Coordinating State Sales Taxes with a Federal VAT: Opportunities, Risks, and Challenges

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I. Introduction

Federal adoption of a value added tax (VAT) would create opportunities for the states to improve their tax systems substantially, by replacing their existing retail sales taxes (RSTs), which are badly flawed, with state VATs or by reforming their RSTs. There is, however, a risk that state sales taxes would be made worse, rather than better. Moreover, in the absence of coordination between state and federal revenue authorities, costs of compliance and administration could escalate, because of the need to comply with two quite different taxes. But meshing either state VATs or state RSTs with a federal VAT would be challenging and could entail significant loss of state fiscal sovereignty. Achieving destination-based taxation of interstate trade is especially problematic. The existence of local sales taxes further complicates the task.

This paper discusses these opportunities, risks, and challenges, on the assumption that a transactions-based credit-invoice method VAT would be enacted as an additional source of federal revenue.[2] It does not discuss other aspects of the desirability of the federal government's entering what has long been considered the fiscal preserve of state and local governments, including whether a federal RST might be preferable to a VAT. Nor does it consider the daunting prospect that the entire federal income tax would be replaced by a VAT.[3]

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[2]Very different issues would arise if the federal government were to adopt an accounts-based value added tax, such as the subtraction-method business transactions tax, or if a state had such a tax. It would seem quite difficult to coordinate state sales taxes with what (in McLure 1987) I call the "naive"version of a subtraction-method VAT. If the federal tax were to allow deductions only for purchases that have been taxed, it would resemble a credit-method tax. For further discussion, see Schenk (1993) and (1998).

[3]On this, see Strauss (1997), Gale (2005) and Fox and Murray (2005). I do not discuss the possibility that the combined federal-state-local tax rate would be so high that

II. Preliminaries

Before turning to the coordination of state sales taxes with a federal VAT, it will be useful to set the stage, by describing the characteristics of an ideal sales tax, defects of existing state sales taxes, how a VAT achieves the characteristics of an ideal sales tax, the difficulty of achieving destination-principle taxation of interstate trade, how the European Union (EU) and Canada handle the issues discussed here, in the latter case focusing on the "dual VAT"employed by Quebec and the federal government of Canada, and what I mean by "coordination" in what follows.

A. Characteristics of an Ideal Sales Tax

A well-designed sales tax system would exhibit five characteristics, three economic, one administrative, and one political:

1) essentially all sales to consumers in a given jurisdiction would be taxed at a single rate;

2) essentially all sales to business would be exempt;[4]

3) sales would be taxed under the destination principle, which means that exports from the taxing jurisdiction would occur tax-free and imports into the jurisdiction would bear the same tax as domestic (or local) products;[5]

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evasion would become unmanageable, but experience in the European Union suggests that this would not be a problem, as long as the federal rate were below 10-15 percent. To my thinking, the best proposal for a federal VAT is that in Graetz (2002), which would combine a VAT of 14-15 percent with a federal individual income tax exemption of $100,000. Such a proposal would have state income tax implications, which I also do not explore.

[4] I focus on the tax treatment of sales to households and businesses, including commercial operations of governments and non-profit organizations, setting aside the tax treatment of purchases of non-commercial arms of governments and non-profit organizations, which can be either taxed or exempt (or zero-rated, under a VAT). For most purposes I lump sales to businesses that are not registered for VAT like sales to households.

[5] A well-know theorem states that, under certain ideal conditions, the choice between origin- and destination-based sales taxes would not matter, because the difference would wash out in differences in exchange rates or (of more relevance in the domestic context) differences in price levels. Leaving aside the fact that the ideal conditions are not likely to be realized, there are at least three reasons to prefer the destination principle. First, in order to implement the origin principle, it would be necessary either to have uniform rates, which would eliminate state sovereignty in this area, or to value exports and imports, which raises the specter of manipulating and monitoring transfer prices between related entities – a problem that would be insuperable

4) the first three objectives could be met without undue costs of compliance and administration; and

5) each level of government would have the power (and the responsibility) to set its own tax rate.[6] (Note that compliance with the first two characteristics would eliminate the power of each level of government also to determine its sales tax base.)

In what follows these five characteristics are the criteria used to judge federal and state (and local) sales taxes and schemes to coordinate them.

B. Characteristics of Existing RSTs

Existing state RSTs violate the first four of these principles: 1) many sales to consumers, especially of services, are exempt; 2) many sales to business are taxed; 3) the destination principle is seriously violated, and 4) the system is incredibly complicated. Exemptions, including those for only selected business purchases, based on the intended use of the product, create complexity. Violation of the destination principle is inherent in the taxation of business purchases. Even though exports from a state are generally exempt, the hidden taxes paid before the export stage are not rebated. Similarly, even if imports into the state are subject to the RST, they are not burdened with the hidden taxes paid on local production before the import stage. Moreover, because of the complexity of the state sales tax "system" caused by differences in tax bases and administrative procedures, the US Supreme Court has ruled in *Quill* that an out-of-state vendor that does not have a physical presence in a state (hereafter called a remote vendor) cannot be required to collect use tax on direct sales to purchasers in the state, and in-state purchasers (especially consumers and small businesses), who are legally liable for the use tax, generally do not remit the tax, except in rare cases (for example, when tax must be paid in order to register an automobile).[7] The states have recently undertaken the Streamlined Sales Tax

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at the state level. Second, the destination principle probably reflects better where public services are provided. Finally, the origin principle would be politically unpopular (imagine having to compete with untaxed imports and not being able to make exports tax-free), would be under constant attack, and might be unsustainable. The result might be either a "race to the bottom"or a shift to the destination principle. For thoughtful advocacy of origin-based taxation in the context of a customs union between Canada and the US, see Kesselmam (2004).

[6]For justification of these assertions, see McLure (2000a) and (2000c). I leave open the possibility of exempting some sales to consumers (e.g., of prescription drugs) and taxing some sales to business (e.g., of luxury automobiles ostensibly used in business). This description of an ideal sales tax does not refer to use taxes, which are an artifact of US constitutional jurisprudence. Taxation that is economically equivalent to a use tax is inherent in a destination-based sales tax.

