# Radical Tax Reform for the 21st Century: The Role for a Consumption Tax

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## I. INTRODUCTION

The end of the millennium is a time to reflect on the past and make proposals for the future. Politicians and commentators have been active in proposing ways in which Congress can radically change the federal tax system. Members of Congress held public hearings outside Washington, D.C., to hear complaints on claimed abuses in the IRS's treatment of taxpayers. These Members then coupled taxpayer discontent over the existing system with proposals to replace some or all of the income taxes, and maybe some other federal taxes as well. A variety of federal taxes on consumption have been proposed to raise the lost revenue. If the United States were to completely replace the federal income taxes with a tax on consumption, indeed, the United States might become the most attractive tax haven in the world.[1]

This article begins with a brief review of the changes in federal, state and local taxes up to World War II, and then in the last half of the century. This review is followed by a discussion of how the United States has not followed the movement toward consumption taxation taking place in other highly industrialized nations, in developing nations, and in the emerging economies of Eastern Europe. The major radical tax reform proposals in the United States in the 1990s are then reviewed, with the article focusing on those that use revenue from two forms of value added tax (VAT) to take a projected 100 million taxpayers off the federal income tax rolls.

## II. TAXATION IN THE TWENTIETH CENTURY

### A. Tax Systems in 1902

The tax structure in the United States is radically different near the end of the millennium than it was at the beginning. If we step back to the beginning of the twentieth century, we see a tax system without any federal, state or local income taxes imposed on

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1 *See* MICHAEL GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 273 (1997).

individuals and businesses. State and local governments relied heavily on property taxes, which accounted for about 82% of their total tax collections in 1902.[2] The composition of the 1902 tax regime in the United States was as follows:

TABLE 1. FEDERAL AND NON-FEDERAL TAX SOURCES IN 1902[3] (FIGURES IN MILLIONS OF DOLLARS)

| | Federal | State & Local |
|---|---|---|
| Income | 0 (0%) | 0 (0%) |
| Consumption | 487 (95%) | 28 (3%) |
| Property | 0 (0%) | 706 (82%) |
| Other | 26 (5%) | 126 (15%) |
| TOTAL | 513 (100%) | 860 (100%) |

Of the $487 million in federal revenue obtained from items of consumption, customs levies accounted for approximately 40%, and alcohol and tobacco taxes about another 40%, with most of the rest coming from postal services.[4]

In 1902, state and local tax revenue came mainly from property taxes and select excise taxes.[5] Starting in 1911, states began to introduce individual and corporate income taxes.[6] Sales taxes were introduced as a desperation measure during the Depression era, with 24 states adopting general sales taxes (in contrast to selective excise taxes on particular products or services) by 1938. Now, 45 states and the District of Columbia rely on general sales taxes.[7]

At the federal level, the income tax on corporations was reintroduced in the 1910 fiscal year, and the income tax on individuals was introduced in the 1914 fiscal year. In the history of federal taxation, the twentieth century can be characterized as the period that witnessed the development, refinement, and, some would claim, the near collapse of the income tax on individuals and businesses.

2 *See* TAX INSTITUTE OF AMERICA, FEDERAL-STATE-LOCAL FISCAL RELATIONSHIPS 10 tbl.7 (1968).

3 *See* J. ROBERT ARONSON & JOHN L. HILLEY, FINANCING STATE AND LOCAL GOVERNMENTS 238 tbl.A-2 (4th ed. 1986). The percentage of total revenue is in parentheses.

4 *See* U.S. DEP'T OF COM. & LAB., STATISTICAL ABSTRACT OF THE UNITED STATES: 1903, at 29-40 tbl.7 (1904).

5 *See* ARONSON & HILLEY, *supra* note 3.

6 By 1919, eight or nine states had income taxes. The number grew to 31 states by 1940, and now totals 44 states. *See* ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, SIGNIFICANT FEATURES OF FISCAL FEDERALISM: BUDGET PROCESSES AND TAX SYSTEMS 32-33 tbl.12 (1995) [hereinafter ACIR REPORT].

7 *See id.*

## B. Post-World War II Changes in the U.S. Economy and in Federal, State and Local Tax Systems

At the close of World War II, the United States had a production economy, and American businesses exported technology to the war-torn regions of the world. Currency rates were fixed, and the United States was on the gold standard, with the value of gold set at $35 per ounce.

The changes in the U.S. tax system since World War II, while significant, are less dramatic than those that occurred from 1900 to 1945. The change in the federal tax structure from 1945 to 1997 is as follows (figures in parentheses represent the percentage of total budget receipts accounted for by each line item for each fiscal year):

TABLE 2. FEDERAL TAX STRUCTURE IN 1945 AND 1997[8]

| | 1945 | 1997 |
|---|---|---|
| Individual income | $18.37 billion (40.7%) | $737.46 billion (46.7%) |
| Corporate income | 15.99 billion (35.4%) | 182.29 billion (11.5%) |
| Payroll taxes | 3.45 billion (7.6%) | 539.37 billion (34.2%) |
| Excise taxes | 6.27 billion (13.9%) | 56.92 billion (3.6%) |
| Other | 1.08 billion (2.4%) | 63.24 billion (4.0%) |
| TOTAL | $45.16 billion (100%) | $1579.28 billion (100%) |

The comparisons, as a percentage of gross domestic product, are more revealing. The individual income tax has remained remarkably constant, while corporate income taxes have declined almost as much as payroll taxes have increased. The comparative data are as follows:

TABLE 3. FEDERAL TAXES AS A PERCENTAGE OF GNP/GDP[9]

| | 1945 | 1997 |
|---|---|---|
| Individual income | 8.3% | 9.3% |
| Corporate income | 7.2% | 2.3% |
| Payroll | 1.6% | 6.8% |
| Excises | 2.8% | 0.7% |
| Other | 0.5% | 0.8% |

In 1945, the federal government took 20.4% of GNP in taxes. The figure for 1997 was 19.9% of GDP.

8 The information in this chart is taken from EXECUTIVE OFF. OF THE PRESIDENT OF THE UNITED STATES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1999, HISTORICAL TABLES 27-28 tbl.2.1, 29-30 tbl.2.2 (1998) [hereinafter 1999 BUDGET].

9 *See id.* at 31-32 tbl.2.3. The United States used gross national product, rather than gross domestic product, in 1945.

