

Comments on “How to Coordinate State and Local Sales Taxes with a Federal Sales Tax”

By

John L. Mikesell

Chancellor’s Professor of Public and Environmental Affairs

Director, Master of Public Affairs Program

Indiana University

Professor McLure’s review and analysis of the options for coordination of federal with state and local sales taxes is comprehensive and definitive. His big point, as I see it, is that a federal VAT makes much greater sense than an federal RST and that state and local RSTs can survive with such a tax, although a state-local variety of VAT would be even more sensible, although probably impractical in at least the short run. I have no quarrel with those conclusions. Although model RSTs and VATs are administratively different ways of taxing exactly the same base (household consumption expenditure), the imperfections in application of the two are what make for a preference of the one over the other. In a conference full of VAT experts, it may be of some service to comment on the U. S. RST as it operates and to reflect on how that would matter for the states, should the unwise alternative of a federal RST be adopted. At the outset, it is well to observe that the combination of a national VAT and regional RSTs is clearly feasible – there is evidence in Canada now and there was evidence in Russia at the end of the twentieth century.<sup>1</sup> But it is less clear about the capacity to operate the combination of a national RST with subnational RSTs. I know of no experience with this combination. And the experience in the United States with state RSTs that are not fully coordinated with local RSTs has been one of difficult administration and compliance.

For the United States, the federal RST / subnational RST combination would appear to be attractive. The federal establishment is as unready to administer a high rate RST as it is unready to administer a high rate VAT, so new ground would be crossed in either event. What about the federal RST alternative? At the outset, this would appear to be a logical choice for the United States because of several important factors.

1. While the federal tax administrators do not know how to administer a broad, transaction-based tax on consumption expenditure, the states do (although not at the national level). They know

---

<sup>1</sup> Russian experience at the end of the 20<sup>th</sup> century also supports that view. In this case, regional retail sales taxes were added to an existing national value added tax without great difficulty. The taxes were included in prices, along with the VAT, and, when the retail sales taxes were eventually abolished, the public concern was that prices would fall by the appropriate amount. There was little controversy with the implementation of the taxes. (John L. Mikesell, “Decentralizing Government Finances in the Russian Federation: The Regional Sales and Imputed Income Taxes,” *Proceedings of the Ninety-second Annual Conference on Taxation of the National Tax Association* (1999)).

how to structure a feasible RST and then to administer it and surely the federal administrators would be clever enough to learn from those administrators, although some draft proposals for federal RSTs show little familiarity with the state taxes. They would not have to rely on foreign experts to install such a tax.

2. The American public is familiar with retail sales taxes through the 45 state taxes and the 36 states in which local governments levy the tax.<sup>2</sup> Even those people in the few non-sales tax areas have experienced retail sales taxes in their travels. And for the general public, compliance is simple – no recordkeeping, no forms, no schedules to keep track of, and so on. No public education campaign would be necessary if the federal government decided to levy a RST. It would not bring something “foreign” into the US system.
3. Vendors – the entities responsible as conduits between the taxpaying customer and the taxing government – are familiar with the retail sales tax system, the accounting that is required, the meaning of exemptions, the use of suspension certificates, and all the mechanisms of compliance. They would have little new terminology or techniques to learn with a federal RST.
4. The noncompliance gap for state retail sales taxes is remarkably low. Most compliance studies done in American states find noncompliance gaps that are less than 5 percent.<sup>3</sup> Such low rates are dramatically below noncompliance rates found by the Internal Revenue Service for the federal income tax and well below the VAT noncompliance rates found, for instance, by Her Majesty’s Revenue & Customs in the UK.<sup>4</sup> Improved compliance would be a strong advantage of a federal RST. The state retail sales tax base is heavily concentrated in a small number of entities. For example, 7% of the sales tax returns in Iowa cover 74% of the tax base, so even relatively modest audit coverage can directly protect a huge share of the total base.<sup>5</sup>
5. The American public has considerable acceptance of the retail sales tax. No tax is wildly popular but, among the broad base alternatives – the federal individual income tax, the local property tax, and the retail sales tax – the most recent Tax Foundation survey found the retail sales tax to be regarded as marginally less unfair than the other two options.<sup>6</sup> The attitude might change with

---

<sup>2</sup> There are 36 states in which at least one local sales tax is levied – the taxing locality can be named. Careful examination has located no local sales taxes in the 14 other states. But one might be lurking somewhere in these other states, outside the reach of CCH, state websites, leagues of municipalities, inquiries to state tax departments, Google, etc. I can’t prove their absence – just as I was never able to prove beyond all doubt to my daughter that no dinosaurs existed anywhere on earth when she was in kindergarten in the early 1970s.