[7]Increasingly states are including a line in their income tax forms where use tax liability is to be declared. Unless supported by a presumption that a certain percentage of

Project (SSTP).[8] It is hoped that if the SSTP achieves enough simplification either the Congress or the US Supreme Court will override *Quill*.

Violation of the first two principles of good sales tax design is primarily a matter of poor state tax policy, not administrative necessity. There is little administrative reason that state tax bases could not include essentially all sales to consumers and exempt essentially all sales to business.[9] (Note that one of the problems that has stymied efforts to tax services, the need to apportion sales of services to a multistate business, vanishes if all sales to business are exempt.) If those reforms were made, most differences in state tax bases – and thus most of the complexity resulting from those differences – would also be eliminated, without the need for multilateral action by the states. The only remaining violation of the destination principle would be the failure to collect tax on direct sales to in-state consumers by out-of-state vendors. Given the uniform tax base implied by satisfaction of the first two rules, it would not be difficult for out-of-state vendors to collect use taxes, provided the states also adopted uniform administrative procedures – a reform that, unlike creation of a uniform tax base, would require multilateral action. With that simplification, *Quill* should be overturned, in which case state RSTs would exhibit all five characteristics of an ideal sales tax.[10]

The previous paragraph might sound a bit like saying, "If pigs had wings, they could fly." But in this case the pigs have deliberately *chosen* not to have wings and thus cannot fly – and the Supreme Court has rightly responded by limiting their exercise of fiscal sovereignty with its

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income is spent on purchases from remote vendors (which effectively converts the use tax to an income tax surcharge) or audits based on information obtained from remote vendors, this form of self-declaration is a tax on honesty – and one targeted at those of us who could not conceivably plead ignorance of our legal liability to pay use tax.

[8]For a description and analysis of the SSTP and its work product, see Hellerstein and Swain (2004).

[9]For a recent proposal a to address both of these defects, see State of Utah (2004). There would, of course, be room for abuse by those who claim business purchase exemptions for "dual use" products intended for personal consumption. My guess is that the taxation of business inputs largely reflects flawed thinking about policy ("If families pay sales tax, why shouldn't business?") and the desire to hide the true cost of government, rather than careful consideration of administrative realities.

[10]For elaboration on these points, see McLure (2000a). Local sales and use taxes complicate matters; they are considered in Section IIII D below. Electronic commerce sales of digital content to households by vendors located in foreign countries pose difficult administrative problems that are noted, but not considered fully. See also McLure (2003a). With the reforms suggested, including over-ride of *Quill*, taxation of domestic e-commerce sales would pose much less serious problems.

decision in *Quill*.[11] Introduction of a federal VAT would provide the opportunity to rectify all the defects of existing RSTs, through adoption of state VATs or improvement of existing sales taxes.

C. How VAT Achieves the Economic Characteristics of an Ideal Sales Tax

Under a prototypical VAT, tax is levied on all sales, whether to consumers or to business, but businesses that are registered for VAT are allowed a credit ("input credit") for VAT paid on their purchases ("input VAT").[12] Thus the first two characteristics of an ideal sales tax are achieved.[13] Destination-principle treatment of international trade in goods is achieved by taxing

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[11]Note that the Streamlined Sales Tax Project, even if successful, as judged by its own limited objectives, would not achieve any of the first four characteristics of an ideal sales tax. States could (and presumably would) still exempt many products sold to households, they could (and presumably would) still tax many business inputs, the system would remain far more complicated than it needs to be, and (due to the taxation of business inputs) destination-based taxation would not be achieved, even if *Quill* were overturned.

[12]The VAT described here employs the credit method, rather than either the subtraction or addition method. Either exemption or zero-rating of domestic sales complicate the story.

Zero-rating eliminates tax if applied to sales to consumers, as vendors are allowed credit for taxes paid on inputs to zero-rated sales. Otherwise it has no effect, as reduced taxation of business inputs simply reduces credits for input VAT. It is generally not necessary to distinguish between inputs to taxable sales and inputs to zero-rated sales, as credits for input VAT are allowed for tax paid on both.

Exemptions reduce tax (by the amount of tax not collected on value added at the last stage), if applied to sales to consumers. Otherwise they increase tax, by breaking the chain of input credits. If a given trader makes both taxable (or zero-rated) sales and exempt sales, it is generally necessary to distinguish between inputs to taxable (or zero-rated) sales and inputs to exempt sales, as input credits are only allowed for tax paid on the former.

Both exemptions and zero-rating at the retail level violate the first characteristic of an ideal sales tax. Exemptions before the retail stage violate the second and third characteristics, by breaking the chain of input credits. Both zero-rating and exemptions create complexity. For a more complete explanation of the mechanics of a VAT, including the mechanics of exemptions and zero-rating, see McLure (1987). For convenience of exposition in what follows I generally suppress references to non-registered traders, which pay tax on their purchases, make sales that are de facto exempt, and are not allowed credits for input VAT, lumping this group together with consumers.

[13]No country fully follows this prototypical model, in part because it is administratively difficult to apply to some sectors (financial services and real estate), in

all imports and zero-rating (applying a zero rate to) all exports; since exporters are allowed a credit for tax on purchased inputs (and a refund, if appropriate), exports occur tax-free.[14] Together the taxes applied to imports and the zero-rating and rebate of VAT on exports are sometimes called border tax adjustments or BTAs.

D. The Vexing Problem of Trade between Subnational Jurisdictions

Until recently it has been thought difficult to impose a subnational VAT, because of the difficulty of implementing the destination principle at acceptable costs of compliance and administration.[15] Two types on interstate sales – to consumers and to businesses – pose quite different problems.[16]

Ideally interstate sales to consumers would be subject to the VAT prevailing where they live, with tax remitted to their jurisdictions of residence if collected by businesses located elsewhere. As the recent debate over taxation of electronic and other forms of remote commerce has shown, this is not easily achieved, even if there are no legal barriers to it, as there are in the US.

