

The Plethora of Consumption Tax Proposals: Putting the Value Added Tax, Flat Tax, Retail Sales Tax, and USA Tax into Perspective

ALAN SCHENK*

TABLE OF CONTENTS

I.	INTRODUCTION	1282
II.	REASONS TO LOOK AT CONSUMPTION TAX ALTERNATIVES NOW	1286
III.	A BRIEF HISTORY OF CONSUMPTION TAXES	1290
	A. <i>From Ancient Egypt to World War II</i>	1290
	B. <i>Multistage VATs Replaced the Turnover Taxes</i>	1292
IV.	PLACEMENT OF U.S. TAX SYSTEM IN WORLD TAX SYSTEMS	1293
	A. <i>Widespread Use of Consumption Taxes</i>	1293
	B. <i>Comparison of U.S. Taxes With Those Elsewhere</i>	1294
V.	UNITED STATES PROPOSALS FOR A CONSUMPTION TAX	1295
	A. <i>Comparison of Income and Consumption Taxes</i>	1295
	B. <i>Outline of Major Proposals</i>	1297
VI.	DEFINING THE CONSUMPTION TAX BASE, IDENTIFYING THE TAXPAYER AND CALCULATING TAX LIABILITY	1300
	A. <i>Introduction</i>	1300
	B. <i>Definition of the Base</i>	1301
	C. <i>Identification of the Taxpayer</i>	1302
	D. <i>Calculation of Tax Liability</i>	1305
	1. <i>Addition and Subtraction Forms of VAT</i>	1305
	a. <i>Credit-Invoice VAT</i>	1306
	b. <i>Credit-Subtraction VAT Without Invoices</i>	1307

* Professor of Law, Wayne State University Law School.

	c. Sales-Subtraction VAT	1308
	d. Addition Method VAT	1309
	2. USA's Income and Business Tax	1311
	3. Flat Tax	1313
	4. Retail Sales Tax	1315
VII.	SWITCHING FROM AN INCOME- TO A CONSUMPTION-BASED SYSTEM . .	1317
	A. Introduction	1317
	B. Administration and Compliance Costs	1318
	C. Effect on Corporate Dividend Policy	1320
	D. Financing Business Operations	1321
	E. Federal-State Fiscal Relations	1321
	F. International Trade Implications	1322
VIII.	CONCLUSION	1326

*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?¹*

I. INTRODUCTION

Public discontent with taxes has a long history in the United States that dates back to the Revolution, but has had a renaissance since the 1970s. At the state level, California voters adopted Proposition 13,² which capped the ad valorem tax on real property at one percent of the full cash value of the property.³ Copycat legislation was enacted in several other states. At the federal level, public opposition to high income tax rates and to tax shelters perceived to disproportionately benefit the rich culminated in the enactment of the Internal Revenue Code of 1986, which dramatically reduced tax benefits from real estate and other tax shelter investments. It also reduced the top individual income tax bracket from fifty to twenty-eight percent and the top corporate rate from forty-six to thirty-four percent. In 1993, the top individual rate crept back up to 39.6 percent and the top corporate rate to thirty-five percent.⁴

1. THOMAS HOBBS, *LEVIATHAN* 184 (Dutton ed. 1914).
2. Proposition 13 amended the California Constitution, article XIII, section A (amended 1986).
3. "The maximum amount of any ad valorem tax on real property shall not exceed one percent (1%) of the full cash value of such property. The one percent (1%) tax to be collected by the counties and apportioned according to law to the districts within the counties." CALIF. CONST., art. XIII, § (A)(1)(a) (1986).
4. The 39.6% individual rate and the 35% corporate rate became effective for tax years beginning after December 31, 1992 for individuals and on or after January 1, 1993 for corporations. See Pub. L. No. 103-66, §§ 13201(a), 13221(a)(1)-(3), 107 Stat. 457,

Tax rate increases are politically unpopular. After decades of trying to reduce budget deficits by increasing the tax base, changing accounting rules, or using other tactics to wring additional revenue out of the existing federal income tax system, Congress started looking at more fundamental reforms in order to bring the budget back into balance and to reduce the national debt.

In 1679 Sir William Petty wrote that when the public is unhappy with an existing tax, a politician can attract support by proposing a new tax to cure the ills of the old one.⁵ This phenomenon, when viewed in light of public discontent with the existing income tax, may explain the congressional interest in tax plans that would radically or fundamentally change the federal tax system. A common thread in these proposals is the recommendation that we shift from a system that relies mainly on taxes measured by income (income and payroll taxes) to a system that relies increasingly on taxes measured by consumption, whether in the form of sales taxes, value-added taxes (VATs), or a consumption-based tax imposed on individuals. A shift from individualized income taxes on individuals to a value-added or sales tax is what Richard Musgrave refers to as a move to a “depersonalized system [that] would reduce taxpayer awareness of the fiscal process and thereby dilute responsible fiscal citizenship.”⁶ Our income tax is imposed on receipts used both for consumption and savings. If a consumption tax replaces part or all of our income taxes, the new tax system will be levied on funds used for consumption. To raise the same amount of revenue, it is likely that the rates must be increased.⁷

What is a consumption tax? In OECD countries, “(g)eneral consumption taxes are . . . all taxes (other than import and export duties) levied on the production, leasing, transfer, delivery or sales of a wide range of goods and/or the rendering of a wide range of services . . . irrespective

477 (1993).

5. “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* 60 (1679).

6. Richard A. Musgrave, *Clarifying Tax Reform*, 70 *TAX NOTES* 731, 732 (1996). See also John S. Nolan, *The Merit of an Income Tax Versus a Consumption Tax*, 71 *TAX NOTES* 805 (1996).

7. Nolan, *supra* note 6, at 808.

of the stage of production or distribution at which they are levied.”⁸ Sales taxes, value-added taxes, and other multistage cumulative taxes are consumption taxes. Of the twenty-five members of the Organization for Economic Cooperation and Development (OECD), only the United States and Australia do not have a VAT.⁹

Since 1970, a series of national task forces and commissions have reviewed the federal tax structure. For example, President Nixon’s 1970 Task Force on Business Taxation considered, but did not recommend, the adoption of a VAT, concluding that, in large part because of the added cost of another tax, a value-added tax should be considered only if significant additional revenue must be raised.¹⁰ The 1992 Center for Strategic and International Studies Strengthening of America Commission, co-chaired by Senators Nunn and Domenici, recommended the replacement of the current income tax system with a consumption-based system.¹¹ The 1995 report of the Bipartisan Commission on Entitlement and Tax Reform studied the escalating cost of entitlement programs and discussed the need to reduce dependence on Social Security by increasing reliance on private retirement savings, but did not make any recommendations to change the federal tax system.¹² The Kemp Commission (chaired by Jack Kemp) reviewed the current federal tax system that it described as a system with increasing rates and complexity that limits economic opportunities for Americans. The Commission recommended, without specifics, a tax structure with a single, low rate tax as part of a comprehensive tax reform effort.¹³

8. ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, CONSUMPTION TAX TRENDS 7 (1995) [hereinafter OECD, CONSUMPTION TAX TRENDS].

9. *Id.* at 11.

10. BUSINESS TAXATION, THE REPORT OF THE PRESIDENT’S TASK FORCE ON BUSINESS TAXATION 61 (1970).

11. THE CSIS STRENGTHENING OF AMERICA COMMISSION, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, PUB. NO. 1 (1992). The basic tax recommendations later were incorporated into the USA tax system, discussed *infra* at text accompanying note 82.

12. BIPARTISAN COMMISSION ON ENTITLEMENT AND TAX REFORM: FINAL REPORT TO THE PRESIDENT (Jan. 1995).

13. National Commission on Economic Growth and Tax Reform, *Unleashing America’s Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century*, reprinted in 70 TAX NOTES 413 (1996) [hereinafter Kemp Commission]. The Commission (a private organization) was appointed by Senate Majority Leader Bob Dole and House Speaker Newt Gingrich. The Commission’s core recommendations are to:

- Adopt a single, low tax rate with a generous personal exemption
- Lower the tax burden on America’s working families and remove it on those least able to pay
- End biases against work, saving, and investment
- Allow full deductibility of the payroll tax for working men and women
- Require a two-thirds super-majority vote in Congress to increase tax rates

Members of Congress have proposed several different kinds of consumption-based taxes,¹⁴ including a national retail sales tax, a variety of multistage value-added taxes, a flat tax, and a consumption-based tax on individuals that is tailored to individual circumstances. Advocates want to use the revenue from these new taxes for different purposes—to pay down the national debt, finance new or expanded federal programs, or replace some or all of the income and payroll taxes. Some of the proposed taxes are to be collected by business as they make sales and some are imposed on individuals.

Proponents claim that consumption taxes¹⁵ are needed, among other reasons: (1) To improve the United States' competitive position in

Id. at 424.

The Commission believes that this new tax system can satisfy our six working principles:

- Economic growth through incentives to work, save, and invest;
- Fairness for all taxpayers;
- Simplicity so that anyone can figure it out;
- Neutrality so that people and not government can make choices;
- Visibility so that people know the cost of government; and
- Stability so that people can plan for their future.

Id. at 424.

For a preliminary estimate of the implications of the Commission report in light of various congressional proposals, see William G. Gale, *The Kemp Commission and the Future of Tax Reform*, 70 TAX NOTES 717 (1996).

14. There also has been at least one proposal to retain, but substantially reform, the corporate and individual income taxes. Representative Gephardt's plan calls for a single 10% individual income tax rate for most taxpayers and allows deductions only for mortgage interest. See STAFF OF JOINT COMMITTEE ON TAXATION, 104TH CONG., 2D SESS., IMPACT ON INTERNATIONAL COMPETITIVENESS OF REPLACING THE FEDERAL INCOME TAX 88 (Jt. Comm. Print 1996) (discussing Richard Gephardt's proposal, the "Ten Percent Tax Plan").

15. The tax literature is replete with arguments for and against a consumption tax system. See MURRAY L. WEIDENBAUM ET AL., *THE VALUE ADDED TAX: ORTHODOXY AND NEW THINKING* (1989); AMERICAN COUNCIL FOR CAPITAL FORMATION, CENTER FOR POLICY RESEARCH, *THE CONSUMPTION TAX: A BETTER ALTERNATIVE?* (Charles E. Walker et al. eds., 1987); CHARLES E. MCLURE, JR., *THE VALUE-ADDED TAX: KEY TO DEFICIT REDUCTION?* (1987); U.S. DEP'T OF THE TREASURY, *3 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH* (1984); U.S. DEP'T OF THE TREASURY, *BLUEPRINTS FOR BASIC TAX REFORM* (1977). See also Alan Schenk, *Value Added Tax: Does This Consumption Tax Have a Place in the Federal Tax System?*, 7 VA. TAX REV. 207 (1987); Bruce Bartlett, *The Case Against a Value-Added Tax*, BACKGROUNDER (The Heritage Foundation, Wash., D.C.), Nov. 5, 1985, at 1; Eugene F. Bogan, *A Federal Tax on Value Added—What's Wrong with It? Plenty!*, 49 TAXES 600 (1971); Dan Throop Smith, *Value-added Tax: The Case For*, HARV. BUS. REV., Nov.-Dec. 1970, at 77; Stanley S. Surrey, *Value-added Tax: The Case Against*, HARV. BUS. REV., Nov.-Dec. 1970, at 86.

world markets, (2) to increase the savings rate in order to increase capital formation and create jobs, and (3) to simplify or replace the income tax and, with it, reduce the time and cost to prepare tax returns.

Americans have grown up with a federal income-based tax system. It is not surprising that some politicians and commentators approach consumption taxes from an income tax perspective. For example, it may be hard to detect from the statements of those proposing a flat tax that this tax not only has a single tax rate designed to simplify compliance, but has a dramatically different tax base that does not include interest, dividends, capital gains, and other returns to capital investments. Others discuss consumption taxes from a consumption tax perspective.

This Article starts with the reasons for the interest in fundamental tax reform that includes a federal consumption tax. A brief history of consumption taxes follows, discussing how the United States federal tax system fits into the array of tax systems used in highly industrialized nations. The Article explains the various forms of consumption taxes and fits the U.S. proposals into this collage. Some significant elements of these consumption taxes, such as the tax base, the identification of the taxpayer, and the method of calculating tax liability, are explored. The Article concludes with an analysis of the impact of a shift to a federal tax on consumption.

