity may be measured by individuals' lifetime or annual consumption.²⁰³ In this section, however it is assumed that annual income is a better yardstick of ability to pay taxes.²⁰⁴

Vertical equity assumes that the tax burden should be progressive as to income. For many years, the federal tax system relied on steeply progressive individual income tax rates to implement our concept of vertical equity. However, since the early 1960s, Congress has cut the top individual tax rate from ninety-one percent to twenty-eight percent.²⁰⁵ Judged by traditional support for a progressive federal tax system, the VAT is not as equitable as progres-

¹⁹⁸ See J. Pechman, *supra* note 24, at 60.

¹⁹⁹ See *id.* at 73.

²⁰⁰ See P. Musgrave & R. Musgrave, *supra* note 24, at 215-24.

²⁰¹ The measurement of horizontal equity also depends in part upon the definition of the taxable unit; that is, should equity be based on individual or household income, or each? Second, it is unclear if the appropriate measuring rod is taxable income, economic income or some other standard. See, e.g., Shoven & Taubman, *supra* note 196, at 205.

²⁰² See Hobbes, *supra* note 45 at 184; see also Bradford & Toder, *Consumption vs. Income Base Taxes: The Argument on Grounds of Equity and Simplicity*, 1976 Proc. of 69th Ann. Conf. on Tax'n of Nat'l Tax Ass'n 25, 29.

²⁰³ See Bradford & Toder, *supra* note 202, at 30.

²⁰⁴ Typically, a tax period of one year is used to judge equity in the distribution of the tax burden of a particular tax. See *id.* at 30-31. But see J. Pechman & B. Okner, *Who Bears the Tax Burden* 52 (1974) (arguing that family economic decisions, such as housing and other consumption choices, tend to be made on the basis of expected income over a period of years, and thus "[e]ffective rates of tax based on income for a single year may not be representative of the tax burdens of families with unusually low (or high) incomes").

²⁰⁵ Compare Int. Rev. Code of 1954 § 1 (1954) (maximum income tax rate of 91%) with I.R.C. § 1 (maximum income tax rate of 28%).

sive income taxes. However, consider (1) the recent dramatic reduction both in the number of brackets and the top rate for the individual income tax, resulting in mildly progressive rates for taxpayers remaining in the tax system; (2) the reduced rate corporate income taxes; and (3) the flat-rate payroll taxes. In light of this new federal tax structure, it is no longer clear that Congress and the taxpaying population would view a single rate, broad-based VAT as providing an "inequitable" distribution of the tax burden.

Broad-based sales taxes are considered regressive because they impose a higher tax burden, as a percentage of income, on lower income groups (especially those below the poverty level) than on higher income groups. But there are two points worth noting. First, there is some evidence that a VAT burden is proportional to income, rather than regressive.²⁰⁶ Second, the regressivity of one tax may be accommodated by making adjustments in the progressive taxes if, as a result, the overall federal system possesses an acceptable degree of progressivity.

The Treasury Department, in its 1984 report on tax reform,²⁰⁷ discussed the concept of progressive and regressive taxes. It suggested that there are two equity issues that affect taxes like sales tax or VAT—the regressivity of the tax and the absolute burden of the tax on the poor.²⁰⁸ Congress can reduce the regressivity of a VAT by granting tax preferences on necessities that account for most or all of the consumption by lower income taxpayers. However, it would be more difficult for Congress to offset the absolute burden of a VAT on the poor, unless Congress grants a refundable tax credit or reduces other taxes that they now pay. With the movement to reduce the number of return-filing taxpayers (individual income tax returns),²⁰⁹ it is less likely that Congress would offset the burden of a VAT on the poor through refundable credits obtained by filing returns.

Based on principles of horizontal and vertical equity and using income as the standard by which equity principles are measured, VAT does not fare as well as income and payroll taxes. Testing for

²⁰⁶ Pohmer, Germany, in *The Value Added Tax: Lessons from Europe*, supra note 83, at 96-97.

²⁰⁷ See supra note 1.

²⁰⁸ 3 Treasury Proposal, supra note 1, at 43.

²⁰⁹ See 1 Treasury Proposal, supra note 1, at 5.

horizontal equity, the individual income tax scores well. By tailoring the tax to individual circumstances, Congress can tax those with equal taxable incomes equally.²¹⁰ Assuming that the corporate tax is borne by shareholders, the corporate tax does not meet the standards of horizontal equity. At various levels of individual income, stock ownership, as well as dividend policy among corporations, vary widely. Assuming that the employer's and employee's share of social security taxes are borne by labor, the payroll taxes deviate somewhat from the standard of horizontal equity. Since they are imposed only on taxable wages, a retired person earning \$25,000 income exclusively from social security benefits and from savings is not subject to the social security taxes, while a worker with \$25,000 income earned exclusively from wages would be subject to this tax.²¹¹ Testing for horizontal equity, VAT ranks quite low. At the low and middle income ranges, because taxpayers spend most or all of their disposable income on consumption, there is a significant correlation between income and consumption. This is not true at higher income levels, and even within other ranges, taxpayers have different kinds and amounts of consumption expenditures. Selective excise taxes are worse than a broad-based VAT. There are wide variations in the excise tax burden for individuals at any given level of income because it is totally dependent upon their level of consumption of the taxed items.

A progressive individual income tax can be designed to achieve vertical equity. Before the 1986 reforms, the tax rates for individuals were progressive as to income, taxing high income individuals or family groups at higher effective tax rates than those earning lower levels of income. The 1986 Act reduced to two the number of tax rate brackets. Consequently, Congress has dramatically reduced the structural progressivity in the individual income tax. When the corporate income tax is borne by shareholders, then within the limits of a two rate individual income tax system, the corporate tax is somewhat progressive as to income because data indicates that income from capital, including dividend income, in-

²¹⁰ However, see the various tax rate schedules for various categories of taxpayers, such as unmarried individuals, married couples, and heads of household in § 1. See I.R.C. § 1.

²¹¹ Even if the employer's share of social security taxes is shifted to consumers, the tax does not meet the standards of horizontal equity because it will be borne in relation to consumption of goods and services and thus may not bear any direct relationship to the consumers' incomes.

creases as individual income rises.²¹² If social security taxes ultimately are borne by labor, then up to the wage cap, it is proportional to wage income. As the ratio of wages subject to social security taxes to total income declines (especially when wage income exceeds the ceiling), social security taxes become decidedly regressive as to income.²¹³ To the extent that business considers social security taxes as costs to be shifted into product prices then, like excises and VAT, they are regressive as to income.

Selective federal excise taxes and VAT do not fare well when tested by a traditional view of vertical equity, at least when measured annually rather than over a lifetime. Excises on items like alcohol and tobacco tend to be regressive as to income because consumption of these items represents a decreasing proportion of income as annual income increases.²¹⁴ If a consumption tax like a VAT has a broad base, it may, at best, be proportional as to consumption. However, the proportion of income used for consumption tends to decline as individual or household income increases. Thus, even if basic necessities are exempt from tax, a VAT or other general consumption tax likely will not become progressive as to income.

Some commentators have suggested that an analysis of equity in the distribution of the tax burden must consider not only the incidence of the tax imposed, but also the distribution of benefits financed by the tax.²¹⁵ However, this approach conflicts with the focus of an ability to pay analysis. If (1) it is desirable that lower income families receive benefits that outweigh their tax burden and (2) ability to pay taxes is the appropriate standard, then a VAT is less desirable as a funding source for social welfare programs than income taxes.²¹⁶

²¹² See J. Pechman, *supra* note 24, at 140.

²¹³ See *id.* at 212.

²¹⁴ *Id.* at 192. Consumption is a declining percentage of income once disposable income exceeds the amount required to obtain necessities. The data supporting the regressivity of consumption taxes is based on the ratio of annual consumption to annual income. If lifetime consumption and lifetime income are the barometers, then the consumption tax still may be regressive, but less so. For a discussion of this issue as it pertains to a consumption-style personal income tax, see Andrews, *supra* note 46, at 1174-75.

²¹⁵ See J. Bickley, *National Sales Tax: Selected Policy Issues* 35 (1984); W. Sher & R. Pinola, *Microeconomic Theory* 735 (1981); Aaron, *supra* note 83, at 4-5.