Because of the risks of tax evasion, the amounts of money involved, and the potential implications for fiscal sovereignty, the most ink has been spilled on interstate sales to

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part to remove the compliance burden on small business (via exemption), in part for distributional and other political reasons (via exemption or zero-rating of "necessities"), and in part for revenue reasons (via limitations on input credits). New Zealand perhaps comes closest among developed countries.

[14]Electronic sales of digital content directly to consumers from outside the nation are not easily taxed. Similar sales to registered traders can be handled through reverse charging. See McLure (2003b).

[15]Richard Bird wrote in 1994, "[N]o one, anywhere, has managed to work out an acceptable system for taxing sales independently at two levels of government." Bird (1994, p. 47) (See, however, Cnossen, 1983, which describes a system based on zero-rating and reverse charging.) Thus in McLure (1971) and (1980), because of the perceived need for border controls to implement a destination-based VAT, I favored a uniform-rate, origin-based, state VAT to accompany a federal VAT. I also argued that a federal RST would be superior to a federal VAT, because it would facilitate destination-based state and local RSTs. McLure (1988) reaches conclusions that are more consonant with those in the present paper. The Brazilian states have levied origin-based VATs since 1967. The Brazilian state VAT also has many (but different) problems that cannot be discussed here. See, however, Varsano (2000).

[16]For further explanation, see also McLure, 2003a.

businesses,[17] at least until the advent of electronic commerce caused a deluge of ink.[18] It clearly would not do to erect customs houses between the American states in order to implement BTAs; indeed, it was the desire to eliminate border controls that led the European Union (EU) to adopt the current "deferred payment" system. Under that system, exports from the EU Member State of origin to registered traders in the Member State of destination are zero-rated (as under the conventional BTA system), but no tax is collected on imports at borders between Member States. Rather, business purchasers in the destination Member State self-assess ("reverse charge") the tax they owe on the transaction, simultaneously remitting the tax and taking a credit for it in the same VAT return. (Reverse charging does not affect the final outcome. Without reverse charging, the buyer's input credits would be lower by the amount of tax not paid on imports.) The deferred payment system has at least two potential disadvantages: a) consumers may pose as vendors located in another Member State in an effort to make zero-rated purchases – a problem that is minimized but not eliminated by the VAT Information Exchange System (which requires reporting of cross-border sales and acquisitions) and bilateral cooperation between tax administrations of Member States and b) vendors must distinguish between – and treat differently – local sales (to both households and businesses) and sales to registered traders in other Member States (and, of course, exports to third countries, which are also zero-rated).[19]

E. The Canadian Solution

Since 1991 the Canadian government has imposed a VAT, which it calls the Goods and Services Tax (GST); the GST rate is 7 percent. The federal government administers the GST, except in Quebec. The Canadian provinces have responded in four distinct ways.[20] First, Alberta, has no sales tax. Second, Quebec imposes a 7.5 percent destination-based VAT, the Quebec sales tax or QST. (Since the federal GST is included in the base of the QST, the combined GST/QST tax rate is 15.025 percent, and the QST is, in effect, 8.025 percent of sales subject to both taxes. It would, of course, be much "cleaner" and more transparent to levy both

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[17]See generally Cnossen (1990) and Poddar (1990), as well as the more recent literature cited in note 30. Piffano (2003) describes and assesses many of the techniques that have been proposed to deal with this problem.

[18]Unlike the US discussion of e-commerce and sales taxes, the EU discussion of VAT and e-commerce has focused almost entirely on sales to consumers because the system based on zero-rating and reverse charging "gets it right" for sales to business. See McLure (2002) and (2003a).

[19]Cnossen (2001) expresses doubt that the first of these is a major reason for concern, noting (p.497) "the Member States do not complain about the regime." The solution in Keen and Smith (1996) and (2000) is motivated by the second of these concerns.

[20]On the Canadian "system," and especially the "dual VAT" levied in Quebec, see Bird and Gendron (1998) and (2000).

federal and state VATs on a base that excluded both taxes.) Except on imports from abroad, the province administers the federal GST, as well as the QST. Third, three provinces (Newfoundland and Labrador, Nova Scotia, and New Brunswick) participate in the Harmonized Sales Tax (HST), which the federal government administers. In those provinces the HST rate is 15 percent – 8 percentage points higher than the GST rate imposed elsewhere, and the revenue attributable to the higher rate is divided among the participating provinces in proportion to estimated consumer spending. The provincial part of the HST is thus essentially a tax-sharing arrangement that leaves no latitude for either the federal government nor individual participating provinces, acting unilaterally, to vary their tax rates; it thus violates the fifth principle stated above (state sovereignty over rates). Significantly, most other provinces have strongly rejected participation in the HST, which the federal government has favored.[21] It seems unlikely that any American state would accept the loss of fiscal sovereignty inherent in such a deal; nor should they.[22] I thus do not consider this alternative further.[23] Finally, the remaining provinces continue to levy (and administer) retail sales taxes (called PSTs in Canada) that generally resemble those of the American states and share their faults.[24] There is generally no coordination in the federal administration of the GST and provincial administration of the PSTs, although the Canada Revenue Agency does collect PSTs (as well as HST and QST) on imports into the country. Finally, there are no local sales taxes in Canada.

Quebec's experience with the QST shows conclusively not only that uncoordinated retail sales taxes can co-exist with a national VAT but, far more important, that a subnational VAT can be implemented. Quebec has a crucial advantage in implementing its QST that the EU Member

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[21]Manitoba and Saskatchewan were more inclined to join the HST than the economically stronger provinces (Alberta, British Columbia, Ontario, and Quebec). If they had done so, an interesting question would have arisen. While it may (or may not) make sense, in essence, to treat the three small contiguous provinces that did join as one region for HST purposes (via the single rate and revenue sharing), it seems far less sensible to lump the large provinces of Manitoba and/or Saskatchewan, which are not contiguous to the other three, together with them. There seems to be no (non-political) reason not to treat them as distinct and allow them to have their own HST rates.

