COMMENT

THE JAPANESE CONSUMPTION TAX: VALUE-ADDED MODEL OR ADMINISTRATIVE NIGHTMARE?

BARRY M. FREIMAN, C.P.A.*

INTRODUCTION

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.

Alan A. Tait

On April 1, 1989, Japan enacted the three percent Consumption Tax (CT), becoming the forty-sixth nation to impose a variation of the “indirect” tax known as a value-added tax (VAT). Authorities

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* The author is currently a May, 1991 J.D. candidate at The Washington College of Law, The American University.


3. A. TAIT, supra note 1, at 39-41. Other countries levying some form of VAT are Argentina, Austria, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cote d’Ivoire, Dominican Republic, Ecuador, Guatemala, Haiti, Honduras, Hungary, Indonesia, Israel, Korea,
impose a VAT along the chain of production and distribution on the value added by each producer or distributer to a good or service.\textsuperscript{4} VAT calculations are similar to those required to calculate American state sales taxes.\textsuperscript{5} The VAT differs from the sales tax, however, in

Madagascar, Mexico, Morocco, New Zealand, Nicaragua, Niger, Norway, Panama, Peru, Philippines, Senegal, Sweden, Taiwan, Turkey, and Uruguay. \textit{Id.} In addition, the European Economic Community (EEC) requires its members (Belgium, France, Germany, Luxembourg, Italy, the Netherlands, Portugal, Spain, Greece, Ireland, Denmark, and the United Kingdom) to adopt a VAT as a condition of membership. Turnier, \textit{Designing an Efficient Value Added Tax}, 39 \textit{TAX L. REV.} 435, 436 n.2 (1984) (describing VATs in EEC). Several other nations may enact proposed VATs as well, including Canada, Iceland, and Poland. A. Tait, \textit{supra} note 1, at 40-41.


There are three alternative methods used to determine a taxpayer's VAT liability. Two of these are "direct" VATs and the third is an "indirect" VAT. A. Tait, \textit{supra} note 1, at 4-5. The first "direct" VAT is the addition method, which imposes VAT directly on the sum of the four general economic factors of production (profits, wages, rent, and interest). Schenk, \textit{Value Added Tax: Does This Consumption Tax Have a Place in the Federal Tax System?}, 7 VA. TAX REV. 207, 226 (1987) [hereinafter Schenk, \textit{Value Added Tax}] (discussing economic factors of production). The VAT adopted, though never enacted, by Japan in 1950 allowed for an optional calculation using the addition method. Bronfenbrenner, \textit{The Japanese Value-Added Sales Tax}, 3 \textit{NAT'L TAX} J. 298, 312-13 (1950) (discussing 1953 amendment that allowed addition method). In fact, the Japanese accounting industry of the time argued for an addition method VAT because, industry members claimed, it was a more practical measure of Japanesefua-kachi (added-value) than the sales-subtractive method. Id. at 306 (relating opposition to 1950 VAT); see G. Gregory, \textit{The Logic of Japanese Enterprise} 27 (Sophia University Institute of Comparative Culture Business Series No. 92, 1982) (noting that added-value is useful concept in Japan where highest priority is "efficient management of scarce resources").

The second "direct" VAT is the sales-subtractive method or business transfer tax. A. Schenk, \textit{Value Added Tax—A Model Statute and Commentary: A Report of the Committee on Value Added Tax of The American Bar Association Section of Taxation} 3 (American Bar Association Section of Taxation, 1989) (proposing model tax statute and providing commentary) [hereinafter Value Added Tax Act refers to the proposed legislation and A. Schenk, \textit{Commentary} refers to the commentary].

The "indirect" VAT is the subtractive-indirect or credit-subtractive method. This VAT differs from the addition and sales-subtractive methods because it is a transactional tax, applying the tax rate to each individual component of value-added (qualifying sales multiplied by the applicable tax rate less VAT paid to suppliers on qualifying purchases) as opposed to a period tax, which applies the tax rate to a net figure representing value-added at a certain point in time. A. Schenk, \textit{Commentary}, \textit{supra} at 4. The Japanese CT is a variation of the credit-subtractive VAT. \textit{See infra} text accompanying notes 98-113 (discussing computation of CT liability). The EEC nations impose a credit-subtractive VAT as well. See Chiu & Siegel, \textit{What the Value-Added Tax Is All About, 67 TAXES: THE TAX MAGAZINE} 3, 4-5 (1989) (describing credit-subtractive VAT used in EEC).

5. \textit{See} McLure, \textit{The Value-Added Tax: Effects on Productivity and Equity}, 20 \textit{TAX NOTES} 971, 972 (1983) (describing VAT as alternative sales tax calculation); \textit{see also} DEPARTMENT OF TREASURY, \textit{supra} note 4, at 5 (defining VAT as "multistage sales tax"). If the United States
that the taxpayer reduces the sales tax base\(^6\) by the VAT paid to previous producers or distributors\(^7\) in the chain.\(^8\)

VATs are broad-based taxes that generally provide few exemptions from tax liability.\(^9\) In this respect, the VAT, as a consumption tax,\(^10\) differs drastically from an income tax that generally provides many "exemptions" from tax vis-a-vis deductions and credits from gross income.\(^11\)

The CT sparked a fierce political struggle between Japan's ruling Liberal Democratic Party (LDP),\(^12\) the Japanese Socialist Party (JSP),

adopted a federal VAT, its similarity to state sales taxes could cause friction between the federal and state governments because the federal government has traditionally reserved the sales tax base for the states. Aaron, *The Political Economy of a Value-Added Tax in the United States*, 38 Tax Notes 1111, 1115 (1988) (making federalism argument in relation to United States VAT). But see Brannon, *The Value Added Tax is a Good Utility Infielder*, 37 Nat'l Tax J. 308, 309 (1984) (arguing that federal and state governments presently impose income, tobacco, and alcohol taxes on similar tax bases); Schenk, *Value Added Tax, supra* note 4, at 294 (explaining that adoption of significant federal excise taxes during World War II did not hamper states' ability to collect sales taxes). In fact, availability of the deduction under section 164 of the Internal Revenue Code for state and local taxes paid during the tax year may actually enhance taxpayer compliance with state income taxes. *Id.*; see I.R.C. § 164 (1986) (setting forth deduction for state and local taxes).


7. See *id.* (identifying this component of VAT equation as input tax credit); see also supra note 4 and accompanying text (describing different VAT methods).

8. The normal retail sales tax, like that levied by many states, is designed to function as a tax on consumer spending. J. Due & J. Mikesell, *Sales Taxation: State & Local Structure & Administration* 50 (1983) (analyzing structure of retail sales tax). That is, although the seller is ultimately liable for payment of the tax, it passes that liability on to the purchaser, i.e., the consumer, by raising the price of the product sold. *Id.* It is idealistic to assume, however, that all businesses will sell their goods to the next link on the chain of production and distribution free of retail sales tax. See McLure, *State and Local Implications of a Federal Value-Added Tax*, 38 Tax Notes 1517, 1520 (1988) (noting some non-retail businesses actually incur sales tax in United States). When a business incurs sales tax on its transfer of a product to another business, and a retailer also incurs sales tax upon final sale of the product to the consumer, an element of double taxation, or cascading, is introduced. *Id.* at 1520, 1527. The VAT avoids the cascading that may result from a retail sales tax by allowing the input tax credit against gross tax liability. Schenk, *supra* note 6, at 1626.


10. According to Thomas Hobbes, consumption is a better measure of tax liability than income because one should pay for withdrawing from society's limited resources and not be liable to pay for what one contributes to those resources (that contribution presumably being measured by one's income). Schenk, *Value Added Tax, supra* note 4, at 225 (noting T. Hobbes, *Leviathan* 184 (Dutton ed. 1914)).


12. The LDP has been the ruling political party in Japan for 35 years. Hiatt, *Japanese Keep LDP in Power*, Wash. Post, Feb. 19, 1990, at A1, col. 6. The LDP is the largest, most conserva-
and three smaller Japanese political parties. The LDP had held a majority in both houses of the Japanese Diet since 1955. However, the JSP defeated the LDP in the July 1989 general elections for the House of Councilors. Most voters, particularly consumers, disapproved of the CT because of anticipated price increases following its introduction.
Diet members failed to reach a compromise regarding the CT during a 1989 "extraordinary session." Accordingly, Japan held a general election on February 18, 1990, in which the LDP retained its majority in the lower house. It is unclear, however, whether the LDP victory represents public approval of the CT or frustration over dissatisfying alternatives.

The Japanese CT is only one provision of the 1988 Japanese tax reform. When one views the 1988 tax reform in its totality, it is surprising that the CT has been so controversial, because it is only one factor in an overall reduction of tax revenues. Although the Japanese government expects gross CT revenues for fiscal 1990 of approximately six trillion yen ($46 billion), the entire tax reform...
package will actually reduce tax revenues by almost 3.1 trillion yen ($23 billion). 23

The CT law contains several unique and innovative VAT features, including easier record-keeping requirements for taxpayers,24 the use of very few tax exemptions coupled with a low three percent tax rate,25 and preferential treatment for small and medium-sized businesses.26 These value-added-tax features warrant serious consideration by tax analysts in the United States. Tax scholars have debated the merits of a United States VAT for several years,27 but have been unable to ascertain whether a new tax, such as a VAT, would be superior to the current income tax system.28

This Comment assumes that the goal of any system of taxation is to balance the competing objectives of efficiency and equity29 and proposes that the Japanese CT presents a novel approach in resolving this tradeoff by imposing a low tax rate on an extremely broad tax base.30 In addition, the Comment concludes that the simplified record-keeping requirements of the CT law encourage compliance


23. Guttman, supra note 2, at 1019.


25. See infra notes 119-30 and accompanying text (listing activities and transactions entitled to tax exemption under CT law).

26. See infra notes 131-34 and accompanying text (discussing administrative merits of preferential treatment for small and medium-sized businesses).


28. This Comment will not specifically consider the tax ramifications of the CT on United States citizens. Generally, however, a United States taxpayer may deduct VAT paid to a foreign government (I.R.C. § 164 (1986)) or report a tax credit for the VAT paid vis à vis the foreign tax credit (I.R.C. § 903 (1986)). The tax must be either an income or war tax, or a tax in lieu of an income or war tax to be eligible for the foreign tax credit. J. BISCHEL & R. FEINSCHREIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION 66, 68 (2d ed. 1985) (explaining “in lieu of” test). VATs are generally ineligible for the foreign tax credit. Id. at 68.


30. See infra notes 99-105 and accompanying text (illustrating CT calculations).
with its requirements.\textsuperscript{31}

Part I considers the history of VAT in Japan. This section illustrates the extent to which Japan's prior experience with a VAT following World War II shaped its current disposition against value-added taxation. This section also reveals some similarities and differences between the American and Japanese tax structures. Part II presents a brief overview of the CT law, including methods of calculating the tax, exemptions from the tax, and the determination of who pays the tax. Part III analyzes the law, concentrating on the unique characteristics of the CT and compares its provisions with those of recently proposed VAT legislation in the United States.

This Comment concludes that the Japanese Diet should not repeal the CT; rather, it should grant an exemption or establish a credit system for consumer food purchases to appease Japan's consumer movement. This Comment also urges the United States to adopt a broad-based VAT with a low rate, modeled after the Japanese CT legislation. The United States can use VAT revenues either to reduce the growing budget deficit\textsuperscript{32} or to fund proposed social programs.\textsuperscript{33}

I. A Brief History of Japanese Tax Policy

The current predisposition against value-added taxation in Japan may be an outgrowth of that nation's previous experiences with a VAT during the Allied occupation following World War II.\textsuperscript{34} An American-led post-war mission to Japan developed a Japanese VAT to raise substantial local revenues.\textsuperscript{35} The Diet repealed the tax prior to its implementation for several reasons, one of which was public disapproval.\textsuperscript{36} This experience resulted in a general aversion to indirect taxes such as the VAT.\textsuperscript{37}

Prior to the introduction of the CT law in 1988, Japan relied less
on indirect consumption taxes than any country in the world.\textsuperscript{38} Japan utilized an indirect tax, the commodity tax, until its repeal and replacement with the CT in 1989.\textsuperscript{39} The commodity tax was, however, an ineffective, inefficient, and confused system of multiple rate taxes.\textsuperscript{40} By the mid-1980s, Japan desperately needed to simplify its indirect tax structure.\textsuperscript{41}

Japanese lawmakers have tended to rely on existing European and American legislation in promulgating their own laws. Japan based its original tax structure on Western systems and deviated from this structure only once, during World War II, when the government needed to finance the war effort.\textsuperscript{42} After the war, the Allies rebuilt Japan's tax system in their own image, successfully "American-izing" the Japanese tax structure.\textsuperscript{43} Today, the tax system reflects both East and West; in particular, the CT is Japan's version of the European VAT.

