IMPLEMENTING STATE AND LOCAL SALES TAXES IN THE CONTEXT OF A FEDERAL VALUE ADDED TAX

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INTRODUCTION

THE WELL-KNOWN DEFECTS OF THE RETAIL SALES tax (RST), as it has traditionally been structured by the U.S. states – the taxation of many sales to business and the failure to tax many services provided to households – and the inherent difficulties, both political and technical, of improving it have led many to ask whether a state value added tax (VAT) would be feasible and to search for ways to answer that question in the affirmative.[1] Until relatively recently the consensus was that it would be extremely difficult, if not impossible, to implement a subnational VAT that relied on border tax adjustments to tax imports and eliminate tax on exports, thereby achieving destination-based taxation.[2] Then Quebec demonstrated that a subnational VAT is feasible, at least in a country with a federal VAT.[3]

There is reason to believe – or at least to hope – that the federal government will finally enact a VAT, either to finance health care or to reduce the federal budget deficit, as proposed, for example, by Len Burman (2009), and Rudolph Penner (2010), respectively. If that happens, states may finally be able to implement a VAT, rather than relying on defective forms of taxation such as their existing RSTs and corporate income taxes, the recently enacted Ohio commercial activities tax, which is a form of gross receipts tax, or an apportioned subtraction-method VAT such as was recently proposed in California and is critiqued in McLure (2010b).

The situation in Canada differs in one crucial respect from that in the United States; local governments in Canada do not rely on revenues from general sales taxes, as they do here, where local governments in more than 30 states levy such taxes. The apparent difficulty of combining either a local RST or a local VAT with a state VAT led me to opine in an earlier paper (McLure, 2005) that it might be better to see the introduction of a federal VAT as an opportunity to improve state RSTs, on which local counterparts could be piggybacked, rather than to impose state VATs.

Further analysis suggests that the range of options open to state governments and their localities in the event that the federal government were to adopt a VAT is somewhat greater than previously thought.[4] In particular, it should be possible to combine a particular form of local VAT or RST with a state VAT, but it would probably be better to take the opportunity to improve state RSTs and piggybacked local RSTs. This paper discusses whether and how various forms of state and local sales taxes could be coordinated with a federal VAT. It is assumed that state and local governments would – or at least could – retain control of sales tax rates.

A federal VAT would likely eliminate tax on virtually all business purchases by allowing input credits for tax paid on them and subject most nonbusiness services to tax. Conformity of state and federal tax bases, admittedly politically difficult, because of both inertia and the desire of state legislatures to retain control of the definition of the tax base, would thus improve state taxes, through reduced taxation of business inputs and increased taxation of services, as well as facilitating administrative cooperation. Administrative cooperation would include state utilization of federal registration and exchange of information.

ACHIEVING DESTINATION-BASED TAXATION

Achieving destination-based state taxation, in which imports are taxed and exports occur tax free, while automatic under an ideal RST in which all business purchases are tax-exempt, has long been seen as the primary obstacle to introduction of state VATs. This paper, based on McLure (2010a) examines several ways that have been proposed to deal with this problem: a "traditional" RST, an EU-style VAT, a "standard" VIVAT of the type proposed for the European Union (EU), the CVAT proposed for use by LDCs, the "dual VAT" employed in Canada, and what I call a zero-rate VIVAT – an ideal RST implemented via the VIVAT mechanism. (These terms are explained below, where references are provided.)

Traditional RST

Because traditional state RSTs tax many B2B (business-to-business) sales, it would be difficult to base state RST exemptions for registered traders on federal registration. Also, because many services subject to federal VAT would be exempt from RST, it would be difficult to "piggyback" state administration on federal administration. Although Canada has had a federal VAT since 1991, there has been essentially no coordination between it and provincial retail sales taxes, which have exhibited the same defects as their U.S. cousins.

EU-type VAT

In the EU, where all Member States (MSs) are required to levy VATs, all exports are zero-rated. B2B imports from another MS are not taxed at the border, as other imports are; rather, they are subject to reverse charging – buyer recognition of tax liability, which is immediately offset by an input credit. The zero-rating of exports leads to massive refunds, and reliance on reverse charging of imports creates the risk of carousel fraud. Significantly, these issues cannot arise under an RST.

In the EU refunds amount to 38.1 percent of gross VAT collections. In Canada (federal VAT only) and New Zealand, the comparable figures are 50.3 percent and 35.5 percent, respectively.[5] The genesis of refunds is not known, but the lion's share are likely associated with exports. Carousel fraud is a special case of missing trader fraud based on credits and refunds for taxes not remitted; see Keen and Smith (2006). Although there is no evidence on the extent of either refunds or carousel fraud in Quebec, the existence of the federal VAT, which has no analog in the EU, may discourage the latter. By comparison, one can assume that refunds due on interprovincial trade are large and that refunds on interstate trade would be large in the United States.

Dual VAT

The dual VAT employed by Quebec (described in Bird and Gendron, (1998, 2000, and forthcoming; Bird, 2005) is essentially an EU-style VAT, characterized by federal/provincial administrative cooperation, something that cannot exist in the EU. (Quebec administers the federal VAT on its territory.) Even if this approach could be used at the state level in the United States, it would not be feasible at the local level, because of the complexity of the required border adjustments (export rebates and import taxation or reverse charging) on trade between localities, some of which is interstate.

