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1 Introduction

I. Scope of Book

The value added tax (VAT) has spread around the world more quickly than any other new tax in modern history.[1] This book covers value added tax and, in some parts, other consumption taxes in use or proposed in developing and developed countries.

Tax on consumption generally refers to a tax on final consumption, consisting mainly of goods and services acquired by individuals for their personal use or satisfaction. It generally does not include business inputs (goods and services used by business in the production or distribution of goods or in the rendition of services).

It is difficult for a business to operate internationally without considering the implications of sales tax or value added tax, whether or not the company's country of residence has a broad-based tax on consumption. For example, the United States does not have a sales tax or value added tax, except at the state and local levels of government. Nevertheless, a U.S. business operating in, shipping goods or transferring intellectual property or providing or receiving services to and from other countries must consider the VAT implications of exports to or imports from those countries.

This book explores value added and other consumption tax principles from a comparative perspective. We hope that this study may lead to suggestions for improving existing VAT systems and designing new ones. We discuss VAT in the Member States of the European Union (EU), and explain major departures from the EU model in non-European countries (especially in New Zealand, China, Japan, and South Africa).

[1] See Appendix, listing the countries with VATs and sales taxes.

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II. Development of Taxes on Consumption – A Brief Review of History

Most early forms of taxation were levies on land or on the produce from land.[2] The tax on land in early civilizations was payable in kind with the produce from the land.[3] The tithe in Egyptian kingdoms was imposed as a proportion of agricultural produce.[4] In the days of the city-states of Athens and Rome, while there were taxes in the form of rents from state-owned land (including taxes on natural resources extracted from these lands), the rulers supplemented revenue from land with indirect taxes.[5] Customs duties were imposed at the ports and taxes were extracted at the markets for goods that arrived by land.[6] In the third century AD, Diocletian imposed fees (or taxes) on the monopolies that he granted for the production and sales of goods.[7]

During the late thirteenth century, England imposed taxes on its wool exported by the Italian merchants who were granted the monopoly on this export. This "Ancient Custom," as it was known, later was expanded to cover all exports of goods from England.[8] In the late Middle Ages, in Italy and elsewhere, goods produced by artisans were taxed by taxing the guilds. The guilds raised the needed funds by taxing their members.[9]

The taxation of goods changed as firms were organized to produce goods and sell them through distributors to retailers. It became common, especially in Europe, to impose tax on business turnover (gross receipts). Thus, a cascading turnover tax was imposed every time goods were transferred in the process of production and distribution to the final consumer. The tax cascaded because the business purchaser, who could not reclaim the tax, increased the price of its output to cover the tax. Thus, "the tax component of the price of goods becomes larger and larger the more stages there are between producer and consumer – with obvious distortionary effects as between highly integrated enterprises and other enterprises."[10] For example, assume that a lumber mill sells lumber to a carpenter for a pretax price of $1,000. With a 1% turnover tax, the mill adds $10 tax and charges a tax-inclusive price of $1,010. The carpenter fashions the lumber into tables and sells the tables to a retailer. To its $5,010 pre-turnover-tax

[2] Land, as a representation of wealth, was a favorite subject of taxation because it was visible and the tax was collectible.

[3] C. Webber & A. Wildavsky, *A History of Taxation and Expenditure in the Western World* 44 (Simon & Schuster 1986). In the early civilizations of the Sumer city-states, tax payable in grain was transported to the ruler's storehouses. *Id.* at 43.

[4] *Id.* at 71.

[5] *Id.* at 107.

[6] *Id.*

[7] *Id.* at 112.

[8] *Id.* at 197.

[9] *Id.* at 149.

[10] See J. Owens, "The Move to VAT," 2 *Intertax* 45 (1996) [hereinafter Owens, The Move to VAT].

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TABLE 1.1. Turnover tax for nonintegrated and vertically integrated business

	Nonintegrated	*Vertically integrated*
Mill sale to carpenter	$10	
$1,000 × 1%		
Carpenter sale to retailer	50	
$5,010 × 1%		
Retailer sale to consumers	101	
$10,060 × 1%		
Carpenter sales directly to consumers		$100
$10,000 × 1%		
Total tax imposed and collected	$161	$100

price (including the $10 tax on the lumber), the carpenter adds $50 tax for a tax-inclusive price of $5,060 (the numbers are rounded to dollars). The retailer sells the tables to consumers for a pretax price of $10,060. The retailer adds $101 tax for a tax-inclusive price of $10,161. The government collects a total tax of $161 (10 + 50 + 101).