A. Japanese Tax Policy: Pre-World War II

The Japanese government announced plans to create the nation's first organized tax system in 1868.\textsuperscript{44} Like many reforms of that period, the plan borrowed heavily from Western tax ideology.\textsuperscript{45}

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38. Pechman, \textit{World Tax Reform: A Progress Report}, 39 Tax Notes 245, 246 (1988). In 1985, consumption taxes (including sales, value-added and excise taxes, border taxes, taxes on transfers of property and securities, and other taxes) comprised only 4.8% of gross domestic product (GDP) in Japan. \textit{Id.} This is substantially less than the percent of tax revenue from consumption taxes to GDP in other countries: Denmark (17.7%), France (15.4%), Sweden (13.8%), the United Kingdom (12.4%), and the Netherlands (12.1%). \textit{Id.} In the United States, however, consumption taxes, comprised mainly of national excise taxes, were 5.2% of the GDP in 1985.

39. J. Pechman, \textit{supra} note 16, at 418-19. The commodity tax was an indirect tax consisting of two classes of taxable items. \textit{Id.} at 418. Class one consisted of precious stones, metal products, fur, carpet, and similar items. \textit{Id.} The tax rate for most class one items was 15%. \textit{Id.} Class two consisted of televisions, cameras, furniture, and similar items, taxed at several different rates, ranging from five percent for coffee to 30% for yachts. \textit{Id.} In 1989, the CT replaced the national commodity tax, the local levies on electricity, gas and timber delivery, and the following national taxes: playing-cards tax, sugar excise tax, admission tax, and travel tax. Main Points of Tax Reform § 4(1)(8); see infra notes 281-84 and accompanying text (discussing intended uses of CT revenues).


43. See \textit{id.} at 580 (discussing similarities between United States and Japanese tax structures subsequent to World War II).


45. Uematsu, \textit{supra} note 42, at 569. The Japanese system of national taxation developed during the Meiji regime, or restoration, a period of major Japanese reforms. The promulga-
most twenty years later, in 1887, Japan adopted the national income tax. It is not surprising that the first major Japanese tax was an income tax, because many Western nations relied heavily on that tax at the time.

Although the Japanese government did not impose the national income tax on corporations, the corporate entity became subject to an income tax by the Income Tax Law of 1899. This law exempted dividends from taxation, thereby preventing the "double taxation" that often results from the simultaneous imposition of both corporate and individual income taxes. Notions of equity vanished from Japanese corporate tax policy by 1940, however, when taxing authorities amended the corporate income tax to impose a flat eighteen percent tax rate on corporate income. Taxing authorities used this tax to finance the Japanese war effort in World War II. After the war, Japan needed both an economic overhaul and a tax restructuring to finance the country's post-war reconstruction.


Japan desperately needed an effective tax system after World War II. The government owed 105.7 billion yen for debts incurred dur-
ing the war,\textsuperscript{53} inflation soared to an all time high,\textsuperscript{54} and a large group of Japanese businesses formed an elite cartel known as the "Zaibatsu," which controlled the entire Japanese economy.\textsuperscript{55} Although the existing tax system taxed both "direct" and "indirect"\textsuperscript{56} tax bases at inordinately high rates, taxpayer compliance was notoriously low, and revenues were inadequate.\textsuperscript{57} Initial efforts to reform the Japanese tax system in 1946 met the nation's short-term objectives but failed to consider long-term goals.\textsuperscript{58} Subsequently, the Allies sought to overhaul the entire Japanese tax structure, but various economic, social, and administrative factors undermined these reforms and ultimately led to the current disdain for value-added taxation.\textsuperscript{59}

1. The 1946-1947 tax reforms

The Allied occupation following World War II supervised a massive tax reform effort in 1946 designed to rebuild the Japanese economy.\textsuperscript{60} The two most important reforms to the heavily indebted Japanese government were the Capital Levy, a tax on wealth, and the War Indemnity Special Tax, which was actually a scheme to release the Japanese government from its obligation to repay war debts.\textsuperscript{61} The government also narrowed income tax rates, from

\textsuperscript{53} Id. at 133. War debts included unpaid claims from war damages and government contract terminations, insurance claims and other war indemnities, and claims by private banks for defaults on loans secured by the Japanese government. \textit{Id.}

\textsuperscript{54} Id. at 129-31.

\textsuperscript{55} See Kanazawa, \textit{The Regulation of Corporate Enterprise: The Law of Unfair Competition and the Control of Monopoly Power}, in \textit{Law in Japan: The Legal Order in a Changing Society} 480, 484 (A. von Mehren ed. 1963) (explaining that dissolution of Zaibatsu was one of principal objectives of Allied occupation). Tax analysts urged the government to use the tax structure to break up the Zaibatsu. \textit{See infra} notes 61 & 75 and accompanying text (discussing uses of tax structure to eliminate Zaibatsu).

\textsuperscript{56} Shavell, supra note 51, at 130-31 (illustrating tax rates for 1940 through 1945). Between 1945 and 1948, the following indirect taxes were all in effect at one time or another: liquor, beer, and sake taxes, commodity tax, admissions tax, textile excise tax, horse-racing tax, sugar excise tax, haircut and beauty parlor tax, soft drink tax, transportation tax, tonnage tax, building construction tax, amusement and recreation tax, stamp tax, and other minor taxes. \textit{Id.} at 130. By 1947, the national government relied less on indirect taxes, although the local governments relied more on indirect taxes at that time. \textit{Id.}

\textsuperscript{57} Shavell, supra note 51, at 131, 141.

\textsuperscript{58} \textit{See infra} notes 60-63 and accompanying text (describing 1946 reform).

\textsuperscript{59} \textit{See infra} notes 64-87 and accompanying text (discussing Shoup Mission).

\textsuperscript{60} Shavell, supra note 51, at 141. The Allied occupation supplied military teams that supported the tax reform and encouraged taxpayer compliance. \textit{Id.} The allied nations rebuilt Japan to a point where, less than 50 years later, it has economically surpassed many of the nations involved in the post-war reconstruction. \textit{See Merrill Lynch, supra note 9} (noting that economic growth in Japan has surpassed that of EEC nations since 1981). In fact, Japan's growing economic strength is one of the major factors behind the EEC unification in 1992. \textit{Id.}

\textsuperscript{61} Shavell, supra note 51, at 132-33. The government imposed the Capital Levy mainly to eliminate the power of the Zaibatsu. The War Indemnity Special Tax was actually a form of cancellation of indebtedness whereby tax liability would be cancelled by releasing the govern-
fifty-five percent to ninety-seven percent, in pre-reform 1946, to twenty percent to eighty-five percent, in 1947,\textsuperscript{62} and transferred some of the national indirect taxes to the local governments.\textsuperscript{63} Despite these short-term modifications to the existing tax structure, Japan still needed a permanent tax system to provide the economic support necessary to rebuild the country during the latter half of the twentieth century.

2. \textit{The recommendations of the Shoup Mission}

The Report on Japanese Taxation prepared by the Shoup Mission\textsuperscript{64} in 1949 set forth a plan to meet the objectives of the Allied occupation,\textsuperscript{65} stabilize the Japanese economy,\textsuperscript{66} and create the most modern system of national taxation in the world—all to be drafted in five months.\textsuperscript{67} The most fascinating aspect of the Shoup Mission’s recommendations, however, does not lie in its grand ambition, but in its proposal for Japan to adopt the enterprise tax, the first broad-based VAT in the world.\textsuperscript{68}

The Diet adopted the 1950 VAT at an extraordinary session convened specifically to consider it.\textsuperscript{69} The Diet, however, delayed implementing the tax until 1954 when the government finally repealed the tax due to pressures from groups expecting to be hit heavily by the VAT levy.\textsuperscript{70} The 1950 VAT, like the 1989 CT, appeared innocuous, but generated great public outrage after its adoption.\textsuperscript{71} It was a...
sales-subtractive VAT\textsuperscript{72} that, unlike the national CT passed in 1989, was a local tax designed to replace the business activity or enterprise tax.\textsuperscript{73} The Shoup Mission recommended a VAT, in lieu of a retail sales tax, in an effort to spare the typically small Japanese retailer\textsuperscript{74} and to place the burden of tax compliance on large producers and distributors.\textsuperscript{75}

Several economic, social, and administrative factors account for the failure of both the 1950 VAT and many of the Shoup Mission recommendations in general. The unresponsiveness of the Allies to Japanese public opinion was a principal factor in this failure.\textsuperscript{76} First, farmers and other consumers feared that the VAT would cause higher prices for consumer goods because producers and distributors would simply pass the tax burden through the chain of production and distribution.\textsuperscript{77} Second, small businesses believed that the administrative and compliance costs of the VAT would be too great for them to bear.\textsuperscript{78} Third, Japanese labor organizations and political parties inherently distrusted the VAT because they believed that it promoted the employment of machines rather than people.\textsuperscript{79}

\textsuperscript{72} Schenk, supra note 6, at 1627; see supra note 4 and accompanying text (defining tax base of sales-subtractive VAT). An amendment to the tax allowed certain industries (private railroads, shipping industries, banks, insurance companies, warehousing, and others) to use, in lieu of the credit-subtractive method, an arbitrary percentage of gross income from sales as the tax base. Bronfenbrenner, supra note 4, at 312. The members of the Shoup Mission opposed this amendment. \textit{Id.} at 313 n.22. A later amendment, in 1953, permitted use of the addition method instead of the credit-subtractive method. C. Sullivan, The Tax on Value Added 147 (1965). This combination of VAT methods proved confusing to the Japanese. \textit{Id.}

\textsuperscript{73} Uematsu, supra note 45, at 578. The business activity or enterprise tax was a local tax, the revenues from which went to the prefectures. Bronfenbrenner, supra note 4, at 299. A prefecture is the Japanese equivalent of a state in the United States. \textit{Id.} The government enacted the business activity tax in 1878. It split into two taxes, the local enterprise tax and the national enterprise profits tax, in 1896. Uematsu, supra note 45, at 577. The government based the local tax on such factors as sales, building rent, capital, and number of employees. The national tax used business profits as the tax base (as did the tax prior to the 1896 split). \textit{Id.} In 1940, the two taxes were recombined into a single local tax. \textit{Id.} at 578. The tax became the business activity tax in 1948. \textit{Id.} The tax is still in effect. J. Pechman, supra note 16, at 425.

\textsuperscript{74} See Bronfenbrenner, supra note 4, at 300 (noting burdens on retailers of complying with VAT). Apparently, the Shoup Mission concluded that there were too many small retailers for the effective enforcement of such a tax. Bronfenbrenner & Kogiku, supra note 67, at 241. See supra note 55 and accompanying text (explaining this burden actually furthered post-war objective of discouraging Zaibatsu). Large businesses objected to the VAT, claiming an inability to pass on the tax in full. Bronfenbrenner, supra note 4, at 310-11.


\textsuperscript{76} Id. at 353; see infra notes 173-83 and accompanying text (noting effect of VATs on consumers).

\textsuperscript{77} Bronfenbrenner, supra note 4, at 307-08.

\textsuperscript{78} Id. at 311. This was an unsophisticated way of claiming that the VAT was not sav-
Culturally, the major goal of the Shoup Mission, to create a modern tax system, was an unrealistic objective. Japan’s homogenous society considered immediately suspect any system created by gaijin (foreigners). In addition, the rapid deterioration of relations between the Allied occupiers and the Japanese people heightened disapproval of the Shoup Mission recommendations.

Various administrative problems also undermined the Shoup Mission recommendations. For instance, most Japanese people did not understand the term “value-added tax,” which translated literally to fuka-kachi-zei, a term that some interpreted to mean “double tax” or “tax on gross income.” Also, technical deficiencies were inevitable because the Shoup Mission drafted its recommendations in only five months. Finally, the report predicted its own demise when it warned that the Shoup Mission recommendations were indivisible: the Diet should either enact all or none of the proposals to maximize economic reform.

The Shoup Mission may have failed in its quest to establish the most modern tax system in the world, but it succeeded, at least partially, in its effort to “American-ize” the Japanese tax system. Both the United States and Japan relied predominantly on revenues from direct taxes, such as the income tax, rather than on indirect consumption taxes, such as the European VAT.

C. Living With the Consequences of Shoup: Modern Japanese Tax Policy

During the period after the Shoup Mission and before the 1988 tax reform, there were more similarities than differences between Japanese and American tax policies. Both nations relied more on income taxes than on indirect taxes such as the VAT, indicating a
mutual preference for a progressive and relatively broad tax base. They both seemed willing, however, to sacrifice some of that broadness to maintain the progressive structure of an income tax, rather than to adopt the regressive structure of a VAT. The two systems of taxation diverged during the 1980s, enabling Japan to change its traditional world tax policy role from student of the West to sensei (teacher).

By 1980, Japan was considering re-introducing the VAT to raise substantial revenues at low tax rates. Although these efforts failed, the VAT reappeared in a 1985-86 tax reform proposal designed to replace the confusing commodity tax. The 1986 VAT sought to “neutralize” the indirect tax system so that different products and services would be taxed at identical rates. In addition, the government intended to use VAT revenues to fund reductions in corporate and individual income tax rates. These efforts also failed, in part because the law required taxable enterprises to obtain code numbers from the tax office, which could, and likely would, be used as registration numbers for other major Japanese taxes. Despite this well-entrenched history as a no-VAT country, former Prime Minister Noboru Takeshita endorsed passage of the 1989 CT law.

