

U.S. State Sales Tax Systems: Inefficient, Ineffective, and Obsolete

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In this article, Frieden and Lindholm argue that U.S. state sales tax systems are among the most inefficient and ineffective general consumption taxes in the world, and that this systemic failure is reflected in a dangerous underreliance on consumption taxes and an overreliance on income, payroll, and property taxes overall in the United States.

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After the pandemic, federal and state tax systems in the United States will face a critical test.¹ And based on the current overreliance on income, 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world, the United States has no broad-based consumption tax at the national level, and by international standards, only outdated, structurally flawed state and local retail sales tax systems at the subnational level.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 U.S. 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.²

This article compares the structure and operation of the consumption taxes levied in the United States, Canada, and the European Union³ 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 U.S. 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

¹This article is based in part on Karl A. Frieden and Douglas L. Lindholm (with Ros Barr (EY's global indirect tax knowledge leader) and David Robertson (EY Law Canada)), "A Global Perspective on U.S. State Sales Tax Systems as a Revenue Source: Inefficient, Ineffective and Outdated," Council On State Taxation/State Tax Research Institute (forthcoming Dec. 2020). The authors would like to thank Jana Hayashi,³ a COST Research Fellow, for her valuable assistance with copy editing and footnotes in both this article and the larger COST/STRI study.

²The 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 2018. See OECD, Global Revenue Statistics Database, chart of taxes on goods and services as a percent of all taxes for 2018.

³The 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 Europa.eu, The 27 Member Countries of the EU.

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.

States and localities have stumbled along for decades with the current system, managing to raise \$424 billion a year in sales taxes — about 22 percent of all state and local tax revenues or about 8.3 percent of all government tax revenues.⁴ 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 Cooperation and Development.⁵ 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 in the short term and rising government debt levels in the long term expose the vulnerability of a U.S. federal/state tax system that must address these calamities while lacking what virtually every other advanced nation has: a balanced tax mix that includes a broad-based consumption tax.

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 (wealth taxes and mark-to-market for securities); and
- payroll taxes (including “head taxes,” state unemployment tax, and raising the income threshold of the Social Security payroll tax).⁶

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*⁷ 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 Party proposals to reverse tax reductions in the Tax Cuts and Jobs Act; rising demands for government spending on pandemic relief, social programs, infrastructure,

⁶ At the federal level, President-elect Biden's campaign tax proposals, if enacted, would raise over \$4 trillion over 10 years. The primary Biden tax proposals are: raising the corporate income tax rate to 28 percent; applying a Social Security payroll tax of 12.4 percent to earnings above \$400,000; taxing capital gains and dividends at 39.6 percent on incomes above \$1 million; imposing a corporate minimum tax on book income; doubling the tax rate on global intangible low-taxed income and raising personal income tax rates for high-income and passthrough-entity taxpayers. Committee for a Responsible Federal Budget, “The Cost of the Trump and Biden Campaign Plans” (Oct. 7, 2020). See also Gordon B. Mermin et al., “An Analysis of Former Vice President Biden's Tax Proposals,” Tax Policy Center (Mar. 5, 2020). On the earlier Democratic primary candidate plans, see Amir El-Sibaie, Tom VanAntwerp, and Erica York, “Tracking the 2020 Presidential Tax Plans,” Tax Foundation (Nov. 20, 2019). For a series of similar income, payroll, and property/wealth tax increase recommendations at the state level, see the website for Project SAFE (State Action in Fiscal Emergencies). 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; 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 1/pillar 2 project is similarly focused on major changes to corporate income tax laws in advanced nations including a global minimum tax. OECD/G-20 Base Erosion and Profit Shifting Project, “Tax Challenges Arising From Digitalisation — Report on Pillar One Blueprint,” Oct. 14, 2020.

⁷ *South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018).

⁴ Andrew Phillips and Muath Ibaid, “The Impact of Imposing Sales Taxes on Business Inputs,” EY 3-4 (May 2019); EY, COST, and STRI, “Total State and Local Business Taxes: State-by-State Estimate for Fiscal Year 2019,” figs. 1a, 2 (forthcoming Nov. 2020); and OECD, Revenue Statistics — OECD Countries: Comparative Tables, tbl. 5110.

⁵ OECD, *supra* note 4, 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, but because the data is unweighted, the U.S. share of 1/37 of the OECD calculation does not materially change the average. The 37 countries in the OECD are: Australia, Austria, Belgium, Canada, Chile, Colombia, 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.

and climate change;⁸ and polling data showing a substantial majority of Americans support higher taxes on wealthier households,⁹ it is unsurprising that income, 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. 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 article describes the importance of consumption taxes in a balanced

revenue system; explains why true consumption taxes are the preferred tax for minimizing impacts on economic growth and competitiveness; and highlights statistical differences between the United States, EU, and OECD in relative reliance on consumption taxes and income, payroll, and property taxes. Section II measures the performance of general consumption taxes in the EU, Canada, and the United States against the three key features of an optimal consumption tax:

- a harmonized and broad-based tax on household goods and services;
- an exemption (or credit) for business inputs; and
- centralized and simplified tax administration.

It shows how U.S. state and local sales tax systems are structurally and operationally flawed, deviating significantly more from these principles than EU 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 article suggests 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.

I. 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

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

⁸In an October 2020 poll for *The New York Times* by Survey Monkey: 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,” *The New York 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 and Brian Kennedy, “Two-Thirds of Americans Think Government Should Do More on Climate,” Pew Research Center (June 23, 2020).

⁹In a January 2020 Reuters/Ipsos poll, 64 percent 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 and Chris Kahn, “Majority of Americans Favor Wealth Tax on Very Rich: Reuters/Ipsos poll,” Reuters, Jan. 10, 2020.

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.

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 G-20¹¹ ministers and central bank governors. In that report, the OECD concluded that the 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.¹²

¹⁰G. 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,” *The Washington 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 and 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); and 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).

¹¹The G-20 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 G-20 nations comprise roughly two-thirds of the world’s population and 80 percent of global GDP.

¹²OECD, “Tax Policies for Inclusive Growth in a Changing World” (July 2018).

B. The United States Relies Less on General Consumption Taxes Than Any Other Advanced Nation

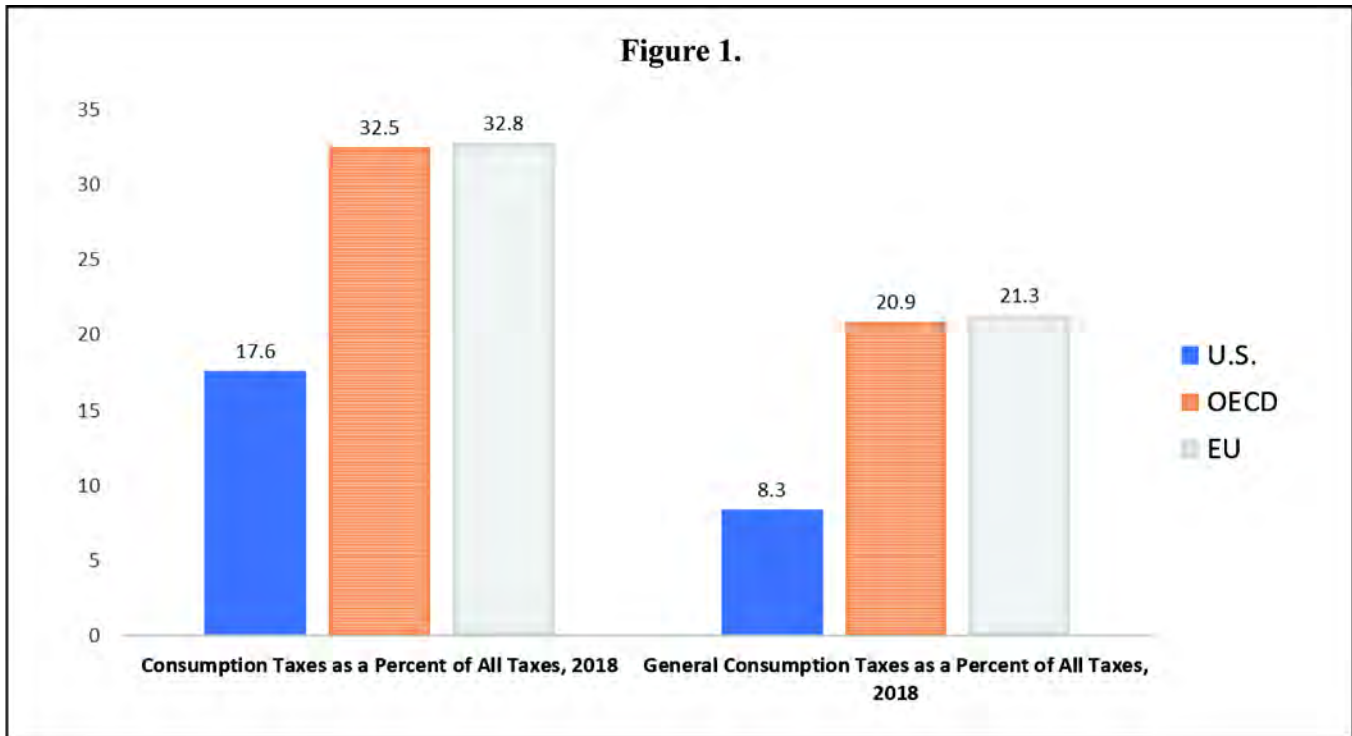
From a statistical perspective, the gap between the United States and other advanced nations in terms of relative reliance on consumption taxes is clear and is growing. The United States is significantly less reliant on consumption taxes as a share of overall taxes than any other advanced nation in the world.¹³ In 2018, consumption taxes accounted for about 17.6 percent of all taxes in the United States compared with 32.5 percent of all taxes in OECD nations and 32.8 percent of all taxes in the EU.¹⁴ The consumption tax share is even higher in other geographies including Asia (37.6 percent), North and Central America (47 percent), South America (48 percent), Africa (53.7 percent), and Oceania (57.9 percent).¹⁵

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 European VAT, the Canadian goods and services tax/harmonized sales tax, and retail sales taxes in U.S. states and certain Canadian provinces. In 2018, taxes on general consumption accounted for

¹³OECD, *supra* note 2.

¹⁴The EU statistic is based on the 22 of 27 EU countries that are OECD members. These 22 countries make up 93 percent of the EU population. Consumption taxes accounted for 23.4 percent 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 percent) than the EU countries (17 percent); and because the OECD has some of the best data available on international tax trends. OECD, *Revenue Statistics 2019*, tbl. 3.6 (2019).

¹⁵Cristina Enache, “Sources of Government Revenue in the OECD, 2020,” *Tax Foundation Fiscal Fact No. 695* at 11 (Feb. 2020). Consumption taxes account for about 56 percent of all taxes in China, the major economic competitor to the United States. OECD, *supra* note 2.



8.3 percent of all taxes in the U.S. compared with 20.9 percent of all taxes in OECD nations and 21.3 percent of all taxes in EU countries (see Figure 1).¹⁶ In Canada, taxes on general consumption account for 14.2 percent of all taxes.

This nearly 3-to-1 differential between the OECD and 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 40 years, taxes on general consumption as a share of total taxation in the United States increased modestly from 7 percent in 1975 to 8.3 percent in 2018 or about one-fifth. By comparison, taxes on general consumption as a share of total taxation in the OECD nations increased significantly from 13.4 percent in 1975 to 20.9 percent in 2018 or about three-fifths.¹⁷

By another measure, taxes on general consumption as a percentage of GDP in the United States increased slightly from 1.7 percent in 1975 to 2 percent in 2018 or about one-fifth. By contrast, taxes on general consumption as a percentage of GDP in the OECD nations increased substantially from 4.2 percent in 1975 to 7.3 percent in 2018 or about three-quarters (see Figure 2).¹⁸

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, payroll, and property) than any of the other OECD or EU countries. In 2018, taxes on income, payroll, and property accounted for over four-fifths of all taxes in the United States compared with about two-thirds in OECD and EU nations. The differential was most pronounced with income and property taxes. Income taxes (both personal and corporate) accounted for 45.1 percent of all taxes in the United States, compared with the OECD average of 33.4 percent and EU average of 29.3 percent. In

¹⁶ OECD, *supra* note 4, at tbl. 5110, as measured by share of total taxation.

¹⁷ *Id.* at tbl. 5110, as measured by share of total taxation and share of GDP.

