The Missing Piece of the US Tax Reform: Would VAT Make America Great Again?

Taking into account the rapid expansion of VAT, its reputation for revenue generation and President Trump’s concerns about fair trade policy, the question arises why the United States does not have and does not intend to implement a VAT. In this article, the author summarizes and comments on President Trump’s and House Republicans’ positions on VAT and border tax.

1. Introduction

VAT is the fastest-spreading type of tax. Implemented in over 160 countries around the world, it is well known for its ability to generate substantial amounts of revenue. VAT has become the cornerstone of the EU economic system, warranting the non-distortive trade policy in the internal market and respecting the EU fundamental freedoms. It has recently been adopted by the Bahamas (2015) and Malaysia (2015). VAT implementation reforms are currently underway in India and the Gulf Cooperation Council (GCC) countries.

President Trump’s position on VAT is rather ambiguous. On several occasions, the President mentioned that VAT creates a disadvantage for US companies exporting abroad and takes US jobs away. However, he also admitted that he liked the concept of VAT. VAT does not seem to be popular among the Republicans either. According to the report A Better Way (commonly referred to as “the Blueprint”), which sets out tax reform proposals developed by House Republicans, the operation of foreign VAT systems is believed to result in a “unilateral penalty on US exports” and a “unilateral subsidy for US imports”.²

To create a level playing field for US companies exporting abroad (and to offset the disadvantages caused by foreign VAT systems), President Trump suggested imposing additional levies on goods imported into the United States (a border tax or reciprocal tax). House Republicans came up with a more complex idea – a border adjustment tax (also known as a destination-based cash flow tax) – which calls for replacing the current corporate income tax with a 20% tax on domestic sales. The tax would eliminate the deduction of purchases of materials produced outside the United States.

On 26 April 2017, the White House presented a one-page note outlining the core principles of Trump’s tax reform, which is meant to be “one of the biggest tax cuts in American history” and “the most significant tax reform since 1986”.³ On 23 May 2017, President Trump submitted the Budget of the US Government for Fiscal Year 2018 (A New Foundation For American Greatness) to the US Congress.⁴ The section of the proposed budget titled Simplify the Tax Code and Provide Tax Relief repeats the content of the one-page reform outline. Both the reform outline and the proposed budget are silent on the question of any possible border adjustments. It remains unclear whether the failure to endorse the border adjustment tax – or any other form of border tax – indicates abandoning the idea as a whole or whether such taxes will be included in the reform at a later stage.

Taking into account the rapid expansion of VAT, its reputation for revenue generation and the United States’ concerns about fair trade policy, the question arises why the United States does not have and does not intend to implement a VAT. To provide background for a discussion, this article will first look at the main characteristics and proliferation of VAT systems worldwide. Second, it will summarize President Trump’s and House Republicans’ positions on VAT and border taxes. Next, it will provide a simple case study – importing goods from the United States into Europe – as a basis for the evaluation of President Trump’s and House Republicans’ positions. The subsequent sections will comment on the statements made by the President and House Republicans and examine whether the United States would benefit from implementing a VAT system.

2. VAT Systems

Indirect taxes can be imposed at all stages of the manufacturing and distribution chain or only at one stage. The most widespread multi-stage tax is value added tax (VAT), also called goods and services tax (GST). Limited to fewer than ten countries in the late 1960s, it has now been implemented by over 160 jurisdictions, where it often accounts for a large part of the total tax revenue. An example of a single-stage indirect tax is a retail sales tax (RST), which applies only to supplies to final consumers. Retail sales taxes have been implemented by 45 US states and the District of Columbia.

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Two main principles that govern the inter-jurisdictional application of indirect consumption taxes are the destination principle and the origin principle. Under the former, goods are taxed where they are consumed (i.e. exports are exempt and imports are taxed on the same basis as domestic production). Under the latter, goods are taxed where they are produced (i.e. exports are taxed and imports are exempt). The destination principle is regarded as the theoretically correct way to tax consumption, since it ensures that all consumption within a particular jurisdiction is treated in the same way and ensures neutrality in cross-border trade. Under this principle, VAT is allocated to the country of consumption by applying appropriate border tax adjustments: exports are freed of tax and imports are taxed in the same manner as domestic consumption.