²¹⁶ J. Bickley, *supra* note 215, at 35. As part of the analysis of the ratio of income to tax, arguably, the benefits received from the new revenue source should be included as part of

Based on traditional views about horizontal and vertical equity, a progressive rate individual income tax permits the most equitable distribution of tax burden, with corporate income and payroll taxes less desirable but better than selective excise taxes. A VAT would rank higher than selective excises, would be difficult to compare with social security taxes, and would be decidedly worse than corporate and individual income taxes. However, while it is too early to make a definitive judgment, in light of the 1986 reforms that dramatically reduced the top corporate and individual income tax rates, and reduced to two the number of individual tax rate brackets, it is possible that taxpayers collectively have changed our concept of vertical equity and no longer consider highly progressive taxes essential to achieve an equitable distribution of the federal tax burden. If so, then a VAT may not rank so poorly, based on ability to pay principles.

4. *Neutrality or Economic Efficiency*

A common tax policy goal is to develop a tax system that fosters economic efficiency or neutrality.²¹⁷ A tax is economically efficient if it does not distort economic behavior; that is, the tax is neutral as to:

- (1) a business' choice among various forms of operation;
- (2) a consumer's choice among possible consumption expenditures;
- (3) an individual's choice between consuming now or saving for future consumption; and
- (4) an individual's choice between working or preferring leisure.²¹⁸

If Congress considered increasing the existing income-based individual income tax or enacting a broad-based C-style VAT and neither choice would change relative prices of goods or services, then these alternatives would be neutral as to consumers' choices among consumer items. However, if the VAT were riddled with exemptions or other preferences, it would not foster economic efficiency. Such a VAT would distort choices consumers must make between taxable and tax-preferred consumption items. Similar

the individual or family income, even if it is not subject to income tax.

²¹⁷ See McLure, Jr., *supra* note 51, at 121.

²¹⁸ J. Bickley, *supra* note 215, at 25-26.

inefficiency would occur if Congress increased the income tax that incorporated preferences for the consumption of certain goods or services.²¹⁹

Whether or not increases in individual income tax or VAT change relative prices, these tax increases may create other distortions. Compared with a new broad-based VAT, an increase in a progressive individual income tax may distort choices individuals make between current and future consumption or between work and leisure. With the 1986 base broadening and rate reducing reforms, these distortions under the individual income tax have been reduced substantially. However, if the new VAT included a substantial number of "item" preferences, the resulting VAT may distort an individual's decision to consume now or save to consume in the future (the incentive to consume exempt items currently may distort this choice), but to the extent of the preferences, it may be neutral as to an individual's decision to work or prefer leisure, since neither labor income used to consume exempt goods nor the value of leisure would be subject to a VAT.²²⁰

The corporate income tax is not a neutral tax because it distorts a business' choice of form of operation. The two tier system of taxing business profits at the corporate level and taxing dividend income at the shareholder level affects the choice between operating a business in corporate versus noncorporate form.²²¹ The separate corporate level tax also may create differences in relative prices of items produced by corporate and unincorporated firms.²²² Since a business can reduce its corporate tax by paying interest on debt, but not by paying dividends on equity, the corporate tax distorts the choice between debt and equity financing for business operations. Finally, the 1986 base-broadening and rate-reducing reforms left the corporate top rate above the individual top rate, further discouraging operation as a taxpaying corporation.²²³

It has been asserted that the corporate tax may serve as an umbrella to protect inefficient corporations that otherwise could not

²¹⁹ For example, the existing individual income tax exempts health and accident insurance provided by employers from taxation, thus encouraging workers to take part of their wages in this tax-free form.

²²⁰ J. Bickley, *supra* note 215, at 26.

²²¹ See McLure, Jr., *supra* note 51, at 173.

²²² *Id.*

²²³ See I.R.C. §§ 1, 11.

compete with profitable taxpaying corporations.²²⁴ To the extent that industry leaders are able to shift part of the corporate tax forward into product prices, this price increase permits the more inefficient corporations to compete with the price setting leaders and thereby remain in business despite their inefficiency. For example, assume the price setting (PS) Corporation shifts its corporate tax (amounting to about \$.50 per widget) into the \$10.50 price for widgets. An inefficient, competing (IC) Corporation has higher production costs, but still can obtain customers for its widgets if it sells them for not more than \$10.50 per unit. At this price, the IC Corporation earns no profit and therefore pays no corporate tax. If the corporate tax were replaced with a VAT, PS Corporation could sell at a pre-VAT ten dollar price and add a VAT on the sale. At this ten dollar pre-tax price, the IC Corporation would sustain losses of \$.50 per unit and ultimately may close. Over time, if the corporate tax is shifted, the replacement of the corporate tax with a VAT can be expected to drive the inefficient corporations out of business. However, it is not clear that Congress supports a national goal of promoting economic efficiency in business, if it occurs at the cost of insolvency for marginal businesses.²²⁵ Indeed, new businesses typically are not very efficient during their formative years and national policy promotes capital formation for new enterprises to hire additional workers. The replacement of most or all of the corporate tax with a VAT could produce a federal tax structure that distorts economic decisions on the form of business operation if corporations could become tax shelters for owners to accumulate earnings and avoid the shareholder level tax. However, if Congress coupled the adoption of a VAT with the integration of the individual and corporate income taxes, the tax shelter phenomenon could be avoided.

Payroll taxes are imposed on wages up to a statutory ceiling for covered employees and self-employed individuals and, as taxes withheld from wages, are neutral as to individuals' choices among consumer items and as to individuals' choices between current consumption and savings for future consumption. Since they are im-

²²⁴ See Business Taxation, *supra* note 173, at 65.

²²⁵ For example, Congress helped the ailing, unprofitable Chrysler Corporation rather than permit it to terminate its domestic manufacturing operations. See Chrysler Corp. Loan Guarantee Act of 1979, Pub. L. No. 96-185, §§1-18, 93 Stat. 1324, 1324-36.

posed on wages up to a statutory ceiling, payroll taxes may create individual preferences for leisure over work until the ceiling is reached; they then do not distort this choice, since they then do not tax either work or leisure. A broad-based VAT does not have any significant efficiency or neutrality advantages over existing payroll taxes, except as to the latter's preference for leisure over work at payroll levels below the statutory cap.²²⁶

5. *VAT as a Fiscal Tool to Promote Economic Goals*

The focus of the 1986 tax reforms was to broaden the base and reduce the top rates for the individual and corporate income taxes. In the process, Congress reduced the role of income taxes in affecting economic or industrial policy. For example, Congress reversed prior tax policy that encouraged the modernization of plants and equipment with the investment tax credit and rapid depreciation, and that had encouraged the investment in research and development and in certain kinds of real estate. It would be ironic if Congress now found VAT attractive as a fiscal tool to promote economic or industrial policy goals. Yet, a VAT can be used as a fiscal tool to affect the economy in very discreet ways.²²⁷

If Congress enacted a VAT and granted the President the power to alter the VAT rates within a prescribed range (to alter a ten percent VAT rate by twenty percent—up to twelve percent or down to eight percent), then the government may be able to increase the VAT rate to reduce consumption and thereby slow down an overheated economy or may reduce the VAT rate to stimulate a stagnant economy. If Congress retained the power to make these modest short term rate changes, they may be less effective as a fiscal tool. While Congress debated a bill to increase the rate to stifle consumption, consumers could accelerate their purchases to avoid the proposed increase. Likewise, if Congress wanted to cut the VAT rate temporarily to stimulate consumer spending, the normal tax legislative process might delay enactment of the tax cut until it was no longer needed.

Congress could alter VAT rates on selected consumer items to stimulate or dampen demand in particular industries or particular

²²⁶ See generally McLure, Jr., *supra* note 51, at 174.

²²⁷ It is assumed here that the VAT would be an invoice method tax which would be shifted to consumers in the form of higher prices for taxable items.

segments of the economy. For example, to reverse a recession in the auto industry, Congress or the President (if the latter is granted power to adjust rates) could stimulate car buying by cutting the VAT rate on automobiles for a limited period of time.

Notwithstanding the attractiveness of a VAT as a fiscal tool to achieve economic, social, or other national policy goals, it would be undesirable to enact a new VAT to serve these functions rather than to serve basically as a revenue raising measure.²²⁸ If the federal government wants to stimulate or dampen the economy, it may find that it would be more effective to rely on monetary than fiscal policy. Congress cannot justify adoption of a broad-based federal tax on consumption just to obtain this potential fiscal tool.

On balance, the economic considerations discussed do not favor the use of a VAT as a fiscal tool. Instead, reliance on existing federal income and payroll taxes is a better course, and a VAT should be considered only as a revenue raising measure.

D. Impact of VAT on International Trade

In the 1980s, the United States' balance of trade deteriorated substantially.²²⁹ For 1986, exports were \$376.2 billion, or 8.9% of GNP, imports were \$481.7 billion, and the net of imports over exports were \$105.5 billion (2.5% of GNP).