[22]The federal government of Canada paid the HST provinces a billion dollars to join the system, in order to offset revenue loss resulting from the switch. See Bird and Gendron (1998, p. 441, n. 19).

[23]The treatment of interprovincial trade of the HST provinces is similar to that described below for the QST.

[24]For a recent indictment of Ontario's PST, see Robertson (2005).

States lack: a federal VAT with which to coordinate administration of the QST.[25] Of course, the American states would have exactly the same advantage if the federal government were to adopt a VAT.

Quebec's QST is implemented much like the VAT in the EU, except that, for constitutional reasons explained below, Quebec gives businesses registered for QST the option of not paying tax on purchases, provided they would be eligible to claim input credits if the tax were paid. Exports from Quebec are zero-rated for QST purposes, whether the purchaser is in another province or in another country. The Canadian government collects QST on imports into Quebec from foreign countries, but (also for constitutional reasons) not QST on imports from other provinces. QST is self-assessed in the case of interprovincial imports by consumers (and by registered traders choosing not to purchase on a non-taxable basis) from vendors not registered for QST. (In the case of imports by businesses registered in Quebec any self-assessed tax "washes out," as in the EU scheme for reverse charging.) As in all systems that rely on self-assessment by consumers, non-compliance is a problem.

There are several unique features of the Canadian/Quebec experience that must be kept in mind in appraising its relevance as a precedent for the United States. First, the Canadian federal government had long levied a sales tax (at the manufacturing level) before switching to the GST. By comparison, while the US government has long levied excise taxes, it has no experience in the general sales tax field.

Second, Quebec's strong desire to administer its own tax, rooted in cultural and linguistic differences, has no direct counterpart in the US. The provinces that levy PSTs also administer them, but there is no consideration of their also administering the very different federal GST or of federal administration of provincial PSTs. Of course, the US states also prefer to administer their own taxes.

Third, although there were initially significant differences in the federal and Quebec tax bases, as well as incomplete allowance of input credits and rate differentials in the QST (4 percent on services, compared to 8 percent on goods), these differences are now minimal.[26] This uniformity facilitates coordination and administration of both GST and QST by a single agency.

Fourth, some features of the QST reflect the particular constitutional situation in Canada. Article 92(2) of the Canadian constitution provides that (except with respect to certain natural

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[25]The EU Member States have, however, largely harmonized their tax bases and administrative procedures. Although administration has not been unified, there is substantial bilateral cooperation.

[26]Bird and Gendron (1998) describe these early deviations in general terms. For a description of the current QST system and its interaction with the GST and HST, see Ministère du Revenu du Québec (2003). The most significant current difference in the federal and provincial tax bases is that, because of competitive fears, financial services, which are exempt under the GST, are zero-rated under the QST. Also, so-called large business are not allowed QST input credits on purchases of certain motor vehicles and fuels used therein, non-manufacturing utilities, telecommunications services, and certain food, beverages, and entertainment.

resources) provincial tax authority is limited to "Direct Taxation within the Province...." While this provision has been interpreted to allow provinces to levy sales taxes, such taxes must be carefully structured to pass constitutional muster. Thus to avoid the risk that the QST might be found to be an indirect tax, firms can makes purchases that are eligible for input credits on a non-taxable basis. This difference in the GST and the QST does, of course, complicate administration. In administering the HST, the federal government requires that vendors registered for GST located anywhere in Canada making remote sales into the HST region collect the provincial part of the HST, as well as the federal part. By comparison, both provincial and federal collection of QST in the analogous situation may be precluded by the Canadian constitution, unless the vendor is registered for QST. This may create a considerable and growing hole in the QST tax base. There is little doubt that the Congress, acting pursuant to the Commerce Clause, could impose on remote vendors a duty to collect state VAT on remote sales in such situations, thereby rendering *Quill* moot.

Fifth, because Quebec is the only province that levies an independent VAT, there is no issue of coordinating QST with VATs of other provinces, and problems of federal-provincial coordination and provincial administration of the federal GST are minimized. It is worth noting, however, that if the Quebec system were generalized to other provinces, a firm exporting from one VAT province to a firm in another VAT province would need to deal with only the province where it operates (to claim the benefits of zero-rating of exports); similarly, the importing firm would need to deal only with its own provincial tax authorities (to pre-pay the tax and take credit for it, if it did not choose to make non-taxable purchases).[27] Of course, if remote vendors were required to collect the VAT of the province of destination, this characterization would not be accurate. As noted, a non-resident firm that is registered for QST is required to collect QST on sales made to consumers in Quebec.

Sixth, as noted above, there are no local sales taxes in Canada. The existence of local sales taxes is a crucial determinant of the kind of coordinated scheme that would make sense for the United States.

F. Aspects of Coordination

The lack of uniformity of tax bases and administrative procedures (registration, reporting, auditing, appeals, etc.) across states and the lack of administrative cooperation among states (e.g., via "one-stop registration" and joint audits) are the chief causes of complexity of the sales tax system, as it is experienced by businesses operating in more than one state.[28] That complexity is, in turn, what justified the Supreme Court's decision in *Quill* that effectively eliminates taxation of remote sales to households. The power to determine sales tax bases and administrative procedures is often seen as an important element of state fiscal sovereignty. But I

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[27]See Hill and Rushton (1992).

[28]To get the flavor of this complexity, see the discussion of measures the Streamlined Sales Tax Project has suggested to simplify the system in Hellerstein and Swain (2004). It is worth noting that more than 100 pages of small print are needed to describe the *simplified* system and its rationale.

believe that the costs caused by lack of uniformity and cooperation (i.e., needless costs of compliance and administration, as well as revenue lost because of *Quill*) far outweigh the benefits of this type of fiscal sovereignty. By comparison, the lack of uniformity of state sales tax rates creates almost no complexity, but is clearly essential to the exercise of fiscal sovereignty.[29] Thus I strongly favor greater uniformity of tax bases and administrative procedures and greater cooperation in administration, but complete state latitude in setting tax rates. In what follows I use the short-hand term "coordination" to describe only the former. (Note that the Canadian HST also "harmonizes" provincial tax rates.) The introduction of a federal VAT would provide the opportunity for coordination of state taxes with the federal tax and thus greater coordination of state taxes. Coordination of federal and state taxes may or may not involve administration by a single level of government. In either event, administrative procedures, like tax bases, should be brought into conformity. Whether more than one level of government administers the tax should be a question of who implements those uniform procedures.

