# Fixing Obsolete State Sales Tax Systems: Incremental and Transformational Approaches

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# Agenda

- Brief Historical Context
- What's Wrong with State Sales Tax Systems?
- Incremental Approaches to Reforming State Sales Tax Systems
- Transformational Approaches to Modernizing State Sales Tax Systems

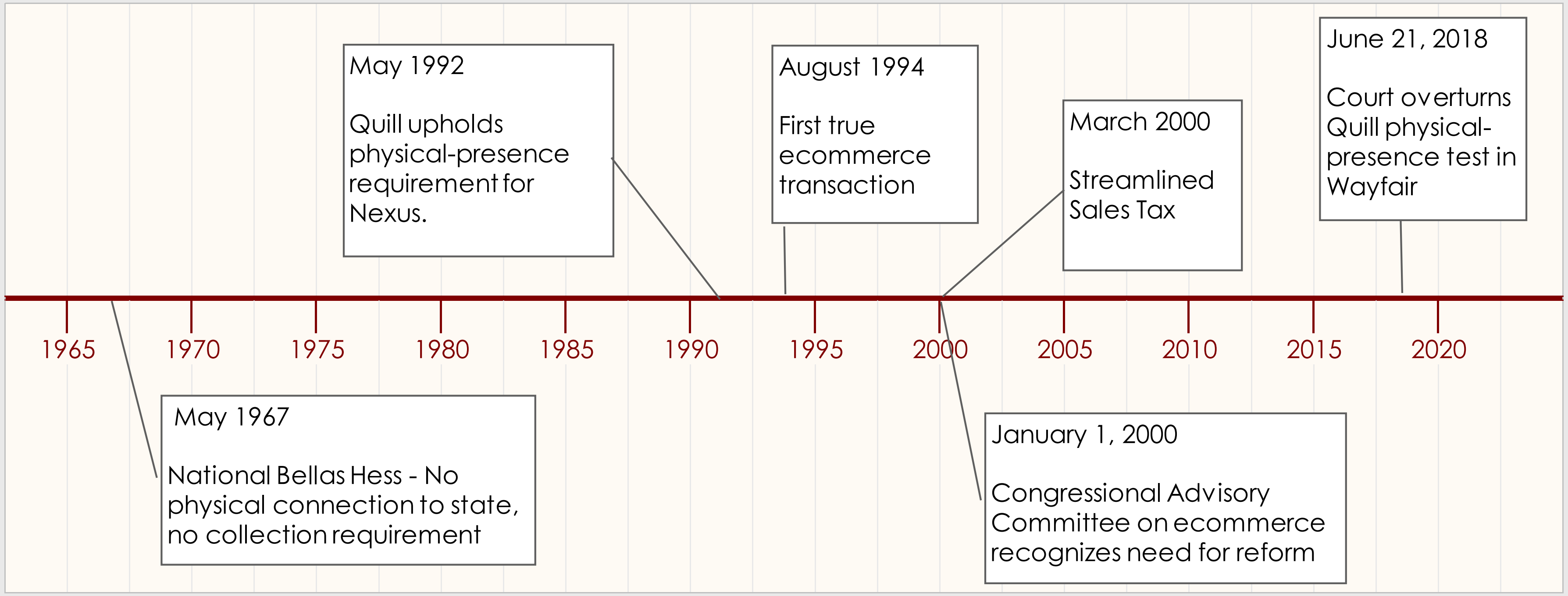
# BRIEF HISTORICAL CONTEXT

# How Did We End Up With This Mess?

- The retail sales tax was originally enacted during the Great Depression
  - Mississippi and/or Kentucky were the first states to adopt a sales tax in or around 1930
  - States were desperate for revenue as property and income tax collection declined
  - The sales tax initially was intended as a limited and temporary measure, but a couple of dozen other states joined MS and KY in enacting a sales tax before the end of the 1930s and the majority of the rest followed in the 1940s, 1950s, and 1960s
- Widespread exemption of services
  - Enacted in the context of a manufacturing economy
  - Argument (unpersuasive as it was) that a tax on services was akin to a tax on wages/labor in the context of the high unemployment of the Great Depression
  - Significant services of that era politically difficult to tax
  - Legislatures tend to model taxes on legislation in other states and so exemption of services became the prevalent pattern

## HISTORY OF SST

*National Bellas Hess* to *Wayfair*



# What's Wrong with State Sales Tax Systems?

# Polling Question #1

If you were given carte blanche by all U.S. federal, state, and local jurisdictions to design a consumption tax, what would it look like?

A. A sales and use tax system *exactly* as it exists today
B. A sales and use tax system but require each state (and its localities) to conform to the current Streamlined Sales and Use Tax Agreement (SSUTA)
C. A European-style value-added tax (VAT), but designed for revenue sharing with state governments
D. Consumption taxes?!?! Let's abolish them all!!!

# Inefficient, Ineffective, and Obsolete State Sales Tax Systems

## Inefficient Systems:

– U.S. State sales tax systems are among the most **inefficient** general consumption taxes in the world when measured by the conventional metrics of an optimal consumption tax

– First, state sales tax systems rely more on **business inputs** than virtually any other general consumption tax in the world

- For instance, business inputs account for 42% of all sales taxes in the U.S. compared with 17% of all GST revenues in Canada
- This violates a cardinal rule of a good consumption tax – that it is applied to household not business consumption.

