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The Internet Tax Solution
Tax Competition, Not Tax Collusion

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Executive Summary

A heated debate is once again under way in Congress over the tax treatment of electronic commerce and the Internet Tax Freedom Act of 1997. The ITFA imposed a moratorium on state and local taxes on Internet access and banned "multiple or discriminatory" taxes on electronic commerce. That moratorium was intended to last only three years but was extended by Congress in 2001 for another two years. It will lapse on November 1, 2003.

The ITFA has been a remarkably misunderstood or misinterpreted statute and has very little to do with what really lies at the heart of this debate—the effort by state and local governments to collect sales and use taxes on remote vendors in interstate commerce (mail order, catalog, and e-commerce companies). Contrary to press reports and statements made by some members of Congress, the ITFA moratorium does not directly affect the ability of states and localities to impose sales and use taxes on purchases made over the Internet.

What state and local officials are really at war with is not the ITFA but 30 years of Supreme Court jurisprudence that has not come down in their favor. Their ultimate goal is to overturn those precedents, which held that states could require only firms with a physical presence—or "nexus"—in their jurisdictions to collect taxes on their behalf. State and local tax officials have worked to eliminate or water down these restrictions on their tax reach but thus far have not been able to get around them or convince Congress to authorize the imposition of collection obligations on interstate vendors.

Although extending the existing ITFA moratorium and continuing to uphold the Supreme Court's nexus jurisprudence makes good sense, Congress must also take an affirmative stand against efforts by state and local governments to create a collusive multistate tax compact to tax interstate sales. Other options exist that state and local governments can pursue before looking to impose unconstitutional tax burdens on interstate commerce. Of course, getting runaway state spending under control would go a long way toward solving many of their supposed problems. Merely extending sales tax collection responsibilities to electronic commerce—which constitutes less than 2 percent of all retail activity in the United States—will not solve the fiscal crisis that state and local governments have created through their profligate spending habits.

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Introduction

Many policymakers, journalists, and others view the debate over Internet taxation in fairly narrow terms. They believe the debate is really about whether or not federal, state, or local legislators should "tax the Net." Consequently, the war of words has focused on competing bumper-sticker slogans such as "Don't Tax the Net" and "Level the Tax Playing Field."

Framing the debate in this manner grossly underestimates the complexity and importance of the issue. For instance, the don't-tax-the-net side chooses to ignore the fact that the Internet is not really a "tax-free zone." Although states cannot force remote vendors of interstate commerce to collect and remit sales taxes, states have a corresponding "use tax" that requires consumers in their jurisdiction to remit the tax owed on out-of-state purchases. However, those levies are difficult to enforce. In other words, the absence of use tax collection is what makes the Internet (e.g., mail order and catalog sales) appear to be tax free. Anti-tax activists ought to ask themselves whether this is really the best way to achieve lower tax rates and smaller government. It is possible that states simply offset tax losses on remote sales by raising taxes on other classes of goods or vendors. Finally, there are legitimate tax fairness issues at stake. All other things being equal, similar goods and services should be taxed in similar ways.

The arguments offered by those people who would like to extend the sales tax to Internet purchases seldom prove valid. In particular, the level-playing-field argument—the notion that interstate vendors have a significant tax advantage over Main Street vendors—does not hold water. Indeed, to the extent that there is a genuine level-playing-field problem with regard to the sales tax, it is often one of the states' own making, because the current system is riddled with exemptions and special rules.

Attempts to blame the rise of the Internet for a decline in the sales tax base or state and local revenues are completely without merit. Internet business represents a minuscule portion of aggregate retail activity in the United States and can hardly be fingered as the culprit for recent state and local government budget shortfalls. In fact, according to the U.S. Department of Commerce, e-commerce activity accounted for just 1.3 percent of all aggregate retail sales in 2002.[1]

Regardless, as policymakers debate this contentious issue, three themes or principles should guide the discussion.

Federalism: A Two-Sided Coin

Although state and local governments must lead reform efforts, Congress has an important role to play. Although the sales tax is a state and local system, efforts to impose collection responsibilities on out-of-state vendors automatically warrants some degree of federal oversight by Congress. Because the debate is infused with endless talk of protecting federalism and states' rights, it is important to understand what is meant by those terms. Many state and local officials and tax administrators seem to believe that states' rights means that state and local governments should be free to impose any type of tax or regulatory regime on commercial activities, even if interstate activities are involved. Such an argument shows a misunderstanding of the federal system that the Founding Fathers set forth in the U.S. Constitution.

Federalism is a two-sided coin: one side is states' rights and the other is interstate commerce. The vast majority of tasks undertaken by the federal government since the New Deal have been an unjustifiable usurpation of the powers that the Constitution granted to the states or the citizenry. But the Constitution was also an explicit rejection of the Articles of Confederation: the disadvantages of untrammeled states' rights were trade disputes, protectionism, and interference with the flow of interstate commerce. Consequently, the Founders granted Congress the authority to take steps to regulate commerce among the states—that is, to keep open the channels of interstate commerce to ensure that free trade would win out over state protectionism.

Applying the Founders' vision to high-tech markets they could not have foreseen is tricky but not impossible. In the debate over the taxation of e-commerce it means that Congress will need to oversee state-led reform efforts to ensure that states do not impose unconstitutional tax collection burdens on remote vendors in interstate commerce. In addition to extending the current ITFA moratorium on "multiple and discriminatory" taxes as well as Internet access taxes, Congress will consider whether to put its stamp of approval on a multistate tax compact or collection agreement called the Streamlined Sales Tax Project.

The SSTP is presented as an effort to simplify and harmonize sales tax administration among the states in order to get around constitutional hurdles to taxing remote vendors. Although simplification is a laudable goal, tax harmonization can also have a downside. In particular, even though advocates of the SSTP talk only about harmonizing tax-base definitions and collection systems, the next logical step may be the harmonization of tax rates. Indeed, many retailers may demand that Congress force the states to adopt one rate per state to achieve the ultimate form of sales tax simplification.

Congress should reject such proposals and be wary of collusive tax compacts that would in the long run grant the states open-ended tax authority over the channels of interstate commerce, not only because of the potential constitutional issues they raise, but because tax competition between and among the states might be negatively affected. Preserving or enhancing tax competition should be a guiding theme in this debate.

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"Fairness" and "Neutrality" Aren't Neutral Terms

Although fairness and neutrality animate efforts to extend sales tax collection obligations to Internet vendors, the current sales tax system is hardly perfectly fair or neutral, and efforts to extend it to the Internet would raise different fairness and neutrality issues. Although state and local officials are rushing to devise a mechanism to tax interstate sales, and e-commerce in particular, they have paid much less attention to the fact that constant political meddling and special-interest favoritism have turned the sales tax base into Swiss cheese. Countless special rules, exemptions, and loopholes have been devised for favored industries or products.

Of course, for those people who desire fewer taxes in general, the fact that many goods and services are exempt offers a certain kind of tax relief. But the downside of such exemptions is that politicians might use them as an excuse to raise the rates on other activities or certain groups of taxpayers. In fact, as states engaged in a spending frenzy in the 1990s, many legislators increased sales tax rates. Moreover, the average state sales tax rate has increased from 1.2 percent in 1950 to almost 5 percent today. The combined state, city, and county rate is now closer to 6 percent. Despite steady tax rate increases, however, spending has often outpaced revenues and led to claims of budget shortfalls.

Is the Internet somehow to blame for the current situation? Will taxing e-commerce make up for the perceived tax shortfalls many governments fear? Unlikely on both counts. Even if state and local officials succeeded in devising a sales tax collection scheme to capture the minuscule portion of retail economic activity generated by the electronic commerce sector, it would likely be a Pyrrhic victory, especially if states kept increasing spending.

Extending current sales tax collection schemes to the Internet in the name of fairness seems particularly hypocritical given the many games politicians have played with the current sales tax system. Moreover, it would hardly be fair to demand that interstate vendors collect and remit sales taxes in jurisdictions where they have no physical presence and consume no government services.

In the end, the debate over Internet taxation comes down to a question of which overarching tax philosophy will prevail in the future: tax competition or tax collusion?

More Than One Way to Skin This Cat

The leading solution favored by the states—a multistate compact on "simplified" and harmonized sales and use tax collection—is not the only solution available. State and local lawmakers have several options. They can maintain the status quo. They can reduce their reliance on sales and use taxes or perhaps even eliminate them entirely. Or they can search for an alternative method of taxing consumption. But those options are not very likely to gain much political support given the popularity of the sales tax with state and local legislators.

That means policymakers will ultimately be forced to choose between two systems of sales tax reform. The first option, which has strong support from state and local politicians, is a "destination-based" sales tax regime organized by a multistate compact, which would give states the power to impose tax collection duties on vendors outside their jurisdictions after tax rates and product definitions had been sufficiently "simplified" to get around Supreme Court or congressional protections of interstate commerce. That is the SSTP model.

The second option, which has received much less attention, is an "origin-based" tax regime, under which states would exercise their right to tax equally all sales inside their borders, regardless of the buyer's residence or the ultimate location of consumption. Under that model, all sales would be "sourced" to the principal place of business for the seller and taxed accordingly. In fact, in many instances we already find ourselves in an origin-based tax regime. For example, someone who lives in Washington, D.C., but buys a good across the Potomac River in Virginia is taxed at the origin of sale in Virginia regardless of whether he brings the good back into the District. Each day in America, millions of cross-border transactions take place that are taxed only at the origin of the sale; no questions are asked about where the good will be consumed. So why not extend the same principle to cross-border transactions involving Internet, mail order, or other interstate sales? Although such an origin-based, or "seller-state," sourcing methodology has a growing number of proponents, it remains controversial and unpopular within political circles since many policymakers fear a "race to the bottom" in terms of intense tax competition.

In the end, the debate over Internet taxation comes down to a question of which overarching tax philosophy will prevail in the future: tax competition or tax collusion? States can choose to remain truly independent governmental entities that respect each other's sovereignty by avoiding extraterritorial tax schemes and abiding by the protections for interstate commerce that were established in the Constitution and upheld in later Supreme Court cases. Alternatively, the states could choose to enter into a collusive multistate compact for interstate sales and use tax collection, such as the SSTP, which would require that they surrender a large degree of their sovereignty (and the sovereignty of their subordinate local government units in particular) in an effort to extract a small amount of revenue from interstate commercial activities.

The states would be wise to reject the latter position and the cumbersome and potentially unconstitutional regime that it entails. Instead, they should embrace tax competition and search for solutions that are consistent with it, such as an origin-based tax system. Congress must continue to monitor these developments and stand firm against any effort by the states to supercede its authority over the channels of interstate commerce. Of course, in the end, maintaining the current Supreme Court nexus jurisprudence is a perfectly acceptable solution, especially in light of some of the other alternatives being considered.

The Complexities of Sales Tax Administration

Although there is little agreement about how to address the issue of Internet taxation, the antagonists in this contentious debate appear to agree on at least one point: the current system of state and local sales taxation in the United States is threatened by the realities of the modern, service-based, Information Age economy. For example, during the heated 1999–2000 debates of the Advisory Commission on Electronic Commerce, or Internet Tax Commission as it was commonly known, Republican governors James Gilmore of Virginia and Mike Leavitt of Utah were frequently at odds on whether and how to tax e-commerce. Nonetheless, they agreed that the current sales tax system would have to be reformed in light of the changing nature of the economy. As Governor Gilmore, who also served as chairman of the ACEC, noted:

> *The Internet changes everything.* More to the point, the Internet changes everything *including government*. Old rules do not work well in this new borderless economy. Sometimes they do not work at all. Regardless, change is everywhere, and government has to change as well.[2]

Likewise, Governor Leavitt, who generally supports the application of some type of tax regime to the Internet, agreed with Governor Gilmore, arguing: "The existing system of sales tax will not work in the 21st century. It is unthinkably complex and incompatible with the direction of commerce in the world. So we [must] modernize it."[3]

These statements raise three questions that policymakers have yet to fully confront:

- What is it about the current state and local sales tax system in the United States that is so troubling that it would force intellectual combatants such as Governors Gilmore and Leavitt to jointly denounce it?
- If Gilmore and Leavitt are correct in their belief that the current system of sales and use taxation in America is at odds with modern economic realities, how can it be altered to ensure that it does not unjustly burden buyers or sellers?
- If the sales tax cannot be fixed, what, if anything, will replace it?

To answer those questions, a bit of historical background is necessary.

The Sales Tax, Theory and Reality

The sales tax dates back to the Great Depression, when politicians thought that declining revenues, from property taxes in particular, necessitated temporary alternative sources of revenues.[4] The sales tax is one of many "temporary" taxes that never went away, however. Today, all but five states have a sales tax.[5] Most states rely on a sales tax for the bulk of their general fund revenues, and general sales tax receipts make up roughly one-third of overall state revenues.[6]

Most economists agree that an efficient tax should have the following properties:

- **Simplicity**. The tax should be easy to understand and inexpensive to administer.
- **Neutrality**. The tax should not divert economic resources from more productive to less productive uses or create biases in favor of particular taxpayers, activities, or industries.
- **Equity**. The tax should not impose burdens on taxpayers without offering them corresponding gains or proportional benefits in return.
- **Transparency**. The tax should not be imposed in ways that obscure its burden; that is, it should not be a hidden tax.
- **Low Rates**. Lower tax rates reduce general collection and administration burdens for taxpayers and minimize distortions in the base since higher rates create pressures for carve-outs.

In theory, sales taxes have many of those properties. The sales tax is a tax on all individual consumption. Consumption taxes can be fair and efficient if the system treats all taxpayers equally and does not have a discriminatory structure. The sales tax could achieve this goal and was probably even meant to do so. In addition, unlike income taxes, sales taxes do not create a destructive

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bias against savings and investment that reduces capital formation. So, a sales tax could be viewed as a relatively fair and economically efficient way of raising revenue.

