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LESSONS FOR POLICY MAKERS FROM THE HISTORY OF CONSUMPTION TAXES

Abstract: A consumption-based tax system has attracted a variety of supporters, including proponents of tax simplification and policy makers in search of more or alternative revenue sources. Such a system could involve the use of a value-added tax (VAT) or a sales tax. Policy makers and legislators should consider the history of the background of the VAT. A cursory review of the development of sales taxes is presented as a background for the problems that might be encountered in adopting the VAT. This review of the historical development shows that there are numerous and complex issues requiring careful study.

INTRODUCTION

> When thousands of hard pressed taxpayers and others have reached the stage of desperation, when they are willing to try anything — any patent medicine or panacea — then they are in a mood which makes them easy victims not only of their own self deceptions but also of the alluring promises of others always anxious to find opportunities to shove their tax burdens off their own shoulders regardless of where they fall. In such times the majority of the people are not inclined to weigh alternatives carefully and may accept very questionable measures [Blakey, 1935, p. 70].

Legislators and policy makers are considering a number of alternative tax system proposals, including a flat-rate income

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tax, a national sales tax, a value-added tax (VAT), and other consumption-based systems. A consumption-based tax system has attracted a variety of supporters, including proponents of tax simplification and policy makers in search of more or alternative revenue sources [Anderson, 1994, p. 77]. Such a system could involve the use of a VAT or a sales tax. Blakey issued the above warning in 1935, alarmed over the rapid spread of sales taxes in the U.S. He would surely have cautioned us to study past experiences when considering alternatives.

Policy makers and legislators should consider the history of consumption taxes. The primary focus of this paper is on the background of the VAT. A cursory review of the development of sales taxes in the U.S. is presented as background for the problems that might be encountered in adopting a VAT. No other study could be found that examined the history and past experiences with VAT and sales taxes in the U.S. and other countries. This analysis is particularly important in light of the sweeping tax reforms that are being discussed in Congress. The question addressed in this paper is, what can be learned from the European and American experiences with consumption taxes? Specifically, what events trigger the passage of a consumption tax?

VAT DEFINED

Trebby [1990, p. 8] defined a VAT as "a tax on the value added by a firm during the production and distribution process to the goods and services that it purchases from other firms." Aaron [1981, p. 2] defined "value added" as "the difference between the value of a firm's sales and the value of the purchased material inputs used in producing goods sold." He continued by stating that value added is the sum of a firm's wages and salaries, interest payments, and before-tax profits.

A comparison of a VAT and a retail sales tax reveals that "the VAT is a multistage tax; the retail sales tax is a single-stage tax" [Price and Porcano, 1992, p. 45]. Table 1 provides a comparison of a VAT and a retail sales tax using hypothetical data relating to the production and sale of an oak basket.

Assume a tree farmer cuts down an oak tree (at no cost to the farmer). He sells enough of the wood to make one oak basket to a sawmill owner for $8.00. The sawmill owner cuts the wood into oak strips and sells them to a basket weaver for $12.00. The basket weaver weaves the strips into a basket and sells it to a craft-shop owner for $20.00. The craft-shop owner sells the oak basket to a customer for $30.00.

TABLE 1

Comparison of VAT and Retail Sales Tax

Stage	Product	Price	Value Added	5% VAT	5% Retail Sales Tax
1	log	$ 8.00	$ 8.00	$ .40	
2	strips	12.00	4.00	.20	
3	basket	20.00	8.00	.40	
4	basket	30.00	10.00	.50	$1.50
Total Tax				$1.50	$1.50

The total VAT paid is $1.50 or 5% of the sum of the values added at each stage. Note that the VAT generates the same amount of tax revenue as a retail sales tax of equal percentage. The major difference is that the VAT is assessed at the various intermediate stages of production whereas the retail sales tax is assessed only at the point of sale to the final consumer.

BACKGROUND OF THE PROBLEM

Many states face budget deficits and financial problems [Barney et al., 1992, p. 61]. Factors contributing to these crises include the obsolescence of state tax structures [Bucks, 1992, p. 557], the instability of tax revenues [Gold, 1991, p. 277], and the inability of state revenue growth to keep pace with the growth of the general economy [Kirchheimer, 1992, p. 79]. States are also facing the possibility that the federal government, in an attempt to reduce the federal budget deficit, will shift responsibility for many social services to state governments.

Policy makers are considering alternatives for fundamental state tax reform. A national task force composed of several state government organizations examined various reform options. The organizations represented on the task force include the National Governors' Association, the Multistate Tax Commission, the Federation of Tax Administrators, and the National Association of State Budget Officers. Task-force members view the VAT as a viable option for restructuring state tax systems [Hoerner, 1992, p. 698]. Bucks [1992, pp. 557, 560-561] suggested that the obsolete elements of state tax systems relate to economic activity flowing across state lines. He proposed a common system of taxation of interstate and international commerce — a National Enterprise Tax. One basis for this common system of taxation is the VAT.

