STRI

State Tax Research Institute

A Global Perspective on U.S. State Sales Tax Systems as a Revenue Source: Inefficient, Ineffective, and Obsolete

BY KARL A. FRIEDEN AND DOUGLAS L. LINDHOLM

With Ros Barr (EY) providing analysis of the European Union VAT system, and David Douglas Robertson (EY) providing analysis of the Canadian GST/provincial sales tax system.

NOVEMBER 2021

ABOUT STRI

The State Tax Research Institute (STRI) is a 501(c)(3) organization established in 2014 to provide educational programs and conduct research designed to enhance public dialogue relating to state and local tax policy. STRI is affiliated with the Council On State Taxation (COST). For more information on STRI, please contact Douglas L. Lindholm at dlindholm@cost.org.

ABOUT THE AUTHORS

Karl A. Frieden is Vice President and General Counsel for the Council On State Taxation (COST). Douglas L. Lindholm is the President and Executive Director of COST. Rosamund "Ros" Barr is Ernst & Young's (EY) Global Indirect Tax Knowledge Leader based in London. David Douglas Robertson is a Partner with EY Law Canada.

ACKNOWLEDGEMENTS

The authors would like to thank Jana Hayashi, a COST Research Fellow, for her valuable assistance with copy editing, research and footnotes in this study. The authors would also like to thank two other individuals who previously helped develop data utilized in this study: Andrew D. Phillips, EY's Global Government & Infrastructure Economic, Finance, and Tax Leader with his co-authorship of several COST/STRI studies on "The impact of imposing sales taxes on business inputs"; and Fredrick J. Nicely, Senior Tax Counsel for the Council On State Taxation with his co-authorship of the COST Scorecard "The Best and Worst of State Sales Tax Systems."

TABLE OF CONTENTS

EXECUTIVE SUMMARY

- Two financial crises are converging on the U.S. economy: the fiscal impact of the unprecedented COVID-19 pandemic and the longer-term repercussions of escalating levels of federal debt. In the short-term, the federal government has spent a staggering $6 trillion on COVID relief and economic stimulus in 2020 and 2021. In the long term, the Congressional Budget Office (CBO) estimates the federal debt-to-GDP ratio will rise to about 102% in 2021, compared to 79% at the end of 2019, and 35% in 2007 before the start of the previous recession.
- With enormous unfunded liabilities for health care and social security for an aging U.S. population, significant deferred infrastructure investments, and the rising impact (and cost) of climate change, the federal debt is on an unsustainable course. The CBO estimates that the debt-to-GDP ratio will increase to an almost unimaginable 202% in 2051, nearly five times the average federal debt level for the last 50 years.
- Current federal and state tax systems in the United States will be sorely challenged to satisfy these budgetary demands, which will require an effective, balanced, and efficient mix of taxes to meet the demands of burgeoning deficits and government spending and to avoid hindering economic growth.
- Generally, governments can choose between taxes based on when money is spent (consumption taxes), when money is earned (income and payroll taxes), and the value of assets (property and wealth taxes). A good tax system is balanced between different revenue sources that meet key policy objectives such as equity, economic growth, transparency, ability-to-pay, and stability. However, the United States will enter the post-pandemic period with a tax composition that is dangerously imbalanced toward over-reliance on income, social insurance (payroll), and property taxes and under-reliance on consumption taxes.
- The under-reliance on consumption taxes in the mix of U.S. federal and state taxes is of great concern because taxes on general consumption provide government with one of the best means for raising revenue without deterring economic growth. Economists have long recognized the superiority of consumption-based tax systems over income-based tax systems to foster international competitiveness and economic efficiency.
- Compared with other advanced nations, the United States is at the absolute bottom in terms of reliance on consumption taxes as a share of overall taxes. In 2019, consumption taxes accounted for about 32.3% of all taxes in the Organisation for Co-operation and Development (OECD) nations and 32.8% of all taxes in EU countries, compared to 17.6% in the United States.

- Conversely, the United States relies more on income, social insurance, and property taxes as a share of all taxes than any other OECD nation. The imbalance is more pronounced at the federal government level, where there is no general consumption tax. In 2018, income and social insurance taxes made up 92% of total U.S. federal government taxes, compared with an average of 62.8% of all income and social insurance taxes at the federal/central government level in all OECD nations. The imbalance at the U.S. federal government level is enormously important because this is where virtually all government debt will accumulate over the next several decades.
- The United States not only relies less on consumption taxes (as a share of all taxes) than all other advanced nations, but its primary consumption tax—the state and local retail sales tax—is less efficient and effective than virtually any other consumption tax based on traditional performance metrics. Indeed, these two characteristics of the U.S. tax system are interconnected as the cumulative impact of suboptimal, poorly designed and narrowly based state sales tax systems impedes use of a general consumption tax to balance the tax burden among different tax types.
- This study provides an international perspective on U.S. state and local sales tax systems through a comparison to the primary general consumption taxes in the European Union (the Value-Added Tax (VAT)) and in Canada (the Goods and Services Tax/Harmonized Sales Tax (GST/HST) and a few provincial sales taxes). In particular, the study evaluates the efficiency, efficacy, and historical development of general consumption taxes in each of these geographies based on three key principles of an optimal consumption tax: (1) a harmonized and broad-based consumption tax on household goods and services; (2) an exemption (or credit) for business inputs; and (3) centralized and simplified tax administration.
- No general consumption tax that spans a nation or a continent is without its imperfections and onerous compliance burdens. But the key issue in the comparison of the design and operation of the EU and Canadian systems with the U.S. system is relative performance. By this measure, U.S. state and local sales tax systems remain an outlier, deviating significantly more from the principles of an optimal consumption tax than their EU or Canadian counterparts. U.S. state sales tax bases are not harmonized and generally tax a much narrower range of household goods and services. State sales tax systems offer no broad exemption for business inputs and rely on revenues from business purchases (and sales tax pyramiding) more than any other advanced nation in the world. And state sales tax administration is highly decentralized and nonuniform, at least for the larger states that have not adopted the Streamlined Sales and Use Tax Agreement (SSUTA).
- Four options are available to U.S. policymakers to transform state sales tax systems and address the dangerous imbalance in sources of tax revenue:

  (1) replace current state sales tax systems with a national consumption tax collected, administered, and redistributed at the national level. This change is highly unlikely politically and perhaps undesirable as well.

(2) exercise federal preemption that mandates state harmonization and broadening of the sales tax base of household goods and services, exempts business inputs, and centralizes and simplifies tax administration. This option also faces strong political headwinds because it cuts against the strong tradition of federalism and state sovereignty over state taxes.

(3) continue to implement incremental fixes through unilateral state legislation or collaborative state action such as the SSUTA. This is certainly the most politically feasible option, but we must be realistic about the limited prospect for fundamental reform. No country has succeeded in transforming a retail sales tax from within into an efficient and effective broader-based tax on household consumption with an exemption for business inputs; all have abandoned the effort in favor of a VAT or a hybrid VAT/sales tax system. This option, however, may be the only avenue available to the United States in the short-term, so it should be pursued regardless of other corrective efforts.

(4) implement a hybrid federal/state government consumption tax similar to the Canadian national/provincial model that incentivizes state cooperation and collaboration in a harmonized national consumption tax system over time. This change may be politically less attractive in the short term, but has the potential to preserve federalism while concurrently creating a better designed, scalable, and economic growth-friendly consumption tax. This study concludes that the Canadian model is best suited to achieve systemic change in the United States while maintaining traditional state sovereignty over consumption tax revenues.

INTRODUCTION:

After the pandemic, federal and state tax systems in the United States will face a critical test. And based on the current overreliance on income, social insurance (payroll), and property taxes, and underreliance on consumption taxes, the overall U.S. tax system is not up to the challenge. Virtually alone among the nations of the world, the United States has no broad-based consumption tax at the national level, and by international standards, only outdated, structurally flawed state and local retail sales tax systems at the subnational level. The United States relies less on consumption taxes and more on income, payroll, and property taxes as a share of all taxes than any other advanced nation in the world.[1]

The obsolescence of state sales tax systems harms the nation's international tax competitiveness and undercuts its ability to use consumption taxes as a scalable option for raising revenue and balancing the composition of tax types.

This study compares the structure and operation of the consumption taxes levied in the United States, Canada, and the European Union,[2] and explains why U.S. state retail sales taxes are failing as part of a balanced revenue system. The failure is twofold: First, less reliance on consumption taxes in the United States leads to a dangerous imbalance in the nation's overall tax mixture and an underuse of the revenue source with the least negative impact on economic growth. This undermines the resilience and consistency of the U.S. tax revenue stream. Second, state and local retail sales tax systems are among the most inefficient and ineffective consumption taxes in the world, with a tax base overinclusive of business inputs and underinclusive of household goods and services, and with tax administrative rules that generally lack harmonization or simplification. The obsolescence of state sales tax systems harms the nation's international tax competitiveness and undercuts its ability to use consumption taxes as a scalable option for raising revenue and balancing the composition of tax types.

1 The United States relies less on consumption taxes as a share of total tax revenues than any of the over 100 nations included in the OECD global data for 2019. See OECD, Global Revenue Statistics Database, chart of taxes on goods and services as a percentage of all taxes for 2019, https://www.oecd.org/tax/tax-policy/global-revenue-statistics-database.htm (last visited Sept. 1, 2021). In this paper we use "social insurance" taxes and "payroll" taxes interchangeably.

2 The EU Member States are: Austria, Belgium, Bulgaria, Croatia, Cyprus, Czechia, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden. See The 27 member countries of the EU, Eur. Union, https://europa.eu/european-union/about-eu/countries_en (last visited Nov. 20, 2020).

States and localities have stumbled along for decades with the current system, managing to raise $424 billion a year in sales taxes—about 22% of all state and local tax revenues or about 8.2% of all government tax revenues.[3] However, the general consumption tax share of all taxes in the United States is still abysmally low by international standards, equivalent to about two-fifths of the average of the industrialized nations in the Organisation for Economic Co-operation and Development.[4] And time may be running out for the United States to modernize and expand its general consumption tax system. The dual fiscal crises resulting from the COVID-19 pandemic and rising long-term federal government debt levels are exposing the vulnerability of the U.S. federal/state tax system that must address these calamities while lacking tools available to nearly every other advanced nation: a balanced tax mix that includes a broad-based consumption tax.

. . . the general consumption tax share of all taxes in the United States is . . . equivalent to about two-fifths of the average of the industrialized nations . . .

Surprisingly, the failure of the United States to develop a modern consumption tax system—and its far-reaching tax policy implications—receives scant attention in U.S. tax policy circles or in the tax media. The tax proposals gaining the most visibility at the federal and state levels almost all relate to non-consumption taxes, including:

- income taxes (corporate tax rate increases, global minimum taxes, personal income tax rate increases on high-income households, and base broadening to include more foreign-source income);
- gross receipts taxes (including digital services taxes);
- property taxes (including wealth taxes and mark-to-market for securities); and
- social insurance taxes (including "head taxes," state unemployment tax, and raising the income threshold of the Social Security payroll tax).[5]

3 EY, The impact of imposing sales taxes on business inputs, 3–4 (May 2019); EY, COST, & STRI, Total State and Local Business Taxes: State-by-State Estimate for Fiscal Year 2019 (Nov. 2020) at Figs. 1a, 2; OECD, Revenue Statistics—OECD countries: Comparative tables, tbl.5110 https://stats.oecd.org/Index.aspx?DataSetCode=REV (last visited Sept. 1, 2021). In this study both 2018 and 2019 OECD data are used, depending on when the analysis was completed. But there are no, or only very minor, differences between the 2018 and 2019 statistics for most countries.

4 OECD, supra note 3, at tbl.5110. The OECD nations' averages are unweighted. The U.S. data is included in the OECD data, because the United States is an OECD member. However, since the data is unweighted, the U.S. share of 1/38 of the OECD calculation does not materially change the average. The thirty-eight countries in the OECD are: Australia, Austria, Belgium, Canada, Chile, Colombia, Costa Rica, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Together, the OECD countries make up about one-half of the world's economic production.

5 At the federal level, President Biden initially proposed about $4 trillion (over ten years) of corporate and personal income tax increases in April 2021 tax reform legislation. During the course of the Congressional debate, the Biden administration's tax proposals were lowered to about $1.75 trillion (over ten years) of corporate and personal income tax increases. *See* "The Made in America Tax Plan", U.S. Treasury, April 7, 2021. Available at https://home.treasury.gov/system/files/136/MadeInAmericaTaxPlan_Report.pdf. See "Fact Sheet: The American Families Plan, The White House, April 28, 2021. https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/28/fact-sheet-the-american-families-plan/. On the revised Biden tax proposals, see: Jonathan Curry, "Democrats Try to Unify Around Biden's "$1.75 Trillion Plan", Tax Notes, October 21, 2021. For a series of similar recommendations for state tax increases, see the website for Project SAFE (State Action in Fiscal Emergencies) Project SAFE, UVA Law, https://www.law.virginia.edu/academics/program/project-safe (last visited Dec. 15, 2020). The revenue-raising proposals highlighted by this group of tax law professors include excess profit taxes; mark-to-market taxes on wealth and securities; gross receipts taxes on digital services and advertising; increased taxes on GILTI and other foreign source income; decoupling from federal corporate tax deduction provisions; and other taxes on wealthy individuals and businesses. At the international level, the OECD's Pillar One/Pillar Two project is similarly focused on major changes to corporate income tax laws in advanced nations. OECD, Tax Challenges Arising from Digitalisation—Report on Pillar One Blueprint, OECD/G20 Base Erosion and Profit Shifting Project (2020).

. . . the shifts occur within a federal/state/local tax system that is historically and dangerously skewed toward non-consumption taxes.

Consumption tax solutions are rarely part of the conversation. Even in the sphere of state and local sales tax, the policy discussion is overwhelmingly focused on post-*Wayfair*[6] issues about enforcement of collection duties by remote sellers and marketplace providers, and not on the structural design flaws and revenue generation weaknesses of state sales tax systems.

Given the current U.S. political and economic environment, with Democratic proposals to reverse tax reductions in the Tax Cuts and Jobs Act (TCJA); demands for government spending on pandemic relief, social programs, infrastructure, and climate change;[7] and polling data showing a substantial majority of Americans support higher taxes on wealthier households,[8] it is unsurprising that income, social insurance (payroll), and property (including wealth) tax proposals are at the forefront of tax policy discussions. The political pendulum frequently oscillates between raising or lowering taxes on high-income households and businesses, depending on whether the prioritized goal is income distribution and the social safety net or capital investment and economic competitiveness.[9] Nonetheless, the shifts occur within a federal/state/local tax system that is historically and dangerously skewed toward non-consumption taxes. In this context, the virtual absence of any meaningful dialogue at the federal or state levels on the need for a more robust and better-designed general consumption tax to complement, balance, or supplant reliance on income, payroll, and property taxes, is deeply troubling.

Section I of this study explains why true consumption taxes are the preferred tax for minimizing impacts on economic growth and competitiveness; highlights statistical differences between the United States, European Union, and OECD in relative reliance on consumption taxes and income, payroll, and property taxes; and details the escalating federal debt crisis in the United States and the inadequacy of the U.S. tax system to address it. Section II measures the performance of general consumption taxes in the European Union, Canada, and the United States against the three key features of an optimal consumption tax:

---

6 *South Dakota v. Wayfair Inc.,* 138 S. Ct. 2080 (2018). For greater discussion of the impact of *Wayfair*, see Section II. C. 3. and Appendix Section C, infra.

7 In an October 2020 poll for The New York Times by SurveyMonkey, nearly three in five respondents say they support "a national health plan, sometimes called Medicare for All, in which all Americans would get their insurance from a single government plan . . . A slightly higher share of respondents supports the government providing free tuition to any American who attend a two- or four-year college or university, including more than 7 in 10 independent voters." Jim Tankersley, Why Trump's Efforts to Paint Biden as a Socialist Are Not Working, N.Y. Times (Oct. 14, 2020). In a 2020 Pew Research Center poll, two-thirds of the respondents believed the federal government is doing too little to reduce the effects of climate change. Alec Tyson & Brian Kennedy, Two-thirds of Americans Think Government Should Do More on Climate, Pew Research Ctr. (June 23, 2020), https://www.pewresearch.org/science/2020/06/23/two-thirds-of-americans-think-government-should-do-more-on-climate/.

8 In a January 2020 Reuters/Ipsos poll, 64% of respondents (including a majority of Democrats and Republicans) strongly or somewhat agreed that "the very rich should contribute an extra share of their total wealth each year to support public programs." Howard Schneider & Chris Kahn, Majority of Americans favor wealth tax on very rich: Reuters/Ipsos poll, Reuters (Jan. 10, 2020), https://www.reuters.com/article/us-usa-election-inequality-poll/majority-of-americans-favor-wealth-tax-on-very-rich-reuters-ipsos-poll-idUSKBN1Z9141.

9 Over the last fifty years, the top marginal individual income tax rate fluctuated from a high of 70% to a low of 28%, before settling into a range of 35% to 40% over the last two decades. *Historical Highest Marginal Income Tax Rates: 1913 to 2020,* Tax Pol'y Ctr. (Feb. 4, 2020), https://www.taxpolicycenter.org/statistics/historical-highest-marginal-income-tax-rates.

(1) a harmonized and broad-based tax on household goods and services;

(2) an exemption (or credit) for business inputs; and

(3) centralized and simplified tax administration.

Section II further shows how U.S. state sales tax systems are structurally and operationally flawed, deviating significantly more from these principles than European Union and Canadian consumption tax systems.

Section III provides an overview of the global transformation of consumption taxes and highlights the status of the United States as an outlier—the only country in the world that still relies on an outdated retail sales tax model as its primary general consumption tax. Section IV analyzes options to modernize and transform state sales and use tax systems, including a national VAT, stronger federal regulation, revitalized collaboration among the states, and the creation of a hybrid national/state consumption tax like the Canadian model. This study concludes that the latter solution (that is, a hybrid national/state model) is best suited to achieve systemic change while maintaining state sovereignty over sales tax revenues.

The Appendix explores the historical development of general consumption taxes in the European Union, Canada, and the United States. The Appendix also examines the factors that have impeded the United States, alone among industrialized nations in the world, from establishing a general consumption tax at the federal government level.

SECTION 1

THE IMPORTANCE OF TRUE CONSUMPTION TAXES AS PART OF A BALANCED FEDERAL/STATE TAX SYSTEM

A. THE BENEFITS OF A TRUE CONSUMPTION TAX TO A BALANCED TAX SYSTEM

Economists have long favored consumption-based tax systems over income-based tax systems to foster international competitiveness and economic efficiency.

The underreliance on consumption taxes among U.S. federal and state taxes is of great concern because taxes on general consumption provide government with one of the best ways to raise revenue without deterring economic growth. Economists have long favored consumption-based tax systems over income-based tax systems to foster international competitiveness and economic efficiency.[10] True consumption taxes are levied on consumers, not on producers, and are sourced to the location of consumption, not production. These features mitigate adverse impacts on domestic investment and job creation, avoid the cascading of taxes on business inputs, and minimize tax penalties on exports.

Traditional income tax rules utilized by most advanced nations generally allocate income based on the location of the income-producing activity and thus struggle to adapt to digital business models less reliant on physical presence or the physical delivery of goods and services. The OECD nations, together with about 100 other countries, have worked diligently over the last decade in the Base Erosion and Profit Shifting (BEPS) project to reform global income taxes, with mixed results. In this environment, the advantages of well-designed and border-adjusted consumption taxes (with no tax on exports) are enhanced.[11]

The key factor is not the aggregate level of consumption taxes, but the share and balance of consumption taxes in the overall tax mix.

The key factor is not the aggregate level of consumption taxes, but the share and balance of consumption taxes in the overall tax mix. Attaining the appropriate balance of consumption taxes in the composition of taxes is increasingly important given the limitations and complexities of imposing income taxes in an era of global supply chains and digital commerce. In 2018, the OECD published "Tax Policies for Inclusive Growth in a Changing World" for the G20[12] ministers and central bank governors. In that report, the OECD concluded that the

[10] G. Baron Coleman, *The Question Is Not if, but What, We Shall Tax: A History and Comparison of Federal Income and Consumption Taxes and a Look at a Modern Proposal,* 9 Fla. St. U. Bus. Rev. 1, 2 (2010); Lori Montgomery, Once Considered Unthinkable: U.S. Sales Tax Gets Fresh Look, Wash. Post (May 27, 2009) at A15 (quoting former Federal Reserve Board Chair Alan Greenspan that a VAT "raises revenue without significantly impacting the economy"); Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax,* 58 Stan. L. Rev. 1413, 1417 (2006); John L. Mikesell, *The American Retail Sales Tax: Considerations on Their Structure, Operations, and Potential as a Foundation for a Federal Sales Tax,* 50 Nat'l Tax J. 149, 151 (1997); Matthew McMahan, *The International Effects of the Adoption of a Consumption Tax in the United States,* 39 Vand. J. Transnat'l L. 519, 542 (2006).

[11] On the special challenges of the digitalization of the global economy and the adaptation problems of corporate income tax rules see: OECD, *Tax Challenges Arising from Digitalisation—Interim Report 2018: Inclusive Framework on BEPS* (2018).

[12] The G20 members are: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union. Together, the G20 nations comprise roughly two-thirds of the world's population and 80% of global GDP.

desirability of consumption taxes increases with globalization and the growth of the digital economy. The OECD stated:

> OECD research has highlighted the need to shift the tax mix away from income taxes toward taxes that have less negative impacts on economic growth, including taxes on property and on consumption . . . A tax mix shift towards taxes on less mobile tax bases can ensure that the tax system becomes more resilient and is less vulnerable to the effects of globalization.[13]

The United States is significantly less reliant on consumption taxes as a share of overall taxes than any other advanced nation in the world.

B. THE UNITED STATES RELIES LESS ON GENERAL CONSUMPTION TAXES THAN ANY OTHER ADVANCED NATION

From a statistical perspective, the gap between the United States and other advanced nations in terms of relative reliance on consumption taxes is clear and is growing. The United States is significantly less reliant on consumption taxes as a share of overall taxes than any other advanced nation in the world.[14] In 2019, consumption taxes accounted for about 17.6% of all taxes in the United States compared with 32.8% of all taxes in the European Union and 32.3% of all taxes in OECD nations.[15] The consumption tax share is even higher in other geographies including Asia (37.6%), North and Central America (47%), South America (48%), Africa (53.7%), and Oceania (57.9%). In China (calculated separately from the rest of Asia), consumption taxes account for about 41.3% of all taxes.[16]

Roughly one-third of consumption taxes in OECD nations consist of excise taxes on specific goods and services such as gasoline, cigarettes, liquor, and customs and import duties. The other two-thirds, which are the primary focus of this article, are derived from general consumption taxes on goods and services levied via the EU VAT, the Canadian GST/HST, and retail sales taxes in U.S. states and certain Canadian provinces. In 2019, taxes on general consumption accounted for 8.2% of all taxes in the United States, compared with 21.3% of all taxes in EU countries, and 21.2% of all taxes in OECD nations (see Figure 1).[17] In Canada, taxes on general consumption account for 14.1% of all taxes.

The two and one half-to-one differential between the OECD, EU nations, and the United States in terms of reliance on general consumption taxes, reflects the fact that the United States has never developed a broad-based consumption tax, at least by international standards. Over the last forty years, taxes on general consumption as a share of total taxation in the United States increased modestly from 7% in 1975 to 8.2% in 2019 or about one-fifth. By comparison, taxes on general consumption as

---

13 OECD, *Tax policies for inclusive growth in a changing world*, 15 (July 2018).

14 OECD, supra note 1.

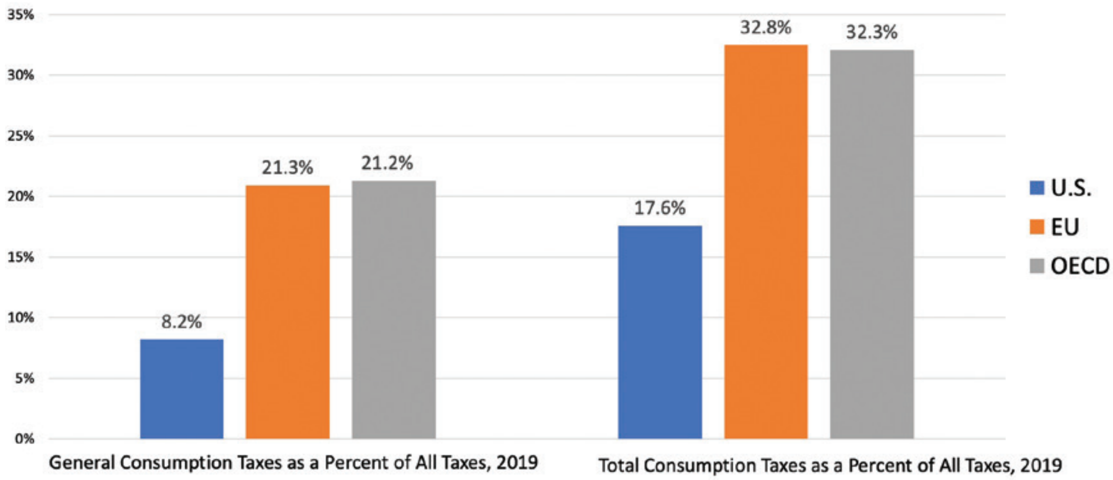
15 The EU statistic is based on the twenty-two of twenty-seven EU countries that are OECD members. These twenty-two countries make up 93% of the EU population. Consumption taxes accounted for 22.9% of all taxes in Canada. The OECD and EU averages are unweighted. This article frequently uses data on OECD nations because they represent a larger portion of world production (50%) than the EU countries (17%); and because the OECD has some of the best data available on international tax trends. OECD, supra note 3, at tbl.5000. OECD, Revenue Statistics 2019, tbl.3.6 (2020), https://www.oecd-ilibrary.org/sites/0bbc27da-en/1/2/3/index.html?itemId=/content/publication/0bbc27da-en&_csp_=fb150f38de3d79feb040c95e33debbe5&itemIGO=oecd&itemContentType=book.

16 Cristina Enache, Sources of Government Revenue in the OECD, Tax Found. Fiscal Fact No. 748 (Feb. 11, 2021), at 11. Fiscal Fact No. 695 at 11 (Feb. 2020). On China, see OECD, supra note 1.

17 OECD, supra note 3, at tbl.5110, as measured by share of total taxation.

. . . the United States relies more on revenues from the other three major tax types (income, social insurance/payroll, and property) than any of the other OECD or EU countries.

FIGURE 1. THE U.S. RELIES LESS ON CONSUMPTION TAXES THAN ALL OTHER ADVANCED NATIONS (AS A SHARE OF ALL TAXES)



a share of total taxation in the OECD nations increased significantly from 13.4% in 1975 to 21.2% in 2019 or about three-fifths.[18]

By another measure, taxes on general consumption as a percentage of GDP in the United States increased slightly from 1.7% in 1975 to 2% in 2019 or about one-fifth. By contrast, taxes on general consumption as a percentage of GDP in the OECD nations increased substantially from 4.2% in 1975 to 7.3% in 2019 or about three-quarters (see Figure 2).[19]

C. THE IMBALANCED U.S. TAX SYSTEM

Absent a broader-based consumption tax, the United States relies more on revenues from the other three major tax types (income, social insurance/payroll, and property) than any of the other OECD or EU countries. In 2019, taxes on income, social insurance, and property accounted for over four-fifths of all taxes in the United States compared with about two-thirds in OECD and EU nations.[20] The differential was most pronounced with income and property taxes. Income taxes (both personal and corporate) accounted for 45.4% of all taxes in the United States, compared with the OECD average of 33.6% and EU average of 29.3%. In that same year, property taxes accounted for 12.1% of all taxes in the United States, compared with the OECD average of 5.6% and the EU average of 4.1% (see Figure 3).[21]

The imbalance is even more pronounced at the federal government level. In 2018, income and social insurance taxes made up 92% of total U.S. federal government taxes, compared with an average of 62.8% of all income and social insurance taxes at

18 Id. at tbl.5110, as measured by share of total taxation.

19 Id. at tbl.5110, as measured by share of GDP.

20 Enache, supra note 16, at 10–11. In this study, we use the terms “payroll taxes” and “social insurance” taxes interchangeably.

21 Id.

FIGURE 2. GENERAL CONSUMPTION TAX AS A PERCENTAGE OF GDP: U.S. COMPARISON WITH OECD NATIONS, 1975–2019

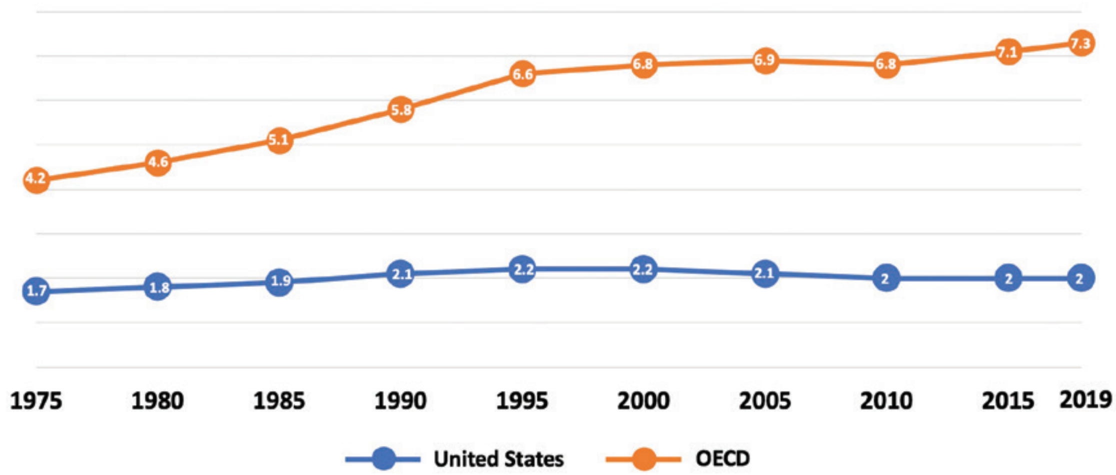
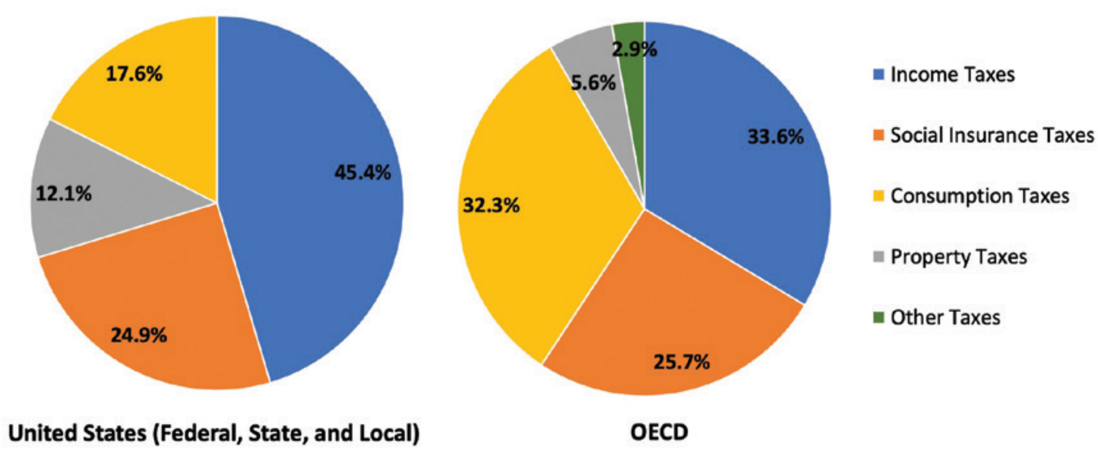


FIGURE 3. THE U.S. RELIES MORE ON INCOME, SOCIAL INSURANCE AND PROPERTY TAXES THAN ANY OTHER ADVANCED NATION: AVERAGE SOURCES OF TAX REVENUE, 2019



the federal/central government level in all OECD nations. Conversely, consumption taxes made up only 4.1% of all U.S. federal government taxes compared with an average of 35.1% of all federal/central government level taxes in the OECD nations as a whole.[22] The imbalance at the U.S. federal government level is enormously important from a fiscal policy perspective because that is where virtually all of the government debt will accumulate over the next several decades.

[22] The OECD data is from: OECD, supra note 3, tbls.2000 (social security statistics), and 5000 and 5110 (federal or central government level statistics). The OECD separates social security taxes from the federal/central government totals so the two are combined for purposes of this comparison. The U.S. data is from CBO, *The Budget and Economic Outlook: 2019–2029,* 91 tbl.4-1 (Jan. 2019). About three-quarters of the OECD nations do not have a system of "federalism," so the national governments in these countries are referred to as "central" governments.

This level of federal debt is nearly triple the 40-year average of federal debt before 2007, and nearly equal to the World War II record level of 106%.

D. THE OVERRELIANCE ON INCOME, SOCIAL INSURANCE, AND PROPERTY TAXES WILL WORSEN

The problem of overreliance on income, social insurance, and property taxes in the United States is about to worsen. In 2021, two financial crises are converging on the U.S. economy: the short-term fiscal impact of the unprecedented COVID-19 pandemic and the longer-term repercussions of escalating levels of federal debt. At the state level, significant revenue shortfalls have been largely offset in most jurisdictions by state rainy day funds and federal government pandemic relief assistance.[23] At the federal level, pandemic-related stimulus and relief spending totaled about $6 trillion in 2020 and 2021 resulting in the two highest years of federal deficits since World War II.[24] Based on CBO statistics, the federal debt-to-GDP ratio will rise to about 102% in 2021, compared with 79% at the end of 2019 and 35% in 2007, before the start of the previous recession.[25] This level of federal debt is nearly triple the 40-year average of federal debt before 2007, and nearly equal to the World War II record level of 106%.[26] (See Figure 4)

Although the United States endured several severe financial crises during the post-World War II era, the current crisis is significantly more far-reaching. Among the converging factors contributing to the dire long-term fiscal outlook are:[27]

- back-to-back record-breaking recessions;
- large tax cuts in the TCJA that added $1.5 trillion in federal debt;
- the pandemic health crisis and unprecedented levels of government relief and stimulus aid;
- the looming threat of climate change (with potentially significant government and business costs to deter global warming);
- significant deferred infrastructure investment and maintenance costs for surface transportation, airports, school facilities, water supplies, electricity networks, and solid waste; and
- enormous unfunded liabilities for health care and social security for an aging U.S. population.

---

23 The American Rescue Plan Act of 2021 provided about $350 billion in state and local government aid. Garrett Wilson & Erica York, The American Rescue Plan Act Greatly Expands Benefits Through the Tax Code in 2021, Tax Found. (March 12, 2021). See also CRFB, *Five Ways to Improve the House COVID Relief Package* (Feb. 22, 2021. Michael Leachman & Elizabeth McNichol, Pandemic's Impact on State Revenues Less Than Earlier Expected But Still Severe, Ctr. on Budget & Pol'y Priorities (Oct. 30, 2020).

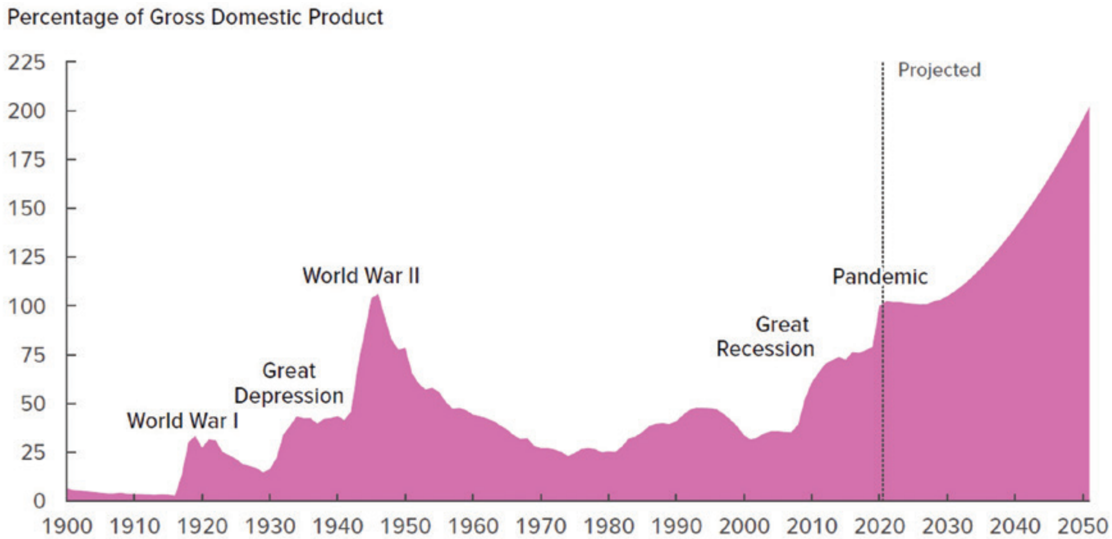
24 CRFB, *New Budget Projections Show Record Deficits and Debt* (Mar. 11, 2021).