Thanks to special-interest rent seekers and politicians, however, the theoretically simple sales tax regime has become very complex and sometimes quite burdensome. Vendors, for instance, have to keep up with a wide variety of unique product definitions, product and service exemptions, and sales tax holidays, as well as the many intricacies of local sales tax systems. Things are even more complicated for vendors operating in more than one state (i.e., remote vendors in interstate commerce). If those vendors must collect and remit the sales or use taxes for state and local governments, the complexities can become overwhelming and impose an expensive compliance burden on retailers. That can present a substantial challenge and economic burden, given that 46 states and approximately 7,500 local governments impose different sales tax rates and product definitions, according to Robert J. Cline and Thomas S. Neubig of Ernst & Young.[7]

The concern is also that remote vendors might be forced to collect and remit sales and use taxes to jurisdictions in which they have no physical presence and therefore receive no corresponding benefits for their tax collection efforts. Of course, the flip side is that if remote vendors do not collect any taxes, Main Street vendors will claim they are being unfairly burdened because they do have to collect taxes on comparable products.

To summarize, in the debate over the taxation of remote sales and e-commerce, many state and local officials have chosen to focus primarily on one of the principles associated with an optimal tax system (neutrality) and argue that the central focus of ongoing sales tax reform talks should be rectifying the supposed preferential treatment of remote sellers relative to Main Street businesses.

Main Street vendors and tax officials argue that the current sales tax regime distorts economic activity, causing a shift in sales and resources from conventional store sales to e-commerce and mail order companies by taxing the former and not the latter.[8] The argument that the sales tax regime should not artificially favor some goods and some channels over others possesses some force. "It is a standard principle of both legal systems and economics that similarly situated goods and services should be treated alike or discriminatory rules or price distortions will occur," argues Karl Frieden, author of *Cybertaxation: The Taxation of E-Commerce*.[9] However, adding an extra layer of tax in the name of neutrality does not seem like a good idea either.

Further Economic and Legal Principles

It seems reasonable to ask whether perfect tax neutrality—to the extent it is even possible—should be achieved at any and all costs. What should happen when other important goals or values come in conflict with tax neutrality? In particular, in the case of e-commerce and remote sales, should constitutional principles such as the right to due process and the free flow of interstate commerce be set aside in an attempt to achieve perfect tax parity? And what about the principle of tax competition between and among the states?

At least with regard to due process and interstate commerce concerns, Supreme Court decisions have made it clear that such principles are worthy of consideration and may need to trump efforts to create perfect tax parity. For example, in three important cases—*National Bellas Hess, Inc. v. Department of Revenue of State of Illinois* (1967),[10] *Complete Auto Transit, Inc. v. Brady* (1977),[11] and *Quill Corporation v. North Dakota* (1992)[12]—the Court said that various equity and efficiency concerns need to be taken into consideration when state and local governments attempt to impose collection burdens on remote sellers of interstate goods.

The Court's 1967 decision in *Bellas Hess* built on the foundation of its earlier 1954 decision in *Miller Bros. Co. v. State of Maryland*,[13] which held that the state of Maryland could not constitutionally impose a use tax obligation on a Delaware seller who had no physical retail outlets or sales persons in Maryland. Although the Court had upheld the power of states to impose tax collection liabilities on out-of-state sellers in some earlier cases,[14] in each of those cases the Court had found that the presence of local agents or retail stores in the taxing state was sufficient for the state to demand the businesses to collect taxes since, "in those situations the out-of-state seller was plainly accorded the protection and services of the taxing State."[15]

In *Bellas Hess* the Court noted that it had "never held that a State may impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail."[16] And reiterating what it had said in the earlier case of *State of Wisconsin v. J.C. Penney Co.* (1941),[17] the Court declared, "The simple but controlling question is whether the state has given anything for which it can ask return."[18]

In other words, state and local businesses collect sales (and other) taxes for a given jurisdiction because they can expect to take advantage of the government programs or public services made possible by those funds, such as roads, schools, parks, police, and fire protection. Remote vendors engaging in interstate transactions, however, typically do not benefit from the programs or services those taxes fund. Therefore, on Due Process Clause grounds, the Court found that to impose such collection obligations would be tantamount to taxation without representation, or taxation without any corresponding benefit. Similarly, on Commerce Clause grounds the Court found that if a company did not have certain "minimal contacts" with a particular taxing jurisdiction, it would be unfair to impose collection burdens on out-of-state vendors.[19] The threshold of physical presence or minimal contacts necessary to trigger tax collection duties is known as "taxable nexus," and it is the central animating principle—and most widely debated concept—in the debate over the taxation of remote commerce.

The *Bellas Hess* nexus framework was refined in the Court's 1977 *Complete Auto Transit* decision, which established a formal four-part test to determine whether a state sales tax would be considered constitutional. Although the *Complete Auto Transit* case dealt specifically with income tax apportionment among the states, it clearly has some relevance to the debate over the imposition of transaction taxes such as the use tax. Under the four-part test, for a sales tax to pass constitutional muster it must

- Be applied to an activity with a substantial nexus within the taxing state.
- Be fairly apportioned.
- Not discriminate against interstate commerce.
- Be fairly related to the services provided by the state.

The logic behind the Court's framework in *Complete Auto Transit* flowed directly from the Commerce Clause even though Congress has not passed any specific statute governing this particular controversy. As the Court noted in *Bellas Hess*, "The very purpose of the Commerce Clause was to ensure a national economy free from . . . unjustifiable local entanglements." This is an example of the Court applying what is know as "dormant Commerce Clause" analysis to a controversy on which Congress has failed to act or provide guidance.[20]

However, with regard to sales and use tax nexus, no decision has been more important, or created more controversy, than the Court's 1992 decision in *Quill Corp. v. North Dakota*. The *Quill* ruling is particularly important because it was the Court's last major statement on nexus matters related to the sales and use tax obligations that states can impose on remote vendors. Therefore, it still governs taxation of mail order and catalog sales and, by extension, electronic commerce.

In *Quill*, the Court ruled that the Commerce Clause prevented North Dakota from compelling the Quill Corporation, an out-of-state mail order company, to collect and pay use taxes on products sold to customers located in North Dakota because the company had no

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outlets, sales people, or property in the state. This reinforced the earlier nexus precedents found in *Bellas Hess* and *Complete Auto Transit*. It is important to note, however, that although the Court reaffirmed the physical presence nexus test in *Quill*, it did so exclusively on Commerce Clause grounds and largely disposed of Due Process nexus protections for remote vendors. The Court argued that "due process jurisprudence has evolved substantially since *Bellas Hess*," to the point that the Court would now abandon "formalistic tests focused on a defendant's presence within a State in favor of a more flexible inquiry into whether a defendant's contacts with the forum made it reasonable" for the state to demand collection of sales and use taxes.[21]

The Court stressed that because the Quill Corporation had "purposefully directed" its retail activities at North Dakota residents, "the magnitude of those contacts are more than sufficient for due process purposes, and the tax is related to the benefits Quill receives from access to the State."[22] Some scholars argue that the facts in *Quill* are not entirely analogous to Internet sales, however, and it remains an open question whether the Court would overturn state-based efforts to tax remote Internet commerce on Due Process Clause grounds. [23] It could be the case that more traditional due process analysis, such as the logic employed in the *J.C. Penney* and the *Bellas Hess* cases, would prevail if Internet vendors pushed a constitutional challenge on these grounds. But resolving that question through the courts would be a long and costly process.

As the law currently stands, therefore, Due Process Clause protections have been largely eliminated, but Commerce Clause–related nexus standards still protect interstate vendors from state and local tax collection schemes. Understanding that their hands are tied by the Constitution, the courts (in the *Quill* decision in particular) and state and local legislators and tax collectors have worked for many years to evade the nexus restrictions while simultaneously pushing Congress and the courts to abandon those protections for interstate vendors. Thus far, Congress and the courts have refused to oblige, although legislation was introduced in Congress following the *Quill* decision that would have overturned the remaining Commerce Clause restraints on taxation of remote vendors.[24] Although the legislation was the subject of intense debate (and did not pass), one fact that is undisputed is the role of Congress in resolving this matter so long as Commerce Clause considerations are on the table. As the Court noted in *Bellas Hess*, "Under the Constitution, this is a domain where Congress alone has the power of regulation and control."[25] And in *Quill*, the Court concluded, "the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve.... Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes."[26] As discussed below, it remains to be seen whether Congress will act at all to resolve these nexus controversies or whether it will continue to rely on the courts to handle nexus disputes under existing but dormant Commerce Clause precedents.

Tax Competition as a Guiding Principle

One of the many benefits of a federalist system of government is that it encourages jurisdictions to compete for the allegiance of the citizenry. As the pioneering work of Charles Tiebout and many other economists and political scientists has illustrated,[27] tax competition provides governments with powerful incentives to keep their tax rates low, improve government efficiency, and attract businesses and individuals. Some governments offer citizens or businesses a veritable capitalist paradise, free of significant tax or regulatory burdens, while others offer a more activist government that appeals to a different part of the populace. This encourages citizens and companies to "vote with their feet" and find jurisdictions that suit their tastes.

Of course, whether a reduction in tax rates is a desirable outcome depends on one's perspective. Those who want lower tax rates and tax reform favor competition between countries and between state and local governments. We should not overlook the fact that sales tax competition may give state governments an added incentive to rationalize and simplify their tax systems. In particular, if tax rates fall because of cross-border competition, it is likely that loopholes will disappear and the tax base will be simplified.

Regardless, cross-border tax competition often raises neutrality and fairness questions when the impact on the national marketplace is considered. For example, is it "fair" that Massachusetts consumers drive into New Hampshire each weekend to take advantage of sales tax–free shopping opportunities and then return home to consume those goods? One way to view this phenomenon is that Massachusetts is being unfairly deprived of tax revenues because of such cross-border shopping. At the same time, similar activities occur frequently in many jurisdictions and can be viewed as an important check on the taxing power of any single government entity. If Massachusetts officials attempt to impose too great a burden on their citizens or companies, those entities may shop elsewhere or relocate. That is a healthy part of a federalist system of government. Without a "release valve," or some sort of escape mechanism, federalism would be an empty vessel. "So long as states and localities are allowed to set sales tax rates and define what is taxable, there will be cross-border competition for consumers. It will be no different in cyberspace," notes Doug Lathrop, director of the Tax and Fiscal Policy Task Force for the ALEC.[28]

Even though cross-border commercial activity will sometimes raise tax neutrality concerns, a good case can be made that the principle of tax competition should receive equal consideration in discussions about the future of sales tax policy in America. There are good reasons to challenge the assertion that tax parity or neutrality should be achieved by any means necessary. That is especially true given the increasing complexity and compliance burdens associated with the sales tax.

Sales Tax Complications

The current sales tax system is complicated by (1) endless political meddling with the sales tax code to create special rules and exemptions for a variety of goods and industries; (2) a general exemption for the service sector; and (3) the rise of interstate commerce, or "remote sales" activity (e-commerce, mail order, catalog sales), which poses unique tax collection problems for state and local governments.

The Exemptions Game

Politicians have long used the tax code as a method of favoring special interests or advancing various sociopolitical objectives. With the sales tax, state and local officials have created a substantial number of exemptions or special rules for politically favored causes, products, or entire industries.

Take agriculture, for example. Farmers produce crops that are sold in the same way as countless other commodities in the marketplace. Yet numerous agricultural inputs, products, machinery, and final outputs are exempted from sales taxes in most jurisdictions.[29] Other significant goods-based exemptions seen in most jurisdictions include food and groceries, clothing and textiles, and pharmaceuticals (especially prescription drugs). The rationale for such exemptions is rather straightforward: such products are "special" or "too important" to be included within the sales tax base because they are considered necessities for many individuals. In addition, sales tax "holidays" (for example back-to-school week or Christmas shopping season)[30] are increasingly frequent and popular in many taxing jurisdictions.

Regardless of the sociopolitical rationales behind such exemptions, some critics argue that those exemptions and holidays put pressure on legislators to raise rates on other products or producers to make up for "shortfalls." More important for the purposes of this paper, efforts to carve out special exemptions for entire industries or classes of goods have created complicated and sometimes

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quite bizarre product classification regulations. Exemptions for food are notoriously ambiguous and confusing. As a recent *USA Today* column asked, "Is a Twix bar candy or a cookie? Is dandruff shampoo a beauty aid or medical supply?"[31] If granola bars are "candy" they would likely be taxed in many states, but if they are "food" they would not. Marshmallows present a similar challenge: taxable candy or tax-exempt food additive? And should "fruit juice" be taxed as a "soft drink" or exempted like the fruits from which it comes? What if it's not 100 percent pure fruit juice? The tax treatment of some goods, such as shoes, varies widely. Some states exempt shoes as clothing, while others have created unique tax treatments for athletic shoes or boots.

Definitional disputes have added even greater complexity to the sales tax system in the United States, especially for interstate vendors, who often have to contend with dozens, if not hundreds, of conflicting product classification schemes. Again, because state and local governments rely on business vendors to calculate and collect the sales tax at the time of sale, compliance costs are a serious matter for businesses. Vendors must accurately determine the proper tax treatment of individual goods or run the risk of repercussions—namely expensive and time-consuming audits—from state and local tax administrators. In theory the sales tax is considered a pass-through expense to the consumer and is not supposed to impose significant burdens on vendors in terms of collection and compliance costs, but clearly it can pose costly burdens. Large vendors may have little difficulty making such determinations and calculations, but smaller businesses or remote vendors with less support staff may encounter difficulties in handling tax compliance burdens. And with the threat of audits always lurking overhead, companies must take great pains to try to understand and comply with this increasingly complex system.

The increasingly service-oriented economy challenged the traditional state and local sales tax system.

The Rise of the Service Sector

When the sales tax was first being formulated during the 1930s, tracing and taxing the sale of commodities was a far more rudimentary undertaking because the industrial economy of the time was primarily goods based. In other words, most commodities were tangible goods, typically sold over the counter at a retail commercial establishment. Moreover, as discussed in more detail below, interstate commerce was a much smaller proportion of economic activity than it is today. That made sales tax collection a fairly routine matter.

