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E-Taxes: Between Cartel and Competition

By Michael S. Greve

With the expiration of a federal moratorium on special and discriminatory taxes this October, Congress must again deal with a problem that seems to defy a sensible solution. State and local officials claim that customer flight into the "tax-free" Internet threatens local budgets and public services. Conventional retailers complain that sales taxes on a local book purchase—but not on an identical order from Amazon.com—constitute an unwarranted e-commerce subsidy. Internet and catalog sellers respond that an obligation to collect taxes on sales in thousands of taxing jurisdictions would entail inordinate compliance costs. It is possible, however, to harmonize the contending principles of federalism, economic efficiency, and tax equity—by taxing all sales, through whatever channel, at their source. Federalist Outlook *No. 8 makes the case for a radically reformed, origin-based sales tax system. It is based on the author's August testimony before the Senate Finance Committee.*

What Problem?

Surprising but true: for all the controversy over Internet *sales* taxes, we do not actually have a problem with sales taxes, on the Net or elsewhere. Rather, we have a problem with *use* taxes. Use taxes are owed by customers to their home states (and local jurisdictions) on purchases from out-of-state companies. For practical and political reasons, governments find it inconvenient to collect use taxes—except on big-ticket, easily traced items, such as boats and cars—from individual, in-state citizens. Thus, the common practice is to impose the tax collection and remittance obligations on out-of-state sellers.

States are free to levy use taxes on their own citizens. The question is whether they may impose the obligation to calculate, collect, and remit those taxes on remote sellers. Under a 1992 Supreme Court precedent, *Quill Corp. v. North Dakota,* the states are forbidden from doing so unless the seller has a "nexus," such as a store, in the taxing jurisdiction.[1] That is why a purchase at a local bookstore is subject to the local sales tax, whereas the same purchase from Amazon.com, though technically subject to an equivalent use tax, is effectively "tax free."

For many years, state and local governments have lobbied Congress to overrule *Quill* (which it may do under its interstate commerce power) and to extend the states' tax authority to remote sellers. That demand, however, runs headlong into the direct marketing industries' strenuous objections to being regulated by jurisdictions with which they have no tangible connection. The e-commerce camp's position, in turn, conflicts with the principle of tax equity, championed vigorously by Main Street retailers. (Little love is lost between the Direct Marketing Association and Wal-Mart, the leader of the retailer faction.) Attempts to reach a compromise between those conflicting positions have produced handsome profits on K Street and a lot of bad blood, but no measurable progress.

Those futile efforts should be abandoned. Instead of tweaking the sales tax regime, Congress should use the e-commerce brawl as an opportunity for fundamental reform. Congress should provide that interstate sales through whatever channel

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(direct, catalog, or Internet) are subject to sales taxation at their point of *origin,* meaning the seller's home state—not, as is currently the case, on the basis of their *destination,* meaning the customer's home state. A shift to origin-based taxation would foster healthy tax competition and reconcile the conflicting principles of federalism, tax equity, and efficiency. Moreover, it would set a useful precedent for resolving other, potentially larger policy disputes at home and abroad.

Principles

For all the acrimony among the affected interests, the principles of efficiency, equity, and federalism are in fact on common ground when it comes to e-commerce taxation. The difficulty lies in reconciling the principles.

Efficiency. State and local governments, the business community, customers, and tax economists all agree that sales taxes should be easy and cheap to administer. All agree, moreover, that the existing sales and use tax regime is absurdly cumbersome and expensive. Compliance costs per tax dollar collected range from 14 percent for large businesses to eighty-seven cents for small companies.[2] Even with the best intentions (and the best tax software), companies find it inordinately difficult to determine their tax remittance obligations in some 7,500 taxing jurisdictions with different and constantly changing tax rates, definitions, and reporting requirements.

Equity. Happily, "[v]irtually all concerned parties agree that state taxes on electronic commerce should be economically neutral."[3] Less happily, not everyone agrees on the meaning of *neutrality* or its cousins, *equity* and *fairness.* Tax experts argue that taxes should not divert economic resources from one use to an alternative use—in this instance, from conventional sales to e-commerce sales. Naturally, Main Street merchants and state and local government lobbies have made much of that argument—arguably, too much, since no conceivable state and local sales tax regime can be entirely neutral.[4] Nonetheless, the argument that our sales tax regime should not artificially favor some sales channels over others possesses considerable force.