Some states have conducted studies of their own tax structure and looked at the VAT as an option for tax reform. The KPMG Peat Marwick Policy Economics Group [1992, pp. 527-530], conducting a study of the New Hampshire state and local revenue structure, concluded that the VAT was an effective tax reform strategy for both the short-run and long-run problems of that state. According to the Texas Deputy Controller of Public Accounts, efforts to balance the state's budget over the next decade will possibly include a new tax source such as the VAT [Hubbard, 1992, p. 645]. The Florida Taxation and Budget Reform Commission commissioned a study in which the Price Waterhouse Business Tax Model simulated two options, one of which replaced the corporate income tax with a VAT.[1]

Advocates of tax reform and simplification are promoting new tax structures. They note that the present tax structure is too complex, is inefficient, imposes a heavy compliance burden, and does not encourage savings [Nellen, 1995, p. 44]. Four major reform proposals recently suggested are the VAT, a national retail sales tax, a flat tax, and the USA Tax Act of 1995. The VAT is supported by House Ways and Means Chairman Bill Archer of Texas as a means to encourage savings by taxing consumption. The national retail sales tax is proposed by Senator Richard Lugar of Indiana. Bills calling for a flat tax, generally a system with a single tax rate, have been introduced by Senator Arlen Specter of Pennsylvania and House Majority Leader Dick Armey of Texas. The USA Tax Act of 1995, introduced by Senators Sam Nunn of Georgia, Pete Domenici of New Mexico, and Bob Kerrey of Nebraska, replaces the current income tax with an individual income tax that allows a deduction for net new savings and adds the VAT as a business tax [Willens and Phillips, 1995, pp. 39-41]. While not supporting any of the current tax reform proposals, a recent report of the National Commission on Economic Growth and Tax Reform, chaired by Republican Jack Kemp, pointed out faults of the current tax structure and called for a single tax rate with many deductions [AICPA, 1996, p, 27]. In addition to these proposals for tax reform, the National Commission on Restructuring the Internal

[1] The other option made two additions to the existing corporate tax structure. It added a minimum tax based on the size of the business and also provided for subchapter S treatment for qualifying corporations [see Price Waterhouse, 1991, pp. 273-274].

Revenue Service (IRS) has published a study calling for significant changes in the way the IRS is structured and governed [AICPA, 1997a, p. 21].

State governments are looking for a tax structure that will enable their tax revenues to keep pace with economic growth. Most states have balanced-budget constraints that increase the importance of volatility of tax revenues as a consideration in restructuring state tax systems. Policy makers are considering the VAT as a viable option. A review of the literature reveals a thorough examination of many issues related to the VAT. One area of interest not widely addressed in the literature is the historical development of the VAT and the debate over a national sales tax.

VAT BACKGROUND

Popularity of the VAT: Tait [1988, p. 3] called the rise of the VAT an unparalleled fiscal phenomenon. In describing how the VAT has swept the world, he used the simile, "VAT may be thought of as the Mata Hari of the tax world — many are tempted, many succumb, some tremble on the brink, while others leave only to return, eventually the attraction appears irresistible." The VAT is no longer a tax associated only with European countries; it has spread to every continent [Tait, 1988, p. 3; Trebby, 1990, pp. 6-18]. Each year brings new adopters. Canada has implemented a Goods and Services Tax (GST) which is a VAT similar to that used in most European countries [Payne, 1991, pp. 25-26].

The VAT is truly an international phenomenon. The VAT is the standard form of sales tax throughout most of the world. Nineteen of the 23 countries comprising the Organization for Economic Coordination and Development (OECD) have adopted some type of VAT. Japan (in 1989) and Canada (in 1990) were the latest OECD countries to jump on the bandwagon. The VAT is also used in most Latin American countries, several southeast Asian countries, Korea, many African countries, the Caribbean, and New Zealand. It is a revenue generator for governments worldwide [Due, 1990, p. 383, 1991, p. 269; Price and Porcano, 1992, p. 45].

The attractiveness of the VAT has not gone unnoticed in the U.S. It has attracted considerable attention at the national level. Chambliss [1989, p. 24] wrote: "Next to nuclear disarmament, no topic has taken up more seminar time at Washington think tanks and policy boutiques than the VAT."