II. THE CONSUMPTION TAX LAW

The Japanese CT law advances traditional VAT concepts. It is one of the few single rate VATs employed in the world and its current incarnation exempts very few items and activities from tax liability. In addition, its simplified record-keeping requirements and preferential treatment for small- and medium-sized businesses promote taxpayer compliance.

89. See Aaron, supra note 5, at 1114 (explaining regressive tax takes proportionally more from low-income groups than from high-income groups).
90. The United States Tax Reform Act of 1986 (TRA) exemplifies a reinforced belief by the federal government in the structure of the income tax. Zodrow, A Direct Consumption Tax As an “Add-On” Tax, 38 TAX NOTES 1389, 1389 (1988); cf. McLure, supra note 8, at 1518 (reasoning that VAT is more likely in post-TRA United States). The TRA lowered marginal tax rates and substantially broadened the income tax base by, inter alia, limiting the Individual Retirement Account [hereinafter IRA] deduction and eliminating the preferential capital gains tax, thereby expressing a preference for broad-based taxation. Id.
91. A. Tait, supra note 1, at 36.
92. See supra note 39 and accompanying text (describing recently repealed commodity taxes).
94. A. Tait, supra note 1, at 36.
95. Id. at 36-37. Japanese taxpayers resented using one tax to enforce another. Id. at 37.
96. Schenk, supra note 6, at 1626.
97. A. Tait, supra note 1, at 39.
A. How Does One Compute Net Tax Liability?

The CT is a variation of the credit-subtractive method used predominantly in the EEC. The taxpayer computes output tax liability by multiplying taxable sales by the standard three percent tax rate. The taxpayer then computes the net tax by reducing the output tax liability by the amount of taxes paid on qualifying purchases. The law also allows the taxpayer deductions against output tax liability for: (1) sales returns and allowances, discounts, rebates, and other refunds; (2) uncollectible trade receivables, i.e., bad debts; and (3) excise and other taxes paid as of April 1, 1989, on goods in distribution or inventory.

Some businesses may use several available alternative calculations to determine their net CT liability. First, when a taxpayer makes nontaxable sales exceeding five percent of total sales, the taxpayer computes its input tax credit by either of two simplified calculations.

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98. See infra notes 109-13 and accompanying text (noting differences between EEC VATs and CT).
99. See supra note 6 (explaining computation of output tax).
100. Japanese CT § 3. The tax base is either sales price (including other indirect taxes) for domestic transactions or delivery price (including duty, other indirect taxes, freight and insurance) for imported goods. Arthur Young, Japanese Consumption Tax 6 (1989) (outline of CT law available from Ernst & Young, Tokyo, Japan).
102. Japanese CT § 7(1)(a). All purchases corresponding to taxable sales are creditable, qualifying purchases. Arthur Young, supra note 100, at 10. When a taxpayer initially records a purchase in its books of account, the taxpayer debits an expense account and credits cash or accounts payable. Schenk, supra note 6, at 1627. The amount recorded in the taxpayer’s accounting records includes any potentially creditable CT paid to the supplier. Id. Under the CT system, purchases, as debited in the taxpayer’s bookkeeping system, multiplied by 3/103 (the denominator of 103 reverses out the CT already included in the gross purchases amount), yields the input tax credit. Id.; accord, Arthur Young, supra note 100, at 10 (demonstrating CT calculations).

For purposes of determining the period in which taxable sales and purchases occur, the CT law generally requires that taxpayers use the accrual method of accounting. Schenk, Policy Issues, supra note 4, at 118. The accrual method recognizes income when earned, not necessarily received, and expenses when incurred, not necessarily paid. S. Surrey, supra note 11, at 615-16.

103. Japanese CT § 7(2). The taxpayer takes the deduction in the tax period when the discount or other refund is made. Id.
104. Id. § 7(3).
105. Id. § 11(2). This provision is a transitional measure designed to appease taxpayers. The proposed Value Added Tax Act contains a similar provision. Value Added Tax Act § 4040; see A. Schenk, Commentary, supra note 4, at 189-90 (commenting that section 4040 is potential administrative nightmare).
106. See Japanese CT §§ 6(1)-(11) (describing nontaxable sales); see also infra notes 128-30 and accompanying text (listing tax exempt items under CT law).
lations designed to accurately reflect CT paid on taxable sales. 107 Second, a small or medium-sized business enterprise with taxable sales not exceeding 500 million yen ($3.8 million) may reduce its output tax liability by an estimated input tax credit equal to eighty percent of taxes paid on taxable sales. 108

The credit-subtractive VAT used in the EEC requires the taxpayer to substantiate the claimed input tax credit with supporting tax invoices. 109 These invoices must show, among other things, the amount of VAT paid by the purchaser to the seller as part of the purchase price of a product or service. 110 Theoretically, the invoice method provides an audit trail by which the government can verify the accuracy of the input tax credit. 111

In contrast, the Japanese CT law uses an account-based or books of account method that allows the taxpayer to use its existing accounting system to substantiate claimed input tax credits. 112 This method recognizes the inconvenience to businesses of changing their billing systems to accommodate the requirements of the invoice method. 113

107. Japanese CT §§ 7(1)(b)(i)-(ii). The two methods are: (1) the itemized method in section 7(1)(b)(i), and (2) the proportional method in section 7(1)(b)(ii). Id. Each method computes output tax liability like the general formula. See supra notes 99-101 and accompanying text (outlining formula and discussing elements). The calculation of the input tax credit under the itemized method is as follows: tax paid on purchases corresponding to taxable sales plus the product of purchases corresponding to both taxable and nontaxable sales multiplied by 3/103, multiplied by taxable sales over total taxable and nontaxable sales. Japanese CT § 7(1)(b)(i). There is an optional method of allocating between taxes paid on taxable and nontaxable sales that the NTA must approve in advance. Id. The tax authorities base this allocation on factors such as the number of employees and floor space. Id. The calculation of the input tax credit under proportional method is as follows: CT paid on qualifying purchases multiplied by the quotient of taxable sales divided by total sales. Id. § 7(1)(b)(ii); see Schenk, supra note 6, at 1629-30 (demonstrating CT calculations).

108. Japanese CT § 8(3). For wholesalers, the applicable percentage of deemed purchases is 90%. Id. This election is irrevocable for two years. Id.

109. A. Tarr, supra note 1, at 279-80.

110. Tax invoices in the EEC usually include the names and addresses of both the purchaser and seller, the seller’s VAT registration number, the invoice number and date, the shipping or supply date (when different from the invoice date), a description of the goods or services, purchase price excluding VAT, the applicable VAT rate, and VAT charged to the purchaser at each of these rates. Id.

111. See Turnier, supra note 3, at 460-61 (providing examples of invoice method). But see Schenk, Value Added Tax, supra note 4, at 286 (revealing fallacy of supposed benefit of invoice method). European tax scholars initially perceived the VAT as a means to increase taxpayer compliance. Id. However, civil servants in the tax system find general VAT administration, including verifying timely filings of returns and reviewing propriety of refund claims, so time-consuming that cross-checking invoices, to verify that the input tax credit claimed by the purchaser equals the VAT charged by the seller, is impractical. Id.

112. Japanese CT § 7(1)(c); see infra notes 149-64 and accompanying text (discussing account-based feature of CT).

113. Schenk, Policy Issues, supra note 4, at 112, 118.
B. Who Pays the Tax?

The government imposes the CT on the value of goods and services consumed in Japan.\textsuperscript{114} The law subjects both goods and services sold or leased to Japanese businesses by other Japanese businesses and goods and services imported into Japan to the tax.\textsuperscript{115} Ultimate tax liability rests with the business enterprise that sells or leases goods and services to other domestic businesses.\textsuperscript{116} The recipient of imported goods is ultimately liable for the tax on receipt of the goods from bonded warehouses.\textsuperscript{117}

C. Who Does Not Pay the Tax?

The government does not tax all business enterprises. An entity may be either wholly or partially exempt from the tax or be engaged in an activity that is zero-rated under the law.\textsuperscript{118} An exempt enterprise is treated as "outside" the tax system.\textsuperscript{119} An exempt organization, therefore, may not claim a refund for VAT paid to suppliers.\textsuperscript{120} An enterprise engaged in a zero-rated activity is part of the tax system; the taxpayer's rate of tax is simply zero.\textsuperscript{121} Thus, an organization engaged in a zero-rated activity, such as exporting,\textsuperscript{122} may

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\textsuperscript{114} Japanese CT § 1. The concept of a tax jurisdiction imposing tax only on goods and services consumed in that jurisdiction is known as the destination principle. Schenk, supra note 6, at 1627; see infra notes 219-28 and accompanying text (describing zero-rating of exports under destination principle VAT). In contrast, the 1950 VAT would have imposed the tax based on the origin principle. C. SULLIVAN, THE TAX ON VALUE ADDED 146 (1965); see Cnossen, The Irrelevance of the Restricted Origin Principle, 20 TAX NOTES 521, 522 (1983) (describing origin principle as confining tax liability to value-added within applicable tax jurisdiction). The EEC rejected a recent proposal that its member nations move to the origin principle after the EEC unification in 1992. DuBois, EC Ministers Agree to End Border Checks, Wall St. J., Oct. 10, 1989, at A15, col. 3.

\textsuperscript{115} Japanese CT § 1. Only transfers of assets for valid consideration are taxable domestic transactions. ARTHUR YOUNG, supra note 100, at 4. Domestic transactions subject to the CT include transfers of tangible and intangible property, performance of services, and leasing activities. \textit{Id.} Import transactions are taxable even when there is no valid consideration. Import transactions subject to the tax include only tangible assets. \textit{Id.}

\textsuperscript{116} Japanese CT § 2. The Japanese government exempts casual sales from the CT. ARTHUR YOUNG, supra note 100, at 2. In contrast, the recently proposed Value Added Tax Act in the United States would impose VAT on certain casual, i.e., nonbusiness, sales where the dollar amount of the sale exceeded some \textit{de minimis} threshold. See infra notes 266-67 and accompanying text (discussing tax on certain nonbusiness sales).

\textsuperscript{117} Japanese CT § 2. The recipient of imported goods ordinarily must pay the corresponding tax liability before receipt of the goods. \textit{Id.} § 9(2). However, the taxpayer may defer payment of the tax in one of two ways. First, the taxpayer may place the goods in a bonded warehouse area, in which case the tax will be due before the goods are withdrawn from the bonded area. \textit{Id.} Second, the taxpayer may post collateral, in which case the tax payment may be deferred for up to three months. \textit{Id.}

\textsuperscript{118} A. TArT, supra note 1, at 49-60.

\textsuperscript{119} \textit{Id.} at 49.

\textsuperscript{120} Chiu & Siegel, supra note 4, at 5.

\textsuperscript{121} A. TArT, supra note 1, at 49.

\textsuperscript{122} Japanese CT § 5.
credit the VAT paid to its suppliers, which may actually entitle it to a net CT refund.  

1. Zero-rating of exports

Exporting is the only zero-rated activity in the Japanese CT legislation.  

124 It is entirely consistent with a destination principle VAT such as the CT to zero-rate exports.  

125 The exporter does not pay tax on the value added to goods and services, yet claims credits for VAT paid to suppliers.

2. Wholly and partially exempt transactions

Several types of entities engaged in otherwise taxable activities are exempt from the CT.  

128 The government provides some exemptions to promote certain activities, such as the exemption designed to promote the sale of government securities.  

129 Other exemptions exist simply because the government already imposes a more effective tax on that item than the CT.

The CT legislation relieves small and medium-sized business enterprises from paying all or part of their potential tax liability. First, the law exempts those enterprises with taxable sales during the base period of less than thirty million yen ($231,000) from paying the

123. Chiu & Siegel, supra note 4, at 5. This would occur if the enterprise engaged in only zero-rated activities or in a greater proportion of zero-rated activities than non-zero-rated taxable activities.

124. Japanese CT § 5. Although the CT legislation refers to exporting as an exempt transaction, as opposed to a zero-rated activity, the CT law treats exports as if they were zero-rated by allowing exporters to deduct CT paid to suppliers. Id.; see also Main Points of Tax Reform, supra note 2, § 4(1)(3) (describing zero-rating of exports).

125. See infra notes 219-28 and accompanying text (discussing zero-rating of exports under CT).

126. When services are performed both inside and outside the tax jurisdiction, the taxing jurisdiction must decide whether or not to impose VAT on that transaction. See TRAC Act § 4006(b)(2) (proposing de minimis-type rule for services performed both inside and outside United States tax jurisdiction). This rule would impose VAT on services when more than 50% of such services were performed in the tax jurisdiction. Id.


128. See A. Tait, supra note 1, at 51 (describing legislative process of deciding what activities should be taxed, exempt, or zero-rated as theoretically simple but practically impossible). Public policy is often the principal motivation underlying tax code provisions. See S. Surrey, supra note 11, at 46 (listing promotion of socially desirable objectives as one of goals of tax system). Both the United States and Japanese tax codes allow deductions for socially motivated reasons, such as the deductions available for casualty losses, medical expenses, and charitable contributions. Compare J. Pechman, supra note 16, at 407-08 (listing deductions under Japanese income tax code with I.R.C. §§ 165(h), 213 & 170 (1986) (allowing deductions for casualty losses, medical care, and charitable contributions, respectively).