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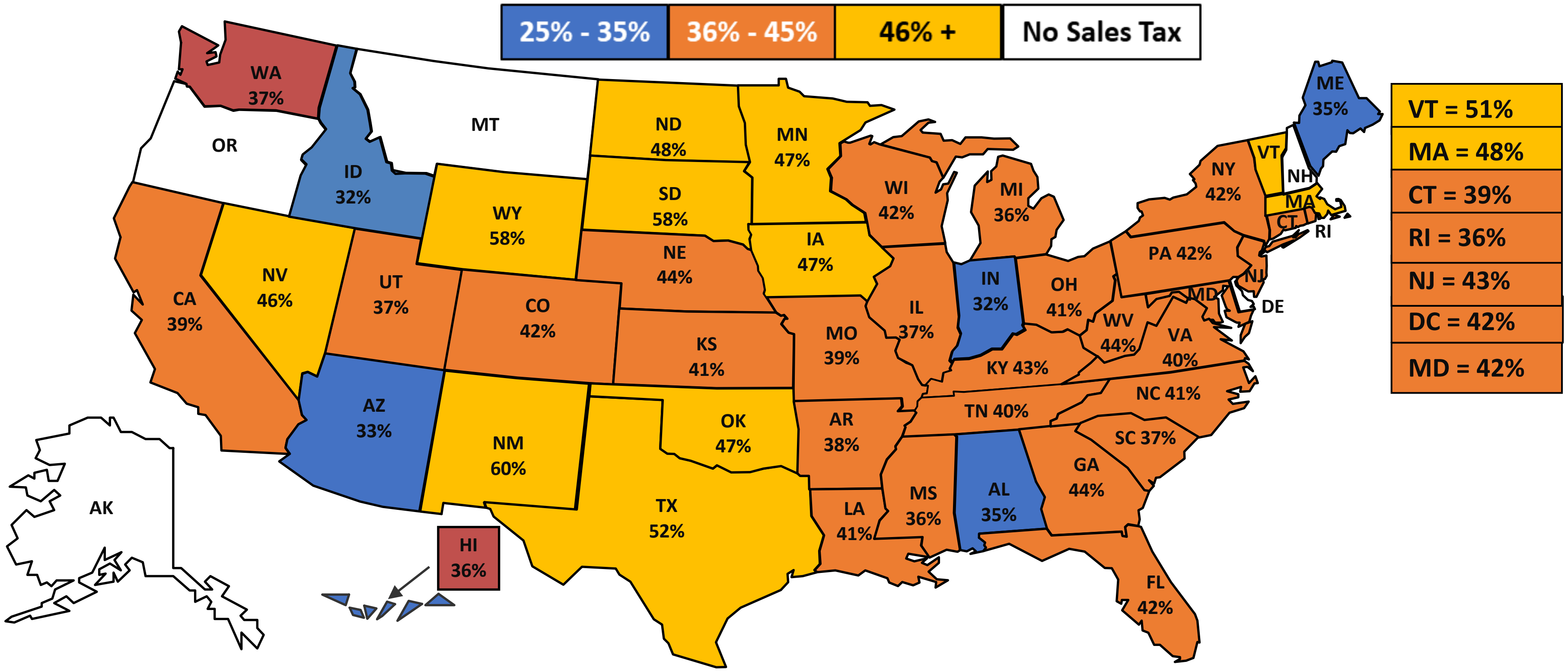
# Business Inputs Make up Between 32% and 60% of Total Sales Tax Collected in the U.S., with an Average of 42%

## Business Inputs Share of Total Sales Tax Collected




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

# Inefficient, Ineffective, and Obsolete State Sales Tax Systems

Inefficient Systems (cont.):

- Second, the **U.S. sales tax base of household goods and services is much narrower and less harmonized** than in other OECD countries. The average breadth of state sales tax bases is 37% compared with a 56% average for all OECD countries. Once business inputs are excluded, the average U.S. state sales tax base includes about 21% of total household goods and services.
- Third, the U.S. has one of the most decentralized and administratively cumbersome consumption tax systems with 46 independent state tax administrations and over 10,000 local tax rates.
  - This administrative complexity is lessened in the one-half of sales tax states that adopt the Streamlined Sales and Use Tax Agreement (SSUTA) and adhere to certain uniform administrative rules.

# Streamlined Goals

- Simpler system for administering state and local sales taxes
- Uniformity
- Balance state sovereignty with simplification and uniformity
- Use technology to ease the retailer's tax collection and reporting

# Key Features of SSUTA

- State level administration of local sales and use taxes
- Common state and local tax bases within a state
- Uniform destination-based sourcing rule for goods and services
- One-stop central registration system
- Uniform definitions

# Key Features of SSUTA

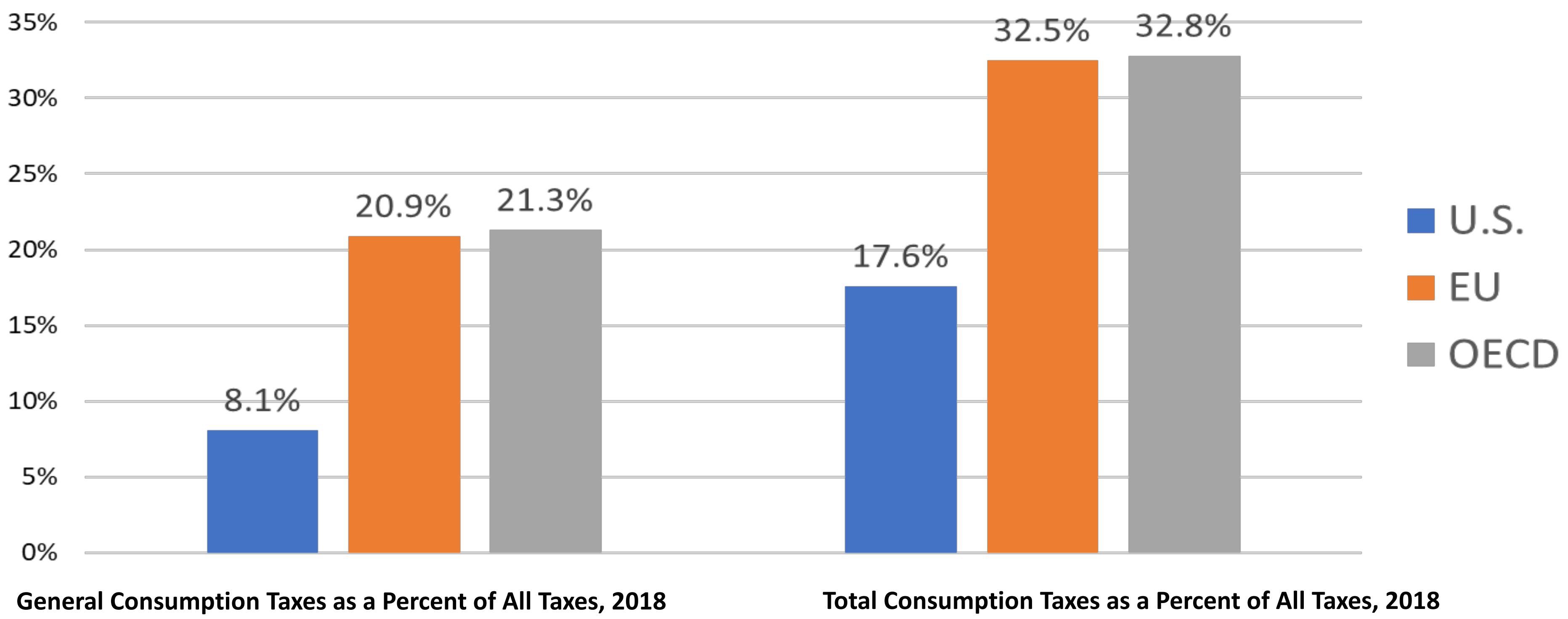
- Uniform simplified electronic return
- Rate and boundary databases
- Taxability matrix
- Simplified exemption administration
- Liability relief provisions
- Certified Service Providers (CSPs)