The VAT has also received much notice at the state level. State legislatures, facing severe budget deficits and financial problems, look to VAT as a potential new revenue source. Two states, Louisiana and Michigan, have adopted a form of VAT. Other states have considered adoption (Texas, Florida, and the Territory of Guam) [Reinstein et al., 1990, p. 589; Due, 1991, p. 272; Ebel, 1991, p. 305].

Judicial, Legislative, and Political Considerations: In Trinova Corporation v. Michigan Department of Treasury [1991], the U.S. Supreme Court ruled that the states have the authority to adopt a VAT and that such a tax does not interfere with interstate commerce. This decision held that a VAT imposed on a taxpayer doing business within and without the State of Michigan did not violate either the due process clause or the commerce clause of the U.S. Constitution [1991, p. 836]. In discussing the ramifications of this decision, Weindruch and Repp [1991, p. 22] concluded that "more states may be willing to adopt a form of a VAT in lieu of a corporate income tax as a means of generating a greater and more stable source of revenues."

The adoption of a national VAT is viewed as an intrusion into an area of taxation historically reserved for the states. The General Accounting Office (GAO) [1989, p. 45] reported that 45 states have a broad-based consumption tax that generates a significant portion of their total tax revenues. State government officials fear that the adoption of a national VAT would make it difficult to increase state sales tax revenues. They also fear that a federal VAT would increase the pressure on states to conform with the federal tax base. Brown [1991, p. 6] pointed out that state government officials oppose a federal VAT because it could inhibit or interfere with state use of this tax base in the future. Bucks [1992, p. 561] proposed that the states jointly establish a common system of taxation using the VAT to safeguard state powers by slowing or blocking federal entry into consumption-based taxes.

The VAT Compared to the Sales Tax: Pechman [1987, pp. 204, 206] compared the VAT to the retail sales tax. While pointing out that the two taxes are similar on both economic and equity grounds, he concluded that the retail sales tax presents fewer administrative problems because it involves fewer taxpayers and less complicated calculations to determine tax liability. Although the administrative costs of the VAT are much higher than those of the retail sales tax, any efficiency advantages of the retail sales tax may be offset by resulting inequities. The administrative burden of collecting, accounting for, and remitting the sales tax rests on a small segment of society — the retail sellers. While the VAT is similar to the retail sales tax, it is collected differently, applies more broadly, and may provide rebates to consumers not residing in the taxing district [Utz, 1993, pp. 142, 144].

From an economic theory viewpoint, the VAT is viewed as very similar to a retail sales tax. The VAT may be inferior to the retail sales tax on efficiency grounds because of its higher administrative and compliance costs, but political considerations may favor the VAT because it is less visible to the ultimate consumer [Break, 1985, p. 154; Holcombe, 1988, pp. 214, 216-217].

The primary differences between a sales tax and a VAT are the taxpayers (suppliers or demanders) and the timing of revenue flows to the government [Holcombe, 1988, p. 214]. There are different collection points for the respective tax liabilities. The retail sales tax is collected by the retail seller on a destination basis while the tax liability is based on the retail selling price. The VAT is levied at each stage of production and distribution. It is paid directly, rather than indirectly, by all firms involved in the production and distribution process and is collected on a source basis [Brown, 1991, p. 3]. These considerations suggest that the retail sales tax and the VAT could differ in terms of volatility because of differences in collection points and the timing of revenue flows to the government.

SALES TAX HISTORY

Origin of the Sales Tax: The origin of the sales tax is "shrouded in the dimness of ancient times and it or some variant has been present in certain forms in all or nearly all systems of public finance of which we have detailed knowledge" [Blakey, 1935, p. 64]. Many of the ancient types were more like selective sales taxes or excise taxes than general sales taxes. There has been much confusion over the distinction between sales and excise taxes [Blakey, 1935, pp. 63-64, fn. 3]. Sales taxes existed in ancient Egypt [Adams, 1982, p. 17]. The early Roman Republic assessed a sales tax on the sale of slaves at auction [Adams, 1982, p. 57]. Caesar Augustus used the sales tax as a supplement to an inheritance tax. In 40 A.D., Caligula abolished the sales tax altogether with a flourish of trumpets [Adams, 1982, pp. 76-77].

The revival of the use of general sales taxes "is generally dated from the adoption of the war and post war emergency general turnover taxes of Germany (July, 1918) and France (June, 1920) and the manufacturers' sales tax of Canada (May, 1920)" [Blakey, 1935, p. 64]. Similar taxes have been considered by Congress, but a general sales tax has never been adopted at the national level in the U.S. Thirty or more foreign countries adopted sales taxes in the 1930s [Blakey, 1935, p. 64]. Sales taxes were "confined almost wholly to foreign countries until 1930, one might almost say until 1933, but the cumulative pressures of the [Great Depression] forced the acceptance of such taxes by numerous American commonwealths" [Blakey, 1935, p. 63].