129. Japanese CT § 6(2).

130. See Japanese CT § 6(6) (exempting stamp sales from CT liability). The government
These enterprises may elect to register for the tax so that businesses with net input credits may claim refunds.\(^{132}\) Second, business enterprises with taxable sales\(^{133}\) between thirty and sixty million yen (\$231,000 and \$462,000) may claim a marginal or partial exemption from tax liability.\(^{134}\)

### III. Analysis

Every system of taxation balances efficiency, equity, and simplicity.\(^{135}\) An efficient tax structure minimizes the number of taxpayers,\(^{136}\) the number of difficult decisions that a taxpayer must make,\(^{137}\) administrative burdens and documentation requirements,\(^{138}\) and the taxpayer’s need to rely on tax professionals in complying with the law.\(^{139}\) An equitable tax structure imposes tax equally among equals (horizontal equity) and proportionally among

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\(^{131}\) See Schenk, *Value Added Tax*, supra note 4, at 238-39 (stating input tax credit is related to use of item by item preferences and giving examples of calculations). Exempt enterprises do not collect VAT on their sales, but do pay the tax on purchases. *Id.* Accordingly, these businesses have refundable net input credits. *Id.*

\(^{132}\) *Id.* § 8(1) (defining as third year before the current tax year for sole proprietors, partnerships, and corporations with fiscal year of one year).

\(^{133}\) *Id.* § 8(1)-(2). This is net of taxes. *Id.*

\(^{134}\) *Id.* § 8(2). The taxpayer computes tax liability as if it were not entitled to any preferential treatment and multiplies the resulting tax liability by the fraction of taxable sales less 30 million yen divided by 30 million yen. Enterprises that use the simplified tax scheme for small and medium-sized businesses (discussion supra note 107 and accompanying text) may also exercise this marginal exemption. *Id.*

\(^{135}\) S. SURREY, supra note 11, at 46-47.


\(^{137}\) *Id.* at 1263.

\(^{138}\) *Id.* at 1265.

\(^{139}\) *Id.* at 1267.
nonequals (vertical equity).\textsuperscript{140}

Notions of equity permeate the basic goals of a tax system. These goals include the redistribution of wealth indirectly through transfer payments or directly through the tax system,\textsuperscript{141} the stimulation or deflation of the economy by manipulating tax rates,\textsuperscript{142} the promotion of socially desirable objectives,\textsuperscript{143} the promotion of economic and investment objectives,\textsuperscript{144} and the deterrence of certain activities.\textsuperscript{145} A simple tax structure has attributes of both an efficient and equitable tax system. Taxing authorities achieve a simple tax structure when they minimize the costs of administering the tax and the taxpayer’s costs of complying with its requirements.\textsuperscript{146}

The CT law presents a novel approach to the trichotomy between efficiency, equity, and simplicity by easing typical VAT compliance costs while raising substantial tax revenues. The CT drafters may have created some unanticipated problems, however, in failing to promote the tax effectively prior to its April 1989 implementation.\textsuperscript{147} The following analysis of the CT law focuses on the unique

\textsuperscript{140} Gravelle, Assessing a Value-Added Tax: Efficiency and Equity, 38 Tax Notes 1117, 1118-20 (1988).

\textsuperscript{141} S. Surrey, supra note 11, at 46. The Medicare system is an example of wealth redistribution vis-à-vis transfer payments. Id. The earned income credit, a dollar-for-dollar tax reduction for low-income groups subject to a phase-out as the earned income of the individual increases, is an example of wealth redistribution. I.R.C. § 32 (1986); see infra notes 215-18 and accompanying text (suggesting credit system patterned after earned income credit to combat regressivity of CT).

\textsuperscript{142} S. Surrey, supra note 11, at 46.

\textsuperscript{143} Id. The deduction for charitable contributions available in both the United States and Japan exemplifies this objective.

\textsuperscript{144} S. SURREY, supra note 11, at 46. The preferential 20% tax rate for capital gains on the disposition of securities in the 1988 Japanese tax reform represents a policy decision by the Japanese taxing authorities to promote investment in the private sector.

\textsuperscript{145} S. Surrey, supra note 11, at 46. The taxation of so-called illegal income (i.e., money received during illegal activities such as gambling) exemplifies this policy objective. I.R.C. § 61 (1986); see C. SCHULTZE, THE PUBLIC USE OF PRIVATE INTEREST 50-51 (1977) (proposing imposition of tax on sulfur dioxide polluters to discourage sulfur dioxide pollution).

\textsuperscript{146} S. Surrey, supra note 11, at 47. Administrative costs include the costs incurred in processing tax returns, examining returns for accuracy, policing prompt filings and tax payments, educating the public, and other administrative functions. DEPARTMENT OF TREASURY, supra note 4, at 111-22. Recent estimates in the United States indicate the potential administrative burden of a VAT. See id. at 111, 121 (estimating that VAT would require IRS to hire 20,000 additional employees and incur annual administrative costs of $700 million).

Costs of compliance include those costs necessary to complete tax returns, compile and maintain adequate accounting records, and retain professional tax advice. Such costs do not include opportunity costs, i.e., costs of foregone alternatives, associated with payment of the tax, costs of the effect of the tax on consumption and production, and psychological costs generated by the public’s general fear of taxation. Sandford, What it Costs to Pay Tax, ACCT. 140 (Feb. 1989).

\textsuperscript{147} See Brauchli, They’ll See Results When Viewers Go Out to Replace Smashed TVs, Wall St. J., Nov. 3, 1989, at B1, col. 1 (describing unsuccessful television and print advertising campaign begun October 1989 to promote CT). Japanese consumers apparently do not understand the CT. The best evidence of this lies in their alliance with the JSP. Lehner, In Japan, supra note 15, at A10, col. 1. The JSP advocates replacing the CT with a series of commodity taxes
characteristics of the tax, including its use of the account-based method, and argues that such innovations are superior to VAT concepts employed in other existing VAT legislation. Finally, this analysis compares the CT law to two recent United States VAT proposals and argues that the CT is a more realistic approach to VAT policy than these American proposals.

A. Efficiency of the CT Law: The Account-Based Feature of the CT

The account-based feature of the Japanese CT sacrifices ease of administration for ease of compliance. By relying on an enterprise's books of account, in lieu of tax invoices, the CT minimizes the compliance burdens inherent in an invoice system. In this respect, the tax is an efficient levy which, by its simplicity, promotes adherence to the requirements of the law.148

1. Benefits and critiques of the account-based method

The account-based method is less burdensome than the invoice method. Thus, taxpayers do not need as much time between adoption and implementation of the tax to establish new accounting procedures.149 Accordingly, governments may implement the tax more quickly than they could implement an invoice method VAT.150 The account-based method may also reduce the administrative costs necessary to educate the public about the tax. In exchange for these benefits, however, some analysts contend that the CT adds significant administrative detriments.

Proponents of the invoice method argue that the tax invoice requirement deters tax evasion because it provides tax authorities with a means to cross-check the claimed input tax credit against the applicable amounts listed on supplier issued sales invoices.151 In addi-
tion, these analysts contend that the account-based system actually enhances the taxpayer’s opportunities to avoid paying tax by allowing taxpayers to compute the input tax credit based on “deemed” qualifying purchases instead of actual qualifying purchases.152

Finally, some critics maintain that the account-based feature converts the credit-subtractive VAT from a transactional tax to a period tax.153 Without invoices, an account-based, credit-subtractive VAT is incapable of accommodating multiple VAT rates and, thus, taxpayers can only calculate VAT at a certain point in time and at only one rate.154 In a multiple rate account-based system, taxpayers would be unable to compute accurately VAT liability from their accounting records because their records do not encompass the necessary detail of supplier issued tax invoices.155

2. **Response to critiques of account-based method**

European practice illustrates the fallacy inherent in these critiques. Although the invoice method does deter tax evasion in theory, the majority of countries currently using the invoice method find general VAT administration so time-consuming that cross-checking invoices to claimed input tax credits, absent clear evidence of taxpayer fraud, is virtually impossible.156 In fact, the account-based system, in expressly allowing what would clearly be considered VAT evasion in a European credit-subtractive invoice method VAT,157 alleviates administrative burdens on the tax authorities to

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152. Schenk, *Policy Issues*, supra note 4, at 116. In computing the input tax credit under the general CT formula, the taxpayer multiplies $9/103$ by the amount of tax inclusive purchases found in the taxpayer’s accounting records. *See supra* note 102 (discussing computation). The CT law contemplates that this figure will likely include purchases from exempt suppliers who actually did not charge the taxpayer any VAT on the sale. *See Japanese CT § (7)(1)(a)* (including purchases from tax-exempt enterprises, such as exporters, in taxable purchases). Therefore, the input tax credit will reflect “deemed” qualifying purchases instead of actual qualifying purchases. Schenk, *Policy Issues*, supra note 4, at 116.

153. *See supra* note 4 (defining transactional tax as one that applies tax rate to each individual component of value-added and period tax as one that applies tax rate to net figure representing value-added at specified time period).

154. A. Schenk, *Commentary*, *supra* note 4, at 4-5.

155. *See supra* note 110 (listing typical contents of tax invoices).

156. Schenk, *Value Added Tax*, supra note 4, at 286-87; *see A. Tatt*, supra note 1, at 304 (naming Korea as only country imposing invoice method VAT to institute policy of cross-checking invoices).

157. A. Tatt, *supra* note 1, at 308. Some other common forms of VAT evasion include: failing to register with the VAT authorities; inflating claims for VAT refunds (usually done by emerging businesses, where it is not unusual for purchases to exceed sales as new businesses make substantial capital expenditures); overstating the input tax credit by claiming deductions for purchases corresponding to nontaxable sales; underreporting sales; misdescribing items in a multiple rate VAT system; and fabricating shipments to places outside the applicable tax jurisdiction for domestic sales, thereby enabling the taxpayer to deduct purchases related to the sale but not charge VAT to the next purchaser. *Id.* at 307-14. Generally, a purchaser and
search for this type of nonpayment of tax.\textsuperscript{158}

Additionally, because tax evasion is unprofitable when tax rates are low,\textsuperscript{159} one may justify the account-based feature of the Japanese CT by the fact that the three percent CT rate is the lowest VAT rate in the world.\textsuperscript{160} Therefore, the incidents of tax evasion that will occur should, in aggregate, involve an insignificant amount. Finally, the argument that the CT is virtually a period tax, rather than a transactional tax, is relevant only in a multiple rate system\textsuperscript{161} where classification of purchases into different categories is both material and necessary.\textsuperscript{162} This argument is irrelevant to the CT single rate system,\textsuperscript{163} a superior system to the multiple rate structure used predominantly in the EEC.\textsuperscript{164}

\textbf{B. Equity in the CT Law: Elements of Regressivity in the System}

One important VAT consideration over the years has been its effect on consumers.\textsuperscript{165} Although tax scholars originally envisioned the VAT as a tax on business,\textsuperscript{166} most business enterprises "fund" their inability to offset their output tax completely with input credits by charging a higher price on the product or service.\textsuperscript{167} As businesses continue to shift the tax burden forward through the chain of

\textsuperscript{158} See Schenk, \textit{Policy Issues}, supra note 4, at 118 (stating that compliance benefits of invoice VAT may be overstated because agencies responsible for VAT administration lack adequate personnel to conduct full-scale investigations).

\textsuperscript{159} See Schenk, \textit{Value Added Tax}, supra note 4, at 284 (stating that tax should be imposed at lowest possible level because taxpayers find evasion unprofitable when rates are low). When tax rates rise, compliance becomes less profitable and incidents of tax evasion increase. \textit{Id.}

\textsuperscript{160} Japanese CT § 4; Schenk, \textit{Policy Issues}, supra note 4, at 113.

\textsuperscript{161} See Turnier, \textit{supra} note 136, at 1260 (discussing multiple rate systems). A multiple rate system imposes a standard VAT rate for most items and either, or both, of the following: reduced rates for certain necessities, such as food or medical care, or luxury rates for certain luxury-type goods. \textit{Id.}

\textsuperscript{162} McLure, \textit{supra} note 5, at 976.

\textsuperscript{163} Japanese CT § 4. This does not include the zero-rating of exports and the six percent transitional rating for passenger vehicles. \textit{Id.} §§ 4-5.

\textsuperscript{164} See infra notes 184-90 and accompanying text (discussing superiority of single rate CT system). For example, Germany uses a 14\% general VAT rate but taxes food, books, periodicals, and art at a preferential seven percent rate. J. Pechman, \textit{supra} note 16, at 265, 278. Of the 12 member nations of the EEC, only Denmark and the United Kingdom employ the single rate structure. See A. Tarr, \textit{supra} note 1, at 40-41 (listing VAT rates for various countries).

\textsuperscript{165} See A. Tarr, \textit{supra} note 1, at 220 (explaining that ideal is efficient VAT because it does not distort consumer choices).