¹⁸ *Id.*

Figure 2.
General Consumption Tax as a Percentage of GDP:
U.S. Comparison With OECD Nations 1975-2018

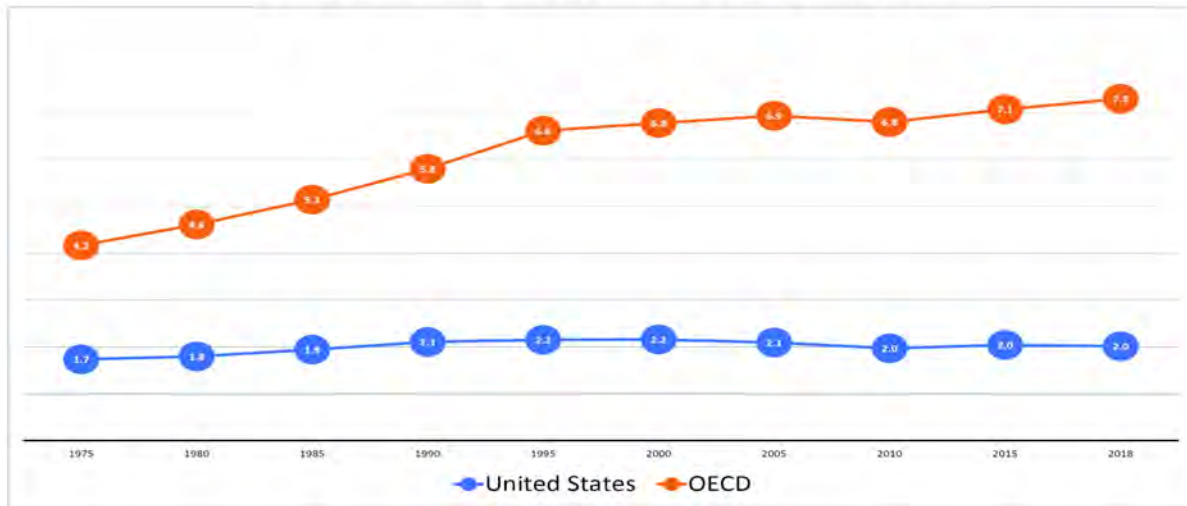
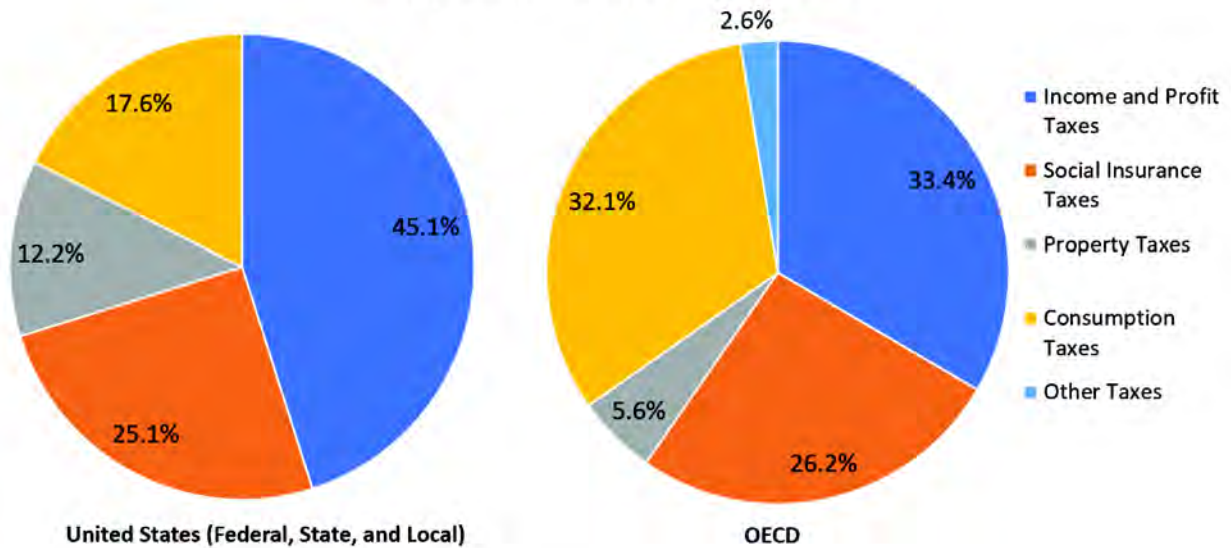


Figure 3.
Average Sources of Tax Revenue, 2018



that same year, property taxes accounted for 12.2 percent of all taxes in the United States, compared with the OECD average of 5.6 percent and the EU average of 4.1 percent (see Figure 3).¹⁹

The imbalance is even more pronounced at the federal government level, especially after payroll taxes — which are generally earmarked for old age and healthcare programs — are removed from the mix. Excluding payroll taxes, income taxes and property taxes make up 94.3 percent of U.S. federal government taxes,

¹⁹Enache, *supra* note 15, at 10-11.

compared with 41.5 percent in the OECD nations as a whole and 39.7 percent in the EU.²⁰

D. The Overreliance on Income, Payroll, and Property Taxes Will Get Worse

The problem of overreliance on income, payroll, and property taxes in the United States is about to get worse. In 2020, two financial crises are converging on the U.S. economy: the short-term economic impact of the unprecedented COVID-19 pandemic and the longer-term repercussions of escalating levels of federal debt. At the state level, revenue shortfalls for fiscal 2020 to fiscal 2022 could total \$275 billion or more (net of rainy day funds and federal aid received to date), depending on the severity of the economic downturn.²¹ At the federal level, the government can more readily increase spending by incurring unfunded deficits. Short-term federal fiscal and tax stimulus measures exceeded \$3 trillion in 2020, with trillions more likely in the next few years to lift the United States out of the post-pandemic recession.²² Based on Congressional Budget Office statistics, the federal debt-to-GDP ratio will rise to 98 percent in 2020, compared with 79 percent at the end of 2019 and 35 percent in 2007, before the start of the previous recession. Even assuming no additional federal pandemic relief, federal debt will increase to 107 percent in 2023, not only exceeding the highest peacetime

levels ever recorded, but surpassing the World War II record level of 106 percent.²³

Although the United States has endured many fiscal crises during the post-World War II era in which major tax and budget reforms took center stage, there is reason to believe this crisis is more far-reaching in both scope and depth. The U.S. economy is facing back-to-back record-breaking recessions, the looming threat of climate change, and enormous deferred costs of providing health care and social security for an aging U.S. population. Federal debt is on a potentially unsustainable course with CBO estimates showing the debt-to-GDP ratio rising to 195 percent in 2050, assuming current laws stay in place.²⁴ The financial costs of addressing these cascading crises arise primarily at the federal level, but similar fiscal challenges will certainly converge at the state level.²⁵

The widening gap between government spending and government revenues is not a sustainable paradigm and is likely to generate consideration of substantial tax increases in the near future. Given the current structure of the U.S. tax system, federal and state tax increases, if or when they occur, will likely be heavily or exclusively concentrated on income, payroll, and property taxes, which constitute over 80 percent of the aggregate U.S. tax base and over 95 percent of the federal tax base. There will be little or no balancing with consumption taxes at the federal level (given the absence of a federal consumption tax), and the state level (given the inherent limits on revenue generation of state retail sales tax systems). If the Democratic party gains control of the presidency and Congress over the next few

²⁰ OECD, *supra* note 14, at tbl. 3.16. While the federal government does not have a tax on general consumption, it does have a few taxes on specific goods and services. *Id.*

²¹ Michael Leachman and Elizabeth McNichol, "Pandemic's Impact on State Revenues Less Than Earlier Expected but Still Severe," Center on Budget and Policy Priorities (Oct. 30, 2020). The CBPP study estimated the state and local revenue losses at between \$275 billion and \$415 billion. *See also* Lucy Dadayan, "COVID-19 Pandemic Could Slash 2020-21 State Revenues by \$200 Billion," Tax Policy Center (July 1, 2020).

²² According to estimates by the Committee for a Responsible Federal Budget, President-elect Biden's campaign fiscal and tax plans, if enacted, will increase the federal debt-to-GDP ratio to 128 percent 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. Of interest, President Trump's campaign fiscal and tax plans would have increased the federal debt by about the same amount, albeit with more tax cuts and less government spending. Committee for a Responsible Federal Budget, "The Cost of the Trump and Biden Campaign Plans," *supra* note 6. If President-elect Biden's COVID response stimulus proposals are included, the federal debt-to-GDP ratio could increase to 137 percent by 2030. Committee for a Responsible Federal Budget, "The Cost of the Trump and Biden COVID Response Plans," US Budget Watch 2020 (Oct. 29, 2020).

²³ Congressional Budget Office, "The 2020 Long-Term Budget Outlook," (Sept. 2020).

²⁴ CBO, *supra* note 23; Alan Auerbach et al., "Fiscal Effects of COVID-19," Brookings Papers of 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 and Viard, "No Free Lunch: The Federal Fiscal Imbalance Is Still a Problem," *Tax Notes Federal*, Nov. 16, 2020, p. 1117.

²⁵ Federal and state finances are significantly intertwined as federal aid accounts for 31 percent of all state budgets and 23 percent of all state and local budgets. CBPP, "Federal Aid to State and Local Governments" (Apr. 19, 2018).

years, this trend will accelerate as proposals to impose more income, payroll, and property/wealth taxes on the top 2 percent of households and businesses are considered.²⁶

Over the long term, however, it is simply not possible to bridge the growing fiscal chasm solely with taxes on high-income households or businesses.²⁷ Exacerbating the current imbalance in the composition of taxes by increasing only non-consumption taxes (income, payroll, and property) imperils future economic growth and will run headlong into political and practical limits of revenue raising from a narrow range of the population.

Of course, creating the appropriate mix and level of taxation reflects several political, social, and economic dimensions. 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). No single mix is optimal, and governments will invariably change the composition of taxes over time. However, the United States will enter the post-pandemic period with a tax mix that is already recklessly imbalanced, with an overreliance on income, payroll, and property taxes and an underreliance on consumption taxes. 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 veers further away from internationally accepted norms and rational tax policy.²⁸

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.

However, 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 EU and Canada are, used to offset or mitigate the proportional or slightly regressive tendencies of a consumption tax.²⁹ 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.

²⁶ On President-elect Biden's campaign tax proposals, see Committee for a Responsible Federal Budget, "The Cost of the Trump and Biden Campaign Plans," *supra* note 6. The Penn Wharton Budget Model found that under the Biden tax plan, families with adjusted gross income of \$400,000 or less — about 98.5 percent of all households — would not have direct tax increases. Penn Wharton Budget Model, PWBWM Analysis of the Biden Platform (Sept. 14, 2020).


²⁷ See Brookings Institution economist William Gale's estimates of the wide range of budget cuts and tax increases required to reduce the federal debt by two-thirds in 2050. Gale, *Fiscal Therapy: Curing America's Debt Addiction and Investing in the Future* 1-8, 56 (2019) (hereinafter "Fiscal Therapy"), p. 15, and chaps. 7-14.

²⁸ 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, payroll, and property taxes is vitally important. While such 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.

²⁹ 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," OECD Taxation Working Papers No. 49 (Aug. 10, 2020), at 37.

Figure 4.



The Principles
of an Optimal
Consumption
Tax

- A Harmonized and Broad-Based Tax on Household Goods and Services
- An Exemption for Business Inputs
- Centralized and Simplified Tax Administration

Canada, for example, provides a quarterly GST/HST (harmonized sales tax) cash rebate to lower-income Canadians. During the COVID-19 crisis, the Canadian government temporarily doubled the credit to provide financial assistance to these lower-income households. 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.³⁰

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.³¹ 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 a function of the composition of taxes.

II. An International Comparison of General Consumption Taxes in the EU, 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 and local 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 use of a tax on general consumption to balance the tax burden among different tax types.

This section compares the performance of state and local tax systems to the primary general consumption taxes in the EU (the VAT) and Canada (the GST/HST and a few provincial sales taxes). We evaluate the efficiency, efficacy, and historical development of general consumption taxes in each of these geographies based on the three key principles of an optimal consumption tax (see Figure 4):

³⁰ See generally Gale, "Raising Revenue With a Progressive Value-Added Tax," *The Hamilton Project* (Jan. 28, 2020).

³¹ Gale, *Fiscal Therapy*, *supra* note 27, at 90 fig. 5.1.

- a harmonized³² and broad-based consumption tax on household goods and services;
- an exemption (or credit) for business inputs; and
- centralized and simplified tax administration.³³

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 EU 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 simplification — 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.³⁴ This article provides an 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, the U.S. sales tax system is inefficient in satisfying optimal consumption tax metrics and ineffective in raising revenue to provide a better

balance in the overall composition of taxes. The EU and Canadian experiences provide useful precedents showing how obsolete retail sales tax or turnover tax systems levied under multiple levels of government (similar 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 EU consists of 27 EU member states (nations) with 445 million inhabitants. In addition, the United Kingdom, with its 70 million inhabitants, left the EU in January 2020, but will continue to follow EU VAT rules at least until the end of 2020. Preconditions to EU membership are adoption of a common system of a VAT and the adaptation of a member state's domestic legislation to EU laws.