Implementation of State Sales Taxes: The sales tax became the major revenue source for states in the 1930s [Pechman, 1987, p. 259]. It continues to be one of the largest sources today as the general sales tax and the personal income tax each provide more than 30% of total state tax revenues [Gold, 1994, p. 703]. According to a recent report, general sales taxes generated $132.7 billion for the states in 1995, the individual income tax $126.3 billion, and all other taxes $142.5 billion [AICPA, 1997b, p. 23). In 1902, almost half of state revenue was derived from property taxes and the remainder from excise taxes [Pechman, 1987, p. 259]. "The rapid development of general sales taxes is one of the most striking of post war [World War I] phenomena" [Blakey, 1935, p. 63]. The revival of the sales tax was almost completely confined to foreign countries until the depression of the 1930s forced its adoption by a number of states. During this time, many were hailing the sales tax as the savior of our public finances [Blakey, 1935, p. 63]. Opposition to the sales tax was countered with the claim that it was an emergency measure and, hence, only temporary. However, critics of the time were skeptical given past experiences with taxes. One opponent noted that efforts were underway to make the sales tax permanent in states where it had been limited and to increase the rates in several states [Bloomfield, 1935, p. 593].

Blakey cited a number of reasons for the rapid spread of sales taxes but in general it was the inability to balance budgets [Blakey, 1935, p. 64]. He argued that there were better major sources of revenue than sales taxes for federal and state governments. However, if sales taxes were to be used, the Federal government could administer the system more uniformly and efficiently. Blakey [1935, p. 69] was amazed at how rapidly the sales tax movement was spreading to state and local governments. He asked these questions:

> Are we to believe that this tax is the panacea for our financial ills? Or if not panacea, is it the best available fiscal measure to pull us through the present emergency? Moreover, does it have features of permanent value for Federal, state or local purposes? In particular what have been the experiences of those governments which have adopted the sales tax?

These are the same questions policy makers and the public should be considering in the current debates.

Discussions about National Sales Tax: Just as state governments were looking to the sales tax as the remedy for balancing budgets, the Hoover administration and Treasury Secretary Ogden Mills proposed in 1932 a national sales tax, euphemistically called a manufacturers' excise tax. This proposal encountered

opposition from Congress because of the tax's regressive nature. Bipartisan opposition, as reflected in this 1933 cartoon, led to the defeat of the proposal [Kennon and Rogers, 1989, p. 265].

Again in 1942, Treasury Secretary Morgenthau proposed a sales tax to the Senate Finance Committee, but it was flatly rejected. Several groups testified before the House Ways and Means Committee in support of a national sales tax, including the U.S. Chamber of Commerce. The Committee was flooded with postcards from consumers in opposition. Although some Republicans favored the sales tax, it was not included in the Committee bill [Kennon and Rogers, 1989, pp. 301-302]. A national sales tax was thought to be a way to meet the high costs of World War II as Uncle Sam points out to the Ways and Means chairman in the following cartoon [Kennon and Rogers, 1989, p. 299]. A 5% "Victory Tax" on income over $624 was apparently seen as more palatable.

Curiously, business and labor groups have not shown a consistent or uniform position toward sales taxes. Supporters hoped to shift tax burdens from property, incomes, inheritances, or business. Public employees saw the tax as a way to protect their jobs. Major opposition came from associations of retail merchants, who were sometimes joined by wholesalers and manufacturers, labor, and agricultural organizations. However, this opposition was often disjointed. Several agricultural groups testified against a national sales tax in 1932 but advocated state sales taxes in hopes of decreasing or eliminating real estate taxes [Blakey, 1935, p. 65].

Again in 1951, when Congress was desperately looking for revenues to counter an anticipated deficit and increased defense spending, the Ways and Means Committee rejected a proposal for a sales tax. Some form of sales tax had been advocated by business groups as an alternative to increased corporate taxes [Kennon and Rogers, 1989, pp. 310-311].

One of the four major tax reform proposals currently being considered is a national retail sales tax. Senator Lugar proposes a 17% national sales tax on the retail price of taxable goods and services [Willens and Phillips, 1995, p. 40].