\textsuperscript{166} See Bronfenbrenner, \textit{supra} note 4, at 301 (explaining that Shoup Mission preferred VAT to retail sales tax because VAT, as tax on large businesses, would prevent reemergence of Zaibatsu).

\textsuperscript{167} See Schenk, \textit{Value Added Tax}, supra note 4, at 283-84 (arguing that implementation of VAT will cause increase in prices).
production and distribution, the price of the product or service increases. Therefore, tax scholars argue, the consumer ultimately bears the tax burden vis a vis higher product prices.

1. An introduction to the regressivity debate

The most controversial effect of the CT on consumers is its potential regressivity. VATs are generally considered regressive levies because low-income groups, who spend a greater proportion of their income on consumer goods than high-income groups, bear the same amount of tax on their consumer purchases as do more affluent members of society. Legislators can counteract regressivity with multiple tax rates, zero-ratings, and exemptions. However, their use, however, may add administrative and compliance costs that would outweigh any derived benefit.

2. The CT and consumer prices: the neutrality issue

Japanese consumer prices have increased gradually since the introduction of the CT in April 1989. Economists attribute part of this increase to the implementation of the tax, but it is unknown whether or not these increases will continue in the future. Some analysts perceive the inflationary effect of a VAT as a short-term phenomenon and claim that prices level off after businesses “build”

168. Cf. Schuyler, supra note 11, at 574 (contending notion that tax shifts forward to consumers is inaccurate because it shifts backward to producers and suppliers). Taxing authorities in Japan apparently resolved this dispute by taxing consumers rather than businesses. The latter is evidenced by the chosen name for the tax: consumption tax (i.e., tax on consumers), not value-added tax (i.e., tax on value-added by producers and suppliers).

169. See Gravelle, supra note 140, at 1118 (arguing that one major problem with VAT is probability that it would produce inflation); see also Schuyler, supra note 11, at 573 (explaining that inflation, as “monetary phenomenon,” would only occur if government accelerated growth of money supply at same time that it introduced VAT); cf. Aaron, supra note 5, at 1113 (arguing that inflationary effect of VAT could be lessened by modifying Consumer Price Index formula to remove impact of VAT from its calculation).

170. Zodrow, supra note 90, at 1995. But see Brannon, Is the Regressivity of the Value-Added Tax an Important Issue?, 9 Tax Notes 879, 881 (1979) (reasoning that regressive nature of VAT should be irrelevant because government has options to alleviate regressivity). However, it is important to note that a progressive tax structure may defeat efficiency.

171. See Japanese CT §§ 5-6, 8 (listing exemptions and zero-ratings under CT legislation).

172. Schenk, Policy Issues, supra note 4, at 122. See generally infra notes 184-90 and accompanying text (comparing single rate system to multiple rate system); infra notes 191-239 and accompanying text (examining zero-ratings and exemptions).


174. Id. Japanese economists attributed part of this price increase to the CT, explaining that prices did not rise by the amount of the full three percent CT rate because of the simultaneous repeal of Japan’s high indirect commodity taxes. Id.; see supra note 39 and accompanying text (discussing commodity taxes).
the VAT into the pricing structure of goods and services.\textsuperscript{175}

In contrast, other analysts fear that businesses will take advantage of this allegedly one-time price increase to justify discretionary price increases.\textsuperscript{176} Nevertheless, the Japanese government is trying to minimize the likelihood of impending inflation by relaxing Japan’s antitrust regulations to accommodate a controlled level of price increases.\textsuperscript{177}

A related issue is the alleged effect of the VAT on product (or service) choices made by consumers. Economists classify a tax as “neutral” with respect to consumer choices\textsuperscript{178} if it leaves those choices unaffected by its imposition.\textsuperscript{179} Tax analysts agree that the VAT would be neutral if it taxed all goods and services equally.\textsuperscript{180} In such a system, the government would levy the tax on the value-added to all goods and services so that consumers would not have to choose products based on a determination of which impose VAT and which do not.\textsuperscript{181} Multiple rates, exemptions, and zero-ratings may force consumers to be tax conscious in their product choices.\textsuperscript{182}

In this regard, the Japanese CT appears to be relatively neutral, be-

\textsuperscript{175} See \textit{Department of Treasury, supra} note 4, at 20-21. Assuming a VAT rate of 10\% in the United States, consumer prices would rise approximately 88\% in a one-time increase. \textit{Id.}

\textsuperscript{176} See \textit{Stearns, supra} note 173 (reporting fears of Bank of Japan and other Japanese monetary authorities that businesses will use CT as “smokescreen” on which to blame discretionary price increases).

\textsuperscript{177} \textit{Arthur Young, supra} note 100, at 1 (stating that certain provisions of Japan’s antitrust laws have been relaxed to permit industry-wide price increases).

\textsuperscript{178} An additional aspect of VAT neutrality is its effect on the decision whether to consume now or to invest. \textit{See Brannon, The Fairness of the Savings ‘Loophole’ in a Consumption Tax Depends on Having a Tax at Death, 38 Tax Notes 1253, 1254 (1988) (arguing that VAT favors investment over consumption). But see \textit{Department of Treasury, supra} note 4, at 19 (viewing VAT as savings-neutral). Consumer spending in Japan dropped 1.9\% from August 1988 to August 1989. \textit{Japan Consumer Spending Fell, Wall St. J., Oct. 23, 1989, at A11, col. 2. It is unknown what effect the CT had on this drop although the Statistics Bureau of the Prime Minister’s office attributed it to the typhoons during the month which discouraged shoppers. Id.}

One analyst contends that, because VAT’s favor savings (i.e., investment income), the most equitable method of imposing the tax would be to simultaneously impose a 15-30\% accessions tax on the recipient of inheritances. \textit{Brannon, supra} note 178, at 1254-55. \textit{But see Brannon, supra} note 5, at 307 (explaining that accessions tax is unlikely due to general disfavor of such taxes).

\textsuperscript{179} \textit{McLure, supra} note 32, at 84; cf. \textit{A. Okun, supra} note 29, at 99 (explaining that neutral tax system is “fantasy” because public opinion dictates tax expenditure decisions, not market).

\textsuperscript{180} \textit{See McLure, supra} note 5, at 972 (criticizing accepted view).

\textsuperscript{181} \textit{See A. Tarr, supra} note 1, at 42 (arguing that multiple VAT rates distort consumer and producer choices).

\textsuperscript{182} In Morocco, for example, where basic food is exempt from VAT but processed food is not, assume that tax authorities classify natural peanut butter as a basic food and processed peanut butter as processed food. If prices of goods and services subject to VAT increase subsequent to its initial imposition, the consumer will choose the presumably lower-priced, tax-exempt product. \textit{See A. Tarr, supra} note 1, at 52 (summarizing exemptions and zero-ratings for VATs of world).
cause it uses only one tax rate and employs exemptions and zero-ratings sparingly.\textsuperscript{183}

3. \textit{The superiority of the single rate CT system}

The theories underlying multiple VAT rates bespeak the eternal tax conflict between efficiency and equity.\textsuperscript{184} The policy choice made by legislators in multiple tax rate jurisdictions reflects a belief that some amount of administrative inconvenience, or inefficiency, is necessary to ensure that the VAT remains a progressive, or equitable, levy.\textsuperscript{185} Although the two categories of multiple VAT ratings—low rating of necessities and high rating of luxury goods—may be popular among the VAT statutes of Europe,\textsuperscript{186} tax scholars generally abhor these systems as imposing too great an administrative burden to justify their equitable result.\textsuperscript{187}

The Japanese CT rate structure promotes efficiency and equity to a great extent. On one hand, single rate VATs are more efficient than multiple rate VATs.\textsuperscript{188} On the other hand, the single rate VAT structure of the Japanese CT is relatively equitable because the present rate is so low that it may not unduly burden any individual consumer.\textsuperscript{189} To the extent that the CT remains regressive, though, the Japanese government implemented several zero-ratings and exemptions to inject progressivity into the law.\textsuperscript{190}

4. \textit{Enterprises or activities excluded from CT liability}

The process of deciding which goods and services should receive

\begin{itemize}
\item \textsuperscript{183} Japanese CT §§ 4-6.
\item \textsuperscript{184} See supra note 29 (tracing origins of efficiency/equity debate).
\item \textsuperscript{185} McLure, supra note 5, at 974.
\item \textsuperscript{186} See supra note 164 and accompanying text (pointing out that only two of European Community's 12 members have single rate VAT structures).
\item \textsuperscript{187} A. Tarr, supra note 1, at 42. As the number of rates increases, the risk of error, by either the taxpayer or the taxing authorities, increases as well. \textit{Id.}; accord McLure, supra note 5, at 974 (explaining that risk of error increases as number of rates increases). In particular, low rating too many items may translate into higher income or other tax rates. A. Tarr, supra note 1, at 42-43. This must have been an especially important consideration to Japanese legislators because the government plans to use a portion of the CT revenues to finance reductions in marginal tax brackets in the individual and corporate income taxes. Bossons, \textit{International Tax Competition: The Foreign Government Response in Canada and Other Countries}, 41 NAT'L TAX J. 347, 351 (1988); see supra note 12 and accompanying text (providing overview of other major Japanese tax reforms).
\item \textsuperscript{188} A. Tarr, supra note 1, at 42.
\item \textsuperscript{189} See Japanese CT § 4 (setting CT rate at three percent). In this light, the current social and political struggles in Japan over the CT are surprising. A 3\% VAT levy, in and of itself, is not overly burdensome. More often, however, VAT rates skyrocket over time. A. Tarr, supra note 1, at 40-41, 227. In the United Kingdom, for example, the original 1973 VAT rate was 10\%. The current rate is 15\%. \textit{Id.} at 41. As of July 1, 1989, only Chile, Costa Rica, and Peru reduced their VAT rates after introducing the tax. A. Tarr, supra note 1, at 40-41.
\item \textsuperscript{190} Discussion \textit{infra} notes 204-39 and accompanying text.
\end{itemize}
preferential treatment under any tax law appears to be a simple task: the government should not tax activities it wants to encourage indirectly or does not want to discourage indirectly.\textsuperscript{191} In practice, however, for every group that receives a perceived benefit under the tax law, other groups analogize their function to that of the "chosen" group and claim a right to preferential tax treatment as well.\textsuperscript{192} Under a VAT system, such claims pose three related problems.

First, some governments, the United States among them, are susceptible to pressures from lobbying groups.\textsuperscript{193} For instance, the Tax Reform Act of 1986 contains several sections designed solely to accommodate one specific party or transaction.\textsuperscript{194} Accordingly, what may begin as a broad-based tax sometimes becomes so riddled with exceptions from tax liability that the final law thwarts its own revenue-raising efforts.\textsuperscript{195}

Second, a tax law containing many exceptions is more difficult to administer than a pure broad-based tax.\textsuperscript{196} Complex legislation may encourage taxpayers to evade taxes, which would require keen and costly examinations of tax returns by taxing authorities.\textsuperscript{197} In addition, a tax law with many exemptions is expensive to administer, because taxing authorities must educate themselves and the public about the tax, enforce detailed documentation requirements, and oversee other procedures associated with the administration of the tax.\textsuperscript{198} Third, as administrative burdens rise, the costs of complying

\textsuperscript{191} A. TARR, supra note 1, at 52.


\textsuperscript{193} Schenk, Policy Issues, supra note 4, at 113; accord Turnier, supra note 3, at 462 (explaining that United States political process is particularly susceptible to outside pressures such as lobbyists).


\textsuperscript{195} Turnier, supra note 136, at 1264.

\textsuperscript{196} Gravelle, supra note 140, at 1122 (noting efficiency benefits of VAT may be offset by high administrative costs).

\textsuperscript{197} See DEPARTMENT OF TREASURY, supra note 4, at 111 (estimating that United States VAT would require 20,000 additional IRS employees and $700 million in added administrative costs annually). These estimates do not consider costs incurred by other federal agencies, such as those of United States Customs agents required to oversee the taxation of imports. Id. at 122.

\textsuperscript{198} See id. at 111-22 (categorizing administrative costs). These categories include costs incurred to oversee: (1) general information; (2) recordkeeping; (3) filing of returns; (4) payment of taxes; (5) imports subject to tax; (6) general enforcement; (7) public education; and (8) manual and data processing of returns. Id.
with the tax also rise.199

The Japanese CT law uses zero-ratings and exemptions to achieve its equitable objectives.200 The law exempts eleven named items,201 zero-rates exports,202 and either wholly or partially exempts small and medium-sized businesses from paying the tax.203

a. Zero-ratings: the best way to combat regressivity?

The Japanese CT does not zero-rate or exempt many of the traditionally preferred goods and services in a VAT system;204 as such, it places a priority value on efficiency over equity. The CT exemptions are designed to promote political or governmental objectives, such as the purchase of national-government bonds,205 the sale of nationally regulated gambling and lottery tickets,206 and the provision of medical services provided under national insurance laws,207 rather than the promotion of socially desirable goals.208

Japanese tax legislators created a generally regressive tax that may unduly burden low-income groups.209 The government compensated for this potential regressivity by taxing consumption at an extremely low rate to create what should be, in theory, a relatively unobjectionable tax.210 The government might have implemented other provisions, however, to combat the regressivity of the CT in lieu of its reliance on low tax rates and few exclusions.