# Inefficient, Ineffective, and Obsolete State Sales Tax Systems

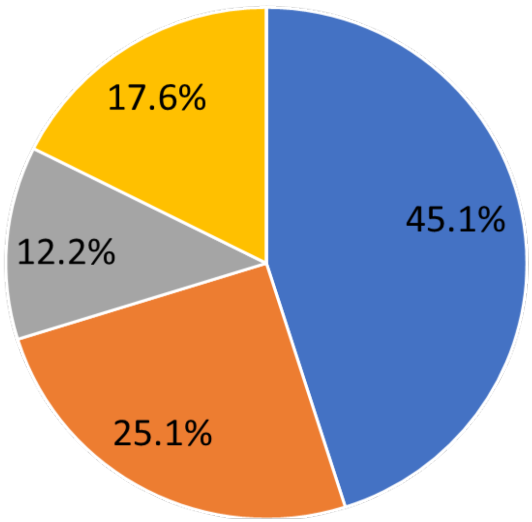
## Ineffective Systems:

- U.S. state sales tax systems are **ineffective** in raising sufficient revenues to balance the overall composition of taxes close to international norms.
- The U.S. relies less on consumption taxes as a share of all taxes than any other advanced nation in the world.
- This is highly problematic since broad-based consumption taxes provide government with one of the best ways to raise money without deterring economic growth.
    - True consumption taxes are sourced to the location of consumers, not producers, and thus mitigate adverse impacts on domestic investment and job creation.
- Conversely, the U.S. relies more on income, payroll (social insurance), and property taxes than any other advanced nation in the world.

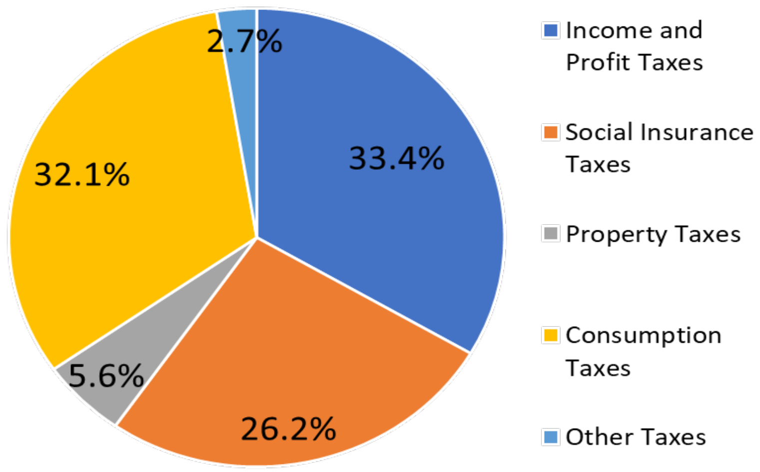
# The U.S. Relies Less on Consumption Taxes than any other Advanced Nation (as a Share of all Taxes)



# The U.S. Relies More on Income, Payroll & Property Taxes Than Any Other Advanced Nation (Average Sources of Tax Revenue, 2018)




United States (Federal, State, and Local)




OECD

# Inefficient, Ineffective, and Obsolete State Sales Tax Systems

**Obsolete Systems:**

- The U.S. is the only nation in the world that relies on an **outdated** retail sales tax system, at the subnational level, as its primary general consumption tax.
- As recently as the 1960s, almost all advanced nations utilized retail sales taxes or turnover taxes (akin to gross receipts taxes) as their primary general consumption taxes.
- Since then, however, almost all nations (except for the U. S.) have abandoned outdated and inefficient retail sales taxes and turnover tax systems and replaced them with national value added taxes (VATs) or hybrid national/state VATs.

# Inefficient, Ineffective, and Obsolete State Sales Tax Systems

## Obsolete Systems (cont.):

- The obsolescence of retail sales taxes and turnover taxes was recognized **one hundred years ago**, in 1921**,** by the American economist and tax policy expert Thomas Adams.
- Adams' critique focused on the single most important structural flaw of these first-generation consumption taxes: **taxing consumption at more than one level**. He proposed a system to avoid the pyramiding of tax "by giving the tax the form of a sales tax with a credit or refund for taxes paid by the producer or dealer (as purchaser) on goods bought for resale or for necessary use in the productions of goods for sale."
- **Adams' analysis took about 50 years to gain acceptance, but eventually led to the replacement of these obsolete consumption taxes with national VATs or hybrid national/state VATs.**

# Since 1965, All Advanced Nations (other than the U. S.) Replaced Outdated Sales Tax and Turnover Tax Systems with National VATs or Hybrid National/State VATs

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

# Incremental Approaches to Reforming State Tax Systems

# Polling Question #2

If you were given carte blanche by all U.S. federal, state, and local jurisdictions to implement one reform to current state and local sales and use tax systems, which reform would you implement?

A. I would prohibit class action and false claims/qui tam actions.

B. I would provide an exemption for business-to-business transactions.

C. I would FINALLY put to bed this ridiculous idea of so-called “real-time” sales tax collection.

D. I would require each state (and its localities) to conform to the current SSUTA (I know we said “one,” but hey…).

E. I would eliminate all exemptions and lower the rate - wait, am I at the right webinar?

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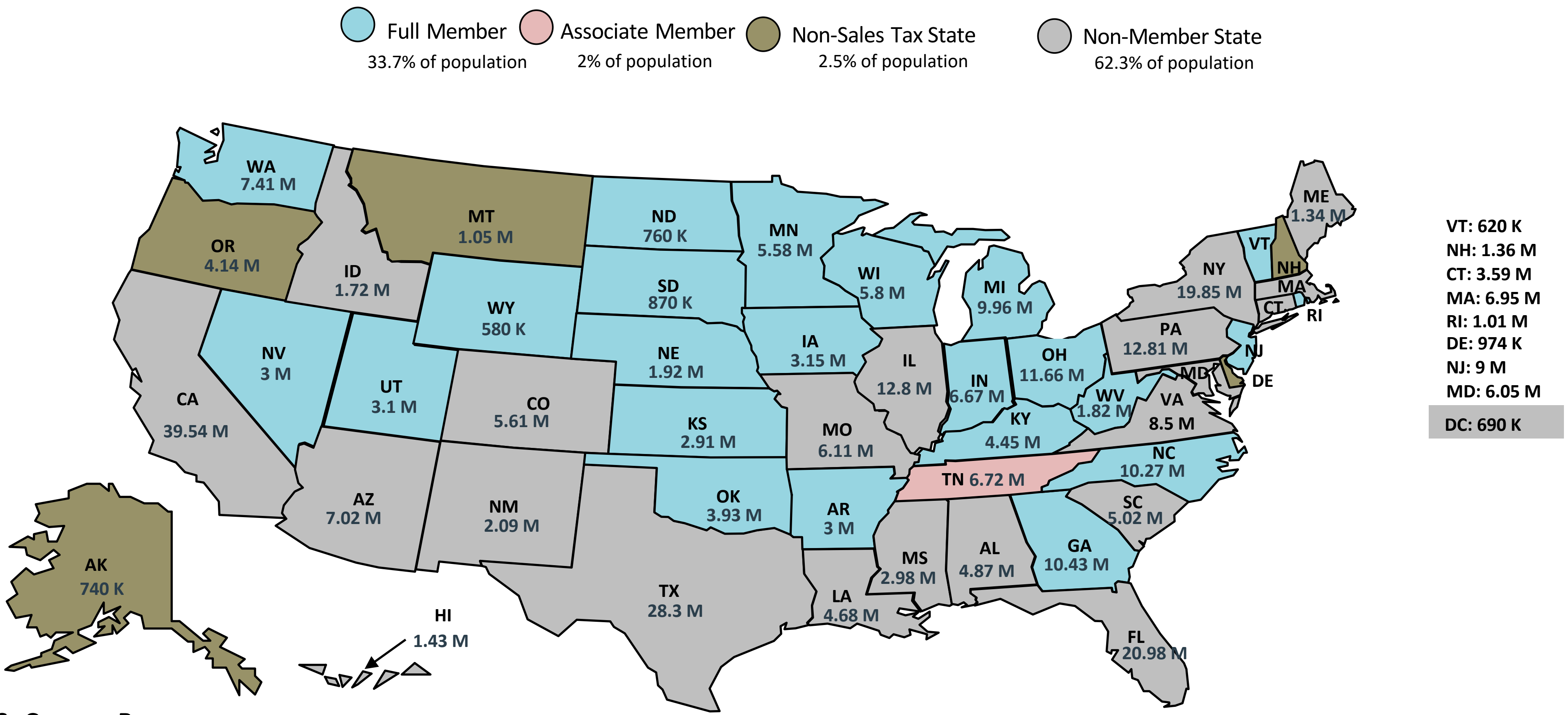
# The Streamlined Sales and Use Tax Agreement (SSUTA) Has Only Been Adopted by States with One-Third of the U.S. Population