Federalism. Governors and state organizations argue with great conviction that Congress should not interfere with the states' authority and autonomy over their traditional sources of revenue. They have a good point: over the entire course of American history, the states and the national government have remained very respectful of each other's revenue sources and taxing authority. Early in the e-commerce debate, proposals surfaced to nationalize sales taxes and to distribute the proceeds to the states. Those proposals, mercifully, have died a well-deserved death. Any form of joint state-federal taxation would eventually transform the states from autonomous actors into supplicants and administrators of federal largesse. That result cannot be in anyone's interest.

Compromise?

Compromise efforts—embodied, for example, in bills before the Senate Commerce Committee—attempt to reconcile clashing interests by granting state and local governments expanded tax authority over "remote" commerce in exchange for a credible commitment to "simplify" and "harmonize" sales and use taxes. The search for a compromise along those lines, however, is a fool's errand.

- "Simplification" must, at a bare minimum, mean a single tax rate for each state that charges sales tax and the District of Columbia. Even under that regime, sellers would be stuck with forty-six different sales tax regimes, but forty-six taxing jurisdictions beat 7,500 local jurisdictions any day of the week. A single-rate regime, however, would effectively wipe out the tax autonomy of local jurisdictions. That is not going to happen.

- From a tax efficiency standpoint, what really needs simplification is not the tax *rate* but the tax *base*.[5] Questions as to whether Air Jordans constitute taxable sportswear or tax-exempt footwear are legendary, as are questions as to whether potato chips and French fries do or do not constitute food. (The National Governors Association has, without a sense of irony, issued a press release on the complexities of taxing a marshmallow.) For all the easy ridicule, however, most of the seemingly absurd complexities have plausible reasons. Variations in the tax base reflect political efforts to favor domestic over foreign industries; attempts to mitigate the regressive effects of sales taxes; differences in local customs and habits; varying social judgments concerning individual consumption patterns that ought to be discouraged or encouraged; and many other considerations. Even if all the variations and exemptions were

wholly irrational and illegitimate, which they are not, the forces that produced them are not going to go away. Even if it were possible to harmonize the sales tax base once (an extremely doubtful proposition), variations would soon reappear.

State officials nonetheless insist that better technology can produce simplification and efficiency. A number of states participate in the "Streamlined Sales Tax Project" (SSTP), a centralized, computerized sales tax data collection and administration system sponsored by the Multistate Tax Commission and the Federation of Tax Administrators. Comparable experiments to centralize the calculation of *local* taxes in a few states, however, have proven unsuccessful. A representative of TAXWARE International, Inc., a producer of tax compliance software, has testified that existing technology cannot cope with the maze of definitions, exemptions, and reporting and remittance requirements.[6] Moreover, the SSTP proposal raises grave privacy concerns. Considering the public unease over personal data collection and use, a governmentally sponsored and administered data collection system on interstate sales is not an appealing idea.

Putting those pragmatic considerations aside, an extension of the existing sales and use tax regime, *no matter how "simplified" and "harmonized,"* poses a serious threat to our most elementary political principles.

First, the imposition of tax collection, reporting, and remittance obligations on out-of-state parties severs (as the economists say) the *political* incidence of taxation from its *economic* incidence. That is a variation on a theme our ancestors called "taxation without representation."

Second, the genius of American federalism is that citizens choose their state, not the other way around.[7] That principle applies not only to permanent physical relocations but also to work, tourism, and other activities—including shopping. Under the existing tax regime and especially under its proposed extension to remote sales, however, a citizen's home state tax law tags after him like a junkyard dog. Such a system negates the citizen choice that is federalism's principal attraction.

Third, that system constitutes an insult to state sovereignty. States' rights, like individual rights, must end where another's rights begin. Federalism means that states may regulate and regiment their own citizens—but not the citizens of other states. The imposition of use tax collection obligations by each state on foreign entities amounts to mutual regulatory aggression on other states' corporate citizens. That is not federalism but a federally sponsored tax cartel.

Origin-Based Taxation

The existing sales-and-use tax regime taxes interstate sales transactions on the basis of their *destination*—that is, the customer's residence. All the seemingly intractable problems of the e-tax debate—in particular, the differential treatment of "Main Street" and "remote" sales, as well as the extravagant compliance and administrative costs—stem from the choice of destination as the regulatory principle, not from decentralization per se.

