Prior U.S. Flirtations With VAT

By Alan Schenk

VAT is the fastest-spreading tax system in history. In the United States, however, VAT has become the most studied tax system that has never been seriously considered by Congress.¹ I became involved with VAT in 1968 when a Treasury official told me the hottest political issue for the next five years might be the VAT. Since then the VAT has been the subject of studies by presidential panels, government agencies and commissions, and the Joint Committee on Taxation. It has also been the focus of numerous reports by nongovernmental organizations.²

The tax literature over the past 40 years includes many proposals for tax reform that would shift our federal tax system from one heavily dependent on income taxes to one more reliant on consumption taxes. None of them has come to fruition. If that makes it appear that there’s little likelihood that the United States will ever seriously debate a VAT, consider that it took Japan about 40 years from when the government first enacted a preliminary version of the tax in 1950 (which was repealed in 1954) until a modern VAT became effective in 1989.

A broad-based tax on consumption is usually proposed for one of three reasons: to finance fundamental tax reform (that is, to use VAT revenue to reduce or repeal existing federal taxes), to raise additional revenue to reduce the federal budget deficit, or to finance specific entitlement programs (such as national healthcare). Most discussions about VAT in America have been linked


to the first of these propositions: fundamental tax reform. Past proposals for a broad-based consumption tax usually took one of the following forms:

- The credit invoice VAT or sales subtraction VAT;
- The retail sales tax (RST);
- The consumed-income tax; or
- The flat tax.

Differences between the two types of VAT are explained briefly in this essay and covered in more depth elsewhere in this publication. The RST resembles the various sales taxes imposed by 45 of the 50 U.S. states and the District of Columbia. The consumed-income tax, unlike the first two models, is an individualized tax. Each individual taxpaying unit is taxed on its annual income less contributions to personal savings. This can be conceptualized as a tax on consumption (income = consumption plus savings). The flat tax is typically patterned after a model devised by Robert Hall and Alvin Rabushka. Each of these models is discussed below.

**Congressional Hearings and Administration Panels**

There have been congressional proposals for a national sales tax to finance our country’s wars. They include a proposal in 1862 to finance the Civil War and a proposal in 1942 to finance World War II. The Treasury Department opposed the 1942 sales tax proposal. Neither proposal was enacted.

Soon after President Nixon took office in 1969, it was widely reported that his administration was considering a federal VAT with the revenue to be shared with state and local governments to reduce their reliance on property taxes and to fund education spending. Reportedly the plan was delayed in part because American tax professionals (lawyers and accountants) were unfamiliar with the VAT. In 1969 Nixon established a task force on business taxation to look at business tax policy. Most of the task force concluded that a VAT shouldn’t be adopted as a substitute, in whole or in part, for the existing federal tax structure. Two dissenters on the task force recommended that a VAT be introduced. However, they differed on whether it should be a partial or total substitute for the corporate income tax.
In 1971 the American Bar Association established a special subcommittee to study VAT so that the Section of Taxation could respond to a proposal for a federal VAT and assist Treasury and Congress in formulating a VAT design. The American Institute of Certified Public Accountants established a comparable committee on VAT.

While there were congressional hearings on Nixon’s New Economic Policy, which included tax benefits for exporters, there was no action on a VAT. In 1972 Nixon asked the Advisory Commission on Intergovernmental Relations to consider the replacement of residential school property taxes with a federal VAT. The advisory commission concluded that a “massive new Federal program designed specifically to bring about property tax relief is neither necessary nor desirable.”

In January 1977, only days before the changeover from President Ford to President Carter, Treasury Secretary William E. Simon issued “Blueprints for Basic Tax Reform.” This document discussed the possible use of a cash flow, consumption-based tax to replace taxes on income of households, individuals, trusts, and corporations. This kind of tax on consumption, while proposed again by members of Congress, did not receive committee action.