The United States and most of its trading partners²³⁰ collectively have limited their ability to use tax preferences to stimulate export trade. Parties bound by the General Agreement on Tariffs and Trade (GATT)²³¹ can exempt exports from their indirect taxes like VAT, but may not exempt exports from their income, payroll, and other direct taxes.²³²

²²⁸ See McLure, Jr., *The Value-Added Tax: Effects on Productivity and Equity*, 20 Tax Notes 971, 976 (Sept. 26, 1983).

²²⁹ See *supra* p. 236, Table 6 for 1982 data. In 1983, the United States registered a \$6.1 billion deficit. Commerce Survey, *supra* note 130, at 20, Table 1.1. It grew to \$58.9 billion in 1984 and to \$79.2 billion by 1985. *Id.*

²³⁰ Most of the countries in the free world, accounting for about 80% of world trade, adhere to the General Agreement on Tariffs and Trade (GATT). See *International Trade Agreements*, 2 Int'l Trade Rep. (BNA) ¶ 75:0101, IA (1985).

²³¹ The United States agreed to adhere to GATT, effective January 1, 1948, 61 Stat. A3, T.I.A.S. No. 1700. GATT was amended as part of the Trade Agreements Act of 1979. Trade Agreements Act of 1979, Pub. L. 96-39, § 2, 93 Stat. 144, 147-48.

²³² Art. XVI(4) of GATT provides, in pertinent part, that:

[C]ontracting parties shall cease to grant either directly or indirectly any form of

In addition to affecting international trade through border tax adjustments (imposing tax on imports and providing rebates for tax on exports), a nation may make its products more attractive in the international marketplace by adjusting the value of its currency. However, the United States and other nations bound by the rules of the International Monetary Fund cannot freely adjust their currency exchange rates.²³³ Indeed, as discussed below, the United States has even less flexibility than most of its major trading partners to use dollar exchange rate changes to alter its balance of trade position.

With floating exchange rates, a nation's imbalance (surplus or deficit) in its balance of trade position ultimately should be brought into balance. However, balance of trade is only one factor in a nation's balance of payments. In addition, since the dollar serves not only as a medium of payment for the United States, but also as an international currency, the value of the dollar is not as responsive as many other floating currencies to trade or balance of payments imbalances. Further, some of our trading partners, such as Taiwan and South Korea, traditionally linked the value of their

subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market.

GATT, March 10, 1955, Ad. Art. XVI(4), 8 U.S.T. 1767, 1777, T.I.A.S. No. 3930, at 11, 278 U.N.T.S. 168, 184.

Moreover, according to GATT, "[t]he exemption of an exported product from duties on taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy." *Id.* at Annex I, Ad. Article XVI, 8 U.S.T. at 1798-99, T.I.A.S. No. 3930, at 33, 278 U.N.T.S. at 218. Thus, a contracting party to GATT can exempt exports from VAT, since it is borne by domestic consumption, but it cannot exempt exports from income or payroll taxes, since it is not feasible for a nation to identify the extent to which these taxes are included in the prices of like products sold domestically.

²³³ The United States and other members of the International Monetary Fund undertake "to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." Second Amendment to the Articles of Agreement of the International Monetary Fund, 5 April 30, 1976, Art. I, 29 U.S.T. 2203, 2205, T.I.A.S. No. 8937, at 2. Further, they agree to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members. . . ." *Id.* at Art. I(iii), 29 U.S.T. at 2205, T.I.A.S. No. 8937, at 2. Professor Surrey suggested that, without enacting a federal VAT, the United States may have been able to justify low rate border tax adjustments consistent with GATT. See *A Review of Balance of Payment Policies: Hearings Before the Subcomm. on International Exchange and Payments of the Joint Economic Comm., 91st Cong., 1st Sess 45 (1969) (statement of Stanley S. Surrey)*

currencies to the value of the dollar.²³⁴ Trade imbalances with these trading partners have not self-corrected even if there was a change in the value of the dollar.²³⁵ Thus, it is not surprising that even though the value of the dollar fluctuated dramatically from 1983 to 1986, the United States suffered a chronic balance of trade deficit.²³⁶

If chronic deficits in the United States' balance of trade reduce domestic employment and GNP significantly, Congress may decide that it is necessary to change domestic policies, including federal tax policy, in order to promote export trade. A nation can improve its balance of trade by stimulating exports or discouraging imports. It may focus on the price of its exports in the international marketplace and the price of imports in its domestic market. Fiscal and monetary policies as well as targeted programs then may be adopted to alter the level of imports or exports. Alternatively, the government may attempt to improve the balance of trade by imposing customs duties, VAT, or another indirect tax on imports and by rebating the VAT or other indirect tax on exports. The government could also encourage exports by providing low-interest rates to finance these sales, providing foreign marketing assistance, or, in other ways, providing funds to reduce exporters' costs and thereby, indirectly, permitting exporters to reduce their export prices.

Under the existing federal tax system, value that is added in the United States to exports, imports, and domestically-produced and consumed goods and services is subject to income and payroll taxes. However, value added outside the United States to imported goods and services is not subject to these taxes, but bear only customs duties.²³⁷ If instead of increasing income or payroll taxes, Congress enacted a destination principle VAT with border tax adjustments, the effect would be to relinquish tax jurisdiction over the value added to exports and, in its place, tax value that is added to imports outside the United States.²³⁸ Thus, during years like

²³⁴ Leung, *Taiwan Comes Under Fire for Pushing its Currency up Against the U.S. Dollar*, *Wall St. J.*, Jan. 16, 1987, at 27, col 2.

²³⁵ *Id.*

²³⁶ Commerce Survey, *supra* note 130, at 20, Table 1.1.

²³⁷ Both imports and domestically produced goods must bear federal excise taxes.

²³⁸ Congress relinquished jurisdiction to impose the full corporate income tax on some export profits. See I.R.C. §§ 921-26, 991-99. With the current balance of trade deficits, there

1986, when imports outstripped exports by over \$105 billion, the Treasury would receive a fiscal dividend based on the excess of the tax imposed on imports over the tax rebated on exports.

Can reliance on VAT rather than direct income and payroll taxes improve our balance of trade? In part, it depends upon whether relative prices of American exports will be lower if the United States reduces its traditional reliance on direct taxes in favor of a VAT. The impact of various taxes on relative prices depends both upon the extent to which the alternative taxes are shifted into prices of goods and services and to which they affect inflation.²³⁹ For this purpose, it is assumed that a corporate or individual income tax hike would not be shifted to consumers by businesses subject to these taxes. In contrast, if the new VAT is enacted to raise total federal revenue and the Federal Reserve accommodates the new VAT with an increase in the money supply, it is reasonable to assume that the VAT will be shifted to consumers. However, with border tax adjustments, the new VAT should not alter the relative prices of domestically produced and imported goods.²⁴⁰ In fact, coupling the price increases resulting from VAT with the VAT rebate for exports, export prices should remain at their pre-VAT levels.²⁴¹ Given these assumptions on shifting,²⁴² a VAT with border tax adjustments likely will not alter the balance of trade if it is enacted in lieu of an increase in individual or corporate income taxes.²⁴³

In contrast to the above assumptions, here it is assumed that a new VAT is enacted in lieu of increases in taxes, such as payroll taxes, that are considered product costs and shifted to consumers.²⁴⁴ With these assumptions, it is likely that the tax shift will

should be some net revenue gain if VAT were substituted for some income and payroll taxes.

²³⁹ See *supra* notes 157-74 and accompanying text.

²⁴⁰ Brannon, *supra* note 117, at 1389.

²⁴¹ *Id.* at 1388-89.

²⁴² Basically, the assumptions in the text are similar to the conclusions reached earlier in this article. See *supra* notes 157-74 and accompanying text; see also Brannon *supra* note 117, at 1388-89 (making the same assumptions)

²⁴³ See Brannon, *supra* note 117, at 1389; see also McLure Jr., *supra* note 228, at 974-75 (expressly rejecting the argument that border tax adjustments that accompany a VAT are the equivalents to import duties and export rebates).