The post-war period witnessed a substantial expansion of the state and local sector, its revenue and programs. In 1945, about 20% of tax revenue at all levels of government came from state and local taxes.[10] After the war, property taxes had become largely a local tax,[11] and 31 states and Hawaii had imposed a state or local tax on the income of individuals or corporations.[12] State retail sales taxes were imposed mainly on sales of goods, with only select services subject to tax. By the mid-1990s, state and local taxes increased to about one-third of the total revenue at all levels of government.[13] Property and sales taxes then accounted for about 64% of total state and local revenue.[14] Over this 50-year period, sales tax revenue dropped from 25% to 20% of state and local revenue, ignoring revenue-sharing.[15]

There has been a dramatic change in revenue-sharing and other federal transfers back to the state and local governments over the past five decades. In 1945, federal grants to state and local governments amounted to 0.9% of federal outlays.[16] The estimate for 1998 is 15% of federal outlays.[17]

The composition of our personal consumption expenditures also changed during this period. In 1945, of total personal consumption expenditures of $119.7 billion, $79.9 billion (67%) was for durable and nondurable goods,[18] and $39.8 billion (33%) was for services.[19] By 1997, total personal consumption expenditures were $5.5 trillion. Durable and nondurable goods dropped to 41%, and services almost doubled to 59%.[20] This change in the nature of the economy has prompted some states to expand their sales tax bases to include more services.[21]

Some congressional proposals for radical tax reform during the waning years of this millennium tap into perceived public discontent with the individual income tax return filing requirements that many taxpayers fear they cannot complete without the assistance of tax return preparers. As a prelude to the later discussion

10 *See* ECONOMIC REPORT OF THE PRESIDENT 305 tbl.B-67 (1969) [hereinafter 1969 ECONOMIC REPORT].

11 *See* J.F. DUE & J.L. MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 2 (2d ed. 1994).

12 *See* ACIR REPORT, *supra* note 6, at 32-33 tbl.12.

13 *See* ECONOMIC REPORT OF THE PRESIDENT 378 tbl.B-83 (1998) [hereinafter 1998 ECONOMIC REPORT]. The state and local portion excludes federal grants.

14 *See id.* at 381 tbl.B-86.

15 *See id.*

16 *See* 1999 BUDGET, *supra* note 8, at 203-04 tbl.12.1.

17 *See id.*

18 "Durable goods" include motor vehicles and parts, furniture and household equipment, while "nondurable goods" include food, clothing and shoes, gasoline and oil, and fuel oil and coal. *See* 1998 ECONOMIC REPORT, *supra* note 13, at 300 tbl.B-16.

19 *See* 1969 ECONOMIC REPORT, *supra* note 10, at 239 tbl.B-10.

20 *See* 1998 ECONOMIC REPORT, *supra* note 13, at 300 tbl.B-16.

21 *See* DUE AND MIKESELL, *supra* note 11, at 90, 319.

of proposals to take 100 million taxpayers off the income tax rolls, it is helpful to look at tax return data over the last six decades. World War II is generally viewed as the event that converted the federal individual income tax from a tax imposed only on high income individuals to a tax imposed on the masses.[22]

In 1939, 6% of the population filed 7.6 million individual income tax returns.[23] By 1945, about 50 million individual income tax returns were filed, representing about 35% of the total population of 140 million.[24] In contrast, in 1995, over 118 million individual income tax returns were filed,[25] representing about 45% of the total population of 263 million.[26]

## III. UNITED STATES WATCHES WORLD TAX SYSTEMS SHIFT TO VALUE ADDED TAXES

### A. Introduction

During the last several decades of the twentieth century, the most dramatic change in tax systems around the world has been the conversion of turnover and other national sales taxes to value added taxes (VATs).[27] The movement began with the adoption of a limited form of a VAT in France in 1954.[28] France eventually extended the tax down to the retail stage.[29]

The Treaty of Rome, which created the European Economic Community, requires all member states to adopt a VAT as a condition of membership.[30] The expansion of the European Union thus increased the number of nations with a VAT. In addition, the International Monetary Fund has assisted many developing countries in drafting VATs to provide the revenue needed to place themselves on a sounder financial footing. The emerging countries of the former Soviet Union followed this trend and adopted

22 *See* GRAETZ, *supra* note 1, at 266.

23 *See* BUREAU OF THE CENSUS, U.S. DEP'T OF COM., STATISTICAL ABSTRACT OF THE UNITED STATES: 1949, at 337 tbl.368 (1950) (number of tax returns) [hereinafter 1949 STATISTICAL ABSTRACT]; BUREAU OF THE CENSUS, U.S. DEP'T OF COM., STATISTICAL ABSTRACT OF THE UNITED STATES: 1952, at 5 tbl.2 (1953) (population interpolated from decennial Census figures) [hereinafter 1952 STATISTICAL ABSTRACT].

24 *See* 1949 STATISTICAL ABSTRACT, *supra* note 23; 1952 STATISTICAL ABSTRACT, *supra* note 23.

25 *See* INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREAS., STAT. OF INCOME BULL., Spring 1998, at 12 fig.A.

26 *See* 1998 ECONOMIC REPORT, *supra* note 13, at 321 tbl.B-34.

27 For a discussion of the nature of value added taxes, *see infra* Part IV.

28 The 1954 VAT covered only the industrial sector of the economy. *See* Jean-Pierre Balladur & Antoine Coutiere, *France*, *in* THE VALUE ADDED TAX: LESSONS FROM EUROPE 19 (Henry J. Aaron ed., 1981).

29 The VAT was expanded to the retail level in 1969. By 1979, the VAT covered virtually all economic activities, with permanent exemptions for the medical, educational, artistic and sporting professions. *See id.* at 20.

30 *See* Treaty Establishing the European Economic Community, Mar. 25, 1957, art. 99, 298 U.N.T.S. 11, 76.

VATs.[31] New Zealand, Canada, and Japan enacted VATs to replace other forms of sales tax.[32] The Australian government is committed to replacing its single stage sales tax with a VAT.[33] Once Australia enacts a VAT, the United States will have the distinction of being the only country of the large industrialized nations that form the Organization for Economic Cooperation and Development (OECD) that does not levy a VAT at the national level.[34] There are now about 100 countries with VATs.

Consistent with their obligations under the World Trade Organization (formerly the General Agreement on Tariffs and Trade), WTO member nations can impose border tax adjustments (BTAs) for indirect taxes. Nations with VATs impose the VAT on imports and rebate the tax on exports.[35] Countries like the U.S., which rely on direct taxes like income taxes, cannot rebate those taxes on exports.

## B. Congressional Proposals to Board the Global VAT Rocket

In 1970, the Nixon administration considered, but did not propose, a value added tax to fund a revenue-sharing program aimed at forcing states to reduce reliance on property taxes to fund education.[36] House Ways & Means Committee chair Al Ullman proposed a value added tax in 1979 and 1980 to finance reductions in federal income and payroll taxes.[37] Nevertheless, it was not until the 1990s that politicians from both major parties made proposals for radical tax reform that attracted significant public attention.[38]

Recent congressional proposals to radically change the federal tax system are marked by the use of the revenue from a new broad-based tax on consumption, either to close down the Internal Revenue Service and have the states administer the new tax, or to abolish federal income taxes (and reduce or abolish payroll taxes). These proposals create revenue-neutral shifts in taxes, and are discussed next. Two proposals which do not propose the replacement of all or part of the current federal income tax system, and

31 *See* ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, CONSUMPTION TAX TRENDS 11 (1995) [hereinafter CONSUMPTION TAX TRENDS].

32 *See id.*

33 A New Tax System (Goods and Services Tax) Bill 1998 (House of Representatives, Austl.).

34 *See* CONSUMPTION TAX TRENDS, *supra* note 31, at 11.

35 *See* Protocol Amending the General Agreement on Tariffs and Trade, Mar. 10, 1955, § 1(L), 8 U.S.T. 1767, 1777, 278 U.N.T.S. 168, 184 (added art. XVI(4)) [hereinafter GATT].