It must be recognized that coordination with federal taxation carries risks (coordination with bad or unstable federal policy), as well as possible benefits (coordination with good and stable policy). Writing in the Canadian context, Rushton (1993, p. 98), has said, "In general provincial governments were wary about changing sales tax regimes to a system which might ultimately be overhauled by the next federal government..." US experience with the income tax demonstrates clearly that such wariness is more than justified.

III. Coordination of State RSTs and VATs with an Ideal Federal VAT

In thinking comprehensively about coordination of state sales taxes with a federal VAT, it is necessary to consider both what the federal tax base might be and what kinds of sales taxes the states might levy – VAT or RST (or none), the base of each, and who would administer the two taxes in a particular state. This is a tall order, given the large number of possible combinations and permutations. Since my crystal ball does not tell me the most likely combination, I make two alternate assumptions about the federal VAT and three about the possible constellation of state taxes. In this section I consider a federal VAT that exhibits the characteristics of an ideal sales tax (taxation of all sales, input credits for all VAT on business inputs, and destination-based treatment of foreign trade).[30] In that context I consider three state

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[29]Lack of uniformity of local sales tax rates is often cited as a source of complexity, but complexity of local sales taxes is due more to lack of clear and uniform sourcing rules (and, in some states, differences in state and local tax bases) than to differences in local tax rates, per se. After all, even with uniform rates, problems of sourcing sales to local jurisdictions would remain.

[30]I ignore the possibility that the federal VAT might contain an exemption for small business. A federal VAT exemption not matched by state exemptions would create a "disconnect" between the federal and state taxes. Since existing state sales taxes do not provide such exemptions it is not clear that the federal VAT should. Because VAT exemptions provided before the final stage (sales to consumers) increases tax, optional

sales tax scenarios. In Subsection A all states adopt a VAT (useful primarily as a benchmark, since it is unlikely that the states that currently do not levy sales taxes would levy a VAT, in the absence of federal coercion or a strong incentive to do so, especially since it would be difficult to impose local surtaxes on a state VAT). In Subsection B no state adopts a VAT (and some continue not to have RSTs), and in Subsection C some states adopt a VAT, but some keep their RSTs and some have neither. For each of the three state sales tax scenarios I consider both state taxes that conform to the principles of an ideal sales tax and taxes that continue to depart from the ideal. Subsection D considers the feasibility of implementing local surtaxes on various types of state sales taxes and subsection E which level(s) of government should administer the two taxes. Section IV briefly considers coordination in the context of a federal VAT that deviates from the ideal, by exempting or zero-rating some products.

A. Universal State VAT

Consistent federal and state VATs. If the federal government were to adopt the ideal VAT and all the states were to adopt a destination-based VAT, levied on the same base as the federal tax, but at rates chosen by the various states, it should be relatively easy to achieve all the characteristics of an ideal state sales tax. As in the prototypical VAT, essentially all sales to consumers would be subject to both taxes and input credits would eliminate all state and federal VAT on business inputs. US exports would occur tax-free, and both state and federal VATs would be collected on tangible imports from other countries, though perhaps not on digitized imports by consumers.

Taxation of intrastate sales under a VAT, shown in the first column of Table 1, needs no explanation. The challenge lies in achieving destination-based state taxation of interstate trade. For business-to-business interstate transactions, the deferred payment system described earlier could be employed.[31] Thus interstate exports to registered traders would be zero-rated, and the

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registration should be allowed. This issue – and the treatment of farmers – deserves further consideration.

[31]Under the “viable integrated VAT” (VIVAT) scheme described in Keen and Smith (1996) and (2000), all sales to business would be taxed at the same rate throughout the EU, thus eliminating the need to distinguish between business customers, depending on where they are located, but not the distinction between sales to businesses and sales to consumers. Alternatively, the “little boat”model developed by Varsano (2000) and described in McLure (1999) and (2000b) would impose a uniform “compensating value-added tax” (CVAT) on all interstate exports to prevent this type of abuse. The VIVAT system – at least one with a positive VIVAT rate – assumes that all subnational jurisdictions participate, and the CVAT works best if they do. Canadian experience suggests that the US would not need to employ either device if state VATs were levied in the context of a federal VAT. For discussions of these alternatives, see Cnossen (2001) and Fox (2001). In the “Prepaid VAT (PVAT) described by Poddar and Hutton (2001) vendors would be allowed to zero-rate interstate sales only if the purchaser provided evidence that VAT had been paid to the state of destination. This scheme seems hopelessly complicated. See also note 31.

same transaction would be subject to self-payment of tax by the importer. ("Self-pay" is the US term for self-assessment or reverse-charging.) This is shown in the VAT entry for interstate sales to business in Table 1.

Table 1
Taxation of Intrastate and Interstate Sales to Businesses and Households, under Ideal Forms of VAT and RST

Sales to:	Intrastate Sales	Interstate Sales
Business	VAT: Tax/input credit RST: Exemption	VAT: Zero rate/self pay RST: Exemption
Households	VAT: Taxed at retail RST: Taxed at retail	VAT: Subject to destination state tax RST: Subject to destination state tax

By comparison, on interstate sales to consumers, vendors would collect the state VAT of the state of destination, perhaps employing the sourcing rules developed by the Streamlined Sales Tax Project.[32] (See the VAT entry for interstate sales to households in Table 1.) The underlying federal VAT would help prevent consumers from claiming to be out-of-state businesses eligible to make zero-rated purchases, as only traders registered for federal VAT would be eligible for that treatment.[33] With such a system in place, compliance by remote

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[32]Note that this sentence refers only to the SSTP's *sourcing rules*, not its definitions of products, which would have no place in this system. An alternative would be to have origin-based taxation of interstate sales to consumers, except in the case of things like automobiles that must be registered. This is a distinctly second-best choice, except for vendors whose interstate sales fall below some minimum level. Of course, if federal-state cooperation were not legislatively authorized, *Quill* would presumably remain valid, unless overturned judicially, and origin-based taxation – or no taxation of such transactions – might be the only alternative except in the case of vendors with a physical presence in the market state.