To take an extreme comparison, assume that the carpenter operates the carpenter's own mill and sells crafted tables directly to consumers. If there were no turnover tax on the mill's purchase of trees, and if the carpenter sells the tables to consumers for pretax prices of $10,000 (because the carpenter would not bear the $60 tax imposed by the multiple turnovers), the carpenter would add a turnover tax of $100, for tax-inclusive prices totaling $10,100. This comparison made in Table 1.1 illustrates some of the deficiencies of the turnover tax – the cascading of taxes and the incentive to integrate a business vertically.

When businesses must pay turnover tax on business inputs, at each subsequent turnover of goods (i.e., sale), the values previously taxed are again subjected to tax in a process often referred to as pyramiding or cascading. In the earlier example, the carpenter charges $50 tax on the $5,010 sales price, which includes the $10 tax buried in the carpenter's $1,010 cost for the milled lumber (or, to put it differently, the carpenter collects a total of $60 tax from the retailer, of which the $50 tax charged on the sale is paid to the government and the $10 buried in the pretax $5,010 price is paid to the carpenter's lumber supplier).

As indicated, the cascading tax element in retail sales is reduced if the carpenter vertically integrates. The classic example of a vertically integrated American business was the Ford Motor Company's River Rouge complex (in Dearborn, Michigan), which processed the steel and glass and other parts for the cars that were assembled on its assembly line. A more recent example is the Benetton company, which operates its own retail shops to sell the apparel the company manufactures.

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TABLE 1.2. Improved turnover tax for nonintegrated and vertically integrated business

	Nonintegrated	*Vertically integrated*
Mill sale to carpenter		
Taxable sale of $1,000 × 1%	**$10**	
Carpenter sale to retailer		
Taxable sale – $5,000* × 1%	**50**	
Credit for tax on purchases	**(10)**	
Retailer sales to consumers		
Taxable sale – $10,000** × 1%	100	
Credit for tax on purchases	**(50)**	
Carpenter sales directly to consumers		
Taxable sales – $10,000 × 1%		**$100**
Total tax imposed and collected	$100	**$100**

* The price would be $5,000 instead of $5,010 because the carpenter recovers the $10 tax on his taxable purchases.
** The sales prices would total $10,000 instead of $10,060 because the retailer would only be charged a pretax price of $5,000 and he would recover the $50 tax charged on the purchase of the tsables.

In Germany, Dr. Wilhelm von Siemens recognized the problems with turnover taxes and developed what he referred to as the "improved turnover tax" or "the refined turnover tax."[11] Thomas S. Adams discussed a value added concept in the United States in 1921.[12] The principle was to reduce the tax on sales by the tax already paid on business inputs to avoid the tax-on-a-tax effect and to remove the incentive to vertically integrate a business. The effect of this "improved" turnover tax for a nonintegrated series of businesses and a vertically integrated business is illustrated in Table 1.2.

This "improved" turnover tax is imposed and collected at each stage of the production and distribution of goods and services whenever there is a transaction, but the net tax liability represents only the tax on the value that has been added by the selling business at that stage. By granting a reduction in tax liability for the tax imposed on taxable purchases (the input tax credit), the tax base at each stage basically is limited to the value added by the employment of labor and capital. Before the widespread use of multistage VATs, some countries imposed single-stage consumption taxes. Single-stage taxes at the retail level are still used by almost all states

[11] C. Sullivan, *The Tax on Value Added* 12 (Columbia University Press 1965) [hereinafter Sullivan, Tax on Value Added], citing Gerhard Colm, "Methods of Financing Unemployment Compensation," **II** *Social Research 161* (May, 1935).

[12] Sullivan, Tax on Value Added, *supra* note 14, at 41, citing T. Adams, "Fundamental Problems of Federal Income Taxation," XXV *Quarterly Journal of Economics* 553 (1921). Adams referred to his proposal as a tax on "approximate net income" or "modified gross income" and recommended it to replace the direct personal income tax. *Id.*

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in the United States and by several provinces in Canada. More commonly, a single-stage tax is imposed at the manufacturer's or wholesaler's level, but most of these have been replaced by VATs.

III. Direct and Indirect Taxes on an Income or Consumption Base

A. Direct and Indirect Taxes

Direct and indirect taxes can be imposed on an income base or consumption base. But what is the distinction between a direct and indirect tax?