36 *See* Eileen Shanahan, *Nixon's Property-Tax Cuts Rejected by Advisory Group*, INT'L HERALD TRIBUNE, Dec. 16-17, 1972, at 3.

37 H.R. 5665, 96th Cong. (1979); H.R. 7015, 96th CONG. (1980).

38 There was a proposal for a sales-subtraction VAT, called the Business Transfer Tax (BTT), in 1985 by Senator Roth, with the tax creditable against the employer's share of its FICA tax. It was described by Senator Roth as a tax on net business receipts. 131 CONG. REC. S5675 (daily ed. May 8, 1985) (statement of Senator Roth upon the introduction of S. 1102).

which are, therefore, not discussed further, use a new VAT as a source for additional federal revenue.[39]

## IV. Brief Review of Proposals for a VAT and Other Taxes on Consumption

Most of the proposals for a national tax on consumption contain value added tax elements. A value added tax is a multistage sales tax imposed on goods and services. Like a retail sales tax, a VAT is collected by businesses and is expected to be shifted forward to consumers in product prices. In fact, the degree of forward shifting depends on competitive forces and a firm's competitive position in its industry.

A retail sales tax (RST) is a single stage tax imposed on the value of taxable goods and services purchased by consumers at the retail stage. A VAT, on the other hand, is imposed on the value added by a taxable firm at each stage of production and distribution as goods are produced and services are rendered. The components of "value added" are wages (the largest element in most businesses), profit as calculated for VAT purposes,[40] rent expenses, and interest expenses.[41] In simplified terms, a firm's value added is the difference between its taxable sales and its taxable purchases used in making those taxable sales. Since the seller can recover VAT paid on its taxable purchases, there is no cascading of tax as goods go through several stages of production and distribution. The taxes remitted at each stage should add up to an amount equal to the retail prices paid by consumers for taxable items multiplied by the tax rate. If it works properly, the VAT should raise the same revenue, and consumers should pay the same tax-inclusive price under a VAT, as under a single-stage RST imposed on the same tax base at the same rate.

For example, if a lawyer purchases a computer, software, desks and office supplies, and pays rent and other utility bills, totaling $14,000, and charges legal fees of $25,000 in a single tax period, then with a 10% European-style VAT imposed on tax-exclusive prices, the lawyer will charge $2500 VAT on his fees (re-

39 H.R. 16, 106th Cong. (1999) (the Dingell bill to finance national health care); S. 237, 104th Cong. (1995) (the Hollings bill to finance national health care and to fund reductions in the national debt).

40 With a consumption-style VAT like that used almost universally, depreciation is added back and the cost of capital goods are deducted. Under the income tax in the U.S., items of inventory are charged to cost of goods sold in the year of sale. Under a VAT, a business can deduct purchases of inventory at the point of purchase, not when the purchased items are sold.

41 Rent and interest expenses are included in the tax base of the user of these services if rent and interest are not taxable to the provider of these services. These four factors of production (wages, profit, rent and interest) represent the elements in an addition method VAT. *See* Carl Shoup, *Theory and Background of Value-Added Tax*, 1955 Proc. of 48th Ann. Conf. on Tax'n of the Nat'l Tax Ass'n 7.

ferred to as output tax), will credit against his output tax liability the $1400 VAT listed on his purchase invoices (referred to as input tax), and will remit $1100 net VAT liability to the government, calculated as follows:

| | |
|---|---|
| Output tax | |
| $25,000 fees x 10% VAT | $2500 |
| Input tax credit | |
| $14,000 purchases, on which $1400 tax is paid | (1400) |
| Net VAT liability | $1100 |

If these legal fees are paid entirely by a single client, who is a retailer, and the retailer makes taxable sales of $300,000 and has other taxable purchases of inventory and other inputs of $160,000, the retailer's net VAT liability is $11,500, calculated as follows:

| | | |
|---|---|---|
| Output tax | | |
| Taxable retail sales $300,000 x 10% tax | | $30,000 |
| Input tax credit | | |
| Legal services $25,000, on which $2500 tax is paid | (2500) | |
| Other taxable purchases $160,000, on which $16,000 tax is paid | (16,000) | (18,500) |
| Net VAT liability | | $11,500 |

Consumers who purchase from the retailer will be charged VAT equal to $30,000 (10% of the pre-tax retail price) and will pay a tax-inclusive price of $330,000. This is the same amount that they would have paid under a 10% retail sales tax imposed on the $300,000 pre-tax retail price.

The consumption tax proposals made by members of Congress and presidential candidates in the mid-1990s were mainly forms of a value added tax or a retail sales tax. A European-style VAT, like the one described above, was proposed by Senator Hollings, Congressman Dingell, and Professor Michael Graetz.[42] Most of the remaining VAT proposals were for a sales-subtraction VAT, which is buried in product prices. The other consumption tax proposals were for a flat tax (a bifurcated VAT) and a national retail sales tax. A sales-subtraction VAT is described first.

Unlike the transactional European-style VAT, which is imposed on each taxable sale and generally is listed on sales invoices, the sales-subtraction VAT is a period tax, which is buried in product prices. The sales-subtraction VAT is generally calculated from account totals for taxable sales and taxable purchases for each tax period. These totals are tax-inclusive, and the tax, therefore, is imposed on tax-inclusive prices. To raise the same

42 On the Hollings and Dingell VATs, *see supra* note 39. The Graetz proposal is discussed later in this section. *See infra* notes 61-65 and accompanying text.

revenue as a 10% VAT imposed on tax-exclusive prices, the sales-subtraction VAT rate is 9.0909%. Applying the sales-subtraction VAT to the above example, the lawyer will remit the same net VAT liability of $1100 and the retailer will remit the same net VAT of $11,500, calculated as follows:

| Lawyer | |
|---|---|
| Taxable sales at tax-inclusive prices | $27,500 |
| Less taxable purchases at tax-inclusive prices | (15,400) |
| Tax base | 12,100 |
| Tax rate | 9.0909% |
| Net VAT liability | $1100 |
| **Retailer** | |
| Taxable sales at tax-inclusive prices | $330,000 |
| Less taxable purchases at tax-inclusive prices | |
| Legal services | (27,500) |
| Other taxable purchases | (176,000) |
| Tax base | 126,500 |
| Tax rate | 9.0909% |
| Net VAT liability | $11,500 |

As the above examples illustrate, consumers pay the same $330,000 tax-inclusive prices under the sales-subtraction VAT as under the European VAT, assuming that the entire VAT is shifted forward to purchasers under both forms of VAT.

As a tax buried in product prices, this VAT does not handle exemptions well.[43] Indeed, if the tax is not imposed at a single rate on a comprehensive base, the sales-subtraction VAT "breaks down."[44] The VAT proposed by Congressman Gibbons is free of exemptions and is imposed at one rate, but it has not been subjected to the legislative process.[45]

Congressman Armey's flat tax,[46] proposed in 1995, is in essence a tax on consumption, with a tax base that in theory resembles the sales-subtraction VAT just described. The flat tax base, however, is bifurcated into a business tax (BT) and an income tax (IT). In contrast to a pure VAT, which imposes tax on the value added by a business from labor, profit, rent and interest expenses,

43 Unless a system of distinguishing exempt from taxable sales and disallowing deductions for exempt purchases exists, the revenue lost on the exempt sale is difficult to recoup from the business using the exempt item.