A study by the AICPA pointed out that state governments using a retail sales tax exempt many types of goods and services. These exemptions include necessities, such as food, clothing, and housing; certain types of services, such as financial services and governmental services; and goods and services provided by charities. They increase administrative burdens, escalate compliance costs, and impede economic efficiency. Retail businesses must decide which items are exempt and then distinguish taxable from nontaxable sales. In addition, most states provide preferential treatment in the form of tax relief for certain sectors. This complexity results from political considerations. The AICPA study concluded that "there is nothing in the history of the Federal tax legislative process to suggest that a Federal consumption tax would be untainted by special interest provisions" [Sullivan, 1995, p. 13]

VAT HISTORY

Origin of the VAT: Concerning the origin of the VAT, Lindholm [1980, p. 24] wrote, "the roots of the value-added tax are embedded in U.S. economic theory and data." The U.S. has imported most of its taxes. For example, the income tax was imported from England, the inheritance tax from France, the sales tax from Spain and Holland, and the property tax from China and Europe. However, if adopted in the U.S., the VAT would not be an imported tax [Lindholm, 1984, pp. 119-120]. The idea goes back to the 1920s when gross national product (GNP) data was first gathered. U.S. economists proposed the VAT out of a desire for a neutral tax that would generate substantial revenues without seriously distorting the resource allocation function of the free market system. The VAT is conceptually a tax on GNP, the market value of all final products produced in the economy. When U.S. economists provided the statistics making it possible to calculate GNP and measure current production activity, the VAT became the next logical step [Lindholm, 1980, p. 25].

Crum [1982, pp. 25-42] agreed that the VAT did conceptually and theoretically originate in the U.S. He contended, however, that the VAT emerged much earlier than the 1920s and provided evidence to support his contention. He argued that the individual elements of the VAT are traceable to colonial times.

The most active research and discussion on the VAT occurred in the U.S. and, to a lesser degree, in Germany. T.S. Adams, the father of the 1913 income tax legislation, created the early climate favorable to the reception of the VAT. His writings provided strong support for the VAT as the best approach to the taxation of businesses [Lindholm, 1980; Crum, 1984, p. 5]. Adams described the VAT as the most appropriate tax on business activity and advocated its adoption in 1922 [Trebby, 1990, p. 7].

Adams was not alone in creating a favorable climate for the VAT. In 1934, Gerhard Colm, a leading U.S. government tax expert, published an article in *Social Research* explaining and recommending the VAT. He also cited the works of Paul Studensky, a U.S. tax researcher, as providing an ethical and philosophical foundation for the VAT. This favorable reception led to the introduction of Senate Bill 3560 on March 11, 1940 by Senator C. Joseph O'Mahoney of Wyoming. This legislative proposal, although unsuccessful, called for the enactment of a VAT by the federal government [Lindholm, 1984, p. 121].

History of VAT in Europe: Although the U.S. and Germany were most active in researching and discussing the VAT as a national tax, France was the first country to adopt and implement it [Lindholm, 1984, p. 121]. While Japan passed legislation in 1950 to establish a national VAT, the legislation was repealed before it became effective [Crum, 1984, p. 5]. France officially adopted the VAT on April 10, 1954 to allocate a part of the business sector's productivity to the public sector [Lindholm, 1980, p. 25]. However, the tax was not truly a VAT because it extended only through the wholesale level. Denmark adopted Europe's first true general VAT in July 1967 [McLure, 1972, p. 60].

The VAT then began to sweep throughout the continent. The rapid adoption of the VAT by European countries was an important factor in the economic integration process of Western Europe. This process began with the establishment of the European Economic Community (EC) following the Treaty of Rome in March 1957. The abolition of all customs duties and quotas in trade between EC members was an important step toward a common market. However, the most essential step was the development of a common system of taxes to replace the various taxes utilized by EC members. The various taxes were the source of distortion in competitive economic conditions among the member countries [Schiff, 1973, p. 5].

The Commission of the EC established the Fiscal and Financial Committee (FFC), chaired by Professor Fritz Neumark. The FFC, in the Neumark Report, recommended that all EC members replace their various taxes with a VAT that was identical in structure, rates, exemptions, and other details to every degree possible [Schiff, 1973, pp. 5-6].

All members of the EC agreed with the recommendation. January 1, 1970 was established as the target date for VAT adoption by all members of the EC [Crum, 1984, p. 5]. Table 2 reports the VAT adoption date by selected European countries. Some member countries adopted the tax before the target date. The final column in Table 2 is the 1996 standard VAT rate. Note that all countries have increased their rates, some substantially.

The provision in the Neumark Report calling for uniform tax rates was considered an infringement of national sovereignty, and the establishment of the tax rates was therefore left to the individual countries. This resulted in varying rate structures among them both at the point of adoption and subsequently [Schiff, 1973, pp. 6-7].

TABLE 2

VAT Rates and Dates of Adoption
Selected European Countries

Country	Date of VAT Adoption	Standard VAT Rate at Date of Adoption	1996 Standard VAT Rate
Denmark	July 1967	10.0%	25.0%
France	January 1968	13.6	20.6
Germany	January 1968	10.0	15.0
Netherlands	January 1969	12.0	17.5
Norway	January 1970	20.0	23.0
Sweden	January 1969	11.1	25.0
United Kingdom	April 1973	10.0	17.5

Sources: Tait, 1988, p. 40 and Ernst & Young
http://www.taxcast.com, 1996.