Taxes customarily have been classified either as direct or indirect taxes. "A *direct tax* is one that is assessed upon the property, business or income of the individual who is to pay the tax. Conversely *indirect taxes* are taxes that are levied upon commodities before they reach the consumer who ultimately pay[s] the taxes as part of the market price of the commodity."[13] This distinction, based on the incidence of the tax, has been criticized because "modern economic theory" points out that income taxes (considered a direct tax) may be shifted.[14]

According to J. S. Mill's classic economic principles, the distinction between direct and indirect taxes relates to

> whether the person who actually pays the money over to the tax collecting authority suffers a corresponding reduction in his income. If he does, then – in the traditional language – impact and incidence are upon the same person and the tax is direct; if not and the burden is shifted and the real income of someone else is affected (i.e., impact and incidence are on different people) then the tax is indirect.[15]

In the field of international trade, an Annex to the World Trade Organization (WTO) agreement defines "direct taxes" as "taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property" and "indirect taxes" as "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges."[16]

13 *The Guide to American Law*, vol. 10:25 (1984) (defined by Schenk).

14 See, for example, V. Thuronyi, Comparative Tax Law, 54–55 (Kluwer 2003).

15 David Walker, "The Direct-Indirect Tax Problem: Fifteen Years of Controversy," 10 *Public Finance* 153, 154 (1955), citing John Stuart Mill, *Principles of Political Economy with Some of Their Applications to Social Philosophy*, Book V, ch. III (Ashley ed. 1848), new impression, Longmans, Green and Co. (London 1920).

16 Agreement on Subsidies and Countervailing Measures, Annex I (Illustrative List of Export Subsidies), item (e), footnote 58. The SCM is Annex 1A to the WTO. Item (e) treats as an export subsidy the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises, and footnote 58 to the term "direct taxes" includes the definitions in the text.

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The direct versus indirect tax distinction has legal significance in countries subject to the WTO rules.[17] Under the Subsidies and Countervailing Measures (SCM) Agreement,[18] which is Annex 1 to the WTO, a contracting party is restricted in its ability to grant subsidies to exports or to impose more burdensome taxes on imports than apply to domestic goods.[19]

According to the WTO rules, border tax adjustments for indirect taxes do not constitute subsidies of exports or disadvantages to imports.[20] This WTO direct–indirect tax distinction apparently does not depend on who bears the tax.[21] The prohibition against export subsidies may affect the border adjustability of some of the federal taxes proposed in the United States to replace or supplement the federal income taxes, especially proposals for a sales-subtraction VAT that allows a deduction for wages paid.

[17] This direct–indirect distinction has been blurred in Canada. "In Canada, both the federal and provincial governments have the constitutional authority to levy sales taxes." N. Brooks, *The Canadian Goods and Services Tax: History, Policy, and Politics* 141 (Australian Tax Foundation 1993). The federal government has broad power to raise revenue with any mode or system of taxation, but the provincial governments are authorized to impose only direct taxes. Although a sales tax typically is considered an indirect tax, a 1943 Canadian Privy Council case held that a provincial retail sales tax was a direct tax for constitutional purposes. *Id.* at note 304. Professor Brooks quoted from the case: "[W]hen the purchase is made by an agent acting for his principal the tax nevertheless remains 'direct', being paid by the agent for and on behalf of his principal who really bears it." *Atlantic Smoke Shops Ltd v. Conlon*, [1943] A.C. 550, at 551.

[18] The Agreement on Subsidies and Countervailing Measures [hereinafter SCM Agreement], supplementing GATT, Arts. VI and XVI.

[19] The WTO, incorporating Article XVI of the original 1994 GATT agreement, provides the following: "[C]ontracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." Uruguay Round of Multilateral Trade Negotiations General Agreement on Tariffs and Trade, Apr. 15, 1994 [World Trade Organization, or WTO], encompasses, among other agreements, the General Agreement on Tariffs and Trade (GATT) 1994. The quote is from GATT 1994, Ad Art. XVI(4). *The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts* (GATT Secretariat 1994) [hereinafter GATT], p. 509. If a contracting party grants or maintains any subsidy to increase exports or reduce imports, it is obligated to notify the other contracting parties "in writing of the extent and nature of the subsidization of the estimated effects … and of the circumstances making the subsidization necessary." *Id.* at Art. XVI.

[20] Whereas "government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)" is a subsidy under SCM, *supra* note 18, Article l.l(a)(l)(ii), a footnote to that item provides that "the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."

[21] It is not clear if the direct–indirect tax distinction applies to imports. See letter from Leslie B. Samuels, Assistant Secretary for Tax Policy, U.S. Dept. of Treasury, to Senator Sam Nunn, February 1995.