Source: U.S. Census Bureau

# Ongoing Efforts to Expand and Improve SSUTA

- **Expand Membership or Participation of non-SSUTA States**
  - Ongoing efforts to get additional states to join SSUTA.
    - Push for Florida and Missouri to do "SSUTA Light"
  - Governing Board approved resolution encouraging non-SSUTA states to use its central registration and CSP services
- **Streamlined Sales Tax Project Activity**
  - Working with the BAC on extensive list of disclosed practices of the states' marketplace facilitator laws
- **Governing Board Meetings**
  - Network with other businesses, state tax administrators, and, importantly, state legislators interested in tax issues

# Streamlined and Nonmember State Participation

# Nonmember State Participation

## Goal of Nonmember State Participation

Address third point raised by Supreme Court in *Wayfair* decision

Reducing “undue burdens”

Not re-inventing the process

Work in conjunction with current Streamlined states

Not having to separately certify or negotiate contracts with the CSPs

Contract compliance audits of CSPs conducted by Streamlined

Uniformity for the CSPs

# Nonmember State Participation

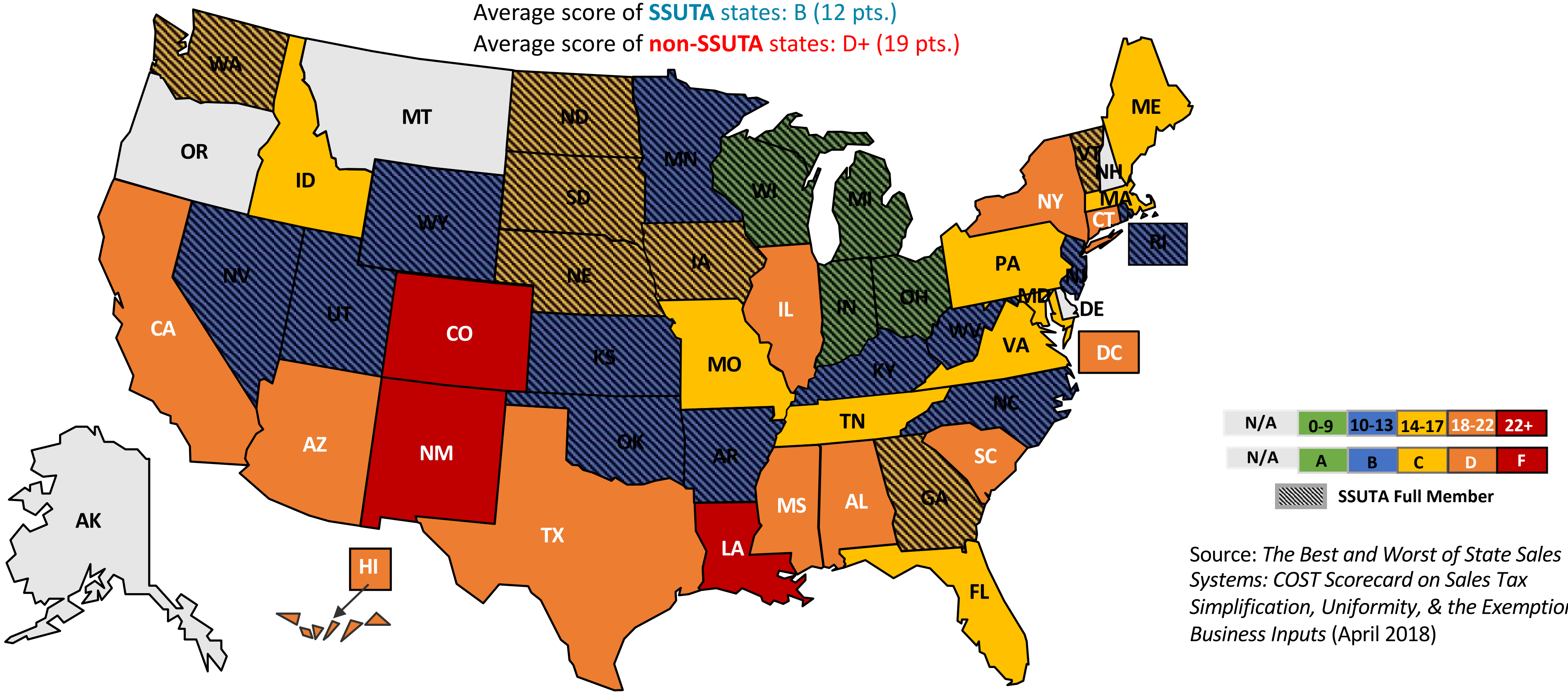
**Limited requirements**

Requirements

- Use of Streamlined Sales Tax Registration System
- Develop and post rate and jurisdiction databases
- Complete and post taxability matrix noting differences
- Complete and post certificate of compliance
- Participate in CSP certification process and CSP contract
- Provide liability relief for reliance on state-provided information
- Pay annual membership dues

# States Can Improve Sales Tax Systems by Adopting More of the Criteria for an Optimal Sales Tax Identified in the COST Sales Tax Scorecard

Average score of **SSUTA** states: B (12 pts.)
Average score of **non-SSUTA** states: D+ (19 pts.)