This Article gives only minor attention to the issues covered in the other Symposium articles. Reuven Avi-Yonah discusses the international implications of a switch to a consumption tax; Alice Abreu discusses the effect of such a switch on power and choice; Jane Gravelle discusses the distribution effects of this kind of tax change; Dan Bucks and Michael Mazerov discuss the impact of a new federal consumption tax on state and local tax regimes; Lester Snyder and Roger Higgins look at the effects of consumption taxes on certain kinds of taxpayers (especially the family, small closely held corporations, and trusts); Peter Faber examines the impact of consumption tax proposals on taxable and nontaxable acquisitions and liquidations; and Fred Brown closes by contrasting a complete accrual tax system with the various consumption tax proposals.

II. REASONS TO LOOK AT CONSUMPTION TAX ALTERNATIVES NOW

In June 1995, U.S. House Ways and Means Chairman Archer announced hearings on replacing the federal income tax with this statement: "I am committed to tearing the income tax out by its roots. If we don't tear it out by its roots, I am afraid it will grow back just as

tangled as it is now."¹⁶ According to Richard Musgrave, the income tax age may be coming to an end. "The goal is no longer to improve the income tax by broadening its base but to replace it, fully or partly, with a new model."¹⁷

Why the disenchantment, or perceived disenchantment, with the income tax? Much of the opposition voiced by individual filers relates to the complexity of the income tax, especially if they have income from investments.¹⁸ Some proposals seek the complete elimination of tax on income from investments if that income is saved, not spent.¹⁹

The business community has voiced discontent with the income tax, more specifically with the corporate income tax. Currently, the taxation of business income varies, depending upon the form of operation—proprietorship, partnership, taxpaying corporation, S corporation, and limited liability company—and on the extent to which the business is financed with equity capital or borrowed funds. The tax differences flowing from the form of operation, especially between taxpaying corporations and other investment vehicles, occur because income from investments in noncorporate form is taxed only to the owners, while corporate income is taxed at the corporate level.²⁰ Moreover, after-tax corporate profits are taxed again when distributed to shareholders as dividend income, resulting in what commonly is referred to as the double tax effect.²¹

16. As part of his announcement of the hearings to replace the income tax, Chairman Archer suggested that any proposal to replace the income tax should be measured against four goals: (1) Is it easy to comply with and does it reduce the role of the Federal Government in our lives; (2) Does it encourage greater savings and investment; (3) Does it improve the international competitiveness of American workers and businesses; and (4) Does it pick up revenue from the underground economy and others who currently do not comply with the tax laws? I believe that a broad-based tax on consumption best meets these goals

Replacing the Federal Income Tax: Hearings Before the House Comm. on Ways and Means, 104th Cong., 1st Sess. 2 (1995) [hereinafter *Replacing the Federal Income Tax*].

17. Musgrave, *supra* note 6, at 732.

18. See James M. Bickley, *Flat Tax: An Overview of the Hall-Rabushka Proposal*, 71 TAX NOTES 97 (1996).

19. See, e.g., USA Tax Act of 1995, S. 722, 104th Cong., 1st Sess., 141 CONG. REC. S5664 (1995) [hereinafter USA Tax].

20. This effect occurs for corporations that do not elect S corporation treatment. See I.R.C. §§ 1361-1379 (1994).

21. See BORIS BITTKER & JAMES EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 1.07[7], 1.08[1] (6th ed. 1994).

The tension between debt and equity financing occurs because a corporation can avoid the corporate-level tax with deductible interest paid to creditors, but not with nondeductible dividends paid to shareholders. With a consumption-based tax, the tax burden does not depend on the form of business operation or on the extent to which a business is financed with debt or equity capital.

Advocates for dramatic or fundamental tax reform usually use the low rate of net American savings and the high level of taxpayer noncompliance as additional support for fundamental reform. There is scant evidence that a move toward greater reliance on consumption taxes collected by business would significantly improve the savings rate²² of Americans or significantly increase taxpayer compliance with federal taxes.

The rise in the reported level of taxpayer noncompliance with federal income taxes²³ may be due in part to the Internal Revenue Service's improved techniques in estimating the loss of revenue, rather than from any real increase in taxpayer cheating. However, the addition of another federal tax, especially if coupled with a reduction in rates for existing taxes, may improve tax compliance. Experience indicates that tax evasion is lower if a tax is imposed at a lower rate rather than a higher rate.²⁴

Existing federal taxes are levied predominantly at the source of income (income and payroll taxes). If a tax like a VAT is added to the tax system, a portion of the tax revenue will be levied at the point of use of funds—when sales are made to consumers. Individuals with ill-gotten gains or those who are otherwise outside the income and payroll tax nets will pay the consumption tax when they make taxable purchases.

The corporate income tax may play a key role in any fundamental tax reform. Many congressional proposals for dramatic tax reform target the corporate tax for extinction.²⁵ Corporate tax revenue measured either as a percentage of federal revenue or as a percentage of the economy (gross domestic product), has fluctuated significantly over the past fifty years. At the high end, it was 32.1 percent of revenue and 6.2 percent

22. See, e.g., John R. Moroney & Lorence L. Bravenec, *Consumption Taxes & Savings Rates: Evidence From Six OECD Countries*, 71 TAX NOTES 235 (1996).

23. See, e.g., GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: I.R.S. CAN IMPROVE ITS PROGRAM TO FIND TAXPAYERS WHO UNDERREPORT THEIR INCOME (1991). For 1987, the IRS estimated that underreported income accounted for \$48 billion in unpaid income tax. *Id.* at 2.

24. See, e.g., MICHAEL H. WILSON, MINISTER OF FINANCE (CANADA), TAX REFORM 1987: SALES TAX REFORM 7 (1987) [hereinafter CANADIAN SALES TAX REFORM].

25. See, e.g., USA Tax, *supra* note 19.

of Gross Domestic Product (GDP) in 1952, and at the low end it dropped to 6.2 percent of revenue and 1.1 percent of GDP in 1983.²⁶ Some businesses that historically have been on the corporate tax rolls are no longer contributing to the corporate tax revenue. Congress made the S corporation election (to be taxed basically as a partnership with no corporate level tax)²⁷ more attractive for small businesses with the 1980 reform of subchapter S and the broader 1986 tax reform.²⁸ In 1988, the Internal Revenue Service recognized a properly structured Limited Liability Company (LLC) as an entity taxable as a partnership.²⁹ The LLC legislation spread across the country. What started as an ideal vehicle for the flow-through of losses from real estate investments is being used by businesses in other industries. Indeed, the Service has made it possible for unincorporated businesses with significant characteristics of a corporation to check a box in order to be taxed as a partnership or proprietorship.³⁰ Unless Congress decides to tax LLCs as corporations,³¹ Congress may find that the number and kinds of businesses subject to the corporate tax will decline further. With corporate tax revenue at only 11.6 percent of federal revenue in 1995³²

26. OFFICE OF MANAGEMENT & BUDGET, HISTORICAL TABLES: BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 1997, tbls. 2.2 & 2.3 (1996) [hereinafter HISTORICAL TABLES]. Congress reduced the corporate tax base by reducing the rates and liberalizing depreciation on capital purchases.

27. There are a few exceptions when corporate level tax is paid by an S corporation. See, e.g., I.R.C. §§ 1374, 1375 (1994).

28. With the 1986 reforms, the top corporate tax rate (34%) exceeded the top individual rate (28%), and all corporate distributions of appreciated property became taxable at the corporate level. On the last point, see I.R.C. § 311(b) (1994). See generally Pub. L. No. 99-514, 100 Stat. 2085 (1986). This changed again after 1992, when the top individual rate was raised to 39.6% and the top corporate rate was increased to 35%. See Pub. L. No. 103-66, §§ 13201, 13221(a), 107 Stat. 457, 477 (1993). There was a two point spread in 1991 and 1992, when the top individual rate was increased to 36% and the top corporate rate was 34% and a surtax on taxable income exceeding \$100,000 eliminated the benefit of the lower 15% and 25% rates.

29. See Rev. Rul. 88-76, 1988-2 C.B. 360 (ruling on the Wyoming Limited Liability Company Act).

30. See Treas. Reg. § 301.7701-1 to -3 (as amended by T.D. 8697, 1997-2 C.B. 11).

31. When corporations began organizing part of their operations (such as part of the drilling operations of an oil and gas corporation) as publicly traded partnerships, Congress responded by treating most such partnerships after 1987 as corporations for tax purposes. See I.R.C. § 7704 (1994 & West Supp. 1996).

32. HISTORICAL TABLES, *supra* note 26, tbl. 2.2. In contrast, the individual income tax accounted for 43.6% of federal revenue in 1995. *Id.*

and with concern about the complexity of the corporate tax growing, pressure on Congress to replace the corporate tax may increase. In this climate, consumption tax advocates may package the replacement of the corporate tax with a broad-based tax on consumption (such as a VAT) as a base-broadening tax reform measure.

Congressional proposals to reduce the tax imposed on returns to capital—such as capital gains—generally meet with strong political opposition. As part of the 1986 tax reform, the top rates on capital gain and ordinary income were set at parity at twenty-eight percent. When the top individual income tax rate was increased above twenty-eight percent, Congress imposed a twenty-eight percent cap on an individual's net capital gain. Congressional attempts to reduce the maximum twenty-eight percent rate on capital gains have been thwarted. A tax on consumption does not reach income from interest, dividends, capital gains, and other returns to capital until those receipts are used for consumption. It remains to be seen whether an electorate opposed to reducing the top income tax rate on capital gains will support the replacement of the income tax with a consumption tax that completely removes from the tax base capital gains and other returns to capital.

III. A BRIEF HISTORY OF CONSUMPTION TAXES

A. *From Ancient Egypt to World War II*

Indirect taxes, especially on goods and services, have played a significant role in fiscal systems throughout the history of Western civilizations.

In early Egypt and Mesopotamia when temple and government were synonymous, a highly organized system of financial administration was unnecessary. The priest-king maintained himself, the lesser priests and his followers with produce of the royal domain. Voluntary donations brought to the temple by residents of nearby land supplemented royal production.³³

As kingdoms grew and distant lands were conquered, voluntary tributes became compulsory levies, and an administrative system was necessary to collect the taxes. Early compulsory taxes in Mesopotamia were fixed portions (tithes) of the land's production.³⁴

33. CAROLYN WEBBER & AARON WILDAVSKY, A HISTORY OF TAXATION AND EXPENDITURE IN THE WESTERN WORLD 49 (1988).

34. *Id.* at 51. The same was true elsewhere. Other early taxes included *corvée*, or forced labor. *Id.* at 68. “[D]uring the Tang Dynasty in China, 80 to 85 percent of the government's tax revenues were paid in grain.” *Id.* at 71.

During the period 200-80 B.C.E., import and export duties were imposed but did not raise significant revenue.³⁵ Augustus, starting in 6 A.D., imposed indirect taxes that included a one percent tax on sales at public auction (such as a sale to settle a decedent's estate), and a four percent tax on the sale of slaves.³⁶

From the Roman Republic to the Middle Ages, the property tax was the predominant direct tax, and customs duties served as the most important indirect tax.³⁷ In fact, customs duties were imposed several times as goods traveled through ports and city gates, and over bridges.³⁸ Direct taxes in that period "symbolized dishonor, incompatible with the ideal of a free citizen. In Athens, for example, only low-status residents, such as prostitutes and aliens, paid direct taxes."³⁹ In the Roman Republic, the indirect taxes⁴⁰ were those imposed on provinces (the conquered lands). They included "provincial tithes, sales taxes, [and] inheritance taxes"⁴¹

The period between the eleventh and early thirteenth centuries marked the transition from taxation by fiat of the king to taxation by consent.⁴² To collect the taxes on imports and exports, tax collectors were posted at ports in England and at the borders in other countries. Beginning in the late thirteenth century, European communal governments levied an array of indirect taxes, especially on imported goods.⁴³ The form of taxation tended to follow the feasible administrative structure and technology of the time.⁴⁴

In the early modern era of the fifteenth through eighteenth centuries, nobles were exempt from tax, but poor peasants and small merchants remained taxable. Land remained an important subject of tax, but

35. JAMES COFFIELD, *A POPULAR HISTORY OF TAXATION FROM ANCIENT TO MODERN TIMES* 10 (1970).

36. *Id.* at 26-27.

37. *Id.* at 27.

38. WEBBER & WILDAVSKY, *A HISTORY OF TAXATION AND EXPENDITURE IN THE WESTERN WORLD*, *supra* note 33, at 108.

39. *Id.* at 108.