25 Congressional Budget Office (CBO), *The 2021 Long-Term Budget Outlook* (Mar. 2021). CRFB, *Analysis of CBO's March 2021 Long-Term Budget Outlook* (March 4, 2021). The CBO federal debt estimates have been adjusted to account for the passage of American Rescue Plan. See CRFB, supra note 24.

26 See CBO, *supra note 25;* CRFB, supra note 25; CRFB, supra note 24.

27 The U.S. economy contracted by 3.5% in 2020 and 2.5% in 2009, the worst two years on record since 1946. Rachel Siegel, Andrew Van Dam & Erica Werner, *2020 was the worst year for economic growth since the Second World War,* Wash. Post (Jan. 28, 2021). During the presidential campaign in 2020, current President Joe Biden released a $2 trillion spending plan over four years to support renewable energy sources and create more energy-efficient automobiles, homes and commercial buildings. Brady Dennis & Dino Grandoni, *How Joe Biden's surprisingly ambitious climate plan came together,* Wash. Post (Aug. 1, 2020); *The Biden Plan To Build A Modern Sustainable Infrastructure And An Equitable Clean Energy Future,* Biden Harris (last visited Mar. 23, 2021), https://joebiden.com/clean-energy/; The American Society of Civil Engineers estimates the long-term investment gap between what is spent and what is needed totals $2.59 trillion over ten years. Am. Soc'y of Civil Eng'rs, *A Comprehensive Assessment of America's Infrastructure: 2021 Report Card for America's Infrastructure* (2021); CBO, supra note 25.

FIGURE 4. FEDERAL DEBT HELD BY THE PUBLIC, 1900 TO 2051



Data source: Congressional Budget Office. See www.cbo.gov/publication/56977#data.

. . . federal debt is on an unsustainable course with CBO estimates showing the debt-to-GDP ratio more than doubling to 202% in 2051 . . .

As a result, federal debt is on an unsustainable course with CBO estimates showing the debt-to-GDP ratio more than doubling to 202% in 2051, assuming current laws stay in place.[28] The Committee for a Responsible Federal Budget estimates that under an alternative (and more pessimistic) scenario the debt-to-GDP ratio could actually reach an astounding 259% in 2051.[29] The fiscal impact of addressing these cascading crises arises primarily at the federal level, but state finances are also at risk because of the close inter-relationship between federal and state revenues.[30]

Our goal here is not to pass judgment on the need for, timing, or scope of the various federal stimulus and aid packages, including the American Recovery and Reinvestment Act of 2009, the Tax Cuts and Jobs Act (2017), the Coronavirus Aid, Relief, and Economic Security (CARES) Act (2020), the Response and Relief Act (December 2020), and the American Rescue Plan Act (2021) that contributed to the tripling of federal debt in the last 15 years. Rather, it is to look ahead to the political and economic peril of the toxic mix of escalating cumulative debt and a dysfunctional U.S. tax system not designed to adequately address it.

In doing so, however, we must remain cognizant of the likelihood that federal debt levels will rise even further based on unforeseen future events such as recessions, pandemics, climate catastrophes, and inflationary surges. A review of the recent

28 CBO, supra note 25.

29 CRFB, supra note 24. Alan Auerbach et al., Fiscal Effects of COVID-19, Brookings Papers on Economic Activity (Sept. 24, 2020). Even in a period of low interest rates, rapidly rising federal debt should not be ignored. According to Sita Slavov and Alan Viard: “To be sure, the appropriate level of government debt is likely to be higher in a low-interest-rate economy than in a high-interest-rate economy. Nevertheless, the current-law trajectory—in which debt continues to grow even after reaching staggeringly high levels—is both undesirable and unsustainable.” Slavov & Viard, No Free Lunch: the Federal Fiscal Imbalance Is Still a Problem, Tax Notes Fed. 1117 (Nov. 16, 2020).

30 Federal and state finances are significantly intertwined as federal aid accounts for 31% of all state budgets and 23% of all state and local budgets. Ctr. on Budget & Pol’y Priorities, *Federal Aid to State and Local Governments* (Apr. 19, 2018), https://www.cbpp.org/sites/default/files/atoms/files/policybasics-federalaid.pdf.

At the federal level, the United States is a complete outlier, relying on a precarious two-legged stool (income and social insurance taxes), rather than a balanced three-legged stool (income, social insurance, and consumption taxes) as primary sources of revenues.

history of CBO estimates of future federal debt levels is sobering. In the decade before the COVID pandemic, the CBO predicted a federal debt increase to 73% of GDP by 2023 and 144% by 2049, estimates the CBO has now revised upward by an additional two-fifths.[31]

The widening gap between government spending and government revenues is not a viable paradigm and is likely to generate consideration of substantial tax increases (and other budget measures) in the near future. Over the last 50 years, the average gap (deficit) between federal government spending and revenues was about 3.3% of GDP. However, based on current law projections, the CBO estimates an upward trajectory of the average federal deficit to 5.5% of GDP in 2031, 9.4% of GDP in 2041, and 13.3% of GDP in 2051. To put that in perspective, the CBO predicts that federal government spending (including escalating interest payments) will total 31.8% of GDP by 2051 while federal revenue will total only 18.5% of GDP.[32] (See Figure 5.)

The absence of a general consumption tax option at the federal level in the United States is particularly concerning because that is where virtually all of the long-term public debt is accumulating and where a disproportionate share of tax increases will likely occur. Any future federal tax increases will fall heavily or exclusively on income and social insurance taxes, exacerbating the current imbalance between consumption and non-consumption taxes.

At the federal level, the United States is a complete outlier, relying on a precarious two-legged stool (income and social insurance taxes), rather than a balanced three-legged stool (income, social insurance, and consumption taxes) as primary sources of revenues. These two revenue sources make up 92% of all federal government revenues, compared with an average of 62.8% average among all OECD nations. Conversely, general consumption taxes make up 0% of all U.S. federal taxes compared with an average of 23.4% at the federal/central government level in the OECD nations. While the United States does impose special consumption taxes on specific goods and services (*e.g.*, motor fuels, alcohol, tobacco, airplane tickets, import duties), total consumption taxes still make up only 4.1% of all federal taxes, compared with an average of 35.1% of all taxes at the federal/central government level in the OECD nations (see Figure 6).[33]

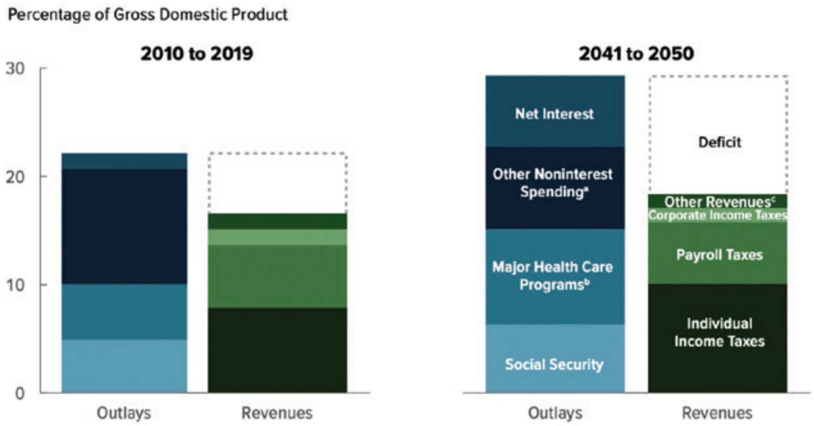
If the political pattern of recent decades holds, the Biden administration, assuming it gets support from a (narrowly) Democratic Party-controlled Congress, will raise taxes on high income households and businesses. Over the last 40 years, individual income tax rates on affluent households have increased under Democratic presidents Barack Obama and Bill Clinton and decreased under Republican presidents Ronald Reagan, George W. Bush and Donald Trump. The only exception was Republican president

[31] CBO, *The 2013 Long-Term Budget Outlook* (Sept. 2013); CBO, *The 2019 Long-Term Budget Outlook* (June 2019). According to estimates by the Committee for a Responsible Federal Budget, President Biden's campaign fiscal and tax plans, if enacted, will increase the federal debt-to-GDP ratio to 128% by 2030 with spending programs exceeding potential tax increases by about $5 trillion. Tax increases on high income households and business would be more than offset by additional government spending on infrastructure, climate change, health care and education. The former President Trump's campaign's fiscal and tax plans would have increased the federal debt by about the same amount, albeit with more tax cuts and less government spending. CRFB, supra note 5.

[32] CRFB, supra note 24; CBO, supra note 25.

[33] For OECD data see OECD, supra note 3, tbls.5000, 5110 (federal or central government level statistics). See tbl.2000 for the social insurance (social security) statistics. The OECD separates social security taxes from the federal/central government totals so the two are combined for purposes of this comparison. For U.S. data see CBO, supra note 22, at 91 tbl.4-1.

FIGURE 5. THE FEDERAL BUDGET, ON AVERAGE, 2010 TO 2019 AND 2041 TO 2050



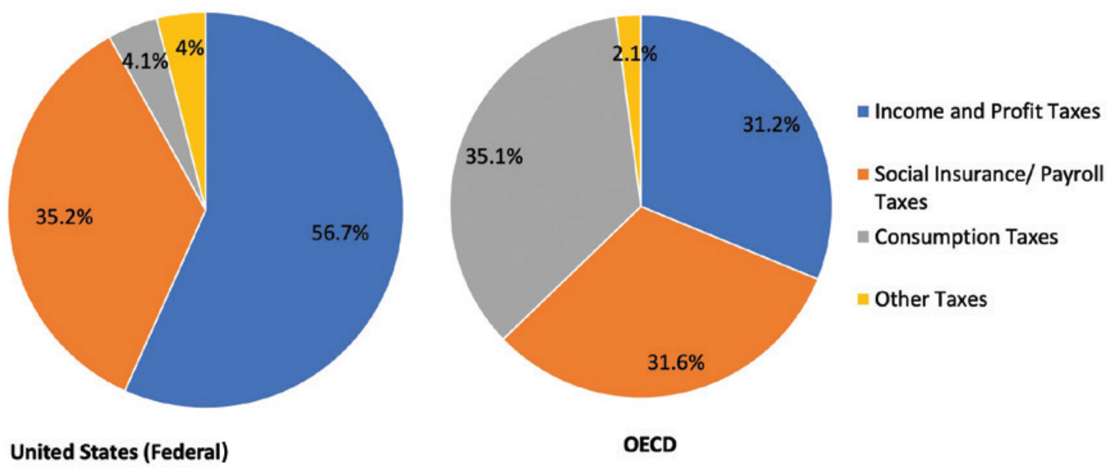
Source: Congressional Budget Office.

a. Consists of all federal spending other than that for Social Security, the major health care programs, and net interest.

b. Consists of spending for Medicare (net of premiums and other offsetting receipts), Medicaid, and the Children's Health Insurance Program, as well as outlays to subsidize health insurance purchased through the marketplaces established under the Affordable Care Act and related spending.

c. Consists of excise taxes, remittances to the Treasury from the Federal Reserve System, customs duties, estate and gift taxes, and miscellaneous fees and fines.

FIGURE 6. THE U.S. TWO-LEGGED STOOL VS. THE OECD THREE-LEGGED STOOL: SOURCES OF TAXES AT THE FEDERAL/NATIONAL GOVERNMENT LEVEL (CBO AND OECD 2018)



George H.W. Bush who raised individual income tax rates as part of a budget deficit reduction package. Indeed, President Biden's tax proposals include significant new income tax increases on high-income households and large corporations.[34]

[34] *See* "The Made in America Tax Plan", supra note 5; and "Fact Sheet: The American Families Plan", supra note 5. Even if no new federal legislation is enacted, income taxes imposed on high income households will increase to the levels at the end of the Obama administration, when the personal income tax cuts in the Tax Cuts and Jobs Act expire at the end of 2025. CBO, supra note 25, at 35–36.

Over the long term, it is simply not economically or politically feasible to bridge the growing fiscal chasm solely with taxes on high-income households or businesses.

The real question is what happens next, after the course correction that typically follows a change in political party control at the national level. Over the long term, it is simply not economically or politically feasible to bridge the growing fiscal chasm solely with taxes on high-income households or businesses. A return to 1970s-level marginal personal income tax rates of 70% on households or corporate income tax rates of 48% on corporations is not a realistic or a desirable option.[35] Exacerbating the current imbalance in the composition of taxes by increasing only nonconsumption taxes (income and social insurance taxes) imperils future economic growth and runs headlong into political and practical limits of raising revenue from a narrow segment of the population.

Generally, governments can choose between taxes based on when money is spent (consumption taxes), when money is earned (income and social insurance (payroll) taxes), or on the value of assets (property and wealth taxes). A good tax system is balanced between different revenue sources that meet key policy objectives such as equity, economic growth, transparency, ability-to-pay and stability. However, the United States will enter the post-pandemic period with a tax mix that is already recklessly imbalanced, with a near total reliance at the federal level on income and social insurance taxes, just two of the three legs of a balanced tax composition. Voters on both sides of the political spectrum, whether they favor more, less, or the same amount of government spending, should be concerned about an imbalanced tax mix that ignores the need for a broad-based consumption tax and is ill-equipped to respond effectively to the growing fiscal crisis.[36]

E. ADDRESSING CONCERNS ON THE SLIGHT REGRESSIVITY OF CONSUMPTION TAXES

A primary impediment to rebalancing U.S. tax revenue sources by increasing the share of consumption taxes is the concern that such taxes are regressive and harmful to lower-income households. Although it is widely accepted that well-designed consumption taxes are beneficial to economic growth—compared with other taxes—a potential downside is that these taxes may unfairly burden lower-income households that purchase more goods and services in proportion to their income than higher-income households. This is an important public policy concern, particularly in an era in which income inequality has emerged as a polarizing national political issue.

35 See Brookings Institution economist William Gale's estimates of the far-reaching budget cuts and tax increases required to reduce the federal debt by two-thirds in 2050. William G. Gale, Fiscal Therapy: Curing America's Debt Addiction and Investing in the Future (Oxford Univ. Press 2019). Gale estimates that if only income tax rate increases are utilized to close the gap, the rates would need to rise by 50%. Id. at 1–8, 56, 60. Gale's estimates may understate the required tax increases since they were made prior to the additional deficit spending during the 2020–21 COVID-19 Pandemic.

36 See Karl A. Frieden and Barbara M. Angus, Convergence and Divergence of Global and U.S. Tax Policies, Tax Notes State 972-976 (Aug. 30, 2021). The United States is at the low end of OECD nations, particularly among the largest countries, in terms of overall taxes as a percentage of GDP. This reflects a long tradition in the United States of skepticism and resistance toward higher taxes and larger government. It is unclear whether the United States will ever come closer to OECD norms for levels of taxation as a percentage of GDP. Regardless, a balanced mix of taxes not overly reliant on income and social insurance taxes is vitally important. While income and social insurance taxes may be useful to address goals such as tax fairness and income inequality, if not balanced with broad-based consumption taxes, they could undermine other goals such as efficiency in revenue generation and economic growth.

Opposition to consumption taxes has a long history in the United States, particularly from the progressive side of the political spectrum. As federal tax policy evolved, during the first half of the 20th century, Democratic Presidents Woodrow Wilson and Franklin D. Roosevelt set the tone with strong opposition to "regressive" consumption taxes and strong support for "progressive" income taxes (see discussion in the Appendix Part 3). While the notion of "ability to pay" is an important element of any tax system, if carried too far, it undermines the capacity of the country to balance the composition of taxes and to raise a sufficient level of revenues to pay for government programs and avoid structural deficits and runaway public debt.

The instinctive opposition to taxes on general consumption based solely on an income distribution analysis reflects a narrow-minded perspective that views tax and budget policy on a piecemeal basis.

The instinctive opposition to taxes on general consumption based solely on an income distribution analysis reflects a narrow-minded perspective that views tax and budget policy on a piecemeal basis. Many tax and spending measures can be, and in the case of the European Union, Canada, and other advanced nations, are used to offset or mitigate the proportional or slightly regressive tendencies of a consumption tax.[37] From a tax standpoint, these options include coupling consumption taxes with progressive income taxes, providing refundable income tax credits for sales taxes paid by lower-income households, or providing a full or partial exemption for some types of household consumption that constitute basic necessities. Canada, for example, provides a quarterly Goods and Services Tax/Harmonized Sales Tax (GST/HST) cash rebate to lower-income Canadians.[38] During the COVID-19 crisis, the Canadian government temporarily doubled the credit to provide financial assistance to these lower-income households.[39] Indeed, a broader-based consumption tax is not incompatible with income or property taxes on higher-income households, but rather can play a complementary role.[40]

On the budget side, slightly regressive consumption taxes can be balanced by government spending on programs that disproportionately benefit lower and middle-income households. This, in part, explains why many OECD nations with much greater reliance on consumption taxes still have less income inequality than the United States. Indeed, a study of OECD countries found that government transfers account for a much greater reduction in income inequality than progressive tax policies.[41] The point here is not that the United States should achieve a prescribed level of income redistribution, but rather that these choices are political and economic decisions and not solely a function of the composition of taxes.

---

37 Indeed a 2020 OECD study concluded: "Overall, the paper finds that the VAT is generally either roughly proportional or slightly progressive, with this progressivity driven by the presence of reduced VAT rates and exemptions. This strongly contrasts with the general public perception that VAT systems are regressive." Alastair Thomas, Reassessing the Regressivity of the VAT at 37, OECD Taxation Working Papers No. 49 (Aug. 10, 2020)

38 For details of Canada's GST/HST Credit for lower-income Canadians and the related provincial programs, see Can. Revenue Agency, RC4210 GST/HST (last updated July 02, 2020), RC4210 GST/HST Credit - Canada.ca.

39 Details can be found in Dep't of Fin. Can., *Economic & Fiscal Snapshot 2020,* 17 (2020), https://www.canada.ca/content/dam/fin/publications/efs-peb/homepage/EFS2020-eng.pdf.

40 See generally William Gale, Raising Revenue with a Progressive Value-Added Tax, The Hamilton Project (Jan. 28, 2020) https://www.hamiltonproject.org/assets/files/Gale_LO_01.13.pdf. The coupling of a broad-based consumption tax with higher taxes on upper income households will likely enhance the political viability of a consumption tax.

41 Gale, supra note 35, at 90 fig.5.1. Noted liberal economist John Kenneth Galbraith in the 1950s supported a national sales tax based on the combined effect of the tax and how the money was spent. See John Kenneth Galbraith, The Affluent Society 315 (Houghton Mifflin Company, 1958).

SECTION 2

AN INTERNATIONAL COMPARISON OF GENERAL CONSUMPTION TAXES IN THE EUROPEAN UNION, CANADA, AND THE UNITED STATES

The United States not only relies less on consumption taxes (as a share of all taxes) than all other advanced nations, but its primary consumption tax—the state retail sales tax—is less efficient and effective than virtually any other general consumption tax based on traditional consumption tax performance metrics. Indeed, these two characteristics of the U.S. tax system are interconnected as the cumulative impact of suboptimal, poorly designed, and narrowly based state sales tax systems impedes utilization of a tax on general consumption to balance the tax burden among different tax types.

This section provides an international perspective on state sales tax systems by comparing them to the primary general consumption taxes in the European Union (the VAT) and Canada (the Goods and Services Tax/Harmonized Sales Tax (GST/HST) and a few provincial sales taxes). In particular, we evaluate the efficiency, efficacy, and historical development of general consumption taxes in each of these geographies based on three key principles of an optimal consumption tax (see Figure 7):

(1) a harmonized[42] and broad-based consumption tax on household goods and services;

(2) an exemption (or credit) for business inputs; and

[42] We use the terms "harmonized" and "uniform" somewhat interchangeably in this study. "Harmonized" or "harmonization" are the terms of preference in the European Union and Canada and "uniform" or "uniformity" in the United States stand for essentially the same proposition: that different jurisdictions conform to the same consistent set of definitions or rules for tax bases, exemptions, tax returns, etc. "Simplification" is a somewhat broader concept as it encompasses both uniformity and non-uniform rules that reduce the burden of tax compliance. The overlap of these terms is evident in the stated purpose of the Streamlined Sales and Use Tax Agreement (SSUTA) project which includes three references to "uniform" or "uniformity" and four references to "simplification" or "simplified." See FAQs—General Information About Streamlined, Streamlined Sales Tax Governing Board, Inc. (SSTGB) https://www.streamlinedsalestax.org/Shared-Pages/faqs/faqs—about-streamlined (last visited July 22, 2020) (discussing the purpose of the SSUTA); See also State Guide to the Streamlined Sales Tax Project, SSTGB (revised Mar. 1, 2019), https://www.streamlinedsalestax.org/docs/default-source/guides/state-guide-to-streamlined-sales-tax-project-2019-03-01.pdf?sfvrsn=5cc921f2_4.

FIGURE 7. THE PRINCIPLES OF AN OPTIMAL CONSUMPTION TAX

. . . U.S. state sales tax systems are inefficient in satisfying optimal consumption tax metrics and ineffective in raising revenue to provide a better balance in the overall composition of taxes.

(3) centralized and simplified tax administration.[43]

The similarities between the three geographies create the basis for comparison. Each represent advanced economies that together make up almost two-fifths of the world's economic production. Each has at least two levels of government: the European Union with European Union and national levels; Canada with federal and provincial levels; and the United States with federal, state and local levels. Key concepts within consumption tax principles—harmonization and centralization—generally apply only when more than one level of government or multiple governments at the same level are levying and administering the tax.

The divergence of state sales tax systems from a true consumption tax model has been analyzed and critiqued for decades.[44] This study provides an updated international perspective that brings into sharper focus both the deficiencies of the U.S. approach and its outlier status. In comparison to general consumption taxes in other advanced nations, U.S. state sales tax systems are inefficient in satisfying optimal consumption tax metrics and ineffective in raising revenue to provide a better balance in the overall composition of taxes. The European Union and Canadian experiences provide useful precedents showing how obsolete retail sales tax or turnover tax systems levied under multiple levels of government (similar

---

43 On the principles of an optimal consumption tax see generally John F. Due, Government Finance: An Economic Analysis 312–27 (rev. ed., R. D. Irwin, 1959); Charles E. McLure Jr., Harmonizing the RSTs and GST: Lessons For Canada From the Canadian Experience, Tax Notes Int'l 440–41 (Feb. 5, 2007); Charles E. McLure Jr., Coordinating State Sales Taxes with a Federal VAT: Opportunities, Risks and Challenges, State Tax Notes 35–36 (Oct. 3, 2005) [hereinafter "Coordinating State Sales Taxes"]; John L. Mikesell, Reversing 85 Years of Bad State Retail Sales Tax Policy, State Tax Notes (Feb. 4, 2019); William F. Fox & LeAnn Luna, How Broad Should Sales Tax Bases Be? A Review of the Empirical Literature, State Tax Notes (Aug. 20, 2013). There is broad agreement on the principles of an optimal consumption tax among scholars although the principles are sometimes grouped or stated with slight variations.

44 See John L. Mikesell, The Disappearing Retail Sales Tax, State Tax Notes (Mar. 5, 2012); Charles E. McLure Jr., The Nuttiness of State and Local Taxes—And the Nuttiness of Responses Thereto, State Tax Notes (Sept. 16, 2002).

From the beginning of the European Union . . . replacing less efficient versions of general consumption taxes—retail sales taxes and turnover taxes—was considered a key step towards developing a common market among EU nations . . .

to the current U.S. model) can be transformed to more modern and sustainable general consumption tax systems.

A: A HARMONIZED AND BROAD-BASED CONSUMPTION TAX ON HOUSEHOLD GOODS AND SERVICES

The first principle of an optimal consumption tax requires a harmonized and broad-based tax on household goods and services. "Harmonized" means that the consumption tax base is the same for any level of government in the geography or jurisdiction, thus reducing the compliance burden on taxpayers. "Broad" means that the tax base includes a wide range of consumer goods and services, both to facilitate equal treatment of different business activities and to maximize revenue generation at lower tax rates. "Household" means that only goods and services purchased by individuals or families for personal consumption are included in the tax base to avoid the economically inefficient cascading of taxes on business inputs.

1. The EU VAT Approach

The European Union consists of twenty-seven EU Member States (e.g., nations of the EU) with 445 million inhabitants. Preconditions to membership in the European Union are adoption of a common system of a VAT and adaptation of a Member State's domestic legislation to EU laws (known as the *acquis communitaire*[45]) as appropriate, including the VAT Directives. Although the United Kingdom (and its 70 million inhabitants) left the EU in January 2021, they are expected to follow EU VAT rules for an indeterminate period.

The Harmonized EU VAT Base

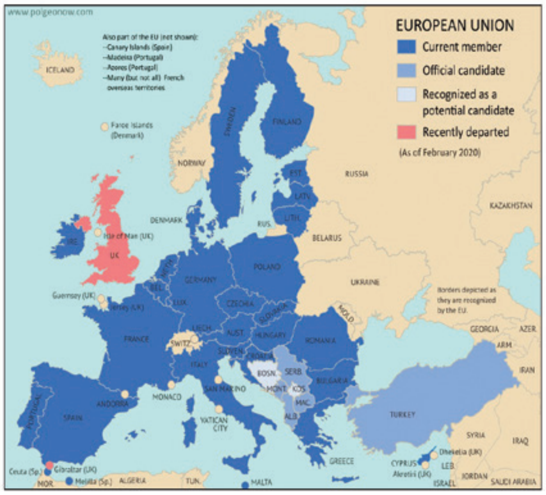
From the beginning of the European Union (and its predecessor European Economic Commission) in the late 1950s and early 1960s, replacing less efficient versions of general consumption taxes—retail sales taxes and turnover taxes—was considered a key step towards developing a common market among EU nations and enhancing international competitiveness. Another benefit of the switch to the VAT was to allow countries to consolidate and rationalize disparate consumption tax systems. That is, aspiring EU Member States could replace a mix of other general and specific consumption taxes with a VAT that taxed a much broader and harmonized range of household consumption of goods and services, and which for the first time provided an exemption (or credit) for business inputs.[46]

---

[45] "The EU's *'acquis'* is the body of common rights and obligations that are binding on all EU countries as EU Members. It is constantly evolving and comprises: the content, principles and political objectives of the Treaties; legislation adopted in application of the treaties and the case law of the Court of Justice of the European Union; declarations and resolutions adopted by the European Union; measures relating to the common foreign and security policy; measures relating to justice and home affairs; international agreements concluded by the European Union and those concluded by the EU countries between themselves in the field of the EU's activities. Applicant countries are required to accept the *acquis* before they can join the European Union. Derogations from the *acquis* are granted only in exceptional circumstances and are limited in scope. The *acquis* must be incorporated by applicant countries into their national legal order by the date of their accession to the European Union and they are obliged to apply it from that date." Glossary of Summaries: Acquis, Eur-Lex, https://eur-lex.europa.eu/summary/glossary/acquis.html?locale=en (last visited Aug. 4, 2020).

[46] On the historical development of the EU VAT, see the Appendix, infra.

FIGURE 8. EU VAT: HARMONIZED AND BROAD-BASED TAX ON HOUSEHOLD CONSUMPTION



- 27 Member States
- Population 445 million
- 27 tax administrations but no local VATs
- One overarching system with a high degree of tax base harmonization
- Broad tax base – covers most goods and services
- VAT legislation governed by EU institutions (e.g., the Council, the Commissions, the EU parliament)
- Member States contribute some VAT revenue to EU

Every EU Member State must utilize a VAT, and that tax must conform to the definitions of goods and services and common tax base set forth in EU law . . .

The twenty-seven EU Member States are sovereign jurisdictions with autonomy to set domestic policies on a range of matters, including many areas of taxation. However, every EU Member State must utilize a VAT, and that tax must conform to the definitions of goods and services and common tax base set forth in EU law (principally, the EU VAT Directives).[47] Thus, comprehensive harmonization of the VAT base exists across all of the EU Member States (see Figure 8).[48]

A Multi-Stage Tax on Final Consumption

The EU VAT, like all other VAT systems, is a multi-stage tax, collected fractionally at every stage of the supply of goods and services. Under the EU VAT, business entities and individuals that sell goods and services are "taxable persons." Taxable persons are responsible for charging, collecting, and remitting VAT to the government but do not generally bear VAT as a business cost. Taxable persons charge VAT on their sales (called output tax) and have a right to deduct VAT paid on business purchases, including direct inputs and overheads (called input tax). Input VAT is recovered by offset against the output VAT charged; or, if there is an excess, by claiming a repayment from the government.

The mechanism for charging and offsetting VAT on supplies made between taxable persons means that the tax is effectively a tax on "final consumption" and therefore

---

47 See Council Directive 2006/112, 2006 O.J. (L347) 1 (EC). The eleven EU members that joined the European Union after 2000, and three other members that had joined earlier all had adopted VATs before joining the European Union. However, upon joining the European Union, they were required to make changes, often significant, to conform their VATs to the harmonized EU VAT rules.

48 Id. at art. 73. Calculating the taxable base is a key concept in VAT, as the tax due at each stage is calculated as a percentage of the value of the goods or services supplied. The extensive harmonization among the EU countries extends not just to goods and services in the VAT base, but also to what is included in the "taxable amount." The VAT Directive defines the concept of "the taxable amount" in broad terms. As with other aspects of EU VAT, Member States must adopt this definition into national law. Generally, the Directive indicates that the taxable amount (i.e., value) includes everything that constitutes consideration obtained or to be obtained by the "supplier" (seller or transferor) for the "supply" (sale or transfer), from the customer or a third party.

neutral for most business entities. The principle of the EU VAT as a tax on final consumption has been reinforced over the years by EU Directives and case law.[49] Further, to ensure fiscal neutrality, imported goods are taxed in the same way and at the same rate as domestic goods, with the tax applied at importation (based on the customs value), whereas exported goods are not subject to VAT.

A Broad-Based Tax on Household Goods and Services

The EU VAT is also a broad-based tax on consumption that applies to most transactions involving goods and services supplied in the European Union. The scope of the VAT—what is included or excluded from the tax base—is set out in Article 2 of the VAT Directive[50] and applies to all EU countries. Once a transaction is within the scope of VAT, additional rules determine the rate of VAT that applies and when the tax must be paid.[51]

The distinction between the supply of goods and the supply of services is highly relevant for a number of aspects of VAT law, including defining where a transaction is taxed and when the tax due must be paid. However, supplies of goods and services do not per se attract different tax treatments or tax rates in the EU VAT system, as may be the case in other sales tax systems.

Broadly, a supply of goods involves "the transfer of the right to dispose of tangible property as owner."[52] The VAT Directive does not define the term "supply of services;" rather, for VAT purposes, any transaction undertaken in the course of business and done for consideration that is not a supply of goods, is a supply of services. As a result, every transaction is either a supply of goods or a supply of services for VAT purposes unless it fails to meet the qualifying criteria (*e.g.*, the seller is not acting in a business capacity) or if the activity is specifically excluded.

This approach means that the VAT is a highly inclusive tax that covers the majority of economic activity undertaken in the European Union. Its broad scope potentially covers all goods and services, because taxability does not depend on a pre-defined list of taxable activities, taxable items, or business sectors. New products and activities are included in the scope of the tax as soon as they are created, and the list of taxed transactions does not need to be amended before taxability applies. This aspect of VAT is crucial in the fast-paced digital economy.[53] Since its inception, the EU VAT was designed as a tax with a broad base to catch all economic activity. This is in contrast

49 For example, in 2005, the European Court of Justice stated: "It is to be remembered that the basic principle of VAT is that it is a consumption tax designed to be borne only by the final consumer." Case C-291/03, MyTravel v. Comm'rs of Customs & Excise, 2005 E.C.R.I -8517.

50 Council Directive 2006/112 supra note 47, at art. 2, sets out the broad scope of EU VAT.

51 In general, any transaction is within the scope of EU VAT if it satisfies various criteria including the status of the supplier, the place where the transaction takes place, and the payment of consideration. If these criteria are present, VAT applies to the transaction unless a provision specifically excludes it. The legislative intent, therefore, is to tax most items with VAT. These items are referred to as taxable supplies. Taxable supplies include goods and services that attract the standard VAT rate and goods and services that are taxed at reduced rates or at a zero rate.

52 Council Directive 2006/112, supra note 47, at art. 14.

53 For example, digital goods can automatically fall within the scope of VAT (generally treated as services), regardless of how they are delivered or marketed. Unlike digital goods under a sales tax, it is not necessary to define them as "tangible property" or to create new categories of taxable services to subject them to tax.

to some of the EU taxes it replaced, such as turnover taxes or retail sales taxes that started with a narrow base and expanded incrementally over time.

Exemptions from the VAT Base

The EU VAT Directive harmonizes not only what is included in the VAT base, but also what is excluded from the base. VAT does not apply to all household expenditure incurred by EU residents. Important exceptions include:[54]

- specified VAT-exempt goods and services (such as health, welfare, education, banking, and insurance);
- supplies purchased from small businesses that are not registered for VAT; and
- goods and services purchased and consumed outside the European Union.

The VAT Directive sets out in detail the goods and services that are "exempt from VAT without credit."[55] This term means that VAT is not charged by the seller (as the supply is exempt from VAT), but the seller has no right to credit or offset any input tax paid on expenditures incurred in connection with supplying those goods or services. It is often simply referred to as exemption (or true exemption).

In addition, some activities are "exempt from VAT with credit."[56] This term means that VAT is not charged by the seller (as the supply is exempt from VAT), but the seller has the right to credit or offset any input tax paid on an expenditure incurred in connection with supplying those goods or services. Exemption with credit is often referred to as VAT zero-rating. The primary example of this category is exports. The exporter does not need to collect VAT on exports but is entitled to an input VAT credit for costs of goods sold or capital purchases relating to the production or provision of exports. In some countries, domestic goods and services may also qualify for exemption with credit, such as basic household necessities, animal feedstuffs, books, and newspapers. In these cases, in countries that apply zero-rating (such as Ireland), it is effectively equivalent to a super-reduced rate of VAT.

Exemption Without Credit

The basic EU exemption without credit provisions are highly harmonized, and the Directive provides little room for discretion other than allowing Member States to lay down conditions to ensure "the correct and straightforward application of those exemptions and of preventing any possible evasion, avoidance or abuse."[57]

The Directive mandates VAT exemption on output VAT (without input VAT credit) for a wide range of activities that are "in the public interest." Typically, these exemptions cover goods and services provided directly to final consumers by non-

---

54 Council Directive 2006/112, supra note 47, at art. 131–135.

55 Id.

56 Id.

57 Id. at art. 131.

profit organizations, governmental bodies, and charitable institutions.[58] They include social welfare, health care, and education services, and exemptions may be restricted by reference to the status of the provider.[59] The Directive also mandates that VAT exemption without credit applies to a range of other activities,[60] many of which are difficult to include in a VAT system. These activities include insurance services, banking services, granting credit, securities transactions, supplying buildings and land, and leasing immovable property.

The differences among EU nations in terms of the portion of the VAT base that is exempt are small. Most simply reflect differences in the size of sectors that cannot be taxed in principle (e.g., rents, the provision of public goods by the government, or financial services). The remaining level of the so-called "actionable" Exemption Gap (*i.e.,* exemptions open to change) is only about 3–4% on average.[61]

Factors that Impact the Breadth of the EU VAT Base

The extensive harmonization of the EU VAT base does not mean that the European Union adopts the broadest possible VAT base of household goods and services. Politics frequently intrude on theoretical norms and that certainly occurs with the EU VAT. The many exemptions allowed by EU VAT rules—even if uniform—reduce the breadth of the VAT base. So too does the frequent use of reduced rates by EU Member States for many basic necessities purchased by lower income households. Nonetheless, the EU tax base, either at standard rates or occasionally at reduced rates, still includes many household goods and services not in the typical U.S. state sales tax base, such as construction services, food for household consumption, prescription medicines, personal services, and professional services.

The end result is that the breadth of the EU VAT base averages about 56% of all household consumption, identical to the OECD average of 56%.[62] Over the forty-year period from 1976 to 2018, the European Union and OECD VAT bases have been relatively stable, rising from 53% in 1976 (both for the European Union and OECD) to 56% for both the EU and OECD in 2018.[63]

---

58 Id. at art. 132.

59 The importance of these exemptions in terms of household disposable income may vary between Member States, depending on whether these activities are mainly provided by business entities in that State or whether they are mainly provided by governmental bodies or charitable organizations. The Directive allows some discretion to Member States to extend or restrict exemption in these categories. However, the important factor in adopting any provisions is generally that they avoid creating "distortion of competition to the disadvantage of commercial enterprises subject to VAT." Id. at art. 133.

60 Id. at art. 135.

61 Ctr. for Soc. Econ. Research (CASE), *Study and Reports on the VAT Gap in the EU-28 Member States: 2019 Final Report,* tbl.4.1 (Sept. 4, 2019), https://ec.europa.eu/taxation_customs/sites/ taxation/files/vat-gap-full-report-2019_en.pdf.