A well-functioning destination-based VAT and RST should have exactly the same consequences, except in terms of which party remits the tax to the tax authorities (under an RST, only retailers collect the tax, whereas, under a VAT, all businesses do). Both systems levy the tax on domestic consumption, regardless of where the goods were produced.

Although there is a wide variety of existing VAT/GST regimes, they can be broadly classified into two categories: traditional (European) VAT and modern GST. The VAT systems of the EU Member States are an example of the former. The modern GST was first implemented in New Zealand (1986) and has had a strong influence on the indirect tax systems implemented by Asia-Pacific nations. The two main differences between the traditional and modern VAT/GST regimes are the rate structure and the number of exempt supplies. In a modern GST system, a single rate is used and the number of exceptions is limited.

More and more countries are recognizing the benefits of having a VAT and implementing reforms to that effect. In 2015, VAT was introduced in the Bahamas (as from 1 January) and Malaysia (as from 1 April). As from 1 July 2017, India will introduce a nationwide GST, which will replace multiple indirect taxes at the central and state levels. GST introduction is regarded as the most significant event in the history of Indian indirect taxation and the most powerful tax reform ever undertaken, one that will make India one unified common market and allow for the seamless movement of goods and services across the country. The six countries of the GCC – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates – are currently preparing for the introduction of a VAT system, which is expected to occur on 1 January 2018.

3. United States – Current Opinions

3.1. President Trump’s Statements

On multiple occasions, President Trump has threatened to impose a levy on goods manufactured abroad and imported into the United States. The levy would punish companies that set up manufacturing operations overseas and, by doing so, move jobs away from the United States. Another objective of the levy, according to Trump, would be to create a level playing field for US companies that are facing import levies when they export goods to other countries. Trump has not clarified the nature of the proposed levy: it is not clear whether he means a new import tax or increasing import tariffs. One thing is clear, however: there should be a levy at the border. “I love a reciprocal tax”, Trump said in an interview with Bloomberg News. “Nobody can fight it. It’s fair, and it’s something that we are working on very strongly.”

During his presidential campaign, Trump repeatedly said he would impose a 45% tax on imports from China. In an interview with the New York Times on 26 March 2016, Trump stated:

[It’s very hard for us to do business in China, it’s very easy for China to do business with us. There’s a tremendous tax that we pay when we go into China, whereas when China sells to us there’s no tax.]

President Trump has frequently claimed that other countries’ VAT regimes function as trade barriers that favour foreign companies exporting into the United States and punish US businesses that export into overseas markets. During the first presidential debate, on 26 September 2016, Trump complained about Mexico’s VAT system:

Let me give you an example. They have a VAT tax. We are on a different system. When we sell into Mexico, there’s a tax. [...] But when they sell into us, there’s no tax. It’s a defective agreement. It’s been defective for a long time, many years, but the politicians haven’t done anything about it.

His statement implies that the Mexican VAT system is one of the reasons why the North American Free Trade Agreement (NAFTA) is such “a horrible one-sided deal”.

In a more recent interview, with The Economist, President Trump admitted that he liked the concept of VAT but claimed that the United States is not yet ready for VAT: “The concept of a VAT I really like. I like a VAT. I don’t think it can be sold in this country. I think it’s too much of a shock to this system.”

5. A neutral tax does not have distortive effects on the economy. In a neutral tax system, it should not make any difference whether expenditure is related to goods imported or locally produced. Imported products should be treated in the same way as domestic products.


3.2. The Blueprint

According to the House Republicans’ Blueprint, foreign VAT systems may have discriminatory effects on US companies and trade. Foreign VAT is believed to be a “unilateral penalty on US exports”. The relevant passage reads as follows:

Today, all of our major trading partners raise a significant portion of their tax revenues through value-added taxes (VATs). These VATs include “border adjustability” as a key feature. This means that the tax is rebated when a product is exported to a foreign country and is imposed when a product is imported from a foreign country. The consequences are most obvious. They reduce the costs borne by exported products and increase the costs borne by imported products. When the country is trading with another country that similarly imposes a border-adjustable VAT, the effects in both directions are offsetting and the tax costs borne by exports and imports are in relative balance. However, that balance does not exist when the trading partner is the United States. In the absence of border adjustments, exports from the United States implicitly bear the cost of the U.S. income tax while imports into the United States do not bear any U.S. income tax cost. This amounts to a self-imposed unilateral penalty on U.S. exports and a self-imposed unilateral subsidy for U.S. imports.13

The Blueprint proposes a 20% destination-based cash flow tax (border adjustment tax) that will be levied on revenue from US domestic sales. Revenue from non-US sales will be excluded from the taxable income. Costs of input materials produced in the United States will be deductible from the taxable income, whereas costs of inputs manufactured abroad will not qualify for a deduction.