From the beginning of the EU (and its predecessor the 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 element to develop a common market among EU nations and enhance international competitiveness. Another benefit of the switch to the VAT was to allow countries to consolidate and rationalize disparate consumption tax systems. That is, the countries could replace a mix of other general and specific consumption taxes with a VAT that taxed a much

³²We use the terms “harmonized” and “uniform” somewhat interchangeably in this article. Harmonized or harmonization are the preferred terms in the EU and Canada and uniform or uniformity is used in the United States for essentially the same proposition. Simplification is a somewhat broader concept because it encompasses both uniform and nonuniform rules that reduce the burden of tax compliance.

³³For a more detailed discussion of this comparative study see Frieden and Lindholm, *supra* note 1. On the principles of an optimal consumption tax see generally John F. Due, *Government Finance: An Economic Analysis* 312-27 (1959); Charles E. McLure Jr., “Harmonizing the RSTs and GST: Lessons for Canada From the Canadian Experience,” *Tax Notes Int'l*, Feb. 5, 2007, p. 439; McLure, “Coordinating State Sales Taxes With a Federal VAT: Opportunities, Risks and Challenges,” *Tax Notes State*, Oct. 3, 2005, p. 35 (hereinafter “Coordinating State Sales Taxes”); Mikesell, “Reversing 85 Years of Bad State Retail Sales Tax Policy,” *State Tax Notes*, Dec. 23, 2019, p. 1147; and William F. Fox and LeAnn Luna, “How Broad Should Sales Tax Bases Be? A Review of the Empirical Literature,” *State Tax Notes*, Sept. 4, 2006, p. 639. 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.

³⁴See, e.g., Mikesell, “The Disappearing Retail Sales Tax,” *State Tax Notes*, Mar. 5, 2012, p. 777; and McLure, “The Nuttiness of State and Local Taxes — and the Nuttiness of Responses Thereto,” *State Tax Notes*, Sept. 16, 2002, p. 841.

Figure 5.
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 harmonization
- Broad tax base – covers most goods and services
- VAT legislation governed by EU institutions (e.g. the Council, the commissions, the European parliament)
- Member states contribute some VAT revenue to EU

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.³⁵

The 27 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 use a VAT, and that tax must conform to the definitions of goods and services and the common tax base in the EU VAT directives.³⁶ Thus, comprehensive harmonization of the VAT base exists across all the EU member states (see Figure 5).

Broad-Based Tax on Household Goods and Services. The EU VAT is also a broad-based tax on household consumption that applies to most transactions involving goods and services supplied in the EU. The scope of the VAT — what is included or excluded from the tax base — is set

out in article 2 of the VAT directive³⁷ and applies to all EU countries. Once a transaction is within the scope of VAT, additional rules determine the rate of VAT and when the tax must be paid.

Broadly, a supply of goods involves “the transfer of the right to dispose of tangible property as owner.”³⁸ The 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 (for example, 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 most economic activity in the EU. Its broad scope potentially covers all goods and services because taxability does not depend on a predefined list of taxable activities, taxable items, or business sectors. New products

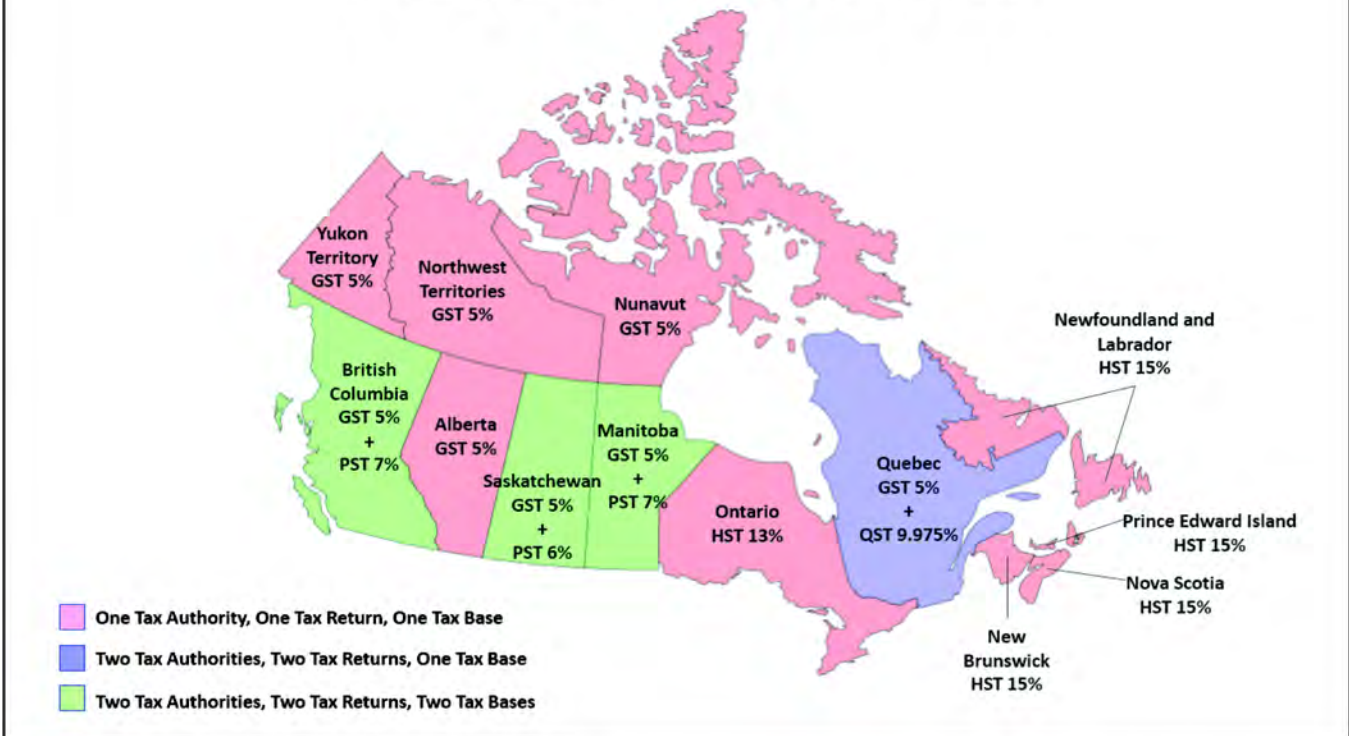
³⁵ On the historical development of the EU VAT, see Frieden and Lindholm, *supra* note 1, at Appendix.

³⁶ Council Directive 2006/112, article 401, 2006 O.J. (L347) 1 (EC).

³⁷ *Id.* at article 2 sets out the broad scope of EU VAT.

³⁸ *Id.* at article 14.

Figure 6.
Canada's Hybrid General Consumption Tax Model



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 crucially important in the fast-paced digital economy.

The EU VAT directive harmonizes not only what is included in the VAT base but also what is excluded. VAT does not apply to all household expenditures by EU residents. Important exceptions include³⁹:

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

The extensive harmonization of the EU VAT base does not mean that the EU adopts the broadest possible VAT base of household goods and services. Politics frequently intrude on theoretical norms, and that certainly applies to 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, personal services, and professional services.

2. The Canadian GST/HST and Provincial Sales Tax Approach

Canada imposes a hybrid national/provincial consumption tax system. At the national level, it levies a GST, which is essentially a VAT. The GST is administered at the national level (except in

³⁹ *Id.* at articles 131-135.

Quebec) and imposes a broad-based tax on household goods and services at a rate of 5 percent.⁴⁰ Five of Canada's 10 provinces have adopted the harmonized sales tax with a tax base harmonized with the national GST and centrally administered by the national government (see Figure 6).⁴¹ 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 in the GST but impose no HST or separate provincial or territorial sales taxes. Taken together, roughly 57 percent of the country's population resides in provinces or territories with a centralized federally administered GST/HST system.

Quebec has its own unique relationship to the GST. Quebec imposes a Quebec sales tax (QST) that is harmonized to the national GST tax base. 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 inside or outside Quebec.⁴² Finally, three Canadian provinces (British Columbia, Manitoba, and Saskatchewan), comprising about 20 percent of the nation's population, impose both a 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.⁴³

The net result of this hybrid model is that about 80 percent of the Canadian population is taxed under a common and harmonized GST tax base, although the administration of the harmonized tax is at the provincial level in Quebec. Further, about 20 percent 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 in

the provinces with a harmonized GST/HST/QST consumption tax base.

The Harmonized GST/HST/QST 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 percent of the population lives in provinces where the national and provincial tax bases are harmonized. Like the development of the EU VAT, the hybrid national/provincial general consumption tax system in Canada was introduced both to replace outdated national and provincial sales taxes that relied too much on the taxation of business inputs and to harmonize disparate consumption tax systems.⁴⁴ The harmonization did not take place all at once. Aside from Alberta and the three territories with no provincial sales taxes, the other provinces discarded their retail sales taxes and harmonized to the GST over a 25-year period beginning with Quebec (in the 1990s); New Brunswick, Nova Scotia, Newfoundland and 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 significant power to the federal government. However, three factors negate this concern. First, although provinces that wish to harmonize must accept the existing tax base as determined by the federal government, a harmonizing province is given the option to exempt selected items from the provincial component of the HST, up to an aggregate maximum of 5 percent of the total GST/HST tax base. 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

⁴⁰ Goods and Services Tax, R.S.C. 1985, c E-15, subsection 165(1).

⁴¹ See Participating province. Government of Canada, Definitions for GST/HST (last updated Sept. 25, 2020).

⁴² Revenu Québec, Basic Rules for Applying the GST/HST and QST.

⁴³ Retail Council of Canada, Sales Tax Rates by Province.

⁴⁴ On the historical development of the Canadian GST/HST system, see Frieden and Lindholm, *supra* note 1, at Appendix.

change. Third, a province also has the option to deharmonize and cancel its Comprehensive Integrated Tax Coordination Agreement (CITCA) with the federal government.⁴⁵

Broad GST/HST Tax Base of Household Goods and Services. As with other VATs around the world, Canada's GST/HST system has a broad tax base of household goods and services. The tax is imposed based on the value of the consideration for a taxable supply, with supply defined as "the provision of property or a service in any manner."⁴⁶ A "service" is generally defined broadly to be "anything other than . . . property."⁴⁷

Although the Canadian GST/HST uses terminology similar to the EU VAT to define what is included in 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.⁴⁸ Based on OECD statistics, the GST/HST base is about 15 percent less broad than the average OECD VAT base.⁴⁹

The list of exempt supplies — those not subject to GST/HST, but for which the supplier is not entitled to recover the GST/HST payable on their inputs — includes real property (excluding commercial property and new residential property); healthcare services; education services; personal care services; legal aid services; supplies by charities, nonprofits, governments, and public institutions; and Canadian-domestic financial services.⁵⁰

⁴⁵ The CITCA provides that a province cannot deharmonize within the first five years of commencement of the agreement and thereafter only on 18 months' notice. This was tested in 2013 by British Columbia, which harmonized on July 1, 2010, and then deharmonized on April 1, 2013. So, despite the terms of the CITCA, the provinces and federal government can always agree on other terms.

⁴⁶ Government of Canada, *supra* note 41, at Supply.

⁴⁷ *Id.* at Service.

⁴⁸ Like other VAT systems, Canada divides items excluded from the GST/HST base into two categories: zero-rated supplies and exempt supplies. The list of zero-rated supplies — items technically subject to tax at a rate of 0 percent but for which the supplier is still entitled to claim input tax credits — includes: prescription drugs and biologicals; medical devices; basic groceries; agricultural and fishing; and exports, international transportation and travel, and non-Canadian financial services. The relatively large number of zero-rated supplies narrows the breadth of the GST/HST tax base. See Zero-rated supplies. Government of Canada, General Information for GST/HST Registrants (last updated Oct. 10, 2020).

⁴⁹ OECD, *Consumption Tax Trends 2018: VAT/GST and Excise Rates, Trends and Policy Issues* 53 (2018).

⁵⁰ Government of Canada, *supra* note 48, at Exempt supplies.

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. Each province has complete sovereignty over what is included or excluded from its sales tax base.

Second, in terms of the composition of the tax base, the provincial retail sales taxes suffer from an underinclusion of household goods and services and an overinclusion of business inputs.⁵¹ 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, the provincial retail sales taxes are not designed to exclude business inputs from the tax base.