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B. Income and Consumption Base for Tax

Thomas Hobbes, in his *Leviathan*, advocated consumption as an appropriate base for taxation. In his view, people should pay tax on the basis of what they consume (withdraw from society's limited resources) rather than on what they earn in income (contribute to those resources through their labor). Both receive the protection from the government.[22]

Income and consumption can be viewed as different aspects of "consumption" in a broad sense. In this respect, income represents the potential power to consume and consumption represents the exercise of the power by consuming goods and services. An annual tax on individuals can be imposed on an income base or on a consumption base (the hybrid income-consumption base is used to impose the individual income tax in the United States).

As discussed earlier, taxes can be classified as direct or indirect. Direct taxes imposed on an income base include the familiar individual and corporate (or business) income tax and the payroll taxes. A direct tax such as the income tax imposed on individuals can be imposed on a consumption base by removing returns to capital (such as interest, dividends, and capital gains) from the tax base.[23] For example, a personal expenditure tax was used briefly in India and Sri Lanka and was proposed in the United States in 1995.[24] Many forms of indirect taxes can be levied on a consumption base, including selective excise taxes, a turnover tax, a single-stage sales tax (such as a manufacturer or a retail sales tax), or a multistage sales tax such as a value added tax.[25]

This book does not discuss the politics of raising revenue with an income-based tax or a consumption-based tax, or both, but includes the following thoughts on the importance of considering spending as well as taxation as part of fiscal policy.

One complaint about a VAT is that it is a regressive tax – the tax represents a larger percentage of the income of a low-income household than of a high-income household. One response to this argument comes from John Kenneth Galbraith, who focuses not only on the incidence of the tax but also on the combined effect of the tax and how its revenue is spent:

> The relation of the sales tax to the problem of social balance is admirably direct. The community is affluent in privately produced goods. It is poor in public services. The obvious solution is to tax the former to provide

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

[23] See lessons of tax reform, at Box 2, pp. 24–25 (World Bank 1991) [hereinafter Lessons of Tax Reform]. On consumption tax, see the in-depth discussion in B. Fried, "Fairness and the Consumption Tax," 44 *Stanford Law Review* 961 (1992).

[24] See S.722, USA Tax Act of 1995, 104th Cong., 1st Sess., 141 Cong. Rec. S.5664 (Apr. 24, 1995).

[25] See discussion of Direct and Indirect Tax in Section III.

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> the latter – by making private goods more expensive, public goods are made more abundant. Motion pictures, electronic entertainment and cigarettes are made more costly so that schools can be more handsomely supported. We pay more for soap, detergents and vacuum cleaners in order that we may have cleaner cities and less occasion to use them. We have more expensive cars and gasoline so that we may have more agreeable highways and streets on which to drive them. Food being relatively cheap, we tax it in order to have better medical services and better health in which to enjoy it.[26]

According to the staff of the Fiscal Affairs Department of the International Monetary Fund.

> Fiscal policy – taxation and spending – is a government's most direct tool for redistributing income, in both the short and the long run. However, the effect of redistributive tax policies, especially in the face of globalization, has been small. Policymakers should focus on developing a broadly based, efficient, and easily administered tax system with moderate marginal rates. Although the primary goal of the tax system should be to promote efficiency, policymakers also need to consider how to distribute the burden of taxation so the system is seen as fair and just.
>
> The expenditure side of the budget offers better opportunities than the tax side for redistributing income. The link between income redistribution and social spending – especially spending on health and education, through which governments can influence the formation and distribution of human capital – is particularly strong, and public investment in the human capital of the poor can be an efficient way to reduce income inequality over the long run.[27]

IV. Tax Structures in Developed and Developing Economies

This section includes some comparative data on the composition of tax regimes in developed countries. Many developing countries find it difficult to collect personal income tax in agricultural economies with a dispersed population. "As a result, the personal tax base [in developing countries] is often limited to public employees and employees of large firms, particularly multinational firms. … Taxes on the income of large companies – including taxes levied on the profits of large mining operations and agricultural estates – present fewer administrative difficulties."[28]

In many developing countries, sales taxes at the retail or manufacturer level, complicated with numerous exemptions on imports and domestic

[26] John Kenneth Galbraith, *The Affluent Society* 238 (4th ed. Houghton Mifflin Co. 1984).

[27] Excerpt from "*Should Equity Be a Goal of Economic Policy?*" by staff of IMF's Fiscal Affairs Department, 35 Finance and Development #3, Sept. 1998, p. 4.

[28] See Lessons of Tax Reform, *supra* note 23, at 16.