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

# COST's Categories for Grading States on Performance of their Sales Tax Systems

## Scorecard Categories

- Exemption for Business-to-Business Transactions
- Fair Sales Tax Administration
- Centralized Sales Tax Administration
- Simplification & Transparency
- Reasonable Tax Payment Administration
- Fair Audit/Refund Procedures
- Other Issues Impacting Fair Tax Administration

## What the Scorecard Does Not Grade

- Tax Rate Differences
- Tax Base Breadth (other than Taxing Business Inputs)

# Opposing Tax Policies that Make State Sales Tax Systems Worse

- **Along with making improvements to sales tax administration, an incremental approach also seeks to prevent state sales tax systems from becoming worse.**

- **Recent initiatives include opposing:**
  - The taxation of social media and/or digital advertising that is discriminatory in violation of ITFA
  - The  accelerated sales tax remittance (ASTR) legislation in Massachusetts and other states
  - The broadening of sales tax bases to include a large number of services without adequately exempting business purchases

# AD HOC Approach is Making Things Much Worse

**Many state and local taxing authorities are (improperly) making ad hoc policy decisions to expand the sales/use tax base and/or increase revenue**

- Lengthy and costly administrative and judicial litigation is a waste of resources on both sides
- Inappropriately forces the courts to make policy decisions
- Results in inconsistent results across different jurisdictions
- Places taxpayers trying to decide whether to collect sales/use tax in a Catch-22 situation

# Example of AD HOC Approach in Non-SSUTA Jurisdictions

- *Normand v. Cox Commc'ns Louisiana, LLC, 167 So. 3d 156 (La. App. 5 Cir. 2014)*
- *Commonwealth of Kentucky, Finance & Administration Cabinet, Department of Revenue v. Netflix, Inc.* Civil Action No. 15-CI-01117 (Franklin Cir. Court, Aug. 21, 2016)
- *Labell v. City of Chicago*, 147 N.E.3d 732, 737 (Ill. App. Ct. 1st Dist. 2019), *appeal denied,* 144 N.E.3d 1175 (Ill. 2020)
- *Apple Inc. v. City of Chicago, No. 2018 L 050514*
- *Pending cases across the country, including various class actions brought by cities across several states*

# Catch-22 for Taxpayers and Staggeringly Inefficient Results

- Squeezing square pegs into round holes—taxing authorities apply arcane statutes and ordinances to new products and services
- Large assessments, including penalties and interest for back taxes, forcing taxpayers to devote significant resources to litigate through (often lengthy and costly) administrative process and ultimately court
- Even with going-forward enforcement, taxpayers forced to decide whether to:

  (a) Start collecting and remitting what they believe to be an illegal tax, thereby potentially subjecting themselves to consumer class action

  (b) Do not comply with taxing authority and brace for litigation, thereby potentially having to pay millions in out-of-pocket costs and taxes

  (c) Pay out of pocket and file claims for refund (if allowed), thereby again potentially having to pay millions in out-of-pocket costs and taxes
- And what do we get for all this trouble? At best, a patchwork of cases applying different rules to different taxpayers, thereby increasing confusion and inefficiency across the entire system

# States with Failed Broad-Based Expansion of Sales Tax to Services

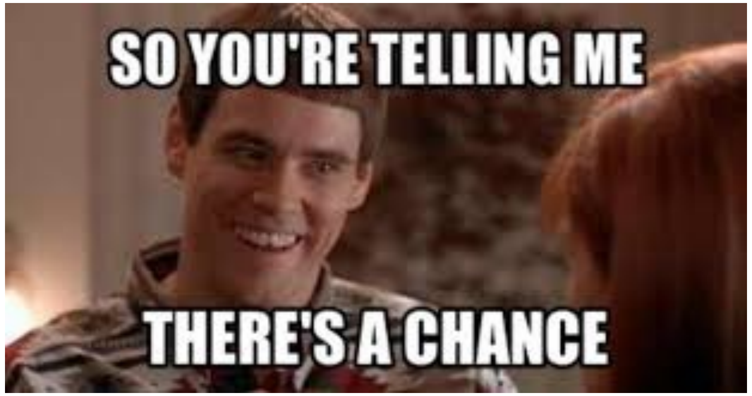
| State | Year | Party of Governor | Result of Legislation |
|---|---|---|---|
| Florida | 1987 | Republican | Repealed after 6 months |
| Massachusetts | 1990 | Democratic | Repealed after 3 days |
| Maryland | 2007 | Democratic | Repealed after 5 months |
| Michigan | 2007 | Democratic | Repealed after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

# Transformational Approaches to Modernizing State Sales Tax Systems

# Polling Question #3

**What do you think are the chances of U.S. federal, state, and local jurisdictions adopting a value-added tax in the next 20 years?**

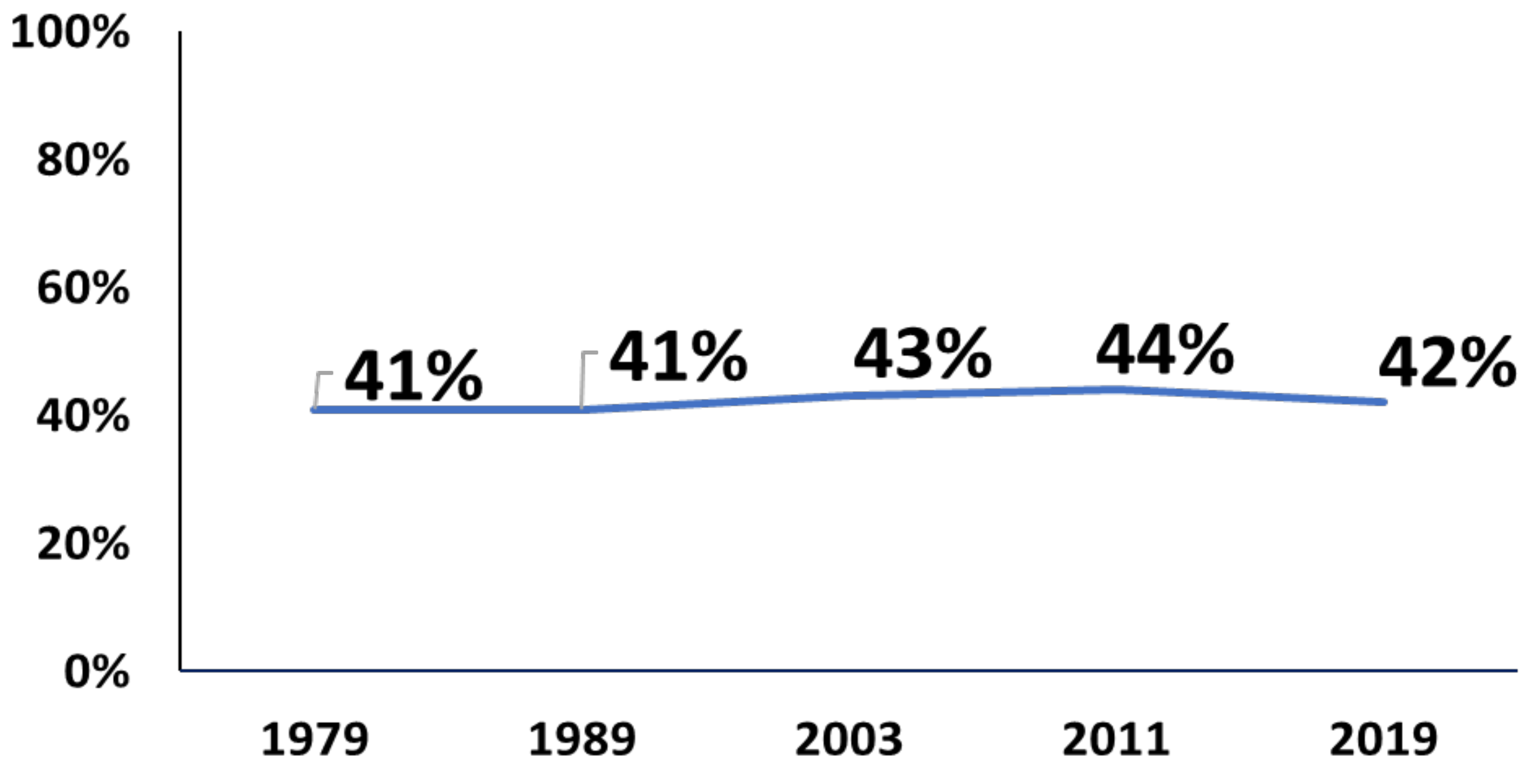
A. 100%
B. 75% - 99%
C. 50% - 74%
D. 25% - 40%
E. 1% - 24%
F. Less than 1% (see graphic)