44 *See* CHARLES E. MCLURE, JR., THE VALUE-ADDED TAX: KEY TO DEFICIT REDUCTION? 71 (1987). For other differences between the European VAT and the sales-subtraction VAT, *see id.* at 71-86.

45 The Gibbons proposal is discussed in detail later in this section. *See infra* notes 51-60 and accompanying text.

46 H.R. 2060, 104th Cong. (1995). The Armey Flat Tax was patterned on the flat tax proposed by two senior fellows at the Hoover Institution. *See* ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995).

the BT gives a business a deduction for wages paid to workers and contributions by the business to employee retirement plans. The "wage" portion of the base is reportable by, and taxable to, workers. Workers must file IT returns, reporting their wages and distributions from retirement plans (along with any unemployment compensation). Even so, the combined BT and IT would be equivalent to a VAT base, except that a worker subject to the IT portion of the flat tax can claim a standard deduction linked to her filing status and family size. This deduction is designed to provide some progressivity to the flat tax system, but it distorts the tax base.[47] The taxation of international transactions under the flat tax also departs from the principle used in the VAT and other consumption tax proposals. It relies on the origin principle to tax international transactions. Unlike the universally used destination principle for a VAT, which taxes imports and removes tax from exports, the flat tax taxes exports and does not tax imports.[48]

A national retail sales tax was proposed in 1996 by Congressman Schaefer.[49] His proposal would replace the federal income taxes, estate and gift taxes, and some excise taxes with a 15% retail sales tax that would be administered by conforming states. To be a conforming state, a state must have a retail sales tax that is harmonized with the new federal retail sales tax. Proponents of this sales tax claim that their proposal would permit the shutdown of the IRS.[50]

The remainder of this article focuses on the specifics of two reform proposals that rely on revenue from a new VAT to take 100 million individuals off the individual income tax rolls. These proposals represent a middle ground between retaining the existing income taxes and repealing the income taxes entirely. The proposals were made by Congressman Sam Gibbons and Professor Michael Graetz. The Gibbons legislative proposal, discussed first, recommends the replacement of about 90% of current federal

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47 The standard deduction is based on the taxpayer's filing status and the number of dependents. *See* H.R. 2060 § 101 (proposed I.R.C. § 63).

48 The origin principle may have been selected, in part, to avoid conflict with U.S. obligations under the World Trade Organization rules that allow border tax rebates only for indirect taxes on product prices. *See* GATT, *supra* note 35. Some commentators claim that under certain conditions, where relative wages and prices or exchange rates are flexible, in the long term, the origin and destination principles have similar effects on trade. *See* Martin Feldstein & Paul Krugman, *International Trade Effects of Value-Added Taxation*, *in* TAXATION IN THE GLOBAL ECONOMY 263 (Assaf Razin & Joel Slemrod eds., 1990); Victoria P. Summers, *Book Review of Gary Clyde Hufbauer, assisted by Carol Gabyzon, Tax Reform and Border Tax Adjustments*, 49 NAT'L TAX J. 687 (1996).

49 H.R. 3039, 104th Cong. (1996).

50 This claim that the IRS can be shut down is exaggerated. For example, there are several states without retail sales taxes. It is unlikely that these states would set up the apparatus to collect the federal sales tax. In addition, under the Schaefer bill, there is a mechanism for the federal collection of sales tax from businesses that operate in multiple states. *See id.* § 4 (proposed I.R.C. § 33).

taxes.[51] Congressman Gibbons, before his retirement, proposed a 20% sales-subtraction VAT to replace much of the individual income tax, the corporate income tax, and the Social Security and Medicare taxes. A central feature of his plan is to remove most individuals from the income tax rolls, leaving the individual income tax as a tax only on high income individuals.[52]

Congressman Gibbons' proposal is designed to be revenue neutral and to achieve roughly the same distribution of tax burden among income groups as the existing federal tax structure.[53] His five principles of fundamental tax reform are:

(1) Revenue neutrality,

(2) Fairness as reflected in the equitable distribution of tax burden,

(3) Simplicity, "thereby avoiding the ill will and skepticism generated by the current Federal tax system,"

(4) Economic efficiency "to minimize interference in economic markets," "encourage economic growth," and "promote the vigor and competitiveness of American companies," and a

(5) Border adjustable tax that "promote[s] the competitiveness of American companies."[54]

To maintain the current degree of progressivity and distribution of federal tax burden, referred to by Mr. Gibbons as "tax fairness," he proposes tax burden adjustments. The tax burden adjustments consist of a tax rebate to low-income individuals with incomes up to $30,000, and a "burden assessment" that taxes individuals on incomes above $75,000.[55] In 1996, about 42 million taxpayers that fit between $30,000 and $75,000 in income would neither receive a rebate nor be subject to the tax imposed on higher-income individuals. The tax burden for these 42 million taxpayers would be limited to the 20% VAT that they would pay on their taxable purchases.

The tax rebate (which is designed to reimburse low-income individuals for some or all of the VAT that they pay on purchases) would be available to the estimated 50 million taxpayers in 1996 who had annual adjusted net income of no more than $30,000.[56]

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51 *See* 142 CONG. REC. E1572 (daily ed. Sept. 11, 1996) (introductory statement by Rep. Gibbons).

52 *See* H.R. 4050, 104th Cong. §§ 101-102 (1996).

53 *See id.* § 1(c) .

54 *See id.* § 1(b).

55 *See id.* § 301 (proposed I.R.C. §§ 1601-1602 and 1611-1612).

56 *See* 142 CONG. REC. E1573 (daily ed. Sept. 11, 1996). A married couple must file a joint return to qualify for the rebate. *See* H.R. 4050 § 301 (proposed I.R.C. § 1601(c)). The rebate is equal to the applicable percentage of the portion of the adjusted net income that does not exceed $30,000. *See id.* (proposed I.R.C. § 1601(b)(1)). The "applicable percentage is 20 percent reduced (but not below zero) by 2/3 of 1 percentage point for each whole $1,000 of the individual's adjusted net income." *Id.* (proposed I.R.C. § 1601(b)(2)). The adjusted net income is net income (adjusted gross income with some modifications) plus the

The rebate is phased out as individuals approach $30,000 in income. The rebate may be made by direct government payment to the individual, by payment incident to federal transfer payments or social security benefits, or by payment with wages by an employer to employees with eligible certificates.[57]

The burden assessment on high-income individuals includes a 17% tax on the net income of an assessable person in excess of the threshold amount, which generally will be $75,000 for an individual and zero for a trust.[58] For these persons, most of the current individual income tax rules will remain, although some will be repealed and some new rules will have to be added.[59] Net income is adjusted gross income with additions for certain items excludible under the current income tax.[60]

The Gibbons VAT is broadly based and covers businesses with annual gross receipts of $12,000 or more. Isolated or infrequent sales by individuals, such as garage sales, are not taxed. As a tax on sales of goods and services, the proposed VAT does not tax busi-

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value of certain federal transfer payments (including aid to families with dependent children, food stamps, and certain other federal assistance). *See id.* (proposed I.R.C. § 1601(b)(3) & (4)).