²⁴⁴ See Brannon, *supra* note 117, at 1389. This assumption conflicts with the assumption earlier in the article that payroll taxes, in the long term, are borne by labor.

encourage exports and discourage imports. Indeed, if a new VAT financed cuts in payroll taxes, the benefit to exports should be more visible. The payroll tax cuts should reduce prices of goods and the VAT border tax adjustments should leave the exports free of VAT, permitting exporters to pass the price reductions induced by the reduced payroll tax on to foreign buyers. However, American trading partners may charge that if the United States replaced payroll taxes with a border adjusted VAT, the border adjustments would violate its obligation under GATT²⁴⁵ and, if the switch had a significant effect on American exports, may support retaliatory action by them. While replacement of some payroll taxes with a VAT, rebatable on exports, may improve the short-term balance of trade, with floating exchange rates and possible retaliatory action under GATT, it is doubtful such a shift would correct the chronic balance of trade deficits.²⁴⁶

E. Tax Administration and Taxpayer Compliance

1. Taxpayers' Attitudes Towards Existing Taxes

In the Middle Ages, taxation was perceived as a liberating tool. During the reign of Philip IV, individuals could pay a tax in order to gain exemption from military service.²⁴⁷ Cities and towns could make payments to rulers "in lieu" of their obligations to house and feed the armies.²⁴⁸ Today, it is difficult to identify a tax that is perceived by taxpayers as a "good tax." Thus, in a contest for favorite taxes, the debate centers on which tax is the least objectionable.

An individual's perception of an entire tax system may depend on his view of how taxes burden him. Attitudes toward a particular tax also may vary, depending upon whether it is viewed as a tax borne by business or a tax shifted to consumers. A taxpayer's preference for an income- or consumption-based tax also may be colored by whether he views an individual's welfare as "best measured by standard of living (usually identified with consumption)

²⁴⁵ See *supra* note 231.

²⁴⁶ See *Business Taxation*, *supra* note 173, at 68-69. If the value of a VAT to influence balance of trade was too problematic in 1970, when there were fixed currency exchange rates, it would be even more problematic with the existing system of floating exchange rates.

²⁴⁷ J. Strayer & C. Taylor, *Studies in Early French Taxation* 56-57 (1939).

²⁴⁸ G. Ardant, *Theorie Sociologique de l'Impot* 49-50 (1965).

or ability to pay (usually identified with income)."²⁴⁹

The most comparable existing tax to a VAT is the state sales tax. Repeatedly, taxpayer opinion polls have indicated that state sales taxes rank as one of the least offensive forms of taxation.²⁵⁰ In spite of the regressive effects of most broad-based sales taxes and the fact that the federal government traditionally relied on progressive income taxes to raise a large proportion of federal revenue, the public opinion polls indicate that taxpayers apparently view as fair the pay-as-you-consume retail sales tax levied on all consumers of taxed goods.²⁵¹ Taxpayers may prefer a sales tax paid in small increments to an income tax withheld in large amounts²⁵² because they see their income tax withholding listed on their year-end W-2 forms and their total income tax liability on their annual tax returns, while most taxpayers do not keep account of their total sales tax payments. Some favor the sales tax because it is perceived as a tax paid by everyone, including wealthy individuals who may be able to minimize their income tax liability by investing in tax-preferred investments.²⁵³ Notwithstanding the above, it is difficult to obtain a fair comparison of taxpayer attitudes toward federal income taxes and state and local sales taxes, since the average family's income tax burden outstrips its sales tax burden by about ten to one.²⁵⁴ Interestingly, taxpayers do not seem to prefer state sales taxes over state income taxes, even though, between the two, the average taxpayer bears a heavier state income tax bur-

²⁴⁹ Bradford & Toder, *supra* note 202, at 25. In their article, Bradford and Toder argue that if a lifetime perspective is used, consumption is superior to income as a measure of ability to pay. *Id.* at 30.

²⁵⁰ See, e.g., Advisory Comm. on Intergovernmental Relations, *Changing Public Attitude on Governments and Taxes 1* (1986). To put the 1986 poll into perspective, 37% of those polled chose the federal income tax as the worst tax, 28% chose the local property tax, while 17% chose state sales tax and eight percent chose the state income tax. *Id.*

²⁵¹ A 1981 analysis of "tax surveys" indicates that Americans tend to prefer state and local taxes over federal taxes. Harstad, *Interpreting Americans' Attitudes Toward Taxes*, 13 *Tax Notes* 1083, 1098 (November 9, 1981). For example, surveys indicate that Americans prefer state income taxes over federal income taxes. *Id.*; see also J. Bickley, *supra* note 215, at 21-23 (noting that the federal income tax has ranked as the worst and least fair tax for the past eight years).

²⁵² Harstad, *supra* note 251, at 1098.

²⁵³ *Id.*

²⁵⁴ *Id.* at 1099. Consistent with their self interest, low income individuals who pay little or no income tax, but pay sales taxes, tend to be critical of the sales tax, while high income individuals who tend to pay proportionately lower sales taxes tend to favor them. *Id.*

den.²⁵⁵ Finally, an analysis of tax surveys concludes that "survey comparisons between the federal income tax and the state sales tax have so many inherent biases as to defy any reliable conclusion about a public preference for income versus consumption taxation."²⁵⁶

The public's relatively positive view of state sales taxes may not translate into public enthusiasm for a federal VAT. Assuming the choice to raise revenue is between adopting a national sales tax or increasing the individual income tax, in a 1983 survey, Americans favored a national sales tax.²⁵⁷ However, in an earlier 1979 survey, taxpayers opposed the substitution of a VAT for existing federal taxes by approximately five to one.²⁵⁸

2. *Compliance and the Underground Economy*

Historically, the United States has a higher level of voluntary taxpayer compliance²⁵⁹ and lower tax collection costs than the other Western industrialized nations. Nevertheless, it is estimated that there is a multibillion dollar underground economy which operates outside the existing federal income tax system. Some workers who receive cash for services and some persons who sell goods or render services do not report their income or gain from these transactions. In 1979, then Commissioner of the Internal Revenue Jerome Kurtz reported that for 1976, individuals failed to report \$75 to \$100 billion of income from legal sources and another \$25 to \$35 billion of income from criminal activities,²⁶⁰ resulting in a total estimated revenue loss of \$19 to \$26 billion.²⁶¹ In that year, re-

²⁵⁵ Id.

²⁵⁶ Id. at 1098.

²⁵⁷ J. Bickley, *supra* note 215, at 21-23.

²⁵⁸ Harstad, *supra* note 251, at 1100.

²⁵⁹ Noncompliance generally includes failure to file returns, filing inaccurate returns, or failing to pay the tax reported on filed returns. See Research Div., Office of the Assistant Comm'r for Planning, Fin. & Research, Internal Revenue Service, *Income Tax Compliance Research: Estimates for 1973-1981* 19 (1983) [hereinafter *Income Tax Compliance Research*].

²⁶⁰ Internal Revenue Service, *Estimates of Income Unreported in Individual Income Tax Returns* at ii (1979) [hereinafter *Estimates of Income Unreported*].

²⁶¹ *Underground Economy: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 96th Cong., 1st Sess. 68* (1979) (Statement of Hon. Jerome Kurtz, Commissioner of the Internal Revenue Service) [hereinafter *Underground Economy*].

ported income totaled \$1.073 trillion.²⁶² Thus, about eighty-nine percent of the estimated \$1.208 trillion of reportable income was reported.²⁶³ These estimates place unreported income at under four percent of GNP. Projecting from this earlier data, the Internal Revenue Service estimated that the "tax gap" rose to \$81.5 billion in lost revenue by 1981, with about ninety-two percent attributable to individuals.²⁶⁴ The Service also estimated that, during this period, voluntary compliance declined further.²⁶⁵ Even though there was only a small percentage drop in compliance, it is significant, both because it reflects a trend toward increased noncompliance and because the dollar increase in lost revenue is so large.²⁶⁶

One estimate of noncompliance places the tax gap at about 7.5% of GNP.²⁶⁷ While, when measured by American expectations, this level of noncompliance is high, it likely is lower than the level of cheating that is the norm in most other countries.²⁶⁸ It is not clear if noncompliance actually has increased in recent years or if the 1979 study (or its progeny) merely has documented the level of noncompliance that previously existed.

One goal of tax reform is to reduce the rates at which existing taxes are levied and to impose any new tax at the lowest possible rate. Taxpayers likely pay, and thus the Service can collect, more easily, taxes levied at lower rates. As tax rates increase, taxpayers find it more profitable to evade the high rate tax. Thus, it was predictable that the level of tax cheating in the United States

²⁶² *Id.*

²⁶³ Some commentators have criticized the Service estimates. For example, Dr. David M. O'Neill of the U.S. Bureau of the Census estimates that the tax gap was about 7.5% in 1981, not the Service's estimate of 3.4% of GNP. See Staff of the Joint Economic Comm., 98th Cong., 1st Sess., *Growth of the Underground Economy, 1950-81: Some Evidence from the Current Population Survey 14* (Joint Comm. Print 1983) [hereinafter *Growth of the Underground Economy*].

