Subnational Value Added Taxes: Already Tried and Failed

by William Hays Weissman

I attended the American Bar Association Section of Taxation meeting in Washington a few weeks back. I enjoy those meetings because I get to see friends from different parts of the country. I also invariably learn something new about topics that are of interest to me, even if not directly related to my practice. That was true of a panel about subnational value added taxes.

I've seen quite a bit in the popular press — and by that, I mean primarily *The Wall Street Journal* and *The New York Times* — lately about a possible VAT at the federal level. One of President Obama's senior policy advisers, former Federal Reserve Chair Paul Volcker, talked about a national VAT earlier this year. And the president's spokesperson only recently went so far as to deny a VAT was under consideration, which would not have been necessary if so many people weren't talking about the possibility of one being enacted.

The panel on subnational VATs included two very smart people: Prof. Richard Pomp from the University of Connecticut and Prof. Kirk Stark from the University of California at Los Angeles. The impetus for a panel to discuss subnational VATs was California's recent Commission on the 21st Century Economy, of which Pomp was a member. The commission issued a report several months back proposing to eliminate California's corporate income tax, lower personal income tax rates, and replace those taxes with a business net receipts tax (BNRT) that was described as being something akin to a VAT. Pomp and Stark explained why the BNRT was a bad idea, if not entirely for the same reasons.

Another panelist, Linneu Mello, a law professor from Rio de Janeiro, described Brazil's experience with both national and subnational VATs. Brazil's states have to agree on credits and incentives, and the input and refund rates are substantially uniform (although there are a couple of different rates). This is probably an oversimplification, but what makes subnational VATs work in Brazil is cooperation among the states, guided in part by the federal government.

The primary message I walked away with was that VATs don't work at a subnational level because of self-interest. Simply put, unless the states give up some autonomy to direct their tax systems, a subnational VAT can't work because there has to be at least a partially level playing field among the states. Good luck achieving that in the United States.

> ***Unless the states give up some autonomy to direct their tax systems, a subnational VAT can't work. Good luck achieving that in the United States.***

It struck me as I listened to the panelists that the United States already tried a version of subnational VATs, and the VATs failed miserably. When the United States was originally formed, it did not have a commerce clause or any other limitations on state taxation. Rather, the Articles of Confederation largely let the states do what they wanted. That created situations in which states imposed high tariffs on each other, and restrictions on imports also made it possible that a product could not be imported at all. Federalist Paper Number 42, written by James Madison, pointed out the problems of leaving the states to their own devices when it comes to import and export clauses and taxation:

> The defect of power in the existing Confederacy to regulate the commerce between its several members, is in the number of those which have been clearly pointed out by experience. To the proofs and remarks which former papers have brought into view on this subject, it may be added that without this supplemental provision, the great and essential power of regulating foreign commerce would have been incomplete and ineffectual. A very material object of this power was the relief of the States which

import and export through other States, from the improper contributions levied on them by the latter. Were these at liberty to regulate the trade between State and State, it must be foreseen that ways would be found out to load the articles of import and export, during the passage through their jurisdiction, with duties which would fall on the makers of the latter and the consumers of the former. We may be assured by past experience, that such a practice would be introduced by future contrivances; and both by that and a common knowledge of human affairs, that it would nourish unceasing animosities, and not improbably terminate in serious interruptions of the public tranquility. To those who do not view the question through the medium of passion or of interest, the desire of the commercial States to collect, in any form, an indirect revenue from their uncommercial neighbors, must appear not less impolitic than it is unfair; since it would stimulate the injured party, by resentment as well as interest, to resort to less convenient channels for their foreign trade. But the mild voice of reason, pleading the cause of an enlarged and permanent interest, is but too often drowned, before public bodies as well as individuals, by the clamors of an impatient avidity for immediate and immoderate gain.

The necessity of a superintending authority over the reciprocal trade of confederated States, has been illustrated by other examples as well as our own. In Switzerland, where the Union is so very slight, each canton is obliged to allow to merchandises a passage through its jurisdiction into other cantons, without an augmentation of the tolls. In Germany it is a law of the empire, that the princes and states shall not lay tolls or customs on bridges, rivers, or passages, without the consent of the emperor and the diet; though it appears from a quotation in an antecedent paper, that the practice in this, as in many other instances in that confederacy, has not followed the law, and has produced there the mischiefs which have been foreseen here. Among the restraints imposed by the Union of the Netherlands on its members, one is, that they shall not establish imposts disadvantageous to their neighbors, without the general permission.[1]

[1]James Madison, Federalist Paper No. 42, "The Powers Conferred by the Constitution Further Considered," Jan. 22, 1788.

Similarly, Justice Joseph Story, in his 1840 treatise on the U.S. Constitution, commented on the Articles' defects regarding the fledgling nation's economic interests:

The Articles of Confederation had scarcely been adopted, before the defects of the plan, as a frame of national government, began to manifest themselves . . . the Continental Congress had no power to regulate commerce, either with foreign nations, or among the several States composing the Union. Commerce, both foreign and domestic, was left exclusively to the management of each particular state, according to the views of its own interests, or its local prejudices. The consequence was, that the most opposite regulations existed in the different States; and, in many cases, and especially between neighboring States, there was a perpetual course of retaliatory legislation, from their jealousies and rivalries in commerce, in agriculture, or in manufactures. Foreign nations did not fail to avail themselves from this suicidal policy, tending to the common ruin.[2]

That state of affairs was not unnoticed by the business community at the time, which complained bitterly about the situation and pushed for reforms.[3] For example, a letter to *The Connecticut Courant* dated September 10, 1787, said that "trading and manufacturing companies suspend their voyages and manufactures till they see how far their commerce will be protected and promoted by a national system of commercial regulations."[4] In other words, businesses actually would refuse to engage in commerce because of the uncertainty surrounding the regulation and taxation of commerce by the states, which were constantly changing the rules for their own advantage. Does that sound familiar to anyone?