57 *See id.* (proposed I.R.C. §§ 1601(f) & 1602). Payments by employers are treated as payments of VAT, not payments of compensation. *See id.* (proposed I.R.C. § 1602(d)).

58 *See id.* (proposed I.R.C. § 1611(a) & (d)). The threshold for an individual is zero if the person is married, does not file a joint return, and does not live apart from his or her spouse. An assessable person is an individual, estate or taxable trust. *See id.* (proposed I.R.C. § 1611(b)). Congressman Gibbons estimated that there were 17.5 million taxpayers (16% of current taxpayers) in this group in 1996. 142 CONG. REC. E1573 (daily ed. Sept. 11, 1996).

59 An individual, estate or taxable trust that owns stock in specified corporations must include as dividend income the amount the person would have received if the corporation had made a pro rata distribution of certain of its undistributed income to shareholders on the last day of the corporation's taxable year. Undistributed income is net income reduced by certain corporate distributions to its shareholders during the taxable year. *See* H.R. 4050 § 301 (proposed I.R.C. § 1612(c)(1)). The amount that the person would have received if the corporation had distributed pro rata is "an amount which bears the same ratio to the undistributed income of the corporation for the taxable year as the portion of such taxable year during which such corporation is an applicable corporation bears to the entire taxable year." *Id.* (proposed I.R.C. § 1612(a)). This rule applies to a corporation operating a service-related business and to a closely held C corporation. *See id.* (proposed I.R.C. § 1612(b)(1)). A service-related business is any trade or business within I.R.C. § 1202(e)(3)(A). *See id.* (proposed I.R.C. § 1612(b)(2)). A closely held C corporation is "any C corporation if, at any time during the last half of the taxable year, more than 50 percent in value of its outstanding stock is owned, directly or indirectly through the application of section 544, by or for not more than 10 individuals." *Id.* (proposed I.R.C. § 1612(b)(3)). An applicable corporation does not include a corporation exempt from tax. *See id.* (proposed I.R.C. § 1612(b)(1)).

60 *See id.* (proposed I.R.C. § 1611(c)). Net income is determined the same way as taxable income under chapter 1 in effect on the day before this section is enacted. *See id.* (proposed I.R.C. § 1612(c)(2)). Net income is calculated without the exclusions under §§ 911, 931, 933, 457, and the 402(g)(3) elective deferral. Tax-exempt interest must be added back to AGI, and deferred compensation is included in gross income in the first taxable year when there is no substantial risk of forfeiture within § 457(f)(3), but this rule does not apply to a plan or contract under § 457(f)(2). Gross income of a trust or estate is to be determined under § 67(e). *See id.* (proposed I.R.C. § 1611(c)(2)-(4)).

nesses on income earned on income-producing property, such as interest on bonds and dividends on stock.

In his 1997 book, *The Decline (and Fall?) of the Income Tax*, Professor Michael Graetz outlined the broad principles of his proposal to use a European-style VAT to replace the income tax for an estimated 100 million individual tax filers with adjusted gross income of less than $75,000, making "the federal tax system much more economically efficient and friendlier to savings and capital formation without introducing the inherent unfairness of completely substituting a consumption tax for income taxation."[61] According to Professor Graetz, his plan "would return the income tax to its pre-World War II status, when it supplied progressivity to the United States tax system by limited application only to people at the top of the income tax scale."[62] An option that he suggests is to tax income exceeding $75,000 or $100,000 at a flat 20% rate.[63] Graetz disagrees with those who would use the replacement of the income tax with a VAT as the opportunity to repeal the estate and gift taxes as well.[64] He offers an alternative that radically changes the estate and gift taxes, but still taxes the transfer of wealth during life or at death. Gifts and inheritances would be taxable as income under his proposed income tax system, imposed only on high income individuals, so that "transfers to people without substantial other income" would be exempt and other transfers that now may be subject to a 55% estate and gift tax rate would be taxable at the 20% rate applicable to taxpayers with adjusted gross income above $75,000.[65]

## V. Comparison of European and Sales-Subtraction VATs

There are differences between the Graetz and Gibbons proposals to use new VAT revenue to remove all but high income individuals from the income tax rolls and make other changes in the federal tax system. For example, there are differences in the taxes that would be replaced. There are also differences between a European invoice VAT (the Graetz proposal) and a sales-subtraction VAT (the Gibbons proposal). If the impact of a federal VAT on

61 Graetz, *supra* note 1, at 265. For the 1996 tax year, of the 121 million returns filed, 12 million were from taxpayers with adjusted gross income of $75,000 and above. The Graetz plan has other noteworthy features. The plan would allow the taxation of individuals with incomes above $75,000 at a flat 21% rate. "By applying the current minimum-tax rules to these people or slightly increasing their tax rates, deductions for charitable contributions, medical expenses, and home mortgage interest could be allowed. Alternatively, broadening the tax base by eliminating other tax breaks might permit retention of these deductions without increasing the tax rate." *Id.*

62 *Id.* at 266.

63 *Id.* at 265.

64 *Id.* at 267.

65 *See id.* at 268.

state and local tax and on taxpayer compliance costs could be ignored, the European VAT would be the better choice.

The European VAT, which is imposed on each taxable sale (a transactional tax), typically is stated separately on sales invoices. This kind of VAT permits more precise border tax adjustments, and more easily accommodates changes in the tax rate as well as grants of tax exemptions for political, economic or other reasons. It also provides a useful audit trail to cross-check taxable sales by sellers with claims of input credits by purchasers.

The sales-subtraction VAT, a period tax buried in product prices, more easily operates alongside state sales taxes, and, because of the distortions and complexities they cause, this form of VAT deters both changes in the tax rate and the grant of exemptions for particular goods and services. These limits on the flexibility of a sales-subtraction VAT may be viewed by some as its greatest strength. A few of the differences between the Graetz and Gibbons VAT proposals are discussed next.

A. Taxes Replaced and VAT Rates

Gibbons proposed the replacement of much of the individual income tax, the corporate tax, the Social Security tax and the Medicare tax with a VAT. According to Gibbons, a 20% VAT rate is needed to finance these changes, including rebates to an estimated 50 million individuals with adjusted gross income under $30,000. The proposal also includes a 17% income tax imposed on "net income" above $75,000.

The Graetz alternative discussed here contemplates a 20% VAT to replace fewer taxes. Graetz would replace the individual income tax for filers with adjusted gross income of less than $75,000 or $100,000, and would impose a higher 20% income tax on those with incomes above the threshold. He does not propose any rebates to low-income families. Instead of repealing the estate and gift taxes, he would require donees and devisees to include gifts and inheritances in income, taxable only to those high income individuals who are subject to the 20% income tax. An option also discussed in the Graetz plan was to increase the VAT rate by 2% in order to cut the corporate income tax to 20%.[66]

B. Border Tax Adjustments

The European VAT proposed by Graetz permits fairly precise border tax adjustments (BTAs), compatible with the BTAs used by many of our trading partners. The tax is separately stated on invoices at each stage of production and distribution, so the input

66 *Id.* at 266.

tax credit can be calculated with precision. Exports are free of tax. No tax is imposed on export sales and the exporter can claim a credit for all VAT paid on purchases attributable to the exports. Imports are fully taxed at the VAT rate.

