Exploring the Origins and Global Rise of VAT

By Kathryn James

Kathryn James is with the faculty of law at Monash University in Melbourne.

From relatively inauspicious beginnings in the early 20th century, the VAT has been adopted by more than 140 countries and accounts for approximately 20 percent of worldwide tax revenue.[1] Perhaps only the income tax provides a stronger example of 20th-century tax policy convergence. As Sijbren Cnossen wrote, "The nearly universal introduction of the value added tax should be considered the most important event in the evolution of tax structure in the last half of the twentieth century."[2]

As the only developed nation without a federal VAT, the United States remains the highest-profile exception to the trend toward VAT. This exceptionalism persists in the face of a growing belief among U.S. tax policy commentators that the introduction of a VAT is either inevitable, or at least a possibility in light of burgeoning federal government debt and spending commitments. This essay examines how the global history of VAT is relevant to the U.S. debate.

Origins

The origins of the VAT have never been decisively settled. Attribution is variously accredited to one of two sources: the German businessman Wilhelm Von Siemens in 1918, or the American economist Thomas S. Adams in his writing between 1910 and 1921.[3]

Von Siemens's VAT concept was seen as a technical innovation that brought a key improvement to the turnover tax. VAT

---

[1]Liam Ebrill et al., *The Modern VAT* 1-14 (2001); Michael Keen and Ben Lockwood, "The Value-Added Tax: Its Causes and Consequences" 3 (IMF, Working Paper 183, 2007).

[2]Sijbren Cnossen, "Global Trends and Issues in Value Added Taxation," 5 *International Tax and Public Finance* 399 (1998).

[3]C.F. von Siemens, *Improving the Sales Tax* (1921); Clara K. Sullivan, *The Tax on Value Added* (New York, 1965), 17.

allowed for the recovery of taxes paid on business inputs and therefore avoided the cascading problems that arise with a turnover tax. While the innovation was clearly important, it hardly meant the revolutionary overthrow of the fiscal order.

Adams saw the VAT as an alternative to the business income tax.[4] He was focused on federal tax policy, and since there was no national sales tax his concern was not with technical modification to an extant regime but with a major alteration of the existing federal income tax system.

The fate of the VAT in Western Europe and the U.S. has largely reflected the different motives of the tax's innovators. Germany, along with much of Western Europe, came to embrace the VAT as a superior technical modification to sales taxes already in place, and as an adjunct to the income tax. By contrast, U.S. policymakers' ambitious and intermittent pursuit of the VAT — often as a proposed substitute for the federal income tax — has remained fruitless.

The Rise of VAT

The VAT was first introduced at a national level in France in 1954. Its original coverage was limited, and France did not move to a full VAT that reached the broader retail sector until 1968. The first full VAT in Europe was enacted in Denmark in 1967, although the country did not join the European Economic Community until 1973.[5]

VAT adoption progressed in two major phases. The first occurred mostly in Western Europe and Latin America during the 1960s and 1970s. The rise of the VAT in Western Europe was accelerated by a series of EEC directives requiring member states to adopt a harmonized VAT upon entry to the European Union.[6]

---

[4]Thomas S. Adams, "Fundamental Problems of Federal Income Taxation," *Quarterly Journal of Economics* 35 (4) (1921), 528, 553.

[5]Ebrill et al., *supra* note 1, at 4; Sullivan, *supra* note 3, at 15.

[6]First Council Directive (67/227/EEC) and Second Council Directive (67/228/EEC) of April 11, 1967. The Sixth Council Directive was the main document on harmonization: Directive 77/388/EEC of May 17, 1977 — the recast of this directive is the main operative directive on the EU VAT — VAT Directive 2006/112/EC of November 28, 2006.

The second phase of VAT adoption occurred from the late 1980s with the introduction of VAT in some high-profile industrialized countries outside the EU, such as Australia, Canada, Japan, and Switzerland. This phase also witnessed the massive expansion of VAT in transitional and developing economies, most notably in Africa and Asia.

The IMF and the World Bank are identified as key influences in the rapid adoption of VAT among these countries.[7] Less has been said about the significant role of U.S. policymakers and agencies in promoting VAT. This activity includes the pioneering, albeit unsuccessful efforts of the Shoup Mission to introduce VAT during the post-World War II U.S. occupation of Japan[8] and the prominent role played by the U.S. Agency for International Development (USAID) in promoting VAT through the provision of funding and technical assistance to developing and transitional economies.[9]

Ironically, U.S. tax policy experts have been at the forefront of exporting a tax reform abroad that has consistently eluded them at home.