[33]In theory, interstate sales to registered traders could also be taxed by destination jurisdictions under the SSTP sourcing rules; in that case destination jurisdictions would allow input credits for these taxes. Poddar (1990, p. 110-11) describes such a system, which he calls a "Joint National State VAT":

... Each vendor is required to compute the federal and state taxes on each sale. ... The state tax .. would be that of the state to which the goods are shipped by the vendor. The vendors would report their output tax for the federal and each of the state governments separately. ... Similarly, they would segregate their input taxes for each government. ... The output and input taxes reported by vendors would be credited and debited to the accounts of appropriate governments by the tax collection agency. The net balance in

vendors would be relatively simple. Implicit in this description is the assumption that the Congress would authorize the described federal-state coordination, including a requirement that remote vendors collect tax on sales to households, making *Quill*'s strictures obsolete.

State deviation from the federal VAT. Quebec's initial experience, in which the federal and provincial tax bases differed more than now and the province did not allow input credits for all tax on business purchases, may seem to suggest that neither absolute uniformity of national and subnational tax bases nor credits for all input taxes is required for a dual VAT to function. But such a conclusion should be accepted only with great caution. Certainly, anything resembling the lack of uniformity currently found in state RSTs would make federal-state coordination extremely difficult, and could swamp the system.

State deviations from the federal tax treatment of sales could take the form of either exemptions or zero-rating (or even rate differentiation) and could differ from state-to-state. Both exemption and zero-rating would imply different tax treatment of a given sale for federal and state VAT purposes, as state tax would not be collected on zero-rated and exempt sales. Though not desirable, zero-rating of intrastate sales would probably be relatively innocuous, if considered by itself. Businesses making zero-rated sales would be allowed input credit for all taxes paid on purchases, and businesses making zero-rated purchases would have no input credits for such purchases. By comparison, exemptions, the primary enemy of simplicity in any VAT, would especially complicate compliance and administration in a dual VAT, as input credits should not be allowed for tax paid on inputs to exempt sales. Thus on a given business purchase input credits might be allowed for federal VAT, but not for all state VATs.

Differences in federal and state VATs would be especially problematical in the case of interstate sales. Recall that Quebec relies on self-assessment to collect QST on interprovincial imports by households, unless the vendor is registered for QST. Since self-assessment works satisfactorily in neither Canada nor the US, this is tantamount to giving up virtually all revenue from this type of sale and subjecting local merchants to unfair competition from remote vendors. Given the attention the states have paid to taxation of remote commerce in recent years, it seems unlikely that they would accept the Quebec solution in this case, nor should they, given the opportunity to solve the problem a federal VAT would offer. The system described above relies

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> these accounts would be identical to what it would be if the tax were imposed and collected by each level of government separately at a given rate.
>
> ...[A]lthough each sale invoice would have two tax amounts (one for the federal government and one for the state to which the goods are shipped), the tax return of the vendors that make interstate sales could potentially have as many output tax entries as there are governments (number of states plus the federal) in the country. The input side of the return would consist of only two entries, on the assumption that all of the purchases by the vendors were taxed at the rate prevailing in the state of residence.
>
> Both EU and Quebec experience with the deferred payment system for sales to registered traders suggests that this complicated treatment of sales to business purchasers would be unnecessary.

instead on collection of tax on this type of transaction by remote vendors, just as all Canadian vendors registered for GST must collect HST on sales made into the HST provinces. Even with the uniform state definitions of products provided by the SSTP, deviations from the federal tax base would make the system needlessly complicated. Although the complexity could perhaps be managed, perhaps the federal government should refuse to cooperate in the administration of state taxes that do not conform fairly closely to the federal tax base. That would probably make non-conforming state VATs infeasible.

Ordinarily one would expect subnational VATs to deviate from an ideal national VAT primarily in their treatment of products sold primarily to households, since any failure to allow complete input credits would harm the competitive position of the taxing state. But for revenue reasons Quebec initially did not allow complete input credits and still does not allow them for large companies. Moreover, the states' steadfast refusal to eliminate RST on business inputs, despite the obvious negative effects on competitiveness, makes one wonder whether they would want to allow credits for all input taxes.[34] The risk that they might not allow full input credits is especially worrisome, given the inclusion of most services in the comprehensive federal VAT tax base. Increased state taxation of business services, without compensating input credits, besides complicating compliance and administration, would be a real step backwards on policy grounds. Perhaps the federal government should also refuse to cooperate in the collection of state taxes that do not allow complete input credits.

B. No State VATs

The opposite extreme would involve no state VATs, with continued state reliance on the RST (or no sales tax). Canadian experience shows that this is a viable option, as five of the Canadian provinces continue to levy retail sales taxes, despite the presence of the federal VAT and the superior model of the QST. In Canada there is no coordination of tax bases and not much coordination of administration of PSTs with the GST. This reflects political choice, rather than a view that coordination is inherently impossible. Lack of coordination does, of course, involve complexity and duplication of effort. This subsection examines whether it would be possible to coordinate the bases and administration of a federal VAT and state RSTs.

Ideal RST. It has been suggested that the Canadian provinces should levy improved PSTs, administered by the federal government, rather than follow the QST model. Mintz, Wilson, and Gendron (1994, p. 677) set out four principles such a system should follow:

- a final stage tax on consumer goods and services, in broad concordance with the federal base;
- only one level of government would be responsible for collecting and auditing the sales tax;

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[34] I assume, by comparison, that states would zero-rate exports to other states, rather than only exempting them. Exemption of exports might also constitute grounds for refusing federal cooperation.