²⁶⁴ See *Income Tax Compliance Research*, *supra* note 259, at 2, 7. The estimated revenue loss from selected illegal activities was about \$9 billion. *Id.* at 2. The Service recognizes that these estimates of the "tax gap" are subject to substantial limitations. It cannot accurately estimate the loss in revenue: (1) resulting from transfers of funds to tax haven countries, and (2) resulting from income earned "on the side." *Id.* at 15.; see also *infra* notes 275-79 and accompanying text.

²⁶⁵ See *Income Tax Compliance Research*, *supra* note 259, at 11.

²⁶⁶ *Id.*

²⁶⁷ See *Growth of the Underground Economy*, *supra* note 263, at 14.

²⁶⁸ See *Underground Economy*, *supra* note 261, at 212-14 (statement of Mr. Jeffrey Nichols).

would increase when, in the 1970s, inflation pushed taxpayers into higher tax rate brackets under our progressive individual income tax structure. As publicity about tax cheating in the United States increased, taxpayers confidence in the fairness of the federal income tax deteriorated. Indeed, this perception of unfairness served as part of the justification for the 1986 base broadening, rate reducing reforms that resulted in a two rate individual income tax system with a top rate of twenty-eight percent.²⁶⁹ Nevertheless, it is not so clear that cuts in tax rates, by themselves, increase compliance with the lower rate tax. The 1986 reforms represent the only American experience with a dramatic decline in federal income or payroll tax rates in recent memory. It will take some years before data can document whether these rate cuts actually increase tax compliance.

3. *Comparison of Noncompliance Under an Income Tax and VAT*

It is commonly assumed that a substantial part of individual income tax evasion is attributable to sales by informal vendors.²⁷⁰ Actually, these sales of \$17 billion represent only about 6.8% of the 1981 total unreported legal source income under the individual income tax, and most of this noncompliance arose from home repairs, food, child care, domestic services, auto repair, sidewalk vendor sales, flea market goods, and lawn maintenance.²⁷¹ The above estimates may not accurately reflect moonlighting that is performed for businesses that report their legal source income. The Service's report on taxpayer compliance acknowledged the difficulty that researchers have in measuring "off the books wages and informal supplier earnings."²⁷² Yet, this report discounted claims that there has been a dramatic growth in the "underground economy,"²⁷³ stating that "[T]hese claims have been supported with indirect, circumstantial evidence, anecdotes, and theoretical argu-

²⁶⁹ See I.R.C. § 1.

²⁷⁰ Informal vendors generally are those who can sell goods or perform services as sole proprietors alone or with only a few employees.

²⁷¹ Income Tax Compliance Research, *supra* note 259, at 101, Table D-2.

²⁷² See *id.* at 15.

²⁷³ Tax noncompliance is much broader than the popular term, "underground economy." For example, unreported interest received on savings accounts is part of the "tax gap," but is not considered "underground" income. See *id.* at 6.

ments. Direct empirical evidence to support the thesis of a thriving 'underground economy' in the United States, however, has not been forthcoming.²⁷⁴

The Europeans touted the VAT as a tax that would increase taxpayer compliance. The European-style invoice method VAT uses the seller's tax invoice as part of its self-policing mechanism. The business purchaser will demand a tax invoice from its seller in order to support its claimed input tax credit on purchases.²⁷⁵ Since the buyer will claim the input tax credit, the government can cross-match the buyer's input tax credits against the seller's reported sales and uncover unreported sales. Notwithstanding their faith in the tax invoice, European countries relying on VAT have sustained significant revenue losses from evasion under their VATs.²⁷⁶ While invoice matching may reduce evasion, the Europeans found that civil servants administering VAT spend much of their time verifying the timely filing of returns and reviewing taxpayer claims for VAT refunds, leaving little time to match tax invoices.²⁷⁷ In addition, the buyer has no incentive to ensure that the seller paid the tax listed on its invoice. It would be costly for tax

²⁷⁴ Id. at 91. To gather its data, the Service hired an independent survey firm, who guaranteed anonymity to those surveyed. The surveyor still had to interview consumers, not vendors, and therefore gathered data on vendor noncompliance only indirectly. Id.

²⁷⁵ See supra pp. 240-41.

²⁷⁶ See Pohmer, supra note 206, at 91. Italy reportedly has the most pervasive VAT evasion, amounting to approximately 40% of national income accounts estimates. Id. at 36. In Belgium, eight percent of VAT is evaded, even though it has an extensive computer matching program for imports. In the Netherlands, based on 1976 field audits, it was reported that 34% of the audited businesses evaded tax, resulting in evasion of 1.2% of receipts. Id. at 87. Some of the VAT evasion in Europe results from sellers issuing false invoices listing VAT, but the seller does not report it as part of its output tax, yet the buyer claims the input tax credit for the VAT reported on the invoice received. See Office of Tax Analysis, U.S. Dep't. of the Treasury, *Value-Added Tax: European Experience and Lessons for the United States* 60 (1980).

²⁷⁷ See Cnossen, *The Netherlands, The Value Added Tax: Lessons from Europe*, supra note 83, at 51. Under its VAT, effective in 1986, the Republic of China adopted an ambitious program to place tax invoice data in its VAT computer base. For business-to-business sales, the seller must issue invoices with four copies. The seller sends one copy with its report of output tax on sales and the buyer sends one copy to support its claimed input tax credit. These two copies are entered into the computer and cross-matched. This program applies to invoices for sales above some administratively-determined amount. It is too early to judge the effectiveness (including cost considerations) of this program to minimize evasion. The information about this program was obtained by the author from Ministry of Finance personnel in Taiwan. Interview with Mr. Chieng Chin-Chan, Director, 1st Div., Dep't of Taxation, Ministry of Fin., Republic of China (August, 27 1987).

administrators to cross-match all claimed input tax credits on invoices issued by one seller in one tax period against that seller's reported output tax for that period.²⁷⁸

A substantial part of the individual income tax is withheld at the source of the income through a withholding tax on wages. In contrast, while consumers of taxed items bear the VAT, it is collected by the seller who, in turn, remits it to the government. It therefore has been suggested that if Congress relied on taxes imposed both at the source and the use of funds, individuals that evade tax at the source of their income still would contribute to federal revenue by paying VAT when they spend their income on personal consumption items. However, if Congress enacted a VAT rather than increasing revenue from the existing individual income tax, it is unlikely that there would be any appreciable change in the level of income and VAT compliance by informal vendors. Evasion by informal vendors accounts for only a small proportion of income tax evasion attributable to "cash-related informal arrangements."²⁷⁹ These vendors supply goods and services for cash, they service predominantly private consumers, and they ordinarily do not have to provide receipts or other documentation of their sales. They probably would remain outside the income tax system and legally may not be subject to the VAT system if their sales do not exceed the minimum annual turnover required for inclusion in the system. The informal vendors that would be subject to VAT, but that fail to report their sales for income tax purposes, likely would extend their noncompliance to VAT. Some VAT revenue may be collected from this sector because these vendors will pay VAT on their business purchases that are subject to VAT. In addition, they will pay VAT on their purchases of personal consumption items. Even if VAT were collectible from these informal vendors who currently evade the income tax, this benefit alone would not justify the adoption of a new tax with its attendant tax administration and taxpayer compliance costs.

²⁷⁸ See Hemming & Kay, *The United Kingdom*, in *Value Added Tax: Lessons from Europe*, supra note 83, at 87. For this reason, in the United Kingdom, "compliance is imposed by random checks of accounting procedures." *Id.*

²⁷⁹ "Cash-related informal arrangements" include informal sales to households, moonlighting, and gross receipts skimming, collectively commonly known as sales "on the side." See *Estimates of Income Unreported*, supra note 260, at 118-19.

4. Tax Administrative Costs Under an Income Tax and VAT²⁸⁰

The United States spends, as a percentage of tax collections, less than most countries on the administration of the federal tax laws. In fact, this cost has varied remarkably little over the past few decades, and it has not increased when the tax laws became more complex or the number of taxpayers increased. During this period, it has ranged between 0.38% and 0.56% of tax collections.²⁸¹ The Service does not publish a breakdown of administrative costs by type of tax, so it is difficult to compare American costs to collect income taxes with those of other nations. Nevertheless, since our overall costs are dramatically less than those in European countries, it is reasonable to assume that our cost to administer the federal income taxes is less than the reported costs to administer income taxes abroad.