The 'Good' VAT

Commentators generally agree as to what constitutes an ideal or 'good' VAT regime. The prescriptions entail a flat rate VAT extending through to the retail stage of the economy, levied on a broad consumption base of goods and services with minimal exclusions.

What distinguishes a VAT from the retail sales taxes common throughout the U.S. states is that the VAT is levied on each transaction in the production chain, rather than being collected

---

[7]Ebrill et al., *supra* note 1 at xi estimate that well over half of all countries that have introduced a VAT during the last 20 years have used IMF Fiscal Affairs Department advice in doing so; Keen and Lockwood estimate that a country's participation in a noncrisis IMF program indicates that the country is 25 percent more likely to take up a VAT in the following year: Keen and Lockwood, *supra* note 1, at 18.

[8]Shoup Mission, "Report on Japanese Taxation" (1949); Shoup Mission, "Second Report on Japanese Taxation" (1950).

[9]Recent examples of countries that have received assistance from USAID in introducing a VAT include Serbia, Egypt, El Salvador, Guatemala, and Jamaica: see *Case Studies — USAID Assistance in Fiscal Reform*, *available at* http://www.fiscalreform.net/index.php?option=com_content&task=section&id=9&Itemid=65, accessed June 10, 2010.

only at the retail stage, with business being able to obtain full credit or an immediate deduction for VAT paid on inputs (including capital goods) offset against the VAT collected on outputs. As a result, the tax is intended to be borne only at final consumption. There is strong support, although not necessarily consensus, for levying VAT on a destination basis, meaning it would be payable in the jurisdiction where consumption rather than production occurs. This has the intended effect of making exports exempt or zero rated for VAT purposes.

The consensus as to what constitutes an ideal VAT is matched by a widespread acknowledgment that these prescriptions "are often met in only in the breach."[10] Today we can speak of three main varieties of VAT: the European model, the New Zealand model, and the Japanese model. Of the three major types of VAT in existence, New Zealand's comes closest to resembling the ideal — that is, levied at a single rate on a relatively broad base. Most jurisdictions have adopted a European-style VAT marked by multiple rates and varying degrees of exemptions. In practice, no two VATs look exactly alike, with differences in rates, thresholds, exemptions, refund, and coverage. Some VATs exist subnationally or are limited to the manufacturing or wholesale level.

Like with any other tax, the revenue-generating potential of the VAT is relative to a country's administrative capacity. The VAT produces far less revenue, far less efficiently, in countries with weak administrative capacity.[11] Even when supported by high-level administrative capacity, and despite exaggerated claims to the contrary, real-world VATs are not immune from tax avoidance and evasion activities. Most of those problems involve taxpayer exploitation of the credit invoice mechanism.[12]

---

[10]Cnossen, *supra* note 2, at 400.

[11]Sam Skogstad and Mark Gallagher, "Building Capacity in Revenue Policy and Administration" (USAID Fiscal Reform and Economic Governance Best Practice Note), accessed June 10, 2010.

[12]Some estimates place the cost of VAT fraud within the EU alone at $340 billion per annum: John Norregaard and Tehmina S. Khan, "Tax Policy: Recent Trends and Coming Challenges," 39 (IMF, Working Paper 274, 2007).

VAT's Popularity

Many believe the VAT spread globally because it is the consumption tax best suited to the revenue needs of states in an increasingly globalized economy. Even those who recognize the role of key regional and international institutions in promoting VAT often attribute the motives behind the promotion to the merits of the policy instrument itself.

As a result, the rise of the VAT is attributed to such virtues as the tax being the best method of taxing general consumption, its neutral treatment of exports, and its revenue-raising capacity — which may be a matter of concern for those opposed to enhancing government's ability to provide public goods and services.[13]

These factors may explain VAT's global rise and its appeal to policymakers. They also offer a useful political strategy for promoting the adoption of VAT in the few places where it doesn't exist. Rather than assess the relative merits of VAT (which is done amply elsewhere in this volume), this essay highlights how reference to these putative merits alone does not provide a full account of VAT implementation worldwide. Championing the VAT's virtues may overlook why many VAT regimes depart from ideal policy standards. These departures from "good" policy prescriptions are often the result of localized circumstances and trade-offs designed to buy necessary political support. For example, the first European VATs were not adopted as stand-alone tax structures but through the gradual amendment of existing turnover taxes. That means many of the exemptions or reduced rates in Western European VATs are based on the original turnover tax that the VAT replaced.

To explain why VAT regimes frequently depart from the ideal, it's necessary to focus on the tax's history as a policy idea or instrument whose acceptance has been highly political, fiercely contested, and shaped by local conditions. This calls for more exploration of how what is now a global phenomenon has been implemented domestically.