<sup>3</sup> The Washington state compliance study for 2008 found the sales tax noncompliance rate to be 1.7% of sales tax liability. (Department of Revenue Compliance Study, Research Report 2008 – 5, July 10, 2008)

<sup>4</sup> HM Revenue and Customs, *Measuring Indirect Tax Gaps – 2008* (November 2008).

<sup>5</sup> Tax Research and Fiscal Analysis Section, Iowa Department of Revenue, *Iowa Retail Sales and Use Tax Report, Annual FY 2008*.

<sup>6</sup> Andrew Chamberlin, *What Does America Think About Taxes? The 2007 Annual Survey of U. S. Attitudes on Taxes and Wealth*, Tax Foundation Special Report No. 154 (April 2007).

heavier use, but it does create a favorable possibility, particularly in comparison with an entirely new alternative that the VAT would be.

These arguments of convenient implementation of a federal RST do not stand up to analysis. The problems stem from both economic and administrative impacts.

1. Analysis of hypothetical VAT and RST structures often compare ideal systems which, unfortunately, do not closely resemble the tax in practice and the American retail sales taxes in particular fall far from the ideal. And what is the ideal for a RST? One cannot express the standard more clearly than John Due did a number of years ago: the retail sales tax “should apply to all expenditures for personal consumption purposes but not to any transactions involving use in a business activity.”<sup>7</sup> Such a tax would produce a uniform distribution of governmental cost according to levels of household consumption expenditure, which is presumed to be what adoption of a retail sales tax intends. As practiced by the states and localities, among the differences from the ideal include narrow coverage of household purchases of services, a considerable exemption of household purchases of important categories of goods, and a stubborn inclusion of business purchases in the sales tax base. These structural problems may not create great fiscal or economic havoc when the tax rates applied are relatively modest – but a fiscally important federal RST would not involve a modest tax rate and, should the federal government follow the American template for RST design, the resulting problems of dislocation, distortion, disruption, and evasion could be considerable. Any federal RST that general follows the lead of what the states have levied will be considerably different from the ideal RST. What the states have gotten away with would not likely be acceptable with the necessary higher rates of a fiscally meaningful federal RST.
2. Levying a federal RST on top of the state RSTs would not be a simple matter for administration and compliance.<sup>8</sup> In this regard, I am a bit at odds with Professor McLure’s conclusion: I do not believe that coordination with this option would be the simplest. The state bases are not the same, for instance, in terms of rules, regulations, or coverage of consumer or business purchases, taxation of purchases and sales of nonprofit organizations, and extent to which services are taxed. The great diversity of tax base can be shown by the range across states of the ratio of the sales tax base to state personal income: the ratio for the five broadest base states is 0.7837 versus 0.2663 for the five narrowest. There are major differences in tax coverage and those differences would conflict with the federal tax, however it is structured. While the Streamlined Sales Tax Project has standardized definitions across member states, it has not lead to a unification of the base to a single standard and, importantly, a number of economically important states, for example, California, Texas, New York, Florida, Illinois, Georgia, and Pennsylvania -- are not even parties to the standardization. In practice, there would be a dual (or worse, depending on local taxes)

---

<sup>7</sup> John F. Due, “Sales Tax Exemptions – The Erosion of the Tax Base,” *Revenue Administration, 1982: Proceedings of the Fiftieth Annual Meeting of the National Association of Tax Administrators* 50(1982): 200.

<sup>8</sup> A simple piggybacked federal RST would be the worst of all possible worlds, bringing a grand “race to the bottom” incentive for restructuring and administration of their own taxes in an effort to move the federal tax burden to other states.

system in place everywhere state or local RSTs are levied now, creating a vexing situation for tax administrators, vendors, and customers.<sup>9</sup> The reality of these issues has been made clear in the states in which local sales taxes are structured and collected independently of the state system. A federal RST would not be simple to install with the state RSTs. Indeed, it would be most vexing for those having to deal with it. It might be simple for the taxpaying public, but it would be a far different matter for vendors who have to make the systems function. Of course, the system would be simpler if states would harmonize on the federal base and accept uniform federal administration. Neither of these changes is likely to happen.<sup>10</sup> The evidence is that states are not likely to swarm to a good idea in tax policy, so it is critical that a federal sales tax be able to peacefully coexist with something approximating the batch of state sales taxes now in place. A federal VAT is far better able to do that than would a federal RST.