The administrative costs to collect a multistage VAT is much higher than a single stage sales tax levied at the manufacturing, wholesale or retail level. For example, the United Kingdom replaced its wholesale level purchase tax²⁸² with a broad-based multistage VAT. The purchase tax included 75,000 collection points and was administered by 1,600-1,700 civil servants. In contrast, the VAT had 1.25 million collection points and was administered by 11,000 civil servants.²⁸³ The tax administrative costs (as well as taxpayer compliance costs) under the European VATs seem to depend "on whether businesses are accustomed to keeping good written records and on the shares of activity carried out by small businesses."²⁸⁴ There is a basic threshold cost to organize a staff to administer a federal VAT. In the United Kingdom, during the early years with its new VAT, the administrative costs were about

²⁸⁰ "Tax administrative costs . . . are the costs incurred by the revenue authorities in the taxation process." C. Sandford, M. Goodwin, E. Hardwick & M. Butterworth, *Costs and Benefits of VAT 13* (1981) [hereinafter *Costs and Benefits*].

²⁸¹ 1984 Commissioner & Chief Counsel, *Internal Revenue Ann. Rep.* 71, Table 22.

²⁸² The United Kingdom also replaced its selective employment tax with the VAT. The selective employment tax, introduced in September, 1966, was designed to encourage the redistribution of labor into manufacturing and to support regional development policy. It taxed selected services, such as hotels and restaurants. See National Economic Dev. Office (United Kingdom), *Value Added Tax 21, 29 & 110-11* (1971) [hereinafter *United Kingdom Report*].

²⁸³ See A. Prest, *supra* note 174, at 13.

²⁸⁴ See Pohmer, *supra* note 206, at 8.

two percent of VAT collections,²⁸⁵ but when rates increased in 1979, the administrative costs declined to 1.25% of tax collections. Administrative costs do increase as the number of preferences granted under the VAT scheme increase.²⁸⁶ With only a single positive rate, the early British VAT system was costly to administer because it included many categories of exempt and zero-rated items. Commentators have argued and the European experience has confirmed that the cost to administer a VAT is higher if the VAT is imposed at multiple positive rates.²⁸⁷ In some cases, the estimates of the added burden have been exaggerated. For example, before the adoption of the British VAT, it was estimated that the use of multiple tax rates rather than a single tax rate could increase administrative costs between fifty and eighty percent.²⁸⁸ In fact, the switch from a single to multiple positive rates necessitated only a ten percent increase in staff.²⁸⁹ In part, this small increase may have been attributable to the fact that the United Kingdom already employed a large number of civil servants to administer the single positive rate system that included exemptions and zero rating on a large number of consumer items. The cost to administer an American VAT would depend upon the scope of the tax, the number of taxpayers, the length of the tax periods, the number of tax rates, and the extent of tax preferences granted.

Treasury, as part of its 1984 report to the President on tax reform, examined the possible adoption of a federal VAT. Treasury estimated that, when a broad-based VAT was fully implemented, it would require over 20,000 staffing positions and would cost an estimated \$700 million to administer.²⁹⁰ In England, when Parlia-

²⁸⁵ See Hemming & Kay, *supra* note 278, at 86.

²⁸⁶ The Customs and Excise Department claimed that it was costly to administer the tax refund procedure for 30% of registered traders that received VAT refunds. If the number of zero rated items were reduced, those costs would decline. See A. Prest, *supra* note 174, at 36.

²⁸⁷ See United Kingdom Report, *supra* note 282, at 41.

²⁸⁸ See *id.*

²⁸⁹ See 890 Parl. Deb., H.C., (5th Ser.) 304 (1975). Nevertheless, the introduction of multiple rates created complex line drawing problems. For example, it became necessary to distinguish between a wedding ring, taxed as jewelry at a higher rate, from a bishop's ring taxed at the standard rate. See A. Prest, *supra* note 174, at 30.

²⁹⁰ 3 Treasury Proposal, *supra* note 1, at 124, app. at 9-B. Treasury estimated that there would be 20 million VAT taxpayers filing quarterly returns. *Id.* at 113. In contrast, in 1984, there were 5.5 million firms registered under the state retail sales taxes. While the estimate of 1988 total personal consumption expenditures was \$3,127 billion, a more realistic comprehensive base may be \$2,408 billion, producing \$24 billion in revenue for each percentage

ment adopted VAT, it added a new tax tribunal solely to handle VAT disputes.²⁹¹ The above Treasury estimates of the cost of adopting a federal VAT did not include any costs to the Justice Department for district court or appellate litigation or costs for existing or new courts to handle the additional cases. Therefore, the total cost to implement an American VAT would be even higher.

If VAT were enacted, the new structure needed to administer the tax would increase the total cost (as well as the cost as a percentage of revenue) to administer the federal taxes. Using Treasury's cost estimates, if Congress adopted a five percent VAT that raised \$100 billion in revenue, the administrative cost would be at least 0.7% of revenue. The actual total costs are likely to be higher. In contrast, it would cost only marginally more than the current tax administrative costs to raise an additional \$100 billion from existing federal income and payroll taxes. In addition, even if the adoption of VAT permitted Congress to reduce income and payroll tax revenue, it is unlikely that the latter tax cuts would result in any meaningful reduction in the Service's costs to administer the income and payroll taxes.

Even if the United States adopted a broad-based VAT with no preferences linked to the nature of the goods sold or services rendered, the statute would raise line drawing problems that would increase the tax administrative costs (as well as taxpayer compliance costs). For example, normal jurisdictional rules under a destination principle VAT create interpretative problems. If the VAT is rebated only on exports of goods and imposed only on imports of goods, but not services, it is necessary to distinguish between goods and services. Even in countries that define these terms in excruciating detail, there are disputes about the differences between goods and services that ultimately must be resolved by the courts or the legislature.

Under VAT statutes, the legislatures generally provide some preferences based on the nature of the goods sold or services rendered. In close cases, sellers take aggressive tax positions and claim

point of VAT. *Id.* at 85-86. Treasury did not base its estimated administrative cost of \$700 million on a predetermined VAT rate or estimate of VAT revenue. *Id.* at 113.

²⁹¹ The VAT Tribunals were created "to provide an inexpensive method of making an appeal and to prevent clogging the courts with unnecessary detail. A. Prest, *supra* note 174, at 27.

that their goods or services come within the granted exemption or zero-rate. This tension breeds litigation. For example, some industries, such as housing and financial intermediaries, present intractable tax base problems. Because of political concerns and administrative problems relating to the taxation of housing, and due to difficulty defining value added by insurance companies, banks and other financial intermediaries, legislatures have often exempted from VAT, housing and transactions by financial intermediaries. However, on the fringes, there are disputes as to whether particular goods or services come within these preferences.

5. *Taxpayer Compliance Costs Under an Income Tax and VAT*²⁹²

Taxpayers are accustomed to filing individual and corporate income tax returns based on annual accounts and maintaining the required business records. In addition, in most states, retailers maintain records and file returns required under state retail sales taxes. Even small retailers comply with the sales tax laws. While the retail sales tax bases (with limited categories of taxable services) are narrower than the typical VAT, it is likely that the level of compliance with a VAT would be comparable.

It is difficult to estimate the cost for taxpayers to comply with a federal VAT, but since the compliance demands tend to be most onerous for small businesses, compliance costs likely are distributed regressively as to income.²⁹³ When the European nations enacted VATs, many small businesses with manual accounting found it necessary to revise their invoice forms and mechanize their accounting procedures by purchasing automated cash registers or bookkeeping machines.²⁹⁴ Soon after Germany switched from its turnover tax to VAT, according to a survey of German businesses,

²⁹² "Tax compliance costs . . . may be defined as the costs which are incurred by taxpayers or by third parties in meeting the requirements of the tax system, over and above the tax liability itself and over and above any harmful distortions of consumption or production to which the tax may give rise." *Costs and Benefits*, supra note 280, at 13. Unlike administrative costs, which can be borne out of revenue and shared by all taxpayers, compliance costs are borne by individual taxpayers and tend to vary, depending upon the nature and size of the taxpayer and other factors. See *id.* at 14.

²⁹³ Pohmer, supra note 206, at 51-52. For a detailed British study of compliance costs, see *Costs and Benefits*, supra note 280, at 13-25.