---

[13] *See, for example*, OECD, Consumption Tax Trends, 23 (2008); Ebrill et al., *supra* note 1 at xi.

The introduction of national broad-based consumption taxation in developed countries such as Australia, Canada, and Japan was met with fierce and prolonged resistance. Each site of resistance has adopted a VAT that departs in varying degrees from the ideal policy prescriptions. In Australia and elsewhere this was evidenced by the exclusion of food and some essential services from the VAT base to reduce objections to the VAT's regressivity. In Japan it was reflected in the adoption of a low-rate, subtraction method VAT. In Canada it has resulted in a slow and protracted process of harmonizing a federal VAT with provincial sales taxes.

Focusing on the factors that have shaped domestic implementation of VAT in those three jurisdictions and elsewhere helps reveal much of what is left untested or unsaid regarding the global rise of the VAT. It's especially useful to a U.S. audience set to either grapple with implementation or continued resistance.

Challenging the Assumptions

Few of the propositions offered to explain the VAT's rise have been tested, let alone proven. It's one thing to argue that the VAT's neutral treatment of exports makes it more suited to the demands of a globalizing economy. It's another thing to show that that feature helps win domestic political acceptance of the tax. The trade competitiveness argument did not resonate with a skeptical Canadian public.

Patterns of resistance to a U.S. federal VAT are already detectable. Every VAT-style reform proposal offered, from President Richard Nixon to George W. Bush, has met with a similar pattern of opposition: Businesses feared the perceived complexity and administrative burden of the VAT; state and local governments were concerned about the balance of federal taxing power and intrusions into the sales tax area; liberals denounced the perceived regressivity of a VAT; conservatives feared the VAT's reputation as a money machine that would fuel government growth.[14] This

---

[14]U.S. Treasury Department, Office of the Secretary, 98th Congress, "Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President" 1-2 (1984) at 192; U.S. President's Advisory Panel on Federal Tax Reform, 109th Congress, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," at xiv (2005).

clamorous opposition often drowns out appeals that are based on technical virtues such as export neutrality.

Unveiling the Motives

Whether intentional or otherwise, the presentation of the VAT as a mere technical innovation ignores the difficult political, economic, and moral questions that often accompany decisions to introduce the tax.

For example, in the U.S. one key question is whether a consumption tax or the income tax is the preferred revenue base. Although the answer need not be an either/or proposition, it is frequently portrayed as one by proponents of tax reform.

That the U.S. income tax base has moved so steadily to a consumption tax base complicates the question of the tax mix. The more the income tax shifts toward a consumption base, the less likely it is that the tax will offer a reliable means of preserving progressivity, and the greater the pressure will be to compensate for the VAT's regressivity through the design of the VAT itself.

Suggestions to compensate for the VAT's regressivity through the spending side must compete with the leviathan rhetoric that has pervaded recent U.S. VAT debate whereby the VAT's perceived success in generating revenue has conservatives fearing that the adoption of an effective revenue raiser will fuel growth of the public sector.

Domestic Institutions Matter

The furor in the U.S. over healthcare reform demonstrates the difficulty of pursuing measured debate on issues that stir fiercely partisan divisions over the appropriate role of the state. The labyrinthine structure of the policymaking process, replete with veto points, presents a minefield for prospective reformers, particularly in the self-interested politics of tax reform.

Tax politics in this environment has often meant the accretion of benefits for special interests — a process that rarely attracts much public scrutiny. It also results in myriad proposals from various groups keen to advocate for tax policy in their own interest. Whereas powerful interest groups were united behind a VAT starting in the mid-1990s in Australia, U.S. business and other conservative lobbyists remain hopelessly divided on their preferred vehicle for tax reform, proffering everything from various flat tax proposals to unlimited savings allowance taxes and VATs.[15]

Unlike in several other developed jurisdictions, the absence of an extant national sales tax has denied prospective VAT reformers a powerful selling point — namely that the VAT is an overdue replacement for an inferior sales tax such as the turnover tax or wholesale sales tax. Conversely, the absence of a national sales tax inflates the ambitions of would-be tax reformers who focus on the flaws of the income tax and propose its wholesale replacement with various other models. This constitutes a much more radical shift than simply replacing a bad sales tax system with a better one.

Conclusion

While the rise of the VAT in the late 20th century was significant, conflating the reasons for its advancement with the putative merits of the tax largely ignores how the VAT has developed across the world. U.S policymakers who are considering a VAT as an alternate revenue source to address the country's burgeoning debt would benefit from looking past the banner-waving to the political realities of VAT implementation elsewhere and at home. ■

[15] *See, e.g.*, discussion in Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* 442-448 (rev. ed. 2007).