One alternative could have been an expansion of the list of zero-rated or exempt items under the law. Most EEC nations zero-rate

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199. See Turnier supra note 139, at 1263 (explaining that efficient tax system minimizes, inter alia, number of difficult decisions that taxpayers need to make).

200. See supra notes 119-34 and accompanying text (discussing exempt transactions and zero-rated items under Japanese CT law).

201. Japanese CT § 6; see also supra note 130 (listing exempt items).


203. Id. § 8.

204. Most notably, the CT does not provide preferential treatment for food purchases. Compare id. §§ 5-6 (listing CT exclusions) with J. Pechman, supra note 16, at 297, 334 (essay authored by N. Morris) (listing United Kingdom VAT exclusions). Zero-rated items in the United Kingdom include food, water, books, fuel, power, construction, exports, transportation, children's clothing, and protective clothing. Id. Exempt items in the United Kingdom include land, insurance, postal service, betting, finance, education, health services, burial, and cremation. Id.

205. Japanese CT § 6(2).

206. Id. § 6(5).

207. Id. § 6(9).

208. See supra note 128 and accompanying text (describing CT exemptions as motivated politically, not socially).

209. See Schenk, Policy Issues, supra note 4, at 122 (arguing broad-based VAT is regressive because proportion of income spent on consumption declines as income rises). Low-income households spend all of their income on necessities while higher-income households can save. Id.; see supra notes 170-72 (describing regressivity in general).

210. See Schenk, Policy Issues, supra note 4, at 113 (reasoning that Japanese taxpayers are unlikely to evade tax when compliance costs are low).
The Japanese Consumption Tax

food and other necessities\textsuperscript{211} to reduce the indirect tax burden on low-income consumers.\textsuperscript{212} The public relations benefit of such a system in Japan would outweigh any administrative complications that the provision would add to the tax system. Japan's experiences indicate that the most important aspect of a new tax may be its public perception.\textsuperscript{213} Japanese consumers might have viewed a zero-rating for groceries, for example, as highly beneficial despite the possibility of a one to two percent higher CT rate to compensate for foregone tax revenues.\textsuperscript{214}

Some tax scholars believe, however, that zero-ratings do not focus on the problem presented by regressive tax structures: how to provide a benefit directly to low-income groups.\textsuperscript{215} Therefore, a second alternative that may deal more effectively with this problem is the establishment of a credit system, similar to the earned income credit in the United States Internal Revenue Code, for certain necessities.\textsuperscript{216} This system would specifically target low-income earners as groups warranting preferential treatment under the law. The available credit would decrease as income rises and eventually phase-out when income peaks at a certain level.\textsuperscript{217} This solution, however, may involve substantial administrative costs.\textsuperscript{218}

\begin{itemize}
\item \textbf{b. Zero-rating of exports and related issues: does the CT favor Japanese goods and services over foreign products?}
\end{itemize}

One of the most often debated VAT policy issues concerns the VAT's effect on the competitiveness of foreign products in international trade.\textsuperscript{219} Many analysts believe that the introduction of a des-

\begin{itemize}
\item \textsuperscript{211} Necessities are those products and services purchased in larger quantities by low-income groups than by high-income groups. \textit{See} TRAC Act § 4012(a) (zero-rating food, housing, and medical care).
\item \textsuperscript{212} \textit{See supra} note 204 (comparing extensive list of zero-rated items in United Kingdom with CT law).
\item \textsuperscript{213} \textit{See Ohmae, supra} note 16, at A19, col. 3 (reporting Japanese frustration with CT because people did not know what to expect when government enacted law).
\item \textsuperscript{214} \textit{See Brannon, supra} note 5, at 307 (reasoning that middle class might perceive VAT exclusion of food purchases as beneficial despite possibility that VAT rates would be percentage point higher to accommodate exclusion); \textit{see also supra} note 19 (noting Japanese government is currently considering exemption for food and other necessities).
\item \textsuperscript{215} \textit{See Zodrow, supra} note 90, at 1396 (explaining that some analysts oppose zero-ratings for necessities because they benefit all groups, not just low-income earners).
\item \textsuperscript{216} McClure, \textit{supra} note 8, at 1524; \textit{see I.R.C.} § 32 (1986) (setting forth earned income credit).
\item \textsuperscript{217} The earned income credit under the Internal Revenue Code phases out completely when earned income exceeds $11,000. \textit{I.R.C.} § 32 (1986); \textit{see S. Surrey, supra} note 11, at 573 (describing earned income credit in detail).
\item \textsuperscript{218} \textit{See Zodrow, supra} note 90, at 1396 (stating tax credit system targets lower income households but requires high administrative costs to avoid fraud and to refund payments).
\item \textsuperscript{219} \textit{See, e.g., Department of Treasury, supra} note 4, at 21-23 (contending that VAT rebates put all products on "equal footing" in international markets); Brannon, \textit{Does VAT Provide}
destination principle VAT\(^{220}\) actually increases the competitiveness of the taxing jurisdiction's products in foreign markets.\(^{221}\) In contrast, some experts maintain that this perceived benefit does nothing more than provide relief from inflation,\(^{222}\) currency adjustments,\(^{223}\) and retaliatory actions by other countries.\(^{224}\)

This competitiveness issue raises an interesting issue that is especially relevant to Japan: should notions of equity in a tax structure apply equally to both foreign and domestic consumers? If so, and if

\(^{a}\) Balance of Trade Advantage?, 30 Tax Notes 1387, 1389 (1986) (arguing that VATs are merely border tax adjustments); Garber, The Role of Consumption Taxes in Tax Reform Around the World, 41 Nat'l Tax J. 357, 364 (1988) (admitting uncertainty surrounding alleged competitiveness of products exported from VAT jurisdiction to foreign markets); Zodrow, supra note 90, at 1999 n.2 (suggesting that VATs may provide trade advantage to extent they replace other noncreditable taxes).

\(^{220}\). See supra note 114 and accompanying text (defining and explaining destination principle).

\(^{221}\). Zodrow, supra note 90, at 1999. Some authorities argue that the introduction of a VAT enhances trade advantage by allowing exporters to charge lower prices for their products than they would charge in a corporate income tax system at the same per product profit. This occurs because a taxpayer in a destination principle VAT jurisdiction is not liable for VAT on its export sales and may claim input tax credits for any VAT paid on corresponding purchases. Japanese CT § 5; see \textsc{Department of Treasury}, supra note 4, at 21-22 (explaining that General Agreement on Tariffs and Trade (GATT) allows countries to provide rebates for indirect taxes, such as VATs, but not for direct taxes). As such, the CT may have dumping implications. See Zenith Radio Corp. v. United States, 437 U.S. 443, 450-62 (1978) (discussing dumping implications in allowing rebate of Japanese commodity tax to companies that export products); see also supra note 39 and accompanying text (identifying Japanese commodity tax as predecessor to CT and describing tax). The Supreme Court explained that it would not be excessive to allow a five dollar commodity tax rebate upon exportation of a product if the taxing authorities imposed a five dollar tax “at the factory.” Zenith Radio Corp., 437 U.S. at 450-53. However, an eight dollar rebate upon exportation would be excessive if the taxing authorities only imposed a five dollar tax “at the factory.” \textit{Id.} One defines dumping as the process by which exporters “sell goods abroad at less than the fair market price at home.” BLACK’S LAW DICTIONARY 451 (5th ed. 1979); see Fisher, The Antidumping Law of the United States: A Legal and Economic Analysis, 5 Law & Poly. Int’l Bus. 85, 86-93 (1973) (discussing economics of dumping).

\(^{222}\). \textsc{Department of Treasury}, supra note 4, at 21 (stating that VAT initiation may only result in one time price level increase and reasoning that price level impact may be offset through reduction of other taxes). Experts who do not believe VATs increase international competitiveness perceive the rebate feature of a destination principle VAT as merely a border tax adjustment designed to put products sold internationally on “equal footing.” \textit{Id.} at 22. The effect of the destination principle is to counteract the inflated prices that often accompany the enactment of a VAT vis a vis the rebate feature. \textit{Id.}

\(^{223}\). See Brannon, supra note 219, at 1389 (arguing that, even if there was short-term increase in competitiveness of exports, increased purchases would raise value of exporting country’s currency that would offset benefits of temporary attractiveness of exports); cf. Garber, supra note 219, at 364 (indicating alleged currency adjustments do not consistently occur after VAT is introduced); Schenk, Value Added Tax, supra note 4, at 278 (noting that countries belonging to International Monetary Fund, of which Japan is member, may not liberally manipulate currency rates). Despite forecasts by some tax analysts that the temporary competitiveness of exported goods may result in currency value increases, the Japanese yen has actually weakened during the first five months since April 1, 1989, which may actually strengthen Japanese exports. Ono, Japan’s Trade Surplus Shrinks But Imbalance With U.S. Widens, Wall St. J., Oct. 13, 1989, at A11, col. 4.

\(^{224}\). Brannon, supra note 219, at 1389 (stating political pressures placed on foreign government representative might trigger potential retaliatory trade actions).
one accepts the premise that a VAT increases the competitiveness of exported goods, then the United States may perceive the CT as another means by which Japan can increase the competitiveness of its goods at the expense of United States domestic goods. This is relevant to the extent that the CT payment provisions actually favor domestic goods over imported goods. Domestic businesses have the potential to enjoy greater flexibility in handling cash flow than import businesses. Importers must pay taxes prior to removing their goods from bonded areas, while domestic businesses collect taxes from purchasers, retaining those funds on the government's behalf until the applicable CT return filing period. This allows domestic business enterprises to "play the float" with their tax payments, an option unavailable to importers.

c. Preferential treatment for small and medium-sized businesses

Small and medium-sized business enterprises must consider whether or not their position should be one of CT advocacy or CT opposition. On one hand, small and medium-sized businesses may bear unduly high costs of compliance with the requirements of the law. On the other hand, these business enterprises may desire to register for the tax to be eligible for net VAT refunds, or, perhaps more importantly, to avoid the appearance, if not the reality

225. See Trade Imbalances—The Japanese View, Wall St. J., Sept. 18, 1989, at C16, col. 1 (special advertising section: Japan business survey) (reporting that Japan has $50 billion trade surplus with United States although its world-wide trade surplus appears to be dwindling). It is generally accepted that the destination principle is superior to the origin principle. See generally Cnossen, supra note 114 (advocating use of destination principle by EEC and United States). Recent developments in the EEC indicate continued reliance on the destination principle over the origin principle for the foreseeable future. See supra note 114 and accompanying text (noting that EEC rejected suggestion to convert all VATs to origin principle subsequent to 1992 European unification).

226. Japanese CT § 9(2). Importers usually do not have any input tax credits available because they purchase supplies for their products outside the tax jurisdiction and thus do not incur any CT on their purchases.

227. Id. § 9(1). The government requires taxpayers to file CT returns within two months of the last day of either the calendar year (for personal enterprises) or the fiscal year (for corporations). Id. §§ 9(1)(a) & (c). In addition, enterprises that paid CTs exceeding 300,000 yen in the previous tax period must file estimated payments within two months of the final day of the first half of the tax year. Id. § 9(1)(b). Businesses may also elect to file CT returns on a quarterly basis. Id. § 9(1)(a). Most businesses expecting a net CT refund will file on this basis to avoid operating at a negative float, i.e., allowing the government to hold their money for the length of the full reporting period. Schenk, Policy Issues, supra note 4, at 116 (detailing extra burdens, derived from VAT compliance, under VATs creating negative cash float).

228. See Schenk, Policy Issues, supra note 4, at 116 (indicating that taxpayer enjoying positive float earns interest that offsets burden of VAT compliance).

229. Turner, supra note 5, at 459 (indicating small businesses must balance VAT compliance burdens with perceived benefits of VAT compliance).

230. See id. (positing compliance with VAT is more difficult for smaller businesses that do not have existing internal labor structure and economies of scale that can ease VAT compliance).
of commercial insignificance.\textsuperscript{231} The Japanese CT law responds effectively to these competing considerations of small and medium-sized businesses by providing several levels of small business exemptions and by establishing a simplified tax calculation for qualifying entities.\textsuperscript{232}

First, the law provides two levels of exemptions: (1) complete exemption for small-sized businesses\textsuperscript{233} and (2) partial exemption for medium-sized businesses.\textsuperscript{234} In providing these exemptions, the CT legislators were sympathetic to medium-sized businesses from which the government should collect some, but not the total, tax.\textsuperscript{235}

Second, the simplified system available to small and medium-sized businesses allows businesses with taxable sales under 500 million yen ($3.8 million) to compute the input tax credit under a system even simpler than the account-based method.\textsuperscript{236} This may encourage businesses eligible for the complete or partial exemptions to either register for the CT or to comply more readily with its requirements.\textsuperscript{237}

Both the complete and partial small business exemptions and the simplified input tax credit calculation for small and medium-sized businesses complicate tax administration.\textsuperscript{238} These arrangements, however, may actually improve tax collection to the extent that small and medium-sized businesses comply with the law more readily than they might absent preferential treatment.\textsuperscript{239}

\textsuperscript{231} Id. In addition, managers of small and medium-sized business enterprises may use the CT to centralize control of their companies. See Chiu & Siegel, supra note 4, at 4 (noting that VAT can be powerful internal control tool).