3. U.S. State Sales Tax 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 90-year history of state sales tax systems, the tax bases among the 45 states and the District of Columbia 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, 15 states also allow some variation between their state and local sales tax bases.⁵²

The state and local sales tax bases in the United States not only lack uniformity but are generally narrow as well, at least by international standards. Most states impose a sales tax on a

⁵¹ When Newfoundland and Labrador and New Brunswick harmonized with the GST in the mid-1990s, a study found that the new provincial harmonized tax base was between 17.7 percent and 21.7 percent broader than the previous retail sales tax base. Pierre Bocti and David Douglas Robertson, "Sales Tax Harmonization: The Facts & Nothing but the Facts," at 29-31. The paper was prepared for the 25th annual CICA Commodity Tax Symposium (Sept. 25-28, 2005).

⁵² Frieden and Fred Nicely, "The Best and Worst of State Sales Tax Systems: COST Scorecard on Sales Tax Simplification, Uniformity, and Exemption of Business Inputs," COST, at 21-66 (Apr. 2018) (hereinafter "Sales Tax Scorecard").

Figure 7.
Harmonization of the General Consumption Tax Base

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

wide range of goods, but only a limited number of services. Further, because states have complete autonomy to set their sales tax rates, a wide variety of 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) among the states was about 37 percent.⁵³ The sales tax breadth ranged from a low of 18 percent in Virginia to a high of 109 percent in Hawaii. The share was less than 25 percent in California, Maryland, Massachusetts, New Jersey, and Virginia; and over 50 percent in Wyoming, North Dakota, New Mexico, South Dakota, and Hawaii.⁵⁴

The complete absence of any harmonization of the sales tax base among state sales tax systems stands in sharp contrast to the outcomes in the EU 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 10 Canadian provinces with 80 percent of the country's population have harmonized their provincial sales tax bases to the national GST (see Figure 7).

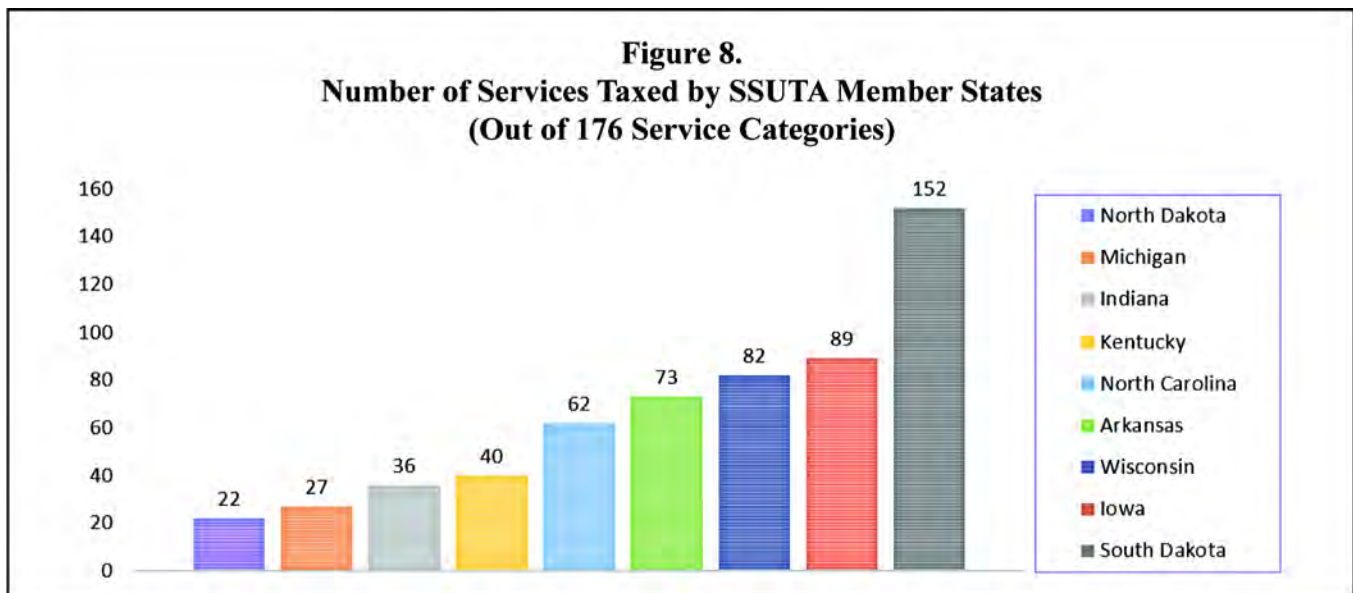
The wide divergence in sales tax breadth among the states is partially caused by the lack of uniformity among the states in various categories of goods included in the sales tax base. For instance, in 2018, of the 46 states (including the District of Columbia) with sales taxes, seven taxed food for home consumption; 21 taxed residential electricity and gas; 35 taxed nonprescription drugs; and 38 taxed clothing.⁵⁵

The differences in sales taxation of services are even more stark. 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 46 states (including the District of Columbia) with sales taxes, five taxed legal services; six taxed barber shops; 10 taxed interior design; 19 taxed streaming videos; 21 taxed landscaping; 21 taxed laundry/dry cleaning (non-

⁵³ Mikesell, "State Retail Sales Taxes in 2018," *Tax Notes State*, Sept. 30, 2019, p. 1339.

⁵⁴ *Id.* The Hawaii percent is above 100 percent 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.

⁵⁵ Federation of Tax Administrators, *State Sales Tax Rates and Food & Drug Exemptions* (Jan. 2020); Mikesell, *supra* note 33, at 393.



coin-operated); and 23 taxed health clubs/tanning salons.⁵⁶

The absence of harmonization of the U.S. sales tax base is apparent both in the larger states that have not joined the Streamlined Sales and Use Tax Agreement, and among the SSUTA states themselves. Although the SSUTA calls for uniform definitions for many goods and some services, it does not require states to harmonize their sales tax bases. As a result, the sales tax bases among the SSUTA states remain widely divergent, reflecting as many differences as among the states that are not SSUTA members. The 2017 FTA study found that the number of services taxed by SSUTA states (out of a possible 176 services) ranged from a low of 22 (North Dakota) to a high of 152 (South Dakota) (see Figure 8).⁵⁷

The Narrow Breadth of U.S. Sales Tax Bases Compared With Other Nations. The narrow breadth of the collective U.S. state sales tax bases compared with the EU VAT base and the Canadian GST/HST 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 tax base among EU member states equals 55 percent of final consumption, compared with 56 percent for all OECD member countries. In the Canadian GST/HST, the tax base equals 47 percent of final consumption.⁵⁸ By contrast, in U.S. state sales tax systems the average tax base equals only 37 percent of final consumption.⁵⁹ (See Figure 9.)

⁵⁸ OECD, *supra* note 49, at 53-59. The EU VAT base breadth and Canada GST base breadth are based on the OECD statistic called the "VAT Revenue Ratio" (VRR). The VRR approximates the breadth of the VAT base that compares VAT collections with the potential VAT base of household goods and services as measured at the standard VAT rate. However, the reductions from 100 percent 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 ineligible for input VAT credits. 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 healthcare, 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.

⁵⁹ EY, *supra* note 4, at 6; Mikesell, *supra* note 33, at 395. The OECD statistics do not calculate a VRR for the United States because it has no VAT. However, a similar concept used to measure the breadth of the U.S. sales tax base is the "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 34, at 782-785.

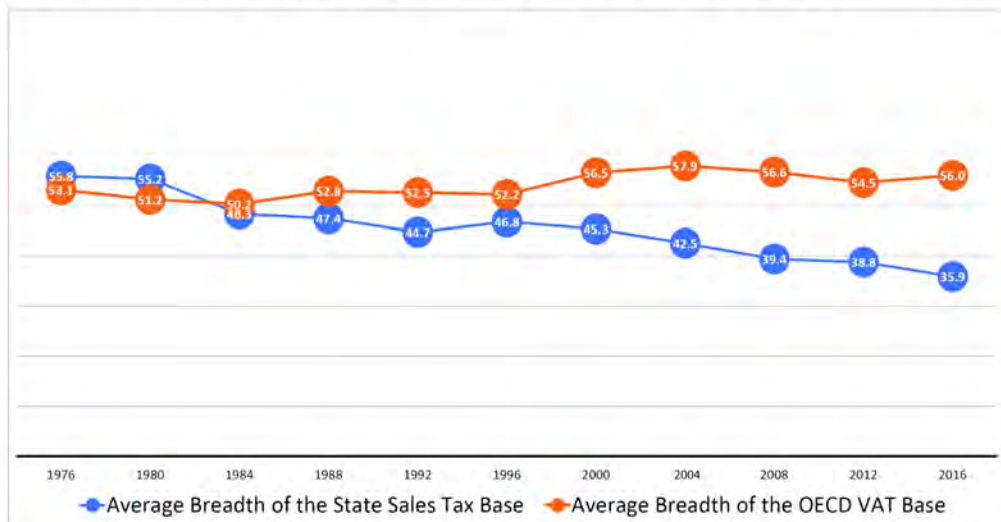
⁵⁶ FTA, 2017 Services Taxation Survey (2017).

⁵⁷ FTA, "FTA Survey of Services Taxation — Update," *By the Numbers*, at 2 (July-Aug. 2017).

Figure 9.
Breadth of General Consumption Tax Bases

Geography	Breadth of Consumption Tax Base
OECD VATs	56%
European Union VAT	55%
Canada GST/HST/QST	47%
U.S. State Sales Tax Systems	37%

Figure 10.
The Comparative Breadth of the U.S. Sales Tax Base and the OECD VAT Base: 1976-2016



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 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 39 percent, but the breadth of collective U.S. state and local sales tax bases falls to 21 percent.⁶⁰

⁶⁰ For the calculation of the U.S. sales tax breadth, see EY, *supra* note 4, at 4. For the calculation of the Canadian GST breadth, see *supra* note 58.

U.S. state and local sales tax bases have been narrowing, not expanding, over the last 50 years. The breadth of state sales tax bases declined from 54.4 percent in 1970 to 36.6 percent in 2018.⁶¹ In relative terms, state and local sales tax bases today are about two-thirds of 1970 levels. The decline is largely attributable to the growth of predominantly untaxed household services.⁶² By contrast, the EU VAT and Canadian GST bases have been stable over the same time — actually increasing slightly to 55 percent (EU) and 47 percent (Canada), to reflect the inclusion of a broader range of household services in the tax base (see Figure 10).⁶³

The narrowing of the sales tax breadth in the U.S. 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 enumerated services with new ones added incrementally.⁶⁴ As noted, this methodology creates significant scope and definitional difficulties, as opposed to the “inclusive” statutory approach to both goods and services in the EU VAT and Canada GST/HST.

As a result, the U.S. approach has failed to keep pace with the rapidly expanding and diversifying service economy. 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.⁶⁵ 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.⁶⁶ It is much more difficult, both practically and politically, to add new services incrementally than it is to default to the inclusion of all services unless specifically excluded.

The new post-*Wayfair* ability of states to impose a sales tax collection responsibility on remote sellers increases sales tax revenues as new sellers and marketplace providers register with the 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 modest, at least in relation to current sales tax revenues. In a November 2017 study, the U.S. Government Accountability Office concluded that 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 percent of state and local sales tax revenue.⁶⁷

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 consumption that applies uniformly at the national level, only the EU has instituted a VAT with a broad tax base on household goods and services that is harmonized at the continent level. This makes the EU one of the world leaders

⁶¹ 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 (not including local tax rates) has increased from 3.53 percent in 1970 to 5.6 percent in 2017, a 58.6 percent increase. Mikesell, *supra* note 33, at 395. For the 2018 statistics, see Mikesell, *supra* note 34, at 1344.

⁶² Mikesell, *supra* note 33, at 395.

⁶³ OECD, *supra* note 49, at 90.

⁶⁴ 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, sections 1, 6 (West 2020).

⁶⁵ FTA, *supra* note 57.

⁶⁶ On the future state tax issues relating to autonomous vehicles, see William F. Fox, “The Influence of Autonomous Vehicles on State Tax Revenues,” 73(1) *Nat’l Tax J.* 199-234 (Mar. 2020).

⁶⁷ U.S. GAO, GAO-18-114, *States Could Gain Revenue From Expanded Authority, but Businesses Are Likely to Experience Compliance Costs* 12 (2017). The COVID-19 pandemic may increase the share of tax collections by remote sellers, but much of that increase displaces tax collections by brick-and-mortar sellers and does not add new sources of revenue. 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 percent in 1975 to 7.1 percent in 2018 and pretty much flattened out to between 6 and 7 percent of all taxes over the last 20 years. See OECD, *supra* note 4, at tbl. 5120 as measured by share of total taxation. Finally, carbon taxes may gain more support as the climate change debate heats up, but many unanswered questions remain about whether and how such taxes would operate. See Kyle Pomerleau and Elke Asen, “Carbon Tax and Revenue Recycling: Revenue, Economic and Distributional Implications,” Tax Foundation Fiscal Fact 674 (Nov. 2019).