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TABLE 1.3. Total taxes as percentage of GDP

	1985	*2010*
Canada	32.5	31.0
France	42.8	42.9
Germany	36.1	36.1
Japan	26.7	27.6
New Zealand	30.9	31.5
Sweden	47.4	45.5
United Kingdom	37.0	34.9
United States	25.6	24.8
OECD Unweighted Avg.	32.5	33.8

OECD (2012), "Tax Levels and Tax Structures, 1965–2011," table 2, in *Revenue Statistics 2012*, OECD Publishing; http://dx.doi.org/10.1787/rev_stats-2012-4-en-fr.

sales, have been replaced by value added taxes, but unfortunately, they tend to bring many of the exemptions from the repealed taxes on consumption into their VATs.[29]

Developing countries must import a significant portion of the goods sold in the domestic market and raw materials and supplies used in domestic production. Taxes on imports (Customs duties and VAT) may represent a much larger percentage of revenue than taxes on domestic sales. The majority of VAT revenue will be collected by Customs and Excise personnel at the border. The remainder of VAT will be collected by the agency (if separate from Customs) responsible for the VAT.

Compared with developing countries, developed (or industrial) countries impose higher taxes as a percentage of gross domestic product (GDP) and tend to rely more heavily on direct personal income and payroll taxes.

In this book, we will concentrate on taxes imposed on goods and services. The tax on goods and services in the countries listed in Table 1.3 are depicted in Table 1.4. The data compare 1985 and 2010. Japan and the United States imposed the lowest tax on goods and services, as a percentage of GDP, in 2010.

Table 1.3 reveals that total taxes as a percentage of GDP remained fairly consistent, with total tax in some countries declining between 1985 and 2010. As a percentage of GDP, Table 1.4 shows that Germany, Japan, New Zealand, and Sweden increased their reliance on goods and services taxes, whereas Canada, France, the United Kingdom and the United States reduced their reliance on these taxes.[30] Although many assume that once

[29] See, for example, the Ghana Value Added Tax 1998, Schedule 1.

[30] "It is apparent that, over the longer term, the OECD member countries have relied increasingly on taxes on general consumption to provide their tax revenue." OECD

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TABLE 1.4. Total tax on goods and services as percentage of GDP (the date in parentheses is the date VAT was introduced or became effective)

	1985	*2010*
Canada (1991)	10.3	7.5
France* (1968)	12.7	10.7
Germany (1968)	9.3	10.6
Japan (1989)	3.7	5.2
New Zealand (1986)	7.2	12.5
Sweden (1969)	12.6	13.4
United Kingdom (1973)	11.7	10.7
United States (no VAT)	4.8	4.5
OECD Unweighted Avg.	10.4	11.0

OECD (2012), "Tax Levels and Tax Structures, 1965–2011," table 23, in *Revenue Statistics 2012*, OECD Publishing; http://dx.doi.org/10.1787/rev_stats-2012–4-en-fr. Goods and services taxes include sales and value added taxes, excises and customs duties, and taxes on the use of goods such as motor vehicle taxes, and others.
* France introduced a form of VAT in 1954, but it did not become broadly based and imposed down to the retail stage until 1968.

enacted, the VAT rate only increases – and many have – the tax rate in some countries has in fact declined.[31]

V. The Value Added Tax

The VAT, as it is employed around the world, is two independent taxes that are joined with the credit for tax on purchases (including imports) against the tax imposed on sales. Indeed, the collection of the tax on imports and tax on domestic sales typically is administered by different departments of the tax authority – customs for imports and inland revenue (or a comparable department) for tax on domestic (including export) sales.

The First Council Directive on VAT, issued by the European Commission, includes a detailed definition of a VAT:

> The principle of the common system of value added tax involves the application to goods and services of a general tax on consumption exactly

CONSUMPTION TAX TRENDS 20 (OECD 2004). In part, this resulted from a "substitution of VAT/GST for [excises and] other consumption taxes." *Id.* at 23.

31 Of the countries with VATs listed in Appendix, 13 lowered their rates between 2006 and 2014, whereas 47 raised their rates. Canada reduced the GST rate from 7% to 6% and then 5%. See Governor General Michaelle Jean's speech from the Throne, April 4, 2006, in which she said in part: "[T]he Government will reduce the Goods and Services Tax by one percent. Cutting the GST will help all Canadians deal with the rising cost of living, put money back in people's pockets and help stimulate the economy …. The Government will continue with a responsible approach to lowering taxes for the benefit of Canadians and the Canadian economy, including a further reduction of the GST to five percent."

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