If Congress adopts a sales-subtraction VAT like the Gibbons proposal, the rebate of tax on exports will depend on estimates of the VAT element in exported goods and services. This need to use estimates arises because the VAT is a period (not transactional) tax, which is buried in product prices. While the tax base can and should be the same for a European and sales-subtraction VAT, the Gibbons VAT deviates from a pure VAT. To be comparable, the Gibbons VAT should limit deductions for purchases to the cost of purchases that were subject to VAT. However, in the Gibbons sales-subtraction VAT, a business also can deduct the cost of purchases from exempt small businesses.[67] The imposition of tax on imports also should depend on estimates of the tax burden on domestically produced goods and domestic services, so that the same burden is imposed on the imports. The Gibbons VAT is imposed on the full value of all taxable imports.

The use of estimates, rather than precise BTAs, opens the possibility that our trading partners will de-couple the precise VAT element in their exports and the BTAs that they authorize for exports. At least one country, Japan, currently relies on estimates (or intentionally allows rebates exceeding the tax element in exports) for its BTAs.[68] The Japanese Consumption Tax (CT), like the Gibbons VAT, allows input tax credits for presumed tax on purchases from small businesses exempt from VAT. To date, Japan's trading partners have not objected.

Some commentators have questioned if BTAs for a sales-subtraction VAT are compatible with our obligations under the WTO rules that restrict border tax adjustments.[69] The WTO permits the rebate of indirect taxes on exports, but not direct taxes.[70] The method of calculating VAT liability does not alter the economic effects of the tax. If a European VAT is compatible with WTO, the sales-subtraction VAT imposed on the same base should be as well. "If, however, Congress approaches the BAT [business activities tax] like an income tax and grants or denies deductions for

67 *See* H.R. 4050, 104th Cong. § 201 (1996) (proposed I.R.C. §§ 10014 on deductions, and 10041 on the small business exemption). With a nominal $12,000 small business exemption, distortion in prices or distortions in BTAs likely will be minimal.

68 During the years that the European countries relied on turnover taxes, they based BTAs on estimates that were less precise then the estimates required under the Gibbons VAT.

69 For example, according to JOINT COMMITTEE ON TAXATION, FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, (JCS-6-91), May 30, 1991, at 304: "there is considerable uncertainty as to whether a subtraction-method VAT would be legal under GATT."

70 *See* GATT *supra* note 35.

economic, administrative, or political reasons, [Congress could] . . . change the nature of the tax so substantially that our trading partners may successfully claim that the tax no longer is an indirect tax that is border adjustable under GATT [WTO]."[71]

## C. Fiscal Federalism

A sales-subtraction VAT may be more compatible with state sales taxes than a European VAT. Both proposals, however, may have a significant effect on state and local revenue and administration. State and local governments now raise about 20% of their revenue from sales tax and 15% from individual and corporate income taxes.[72] If state and local sales tax and the Graetz-proposed European VAT are separately stated on invoices and are added at the cash register, the high total rate may affect the states' ability to increase their sales tax rates in the future. If the Graetz or Gibbons proposal removes 100 million taxpayers with adjusted gross income of not more than $75,000 from the federal income tax rolls, these taxpayers still must calculate their income in order to file their state and local income tax returns. As a result, the Graetz and Gibbons proposals may not significantly reduce taxpayer compliance costs for individuals exempt from the federal income tax. Graetz acknowledges this problem.[73] States would no longer be able to rely on federal tax data and federal audits to help enforce state and local income taxes on these 100 million individuals who are no longer on the federal individual income tax rolls. It is not clear whether states could afford to increase their audits of these taxpayers, many of whom would have relatively small state and local tax liabilities.

> It is not clear that radical federal tax reform will spawn radical state tax reform. On a more modest level, when Congress repealed the federal individual income tax deduction for state and local sales tax, some commentators speculated that states would

71 Oliver Oldman & Alan Schenk, *The Business Activities Tax: Have Senators Danforth & Boren Created a Better Value Added Tax?*, 10 TAX NOTES INT'L 55, 62 (1995). The Gibbons bill itself gives some advance indication of the temptation of members of Congress to treat the sales-subtraction VAT like an income tax. The bill denies deductions for purchases that violate federal, state or local law. H.R. 4050 § 201 (proposed I.R.C. § 10015). In contrast, the European VAT, under the Sixth VAT Directive, disallows deductions for items that represent final consumption. Sixth Council Directive of May 17, 1977, On the Harmonization of the Laws of the Member States Relating to Turnover Taxes — Common System of Value Added Tax: Uniform Basis of Assessment, 1977 O.J. (L 145) 1, *explored in detail in* B.J.M. TERRA AND JULIE KAJUS, A GUIDE TO THE EUROPEAN VAT DIRECTIVES (1994). For example, the Sixth Directive, Art. 17(6) disallows deductions for luxuries, amusements and entertainment.

72 *See* 1998 ECONOMIC REPORT, *supra* note 13, at 381 tbl.B-86.

73 GRAETZ, *supra* note 1, at 262.

shift from nondeductible sales taxes to deductible income and property taxes.[74] This shift has not occurred.[75, 76]

If states are pressured into piggybacking their individual income taxes on a reformed federal individual income tax with a $75,000 exemption, the states somehow must recoup the revenue now raised from the income groups excluded from that tax, a potentially difficult task for those states with an aversion to sales taxes or with a commitment to providing a favorable tax climate for business.

If Congress adopts a VAT like the harmonized VAT used in the European Union, the tax base will be broader, and the timing and reporting rules may differ significantly from those in use under most state and local retail sales taxes.

The Canadian experience operating a European VAT (the Goods and Services Tax, or GST) at the national level and retail sales taxes at the provincial level may be predictive of problems that the United States might face if Congress adopted the Graetz proposal. Public opposition in Canada to the introduction of the GST resulted in part from the sticker shock experienced by consumers in provinces with retail sales taxes when the 7% GST was coupled with the provincial sales tax (typically 8%), both being added at the cash register. This public discontent arose even though the Canadian shift from the outdated manufacturer's sales tax to the GST was revenue-neutral.

The Canadian response to the opposition to the GST was to harmonize the provincial sales tax and the GST in those provinces that were willing to defer to the federal GST base and rules. The combined tax is the Harmonized Sales Tax, which eventually will be administered by a new customs and revenue agency.[77] Equally significant, the GST, or the HST, ultimately will be buried in product prices, even though merchants will be required to disclose the tax or tax rate on sales invoices.[78] The Graetz VAT also could be buried in retail prices, but as a transaction-based tax, businesses still must comply with two transaction-based sales taxes imposed on different bases in states with state retail sales taxes. The com-

74 *See* Charles E. McLure, Jr., *State and Local Implications of a Federal Value-Added Tax*, 38 TAX NOTES 1517, 1526 (1988).