62 OECD, Consumption Tax Trends 2020: VAT/GST and Excise Rates, Trends and Policy Issues 49–54, 96–97 (OECD Publishing, Paris, 2020). The EU VAT base breadth is based on the OECD statistic called the "VAT Revenue Ratio (VRR)." The VRR approximates the breadth of the VAT base that compares VAT collections to the potential VAT base of household goods and services as measured at the standard VAT rate. However, the reductions from 100% reflect not just VAT exemptions and reduced rates, but also fraud, tax evasion, or other compliance problems. The "numerator" of VAT collections includes not just household consumption, but also business inputs to the extent they are not eligible for input VAT credits. For more on the types of goods and services included in the EU VAT base, see Id. at ch. 2.

63 Id. at 90. Over the course of the forty-year period, some nations' VAT bases increased and some decreased, but the trend line was remarkably stable. The average OECD VRR fluctuated during the forty-year period in the narrow range between 50% and 59%. Id.

2. The Canadian GST and Provincial Sales Tax Approach

Canada imposes a hybrid national/provincial consumption tax system. At the national level, Canada levies a GST which is essentially a VAT. The GST is administered at the national level (except in Quebec) and imposes a broad-based tax on household goods and services at a rate of 5%.[64] Five of Canada's ten provinces have adopted the HST with a tax base harmonized with the national GST and centrally administered by the national government (see Figure 9).[65] Each province has its own tax rate and some limited control over what is included or excluded from the harmonized tax base. The province of Alberta and Canada's three territories are included within the GST but impose no HST or separate provincial or territorial sales taxes. Taken together, roughly 57% of the country's population resides in provinces or territories with a centralized federally administered GST/HST system.

The province of Quebec, with 23% of the nation's population, has its own unique relationship to the GST. Quebec imposes a Quebec Sales Tax (QST) that is harmonized to the national GST tax base.[66] However, administration of the GST/QST is different in Quebec, with responsibilities divided between the national government and the Quebec provincial government, depending on whether the business is based in or out of Quebec.[67] Finally, three Canadian provinces (British Columbia, Manitoba, and Saskatchewan) comprising about 20% of the nation's population, have both GST administered at the national level and a separate, non-harmonized provincial sales tax (more akin to the U.S. retail sales tax) administered at the provincial level (see Figure 9).[68]

The net result of this hybrid model is that about 80% of the Canadian population is taxed under a common and harmonized GST tax base . . .

The Harmonized GST/HST/QST Tax Base

The net result of this hybrid model is that about 80% of the Canadian population is taxed under a common and harmonized GST tax base, although administration of the harmonized tax is at the provincial level in Quebec. Further, about 20% of the country's population lives in three provinces that impose a dual consumption tax system with both a GST administered at the national level and a sales tax administered at the provincial level. Significantly, the vast majority of Canada's industrial, commercial, and international trade activity is located in the provinces with a harmonized GST/HST/QST consumption tax base.

Introduced in 1991, Canada's hybrid GST/HST/QST system gradually transformed Canada from a country without a common sales tax base to a country where about 80% of the population lives in provinces where the national and provincial tax bases are harmonized. Aside from Alberta and the three territories with no provincial sales taxes, the other provinces discarded their retail sales taxes and harmonized to the

64 GST is enacted pursuant to Part IX of the Excise Tax Act (ETA), R.S.C. 1985, c E-15. The federal 5% rate is imposed on domestic transactions pursuant to ETA subsec. 165(1). The provincial rate for those provinces that have "harmonized" with the federal GST/HST system is imposed pursuant to ETA subsec. 165(2).

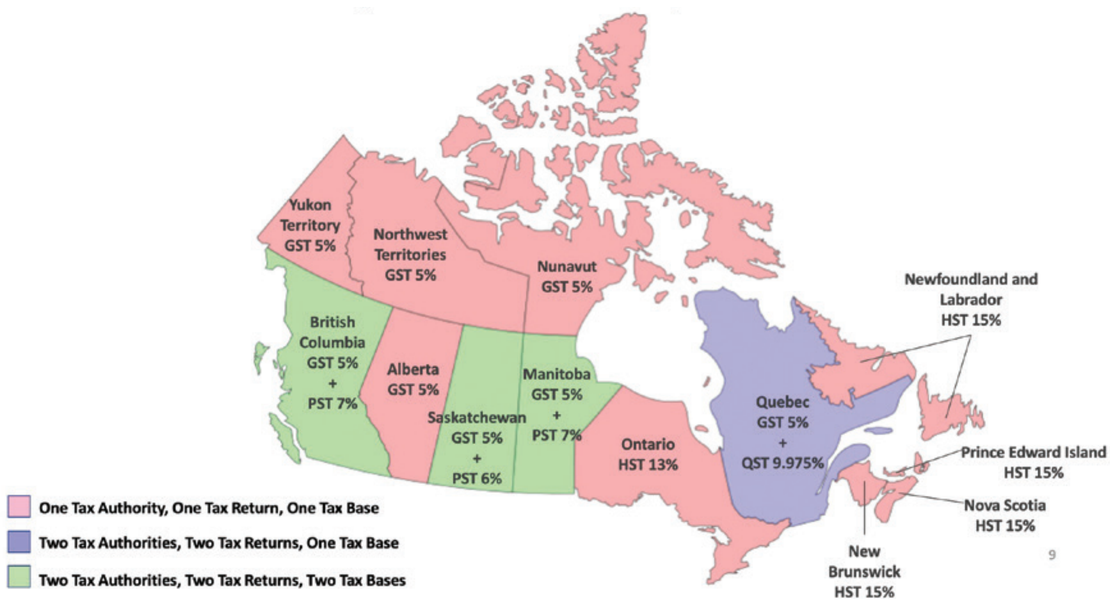
65 See ETA, supra note 64, at subsec. 123(1) "participating province" and Schedule VIII. See also Definitions for GST/HST, Gov't. of Can., https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/gst-hst-businesses/definitions-gst-hst.html#province (last updated Sept. 25, 2020).

66 Basic Rules for Applying the GST/HST and QST, Revenu Que., https://www.revenuquebec.ca/en/businesses/consumption-taxes/gsthst-and-qst/basic-rules-for-applying-the-gsthst-and-qst/ (last visited Nov. 30, 2020).

67 Id.

68 Sales Tax Rates by Province, Retail Council of Can., https://www.retailcouncil.org/resources/quick-facts/sales-tax-rates-by-province/ (last visited Oct. 14, 2020).

FIGURE 9. CANADA'S HYBRID GENERAL CONSUMPTION TAX MODEL



GST over a twenty-five year period beginning with Quebec (in the 1990s); New Brunswick, Nova Scotia, and Newfoundland & Labrador (1997); Ontario (2010); and Prince Edward Island (2013).

Critics assert that by "harmonizing" with the federal GST/HST system, the Canadian provinces are ceding a significant power to the Canadian federal government. However, three factors negate this concern. First, although provinces that wish to harmonize must accept the existing tax base (the basket of goods and services subject to GST) as determined by the federal government, a harmonizing province may exempt select items from the provincial component of the HST, up to an aggregate maximum of 5% of the total GST/HST tax base. The only other limitation is if a province exempts an item or category of goods from the provincial component of its HST, and another harmonized province already has a similar exemption, then the harmonizing province must accept the scope and definition of the other province's HST exemption. This requirement is necessary because the tax is administered by a single tax authority—the Canadian Revenue Agency (CRA).[69]

Second, each "harmonized" province remains responsible for setting its own provincial HST rate. Accordingly, a province can choose to increase or decrease the provincial tax rate, subject to providing the federal government with adequate notice to properly implement the change. Third, a province reserves the option to "de-

69 For example, when Ontario decided to replace its PST and harmonize with the GST/HST system in 2010, under Ontario's PST system, children's clothing was exempt from PST. The then-premier of Ontario said at the time that he was not going to be the premier that imposed PST on kids clothes, and therefore, Ontario chose to exempt from the provincial component of the HST (i.e., the provincial 8% of the total 13% tax) children's-sized clothing. However, when subsequent provinces elected to "harmonize" and sought to exempt children's clothing from their HST, they were required to adopt the parameters of Ontario's HST-exemption for children's-sized clothing as previously agreed between the federal and Ontario governments, and subsequently enacted into federal law.

harmonize" and cancel its Comprehensive Integrated Tax Coordination Agreement (CITCA) with the federal government.[70] The CITCA typically provides that a province cannot "de-harmonize" within the first five years of commencement of the agreement and thereafter only with eighteen-months notice. This was tested in 2013 by the Province of British Columbia, which "harmonized" on July 1, 2010, and then "de-harmonized" on April 1, 2013.[71] So despite the terms of the CITCA, the provinces and federal government can always agree on other terms.

A Broad-based Tax on Household Goods and Services

As with other VATs around the world, Canada's GST/HST system has a very broad tax base. The tax is imposed on the value of the consideration for a "taxable supply," with "supply" defined as "the provision of property or a service in any manner."[72] Further, "property" is defined broadly to include any form of property (real, tangible, intangible, corporeal, incorporeal) and any right in respect of any property, but excludes money.[73] A "service" is also defined broadly to be "anything other than . . . property."[74] Accordingly, unlike sales and use taxes, no form of property (real, tangible, intangible, etc.) or service is initially excluded from the tax base.

Inclusions and Exclusions from the GST/HST Base

Although the Canadian GST/HST uses terminology very similar to the EU VAT to define what is included or excluded from the taxable base, important differences distinguish the two systems. In particular, Canada tends to exempt more goods and services from the GST/HST base for tax policy and other reasons. Based on OECD statistics, the GST/HST base is about 12.5% less broad than the average OECD VAT base.[75]

To exclude items from the GST/HST tax base, the legislation differentiates between a "taxable supply," "zero-rated supply," and an "exempt supply." A "taxable supply" is the provision of a property or service in any manner made in the course of "commercial activities."[76] If the supplier is required to register for GST/HST purposes, it must charge and collect GST/HST from the recipient of the supply; however, the supplier is entitled to recover (as input tax credits) any GST/HST levied on expenses incurred to make the taxable supply.

A "zero-rated supply" is a subcategory of "taxable supply." Technically, it is a "taxable supply" but at a rate of 0%. The practical effect is that the recipient is not charged

---

70 For example, see Ontario's Comprehensive Integrated Tax Collection Agreement with the Canadian federal government found at https://www.fin.gov.on.ca/en/publications/2009/citca.html.

71 See Changes to the Harmonized Sales Tax (HST), Gov't. of Can., https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/changes-harmonized-sales-tax-hst.html (last updated Apr. 16, 2013).

72 ETA, supra note 64, at subsec. 123(1) "supply."

73 ETA, supra note 64, at subsec. 123(1) "property."

74 ETA, supra note 64, at subsec. 123(1) "service."

75 OECD, supra note 62, at 96-97. The Canadian GST base breadth is based on the OECD statistic called the "VAT Revenue Ratio (VRR)." The VRR is just an approximation of the breadth of the GST base. It compares GST collections to the potential GST base of household goods and services as measured at the standard GST rate. However, the reductions from 100% reflect not just GST exemptions and reduced rates, but also fraud, tax evasion or other compliance problems. The "numerator" of GST collections includes not just household consumption, but also business inputs to the extent they are not eligible for input GST credits.

76 See ETA, supra note 64, subsec. 123(1) for definitions.

tax, and the supplier is still entitled to full input tax credits in respect of the GST/HST the supplier incurs to make the supply.[77] The most obvious example of a zero-rated supply is a sale of goods for export from Canada. The supplier is not required to charge and collect GST/HST from its customer but is still entitled to recover all GST/HST incurred to make the sale.

An "exempt supply" is any supply of property or service that is specifically enumerated in Schedule V of Canada's GST/HST legislation. The key distinction between a "taxable supply" and an "exempt supply" is that while a supplier who makes a taxable supply is required to (a) charge and collect tax from the recipient of the property or service in question, but (b) is entitled to full input tax credits with respect to the GST/HST incurred to make the supply, a supplier who makes an exempt supply (a) does not charge or collect any GST/HST from the recipient, and (b) is not entitled to recover any of the GST/HST the supplier pays on expenses incurred to make the exempt supply.[78]

Zero-Rated Supplies

In Canada, zero-rated supplies—items technically subject to tax at a rate of 0%, but for which the supplier is still entitled to claim input tax credits—fall into the following categories:[79]

- prescription drugs and biologicals
- medical and assistive devices
- basic groceries
- agricultural and fishing
- exports, international transportation and travel, and non-Canadian financial services

Canada utilizes the zero-rated supplies concept more freely than the EU VAT countries, with tax and public policy reasons to support each of these categories. With a zero-rated supply, because the supplier is entitled to recover the GST/HST incurred on expenses to make the supply, the item is effectively free from GST/HST. For example, prescription drugs and medical devices, along with basic groceries, are all zero-rated to reduce the burden of the GST/HST on basic necessities.[80]

Exempt Supplies

The list of exempt supplies in Canada—those not subject to GST/HST but for which the supplier is not entitled to recover the GST/HST payable on their inputs, are as follows:[81]

- real property (excluding commercial property and new residential property)

---

77 ETA, supra note 64, at subsecs. 123(1) "zero-rated supply" and 165(2).

78 Id. at subsecs. 123(1) "exempt supply" and "commercial activities" and 169(1).

79 See Zero-rated supplies. General Information for GST/HST Registrants, Gov't. of Can., https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/rc4022/general-information-gst-hst-registrants.html (last updated Oct. 10, 2020). See also ETA, supra note 64, at subsec. 123(1) and Schedule V.

80 In addition, the reason agricultural and fishing items are listed as zero-rated is principally because in Canada—like many countries—policy makers try to avoid taxing fishers and farmers. Exports (along with international travel and non-Canadian domestic financial services) are zero-rated for competitiveness reasons. One of the principal reasons the GST was introduced in Canada was to eliminate sales tax as an embedded cost on the country's exports, thereby making Canadian products and services more competitive globally.

81 Gov't. of Can., supra note 79, at Exempt supplies.

- healthcare services
- education services
- child and personal care services
- legal aid services
- supplies by charities, not-for-profits, governments and public institutions
- Canadian-domestic financial services

With the exception of real property and Canadian-domestic financial services, all other categories of exempt supplies in Canada fall within the purview of services supplied or delivered by government-funded programs. Healthcare and education in Canada are primarily delivered by publicly funded hospitals, universities, colleges, and schools. And while the services of doctors, dentists, and other healthcare providers are provided by individuals in private practice in Canada, these services are funded primarily by provincial healthcare programs or private insurance plans. With respect to services provided by charities, not-for-profits, governments, and other public institutions, making these services and items exempt supplies for GST/HST purposes means that the provider does not charge or collect any GST/HST, but also is not entitled to input tax credits on GST/HST incurred on its expenses.[82]

Canada's three stand-alone provincial retail sales taxes suffer from the same structural design flaws as U.S. state and local retail sales taxes.

Provincial Retail Sales Taxes

Canada's three stand-alone provincial retail sales taxes suffer from the same structural design flaws as U.S. state and local retail sales taxes. First, no harmonization of the sales tax base exists among the three provinces that maintain their own provincial sales tax (in addition to the national GST). Each province has complete sovereignty over what is included or excluded from its sales tax base, and provincial sales tax bases are completely independent of both the GST tax base and other provincial sales tax bases.

Second, in terms of the composition of the tax base, provincial retail sales taxes suffer from an under-inclusion of household goods and services and an over-inclusion of business inputs.[83] Like U.S. state sales taxes, Canadian provincial sales taxes focused initially on the taxation of goods, and only fitfully and gradually added the taxation of services. In addition, provincial retail sales taxes were not designed to exclude business inputs from the tax base.

82 Note, however, that many providers in the Municipalities, Universities, Schools, and Hospitals (MUSH) sector are entitled to rebates of a portion of the non-recoverable GST/HST they incur on their expenses, thereby reducing the overall tax rate they incur on their inputs. The same applies for new residential properties (including new residential rental property). With respect to real property, the sale and leasing of commercial property is generally a taxable supply in Canada (with the supplier entitled to fully recover the GST/HST incurred on their expenses), but residential rents and sales of used residential property is not; these are generally considered exempt supplies, thereby moving the GST/HST tax burden back one level from the consumer to the final supplier (i.e., the residential landlord who must incur non-recoverable GST/HST on acquiring the rental property and repairs and maintenance thereto). Domestic Canadian financial services are also exempt supplies for GST/HST purposes, principally because GST/HST is a value-added tax, and financial services are essentially market intermediation services. No VAT jurisdiction to our knowledge has yet been able to determine an efficient way to only impose VAT (such as Canadian GST/HST) on the margins earned by financial institutions such as banks, credit unions, insurers, broker-dealers, etc. Accordingly, for these financial intermediaries in Canada, GST/HST is one of their more significant costs.

83 When Newfoundland & Labrador and New Brunswick harmonized with the GST in the late-1990s, one study found the new provincial harmonized tax base was between 17.7% and 21.7% broader than the previous retail sales tax base. David Douglas Robertson, Sales Tax Harmonization: The Facts & Nothing but the Facts, prepared for the 25th Annual CICA Commodity Tax Symposium at 29–33 (Sept. 25–28, 2005), available through https://www.cpastore.ca/product/excise-automated-reference-library/166.

Over the ninety-year history of state sales tax systems, the sales tax bases among the forty-five states and D.C. have never been harmonized; each state has virtually unrestrained sovereignty to choose its own tax base.

3. U.S. State Sales Tax Systems' Approach

In the United States, state retail sales tax systems are not designed to either harmonize sales tax bases among the states or tax a broad range of household goods and services. Over the ninety-year history of state sales tax systems, the sales tax bases among the forty-five states and D.C. have never been harmonized; each state has virtually unrestrained sovereignty to choose its own tax base. Not surprisingly, huge variations exist among the states regarding what is included or excluded from the tax base. To make matters worse, fifteen states also allow some variation between their state and local sales tax bases.[84]

The state and local sales tax bases in the United States not only lack uniformity, but are generally very narrow as well, at least by international standards. Most states impose a sales tax on a wide range of goods, but only on a limited number of services. Further, because states have complete autonomy to set sales tax rates, a wide variety of sales tax rates exist among the states.

The Lack of Harmonization of the Sales Tax Base

A key indicator of the lack of harmonization in U.S. sales tax systems is the significant variation in the breadth of the sales tax base among the states. In 2018, the average sales tax breadth (taxable base as a percentage of total household consumption) was about 37%.[85] The sales tax breadth ranged from a low of 18% in Virginia to a high of 109% in Hawaii. The share was less than 25% in Virginia, California, Maryland, Massachusetts, New Jersey and Virginia; and over 50% in Wyoming, North Dakota, New Mexico, South Dakota, and Hawaii.[86]

The complete absence of harmonization of the sales tax base among state sales tax systems stands in sharp contrast to the outcomes in the European Union and Canada. As discussed above, the EU VAT base is fully harmonized, and adoption of the EU VAT (with its uniform base) is a precondition to EU membership. Similarly, seven out of the ten Canadian provinces with 80% of the country's population have harmonized their provincial sales tax bases to the national GST (see Figure 10).

The wide divergence in sales tax breadth among the states is partially due to the lack of uniformity among the states in various categories of goods included in the sales tax base. For instance, in 2018, of the forty-six states (including D.C.) with sales taxes, seven taxed food for home consumption; twenty-one taxed residential electricity and gas; thirty-five taxed nonprescription drugs; and thirty-eight taxed clothing.[87]

---

84 Karl Frieden & Fred Nicely, The Best and Worst of State Sales Tax Systems: COST Scorecard on Sales Tax Simplification, Uniformity, and Exemption of Business Inputs, Council on State Taxation 1, 21–66 (Apr. 2018) [hereinafter "Sales Tax Scorecard"].

85 John L. Mikesell, State Retail Sales Taxes in 2018, State Tax Notes 1339, 1345 (Sept. 30, 2019).

86 Id. The Hawaii percent is above 100% because of the impact of imposing sales tax on its robust tourism industry. States with higher sales tax breadths do not necessarily tax a broad base of household goods and services. The design of the retail sales tax includes a significant portion of business inputs in the sales tax base. For instance, only three smaller population states have enacted truly broad-based sales taxes, and two of the three (South Dakota and New Mexico) rely on business inputs for about three-fifths of their tax base. The business input ratio in Hawaii—36%—is lower only because that state garners so much revenue from its tourism industry. That also explains why the sales tax breadth overall is over 100% in Hawaii as much of the revenue comes from out-of-state tourists.

87 Fed'n of Tax (FTA), State Sales Tax Rates and Food & Drug Exemptions (Jan. 2020), https://www.taxadmin.org/assets/docs/Research/Rates/sales.pdf; Mikesell, supra note 43, at 393.

FIGURE 10. HARMONIZATION OF THE GENERAL CONSUMPTION TAX BASE

Geography	Harmonized Base as of Percent of Population
European Union VAT	100%
Canada GST/HST/QST	80%
U.S. State Sales Tax Systems	0%

The absence of harmonization of the U.S. sales tax base is apparent both in the larger states that have not adopted the Streamlined Sales and Use Tax Agreement (SSUTA), and among SSUTA states themselves.

The differences in state sales taxation of services are even more glaring. The Federation of Tax Administrators (FTA), a trade association representing state revenue departments, periodically publishes a survey of the inclusion of distinct service categories in state sales tax bases. Its most recent survey, published in 2017, found that of the forty-six states (including D.C.) with sales taxes, five taxed legal services; six taxed barber shop services; ten taxed interior design; nineteen taxed streaming videos; twenty-one taxed landscaping; twenty-one taxed laundry/dry cleaning (non-coin operated); and twenty-three taxed health clubs/tanning salons.[88]

The differences among state sales tax bases regarding the taxation of digital products, typically classified as either goods or services or some combination thereof, are also significant. Digital products, so named because they can be accessed or transferred by digital means, are one of the fastest growing business sectors in the United States. This category includes a broad range of goods and services, many of which were previously supplied in tangible form or by in-person services, including software, information, books, music, film and entertainment, and photos. Some states such as California, Nevada, and Missouri tax few or no digital products. Other states such as New Jersey, Ohio, and Texas tax most digital products. Some states tax or exempt digital products depending on whether they are delivered directly to consumers or accessed in the cloud.[89]

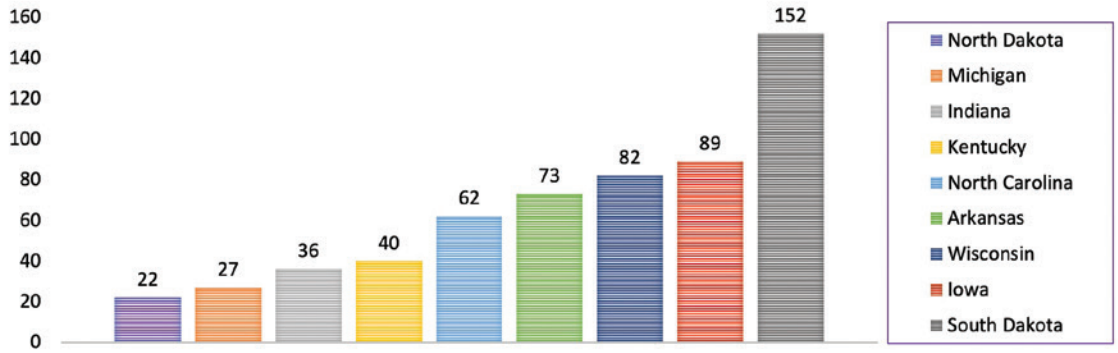
The Absence of Harmonization of the Sales Tax Base in SSUTA Member States

The absence of harmonization of the U.S. sales tax base is apparent both in the larger states that have not adopted the Streamlined Sales and Use Tax Agreement (SSUTA), and among SSUTA states themselves. Although SSUTA calls for uniform definitions for many goods and some services, it does not require states to harmonize their sales tax bases. Instead, the SSUTA rule simply dictates that if the state taxes a particular good or service covered by a uniform definition, it must utilize the SSUTA definition of the taxable good or service.

88 FTA, 2017 Services Taxation Survey (2017), https://www.statetaxissues.org/services/2017/.

89 Sales Tax Scorecard, supra note 84, at 14.

FIGURE 11. NUMBER OF SERVICES TAXED BY SSUTA MEMBER STATES (OUT OF 176 SERVICE CATEGORIES)



As a result, sales tax bases among SSUTA states remain widely divergent, reflecting as many differences as found among states that have not adopted SSUTA. The FTA 2017 study found that, out of a possible 176 services, the number of services taxed by SSUTA states ranged from a low of 22 (North Dakota) to a high of 152 (South Dakota). (See Figure 11)[90]

The Narrow Breadth of U.S. Sales Tax Bases Compared to Other Nations

Sales tax bases in the United States not only lack harmonization, but are relatively narrow as well, at least by international standards. Currently, most states impose sales tax on most tangible goods, but only on a limited number of services. The narrow breadth of the collective U.S. state sales tax bases compared with the EU VAT base and the Canadian GST base is evident in the comparison of the ratio of the consumption tax base over the total value of household goods and services. In the EU VAT, the average value-added tax base among EU Member States equals 56% of final consumption, the same as the overall OECD member country average. In the Canadian GST, the tax base equals 49% of final consumption.[91] By contrast, in U.S. state sales tax systems the average base equals only 37% of final consumption.[92] (See Figure 12)

These calculations somewhat overstate the true breadth of the household consumption base because they include business inputs in the numerator (to the extent business purchases are taxed) but not in the denominator (which only consists of total household consumption). This is particularly distortive in U.S. state sales tax

90 FTA, FTA Survey of Services Taxation—Update, By the Numbers (July–Aug. 2017) at 2. For a greater discussion of the Streamlined Sales Tax Project and its Streamlined Sales & Use Tax Agreement, see Section II. C. 3., infra.

91 OECD, supra note 62, at 49–54, 96–97. The European Union and Canada numbers are based on the OECD statistic called the VAT Revenue Ratio (VRR). See explanation of the calculations in supra notes 62, 75. None of the three geographies tax much more than one-half of household consumption because of the near universal exemption from the consumption tax base of health care, education, and financial services, the impact of other base-reducing measures such as small business exemptions and reduced rates on food and other basic necessities, and compliance/fraud issues.

92 EY, supra note 3, at 6; Mikesell, supra note 43, at 395. The OECD statistics do not calculate a VRR for the United States since it has no VAT. However, a similar concept used to measure the breadth of the U.S. sales tax base is the so-called "sales tax breadth" concept. For a discussion of the slight differences between the VRR (C-efficiency) concept and the sales tax breadth calculation, see Mikesell, supra note 44, at 777, 782–785.

FIGURE 12. BREADTH OF THE GENERAL CONSUMPTION TAX BASE

Geography	Breadth of Consumption Tax Base
OECD VATs	56%
European Union VAT	56%
Canada GST/HST/QST	49%
U.S. State Sales Tax Systems	37%

U.S. state sales tax bases have been narrowing over the last fifty years. . . . In relative terms, state sales tax bases today are about two-thirds (67%) of 1970 levels.

systems, which tax a higher ratio of business inputs than any of the countries with VATs. For instance, with business inputs excluded, the breadth of the Canadian GST consumption tax base drops to 41%, and the breadth of the collective U.S. state sales tax bases falls to 21%.[93]

The Historic Shrinking of the State Sales Tax Base

U.S. state sales tax bases have been narrowing over the last fifty years. The breadth of state sales tax bases declined from 54.4% in 1970 to 36.6% in 2018.[94] In relative terms, state sales tax bases today are about two-thirds (67%) of 1970 levels. The decline is largely attributable to the growth of predominantly untaxed household services.[95] By contrast, the EU VAT and Canadian GST bases have been stable over the same time span; actually increasing slightly to 56% (European Union) and 49% (Canada), to reflect the inclusion of a broader range of household services in the tax base (see Figure 13).[96]

From 1970 to 2017, sales tax revenues as a share of all state taxes remained relatively constant because the narrowing of sales tax bases has been generally offset by increases in sales tax rates. The mean state-level statutory sales and use tax rate has increased from 3.53% in 1970 to 5.6% in 2017, a 58.6% increase.[97]

The narrowing of the sales tax base breadth in the United States relative to other countries is primarily attributable to structural design flaws of state retail sales tax statutes. While the typical state sales tax statute encompasses a broad range of tangible goods (with some carved out exceptions), it generally includes only specifically

93 For the calculation of the U.S. sales tax breadth see EY, supra note 3, at 4. For the calculation of the Canadian GST breadth, see OECD, supra note 62.

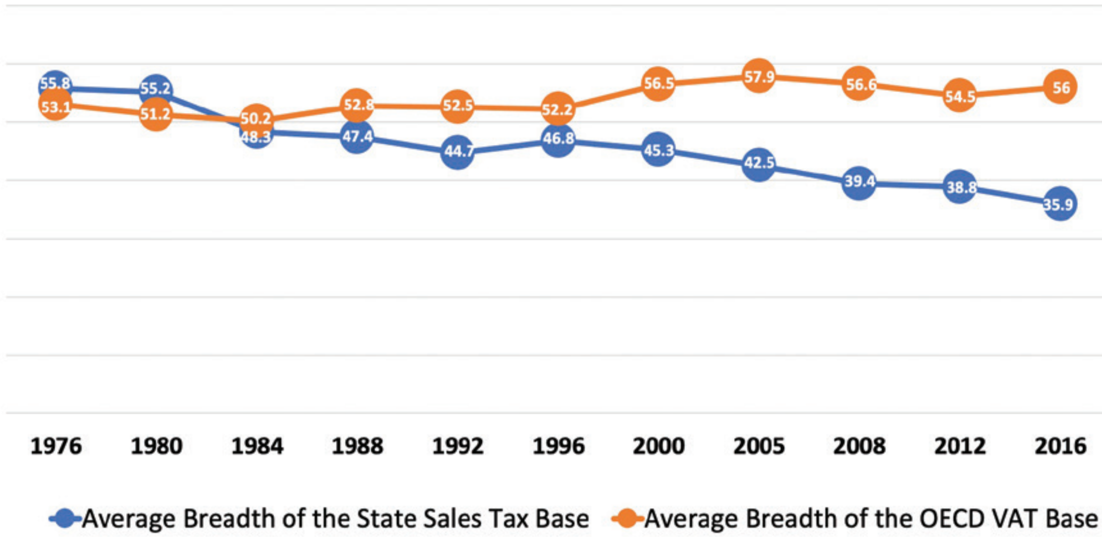
94 Mikesell, supra note 43, at 395. For the 2018 statistics, see Mikesell, supra note 85, at 1344.

95 Id.

96 OECD, supra note 62, at 96–97

97 Mikesell, supra note 43, at 395.

FIGURE 13. THE COMPARATIVE BREADTH OF THE U.S. SALES TAX BASE AND THE OECD VAT BASE: 1976–2016



enumerated services with new ones added incrementally.[98] This methodology creates significant political and administrative difficulties, as compared to the "inclusive" statutory approach to both goods and services in the EU VAT and Canada GST/HST.

The inability of state sales tax bases to keep pace with the rapidly expanding and diversifying service economy is proof of the failure of this approach. The 2017 FTA Survey discussed above identified 176 different categories of services. Currently, services make up almost two-thirds of all household purchases (not including housing), but only a small percentage of the sales tax base in most states.[99] The digital economy exacerbates this disconnect, as innovations and new business models such as 3D printing, autonomous vehicles, streaming, and cloud computing create new categories of services that do not fit neatly into existing sales tax base definitions.[100]

It is much more difficult to add new services incrementally than it is to default to the inclusion of all services unless specifically excluded. For instance, most professional services such as legal and landscaping services have a large business-to-business component that should not be taxed under an optimal consumption tax. If a state tries to add these services to the tax base on a wholesale basis, both for household and business use, it runs into formidable opposition to expansion of the sales tax on business inputs. If a state tries to add these services incrementally and isolate the smaller portion of such services purchased by households, it is not always clear which services are purchased for personal or for business use. Even if that can be determined, it is difficult to explain politically why a household should pay a sales tax for legal services related to drawing up a will or landscaping services related

98 See, for example, the broad definition of tangible personal property (and exemptions) and the narrow definition of services in Massachusetts. Mass. Gen. Laws Ann. ch. 64H, §§1, 6 (West 2020).

99 FTA, supra note 88.

100 On the future state tax issues relating to autonomous vehicles, see William F. Fox, *The Influence of Autonomous Vehicles on State Tax Revenues,* 73 Nat'l Tax J. 199, 199–234 (Mar. 2020).

to a backyard project, while a large business is exempt from such services when performed in a commercial setting.[101]

The Future Expansion of the Sales Tax Base

States have experienced more (albeit still modest) success in incrementally expanding sales tax bases with respect to services where less business use is prevalent (e.g., health club memberships); where the service is related to goods already subject to sales tax (e.g., taxing labor services relating to the repair of tangible or real property); or where sales tax bases already include the tangible form of an item now delivered over the Internet (e.g., digital services such as streaming of books, music, and movies).[102]

The new post-*Wayfair* ability of states to impose a sales tax collection responsibility on remote sellers will increase sales tax revenues as new sellers and marketplace providers register with states. However, *Wayfair* only changed the sales tax jurisdictional rules, it did not alter the limited breadth or lack of harmonization among state sales tax bases. Overall, the fiscal impact of imposing a sales tax collection responsibility on remote sellers is not significant, at least in relation to current sales tax revenues.[103]

At best, future sales tax base expansions by some states will only slow down or flatten the historic decline of the breadth of the U.S. sales tax base. There is little reason to believe that these changes will significantly reverse long-term trends or push the United States in the direction of international norms of broader-based consumption taxes on household goods and services, unless the United States substantially transforms its state retail sales tax systems (see discussion in Section IV, infra).

***Wayfair* only changed the sales tax jurisdictional rules, it did not alter the limited breadth or lack of harmonization among state sales tax bases.**

4. Summary: Harmonization and Breadth of the Tax Base in the EU VAT, Canadian Hybrid System, and U.S. State Sales Tax Systems

The level of harmonization of the EU VAT base is a truly a remarkable tax policy achievement. While nearly all advanced countries (other than the United States) impose a nationally administered VAT with a broad tax base on household

[101] VAT systems typically avoid these problems, because new services typically fall within existing broad definitions of taxable services. For instance, all legal services are initially subject to VAT, and the businesses that use such services to produce other goods or services subject to output VAT simply claim an input VAT credit on the supply of legal services. The structural design of a VAT statute facilitates maintaining a broad tax base of household services without having to enact new legislation adding specifically enumerated services. As noted above, only 10% to 50% of states tax a range of services including barber shops, interior design, streaming videos, landscaping, laundry/dry cleaning, labor services on automotive repairs, and health clubs/tanning salons. By contrast, all of these services are fully included in the EU VAT and Canadian GST tax bases, at least to the extent of household consumption of these services.

[102] For a discussion of the potential for sales tax base expansion to household goods and services, see generally, Michael Mazerov, Expanding Sales Taxation of Services: Options and Issues, Ctr. on Budget & Pol'y Priorities (July 2009); John L. Mikesell, Considering Sales Taxation of Services in Indiana, Ind. Fiscal Pol'y Inst. (Mar. 29, 2017); Jared Walczak, Modernizing Utah's Sales Tax: A Guide for Policymakers, Tax Found. (June 4, 2019). Where states tax digital goods that were formerly provided in tangible form, the sales tax base is not necessarily expanded, but rather prevented from shrinking even further. Another potential source of U.S. consumption tax revenue is increased taxes on specific goods and services such as cigarettes, gas, liquor and marijuana. However, over the last four decades, these taxes have actually decreased as a share of all taxes in the United States from 10% in 1975 to 7.1% in 2018 and pretty much flattened out between 6% and 7% of all taxes over the last twenty years. OECD, supra note 3, tbl.5120

[103] In a November 2017 study, the U.S. Government Accountability Office concluded the annual revenue gain from expanded tax collection authority on remote sales would be between $8.5 billion and $13.4 billion, or about 2% to 4% of state and local sales tax revenue. U.S. Gov't Accountability Office, GAO-18-114, States Could Gain Revenue From Expanded Authority, but Businesses are Likely to Experience Compliance Costs 12 (2017). For greater discussion of the impact of *Wayfair,* see Section II. C. 3. and Appendix Section C, infra.

U.S. state sales tax systems clearly fail to satisfy the first principle of an optimal consumption tax with less harmonization and a narrower tax base of household goods and services than virtually any other advanced nation.

consumption that applies uniformly at the national level, only the European Union has instituted a VAT with a broad tax base on household goods and services that is harmonized at a continental level. This makes the European Union one of the world leaders in satisfying the first principle of an optimal consumption tax. The breadth of the EU tax base is close to—but not higher than—the OECD average because of significant exemptions at the EU level and extensive use of reduced tax rates at the national level.