\textsuperscript{232} Japanese CT § 8(2) (listing exemptions and providing calculation).

\textsuperscript{233} Id. § 8(1); see supra notes 131-32 and accompanying text (discussing complete exemption from CT for small-sized businesses).

\textsuperscript{234} Japanese CT § 8(2); see supra notes 133-34 and accompanying text (discussing partial exemption from CT for small and medium-sized businesses).

\textsuperscript{235} See Turnier, supra note 3, at 459 (positing reasons that small or medium-sized business enterprise would register for CT).

\textsuperscript{236} See supra note 107 (describing simplified tax calculation for small and medium-sized business enterprises); see also supra notes 149-64 and accompanying text (analyzing account-based method in detail).

\textsuperscript{237} Businesses eligible for the complete exemption under section 8(1) may register for the tax, electing to use the simplified system to ease compliance burdens while maintaining the appearance of commercial viability. Japanese CT § 8(1). Businesses eligible for the partial exemption under section 8(2) may also use the simplified system. Id. §§ 8(2)-(3). This, in turn, may encourage greater taxpayer compliance as the simplified system will ease documentation requirements and the partial exemption will lighten the tax obligation of the partially exempt organization. See A. Tait, supra note 1, at 113 (noting record-keeping burdens of small enterprises in complying with VAT); see also Turnier, supra note 3, at 459 (comparing high compliance costs to notions of commercial viability in determining whether small businesses should register for CT).

\textsuperscript{238} See supra notes 196-98 and accompanying text (describing administrative burdens caused by excessive exceptions to tax).

\textsuperscript{239} Turnier, supra note 3, at 459 (suggesting small businesses may decide benefits of
C. A Brief Comparison of the CT with Recent Proposed VAT Legislation in the United States

The Japanese CT law provides a more realistic framework of value-added taxation than either of two recently proposed United States VAT statutes: the Value Added Tax Act (Act)\(^\text{240}\) and the Tax Reform and Competitiveness Act (TRAC).\(^\text{241}\) Although both proposals are broad-based, consumption-style,\(^\text{242}\) destination-principle,\(^\text{243}\) invoice-method VATs,\(^\text{244}\) each presents a different approach to the tradeoff between efficiency and equity. The final decision as to which of the two statutes is viable in the United States depends on where one draws the line between the efficient administration of the tax system and the equitable enforcement of those tax laws.\(^\text{245}\)

1. The Value Added Tax Act

The American Bar Association (ABA) drafted the Value Added Tax Act as a model statute that it would support if the United States ever enacted a VAT.\(^\text{246}\) The Act probably would not be adopted in its present form due to legislative pressures it has yet to undergo.\(^\text{247}\) It is an important proposal, however, in considering the ongoing struggle between efficiency, equity, and simplicity because it represents the extreme view that efficiency is of paramount importance—even at the sake of accompanying regressivity.\(^\text{248}\)

The tax base of the VAT proposed in the Act is extremely broad.\(^\text{249}\) Although the Japanese CT also functions as a broad-based levy, that law compensates for its breadth of coverage by im-

\(^{240}\) See supra note 4.


\(^{242}\) See supra note 4 (defining consumption-style VAT).

\(^{243}\) See supra note 114 (comparing destination principle with origin principle).

\(^{244}\) See supra notes 110-11 and accompanying text (discussing invoice method VAT used in EEC).

\(^{245}\) See generally Schenk, Policy Issues, supra note 4, at 122-23 (comparing Japanese CT to New Zealand VAT and VAT proposals in United States and Canada on efficiency and equity grounds).


\(^{247}\) See Schenk, Policy Issues, supra note 4, at 113 (explaining that Value Added Tax Act may be as broad-based as it is because it has not yet gone through legislative process); see also supra notes 193-94 and accompanying text (noting general susceptibility of legislatures to outside pressures).

\(^{248}\) See A. SCHENK, COMMENTARY, supra note 4, at 70-72 (inferring certain expenditures represent too great percentage of total United States consumer expenditures for government to consider granting them preferential treatment under Act).

\(^{249}\) Schenk, Policy Issues, supra note 4, at 114.
posing a low three percent tax rate. The authors of the Value Added Tax Act did not include a suggested rate in their proposal. Such a rate would have been an important factor in considering the viability of the Act.

The Value Added Tax Act, like the CT law, provides few zero-ratings and exemptions. The Act zero-rates exports, thereby establishing the tax as a destination principle VAT. In addition, the drafters provided exemptions for few activities, such as transfers of property in bankruptcy and sales of property or services outside the United States that do not constitute taxable export transactions.

The drafters of the Act maintain that measures targeted toward low-income groups would offset the regressive effects of the tax better than extensive zero-ratings and exemptions. For instance, they suggested that the government increase food stamps, employ income tax credits, and reduce other tax rates to specifically accommodate low-income groups in lieu of zero-rating food. The drafters argued that food purchases are too great a percentage of total personal consumption to allow all groups to escape taxation on these purchases.

Despite some similarities, the Value Added Tax Act differs substantially from the CT law: the Act uses the invoice method, does not provide preferential treatment for small businesses, and taxes

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250. See supra notes 188-89 and accompanying text (discussing combination of broad base and low rate in Japanese CT).
251. See Value Added Tax Act § 4001(b) (failing to set tax rate).
252. See supra notes 119-54 and accompanying text (discussing zero-ratings and exemptions in CT law).
254. See supra note 114 and accompanying text (discussing destination principle).
255. Value Added Tax Act § 4004. The Act exempts the following transactions from VAT liability:
   (1) transfers by a debtor to a creditor of either possession or a security interest in property or services, such as posting of collateral (but an actual transfer of ownership is a taxable sale under Value Added Tax Act § 4039),
   (2) transfers to a fiduciary representing the interests of a legally disabled owner in his or her fiduciary capacity,
   (3) transfers of property in bankruptcy,
   (4) property imported duty-free under United States tariff laws,
   (5) sales of property or services outside of the United States that do not constitute export transactions,
   (6) any other transaction as determined by the Secretary provided granting such an exemption does not reduce net tax revenue.
Id. § 4004.
256. A. Schenk, Commentary, supra note 4, at 71-72.
257. Id. at 71.
258. Id. at 70 (noting that food purchases comprised 16% of total 1985 personal consumption). Medical care is also not zero-rated under the Act for similar reasons. See id. at 72 (noting expenses of medical care comprised 12.5% of total 1985 personal consumption).
large non-business transactions. Unlike the CT law, which calculates the input tax credit based on “deemed” qualifying purchases, the Act disallows any input tax credit unsubstantiated by a tax invoice and imposes penalties on taxpayers who fail to provide a tax invoice when it is required.

The Act taxes small and medium-sized businesses like all other business entities. In contrast, the CT law provides several levels of exemptions, as well as simplified tax calculations, for small and medium-sized businesses. The commentary to the Act indicates that the drafters would prefer simplified accounting procedures, such as alternative calculations and easier record-keeping requirements, to a small business exemption. Nevertheless, the commentary to the Act includes a de minimis exemption for small businesses that the ABA would recommend in the event Congress absolutely required inclusion of a small business exemption.

The most unusual provision of the Value Added Tax Act is its imposition of tax liability on nonbusiness sales exceeding an undisclosed threshold amount. The CT law, and most other VAT legislation, imposes tax only on business transactions. The Value Added Tax Act sacrifices equity in favor of efficient tax collection by imposing a tax on an extremely broad business and non-business tax base.

2. The Tax Reform and Competitiveness Act

The Tax Reform and Competitiveness Act (TRAC Act), proposed by the United States Senate, presents the opposite approach to the

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259. See supra notes 98-113 and accompanying text (discussing calculation of CT).
260. Value Added Tax Act § 4022(c). The Act requires the tax invoice to contain the seller's name and identification number, the purchaser's name, the amount of tax paid on the transaction, and other specified information. Id. § 4022(b).
261. Id. § 6652(m). The Act does not specify dollar amounts of penalties. Id.
262. See A. SCHENK, COMMENTARY, supra note 4, at 86-92 (recommending against complete exemption for small and medium-sized businesses).
263. See supra notes 131-34 and accompanying text (describing preferential treatment for small businesses under CT law).
264. See A. SCHENK, COMMENTARY, supra note 4, at 86-87 (determining that such measures would neither reduce tax revenues nor lessen VAT neutrality).
265. See id. at 90-91 (suggesting that Congress set low de minimis level of sales to reduce possible distortion caused by removal of smaller producers and distributors from chain).
266. Value Added Tax Act § 4003(a)(3)(A); see Schenk, Policy Issues, supra note 4, at 114 (noting taxability of non-business transactions in support of assertion that Act imposes “exceptionally broad-based tax”). The commentary to the Act suggested $50,000 as a threshold amount. See A. SCHENK, COMMENTARY, supra note 4, at 25 (recommending $50,000 as adequate threshold so as to reduce number of VAT returns filed).
267. See Schenk, Policy Issues, supra note 4, at 114-16 (naming Value Added Tax Act as only VAT to tax non-business transactions as compared with Japanese CT, New Zealand VAT, and proposed Canadian VAT); see also supra notes 114-17 and accompanying text (describing types of transactions subject to CT).
Value Added Tax Act and the CT law by providing many zero-ratings and exemptions to create an overly equitable, highly inefficient tax. The suggested tax rate for this VAT is surprisingly low at five percent.\textsuperscript{268} Taxpayers would calculate this tax under the invoice method.\textsuperscript{269}

Like the CT law, the TRAC Act zero-rates exports;\textsuperscript{270} however, unlike the CT law, the TRAC Act zero-rates several other items, including food, housing, and medical care.\textsuperscript{271} The TRAC Act also grants a \textit{de minimis} exemption for small businesses.\textsuperscript{272} Although the consequent tax contemplated in the TRAC Act is progressive, it is generally accepted that abundant zero-ratings breed high administrative costs.\textsuperscript{273}

Finally, the VAT proposed in the TRAC Act is one of six measures designed to simultaneously stimulate the economy and reduce the budget deficit. According to Senator Hollings, the proposed VAT would increase government revenues by $53 billion.\textsuperscript{274} In light of


\textsuperscript{269} See TRAC Act § 4022 (listing requirements of tax invoices). The TRAC Act requires the same information to be included in tax invoices as is required by the Value Added Tax Act. \textit{See supra} note 261 (listing requirements of tax invoices under Value Added Tax Act).

\textsuperscript{270} TRAC Act § 4013(3).

\textsuperscript{271} The TRAC zero-rates the following items:

1. food,
2. sale or lease of principal residence,
3. medical care,
4. sales by farmers and fishers,
5. performance of mass transit services,
6. exports,
7. interest,
8. sales to governmental entities,
9. educational activities of governmental entities,
10. sales by governmental entities where separate charge is not made,
11. transactions entered into by organizations exempt under I.R.C. § 501(c)(3) (1986).


\textsuperscript{272} \textit{Id.} § 4023. This provision is similar to the small business exemption included in the commentary to the Value Added Tax Act. \textit{See supra} note 265 and accompanying text (noting this provision of Value Added Tax Act).

\textsuperscript{273} \textit{See supra} note 198 and accompanying text (discussing VAT administrative costs).


1. a five percent VAT,
2. a reduction in the FICA tax rate from 6.2 to 5.1 percent,
3. a preferential tax rate on capital gains,
4. an IRA tax deduction,
5. an investment tax credit, and
6. a Federal revenue sharing program with the states.

\textit{Id.} Other than the VAT, all of these measures would increase the budget deficit. \textit{See id.} (de-
the zero-ratings and exemptions contained in the TRAC Act, however, it appears unlikely that this highly inefficient tax could substantially reduce the budget deficit.\textsuperscript{275}

3. The CT: efficiency/equity middle ground

The Japanese CT is a compromise between the highly efficient and regressive structure of the Value Added Tax Act and the highly equitable and progressive structure of the Tax Reform and Competitiveness Act. The final answer as to whether the Japanese CT presents a positive step in the evolution of value-added taxation hinges on the balancing between the compliance benefits of an account-based, credit-subtractive VAT and the added administrative burdens of such a tax.\textsuperscript{276} At minimum, the Japanese CT law clarifying that these measures would increase deficit by $53.1 billion). These proposals would stimulate savings and investment and would be compensated for by the VAT. \textit{Id.} In addition, the VAT could be used in future years to reduce and eventually eliminate the Federal deficit. \textit{Id.; see also supra} note 22 and accompanying text (discussing role that VAT could play in reducing budget deficit).