75 *See, e.g.*, NATIONAL CONFERENCE OF STATE LEGISLATURES & NATIONAL GOVERNORS' ASS'N, FINANCING STATE GOVERNMENT IN THE 1990s 10 (Ronald Snell ed., 1993).

76 Alan Schenk, *A Federal Move to a Consumption-Based Tax: Implications for State and Local Taxation and Insights From the Canadian Experience*, 3 ST. & LOC. TAX LAW. 89, 107 (1998).

77 For a discussion of the lessons the United States can learn from the Canadian harmonization effort, *see id.* at 111-17.

78 *See id.* at 113. The tax-inclusive pricing has been delayed until "provinces together having at least fifty-one percent of the total population" of certain provinces have tax-inclusive pricing. Excise Tax Act, R.S.C., ch. 10, § 242(1) (1997) (Can.) (adding Division XI).

pliance burden may be increased if a business makes sales both at retail and pre-retail stages.

The Gibbons VAT will have some, but not all, of the same effects. There will not be the sticker shock at the check-out counter, because only the state sales tax, not the VAT, will be added there. The sales-subtraction VAT is a period tax, not a transactional tax, and therefore is not calculated and added to the price of each taxable sale at the cash register. The Gibbons VAT still represents a second sales tax with a tax base different than state RSTs. The Gibbons VAT, like the Graetz proposal, may pressure state and local governments to remove individual income tax from taxpayers deleted from the federal income tax rolls because they have adjusted gross income of not more than $75,000.

Japan relies on a VAT, called a Consumption Tax (CT), which is a European-style credit method VAT, except that it does not rely on tax invoices. A detailed examination of the CT is beyond the scope of this article, but it deserves serious exploration as a possible better alternative to handle the federal-state issues, without some of the disadvantages of the sales-subtraction VAT.[79] In structure, the CT resembles the European VAT, with input tax credited against tax on taxable sales, rather than the sales-subtraction VAT, which allows deductions from taxable sales to obtain the tax base subject to tax. Congress, therefore, might not be tempted to grant tax exemptions or deductions with a Japanese-style CT like those that have riddled the income taxes. A central feature of the European VAT is its reliance on "tax invoices" issued by registered traders who must separately state the VAT charged on the sale. Input credits are available only for the VAT listed on the tax invoices. The tax invoice, however, is not central or even required under the Japanese CT, since input credits can be calculated from the tax-inclusive costs of taxable purchases recorded in purchase records. It is, therefore, more compatible with state RSTs than the European VAT.

## VI. A Consumption Tax for the 21st Century

The following is a brief summary of selected issues that will affect any effort to replace various existing federal taxes with a VAT. Most need further study.

### A. Trigger for Radical Tax Reform

Experience with tax legislative changes since 1913 indicates that, in the absence of shocks to the economy like a major war or a depression, Congress tends to change the tax system incre-

79 For a discussion of the Japanese CT, see Alan Schenk, *Japanese Consumption Tax After Six Years: A Unique VAT Matures*, 69 Tax Notes 899 (1995).

mentally. It is not clear that public discontent with the individual income tax is sufficient to provide the broad-based support needed for radical reform. Indeed, Congress may not take the lead on controversial radical tax reform without support from a popular President.

B. Pressure to Simplify the Income Tax

The claim that a move to a VAT is a move to simplify the federal tax system is an exaggeration, especially if the tax is broadly based and covers such items as real property, financial intermediation services, and services rendered by government agencies and nonprofit organizations. Any "simplification" resulting from the Graetz or Gibbons proposals really represents a shift in the tax compliance burden. The 100 million individuals who will be removed from the individual income tax rolls may have little or no contact with the Internal Revenue Service, unless they have to file for the tax rebates under the Gibbons plan, but without corresponding reform at the state and local levels, individuals still must maintain records and calculate income tax liabilities for subnational income taxes. On the other hand, the new VAT will subject almost all businesses, large and small, to reporting, collection and payment obligations under the VAT. These compliance costs (as a percentage of sales) are much higher for small businesses.[80]

C. Remove Tax From Returns to Savings

The proposals to move from the individual income tax to a VAT represent a major shift in tax policy. Since the inception of the income taxes, the tax base has included returns on investments, whether in the form of interest on loans, dividends on stock, or gains from the sale of investment assets. These returns on savings are not included in the VAT base.

Pressure to reduce tax on returns to savings is designed to encourage investment in new or expanding businesses. A shift to consumption-based taxation tends to encourage savings over consumption, a goal that has attracted support inside the Beltway, on Wall Street and in the boardrooms. It is not clear, however, if a proposal to reduce taxes on interest, dividends, and capital gains to zero will receive the broad-based support of American taxpayers on Main Street that may be needed to enact such dramatic changes in our federal tax system.

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

D. Pressure to Increase Social Security Benefits May Change

The current system, which nominally links Social Security benefits to payroll tax revenue, imposes half of the FICA tax on employers and half on employees. This scheme provides a workable balance between the interests of workers to increase retirement benefits and the interests of employers to restrain the rate on their share of the tax. This balance between competing constituencies would no longer exist if, as Gibbons proposes, Congress replaces the FICA tax with a VAT.

E. Transition and Reaction to a Consumption-Based Tax

The taxation of existing capital and the tax burden on various age groups raise significant transitional issues if Congress replaces taxes levied on an income base with a tax on consumption, especially if this change occurs without a lengthy phase-in period. Many of these issues have been explored elsewhere and will not be discussed in any detail here.[81]

Public reaction to radical tax reform may depend upon the taxes that are repealed and upon the transitional adjustments, if any, provided. The implications will be severe if Congress follows the Gibbons proposal, which repeals the corporate and part of the individual income tax, and the Social Security and Medicare taxes, rather than the Graetz plan, which retains the payroll taxes, keeps the corporate tax but with some possible rate change, and keeps the individual income tax structure intact for the high income taxpayers who are to be subject to the new flat income tax rate. For example, businesses with capital goods that are not fully depreciated when the VAT becomes effective will feel disadvantaged if the VAT replaces the income tax on business and they cannot recoup the remaining cost of the capital goods for tax purposes. The "Baby Boom" generation may object to the introduction of a VAT, especially if it replaces payroll taxes, because they financed their parents' Social Security and Medicare benefits with their payroll tax payments during their working years, and they will be required to finance their own Social Security checks with the VAT that they pay as they use their savings and retirement benefits on consumption during their retirement years.

F. Progressivity of the Federal Tax System

Dr. Carl Shoup's message to post-war Japan resonates today. To paraphrase him, ultimately a tax system, to have public support, must represent the shared values of the taxpaying public as

81 *See, e.g.*, Avishai Shachar, *From Income to Consumption Tax: Criteria for Rules of Transition*, 97 HARV. L. REV. 1581 (1984) (discussing a transition from an individual income tax to a cash-flow, consumption-based income tax).

to what is fair.[82] In the United States, the concept of vertical equity (taxpayers with unequal incomes should pay unequal taxes) has been reflected in our support for progressive taxes. The individual income tax provides much of the progressivity in the federal system.