Canada's hybrid GST/HST/provincial sales tax system takes a bifurcated approach to the harmonization and breadth of the tax base of household goods and services. The seven provinces and three territories that make up 80% of Canada's population (and harmonize their sales taxes to the GST/HST), achieve nearly complete harmonization of the consumption tax base that includes a broad range of household goods and services, thus satisfying the first principle of an optimal consumption tax. Conversely, in the three provinces that make up 20% of Canada's population (British Columbia, Manitoba, and Saskatchewan) where the national GST and separate provincial retail sales taxes coexist, there is no harmonization of the provincial sales taxes to the GST or to each other. The provincial sales tax base of household goods and services is also much narrower than the GST base.

U.S. state sales tax systems clearly fail to satisfy the first principle of an optimal consumption tax with less harmonization and a narrower tax base of household goods and services than virtually any other advanced nation. The United States is an outlier for reasons that are partly historic, partly structural design, and partly a result of U.S. federalism. U.S. state sales tax systems were created before the service economy expanded. The structural design of a retail sales tax, unlike a VAT, starts with a more limited tax base comprised primarily of goods, not services. Finally, the United States is one of the few countries in the world that imposes extensive, non-harmonized subnational consumption taxes.

B. EXEMPTIONS (OR CREDITS) FOR BUSINESS INPUTS

The second principle of an optimal consumption tax is the exemption (or credit) for business inputs. This principle complements the first principle: if business inputs are generally exempt then a consumption tax is imposed predominantly on household goods and services. The second principle is a precondition to the beneficial economic impact of a general consumption tax because it eliminates the economically inefficient cascading of taxes on business inputs.[104]

1. EU VAT Approach

Recovery of VAT on Business Inputs

According to the OECD, "The overarching purpose of a VAT is to impose a broad-based tax on consumption, which is understood to mean final consumption by households . . . A necessary consequence of the fundamental proposition that a VAT

[104] The exemption (or credit) for business inputs also complements the destination-sourcing principle as it makes exports tax-free and maintains the neutrality of the VAT on exports and imports. See McLure, Coordinating State Sales Taxes, supra note 43, at 35.

is a tax on final consumption by households is that the burden of the VAT should not rest on businesses."[105]

The mechanism for ensuring that a VAT is a tax on final consumption is the availability of VAT credits for business inputs. This is an essential feature of the EU VAT and it applies in the VAT system adopted by all EU Member States. Taxable persons (e.g., businesses) are responsible for charging, collecting and remitting VAT to the government,[106] but do not generally bear VAT as a business cost. Taxable persons charge VAT on their sales (called output tax) and are granted a credit for VAT paid on business purchases, including inventory for resale, direct inputs, overheads, capital purchases, and imports (called input tax).[107] Taxable persons offset VAT charged with VAT paid in a filing period and remit the difference to the relevant tax administration.[108]

When a taxable person reclaims more input tax than it has paid in output tax on sales for a certain period, the result is an input tax credit. This situation may occur for a variety of reasons, including when the supplier is an exporter, the supplier's goods or services are chargeable at a reduced rate of VAT but its inputs are charged with a higher VAT rate, the supplier is in a business start-up period before trading begins, or as a reflection of seasonal buying patterns. In some jurisdictions, the taxpayer must carry forward to future periods any excess input tax to offset future output tax.[109] In other jurisdictions, the taxable person may claim a repayment of the excess tax from the tax administration.

Charging and offsetting VAT on supplies made between taxable persons means that the tax is effectively neutral for most business entities. The total tax charged is directly proportional to the value of the goods or services supplied at each stage. The tax is collected in stages, but the full burden is borne by the final consumer, regardless of how many stages are in the supply chain.

Cross-Border Supplies

To ensure fiscal neutrality, exports of goods and services are not generally taxed (*i.e.*, zero-rated or exempt with credit). However, exporters retain the right to deduct input tax. Imported goods are taxed in the same way and at the same rate as domestic goods, with the tax applied at importation (based on customs value). Taxable persons treat VAT paid at importation as if it were input tax.

A similar rule applies to intra-European Union supplies of goods and to cross-border supplies of services supplied between taxable persons (B2B). In these cases, the buyer of the goods or services self-assesses tax due (effectively charging output tax on behalf of the seller) and recovers the self-assessed tax as input tax. [110]

---

105 OECD, International VAT/GST Guidelines, 14 (OECD Publishing, 2017).

106 Council Directive 2006/112 supra note 47, at art. 206.

107 Id. at art. 168.

108 Id. at art. 179.

109 Id.

110 To satisfy the principle that VAT is a tax on final consumers, VAT incurred on goods or services purchased by businesses that are not established in that jurisdiction may also be refunded as input tax. Under the terms of the EU VAT Directive, every EU Member State must refund VAT incurred by businesses that are neither established nor registered for VAT in that Member State. A non-established business may claim VAT to the same extent as a VAT-registered business in the Member State. However, different eligibility rules and procedures may apply to European Union and non-EU claimants. Council Directive 2006/112 supra note 47, at art. 171.

The very design of a VAT avoids tax cascading or pyramiding by allowing input VAT credits at each stage of the supply chain.

Small Businesses

Many EU Member States exempt small businesses that trade below a certain turnover (sales) threshold from VAT compliance obligations, including the obligation to charge output tax and the right to deduct input tax. The turnover threshold varies among EU Member States but is typically between $25,000 and $100,000.[111]

The ability to avoid VAT registration allows many small businesses to trade more effectively because they do not need to add VAT to prices charged to customers or comply with the detailed accounting and compliance obligations required of taxable persons (such as issuing VAT invoices and filing periodic VAT returns). However, most small businesses not registered for VAT inevitably pay VAT on inputs and bear it as a cost. The exemption for small businesses from EU VAT registration (or at least the option to not register) compares favorably with U.S. state sales tax systems. Most states have small business registration exemptions, but only for remote sellers, and not for all sellers.[112]

Tax Administration Benefits

Charging VAT at each stage of production also enhances tax administration and taxpayer compliance because it provides paper or electronic records throughout the supply chain. Under a VAT, businesses generally need not determine whether a business-to-business transaction is made to an exempt customer, as required in a sales and use tax system with a sale-for-resale or exempt-purchase certificate. The seller simply charges VAT and lets the business customer claim or not claim the input VAT on the business customer's VAT return. This makes it easier for government auditors by reducing gaps in the flow of business-to-business or business-to-consumer transactions.[113]

Tax Pyramiding is Minimized

The very design of a VAT avoids tax cascading or pyramiding by allowing input VAT credits at each stage of the supply chain. To obtain an input VAT credit, the business purchaser need not be in a favored industry such as manufacturing or agriculture as is often the case in a sales and use tax system. There is no need to distinguish between purchases for resale, purchases of ingredient and component parts, or purchases of machinery, equipment or software used in production or commercial activities. As long as the inputs are used in a supply chain in which output VAT is collected in the next stage (or the sale is zero-rated as with exports), then any VAT paid on such inputs is eligible for an input VAT credit.

---

111 Id. contains details of the VAT registration thresholds in each jurisdiction. On small business thresholds, see OECD, supra note 62, at 89–93.

112 VAT paid by taxable persons that is not allowable for an input tax credit is known as non-deductible input tax. Restrictions related to input tax may vary between Member States, but the limitations commonly apply to specific types of business expenditures that may have some personal or non-business usage (such as mobile phone costs, providing business gifts, purchasing and leasing cars, and business entertainment). The principles of any input tax deduction restrictions are governed by EU VAT law. Although these restrictions are important, they only apply to a small percentage of expenditures, and therefore do not represent a significant deviation from the "flow-through" principle of VAT.

113 See generally Alan Schenk & Oliver Oldman, Value Added-Tax: A Comparative Approach (Cambridge University Press, 2007). Charging VAT at each stage, however, can have the slightly opposite impact of requiring more sellers to register to collect the tax.

Generally, businesses incur nonrecoverable input VAT on their purchases only when no output VAT is due or collected on their sales. For example, purchases made by financial institutions and nonprofit healthcare or educational institutions get no input VAT credits because their outputs are exempt from VAT. Aside from financial institutions (exempt from VAT because of the complexities of imposing a consumption tax on financial transactions), most nonrecoverable input tax is borne by government and nonprofit businesses that are the primary service providers in sectors exempt from VAT. The goods or services sold by for-profit businesses (other than in the financial industry) are almost always subject to output VAT, and therefore these entities may recover the input VAT on their purchases or capital investments.

As a result, virtually all for-profit businesses other than those in the financial or real estate industries, are entitled to input tax credits, and thus are not effectively taxed on their business inputs.

2. The Canadian GST and Provincial Sales Tax Approach

Canada's hybrid consumption tax model approaches the taxation of business inputs in two very different ways. The GST/HST/QST consumption tax (covering six provinces and three territories with 80% of Canada's population) follows the EU VAT model and provides a broad credit for business inputs. The provincial sales tax (covering three provinces with 20% of Canada's population) follows the U.S. state retail sales tax model that provides no blanket exemption (or credit) for business inputs.

The GST/HST Approach to Input Credits and Exempt Supplies

The mechanism that ensures GST/HST is a tax on final consumption is the ability to obtain GST input tax credits.[114] Like the EU VAT, this is an essential feature of Canadian GST/HST. Businesses charge GST/HST on their sales (called output tax) and have a right to a credit for GST paid on business purchases, including direct inputs, overheads, and imports (called input tax). Because Canada's GST/HST system, like the EU VAT, distinguishes between taxable supplies and exempt supplies for business sectors, the system does not eliminate GST/HST on business inputs. However, unlike U.S. state sales and use taxes, which indiscriminately tax business inputs almost equally with consumer spending, the imposition of GST/HST on business inputs is limited to sectors in which the business output is not subject to tax (for example, healthcare, education, some real property transactions, and financial services).

As noted in Section II. A. 2., to the extent that GST/HST is imposed on business inputs as a nonrecoverable cost, in Canada it is limited primarily to the following categories of businesses not subject to GST on their sales:

- residential landlords
- doctors, dentists, and other healthcare professionals
- municipalities, universities, public colleges, schools, and hospitals
- financial institutions, including banks, credit unions, insurers, and broker dealers.

As a result, virtually all for-profit businesses other than those in the financial or real estate industries, are entitled to input tax credits, and thus are not effectively taxed on their business inputs. Consequently, the structural design of the GST/HST provides an input credit for purchases and investments by energy producers, manufacturers,

[114] ETA, supra note 64, at subsec. 169.

Virtually all states with sales taxes find it difficult to resist taxing business purchases of goods and services because of the significant revenue potential.

distributors, retailers, utilities, service providers, digital platforms and virtually all other for-profit businesses.

The Share of Business Inputs in Total GST Collections

A 2005 study based on data provided by Statistics Canada analyzed the share of GST revenues attributable to household consumption as compared to other sources. The study found that of the total GST revenues collected by the federal government, 83% was attributable to household consumption (i.e., GST paid by individual Canadians). The remaining 17% came from the non-recoverable GST incurred by businesses, non-profit organizations, and governments making GST-exempt supplies. Banks, insurance companies, and financial institutions accounted for about 8% of federal GST revenues, and medical, dental, and other healthcare professionals contributed about 2%. Residential landlords contributed about 3% of total federal GST revenues, and the remaining 4% was incurred by public sector bodies (universities, colleges, schools, hospitals, charities, and not-for-profit organizations) (see Figure 14).[115]

The Canadian GST/HST and Retail Sales Tax: Two Very Different Approaches to Taxing Business Inputs

While the Canadian GST follows the structural design of the EU VAT by providing a credit for business inputs, the three Canadian provinces with retail sales taxes follow the U.S. retail sales tax model with no comprehensive exemption for business inputs. Like U.S. state sales tax systems, taxation of business inputs is deeply embedded in Canadian provincial sales tax systems. Thus, the share of business inputs as a percentage of provincial sales tax is much higher than with the GST, likely approaching the two-fifths or higher levels of U.S. sales tax systems.[116]

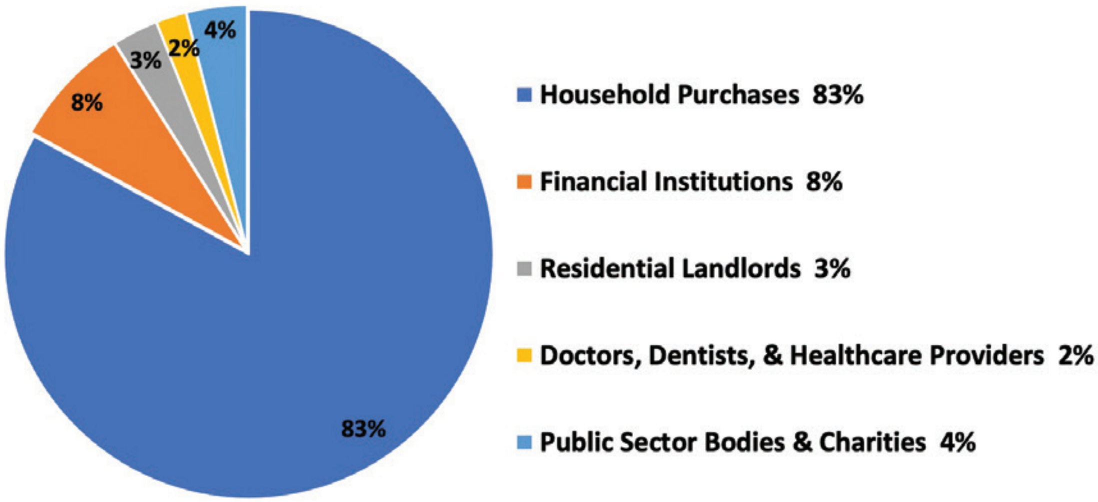
3. The U.S. State Sales Tax Systems' Approach

Unlike the EU VAT or the Canadian GST, U.S. state and local sales taxes are not grounded on a consumption tax principle that exempts business inputs. Instead, household consumption and business inputs are included in state and local sales tax bases depending on a state-by-state process that reflects a haphazard mix of history, political expediency and finances. Virtually all states with sales taxes find it difficult to resist taxing business purchases of goods and services because of the significant revenue potential. Although inclusion of business inputs in the sales tax base violates a key principle of an efficient and effective consumption tax and contributes to the

115 David Douglas Robertson, Don't Tax Me When I Earn It, Tax Me When I Spend it: Why Cutting the GST is the Wrong Choice for Canadians, at 3 (paper presented in Toronto, Ontario on Mar. 15, 2006). These percentages were provided by Statistic Canada and are based on the years 2000 to 2002. This study has not been updated, but those businesses not entitled to input tax credits—financial institutions, doctors, dentists, healthcare professionals, residential landlords, etc.—have remained the same since then. The only significant change in the intervening years would likely increase the share of total GST revenues attributable to household consumption, because the federal government now provides a 100% rebate (instead of 57%) to municipalities for the GST they incur, which lowers the share of GST paid by public sector institutions.

116 See Bird, Is a State VAT the Answer? What's the Question?, State Tax Notes 815 (Sept. 24, 2007); "Even more common in an RST [retail sales tax] system is tax cascading. As RSTs tax business consumption, RST becomes a cost which a business must take into consideration in determining their selling price. If they are selling RST-taxable goods, RST must also be paid by their customers. If their customers are other businesses selling RST-taxable goods, RST [is] now being paid at two stages of the economic chain and will once again be paid at a third when that business sells their product. In this way, RST cascades from one transaction to another, such that the embedded RST cost on a particular good is generally substantially higher than the RST actually paid by the final consumer purchasing for their personal use." Robertson, supra note 83, at 20.

FIGURE 14. SHARE OF CANADA GST PAID BY HOUSEHOLDS (83%) VS. BUSINESS/NON-PROFITS (17%)



The consistency of state sales tax systems' reliance on business inputs for an average of two-fifths of state sales tax bases clearly reflects a design flaw in retail sales tax systems that have no overarching principle or structural mechanism for excluding business inputs.

cascading of sales taxes (*e.g.*, taxing both inputs and outputs in the same related transactions), the practice remains a dominant feature of U.S. sales tax systems.

The cumulative impact of the failure to exempt business inputs from the U.S. sales tax is evident from the high share of total U.S. sales and use tax accounted for by business inputs. According to a study by Ernst & Young, in fiscal year 2017 state and local sales taxes on business inputs totaled 41.7% of aggregate state and local sales taxes.[117] No state had a share of sales tax on business inputs lower than Indiana at 32%. The business share of sales tax varied by state, from 32% in Indiana to 60% in New Mexico, and it exceeded 50% in five states (see Figure 15).[118]

The relative sales tax burden on businesses has been virtually unchanged during the last two decades despite a substantial growth in sales tax revenues. The first Ernst & Young study of the sales taxation of business inputs for fiscal year 2003 found that sales tax collections on business inputs totaled 43% of total state and local sales taxes, similar to the 42% estimated for fiscal year 2019[119] Indeed, earlier studies based on data for 1979 and 1989 reached a similar conclusion with the business input share of sales tax at approximately 41%.[120] The consistency of state sales tax systems' reliance on business inputs for an average of two-fifths of state sales tax bases clearly reflects a

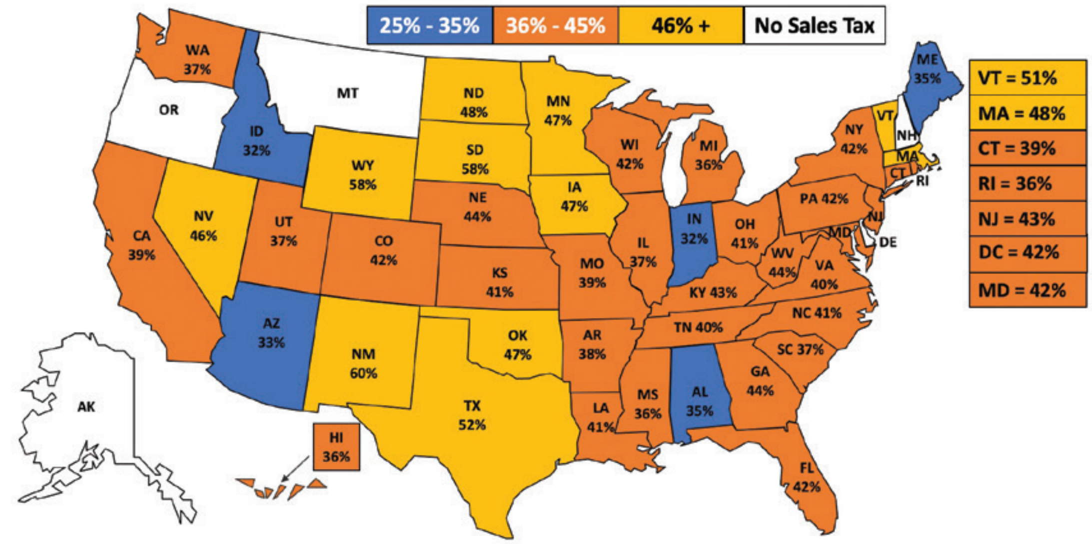
117 EY, supra note 3, at 7.

118 Id. at 9.

119 For the 2003 statistic on Figure 16, see Robert Cline et al., Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services, Council On State Taxation 1, 5 (Jan. 25, 2005). For the 2011 statistic on Figure 16, see Robert Cline, et al., What's Wrong with Taxing Business Services?: Adverse Effects from Existing and Proposed Sales Taxation of Business Investment and Services, Council On State Taxation 2 (Apr. 4, 2013). For the 2019 statistics on Figure 16 see EY, COST, & STRI, Total State and Local Business Taxes: State-by-State Estimate for Fiscal Year 2019 (Nov. 2020), supra note 3, at 2.

120 Raymond J. Ring, Jr., *The Proportion of Consumers and Producers' Goods in the General Sales Tax,* 42 Nat'l Tax J. 167, 167–179 (1989); Raymond J. Ring, Jr., *Consumers' Share and Producers' Share of the General Sales Tax,* 52 Nat'l Tax J. 79, 79–90, (1999). The business inputs data in these studies includes a small portion of government and non-profit organization purchases, but no household consumption.

FIGURE 15. BUSINESS INPUTS MAKE UP 42% OF ALL STATE AND LOCAL SALES TAXES BUSINESS INPUTS SHARE OF TOTAL SALES TAX COLLECTED



The Impact of Imposing Sales Taxes on Business Inputs, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (May 2019)

design flaw in retail sales tax systems that have no overarching principle or structural mechanism for excluding business inputs (see Figure 16).

This structural flaw in retail sales taxes is particularly evident in the five states that rely on sales taxes for 50% or more of their total state tax revenues: Florida, Nevada, South Dakota, Tennessee, and Texas. None of these states impose a personal income tax, which explains in large part the heavy reliance on sales taxes. Of these five states, Tennessee (at 40%) is the only one with a business inputs share of all sales taxes less than the national average of 42%. The business inputs share for the other four states are: Florida (42%); Nevada (46%); Texas (52%); and South Dakota 58% (see Figure 17).[121]

Business Purchase Exemptions from Sales Tax

State sales tax systems in the United States generally include both household and business purchases in the sales tax base, but exempt certain business-to-business transactions, including sales for resale of the same product, without value added, between manufacturers, distributors, and retailers. For example, a refrigerator sold by a manufacturer to a distributor, to a retailer, and then to the ultimate household consumer would only incur tax on the final sale.

Similarly, certain industries, such as manufacturing, enjoy broader sales tax exemptions both for the machinery used in production and the ingredient and component parts that make up the final product. Manufactured products are ultimately resold, so the equipment, supplies, and materials consumed in a manufacturing operation should be exempt from a state's sales tax. However, even here, significant variations exist among states. Twelve states currently allow no or significantly restricted exemptions for

---

[121] EY, supra note 3, at 8; Mikesell, supra note 85, at 1344.

FIGURE 16. HISTORICAL TREND OF BUSINESS INPUTS AS A SHARE OF ALL STATE AND LOCAL SALES TAXES

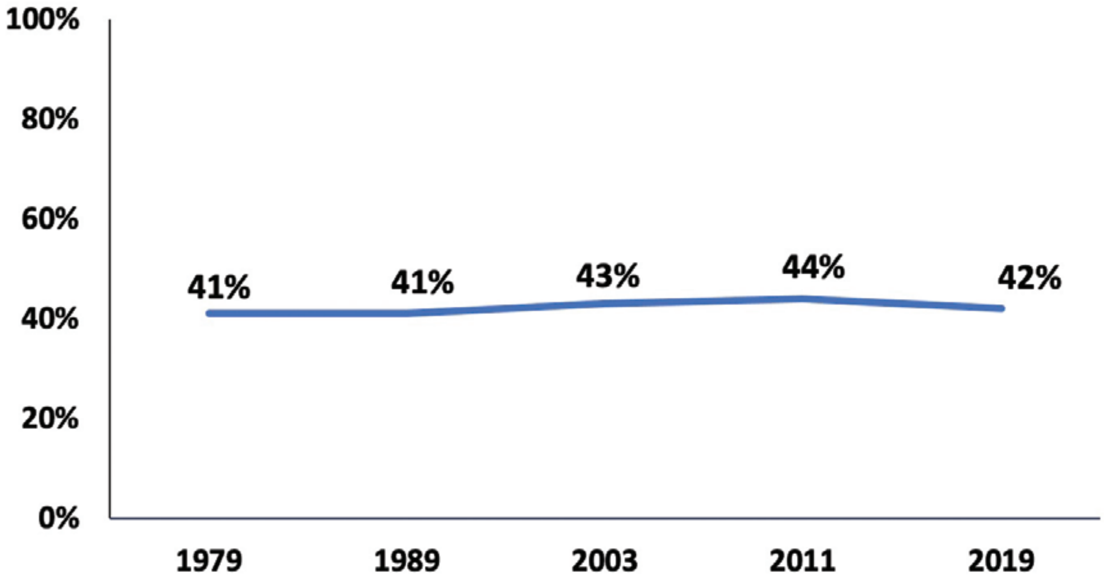


FIGURE 17. STATES WITH 50% OR MORE RELIANCE ON SALES TAX REVENUE

States	Sales Tax as a Percentage of all State Taxes	Business Inputs as a Share of all Sales Taxes
Florida	64%	42%
Nevada	53%	46%
South Dakota	63%	58%
Tennessee	52%	40%
Texas	62%	52%

Other than a few favored industries, the sales taxation of business inputs is widespread and arbitrary.

machinery used in manufacturing, while only two states allow broad exemptions for all inputs purchased in the manufacturing process similar to what is available under the EU VAT or Canadian GST (see Figure 18).[122]

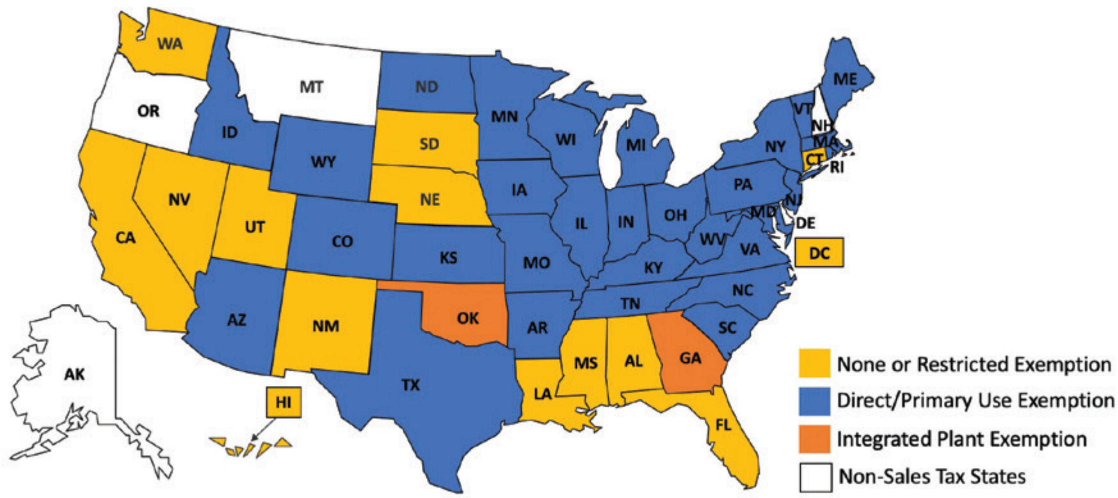
Other than a few favored industries, the sales taxation of business inputs is widespread and arbitrary. Inclusion of business inputs in the tax base follows no consistent philosophy, but rather a state-by-state process that reflects a haphazard mix of politics and finances. While the business input share of state and local sales taxes varies between 32% and 60% among the states, certain industries such as telecommunications, electric and gas utilities, cable television, retail trade, and information services are much more likely to see both business inputs and outputs subject to sales tax.[123]

122 Sales Tax Scorecard, supra note 84, at 9.

123 EY, supra note 3, at 13–14, 25.

. . . **the taxation** of business-to-business transactions creates large and widespread distortions that affect all sectors of a state's economy.

FIGURE 18. MANUFACTURING INPUT SALES TAX EXEMPTIONS BY STATE



The Best and Worst of State Sales Tax Systems: COST Scorecard on Sales Tax Simplification, Uniformity, & the Exemption of Business Inputs **(April 2018)**

Pyramiding of State Sales Tax

One of the key ramifications of taxing both inputs and outputs in certain industries is the economically inefficient pyramiding of sales taxes. The chart below illustrates the extensive pyramiding from sales taxes on inputs and outputs in the telecommunications, cable, electric, and natural gas utility sectors. Of the forty-five states and D.C. with sales taxes, only nine do not double tax any of these three service industries. Ten states double tax one of them, sixteen impose a double tax on two of them, and eleven double tax all three (see Figure 19).[124] By comparison and based on their structural designs, no pyramiding of tax occurs in any of these industries under the EU VAT and the Canadian GST.

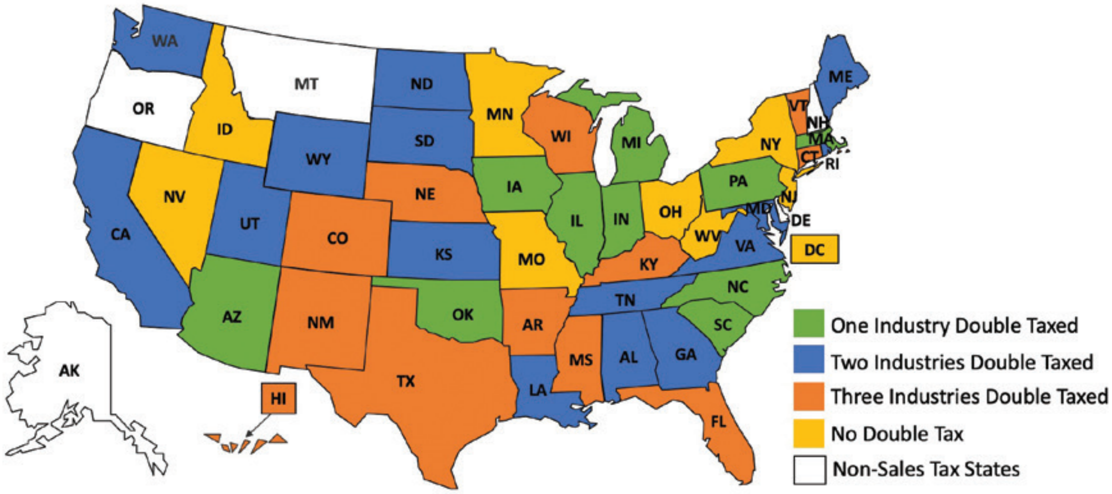
The pyramiding of sales tax on both business inputs and outputs is an undesirable outcome because it affects business choices such as location of jobs and investment, input purchases, and organization of business structures. Pyramiding adds substantially to the supply chain costs of production or provision of services in a state and for the entire nation, thus discouraging capital investment and penalizing exports. It favors larger organizations that can internalize some costs without incurring sales taxes, putting smaller businesses at a significant cost disadvantage purely because of a distortive sales tax policy. Although all taxes have some distortive effects, the taxation of business-to-business transactions creates large and widespread distortions that affect all sectors of a state's economy. The extensive inclusion of business inputs in the sales tax base undercuts the primary advantage of taxes on general consumption over other tax types—that they can raise substantial revenues with the least impact on business and economic growth.[125]

From a public policy perspective, the irrationality of basing a consumption tax almost equally on business inputs and household consumption is highlighted by a

[124] Sales Tax Scorecard, supra note 84, at 10.

[125] See generally, EY, supra note 3.

FIGURE 19. CASCADING TAXES: THE U.S. SALES TAXATION OF BUSINESS INPUTS IN TELECOMMUNICATIONS, CABLE, AND ELECTRIC AND NATURAL GAS UTILITIES



The Best and Worst of State Sales Tax Systems: COST Scorecard on Sales Tax Simplification, Uniformity, & the Exemption of Business Inputs (April 2018)

comparison of the state and local tax revenues raised by the sales taxation of business inputs and the income taxation of business corporations. In fiscal year 2019, the aggregate state and local sales tax collections on business inputs totaled $177.3 billion compared to corporate income tax collections in the same year of $77.1 billion.[126] Thus, sales tax collections on business inputs were about two and one-third times larger than total combined state corporate income tax collections. In terms of the share of total state and local taxes imposed on businesses, sales taxes on business inputs accounted for 21.3% of such taxes, compared to 9.3% for state corporate income taxes.[127] Ideally, a well-designed consumption tax would never tax for-profit businesses on input purchases, let alone collect far more tax revenue from businesses under the sales tax than under the corporate income tax.

The Political Consequences of Taxing Business Inputs

Strong historical evidence suggests that the failure of states and localities to exclude business inputs from the sales tax base is a critical factor precluding states from taxing a wide range of consumer services and preventing the sales tax share of all taxes from growing. Over the last thirty years, about one-quarter of the sales tax states tried to enact sweeping sales tax reform that would extend the sales tax base to cover all or most services. The state and local political landscape is littered with failed legislative efforts to comprehensively expand the sales tax base to services, even when such legislation received high-level gubernatorial or legislative support. Among the states where base broadening legislation failed, or was enacted and almost immediately repealed, are Florida (1987), Massachusetts (1991), Maryland (2007), Michigan

[126] Estimates of business taxes by tax type are from EY, COST, & STRI, supra note 3, at tbl.1. The sales taxes imposed on business purchases do not include sales taxes collected by business on sales to households.

[127] Id.

(2007), Nebraska (2013), Ohio (2013), Louisiana (2013), Minnesota (2013), Maine (2015), Pennsylvania (2015), Utah (2019), Mississippi (2021), and West Virginia (2021) (see Figure 20).[128]

Several factors have contributed to the failure of states to enact transformative sales tax base expansion, including the difficulty of enacting large-scale tax reform, the objection of impacted service providers, and the general public's resistance to new taxes.[129] The most important factor, however, has been the principled opposition from the business community to expanded sales taxation of business inputs.[130] Generally, the business community did not object to the state's broadening of the sales tax base to include a wide range of household services, but did object to the inclusion of business-to-business services in the tax base. By now, the historic lesson should be clear: states that include business purchases in sales tax base expansion not only diverge from theoretical norms of an ideal consumption tax system, but also risk near-certain defeat of comprehensive base-expansion legislation.

Conversely, in the event that some states escape this political "Catch-22" and manage to expand the sales tax base to include a wide range of both business and household services, the outcome will be even more damaging to state tax policy and economic growth than the current situation.[131] For instance, two-thirds or more of all legal services, data processing and other information services, and waste management and remediation services are purchased by businesses that produce other goods or services.[132] The business share of sales tax base expansion to services legislation was estimated at 70% in Florida (1987), 80% in Minnesota (2013), and 90% in Nebraska (2013).[133] If states enact legislation to expand the sales tax base to encompass most or all services, the proportion of all sales taxes paid by businesses will rise significantly from the current 42% share.

---

128 Id. at 16–21. Mississippi and West Virginia in 2021 are the latest states to attempt a significant sales tax base broadening initiative. Both legislative proposals, backed by Republican governors in each state, would reduce or eliminate the state personal income tax, but as a tradeoff, would significantly expand the sales taxation of business inputs and increase the sales tax rate. On Mississippi, see Katherine Loughead & Jared Walczak, Evaluating Mississippi's Plan to Phase Out the Individual Income Tax, Tax Found. Fiscal Fact No. 752 (Mar. 2021).

129 EY, supra note 3, at 16-21. In recent years, several states such as Maine and Pennsylvania included at least a partial exemption for business inputs in their proposed legislation to significantly expand the sales tax base to services. While these legislative initiatives failed for other political or policy reasons, they do reflect an awareness among some states of the structural flaws within the current sales tax structure. Utah provides a compelling example of the political straitjacket for states that try to expand their sales taxes to include services. In 2019, Utah tried to enact sweeping sales tax base expansion legislation that would have included most services in the tax base. Utah had several things working in its favor: a united political leadership with Republican party control of the Governor's office and both houses of the Legislature; a business-friendly state administration that was undeterred by political arguments against the expansion of a consumption tax; and a compelling need for the replacement of other tax revenues with sales tax revenues because of a constitutional restriction on the use of income tax revenues for certain budget purposes. Nonetheless, the legislative proposal did not adequately exempt business inputs, and met fierce opposition from the business community. Subsequent revised legislation relied too heavily on the addition to the base of food for home consumption, which drew the ire of the more progressive elements of the electorate. In the end, the state gave up its efforts to expand the sales tax base and instead sought revenues from another source. See generally, Billy Hamilton, Taking the Plunge on Sales Tax Modernization in Utah, State Tax Notes (June 24, 2019).

130 EY, supra note 3, at 16–21.

131 For example, two law professors recently advocated a broad expansion of the sales tax base to tax more digital services. They acknowledged that an ideal consumption tax system should exempt business purchases, but they illogically supported the taxation of business purchases of digital services based on the need to create "parity" with the existing (and substantial) taxation of business purchases of tangible property. Orly Mazur & Adam Thimmesch, Closing the Digital Divide in State Taxation: A Consumption Tax Agenda, State Tax Notes 966 (Nov. 30, 2020). In the 2021 legislative session, two additional states, Mississippi and West Virginia have sweeping proposals to broaden the sales tax base and increase the sales tax rate in exchange for a significant reduction or elimination of the personal income tax.

132 EY, supra note 3, at 18.

133 Robert Cline, et al., supra note 119, at 13, 16–17.

FIGURE 20. STATES WITH FAILED BROAD-BASED EXPANSION OF SALES TAX TO SERVICES

State	Year	Party of Governor	Result of Legislation
Florida	1987	Republican	Repealed after 6 months
Massachusetts	1990	Democratic	Repealed after 3 days
Maryland	2007	Democratic	Repealed after 5 months
Michigan	2007	Democratic	Repealed after 1 day
Louisiana	2013	Republican	Not Enacted
Minnesota	2013	Democratic	Not Enacted
Nebraska	2013	Republican	Not Enacted
Ohio	2013	Republican	Not Enacted
Maine	2015	Republican	Not Enacted
Pennsylvania	2015	Democratic	Not Enacted
Utah	2019	Republican	Not Enacted
Mississippi	2021	Republican	Not Enacted
West Virginia	2021	Republican	Not Enacted

. . . the overall share of the Canadian GST accounted for by business inputs (17%) is only about two-fifths of the share of business inputs in the U.S. sales and use tax (42%).