The previous congressional VAT proposal, the Deficit and Debt Reduction Act of 1989, would have required that tax revenues be placed in a “Deficit Reduction Trust Fund” that the United States government could use to reduce the deficit. \textit{See Savings Regulator Seeks} $100 \textit{Billion for Bailout in ’91}, N.Y. Times, July 31, 1990, at 1, col. 6 (projecting United States budget deficit to reach $163 million). Senator Hollings, sponsor of both the 1989 Deficit Act and the 1990 TRAC Act, perceives a VAT as the best method to reduce the United States deficit because it would raise “one heck of a lot of money.” 135 CONG. REC. S1665 (daily ed. Feb. 23, 1989) (statement of Sen. Hollings). The Deficit Act would have expressly prohibited the use of collected revenues for any purpose other than deficit reduction. \textit{See Deficit and Debt Reduction Act of 1989} § 3114(a). The government may also pay costs associated with administering the tax out of the trust fund. \textit{Id.} § 3114(c)(2).

\textsuperscript{275} See Gravelle, \textit{supra} note 140, at 1117 (stating administrative costs involved require VAT system capable of generating $100 billion). Considering that the Deficit Act was only estimated to raise $53 billion, a United States VAT would have to contain fewer zero-ratings and exemptions to be successful. \textit{See GAO Report Examines Revenue, Benefits, Regressivity, Compliance Costs of VAT}, Daily Rep. for Executives, at G9 (Sept. 29, 1989) (indicating that VAT without exemptions or zero-ratings would raise $125 billion).

\textsuperscript{276} The following chart compares the CT law with the Value Added Tax Act and the TRAC Act:

<table>
<thead>
<tr>
<th></th>
<th>VALUE ADDED TAX ACT</th>
<th>TAX REFORM AND COMPETITIVENESS ACT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Style:</strong></td>
<td>consumption</td>
<td>consumption</td>
</tr>
<tr>
<td><strong>Principle:</strong></td>
<td>destination</td>
<td>destination</td>
</tr>
<tr>
<td><strong>Method:</strong></td>
<td>Account-based</td>
<td>Invoice</td>
</tr>
<tr>
<td></td>
<td>Credit-Subtractive</td>
<td>Credit-Subtractive</td>
</tr>
<tr>
<td><strong>Rates:</strong></td>
<td>single (three percent)</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Zero-Rate:</strong></td>
<td>exports</td>
<td>exports</td>
</tr>
<tr>
<td></td>
<td>supra note 130</td>
<td>supra note 255</td>
</tr>
<tr>
<td><strong>Exempt:</strong></td>
<td>N/A</td>
<td>11 categories 44</td>
</tr>
</tbody>
</table>

The most efficient and least equitable statute is the Value Added Tax Act because it provides few exemptions and zero-ratings. \textit{See supra} notes 136-45 and accompanying text (listing characteristics of efficient and equitable tax system). The least efficient and most equitable statute is the TRAC Act because it provides many extensive zero-ratings. \textit{Id.}
presents a more realistic view of the efficiency/equity/simplicity debate.

IV. RECOMMENDATIONS

Deriving a completely new tax system may be substantially easier than modifying a pre-existing tax structure. This Comment recommends that the United States devise a VAT. The proposal that follows reflects the author’s preferred balance of the competing objectives of efficiency, equity, and simplicity. Unlike the United States, Japan need only revise the CT law slightly by providing preferential treatment for consumer food purchases to respond to growing consumer disapproval of the tax.

A. Recommendations for Japan

Despite pressures to abolish the CT, it should be upheld as a positive means to accomplish several important tax objectives. The CT is only part of a larger scheme to provide substantial tax cuts. The CT suffers because of the Japanese government’s failure to promote accompanying cuts in Japan’s already high income tax rates.

One suggested revision to the CT is to earmark all CT revenues for either the care of elderly or some other specific purpose. The government presently uses CT revenues to reduce Japan’s budget.

278. See supra notes 19-20 (summarizing other reforms).
279. Prior to the 1988 tax reforms, the individual income tax rates ranged from 10.5% to 60% in 12 brackets, the individual inhabitants tax (prefectural tax) ranged from 5% to 16% in seven brackets, and the corporate income tax rates were 42% for ordinary corporations and 30% for small and medium-sized corporations. After the 1988 tax reforms, the individual income tax rates ranged from 10% to 50% in only five brackets, the individual inhabitants tax ranged from 5% to 15%, and the corporate income tax rates were 40% for ordinary corporations in 1989 (37.5% in 1990) and 29% for small and medium-sized corporations in 1989 (28% in 1990). Main Points of Tax Reform §§ 1(1), 5(1). In comparison, the maximum United States individual income tax rate is 28% and the maximum United States corporate income tax rate is 34%. I.R.C. §§ 1, 11(b)(1)(C) (1986).
deficit,\textsuperscript{281} supplement the revenues of the prefectures\textsuperscript{282} and local governments,\textsuperscript{283} and fund the tax cuts provided by the other 1988 tax reforms.\textsuperscript{284} It is questionable whether all CT revenues should be earmarked for any one purpose, even Japan’s growing elderly population, although a portion of such revenues should be used to care for this growing sector of the Japanese population.\textsuperscript{285} The government needs CT revenues for several purposes and should not limit its potential benefit to only one group or project.

An exclusion for food purchases may be necessary for the continued vitality of the CT. Although efficiency goals motivated the CT legislators,\textsuperscript{286} and a zero-rating for food would be inefficient, it is nevertheless required to make the CT more palatable to the growing Japanese consumer movement.\textsuperscript{287}

Alternatively, the government should consider implementing a credit system\textsuperscript{288} for consumer food purchases rather than a zero-rating. Zero-ratings are administratively burdensome, and thus should be avoided. Although a credit system also imposes administrative burdens, the taxing authorities could circumvent them by allowing consumers to credit the CT incurred on their food purchases.

\textsuperscript{281} See supra note 225; see Ono, supra note 223, at A11, col. 4 (reporting drop in global trade surplus from $7.76 billion in September 1988 to $7.24 billion in September 1989).

\textsuperscript{282} See supra note 73 (outlining development of assistance of prefectures through tax revenues).

\textsuperscript{283} Japanese CT § 13. The CT law also established the consumption transfer tax (CTT) to transfer 20% of CT revenues to the prefectoral and local governments. Id. § 13(1); see also Main Points of Tax Reform § 6(1) (revealing that prefectoral governments will receive six-elevens of CTT and municipal governments will receive five-elevens of CTT). The local governments also receive CT revenues through the Local Grants Tax. Id. § 6(2); J. Pechman, supra note 16, at 426. Although the national government collects almost two-thirds of all taxes in Japan, it transfers approximately 35% of collected taxes to the prefectures and local governments. O'Keefe, supra note 2, at 401.

\textsuperscript{284} See supra notes 19-20 (discussing other reforms).

\textsuperscript{285} Ironically, the argument for earmarking CT revenues for the elderly underscores one of the fundamental debates regarding the regressivity of VATs in general. See Aaron, supra note 5, at 114 (presenting argument that VAT is double taxation of elderly); see also supra note 5, at 976 (expressing equity issues connected with VAT, regressivity, and elderly). But see Schuyler, supra note 11, at 574 (implying that this contention relies on faulty assumption that VAT shifts burden of taxation forward to consumers and arguing it actually shifts backward to producers and suppliers). Opponents of value-added taxation base their argument on the premise that the elderly finance their retirements, in part, through savings of past income. Such income has already been taxed at pre-VAT income tax rates. Aaron, supra note 5, at 114. By using VAT revenues to finance income tax rate reductions, taxing the consumption of the elderly constitutes double taxation of their income: first, when the elderly taxpayer earned his or her income, and second, when the elderly taxpayer spends the funds during his or her retirement years for personal consumption. Id.

\textsuperscript{286} See supra notes 205-08 and accompanying text (discussing apparent legislative objective of promoting efficiency over progressivity).

\textsuperscript{287} See supra notes 213-14 and accompanying text (explaining that middle class might be more receptive to VAT that zero-rated food).

\textsuperscript{288} See supra notes 215-17 and accompanying text (analogizing such system to earned income credit in Internal Revenue Code).
against their income tax liability on their income tax returns. This alternative would be equitable to consumers and efficient to tax administrators because it does not create the paperwork generated by either a zero-rating or a separate tax form.

**B. Recommendations for the United States**

The United States should impose a VAT similar to the Japanese CT with some attributes of both the Value Added Tax Act and the TRAC Act. An American VAT could provide substantial revenues that may be used to reduce the budget deficit,\(^{289}\) lower other tax rates,\(^{290}\) fund the social security system,\(^{291}\) or subsidize other social programs.\(^{292}\)

There is some question as to which VAT calculation method would be superior for an American VAT. From an efficiency standpoint, the invoice method VAT may be superior to the account-based method because it would create an audit trail for taxing authorities. However, the account-based feature would be superior from a compliance standpoint.\(^{293}\)

The United States may compromise by allowing small and medium-sized businesses to use the account-based method\(^{294}\) and requiring large taxpayers to use the invoice method. By allowing smaller enterprises to substantiate their input tax credits with their books of account, the tax administration would generate greater tax revenues than they could by implementing any other preferential treatment. In addition, it would alleviate potential feelings of commercial insignificance by smaller taxpayers. The government may also consider allowing large businesses to credit all or part of their

\(^{289}\) See Aaron, supra note 5, at 1111 (explaining that deficit reduction is primary reason for adopting VAT, but suggesting that current deficit projections are understated and actually much larger). But see Blustein, Doubt Growing About Chances for Reducing Budget Deficit, Wash. Post, Sept. 24, 1989, at A18, col. 1 (criticizing efforts to reduce United States deficit as concentrating only on short-term). In solving deficit problems for fiscal 1990, the government placed greater deficit burdens on fiscal 1991 and future fiscal years. Id.

\(^{290}\) See A. Tarr, supra note 1, at 21 (suggesting reductions in corporate and individual taxes through introduction of VAT).

\(^{291}\) Id. at 33.

\(^{292}\) The United States government can use VAT revenues for the defense budget. Id. at 32-33. Such revenues can also be used to fund social programs in, *inter alia*, child care, education, the environment, and the fight against drugs. Id. at 31-33. One imaginative, if not idealistic, tax scholar contends that a popular President could convince the American people to accept a 10% VAT where the proceeds would be paid into a national defense trust fund. This would serve two goals: first, the costs of national defense would be provided for; second, such costs would be removed from the budget as the VAT would supply its sole funding. Galvin, supra note 27, at 278-79.

\(^{293}\) See supra note 146 and accompanying text (defining compliance costs).

\(^{294}\) The government should also provide a complete exemption from the law for smaller business enterprises. See Japanese CT § 8(1) (granting complete exemption for small-sized businesses).
costs in setting up the invoice method against their first year VAT liability to appease their potential dissatisfaction with preferential small business treatment. Although use of the account-based method sacrifices an audit trail, this loss may not prove burdensome because the government collects a smaller percentage of tax revenue from this group. Therefore, an account-based system for small and medium-sized businesses would function like a de minimis rule. The account-based system also simplifies enforcement of the tax as it virtually eliminates the need to search for certain types of tax nonpayment.

CONCLUSION

The most important lesson to be learned from Japan is that an intense public relations campaign must precede the successful introduction of a VAT into a taxing jurisdiction. Japanese consumers were not apprised of the details of the CT and, therefore, did not comprehend the superiority of the CT system over the commodity taxes that it replaced, or the substantial tax cuts that would have been inconceivable but for the CT.

Unlike Japan prior to the introduction of the CT law, the United States is relatively content with its present tax structure. Despite this general comfort with the post-1986 tax system, some serious problems require immediate attention and funding. A new tax system, as opposed to an increase in existing tax rates, might be more palatable to the President, Congress, and the public.

A broad-based VAT similar to that employed in Japan is a consideration whose time has come. In 1949, the United States, through the Shoup Mission, attempted to teach the Japanese something about ideal tax policy. Forty years later, the Japanese, perhaps

295. For example, 90% of the corporations that reported income in 1987 yet paid no federal income tax, were small corporations. Statement of Kenneth W. Gidean, Assistant Treasury Secretary for Tax Policy, Before House Ways and Means Committee Hearing on Tax Reform Act of 1986, Daily Rep. for Executives, at L2 (Feb. 8, 1990).

296. Japanese outrage over the CT appears to be a natural reaction to the volatile combination of political arguments favoring a VAT, business expectations of inordinate compliance costs, and public resignation to impending inflation. A. Tarr, supra note 1, at 172. Taxing authorities should consider several public relation tactics to familiarize the public with a VAT before it is implemented. See id. at 172-77 (listing ways that taxing authorities can minimize VAT transitional problems: publicity to apprise public about tax, register taxpayers early, and send tax officials to firms to oversee propriety of registration and documentation).

297. See supra note 147 and accompanying text (discussing problems of public perception associated with CT).

298. See A. Tarr, supra note 1, at 31 (noting general satisfaction with current United States tax structure).

299. A 1983 survey indicates that the American public would support a national sales tax over an increase in income tax rates. Schenk, Value Added Tax, supra note 4, at 283.
wiser, perhaps more realistic, or perhaps simply more in tune with the interchange between efficiency, equity, and simplicity, may finally return the favor.