But as the United States began a gradual shift to a service-based economy in subsequent decades, questions arose about how and whether to incorporate service-sector activity into the sales tax. The increasingly service-oriented economy challenged the traditional state and local sales tax system because it had historically concerned itself with collecting taxes on tangible goods, not intangible services. Taxing the sale of law books at a local bookstore was easy enough, but how should the legal services be taxed? Likewise, a sales tax can easily be imposed on the sale of building materials, but what about architectural, contractor, or construction services? The sales tax was not designed to capture these activities and thus, they were de facto exempted.

Although some people decry this general service sector exemption—arguing that it is "unfair" to other taxpayers or has raised the tax burden on others—that argument goes both ways. The exemption has been a boon for companies and taxpayers who have been relieved of the burden of paying additional taxes. Taxing services would probably prove impossible in practice anyway. Given the fluid, intangible nature of service-sector activity, imposing taxes on such activities would be far more complicated than taxing goods. In particular, taxing digital services that can move across the planet at the click of a button would entail enforcement efforts that could prove burdensome and intrusive. Finally, practically speaking, taxing services is considered by many people to be political suicide. Limited efforts have been made by some states to expand the coverage of their sales taxes to include services, but those efforts have been met with staunch political opposition and have largely failed.[32] Taxing services has never really been a tenable option.

Remote Sales, Interstate Activity, and E-Commerce

The rise of national markets and "remote sellers" (mail order, catalog, and e-commerce vendors) has posed a different sort of problem for the sales tax system. Even though remote sales typically involve the sale of goods, which have always been subjected to the sales tax, interstate sales create a variety of jurisdictional tax collection problems. That is because the sales tax is a state and local tax—not a national tax—which relies on collection by vendors "at the counter" within a particular taxing jurisdiction.

To understand how problems arise when interstate vendors and commerce enter the picture, it is important to recall how the sales tax is administered. Again, because the sales tax system in the United States was intended to be commodity based, it is typically imposed on consumers as they make purchases of goods over the counter at a commercial establishment. Consequently, state and local governments rely on business vendors to collect the sales tax at the time of sale. Theoretically, the sales tax is considered a pass-through expense to the consumer and is not supposed to impose significant burdens on vendors in terms of collection and compliance costs.

When the sales tax is collected at the counter, it is assumed that the tax will serve as a rough proxy for where the actual consumption of that good will take place. For example, a book purchased in Newark, New Jersey, will be taxed under the sales tax rate and definitions of the city of Newark and the state of New Jersey on the assumption that consumers will "consume" that book in those jurisdictions. More specifically, it assumes that the individuals who purchase that book live within the confines of those taxing jurisdictions and that a tax at the counter will be paid predominately by those individuals who will benefit from the public services provided with those revenues.

Of course, neither of those assumptions is necessarily true. Buyers who live in New Jersey may plan to take the book to New York City and "consume" it there. Alternatively, some book buyers may be from adjoining states, such as New York or Pennsylvania, and take the book back to their home states to "consume" it. At the moment of sale, however, no questions are asked of the consumer about where the ultimate consumption will take place. While this tax sourcing distinction seems like an esoteric and perhaps even irrelevant matter, it is not.

Tax administrators refer to the current system as a "destination-based" sourcing methodology, but that is a misnomer; it is really an "origin-based" sourcing rule, at least for in-state sales. "In fact, it can be strongly argued that the state sales taxes in most states already begin with a point-of-origin sales tax, then default to the destination state in the case of interstate sales," note sales tax experts Andrew Wagner and Wade Anderson.[33] In other words, sales taxes are imposed at the origin of sale, not the final point of destination or consumption. Although this will usually produce results that tax collectors desire, since most goods will be purchased and consumed in the same taxing jurisdiction, there will be many exceptions to the rule. And, given the increasing mobility of both commercial goods and consumers themselves, the assumption underlying the destination-based sourcing methodology breaks down under closer inspection, especially when the rise of interstate sales is factored into the equation.

Hoover Institution senior fellow Charles McLure Jr., a proponent of the destination-based sourcing methodology, nonetheless points out: "Sales taxes function best when *local merchants* sell primarily *tangible products* to *local customers*, as was once the case. However, the italicized words in the previous sentence no longer describe the way the world actually functions. As a result, it is inherently difficult to implement a destination-based sales tax."[34]

So although this origin–destination distinction is largely irrelevant for *intra*state

Tax administrators refer to the current system as a "destination-based" sourcing methodology, but that is a misnomer.

The decision to apply a destination-based sourcing methodology to interstate activity necessitates the adoption of a use tax.

sales, it is vitally important when *inter*state activity is brought into the picture. Because state and local tax collectors have traditionally relied on commercial vendors to calculate and collect the sales tax on purchases at the point of sale, there have always been logistical questions and legal concerns about applying the same collection duties to out-of-state vendors. The decision to apply a destination-based sourcing methodology to interstate activity necessitates the adoption of a use tax as a means of collecting taxes on retail sales activities that originate out of state. Use taxes are owed by customers to their home states (and local jurisdictions) on purchases from out-of-state companies that do not have nexus in that state or locality.[35] Every time an individual purchases taxable tangible goods, whether in person, over the phone, or on the Internet, the purchase is subject to a use tax in the state where the merchandise is used.

In theory, that means that the customer in Virginia who buys a book from Amazon.com is obligated to file use tax forms and remit a use tax based on the prevailing Virginia state and local rate. Compliance with this requirement by individual consumers is extremely low for business-to-customer (B2C) transactions. Much e-commerce is business-to-business (B2B), wherein compliance is much higher. The low compliance rate for B2C transactions is often due to ignorance on the part of taxpayers and should not be considered explicit tax evasion. Also, for practical and political reasons, governments find it very inconvenient and unpopular to collect and enforce use taxes on individual citizens, except for those items that are easily traceable, such as automobiles or boats that must be registered in the state of use. At the end of the day, therefore, the purchase of a book from a bookstore in Virginia is subject to the state sales tax, while the same purchase from Amazon—though technically subject to an equivalent use tax—is effectively "tax free" because of the unenforceability of the use tax.

The unenforceability of the use tax explains why state and local governments have gone to great lengths to evade legal nexus protections and demand direct collection of the sales tax by out-of-state vendors. But, given the practical problems associated with collecting the use tax and the nexus constraints placed on state and local officials by the courts, it is worth asking why those officials persist in their quest to retain and extend a destination-based methodology for sourcing remote sales activities. Why not adopt a pure origin-based standard instead and avoid enforcement and legal hassles altogether? In other words, allow the taxation of interstate vendors only at the origin of a transaction where they have their primary place of business.

The answer, not surprisingly, has more to do with politics than sound economics. "The true premise behind a use tax in the destination state actually has very little to do with consumption. Rather, the purpose is to protect in-state vendors," argue Wagner and Anderson.[36] Indeed, in 1964, Congress convened a Special Subcommittee on State Taxation of Interstate Commerce that subsequently became known as the Willis Commission after its chairman, Rep. Edwin E. Willis (D-La.). Volume 3, Part 3 of the massive Willis Commission report noted:

> As a practical matter . . . outshipments and inshipments present very different problems. So long as there were States which did not impose a sales tax or which imposed it at a lower rate, the States had no interest in taxing outshipments. To do so would produce protests by their own businessmen that they were being placed at a competitive disadvantage to other businessmen located in sales-tax free States or States with lower rates. Accordingly, the States have made very little attempt to tax sales of goods shipped to the buyer in another State.[37]

So the application of a destination-based sourcing rule to interstate transactions was done not to satisfy any particular economic objective, but to avoid the uncomfortable business of imposing taxes on a state's own exports. Better to attempt to impose a tax on another state's imports and avoid burdening domestic vendors with tax collection duties for the goods they send out of state. Even today that largely remains the rationale for a destination-based sourcing methodology for remote sales taxation—even though a switch to a pure origin-based methodology would immediately level the proverbial tax playing field by demanding that all sellers (remote interstate vendors and Main Street businesses alike) collect sales taxes only at the point of sale. The origin-based alternative to destination-based tax collection schemes is discussed in greater detail later in this paper.

The decision to stick with a destination-based sourcing methodology has necessitated a "by any means necessary" crusade by state and local tax administrators to devise a system to get around current nexus constraints in order to collect the use tax owed on interstate transactions. In recent years, state and local tax administrators have worked to devise a multistate solution to the problem of use tax enforcement that will get around the nexus protections required by the courts. The key to this effort—called the SSTP—is the simplification and harmonization of sales tax rates and definitions.

But this system, which will be critiqued more thoroughly below, is still plagued by the same fundamental problem the current system faces—an adamant refusal to abandon the destination-based sourcing rule for interstate transactions. So long as tax officials seek to trace and tax sales based on the final destination or place of consumption, they will always have to deal with legal and logistical difficulties.

Many scholars have pointed out that the advent of widespread e-commerce poses additional problems for a destination-based methodology and the use tax because the Internet makes geography largely irrelevant. "Traditional concepts of tax jurisdiction, such as residency, source, and permanent establishment, cannot be relied on,"[38] note sales tax experts Terry Ryan and Eric Miethke. "In the purely digital world, where both the consummation of the agreement and the exchange of the product or service occurs on-line, location is not just irrelevant; it can be impossible to determine," argues Dean Andal, former chairman of the California Board of Equalization.[39] Bearing such considerations in mind, Frieden appropriately concludes: "It is clear that creation of sourcing rules for a digital economy will be an arduous and frustrating task. No one set of rules is likely to prove ideal, and therefore, a considerable amount of experimentation can be expected."[40]

As an aside, it should be noted that if the sales tax were a uniform *national* tax on consumption, many of these problems would disappear; there would be a single rate and single definition or classification for each commodity. And every interstate vendor would be required to collect and remit that tax because they resided within the confines of the United States. In legal terms, every American corporation has "nexus" or physical presence within the confines of the United States, so they could all be taxed by the federal government regardless of where they where headquartered in the country.[41]

But the United States does not have a national sales tax system at present.[42] Instead, the sales tax is exclusively a state and local tax system. Jurisdictional tax sourcing controversies were bound to arise as interstate commercial activities proliferated. Very little federal guidance exists regarding how to resolve such disputes. To make matters more complicated, state and local taxing jurisdictions often have overlapping boundaries and contradictory tax rules and rates. In the case of the sales tax, each state and local government jurisdiction has formulated its own unique sales tax system. This greatly complicates the sales tax treatment of interstate commerce and makes it very expensive for remote vendors of interstate commerce to administer the system.[43]

According to Cline and Neubig, "high compliance costs result directly from complexities built into each component of the sales tax system: definitions of what is taxable, multiplicity of tax rates, numerous exemptions for specific buyers or uses, overlapping jurisdictions, filing requirements and audit

Many scholars have pointed out that the advent of widespread e-commerce poses additional problems for a destination-based methodology and the use tax.

The moratorium does not directly affect the ability of states and localities to impose sales taxes on purchases made over the Internet.

procedures."[44] They estimate that "for firms selling nationally with collection responsibilities in all 46 states, the compliance costs range from 14 percent of sales tax collected for large retailers, to 48 percent for medium retailers, and 87 percent for small retailers."[45]

This remarkable complexity and the costs associated with it explain why the Supreme Court ruled in the *Quill* decision that it would unduly burden interstate commerce if remote vendors were required to collect sales and use taxes for jurisdictions where they have no physical presence. And it also explains why some state and local officials have attempted to create a multi-state compact such as the SSTP to get around *Quill*'s restrictions and begin taxing interstate activity.

Myths about the Internet Tax Freedom Act

Before summarizing the spectrum of sales tax reform options available to state and local legislators, it is important to clarify some commonly held misperceptions in the debate over Internet taxation, in particular about the ITFA and the role of Congress in this process. Many policymakers, members of the media, and the general public continue to harbor the illusion that an extension of the existing ITFA moratorium will (1) keep the Internet "tax free," (2) increase the disparate treatment of Internet sales and retail states, further eroding the tax base of states and local governments, and (3) allow Congress to impose an unwarranted federal solution on state and local governments. In reality, the ITFA has not and will not do any of these things.

The Moratorium Has Nothing to Do with the Internet "Tax Free Zone"

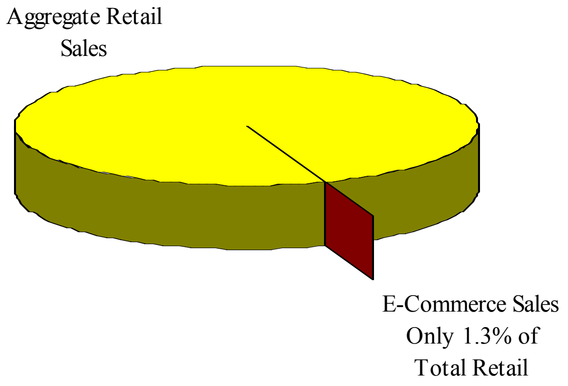
The ITFA imposed a moratorium on state and local Internet access taxes and banned "multiple" and "discriminatory" taxes on electronic commerce. The moratorium lasted only three years but was extended by Congress in 2001 for another two years and will lapse once again on November 1, 2003. Contrary to press reports and even press releases and speeches issued by members of Congress, the moratorium does not directly affect the ability of states and localities to impose sales taxes on purchases made over the Internet.

As mentioned earlier, state taxing activities are constrained by the *Quill* decision, which prevents states from collecting sales taxes from vendors who lack a physical presence, or nexus, in that state. The ITFA merely imposed a moratorium on state and local taxes on Internet access and banned "multiple or discriminatory" taxes on e-commerce. Even if the moratorium were never renewed, state and local tax collectors could not currently tax interstate purchases made over the Internet. Claiming that the ITFA created a "tax-free zone" is only correct with regard to Internet access, which is specifically protected from parochial tax efforts.