4. Summary: Business Input Exemptions in the EU VAT, Canadian Hybrid System, and U.S. State Sales Tax Systems

The structural design of the EU VAT satisfies the second principle of an optimal consumption tax. Business inputs may initially be subject to VAT, but a business can obtain an input VAT credit if its output is subject to VAT or is zero-rated in the case of exports. Indeed, the elimination of the cascading of taxes and the beneficial impact of this change on business investment and international competitiveness was the primary reason why virtually all industrialized nations replaced retail sales taxes and turnover taxes with VATs.

In Canada, the GST/HST (covering 80% of the country's population), follows the EU VAT model with a broad credit for business inputs, satisfying the second principle of an optimal consumption tax. As with the EU VAT, the elimination of tax on business inputs with its beneficial impact on international trade was the primary reason for the replacement of Canada's national manufacturers wholesale tax and eventually most provincial sales taxes by the GST/HST. Before the switch to the GST/HST, the national manufacturers tax had relied on the taxation of business inputs for almost one-half of its revenue.[134] That historic shift was successful because the overall share of the Canadian GST accounted for by business inputs (17%) is only about two-fifths of the share of business inputs in the U.S. sales and use tax (42%). Conversely, Canada's remaining three provinces (with 20% of the nation's population) follow the U.S. state sales tax model and do not exempt all or even most business inputs.

Finally, U.S. state sales tax systems, unlike other advanced nations' consumption tax systems, rely on business inputs for a significant share of the state sales tax base, thus violating the second principle of an optimal consumption tax. The U.S. general consumption tax system is a mix of a sales tax on final household purchases

[134] Richard M. Bird, *The GST/HST: Creating an Integrated Sales Tax in a Federal Country 5–6* (Rotman School of Mgmt., Working Paper No. 2115620, 2012).

The failure of U.S. state sales tax systems to exclude business inputs from the tax base is the single most important factor preventing the United States from having a viable broad-based consumption tax.

and (in effect) a gross receipts tax on a large portion of business purchases in the supply chain. This outcome is due both to the structural design of retail sales taxes and the political appeal of taxing business inputs. In terms of structural design, the retail sales tax has no built-in mechanism to exempt business inputs, as do VAT/GST consumption tax systems. Further, to the extent state sales tax systems have historically relied heavily on business inputs for at least two-fifths of the sales tax base, it is difficult for states to forgo the revenue because of the political appeal of taxing businesses over individuals, and the lack of transparency of the actual effective rates of cascading/pyramiding sales tax systems.

The failure of U.S. state sales tax systems to exclude business inputs from the tax base is the single most important factor preventing the United States from having a viable broad-based consumption tax. This failure subverts the ability of the sales tax to operate as a more economic-growth-friendly (or growth-neutral) consumption tax because so much of the tax burden is on business. This failure also virtually eliminates the possibility that the sales tax can be used as a scalable consumption tax to balance the overall U.S. tax composition because any increase in the sales tax rate or expansion of the sales tax base will likely fall heavily on business, and thus engender strong business opposition.

C: CENTRALIZED AND SIMPLIFIED TAX ADMINISTRATION

The third principle of an optimal consumption tax is centralized and simplified tax administration. The benefits of a harmonized and broad-based tax on household goods and services can be eroded if tax administration is too decentralized or if taxpayer compliance is overly complex and burdensome. Centralization and simplification are particularly important when a tax system includes multiple levels of government such as the tax systems examined in this study: the European Union (European Union and national government levels); Canada (federal and provincial levels); and the United States (federal, state, and local levels).

1. The EU VAT Approach

National Tax Administration of the EU VAT

The EU VAT rules essentially divide harmonization and administration requirements into two categories. First, at the EU level, Member States must harmonize the VAT tax base both in terms of what is included and what is excluded. With few exceptions, the VAT tax base is the same in every member country. Some administrative rules are also harmonized at the EU level. Second, the VAT itself is administered at the national level in each Member State. Subnational VATs do not exist, nor is any EU Member State permitted to add a local component. Even in EU Member States with a federal structure (Austria, Belgium, Germany) or a regional structure (Spain), no subnational or local VATs are permitted.[135]

[135] OECD, supra note 15, at tbl.3.15. Certain EU Member States (such as Austria, Greece and Portugal) apply different VAT rates in different regions of those countries (as permitted by EU law); however, these different rates still apply to the common tax base.

The VAT collected by taxable persons at each stage in the supply chain is remitted to the national tax authorities of each EU Member State.[136] The VAT Directive imposes a high degree of harmonization on EU Member States' VAT systems, but these requirements do not generally apply to most VAT tax rates, administrative procedures, and compliance rules. These are matters where EU Member States often have a high degree of autonomy, and in practice there is little uniformity of administrative practices between jurisdictions.

The VAT Directive imposes a high degree of harmonization . . . but these requirements do not generally apply to most VAT tax rates, administrative procedures, and compliance rules.

VAT Rates are Not Harmonized

The VAT Directive sets the framework for VAT rates in the European Union, but gives national governments freedom to set the number and level of rates they choose, subject to basic rules. In practice, VAT rates are not uniform across the European Union, nor does any EU Member State apply a single VAT rate to all taxable goods and services. This fact adds greatly to the degree of complexity of VAT for taxable persons who must determine the correct VAT rate for every transaction as it occurs.[137]

Each EU Member State must designate a standard VAT rate.[138] This is the default VAT rate that EU countries must apply to all goods and services (unless a specific provision permits a reduced rate or provides an exemption).[139] The standard rate is not uniform across all EU Member States and is not harmonized as such. The standard rate must be at least 15%, but no maximum is specified in EU law.[140] However, EU Member States may not impose a rate higher than their standard rate to any goods or services. Currently, the standard VAT rate in the European Union ranges from 17% in Luxembourg to 27% in Hungary. The EU VAT standard tax rates are generally higher than those in other OECD nations. For instance, over one-half of the OECD countries that are not EU Member States impose standard VAT rates of 17% or less, including Australia (10%), Canada (5% at the national level), Israel (17%), Japan (8%), Korea (10%), New Zealand (15%), and Switzerland (7.7%).[141]

Reduced Rates of VAT

The VAT Directive provides that EU Member States may also apply one or two reduced rates,[142] which may be applied to goods or services listed in Annex III of the VAT

---

136 A small proportion of the VAT collected by each EU Member State is remitted by it to the European Union in the form of a levy. The coordinated administration of VAT within the EU VAT area is an important part of the Single Market. For example, EU Member States share information with businesses about valid VAT identification numbers. Cross-border VAT is declared in the same way as domestic VAT, which facilitates the elimination of border controls. All EU Member States are also required to collect statistical information about intra-EU supplies of goods (INTRASTAT).

137 This position in the European Union contrasts with the situation in some of the VAT and GST regimes introduced in recent years, such as in the Gulf Cooperation Council (GCC) States where a single rate applies in all GCC Member States.

138 Council Directive 2006/112 supra note 47, at art. 96; Council Directive 2018/912, 2018 O.J. (L 162) 1 (EU).

139 EY, Worldwide VAT, GST and Sales Tax Guide 2020 (2020), contains details of VAT rates applied in individual jurisdictions

140 Council Directive 2006/112 supra note 47, at art. 97.

141 OECD, supra note 62, at 66–67.

142 Council Directive 2006/112 supra note 47, at art. 98(1).

Directive[143] and must be at least 5%.[144] In practice, multiple exceptions apply to these requirements for reduced rates. Largely for historical reasons and subject to certain conditions, most EU Member States can depart from these requirements in some way—enabling jurisdictions to keep reduced rates under 5% (including zero rates) and to apply reduced rates to goods and services other than those listed in the Directive.[145]

Currently, reduced rates levied in the European Union range from 0% to 18%.[146] Although the EU tax base is highly harmonized (as the same items are within the scope of VAT), the actual amount of tax borne by final consumers may vary between EU Member States depending on the individual country's mix of tax rates and list of goods and services that may benefit from a rate reduction.

Often, rate differentials offset the slight regressivity of the VAT. Reduced rates, super-reduced rates, and zero rates apply to food items and other basic necessities which, on average, represent a bigger portion of the expenditure of lower income households. Reduced rates are an inefficient way to address regressivity (they also exempt higher income household consumption), and government transfer programs remain the primary method to offset regressivity.

The EU Commission and many economists believe that the number of different rates and the wide VAT rate variations distort the EU VAT system and lead to difficulties for businesses, especially those that operate in multiple EU Member States.[147] The rise of digital commerce has led to additional strains on the EU VAT rate structure. The rate differentials undercut some of the benefits of VAT base harmonization achieved by EU-wide rules. However, EU VAT rules preclude separate rates at the subnational or local levels, sparing taxpayers the confusion and compliance burden associated with provincial-level tax rates in parts of Canada and state and local tax rates in the United States.

Tax Administration Rules

The frequency of domestic VAT reporting and payments, and the form and manner of making VAT declarations, also differ widely between EU Member States. For example, Article 252 of the VAT Directive simply says that domestic VAT returns must be made "at least once a year." In practice, many EU countries require returns more frequently, generally every month or quarter, and businesses with a high turnover are also generally required to make returns and/or payments more frequently. Similarly,

---

143 Id. at art. 98(2).

144 Id. at art. 99.

145 Id. at art. 102–128.

146 The European Commission publishes annual summaries of the reduced rates applied by EU Member States and their scope. VAT rates applied in the European Union as of January 1, 2019. This list indicates some of the wide variations that apply in practice not only as to the rate applied but also to the goods and services that benefit from reduced rates. For example, an item of baby's clothing may be taxed at the 0% rate (in Ireland and the UK), at the 3% rate (in Luxembourg) or at the 27% rate (in Hungary). *VAT rates applied in the Member States of the European Union,* COM (2020), https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/ vat/how_vat_works/rates/vat_rates_en.pdf.

147 The EU Commission has long maintained that EU Member States need to streamline and align their VAT rates for the effective functioning of the EU Single Market. The obvious concern is that different VAT rates applied in different EU Member States create distortions of competition, as they could encourage final consumers and VAT-exempt businesses to acquire goods and services from countries with the lowest VAT rates. See generally Ben Terra, The Ordeal of VAT Harmonisation in the EU (B. Terra ed., 2019). In part, these concerns are countered by rules that tax consumption in the country of destination not in the country of origin. For businesses, this is largely achieved through requiring self-assessment for VAT on intra-Community purchases of goods and services. For final consumers, this is achieved by measures that require suppliers to register for VAT and charge VAT in the customer's country.

processes for tax audits, assessments, and domestic appeals procedures; penalties that apply to errors; or processes that permit voluntary disclosures depend on domestic legislation and are not mandated at the EU level.

Taxable persons operating in multiple EU Member States may find these aspects of VAT compliance and administration particularly burdensome, as the differences between EU Member States make it difficult to adopt efficient centralized VAT accounting and compliance processes. The lack of EU-level harmonization of VAT administrative rules is a constant source of frustration for both tax administrators and large multinational taxpayers, adding significantly to tax compliance costs and VAT input tax fraud. In 2020, the European Union initiated a new four-year program to address the complexity in EU VAT administrative rules, make VAT compliance simpler and fairer, and take advantage of modern technologies. The potential success of these measures remains uncertain as the European Union has stumbled before in trying to rationalize EU VAT administrative rules.[148]

Recent EU Success Towards Uniform Reporting Rules Relating to Digital Commerce

While EU Member States are granted a significant amount of autonomy over administrative rules at the national level, they still work together at the EU level where collective rules are advantageous. The development of certain uniform administrative rules at the EU level is especially evident in connection with digital commerce. While the general rule specifies that each taxable person must register for VAT in every EU Member State where it supplies taxable goods or services, an exception has been carved out for digital commerce. The mini One-Stop Shop (MOSS)[149] scheme allows a taxable person that provides digital services remotely to register for VAT in one EU Member State (the EU Member State of establishment) while charging the correct VAT rate in each customer's country of residence. These new rules illustrate the flexibility of the EU VAT to harmonize not only substantive tax base rules, but some key administrative rules as well.

Input Tax Fraud

The input/output tax mechanism that allows VAT to flow through the supply chain is clearly an important factor in its design, and arguably one of its greatest strengths. Fractional receipts can improve government cash flow and can also protect tax

148 The main objectives of the "Tax Package for Fair and Simple Taxation" include reducing tax obstacles and unnecessary administrative burdens for businesses in the single market; assisting EU Member States in enforcing existing tax rules and improving tax compliance; and helping tax authorities combat tax fraud and evasion more effectively by making better use of existing data and sharing new data more efficiently. See generally Aleksandra Bal, Emerging From Crisis: The Changing EU VAT Landscape 394, Tax Notes Int'l (Oct. 19, 2020).

149 The VAT mini One Stop Shop (MOSS) is an optional scheme that allows businesses to account for VAT—normally due in multiple EU countries—in just one EU country. Businesses that supply cross-border telecommunications, television and radio broadcasting, or digital services to non-taxable persons may be eligible for the scheme. Services covered under the MOSS scheme include website hosting, supply of software, access to databases, downloading apps or music, online gaming, and distance teaching. MOSS means businesses that engage in these activities that otherwise must register with tax authorities in every EU country they sell to, may instead register for VAT, file VAT returns and make payments in one single place. Businesses must apply the rules of the MOSS scheme to their customers in all EU countries they supply to. Two schemes run under MOSS: the union scheme, for businesses established in the European Union or with at least one branch based in an EU country; and the non-union scheme, for businesses not established in the European Union and without any branches based in the European Union. *VAT on digital services (MOSS scheme),* Eur. Union (last visited Sept. 16, 2020), https://europa.eu/youreurope/business/taxation/vat/vat-digital-services-moss-scheme/index_en.htm.

revenues, because if one business in the supply chain does not comply with its obligations, the whole tax amount is not lost.

However, this mechanism can also make VAT vulnerable to certain types of fraud. In general, taxable persons are trusted to be tax collectors. If they do not fulfill their obligations, the revenue may be lost. Also, taxable persons can be paid funds out of government revenues with respect to their purchases if the input tax due exceeds the output tax chargeable in a period. The right to input tax recovery arises when a taxable person is in possession of a valid VAT invoice—even if the purchaser has not paid the supplier, and even if the supplier has not yet paid the output tax to the tax administration.

Fraudulent parties have exploited these aspects of the VAT system by creating fake invoices to gain unjustified repayments of VAT; by creating fictitious cross-border supplies allowing recovery of VAT paid; and by charging and collecting VAT and disappearing before the tax is paid to the tax administration.

To address these issues, in recent years EU Member States have been permitted to vary some rules related to VAT accounting to protect their VAT revenue receipts.[150] For example, an EU Member State may introduce the obligation for the customer to self-assess VAT in certain circumstances or in certain sectors (effectively removing the opportunity for the supplier to go missing with the VAT charged, and removing the right of the customer to obtain a VAT refund from the Member State's budgetary resources).

VAT Compliance Gap

The minimal harmonization of administrative rules or tax rates at the EU level ensures that complying with EU VAT rules in multiple countries is challenging for multinational businesses. The relatively high tax rates imposed on VAT in EU Member States provide an incentive for minimization of VAT payments or outright fraud. The European Union itself measures and reports on the compliance VAT Gap, basically the difference between the amount of VAT collected by each EU Member State and theoretical VAT Total Tax Liability (VTTL) based on laws enacted in that country. In its 2019 report, the European Union reported that the VAT Gap share of the VTTL was 11.2% in 2017.[151] Key factors in the compliance gap are input VAT fraud and other types of non-compliance such as underreporting of retail sales. The compliance gap suggests that the EU VAT, while significantly harmonized and simplified, still creates significant enforcement challenges for individual EU countries and compliance issues for multijurisdictional taxpayers.

2. The Canadian GST and Provincial Sales Tax Approach

Administration of the GST/HST System

In Canada, the degree of centralized and simplified tax administration varies based on the tax regime in different provinces (see Figure 21). About 57% of the population lives in the six provinces and three territories that implement a harmonized GST/HST system with one national tax authority, one tax return, and one tax base. Roughly 23% of the population lives in Quebec, which has a GST/QST system with two tax authorities (national and provincial), two tax returns, and one tax base. The

[150] Council Directive 2006/112, supra note 47, at art. 199.

[151] CASE, supra note 61.

FIGURE 21. CENTRALIZED CONSUMPTION TAX ADMINISTRATION: CANADA

POPULATION – CANADA	2017	% of Total	Sales Tax
Canada	36,708,083		
Newfoundland and Labrador	528,817	1.4%	GST/HST
Prince Edward Island	152,021	0.4%	GST/HST
Nova Scotia	953,869	2.6%	GST/HST
New Brunswick	759,655	2.1%	GST/HST
Quebec	8,394,034	22.9%	GST & QST
Ontario	14,193,384	38.7%	GST/HST
Manitoba	1,338,109	3.6%	GST & PST
Saskatchewan	1,163,925	3.2%	GST & PST
Alberta	4,286,134	11.7%	GST
British Columbia	4,817,160	13.1%	GST & PST
Yukon	38,459	0.1%	GST
Northwest Territories	44,520	0.1%	GST
Nunavut	37,996	0.1%	GST

Summary	
GST/HST – One Administration, One Tax Base	57%
GST & QST –Two Administrations, One Tax Base	23%
GST & PST – Two Administrations, Two Tax Bases	20%

remaining 20% of the population lives in three provinces with two tax authorities (national and provincial), two tax returns, and two tax bases.

Canada's GST/HST system is administered by a single tax authority, the Canada Revenue Agency (CRA), on behalf of the federal and provincial governments—at least for those provincial governments (making up over one-half of the population) that have elected to "harmonize" with the federal GST/HST system. At a practical level, this means that a business registered for GST/HST purposes files a single GST/HST return with the CRA—either monthly, quarterly, or annually—reporting the GST/HST collectible by the business in the relevant period, deducting all GST/HST payable (claiming such amounts as input tax credits), and remitting the difference (the "net GST/HST"). Businesses are not required to track GST/HST for the various provinces separately. Significantly, this also means that a GST/HST-registered business is only subject to audit by a single tax authority, the CRA, with respect to GST/HST compliance; and all assessments, objections, and appeal procedures follow federal rules.[152]

The Quebec Sales Tax Model

The administration of the QST is different than the other five provinces with HSTs. The Minister of Revenue of Quebec administers both the federal GST and the QST for all businesses based in the province.[153] The federal government administers GST/HST and QST for all Selected Listed Financial Institutions based in Quebec (and in the rest of Canada).[154] Businesses located outside of Quebec that are registered for both

[152] For example, if the business sells a widget for $100 to a customer in Ontario (where the GST/HST rate is 13%) and another widget for $100 to a customer in Alberta (where the GST/HST rate is 5%), the business simply reports $18 of GST/HST collectible on their GST/HST return. The business does not have to report $13 of Ontario HST and $5 of Alberta GST.

[153] Revenu Que., supra note 66.

[154] Id.

GST/HST and QST purposes must file separate returns—GST/HST returns with the national government, and QST returns with the province.[155]

Tax Rates

For provincial tax rate purposes, when a province "harmonizes" with the federal GST/HST system, it repeals its provincial sales and use tax and the federal government agrees to increase the GST/HST rate in the province based on the rate determined by the provincial legislature.[156] For example, while the national federal rate of tax in Canada is 5%, when the Province of Ontario "harmonized" in 2010, it eliminated its 8% provincial sales and use tax (Ontario PST) and asked the federal government to increase the GST/HST rate in Ontario by 8%. Thus, the GST/HST rate in Ontario is 13%, with 5% to the federal government and 8% to the province of Ontario.[157]

This raises the following question: how can a single tax administration collect sales taxes at multiple rates for multiple provinces and the federal government and then divide the revenues between the federal government and various harmonized provinces? In Canada, this is done by a relatively complex revenue sharing formula through Comprehensive Integrated Tax Coordination Agreements (CITCAs) entered into between the federal government and the particular province at the time of harmonization.[158]

The Provincial Sales Tax Model

The three remaining provinces that impose a retail sales tax—British Columbia, Manitoba, and Saskatchewan—all administer their sales tax at the provincial level. No coordination exists between the provinces in terms of developing harmonized rules for sales tax administration. Nor do these provinces harmonize with the national government regarding GST administrative rules. For instance, these provinces do not adopt the GST/HST and QST minimum thresholds that relieve many small businesses of the requirement to register for GST purposes in Canada, nor do they provide for less frequent annual filing for many small businesses that must file GST.[159] Similar to U.S. states that do not follow SSUTA, the three provinces exercise their sovereignty

155 Id.

156 This also has a significant tax-collection advantage for any province that chooses to "harmonize." Because the legislation imposing the GST/HST is Canadian federal law, it legitimately imposes an obligation on vendors in one province to charge and collect HST on sales made to customers located elsewhere in Canada. Just as U.S. states face constitutional limitations on their ability to require out-of-state vendors to charge and collect sales taxes from customers in their state, Canadian provinces face similar restrictions under Canada's constitution. Harmonization with the federal GST/HST system eliminates this issue because the tax is imposed under federal law and collected by the federal government for the benefit of the province. Section 92 of The Constitution Act, 1867 limits the powers of Canadian provinces to making laws "in the province" with respect to specific matters. Further, Canadian provinces' legislative authority with respect to taxation is limited to "Direct Taxation within the Province in order to the Raising of a Revenue for Provincial Purposes."

157 See Changes that impact the data. *GST/HST Statistics tables (2010 to 2014 calendar years)*, Gov't of Can. (last updated June 20, 2017), https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/income-statistics-gst-hst-statistics/gst-hst-statistics/gst-hst-statistics-tables-2010-2014-calendar-years.html.

158 These federal/provincial agreements include a revenue allocation mechanism that determines the split of GST/HST revenues between the federal government and "harmonized" provinces. The revenue allocation formula is based on quantifiable data from the Canadian System of National Accounts, Statistics Canada, and the federal Department of Finance. The revenue allocation mechanism is also overseen and monitored by the Revenue Allocation Sub-Committee of the Tax Policy Review Committee set up under the CITCAs, which include a representative from each HST-participating province and the federal government. For example, see The Honourable Dwight Duncan Minister of Finance, *Ontario's Tax Plan for Jobs and Growth: Cutting Personal and Corporate Taxes and Harmonizing Sales Taxes* (2009), https://www.fin.gov.on.ca/en/publications/2009/citca.html.

159 Robertson, supra note 83, at 26.

to legislate their own rules on tax rates, tax returns, audit procedures, and other sales tax administration rules. Unlike in many U.S. states, however, local sales tax administration is not permitted in Canada.

State and local retail sales taxes are handicapped from the outset in terms of centralized and simplified administration . . .

3. The U.S. State Sales Tax Systems' Approach

State and local retail sales taxes are handicapped from the outset in terms of centralized and simplified administration because the design, control, and administration of state sales tax systems reside at the subnational (state government) level, and not the national level. In addition, a majority of states have further burdened sales tax compliance and administration by creating an overabundance of local jurisdictions imposing sales tax rates, and to a lesser degree, autonomy over local sales tax bases. Nonetheless, the collaborative approach of state sales tax systems to centralize and simplify tax administrative rules is the one bright spot in this international comparison for the United States, at least for the one-half of sales tax states that have adopted SSUTA—the Streamlined Sales and Use Tax Agreement.

State-Level Tax Administration

The United States is the only advanced nation in the world that does not levy either a nationally administered consumption tax (like EU countries) or at least a primarily nationally administered consumption tax (like Canada). Uniquely, U.S. sales tax systems comprise forty-six separate state-level taxing jurisdictions, each with a different tax base and tax rates, and at least for the larger states, distinct tax administrative rules.

Each state with a sales/use tax separately imposes, administers, modifies, and litigates disputes for its own distinct sales tax system. Conceptually that makes little sense but is easier to understand given that legislators and revenue officials are elected and appointed, respectively, to look after a state's parochial interests and not the competitive interests of the national economy. The lack of uniformity among state sales tax systems extends not only to sales tax bases but to sales tax rates as well. The median combined state and local sales tax rate in 2019 was 7%. Eight states imposed combined rates of 6% or less, and ten states levied rates of 8.5% or more. The combined rates ranged from a low of 4.4% in Hawaii to a high of 9.55% in Tennessee.[160]

Local-Level Tax Administration

The subnational imposition of the U.S. general consumption tax is exacerbated by the large number of localities that impose their own tax rates, and sometimes their own tax bases. Sales and use taxes are imposed in the United States, not only in forty-five states plus D.C., but also in over 10,000 local taxing jurisdictions. While local autonomy is an important feature of America's unique federalist blend of national and subnational governments, it immeasurably complicates multistate tax compliance.

In the United States, ten states impose state-administered sales taxes with no local sales taxes, and twenty-two states levy state-administered sales taxes with state and local tax rates, but with no differences between state and local tax

160 Janelle Cammenga, State and Local Tax Rates, Midyear 2020, Tax Found. Fiscal Fact No. 716 5 (July 2020).

bases. Eleven states impose state-administered sales taxes with state and local tax rates and some differences (or potential differences) between the state and local sales tax base. Four states—Alabama, Alaska, Colorado, and Louisiana—are clear outliers as each has locally administered sales taxes with some differences between state and local sales tax bases (see Figure 22).[161] The complexity of local sales taxes is compounded by the heavy concentration of local jurisdictions in some states. Seventeen states have over 100 local tax jurisdictions, and six states have over 500 local tax jurisdictions.[162] By comparison, in the European Union and Canada (and in virtually all other nations), consumption taxes are generally imposed only at the national level, and occasionally at the state/provincial level (for example, Canada), but never at the local level.

The Streamlined Sales Tax Project's Successful Harmonization of Sales Tax Administrative Rules

Since 2000, about half the states with sales taxes moved toward more centralized and simplified administrative rules. These efforts were spurred on by two U.S. Supreme Court decisions limiting the ability of states to impose sales tax collection responsibilities on remote sellers. As the Court stated in the first of these cases, *National Bellas Hess:*

> The many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose "a fair share of the cost of the local government" . . . The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements.[163]

The underlying goals of the Streamlined Sales Tax Project were simple: provide sufficient simplification and uniformity for all sellers across participating states such that the burdens identified in *National Bellas Hess* and its progeny, *Quill,* were reduced through "radical simplification."[164] Thus, once the burdens were sufficiently reduced, the limitations on state imposition of use tax collection responsibilities on remote sellers would be unnecessary, and substantial amounts of uncollected use taxes would flow into state coffers.

In November 2002, after two years of work through four separate work groups, model legislation known as the Streamlined Sales and Use tax Agreement (SSUTA) was finalized, approved, and presented to the states for adoption. The SSUTA model provides states with a streamlined system that includes:[165]

---

161 Sales Tax Scorecard, supra note 84, at 21–66 on chart of "Scorecard Detail by State" in the column "Central Tax Admin."

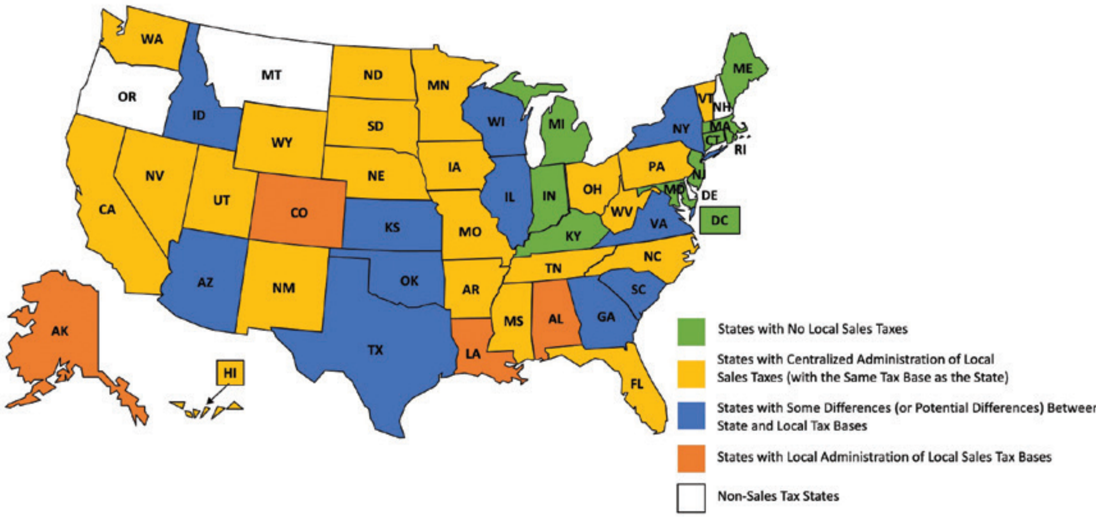
162 Id. at 12.

163 *National Bellas Hess Inc. v. Department of Revenue of Illinois,* 386 U.S. 753, 759–60 (1967).

164 1999 Statement by Utah Governor Michael O. Leavitt, Chairman of the National Governors' Association on the ACEC proceedings, concluding: "A majority of my fellow Commissioners recognized the need for both a level playing field and for radical simplification of state sales tax systems." http://lobby.la.psu.edu/080_Internet_Sales_Tax/Agency_Activities/ACEC/Leavitt.pdf; *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).

165 Diane L. Hardt, Douglas L. Lindholm, & Joseph R. Crosby, *A Lawmaker's Guide to the Streamlined Sales Tax Project,* 22 J. St. Tax'n 1 (2003–04).

FIGURE 22. STATES WITH LOCAL SALES TAX BASES



The SSUTA model is one of the best examples of state collaboration . . . aimed at reducing the complexities inherent in U.S. federalism.

- uniform definitions within tax laws;
- rate simplification;
- state-level tax administration of all state and local sales and use taxes;
- uniform sourcing rules;
- simplified exemption administration for use-based and entity-based exemptions;
- uniform audit procedures; and
- state funding of the system.

Limitations of Streamlined Sales and Use Tax Agreement

The Streamlined Sales Tax Project, through SSUTA, has made great strides to make sales tax administration rules more uniform across the states. To date, twenty-three states have adopted the streamlined rules. The SSUTA model is one of the best examples of state collaboration, in any state policy sphere, aimed at reducing the complexities inherent in U.S. federalism.

However, there are limits to the uniformity gained by adopting SSUTA. First, SSUTA model rules provide uniform definitions of many goods, including some digital products, but only for a few services. Second, given political and practical limits imposed by state sovereignty over sales tax bases and rates, SSUTA made no effort to harmonize actual state and local sales tax bases, instead agreeing only on some definitions to be used if states decide to include the goods or services in their sales tax bases. By failing to address tax base inclusion or exclusion, SSUTA neglected to tackle the nettlesome problem of sales taxation of business inputs and the economic inefficiency it builds into the system. Finally, the SSUTA project steered away from mandating one rate per state in those states with local jurisdictions imposing varying incremental tax rates. Essentially, SSUTA

While half the states with sales taxes have adopted SSUTA, nearly two-thirds of the U.S. population live in states that have not.

only addresses the third of the three principles of an optimal consumption tax: centralized and simplified tax administration.[166]

An even more significant barrier to the Streamlined Sales Tax Project has been the absence of the larger states' participation in uniformity efforts. While half the states with sales taxes have adopted SSUTA, nearly two-thirds of the U.S. population live in states that have not (see Figure 23). None of the largest six states (California, Texas, Florida, New York, Pennsylvania, or Illinois), which account for 44.6% of all sales taxes collected in the United States, follow SSUTA. [167] While many historical and political reasons account for the nonparticipation of these large-population states (and some smaller-population ones as well), their absence deprives the Streamlined Sales Tax Project of the ability to achieve broader centralization of administration and simplification of tax administration rules.

Post-*Wayfair* Doldrums

In June 2018, the U.S. Supreme Court decided *South Dakota v. Wayfair.* In that decision, the Supreme Court overturned the *National Bellas Hess* and *Quill* precedents that had prevailed for fifty years and replaced a "physical presence" test with an "economic presence" test as the precondition to require remote (out-of-state) retailers to collect sales and use taxes. *Wayfair* was widely supported by state governments and most of the business community as a way to level the playing field between retailers with physical and digital locations.

However, the *Wayfair* decision did little to address or alleviate the onerous compliance burden and economic dysfunction of state sales tax systems.[168] Indeed, the *Wayfair* decision exacerbated the situation by mandating new sales tax collection responsibilities for hundreds of thousands of remote sellers within a system that continues to violate all of the key principles of an optimal consumption tax. Despite the U.S. Supreme Court's decision, attaining a level of sales tax simplification that satisfies a constitutional "commerce clause" requirement should <u>not</u> be confused with constructing an efficient, effective, and well-designed consumption tax system.[169]

Furthermore, the *Wayfair* decision weakened the incentive for states to work together to make state sales taxes more harmonized and less complex. It did so by removing

---

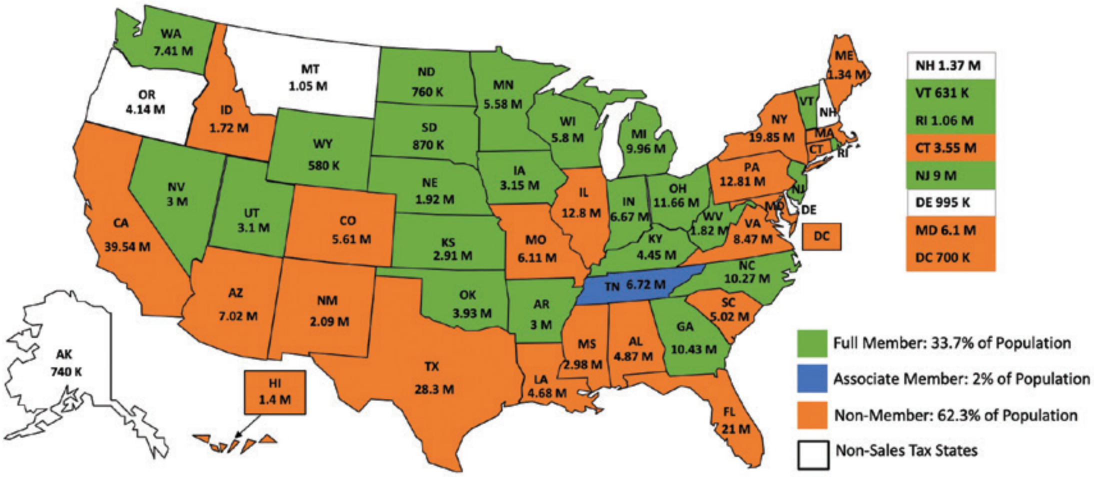
[166] Charles McLure had a similar critique of SSUTA in 2005: "It [SSUTA]deals primarily with arcane, albeit important, essentially non-policy questions of definition and tax administration and not with big policy issues of what the tax base should be; moreover, it side-steps almost entirely the treatment of sales to business . . . Of course, without bringing greater uniformity to the tax base, including a uniform exemption for business purchases, there is a limit to the simplification that can be achieved." Charles E. McLure, Jr., *Understanding the Nuttiness of State Tax Policy: When States Have Both Too Much Sovereignty and Not Enough,* 58 Nat'l Tax J. 565, 572 (2005).

[167] Mikesell, supra note 85, at 1341–42.

[168] *See South Dakota v. Wayfair Inc.,* 138 S. Ct. 2080 (2018).

[169] The gross oversimplification of the structural design and compliance problems with state sales tax systems and limited focus on elements of the third principle of an optimal consumption tax is evident in the statement made by forty-one states (and D.C.) in their *amicus curiae* brief in support of South Dakota in *Wayfair:* "The Internet and modern software—the very same technology that allows online retailers to flourish in the first place—enables retailers to automatically generate the required tax returns and electronically file those returns with ease . . . Today, with the Internet's near-ubiquitous use by retailers, the burden of collection (if any) has become miniscule . . . The very technology that makes online retailers so successful at targeting their customers also allows them to collect and remit the owed sales tax through an automated process that requires minimal effort." Brief for Colorado and 40 Other States, Two United States Territories, and the District of Columbia as Amici Curiae Supporting Petitioner, at 3–4, 22–23, 26–27, *South Dakota v. Wayfair Inc.,* 138 S. Ct. 2080 (2018) No. 17-494.

FIGURE 23. THE STREAMLINED SALES AND USE TAX AGREEMENT (SSUTA) HAS BEEN ADOPTED BY STATES WITH ONLY ONE-THIRD OF THE U.S. POPULATION



Source: U.S. Census Bureau

the states' motivation to work cooperatively in the SSUTA sales tax simplification effort—the requirement in the *Quill* decision restricting states from collecting sales taxes on remote sales until the sales tax compliance burden was significantly reduced either by Congressional mandate or state collaboration. In essence, the *Wayfair* decision validated the states' laser focus on jurisdictional issues and remote-seller collection responsibilities and obscured the states' long-standing failure to develop a modern, broad-based sales tax system.