In 1984, in preparation for the overhaul of the income tax that would follow two years later, Treasury presented a three-volume report to President Reagan entitled “Tax Reform for Fairness, Simplicity, and Economic Growth.” The third volume of the report covered VAT. Treasury did not recommend what it assumed would be a European-style credit invoice VAT, in part because of the anticipated costs of administering the new tax, and because VAT revenue would only reduce, not repeal, the existing income tax.

In 1995 House Ways and Means Committee Chair Bill Archer held hearings on replacing the federal income tax with a broad-based consumption tax. Archer said, “I am committed to tearing the income tax out by its roots. If we don’t tear it out by the roots,

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I am afraid it will grow back just as tangled as it is now." In 1996 the congressional Kemp Commission took a similar position by recommending that the tax code be eliminated and replaced with one that was "simpler and fairer."

The President’s Advisory Panel on Tax Reform, formed in 2005 during the administration of President George W. Bush, was asked to "make the tax code simpler, fairer, and more conducive to economic growth." The panel considered a credit invoice VAT and a partial replacement VAT coupled with significant reductions in individual and corporate income tax rates, but after failing to obtain unanimous support from panel members, chose not to recommend this tax. It did, however, suggest further study of it.

The panel instead recommended the growth and investment tax (GIT) plan that did not include a federal VAT or sales tax. If the GIT were adopted, it would move the federal tax system closer to a consumption base. The GIT includes a progressive tax on labor income and a single rate cash flow tax on business activity. Under the cash flow tax, a business reports sales and deducts both purchases from other businesses and compensation paid to workers. Capital purchases and inventory are expensed. The resulting simplification occurs because a business does not account for inventory and depreciation.

For years there has been a debate over whether the U.S. income tax system should be converted from its current worldwide basis to a territorial basis. The current system taxes a U.S. company on its worldwide income using a foreign tax credit to relieve double taxation of foreign-source earnings. The GIT featured a destination-based territorial approach. If the GIT were border adjustable, it would not tax exports and deny deductions for imports. The panel acknowledged that it was uncertain whether

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4 "Replacing the Federal Income Tax," Serial 104-28, hearings before the House Ways and Means Committee 104th Cong, 1st Sess. 2 (June 6-8, 1995).
5 The President’s Advisory Panel on Federal Tax Reform, “Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System,” Nov. 2005. The president limited considerations to income taxes, and plans had to be revenue neutral.
6 The VAT included a $100,000 small-business exemption that was estimated to reduce the number of registered businesses to about 9 million. Id. at 199.
the GIT would be border adjustable. The GIT is difficult to classify as a VAT, even though it contains some features of different forms of taxes on consumption: a sales-subtraction VAT, the USA tax, and a flat tax.

As President Obama and Congress were debating the terms of and funding for a national healthcare plan, the Senate Finance Committee held a roundtable on financing healthcare reform. A witness at that hearing, Leonard Burman, recommended a VAT to pay for the plan. He estimated that a phased-in 10 percent VAT could fund healthcare for everyone not currently covered by government-provided health insurance. Burman added that the VAT, combined with a refundable tax credit for lower-income households, would be progressive.

Obama recently established a task force chaired by the head of his Economic Recovery Advisory Board, Paul Volcker, to examine ways to close the federal deficit. The task force was asked to report by December 2010 on reform options relating to simplification and enforcement of the federal tax system and reform of the corporate income tax (that is, reducing “corporate welfare”) without violating the president’s pledge not to raise taxes on families making less than $250,000.

Forms of Consumption Taxation

Starting in the late 1970s, proposals began being offered for a VAT, RST, and flat tax. There have also been proposals for an unlimited savings allowance (USA) tax and a two-part VAT that would separate wages from the other economic components of the tax base to introduce progressivity into the system. There have also been proposals to finance a national healthcare program (such as the bill introduced by Rep. John D. Dingell, D-Mich.) or to both finance national healthcare and pay down the

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7The panel recommended a five-year transition to a GIT because of the necessary movement to the expensing of capital goods and inventory, the movement to a territorial system from a global system, and other factors. Id. at 172-175.
9See, for example, H.R. 15, National Health Insurance Act, 109th Cong., 1st Sess (Jan. 4, 2005).
national debt\textsuperscript{10} (such as the bill introduced by Sen. Ernest Hollings). Some RST proposals have been linked with shutting down the IRS and requiring the state governments to administer the tax.