VIVAT

Keen and Smith (1996, 2000) have proposed the "viable integrated value added tax" (VIVAT) for the EU, where the lack of a "federal" government precludes use of the dual VAT. Under it, there would be a uniform origin-based tax on all B2B sales, for which credit could be taken against tax on sales. A clearinghouse would shift revenues from origin to destination states. The VAT rate on B2C (business-to-consumer) sales would be chosen by individual states, which would retain revenues from the tax on such sales.

A state VIVAT of the type described does not appear to be a feasible option for the US, because it would require participation by all states, state agreement on the B2B tax rate, and a clearinghouse – all conditions that are not likely to be fulfilled. It appears, however, that the VIVAT could be a local tax in any single state with a (standard) VAT. The state would collect and credit tax on intrastate B2B sales; thus no clearinghouse would be needed. Local governments would receive tax on B2C sales.

CVAT

Drawing on work by Varsano (2000), I have proposed (McLure, 2000b) that the "compensating value-added tax" (CVAT) could be used as a subnational tax in LDCs where a higher-level government imposes a VAT and perhaps (McLure, 2000a) in the United States. A uniform-rate CVAT would be collected on all interstate sales, state VAT would be collected on in-state sales, and credit would be allowed for CVAT (and VAT) against tax on sales.

Among the potential problems of the CVAT are the requirement that it be employed in all states, the need to agree on a rate for the CVAT, and what Keen and Smith (2000, pp. 744-745) call compliance asymmetry: the need for vendors to treat intrastate and interstate B2B sales differently. Thus the state CVAT is probably also not feasible.

Unlike the VIVAT, the CVAT probably would not work as a local tax in a state with a (standard) VAT. Under this approach a state would collect and credit tax on intrastate-interlocality sales and local governments would receive revenues from the tax on B2C sales. The need to distinguish B2B and B2C intralocality sales, which would not be necessary under a state VAT, would probably render a local CVAT infeasible.

Table 1
Feasible State and Local Sales Tax Options, Assuming a Federal VAT

Option	1	2	3
State tax	Ideal RST (as zero-rate VIVAT)	Standard VAT	
Local tax		Ideal RST (as zero-rate VIVAT)	Standard VIVAT

Zero-rate VIVAT

The zero-rate state VIVAT, which is essentially an ideal form or RST that looks like a VAT and is closely coordinated with the federal VAT, is probably the best option for the United States. Under it, the state and federal tax bases would conform and state registration would, at least in the first instance, be based on registration for the federal VAT. (Revenue loss from a small business exemption is less under a VAT than under a RST, including the zero-rate VIVAT. States might thus prefer a lower federal registration threshold than might otherwise be desirable. Alternatively, state registration might be required for some businesses not registered for the federal tax.) All B2B sales would be zero-rated. VAT on in-state B2C sales would be levied at a rate chosen by the state. Comprehensive deferral and reverse charging, which essentially mimics this approach, was rejected in EU, because it would convert the VAT to an RST. But that is arguably an advantage in the United States, given the history of RST, the lack of familiarity with the VAT, and resistance to change.

The zero-rate state VIVAT does not require that all states participate; it avoids refunds and carousel fraud; and it is consistent with the tradition of state RSTs. Unlike the present system, registration for, and administration of, the federal VAT would help protect the administrative integrity of the state tax. Finally, it could be used at the local level, in combination with either a (standard) state VAT or a zero-rate state VIVAT.

SUMMARY STATEMENT

Both state RSTs and state corporate income taxes exhibit well-known defects that make increased reliance on them problematical.[6] States have recently resorted to a variety of defective taxes such as the Ohio commercial activities tax. It would be far better for them to levy destination-based, credit-method VATs, if that were feasible. Introduction of a federal VAT would make such subnational VATs possible. But there may be an even better way, an improved RST that takes the form of a zero-rate VIVAT.

Table 1 summarizes the feasible options for state and local sales taxes, assuming that the federal government were to adopt a credit-method VAT. Option 1, in which both state and local governments adopt an ideal RST, structured as a VIVAT with a zero rate on all sales to registered traders seems best, for reasons outlined above. If, instead, a state were to adopt a standard VAT, its localities could adopt either the zero-rate VIVAT or a standard VIVAT.

Notes

1 The present author has considered this question in McLure (1972, 1980, 1987, chapter 9, 1988, 2005). Among other early discussions of this topic were Cnossen (1983, 1990), Poddar (1990), Mintz, Wilson, and Gendron (1994), and Bird (1993).

2 The perceived difficulty of implementing a credit-method VAT is presumably one reason some states, most prominently and most persistently Michigan, have resorted to addition or subtraction-based VATs. Partly for constitutional reasons, they have used formulas to apportion value added among states (McLure, 2010a) describes and appraises the recent proposal that California adopt a subtraction-based VAT that employs sales-only apportionment in an effort to achieve destination-based taxation of value added.

3 See Bird and Gendron (1998, 2000, 2010) and Bird (2005). Experience with Canada's Harmonized Sales Tax (HST), in which revenues from a provincial surcharge on the federal goods and services tax (GST) collected in participating provinces are distributed among those provinces in proportion to estimated consumption expenditures, described in Bird and Gendron (2010) does not seem relevant for the United States, as the states are unlikely to accept federal administration of state VATs.

4 The analysis presented here, as in McLure (2010a), from which it is drawn, is based on the assumption that the federal VAT would be a credit-method levy. For arguments that it should be, see Grinberg (2010).

5 Harrison and Krelove (2005, Table 1).

6 Some of these defects are described in McLure (2002).

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