4. Summary: Centralized and Simplified Tax Administration of the EU VAT, the Canadian Hybrid System, and U.S. State Sales Tax Systems

The EU VAT regime is a combination of EU-wide rules requiring harmonization of the consumption tax base coupled with national administration of VAT rates, compliance, audits, and most other administrative rules. When measured by the European Union's own goal of simplifying tax administration at the EU level, the VAT does not satisfy the third principle of a centralized and simplified consumption tax. Although administration is not centralized at the EU level, the EU VAT is at least administered at the national level because EU rules preclude subnational or local consumption tax administration.

The Canadian hybrid GST/provincial sales tax system falls between the national-level administration associated with the EU VAT and the state-level administration connected with the larger U.S. state sales tax systems. In the six provinces and three territories (making up 57% of the population), the joint GST/HST is centrally administered by the federal government with uniform national GST administration rules, thus satisfying the third principle in those provinces. In Quebec (with 23% of the population), the GST is administered at the national level (for non-Quebec

. . . **U.S. state and** local sales tax systems remain an outlier, deviating significantly more from the principles of an optimal consumption tax than their EU or Canadian counterparts.

and financial companies) and at the provincial level for all other businesses, adding complexity to the system. Finally, in the three provinces that maintain their own provincial sales taxes, the GST is administered at the national level and provincial sales taxes are administered at the provincial level, with separate consumption tax administrative rules at the national and provincial levels as well as between the provincial levels.

In the United States, the twenty-three states (with about one-third of the population) that follow SSUTA satisfy the third principle of an optimal consumption tax. These states work closely together through the Streamlined Sales Tax Project to centralize and simplify a significant number of sales tax administration rules. The nearly twenty-year collaboration includes constant monitoring of Project States' sales tax administration rules to ensure good-faith compliance with the agreement. Conversely, the non-SSUTA states (with about two-thirds of the population), provide little or no centralization or simplification of sales tax administrative rules and thus fail to satisfy the third principle of an optimal consumption tax.[170]

D. COMMENTS ON THE INTERNATIONAL COMPARISON OF GENERAL CONSUMPTION TAXES

No general consumption tax that spans a nation or a continent is without its imperfections and onerous compliance burdens. The EU VAT and the Canadian GST/HST are both burdened with administrative and substantive complexities that create deviations from the principles of an optimal consumption tax. In Europe, compliance with and enforcement of the EU VAT are complicated by factors including non-harmonized reduced tax rates, differences in administrative rules in member countries, and input VAT fraud. While the Canadian GST/HST is highly efficient with single administration of both federal and provincial taxes, the failure of three of Canada's ten provinces to abandon provincial retail sales taxes and harmonize with the federal GST/HST system means businesses operating in those provinces must still file separate retail sales tax returns in addition to federal GST/HST returns. Quebec also shares administration of the GST/QST with the national government, adding another layer of complexity to consumption tax compliance in Canada.

But the key issue in the comparison of the design and operation of the EU and Canadian systems with the U.S. system is relative performance. By this measure, U.S. state and local sales tax systems remain an outlier, deviating significantly more from the principles of an optimal consumption tax than their EU or Canadian counterparts. U.S. state sales tax bases are not harmonized and generally tax a much narrower range of household goods and services. They offer no broad exemption for business inputs and rely on revenues from business purchases (and sales tax pyramiding) more than virtually any other advanced nation in the world. And state sales tax administration is highly decentralized and nonuniform, at least for the larger states that are not SSUTA members (see Figure 24).

170 These divergent outcomes are evident from a 2018 COST study evaluating the states on thirty-three elements of an efficient and effective sales tax system. In that study, the SSUTA states averaged a "B" grade, while the non-SSUTA states averaged an abysmal "D+" grade. Sales Tax Scorecard, supra note 84, at 2.

FIGURE 24. EUROPEAN UNION, CANADA AND UNITED STATES CONSUMPTION TAX OVERVIEW

Geography	# of Countries/States and Population	Type of Consumption Tax	Harmonized and Broad Tax Base of Household Goods and Services?	Exemption for Business Inputs?	Level of Administration	# of Local Consumption Tax Jurisdictions
European Union	27 Countries **With 445 million population**	**EU-wide VAT**	**Yes**	**Yes.** Input credits if output taxed	**National**	**None**
Canada	1 Country/13 Provinces and Territories **With 37.6 million population**	**National GST (with harmonized HST)** Three Provinces with own Retail Sales Taxes (RST)	**GST/HST/QST: Yes** (covering 80% of the population) **Provincial RSTs: No** (covering 20% of the population	**Yes.** Input credits if output taxed (for GST/HST/QST) **No** (for RST)	**National** for GST/HST (except Quebec) **Provincial** for RST	**None**
United States	1 Country/50 States + DC **With 331 million population**	**45 States and DC with own Retail Sales Taxes**	**No**	**No** – only some business inputs are exempt. 42% of sales tax base from taxing business inputs	**State Level** (but national uniformity in 23 SSUTA states)	**10,000+**

SECTION 3

THE GLOBAL TRANSFORMATION OF TAXES ON GENERAL CONSUMPTION

A. THE HISTORIC SHIFT AWAY FROM RETAIL SALES TAXES AND TURNOVER TAXES

The United States is the only country in the world that relies on a retail sales tax, a structurally flawed and outdated general consumption tax, as its primary source of consumption tax revenue.

The United States is the only country in the world that relies on a retail sales tax, a structurally flawed and outdated general consumption tax, as its primary source of consumption tax revenue. But this was not always the case. After World War II, most advanced nations relied on either a retail sales tax or a turnover tax as the primary tax on general consumption. The other countries' retail sales taxes were like the current U.S. model because they relied on taxation of both household and business consumption. The turnover tax was similar to a gross receipts tax, with multiple stages of collection, and no credits for taxes paid in earlier stages. Thus, like a sales tax, the turnover tax ended up cascading taxes by taxing intermediate and capital goods and consumer purchases.

The shifts away from these general consumption taxes in the European Union, Canada, and other advanced nations (except the United States) were primarily made to improve economic efficiency and international competitiveness. Both retail sales taxes and turnover taxes were widely criticized for their detrimental impact on economic growth and international trade arising from reliance on extensive cascading of taxes attributable to the inclusion of both business inputs and consumer purchases in the tax base.[171] In 2018, the OECD explained the worldwide transition to a newer general consumption tax model as follows: "VAT is designed to be a tax on final consumption that is broadly neutral towards the production process and international trade. It is widely seen as a relatively growth-friendly tax."[172] In consumption tax systems with multiple levels of taxation (for example, the European Union and Canada), the transition to a VAT also facilitated increased harmonization of the tax base.

B. THE THREE COMPONENTS OF THE GLOBAL TRANSFORMATION OF TAXES ON GENERAL CONSUMPTION

Beginning in the 1960s, the transformation of general consumption taxes had three primary components:

- the replacement of inefficient and ineffective older models of general consumption taxes (retail sales taxes and turnover taxes) with newer and more efficient versions (for example, the EU VAT and the Canadian hybrid Goods and Services Tax/ Harmonized Sales Tax (GST/HST);

171 Terra, supra note 147, at ch. 1. According to John Due, the author of one of the leading treatises in the 1950s on government finance and taxes, the tax burden of turnover taxes depended arbitrarily on how many times a product turned over, making border adjustments for imports and exports problematic. Due, supra note 43, at 322. On turnover taxes, see also Guenter Schindler, Tax Harmonization in Europe and U.S. Business, Tax Found. (1968); Mikesell, Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance, Tax Found. Background Paper No. 53 1, 4 (Jan. 2007).

172 OECD, supra note 62, at 16.

FIGURE 25.

OECD Nations with a Sales Tax Between 1965 and 2018	OECD Nations with a Turnover (Gross Receipts) Tax Between 1965 and 2018	OECD Nations with a Sales Tax in 2018 (There Were No National-level Turnover Taxes in 2018)
Australia	Austria	Canada (in three provinces)
Canada	Belgium	United States
France	Germany	
Greece	Greece	
Iceland	Italy	
Ireland	Lithuania	
Korea	Luxembourg	
New Zealand	Netherlands	
Portugal	Norway	
Slovenia	Poland	
Sweden	Spain	
Switzerland	Turkey	
United Kingdom		
United States		

Between 1965 and 2018, the retail sales tax virtually disappeared outside of the United States as a viable policy choice for imposing a tax on general consumption.

- the displacement of taxes on specific goods and services with more broad-based taxes on general consumption (that more closely fit the model of an economic growth-friendly or neutral consumption tax); and
- the increase of general consumption taxes as a share of all taxes.

Between 1965 and 2018, the retail sales tax virtually disappeared outside of the United States as a viable policy choice for imposing a tax on general consumption. During this fifty-year span, fourteen countries used a retail sales tax as a significant revenue source for at least part of the period. [173] However, by 2018, in addition to the United States, only Canada (in a few provinces) collected more than a *de minimis* amount of revenue from retail sales taxes.[174] Similarly, twelve OECD countries imposed a turnover tax during the period beginning in 1965, but all of these countries abandoned the tax over the following decades (see Figure 25).[175] In every instance, the outdated and inefficient retail sales taxes and turnover taxes were replaced with VATs that applied the tax at only one, and not multiple levels of consumption.

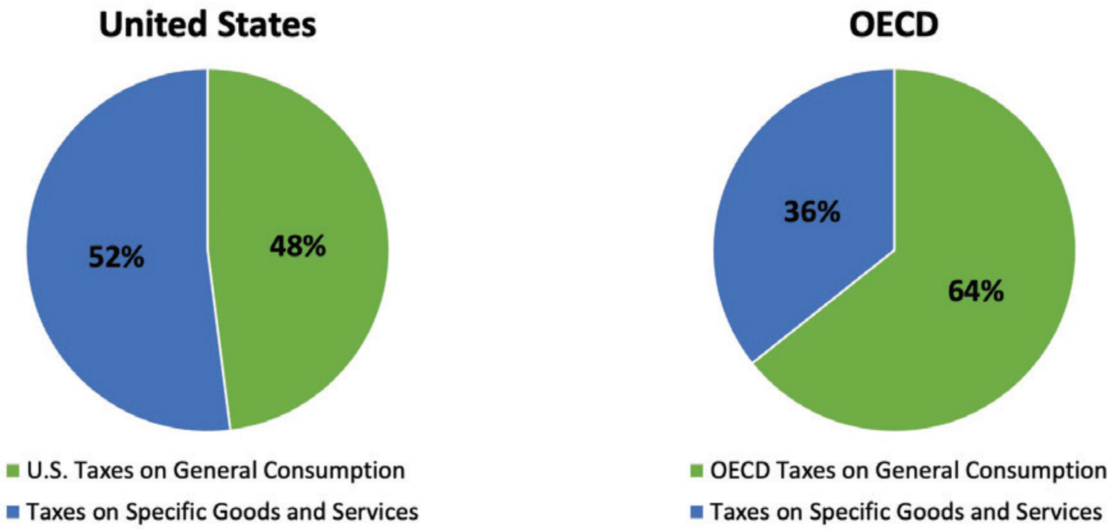
[173] On retail sales taxes, see OECD, supra note 3, at tbl.5112.

[174] Id. Several countries including Australia, Belgium, Hungary, Norway, and Switzerland had a de minimis amount of sales tax in 2018, accounting for less than .3% of all taxes. The OECD data for sales tax identifies Columbia and Israel as having more than a de minimis amount of sales tax in 2018, but this is apparently a mis-categorization since neither country has a sales tax. See EY, supra note 139, at 278 (for data on Columbia), 628 (for data on Israel).

[175] On turnover taxes, see OECD, supra note 3, at tbl.5113. The European countries with turnover taxes in 1965 included Austria, Belgium, Germany, Italy, Luxembourg, Netherlands, Norway, and Spain. See also Garrett Watson & Danie Bunn, Learning from Europe and America's Shared Gross Receipts Tax Experience, Tax Found. (Feb. 12, 2019). For more information on the high level of cascading in gross receipt taxes, see Andrew Chamberlain & Patrick Fleenor, Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes, Tax Found. Special Report No. 147 (Dec. 2006); Garrett Watson, Resisting the Allure of Gross Receipts Taxes: An Assessment of Their Costs and Consequences, Tax Found. Fiscal Fact No. 634 (Feb. 2019).

General consumption taxes as a share of all taxes expanded rapidly in OECD nations other than the United States.

FIGURE 26. TAXES ON GENERAL CONSUMPTION AS A SHARE OF ALL CONSUMPTION TAXES, 2018



The OECD data confirms that the expansion of broad-based taxes on general consumption displaced the reliance in most advanced nations on consumption taxes on specific goods and services. In 1965, taxes on general consumption made up about one-third of all consumption taxes while taxes on specific goods and services made up the other two-thirds. By 2018, the numbers had reversed. Taxes on general consumption made up about two-thirds of all consumption taxes in OECD nations, while taxes on specific goods and services only contributed about one-third of all consumption taxes.[176] Only in the United States—with no national general consumption tax and a subpar general consumption tax at state and local levels—did the share of general consumption taxes remain below the share of taxes on specific goods and services, totaling 48% of all consumption taxes in 2018 compared with the OECD average of 64% (see Figure 26).[177]

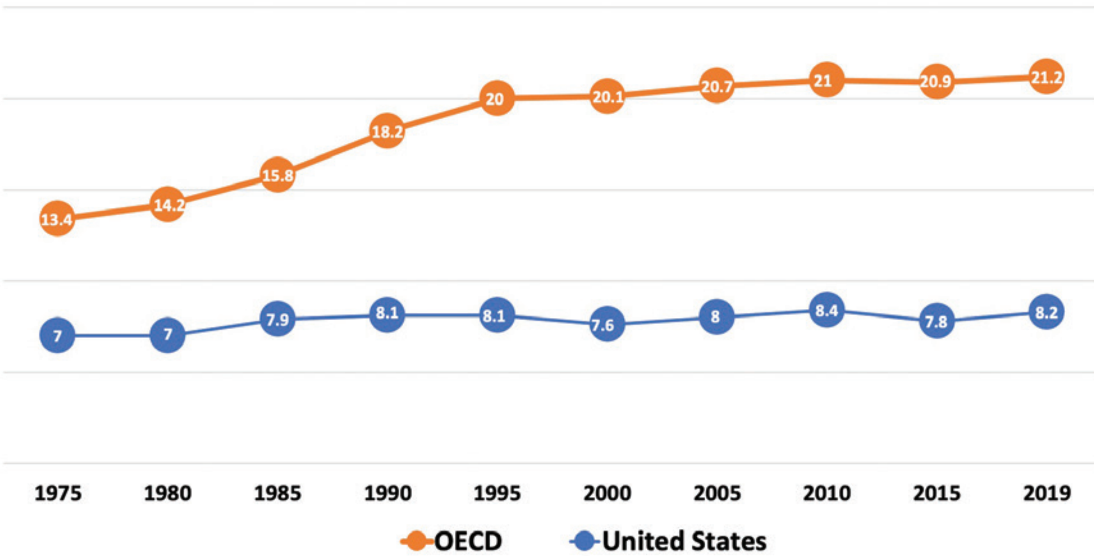
Finally, general consumption taxes as a share of all taxes expanded rapidly in OECD nations other than the United States. Increasingly, governments across the world viewed the VAT as a structurally sound, economically neutral, and scalable tax that could generate sufficient revenues to better balance consumption taxes with income, payroll, and property taxes. As a result, taxes on general consumption as a share of total taxation in OECD nations increased significantly from 13.4% in 1975 to 21.2% in 2019. By contrast, taxes on general consumption as a share of total taxation in the United States increased only modestly from 7% in 1975 to 8.2% in 2019 (and not at all since 1990). (see Figure 27)[178]

176 The 1965 and 2018 statistics are from OECD, supra note 3, at tbls.5000, 5110 as measured by share of total taxation. The VAT displaced less efficient or less effective taxes on general consumption and many taxes on specific goods and services. Id. at tbl.5111.

177 Id.

178 OECD, supra note 3, at tbl.5110 as measured by share of total taxation.

FIGURE 27. GENERAL CONSUMPTION TAX AS A PERCENTAGE OF TOTAL TAXATION: U.S. COMPARISON WITH OECD NATIONS 1975–2019



Whether during recessions or periods of extended growth, state base expansions or contractions, sales tax rate increases or decreases, or the advent of the digital economy, the share of state and local sales tax revenues in the overall U.S. tax mix has been relatively constant, and far below international norms.[179]

The culmination of decades of change to global consumption taxes has left state sales tax systems in the United States as lonely outliers among the world's consumption tax systems. The United States bucked all three of the trends that characterized the transformation of general consumption taxes. It is the only advanced nation:

- that still relies on an outdated retail sales tax as its primary general consumption tax;
- where taxes on specific goods and services make up a larger share of total consumption taxes than taxes on general consumption; and

[179] The differential between the United States and the rest of the OECD countries in terms of taxes on general consumption as a share of all taxes is attributable to both narrower tax bases (see discussion in Section II.A, infra) and lower tax rates in the United States. State and local sales tax rates have steadily increased over the last forty years but remain significantly below rates for taxes on general consumption in other countries. The average combined U.S. state and local sales/use tax rate is 7.22% (in 2020) compared with the average OECD standard VAT rate of 19.3% (in 2018). However, these statistics somewhat overstate the rate differential because many OECD nations use reduced rates (not standard rates) for certain categories of consumer purchases and therefore have a lower blended standard/reduced rate. Moreover, the average OECD standard VAT rate for non-EU members of the OECD is 15%, and five OECD nations have standard rates of 10% or less. The structural design of U.S. sales tax systems makes it difficult to raise sales tax rates because a rate increase falls heavily on both business inputs and household consumption, frequently resulting in opposition from both businesses and voters. And because the sales tax is uniquely imposed at the subnational level in the United States, accounting for one-third of the total national tax base, there is an implicit limit on how much sales tax rates can be raised without creating distortions in the mix of taxes. For U.S. rates, see Cammenga, supra note 160, at 5. For OECD rates, see OECD, Consumption Tax Trends 2018: VAT/GST and Excise Rates, Trends and Administration Issues 66–67 (2019).

. . . **the Canadian** experience is the most relevant to the United States and provides a useful precedent for how a country with a strong tradition of federalism can transform its general consumption tax system . . .

- that did not develop a scalable general consumption tax model and consequently relies less on consumption taxes as a share of all taxes than any other advanced nation.[180]

C. CANADA'S EVOLUTION TO A HYBRID GST/HARMONIZED SALES TAX SYSTEM

Among the OECD nations, the Canadian experience is the most relevant to the United States and provides a useful precedent for how a country with a strong tradition of federalism can transform its general consumption tax system without encroaching on the sovereignty of states over subnational consumption tax revenues. While Canada is roughly one-tenth the size of the United States by population, it similarly has a federalist structure with taxing powers split between the federal government and its ten provinces and three territories. Canada also has municipal governments, although under provincial law their only source of revenue is property taxes, and they lack the legislative authority to impose municipal sales taxes.

The Canadian government's initial plan in the early 1990s was to create a national GST and encourage Canadian provinces to replace provincial-level retail sales tax systems with a single, national harmonized GST. However, discussions and negotiations between the federal government and the provinces broke down. Among the provinces, only Quebec chose to replace its provincial retail sales tax with a provincial VAT (called the Quebec sales tax or QST). Between, 1991 and 1997, Quebec, while maintaining its own QST statute and administration, eventually harmonized its consumption tax base and rules to the national GST.

Over the next twenty years, five Canadian provinces eliminated their provincial sales and use taxes and harmonized with the federal GST system to create the HST. To encourage but not mandate harmonization, the national government offered financial incentives (such as the payment of one additional year of provincial sales tax revenue) and took over administration of the joint GST/HST at no charge to provinces.[181] In essence, the HST was the same as the GST except provinces set their own tax rates (for the provincial portion of the revenues) and had limited authority to deviate from national GST rules. Alberta and the three territories did not impose provincial-level sales taxes, so harmonization was unnecessary. The process last significantly advanced in 2013, when Prince Edward Island adopted an HST, three years after the largest province (Ontario) harmonized its own tax with the national GST. British Columbia, Manitoba, and Saskatchewan have yet to harmonize.[182]

---

180 The retail sales tax comparison is from EY, supra note 139. The comparison of taxes on specific goods and services to taxes on general consumption is based on an OECD nation comparison is from OECD, supra note 3, at tbls.5000, 5110 as measured by share of total taxation. The overall consumption tax comparison is from OECD, supra note 1. The historical deviation was even more pronounced at the U.S. federal government level, where no general consumption tax developed at all and the share of total consumption taxes (on specific goods) dropped to about 5% of total federal taxes in 2018. (See Figures 30 and 35, infra)

181 When Ontario harmonized to the GST in 2010, the federal government paid the province $4.3 billion as an incentive; assumed all the administrative costs of administering the GST/HST in the province; and allowed the province some additional tax base deviations (e.g. zero-rating children's clothing). Bird, supra note 134, at 23.

182 British Columbia initially harmonized to the GST in 2010 but returned to its provincial sales tax in 2013.

By establishing the GST and encouraging provincial sales tax harmonization to the GST/HST, Canada managed to switch from a complex system with a non-harmonized national manufacturers sales tax and highly decentralized and autonomous provincial retail sales tax systems to a largely centralized and harmonized system. As noted, the resulting hybrid GST/HST model applies to approximately 80% of the country's population and uses a harmonized GST base that is centrally administered by the federal government (except in Quebec).

India, a non-OECD country, also provides a useful precedent for the transformation of sales taxes in the United States.

The Canadian model also demonstrates how consumption tax reform can address economist concerns about inefficient general consumption taxes; progressive worries about a regressive consumption tax; conservative fears that a new VAT would become a runaway revenue generator; small businesses complaints about compliance burdens; and subnational governments' nightmare of losing sovereignty over sales tax revenues. The Canadian shift to the hybrid GST/HST model encouraged economic efficiency and international competitiveness by replacing older federal and provincial consumption taxes that relied too heavily on business inputs and cascading sales tax revenues. The Canadian GST addressed regressivity through a combination of refundable tax credits and GST exemptions of goods disproportionately purchased by low-income households.[183] The GST/HST conversion also demonstrated that a national consumption tax need not be a vehicle for endless tax rate increases by actually lowering the national GST rate from its initial 7% in 1991 to its 5% tax rate today. The GST/HST addressed small business fears of onerous compliance burdens by providing a small business registration exemption (although not as generous as many other VAT systems). The provinces maintained their sovereignty over consumption tax revenues, with the largest provinces—Ontario (at an 8% tax rate) and Quebec (at about a 10% tax rate)—collecting significantly more in consumption tax revenues than the national government (see Figure 28).

D. INDIA'S 2017 GENERAL CONSUMPTION TAX REFORM

India, a non-OECD country, also provides a useful precedent for the transformation of sales taxes in the United States. In 2017, India undertook sweeping consumption tax reform to create a harmonized national/subnational GST to replace numerous separate and nonuniform VAT, sales/use taxes, and other consumption taxes at the national and subnational levels. Much like Canada and the United States, India uses a federal system in which the central government shares fiscal and taxing authority with twenty-nine states and seven union territories, all of which can levy taxes under the national constitution. India's pre-reform consumption tax system was a crazy quilt of laws that included a central government tax on the manufacture of goods, a central government tax on the sale of services, state government taxes on the sale of goods, and a central government tax on interstate sales collected and retained entirely by the states. Significantly, the pre-reform system generally did not allow for exemptions or credits for the purchases of business inputs and thus led to cascading of taxes on business and consumer purchases.[184]

183 Robertson, supra note 83, at 32–33. For a history of the Canadian transition to the GST/HST/QST, see Bird, supra note 134.

184 Ajitesh Kir, The Biggest Tax Reform Since Independence: Has the GST Improved the Ease of Doing Business in India?, State Tax Notes 915 (Mar. 5, 2018).

FIGURE 28.

Canadian Provinces and Territories	GST Rate or GST portion of HST Rate	HST or QST Rate	PST Rate	Total Tax Rate
Alberta	5%	0%	0%	5%
British Columbia	5%	0%	7%	12%
Manitoba	5%	0%	7%	12%
New Brunswick	5%	10%	0%	15%
Newfoundland and Labrador	5%	10%	0%	15%
Northwest Territories	5%	0%	0%	5%
Nova Scotia	5%	10%	0%	15%
Nunavut	5%	0%	0%	5%
Ontario	5%	8%	0%	13%
Prince Edward Island	5%	10%	0%	15%
Quebec	5%	9.975% (QST)	0%	14.975%
Saskatchewan	5%	0%	6%	11%
Yukon	5%	0%	0%	5%

The new general consumption tax system in India is a combination of a GST levied and collected by the central government, states, and union territories on a common base of intrastate supplies of goods and services, and a GST levied and collected by the central government on interstate supplies of goods and services (including imports) which are then shared with the state in which they are consumed. [185]

The general consumption tax system in India pre- and post-consumption-tax reform is different from the Canadian model and is still a work in progress. But in approaching comprehensive reform, both countries harmonized and rationalized an inefficient system of taxes on goods and services at the national and subnational levels. Both generally eliminated the economically irrational cascading of taxes on business inputs and consumer purchases. Both developed a new hybrid national/ subnational general consumption tax model, with taxing authority, rate setting, and tax administration divided between national and subnational governments but with a common tax base.[186]

185 Kir, supra note 184; EY, supra note 139, at 457.

186 EY, supra note 139; PwC, 365 days of GST: a historic journey (2018), https://www.pwc.in/assets/pdfs/ india-services/ indirect-tax/365-days-of-the-gst-a-historic-journey/a-historic-journey.pdf.

CAN THE UNITED STATES MODERNIZE STATE SALES TAX SYSTEMS?

4 SECTION

The United States owns the worst of all outcomes from a consumption tax perspective. First, structurally flawed state sales tax systems increase compliance burdens and undermine traditional economic benefits of a consumption tax. From a federalism perspective, it is clearly more onerous to comply with tax systems in forty-five states and D.C., each with different sales tax bases, sales tax rates, and—at least in the non-SSUTA states—different tax administrative rules, than it is to comply with a more harmonized nationally administered or coordinated consumption tax. In 2019, John Mikesell, a noted sales tax expert, commented on the eighty-five year history of the sales tax and its underreliance on taxing household consumption and overreliance on taxing business inputs: "As structured, the tax embodies bad tax policy that appears to worsen over time, putting the sales tax on an unsustainable path."[187]

A good tax system is balanced by different revenue sources that meet key policy objectives such as equity, economic growth, transparency, ability to pay, and stability.

Second, the cumulative impact of suboptimal, poorly designed, and narrowly based state sales tax systems impedes national use of a tax on general consumption to balance the tax burden among different tax types. State sales tax systems are incapable of raising the level of revenues collected by broad-based consumption taxes in other countries. A good tax system is balanced by different revenue sources that meet key policy objectives such as equity, economic growth, transparency, ability to pay, and stability. Unfortunately, the failure of the United States to develop an efficient and effective general consumption tax, at either the national or subnational levels, has led to an overall tax system that is dangerously imbalanced by international norms, overly reliant on income, payroll, and property taxes, and underreliant on consumption taxes.

[187] Mikesell, supra note 43, at 397. Alan Viard made the same point: "Despite their image as consumption taxes, state and local retail sales taxes are actually imposed on a large volume of business purchases, resulting in significant economic inefficiency." Alan D. Viard, Sales Taxation of Business Purchases: A Tax Policy Distortion, State Tax Notes 973 (June 21, 2010).

The time is long overdue for the United States to fix the systemic inadequacy of state retail sales tax systems.

The time is long overdue for the United States to fix the systemic inadequacy of state retail sales tax systems. If properly structured, a redesigned sales tax system would conform to all three principles of an optimal consumption tax with a harmonized and broad-based tax on household goods and services, an exemption or credit for business inputs, and centralized and simplified tax administration. A redesigned tax would also provide the United States with a scalable option to increase the share of consumption taxes and improve the revenue balance with income, payroll, and property taxes.

The United States has stumbled through the post-World II era with an inefficient, ineffective and obsolete general consumption tax system. Absent a transformed and broad-based consumption tax, the country will face dire consequences in the coming years as federal and state governments address revenue shortfalls, rising debt levels, and increasing demands for more government spending, while handicapped by a tax system that is too reliant on income, payroll, and property taxes.

A. OPTIONS FOR MODERNIZING STATE SALES TAX SYSTEMS

From our perspective, policymakers have four options to modernize U.S. state sales tax systems:

(1) Replace state sales tax systems with a national VAT collected, administered, and redistributed at the national level. This change seems highly unlikely politically and perhaps undesirable, given our federalist system of government.

(2) Seek federal preemptive legislation that mandates state harmonization and broadening of the sales tax base of household goods and services, exempts business inputs, and centralizes and simplifies tax administration. This change also faces political headwinds by cutting against the strong tradition of federalism and state sovereignty over state taxes.

(3) Provide incremental fixes through unilateral or collaborative state action. This option appears more feasible politically, but as demonstrated by the struggles of the Streamlined Sales Tax Project, will not fundamentally solve the systemic problem.

(4) Implement a hybrid federal/state government consumption tax based on the Canadian model. This change may be politically less attractive in the short-term but is best-suited to achieve systemic change, maintain state sovereignty over sales tax revenues, and create a better-designed, more economic growth-friendly consumption tax. Like the Canadian process, this solution would require implementation over a period of years.

1. A Radical Fix: A National VAT

The United States could certainly enact a national VAT to replace state sales tax systems with a completely different model of a general consumption tax. This option is mentioned first because it is the solution chosen by almost every advanced country over the last fifty years. However, a stand-alone national VAT has never gained traction in the United States and is not likely to do so in the foreseeable future.[188] It is simply too radical a change in a country with a strong federalist tradition of state governments sharing fiscal and taxing powers with the national government, and because the primary consumption tax is firmly embedded at the state and local level. To completely alter that system and replace the subnational consumption tax with a national consumption tax likely departs too far from political and economic traditions to be a viable solution.

2. Federal Preemption

The second option involves congressional preemption (using commerce clause authority) of state law to mandate greater simplification, harmonization, and expansion of state sales tax bases on household goods and services, including a broad exemption for business inputs. This alternative, although impinging on state sovereignty, is far less radical than the replacement of state sales tax systems with a national VAT. However, numerous pieces of federal preemptive legislation to correct state sales tax deficiencies languished in Congress over the last two decades. In terms of both limited scope and a decided lack of congressional support, the experience gives little reason for optimism regarding this option. But circumstances may change if a systemic failure to develop a well-designed general consumption tax that achieves better balance with other taxes becomes more visibly debilitating to federal and state tax and budget policy. Unfortunately, the difficulty in determining how far-reaching any federal regulation should be, and whether it should address tax policy issues (for example, the scope of the tax base and exemption of business inputs) and simplification and harmonization, would bring about many of the same political fault lines that make the enactment of a stand-alone national VAT unlikely.

3. An Incremental Fix: Unilateral or Collaborative State Action

The third option is to gradually address the problem through unilateral or collaborative state action to modernize, harmonize and broaden state sales and use tax systems. This is the path of least resistance that the states, to a degree, have embarked on over the last few decades. Indeed, this may be the only avenue available to the United States in the short-term, so it should be vigorously pursued. In doing so, however, we must be realistic about the limited prospects for fundamental reform. No country has ever successfully transformed a retail sales tax from within into an efficient and effective broader-based tax on household consumption with an exemption for business inputs; all have abandoned the effort in favor of a VAT or a hybrid VAT/sales tax system.

Indeed, the challenge is greater in the United States than in a country with a national consumption tax system because of the far greater number of states and localities with retail sales taxes that will jealously guard their taxing sovereignty. Of the fifty-one countries that are members of the OECD and/or G20 that together make up 90% of global gross

[188] On numerous occasions over the last fifty years, both Republicans and Democrats, albeit typically at different times, have proposed national VATs or similar broad-based consumption taxes for various purposes. Interest in a national VAT tends to increase during economic downturns or when federal debt levels rise quickly. See the discussion in the Appendix Section 3, infra. See also W. Elliot Brownlee, Federal Taxation in America: A History (Cambridge University Press, 3rd ed., 2016); Schenk & Oldman, supra note 113, at ch. 14.

. . . states should continue to work collaboratively to modernize and harmonize retail sales tax systems.

domestic product, only four countries other than the United States impose subnational taxes on general consumption, and the United States is the only one that imposes its primary general consumption tax at the state and local level (see Figure 29).[189]

It is possible for a state to unilaterally take steps to transform its sales tax base to include more household goods and services and fewer business inputs. The general consumption tax adopted in the United States need not be a carbon copy of the VAT. Nothing prevents a state from enacting a statute to create a model sales tax that copies the better features of a VAT without fully switching to that type of a consumption tax. Unfortunately, the long history of state retail sales tax systems does not give much cause for hope on this front. The last state sales and use tax was enacted in Vermont over fifty years ago. None of the largest-population states (California, Texas, Florida, New York, Illinois, and Pennsylvania) have made much headway toward satisfying any of the three key principles of an optimal consumption tax. None have harmonized or significantly broadened their sales tax bases, at least by international standards; all rely on the taxation of business inputs near or above the national average of 42%; and none have adopted SSUTA to make their tax administration rules more uniform.[190]

Regardless, states should continue to work collaboratively to modernize and harmonize retail sales tax systems. This course of action has the best historical track record, with the Streamlined Sales Tax Project succeeding in at least half of the sales tax states to harmonize many sales tax administrative rules. However, the limitations of this approach are well documented. SSUTA has not garnered support from the larger (and other) states that make up about two-thirds of the population of sales tax states. And in the post-*Wayfair* climate, voluntary collaboration among states may prove even more difficult. Of greater importance, SSUTA only addresses the third principle of an optimal consumption tax—uniformity of sales tax definitions and administrative rules. While it is possible (and desirable) for a collaborative state initiative like the EU directives to address the larger issues of tax base harmonization and exemptions for business inputs, it will be quite difficult to do so within the structural design constraints of retail sales taxes.

Although incremental fixes have significant limitations, some combination of these approaches can and should be undertaken because other viable short-term options are limited. At a minimum, states should not adopt changes to the sales tax base (such as taxation of business services) or sales tax administrative rules that make the system worse. Unfortunately, history suggests that incremental approaches may never go beyond tinkering and/or modest improvement. Over the last forty years, as the rest of the OECD nations have significantly increased

189 Argentina, Brazil, and Canada levy subnational consumption taxes with tax bases separate from the national VAT/GST. India imposes a subnational consumption tax with the same tax base as the national tax. EY, supra note 139. For a list of the fifty-one countries that are members of either the OECD or the G20, see PwC, Survey of Subnational Corporate Income Taxes in Major World Economies: Treatment of Foreign Source Income (2019). Brazil imposes one of the most complex national/subnational consumption tax systems in the world outside the United States but is currently considering proposals to consolidate and harmonize its multiple consumption taxes. See also Robert Goulder, Brazil's Push for a Proper VAT, Tax Notes Int'l 819–822 (Aug. 10, 2020).

190 We do not discuss here the option of a state unilaterally switching from a retail sales tax to a stand-alone state VAT. A few states such as New Hampshire (business enterprise tax) and Michigan (single business tax) have experimented with entity-level taxes levied on a value-added tax base. But this option seems even less viable than unilateral state action to fix retail sales taxes and would not, on its own, lead to the adoption of a nationally harmonized broad-based tax on household consumption in the United States. See generally, Robert Cline & Steven Wlodychak, Federal Tax Reform: Lessons from the States 537, State Tax Notes (Feb. 13, 2012).

FIGURE 29.

	List of OECD/G20 Nations in 2018		List of OECD/G20 Nations with subnational taxes on general consumption	List of OECD/G20 Nations with primary tax on general consumption at the subnational level
Argentina	Greece	Poland	United States	United States
Australia	Hungary	Portugal	India	
Austria	Iceland	Romania	Brazil	
Belgium	India	Russia	Argentina	
Brazil	Indonesia	Saudi Arabia	Canada	
Bulgaria	Ireland	Slovak Republic		
Canada	Israel	Slovenia		
Chile	Italy	South Africa		
China	Japan	South Korea		
Croatia	Latvia	Spain		
Cyprus	Lithuania	Sweden		
Czech Republic	Luxembourg	Switzerland		
Denmark	Malta	Turkey		
Estonia	Mexico	United Kingdom		
Finland	Netherlands	United States		
France	New Zealand			
Germany	Norway			

The cornerstone of the Canadian model is the creation of a national consumption tax . . . to coexist with the subnational system . . .

reliance on general consumption taxes, sales tax revenues in the United States have been flat when measured either as a share of all state taxes (about one-third) or as a share of all federal, state, and local taxes (about 1/12).[191] Supporters of a more fundamental transformation of state sales tax systems that satisfies the three key principles of an optimal consumption tax and reverses the dangerous imbalance between underutilized consumption taxes and overused income, payroll, and property taxes may need to look elsewhere.

4. Adopting the Canadian Hybrid National/State Consumption Tax Model

A fourth option is to adopt a hybrid national/state consumption tax like the Canadian model. While this option has not yet been tried in the United States, it has been reasonably successful in Canada to circumvent the difficulties of transforming sales and use taxes from within. Thirty years ago, Canada, with a federalist system much like the United States, began transforming a national manufacturers tax and nine independent provincial retail sales taxes into a hybrid tax model with a harmonized national/provincial Goods and Services Tax (GST). Today, residual provincial sales taxes are levied on only 20% of the population.