The Net Does Not Pose a Serious Threat to Retail Stores or State and Local Governments

Those who support broadening the ability of states to collect sales taxes on remote retailers suggest that the inability of state governments to collect taxes on e-commerce sales has deprived states of billions of dollars in needed revenue and that essential government services will be imperiled.[46] But this argument doesn't hold water. The U.S. Department of Commerce has been collecting quarterly data on e-commerce retail sales since late 1999.[47] Since that time, e-commerce activity has grown from roughly $5.5 billion in the fourth quarter of 1999 to $14.3 billion as of the fourth quarter of 2002. But as Figure 1 illustrates, despite steady growth, e-commerce activity continues to be a minuscule component of overall consumer spending, accounting for just 1.3 percent of aggregate retail sales in 2002. For the three-year period during which the Department of Commerce has been collecting data, e-commerce has averaged just 1.1 percent of total retail sales. Figure 2 documents e-commerce sales as a percentage of retail activity for each quarter of the past three years.

Figure 1
E-Commerce Sales Only a Sliver of Aggregate Retail Activity (Year 2002 Totals)



Source: U.S. Department of Commerce, www.census.gov/mrts/www/current.html.

Given these data, it is hard to make a credible case that the Internet has caused a fiscal crisis in the states. Indeed, to the extent there is a state and local budgetary "crisis" today, it has much more to do with the massive spending spree by states in recent years.

In fact, just a few years ago, many state and local officials were bragging about their strong fiscal situation. "Money is just pouring in over the transom," noted California governor Gray Davis in March 2000.[48] Similarly, in February 2001 a National Conference of State Legislatures press release quoted NCSL president Jim Costa, a state senator from California, boasting that "most state budgets in recent years have purred like the engine of a luxury car."[49] That same NCSL press release noted that 33 states said revenue growth was on or above target in early 2001 and that 31 states reported that

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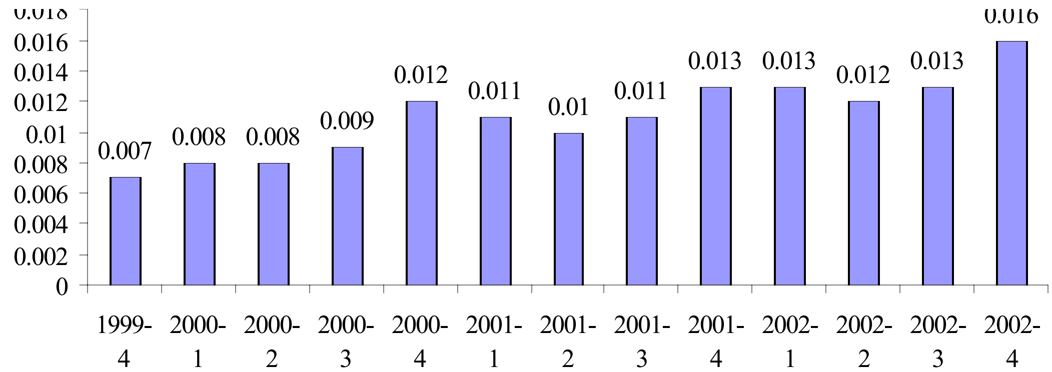
Figure 2
E-Commerce as Percentage of Total Retail Sales (1999–2002, by quarter)



Source: U.S. Department of Commerce, www.census.gov/mrts/www/current.html.

budget cuts would not be necessary to balance FY 2001 budgets.

Various reports and surveys backed up these claims with hard data. Office of Management and Budget surveys note that state and local government tax receipts grew by more than 30 percent between 1994 and 1999, controlling for inflation and the growth in population.[50] Similarly, a recent Cato Institute survey of the fiscal situation in the states revealed that between fiscal years 1990 and 2001, state tax revenue grew 86 percent—more than the 55 percent of inflation plus population growth.[51] Likewise, in December 1998, Michael Flynn of the ALEC published a report on surplus revenue in the states, which noted that states are "in their best financial health in over a decade" with $74 billion in windfall surplus tax revenues over the past four years.[52] Finally, a Nelson A. Rockefeller Institute of Government report showed that as recently as fiscal year 2000, state tax revenues grew by 8.7 percent. Adjusted for inflation, this increase represented the second largest in the last decade.[53]

Today's headlines tell a very different story. "States in Fiscal Crisis," notes the *Washington Post*;[54] "For Struggling States, All Solutions Point to Washington," says the *New York Times*;[55] and "States Want Federal Bailout, But Financial Help Unlikely," reads an *Investors' Business Daily* headline.[56] These headlines reflect the sobering reality many states are facing today: the good times are gone as revenues have dried up and budget surpluses have disappeared.

Exactly what happened in the past few years that led to this reversal of fiscal fortunes for the states? Is the Internet somehow to blame for these budget shortfalls? Given the data presented above regarding the very limited slice held by e-commerce in the much larger economic retailing pie, that's unlikely.

The real cause of the states' fiscal policy woes emanates from their insatiable appetite for spending.

The real cause of the states' fiscal policy woes emanates from their insatiable appetite for spending. Despite the record surpluses of the 1990s, most states continued to spend far more than they take in. According to the National Association of State Budget Officers, state general fund spending grew at an average rate of 5.7 percent from FY90 to FY01 while inflation averaged just 2.8 percent over that same period.[57] The pace accelerated in the late 90s with growth of 7.0 percent in FY99, 6.6 percent in FY2000, and 8.0 percent in FY01.[58] Glenn Hubbard, former chairman of the Bush administration's Council of Economic Advisers, recently told *Investors' Business Daily*, "I don't mean to sound harsh, but the states that are in the worst trouble did, frankly, increase spending substantially during periods in which most economists would have said the (revenue) gains were transitory."[59]

Instead of facing up to their spending habits, state and local officials have attempted to pin the blame on a variety of other factors: the limited tax cuts that some states put in place in the 90s; the lack of increased aid from the federal government; and, of course, the Internet.

But although profligate spending is clearly the real cause of the states' current fiscal policy woes, many officials still claim that e-commerce is a significant drag on revenue generation and that taxing the Internet will help make up at least *some* of the current budget shortfall. Many state and local groups and officials point to a study conducted by Donald Bruce and William F. Fox, economists with the University of Tennessee's Center for Business & Economic Research. Bruce and Fox's study estimates the potential lost revenue for state and local governments at $13.3 billion in 2001 and suggests that this amount will more than triple to $45.2 billion by 2006.[60]

But these numbers have been disputed by other economists and by the Direct Marketing Association in particular, which produced its own study showing losses totaling only $1.9 billion in 2001.[61] The numbers differ radically because of disputes about the tax treatment B2B e-commerce sales and the definition of what should count as "e-commerce sales" to begin with.[62]

Regardless of how much e-commerce retailing activity grows in future, it is highly unlikely that it will subsume all traditional retailing activity or displace a substantial portion of Main Street retail sales. But this debate should not be resolved solely on the basis of economic projections in one direction or the other; sound economic policy and constitutional jurisprudence should govern the final outcome.

Congress Does Have a Role in This Debate

Despite what some state and local groups or officials claim, Congress does have a very important role to play in the debate over the taxation of e-commerce. The Founding Founders included several provisions in the Constitution dealing with federal oversight of the states in order to end factionalism and protectionism among the states. These powers, which were granted to the federal government to protect the economic liberties of the citizenry and to aid in the promotion of a more integrated national economy, have a bearing on the modern debate over e-commerce taxation. They include the following:

- **Article I, Section 8, Clause 3 (the "Commerce Clause"):** [The Congress shall have power] "To regulate commerce with foreign nations, and among the several states, and with the Indian tribes."
- **Article I, Section 9, Clauses 5 and 6 (nondiscrimination in shipping/ trading):** "No tax or duty shall be laid on articles exported from any state. No preference shall be given by any regulation of commerce or revenue to the ports of one state over those of another: nor shall vessels bound to, or from, one state, be obliged to enter, clear, or pay duties in another."
- **Article I, Section 10, Clauses 2 and 3 (additional shipping/trading protections):** "No state shall, without the consent of Congress, lay any imposts or duties on imports or exports . . . [or] lay any duty of tonnage. . . . "
- **Article I, Section 10, Clause 3 (the "Compact Clause"):** "No state shall, without the consent of Congress . . . enter into any agreement or compact with another state, or with a foreign power. . . . "
- **Article IV, Section 2, Clause 1 (the "Privileges and Immunities Clause"):** "The citizens of each State are entitled to all the Privileges and Immunities of Citizens in the several States." (Intended to prevent states from discriminating against constitutional rights of out-of-state citizens.)
- **Article VI, Clause 2 (the "Supremacy Clause"):** "This Constitution . . . shall be the supreme law of the land." (Made it clear that when state laws came into conflict with each other or national laws, federal law was to prevail.)

The combined effect of these enumerated constitutional provisions was a clear declaration that state-based protectionism would not be tolerated; the rights of individual consumers and companies would be protected by Congress and the courts when threatened by oppressive and unjustifiable state actions which adversely affected interstate commerce. The passage of the Fourteenth Amendment in 1868 enshrined important due process and equal protection rights in the Constitution, providing greater protections for citizens from oppressive state actions.[63]

In subsequent decades, these constitutional provisions have been cited by the courts on numerous occasions in controversies related to the regulation of interstate commerce by state and local governments. Congress has often drawn on these powers to justify its oversight of numerous types of interstate activities and multistate disputes.

As debates over the tax treatment of remote vendors came to the fore with the rise of mail order and catalog sales 30 years ago, some state and local officials immediately attempted to impose sales and use taxes on out-of-state vendors. Although the Court wisely forbade such unjust taxation without representation in cases such as *Bellas Hess* and *Quill*, the Court also noted that the ultimate decision regarding the tax treatment of interstate ven-

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dors fell to Congress. In *Bellas Hess* the Court noted, "Under the Constitution, this is a domain where Congress alone has the power of regulation and control."[64] And in *Quill*, the Court concluded that, "the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve."[65] The famous 1965 Willis Commission report on state taxation of interstate commerce also concluded: "The [Commission's] study of sales taxation shows that the present system is exceedingly troublesome to business and falls short of accomplishing the purposes for which it was adopted. As a national problem, the task of making the sales tax effective and workable for interstate sales inevitably falls upon Congress."[66]

Clearly then, the question of whether Congress has a role to play in this debate can be laid to rest with those statements. But what should it do?

The 1999 ITFA moratorium was a fairly sensible first step since it put state and local governments on notice that "multiple or discriminatory" levies on the Internet, as well as taxes on Internet access, would not be tolerated. This action is important because it prevents state and local governments from automatically looking toward the Internet as the latest communications or utility industry "cash cow" that can be milked for billions of tax dollars. Although state and local governments certainly have the right to impose taxes on corporations within the confines of their jurisdictions, all too often they have viewed telecom companies as unique, captive businesses that can be used as a disproportionately large revenue-generating sector.[67] The risk now is that the same mentality will be applied to Internet businesses and that state and local governments will impose a host of levies on Internet services or access in general.

For these reasons, Congress is considering an extension of the existing ITFA moratorium. Rep. Christopher Cox (R-Cal.) and well over 100 co-sponsors have proposed H.R. 49, Internet Tax Nondiscrimination Act, which would make the existing moratorium permanent. Sen. Ron Wyden (D-Ore.) has introduced a companion bill on the Senate side (S. 52).[68] And Sen. George Allen (R-Va.) has introduced legislation in the Senate (S. 150) that is identical to the Wyden measure except that it also eliminates any Internet access taxes that existed prior to October 1, 1998, which were grandfathered into law by the ITFA.

Although extending the existing moratorium and making it permanent is the sensible next step for Congress to take, federal lawmakers could go further and deal with the underlying nexus or sales tax collection issues in one of two decidedly different ways. On one hand, Congress could consider nexus clarification legislation that would largely codify the Supreme Court's *Quill* decision and update it to deal with e-commerce questions. On the other hand, federal lawmakers could take up the question of current state efforts to simplify sales and use tax collection and determine whether to place their stamp of approval on an official multistate compact such as the SSTP.

Each of these proposals was floated in the previous session of Congress and may be entertained once again this session. For reasons outlined in the following section, it would be far more sensible for Congress to undertake nexus clarification and codification than to get involved in the effort to simplify and harmonize state and local tax rates and definitions. Congress should stay out of the latter fight and not approve any formal multi-state compact for the taxation of interstate commerce. Congress certainly has it within its power to authorize either of these efforts. But better alternatives may be worthy of consideration.

Ten Sales Tax Reform Options

Many misperceptions or misstatements have clouded the debate over the taxation of e-commerce as state and local governments persist in their attempts to rework their sales tax systems and design a system to capture remote sales activity. Whether or not their fears regarding increased e-commerce activity are warranted, there are certainly good reasons for state and local officials to investigate long-term sales and use tax reform alternatives. The 10 sales tax reform options listed below outline a broad spectrum of alternatives for state and local officials to consider. Some of these reform alternatives will be given more extensive treatment than others, based on their importance or practicality.

Although Congress can and should exercise an oversight role when these sales tax reforms affect interstate commercial activity, it would be preferable if most of these reforms sprang from the bottom up. To the maximum extent possible, federal authorities should not dictate the direction state and local governments take except to protect the channels of interstate commerce from unconstitutional tax or regulatory burdens.

Option 1: Enact a Multistate "Tax Simplification" Compact

The goal here would be to harmonize tax bases and rates in order to impose use tax collection responsibilities on remote vendors of interstate commerce. Variations of this first reform option have been widely touted by state and local organizations such as the National Governors Association and the National Conference of State Legislatures as the ultimate solution to the current sales tax predicament. These groups have worked with state and local tax administrators to craft a plan known as the SSTP or the "zero burden" sales tax proposal. In a meeting last November, 31 state delegates agreed to move forward with the SSTP plan—now formally known as the Streamlined Sales and Use Tax Agreement—and enact legislation in each of their member states to bring their state and local sales tax laws into conformity with the agreement.[69]

From the outset, the project focused on a possible compromise or quid pro quo involving greater simplification of the sales and use tax system in return for the blessing of Congress or the Courts on a multistate tax collection compact for remote sales. State officials believe this would allow them to get around *Quill* and begin taxing remote sales activity by minimizing the burdens placed on remote vendors.