40. In modern tax terminology, indirect taxes, like the sales tax or VAT, "are taxes that are levied upon commodities before they reach the consumer who ultimately pay[s] the taxes as part of the market price of the commodity." 10 *THE GUIDE TO AMERICAN LAW* 25 (West 1984).

41. COFFIELD, *supra* note 35, at 9.

42. WEBBER & WILDAVSKY, *supra* note 33, at 174.

43. *Id.* at 201.

44. *Id.* at 49.

indirect taxes became more prevalent, representing a significant source of revenue.⁴⁵ Early modern governments expanded the taxation of goods as more and more trade was conducted for money rather than by barter.⁴⁶ Food, drink, clothing, luxuries, playing cards, and other gambling paraphernalia were taxed.⁴⁷

Due to improved administration during the early Industrial Age, beginning around 1775, income taxes and progressive inheritance taxes became popular. Many selective excise taxes were eliminated, and at the urging of free-traders, customs duties were curtailed.⁴⁸ Nevertheless, indirect taxes continued to raise most of the revenue.⁴⁹

By the 1920s, the tax systems of many West European countries and the United States were similar. Income tax, excise taxes, and customs duties accounted for most of the revenue. Indirect taxes accounted for between thirty-five and seventy percent of revenue.⁵⁰

B. Multistage VATs Replaced the Turnover Taxes

After World War II, progressive income taxes became widespread. During this period, general consumption taxes, especially in Europe, tended to be cascading turnover taxes that were levied at each stage of production and distribution.⁵¹ Goods produced by a vertically-integrated business bore less tax because the goods turned over fewer times from the point of manufacture to the sale to final consumers. Years earlier, Dr. Wilhelm von Siemens, a German businessman and government consultant, proposed an improved turnover tax—what later was labeled a value-added tax—to remove the cascade effect by giving each seller a credit against the tax on sales for the tax charged on his business inputs.⁵²

France was the first country to implement the value-added tax concept at the national level. Reportedly at France's urging, as part of the Treaty of Rome, the countries of the European Community were required to adopt the value-added tax as a condition of membership.⁵³ The VAT quickly spread to other West European and Scandinavian countries, to developing countries of South America and Africa, to some of the Asian

45. *Id.* at 261, 270.

46. *Id.* at 271.

47. *Id.* at 272.

48. *Id.* at 336.

49. *Id.* at 336-37.

50. *Id.* at 452.

51. See CLARA K. SULLIVAN, *THE TAX ON VALUE ADDED* 6, 11-16 (1965).

52. See *id.* at 12.

53. See TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [EEC TREATY] art. 99.

countries, to East European countries, and to the former states of the Soviet Union. In many countries the VAT was welcomed as a replacement for the more economically-distorting turnover taxes. The European invoice VAT was viewed as a self-enforcing tax that would increase compliance. The invoice VAT also permitted accurate border tax adjustments consistent with the obligations of many countries under the General Agreement on Tariffs and Trade (now the World Trade Organization, or WTO).⁵⁴

Japan enacted a VAT in 1950, but due to opposition from business and labor, the effective date was postponed until it was finally repealed in 1954. It took until April 1, 1989 for Japan to enact a VAT that took effect.⁵⁵ By this standard, the U.S. still can take many years to debate a VAT or other consumption-based taxes before enacting one, since Al Ullman introduced his modified VAT proposal in 1980.⁵⁶

Part IV compares the current tax system in the United States with the systems in use by some of our trading partners.

IV. PLACEMENT OF U.S. TAX SYSTEM IN WORLD TAX SYSTEMS

A. *Widespread Use of Consumption Taxes*

In 1992 general consumption taxes accounted, on average, for about seventeen percent of tax revenues and almost seven percent of GDP of OECD countries.⁵⁷ This is much more than the almost twelve percent of tax revenue and 3.4 percent of GDP in 1965.⁵⁸ Some of this increase in general consumption taxes resulted from a shift away from other consumption taxes; more specifically, from selective excise taxes.⁵⁹

The major consumption tax in the U.S. is the retail sales tax imposed at the state and local levels of government. The following subsection

54. See OECD, CONSUMPTION TAX TRENDS, *supra* note 8, at 11. See also General Agreement on Tariffs and Trade, Mar. 10, 1955, 8 U.S.T. 1767.

55. See generally Alan Schenk, *Japanese Consumption Tax: The Japanese Brand VAT*, 42 TAX NOTES 1625 (1989).

56. See H.R. 7015, 96th Cong., 2d Sess., 126 CONG. REC. 1888 (1980); H.R. 7481, 7483-85, 96th Cong., 2d Sess., 126 CONG. REC. 1905 (1980).

57. OECD, CONSUMPTION TAX TRENDS, *supra* note 8, at 7.

58. *Id.* tbls. 1 & 2.

59. *Id.* at 8.

shows that the U.S. is near the low end of the compared countries, both in total taxes and in taxes on goods and services, when measured as a percentage of GDP.

B. Comparison of U.S. Taxes With Those Elsewhere

TOTAL TAXES AS A PERCENTAGE OF GDP *		
	<u>1965</u>	<u>1992</u>
CANADA	25.9	36.5
FRANCE	34.5	43.6
GERMANY	31.6	39.6
JAPAN	18.3	29.4
NEW ZEALAND	24.7	35.9
SWEDEN	35.0	50.0
UNITED KINGDOM	30.4	35.2
UNITED STATES	25.8	29.4
OECD UNWEIGHTED AVG.	26.6	38.8
* ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, REVENUE STATISTICS OF OECD MEMBER COUNTRIES 1965-1993, TBL. 3.		

The above table shows that total taxes as a percentage of GDP increased in all of the compared countries between 1965 and 1992. While the following table is not representative of experience in all countries with VATs, in these compared countries, broad-based general consumption taxes (as a percentage of GDP) did not all increase after 1965, when most of them introduced VATs.

TOTAL TAX ON GOODS AND SERVICES AS A PERCENTAGE OF GDP* (THE DATE IN PARENTHESIS IS THE DATE VAT WAS INTRODUCED OR BECAME EFFECTIVE) ⁶⁰		
	<u>1965</u>	<u>1992</u>
CANADA (1991)	10.5	9.5
FRANCE (1968) ⁶¹	13.2	11.7
GERMANY (1968)	10.4	10.6
JAPAN (1989)	4.8	4.1
NEW ZEALAND (1986)	6.9	12.7
SWEDEN (1969)	10.9	13.2
UNITED KINGDOM (1973)	10.0	12.1
UNITED STATES (NO VAT)	5.7	5.0
OECD UNWEIGHTED AVG.	10.0	11.8
* ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, REVENUE STATISTICS OF OECD MEMBER COUNTRIES 1965-1993, TBL. 24.		

V. UNITED STATES PROPOSALS FOR A CONSUMPTION TAX

A. *Comparison of Income and Consumption Taxes*

Congressional proposals for a federal tax on consumption vary widely, not only in the kind of consumption tax proposed but in the use of the revenue generated from any such tax.⁶² A consumption-based tax

60. This data was taken in large part from ALAN A. TAIT, INT'L MONETARY FUND, VALUE ADDED TAX: INTERNATIONAL PRACTICE AND PROBLEMS 40-41 (1988).

61. France introduced a form of VAT after World War II, but it did not become broadly-based and imposed down to the retail stage until 1968.

62. See generally Alan Schenk, *VAT Debate Stimulated by Reform Hearings in the United States*, VAT MONITOR, July/Aug. 1995, at 204.

departs significantly from an income-based tax, although income-based taxes can contain elements of a consumption tax.⁶³

Our current income tax system contains many features of a tax imposed on a consumption base. The individual income tax defers tax on income invested in qualified retirement plans and provides favorable tax treatment for investments in life insurance contracts.⁶⁴ Depreciation deductions that exceed the economic decline in productive assets and the lower tax rate on net capital gains, both features of our income tax, are compatible with a tax measured by consumption rather than income.⁶⁵

The income tax also encourages some forms of consumption. For example, income contributed to qualified charities, payments for self-provided health insurance and out-of-pocket medical expenses, mortgage interest, and real property taxes on personal residences may reduce income subject to tax, and some or all of the gain from the sale of such residences by those aged fifty-five and older is exempt.⁶⁶ Tax-favored fringe benefits provided by employers are not taxed to employees.⁶⁷ Thus, employer payments for employee health insurance are not taxable to the benefitted employees.

With an income-based tax like the individual income tax, income earned from capital (such as interest and dividends) and income from labor (wages and salary) are both taxed, at the source of funds, as income is earned or received. With a transactional, consumption-based tax like a sales tax, income earned from labor or from capital is taxed only if it is diverted to taxable consumption. Income that is saved is not taxed. A consumption-based tax tailored to individual circumstances (such as the income tax (IT) portion of the unlimited savings allowance (USA) tax) taxes current income (as defined) that is not invested to increase net savings.

While our existing income tax requires business to capitalize and depreciate capital goods, a consumption-style VAT allows business to obtain the equivalent of expensing of capital goods. The deduction for increases in savings under the IT portion of the USA tax and the expensing of capital goods under the business tax portion of the USA

63. See Musgrave, *supra* note 6, at 733.

64. See, for example, I.R.C. § 408(e) exempting from tax the current income earned on individual retirement accounts and § 101(a) exempting certain amounts received “under a life insurance contract, if such amounts are paid by reason of the death of the insured.” I.R.C. §§ 408(e), 101(a) (1994 & West Supp. 1996).

65. Nolan, *supra* note 6, at 806-07.

66. See, e.g., I.R.C. §§ 121, 163, 164, 170, 213 (1994).

67. For example, Internal Revenue Code § 106 excludes from gross income “employer-provided coverage under an accident and health plan.” I.R.C. § 106 (West Supp. 1996).

tax, in economic terms, effectively exempts the normal returns on these savings and capital goods.⁶⁸

Some proposals are for a European-style VAT.⁶⁹ There indeed may be significant reasons why the United States would not follow the European lead and adopt its invoice method VAT. Most significantly, if the U.S. decides on a VAT, it must find one that can be coordinated with state and local retail sales taxes. For this and other reasons, some proposals for fundamental tax reform urge a different form of VAT, a national retail sales tax, a flat tax, or a combination of a VAT and a consumption-based cash-flow tax on individuals.

The flat tax is being packaged as a simpler income tax. In fact, the flat tax proposals are consumption-based, not income-based taxes. The public discourse has blurred this distinction.

Some consumption tax proposals are designed to reduce the national debt, some are to provide revenue for various federal programs, some are to simplify the overall tax system, some are to replace income or payroll taxes, and some are to reduce the size of government by reducing the taxing capacity of the federal government. The economic and other effects of a tax shift are affected both by the distribution of the burden of the tax and the distribution of the benefits from the programs financed by the tax revenue or the benefits from the simplification of the tax system or the reduction in the national debt. This Article will not examine the impact of a tax change on the programs financed with the revised tax system.

Part B explains the basic elements of the major consumption tax proposals.

B. Outline of Major Proposals

Senator Hollings and Congressman Dingell introduced bills for a five percent, European-style, credit-subtraction or invoice method VAT. The mechanics of an invoice VAT are discussed in the next Part of this Article. This VAT is designed to be shifted to consumers in the form

68. See Musgrave, *supra* note 6, at 735. Musgrave notes that the "returns that remain in the tax base are rent, monopoly profits, compensation for risk, and reward for superior entrepreneurial effort." *Id.*

69. See, e.g., H.R. 16, 104th Cong., 1st Sess., 141 CONG. REC. E52 (1995), sponsored by Congressman Dingell, and the Hollings bill, both discussed in the next Section.

of higher prices and to be separately stated on sales invoices. The Dingell bill, proposed as an additional revenue source to finance a national health care system,⁷⁰ mirrors the VAT bill originally introduced by House Ways and Means Chairman Al Ullman in 1979.⁷¹ By international standards, Dingell's VAT is a broad-based tax, but it does not tax food, housing, medical care, exports, interest, sales to government entities, education provided by government entities, and services by certain nonprofit organizations.⁷² The Hollings bill had the dual purpose of helping to finance national health insurance and reducing the national debt.⁷³ The Hollings bill, with some minor modifications, is taken from the American Bar Association Section of Taxation Committee on Value Added Tax's model VAT statute.⁷⁴ The Hollings bill, with a broader base, taxes most goods and services, including financial intermediation services and insurance, that generally are not taxed abroad.⁷⁵ It does not tax exports, and it taxes sales by government entities and nonprofit organizations only if provided for a charge or fee.⁷⁶

There have been proposals for a different kind of VAT—a sales-subtraction VAT that will be included in product prices, not added at the cash register or separately stated on sales invoices. In the House, Congressman Gibbons, before he retired from the House, introduced a revenue-neutral twenty percent sales-subtraction VAT to replace the individual and corporate income taxes and the Social Security and Medicare taxes.⁷⁷ A unique feature of the Gibbons VAT is the “burden adjuster” provisions designed to maintain the existing distribution of federal tax burden.⁷⁸ Taxpayers with incomes below \$30,000 receive tax rebates and taxpayers with incomes above \$75,000 (about 17.5 million) will pay a seventeen percent tax on adjusted gross income above

70. H.R. 16, 104th Cong., 1st Sess., 141 CONG. REC. E52 (1995).

71. The bill was modified in 1980. See H.R. 7015, 96th Cong., 2d Sess., 126 CONG. REC. 7481, 7483-85 (1980).

72. *Id.* §§ 3912-15.