²⁹⁴ United Kingdom Report, supra note 282, at 41.

the administrative costs to comply with the new consumption tax were five to twenty percent higher than the costs under the turnover tax.²⁹⁵ However, the survey was taken during the transition period, and it may overstate the actual long-term increase in costs associated with the new VAT.²⁹⁶ Under the British invoice method VAT, taxpayer complaints about the VAT system tend to be "in the nature of special interest pleading or general grumbling [rather] than attacks on the concept of the tax."²⁹⁷

Taxpayer compliance costs depend upon the number of returns that must be submitted annually, the amount of information required on these returns, and the complexity of the tax. A federal VAT would not replace other federal taxes. Even if it were coupled with significant simplification of existing taxes levied on business, the total cost for business to comply with federal taxes would increase. With a VAT riddled with preferences, the taxpayer compliance costs would increase substantially. It would be necessary for businesses to define and segregate high from low or zero-rated sales, segregate taxable from exempt sales, and segregate purchases attributable to taxable and exempt sales.

6. Summary

To date, taxpayers view sales taxes as among the least offensive taxes, but their positive attitude toward sales taxes may result from the fact that they pay less state and local sales tax than most other major forms of tax levied at all three levels of government. It is uncertain whether taxpayers would favor a federal sales tax over the other major federal taxes, especially if the sales tax were imposed at a high rate.

The adoption of a federal VAT will require the establishment of the administrative apparatus and the training of VAT agents and other personnel. It therefore is costly (as a percentage of revenue) to enact a VAT, unless it raises a level of revenue that would justify the added government administrative costs.

Sales taxes constitute a significant revenue source in almost every state. Retailers therefore are familiar with sales tax reporting and recordkeeping requirements. Except for an adjustment needed

²⁹⁵ Id.

²⁹⁶ Id. at 41.

²⁹⁷ Id. at 39.

to account for input tax on purchases (a critical element in a VAT), retailers within the sales tax regimes may find that they do not have to incur significant additional costs to comply with a broad-based VAT with minimal preferences. However, except for those businesses subject to federal excise taxes, manufacturers and other traders above the retail stage and providers of most services at retail do not have experience with sales taxes. They will incur additional costs to comply with a broad-based VAT. Finally, for all businesses, compliance costs would jump if Congress adopted a complex VAT with multiple rates and many preferences.

With a federal VAT, the public may perceive that individuals and businesses that cheat under the income taxes will be contributing to the federal revenue by paying VAT. However, while these income tax evaders in the business sector may bear VAT on their business purchases, they typically underreport their sales for income tax purposes and may extend this evasion by underreporting sales (output tax) for VAT purposes.

The addition of a federal VAT (without a corresponding increase in government spending) should permit a reduction in the deficit and the maintenance of the lower income tax rates enacted in 1986. With low income and VAT rates, Congress may reduce the level of evasion of federal taxes and thereby promote public confidence in the federal tax system.

The sales invoice under the European-style VAT provides an audit trail for government auditors to match the seller's output tax liability and the buyer's input tax credits. In practice, most of the foreign countries have not been able to devote the resources necessary to cross-match these invoices. While the European countries claimed that the invoice made VAT a self-policing tax, they have experienced significant VAT evasion.

Before Congress considers the adoption of a new VAT as a means to increase the overall level of taxpayer compliance, it should consider the imposition of withholding of income tax on interest and dividends, the withholding of tax on business payments to independent contractors providing services, and an increase in the Service's taxpayer compliance budget.²⁹⁸

²⁹⁸ See Estimates of Income Unreported, *supra* note 260, at iv & 8.

F. Federal-State Fiscal Relations

A major source of state tax revenue is the retail sales tax.²⁹⁹ Enactment of a federal VAT may not alter the states' ability to maintain or increase their sales or other taxes.³⁰⁰ There may be some correlation between the level of federal taxes (as a percentage of GNP) and the states' ability to increase their tax revenue,³⁰¹ but it is less likely that the composition of the federal tax system has any direct bearing on the states' tax-raising capacity.³⁰² For example, the federal government's adoption of significant excise taxes (selective sales taxes) during World War II did not hinder the states' ability to raise revenue from the retail sales tax.³⁰³ States still may view the enactment of a federal VAT as an intrusion into their sales tax jurisdiction. The level of state opposition may depend upon the kind of VAT adopted. States may oppose the adoption of the European-style VAT, a transactional form of consumption tax, but may not resist an annual tax on value added, such as Senator Roth's BTT,³⁰⁴ especially if the latter is perceived as a tax borne by business rather than by consumers.

The state attitude toward a federal transactions form of VAT also may vary, depending in part on what programs the new revenue will finance. A state may favor a VAT to finance national health or welfare reform if the new federal programs will replace state-financed programs. States currently differ in their levels of concentration of poor people and in their levels of support for welfare and health care for the nonworking poor. As a group, the industrial states can be expected to be more supportive of a new VAT to be used to fund federal programs that reduce disparities in taxation among the states because, in part, these disparities may encourage the migration of their businesses to low-tax states.

If VAT is used as a revenue supplement to fund the deficit or existing federal programs, the states may be less supportive or may

²⁹⁹ See J. Due & J. Mikesell, *supra* note 43, at 1.

³⁰⁰ Some states cannot increase their sales taxes above their current levels. For example, Michigan already imposes sales tax at the maximum rate permissible under its constitution. See Mich. Const. of 1963, Art. 9, § 8 (1974).

³⁰¹ See Policy Considerations, *supra* note 181, at 73.

³⁰² *Id.*

³⁰³ Tax Foundation, *Facts & Figures on Government Finance*, 16 Biennial Report 139 (1971).

³⁰⁴ See *supra* note 54.

oppose the new tax because they may believe that the new tax will hinder their ability to maintain or increase their sales tax revenue. Although states may also be opposed to a VAT used to reduce other federal taxes, they may nevertheless support such a tax if it is revenue neutral.

A state's attitude toward a federal VAT also may be influenced by the extent to which the state relies on sales taxes for state revenue. Connecticut, with a 7.5% sales tax, and New York (especially with pressure from New York City, that has a combined state-city eight percent rate), may be more opposed to a federal VAT than Georgia or North Carolina, that have three percent sales taxes or New Hampshire, which does not impose a sales tax at all.³⁰⁵

If the federal government enacts a VAT, it could grant states the option to piggyback on the federal tax, using the federal collection machinery instead of the state's own sales tax staff.³⁰⁶ Alternatively, a state could enact a multistage VAT and piggyback on the federal VAT, or if it prefers to limit its sales tax to the retail level, it might piggyback only on retail sales. Over the long term, the piggyback option could lead to uniform state sales taxes. No doubt, some states may view a proposal for piggybacking as a more serious infringement on state sovereignty or state fiscal independence than the adoption of a federal VAT itself. To obtain the full benefit of piggybacking, states would have to relinquish their power to define the tax base, tax terms, and penalties.³⁰⁷

³⁰⁵ See Table of Rates, 2 State Tax Guide (CCH) ¶ 60-000, at 6021. The eight percent combined New York City and state rate does not include a ¼ of one percent transit district tax. See 2 New York St. Tax Rep (CCH) ¶ 60-416.

³⁰⁶ On the possibility and desirability of piggy backing a state VAT on the federal VAT, see Special Comm. on the Value-Added Tax of the Section of Tax'n, ABA, *The Choice Between Value-Added and Sales Taxation at Federal and State Levels in the United States*, 29 Tax Law 457, 470-73 (1976)[hereinafter *Value-Added and Sales Taxation*]. See also Policy Considerations, *supra* note 181, at 73 (outlining the difficulties encountered in piggybacking state tax upon federal tax).

³⁰⁷ There are many technical hurdles that must be overcome before a state could piggyback their sales tax onto a federal VAT, not the least of which is state acceptance of the federal definition of a taxable sale. If a federal VAT operates alongside state retail sales taxes, Congress must decide whether the state sales taxes are includable in the VAT base, and the states must decide if the VAT is includable in the retail sales tax bases. See *Value-Added and Sales Taxation*, *supra* note 306, at 470-73.

VI. CONCLUSION

This article critically examines the question of whether there are policy reasons why Congress should enact a federal VAT. For purposes of this analysis, it is assumed that the federal VAT will be a multistage, transactions form of consumption tax. It will incorporate the European C-style, invoice method applied on a destination principle. The VAT will be collected by sellers, but intended to be shifted forward and be borne by consumers. Further, it is assumed that the tax base will include PCEs as well as government purchases.

Before the 1986 reforms, Congress and the President may have obtained public support for a program that coupled the enactment of a new VAT with structural reforms (including tax cuts) in the existing federal taxes. However, after the two year tax reform debate culminating in the Tax Reform Act of 1986, except for the acknowledged need for corporate reforms,³⁰⁸ it is unlikely that even the temptation of a new revenue source would prompt Congress to revisit basic reform of existing taxes in the near future. It is more likely that Congress would consider increasing tax revenue with existing federal income taxes or a VAT to finance the deficit or new programs.