As to why the FFC in its Neumark Report recommended the VAT as the common tax system, Tait [1974, p. 6] concluded that "it evolved through successive attempts to reduce the inequities of the cascade turnover tax which was the sales tax commonly used by the countries now forming the EEC." A "cascade tax," like the VAT, is a consumption-based tax. It is levied when a sale is made, but it does not allow any deduction or credit for taxes previously paid. Its effect is cumulative and provides advantages to large integrated business enterprises [*Economist*, 1968, p. 58].

While many European countries did have substantial cascade taxes prior to the adoption of the VAT and while most of the significant problems and defects with the cascade taxes were in fact overcome with the new VAT, it is possible that the decision to adopt the VAT was not reached primarily on the basis that it would pose fewer problems than the unsatisfactory cascade tax. Another contention is that the decision to adopt the VAT in Europe was made because of the its universality and general uniformity, its ability to raise substantial amounts of revenue, and its efficiency in terms of dealing with exports and imports [Cohen, 1971, pp. 399-400].

As the VAT swept across Europe, it became a fashionable European tax and accounted for an important share of total tax revenues [Tait, 1988, p. 24]. Table 3 provides information on the VAT's contributions to total tax revenues for selected European countries from 1970 to 1990. In five of the seven selected countries, VAT revenues, as a percentage of total tax revenues, remained constant or increased over the period. In France and Norway, however, VAT revenues fell as a percentage of total tax revenues.

TABLE 3

VAT as Percentage of Total Tax Revenue 1970-1990 Selected European Countries

Country	1970	1975	1980	1985	1990
Denmark	18.8%	16.9%	22.2%	22.0%	20.7%
France	25.5	23.4	21.1	20.0	18.8
Germany	17.1	14.6	16.6	15.8	16.6
Netherlands	14.6	14.4	15.8	16.2	16.5
Norway	23.8	20.5	18.1	18.2	18.8
Sweden	10.3	12.0	13.4	13.9	14.9
United Kingdom	0.0	8.8	14.4	15.2	16.6

Source: Organization for Economic Co-operation and Development, 1996, p. 88.

Member countries of the OECD were increasing the reliance on direct taxes from 1965 to 1975 [Tait, 1988, p. 22] Direct taxes are assessed according to certain taxpayer characteristics. Taxes based on income levels (e.g., individual income, corporate income, and payroll taxes) are direct taxes. Indirect taxes are those taxes assessed according to the characteristics of transactions (e.g.; sales taxes, the VAT, and excise taxes) [Utz, 1993, p. 31].

There was dissatisfaction with this trend of increasing reliance on direct taxes. The VAT, an indirect tax, was proposed and adopted partially as a means of halting the increase in direct taxes. France and Norway were less successful in containing the growth in direct taxes [Tait, 1988, p. 22]. In France, for example, social security taxes on employees and employers, as a percentage of total tax revenues, increased from 34.2%. to 44.2%. Income taxes increased from 15.8% to 17.3%. In Norway, social security taxes on employees and employers, as a percentage of total tax revenues, increased from 11.9% in 1969 to 26.2% in 1990 [OECD, 1992, pp. 109, 135].

History of VAT in the U.S. at the Federal Level: Following the recommendation of the Neumark Commission concerning the adoption of the VAT by the EC, interest in the tax again surfaced in the U.S. The Research and Policy Committee of the Committee for Economic Development, a nonprofit organization of leaders in business and education, studied the VAT in 1966. The committee proposed that the VAT replace the corporate income tax, but the proposal was shelved following much debate over tax incidence. There was general agreement that the burden of the VAT would fall on consumers, but the theoretical and empirical uncertainty as to the incidence of the corporate income tax seriously hampered the debate [McLure, 1984, p. 185].

In 1970, President Nixon suggested that the VAT be adopted to replace local property taxes used primarily to finance public education. He appointed a task force on business taxation to study the VAT [McLure, 1984, p. 186]. The task force members rejected the immediate adoption of the VAT by a vote of 13 to 2. However, they also voted that future revenue needs be met by adopting VAT rather than by increasing corporate and personal income taxes [Lindholm, 1984, p. 121]. Again, there was debate about tax incidence, but in this case, the debate was over the incidence of the property tax. The proposal suffered in part due to the administration's diminishing interest in the VAT as the events of Watergate unfolded [McLure, 1984, pp. 185-186].