73. S. 237, 104th Cong., 1st Sess., 141 CONG. REC. S1072 (1995) [hereinafter Hollings Bill].

74. Alan Schenk, Reporter, VALUE ADDED TAX: A MODEL STATUTE AND COMMENTARY, A REPORT OF THE COMMITTEE ON VALUE ADDED TAX OF THE AMERICAN BAR ASSOCIATION SECTION OF TAXATION (1989) [hereinafter ABA MODEL VAT].

75. Hollings Bill, *supra* note 73, §§ 3934-35.

76. *Id.* §§ 3912-13.

77. H.R. 4050, 104th Cong., 2d Sess., 142 CONG. REC. E1572 (1996).

78. *Id.* (proposing amendment to I.R.C. §§ 1601-1611 (1994)).

that amount.⁷⁹ Low-income taxpayers entitled to the rebate may receive these payments from their employers as a supplement to their paychecks.⁸⁰

Senators Danforth and Boren, before they retired from the U.S. Senate, introduced their 14.5 percent business activities tax—also a sales-subtraction VAT—to replace the corporate income tax and about half of the OASDI payroll tax.⁸¹ Senators Nunn, Domenici, and Kerrey introduced the unlimited savings allowance (USA) tax system to replace the individual and corporate income tax and to reduce the burden of the payroll tax on individuals and businesses by providing credits against their payroll tax liability for some or all of their USA tax liability.⁸² The USA tax includes two interrelated taxes on consumption—an eleven percent business tax (a sales-subtraction VAT) nominally imposed on business, and a progressive, consumption-based tax on individuals imposed at rates from nineteen to forty percent.

There have been several proposals for a flat tax.⁸³ In 1995, Congressman Arney urged Congress to adopt the flat tax as the means to radically transform the individual and corporate income tax and to provide the revenue necessary to repeal the estate and gift tax.⁸⁴ Congressman Arney's flat tax has both a seventeen percent business tax (BT) and a seventeen percent income tax (IT) component.⁸⁵ The BT resembles a sales-subtraction VAT, but with two notable exceptions. Wages, generally included in a VAT base, are deductible in calculating the BT base. The BT adopts the origin, rather than the destination, principle to define the jurisdictional reach of the tax—that is, the BT is

79. *Id.*, 142 CONG. REC. at E1573. Taxpayers generally will file for the rebate or it will be paid along with other government transfer payments. The phased-out rebate equals the applicable percentage of the adjusted net income that does not exceed \$30,000. The applicable percentage is 20%, less 2/3 of one percentage point for each whole \$1,000 of adjusted net income. Adjusted net income includes certain federal transfer payments. *Id.* (proposing amendment to I.R.C. § 1601 (1994)).

80. *Id.* (proposing amendment to I.R.C. § 1602 (1994)).

81. S. 2160, 103d Cong., 2d Sess., 140 CONG. REC. S6527 (1994).

82. USA Tax, *supra* note 19.

83. Congressman Arney and Senator Specter were hopefuls for the 1996 Republican presidential nomination. There also was a flat tax introduced by Senator Helms in 1993. S. 188, 103d Cong., 1st Sess., 139 CONG. REC. S664 (1993).

84. H.R. 2060, 104th Cong., 1st Sess., 141 CONG. REC. E1461 (1995) [hereinafter Arney Flat Tax].

85. Congressman Arney proposed a 20% rate for the first two years. *Id.*

imposed on exports, but not on imports.⁸⁶ Under the destination principle universally used for VATs abroad, tax is imposed on imports and rebated on exports.

The IT portion of the flat tax basically is a tax on wages and on cash distributions from pension plans. It achieves some degree of progressivity by providing a generous standard deduction and an additional deduction for each dependent. The Arney tax plan was patterned after the flat tax proposed in 1983 and refined in 1995 by Robert Hall and Alvin Rabushka.⁸⁷ Senator Shelby introduced a companion flat tax bill in the Senate.⁸⁸ Senator Specter also proposed a flat tax similar to the Arney plan.⁸⁹

The Schaefer national retail sales tax was promoted as an alternative to the present tax system that could be administered by the states. Advocates claim that Congress could curtail the authority of the Internal Revenue Service if states administered the combined federal and state retail sales taxes.⁹⁰ Senator Lugar promoted a national sales tax as a tax to replace the income, estate, and gift taxes.⁹¹

VI. DEFINING THE CONSUMPTION TAX BASE, IDENTIFYING THE TAXPAYER, AND CALCULATING TAX LIABILITY

A. Introduction

Three major aspects of a consumption tax are the definition of the tax base, the identification of those required to file returns, and the rules necessary to calculate tax liability. Each person required to file a return must calculate his tax liability in the prescribed manner. The data needed to calculate tax liability depends on the tax base. The tax base rules, in turn, must cover the taxation of international transactions and must identify the transactions or receipts that are taxable and those that receive special treatment. This Section describes the range of choices in defining the persons required to file returns and the methods of calculating tax liability under the various kinds of consumption taxes.

86. The distinction between the origin principle and the destination principle is discussed *infra* Section VI.A.

87. See ROBERT E. HALL & ALVIN RABUSHKA, *LOW TAX, SIMPLE TAX, FLAT TAX* (1983); see also ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995).

88. S. 1050, 104th Cong., 1st Sess., 141 CONG. REC. S10320 (1995).

89. S. 488, 104th Cong., 1st Sess., 141 CONG. REC. S3416 (1995).

90. H.R. 3039, 104th Cong., 2d Sess., 141 CONG. REC. H1775 (1996) [hereinafter National RST Act].

91. See Dan Balz, *Senator Lugar Formally Enters Presidential Campaign*, WASH. POST, Apr. 20, 1995, at A4.

The definition of the tax base is more complicated. The parameters of a consumption tax base depend on the treatment of international transactions, on whether special treatment is provided for certain items of consumption, and on the treatment of capital goods. The first two elements are briefly discussed here. The next Section discusses the various treatment available for purchases of capital goods.

International transactions can be taxed under the origin or destination principle. Under the origin principle used in the Arney Flat Tax, exports are subject to tax, but imports are not. Under the destination principle, almost universally adopted by countries with VATs, imports are taxed and exports are not taxed.

A nation may give special consumption tax treatment—exemption, zero rating, or a tax rate higher or lower than the standard rate—for certain goods and services. Some countries impose a lower-than-standard rate on some necessities, such as certain food purchased for personal consumption. Higher rates may be imposed on sales of luxury items generally purchased by high-income families or for items such as alcohol and tobacco in order to discourage consumption.

Exemptions and zero rating provide quite different tax treatment. In the common VAT parlance of the United Kingdom and several other nations, an item is exempt if the sale is not taxed, and the seller cannot recover the tax on purchases related to that sale.⁹² For example, financial intermediation services generally are exempt from tax. A bank will not include the value of these services as part of its taxable sales. Likewise, the bank cannot recover the tax on bank purchases relating to these services. If an item is zero rated, the sale is not taxed and tax on purchases related to the sale is recoverable. If exports are zero rated, the export sale is not taxed and the exporter can recover the tax on inventory and other purchases related to those export sales. The effect of special treatment of particular goods and services is not discussed further in this Article.

B. Definition of the Base

The base of a consumption tax can be defined in part by the tax treatment of purchases of capital goods. The broadest base treats the business purchaser of capital goods as the final consumer of those goods.

92. ABA MODEL VAT, *supra* note 74, at 96-97.

With this GDP base, the purchaser cannot recover the tax imposed on his capital purchases. A federal tax base measured by the GDP would have been \$7.246 trillion in 1995.⁹³ The intermediate base reaches national income. With this base, purchasers of capital goods can recover the tax on such purchases over the lives of the goods (similar to depreciation-like treatment provided under the federal income tax). A national income base for 1995 would have been \$5.799 trillion.⁹⁴ The base used almost universally by countries with VATs is a base limited to personal consumption expenditures—a consumption-style (C) tax. With a C-tax base, business purchasers of capital goods can immediately recover the tax imposed on such purchases because the cost of capital purchases is included in the tax base when the user sells goods or services at prices that include these costs. A C-base for 1995 would have been \$4.924 trillion.⁹⁵

C. Identification of the Taxpayer

The number of taxpayers on the tax rolls of a consumption tax depends both on the number of stages of production and distribution that are taxed and on the definition of a taxable seller required to file returns. A consumption tax can be imposed at a single stage or at multiple stages of production and distribution. Tax returns may be required of all providers of goods and services or, for example, only certain sellers engaged in business with annual taxable sales above a threshold amount.

A single-stage tax is imposed at only one level of the production or distribution of goods, such as the retail, wholesale, or manufacturing level, or at only one level of rendering services, such as retail.⁹⁶ Single-stage retail sales taxes (RSTs) are imposed at the state and local levels in the United States and at the provincial level in Canada. A single-stage federal manufacturer's tax was replaced in Canada by a multistage VAT. If a consumption tax is imposed at a single stage only, the taxable stage must be defined with precision. Even so, taxpayers may attempt to shift operations or value added out of the taxable stage.

93. U.S. Dep't of Commerce, Business Situation, SURVEY OF CURRENT BUSINESS, July, 1996, at 1 tbl. 1.1.

94. *Id.* tbl. 1.9. Of this total, employee compensation represents \$4.209 trillion, or 73%. *Id.* tbl. 1.14.

95. *Id.* tbl. 1.1. Of this total, durable goods (including mainly motor vehicles, household equipment, and furniture) was \$606.4 billion, nondurable goods (mainly food, clothing, gas, oil, and fuels) was \$1.486 trillion, and services (including housing, some utilities, household operation, transportation, and medical care) was \$2.832 trillion. *Id.* tbl. 2.2.

96. See generally JOHN F. DUE & JOHN L. MIKESSELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION (1983).

For example, assume that a company manufactures clothes that it sells in company-owned stores. With a tax only at the manufacturing level, the manufacturing arm may sell to its retail stores at a low price in order to reduce the sales subject to the manufacturer's tax.⁹⁷

There are other characteristics of a single-stage tax. A tax at the manufacturing or other pre-retail stage omits value added by downstream sellers. With a single-stage tax that does not exempt all business inputs, some tax on business purchases is included in the cost of taxable products. As a result, there is a cascade or tax-on-a-tax effect with single-stage taxes, especially with state or provincial RSTs.⁹⁸ For example, if a retailer purchases some taxable office supplies or entertains a customer with a taxable restaurant meal, and if the retailer is not exempt from the tax on such purchases, that tax will enter the retailer's pricing of his products and will be taxed again when those products are sold.

Noncompliance may result in a greater revenue loss with a single-stage than with a multistage tax. With a single-stage tax like a retail sales tax, if a retailer underreports sales, the government loses all revenue from that product or service. With a multistage tax like a VAT, if the same retailer underreports sales, the government still may collect some tax from previous sales of those goods by the manufacturer and wholesaler.