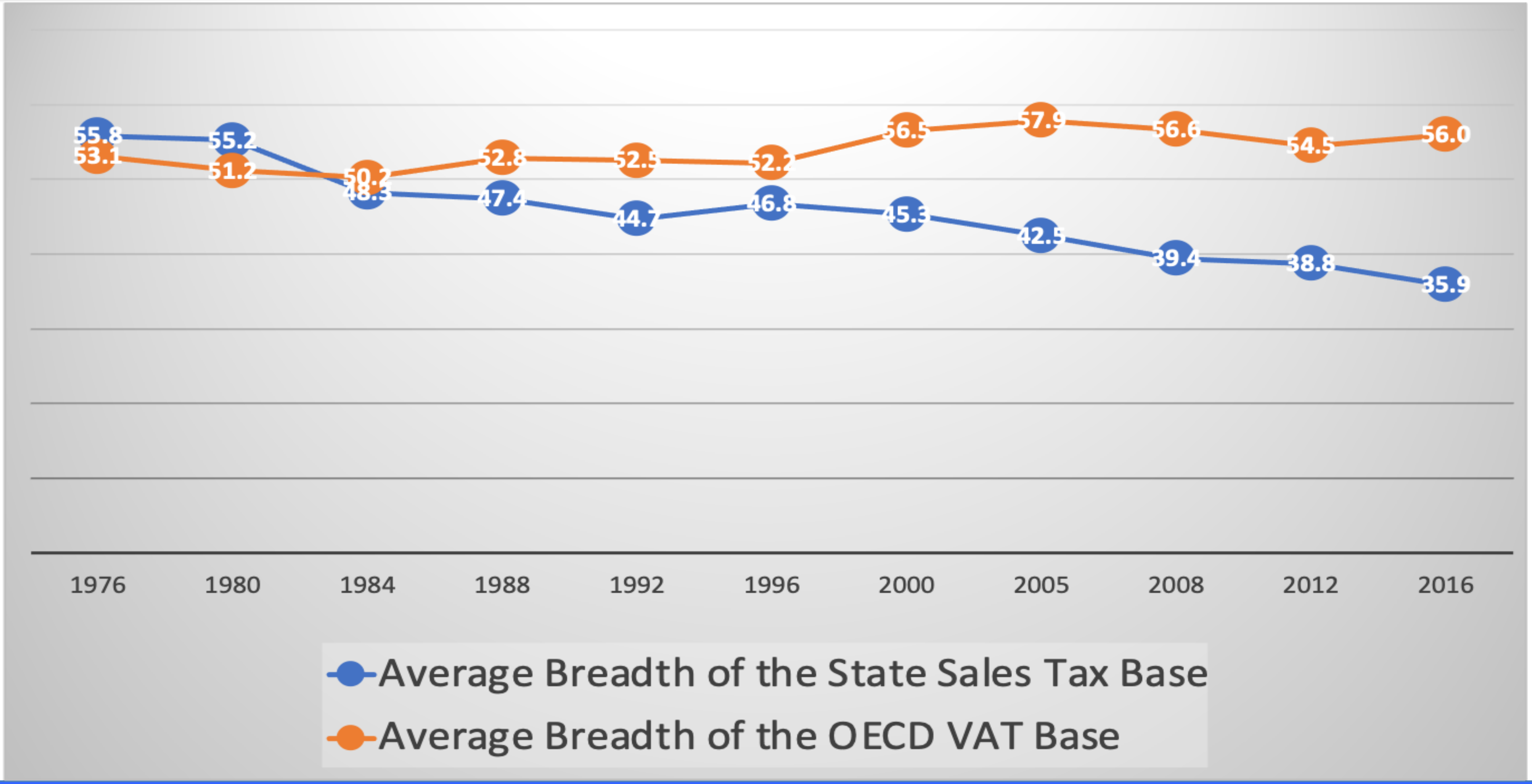
# State Sales Tax Systems Can Be Improved but Not Fundamentally Changed by Incremental Approaches

- COST will continue to actively support incremental approaches to sales tax reform.
- **However, no advanced nation has ever successfully modernized or transformed a retail sales tax system from within.**
- Despite decades of economic, political and technological change, the inefficiency and ineffectiveness of U.S. state sales tax systems has remained virtually unchanged or become even worse. Over the last four decades, state sales tax systems:
  - Consistently tax the same inordinately high level of business inputs
  - Have experienced a precipitous decline in the breadth of average sales tax bases
  - Account for the same persistently low share of overall federal, state and local tax revenues