< each province must be free to set its own rate of sales tax; and

< provincial sales taxes must be eliminated for all exports, business inputs, and capital goods.

It would be slightly more difficult to coordinate the administration of an ideal federal VAT and ideal state RSTs, because of the way the two taxes operate. A VAT is ideally levied on all sales. By comparison, a RST should ideally exempt all sales to business. But it would be possible to allow RST exemptions for all sales that give rise to input credits. This would require that vendors distinguish between whether or not a sale is to a business, and thus eligible for VAT input credit and, by extension, for RST exemption.[35] (Compare the VAT and RST entries for sales to business in Table 1.) For state sales tax purposes proof of registration for federal VAT would replace the resale exemption certificates currently in use.

As in the case of an ideal state VAT considered earlier, it would be necessary for remote vendors to distinguish between interstate sales to businesses, which should be exempt from RST, and interstate sales to households, which should be taxed, presumably under the SSTP sourcing rules.[36] But, since exemption would be allowed for all sales to businesses that are registered for federal VAT, it would not be necessary to distinguish between interstate and intrastate sales to business, as under the state VAT considered earlier. (Compare the VAT and RST lines for intrastate and interstate sales to business in Table 1.) This is a significant advantage of the RST approach, especially when we come to consider local sales taxes below.

An ideal federal VAT and ideal state RSTs would mesh well enough that compliance would be simple enough that *Quill* could be repealed. (Implicit in this judgement is the assumption that the state RST base is as broad as the federal VAT base, except for the presence of RST exemptions for sales to business.)

Defective RSTs. As noted earlier, extant state RSTs generally exhibit three defects: exemption of many sales to households, taxation of many sales to business, and (largely because

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[35]On the difficulty of such distinctions, see Cnossen (2002). If vendors were required to distinguish between types of buyers (households and businesses) in order to implement state RSTs, there might be little administrative reason to go to the trouble to levy a federal VAT; the federal government could simply also levy an RST. There are, however, good political reasons to prefer a federal VAT. It is less likely that sales to consumers will not be taxed, as those who make sales primarily to registered traders do not want their sales to be exempt, to avoid a break in the chain of credits. If these vendors also make sales to consumers, such sales will be taxed. Also, sales to business are not likely to be taxed without input credits, since disallowing credits violates the nature of the VAT system. Finally, higher aggregate tax rates are probably possible with a federal VAT than with an RST.

[36]This system is equivalent to a special form of the VIVAT, with all sales to business subject to a uniform state VAT rate of zero and sales to households subject to the RST rate of the state of destination.

of the second defect, but also because of the complexity that justifies the *Quill* decision) violation of the destination principle. Given the unwillingness of state policymakers to eliminate either of the first two defects or the interstate differences that create complexity, it is worthwhile considering whether state RSTs with those defects could be coordinated with an ideal federal VAT.

If not all sales to business were exempt from RST, it would be necessary for vendors to distinguish between exempt and taxable sales to business, depending on the tax law of the state of destination of sales. This would greatly complicate coordination with the federal VAT, which would require no such distinction. There is also a substantial risk that the states might simply choose to tax services, without exempting business services, since services would be taxed (but with offsetting input credits) under the federal VAT. Other RST exemptions (e.g., of consumer services, food, and clothing) would further complicate administration and coordination, as such exemptions would probably vary from state-to-state and there are no such exemptions under the ideal VAT. Regarding sales by remote vendors, the types of problems that exist now, which the SSTP would reduce but not eliminate, would persist.

C. State VATs and RSTs

If some states adopted VATs and some retained the RST (and some had neither), all the issues described thus far would occur together. Ideal state VATs could be coordinated with the ideal federal VAT fairly easily. Coordination of ideal RSTs would be slightly more challenging, because of the need for vendors to distinguish between business and household purchasers, but it should be feasible. Attempting to coordinate both types of state tax, even in their ideal forms, with a federal VAT may be “a bridge too far.” The states should probably choose one or the other. As explained below, the RST seems the better choice. Finally, coordinating the ideal federal VAT with defective VATs and/or defective RSTs is likely to be difficult, if not impossible.

D. The Problem of Local Sales Taxes

Local sales taxes are an important feature of the American fiscal landscape. Besides providing significant fractions of local revenues in some states, the existence of these taxes (potential as well as actual) is one of the reasons for the US Supreme Court’s decision in *Quill*. It is thus necessary to ask how they fit into the picture – and how they alter the conclusions reached thus far.

The existence of local sales taxes appears to tip the balance in favor of state RSTs, since it would seem much easier to continue local surtaxes on state RSTs than on state VATs. This can be seen from a reexamination of the entries for sales to business in Table 1.[37] Whereas the RST simply exempts all sales to business, the VAT treats intrastate and interstate sales differently, using the textbook input credit method to eliminate tax on intrastate sales to business, but zero-rating interstate sales. Extending this analysis to local taxes, we see the importance of this difference. Under a local RST a sale to a business purchaser registered for federal VAT

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[37] I assume taxation of sales to households by the local jurisdiction of destination. Local sales taxes raise additional questions that cannot be addressed here.

would be exempt, whether or not the purchaser were from another locality. By comparison, under a local VAT the vendor would be required to treat the sales differently (taxed, with an input credit to the purchaser, vs. zero-rated). In theory it would be possible to have state VATs and local RSTs, but it seems more logical to have RSTs at both state and local levels.

E. Administration of a Dual Sales Tax System

There are four ways to administer a dual sales tax:[38] state administration, federal administration, dual administration (with each level of government administering its own tax), and joint administration by an agency that answers to both levels of government.[39] Since VAT audits largely coincide with income tax audits, but RST audits do not, the choice between these options may depend, to some degree, on whether states continue to levy RSTs; but it is dominated by the existence of local RSTs.