A multistage tax, as its name implies, is imposed at more than one stage, and usually at all stages, of the production and distribution of goods and the rendition of services.⁹⁹ The various VATs and the business tax portions of the flat tax and the USA tax are multistage consumption taxes. Louisiana's sales tax imposed on wholesalers' sales to retailers and on sales at the retail level (with credit available to retailers for tax paid to wholesalers) likewise is a multistage tax on consumption.¹⁰⁰

97. See CANADIAN SALES TAX REFORM, *supra* note 24, at 10. Tax can be saved by separating marketing from manufacturing. "It is not uncommon for manufacturers to have their private brand products made by other companies. The [manufacturer's] federal sales tax then applies to the manufacturing cost of the products and does not include advertising and marketing costs incurred later in the production and distribution network." *Id.*

98. See DUE & MIKESELL, *supra* note 96, at 50-51; CANADIAN SALES TAX REFORM, *supra* note 24, at 15.

99. See TAIT, *supra* note 60, at 6-8.

100. See DUE & MIKESELL, *supra* note 96, at 6.

Assuming that a nation decides to impose a broad-based, multistage tax on consumption, such as a VAT, the legislature has the task of deciding who must file returns and account for the tax. The broadest concept of taxable sellers encompasses all providers of taxable goods or services—including employees providing services to their employers, all sellers of taxable goods and services, casual sales by consumers, and isolated services rendered from neighbor to neighbor. This definition of a taxable person is too broad to be administrable. It is unrealistic to require a consumer who sells a used refrigerator to a neighbor for \$75 to file a return and pay a few dollars in tax. The persons required to file returns thus can be narrowed to exclude casual sales, but include services rendered by employees to employers and taxable goods and services sold by businesses. The proposed flat tax, discussed earlier, includes employees on the tax rolls in order to tax the wage portion of the consumption tax base with some degree of progressivity.

To reduce the number of persons on the tax rolls, a consumption tax can exclude employees and still tax the value of their services. This can be accomplished by taxing business sellers on the value of their taxable sales and denying the sellers any reduction in their tax bases for the cost of labor. This approach is used in the VATs adopted elsewhere. For example, under the European VAT, a seller calculates VAT on taxable sales and credits against that preliminary tax liability the VAT paid on purchases from other taxable firms. Since employees are not taxable on their services, the seller cannot claim credit attributable to employee labor.

The number of taxpayers on the tax rolls could be reduced even further by exempting businesses with annual taxable sales below a statutory threshold amount—a small business exemption—or by exempting non-profit organizations and governmental entities. Most countries with VATs exempt certain small businesses, regardless of the nature of their sales.¹⁰¹ VAT typically is imposed only on persons engaged in business on a regular basis who make annual sales above the small business threshold amount.¹⁰² Services of nonprofit organizations and governmental entities also may be exempt unless the provider renders fee-generating services that may compete with private enterprise.

101. See William J. Turner, *Accommodating to the Small Business Problem Under a VAT*, 47 TAX LAW. 963 (1994).

102. See *id.* at 970.

D. Calculation of Tax Liability¹⁰³

This Section explains how a business or individual taxpayer calculates tax liability under the various consumption tax proposals. Except for the national retail sales tax, each proposal either is a VAT or contains elements that resemble a VAT. The various types of VAT will be discussed first, followed by the USA tax, the flat tax, and the national retail sales tax.

1. Addition and Subtraction Forms of VAT

A business subject to VAT can calculate its tax liability under an addition method or one of two subtraction methods. The subtraction methods can be subdivided into two *credit*-subtraction VATs and one *sales*-subtraction VAT. One credit-subtraction VAT, like the Hollings and Dingell bills, is the European-style VAT that relies on invoices and is used with some variations almost all over the world. The other credit-subtraction VAT, illustrated by the Japanese consumption tax, does not rely on invoices. Sales-subtraction VATs, like the proposed Danforth-Boren business activities tax, the Gibbons VAT, and the BT portion of the USA tax, are not in common use elsewhere.¹⁰⁴

An addition method VAT is not used and has not been proposed at the national level in any country. The Michigan single business tax¹⁰⁵ is a modified addition method VAT. The addition method is discussed below because it illustrates the fact that a VAT base consists of the economic factors of production.

103. Some of the concepts discussed in the subsections on the credit-invoice VAT, the sales-subtraction VAT, and the addition method were taken from ABA MODEL VAT, *supra* note 74, at 2-7.

104. Finland relied on a sales-subtraction VAT, enacted in 1978, that had a base analogous to national income. See Carl S. Shoup, *Choosing Among Types of VATs*, in WORLD BANK, VALUE ADDED TAX IN DEVELOPING COUNTRIES 14 (M. Gillis et. al. eds., 1990).

105. Single Business Tax Act, MICH. COMP. LAWS ANN. § 208.1-.145 (West 1986 & Supp. 1996).

a. Credit-Invoice VAT

One form of credit-subtraction VAT relies on invoices. This European-inspired VAT is commonly referred to as the credit-invoice VAT, or simply the invoice VAT. The credit-invoice VATs in use today tax international transactions under the destination principle (imports are taxed and exports are relieved of tax) and almost universally have bases measured by personal consumption. The jurisdictional reach of a consumption tax (based either on the origin or destination principle) and the definition of the consumption tax base have been discussed earlier.¹⁰⁶

A taxable business calculates its tax liability under a credit-invoice VAT as the difference between its output tax liability and its input tax credits (input credits).¹⁰⁷ The output tax is equal to taxable sales multiplied by the tax rate. The input credits generally include the total VAT imposed on purchases from other taxable businesses and listed on the suppliers' tax invoices. The tax on imports also qualifies for the input credit. For example, assume that a wholesaler that sells cleaning supplies makes taxable sales of \$80,000, and has taxable purchases of \$50,000 plus \$5,000 VAT for the same period. Assume also that it imported supplies for \$10,000 and paid \$1,000 VAT on the import. With a ten percent VAT rate, the wholesaler's net VAT liability for the period is \$2,000, calculated as follows:

OUTPUT TAX ON SALES—\$80,000 X 10% RATE	\$8,000
INPUT CREDIT	
TAXABLE PURCHASES—\$50,000 X 10% RATE	(5,000)
TAXABLE IMPORTS—\$10,000 X 10% RATE	<u>(1,000)</u>
NET VAT LIABILITY FOR PERIOD	\$2,000

106. See discussion *supra* Section VI.A.

107. The tax on imports of goods generally is paid at the border. If a business makes both taxable and exempt sales, the tax on purchases attributable to exempt sales does not qualify for the input credit. See Excise Tax Act, R.S.C., ch. E-15 (1985), amended by R.S.C., ch. 45, §§ 169-170 (1990) (Can.).

The European-style credit-invoice VAT permits the seller to quickly reclaim tax on purchases as input credits. As a result, “the seller will not incur substantial interest costs to finance VAT on purchases, and the VAT should not affect the seller’s pricing structure for taxable sales.”¹⁰⁸

b. Credit-Subtraction VAT Without Invoices

Japan is the only country with a credit-subtraction VAT that does not rely on invoices. Under the Japanese consumption tax (CT),¹⁰⁹ a taxable business calculates its output tax liability the same as under a European credit-invoice VAT—that is, the tax-exclusive amount of taxable sales are multiplied by the tax rate. A taxable business generally records taxable purchases at tax-inclusive prices because sellers are not required to issue “tax invoices” that separately report the VAT charged on sales. The CT therefore requires taxable businesses to calculate their tax credits differently. A business calculates input credits by multiplying the tax-inclusive cost of taxable purchases taken from its purchase records by a fraction, using the tax rate as the numerator and 100 plus the tax rate as the denominator. Using the above example, the wholesaler would have the same \$2,000 net VAT liability for the period, calculated as follows:

OUTPUT TAX	
TAXABLE SALES \$80,000 x 10%	\$8,000
INPUT CREDIT	
TAXABLE DOMESTIC SALES \$55,000 x 10/110	(5,000)
TAXABLE IMPORTS \$11,000 x 10/110	<u>(1,000)</u>
NET VAT LIABILITY FOR PERIOD	\$2,000

108. See ABA MODEL VAT, *supra* note 74, § 6151(d). On the cash flow costs of a VAT, *see id.* at 131-34.

109. Shohizei-ho [Consumption Tax Law], Law No. 108 of 1988, pt. IV.

There is a notable difference between the European-style VATs and the Japanese CT, but that difference is not inherent in a credit-subtraction VAT that does not rely on invoices. A business subject to the CT can claim credit for implicit tax in the cost of purchases from exempt sellers such as exempt small businesses. Thus, if a business subject to the CT purchases supplies for \$1,030 from an exempt small business, the business can claim an input credit for the full 10/110 of \$1,030, or \$9.36, even though it is unlikely that the purchase price contains that much CT. Under a European VAT, a credit cannot be claimed with respect to a purchase from an exempt supplier.

c. Sales-Subtraction VAT

A taxable business calculates its tax liability under a sales-subtraction VAT by multiplying its tax base by the tax rate. The tax base is the difference between taxable sales and allowable deductions for purchases. It is calculated from purchase and sales data for each tax period rather than on each taxable sale. Sales invoices generally will not list VAT separately, so account data is recorded at tax-inclusive prices. A 9.0909 percent rate imposed on tax-inclusive prices produces the same revenue as a ten percent rate imposed on tax-exclusive prices. “[The legislature] . . . could require disclosure of tax at the cash register or by a sign posted in retail stores indicating the tax rate that is included in the prices.”¹¹⁰

The wholesaler in the above example would report the same \$2,000 net VAT liability under a 9.0909 percent sales-subtraction VAT as under the ten percent European invoice VAT or the Japanese CT.¹¹¹

110. Oliver Oldman & Alan Schenk, *The Business Activities Tax: Have Senators Danforth & Boren Created a Better Value Added Tax?*, 65 TAX NOTES 1547, 1551 (1994).

111. As noted above, the Japanese CT allows input credits attributable to purchases from exempt entities like some small businesses. A similar allowance may be provided under a sales-subtraction VAT. It is what Dr. Charles McLure, Jr., refers to as the “naive sales-subtraction” VAT. See MCLURE, JR., *supra* note 15, at 71-79.

TAXABLE SALES	\$88,000
TAXABLE PURCHASES	
DOMESTIC	(55,000)
IMPORTS	<u>(11,000)</u>
TAX BASE	\$22,000
TAX RATE	<u>9.0909%</u>
NET VAT LIABILITY FOR PERIOD	\$2,000

d. Addition Method VAT

A taxable business calculates its tax liability under the addition method by multiplying the tax rate by its tax base. The tax base is the sum of the economic factors of production for the tax period.¹¹² The factors of production are compensation, rent and interest expense, and profit. The difficult calculation is for profit. For example, if the tax is a consumption-style VAT, the business must deduct the full cost of capital purchases and add back any depreciation on capital goods deducted in calculating profit for reporting purposes. In addition,

112. For a more detailed discussion of the addition method, see SULLIVAN, *supra* note 51, at 198-99. See also Dieter Pohmer, *Value-Added Tax After Ten Years: The European Experience*, in *COMPARATIVE TAX STUDIES: ESSAYS IN HONOR OF RICHARD GOODE* 243, 245-47 (Sijbren Cnossen ed., 1983).

inventory is deducted for VAT purposes when purchased and not accounted for as part of the cost of goods sold as is done for reporting purposes.

As a period tax, an addition method VAT probably will be treated as a cost of production and included in the pricing structure of taxable goods and services. Since the VAT liability is not based on the . . . sales price [of] . . . goods, it is unlikely that the exact VAT, no more and no less, will be shifted to consumers.¹¹³

To make the example comparable to the above facts, it is assumed that sales and purchases include VAT, and the tax rate is 9.0909 percent. For this purpose, assume that the wholesaler pays \$15,000 compensation to workers, pays \$3,000 in interest and rent expense, and has a \$4,000 profit for VAT purposes. The profit statement for VAT purposes appears as follows:

TAXABLE SALES	\$88,000
EXPENSES	
COMPENSATION	(15,000)
INT. & RENT EXP.	(3,000)
PURCHASES	<u>(66,000)</u>
PROFIT FOR VAT PURPOSES	\$ 4,000

With a 9.0909 percent tax levied on factors of production, the wholesaler's net VAT liability is the same \$2,000, calculated as follows:

113. ABA MODEL VAT, *supra* note 74, at 6.

COMPENSATION	\$15,000
INT. & RENT EXPENSE	3,000
PROFIT FOR VAT PURPOSES	<u>4,000</u>
TAX BASE	\$22,000
TAX RATE	<u>9.0909%</u>
NET TAX LIABILITY FOR PERIOD	\$ 2,000

2. USA's Income and Business Tax

The Nunn-Domenici USA tax bill¹¹⁴ proposes the replacement of the individual and corporate income tax with a consumption-based, progressive tax on individuals described as an income tax (IT), and a tax on business activity (a VAT) described as a business tax (BT).¹¹⁵ The IT taxes individuals on current income that is not invested in savings assets and on funds withdrawn from savings. The IT resembles the existing federal individual income tax structure—an individual can claim deductions from reportable gross income¹¹⁶ to arrive at adjusted gross income (AGI),¹¹⁷ and additional deductions from AGI to arrive at

114. See USA Tax, *supra* note 19.

115. *Id.* §§ 1, 201. For a discussion of some features of the USA tax, see Alan L. Feld, *Nunn-Domenici and Nonprofits*, 68 TAX NOTES 1119 (1995); Louis Kaplow, *Recovery of Pre-Enactment Basis Under a Consumption Tax: The USA Tax System*, 68 TAX NOTES 1109 (1995); Bernard Wolfman, *Corporate Tax Issues Under the Nunn-Domenici Consumption Tax*, 68 TAX NOTES 1121 (1995).