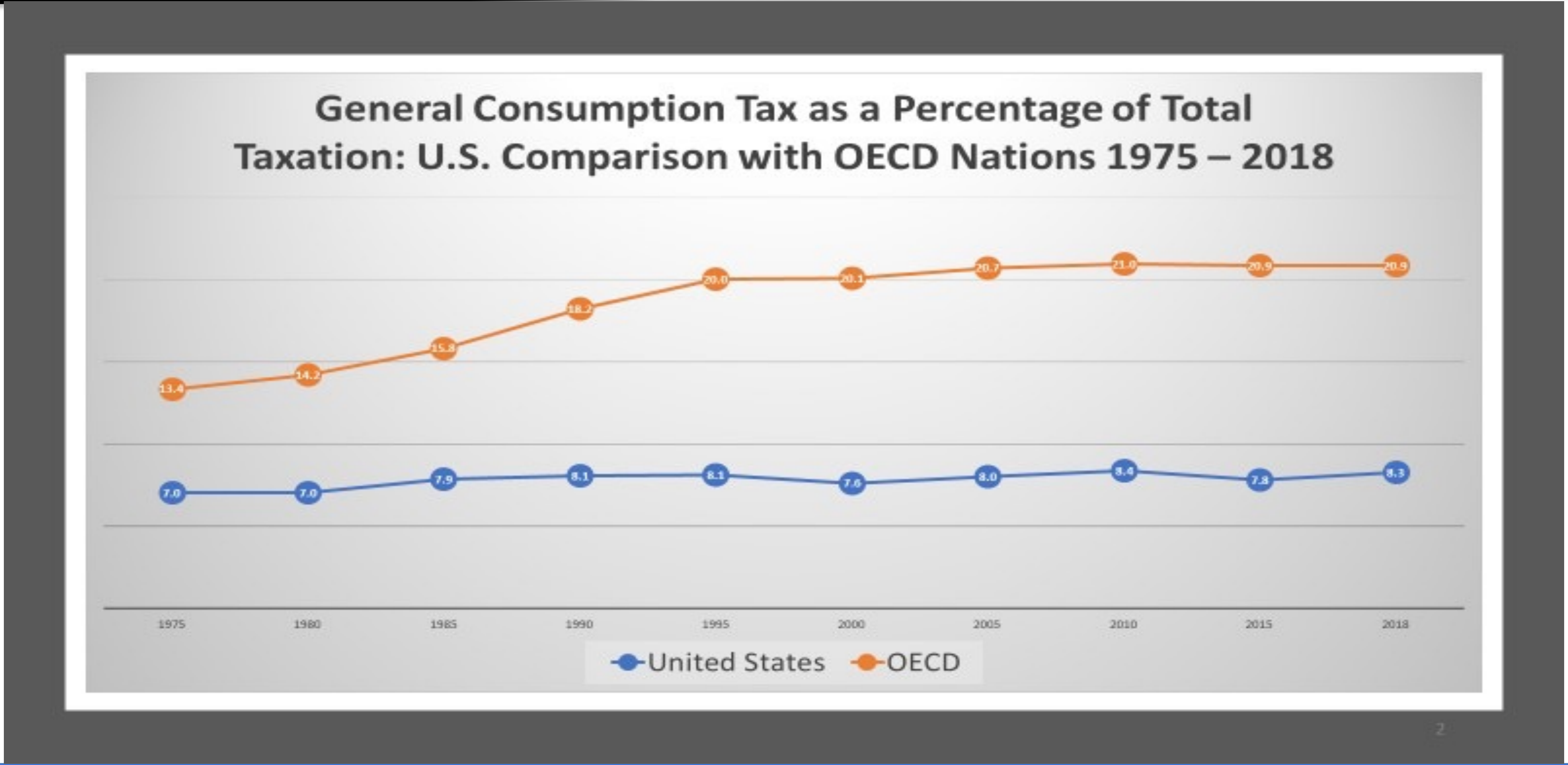
# The Level of Business Inputs as a Share of all State and Local Sales Taxes Has Remained Constant in the U.S. over the Last Four Decades



# The U.S. Sales Tax Breadth Has Significantly Declined Relative to the OECD VAT Base Since the Mid-1970s



# Sales Tax Revenues in the U.S Have Remained Constant (as a Share of All Taxes) and Much Lower than other OECD Nations Since the Mid-1970s



# Should the U.S. Consider Adopting a Value Added Tax?

- Two consumption tax principles are generally agreed upon by economists:
  1) Well-designed general consumption taxes are more economic growth-friendly (or neutral) than income, payroll or property taxes.
  2) A VAT is a more efficient and effective general consumption tax than a retail sales tax.
- But the question is not whether a VAT is a better designed tax, but whether it is feasible or desirable to replace or supplement the current U.S. retail sales tax system with a VAT.

# Should the U.S. Consider Adopting a Value Added Tax?

Given the political and administrative difficulties of structural tax reform, **the U.S. should consider adopting a VAT only if two criteria are satisfied**:

1) The design of the VAT is compatible with the American federalist system of shared fiscal responsibilities between the federal and state governments; and
2) The VAT is necessitated by an economic or fiscal crisis in which the new tax is viewed as the least objectionable of unattractive options for addressing the national calamity.

These conditions effectively preclude two design options: the U.S. should not consider either a stand-alone national VAT that would replace state retail sales tax systems or stand-alone state-level VATs.

# What VAT Design Is Compatible with U.S. Federalism?

- Among the available options, the Canadian hybrid national/ provincial general consumption tax is best suited to the U.S. federalist system.
- The cornerstone of the Canadian model is the creation of a national consumption tax not to replace, but to coexist with the provincial sales and use tax system.
- Over the last 30 years, Canada has had reasonable success in developing a national VAT (GST) with a relatively low tax rate of 5% that is harmonized with the sales tax bases of provinces making up 80% of the nation's population.
- The harmonizing provinces maintain their own tax rates and revenue stream but generally avoid the costs (and complexities) of separately administered sales and use tax systems.

# State Conformity with a Federal-Level Tax is the Norm, Not the Aberration in the U.S.

- The idea of state sales tax systems that partially or fully conform to a federal consumption tax may sound unique in the U.S. context, but state conformity to federal taxes is actually the norm with other state taxes.
- All other significant taxes imposed at the state level piggyback on similar federal taxes as a starting point:
  - personal income taxes
  - corporate income taxes
  - unemployment insurance taxes
  - estate taxes (prior to elimination of the federal credit)
- In fact, federalism works best when states can start with a uniform federal design and adjust as needed for local political and economic factors.

# Does the Current Fiscal Crisis in the U.S. Warrant Consideration of a VAT?

The converging crisis of the COVID-19 pandemic in the short-term and the escalating federal debt crisis in the long-term provides the most compelling rationale for comprehensive consumption tax reform in decades.

Federal debt in the next two years will exceed the all-time debt record set during World War II. Based on current spending and revenue trends, federal debt could double in the next several decades.

Although the U.S. has experienced several fiscal crises during the post-World War II era, there is reason to believe this crisis is more far-reaching in both scope and depth:

- Recovery from an unprecedented pandemic
- Back-to-back record-breaking recessions
- The looming threat of climate change
- Enormous deferred costs of providing elderly health care and social security

# What Other Options for Tax Increases Exist at the Federal Level ?

Given the almost total reliance at the federal level on non-consumption taxes, any substantial future federal tax levies are likely to increase the already dangerous overreliance on income, payroll, and property/wealth taxes, imperiling future economic growth.

The U.S. is the only advanced nation in the world without a general consumption tax at the national level.

The U.S. relies on consumption taxes for less than 5% of all federal taxes, and thus currently has no alternative but to raise revenues from non-consumption taxes.