In 1973, the Advisory Commission on Intergovernmental Relations studied the VAT and concluded that its disadvantages outweighed its advantages. In 1975, the AICPA issued a report on a study concerning the VAT. The report cited the necessity for increased tax revenues but recommended less reliance on traditional income and payroll taxes. To raise the additional revenues, the report called for the adoption of a national sales tax in lieu of a VAT [Trebby, 1990, p. 7].

In 1979, Representative Al Ullman, former chairman of the House Ways and Means Committee, introduced House Resolution 5665 calling for the adoption of a VAT with a tax rate of 10% [Lindholm, 1984, p. 121]. Ullman supported the VAT as a means of reducing the federal deficit and as a way of eliminating the corporate income tax [Ullman, 1984, pp. 226-227]. Congressman Ullman's defeat in the 1980 congressional elections could be interpreted as an indication of the VAT's lack of popularity among the electorate [McLure, 1984, p. 186; Trebby, 1990, p. 7].

In 1988, Senator Hollings proposed a 5% VAT. The proposal provided that half of the VAT revenues would be used to reduce the national debt. Food, housing, and health care were to be excluded from the tax base [Chiu and Siegel, 1989, p. 3]. In September 1989, the GAO issued a briefing report on VAT policy issues to the U.S. Congressional Joint Committee on Taxation. The report pointed out arguments in favor of and against VAT but contained no recommendations [GAO, 1989].

Interest continues in the VAT at the federal level. The VAT was suggested as a method of financing the health care reform proposals of the Clinton Administration. Although the VAT idea was temporarily abandoned, it has resurfaced as reform measures are being discussed in Congress. House Ways and Means Committee Chairman Archer supports the VAT as a means of encouraging savings and investment [Willens and Phillips, 1995, p. 39]. A VAT could also generate significant revenues to reduce the budget deficit [Norton, 1993, p. 77]. A recent study issued by the AICPA reviewed a number of current proposals regarding flat taxes and consumption taxes, providing information about how each of the different approaches operates [Sullivan, 1995, pp. 1-10].

History of VAT in the U. S. at the State Level: There has also been considerable interest in the VAT at the state level. The Brookings Institution recommended the adoption of the VAT in Alabama in 1932 and in Iowa in 1933. Although neither state adopted it, interest continued at the state level [Lindholm, 1980]. Hawaii used a VAT-type business excise tax in the 1930s [Ebel, 1991, p. 305].

In 1953, Michigan became the first state to use the VAT when it adopted the business activities tax (BAT), a "subtraction" type VAT. The value of each business enterprise's contribution to the total output of economic goods and services was the conceptual base for the tax [Papke, 1960, pp. 350-351]. The BAT was levied on the business enterprise's adjusted gross receipts in excess of $12,500. The tax rate was 0.775%. For a "subtraction type" VAT, the base for taxation is calculated by subtracting the amounts paid to suppliers from gross receipts [Reinstein et al., 1990, pp. 589-590].

After seven years of experience, the BAT was deemed successful from an administrative viewpoint and as a revenue provider. However, the tax was viewed as unnecessarily limited in scope and somewhat inequitable due to its various exemption provisions. It was also argued that the $12,500 exemption did not provide adequate relief for small business and resulted in an unfair burden on that sector [Papke, 1960, p. 358].

The Michigan legislature repealed the BAT in 1967 and replaced it with a corporate income tax. The corporate income tax was replaced in 1975 with the single business tax (SBT), an "addition type" of VAT. The SBT was enacted to reduce fluctuations in tax revenues and to provide a more stable basis for taxation [Reinstein et al., 1990, pp. 589 591].

Officials believe that Michigan's VAT is achieving its intended purpose. David Kirvan of Michigan's Department of the Treasury reported that the VAT has been very successful in increasing revenue stability [Hanlon, 1993, p. 307]. Jay Wortley, senior economist with Michigan's Senate Fiscal Agency, agreed that the VAT was much more stable than the corporate income tax [Davenport, 1993, p. 310].

A legislative committee formed to conduct a comprehensive study of Michigan's VAT found that representatives of smaller businesses were opposed to it. The central complaint was that the VAT placed a heavy burden on labor-intensive businesses. This discouraged employment and disproportionally favored investments in capital. Other complaints centered around high compliance costs and complexity. Representatives from banking, automotive companies, and other larger businesses supported continuation of the VAT. They contended that the VAT is a stable source of revenue, adds stability to the tax structure, and is more equitable than the taxes it replaced [Nowak and Engerer, 1993, pp. 564-565]. The legislature, with support from business groups including large and smaller businesses, responded by lowering the rate to 2.3% and raising the filing threshold to $250,000 [Kleine and Cummings, 1994, p. 17].