There are two core elements to the SSUTA.[70] First, the proposal aims to address the lack of uniformity within the existing sales tax system for both rates and product definitions by requiring that participating states enter into a tax compact and abide by the rules laid out under the SSUTA. Sales and use taxes would be administered at the state level and all units of government within a state would need to adopt a common tax base to simplify and harmonize tax administration.[71] Among other things, the SSUTA requires uniformity of major tax base definitions, uniformity of state and local tax bases, and simplification of state and local tax rates.[72] A "governing board," composed of four representatives from each member state, would oversee administration of the compact. The agreement notes that the governing board would have the power to, "employ staff, advisors, consultants or agents"; "promulgate rules and procedures it deems necessary to carry out its responsibilities"; "take any action that is necessary and proper to fulfill the purposes of the Agreement"; and "allocate the cost of administration of the [SSUTA] among the member states."[73] The SSUTA would take effect in a voluntary manner when at least 10 states, representing at least 20 percent of the U.S. population, agree to bring their sales and use tax regimes in line with the agreement. (To gain the force of law and move beyond the voluntary compliance stage, some sort of congressional authorization would likely be necessary.)

Second, the SSUTA plan would use several versions of what John Mikesell calls a "technofix"[74] to achieve greater sales and use tax simplification and get around the legal hurdles preventing states from imposing collection responsibilities on interstate vendors. In order to administer the sales tax and minimize collection costs and other vendor burdens, participating states and local governments

The SSUTA requires uniformity of major tax base definitions, uniformity of state and local tax bases, and simplification of state and local tax rates.

The SSTP/SSUTA scheme raises a host of troubling questions.

could pay Certified Service Providers to handle compliance for vendors that opt to use a CSP as their tax collection agent. Vendors would transmit necessary customer order information to the CSP so that the CSP could calculate the tax owed. These independent third-party organizations would be responsible for remitting the taxes to the states, to removing collection burdens on remote vendors. Alternatively, vendors could opt to use computer tax collection software and systems known as Certified Automated Systems, preapproved by the states to help calculate the taxes due from purchases based on the tax rate of the state where the item is to be sent. A third option would be for vendors to use their own proprietary systems to calculate, collect, and remit the tax owed. In each case the basis for determining the appropriate tax rates would be the zip codes of the buyers.

The SSTP/SSUTA scheme raises a host of troubling questions. To begin, harmonization, uniformity, and simplification—the cornerstones of the SSUTA—have many downsides. "While simplicity sounds nice, the devil will be in the details," argue Wagner and Anderson. "Centralized uniformity for sales tax also invites additional pondering such as the desirability of uniformity and centralization of property tax administration. At what point does state and local revenue sovereignty and autonomy disappear?"[75] For now, the SSUTA will be limited to the harmonization of tax bases between states and some state and local tax rates.[76] This system would entail some loss of state sovereignty and local autonomy over tax policy, especially if "harmonization" was taken to the extreme under the SSUTA. As Charles McLure, a leading simplification proponent, explains, "The SSTP has made amazing progress in achieving simplification. Yet it would not achieve elegant simplicity or economic neutrality until it goes the full nine yards with harmonization."[77] Indeed, as a condition of its approval of the SSUTA, Congress may actually require more harmonization—especially of tax rates—before giving its formal blessing to the compact. In the name of truly simplifying tax administration for vendors, Congress could require the ultimate in sales tax harmonization—one rate per state with no local variations.

But as Fred L. Smith Jr. of the Competitive Enterprise Institute has aptly noted: "Harmonization of tax policy is not necessarily good policy. Competition is useful in the marketplace, but it is perhaps even more valuable in the political world."[78] Bringing greater uniformity to the current system may have some positive benefits, such as more straightforward tax administration, but it would come at the expense of tax competition between the states and localities. Moreover, when supporters of the SSUTA argue for greater uniformity in the sales tax system, they may just be making a covert effort to sustain higher tax rates and expand the current system to incorporate remote vendors on interstate goods and services. But at what cost? The states are essentially proposing to abandon true federalism and jurisdictional tax competition in exchange for the power to potentially recoup a small amount of tax revenue from interstate sales through a uniform system of third-party tax collection. Sadly, it appears that state and local officials would prefer to create a cozy tax cartel instead of relying on a "laboratories of democracy" model of competition between the states.

Many analysts have labeled the SSTP/SSUTA proposal "collusive federalism"[79] or "cartel federalism,"[80] because it runs counter to America's true federalist structure of government and has very little to do with protecting states' rights. In fact, if a state wants to simplify its sales tax base, it can do so and does not need to reach an agreement with other states. Federalism is about state independence, not state collusion. "It is unfortunate that supporters of the SSTP cloak their arguments in federalism. Their arguments rend the concept to the point of meaninglessness," argues Michael Flynn of ALEC.[81] And Empower America co-director Jack Kemp has argued that the proposal "does not appear to conform to its proponents' stated admiration for states' rights. . . . [It] turns over some of the most important state power—the power to formulate tax policy among them—to an ill-defined board or commission empanelled with representatives of unknown origin. . . . [It] would create a sub-national, supra-state, extra-constitutional (and possibly unconstitutional) governance body that is inconsistent with the principles of federalism and state sovereignty." Kemp concludes that the plan "is the very antithesis of American Federalism."[82]

Supporters of the SSUTA strongly dispute the claim that the proposed compact represents a tax cartel, yet there seems to be little doubt that the system would require a significant degree of collusion among the states to work. Participating states would have to agree on tax collection responsibilities and work together to enforce taxes on each other's companies and foreclose the opportunity for companies or consumers to escape taxes. Under this system, when an individual in New York buys a book on Amazon.com, he would be taxed at the New York rate, and Amazon.com would be required to collect that tax on the basis of the buyer's home zip code. It means that the buyer in New York will have no choice but to pay the New York tax rate on his purchases unless he decides to take his car and drive across the state lines to shop outside of New York. In other words, the individual would no longer be able to shop online in order to enjoy a lower tax rate or no tax, because he would systematically be charged the New York rate for every transaction. The State of New York would not be able to place its taxpayers in a situation where they are forced to pay New York's high tax rate without the help of other states that impose the collection responsibility on retailers. The handful of states that did not initially go along with the plan would likely join in very short order once they realized that their companies were being required to collect taxes from and remit them to far-off jurisdictions while they were not collecting taxes on out-of-state companies. This likelihood reinforces the collusive nature of the agreement.

Also, the harmonization and simplification envisioned by SSTP supporters would need to be strictly enforced by a multistate governance body to ensure that the system was truly simple enough to satisfy the *Quill* requirement that undue burdens not be placed on interstate commerce. Some remote vendors have argued that nothing short of one tax rate per state will satisfy that objective. But to go that far would require the SSTP governing board to demand that member states (and especially local governments) surrender an even bigger portion of their autonomy in the name of harmonization and simplification. (Again, Congress may require that anyway as a condition of SSUTA approval.) In fact, the SSUTA currently contains numerous provisions specifying how and when jurisdictions can change their tax rates or rules as well as sanctions for noncompliance.[83] So efforts to break from the pack or break the rules of the compact would be penalized by the governing board. This also reinforces the collusive nature of the SSUTA.

For these reasons, many scholars have expressed concerns about the SSUTA and have even gone so far as to label it a tax cartel. Semantics aside, at a minimum, what is certain is that the SSUTA (or any destination-based tax system that calls for the collection of taxes from out-of-state vendors) will require the blessing of Congress given its ramifications for interstate commerce and the language of Article I, Section 10, Clause 3 of the U.S. Constitution. An attempt by the states to implement the SSUTA compact without the formal permission of Congress would likely raise a court challenge. (Until such formal recognition of the compact by Congress was received the SSUTA would remain voluntary for both states and participating companies.)

Hopefully, Congress will carefully consider any plans to extend the power of the states to collect taxes on out-of-state purchases and to reduce tax competition. Writing for the Claremont Institute, Kent Lassman and Anna Duff note: "Congress must bear in mind the important point that the Constitution seeks primarily to protect interstate commerce, not interstate tax collection. One of the fundamental purposes of the Commerce Clause was

Supporters of the SSUTA strongly dispute the claim that the proposed compact represents a tax cartel, yet there seems to be little doubt that the system would require a significant degree of collusion.

to promote healthy tax competition among states in terms of taxation and regulation."[84] If Congress were to allow states to engage in their tax harmonization plans, a key element of limited government—jurisdictional competition between states—might suffer.

Second, it bears repeating that the reason the states are going to such lengths to overhaul the current sales and use tax system is that they remain wedded to a destination-based tax-sourcing scheme for interstate sales. A destination tax is levied on the full retail value of imports into a state. Interstate exports are exempt, and any tax collected before the export is refunded. Again, advocates of a destination-based tax on interstate imports claim it has several advantages.[85] Most notably, it is supposed to ensure equality of treatment between vendors in order not to distort the location of economic activity and to serve relatively well as a surrogate for user charges for the consumption of public services.

As discussed earlier, however, a destination-based sourcing methodology has many deficiencies. First, many destination-based advocates seem to assume that individuals and society would be better off with a higher tax burden. They reason that, under a destination-based system, the consumer in New York will face the same tax rate whether he buys a book at his local bookstore or over the Internet. The lack of distortion is supposedly consistent with economic efficiency. In other words, adding a tax to the good purchased though the Internet restores economic efficiency because it gets rid of the distortion. Advocates argue correctly that the consumer's decision about where to buy the good is distorted by differences in tax treatments. However, they forget that the tax introduces distortions of its own, causing substantial waste that economists call the deadweight loss of taxes. Then, they improperly assume that the efficiency loss from the distortion (the difference in tax treatment) is bigger than the deadweight loss of the added tax. Such a conclusion seems arbitrary. At the very least, it is an empirical issue that destination-based tax advocates have yet to prove.

States remain wedded to a destination-based tax-sourcing scheme for interstate sales.

People shop online because they want to pay fewer taxes and use the money they did not pay in taxes to buy something else that they really value. According to a study by Austan Goolsbee, "the people living in high sales tax locations are significantly more likely to buy online."[86] We can probably conclude that for those people getting rid of the distortion by forcing them to pay the tax will be less efficient and lessen tax competition.

More important, if tax neutrality is the absolute standard by which we should address all policy problems, then destination-based tax advocates may find themselves on a slippery slope. After all, the destination-based system found in the SSTP does not address the fact that an individual in Washington, D.C., can still, at almost no cost, shop in Virginia where the sales tax rate is lower. Cross-border shopping is still an option that induces a lot of distortions (in fact much more than the Internet considering how widespread cross-border shopping is).[87] So logically—if they really hold tax neutrality to be a sacrosanct principle—advocates of a destination-based tax should be in favor of equalizing or harmonizing sales tax rates across state lines so consumers do not have an incentive to drive to other states to shop and benefit from lower tax rates. In fact, to ensure a strict application of the SSTP or any other destination-based tax system, a taxpayer should face their home-state tax rate regardless of where or how they shop. To achieve perfect "fairness" or "neutrality," Main Street vendors would need to ask every consumer where he or she resides or plans to consume the good.

Kaye Caldwell, public policy director for CommerceNet, says that as a legal matter this may have to be the case for states to comply with constitutional jurisprudence on equal protection. "If states are allowed to impose use tax collection obligations on out-of-state eCommerce and mail order merchants then in order to comply with the Equal Protection clause they will have to impose those obligations on Main Street merchants also."[88] The practical enforcement costs and difficulties of such a requirement are obvious.[89] "Imagine the administrative nightmare for local stores when a convention comes to town!" notes Caldwell. Merchants would need to determine the proper tax jurisdiction, rates, and definitions for every out-of-state visitor.[90] While the SSUTA does not mandate a destination-based methodology so sweeping that *all* vendors will be required to collect such information about consumers, it remains an open question whether Caldwell is correct in thinking that eventual legal challenges brought under the Equal Protection Clause might force such a requirement.

Beside the significant enforcement costs, such a strict application of the destination-based tax principle would essentially eliminate most vestiges of legitimate tax competition and thereby the downward pressure such competition places on overall sales tax rates. Protected from the threat of seeing taxpayers shop in other states because taxes may be lower, tax authorities would have no incentive to keep their own tax rates low. In fact, the most fervent advocates of a destination-based tax explain how its alternative—an origin-based tax system—"while simpler to implement would induce *a race to the bottom*, as states compete to attract footloose industry by lowering taxes."[91]

A final concern related to the SSTP proposal involves the use of CSPs as tax collectors on behalf of the states. Deputizing third parties to collect taxes on behalf of the government is an idea with an unsettling history. In the study of economics, third-party tax collection systems are more commonly known as "tax farming" systems. Tax farming is the contracting-out of tax collection duties to private parties. Third-party agents typically bid for the right to collect taxes on behalf of the government and then take a certain share of the taxes collected to make it a profitable endeavor. Since antiquity, tax farming was viewed by many governments as a more efficient way to collect taxes. In practice, however, tax farming rarely worked as well as promised, and when it did, citizens came to despise it.[92]

This is because third-party tax collection systems create a perverse incentive for the deputized private-sector tax collectors to engage in overzealous enforcement activities in an effort to increase their own profits. To raise more revenues, tax farmers often engaged in disturbing practices. Consequently, citizens have rebelled against tax farming schemes or at least protested their existence. And with good reason. Third-party tax collection schemes pose a serious threat to citizens' property and privacy. Furthermore, the possibility of rampant fraud is always present in such schemes. Simply stated, there are many government functions that should be privatized, but tax collection is not one of them.