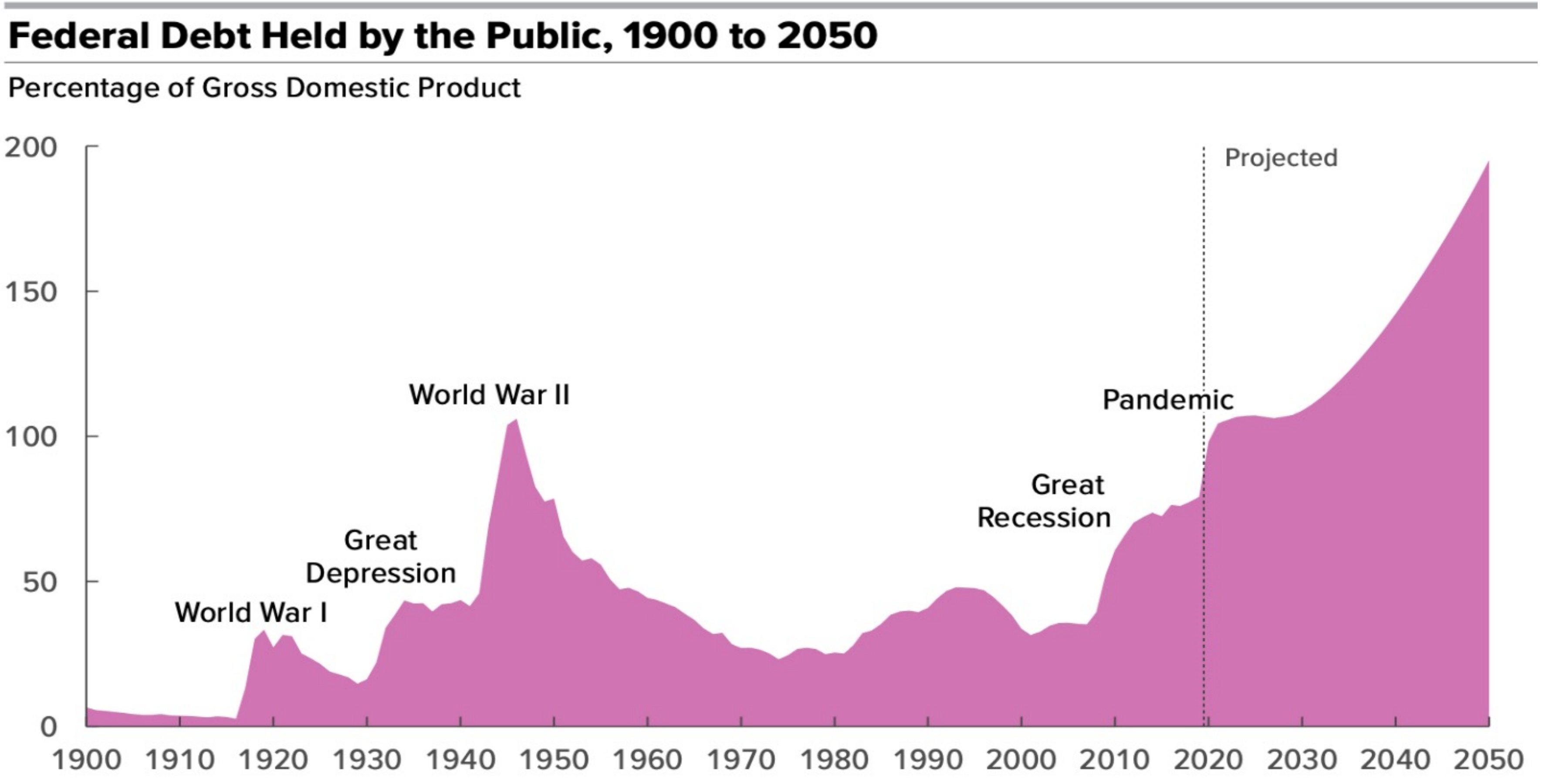
# What Other Options for Tax Increases Exist at the Federal Level ?

Among the potentially less-desirable options for tax increases at the federal level are:

- A shift backwards in the direction of 1970s-level marginal tax rates of 70% on high-income households and 48% on corporations.
- Escalating global minimum tax regimes
- Higher payroll tax rates
- Significantly higher capital gains or wealth taxes
- New gross receipts taxes or financial transactions taxes.

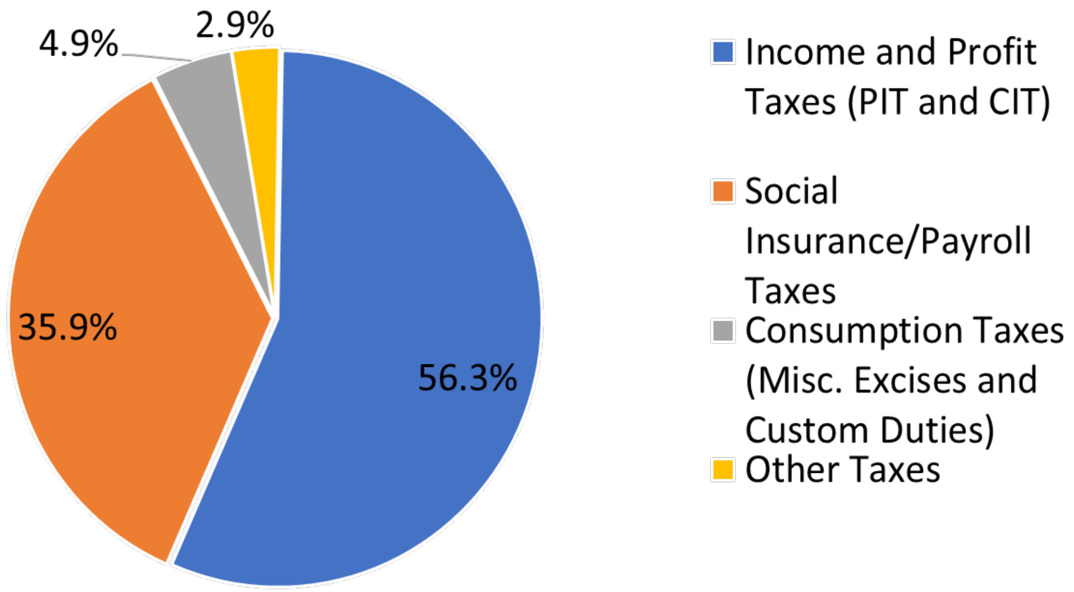
In this environment, a national consumption tax merits serious consideration as a means to raise revenues with less negative impact on capital investment, job creation and economic growth.

# Federal Debt Is Growing at an Unsustainable Rate that May Result in Significant Federal Tax Increases over the Next Two Decades




Source: Congressional Budget Office.

# Without a General Consumption Tax at the Federal Level, Any Tax Increases to Reduce Federal Debt Will Dangerously Exacerbate the U.S. Overreliance on Income and Payroll Taxes




**Sources of U.S. Federal Government Tax Revenue 2019: CBO Data**

# Questions?