The cornerstone of the Canadian model is the creation of a national consumption tax, not to replace state sales and use taxes, but to coexist with the subnational system and encourage states to harmonize with a national tax base and uniform administrative rules. States that choose to conform to the national model would maintain their own tax rates and revenue stream but would avoid the

[191] For sales tax revenue as a share of state taxes, see Mikesell, supra note 44, at 783; Mikesell, supra note 85, at 1343–44. For sales tax revenue as a share of all taxes, see OECD, supra note 3, at tbl.5110.

All other major taxes widely imposed at the state level—the personal income tax, corporate income tax, unemployment insurance taxes, and the estate tax—have piggybacked on similar federal taxes as a starting point.

costs of administering their own sales and use tax systems. This model has the advantage of promoting harmonization of a broader base of household goods and services, exemptions for business inputs, and centralized and simplified administration without depending on state collaboration or federal preemptive regulation. States seeking greater sovereignty over taxes could opt partially or fully out of the system but would forgo any federal incentives designed to encourage harmonization. The national consumption tax rate could be kept low by international standards, like Canada's rate, and supplemented by the state tax rate and revenue stream. The Canadian model is also more scalable, with the capability to raise consumption tax revenues to balance and/or replace income, payroll, and property tax revenues.

While the notion of state partial or full conformity to a federal tax as a means to promote subnational tax uniformity may sound unique or even alien in the context of a sales tax, it has a long tradition in the United States with other state taxes. All other major taxes widely imposed at the state level—the personal income tax, corporate income tax, unemployment insurance taxes, and the estate tax[192]—have piggybacked on similar federal taxes as a starting point. In fact, federalism often works best when states can start with a uniform federal design and adjust as needed for local political and economic factors.

Federal individual and corporate income taxes were initially enacted temporarily in the United States in the 19th century and then on a permanent basis in 1913 after passage of the 16th Amendment authorized Congress to impose taxes on income without apportioning revenues among the states. With a few exceptions, state income taxes were enacted in the following decades, with two-thirds of the states adopting individual and corporate income taxes by 1940.[193] Both state individual and corporate income taxes were enacted with provisions conforming significantly to federal concepts of income, deductions, and exemptions. However, states have made modifications based on state-specific considerations such as income apportionment, tax rates, tax base adjustments, and tax credits.[194]

Similarly, state unemployment taxes are closely modeled after the federal unemployment tax and share both common tax base determinations and an intricate system of federal loans and federal credits to encourage state benefits. The Social Security Act of 1935 (Titles III and IX) established the joint Federal-State Unemployment Compensation Program. Four years later another federal act, the Federal Unemployment Tax Act (FUTA) of 1939, authorized the IRS to collect

---

192 EY, COST, & STRI, supra note 3. Property taxes are locally administered and therefore not included in a discussion of state administered taxes. A smaller state-level tax, the real property transfer tax, is also based on a similar federal-level "documentary" tax, before the federal tax was repealed in 1967. Advisory Comm'n on Intergovernmental Relations, *The Intergovernmental Aspects of Documentary Taxes* (Sept. 1964), https://library.unt.edu/gpo/acir/Reports/policy/A-23.pdf.

193 On federal income tax history, see W. Elliot Brownlee, supra note 183. On state individual income tax history, see Scott Drenkard & Richard Borean, When Did Your State Adopt Its Income Tax, Tax Found. (June 10, 2014). On state corporate income tax history, see Liz Emanuel & Richard Borean, When Did Your State Adopt Its Corporate Income Tax?, Tax Found. (June 19, 2014).

194 While states zealously guard their sovereignty over subnational taxes, the similarities between the federal and state income tax bases are still far more pervasive than the differences.

employer contributions for administration of state programs, and established a system of federal credits that incentivized states to adopt their own statutes with unemployment tax rates of at least 6%.[195]

Finally, state estate taxes have conformed to federal estate taxes for most of the last century. Unlike state income and unemployment taxes, most state estate taxes were enacted before the adoption of the federal estate tax in 1916. However, beginning in 1924 and continuing until 2005, the federal government offered a federal credit for state estate taxes, up to a certain amount. As a result, all fifty states created estate taxes generally conforming to the federal rules and designed to capture all of the revenue up to this threshold amount (*e.g.*, the "pick-up tax"). The states could do so without increasing any resident's tax liability. After the federal government phased out the credit between 2001 and 2005, the vast majority of states effectively repealed their estate taxes. As of 2020, only 12 states and D.C. still levy estate taxes, and most of these still replicate the structure of the old federal pick-up taxes.[196]

For consumption taxes, however, this federal/state model did not take root, largely due to historical accident. Unlike federal personal income, corporate income, unemployment insurance, and estate taxes, which generally preceded or preempted similar state-level taxes, state sales and use taxes were enacted beginning in the 1930s at a time when there was no federal-level general consumption tax. As a result, any subsequent legislation to create a broad-based federal consumption tax was typically viewed as an encroachment on state and local sovereignty over sales and use taxes, and an unnecessary expansion of federal governmental taxing authority (see analysis in Appendix Section 3, infra).

Ironically, harmonization of state sales taxes to a federal consumption tax, should one be enacted, would likely be less complex than harmonization of state corporate income taxes to federal corporate income taxes. With corporate income taxes, three of the most contentious issues where states have diverged significantly from the federal corporate income tax are composition of the filing group (*e.g.*, consolidated returns, mandatory unitary combined reporting, or separate returns); inclusion or exclusion of foreign source income; and the design of apportionment formulas to divide income among the states. However, none of these issues are as problematic with consumption taxes, assuming the tax base is limited to household goods and services and does not include business inputs. The filing group does not matter, just the location of the consumers. Foreign

---

195 Most state unemployment taxes follow FUTA directly or by reference including adoption of FUTA terminology such as "Wages," "Employer," "Employees," and "Covered employment." See generally, Social Security Act of 1935, Titles III, IX; Federal Unemployment Tax Act (FUTA) of 1939. The unemployment tax model for federal/state conformity is actually somewhat of a hybrid between Options 2 (seek federal preemptive legislation that mandates state harmonization and broadening of the sales tax base of household goods and services, exempts business inputs, and centralizes and simplifies tax administration) and 4 (implement a hybrid federal/state government consumption tax) in this Section.

196 Tax Pol'y Ctr, *How do state estate and inheritance taxes work?* (May 2020); Jared Walczak, State Inheritance and Estate Taxes: Rates, Economic Implications, and the Return of Interstate Competition, Tax Found. Special Report No. 235 (July 2017). For a good history of federal and state estate tax history in the United States, see Ian Shapiro & Michael Graetz, Death by a Thousand Cuts: The Fight Over Taxing Inherited Wealth (Princeton University Press, 2005).

There are few precedents anywhere in the world of a subnational income or general consumption tax that does not piggyback on a similar national tax.

source income is not an issue since imports are included and exports are excluded from the tax base. And the division of income among jurisdictions is typically resolved by "destination" sourcing rules that are less complex than income apportionment rules.

Indeed, a hybrid national/state consumption tax approach might help stabilize and preserve U.S. federalism. There are few precedents anywhere in the world of a subnational income or general consumption tax that does not piggyback on a similar national tax.[197] If states do not find a way to modernize state sales tax systems, the acute fiscal need for a broader-based tax on household consumption could eventually force enactment of a competing or preemptive federal consumption tax. Such an outcome would severely undermine state sovereignty over one of the states' main sources of revenue.

Regardless of its merits, adoption of a hybrid national/subnational consumption tax model in the United States would require public support for enactment of a national consumption tax to complement existing subnational sales tax systems. And formidable opposition—not just to enactment but even to consideration of a federal consumption tax—must be anticipated, even if enacted with a low rate like the Canadian GST's 5% rate. A change of this magnitude would require a major economic or political crisis to shake up the status quo.

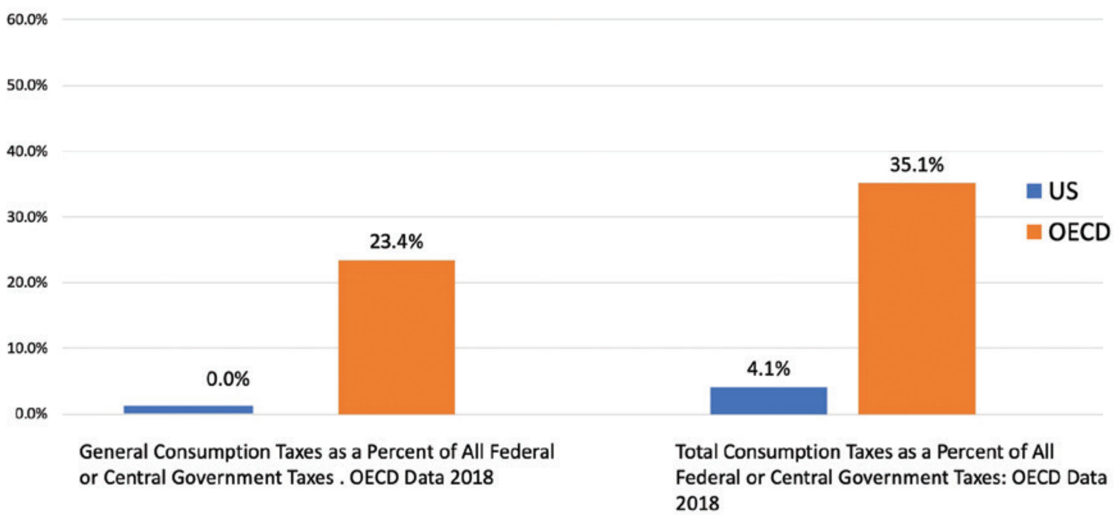
As discussed in Section I, the twin crises of the COVID-19 pandemic and the escalating federal debt crisis provide the most compelling rationale for comprehensive consumption tax reform in decades. In this brewing fiscal crisis, the absence of an efficient and effective broad-based tax on household consumption at the federal government level could place U.S. tax policy in a straitjacket and heavily slant tax policy options toward an even greater overreliance on income and social insurance taxes to reduce short-term government deficits or long-term government debt. At the national (federal) level, the United States relies for its primary sources of revenue (92%) on a precarious two-legged stool (income and social insurance taxes), rather than the balanced three-legged stool (income, social insurance and consumption taxes) of other OECD nations. General consumption tax revenues make up 0% of federal taxes in the United States compared to a 23.4% average in the OECD nations. Total consumption taxes (including taxes on specific goods) make up only 4.1% of federal taxes in the United States compared to a 35.1% average in the OECD nations (see Figure 30).[198]

This structural flaw in the U.S. tax system could both make it politically difficult to raise sufficient revenues to fund government programs and hinder economic stability, because consumption taxes, as noted, are widely recognized as one of the

197 Of the forty-nine countries that are members of the OECD and/or G20, only three countries (other than the United States) impose subnational general consumption taxes that do not piggyback on national consumption taxes, and none of these countries rely on subnational taxes as their primary general consumption tax. EY, supra note 139. Of these fifty-one countries, nine (including the United States) impose subnational corporate income taxes, and all of these subnational taxes conform in whole or in part to national corporate income taxes. PwC, supra note 189.

198 The OECD data is from: OECD, supra note 3, tbls.5000, 5110 (federal or central government level statistics). See tbl.2000 for the social insurance (social security) statistics. The OECD separates social security taxes from the federal/central government totals so the two are combined for purposes of this comparison. The U.S. data is from CBO, supra note 22, at 91 tbl.4-1.

FIGURE 30. CONSUMPTION TAXES AT THE FEDERAL/CENTRAL GOVERNMENT LEVEL



. . . **consumption** taxes . . . are widely recognized as one of the better ways to raise revenue without deterring economic growth.

better ways to raise revenue without deterring economic growth.[199] The advisability and scope of a federal level consumption tax will become clearer as the extent of the short-term and long-term fiscal crises crystallize and remedial alternatives are under consideration.[200] If support for a hybrid federal/state consumption tax model gains traction, it will coalesce around a broader set of goals than just fixing broken state sales tax systems. Timing is important, however, as the Canadian experience makes clear that state government harmonization to a newly enacted national consumption tax would likely occur over a prolonged period.

Economists generally agree on two overriding consumption tax characteristics:

- Well-designed general consumption taxes are more economic growth-friendly (or neutral) than income, social insurance, or property taxes.
- A VAT is a more efficient and effective general consumption tax than a retail sales tax.

However, the key tax policy question in the United States is not whether a VAT is a better designed tax, but whether it is feasible or desirable to replace or supplement the current U.S. retail sales tax systems with a hybrid national/state consumption tax. To that end, the transformation of the U.S. consumption tax system is likely to occur only if the following conditions are met:

---

199 Indeed, discussions by tax luminaries regarding the need for a federal consumption tax are more frequently appearing in the tax press. See comments of Pam Olson, Washington National Tax Services Practice leader, PwC, in Rep. Richard E. Neal et al., Neal, Olson, Mazur Evaluate Economic Relief Measures and What More Is Needed: Transcript, Tax Notes Int'l (June 22, 2020); See also Gale, supra note 40; Robert Goulder, About That Deficit: VAT Dreams and Virus Economics 601, Tax Notes Int'l (May 4, 2020).

200 While a hybrid national/state consumption tax model may be politically unpopular, if the alternative is severe cuts in government spending (including reductions in Social Security), unsustainably higher marginal tax rates on corporate and personal income, new taxes on property and wealth, escalating government debt, and/or the risk of high inflation, then the option may gain traction.

- The United States adopts a hybrid federal/state general consumption tax system similar to the Canadian system, and not a stand-alone national-level or state-level VAT, that is compatible with the U.S. federalist system and state sovereignty over sales tax revenues.
- Consumption tax reform is coupled with measures such as income tax credits for low-income households to address the tax regressivity issue.
- A small business registration exemption is included to protect small businesses from the compliance burden of the new tax system.
- The new hybrid federal/state consumption tax system is perceived as the least objectionable of the unattractive options to reduce government debt; align federal revenues with federal spending; redesign obsolete state sales tax systems; and better balance income and social insurance taxes with consumption taxes in the overall U.S. tax mix.

CONCLUSION

SECTION 5

This study underscores the enormous gulf between the limited reliance on consumption taxes in the United States and their extensive use in other industrialized nations. Worldwide consensus exists—except in the United States—regarding the importance of a well-designed and broad-based tax on household consumption that balances and supplements other sources of tax revenue. To that end, no advanced nation other than the United States relies on retail sales and use taxes—heavily dependent on taxing business inputs—as its primary consumption tax. And no advanced nation relies less on consumption taxes as a share of all taxes than the United States. These two characteristics animate an overall tax system that is dangerously imbalanced, and without a broad-based revenue source that can generate significant revenue while minimizing impacts on economic growth and international competitiveness.

. . . no advanced nation relies less on consumption taxes as a share of all taxes than the United States.

This study shows that the uniquely American approach to consumption taxes is deeply rooted in a strong tradition of subnational government sovereignty over sales and use taxes. The structural design defects of state retail sales tax systems make it difficult to reform such systems incrementally from within. Faced with the challenges of increased demand for government spending and rising federal debt levels, the United States will reach a fiscal crossroads with potentially debilitating consequences if it does not transform its obsolete 90-year-old sales tax system and develop a truly world-class general consumption tax system. Ultimately, U.S. policymakers may continue the current approach, relying increasingly on income, social insurance, and property taxes and less on consumption taxes than any other advanced nation. However, unless current state sales tax systems are replaced with a different general consumption tax model, that outcome will occur not by choice, but by default.

APPENDIX: LESSONS LEARNED FROM THE HISTORICAL DEVELOPMENT OF GENERAL CONSUMPTION TAXES IN THE EU, CANADA AND THE UNITED STATES

The requirement that every member switch to a VAT was made primarily for economic efficiency and tax harmonization reasons.

A. DEVELOPMENT OF THE EU VAT

The adoption of a VAT by the EU nations occurred over a twenty-year period, from 1958, at the beginning of the European Union and its predecessor the European Economic Community (EEC), to 1977, when a harmonized VAT was mandated in the European Union. The EEC did not initially require every Member State to adopt a VAT. In fact, none of the original six members of the EEC (France, Germany, Italy, Belgium, Luxembourg and Netherlands) levied a national VAT when they joined the Commission, although France implemented one soon thereafter. As was common at the time, all of these countries had a mix of consumption taxes that included retail sales taxes, turnover (gross receipts) taxes, and taxes on specific goods and services.

From the beginning, the original members of the EEC instructed the Commission to consider "how the legislation of the various Member States concerning turnover taxes, excise duties and other forms of indirect taxation including countervailing measures applicable to trade between Member States can be harmonized in the interest of the common market."[201] The requirement that every member switch to a VAT was made primarily for economic efficiency and tax harmonization reasons.

Existing taxes on general consumption—the turnover tax and the retail sales tax—were widely criticized for their detrimental impact on economic growth arising from reliance on extensive "cascading" of taxes—essentially taxing both business inputs and consumer purchases.[202] Conversely, the VAT, by its design, avoided the cascading of taxes by providing credits for taxes imposed on business inputs, thereby placing the ultimate incidence of the tax on the final household consumer.[203]

Another benefit of the switch to the VAT was to allow countries to consolidate and rationalize disparate consumption tax systems, replacing an assorted mix of other

201 Terra, supra note 147, at 1.

202 Id. at ch. 1. A turnover tax is similar to a VAT, with multiple stages of collection, except that it typically does not allow credits for taxes paid in earlier stages. Thus, like a retail sales tax, it ends up taxing intermediate and capital goods. According to John Due, the author of one of the leading treatises in the 1950s on government finance and taxes, "The fundamental objection to the turnover tax is its severe discrimination against nonintegrated production and distribution systems." Due noted that the tax burden depended arbitrarily on how many times a product turned over, making border adjustments for imports and exports problematic. Due, supra note 43, at 322. See also Mikesell, supra note 85.

203 One of the EEC Committee Reports at the time, analyzing the type of consumption tax that should be adopted to further the establishment of a common market, summarized the defects of cascading as follows: "It causes distortion of competition within the national economies where it is applied and artificially promotes the concentration of enterprises, but, in addition, it distorts the international trade regulations because of the impossibility of calculating exactly the overall charge of the turnover tax burden on the specific commodity . . . . " Terra, supra note 147, at 2.

taxes on general and specific consumption with a VAT that taxed a much broader and harmonized range of household consumption of goods and services than its predecessor taxes.

The principle of the EU VAT as a tax on final consumption was enshrined in the First VAT Directive in 1967, which instructed Member States to replace their present turnover taxes no later than January 1, 1970 with a VAT.[204] By 1973, the nine members of the EEC had all adopted VATs, but had adopted nine different versions with significant differences in provisions relating to the retail stage, exemptions, deduction of taxes on imports, and the treatment of services across borders.[205] In the ensuing years, the EEC adopted additional directives that mandated more uniformity among the Member State VATs. Finally, in 1977, the Council of the European Communities harmonized the VAT systems of its Member States by issuing the Sixth Directive to provide a uniform basis of assessment.[206]

The extensive harmonization of the EU VAT does not mean that the European Union adopts the broadest or most uniform possible VAT base of household goods and services (see Section II.A, infra). Politics frequently intrude on theoretical norms, and that certainly occurs with the EU VAT. The many exemptions allowed by EU VAT rules reduce the breadth of the VAT base. The frequent use of reduced rates by EU Member States for many basic necessities purchased by lower income households reduces both the breadth and uniformity of the EU VAT tax base. Other OECD nations chose to have a broader VAT base than the EU average of 56% including New Zealand at 99% and Japan at 72%.[207] Nonetheless, the EU VAT base is still much broader and more uniform than the average U.S. state sales tax base (37%).[208]

The harmonization of the EU VAT was just one of many harmonized rules in the European Union relating to tax, trade, immigration and commerce that facilitated the common market approach.[209] The underlying goal of the common market was to create an economic union of sufficient scale and unity to facilitate European competition with other Great Powers including the United States. The ability of the twenty-seven Member States of the European Union to reach accord on so many economic and social issues, including consumption taxes, is remarkable because

---

204 First Council Directive 67/227, art. 1, 1967 O.J. Spec. Ed. 14, 15 (EEC).

205 Terra, supra note 147, at 6.

206 Under EU law, Member States are not permitted to adopt any other taxes on general consumption, but can maintain taxes such as charges on specific goods and services that cannot be characterized as consumption taxes that have the essential characteristics of VAT. Article 401 of the VAT Directive states: "Without prejudice to other provisions of Community law, this Directive shall not prevent a Member State from maintaining or introducing taxes on insurance contracts, taxes on betting and gambling, excise duties, stamp duties or, more generally, any taxes, duties or charges which cannot be characterized as turnover taxes, provided that the collecting of those taxes, duties or charges does not give rise, in trade between Member States, to formalities connected with the crossing of frontiers." Council Directive 2006/112, supra note 47, at art. 401.

207 OECD, supra note 62, at 96–97.

208 OECD, supra note 62, at 96–967; EY, supra note 3, at 6; Mikesell, supra note 43, at 395.

209 In the Single Market, people, goods, services and capital move freely around the European Union - almost as freely as within a single country. The European Union considers that "The Single Market is a powerful engine of our prosperity and wealth, our industry's competitiveness and our continent's standing and influence in the world." *The Single Market: Europe's best asset in a changing world,* COM (Mar. 2019). Council Decision 70/243 of 21 April 1970, gave the European Union financial autonomy and for the budget to be entirely financed from own resources. This was done by replacing Member States' financial contributions by the European Union own resources system, and with the introduction of a VAT-based resource. *Value added tax-based own resource,* COM, (last visited July 30, 2020), https://ec.europa.eu/info/about-european-commission/eu-budget/revenue/own-resources/value-added-tax_en.

earlier in the 20th century many of the same countries were on opposite sides in two horrific World Wars. The success of the European Union in harmonizing its VAT rules also stands in stark contrast to the forty-six subnational state governments in the United States which impose a sales tax on substantially different bases, with little uniformity of rules and processes.

1. Worldwide Adoption of VATs

EU nations were in the forefront of the global shift toward more reliance on general consumption taxes, and on a VAT in particular. In 1965, taxes on general consumption made up 11.9% of all taxes in OECD nations, or about one-third of all consumption taxes. By 2018, taxes on general consumption made up 22.3% of all taxes in OECD nations or about two-thirds of all consumption taxes. The VAT displaced other less efficient taxes on specific goods and services or less effective taxes on general consumption. The VAT increased from 2.2% of all taxes in 1965 (or about one-fifth of all taxes on general consumption) to 20.2% of all taxes in 2018 (or over nine-tenths of all taxes on general consumption).[210]

The trend to adopt VAT systems was not limited to the European Union and the OECD nations. The trend soon became a worldwide phenomenon. Indeed, perhaps the single most important and widespread development in global taxation over the last fifty years has been the adoption of taxes on general consumption in the form of VATs. In the 1960s, only about ten nations imposed a VAT. Currently, 168 countries levy a VAT (see Figure 31).[211]

The VAT systems in non-EU and non-OECD countries have a wide range of tax rates, tax bases and administrative rules. There is no harmonization of the tax base among these 125+ countries as there is with the EU VAT. Some countries such as Brazil have very complicated consumption tax systems. However, all of these non-EU general consumption systems share two crucial characteristics of a VAT—the primary focus on taxing a broad range of household goods and services, and the exemption (or credit) for business inputs.

B. ADOPTION OF CANADA'S GST AND HST

In 1991, Canada adopted a national VAT, called a Goods and Services Tax (GST). At the time, Canada levied a national-level manufacturers' sales tax imposed at the wholesale level on manufactured goods. In addition, nine of the ten Canadian provinces imposed provincial-level retail sales taxes. To understand why Canada replaced its manufacturers' sales tax[212] with the GST and subsequently encouraged provinces to eliminate their provincial sales and use tax systems and harmonize with the federal GST/Harmonized Sales Tax (HST), it is useful to put these transitions into historical context. From the mid-1970s to the early 1990s, Canada was fiscally adrift.

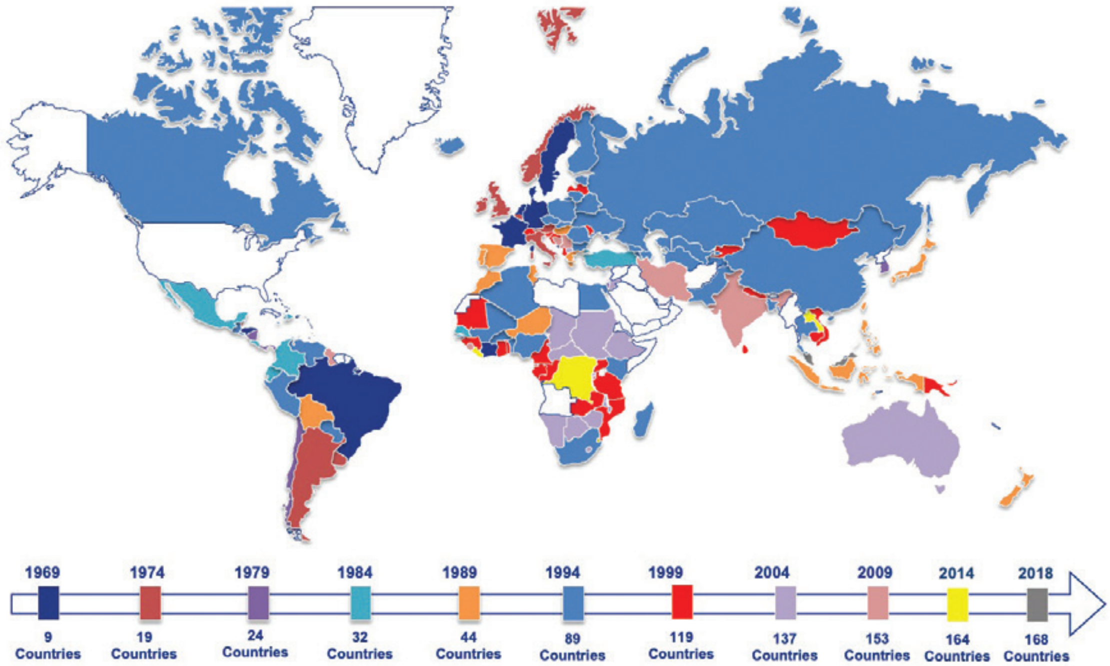
---

210 The 1965 and 2018 statistics are from OECD, supra note 3, at tbls.5110, 5111, 5120 measured by share of total taxation.

211 As the OECD noted in a 2010 publication, "It is probably unprecedented in the long history of taxes that a specific, and somewhat conceptually complex, tax mechanism has spread around the world in less than a half century." OECD, Consumption Tax Trends 2010: VAT/GST and excise rates, trends and Administration issues 64 (OECD Publishing, 2011).

212 The manufacturers' sales tax was a 13.5% tax that the federal government imposed at the wholesale level on manufactured goods.

FIGURE 31. VAT ENACTMENTS TIMELINE



Source: OECD Consumption Tax Trends 2018, pages 194-197

The federal government was running annual deficits that, by the mid-1980s, were totaling more than 8% annually of the country's annual gross domestic product; in 1985, Canada recorded a record annual deficit of $37 billion.[213]

The Canadian federal government, particularly the federal Department of Finance, knew that deliberate steps were needed to rein in the federal government's deficit and debt. A multipronged approach was required, which included everything from reducing and controlling government spending, modernizing Canada's transportation and telecommunications infrastructure, opening up foreign markets to Canadian exports through free trade agreements such as the North American Free Trade Agreement, and "nationalizing" the Canadian federal debt by replacing government debt held by foreigners with debt held by Canadians.

A key component of the federal government's fiscal plan was tax reform. At the time, Canada was a small, open, export-based economy of only 28 million people. The Canadian government understood that relevance in the global economy required the creation of a tax system that encouraged, rather than discouraged, business and innovation. From a tax policy perspective, the plan was simple: (1) reduce, and where possible, eliminate cascading taxes on capital and business inputs (such as those embedded in the national manufacturers' sales tax and provincial sales and use taxes);

213 Those annual deficits were further causing the Canadian federal government's debt to balloon to more than 50% of Canada's GDP. The cost of servicing that debt—paying the interest charges on that debt—only augmented the problem. By the mid-1990s, the Canadian federal government's debt-to-GDP ratio reached a high of 68.4%. For a good history of the Canadian transition to a GST/HST model, see Bird, supra note 134.

Canada's adoption of the GST in the early 1990s, after the initial wave of EU-country VAT enactments, occurred for a very similar reason—to increase the economic efficiency and international competitiveness of the Canadian tax system by eliminating the cascading of taxes . . .

(2) tax consumer consumption, not business consumption; and (3) reduce reliance on corporate income taxes.

A key advantage of the GST over sales and use taxes and other forms of consumption taxes is that the GST increases the competitiveness of domestic businesses in the international marketplace by eliminating tax cascading throughout the domestic production process.[214] Studies in the 1980s found that the business inputs share of the national manufacturers tax was about one-half and the business inputs share of the provincial sales taxes was between one-third and one-half. [215] In fact, given the extent the Canadian economy relies on international exports to foster economic growth, one of the principal reasons the federal government chose to replace the antiquated manufacturers' sales tax with a VAT was to enhance the international competitiveness of Canadian businesses.

The beneficial economic impact of reducing sales taxes on business inputs in Canada is described in a 2004 study by the Canadian Federal Department of Finance. At the time, Canada had utilized a national GST for over ten years, but was still trying to encourage additional provinces, including the key province of Ontario (roughly 40% of Canada's population), to harmonize provincial sales taxes with the national GST. The study examined the principal bases of taxation in Canada and estimated the impact on the economy in general of a reduction in each type of tax. The key finding of the study was that reducing taxes on business inputs and investments has a significantly greater positive effect on economic prosperity than reducing taxes on wages and consumer spending. Figure 32 sets forth the results of the Canadian Department of Finance's study.[216]

With respect to sales taxes, the results of the Department of Finance's study are clear: reducing sales taxes on capital goods and business inputs is among the most beneficial impacts on long-term economic well-being. By comparison, increasing or decreasing consumption taxes on household consumption has the least impact on improving or reducing long-term economic well-being. The study's conclusions are consistent with the results of other Canadian and international studies.[217]

2. Canada's Evolution to a Hybrid GST/Harmonized Sales Tax System

Canada's adoption of the GST in the early 1990s, after the initial wave of EU-country VAT enactments, occurred for a very similar reason—to increase the economic efficiency and international competitiveness of the Canadian tax system by eliminating the cascading of taxes caused both by the national manufacturers tax and provincial retail sales taxes (in provinces that chose harmonization).

The Canadian government's initial plan was to create a national GST and encourage the nine Canadian provinces to concurrently replace provincial-level retail sales

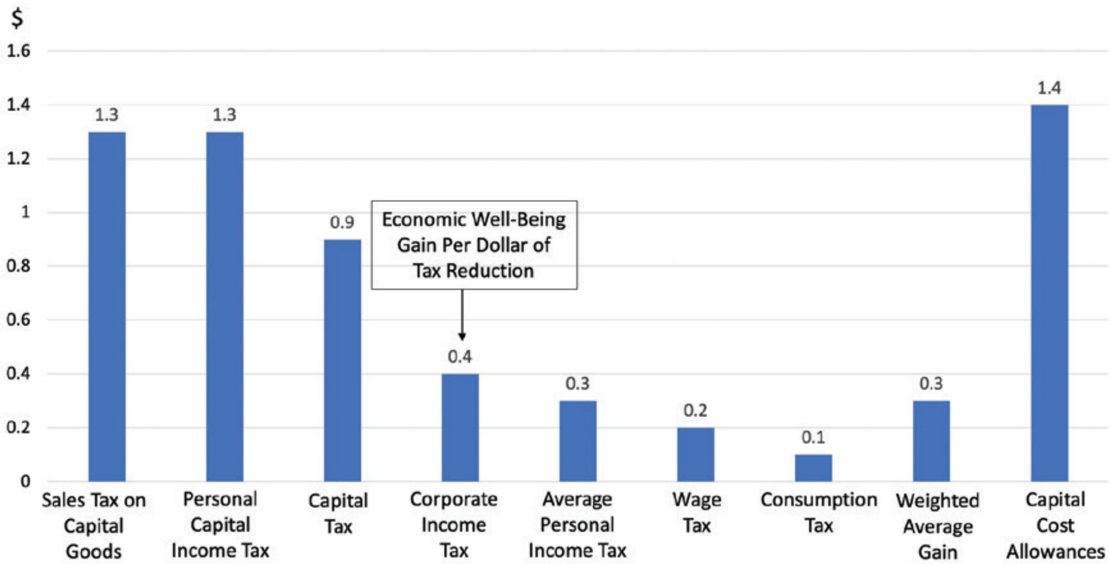
214 While both GSTs and sales and use taxes generally exempt sales made for export from tax, under a sales and use tax system, the tax cascades through the production process, becoming a cost to domestic businesses at each stage of production, and thereby increasing their domestic selling price. This increases the cost of products and services sold for export, making it more difficult for domestic businesses to compete internationally.

215 See Bird, supra note 134, at 5; Bird, supra note 116, at 815.

216 Dep't of Fin. Can., Tax Expenditures and Evaluations 71 (2004), https://www.canada.ca/content/dam/fin/migration/taxexp-depfisc/2004/TaxExp04_e.pdf.

217 Id.

FIGURE 32. LONG-RUN ECONOMIC WELL-BEING GAIN FROM REVENUE-NEUTRAL TAX REDUCTIONS*



*The revenue loss is assumed to be recovered through lump-sum taxation.

tax systems with a single, national harmonized GST. However, discussions and negotiations between the federal government and the provinces broke down. Among the provinces, only Quebec chose to replace its provincial retail sales tax with a provincial VAT (called the Quebec Sales Tax or QST). Between 1991 and 1997, Quebec, while maintaining its own QST statute, harmonized its consumption tax base and rules to the national GST. It did not harmonize its administration. In the two decades that followed, five Canadian provinces eliminated their provincial sales and use taxes and "harmonized" with the federal GST system to create the HST. This process last progressed in 2013, when Prince Edward Island adopted a harmonized sales tax, three years after the largest province (Ontario) harmonized with the national GST in 2010.[218]

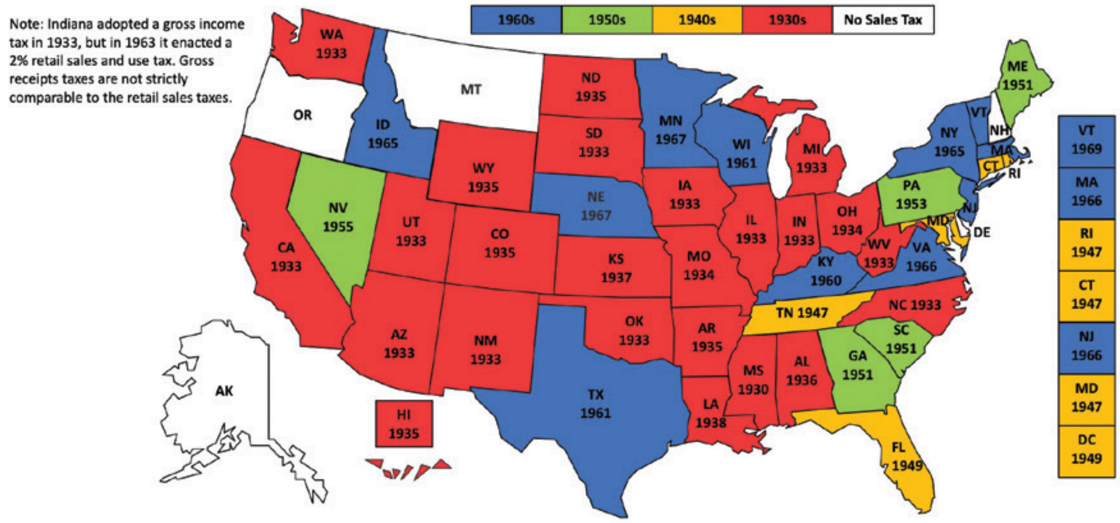
C. HISTORICAL DEVELOPMENT OF U.S. STATE SALES TAX SYSTEMS

1. Enactment of State Sales Tax Systems in the 1930s and 1940s

Economic disruption is often the father of significant tax reform, and the U.S. economy is no exception, particularly as to state adoption of sales taxes. States began enacting sales tax systems during the nadir of the Great Depression in response to a number of coalescing factors: unprecedented decreases in property values (and corresponding property tax revenues), underperformance of federal and state income taxes, and increased spending mandates imposed on states by the federal government. Mississippi is credited with adoption of the first state sales tax in 1930, but twenty-three other states followed suit over the ensuing decade (see Figure 33). As states realized that retail sales taxes could raise large amounts of revenue through a low rate

[218] Initially, British Columbia harmonized to the GST in 2010, but returned to a provincial sales tax in 2013.