116. Gross income includes gross income not previously deferred and withdrawals from previously saved gross income. USA Tax, *supra* note 19, § 1(c)-(e).

117. In arriving at AGI, an individual can deduct alimony, child support, and the unlimited savings allowance. *Id.* § 1(c).

taxable income.¹¹⁸ The USA tax retains only a limited number of existing deductions, but it adds a major deduction—the savings deduction. It is the savings deduction that converts the IT from an income-based to a consumption-based tax.¹¹⁹ Individuals subject to the IT are eligible for tax credits,¹²⁰ most significantly a credit for the employee's share of the FICA payroll tax.¹²¹

The USA tax also includes a BT and a tax on imports. Tax is imposed on imports of property and on services treated as imported.¹²² The BT is an eleven percent consumption-style, destination principle, sales-subtraction VAT. It is unique in that it allows a taxable business to claim a credit against its BT liability for the employer's share of the payroll tax.¹²³ As a destination principle tax, the BT is imposed on imports, but not on exports.¹²⁴ The BT is imposed on a business's gross profit, defined as the excess of taxable receipts over deductible amounts.¹²⁵ A business subject to the BT reduces its receipts from sales of taxable goods and services by the cost of allowable purchases, including imports.¹²⁶ The BT is a consumption-style tax that authorizes businesses to deduct immediately the cost of capital purchases.¹²⁷ However, unlike most foreign VATs, a business subject to the BT cannot claim a refund if it has more deductions than taxable receipts; excess deductions can be carried forward for fifteen years.¹²⁸ It is not clear if the BT is border-adjustable under the World Trade Organization rules because it allows a credit against BT liability for payroll taxes paid.¹²⁹

118. Taxable income is subject to the 19%, 27%, and 40% progressive rates for taxable years beginning in 1996. *Id.* § 15. Deductions in converting AGI to taxable income include the personal and dependency deductions, the family living allowance, and expenditures for homeowners, for education, for charitable contributions, and for transition basis. *Id.* § 101(b).

119. For a discussion of the savings deduction, see Alvin C. Warren, Jr., *The Proposal for an 'Unlimited Savings Allowance,'* 68 TAX NOTES 1103 (1995).

120. See USA Tax, *supra* note 19, §§ 20-23.

121. A comparable credit is available for Tier 1 railroad retirement tax and one-half of the self-employment tax. *Id.* § 21.

122. *Id.* §§ 286-88.

123. See *id.* § 201.

124. See *id.* §§ 203(a), 205.

125. *Id.* § 202.

126. *Id.* § 207.

127. *Id.* § 205(3)(A).

128. The BT is what Charles E. McLure, Jr. refers to as a "naive sales-subtraction" VAT because it allows a deduction for some costs or purchases from entities that are not subject to the BT. MCLURE, JR., *supra* note 19, at 71-79; see also *supra* note 95.

129. See discussion *infra* Section VII.F.

3. Flat Tax¹³⁰

A major difference between the VAT and the flat tax proposals is that the flat tax adds workers to the tax rolls. With a VAT, wages do not reduce the tax base and tax on the wage portion of the value of goods and services is collected by businesses as they sell goods and services for prices that include the cost of labor. With the flat tax, wages are deductible to the business and are taxable to the workers. Rather than a flat rate on services rendered by employees, the flat tax provides some progressivity to the tax imposed on wages. The progressivity provided by taxing wages to employees, rather than as part of a business's tax base, creates some distortion in the consumption base and may produce differing tax burdens to providers of goods or services in the same or different businesses, depending in part on the degree of labor intensiveness in the seller's business.

Congressman Dick Armey proposed a flat tax as part of the Freedom and Fairness Restoration Act.¹³¹ The flat tax consists of a business tax (BT) to be remitted by businesses and an income tax (IT) imposed on individuals.

Tax liability under the BT is similar to the calculation under a sales-subtraction VAT, except for the deductions for wages and contributions to employee retirement plans. A tax of twenty percent¹³² is imposed on taxable business income, defined as gross active income less specified deductions.¹³³ A business must report taxable sales, including export sales, and can deduct (a) the cost of business inputs, (b) wages paid for services performed by employees in the United States, and (c) qualified

130. For additional discussion of the flat tax, see HALL & RABUSHKA, *THE FLAT TAX*, *supra* note 87; Bickley, *supra* note 18; Jane G. Gravelle, *The Flat Tax and Other Proposals: Who Will Bear the Tax Burden?*, CONG. RES. SERV. REP. NO. 95-1141 (Nov. 29, 1995), reprinted in 69 TAX NOTES 1517 (1995); STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., 1ST SESS., DESCRIPTION AND ANALYSIS OF PROPOSALS TO REPLACE THE FEDERAL INCOME TAX (Jt. Comm. Print 1995); Deborah A. Geier, *Cognitive Theory and the Selling of the Flat Tax*, 71 TAX NOTES 241 (1996).

131. See *supra* note 84 and accompanying text.

132. The bill anticipates that the rate will drop to 17% after an introductory period. Armey Flat Tax, *supra* note 84, § 102(a) (proposing amendment to I.R.C. § 11(a) (1994)).

133. *Id.* § 11(b)-(c). Certain governmental entities and exempt organizations are not taxed on their activities. See *id.* § 11(c)(3). Special rules tax financial intermediation services. *Id.* § 11(e).

contributions into retirement plans.¹³⁴ The BT differs from other proposed sales-subtraction VATs in two ways. It is an origin (rather than a destination) principle tax that taxes exports, but not imports.¹³⁵ As discussed above, a business subject to the BT can deduct wages and contributions into retirement plans because those wages and retirement distributions are taxable to workers under the IT.

Businesses with current deductions exceeding gross active income can carry forward the excess deductions to future years, but cannot claim a refund on the basis of those excess deductions.¹³⁶ A business with a carryforward is entitled to increase the carryforward by an interest factor designed to compensate the business for the delay in the use of these excess deductions.¹³⁷

Individuals are subject to a twenty percent tax under the IT portion of the flat tax.¹³⁸ The tax base is wages, taxable distributions from retirement plans, and unemployment compensation, as reduced by the standard deduction.¹³⁹ The standard deduction depends on the taxpayer's filing status¹⁴⁰ and on the number of claimed dependents.¹⁴¹

The outward simplicity of the flat tax may be misleading.¹⁴² The flat tax raises issues that exist under the income and payroll taxes. For example, since wages are deductible by businesses subject to the business portion of the flat tax, wages must be clearly defined for flat tax purposes. The existing opaque distinction between deductible wages and nondeductible dividends paid to an employee who also is a shareholder may carry over to the flat tax.

134. *Id.* § 11(c)-(d).

135. The tax is not border adjustable under the World Trade Organization rules. See discussion *infra* Section VII.F.

136. Arney Flat Tax, *supra* note 84, § 11(g).

137. *Id.* § 11(g)(2).

138. *Id.* § 101 (proposing amendment to I.R.C. § 1 (1994)). The rate is to drop to 17% after an introductory period. *Id.* § 102(a).

139. *Id.* § 63.

140. A person's filing status will be one of the following: Joint, surviving spouse, head of household, or individual not within the other categories. *Id.*

141. *Id.* § 63(b)(3). For example, the basic standard deduction is \$21,400 on a joint return and \$10,700 on an individual return. The deduction for each dependent is \$5,000. *Id.*

142. See Bickley, *supra* note 18, at 107 (suggesting that a firm must add to wages the imputed value of fringe benefits paid to government employees and employees of nonprofits).

"The essence of the flat rate lies not in simplification but in the resulting redistribution of the tax burden."¹⁴³ According to some commentators, the incidence of the flat tax is not clear.¹⁴⁴

Like the other consumption tax proposals, the flat tax is a tax on existing capital if a business cannot recover for flat tax purposes the undepreciated cost of existing capital goods or the cost of existing inventory.

4. Retail Sales Tax

With retail sales taxes (RSTs) in place in forty-five states and the District of Columbia, the United States has extensive experience with this type of consumption tax.¹⁴⁵ A business (whether predominantly selling at retail or higher up the chain of production and distribution), must separate taxable from nontaxable retail sales. Excluding sales returns and other adjustments in taxable sales, the business multiplies taxable sales by the rate to obtain tax liability. To prevent multiple tax, purchases by business for resale generally are exempt from the sales tax. Nevertheless, tax on business inputs account for approximately twenty-five to thirty-three percent of state RST bases.¹⁴⁶ While the tax base is predominantly goods in most states, some states have expanded the scope of their sales taxes to cover some services.¹⁴⁷ All Canadian provinces, except Alberta, impose retail sales taxes.

Included in recent proposals for fundamental reform of the federal tax system is Congressman Schaefer's bill to replace the individual and corporate income taxes, the estate and gift taxes, and some excise taxes with a fifteen percent national retail sales tax.¹⁴⁸ The proposed RST¹⁴⁹ adopts the destination principle to define the jurisdiction to tax

143. Musgrave, *supra* note 6, at 732.

144. Bickley, *supra* note 18, at 101.

145. See DUE & MIKESELL, *supra* note 96, at 7 tbl. 1.3, for a list of states with retail sales taxes.

146. For estimates ranging from 14% to 58%, see *id.* at 321 n.2.

147. *Id.* at 83-105.

148. National RST Act, *supra* note 90. The bill was cosponsored by Congressmen Tauzin and Chrysler. For a discussion of the Schaefer national RST proposal, see David R. Burton & Dan R. Mastromarco, *The National Sales Tax: Moving Beyond the Idea*, 71 TAX NOTES 1237 (1996).

149. In 1993, Laurence Kotlikoff examined the possible replacement of the federal income tax with a sales tax. LAURENCE J. KOTLIKOFF, *THE ECONOMIC IMPACT OF REPLACING FEDERAL INCOME TAXES WITH A NATIONAL SALES TAX*, CATO INSTITUTE

international transactions—that is, exports are not taxed, and imports are taxed.¹⁵⁰ To avoid the cascading of tax that results if business inputs are taxed under an RST, the proposed national RST does not tax purchases by business for resale or for use in producing taxable property or services.¹⁵¹

A unique feature of the national RST proposal is its plan to have conforming states, instead of the Internal Revenue Service, administer the tax.¹⁵² A state can administer the national RST as well as its own RST if it adopts a conforming sales tax and enters into an agreement with the federal government.¹⁵³ For a state to administer the national tax, it must have a state RST rate of at least one percent, and it must harmonize its state RST with the national RST base, adopt the same exemptions, and include most of the same credit and refund provisions.¹⁵⁴ For its services in administering the national RST, an administering state can retain one percent of the funds otherwise payable to the federal government.¹⁵⁵

Under certain circumstances, the federal government may take over the administration of the national RST from an administering state.¹⁵⁶ The federal government also will administer the national tax in non-conforming states that do not harmonize their state RSTs.¹⁵⁷

The bill allocates state RST revenue from interstate sales among conforming states.¹⁵⁸ For this purpose, the bill contains elaborate place of supply rules governing various categories of interstate sales of property and services.¹⁵⁹

The RST bill contains a unique multistate vendor program under which retailers operating in at least five conforming states may elect to have the federal government administer their state and national RST obligations.¹⁶⁰ It is not likely that the bill can achieve the sponsors' announced goal to simplify taxpayer compliance if there exists a

POLICY ANALYSIS (1993). See also Stephen Moore, *The Economic and Civil Liberties Case for a National Sales Tax*, 71 TAX NOTES 101 (1996).

150. National RST Act, *supra* note 90, §§ 1(a), 2(a)(3).

151. *Id.* § 2(a)(1)-(2). These exemptions apply if the seller has a copy of the purchaser's exemption certificate or has no reason to believe that the exemption is not available to the purchaser. *Id.* § 2(d).

152. *Id.* § 31.