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 percent 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 percent 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 comprising primarily 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.⁶⁸

1. European Union 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 is a tax on final consumption by households is that the burden of the VAT should not rest on businesses.⁶⁹

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 EU VAT and it applies in the VAT system adopted by all EU member states. Taxable persons (businesses) are responsible for charging, collecting, and remitting VAT to the government,⁷⁰ but they do not generally bear VAT as a business cost. Taxable persons charge VAT on their sales (called output tax) and have a right to a credit for VAT paid on their business purchases including inventory for resale, direct inputs, overheads, capital purchases, and imports (called input tax).⁷¹ Taxable persons offset VAT charged with VAT paid in a filing period and remit the difference to the relevant tax administration.⁷²

Charging and offsetting VAT on supplies made between taxable persons means that the tax is effectively neutral for most business entities. 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.

Tax Administration Benefits. Charging VAT at each stage of production also enhances tax

⁶⁸ 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 33, at 35.

⁶⁹ OECD, *International VAT/GST Guidelines* 14 (2017) (emphasis added).

⁷⁰ Council Directive 2006/112, *supra* note 36, at article 206.

⁷¹ *Id.* at article 168.

⁷² *Id.* at article 179.

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.⁷³ The one downside of input VAT credits is the potential for fraudulent filings, given the large financial incentive to make false claims.⁷⁴

Avoiding Tax Pyramiding. The 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, there is no requirement that the business purchaser be in a favored industry such as manufacturing or agriculture as might occur 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), any VAT paid on such inputs is eligible for an input VAT credit.

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.

2. The Canadian GST/HST and Provincial Sales Tax Approach

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

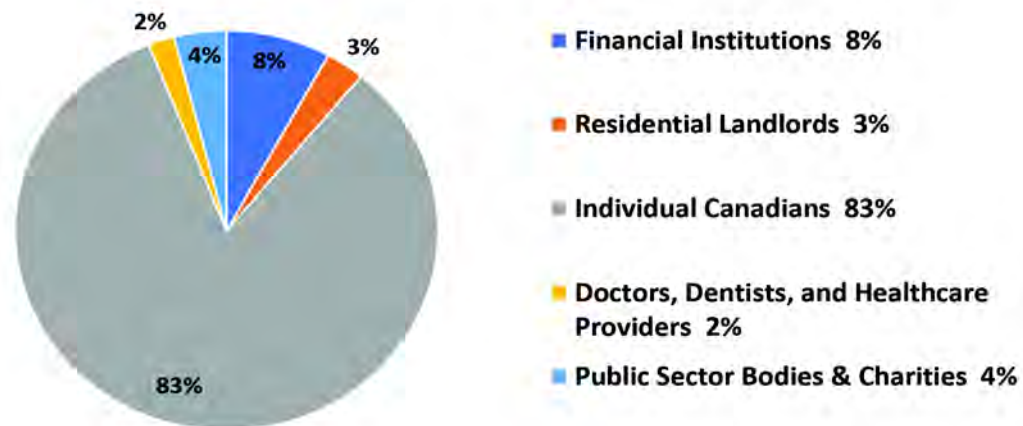
The GST/HST Approach to Input Credits and Exempt Supplies. The mechanism to ensure that GST/HST is a tax on final consumption is the ability to offset GST input tax credits.⁷⁵ Like the EU VAT, this is an essential feature of Canadian GST/HST. Businesses charge GST/HST on their sales (called output tax) 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

⁷³ See generally Alan Schenk and Oliver Oldman, *Value Added-Tax: A Comparative Approach* (2007). Charging VAT at each stage, however, can have the slightly opposite impact of requiring more sellers to register to collect the tax.

⁷⁴ See Frieden and Lindholm, *supra* note 1, section 2A.

⁷⁵ Government of Canada, *supra* note 41, at input tax credit.

Figure 11.
Share of Canada GST Paid by Households (83%) vs. Businesses/Non-Profits (17%)



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).

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; and
- financial institutions, including banks, credit unions, insurers, and broker dealers.

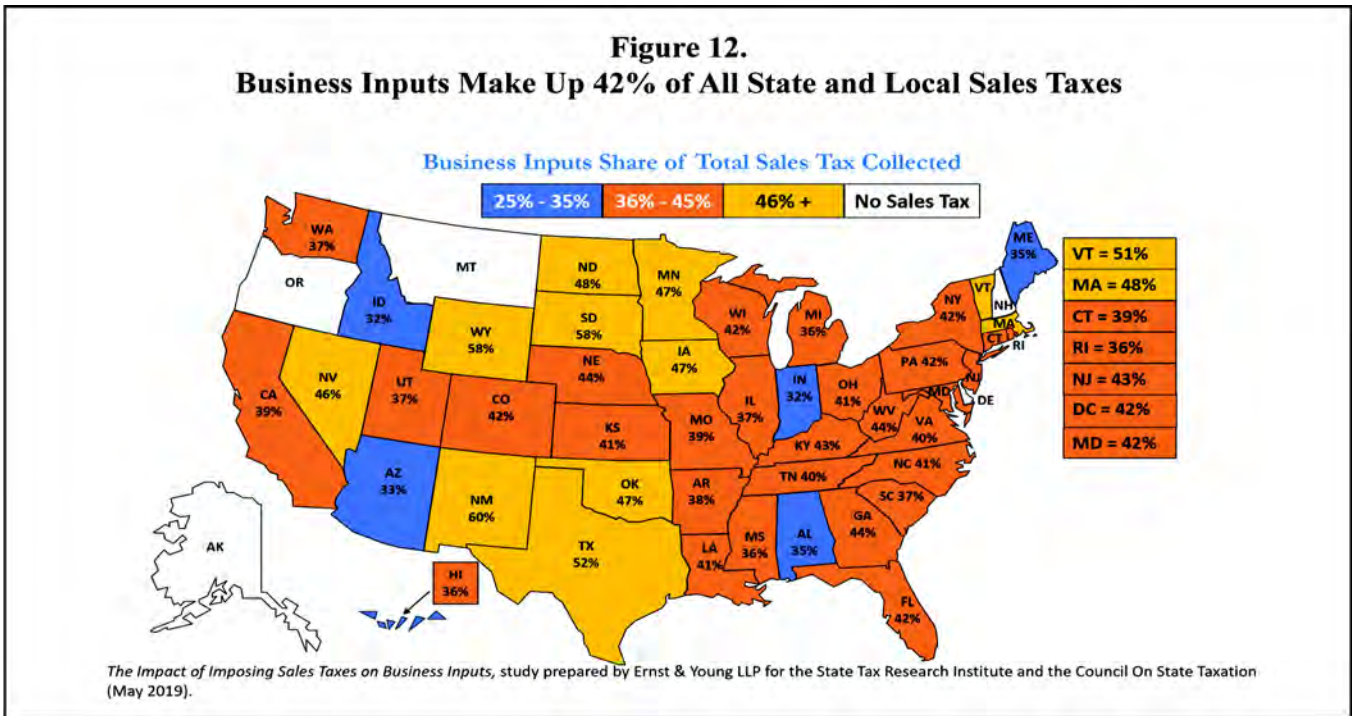
As a result, virtually all for-profit businesses other than those in the financial or real estate industries, are entitled to input tax credits, and thus not effectively taxed on their business inputs. Thus, the structural design of the GST/HST provides an input credit for purchases and investments by energy producers, manufacturers, 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 with other sources. The study found that of the total GST revenue collected by the federal government, 83 percent was attributable to household consumption (that is, GST paid by individual Canadians). The remaining 17 percent came from the nonrecoverable GST incurred by businesses, nonprofit organizations, and governments making GST-exempt supplies. Banks, insurance companies, and financial institutions accounted for about 8 percent of federal GST revenues, and medical, dental, and other healthcare professionals contributed about 2 percent. Residential landlords contributed about 3 percent of total federal GST revenues, and the remaining 4 percent was incurred by public sector bodies (universities, colleges, schools, hospitals, charities, and nonprofit organizations) (see Figure 11).⁷⁶

The Canadian GST/HST and Retail Sales Tax. While the Canadian GST follows the

⁷⁶Robertson, "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. This paper was presented in Toronto, Mar. 15, 2006. These percentages were provided by Statistics Canada and are based on the years 2000 to 2002. Accordingly, the proportion of GST attributable to public sector bodies is now lower because during those years, municipalities — which constituted public sector bodies — were only entitled to recover 57 percent of the GST that they paid. As of February 2004, municipalities are entitled to a rebate of 100 percent of the GST that they incur.



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.⁷⁷

3. The U.S. State Sales and Use Tax Approach

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

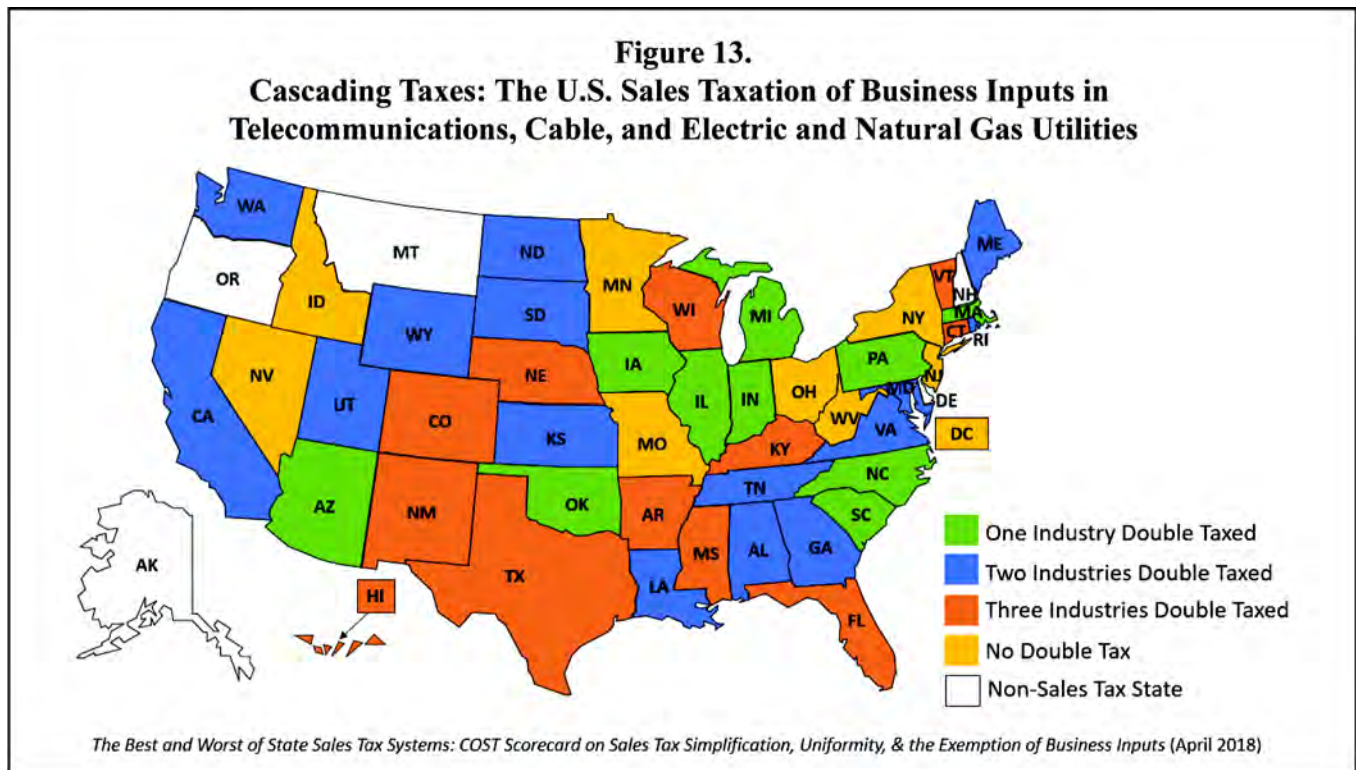
The cumulative impact of the failure to exempt business inputs from the U.S. sales tax is evident from the high share of total U.S. sales and use tax accounted for by business inputs. According to a study by EY LLP, in fiscal 2017 state and local sales taxes on business inputs totaled 41.7 percent of aggregate state and local sales taxes.⁷⁸ The business share of sales tax varied by state, from 32 percent in Indiana to 60 percent in New Mexico, and it exceeded 50 percent in five states.⁷⁹ (See Figure 12.)