The Constitution presumably fixed those defects. Although the Constitution generally left the states free to impose taxes, it did impose two explicit limitations on that sovereign right.[5] First, it limited

[2]Joseph Story, *Story on the Constitution*, sections 28 33 (1840).

[3]Charles A. Beard, *An Economic Interpretation of The Constitution of The United States,* 19-51 (1919).

[4]*Quoted* in Beard, *supra* note 3, at 53.

[5]This sovereign right is no small matter. The U.S. Supreme Court has long acknowledged the inherent rights of the states to tax, limited only by the will of the people and congressional mandate in addition to the specific constitutional prohibitions previously mentioned. For example, in *Union Pacific Railroad Co. v. Peniston*, 85 U.S. 5 (1873), the Court stated:

That the taxing power of a State is one of its attributes of sovereignty; that it exists independently of the Constitution of the United States, and underived from that instrument; and that it may be exercised to an unlimited extent upon all property, trades, business, and

(Footnote continued on next page.)

the states' authority to impose a "duty on tonnage;"[6] and second, it limited the states' authority to tax exports.[7] Of course, the Constitution later added the implicit limitations found in the commerce clause and due process clause of the Fourteenth Amendment.

Arguably, the Founding Fathers could have taken a different approach to resolving the problems inherent in the Articles of Confederation. A system that appears to have fostered a uniform VAT type or consumption type tax might have been possible. Whether that approach is feasible now is difficult to say, but it seems unlikely. Instead, in some respects the environment today is sliding back to what it was like in the 1780s, but rather than imposing import and export duties, there is a race to the bottom of the credit barrel. The movie industry is a great poster child, with states establishing more and more credits to attract film production to their respective states. That is the flip side of the import-export coin: seeking to drive business into the state rather than trying to keep it out.[8]

> ***Although the proposed California BNRT may not have been the right radical change, the current state of affairs isn't an acceptable alternative.***

California can't go it alone, a point made by Pomp (and others). And to believe that 50 states would agree to give up some of their political autonomy to create a more uniform tax system on a subnational level hardly seems realistic. So what is the alternative? Repeal the limitation on the states' right to impose import and export duties? Or the right of the federal government to regulate commerce among the states? That already failed.

It also seems unlikely that Congress is really willing to intervene more forcefully in the area of states' taxing rights. There are a few examples, such as Public Law 86-272 and the moratorium on Internet access taxes, but by and large the states have been left to themselves. Congress is still, after all, made up of representatives of the states.

Whether a national VAT (or congressional meddling in states' affairs to allow a cooperative subnational VAT) is the right solution, and despite Pomp's disagreements with the commission's recommendations, something needs to change in California and most other states as well. As even he pointed out during the panel, California is dysfunctional. Sometimes radical change is necessary.[9] But California can't expect 49 other states to make changes merely because it needs to fix its problems. Although the BNRT may not have been the right radical change, the current state of affairs isn't an acceptable alternative. ☆

Taxing Times — A Practitioner's Perspective is a column by William Hays Weissman.

avocations existing or carried on within the territorial boundaries of the State, except so far as it has been surrendered to the Federal government, either expressly or by necessary implication, are propositions that have often been asserted by this court. And in thus acknowledging the extent of the power to tax belonging to the States, we have declared that it is indispensable to their continued existence. No one ever doubted that before the adoption of the Constitution of the United States each of the States possessed unlimited power to tax, either directly or indirectly, all persons and property within their jurisdiction, alike by taxes on polls, or duties on internal production, manufacture, or use, except so far as such taxation was inconsistent with certain treaties which had been made. And the Constitution contains no express restriction of this power other than a prohibition to lay any duty of tonnage, or any impost, or duty on imports or exports, except what may be absolutely necessary for executing the State's inspection laws. As was said in *Lane County* v. *Oregon:* [footnote omitted] "In respect to property, business, and persons within their respective limits, the power of taxation of the States remained, and remains entire, notwithstanding the Constitution. It is, indeed, a concurrent power (concurrent with that of the General government), and in the case of a tax upon the same subject by both governments, the claim of the United States as the supreme authority must be preferred; but with this qualification it is absolute. The extent to which it shall be exercised, the subjects upon which it shall be exercised, and the mode in which it shall be exercised, are all equally within the discretion of the legislatures to which the States commit the exercise of the power. That discretion is restrained only by the will of the people expressed in the State constitutions, or through elections, and by the condition that it must not be so used as to burden or embarrass the operations of the National government. There is nothing in the Constitution which contemplates or authorizes any direct abridgment of this power by National legislation. To the extent just indicated it is as complete in the States as the like power within the limits of the Constitution is complete in Congress." *Id*. at 29-30.

[6]U.S. Const. Art. I, section 10, cl. 3.

[7]U.S. Const. Art. I, section 9, cl. 5. Pomp's textbook contains a nice discussion of the import-export clause's limitations on state taxation. *See* Richard D. Pomp and Oliver Oldman, *State and Local Taxation,* ch. 5 (4th ed. 2001).

[8]Although perhaps that is better for business, the race to the bottom seems to suggest, as Prof. Stark did, that there is really no reason to have a corporate income tax at all.

[9]As Thomas Jefferson famously quipped in response to Shay's Rebellion, "A little rebellion now and then is a good thing."