153. *Id.* § 31(b). A conforming state can contract with another conforming state to administer the tax for a fee. *Id.* § 31(h).

154. *Id.* § 31(c).

155. *Id.* § 31(e).

156. *Id.* § 31(f).

157. *Id.* § 31(g).

158. *Id.* § 53(a).

159. *Id.* § 53.

160. *Id.* § 33.

patchwork quilt of conforming and nonconforming states. It also is not clear how there can be uniformity in administration of the national RST if the Internal Revenue Service and a series of state departments of revenue administer the tax, especially if some states are lax in their administration in order to use that policy to lure businesses to their "tax friendly" jurisdiction.

VII. SWITCHING FROM AN INCOME- TO A CONSUMPTION-BASED SYSTEM

A. Introduction

There are economic and other impacts that would accompany a switch from our federal system, which relies mainly on income-based taxes, to a structure that raises significant revenue from a broad-based federal tax on consumption.¹⁶¹ The implications of this kind of tax change depend on such factors as the kind of consumption tax selected, on the kinds of programs financed with the tax revenue (benefiting all or only a specific segment of the population), and on the use of the revenue to supplement, replace, or reduce existing taxes. This Section will cover only a few.

Jane Gravelle, in her article in this Symposium, provides an excellent framework to evaluate the distributional impact of the consumption tax proposals.¹⁶² The Congressional Budget Office (CBO) used its tax model to compare the distribution of the tax burden (on an annual basis) resulting from the use of a VAT or a surcharge on the income tax to raise revenue. The CBO found, consistent with assumptions by many economists, that a broad-based VAT is regressive, and a surcharge on the income tax is not.¹⁶³ The use of zero rating or other techniques within the tax to reduce the tax on goods and services used by the poor do not alter the regressivity of the VAT markedly because they are not

161. See Nolan, *supra* note 6. For a comparison of the effects in Canada of a VAT and a surcharge under an income tax, see NEIL BROOKS, AUSTRALIAN TAX RESEARCH FOUNDATION, THE CANADIAN GOODS AND SERVICES TAX: HISTORY, POLICY, AND POLITICS (1993).

162. Jane G. Gravelle, The Distributional Effects of Fundamental Tax Revisions, 33 SAN DIEGO L. REV. 1419 (1996).

163. See CONG. BUDGET OFFICE, EFFECTS OF ADOPTING A VALUE-ADDED TAX 31 (1992) [hereinafter CBO VAT STUDY].

targeted to the poor. A targeted tax credit for low-income families “can largely offset the VAT’s burden on the poor.”¹⁶⁴ Of the recent congressional proposals for a federal tax on consumption, the Gibbons bill addresses regressivity most directly by providing a tax rebate or refund to families with income up to \$30,000.¹⁶⁵

There are other issues pertaining to the choice between an income- and consumption-based tax, such as whether a consumption-based tax will improve the net savings rate in the United States. James Bickley¹⁶⁶ reports that “there is no conclusive theoretical or empirical evidence that a consumption tax will increase the savings rate and consequently the level of national savings.”¹⁶⁷

Section B discusses only selected issues related to a decision to increase reliance on consumption taxes at the federal level. Specifically, it will focus on the impact of the adoption of a major federal tax on consumption on administration and compliance costs, on corporate dividend policy, on financing with debt or equity, on federal-state fiscal relations, and on international trade.

B. Administration and Compliance Costs

Experience in Europe, where VAT rates are in the fifteen percent range, indicates that the cost for government to administer a VAT ranges from about 0.4 percent to 1.0 percent of revenue.¹⁶⁸ Compliance costs to businesses generally decline as sales increase, with the cost ranging from about .003 percent of taxable sales for large businesses to almost two percent of taxable sales for small businesses.¹⁶⁹

An add-on consumption tax in the United States will increase tax administration costs to the government and compliance costs for

164. *Id.*

165. See *supra* text accompanying notes 77-80.

166. Mr. Bickley is a specialist in public finance at the Congressional Research Service of the Library of Congress.

167. Bickley, *supra* note 18, at 102; see CONG. BUDGET OFFICE, ASSESSING THE DECLINE IN THE NATIONAL SAVINGS RATE (1993). According to Bickley, “(h)ighly stylized life-cycle models show that a flat tax would cause a substantial increase in the savings rate, but these models are extremely controversial.” Bickley, *supra* note 18, at 102 (citing Fullerton & Rogers, *Lifetime Effects of Fundamental Tax Reform*, Brookings Institution’s Conference on the Economic Effects of Fundamental Tax Reform, Feb. 15, 1996). A CBO study of “the economic effects of replacing a quarter of the current income tax with a 6 percent VAT on all consumption” suggests “that this tax substitution would, in the long run, increase the savings rate by 0.5 percent” Bickley, *supra* note 18, at 102; see also Moroney & Bravenec, *supra* note 22.

168. CBO VAT STUDY, *supra* note 163, at 68-69.

169. See CEDRIC SANDFORD ET AL., ADMINISTRATIVE AND COMPLIANCE COSTS OF TAXATION 116 (1989).

taxpayers required to file consumption tax returns. According to a report by the U.S. General Accounting Office (GAO), for 1995 a simple broad-based VAT would cost between \$1.22 billion and \$1.83 billion to administer, depending upon the small business exemption.¹⁷⁰ The study assumes that businesses with gross receipts above \$25,000 would file returns and pay the tax electronically.¹⁷¹ If there were no small business exemption, it would cost \$1.83 billion with 24.4 million taxpayers. If businesses making annual taxable sales of up to \$100,000 were exempt, it would cost \$1.22 billion with 9 million taxpayers. These costs escalate if the tax includes special treatment or different rates for certain kinds of sales.¹⁷²

The Internal Revenue Service did its own study, with differing results.¹⁷³ The estimates by the GAO and the Internal Revenue Service have been criticized as too high because they were based on experience under the United Kingdom's VAT that exempts and zero-rates many goods and services.¹⁷⁴

If the flat tax, the USA tax, or the national retail sales tax discussed above replaced the federal income taxes, the Tax Foundation estimated that compliance costs would decline dramatically. By that estimate, the cost would drop from \$226 billion in compliance costs for the income tax in 1996 to \$9.4 billion for the flat tax, \$36 billion for the USA tax, and \$8.2 billion for the national sales tax.¹⁷⁵ These estimates may be too optimistic.

170. UNITED STATES GENERAL ACCOUNTING OFFICE, VALUE-ADDED TAX: ADMINISTRATIVE COSTS VARY WITH COMPLEXITY AND NUMBER OF BUSINESSES, REPORT TO THE JOINT COMM. ON TAXATION 3 (1993) [hereinafter GAO REPORT].

171. See Alan Schenk, *Administrative Costs of a U.S. Value-Added Tax: A Description and Analysis of the Report of the United States General Accounting Office*, VAT MONITOR, July, 1993, at 2 (discussing GAO REPORT, *supra* note 170, at 4).

172. GAO REPORT, *supra* note 170, at 3. The costs could increase by up to \$700 million if exemptions and multiple rates are added. *Id.*

173. IRS ASS'T COMMISSIONER, A STUDY OF ADMINISTRATIVE ISSUES IN IMPLEMENTING A FEDERAL VALUE ADDED TAX (1993). Estimates by the IRS in 1984 placed the cost to administer a VAT in the United States at about \$700 million, but this cost did not include litigation-related costs. See U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT (1993).

174. See Sijbren Cnossen, *Administrative and Compliance Costs of the VAT: A Review of the Evidence*, 8 TAX NOTES INT'L 1649, 1650 (1994).

175. Arthur P. Hall, *Compliance Costs of Alternative Tax Systems*, 71 TAX NOTES 1081 (1996). Under the national sales tax, businesses would be compensated for about one-half of this cost.

The effect on compliance costs of a fundamental tax reform like the proposals discussed in this Article depends in part on what tax changes occur at the state level. For example, if Congress replaces the corporate income tax with a VAT or other consumption tax, compliance costs for some taxpayers may not drop significantly if they still must keep records and prepare returns under state corporate income taxes that rely on the federal corporate tax base.¹⁷⁶

C. *Effect on Corporate Dividend Policy*

The adoption of a federal consumption tax to replace the corporate tax is likely to affect corporate dividend policy. Under the current federal individual and corporate tax rules, corporations pay corporate tax on income they earn. When they distribute after-tax profits to shareholders, shareholders are taxed on the dividend income under the individual income tax. Shareholders of a profitable company who want to diversify their stock investments may prefer to have management use after-tax profits to acquire other corporations rather than distribute those profits as dividends. Management also may prefer to invest after-tax profits rather than distribute them to shareholders who may or may not reinvest them in the corporation. For example, shareholders of General Electric (GE) were not taxed on after-tax profits used to buy RCA and its NBC subsidiary. If GE distributed dividends that its shareholders used to buy RCA stock, the dividends would have been taxable to the shareholders and only the after-tax proceeds could have been used to buy RCA stock. Thus, if a new consumption tax replaces the corporate income tax and a corporation's distributions to shareholders were not taxable to the shareholders when received, shareholders may pressure corporations to distribute, rather than retain and reinvest, corporate earnings. Shareholders then would make the investment decision—whether to reinvest the dividends in the same company or use the funds to purchase stock in other companies.

A dramatic shift from income- to consumption-based federal taxes also may affect the financial markets.¹⁷⁷

176. See Bickley, *supra* note 18, at 106-07.

177. See John E. Golob, *How Would Tax Reform Affect Financial Markets?*, FED. RES. BANK OF KANSAS CITY ECON. REV., 4th Qtr., 1995, at 19-39. Mr. Golob explores the impact of the various proposals on the deductibility of interest expense and the taxation of income from interest, dividends, and capital gains, and the consequent effect on interest rates and stock prices. He concludes that most proposals would reduce interest rates in the credit markets, increase interest rates on municipal bonds under proposals that would remove the tax exemption for that interest, and increase stock prices because most proposals would reduce tax on business. *Id.*

D. Financing Business Operations

The corporate income tax generally encourages business to finance operations with debt rather than equity because payments to debt holders generate tax-deductible interest, and payments to shareholders usually generate nondeductible dividends. This incentive does not exist for businesses that do not have taxable income subject to the corporate tax. These corporations can reduce their financing costs by selling stock (generally preferred stock) to corporate investors that can claim dividends-received deductions of seventy percent or more of the dividends received.¹⁷⁸ The disparity in tax treatment between debt and equity has produced significant tension in the characterization of corporate instruments as either debt or equity.¹⁷⁹

If a consumption tax like a VAT replaces the corporate income tax, there will not be any tax difference between issuing debt or stock. Business decisions will be motivated by business considerations, not on the differences in the tax treatment of debt and equity.

E. Federal-State Fiscal Relations

The potpourri of consumption taxes discussed in this Article have been proposed either as replacements for or supplements to the federal income and payroll taxes. Some are separately stated on sales invoices and some are buried in product prices. The earlier VAT proposals were for European-style VATs imposed on transactions, with the tax to be separately stated on sales invoices. The business tax portions of the USA tax and the flat tax are variations of VATs, but these taxes are period taxes buried in the prices of taxable goods and services. The national retail sales tax presumably will be separately stated on sales invoices. States that harmonize their RSTs with the national retail sales tax base (conforming states) will administer both taxes. In nonconforming states, the state RST and the national sales tax would have to coexist side-by-side, with each imposed on a different base and each with its

178. See I.R.C. §§ 243-246A (1994). See also I.R.C. § 247 (1994) regarding the deduction available to public utilities on dividends they pay.

179. See *id.* § 385.

own tax accounting or timing rules, as well as rules covering the filing of tax returns and penalties.

In Canada, significant consumer and business discontent arose over the adoption of the national VAT (goods and services tax, or GST) to apply along with provincial retail sales taxes (PSTs), especially because both are separately stated and added at the cash register. To add to the confusion, the GST and PST do not tax the same goods and services in the same manner. Business compliance costs in Canada are high. To stem widespread public opposition to the GST, the Canadian government may amend the GST to bury the tax in product prices and may urge provinces to harmonize their PSTs with the GST.