The sales tax burden on businesses has been virtually unchanged during the last two decades despite a substantial growth in sales tax revenues. The first EY study of the sales taxation of business inputs for fiscal 2003 found that sales tax collections on business inputs totaled 42.8 percent of total state and local sales taxes, like the 41.7

⁷⁷ See Richard M. Bird, "Is a State VAT the Answer? What's the Question?" *State Tax Notes*, Sept. 24, 2007, p. 809; and Bocti and Robertson, *supra* note 51, at 20.

⁷⁸ EY, *supra* note 4, at 7.

⁷⁹ *Id.* at 9.



percent estimated for fiscal 2017.⁸⁰ 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 percent.⁸¹ 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.

Pyramiding of State Sales Taxes. One of the key ramifications of taxing both inputs and outputs in some industries is the economically inefficient pyramiding of sales taxes. Figure 13 shows the extensive pyramiding from sales taxes on inputs and outputs in the telecommunications, cable, electric, and natural gas utility sectors. Of the 45 states and the District of Columbia with

sales taxes, only nine do not double tax any of these three service industries. Ten states double tax one of them, 16 impose a double tax on two of them, and 11 double tax all three.⁸² 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 of location of jobs and investment, input purchases, and organization of business structures. Pyramiding adds substantially to the supply chain costs of production or service provision 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

⁸⁰ Robert Cline et al., "Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services," COST (Jan. 25, 2005).

⁸¹ 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); and Ring, "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 nonprofit organization purchases, but no household consumption.

⁸² Sales Tax Scorecard, *supra* note 52, at 10.

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.⁸³

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 services and preventing the sales tax share of all taxes from growing. Over the last 30 years, about one-quarter of the sales tax states tried to enact sweeping sales tax reform that would extend the 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), Michigan (2007), Nebraska (2013), Ohio (2013), Louisiana (2013), Minnesota (2013), Maine (2015), Pennsylvania (2015), and Utah (2019).⁸⁴

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 affected service providers, and the general public's resistance to new taxes. The most important factor, however, has been the principled opposition from the business community to expanded taxation of business inputs.⁸⁵ Generally, the business community objected not to a state's

broadening of the sales tax base to include a wide range of household services, but 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 unlikely 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. 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.⁸⁶ If states enact legislation to expand the sales tax base to encompass some or all of these services, the proportion of all sales taxes paid by businesses will rise significantly from the current 42 percent share.

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 percent 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

⁸³ In fiscal 2019, the aggregate state and local sales tax collections on business inputs totaled \$177.3 billion compared with state corporate income tax collections in the same year of \$77.1 billion. Thus, sales tax collections on business inputs were about 2.33 times larger than total combined state corporate income tax collections. See generally EY, *supra* note 4.

⁸⁴ *Id.* at 16-21.

⁸⁵ *Id.*

⁸⁶ *Id.* at 18.

national manufacturers wholesale tax and eventually most of the provincial sales taxes by the GST/HST. That historic shift was successful because the overall share of the Canadian GST accounted for by business inputs (17 percent) is only about two-fifths of the share of business inputs in the U.S. sales and use tax (42 percent). Conversely, Canada's remaining three provinces (with 20 percent 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. 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 -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 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

are 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 article: the European Union (EU and national government levels); Canada (federal and provincial levels); and the United States (federal, state, and local levels).

1. The European Union VAT Approach

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 EU 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.⁸⁷

National Tax Administration of the EU VAT.

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.⁸⁸ The VAT directive imposes a high degree of harmonization on EU member states' VAT systems, but does 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 lack of EU-level harmonization of VAT administrative rules is a constant source of frustration for both tax administrators and large

⁸⁷ OECD, *supra* note 14, at tbl. 3.15.

⁸⁸ A small proportion of the VAT collected by each EU member state is remitted to the EU 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 required to collect statistical information about intra-EU supplies of goods.

multinational taxpayers, adding significantly to tax compliance costs and VAT input tax fraud. In 2020, the EU 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 EU has stumbled before in trying to rationalize EU VAT administrative rules.⁸⁹

EU VAT Rates. The VAT directive sets the framework for VAT rates in the EU, 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 EU, nor does any EU member state apply a single VAT rate to all taxable goods and services. Each EU member state must designate a standard VAT rate.⁹⁰ 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).⁹¹

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 percent, but no maximum is specified in EU law.⁹² 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 EU ranges from 17 percent in Luxembourg to 27 percent in Hungary. EU VAT standard tax rates are generally higher than those in other OECD nations. For instance, over one-half of OECD countries that are not EU member states impose standard VAT rates of 17 percent or less, including Australia (10 percent), Canada (5 percent at the national level),

Israel (17 percent), Japan (8 percent), Korea (10 percent), New Zealand (15 percent), and Switzerland (7.7 percent).⁹³

Currently, reduced rates levied in the EU range from 0 to 18 percent, and are often applied to basic necessities such as food to address regressivity.⁹⁴ 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. 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.

Recent EU Success Toward 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 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)⁹⁵ 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.

⁸⁹The 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," *Tax Notes Int'l*, Oct. 19, 2020, p. 393.

⁹⁰Council Directive 2006/112 *supra* note 36, at article 96; and Council Directive 2018/912, 2018 O.J. (L 162) 1 (EU).

⁹¹EY, *Worldwide VAT, GST and Sales Tax Guide 2020*, contains details of VAT rates applied in individual jurisdictions

⁹²Council Directive 2006/112, *supra* note 36, at article 97.

⁹³OECD, *supra* note 49, at 66-67.

⁹⁴VAT rates applied in the EU as of Jan. 1, 2019. Europa.eu, "VAT Rates Applied in the Member States of the European Union" (2020).

⁹⁵The 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. Europa.eu, "VAT on Digital Services (MOSS Scheme)" (last updated Mar. 26, 2020).

Figure 14.
Centralized Tax Administration
Canada

POPULATION - CANADA	2017	% of Total	Sales Tax	Summary	
Canada	36,708,083			GST/HST – One Administration, One Tax Base 57%	
Newfoundland and Labrador	528,817	1.4%	GST/HST	GST & QST – Two Administrations, One Tax Base 23%	
Prince Edward Island	152,021	0.4%	GST/HST	GST & PST – Two Administrations, Two Tax Bases 20%	
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		

2. The Canadian GST/HST and Provincial Sales Tax Approach

In Canada, the degree of centralized and simplified tax administration varies based on the tax regime in different provinces. About 57 percent 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 percent 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 remaining 20 percent of the population lives in three provinces with two tax authorities (national and provincial), two tax returns, and two tax bases (see Figure 14).

The GST/HST System. Canada's GST/HST system is administered by a single tax authority on behalf of both the federal and provincial governments — at least for those provincial governments and territories (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 — either monthly, quarterly, or

annually — with the Canada Revenue Agency 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) to the CRA. Businesses are not required to track GST/HST for the various provinces separately. Significantly, this means that a GST/HST-registered business is only subject to audit by a single tax authority, the CRA, regarding GST/HST compliance, and all assessments, objections, and appeal procedures follow federal rules.

The Quebec Sales Tax Model. The administration of the QST is different from 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. The federal government administers GST/HST and QST for all selected listed financial institutions based in Quebec (and in the rest of Canada). Businesses located outside Quebec that are registered for both GST/HST and QST purposes must file separate returns — GST/HST returns with the national government and QST returns with the province.

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. For example, while the national federal rate of tax in Canada is 5 percent, when Ontario harmonized in 2010, it eliminated its 8 percent provincial sales and use tax (Ontario PST) and asked the federal government to increase the GST/HST rate in Ontario by 8 percent. Thus, the GST/HST rate in Ontario is 13 percent, with 5 percent to the federal government and 8 percent to the province.⁹⁶

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, the 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.⁹⁷ Similar to U.S. states that are not members of SSUTA, the three provinces exercise their sovereignty 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.

3. 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, most states have further burdened sales tax compliance and administration by creating an overabundance of local jurisdictions imposing local sales tax rates and, to a lesser degree, autonomy over local sales tax bases. Nonetheless, the collaborative approach of state sales tax systems to centralizing and simplifying 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 adopted the Streamlined SSUTA.

State-Level Tax Administration. The United States is virtually the only advanced nation in the world that does not levy either a nationally administered consumption tax (like the EU countries) or at least a primarily nationally administered consumption tax (like Canada). Uniquely, the U.S. economy has 46 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.

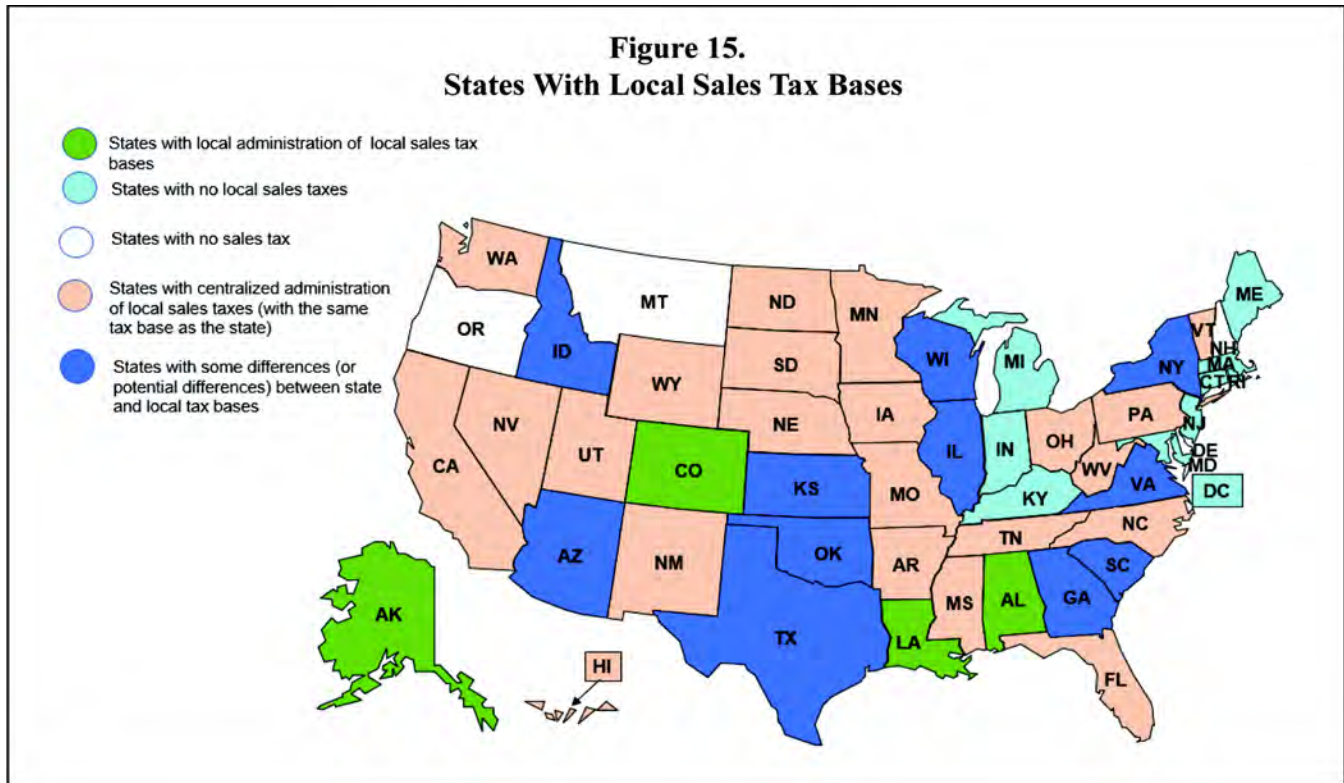
Each state with a sales and use tax separately imposes, administers, modifies, and litigates disputes for its own distinct sales tax system. Conceptually that makes little sense but is easier to understand given that legislators and revenue officials are elected and appointed, respectively, to look after 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 also to rates. The median combined state and local sales tax rate in 2019 was 7 percent. Eight states imposed combined rates of 6 percent or less, and 10 states levied rates of 8.5 percent or more. The combined rates ranged from a low of 4.4 percent in Hawaii to a high of 9.55 percent in Tennessee.⁹⁸

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 45 states plus the District of Columbia, 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

⁹⁶ See changes that impact the data. Government of Canada, GST/HST Statistics Tables (2010 to 2014 Calendar Years) (last updated June 20, 2017).

⁹⁷ Bocti and Robertson, *supra* note 51, at 26.