3. The state RSTs suffer from a history of bad legislation. State legislatures are stubbornly reluctant to remove inputs from the tax base, thereby creating the distortions and pyramided burdens that plague general gross receipts taxes. Those legislators much prefer picking and choosing particular industries and input classes for exclusion, rather than acting in a way that would generally encourage economic development by exempting all business inputs. The reasons are, sadly, purely political: legislators prefer hidden burdens to providing straight information to the public and legislators can better receive favors and praise, not necessarily in that order, from exemptions targeted to a particular benefiting industry or business than from giving general exemptions to encourage overall economic development. The politics of retail sales taxation drives the system to taxation of business inputs, with periodic exemption of a particular activity for political favor. That does not give much hope for a sound RST foundation.
4. Higher statutory rates – the combination of federal and state on taxed transactions – are likely to induce more avoidance and evasion, making the modest non-compliance rates found in state compliance studies no guide as to what would be achieved. The RST places great reliance on the vendor for the proper application of the system – unless the purchaser is an extremely large entity and has qualified for direct payment, the vendor must establish whether each transaction is exempt or taxed. The problem is not with exemption of particular goods – UPC and electronic

---

<sup>9</sup> The local sales taxes cannot easily be assumed away. While local general sales taxes yield only around 11.5% of total tax revenue for the nation as a whole, in a half dozen states the share is around 40%. Putting such revenue in jeopardy would be a distinct fiscal issue. And the SSTP standards have not done much streamlining and simplifying here. For instance, the destination standard for intrastate transactions has forced local businesses to keep track of a multitude of local rates in some areas. The pizza delivery store has to know the appropriate rate and to track sales to particular localities in order to do its job, responsibilities not necessary when taxation was according to location of the store and there were no intrastate local use taxes. By allowing local governments to retain companion use taxes, a source of only minimal revenue, and requiring that local sales taxes be charged at the location of delivery rather than the location of the vendor (a perfectly plausible option historically used in a number of states that significantly reduces compliance and administrative costs), the SSTP has mucked it up rather badly.

<sup>10</sup> The best evidence of this: states unanimously declined the offer of free federal administration of their state individual income taxes in the era of federal general revenue sharing. The program required that the states use the federal tax base but none would surrender this sovereignty, even though many were only modestly out of compliance with their existing law.

point of sale devices make this no particular issue for the RST. The problem lies with goods whose exempt status depends on the nature of purchaser, its intended use, and, for states with enterprise zones, where it is to be put in service. Indeed, a number of states go even further in terms of complexity by limiting equipment exemption for purchases intended to expand productive capacity; purchases for replacement are taxable. That determination cannot be handled with a UPC and that is the sort of evasion that would become an important issue with the additional money at stake from higher statutory rates. This point determines whether the RST approaches its ideal as a uniform consumption tax or whether it operates like a pyramiding gross receipts tax. The odds are not good because the vendor has every incentive to accept the claimed exemption to get the advantage of a price reduction without any loss of revenue on the sale. If the vendor refuses, there is the danger that a competitor will and the sale is lost. The system functions reasonably well with the level of rates currently applied by states (although exemption issues are the most frequently identified problem found on audits), but the incentives would become particularly great at the rates needed for a fiscally significant federal tax. Almost certainly, the addition of the federal rate would cause great, if not insurmountable, stress on the suspension system needed to constrain pyramiding. At the margin, it would endanger an important state and local revenue source.

A federal RST would create important economic issues and questions of compliance and administration. The combination of a federal RST and state RSTs would create a structure not tried anywhere before. Eventually it might work and, should the federal RST more closely follow the ideal sales tax structure by more completely removing business purchases from the base and by more completely including household consumption spending in the base, the federal base could guide the way to improved state and local sales taxes. But, given how the federal government has sliced and diced the income tax structure, that ideal federal base is not likely. Furthermore, the federal RST proposals that have floated do not inspire great confidence that the ideal would emerge. I see no clear advantage in terms of compliance, administration, or economic effects from a federal RST.

In sum, the way to coordinate state and local sales taxes with a federal sales tax is to have a value added tax as the form of that federal tax. Whatever the federal VAT, it could almost certainly coexist with state and local RSTs.<sup>11</sup> The state and local suspension system that is necessary to operation of the RST almost certainly would not conflict with the operation of a federal VAT, whereas it almost certainly would complicate operations of a federal RST. Whether states would ultimately drift to some form of their own VATs would be the product of political dynamics that are beyond my scope of expertise. But my bottom line is consistent with Charlie's conclusion: if the federal government adopts a general sales tax, it should choose a VAT, even though the American experience is with RSTs. There would not be administrative and compliance advantages associated with having both levels employing the same tax and, indeed, there would almost certainly be major problems. A federal VAT could function with state RSTs and it could function if states ultimately drifted toward a form of subnational VAT. There is even some hope that a federal VAT would be closer to the ideal than would a federal RST because there are no domestic bad examples to copy. But a reflection on the current nature of state retail sales taxes shows no reason why

---

<sup>11</sup> Any state – local tax format would be easier if the *Quill* constraints were repealed by Congress or reversed by the Supreme Court.

they could not go on with a federal VAT, even if they continued exactly as they are now, with no restructuring or linking with the federal system.