4. Case Study – Importation of Goods from the United States into Europe

A US car manufacturer sells cars to a Dutch wholesale company. The cars are shipped from the United States to the Dutch port of Rotterdam and are released into free circulation in the Netherlands. Under the EU VAT law, importation is a taxable event subject to VAT. The place of importation is the Member State in which the goods enter the EU VAT territory.14 As a general rule, VAT becomes chargeable and must be paid when the goods are released for free circulation.15

If the US company has not registered for VAT purposes in the Netherlands and acts as the importer of record, it must pay import VAT and is not allowed to recover it. In this situation, it is worse off than a Dutch company importing into the Netherlands or a Dutch company importing into the United States. However, there are many ways to import VAT-free into Europe.

First, the US company could designate the recipient of the goods to act as the importer of record. As the recipient is an EU-based company, it is able to deduct import VAT. Second, the US company could appoint a fiscal representative who would be able to reclaim the import VAT paid. Another possibility for the US manufacturer to avoid the payment of import VAT is to place the goods under a suspensive arrangement (for example, a customs warehouse) following their entry into the European Union. In such a case, import VAT is payable by any person who causes goods to cease to be covered by the arrangement (for example, by a customer who removes the goods from the customs warehouse). Finally, the US company could register for VAT purposes in the Netherlands. VAT registration would allow the US company not only to reclaim the import VAT paid but also to postpone the time of VAT remittance. As an exception to the general rule that import VAT has to be paid when the goods are released for free circulation, many Member States (including the Netherlands) have implemented a postponed accounting system, under which the importer accounts for import VAT through his periodic VAT return. If the importer performs supplies that are 100% taxable, import VAT is deductible on the same return, so that the balance of payment is nil. Postponed accounting eliminates the need for pre-financing of import VAT and generates cash flow advantages. By treating imports more favourably than domestic transactions (on which VAT has to be paid immediately to the supplier), postponed accounting may, in principle, make it more attractive for businesses to purchase goods from outside the European Union than in their own Member State.

5. Comments on the US Proposals

Destination-based VAT systems are commonly thought to encourage exports, since exports are exempt from tax while imports are taxed. Statements to this effect were made by the President and can be found in the House Republicans’ Blueprint. However, empirical research suggests the opposite. Desai and Hines (2005) examined the effect of value added taxes on international trade. They studied 168 countries over a 50-year period (1950-2000) and concluded that countries with a VAT had fewer exports than countries without a VAT.16 Thus, empirical research provides no evidence that adopting a VAT is a means to boost exports.

Both the statements made by the President and the Blueprint claim that VAT operates as a trade barrier and unilateral subsidy. However, according to the WTO Agreement on Subsidies and Countervailing Measures, VAT is not a form of trade subsidy and is perfectly in line with international trade rules. In footnote 1, the Agreement states as follows:

[T]he 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.

As is evident from the case study in section 4, there are many alternatives available that allow VAT-free importation into Europe. The case study showed four scenarios in which the importation of cars from the United States into Europe did not create any VAT burden for the US.


company (designating the recipient as the importer of record; appointing a VAT representative; using a suspensive arrangement; and registering for VAT in the European Union). Thus, US companies do not have to be at a disadvantage when importing goods into countries that have implemented a VAT system.

The United States is the world’s largest trading nation in which imports consistently exceed exports. It has the world’s largest trade deficit, which amounted to USD 502 billion in 2016. President Trump considers the trade deficit to be caused by other countries’ VAT regimes, which act as trade barriers for US companies. Therefore, it is worth investigating whether the countries with the highest tariffs are also the ones that contribute to the US trade deficit.