Despite claims to the contrary and a handful of safeguards included in the SSUTA, the CSP tax collection system being proposed under the compact could pose an equally serious threat to individual and corporate privacy, especially if certain CSPs become overzealous tax collectors or divulge personal data. Under the SSUTA, the CSPs would need to collect a variety of information to successfully collect taxes on interstate commercial transactions. This is quite unlike current *intra*state, origin-based sales tax transactions, which do not require the disclosure of similar information as part of the transaction.

In a typical transaction in a retail store, the buyer and seller exchange little more than money. Occasionally a vendor will ask for the zip code of the buyer, but such information is typically not required to be given by the buyer in order to complete the transaction. Under the SSUTA, there would have to be some way to track the location of the buyer at all times in order to remit money to the appropriate tax collectors. Other forms of consumer information would also be collected by the CSPs to facilitate the sale, including personal information about the consumer and the goods or services purchased. These things could compromise online confidentiality or anonymity and, in turn, discourage e-commerce. "Since most online consumers value their privacy, knowledge that a government contractor's software is embedded in the merchant's software and is recording the

Third-party tax collection schemes pose a serious threat to citizens' property and privacy.

name and address of each purchaser, along with the substance of each purchase—including book selection, the purchase of on-line content and entertainment, and procurement of drugs and other personal items—could inhibit online shopping," concludes attorney Lee Goodman.[93]

To summarize, the tax collection scheme the SSUTA envisions is neither as administratively simple as supporters claim, nor is it free of potential privacy violations. The SSUTA system would place substantial new tax collection obligations on vendors (including, possibly, Main Street merchants)[94] and require consumers to divulge more personal information than is currently required to complete a sale.

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In terms of the practical question of improved sales tax administration, one wonders whether the benefits of the SSUTA system would outweigh the costs and complexities associated with its creation. The current effort to "simplify" the sales tax system looks awfully complex. As Andrew Wagner and Wade Anderson summarize: "Efforts to overly complicate our existing destination-based tax system simply to capture one potentially small area of revenue escaping taxation is tantamount to shooting a mouse with an elephant gun. That is to say, is a radical overhaul of the entire destination-state sales tax really needed?"[95]

Option 2: Expand Efforts to Enforce Use Tax Collection

As previously discussed, every state that has a sales tax also has a use tax on its books, but use taxes remain difficult to collect and are seldom enforced. The level-playing-field concern that has animated state and local efforts to create a harmonized collection scheme for remote commerce such as the SSTP stems from the inability of states and localities to enforce existing use taxes. In theory, therefore, it seems that expanding efforts to collect use tax would address the collection problem and end level-playing-field concerns. It would also get around many of the constitutional concerns raised by state and local attempts to impose collection burdens on remote vendors of interstate commerce. Because use taxes instead impose the collection burden on the individual citizens within a jurisdictions, state and local governments can justly claim they have a right to take steps to collect those taxes.

In recent years some states have taken steps to increase compliance with use tax by stepping up oversight efforts by tax agencies employing new enforcement techniques and educating their citizenry about use tax responsibilities in general. For example, tax authorities in both Michigan and North Carolina have taken steps to make their use tax easier to apply to purchases made over the Internet.[96] They join states such as Connecticut, Idaho, Indiana, Kentucky, Maine, and Wisconsin, which have been trying for years to improve their collection mechanisms for use taxes.

Unfortunately, although this option addresses some of the concerns about neutrality and fairness, it raises other practical questions. To begin, despite stepped-up education and enforcement efforts, experience suggests that the use tax will remain very difficult to enforce. As Saba Ashraf noted in the *Florida State University Law Review* in 1997: "Collecting the use tax from the purchaser, particularly where the purchaser is an individual, is often inefficient and not cost-effective. This is especially so because many consumers do not realize they are subject to the tax."[97]

Also, if enforcement efforts are stepped up, what will happen to taxpayers who have not purchased any goods on the Internet? If a taxpayer reports "zero" in the new line on the income tax form for out-of-state purchases, will he be systematically subjected to an audit? Who will bear the burden of the proof? Will taxpayers have to prove that they did not buy anything on the Internet? How would one challenge the estimate of out-of-state purchases made by tax authorities?

Just how far are state and local officials willing to go to collect the use tax? The eagerness of some officials to capture this revenue was evidenced dramatically during a

December 1999 meeting of the ACEC, when Gov. William Janklow (R-S.D.), now a member of the U.S. House of Representatives, testified on behalf of the National Governors' Association, warning that, ultimately, "we're going to start stopping little brown trucks and going to start examining these packages," to determine whether taxes were paid on each purchase.[98] Although it is unclear whether America's governors and mayors will begin taking such drastic steps to monitor commercial transactions, Rep. Janklow's fears and frustrations regarding e-commerce illustrate the prevailing mood among state and local officials.

Finally, expanded enforcement of use taxes raises serious privacy concerns, because it would require a considerable increase in individual audits and the collection of personal data by state revenue officials. As Dana Mayton, a Kentucky state revenue official, told *USA Today* in 2000, "People really feel that use tax compliance is Big Brother at its finest."[99] In fact, history teaches that we have reason to be concerned about personal data collection by governments. Moreover, there seems to be little sense in going to such extremes to save a tax that is fundamentally unenforceable. "From the average consumer's standpoint, the use tax is probably the most ludicrous and patently unenforceable tax on the books," argues Doug Lathrop.[100] "It requires the citizen to become, in effect, a state tax collector. From what we know of human behavior, it defies logic to expect people to save all their sales receipts from trips to other states, calculate the sales tax of their home state, and then write a check for the amount."

This explains why, in order to effectively levy and collect use taxes on their citizens, states have sought to impose a collection obligation on out-of-state vendors requiring them to calculate, collect, and remit the taxes owed by in-state consumers. But under existing Supreme Court precedent, the states are forbidden to impose such a collection burden on remote vendors unless those vendors have a "nexus," such as a store or shipping center, in the taxing jurisdiction. States and local governments would need Congress to relax or lift the Supreme Court *Quill* restriction that forbids them to impose collection responsibilities for use taxes in such an extraterritorial fashion.

Option 3: Maintain the Status Quo

A third option is to maintain the status quo. If nothing were to change at the state or the federal level, Supreme Court nexus precedents would continue to provide the general guidelines for how sales and use taxes are applied to interstate commercial activity, including mail order, catalog sales, and 800-number sales, as well as e-commerce.

Clearly, maintaining the status quo is a very appealing option, and policymakers would be wise not to abandon it hastily if the alternatives result in higher tax burdens. More specifically, the status quo would clearly be preferable to the other reform options currently being given serious consideration, such as the SSUTA. For one thing, the current legal arrangement has enabled the interstate market for mail order, catalog, and e-commerce activity to thrive, free of burdensome tax collection duties. Although it would be wrong to make an "infant industry" argument for special treatment for these sectors, it seems logical that an increase in the tax burden would have a debilitating effect, especially on the struggling "dot-com" sector. An empirical study by Austin Goolsbee shows that local taxation plays an influential role in online commerce and that "applying existing sales taxes to the Internet might reduce the number of online buyers by 24 percent or more."[101]

Although maintaining the status quo for the interstate market and remote sales tax collection remains an appealing option, state and local officials will continue to bemoan the supposed un-level playing field between remote sellers and Main Street vendors. Even though remote commerce does not pose a serious threat to Main Street businesses or the sales tax base, the argument that the sales tax regime should not artificially favor some

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A better option would be to reinforce and clarify nexus standards in light of the rise of e-commerce and the many confusing tax nexus questions that have resulted.

sales channels over others possesses considerable force. As discussed below, however, there are better ways to address this problem than by adopting a multistate tax compact such as the SSUTA.

Option 4: Reinforce Current Nexus Guidelines

A better option than merely maintaining the status quo would be to reinforce and clarify nexus standards in light of the rise of e-commerce and the many confusing tax nexus questions that have resulted. Building on the Supreme Court's *Quill* decision, the idea would be for federal policymakers to flesh out and clarify situations and activities in which the use of the Internet (as a means of communications and sales solicitation) would not be considered evidence of physical presence and therefore would not establish a business's nexus in a state for tax purposes. This is commonly referred to as establishing "bright-line" nexus tests or standards, because it would provide safe harbors for certain types of commercial transactions while making clear which activities would cross the nexus threshold and establish physical presence so that a tax jurisdiction could impose duties to collect sales or use taxes.

This option was outlined in a bill (S. 2401)[102] introduced in the 106th Congress by Sens. Judd Gregg (R-N.H.) and Herb Kohl (D-Wis.) based on a plan created by Dean Andal of the California State Board of Equalization, a former member of the Advisory Commission on Electronic Commerce.[103] The Gregg-Kohl bill and the Andal plan would have broadened the protections provided by *Quill* by specifically enumerating the types of Internet transactions or activities that could and could not be taxed. Gregg-Kohl would have substituted a "substantial physical presence" standard for the less inclusive "physical presence" test outlined in *Quill*, so it would become clear that without a significant presence in a particular state, companies would not be forced to collect taxes for that taxing jurisdiction. In particular, under the Gregg-Kohl proposal, the following activities *would not*, in and of themselves, establish tax nexus for interstate vendors of e-commerce:[104]

- The solicitation of orders or contracts for tangible or intangible property or services that are approved outside a state and are fulfilled from a point outside the state.
- The presence or use of intangible property in a state, such as patents, copyrights, trademarks, logos, securities contracts, money, deposits, electronic or digital signals, and Web pages.
- The use of the Internet to maintain a Web site accessible by customers in a state.
- The use of an Internet service provider, online service provider, or other types of Internet access providers, or World Wide Web hosting services to maintain, take, or process orders via a Web page site or server located in a state.
- The use of any service producer for transmission or communication by cable, satellite, radio, telecommunication, or similar systems.
- The affiliation with a person located in a state, unless the person is an "agent" of the business entity who meets the substantial physical presence standard.
- The use of independent contractors or representatives for warranty or repair services.

Nexus clarification along those lines would certainly benefit consumers and businesses by answering many complicated questions surrounding the tax treatment of remote sales and e-commerce. As Supreme Court precedents have shown, determining nexus is a messy business, an imprecise science to say the least. Although the courts have struck a reasonable balance when confronted with complicated disputes, there remains a substantial degree of ambiguity in modern nexus jurisprudence. Efforts such as the Andal proposal and the Gregg-Kohl bill clearly cannot anticipate all the possible disputes or future developments involving remote commercial tax disputes, but they can at least attempt to bring nexus law into the 21st century by clarifying the application of Supreme Court and constitutional principles to the more complicated technical issues of the day.

Even though many remote vendors would endorse such a proposal, most state and local officials and tax groups continue to oppose any effort to clarify or refine the *Quill* decision or expand nexus guidelines in general. According to a CRS Report for Congress on Internet tax legislation, "state and local governments generally oppose federal efforts to codify nexus standards, which they view as unduly restricting states' ability to levy business activity (income) taxes as well as sales and use taxes."[105] This is highly unfortunate because a nexus clarification proposal would provide exactly the sort of certainty the current system lacks and offer remote sellers the protection they deserve from unwarranted extraterritorial tax schemes.

Option 5: Specifically Exempt All Internet Sales/E-Commerce from Sales and Use Taxes

Some federal legislators have suggested that the easiest way to solve the problems raised by the imposition of sales and use taxes on the Internet is simply to prohibit the taxation of e-commerce altogether. For example, in the 106th Congress, such outright prohibitions of state and local sales taxation of e-commerce were proposed by Rep. John Kasich (H.R. 3252) and Sen. John McCain (S. 1104). Such reform alternatives were defended on the grounds that e-commerce is the source of increased productivity and as such should be exempted to provide a chance for this important new sector to flourish.

Even though this option might sound appealing to some, it is highly improbable that it would be proposed by many state or local level officials; only federal legislators would be ever be likely to consider seriously such an outright ban on all such taxes. And state and local leaders would certainly challenge the constitutionality of such a move since it would prohibit them from collecting taxes on sales made within their own borders. And, once again, fundamental tax fairness concerns would be left undressed by such a proposal. In fact, a federal ban on all e-commerce taxes would obviously exacerbate existing tax exemptions and asymmetries.

Option 6: Provide Sales Tax Exemptions for Tangible Products with Digital Equivalents

Main Street retailers continue to claim that they suffer a competitive disadvantage relative to their Internet counterparts who do not face the same tax collection burdens. One potential partial solution would be to exempt those items sold by traditional vendors that cyber-retailers sell in digital format, such as musical compact discs, digital videos, books and magazines, and other forms of entertainment. In other words, exempt the sale of all digitized goods, and also exempt their non-digitized counterparts that are sold by traditional vendors.

This was an option debated by the Advisory Commission on Electronic Commerce and subsequently embodied in a legislative proposal (H.R. 4267) put forward by Reps. Henry Hyde (R-Ill.) and John Conyers (D-Mich.) in the 106th Congress.[106]

The problem with this solution is that the concern about a level playing field would remain since many goods not sold through the Internet would still be subjected to a tax. In fact, those goods, and the providers of those goods, would then face a disproportionate sales tax burden as the list of exempted goods expanded. Moreover, even if state and local officials were to consider such a reform option, which seems highly unlikely, it would be extremely difficult for them to decide where to draw the line to determine which goods would be exempted and which would not. Finally, as the universe of goods offered online continues to grow, providing matching online and offline exemptions in the name of tax fairness would place another serious strain on the already diminished sales tax base. For these reasons, this option is not

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likely to be considered seriously by most state or local officials or Congress.

Option 7: Reform Sales Tax Policies or End Exemptions to Broaden the Base

The current sales and use tax base is riddled with holes largely because state and local officials have spent decades playing politics with the tax code to favor certain industries or interests. In one sense, therefore, if state and local officials wanted to get really serious about tax neutrality and create a perfectly level tax playing field, they would need to end all exemptions for favored products and industries (e.g., food, groceries, prescription drugs, and clothing), and all service industry activities.