**Credit Invoice VAT**

The VAT in use in Europe and most of the world is a credit invoice VAT that uses a tax-against-tax (output tax less input tax credits) method for business to calculate its periodic tax liability. The tax authority relies on invoices for audit purposes. The invoices are used to verify the sales reportable by VAT-registered sellers and to verify the claimed input credits by registered purchases.

The VAT can be considered two taxes: a tax on imports collected mainly at the border by customs officials and a tax on domestic supplies administered by the tax administration. The tax on imports of goods, paid at the border, is recovered by a VAT-registered business as an input tax credit. The tax typically is separately stated on sales invoices, although it is buried in retail prices in many countries.

The following example assumes that a 10 percent VAT is imposed on tax-exclusive prices. Taxable sales are $100,000, taxable purchases are $30,000, and taxable imports are $7,000.

<table>
<thead>
<tr>
<th>Output Tax</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax on taxable sales:</td>
<td>$100,000 x 10 percent = $10,000</td>
</tr>
<tr>
<td>Input Tax Credits</td>
<td></td>
</tr>
<tr>
<td>Tax on domestic purchases:</td>
<td>$30,000 x 10 percent = ($3,000)</td>
</tr>
<tr>
<td>Tax on imports:</td>
<td>$7,000 x 10 percent = ($700)</td>
</tr>
<tr>
<td>Net tax liability for the period:</td>
<td>$6,300</td>
</tr>
</tbody>
</table>

In 1979 and again in 1980, House Ways and Means Committee Chair Al Ullman proposed a European-style invoice VAT to

finance an overhaul of the federal tax system, including significant reductions in federal income and payroll taxes. He was from Oregon, one of only five states that has no RST. In 1980 Ullman was up for reelection in what was assumed to be a safe seat, and he lost.

The political lore is that Ullman lost his seat because of his VAT proposal. Since then, presidential administrations and many members of Congress have been reluctant to propose a VAT. But there were other reasons why Ullman lost the race. His only residence in Oregon was a hotel room, a fact exploited by his opponent. Also, because of a war injury, Ullman was unable to campaign as actively as was necessary.

The Ullman VAT and several other VAT proposals over the past 30 years were based on the credit invoice method. They included the VATs proposed by Dingell and Hollings. Prof. Michael Graetz’s Competitive Tax Plan\(^{11}\) includes a credit invoice VAT, with a standard rate ranging between 10 and 14 percent, to fund substantial reductions in the corporate tax and replace the individual income tax on household income below a target of $100,000 per year. Under Graetz’s plan, the existing earned income tax credits and refundable child credits would be replaced by payroll adjustments or a “smart card” designed to provide immediate VAT relief (rather than current year-end relief) to low- and moderate-income workers.\(^{12}\) A small-business exemption would remove about two-thirds of all businesses from the VAT rolls. To provide transparency, the VAT would be separately stated on sales invoices. (See also p. 112 for additional comments from Prof. Graetz.)

A separately stated credit invoice VAT may be more challenging for the tax authorities to administer — and for businesses to comply with — alongside state and local retail sales taxes, although Canada seems to have done it successfully with its goods and services tax.

