

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

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## **Federal VAT: State Opportunities, Risks, and Challenges**

- Federal value added tax (VAT) would create:
  - Opportunities: to improve state sales taxes
  - Risks: that things could become worse
  - Challenges: to coordinate state and federal taxes

## **Characteristics of an Ideal Sales Tax**

- Sales to consumers: taxed at a single rate
- Sales to business: exempt
- Destination principle
  - Exports occur tax-free
  - Imports are taxed like domestic products
- Reasonable costs of compliance/administration
- State sovereignty over tax rate

## **Defects of Existing State RSTs: I**

- Many sales to consumers are exempt
- Many sales to business are taxed
  - Cascading (multiple taxation of value added)
- Unreasonable costs of compliance and administration

## Defects of Existing State RSTs: II

- Destination principle is violated
  - Exports are not tax-free, due to cascading
  - Imports are not taxed like domestic products
    - Does not duplicate cascading
    - US Supreme Court decision in *Quill*:
      - Only sellers with in-state physical presence must collect tax
      - Predicted on complexity caused by lack of uniformity

## Characteristics of an Ideal VAT

- Tax is levied on all sales
- Vendors allowed credit for VAT on purchases
- Destination-principle taxation of international trade
  - imports are taxed
  - Exports are zero-rated
    - No tax on exports
    - Credit for VAT on purchases; refunds, if necessary

## **The Problem of Subnational Trade: I**

- Destination principle thought difficult until recently
  - Cannot have internal border controls
- Sales to consumers: how to tax at destination
  - Self assessment does not work

## **The Problem of Subnational Trade: II**

- Sales to businesses: EU “deferred payment” system:
  - Exports are zero-rated
    - Abuse: carousel schemes (re-importation of zero-rated exports)
  - “Reverse charge” (self- assessment) of tax on imports
    - Credits are lower by the amount of tax not collected
    - Tax is collected at first sale after importation

## **The Canadian Solution: I**

- 7 percent federal Goods and Services Tax (GST)
  - Administered by Canadian Revenue Agency, except in Quebec
  - Provincial administration in Quebec

## **The Canadian Solution: II**

- Four provincial patterns:
  - No sales tax (Alberta)
  - Provincial Sales Taxes (British Columbia, Manitoba, Saskatchewan, Ontario, Prince Edward Island)
    - Similar to state RSTs; same defects
    - No coordination with federal VAT
    - Little coordination between provinces

## **The Canadian Solution: III**

- Four provincial patterns, continued:
  - Harmonized Sales Tax (HST) in 3 provinces (New Brunswick, Newfoundland & Labrador, and Nova Scotia)
    - HST rate is 15 percent (not 7 percent)
    - Federal tax base
    - Federal administration
    - Tax collected on remote sales to HST provinces
    - Revenue sharing based on estimated consumption
    - Rejected by other provinces

## **The Canadian Solution: IV**

- Four provincial patterns, continued:
  - Quebec sales tax (QST): 8.025 percent VAT
    - Essentially federal base
    - Exports: zero-rated
    - Imports from other provinces
      - By households: self assessment
      - By businesses: deferred payment system (as in EU)
    - Benefit of federal VAT registration and audit

## **Aspects of Coordination**

- “Coordination” means:
  - Uniform tax base
  - Uniform administrative procedures
  - Coordinated administration
- “Coordination” does *not* mean:
  - Uniform Tax rates

## **Coordinating State RSTs and VATs with an Ideal Federal VAT: I**

- Coordination of state taxes that are consistent with federal VAT
  - Tax bases that are uniform or consistent
  - Harmonization of administrative procedures
- Interstate sales to households
  - *Quill* could be overturned, because of simplification
  - Vendor remits tax to destination state
  - Federal VAT makes administration feasible, as in HST

## **Coordinating State RSTs and VATs with an Ideal Federal VAT: II**

- State VATs
  - Coordination is feasible
  - Interstate business sales: zero-rating/self-pay (EU/Quebec approach)
  
- State RSTs
  - Coordination is feasible
  - Exemption of business purchases, not input credits
    - Interstate sales, as well as intrastate sales
    - Federal VAT registration replaces exemption certificate for RST

## **Coordinating State RSTs and VATs with an Ideal Federal VAT: III**

- Mixed (both state VATs and RSTs)
  - Coordination may be too complicated
    - Deserves further study
  
- State taxes that are not consistent with federal VAT:
  - Coordination is probably not feasible

## **The Problem of Local Sales Taxes: I**

- May be deciding factor for some states
- Difficulty of local VAT
  - Taxation of business sales
    - Local sales: taxed
    - “Exports” from local jurisdiction: zero-rated

## **The Problem of Local Sales Taxes: II**

- State administration of local RST
  - Recommended by SSTP
  - Suggests state RST, not VAT, for some states
- Query: can both state VAT and state and local RST be coordinated with federal VAT?

## **Administering a Dual Sales Tax: I**

- State administration
  - Difficulty of achieving uniform administration of federal VAT
  - Incentive for lax state tax administration
  - Would the federal government accept it?
- Federal administration
  - Lack of experience with general sales tax
  - Mismatch of requirements/availability of employees
  - Opposition to transfer of employees
  - Federal government unlikely to administer local RSTs

## **Administering a Dual Sales Tax : II**

- Joint federal/state administration
  - Works best for state VATs
  - Less attractive if some states retain RSTs
  - Local RSTs suggests state RSTs and state administration (not state VAT)
- Dual administration
  - Federal administration of its VAT
  - State administration of state VATs and state and local RSTs

## **State Gains from Coordination**

- Improvement of state sales taxes
  - Services would be taxed
  - Sales to business would be exempt
  - Coordination of administration, including procedures
  - *Quill* would become obsolete
- No loss of state sovereignty over tax rates or administration

## **State Losses from Coordination**

- Loss of control over tax bases and administrative procedures
  - Not very sympathetic position
    - States have not exercised sovereignty responsibly
      - Poor design of sales taxes
      - Lack of uniform administrative procedures
  - Risk of coordination with bad federal tax policy
  - Might scuttle coordination