This reform option is highly improbable, however, simply because it is such a politically sensitive solution. There is a reason why the sales tax base ended up the way it did, replete with loopholes and exemptions. Politicians love to tinker with the tax code in order to grant special treatment to interest groups and businesses in exchange for votes. Those interest groups and businesses have little incentive to stop lobbying politicians for such exemptions. In fact, on the rare occasions that state and local officials have attempted to end certain goods- or service-based exemptions, the affected interests fought back with a vengeance and in almost every case killed the proposals or forced the repeal of the reform efforts shortly after they went into effect.[107]

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The more serious problem from a consumer perspective is that it would lead to tax increases on a wide variety of popular goods and services. If the affected industries did not lead the revolt against such proposals, consumers likely would. And practically speaking, taxing services would create significant enforcement burdens and potentially raise privacy questions, especially for digital services.

Option 8: Adopt a Uniform Origin-Based System of Sales Tax Collection

The existing sales and use tax regimes—and most proposals to reform Internet taxation—are based on sourcing interstate sales transactions to the destination of sale (the customer's shipping or billing address).[108] As mentioned previously, relying on a destination-based sourcing methodology raises a variety of problems, especially when the changing nature of the economy is taken into account. "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," notes Michael Greve.[109]

By comparison, under an origin-based sourcing rule—also referred to as a "seller-state," "vendor-state," or "source-based" rule by some scholars—all interstate sales through all channels (traditional stores or cyber-retailers) would be taxed at the point of sale (meaning the company's "principal place of business") instead of at the point of destination, if the state or locality chooses to impose a tax. All goods within a given state or locality would be taxed at the locally applicable rate no matter how they were purchased and no matter where they were consumed.

This option would take care of most of the problems posed by the destination-based methodology that is favored by most state and local policymakers today. Terry Ryan and Eric Miethke, and many other sales tax scholars, have detailed the many advantages of an origin-based system.[110] According to its proponents, an origin-based or seller-state system would do the following:

- **Minimize the burden on sellers** by requiring sellers to know and abide by the tax rates and regulations within their principal place of business instead of the rates and definitions of 7,500 different taxing jurisdictions. This is "an especially important advantage for smaller firms with relatively high compliance costs."[111]
- **Ensure tax parity between Main Street vendors and remote sellers:** "An origin-based sales tax is not discriminatory because it can be applied to

all sales within a state in a uniform and nondiscriminatory manner. By its very nature it tends to level the playing field," argue Andrew Wagner and Wade Anderson.[112] This would eliminate concerns about neutrality and fairness because no difference in tax treatment would occur; in-state Internet vendors would be taxed on the same terms as in-state bricks-and-mortar merchants. For instance, if a consumer purchases a book from Amazon.com, whose principal place of business is Seattle, the sales tax rate for the city of Seattle and the state of Washington would apply, just as if the consumer walked into a traditional store in Seattle and purchased a book while visiting the city.

- **Do away with the need for a multi-state collection arrangement such as the SSTP** by eliminating any need to trace interstate transactions to the final point of consumption. Frieden notes that "if sales are sourced to the vendor state, there is no *Quill Corp. v. North Dakota* or constitutional nexus problem. The vendor state already has the constitutional authority to require the seller to collect sales or use tax in the state of origin."[113]
- **Remove nexus uncertainties and constitutional concerns**, because only companies within a state or local government's borders would be taxed. "An origin-based system wipes away all the questions about nexus and liability for multiple tax jurisdictions," notes Doug Lathrop.[114] Indeed, Paul Gessing of the National Taxpayers Union writes, "This would in essence be the ultimate form of nexus simplification."[115] Although he is not a proponent of an origin-based rule, Karl Frieden nonetheless notes: "If the state-of-origin rule is used, then there need be no burdensome administrative rules on how to identify the state of consumption or, as an alternative, the location of the consumer's billing address. Likewise, there is no need to develop rules for sourcing sales that involve multiple users because these sales are all sourced back to the state of origin."[116] Indeed, opting for an origin-based sourcing rule would likely be a superior alternative to nexus clarification because nexus clarification schemes will always fail to conceive of all the ways in which creative tax collectors might attempt to impose collection duties on remote sellers. By contrast, an origin-based sourcing rule would simply need to define the "principal place of business" for sourcing purposes, and then no additional tax obligations could be imposed. Finally, the constitutionality of an origin-based system should certainly not be a problem, especially in light of the Supreme Court's 1995 decision in *Oklahoma Tax Commission v. Jefferson Lines*,[117] which held that a state could impose a tax on the full value of a bus ticket purchased in Oklahoma even though part of the trip took place out of state. In essence, the Court reasoned that the sales tax should be an unapportioned tax on the full value of a good or service that is affixed at the point where the service is performed or the good is sold.[118] This is basically an endorsement of an origin-based sourcing methodology.[119]
- **Largely remove any need for continued reliance on the use tax** because all transactions would henceforth be sourced to the origin of sale and collected immediately by the vendor at that point. Even proponents of a destination-based system like William Fox and Matthew Murray are forced to admit that origin-based taxes "have clear compliance and administrative cost advantages over their destination-based counterparts through the elimination of the use tax problem."[120]
- **Respect buyers' privacy rights** by eliminating the need to collect any special or unique information about a buyer, and by not using third-party tax collectors to gather information about buyers. Under an origin-based scheme, vendors need only know the tax rates and rules of their principal place of business.[121]

Under an origin-based sourcing rule all interstate sales through all channels would be taxed at the point of sale.

An origin-based system would not require the extensive harmonization or multistate tax administration efforts envisioned in a destination-based plan.

- **Respect federalism principles and enhance jurisdictional tax competition** by permitting each state to determine its own tax policies and encouraging healthy state-by-state tax rivalry. Under an origin-based tax system, tax jurisdictions have an incentive to lower tax rates to attract businesses and hence consumer purchases. Such tax competition between jurisdictions lowers overall tax rates and reduces the inefficiency of the tax system as a whole. In economic terms, origin-based tax systems lead to lower marginal tax rates and to smaller deadweight losses from taxes. In addition: "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," argues Greve.[122] An origin-based system would not require the extensive harmonization or centralized, collusive multistate tax administration efforts envisioned in a destination-based plan like the SSTP.
- **Preserve local jurisdictional tax authority** where a harmonization proposal like the SSTP plans would create a de facto national sales tax system and run roughshod over local governments. Under an origin-based plan, local governments could retain whatever tax rate and tax base schemes they want; no harmonization or centralization would be required.
- **May be more politically feasible** because it remains unclear whether Congress or the courts will alter existing nexus standards and allow extraterritorial taxation by state and local governments according to a destination-based scheme.
- **May maximize the amount of tax collected for states** by making compliance easier and incorporating activities that are currently untaxed. Simply stated, an origin-based methodology would at least offer state and local governments the ability to collect taxes on remote sales activities that originate within their jurisdictional boundaries rather than continue a potentially futile effort to concoct multistate harmonization schemes to enforce use taxes.

Given the many advantages of an origin-based scheme over destination-based alternatives, why haven't many state or local officials considered it as a serious alternative in this debate? State and local officials remain wedded to a destination-based system mostly because they believe that an origin-based system of sales taxation would constrain their ability to tax out-of-state vendors and force them to make tough political decisions within their own jurisdictions regarding how the tax burden is to be assessed. Governors, mayors, and other local tax officials fear the prospect of dealing with the vigorous jurisdictional tax competition that would exist under an origin-based system, because companies could "shop around" for the more hospitable tax environments. Some critics posit that increased tax competition would lead to a "race to the bottom" in terms of tax rates, as state and local governments attempt to attract new companies by lowering rates.[123]

But tax competition is a healthy part of a federalist system of government, and it should be viewed as a benefit, not a drawback, of an origin-based system. Competition between governments serves the same function as competition between private businesses and can help protect taxpayers against abuses or excessive tax burdens. Moreover, the "race to the bottom" fear is probably overblown. Tax policy is only one of many factors consumers or corporations consider when determining where to live or locate their businesses. Proximity to consumers or suppliers, quality of local educational system or worker base, loyalty to local employees and communities, and other general issues related to standard of living are values or considerations that also bear on the minds of businesspeople and consumers when deciding where to reside. Some companies may choose to "pick up shop" and move to more hospitable jurisdictions if tax rates become excessive under an origin-based system, but it is unlikely that there will be a mass exodus of firms from one state to another, or offshore.

A more sophisticated critique of an origin-based methodology for remote sales is that it fails to achieve the primary goal of the sales tax—to assess the tax on those users who benefit from the consumption of public services. Again, in theory, the sales tax is a levy on the consumption or use of goods within a given jurisdiction in return for which the consumer of those goods receives some benefit. An origin-based tax methodology for remote commerce actually better honors this "benefit principle" than does a destination-based system. After all, who is really benefiting more from the taxes that are being paid in the case of an interstate transaction—the seller or the buyer? For the most part, the public services used to facilitate an interstate transaction are primarily "depleted" or consumed in the seller's state, not the buyer's. If remote sellers are forced to collect taxes on behalf of far-off jurisdictions, as the SSTP envisions, the benefit principle is violated, because a remote vendor is in no way benefiting from the public services paid for by those taxes. Moreover, this supposed drawback of the origin-based system has to be measured against the many downsides associated with the current destination-based system, which doesn't work very well in practice and raises a number of constitutional concerns because of the extraterritorial character of remote collection of sales and taxes. An origin-based system, by contrast, raises no such problems.

Of course, an origin-based tax system does raise some technical issues that will need to be worked out. For instance, how do we define the point of origin? In the case of goods purchased over the Internet, is the point of origin the place where the company is headquartered, or the place where the goods are produced? Is it the place from which the good is shipped or the place where the good is received? The origin-based methodology could be worked out among the states or outlined by Congress. Indeed, there already are a few examples of such origin-based systems in place for interstate flower orders,[124] the sale of prepaid long distance calling cards,[125] and the taxation of mobile cell phones.[126] A "principal place of business" rule would likely be the result, determining the origin of sale by calculating where a seller had the bulk of its employees and generated most of its profits.

As long as state and local policymakers remain committed to preserving the sales tax system as their primary tax base, the pure origin-based rule outlined here offers them an economically sensible and constitutionally permissible method of taxing e-commerce sales. And an origin-based system would also be a better alternative for taxpayers and vendors of interstate commerce because it offers them a straightforward tax rule that they can understand and comply with. Regrettably, however, it is not clear where the political support will come from to transform this concept into law. The support is not likely to come from the state governments supporting the SSTP, nor will it come from states that have a limited base of technology companies within their borders. Such states would fear they would be on the losing end of the battle to attract a greater high-tech base, or that an origin-based approach would produce ruinous levels of tax competition. Although such fears are greatly overblown, perception sometimes drives reality in the debate over tax policy and will make it difficult for an origin-based proposal to gain much support.

Option 9: Abolish All Sales and Use Taxes

Because many economists agree that the sales and use tax system seems seriously threatened by its eroding base and potentially intractable compliance problems regarding interstate sales, one radical option to resolve this debate would be for states and localities simply to abolish sales and use taxation altogether. This option could be achieved by find-

As long as state and local policymakers remain committed to preserving the sales tax, the origin-based rule offers them a sensible method of taxing e-commerce.

The goal should be to move toward a system of consumption taxation that is both economically efficient and constitutionally permissible.

ing alternative revenue mechanisms to provide needed government revenues. Correspondingly, of course, government budgets could be trimmed to bring spending down to more reasonable and limited levels.

But although total repeal of the sales tax system is theoretically appealing, practically speaking it is highly improbable. Even in the midst of a general erosion of the sales tax base, most state and local governments remain committed to preserving the sales tax as a revenue mechanism, given their historical reliance on it. Moreover, abolishing the sales tax would pose special problems for states such as Tennessee, Washington, or Florida that do not have an income tax. Abolishing the sales tax in those states would almost certainly lead to calls for the adoption of an income tax, which would not be optimal. However, if states were to entertain the idea of eliminating their sales tax system and moving to an income tax system, there are ways to structure the income tax code to capture consumption activity more efficiently and effectively, as the final option reveals.

Option 10: Adopt a Savings-Exempt Income Tax to Tax Individual Consumption

"If indeed the administrative problems of imposing sales and use taxes through the Internet are insurmountable, exempting electronic commerce from transaction taxes and developing another method of reaching the wealth added by such commerce may be appropriate," argue Ryan and Miethke.[127] Moreover, if the sales tax base continues to experience steady erosion and average sales tax rates continue to rise over time, the sales tax system may become increasingly unworkable and an unfair burden on taxpayers and businesses. If this proves to be the case and no reforms are undertaken in the near term to address the issue, state and local officials may eventually have to consider abolishing product-based (or transaction-based) consumption taxation altogether.

But alternative methods of taxing consumption exist. As Varian has noted, "If you want a consumption tax, there is a much easier way to do it than to track and tax each and every purchase."[128] Like many other economists, Varian endorsed some variation of a savings-exempt income tax (SEIT) or "consumed income tax" as a superior method of levying taxes on individual consumption. As any Economics 101 textbook makes clear, consumption is simply income minus savings. Consequently, taxing consumption through the income tax code presents an alternative way to achieve the same end the sales tax attempts to accomplish. Under a SEIT, after all savings activity was exempted from taxation, the remainder would be consider an individual's consumption activity and taxed by governments at rates of their own choosing. Varian continues:

> Since many forms of savings, like Keogh plans, I.R.A.'s and pension contributions, are deducted from income before the tax is computed, our current federal and state "income" taxes are effectively consumption taxes, at least for many taxpayers. Making savings tax-deductible is better than direct taxation of consumption since it has much lower administrative costs. And the definition of savings can be adjusted so that only saving that leads to real capital formation qualifies for a deduction.[129]

The real advantage of a SEIT is that by shifting consumption taxes to the income code, a greater proportion of actual individual consumption would likely be captured since there would be fewer exemptions for politically favored goods or industries. And all individual consumption of services and interstate goods (including e-commerce) would be captured by a SEIT. So any "level playing field" concerns associated with the current system would disappear. As a result, whereas the current sales tax system in America captures less than 50 percent of real individual consumption by some measures, a SEIT would likely capture most consumption that took place within the economy.