\(^{11}\)M. Graetz, 100 Million Unnecessary Returns (2008).
\(^{12}\)Id. at 203.
Subtraction Method VAT

The subtraction method VAT is calculated in a different, nontransactional manner. That tax is expected to be buried in prices, and data to prepare VAT returns will be taken from the VAT-registered business’s accounting records. Ideally, the tax base is the difference between taxable sales and taxable purchases. The resulting base then is multiplied by the tax rate to arrive at the tax liability for the tax period. Using the above example, but using tax-inclusive amounts and a 9.0909 percent rate, the tax for the period is the same $6,300, calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable sales</td>
<td>$110,000</td>
</tr>
<tr>
<td>Taxable purchases</td>
<td>($33,000)</td>
</tr>
<tr>
<td>Taxable imports</td>
<td>($7,700)</td>
</tr>
<tr>
<td>Tax base</td>
<td>$69,300</td>
</tr>
<tr>
<td>VAT liability at 9.0909 percent</td>
<td>$6,300</td>
</tr>
</tbody>
</table>

There are some inherent differences between the credit invoice and subtraction methods. With a subtraction VAT that is buried in prices, it is difficult for Congress to impose multiple rates. A single rate VAT simplifies the tax considerably. The final consumer does not see the tax paid on purchases. It may be easier to operate this kind of VAT alongside state and local RSTs. A disadvantage of the subtraction method is that the precise amount of tax, if not separately stated on invoices, cannot be calculated for purposes of border tax adjustments.

Several bills proposing a subtraction method VAT have been introduced in Congress over the years. Rep. Sam Gibbons proposed such a tax — at a rate of 20 percent — to replace about 90 percent of federal taxes then on the books. Under his proposal, which was based on 1996 estimates, individual income tax would have been imposed only on incomes above approximately $75,000, and low-income households (below $30,000) would have received tax rebates to offset the VAT paid on purchases.

In form, a subtraction method VAT resembles a corporate income tax; sales are reported, and deductions for certain purchases are allowed. With this method of calculating the tax base, which resembles an income tax calculation, Congress may be tempted to alter the tax base with special deductions. If it does,
the resulting VAT could become as complex as the current income tax that many lawmakers would like to replace.

Economist Bill Helming has proposed a national consumption tax plan that would impose two separate consumption-based taxes (a subtraction method VAT and an RST) to replace federal duties and federal income, estate and gift, excise, and employment taxes. According to Helming, if the VAT and RST rates were each increased by less than 4 percent over rates otherwise needed to replace the repealed taxes, the two new federal taxes could replace all state and local taxes as well.13

Consumption-Based Income Tax

One of the most elaborate proposals to shift from an income-based federal tax system to a consumption-based system was the USA Tax Act of 1995, proposed by Sens. Sam Nunn and Pete Domenici.14 Rep. Phil English introduced a similar simplified USA tax in 2003. Both proposals would have replaced the individual and corporate income taxes. The English bill would have repealed the estate and gift taxes as well.

The plans would have achieved a consumption base for the individual income tax by granting unlimited deductions for new savings. They also would have given individuals a refundable income tax credit for payroll taxes paid. Progressivity would have been provided under the individual income tax component through a family allowance that takes account of family size. The business portion of the USA tax, which also would be imposed on imports, was a cash flow subtraction method VAT. Businesses would have received a credit against the VAT for payroll tax paid.

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14S. 722, USA Tax Act of 1995, 104th Cong., 1st Sess. (Apr. 25, 1995). This proposal was based on the USA tax system paper prepared for Alliance USA and was reprinted in a special supplement to Tax Notes, Mar. 10, 1995.
Flat Tax

The flat tax was promoted by Hall and Rabushka in their 1995 book of the same name and was later proposed by members of Congress and candidates for the Republican presidential nomination.

The flat tax is not a VAT, but has VAT-like attributes. It splits a subtraction method VAT into two parts. The business portion is a cash flow tax that taxes receipts from sales of goods and services (and interest income) and deducts payments to suppliers. Unlike other subtraction method VATs, the flat tax permits businesses to reduce their tax base by wages, salaries, and pensions paid to employees. Like under other VAT regimes, businesses would expense capital costs and inventory purchases.