Under an *origin*-based system, in contrast, interstate sales of all descriptions, through all channels, would be based on the seller's instead of the buyer's domicile state—that is, the company's principal place of business. (Local, in-state sales would be taxed, as they are now, at the locally applicable rate.) Amazon.com's sales would be taxed in the same fashion, at the same rate and by the same entity as would the sales of the local bookstore—that is, by the state of Washington. No discriminatory tax treatment would occur unless a particular state or local jurisdiction decided, for the sorts of industrial policy reasons that often induce jurisdictions to favor some industries over others, to extend tax advantages (or disadvantages) to some sales channel or other. Administrative and compliance costs would plummet. Regardless of how and where a company's products were sold, each company would be subject to reporting and remittance obligations for interstate sales only in its domicile state—and perhaps its local jurisdiction.

At the same time, an origin-based system is fully consistent with sound federalism principles. Each state would be free to tax and regulate its own businesses and citizens as it saw fit. Each state's regulatory autonomy and authority, however, would stop at the border—which is where the state ought to stop.

The origin principle is a perfectly natural choice. We already follow it, in real life, with respect to local sales, even if the parties come from different states. If I, as a Virginia resident, buy a lacrosse stick for my son on a visit to North Carolina, I will be charged the North Carolina sales tax. The seller will not give a hoot whence I came, where I reside, or where the stick is going to be used. If my son (who inexplicably insists on owning a dozen of these infernal instruments) purchases the next stick from the same company, which has no store in Virginia, over the Internet or by phone or mail order, he (or

more likely I) will not pay North Carolina's tax. One of us will instead owe the Virginia use tax—technically speaking, since neither of us has ever paid or been asked to pay that tax. Under the existing system, "simplified" or not, it matters whether the stick came to me, or I came to the stick. An origin-based system would harmonize the tax treatment.

We also follow the origin principle, even in interstate transactions, with respect to (of all items) flowers and, since last year, mobile telephone calls. One reason the origin principle has proved so readily acceptable in those areas is an expected reciprocity of advantage. A few areas (such as college towns) may experience a net export of flowers and thus reap a benefit from origin taxation; a few other areas (such as those with lots of retirement communities) may experience sizable net imports. By and large, though, states are content to ignore the question (Where have all the flowers gone?) because the flows will average out. So, for that matter, will telephone calls.

The expectation that such average reciprocity would *not* prevail is a central reason for the existing, destination-based sales and use tax system. When that system came into being in the 1930s, "consumer" states feared that "producer" states would reap all the advantages from an origin-based system and would thus leave stranded the states that were most in need of revenues. That concern, while understandable in an industrializing country with enormous economic heterogeneity among the states, seems increasingly incongruous in a far more homogeneous, service-oriented, and information-based economy.

It is true that a shift from destination-based taxation to origin-based taxation would tend to benefit the net exporters of taxable retail products and hurt net importers. That objection, however, gains its plausibility chiefly from an unstated baseline comparison with a destination regime under which all interstate sales will in fact be taxed. That assumption is manifestly unrealistic. (As noted, use taxes are rarely collected under the existing system, and even the proposed SSTP cartel would exempt many purchases.) And while producer states might gain from a shift to origin-based taxation, that advantage is easily swamped by tax advantages that the "losing" consumer states may possess.

Excessive Competition?

The elegant, origin-based sales tax solution is subject to one serious objection: it will unleash excessive tax competition or, in the more colorful metaphor, a "race to the bottom."[8] Every jurisdiction will attempt to match the largest number of sellers and purchasers. All else being equal, one might think, the sales tax rate will be zero in every jurisdiction.[9]

All else, however, is not in fact equal. Sales taxes are merely one stick in a bundle of services and obligations that are being offered by each jurisdiction. Thus, a jurisdiction that provides an educated labor force, an excellent infrastructure, a favorable regulatory environment, a sensible and efficient judicial system, or "quality of life" attractions will be able to exact a sales tax. An unattractive jurisdiction that drives up the cost of doing business, meanwhile, will be unable to compensate those self-inflicted disadvantages by becoming a "sales tax haven." It is true, of course, that an origin-based tax system would, relative to the existing sales tax regime, exert downward pressure on sales taxes and, quite probably, change the mix of the tax burden in many and perhaps most jurisdictions. While the magnitude of that effect cannot be forecast, its direction is certain.