⁹⁸ Janelle Cammenga, "State and Local Tax Rates, Midyear 2020," Tax Foundation Fiscal Fact No. 716, 5 (July 2020).



subnational governments, it immeasurably complicates multistate tax compliance.

In the United States, 10 states impose state-administered sales taxes with no local sales taxes, and 22 states levy state-administered sales taxes with state and local tax rates, but with no differences between state and local tax 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.⁹⁹ (See Figure 15.) By comparison, in the EU and Canada (and in virtually all other nations), consumption taxes are

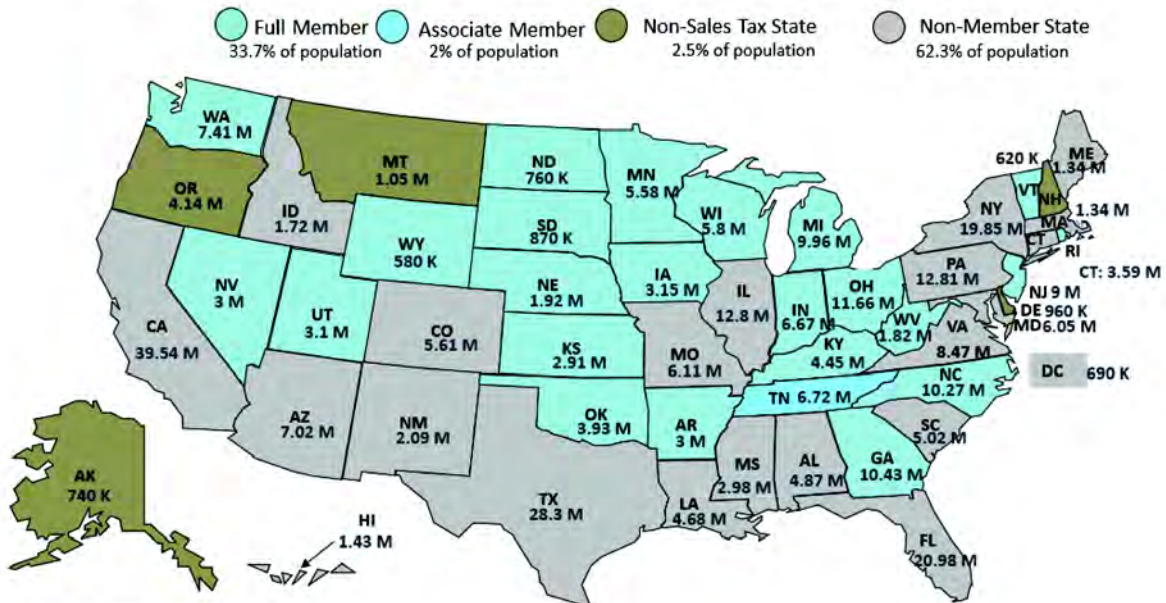
generally imposed only at the national level, and occasionally at the state/provincial level (for example, Canada), but never at the local level.

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 centralization and simplification of 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

⁹⁹ Sales Tax Scorecard, *supra* note 52, at 21-66 on chart of “Scorecard Detail by State” in the column “Central Tax Admin.”

Figure 16.
The Streamlined Sales and Use Tax Agreement
Has Been Adopted by States With Only One-Third of the U.S. Population



Source: U.S. Census Bureau

national economy free from such unjustifiable local entanglements.¹⁰⁰

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.”¹⁰¹ 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 SSUTA was finalized, approved, and presented to the states for adoption. The SSUTA sought to provide states with a streamlined system that includes¹⁰²:

- 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.

The Limitations of the SSUTA. The SSUTA project has made great strides to make sales tax administration rules more uniform across the states. To date, 23 states have adopted the

¹⁰⁰ *National Bellas Hess Inc. v. Department of Revenue of Illinois*, 386 U.S. 753, 759-60 (1967).

¹⁰¹ Statement by former Utah Gov. 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” (1999); and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

¹⁰² Hardt et al., “A Lawmaker’s Guide to the Streamlined Sales Tax Project,” 22 *J. St. Tax’n* 1 (2003-04).

streamlined rules. The SSUTA project is one of the best examples of state collaboration, in any state policy sphere, to reduce the complexities inherent in U.S. federalism.

However, there are limits to the uniformity endorsed by the SSUTA project. 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, the SSUTA project 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, the SSUTA project 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, the SSUTA project only addressed the third of the three principles of an optimal consumption tax: centralized and simplified tax administration.¹⁰³

An even more significant barrier to the SSUTA project has been the absence of the larger states' participation in uniformity efforts. While half of the states with sales taxes are SSUTA members, nearly two-thirds of the U.S. population live in states that are not members (see Figure 16). None of the largest six states (California, Texas, Florida, New York, Pennsylvania, or Illinois), which account for 44.6 percent of all sales tax collected in the United States, are members.¹⁰⁴ 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.

Summary: Centralized and Simplified Tax Administration in the EU, Canada, and U.S. States. 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 EU'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 percent 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 percent of the population), the GST is administered at the national level (for non-Quebec 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 23 states (with about one-third of the population) that participate in the SSUTA project satisfy the third principle of an optimal consumption tax. These states work closely together to centralize and simplify a significant number of sales tax administration rules. The nearly 20-year collaboration includes constant monitoring of member states' sales tax administration rules to ensure good-faith compliance with the agreement. Conversely, the

¹⁰³ 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." McLure, "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).

¹⁰⁴ Mikesell, *supra* note 53, at 1341-42.

Figure 17.
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 (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 some uniform tax administrative rules in 23 SSUTA states)	10,000+

non-SSUTA states (with about two-thirds of the population), have little or no centralization or simplification of sales tax administrative rules and thus fail to satisfy the third principle of an optimal consumption tax.¹⁰⁵

D. Summary of 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 have their own 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 is 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 its single administration of

both federal and provincial taxes, the failure of three of Canada's 10 provinces to abandon their provincial retail sales tax 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 here 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

¹⁰⁵ These divergent outcomes are evident from a 2018 COST study evaluating the states on 33 elements of an efficient and effective sales tax system. In that study, the SSUTA member states averaged a "B" grade, while the non-SSUTA states averaged an abysmal "D+" grade. Sales Tax Scorecard, *supra* note 52, at 2.

larger states that are not SSUTA members (see Figure 17).

III. 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. 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 in the EU, Canada, and other advanced nations (other than the United States) away from these general consumption taxes were made primarily for economic efficiency and international competitiveness reasons. 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.¹⁰⁶ 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."¹⁰⁷ In consumption tax systems with multiple levels of taxation (for example, the EU 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 (the retail sales tax and turnover tax) with newer and more efficient ones (for example, the EU VAT and the Canadian hybrid GST/HST);
- 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 50-year span, 16 countries (about one-half of OECD nations) used a retail sales tax as a significant revenue source for at least part of the period.¹⁰⁸ 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 a retail sales tax (see Figure 18).¹⁰⁹ Similarly, eight OECD

¹⁰⁶ Ben Terra, *The Ordeal of VAT Harmonisation in the EU*, ch. 1 (2019). 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 33, at 322. On turnover taxes, see also Mikesell, "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance," Tax Foundation Background Paper No. 53 1, 4 (Jan. 2007).

¹⁰⁷ OECD, *supra* note 49, at 16.

¹⁰⁸ On retail sales taxes, see OECD, *supra* note 4, at tbl. 5112.

¹⁰⁹ *Id.*

Figure 18.

OECD Nations With a Sales Tax Between 1965 and 2018	OECD Nations With a Sales Tax in 2018
Australia	Canada (in three provinces)
Belgium	United States
France	
Greece	
Hungary	
Iceland	
Ireland	
Korea	
Latvia	
New Zealand	
Portugal	
Slovenia	
Sweden	
Switzerland	
United Kingdom	
United States	

countries used a turnover tax in 1965, but all of these countries abandoned the tax in favor of a VAT over the following two decades.¹¹⁰

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.¹¹¹ 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 percent of all consumption taxes in 2018 compared with the OECD average of 64 percent.¹¹² (See Figure 19.)

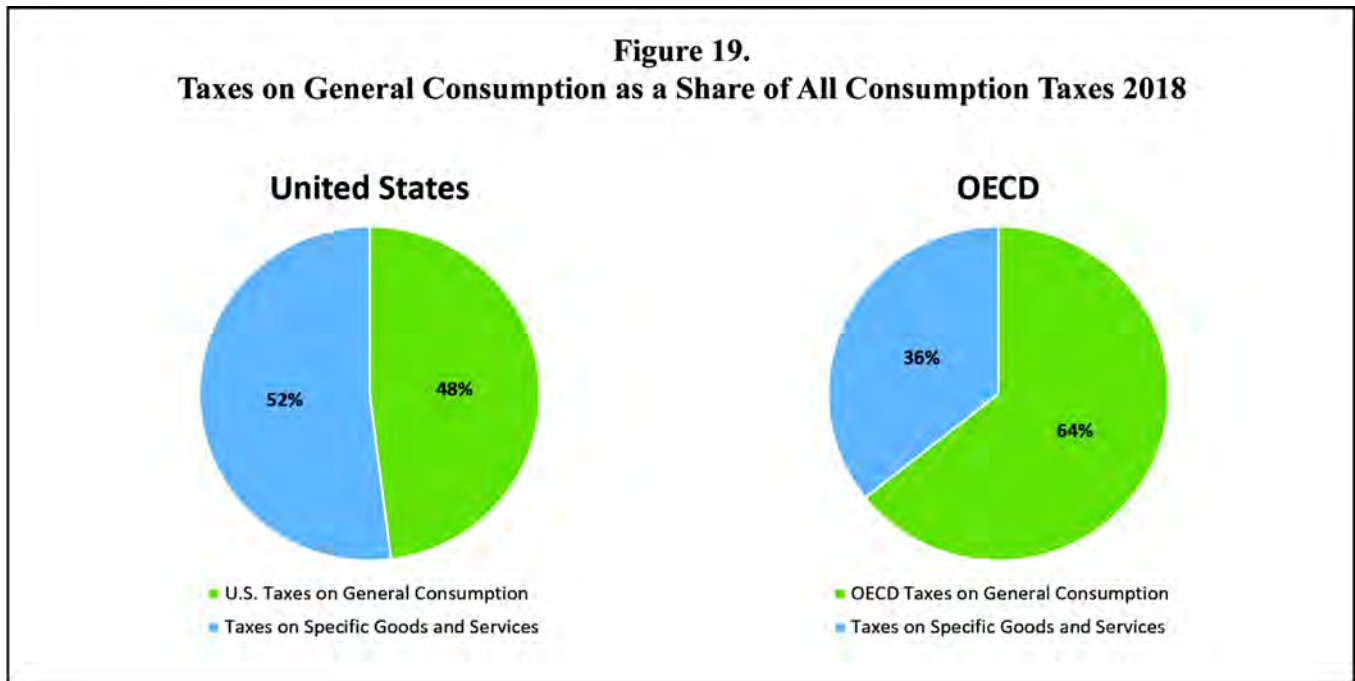
Finally, general consumption taxes as a share of all taxes expanded rapidly in OECD nations

¹¹⁰ On turnover taxes, see *id.* 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 and Daniel Bunn, “Learning From Europe and America’s Shared Gross Receipts Tax Experience,” Tax Foundation (Feb. 12, 2019).

¹¹¹ The 1965 and 2018 statistics are from OECD, *supra* note 4, at tbls. 5000 and 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 as the VAT in OECD countries rose from 2.2 percent of all taxes in 1965 (or about one-fifth of all taxes on general consumption) to 20.2 percent of all taxes in 2018 (or over 9/10 of all taxes on general consumption). *Id.* at tbl. 5111. The trend to adopt VAT systems was not limited to Europe or OECD nations; it soon became a worldwide phenomenon. In the 1960s, only about 10 nations imposed a VAT, compared with 168 today.