In 1965, Louisiana incorporated a value-added tax element in its tax structure [Due, 1991, p. 272]. Manufacturers, wholesalers, jobbers, suppliers, and brokers of tangible personal property receive advance payments of sales tax on sales to retailers [Chiu and Siegel, 1989, p. 4]. The retailers then receive credit for the amount of the advance payment against the sales tax liability based on retail sales. Several states have adopted a value-added element in the tax structure for contractors [Due, 1991, p. 272].

Other states have seriously considered the VAT. The West Virginia legislature adopted the VAT in 1970, but the governor vetoed the enacting legislation [Lindholm, 1980]. The governor of Nevada proposed a modified VAT as a business activity tax as part of his budget for the 1991-1993 biennium, but the legislature voted it down [Brown, 1991, p. 1]. The Texas State Controller proposed a Texas Business Tax, similar to Michigan's SBT, which would repeal the state franchise tax and replace it with the VAT [Brown, 1991, p. 8]. The Constitutional Drafting Committee of the Florida Tax and Budget Reform Commission proposed a constitutional amendment to replace the corporate income tax and other taxes with a VAT [Townsend and Ferguson, 1992a, p. 461]. The governor of Florida prepared draft legislation to impose a VAT for tax years beginning after July 1, 1993 [Townsend and Ferguson, 1992b, p. 222], but the Florida legislature failed to enact the governor's proposal [Townsend and Greene, 1993, p. 890].

Lessons from European Experiences with the VAT: A Brookings Institution study indicated that European countries have successfully utilized different rates for different classes of goods and services and zero rating and exemptions to convert a tax that in its simplest form is regressive with respect to income into a tax that is slightly progressive [Aaron, 1981, pp. 7-9]. The study also indicated that the switch to the VAT was less costly for both business firms and tax agencies because most European countries had an existing sales tax and a collection structure already in place [Aaron, 1981, viii]. Since most states have an existing sales tax, the adoption of a national VAT could piggyback the states' collection efforts and reduce collection costs than otherwise would be the case. Bannock's [1990] study of the administrative cost in Europe pointed out that smaller businesses will bear a relatively heavier burden than larger ones.

Problem areas encountered by European countries in adopting a VAT included agricultural products, nonprofit organizations, sales of secondhand goods, and financial institutions. Most European countries have either exempted these problem areas or have provided lower rates [Aaron, 1981, pp. 9-12].

In looking at the question of increased public spending, the European experience was examined by a recent study presented at the 1996 North American Tax Policy Conference. This study indicated that the VAT did not become a money machine and that, while the overall tax burden increased somewhat from 1970-1990 for the European countries, the increase was due to increased corporate income taxes and not to the VAT [McGowan and Billings, 1996].

SUMMARY

State governments and the federal government are facing severe budget and fiscal problems. Policy makers examining alternatives for tax reform view the VAT as an attractive option for restructuring tax systems.

Although the VAT conceptually originated in the U.S. where it was first proposed as a national tax, France and Denmark were the first countries actually to adopt and implement the VAT.

A European commission recommended the adoption of the VAT by all EC members starting in 1970. Since that date, the VAT has spread across the European continent and is spreading all over the world. There are many lessons to be learned from the extensive European experience. Transition to a new tax system is difficult. Exemptions and multiple rates are necessary to combat regressivity, but they complicate administration and compliance. VAT rates in Europe have all increased, some substantially. As usual, once a new tax is enacted, the rates will be increased over time. The political costs of increasing a consumption tax, which can be passed on to others and is more hidden, are not very high.

Following the commission's recommendation of the VAT for EC members, interest in the VAT was rekindled in the U.S. It was recently mentioned as a revenue source to finance the health-care proposal of the Clinton Administration or as a way to reduce the deficit. Congressman Archer of Texas proposed the VAT as a means of encouraging savings by taxing consumption.

Past experiences suggest that the best chance to pass a VAT tax at the national level is to replace or reduce an existing tax or to meet a temporary emergency. The public will have to be persuaded by these arguments.

The federal income tax and the IRS are currently very unpopular in the U.S. Politicians are focusing on this unpopularity. Reported horror stories from irate taxpayers have generated considerable public debate and caught the politicians' attention. Restructuring of the IRS now has the support of the Clinton Administration. Several measures providing an IRS oversight board have been introduced in Congress. Perhaps the purpose of the IRS-bashing is to make it more politically expedient to replace an unpopular income tax with a more hidden consumption tax. Blakey's warning should be heeded.

The background provided in this study could provide insight into the problems that have occurred in the development of the VAT. Policy makers, having such knowledge when considering VAT as a possible revenue source, could make more informed decisions in comparing VAT with a sales tax. This review of the historical development shows that there are numerous and complex issues requiring careful study.

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