The question, though, is not whether we do or do not want sales tax competition. We have that competition in any event. The evidence is visible up and down I-95, from Delaware's blaring "Tax Freedom" billboards to the busloads of New York shoppers at Potomac Mills, Virginia. The benefits of tax competition, however, are very unevenly distributed. They are more available to the residents of Philadelphia than to those of Salt Lake City; more available to prosperous citizens with cars than to less wealthy and mobile citizens.

State and local officials call that phenomenon tax "evasion" or "flight" and the jurisdictions that offer it tax "havens." Under any name, though, sales tax choice or "evasion" will continue no matter what the U.S. Congress or any individual state may do. The only *legislative* choice is to contain choice and competition within its current artificial and inequitable boundaries or else to expand and democratize it.

Beyond E-Taxes

The choice between origin and destination as a regulatory principle reaches far beyond the e-commerce tax question—substantively and geographically. As to substance, consider the hotly contested question of Internet privacy and consumer protection: Let the service provider's home state govern transactions with customers, and market participants will, sooner rather

than later, sort themselves into jurisdictions that match their privacy preferences.[10] Let the customers' state govern the transactions, and providers must tailor their product to each jurisdiction's specifications or, if tailoring proves impossible or excessively expensive, comply with the most restrictive jurisdiction, which will by definition reflect nobody else's preference. Since either result is intolerable to business, customers, and most states, the destination principle will prompt centralized intervention. In the end, then, states do not really have a choice between regulatory autonomy with or without competition. They have a choice only between autonomy under the competitive conditions of origin-based regulation—or else, neither competition nor autonomy.

Domestically, we can always trump the ill effects of decentralized, destination-based regulation by means of (yet another) preemptive federal law. While such centralized interventions are not always wise, protecting the national common market from regulatory obstacles is a constitutional mandate, entrusted to the U.S. Congress. On an international scale, in contrast, efforts to trump parochial, destination-based regulation through "harmonization" entail the creation of anticompetitive, unaccountable bureaucracies.

Democratic and Republican administrations alike have, by and large, wisely defended international competition against "harmonization." We have likewise resisted the notion that French judges or Brussels bureaucrats have any business regulating the content and practices of American-based Web sites solely because those sites are accessible from European destinations.

We can in some sense afford to suppress regulatory and tax competition here at home and yet champion it in the international arena—simply by throwing our considerable weight around. We do so, however, at the peril of international resentment and recrimination. It is much better to practice at home the competition that we preach abroad—both because we should set an example for a more competitive world economy and because our domestic practices are not easily contained.

Origin-based e-commerce taxation, for a pristine example, is easily scaled internationally. Let us tax our companies' international sales here at home, let foreign countries do the same to their companies, and may the most competitive countries and companies win. Destination-based taxation on an international scale, in contrast, means that we have no cause for complaint when German tax inspectors insist on auditing Apple Computer's books, the better to verify the company's compliance with tax obligations incurred on sales from Aachen to Aschaffenburg. It means, in the end, some sort of international SSTP. I take it that we would not consent to such a scheme. The best way to resist it is to resist it here at home.

The Political Economy of E-Taxation

With little time left until the expiration of the Internet tax moratorium, Congress is unlikely to entertain, let alone adopt, a proposal for serious, origin-based sales tax reform. While such proposals have been floated in the tax literature and by some think tanks (such as the Competitive Enterprise Institute, the Heritage Foundation, the Cato Institute, and—*fons et origo* of my occupation with the subject—by AEI's president),[11] they have received little public legislative debate and consideration. Even after full consideration, moreover, origin-based taxation would have three strikes against it. First, it makes perfect sense. Second, it would have to be enacted over the governors' demand for a congressional endorsement of a state tax cartel—in other words, over their dead bodies. And, third, it would make the affected industries shake hands and go back to making money instead of pestering Congress, which is the last thing Congress wants. The rational legislator's equilibrium point is a "compromise" that keeps the industries at loggerheads and the contributions coming from both sides. A temporary extension of the Internet tax moratorium would serve that purpose. It is the solution most likely to emerge from Congress.