If Congress decides to raise additional revenue, and wants to use standards of individual or family income or family status to distribute the tax burden, it is more appropriate to rely on an annual income or expenditure tax that can be tailored to individual circumstances than to rely on a transactions form of consumption tax, a VAT. In other words, if Congress wants to achieve distributional goals as part of a revenue-raising effort, it should rely on existing income taxes rather than on a VAT, an inherently inferior vehicle to achieve such goals. If, however, Congress decides to alter the federal tax base and distribute part of the tax burden among consumers in proportion to what they take out of our community resources in the form of consumption of taxable goods and services, then a VAT designed to be shifted to consumers is appropriate. In part, it would represent a shift of part of the federal tax burden from an income tax imposed on a base that represents the

³⁰⁸ See Staff of the Senate Fin. Comm., 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff for Submission to the Committee on Finance 73* (1985).

potential power to consume to a consumption tax imposed on a base that represents the exercise of that power through purchases of consumption items.

A federal VAT could significantly change the federal tax base, and, for this reason, could form the basis for a reexamination of the present array of federal taxes. The federal government relies on direct taxes on income (income and payroll taxes) for most of the national revenue. In 1982, they accounted for 80.8% of all federal taxes. Most of the income and payroll taxes are withheld at the source of the income. About eighty-four percent of the individual income tax base and all of the payroll tax bases consist of labor income. Thus, one incentive to add a federal consumption tax is to shift part of the tax burden from the source of the income to the use of after-tax income for consumption. Only selective excise taxes are imposed on the sale of goods and services. While consumers in states with retail sales taxes bear tax imposed on goods and some services subject to the sales tax, units of government and income tax-exempt organizations generally do not bear sales taxes on their purchases. Thus, considering the federal level alone or combining tax imposed at all levels of government, the tax burden on consumer goods and services is distributed unevenly, creating economic inefficiency by encouraging the purchase of untaxed or low taxed items and discouraging the purchase of high taxed items. Especially with the expansion of the service sector of the American economy, a federal VAT would expand the federal tax base by including consumption of goods as well as the relatively untaxed consumption of services. A federal VAT also could raise revenue from sales to the significant charitable-governmental sectors of the economy. Except for the tax on unrelated business income, the charitable sector basically has escaped the income, property, and consumption tax bases at all levels of government. If it were desirable to have them contribute to the federal revenue, Congress may find it easier to impose a VAT on purchases and some sales by units of government and income tax-exempt organizations. As the population ages and the proportion of retirees to workers increases, the payroll tax and to some extent the income tax base may decline. If it is desirable to impose federal tax both on the earning of income during the working years and on the use of savings for consumption during the retirement years, a federal VAT may be used to achieve this goal. It is questionable whether the enactment of a

destination-principle VAT would improve our balance of trade. While the VAT likely will zero-rate exports and tax imports of goods, this VAT jurisdictional rule cannot be expected to increase exports in the long term, especially if the currency markets will correct for significant trade imbalances. A federal VAT may serve to increase the federal taxes levied on imports. Currently, imports contribute to federal revenue only to the extent that customs duties are imposed on imported goods and some imported services. A VAT can tax value that has been added to goods and services outside the United States.

During the post World War II period, the federal government has increased its reliance on payroll taxes, reduced its reliance on corporate taxes, and raised about the same proportion of revenue from the individual income tax. The United States does not rely as heavily as most of our trading partners do on consumption taxes. Also, most of the Western industrialized countries take a larger percentage of their gross national product in taxes. It is not apparent that, for competitive reasons, we should follow their example and rely more heavily on VAT or other forms of federal consumption tax.

On balance economic factors do not favor the adoption of a federal VAT, since Congress could raise revenue from existing income taxes. It is unlikely that taxes, per se, significantly influence the inflation rate, and, to the extent that they do, it is likely that VAT will increase prices and wages more than hikes in income and payroll taxes. VAT taxes consumption and not savings and therefore should encourage savings more than income taxes levied on returns on savings. However, in the early 1980s, Congress enacted savings incentives under the income tax and they did not stimulate significant capital formation. Consequently, while reliance on VAT should encourage savings and capital formation more than reliance on income and payroll taxes, there is conflicting evidence as to whether adoption of a federal VAT will have any positive long-term effect on economic growth.

On equity grounds, a VAT may not fare well. If it is desirable to tailor an individual or family unit's tax burden to individual income or other factors, the individual income tax is better suited to the task. Congress has relied on progressive federal taxes to achieve vertical equity in the federal system, but in light of the 1986 reform that cut the top rate and reduced the number of rate

brackets under the individual income tax, it is not clear that Congress or the taxpaying public continues to regard progressive taxes as an essential component of the federal tax system. Thus, while VAT is regressive as to income (measured over a year rather than a lifetime), if our collective judgment on the concept of vertical equity and the desirable distribution of the federal tax burden is represented by the 1986 Code, then a broad-based VAT may not be viewed as creating a more inequitable federal tax structure. Also, if Congress favored VAT but wanted to offset the regressivity of this sales tax, it could achieve its distributional goals by granting credits under the income tax or increasing benefits under direct grant programs for the poor. Measured by standards of neutrality or economic efficiency, a broad-based VAT scores well. However, if the late Chairman Al Ullman's proposed VAT foretells the kind of VAT Congress would be likely to adopt, an American VAT would include tax preferences and thus would not be neutral as to choices among consumer items.

VAT can be used as a fiscal tool to fine tune the economy by affecting the overall level of consumption of all or selected goods and services (altering the overall rate versus imposing preferential or higher rates on selected items). With the Congressional effort, as part of the 1986 reforms, to eliminate many of the income tax incentives previously used to achieve economic or social goals, it would be inconsistent for Congress now to favor VAT because of this characteristic. There are nonfiscal tools, such as the Federal Reserve's control over the money supply, that the government can use to regulate excessive swings in the business cycle.

For a variety of reasons, individuals tend to favor sales taxes over the federal income tax. Part of the appeal of sales taxes may be the public perception that all consumers must bear sales taxes, while some taxpayers avoid the full impact of the income tax through artful tax planning. Taxpayer compliance may be greater if tax collection is split between taxes imposed at the point of use of income for consumption as well as at the source of the income, especially if the new revenue source permits Congress to raise the required revenue by imposing low rates for all federal taxes. This kind of tax structure minimizes the level of tax-motivated transactions that occur when marginal tax rates are high. However, even if the level of compliance does not increase significantly, if the new balance among federal taxes is perceived as a system in which most

taxpayers pay a fair share of the tax burden, the public will have more confidence in the overall federal tax system. This public confidence may foster taxpayer compliance.

The enactment of a federal VAT will increase costs both for the government to administer and for taxpayers to comply with federal tax requirements. Indeed, given the costs of hiring a staff within the Treasury and Justice Departments to administer the tax as well as the costs incurred by taxpayers in hiring and training employees to comply with a broad-based VAT, a strong argument can be made to rely on existing taxes to raise additional federal revenue. As a percentage of revenue generated, the cost for the government to establish and maintain a structure to administer a low rate VAT (five percent range) likely will be much higher than the cost to administer higher rate income and payroll taxes, especially if the VAT provides preferences for certain consumer goods and services. This cost, as a percentage of revenue, will decline if the tax rate and VAT revenue is increased. A VAT will impose a more onerous burden on small businesses than on large corporations, especially if the former do not rely on automated accounting systems.

It is not clear if the adoption of a low rate federal sales tax would adversely affect the states' ability to raise more (or possibly the same level of) revenue from state sales taxes. The impact of a federal VAT on state revenue raising capacity may be affected more by the combined federal, state, and local sales tax rate. If this rate is high, taxpayers may pressure their representatives at all levels of government to reduce the tax on consumption. This pressure may increase if the VAT is used to materially increase the level of federal tax as a percentage of GNP.

Still, focusing on the above positive and negative attributes of a VAT tends to shift the analysis away from the basic issue of whether Congress should adopt a broad-based federal consumption tax. In part, the answer depends upon what level of taxation we collectively are willing to impose upon ourselves to improve the national standard of living, and how we decide to allocate that burden among taxpayers. In large part, a consensus on the acceptable overall level of taxation depends upon what existing, new or expanded government services are popular enough to merit public finance. If Congress decides to increase total federal revenue, ulti-

mately, the mixture of federal taxes and the allocation of the federal tax burden must reflect the shared values of taxpayers as to what is "fair."