Over the past 60 years, while the individual income tax represented a significant source of federal revenue, the degree of progressivity in the tax rates fluctuated significantly. In 1939, the top combined normal tax and surtax rate was 79%.[83] The top rate peaked at 91% until the Kennedy tax cuts in the early 1960s reduced it to 70%.[84] The top rate was cut back further in stages, until it bottomed out at 28% with the 1986 reforms, and then rose again during the 1990s to 39.6%.[85] This fluctuation suggests that our view about the appropriate degree of progressivity has changed during this period.

If Congress decides to maintain a progressive tax system, a direct and individualized tax like the existing individual income tax or a cash-flow income tax imposed on a consumption base can accomplish that goal more efficiently than an indirect tax like a VAT. If a VAT is chosen to replace most or all of the individual income tax, progressivity, if desired, should be achieved outside the VAT system through devices such as the Gibbons-proposed tax rebate to lower-income households or with adjustments in government transfer payments to low-income families.

### G. Relation Between Taxes and Trade

In an earlier era of fixed currency exchange rates, changes in domestic taxes that have an impact on product prices could alter a nation's competitive position in international markets, and thereby affect its balance of trade. Then and now, many of our trading partners rely on border adjustable indirect taxes—turnover taxes and later, VATs. These BTAs, imposing a VAT on im-

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82 According to Shoup, a nation's "tax system must satisfy the deep, widespread feelings of the people as to what is fair." 1 SHOUP MISSION, GEN. HEADQUARTERS, SUP. COMMANDER ALLIED POWERS, REPORT ON JAPANESE TAXATION 17 (1949) (four-volume report). Indeed, "no one remains in the tax field for long without realizing that nothing he recommends will stand up unless it meets the test of fairness in the distribution of the tax burden." *Id.* at 16.

83 *See* Internal Revenue Code of 1939, Pub. L. No. 76-1 § 10, 53 Stat. 1, 5-6 (1939) (Codified as I.R.C. §§ 11-12).

84 *See* Revenue Act of 1964, Pub. L. No. 88-272 § 111, 78 Stat. 19, 19-23 (1964) (reducing the top rate to 77% for taxable years beginning on or after Jan. 1, 1964, and reducing the top rate further to 70% for taxable years beginning after Dec. 31, 1964).

85 *See* Tax Reform Act of 1986, Pub. L. No. 99-514 § 101(a), 100 Stat. 2085, 2096-99 (1986) (reducing the top rate to 28% for tax years beginning after Dec. 31, 1986); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 §§ 13201-13202, 107 Stat. 312, 457-61 (1993) (increasing the top rate to 39.6% for tax years beginning after Dec. 31, 1992).

ports and rebating it on exports, are consistent with member nations' obligations under GATT (now WTO) rules.

The impact of BTAs in the current international economic climate of floating exchange rates is less clear.[86] First, the U.S. dollar serves as more than just our national currency. Businesses around the world hold U.S. dollars as reserve assets. Second, the new currency adopted by several members of the European Union, the Euro, is expected to join the U.S. dollar as a reserve asset. The impact of the Euro on the dollar's function in international currency markets is not yet clear.

If a congressional replacement of income taxes with a VAT produced a significant improvement in our balance of trade that was not corrected by a change in the value of the U.S. dollar, it is likely that our trading partners would take action to offset the effect of this U.S. tax shift. No country has used VAT revenue to replace all income tax revenue. The potential impact on the domestic economy and on international trade is subject to speculation only. This major tax shift may prompt copycat legislation or retaliatory action by our major trading partners. Whatever the asserted trade benefits of shifting from income to consumption taxes, Congress should not make radical changes in the domestic tax structure just to obtain possible short-term balance of trade advantages.

## VII. Conclusion

If Congress decides to increase reliance on consumption as the base upon which federal taxes are levied, its options include a flat tax, a national sales tax, and a VAT, all of which have been proposed in the last decade of this century. If Congress rules out the origin-based flat tax with its uncertain effects on domestic prices and international competition, and rejects the national sales tax to be administered by the states as a system that may be administered unevenly across the country, it is left with several varieties of VAT. This article focused on the European VAT proposed by Professor Graetz and the sales-subtraction VAT proposed by Congressman Gibbons. The Graetz and Gibbons proposals are designed to take about 100 million taxpayers off the federal income tax rolls, but presumably would retain the current complex individual income tax system for millions of high income taxpayers. The removal of these 100 million taxpayers from the federal income tax rolls could make it more difficult for states to continue taxing those taxpayers under state income tax laws.

Were it not for the operation of a federal VAT alongside state and local sales taxes, the Graetz European VAT proposal would be

86 *But see supra* note 48.

preferable. It would maintain the tradition in the United States of transparent sales taxes, which are separately stated on sales invoices. The Canadian experience with this system, however, makes a VAT buried in product prices, like the Gibbons sales-subtraction VAT, a more acceptable option to operate alongside state retail sales taxes. Negative aspects of the Gibbons VAT include the fact that it is not transparent and it appears, in statutory form, more like a tax on business income. BTAs may be imprecise because the tax is buried in product prices, and if Congress views the VAT as a tax on business, it may distort the tax with exemptions and deductions improper for a broad-based tax on consumption. It is possible to bury a European VAT in retail prices to prevent the sticker shock from two sales taxes being added at the cash register. However, the difference between a period tax (the sales-subtraction VAT) and a transaction tax (the European VAT) still remains.

Radical tax reform should be gradual, occurring in small steps rather than in a "big bang." The core of the Gibbons and Graetz proposals is the enactment of a VAT to fund the removal of 100 million taxpayers from the federal income tax rolls (although for many of those taxpayers, the current income tax system is not unduly complex). Each proposed VAT is collected and remitted by businesses and is expected to be borne by consumers when they purchase taxable goods and services. These proposals represent a shift in tax compliance burden from individuals subject to the income tax to businesses responsible for the VAT record keeping and reporting requirements. The compliance costs imposed on businesses will escalate further for retailers in states with RSTs imposed on different bases if Congress selects a European VAT that is added at the cash register.

Progressivity is retained in both plans with the income tax on high income taxpayers and, under the Gibbons plan, tax rebates to those with low income. There will be winners and losers in the battle over the allocation of the federal tax burden, both among income and age groups.

If Congress embraces the goal to use a VAT to take 100 million taxpayers off the income tax rolls, it should consider the Japanese style VAT as an alternative to both the Gibbons and Graetz VATs, especially at the outset. While it is not an ideal VAT, it contains features that simplify compliance for businesses and make it fit more comfortably alongside state RSTs. Moreover, it is less likely than the Gibbons VAT to be viewed by Congress as a tax on business income susceptible to lobbying pleas for tax exemptions or special deductions.

Radical proposals, such as the complete replacement of federal income taxes, should not be dismissed just because they have

not been tried elsewhere. However, it is not clear that there is public support for the kind of radical tax reform contemplated by the proposals discussed in this article, especially the tax exemption for interest, dividends, and other returns to savings implicit in a tax imposed on a consumption base. Ultimately, any tax reform plan must represent the shared values of the taxpaying public as to what is fair.