A moratorium extension, though, would at least not foreclose a future move toward origin-based reform. Such a reform may occur under two conditions: a full public and legislative debate over the origin principle, in the e-tax context and beyond; and an industry consensus on the principle. A united industry front on a proconsumer position might be able to overcome government opposition.

Direct marketers and the Wal-Mart camp both stand to gain from origin-based taxation. Neither side, however, can afford to make the first move toward that position, since both are beleaguered by regulators who have a hundred ways to get even. Thus, the industries have no choice but to jockey for relative advantage under a system that both view, with ample reason, as absurd. A neutral, efficient, competitive, origin-based system would easily swamp whatever relative advantages either side may hope to gain from massaging the status quo. The

question is whether the parties can see their way to such an agreement.

State representatives describe the e-tax problem as a "collection problem." It is not. As game theorists would say, it is a coordination problem.

Notes

1. *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).

2. Robert J. Cline and Thomas S. Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers* (Ernst and Young, September 1999).

3. Walter Hellerstein, "State Taxation of Economic Commerce: Preliminary Thoughts on Model Uniform Legislation," *State Tax Notes,* April 28, 1997, p. 1315.

4. The only locationally neutral (and in that sense efficient) sales tax is a uniform national sales tax. But even a uniform national sales tax on products, but not services, will at the margin induce an inefficient substitution of services for products. Thus, the only truly neutral tax is a tax on both products and services or else a national prohibition on any sales tax. State and local governments do not advocate either of those options.

5. See Daniel Shaviro, *Federalism in Taxation: The Case for Greater Uniformity* (AEI Press, 1993).

6. Jon W. Abolins (chief tax counsel and vice president, TAXWARE International, Inc.), testimony to the House Judiciary Subcommittee on Commercial and Administrative Law, July 18, 2001.

7. See, for example, Justice John Paul Stevens's analysis in *Saenz v. Roe,* 526 U.S. 489, 510–11 (1999).

8. A possible second objection is based on technical efficiency grounds. An origin-based system implies jurisdictional variations with respect to both the tax base and the tax rate. Those variations will at the margins shape and, relative to a completely neutral system, "distort" both purchasing decisions and firm location. That objection, however, applies also to the existing system and, for that matter, to the SSTP. By technical criteria of locational efficiency, any form of tax competition is *ipso facto* inefficient. The question whether the gains from competition exceed its efficiency costs is the subject of a voluminous literature. One's confidence in the centralized, supposedly efficiency-enhancing approach will stand in direct proportion to one's confidence in the ability of centralized political institutions to generate tax regimes that conform to the optimality criteria on a blackboard at the University of Chicago or the Massachusetts Institute of Technology.

9. That result might in fact occur if retailers were entirely free to designate their home state or to designate their place of incorporation as their home state. The principal-place-of-business rule, in contrast, disciplines the sellers' choices.

10. See Bruce H. Kobayashi and Larry E. Ribstein, "A Recipe for Cookies: State Regulation of Consumer Marketing Information," Federalism Project Roundtable Paper Series no. 1, May 2001 (available at www.federalismproject.org.).

11. See, for example, Andrew Wagner and Wade Anderson, "Origin-Based Taxation of Internet Commerce," *State Tax Notes,* July 19, 1999, p. 187; Terry Ryan and Eric Miethke, "The Seller-State Option: Solving the Electronic Commerce Dilemma," *State Tax Notes,* October 5, 1998, p. 881. For think tanks, see, for example, Jessica Melugin, "Internet Sales Taxation: Beyond the Moratorium," Competitive Enterprise Institute Policy Brief, March 28, 2000; Adam D. Thierer, "E-Commerce: A Taxing Issue," Heritage Foundation, March 23, 2000 (available at www.heritage.org/views/2000/ed032300.html); Aaron Lukas, *Tax Bytes: A Primer on the Taxation of Electronic Commerce* (Cato Institute, December 17, 1999), pp. 37–38; and Christopher C. DeMuth, "After the Ascent: Politics and Government in the Super-Affluent Society," Francis Boyer Lecture, American Enterprise Institute, February 15, 2000 (available at www.aei.org/boyer/demuth.htm). See also Shane Ham and Robert D. Atkinson, *A Third Way Framework for Global E-Commerce* (Progressive Policy Institute, March 2001) (endorsing the origin principle, instead of "harmonization," in an international context).