According to the Global Competitiveness Report 2016–2017, prepared by the World Economic Forum, the countries that have the highest tariffs in the world are, in order, Iran, Bhutan, Sri Lanka and Nepal (see Figure 1). As is evident from Figure 1, trade protectionism (high tariffs) is mostly a policy of developing nations. None of those countries is a major contributor to the US trade deficit. Thus, there is no link between trade barriers and the US trade deficit.

President Trump suggests a simple way to create a level playing field for US companies exporting abroad: a border tax or reciprocal tax, both of which would have the same effect as increasing import tariffs. Increasing import tariffs or imposing additional taxes on imports from certain countries will not encourage domestic manufacturing; factories producing for the US market in China will be moved to Vietnam or another Southeast Asian country. Increasing tariffs has the potential to impede the flow of trade, as there is a risk of retaliation by other countries. Retailers selling imported products will face increased costs that will be passed on to customers. A border (or reciprocal) tax is sure to run afoul of the WTO international trade rules and give rise to international trade disputes.

As indicated in section 2, a well-designed destination-based VAT and RST should have exactly the same consequences: all consumption within a particular jurisdiction should bear the same tax burden. However, the existing US RST systems do not achieve this objective. Currently, only businesses with a physical presence in a state are obliged to collect the RST of that state. Remote sellers (i.e. sellers based in other US states or abroad) are exempt from the obligation to charge the RST of the state where their customers are located if they do not have sufficient nexus with that state. The current situation results from two Supreme Court decisions, National Bellas Hess (1967) and Quill (1992).

Almost every year since the Quill decision, new legislation that would grant states the authority to compel remote sellers to collect state sales and use taxes has been proposed. The Market Fairness Act of 2013 has made the greatest progress so far. It grants states the authority to compel remote sellers to collect sales tax at the time of a transaction, just as local retailers are already required to do. It is surprising that neither President Trump nor House Republicans wish to close loopholes in the existing RST system and show support for legislation that would eliminate the disadvantages for local sellers over non-local retailers.

Figure 1: Countries with highest tariffs

The United States has the largest deficits with some of its top trading partners (in order, China, Japan, Germany and Mexico) (see Figure 2). The trade deficit with China (USD 347 billion) is responsible for 70% of the total US deficit in goods.

Figure 2: Countries contributing to US trade deficit

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22. The Main Street Fairness Act (S. 1452/H.R. 2701), introduced 29 July 2011; the Marketplace Equity Act (H.R. 3179), introduced 13 October 2011; and the Marketplace Fairness Act (S. 1832) introduced 9 November 2011.
23. See http://beta.congress.gov/bill/113th-congress/senate-bill/743. The Marketplace Fairness Act of 2013 was introduced in the Senate as S. 743 (formerly S. 336) on 16 April 2013; and in the House of Representatives as H.R. 684 on 14 February 2013. It was passed by the Senate on 6 May 2013. For more information on the Main Street Fairness Act of 2013, see www.marketplacefairness.org/what-is-the-marketplace-fairness-act/.
6. Outlook

It seems that President Trump considers VAT to be a significant trade advantage for countries that impose the tax and a major disadvantage for countries without the tax. Following his line of reasoning, the most obvious way to eliminate the “unfair trade disadvantage” suffered by US exporters would be to implement a national VAT system in the United States. Instead of blaming other countries (e.g. Mexico) for creating trade imbalances, the United States could fix the problem by imposing import VAT.

Implementing a VAT is not as simple as raising tariffs, but it offers a stable, long-term solution. VAT has proven to be a reliable revenue source that can finance desirable public spending programmes. In countries that have implemented a VAT, VAT revenue is increasing as a percentage of total tax revenue.¹⁴ As the proposed tax reform is all about tax cuts, implementing a strong revenue raiser, such as VAT, seems to be necessary.²⁵

A potential advantage offered by the late date at which the United States might adopt VAT is the opportunity to learn from experiences and best practices elsewhere. The United States would be in an optimal position to implement a tax system that combines the best features of both the traditional VAT and the modern GST. It could learn from the Canadian experience of having both provincial and federal indirect taxes. Finally, it could monitor the implementation of the biggest indirect tax reform in Indian history to see what implementation pitfalls to avoid.

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²⁴ OECD, Consumption Tax Trends (OECD 2016). In the OECD member countries, consumption taxes amount on average to 30.5% of total tax revenue.