In the United States, with a history of strong state autonomy in the tax field, it is not likely that most states will conform their RSTs with either the proposed national sales tax¹⁸⁰ or one of the proposed VATs. It is more likely that a consumption tax buried in product prices, like the business tax portions of the USA tax and the flat tax, can coexist with state RSTs because only the RST will be added at the cash register. State support or opposition to a broad-based federal consumption tax may depend on the federal tax rate "and on the kind of federal programs that will be financed with the [tax]. . . revenue."¹⁸¹

If Congress adopts a federal consumption tax like the separately-stated European VAT, states with RSTs may be opposed because they may fear that it would be more difficult for them to raise their sales tax rates. If a new federal consumption tax replaces the corporate income tax, states may object if businesses then would pressure the states to repeal or replace their corporate taxes. State opposition may be more muted if the federal government relieves the states of some of their financial obligations by using part of the revenue from the new consumption tax to finance those state-funded programs.

F. International Trade Implications

There are a number of international trade and other international tax issues presented by any proposal for the United States to move from an income- to a consumption-based tax system. Many of these issues are covered by Reuvan Avi-Yonah as part of this Symposium,¹⁸² and they

180. Harmonization with a national sales tax may be more likely because the states will hire the personnel to administer the combined tax.

181. Alan Schenk, *Choosing the Form of a Federal Value-Added Tax: Implications for State and Local Retail Sales Taxes*, 22 CAP. UNIV. L. REV. 291 (1993).

182. Reuven S. Avi-Yonah, *From Income to Consumption Tax: Some International Implications*, 33 SAN DIEGO L. REV. 1329 (1996); see also Reuven S. Avi-Yonah, *The International Implications of Tax Reform*, 69 TAX NOTES 913 (1995); Daniel Horowitz,

will not be discussed here. This Section covers two issues: (1) The impact on international trade and on a corporation's operations of a decision to replace the corporate tax with a consumption tax, and (2) the impact of various consumption tax proposals on the United States' obligations under the World Trade Organization rules.

How is our balance of trade likely to be affected by the adoption of a new consumption tax to replace the corporate tax? The short-term effects depend on the extent to which the repeal of the corporate tax will reduce product prices. The long-term effects may depend on a host of responses, including the U.S. monetary policy during the transition and the reactions by our major trading partners. For example, a consumption tax-induced improvement in our balance of trade that improves our balance of payments position may be offset, in the long term, by exchange rate adjustments in the value of the U.S. dollar.¹⁸³ If a consumption-based tax replaces the corporate tax, foreign investments and foreign operations of U.S. companies would not pay U.S. tax either when the income is earned abroad or repatriated to the U.S. Domestic firms with foreign operations will continue to pay foreign income taxes, and they will not be able to claim any credit for those foreign taxes against U.S. consumption tax liability.

It has been suggested that U.S. multinationals are successful if they can "move goods, services, intangibles, and capital across borders without excessive tax burdens."¹⁸⁴ One commentator suggested that the impact on a multinational company of a switch to a consumption-based tax system will depend upon a number of factors.¹⁸⁵ A company must examine the impact of the reform on its own operations as well as on its competitors. A company should estimate the effect of the change on its tax compliance costs. If the reform alters the level of savings and

Evaluating Fundamental Tax Reform: The U.S. Multinational Perspective, 70 TAX NOTES 737 (1996); Harry Grubert & T. Scott Newlon, *The International Implications of Consumption Tax Proposals*, 48 NAT'L TAX J. 619 (1995). There were follow-up comments and responses to this article. Reuven S. Avi-Yonah, *Comment on Grubert and Newlon, "The International Implications of Consumption Tax Proposals,"* 49 NAT'L TAX J. 259 (1996); Harry Grubert & T. Scott Newlon, *Reply to Avi-Yonah*, 49 NAT'L TAX J. 267 (1996).

183. See CBO VAT STUDY, *supra* note 163, at 31. Currency exchange rates depend in part on capital movement, of which trade is a part.

184. Horowitz, *supra* note 182, at 744.

185. *Id.* at 738. These factors are discussed in detail in the article that covers the flat tax, the national sales tax, and the USA tax.

investment, what effect will any resulting change in interest rates and currency exchange rates have on the company's operations? Will tax reform encourage the company and its competitors to relocate or change operations? How will our major trading partners respond to our tax reforms? Finally, consider the effect of the transition rules on the company.

The response by our trading partners to a move in the U.S. toward reliance on consumption tax may depend on whether the treatment of international transactions under the new tax is viewed as a violation of our obligations under the General Agreement on Tariffs and Trade (GATT). This, in turn, may depend upon the kind of consumption tax adopted.

The underlying purpose of the GATT, with the pertinent provisions incorporated into the rules of the World Trade Organization,¹⁸⁶ is to regulate "the impact of taxation on trading relations between independent nations."¹⁸⁷ Under these GATT rules, participating nations (contracting parties) can remove indirect taxes like VAT from exports, but not direct taxes like income and payroll taxes.¹⁸⁸ The tax treatment of imports and exports are commonly referred to as border tax adjustments. In essence, GATT allows border tax adjustments that do not subsidize exports or discriminate against imports.¹⁸⁹

186. See OECD, CONSUMPTION TAX TRENDS, *supra* note 8.

187. Ken Messere, *Consumption Tax Rules*, 48 BULL. FOR INT'L FISCAL DOCUMENTATION 665 (1994).

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

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

General Agreement on Trade and Tariffs, Mar. 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.

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.

Schenk, *supra* note 15, at 278 n.232.

189. Under an array of consumption taxes in effect before VAT spread throughout Europe, there were *taxes occultes* that were buried in product prices. Nations with cascade taxes rebated *tax occultes* in the 1960s. Messere, *supra* note 187, at 668. Indeed, Australia rebated payroll taxes deemed included in export prices. *Id.* At least one commentator in the U.S. urged the government to adopt border tax adjustments independent of our domestic tax system. The U.S. in fact had GATT establish a Working Party to re-examine border tax adjustments, but no changes in the GATT rules occurred. See Stanley S. Surrey, *A Value-Added Tax for the United States—A Negative View*, in TAX POLICY AND TAX REFORM: 1961-1969 492-93 (W. Hellmuth & O. Oldman eds., 1973).

According to Dr. Cnossen, border tax adjustments that rebate a sales-subtraction VAT from exports "would not be acceptable to the international trading community."¹⁹⁰ He suggests that the failure to separately state the VAT component in sales invoices under a sales-subtraction VAT "would invite objections from the trading partners of the U.S. These trading partners would also argue that the [sales-subtraction VAT] is not a tax on products *per se* (but rather an accounts-based tax on value added) and hence not eligible for export rebate under GATT."¹⁹¹

If border tax adjustments are appropriate for a credit-subtraction, European invoice VAT, they should be appropriate for a pure form of sales-subtraction VAT, although commentators in addition to Dr. Cnossen have raised similar concerns.¹⁹² According to the staff of the Joint Committee on Taxation:

Although a subtraction-method VAT has the same base as a credit-invoice VAT, it is not clear whether a subtraction-method VAT is an indirect tax [B]ecause there are no pure subtraction-method VATs currently in existence, there have been no GATT challenges or test cases with respect to the legality of subtraction method border adjustments.¹⁹³

The proposed Schaefer national sales tax is a destination principle tax. The tax is not imposed on exports, and purchases related to those exports are free of tax.

Border tax adjustments are universally accepted for destination principle, European-style VATs like the Hollings and Dingell VAT proposals. Pure destination principle, sales-subtraction VATs like the Gibbons VAT should likewise be border adjustable, notwithstanding the reservations expressed by some commentators, and even if the VAT replaces income and payroll taxes. The business tax (BT) portions of the USA tax and the flat tax, however, may not fare as well. The USA tax's BT grants businesses a credit against BT liability for part or all of

190. See *Replacing the Federal Income Tax*, *supra* note 16, at 305 (statement of Sijbren Cnossen, Ph.D., Professor of Economics, Erasmus University, Rotterdam, The Netherlands).

191. *Id.* at 311.

192. See George N. Carlson & Richard A. Gordon, *VAT or Business Transfer Tax: A Tax on Consumers or on Business?*, 41 TAX NOTES 329 (1988).

193. STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., 1ST SESS., DESCRIPTION AND ANALYSIS OF PROPOSALS TO REPLACE THE FEDERAL INCOME TAX 28 (Jt. Comm. Print 1995). *But see* reference to Finland's prior modified sales-subtraction VAT, *supra* note 104.

the employer's share of the qualified payroll tax.¹⁹⁴ The incidence of this BT is not as clear as for the Gibbons VAT, and its classification as an indirect tax is not as certain. The flat tax's BT, an origin principle tax, by definition is imposed only on value added within the country, and is not subject to border adjustments.

Ultimately, the border adjustability of a Gibbons VAT or the BT portions of the USA tax and the flat tax may have to be resolved as a political issue rather than a legal issue.

VIII. CONCLUSION

This Article suggests that consumption tax proposals have received a more receptive audience in Congress and among other politicians as a means to address both public opposition to income tax increases to fund desired programs, and general public discontent with existing federal taxes. Compared with many of our major trading partners, the United States does not impose heavy taxes as a percentage of gross domestic product, and it relies little on consumption taxes, except for RSTs at the state and local levels.

It is not clear that the American public would support a switch from income-based to consumption-based federal taxes. Some of the proposals, such as Congressman Gibbons' proposed VAT, address the regressivity of a consumption tax with targeted rebates to lower income families. Other proposals do not correct for regressivity. If adjustments to address regressivity are designed to craft a federal tax that mirrors the distribution of the tax burden under the income tax, it is not clear why a VAT is preferable to the existing taxes. If, as a political matter, it is desirable to rely on federal taxes that can be tailored to economic circumstances of individual households, Congress may find that it is easier to accomplish this goal with an individualized income tax or an individualized tax on consumption like the USA income tax rather than a transactions tax on consumption such as a VAT.

This Article discusses the various consumption tax proposals made in recent years, highlighting the similarities among these proposals for a broad-based federal tax on consumption. Some seek to replace existing income and payroll taxes with an IRS-administered consumption tax. The national RST goes further in proposing to have states that harmonize their RSTs with a national RST take over some or all of the IRS function of administering the new tax.

194. See *supra* text accompanying note 123.

VATs adopted elsewhere tend to follow a common pattern—they typically are European-style invoice VATs imposed on consumption which rely on the destination principle to tax international transactions. The differences in VATs tend to involve tax base adjustments, such as zero rating food and exempting many services provided by nonprofit organizations, to accommodate local traditions on untaxed products or services. There also are differences in the treatment of small businesses.

Our federal system, with a wide variety of state and local retail sales taxes, may limit congressional flexibility on its choice of a tax on consumption. Were it not for the need to operate a federal tax on consumption alongside state and local retail sales taxes, a planned progression from the Japanese consumption tax to a European invoice VAT might be the preferred form of VAT for the United States. The concurrent imposition of a separately-stated federal tax on consumption (not an individualized tax on consumption) and the state RSTs might make that option impractical. The other proposed VATs that are buried in product prices—the sales-subtraction VAT like the Gibbons VAT or the business tax portions of the USA or flat tax—may be more palatable.

If Congress enacts a broad-based tax on consumption, the new tax may have economic and other consequences, depending upon the nature of the new tax and on whether it replaces or supplants existing revenue sources. Assuming that the new tax is a VAT, the form of the tax may affect federal-state fiscal relations. A VAT buried in product prices may not be viewed by the states as an intrusion into their sales tax domain and may not be viewed by consumers as a sales tax. If the new tax replaces the corporate income tax, the switch may affect corporate dividend policy and may remove the tax incentive to finance corporate operations with debt rather than permanent capital.

Most countries with VATs tax international transactions under the destination principle—imports are taxed, but exports are not. All of the consumption tax proposals rely on the destination principle, except for the origin-principle flat tax that taxes exports, but does not tax imports. Most of the consumption tax proposals permit border tax adjustments consistent with our obligations under the World Trade Organization rules. The USA tax proposal to allow payroll taxes as an offset to business tax liability raises some WTO concerns, and the Armev flat tax is not border adjustable. It is not clear that the adoption of a federal consumption tax, either as an additional revenue source or to replace existing federal taxes, will have any long-term favorable effect on the

United States balance of trade. A change in the exchange rate of the U.S. dollar resulting from any significant increase in exports may offset any favorable effect from the new tax. The U.S. should not radically change the federal tax system with attendant changes in the distribution of the federal tax burden only to obtain some boost—maybe only temporary—in total exports.

Radical reform such as the elimination of the entire federal income tax system may not be politically feasible. Nevertheless, Congress may find that the introduction of some form of consumption tax such as VAT is possible to supplement existing federal revenues or replace some revenue from existing taxes. A VAT has a broader tax base than the existing corporate income tax because its base includes both labor and profit.