Under the individual tax portion of the flat tax, households report their wages, salary, and pension income received, subject to a family allowance designed to introduce some progressivity into the flat tax. Each portion of the tax may be imposed at a single tax rate. The flat tax should not be confused — as it often is — with a single rate tax imposed on an income tax base, like the existing U.S. individual or corporate income tax.

Sens. Richard C. Shelby, R-Ala., and Arlen Specter, D-Pa., have proposed flat rate taxes imposed on a consumption base. Shelby’s flat tax would replace the income taxes and the estate and gift taxes. His two-part tax includes a flat rate individual tax on wages but not Social Security receipts. Taxpayers subject to the individual tax would obtain deductions based on their status (such as single or married) and the number of their dependents. Also, a separate cash flow tax would be imposed on business activity. The Specter proposal was similar.

In 2003 Rep. Nick Smith introduced his Tax Simplification Act, which would have replaced the Internal Revenue Code with a flat tax. Under the business portion of the tax, if a business’s deductions exceed taxable receipts from business activities, the business must carry over the excess, converted to a tax credit

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16Id. at 55-56.
equivalent, and it is entitled to interest on the amount carried over. The business would not be entitled to a tax refund.

Rep. Phil Crane proposed a flat rate individual income tax imposed on direct or indirect compensation for services (employee compensation and self-employment income) above a threshold exemption. Crane’s tax would have replaced the corporate and individual income tax and the estate and gift taxes. Steve Forbes, a Republican presidential contender in 1996 and 2000, proposed a flat tax with businesses and individuals taxed at the same rate. Individuals would receive deductions for themselves and their dependents.

In 2005 Rep. Michael C. Burgess, R-Texas, introduced the Freedom Flat Tax Act, which would have allowed taxpayers to make an irrevocable election to use a Hall-Rabushka-type flat tax rather than the regular income tax system. Individuals could elect to be taxed under the flat tax rather than the progressive individual income tax. Under the flat tax option, individuals would be taxed only on U.S.-source cash wages, taxable retirement distributions received, and unemployment compensation. From those receipts, the taxpayer could take a standard deduction (based on filing status) and deductions for dependents. Persons engaged in business activity could elect to be taxed on business taxable income at a flat rate. The business tax is an origin principle tax that is imposed on U.S.-source gross active income — domestic and export sales. The business can deduct the cost of purchases, wages, and deductible retirement contributions for employees.

National RST

In 2003 Rep. John Linder, R-Ga., introduced his Fair Tax proposal, which is basically a national RST. He reintroduced the bill in 2005, and Sen. Saxby Chambliss, R-Ga., also proposed a national RST to be administered primarily at the state level. The 23 percent tax-inclusive RST (30 percent if tax exclusive) would replace the individual and corporate income taxes, the payroll and self-employment taxes, and the estate and gift taxes. Monthly sales tax rebates would be paid to low-income households. Their Fair Tax acts envision the abolition of the IRS. States could elect to collect the tax and would be paid a fee for it.
Rep. Billy Tauzin proposed a similar national RST to replace the income taxes, the estate and gift taxes, and some excise taxes, with a rebate to low-income households and a fee paid to businesses that are required to collect the tax. A qualifying state (administering state) could retain 1 percent of the tax it collected and remitted to the federal government. According to one report,\(^{17}\) Tauzin’s proposed 23 percent rate would result in a revenue loss of more than $7 trillion over the next decade. Assuming no tax avoidance or evasion, according to that report, a more realistic rate would have to be 31 percent (44 percent if tax exclusive). The cochairs of the President’s Advisory Panel on Federal Tax Reform questioned the viability of a national RST at any rate above 20 percent.

**Conclusion**

The studies and proposals can be expected to continue without serious congressional action until, as many have said, there is presidential leadership in supporting the adoption of a VAT. The rising deficit and national debt may ultimately put pressure on a president and Congress to seek more federal revenue. As many studies have suggested, if that day comes, the choice is between increasing existing taxes (most likely income taxes) or enacting a broad-based federal tax on consumption, like the VAT.  