State administration. I believe that state administration of both state and federal taxes is neither desirable nor likely. First, it would be difficult to achieve uniform administration of the federal VAT throughout the nation. This problem would be aggravated by the incentive for state tax administrations to be lax in administering the two taxes, in order to reduce the burden of the federal VAT on local consumers. (There is anecdotal evidence that this problem exists in Germany, where the länder administer the federal VAT.) The importance of the last consideration would depend on the relative levels of state and federal tax rates.[40] Federal monitoring of state administration would introduce a new level of complexity. Perhaps most important, I doubt seriously that the federal government would accept this assignment of administrative duties.

Federal administration. Federal administration of both state and federal taxes would create an enormous mismatch between requirements and availability of administrative employees. States would no longer need sales-tax administrators, but the federal government would need them. I do not believe that this justifies state administration of the federal tax, as Dronenburg (1995) does. One obvious solution, federal employment of erstwhile state tax administrators, would presumably face strong political opposition. Even if the federal

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[38]Since Quebec is the only Canadian province with an "independent" VAT, Canada does not fit this classification scheme well. As noted above, Quebec administers the Canadian federal GST, as well as the QST, and the federal government administers the federal GST in the rest of Canada and on imports from abroad, as well as the HST where it applies.

[39]In making this statement I am assuming that local administration of local sales taxes is not on the table. The SSTP would properly eliminate it.

[40]The proposal for a National Retail Sales Tax (NRST), described at http://www.fairtaxvolunteer.org/main.html, envisions state administration of the federal sales tax. Advocates for the NRST suggest that the tax rate for the federal tax would be 30 percent, some four times the average state rate, but this is probably a substantial underestimate; see Gale (2005).

government were willing to administer state sales taxes, it seems unlikely that it would agree to administer local sales taxes, which would probably continue to follow the RST model.

Joint administration. Administration by a joint federal/state agency may be the most logical arrangement for administering state VATs levied in the context of a federal VAT. But it would be much less attractive if some of the states were to continue to levy RSTs. Moreover, it is not clear how it would work if some states switched to the VAT and others continued to levy RSTs. Finally, the existence of local RSTs also places this option in doubt.

Dual administration. As noted above, since local VATs seem to be infeasible, the RST is probably the best option for the states. Dual administration (federal administration of its VAT and state administration of state and local RSTs) seems to be the best way to implement this option, even though it would involve some duplication of administrative effort.[41] Under this option, federal audits of income tax and VAT would be coordinated, and state and local RST audits would build on federal VAT audits.

IV. Coordination State RSTs and VATs with a Defective Federal VAT

Repeating the somewhat tedious exercise of the previous section in the context of a defective federal VAT would be tedious, indeed. It is thus necessary, at the least, to try to guess what kinds of defects might mar the federal VAT. My guess is that input credits would be available, as in the ideal VAT, but that some products might be either exempt or zero-rated.

Zero-rating is generally preferable to exemptions, as administration and compliance are vastly more complicated for exemptions than for zero-rating. Also, if there is a desire to eliminate tax on selected consumer purchases, perhaps for distributional reasons, zero-rating is more effective than exemptions. Finally, exemption creates the risk of breaks in the chain of input credits, whereas as zero-rating does not. But zero-rating also entails greater loss of revenue than exemptions. There is a good chance that revenue considerations would trump conceptual purity and ease of administration and compliance in the design of a federal VAT that departed from the ideal model.

Coordination (with dual administration) might be possible for VATs or RSTs with defects that were consistent with those in the defective federal VAT. Coordination would probably be impossible for state VATs or RSTs with defects that differed markedly from those in the federal VAT.

V. Concluding Remarks

Either a state VAT or a state RST could relatively easily be combined with a federal VAT, as long as all three conformed with the principles of an ideal sales tax. Adding consideration of local sales taxes seems to throw the nod toward state/local RSTs – and towards dual administration (federal administration of its VAT and state administration of state and local

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[41] Note that one of the possible reasons for favoring state administration, state deviations from the federal tax, while relevant for income taxation, is less relevant in this case, since deviations from the federal VAT (except for purchases by business) are much less desirable for sales taxes, which are transactions-based, than for income taxes, which are accounts based.

RSTs). It seems difficult to coordinate defective state RSTs with an ideal federal VAT. Adding a defective federal tax to the mix complicates matters further. Coordination might be possible only with similarly defective state RSTs.

Except in one respect (dual administration, a choice driven partly by the existence of local sales taxes), this conclusion is consistent with the following conclusion Richard Bird (1994, p. 47) reached a decade ago:

> I have increasingly come to think that the only way two levels of government can levy sales taxes at reasonable costs is by agreeing on a common tax base and letting one level of government collect the tax for both. Moreover, although the VAT still may be the best of all possible sales taxes in some general sense, as has often been claimed, in a federal state, in which both levels of government tax sales, I suspect a retail sales tax administered by one level of government -- though perhaps with both collecting revenues from it (e.g., through surcharges) – makes more sense.

Achieving the first-best combination would involve both gains and losses for the states. First on the plus side, state sales taxes would be greatly improved. Services would be taxed, sales to business would be exempt, and administrative procedures would be made more uniform. It is hard to overstate this benefit, even though it is probably greatly underappreciated. Second, the restrictions of *Quill* – and the implied revenue losses and competitive disadvantages for local merchants – would become obsolete. Finally, it should be noted that these gains are achieved without sacrifice of state sovereignty in the setting of tax rates or in tax administration. On the other hand, states would presumably see the loss of control over their tax bases and administrative procedures as negative. Since I do not think that the states have exercised their sovereignty responsibly in designing their sales taxes and failing to introduce uniform administrative procedures, I do not have much sympathy for these concerns.[42] But they might well be enough to scuttle any effort at coordination.

In closing, I note that this entire exercise has been predicted on the proposition that the federal government would be interested in cooperating with the states to improve their sales taxes. Recent history raises doubts about that.[43]

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[42]On Friday I will be speaking at the National Tax Association meetings about "When States Have Both Too Much Sovereignty and Not Enough." When I began writing today's paper I did not know that I would be dealing with a concrete case of too much state sovereignty.

[43]Rushton (1993, p. 99) has observed, [A]rrangements with the states should settled before the federal government implements the tax change rather than after." While doubtlessly true, this observation may be overly optimistic.

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