FIGURE 33. MOST SALES TAX STATUTE ENACTMENTS PRE-DATE THE GROWTH OF SERVICES



Source: *Significant Features of Fiscal Federalism: Budget Processes and Tax System*, Vol. 1, 1994

and a relatively painless and straightforward collection method (per transaction), they continued to grow in popularity. In the 1940s, six more states imposed a sales tax, five more in the 1950s, and eleven in the 1960s. In 1969, Vermont became the most recent state to adopt a broad sales tax. Today, only five smaller population states—Alaska, Delaware, New Hampshire, Montana, and Oregon do not levy general sales taxes, although Alaska and Montana (to a lesser degree) allow elective imposition of purely local sales or "tourism" taxes on certain retail purchases.[219]

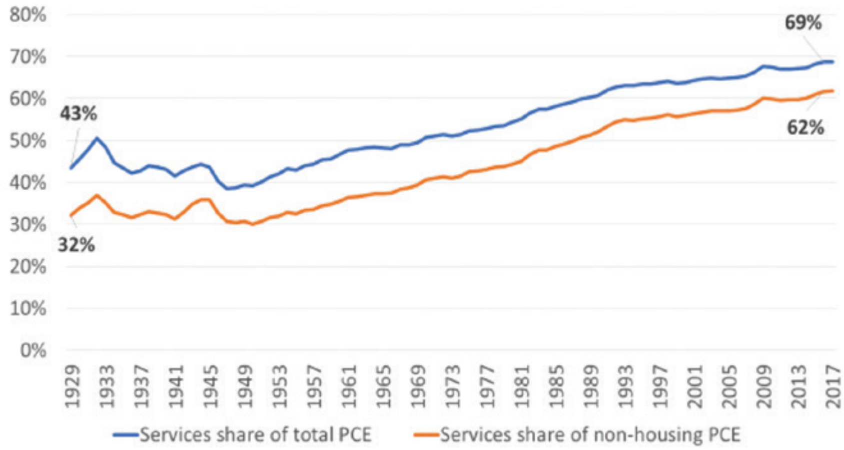
Most state sales tax systems were adopted during a time in American history when economic activity was primarily local and overwhelmingly based on the manufacture and sale of tangible goods. As a result, modern-day state sales tax systems reflect their origins in three significant ways. First, they were adopted without much regard to conformity with administrative rules, product definitions, tax rates, and exemptions provided by other states. Indeed, the U.S. system of federalism provides states with plenary authority to tax economic activity within their borders, and since very little commerce was conducted on an interstate basis when sales taxes were adopted (and at the time interstate commerce was legally exempt from state taxation), little consideration was given to administrative coordination, harmonization of processes, or uniformity of definitions or tax bases between states.

Second, state sales tax statutes were generally drafted to tax all tangible property (unless exempted) and to exempt everything else (*e.g.*, consumer services) unless specifically enumerated as taxable. This was not much of a problem when the primary

---

219 On the historical development of the sales tax, *see generally:* John Due & John L. Mikesell, Sales Taxation: State and Local Structure and Administration (Johns Hopkins Univ. Press, 1983). In addition, New Hampshire has adopted a unique "Business Enterprise Tax"—an entity-level tax imposed on a value-added tax base. See Stan Arnold & William F.J. Ardinger, Top Ten Reasons Why New Hampshire's BET May Provide an Answer to State Tax Reform, State Tax Notes (Nov. 29, 2004).

FIGURE 34. SERVICES AS A SHARE OF TOTAL PERSONAL CONSUMPTION EXPENDITURES, 1929–2017



The Impact of Imposing Sales Taxes on Business Inputs, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (June 2019)

economic engine in the United States was the manufacture and production of tangible goods, but it has created political and practical issues as the service sector has grown over the past fifty years (see Figure 34). Taxation of services has proved difficult for states, because adding services incrementally, as contrasted to the VAT default method that includes all services in the tax base from the outset, is problematic from a definitional and sourcing standpoint, and often results in overreach by capturing business-to-business services in the tax net.

Third, as with the design of virtually all retail sales tax systems throughout the world during the 20th century, the state sales tax base included not only household consumption of goods, but also many business purchases of tangible property including materials, tools, and machinery used in the production, distribution, or retail sale of many consumer goods and services. This development was not surprising because a retail sales tax system contains no built-in mechanism to exempt or credit business inputs as does a VAT. Nonetheless, while initially the taxation of business inputs may have been less of a problem when the economy was still largely intrastate, it became a much larger problem as the economy shifted to interstate and international commerce. In that context, the fact that U.S. sales tax systems rely on cascading revenues derived from the taxation of business inputs for over two-fifths of the collective tax base undermines the efficiency and efficacy of sales taxes.

2. Early 20th Century Reliance on Federal Consumption Taxes on Specific Goods

The early adoption of sales taxes at the subnational level in the United States during the 1930s and 1940s certainly explains why state and local retail sales taxes became the primary tax on general consumption. But it does not fully explain why the United States failed to adopt changes sweeping the rest of the world that led to the creation of better-designed and broader-based taxes on

Ironically, consumption taxes in the United States were utilized first on an expansive basis at the national level, not the state and local level. . . . In 1910, consumption taxes on specific goods accounted for 88% of all federal tax revenues.

general consumption that more efficiently and effectively balance the composition of taxes by raising two and one-half times as much tax revenue as a percent of all taxes than state retail sales tax systems.

Several options were available to the United States that might have altered this historical trajectory. At the federal level, the United States could have followed the lead of other countries and adopted a general consumption tax to supplement or replace state sales tax systems. Since the 1950s, national VATs and hybrid national/subnational VATs had spread across the globe, replacing older and less efficient models of general consumption taxes (*e.g.*, retail sales taxes and turnover taxes). But the United States remained an intransigent outlier, the only nation in the world still relying on an obsolete retail sales tax at the state and local level as its primary general consumption tax.

Ironically, consumption taxes in the United States were utilized first on an expansive basis at the national level, not the state and local level. Prior to ratification of the 16th Amendment to the Constitution and enactment of a permanent federal corporate and individual income tax in 1913, the federal government relied primarily on consumption taxes for revenue. In 1910, consumption taxes on specific goods accounted for 88% of all federal tax revenues. By 1920, consumption taxes had fallen to 12% of all federal tax revenues, as income taxes became the primary source of federal government receipts. While the composition of federal revenues fluctuated over time, since the 1940s consumption taxes have never again accounted for a significant share of federal revenues and have averaged less than 10% of federal tax revenues over the last four decades. In 2018, consumption taxes made up only 5% of federal tax revenues.[220] (See Figure 35)

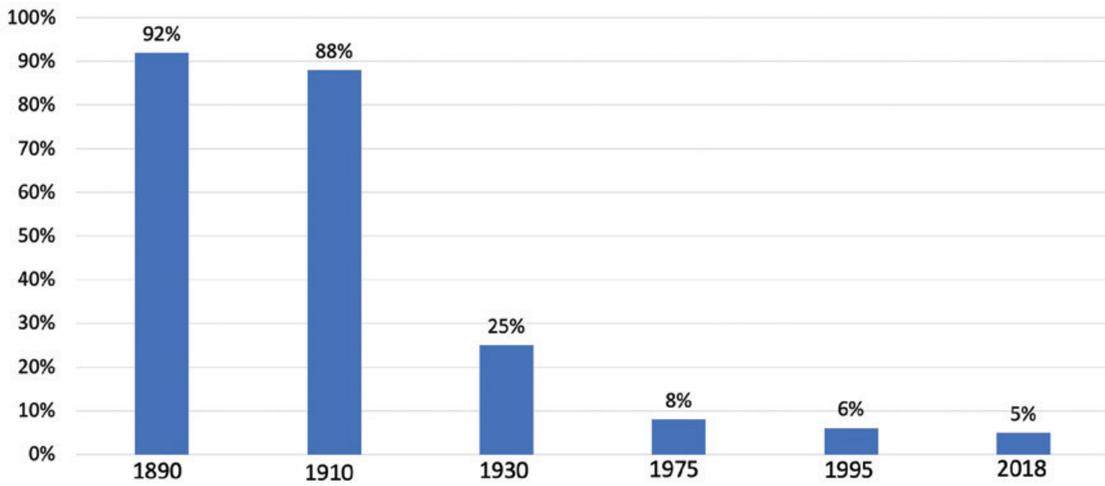
The displacement of consumption taxes by income taxes (and later payroll taxes) at the federal level was, in large part, due to widespread political opposition to consumption taxes in the late 19th and early 20th centuries. At the time, the federal government imposed no broad-based general consumption tax and instead relied almost exclusively on import duties on numerous products (*e.g.*, metals, chemicals, sugar, clothing materials, wooden wares) and narrowly based excises on a small number of products (*e.g.*, alcohol and tobacco). There was a growing perception (backed by contemporaneous studies) that import duties and tariffs were manipulated by domestic political interests, and excise taxes fell disproportionately on low and modest-income households.[221]

Legal historian Ajay K. Mehrotra summarized the switch from import duties and excise taxes as follows: "From the beginning, the late-nineteenth century social movement for fundamental tax reform was driven by populist and progressive calls for a more egalitarian fiscal system. By replacing the national structure of regressive, hidden, disaggregated, and politicized consumption taxes with graduated, transparent, centralized, and professionally administered taxes, revenue reformers were seeking to force those segments of society that had the greatest taxpaying

220 Consumption tax statistics for 1880, 1910, 1920 and 1930 are from: Ajay K. Mehrotra, Making the Modern Fiscal State: Law, Politics and the Rise of Progressive Taxation, 1877–1929 7 (Cambridge University Press, 2013). Consumption tax statistics for 1975, 1995, and 2018 are from OECD, supra note 3, at tbl.5000.

221 Mehotra, supra note 220, at Introduction.

FIGURE 35. CONSUMPTION TAXES AS PERCENT OF ALL FEDERAL GOVERNMENT TAXES IN THE UNITED STATES



ability—namely, wealthy individuals and corporations in the Northeast—to share the burden of funding the demands of a modern, industrial state."[222]

The strong political reaction against regressive consumption taxes on specific goods and services and later against the idea of a national sales tax was a hallmark of Democratic Party tax policy during the Progressive era (President Woodrow Wilson) and the New Deal (President Franklin D. Roosevelt). Under pressure to pay for New Deal social programs, President Roosevelt relented and temporarily increased excise taxes on alcohol, liquor, tobacco, and gasoline to supplement federal income tax revenues. But he held firm against national sales taxes, preferring to expand taxes based on the concept of "ability to pay."[223] During the Republican administrations from 1920 to 1932, the issue of enacting a national sales tax was repeatedly raised, with some high-level support from leading Republicans and Democrats. But ultimately the federal government focused on making changes to federal income taxes and selective use of excise taxes.[224]

3. Historical Impediments to U.S. Efforts to Create Broad-Based Consumption Taxes at the Federal Level

Early 20th century tax history explains **how** the transition from federal consumption taxes occurred, but it does not fully explain **why** the United States did not reconsider this trend and follow the post-World War II pattern of other advanced nations by creating a more robust general consumption tax to balance the composition of taxes. Indeed, numerous economic and political factors, some

222 Id. at 12.

223 Brownlee, supra note 188, at 120–122 (on Roosevelt), 95–106 (on Wilson). For more on Roosevelt's opposition to a national sales tax, see Frank Freidel, Franklin D. Roosevelt: Launching the New Deal 51–59, 446–51 (Little Brown & Company, 1973).

224 Brownlee, supra note188, at 106–20; Freidel, supra note 223, at 106–120. When early versions of a national sales tax were introduced in the 1920s, a divided business community, uncertain of the impact of the new taxes, did not fully support them. Ajay K. Mehrotra, *The Myth of the "Overtaxed" American and the VAT That Never Was,* 2 Mod. Am. Hist. 97–102 (2019).

In the U.S., the complete absence of any model of a general consumption tax at the federal level precluded its replacement with a more modern consumption tax.

unique to the U.S., account for the continued absence of a modern broad-based consumption tax at the federal level in the United States.

First, rejection by the Wilson, Roosevelt, and intervening Republican administrations of a national sales tax between 1913 and the end of World War II led to a divergence between the United States and the majority of other advanced nations that developed broad-based consumption taxes at the national level during the 20th century prior to the introduction of VATs. These first-generation retail sales taxes and turnover (gross receipts) taxes in other countries were inefficient and overly reliant on taxing business inputs. However, as interest in the adoption of more efficient and effective general consumption taxes (VATs) developed after World War II, these other nations were well positioned to modernize and replace existing consumption taxes without having to create wholly new national taxes.[225]

Turnover taxes and sales taxes levied by the national government were a major source of revenue in European countries after World War II. Of the nine European countries with national turnover taxes in 1965, the share of turnover taxes of total government revenues averaged 15.5%.[226] When the European Economic Commission (the forerunner of the European Union) was created in 1957, all six original members imposed national-level general consumption taxes, including five with turnover taxes (Belgium, Germany, Italy, Luxembourg and Netherlands) and one with a sales tax (France).[227] This greatly facilitated the transition of EU countries to national VATs in the late 1960s, as each of these countries substituted VATs for existing large national general consumption taxes, avoiding the need to create entirely new revenue streams. Similarly, consumption tax reforms in Canada in 1991 and India in 2017 both consisted, in large part, of modernizing and replacing outdated national consumption taxes as well as reforms to subnational consumption taxes (see Section IV, infra).[228]

In the U.S., the complete absence of any model of a general consumption tax at the federal level precluded its replacement with a more modern consumption tax. This historical outcome is particularly ironic since one of the two originators of the concept of a national consumption tax with an exemption for business inputs (VAT) was an American economist and tax expert named Thomas S. Adams. In 1921, Adams presciently advocated both for: 1) an improved version of a national consumption tax that avoided pyramiding of tax "by giving the tax the form of a sales tax with a credit or refund for taxes paid by the producer or dealer (as purchaser) on goods bought for resale or for necessary use in the productions of goods for sale;" and 2) a better balance between taxes based on fairness and equity (income taxes) and

[225] See supra Figure 25. See Appendix, Sections 1 and 2, infra. For the majority of advanced nations with a unitary rather than federalist system of government, consumption taxes were only possible at the national level since there was no subnational state or provincial taxing power. Even in the minority of other advanced nations with a federalist or regional system of government (e.g., France, Australia, Germany, and Spain), national consumption taxes developed alongside subnational ones, similarly allowing for evolutionary rather than radical consumption tax reform and modernization. In the OECD, eight countries have federalist systems with state/provincial level taxation (Australia, Austria, Belgium, Canada, Germany, Mexico, Switzerland, and the United States) and one has a regional system (Spain). OECD, supra note 15, at tbl.3.17.

[226] OECD, supra note 3, at tbl.5113.

[227] OECD, supra note 3, at tbl.5113. See also supra Figure 25.

[228] In Canada, the first federal sales tax was introduced in 1920 and replaced by the federal-level Manufacturer's Sales Tax (MST) in 1924. By 1936, the MST accounted for 31% of all federal revenues, although that share fluctuated in future decades. In 1991, the MST was replaced with the GST in Canada. Bird, supra note 134, at 3–5.

those based on administrative simplicity and economic efficiency (a well-designed national sales tax).[229]

Second, taxes on general consumption grew rapidly in the United States during the 1930s, but only at the subnational level. By the end of the decade, more than one-half of all U.S. states had enacted a sales tax (see Figure 33). In the absence of a national sales tax, the states filled the vacuum by rapidly adopting consumption taxes as a key revenue source. Once subnational consumption taxes became the norm in the U.S., any legislation to create a federal general consumption tax had to overcome two significant hurdles—establishing a brand-new tax at the federal level **and** supplanting or augmenting state and local retail sales taxes. This problem was exacerbated over the decades by the growing reliance of state and local governments on retail sales tax revenues, and not surprisingly, their resistance to efforts to supplant or replace such an important funding source.[230] As discussed in Section IV.A.4, infra, the sales and use tax was the only major revenue source at the state level in the United States that did not develop after, and conform with a similar federal tax (*e.g.*, personal and corporate income taxes), or follow a framework established by the federal government (*e.g.*, estate taxes and unemployment taxes).

Other advanced nations have managed to address both regressivity and profligacy in relation to a VAT while achieving the desired goal of a more balanced and sustainable composition of tax types.

Third, groups that might otherwise support a broad-based consumption tax at the federal level have tended to focus more on the negative than the positive elements of consumption tax reform. Progressives in search of government revenue streams dwell more on the regressivity of a VAT (as they did in the Wilson and Roosevelt eras) than on its utility to pay for new or existing government programs and avoid government deficits. Similarly, conservatives and businesses with a self-interest in advocating for broad-based consumption taxes over income and payroll taxes fixate more on the VAT as a "money machine" than on its capacity to create an economic-growth-friendly (or at least neutral) revenue source. The concerns of both progressives and conservatives are not unfounded given the complexity and uncertainty of future federal tax policy outcomes. But other advanced nations have managed to address both regressivity and profligacy in relation to a VAT while achieving the desired goal of a more balanced and sustainable composition of tax types.

Fourth, more than citizens in many large democracies, Americans tend to oppose new or expanded taxation. Of the 37 nations in the OECD, the United States has the sixth-lowest level of total tax revenue as a share of GDP, much lower than any other larger population OECD countries. In 2018, tax revenues as a share of GDP in the United States totaled 24.5%, compared to the OECD average of 33.9%.[231] These numbers have been relatively stable for decades. In 1965, tax revenues as a share of GDP in the United States totaled 23.6%, compared to the OECD average of 29.9%.[232]

The relative resistance to taxes has not inhibited the United States from spending more on current government programs (including economic stimulus) and creating

[229] Thomas S. Adams, *Fundamental Problems of Federal Income Taxation,* 35 Q. J. of Econ. 527, 553 (1921).

[230] For instance, in 1970, when the Nixon administration was considering a national VAT for the United States, a group of Governors met with the Secretary of Treasury David Kennedy and expressed their opposition to the federal government encroaching on a traditional state and local government revenue source. Michael J. Graetz, 100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States 183 (Yale University Press, rev. ed. 2010).

[231] OECD, supra note 3, Total Tax Revenues as % GDP.

[232] Id.

large future obligations to pay for Social Security and Medicare. Rather, it has resulted in a growing gap at the federal level between current/future government spending and the willingness to pay for it. Over the last 50 years, the average gap (deficit) between federal government spending and revenues was about 3.3% of GDP. However, based on current law projections, the CBO estimates the upward trajectory of the average federal deficit to 5.5% of GDP in 2031, 9.4% of GDP in 2041 and 13.3% of GDP in 2051. In a more pessimistic scenario, the Committee for a Responsible Federal Budget estimates that federal deficits will total 17.6% of GDP in 2051.[233] This unresolved tension between government spending and taxation has frequently led to political paralysis, undermining the nation's ability to develop a rational fiscal and tax system.

Not all tax policy debates result in legislative stalemate and inaction. With tax equity issues, for instance, there is a pendulum swing between higher and lower tax rates on high income households depending on the mood of the electorate and the political party in power. Over the last 50 years, the top marginal individual income tax rate fluctuated from a high of 70% to a low of 28% before settling into a range of 35% to 40% over the last two decades.[234] Hostility toward increased tax burdens, however, is more debilitating in connection with structural tax reform than tax rate changes (targeted to high-income households) as evidenced by the limited appeal of any broad-based federal consumption tax legislation over the span of U.S. history.

A final factor that plays a role in distorting rational tax policy (and whether to consider consumption tax reform) is a benign neglect or even embrace of federal deficits and debt. This tendency is generally shared by both political parties, depending on which is in power. When Democrats control the presidency and/or Congress, they are apt to propose additional federal spending programs without offsetting net tax increases and minimize the importance of any increase in federal deficits. Similarly, when Republicans control the presidency and/or Congress, they are likely to propose individual and corporate tax cuts without matching tax increases or base broadeners and either minimize the impact of resulting federal deficits or suggest that more rapid economic growth will offset any net revenue loss. Deficit spending is certainly justified during economic downturns, pandemics, wartime, or other crises that require counter-cyclical spending or tax cuts. Taken to the extreme, however, the irrational perspective that the United States can permanently avoid the laws of fiscal gravity by continuously spending more than available tax revenues is an acceptance, knowingly or not, of the dubious modern monetary theory that "deficits don't matter."[235]

Government debt is somewhat more sustainable for the United States in an era of continuously low interest rates and where the "dollar" is still the world's "reserve" currency. But even here there are limits. If the federal deficit is tolerated when the CBO projects it to average about 4.4% of GDP between 2022–31, what about when it is estimated to average about 11.5% of GDP per year between 2041–51? If

[233] CBO, supra note 25. The Committee for A Responsible Budget estimates the fiscal gap could be even greater with the deficit reaching an unimaginable 17.6% in 2015. CRFB, supra note 24.

[234] Tax Pol'y Ctr., supra note 9. The comprehensive federal tax reform legislation enacted in 1986 and 2017 both resulted in the lowering of individual income tax rates, although the revenue losses were partially or fully offset by base broadeners.

[235] On modern monetary theory, see generally Jonathan Hartley, *The Weakness of Modern Monetary Theory,* 46 Nat'l Aff. (2021); Usman W. Chohan, *Modern Monetary Theory (MMT): A General Introduction,* (CASS Working Papers on Econ. & Nat'l Affairs, Working Paper No. EC017UC, 2020).

federal net interest payments are acceptable when the CBO projects them to average 1.6% of GDP (or 7.3% of all federal outlays) annually between 2022–31, what about when they are projected to average 7% of GDP (or 23.5% of federal outlays) annually between 2042–51?[236] The end result of this approach is not to circumvent any future federal tax increases, but to defer them, and compound the problem for future generations.

4. Initiatives to Enact Broad-Based Consumption Taxes at the Federal Level in the U.S.

Given these cumulative barriers to consumption tax reform, it is not surprising that a broad-based consumption tax at the federal level has never taken root in this country. This failure, however, should not be equated with a complete absence of support in the United States for changing the composition of taxes and reaping the benefits of a more economic-growth friendly general consumption tax. Along with the policy debates over a national sales tax between World War I and World War II, repeated efforts have taken place at the national level since the 1940s to create a VAT or other broad-based consumption tax in the United States. Both Republican and Democratic administrations, albeit typically at different times, have proposed or considered a VAT or similar broad-based consumption tax for various goals including deficit reduction, raising money for health care reform, reducing reliance on income taxes, and international competitiveness.[237]

The only instance where a national sales tax was seriously debated in the U.S. Congress occurred during the wartime emergency of World War II when the legislation foundered due to opposition from the U.S. Department of Treasury and the Roosevelt administration.[238] But on many other occasions, particularly since the 1960s when VATs were first introduced in Europe, national consumption tax proposals (including VATs) gained high level presidential or Congressional support or interest, although political backing for serious consideration or enactment never coalesced.

In the late 1960s and early 1970s, President Nixon (a Republican) asked the U.S. Department of Treasury to draw up a comprehensive VAT proposal for purposes of reducing corporate income and other taxes, and facilitating U.S. exports.[239] In 1979, toward the end of Democratic President Jimmy Carter's administration, Democratic House Ways and Means Committee Chairman Al Ullman introduced a VAT primarily to help shift the composition of federal tax revenues from income and payroll to consumption taxes.[240] Republican President George H.W. Bush briefly considered a VAT as part of deficit reduction negotiations in 1990, as did Democratic President Clinton's administration in 1993 as part of its health care reform legislation.[241]

---

236 CBO, supra note 25, at 7.

237 See generally Brownlee, supra note 188; Mehrotra, supra note 220; Schenk & Oldman, supra note 113, at ch. 14; Kathryn James, The Rise of the Value-Added Tax (Cambridge University Press, 2015).

238 Schenk & Oldman, supra note 113, at 433.

239 Junko Kato, Regressive Taxation and the Welfare State: Path Dependence and Policy Diffusion 125–26 (Cambridge University Press, 2003).

240 Id. at 127.

241 Brownlee, supra note 188, at 217–218 (for data on Bush), 221–225 (for data on Clinton); Kato, supra note 239, at 129–130 (for data on Clinton).

. . . **adoption of** an efficient and effective broad-based general consumption tax in the United States must overcome significant historical and political hurdles, a prospect perhaps conceivable only in response to a long-term fiscal crisis . . .

Similarly, after the deep recession of 2008–2009, a VAT was recommended by a bipartisan tax commission appointed by President Obama (a Democrat) and also independently by several U.S. senators for deficit reduction purposes.[242] Each of these consumption tax proposals, however, failed either because of a combination of the factors discussed above or the abatement of the particular crisis at hand.

Ironically, the most recent consumption tax reform initiative, anticipating resistance to VATs in the U.S. Congress, focused not on creating a national consumption tax but on finding a way to introduce a greater degree of consumption tax principles into the U.S. income tax system. During the buildup to federal tax reform in 2017, the Republican House leadership trumpeted the economic benefits of consumption-based taxes. In the influential document "A Better Way: Our Vision for a Confident America," published in June 2016, the House Ways and Means Committee stated, "Consumption-based tax systems are widely regarded to be more pro-growth than income-based systems . . . There is substantial empirical evidence that moving to or toward a consumption-based tax would have significant economic benefits." However, since no broad-based consumption tax exists at the national level, the drafters of federal tax reform had to turn elsewhere to try to alter the mix of taxes. Republican House leadership sought to graft consumption tax-like principles (*e.g.*, the border adjustment provision) onto the federal corporate income tax—a novel proposal that was later dropped in the face of administrative complexity and fierce political opposition (particularly from businesses reliant on imports).[243]

What is clear from this historical analysis is not that the creation of a modern, broad-based consumption tax at the federal level in the United States is impossible. Any structural tax reform implemented in virtually every other advanced nation in the world, despite all the cultural, political, and economic differences between these countries, is certainly **possible** from a tax policy perspective. Indeed, a long history of leaders in both the Democratic and Republican Parties have supported or at least considered the need for a general consumption tax at the federal level. However, it is also apparent that adoption of an efficient and effective broad-based general consumption tax in the United States must overcome significant historical and political hurdles, a prospect perhaps conceivable only in response to a long-term fiscal crisis in which consumption tax reform is perceived as one of the least objectionable of several unattractive tax policy options.

5. U.S. Efforts to Create a Broader and Better-Designed Consumption Tax at the State and Local Government Level

To this point, we have focused on the historical development, or lack thereof, of a consumption tax at the federal level in the United States. However, transformation of retail sales tax systems into something resembling an efficient, broad-based consumption tax remains a possibility at the state level. In this respect, the United States might not follow the path of other advanced nations with a national

242 Gale, supra note 35, at 249–250.

243 See U.S. House Ways & Means Comm., A Better Way: Our Vision for a Confident America, 33 (June 24, 2016), https://www.novoco.com/sites/default/files/atoms/files/ryan_a_better_way_policy_paper_062416.pdf. Ultimately, the Tax Cuts and Jobs Act (P.L. 115-97) provided significant reductions in federal corporate and personal income taxes but it used deficit financing rather than a shift to another tax type to make up the difference. See Joint Comm. on Taxation, Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act," JCX-67-17 (Dec. 18, 2017).

consumption tax, but could at least try to achieve a similar goal by significantly broadening the sales tax base to cover most services, exempting business inputs, and adjusting sales tax rates as needed.

As discussed at length in this study, however, the prospects are limited for fundamental reform of state retail sales tax systems. No country has ever successfully transformed a retail sales tax from within into an efficient and effective broad-based tax on household consumption with an exemption for business inputs; all have abandoned the effort in favor of a VAT or a hybrid VAT/sales tax system.

About one-third of the states over the last few decades, but particularly since 2010, have tried to enact sweeping consumption tax reform legislation to include most or all services in the sales tax base. These legislative initiatives crossed the typical partisan divide with support from governors of both political parties.[244] Nonetheless, these efforts failed completely and largely for the same reason: they tried to replicate the current inefficient and outdated state sales tax system as applied to goods by including not only household services but significant business services in the tax base. This approach violated the basic norms of a consumption tax and politically doomed the legislation given the fierce and understandable opposition from the business community to the taxation of more business inputs (see more detailed discussion in Section II.B.3, infra).

6. The Streamlined Sales Tax Project

About half of the states with sales taxes, however, adopted comprehensive consumption tax reform in the 21st century. The Streamlined Sales and Use Tax Agreement (SSUTA), developed by the Streamlined Sales Tax Project, addressed what the states perceived as the biggest threat to viable sales and use taxes—the absence of jurisdictional reach to require remote sellers to collect a state's sales and use tax. The Agreement required participating states to legislate more uniformity across a wide range of sales tax administrative rules in order to reduce administrative burdens.

The impetus for SSUTA was two U.S. Supreme Court rulings that limited the ability of states to require mail order sellers, and then Internet sellers, to collect sales taxes on remote sales. In 1967, in *National Bellas Hess,*[245] the U.S. Supreme Court ruled that a state could not impose a use tax collection duty if the seller's only connection to the jurisdiction was through a common carrier or the U.S. mail, largely due to the unfair collection burden imposed on remote sellers by the complexity of state sales tax systems. The Court clearly stated its sweeping concerns on the need for more sales tax uniformity and simplification.[246]

Over the next twenty-five years, sales through mail-order catalogs grew exponentially, and because of the difficulty of enforcing use tax collection against household purchasers, the amount of uncollected use tax grew as well. In 1992, the Court

---

244 EY, supra note 3, at 16–21. See also supra Figure 20.

245 *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.* 386 U.S. 753 (1967). Sales taxes are generally imposed on a destination basis. If the ultimate storage, use, or consumption of a product is different from the location of the sale, states impose a complementary use tax if the initial purchase is not subject to tax. To collect both sales and use taxes, states impose a legal collection duty on sellers of goods and services that requires them to collect and remit such taxes to the jurisdiction of sale or ultimate use. See Due & Mikesell, supra note 219.

246 *See Nat'l Bellas Hess,* 386 U.S. at 759–60.

revisited the issue and handed down its landmark ruling in *Quill v. North Dakota,*[247] which found that the burdens of collection under disparate state systems remained so great that states could only enforce a collection duty if the seller had a physical presence in the state. In *Quill,* the Court took a significant step towards resolving the issue of uncollected use taxes. By bifurcating its due process analysis from its dormant commerce clause analysis, the Court opened the door for a federal legislative solution through Congress' plenary authority to regulate interstate commerce.[248]

Following *Quill,* several bills were introduced (unsuccessfully) in Congress that sought to overturn the decision and compel use tax collection on remote sales, typically with the quid pro quo that the states must first satisfy a minimum threshold of sales tax simplification. By the mid-to-late nineties a new variable had emerged—electronic commerce via the Internet—that substantially raised the amount of uncollected sales taxes and infused a new urgency into states seeking to resolve the jurisdictional issue. In 1998, Congress passed the Internet Tax Freedom Act (ITFA), legislation that limited states' ability to impose multiple and discriminatory taxes on electronic commerce and on Internet access charges. The ITFA also established the Advisory Commission on Electronic Commerce (ACEC) to assess, over a four-year period, the impact of electronic commerce on all forms of state taxation, including use tax collection. Although the ACEC was unable to generate significant consensus on the collection issue, it set in motion a recognition by states that existing sales tax systems needed "radical simplification"[249] to overcome the burdens identified in *Quill*. That recognition coalesced into the Streamlined Sales Tax Project, staffed primarily by sales tax experts at state departments of revenue and endorsed by the National Conference of State Legislatures.[250]

The underlying goals of the Streamlined Sales Tax Project were simple: provide sufficient simplification, uniformity, and harmonization for all sellers across participating states such that the burdens identified in *Quill* were reduced through "radical simplification." Thus, once the burdens were sufficiently reduced, the limitations on use tax collection for remote sales (*i.e.,* the physical presence requirement in *Quill*) would be unnecessary, and substantial amounts of uncollected use taxes would flow into state coffers.

In November 2002, after two years of work through four separate work groups, model legislation known as the Streamlined Sales and Use Tax Agreement (SSUTA) was finalized, approved, and ultimately adopted by twenty-three full-Member States. Unlike systemic consumption tax reform efforts in the European Union and Canada, however, the SSUTA was never designed to radically alter the structure of state sales tax systems to address the first two principles of an optimal consumption tax: the need for a harmonized and broad-

---

247 *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).

248 Hardt, Lindholm, & Crosby, supra note 165.

249 1999 statement by Utah Governor Michael O. Leavitt, Chairman of the National Governors' Association on the ACEC proceedings, concluding: "A majority of my fellow Commissioners recognized the need for both a level playing field and for radical simplification of state sales tax systems." http://lobby.la.psu.edu/080_Internet_Sales_Tax/Agency_Activities/ACEC/Leavitt.pdf

250 Hardt, Lindholm, & Crosby, supra note 165; The Project was organized in March of 2000 and led by Diane Hardt, Wisconsin Department of Revenue, and Charles Collins, North Carolina Department of Revenue. It was initially sponsored by four state organizations: National Conference of State Legislatures, FTA, National Governors' Association, and the Multistate Tax Commission.

based tax on household goods and services and the need for an exemption of business inputs. Rather, because SSUTA's goal was to pave the way for a favorable Supreme Court decision on the jurisdictional issue, its primary focus was on "radical simplification" only of tax administration rules (*e.g.*, the third principle of an optimal consumption tax).

Ultimately, the U.S. Supreme Court reversed its earlier decisions without requiring any major reduction in the complexity of state and local tax rules. In June 2018, the U.S. Supreme Court decided the landmark case *South Dakota v. Wayfair*.[251] In that decision, the Court overturned the *National Bellas Hess* and *Quill* precedents that had prevailed for fifty years, and replaced a "physical presence" test with an "economic presence" test as the precondition for requiring retailers to collect sales and use taxes. Although the decision was hailed by the states because it removed impediments to state and local collection of tax on remote (out-of-state) sales, the *Wayfair* decision also weakened the incentive for states to work together to make state sales taxes more harmonized and less complex.

Ironically, the states have had more success in optimizing consumption tax principles with income taxes than with retail sales taxes. The majority of states have recognized the value of relying on consumption rather than production tax principles as a central tenet of sound tax policy but have applied this axiom not to the development of a broad-based consumption tax, but to the design of a non-consumption tax (that is, the state corporate income tax). Over two-thirds of the states now impose single-sales factor or triple-weighted sales factor formulas for purposes of apportioning multistate income. In addition, about two-thirds of the states have moved toward market sourcing of income from services and intangibles, rather than using a cost-of-performance formula for sales factor purposes. Both trends prioritize consumption tax principles over production tax principles, albeit in the context of an income tax.[252]

The success of the states in this realm produces a bizarre outcome and imbalance, with state corporate income taxes that account for about 4% of all state and local taxes relying increasingly on consumption tax principles (location of consumer), and state sales taxes that account for about 22% of all state and local taxes relying significantly on production tax principles (location of income generator) through the inclusion of business inputs in the tax base.

The history of consumption tax policy in the United States underscores both the unique challenges of creating a general consumption tax at the national level and the dim prospects for transforming state retail sales tax systems from within.

7. U.S. History: Conclusion

The history of consumption tax policy in the United States underscores both the unique challenges of creating a general consumption tax at the national level and the dim prospects for transforming state retail sales tax systems from within. From a global consumption tax perspective, the United States remains an extreme outlier, the only nation without a broad-based consumption tax at the national level, and by international standards, only an outdated, structurally flawed state and local retail sales tax systems at the subnational level.

251 *South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018).

252 A single sales factor looks to the location of consumption rather than production (payroll and property) for purposes of sourcing corporate income. A market sourcing approach emulates the formula historically used for tangible personal property and looks to the location of consumption rather than the location of production for sourcing these types of income. FTA, State Apportionment of Corporation Income (Feb. 2020); Executive Summary: 2019 Survey of State Tax Departments, Bloomberg Tax 22–24 (2019).

Throughout much of its history, there has been a widespread belief in the United States that this country can and should do things differently than other nations. In the tax sphere, this translates into an acceptance of an overall tax system that is skewed more heavily toward income, payroll, and property taxes and away from consumption taxes than any other nation in the world. Of course, there is some basis for this uniquely American confidence grounded in the fact that this country has built the longest-standing democratic republic and the highest achieving economy of any large nation in the world's history. As one of the characters sings at the beginning of the 1975 Robert Altman movie Nashville, "We must be doin' somethin' right to last 200 years."

But there are practical limits to how much we can operate outside conventional international fiscal and tax norms and still maintain our political leadership and competitive edge. The key is to differentiate between American exceptionalism that is unique, innovative, and forward looking, and that which is simply obstinate, counter-productive and backwards. The escalating long-term federal debt crisis both increases the risks of the imbalanced composition of U.S. taxes and highlights the importance of transforming the U.S. consumption tax system. If consumption tax reform occurs, it will be based both on the recognition of the need to modernize inefficient and ineffective retail sales tax systems at the state level, and of the urgency for a more resilient and better-balanced tax mix at the federal level.

STRI

STATE TAX RESEARCH INSTITUTE

Council On State Taxation

122 C Street, NW | Suite 330

Washington, DC 20001 | (202) 484-5222