¹¹² *Id.*

Figure 19.
Taxes on General Consumption as a Share of All Consumption Taxes 2018



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 percent in 1975 to 20.9 percent in 2018. By contrast, taxes on general consumption as a share of total taxation in the United States increased only modestly from 7 percent in 1975 to 8.3 percent in 2018 (and not at all since 1990). (See Figure 20.)¹¹³ 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

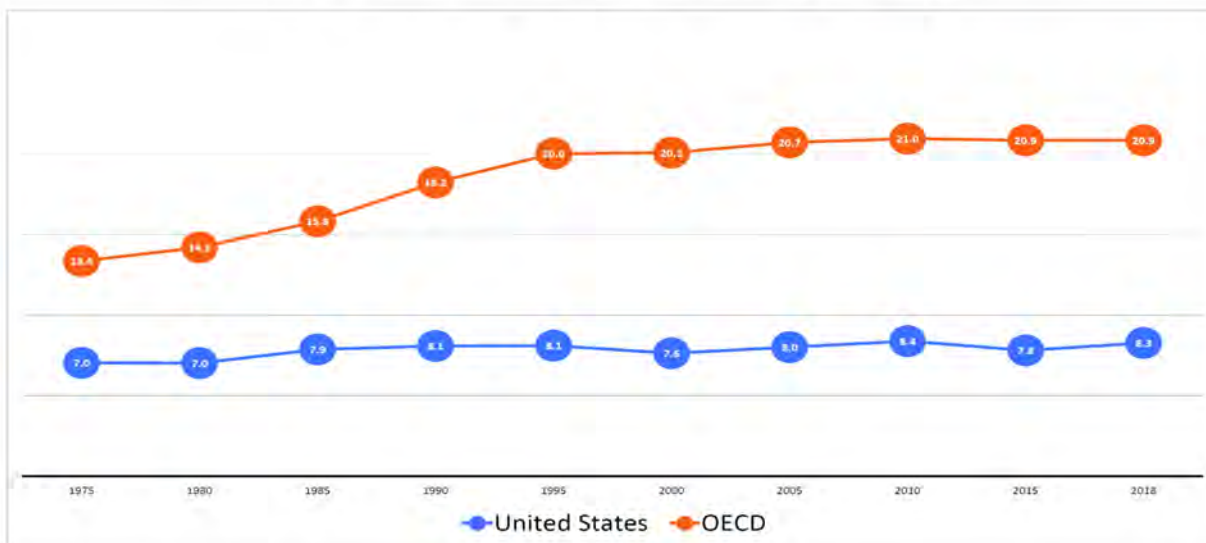
revenues in the overall U.S. tax mix has been relatively constant, and far below international norms.¹¹⁴

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

¹¹³ OECD, *supra* note 4, at tbl. 5110 as measured by share of total taxation.

¹¹⁴ 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 and lower tax rates in the United States. State and local sales tax rates have steadily increased over the last 40 years, but they are still significantly below rates for taxes on general consumption in other countries. The average combined state and local sales and use tax rate is 7.22 percent (in 2020) compared with the average OECD standard VAT rate of 19.3 percent (in 2018). However, these statistics somewhat overstate the rate differential because many OECD nations use reduced rates (not standard rates) for some 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 only 15 percent, and five OECD nations have standard rates of 10 percent 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 business inputs and household consumption, frequently resulting in opposition from both business and voters. Moreover, because the sales tax is uniquely at the subnational level in the United States, which only accounts 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 98, at 5. For OECD rates, see OECD, *Consumption Tax Trends 2018: VAT/GST and Excise Rates, Trends and Administration Issues* 66-67 (2019).

Figure 20.
General Consumption Tax as a Percentage of Total Taxation:
U.S. Comparison With OECD Nations 1975-2018



- 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
- 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.¹¹⁵

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

¹¹⁵ The retail sales tax comparison is from EY, *supra* note 91. The comparison of taxes on specific goods and services to taxes on general consumption is based on an OECD nation comparison: OECD, *supra* note 4, at tbls. 5000 and 5110 as measured by share of total taxation. The overall consumption tax comparison is from the OECD, *supra* note 2.

United States by population, it similarly has a federalist structure with taxing powers split between the federal government and its 10 provinces and three territories. Canada also has municipal governments, although under provincial law their only source of revenue is property taxes, and they do not have the legislative authority to impose a municipal sales tax.

The Canadian government's initial plan in the early 1990s was to create a national GST and encourage the Canadian provinces to replace their 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 20 years, five Canadian provinces eliminated their provincial sales and

Figure 21.

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%

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 the administration of the joint GST/HST at no charge to provinces. 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 advanced in 2010, when the largest province (Ontario) harmonized with the national GST.¹¹⁶ British Columbia, Manitoba, and Saskatchewan have yet to harmonize.

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 percent of the country's population and uses a harmonized GST base that is centrally administered by the federal government (except in Quebec).

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, 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

¹¹⁶ Prince Edward Island adopted a harmonized HST in 2013. British Columbia harmonized to the GST as well in 2010, but then returned to its provincial sales tax in 2013.

regressivity through a combination of refundable income tax credits and GST exemptions of goods disproportionately purchased by low income households.¹¹⁷ 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 percent in 1991 to its 5 percent tax rate today. The provinces maintained their sovereignty over consumption tax revenues with the largest provinces — Ontario (at an 8 percent tax rate) and Quebec (at about a 10 percent tax rate) — collecting significantly more in consumption tax revenues than the national government. (See Figure 21.)

D. India's 2017 General Consumption Tax Reform

India, a non-OECD country, also provides useful precedent for circumstances 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 and use taxes, and other consumption taxes at the national and subnational levels. Much like Canada and the United States, India has a federal system in which the central government shares fiscal and taxing authority with 29 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.¹¹⁸

¹¹⁷ Bockt and Robertson, *supra* note 51, at 32-33. For a history of the Canadian transition to the GST/HST/QST, see Richard M. Bird, "The GST/HST: Creating an Integrated Sales Tax in a Federal Country," University of Calgary, The School of Public Policy SPP Research Papers, Volume 5, Issue 12, March 2012.

¹¹⁸ Ajitesh Kir, "The Biggest Tax Reform Since Independence: Has the GST Improved the Ease of Doing Business in India?" *Tax Notes Int'l*, Mar. 5, 2018, p. 915.

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.¹¹⁹

The general consumption tax system in India pre- and post-consumption-tax reform is different from the Canadian model and is still very much 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 the national and subnational governments, but with a common tax base.¹²⁰

IV. Can the United States Modernize its State Sales Tax Systems?

The United States has the worst of all outcomes from a consumption tax perspective. First, structurally flawed state and local 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 45 states and the District of Columbia, 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 sales tax's 85-year history and its underreliance on taxing household consumption and overreliance on taxing business

¹¹⁹ Kir, *id.*; and EY, *supra* note 91, at 457.

¹²⁰ EY, *supra* note 91; and PwC, "365 Days of GST: A Historic Journey" (2018).

inputs: “As structured, the tax embodies bad tax policy that appears to worsen over time, putting the sales tax on an unsustainable path.”¹²¹

Second, the cumulative impact of suboptimal, poorly designed, and narrowly based state sales tax systems impedes use of a tax on general consumption to balance the tax burden among different tax types. State and local 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.

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:

- 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.
- 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.
- Provide incremental fixes through unilateral or collaborative state action. This option appears more feasible politically but, as demonstrated by the struggles of the SSUTA project, will not fundamentally solve the systemic problem.
- 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 has the upside potential to preserve state sovereignty and federalism while concurrently creating 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 and local 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 50

¹²¹ Mikesell, *supra* note 33, at 397. Alan D. 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.” Viard, “Sales Taxation of Business Purchases: A Tax Policy Distortion,” *State Tax Notes*, June 21, 2010, p. 973.

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.¹²² 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 surface 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 49 countries that are members of the OECD and/or G-20 that together make up 90 percent of global gross 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.¹²³

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

¹²² On numerous occasions over the last 50 years, both Republicans and Democrats, albeit typically at different times, have proposed national VATs or similar broad-based consumption taxes for various purposes, including sharing revenues with state and local governments, deficit reduction, and international competition. Interest in a national VAT tends to increase during economic downturns or when federal debt levels rise quickly. See generally Gale, *Fiscal Therapy*, *supra* note 27, at ch. 14. Leah Durner, Harley Duncan, and Jon Sedon, "Why All the Buzz About VAT?" *State Tax Notes*, Oct. 19, 2009, p. 204.

¹²³ 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 91. For a list of the 49 countries that are members of either the OECD or the G-20, 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*, Aug. 10, 2020, p. 819.

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 50 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 percent; and none have joined the SSUTA to make their tax administration rules more uniform.¹²⁴

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 SSUTA 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. The SSUTA project has not garnered support from the larger (and other) states that make up about two-thirds of the population of the sales tax states. And in the post-*Wayfair* climate, voluntary collaboration among the states may prove even more difficult. Of greater importance, the SSUTA project 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 a retail sales tax.

¹²⁴ 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 taxes that have VAT-like elements. 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 harmonized, broader-based tax on household consumption in the United States. See generally Robert Cline and Steven Wlodychak, "Federal Tax Reform: Lessons From the States," *State Tax Notes*, Feb. 13, 2012, p. 537.

While these 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 40 years, as the rest of the OECD nations have significantly increased 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).¹²⁵ 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 GST. Today, residual provincial sales taxes are levied on only 20 percent 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

¹²⁵ For sales tax revenue as a share of state taxes, see Mikesell, *supra* note 34, at 783, and Mikesell, *supra* note 53 at 1343-44. For sales tax revenue as a share of all taxes, see OECD, *supra* note 4, at tbl. 5110.

their own tax rates and revenue stream but would avoid the 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 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 tax¹²⁶ — 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 personal and corporate income taxes were enacted in the United States in 1913 after passage of the 16th Amendment authorized Congress to impose taxes on income without apportioning revenues among the states, and before state adoption of similar taxes. Both state personal 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

¹²⁶EY, COST, and STRI, *supra* note 4. Property taxes are locally administered and therefore not included in a discussion of state administered taxes.

considerations such as income apportionment, tax rates, tax base adjustments, and tax credits.¹²⁷ 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.¹²⁸

For consumption taxes, however, this federal/state model did not take root, in large part because of a historical accident. Unlike federal personal income, corporate income, unemployment insurance taxes, and estate taxes, which generally preceded similar state-level taxes, sales and use taxes preceded consideration of a national consumption tax, and to a large degree preempted its enactment. As a result, implementation of a national consumption tax is often viewed as an encroachment on state and local sovereignty over sales and use taxes, and an unnecessary expansion of federal governmental taxing authority.

Indeed, a hybrid national/state consumption tax approach might help stabilize and preserve U.S. federalism. There are very few examples anywhere in the world of a subnational income or general consumption tax that does not piggyback on a similar national tax.¹²⁹ If states do not find a way to modernize state and local 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

¹²⁷While 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.

¹²⁸*See generally* Social Security Act of 1935, Titles III, IX; Federal Unemployment Tax Act of 1939 (FUTA).

¹²⁹Of the 49 countries that are members of the OECD and/or G-20, only three countries (other than the United States) have subnational general consumption taxes that do not piggyback onto national consumption taxes, and none of these countries rely on the subnational taxes as their primary general consumption tax. EY, *supra* note 91. Of these 49 countries, nine (including the United States) have subnational corporate income taxes, and all of these subnational taxes conform in whole or in part to national corporate income taxes. PwC, *supra* note 123.

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 the enactment of a national consumption tax to complement the 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 percent 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 in the short term and the escalating federal debt crisis in the long term may trigger such a shake-up. In this unprecedented fiscal environment, the absence of an efficient and effective broad-based tax on household consumption could heavily slant tax policy options toward additional taxes on personal and corporate income, payroll, gross receipts, property, and wealth without adequately balancing these sources with taxes on consumption. This imbalance could both make it politically difficult to raise sufficient revenues to fund government programs and hinder economic recovery, because consumption taxes, as noted, are widely recognized as one of the better ways to raise revenue without deterring economic growth. Indeed, discussions by tax luminaries regarding the importance or inevitability of a federal consumption tax are more frequently appearing in the tax press.¹³⁰

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.¹³¹ 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. Rather, it will catch on because a hybrid federal/state system is perceived as the least objectionable of unattractive options to reduce government debt; align federal revenues with federal spending; better balance income, payroll, and property taxes with consumption taxes in the overall U.S. tax mix; and transform state sales tax systems while maintaining state sovereignty over sales tax revenues. Timing is important, however, as the Canadian experience makes clear that state government harmonization to a newly enacted national consumption tax would likely extend over a prolonged period.

V. Conclusion

This article 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 a retail sales and use tax — 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.

This article 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 that dates back nearly a century. The structural design

¹³⁰ 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 State*, June 22, 2020, p. 1503; see also Gale, Raising Revenue, *supra* note 27; and Robert Goulder, "About That Deficit: VAT Dreams and Virus Economics," *Tax Notes Int'l*, May 4, 2020, p. 601.

¹³¹ 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.

defects of state retail sales tax systems make it very difficult to reform such systems incrementally from within. Transforming state sales tax systems will not be easy but is necessary to maintain a modern world-class fiscal and tax system. Ultimately, U.S. policymakers may choose to continue the current approach, relying increasingly on income, payroll, and property taxes and less on consumption taxes than any other advanced nation. However, unless current state and local sales tax systems are transformed or replaced with a different general consumption tax model, that outcome will occur not by choice, but by default. ■

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