And supporters also claim it would accomplish this without entailing the administrative complexity associated with the current sales and use tax system. For these reasons, a SEIT is certainly a feasible alternative to the current sales tax system and has been endorsed by a number of economists.[130]

As with the other options discussed here, however, there are some serious drawbacks to this reform option. Most notably, abolishing the sales tax outright remains very unpopular among politicians and would present special problems for states that rely exclusively on sales taxes as a revenue-generating method. Until the situation grows more grave for them, many state and local governments will reject any suggestion that the sales tax system should be abandoned. Of course, if they already have an income tax system to fall back on, they may be able to make a transition work over time without much pain. But for states without an income tax, such a transition would be much more difficult and potentially very unpopular with the citizenry. There may also be some difficulty in how "savings" is defined from one taxing jurisdiction to another when creating a SEIT, although this would not likely prevent such a system from being effective. Finally, like other income tax systems and proposals, a SEIT would continue to require the presence of the IRS at the federal level and equivalent bodies at the state level. Supporters of sales tax systems, including a national retail sales tax, point out that sales tax systems would not necessarily require as much bureaucracy, and would therefore pose less of a threat to privacy or civil liberties.

Conclusion

The goal of current sales tax reform efforts should not be to rework America's sales tax system only to create a more Byzantine, intrusive, or anti-competitive system of taxation. The goal should be to move toward a system of consumption taxation that is both economically efficient and constitutionally permissible. And tax competition should be regarded as a virtue, not a drawback, within any new system.

The debate over the taxation of remote sales and e-commerce in particular has brought these issues to the fore. It would be wrong, however, for state and local officials to pin the blame for their sales tax woes on the Internet, which has only recently began posing any sort of threat to the sales tax system, and only a marginal one at that. Most of the issues that state and local officials are being forced to deal with today are longstanding problems largely created by years of meddling with the sales tax code and an unwillingness to adapt to changing economic realities. More specifically, states' fiscal problems have been brought on by their profligate spending habits.

The guiding ethi of this debate must remain tax competition, not tax collusion.

Although all the solutions on the table have a serious downside, a pure origin-based sourcing rule for all sales taxes presents an economically efficient and constitutionally sensible solution to the nagging tax "fairness" and "neutrality" concerns expressed by many policymakers and Main Street vendors. Moreover, an origin-based sourcing rule is vastly superior to a collusive multistate tax compact such as the SSUTA. Preserving the Supreme Court nexus jurisprudence would be a better option than moving forward with the SSUTA plan. Clarifying and codifying those nexus standards would be an even better option. Alternatively, if some states or localities seek to move away from transaction-based consumption taxation, then a savings-exempt income tax might present an alternative method of levying taxes on individual consumption. The important point to recognize is that alternatives exist to the SSUTA plan. But each of them has advantages and disadvantages.

In the end, states and localities may continue to experiment with varying systems of enforcing collection of sales and use taxes and try to make the current system work. But if they choose to do so, they must abide by the constitutional protections and nexus guidelines that have protected the channels of interstate commerce in previous decades.

It would be wrong for members of Congress to abdicate their responsibility to safeguard the national marketplace by giving the states carte blanche to tax interstate commercial activities through a tax compact. The guiding ethic of this debate must remain tax competition, not tax collusion.

Notes

1. See U.S. Department Of Commerce, www.census.gov/mrts/www/current.html.

2. James S. Gilmore III, "No Internet Tax," A proposal submitted to the Policies & Options Paper of the Advisory Commission on Electronic Commerce, November 8, 1999, www.ecommerce commission.org/document/107gilmoreProposal.doc. Emphasis in original.

3. Michael O. Leavitt, "Streamlining the Sales Tax System," Address to the National Press Club, Washington, D.C., November 16, 1999.

4. For more information on the evolution of the sales tax see John Due and John Mikesell, *Sales Taxation: State and Local Tax Structure and Administration*, 2nd ed. (Washington: Urban Institute Press, 1994).

5. Alaska, Delaware, Montana, New Hampshire, and Oregon currently do not impose general sales taxes at the state level. However, numerous boroughs and cities in Alaska have their own local sales taxes. Also, the other four states impose sales-type taxes on specific transactions, such as accommodations.

6. See General Accounting Office, "Sales Taxes: Electronic Growth Presents Challenges; Revenue Losses Are Uncertain," GAO Report to Congressional Requesters, June 2000, p. 14.

7. 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 & Young White Paper, September 8, 1999, p. 12, www.ecommercecommission.org/document/MastersOfComplexity.pdf.

8. See Ariana Eunjung Cha, "Main Street Takes On the Internet," *Washington Post*, September 20, 2000, p. G10; and Louis Jacobson, "Main Street Marshals Its Troops," *National Journal*, April 29, 2000, p. 1364.

9. Karl Frieden, *Cybertaxation: The Taxation of E-Commerce* (Chicago: CCH, 2000), p. 134.

10. *National Bellas Hess v. Department of Revenue of State of Illinois*, 386 U.S. 753 (1967).

11. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

12. *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).

13. *Miller Bros. Co. v. State of Maryland*, 347 U.S. 340 (1954).

14. See *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62 (1939); *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359 (1941); and *Nelson v. Montgomery Ward & Co.*, 312 U.S. 373 (1941).

15. *Bellas Hess* at 753.

16. *Bellas Hess* at 753.

17. *State of Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1941).

18. *Bellas Hess* at 753.

19. Article I, Section 8, Clause 3 of the U.S. Constitution empowers Congress to keep the lanes of interstate commerce free of burdensome state taxation and regulation. It reads: "Congress shall have the power . . . to regulate commerce with foreign nations, and among the several States, and with Indian tribes."

20. For more information on dormant Commerce Clause jurisprudence, see Adam D. Thierer, *The Delicate Balance: Federalism, Interstate Commerce, and Economic Freedom in the Technological Age* (Washington: The Heritage Foundation, 1999), pp. 58–61. As Justice Stephen Field concluded in the Supreme Court's 1875 *Welton v. Missouri* decision, "The fact that Congress has not seen fit to prescribe any specific rules to govern inter-State commerce does not affect the question. Its inaction on this subject . . . is equivalent to a declaration that inter-State commerce shall be free and untrammelled." *Welton v. Missouri*, 91 U.S. 275 (1875). For other examples of such dormant Commerce Clause decisions, see *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1 (1824); *Willson v. Black Bird Creek Marsh Co.*, 27 U.S. 252 (1829); *Cooley v. Board of Wardens*, 53 U.S. (12 How.) 299 (1851); *Philadelphia v. New Jersey*, 437 U.S. 617 (1978); *Pike v. Bruce Church, Inc.,* 397 U.S. 137, 142 (1970); *Bibb v. Navajo Freight Lines, Inc.,* 359 U.S. 520, 529 (1959); *Dean Milk Co. v. City of Madison*, 340 U.S. 349, 354 (1951); *Hunt v. Washington State Apple Advertising Commission*, 432 U.S. 333, 350 (1977); *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269 (1988); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994); *Bendix Autolite Corp. v. Midwesco Enterprises, Inc.*, 486 U.S. 888 (1998).

21. *Quill Corporation* at 298.

22. Ibid.

23. See Terry Ryan and Eric Miethke, "The Seller-State Option: Solving the Electronic Commerce Dilemma," *State Tax Notes*, October 5, 1998, pp. 889–91.

24. Sen. Dale Bumpers (D-Ark.) introduced legislation in the 103rd (S. 1825), 104th (S. 545), and 105th (S. 1586) Congresses that would have authorized state and local collection of taxes from remote vendors.

25. *Bellas Hess* at 753.

26. *Quill Corporation* at 298.

27. Charles Tiebout, "A Pure Theory of Local Expenditure," *Journal of Political Economy*, October 1956. A comprehensive discussion can be found in Daphne A. Kenyon, "Theories of Interjurisdictional Competition," *New England Economic Review*, March/ April 1997, pp. 13–31.

28. Doug Lathrop, "A Square Peg in a Round Hole: The Internet's Challenge to State Tax Systems—Part One," American Legislative Exchange Council, *ALEC Issue Analysis*, March 2000, p. 2.

29. "While agricultural interests have lost much of their clout in many state capitals today, they once exercised powerful influence on state and local tax policies, and those historical taxing patterns have not been erased." Ronald John Hy and William L. Waugh Jr., *State and Local Tax Policies: A Comparative Handbook* (Westport, Conn.: Greenwood, 1995), p. 96.

30. See David Brunori, "Dumber Than a Bag of Hammers," Tax Analysts, *Tax.org*, 2001 STT 48-63, March 5, 2001, www.tax.org/readingsintax policy.nsf/55ae6f9cd4c03e08852566cf00659cb9/ 6f430cfd65f7e30785256b8200802564.

31. Doug Abrahms, "Hurdles Remain in Hammering Out Online Tax Laws," *USA Today*, January 22, 2003, www.usatoday.com/tech/news/techpolicy/20 03-01-22-online-taxes_x.htm.

32. Karl Frieden notes: "Most states . . . still tax virtually no services (other than telecommunications services). In the last 15 years, only two states—Florida and Massachusetts—have made a large-scale effort to expand their tax base to include a wide range of services. Both efforts resulted in a political maelstrom, with the Florida legislation being repealed after six months and the Massachusetts legislation being repealed after three days." Frieden, p. 64.

33. Andrew Wagner and Wade Anderson, "Origin-Based Taxation of Internet Commerce," *State Tax Notes*, July 19, 1999, p. 188.

34. Charles E. McLure Jr., "Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the Sales Tax or Discard It?" *Brigham Young University Law Review*, 2000, p. 88.

35. Typically a use tax is defined as a tax on the storage, use, or consumption of tangible personal property in the state.

36. Wagner and Anderson, p. 190. Dean Andal, former chairman of the California Board of Equalization, agrees, noting: "The use tax is not a surrogate consumption tax as some would suggest. It was a device conceived to protect in-state merchants." Dean Andal, "A Uniform Jurisdictional Standard: Applying the Substantial Physical Presence Standard to Electronic Commerce," Presentation to the Advisory Commission on Electronic Commerce, September 15, 1999, revised November 5, 1999, p. 13.

37. House Committee on the Judiciary, "State Taxation of Interstate Commerce, Part III, Sales and Use Taxes," Report of the Subcommittee on State Taxation of Interstate Commerce, U.S. House of Representatives report no. 565, vol. 3, 89th Congress (Washington: U.S. Government Printing Office, June 30, 1965), p. 613.

38. Ryan and Miethke, "The Seller-State Option: Solving the Electronic Commerce Dilemma," *State Tax Notes*, October 5, 1998, p. 881. Ryan and Miethke continue: "In essence, the remote seller has made it possible for the purchaser to electronically leave its home state and travel to the seller's place of business, look through the merchandise at the store, and bring it to the electronic cash register for purchase." Ibid., p. 882.

39. Andal, p. 13. Cline and Neubig also note: "Identifying where consumption occurs will become increasingly more difficult in the Internet environment where products can be delivered electronically without knowledge of the purchasers' residence and payment can be made in e-cash. E-commerce has the potential to create a large and growing set of retail transactions that may be impossible or costly to attribute to a specific location." Cline and Neubig, p. 24.

40. Frieden, p. 180.

41. See David R. Burton and Dan R. Mastromarco, "Emancipating America from the Income Tax: How a National Sales Tax Would Work," Cato Institute Policy Analysis no. 272, April 15, 1997, www.cato.org /pubs/pas/pa-272.html.

42. Even if America did have a national sales tax it does not mean that it would completely pre-

empt state and local administration of the sales tax. Would states seek to conform their existing tax systems (especially their tax base and definitions) to the national sales tax, or instead work within the confines of the national sales tax system to administer sales taxes according the a federally defined tax base?

43. The complexity of the sales and use tax system for interstate vendors is hardly a recent phenomenon. It was described in similar terms almost 40 years ago by the Willis Commission: "Significant problems have been encountered in the application of the tax to interstate transactions. Viewed broadly, these problems appear to stem from a tax system which tends to divide a national market into insulated blocks of consumers, with each sales tax State erecting its own scheme for taxing consumption within its borders. Could the tax be collected from each individual and business as goods were consumed by them, differences in schemes from State to State would be of little consequence. However, the usual method of imposition everywhere is collection of the tax by the seller at the time of sale. As a result, a firm selling in a number of States is required to meet the peculiarities of the law in each State. If the seller is beyond the jurisdiction of the State or otherwise does not collect the tax, the sale is likely to end up tax free. For local businessmen, this raises the specter of competitive disadvantage; for the States it means a loss of revenue." See House Committee on the Judiciary, p. 879.

44. Cline and Neubig, p. iii.

45. Ibid., p. iii.

46. Michael Mazerov, "A Five-Year Extension of the Internet Tax Moratorium Would Further Erode The Tax Base of States and Localities," Center on Budget and Policy Priorities, September 4, 2001.

47. See U.S. Department of Commerce, www.census.gov/mrts/www/current.html.

48. Quoted in "Minor Concessions: Governors Are Still Itching to Tax the Internet," *Las Vegas Review-Journal*, March 3, 2000, www.lvrj.com/lvrj_home/2000/Mar-03-Fri-2000/opinion/13069957.html.

49. "State Legislatures React to Changing Economy," NCSL *News Release*, February 28, 2001, www.ncsl.org/ programs/press/2001/pr010228.htm.

50. Office of Management and Budget, Historical Tables of the Budget of the United States Government—fiscal Year 2001, Table 1.30.

51. Chris Edwards, Stephen Moore, and Phil Kerpen, "States Face Fiscal Crunch after 1990s Spending Surge," Cato Institute Briefing Paper no. 80, February 12, 2003, p. 1, www.cato.org/pubs/briefs/b p-080es.html.

52. Michael Flynn, "$74 Billion Windfall: Surplus Revenue in the States," American Legislative Exchange Council, *The State Factor* 24, no. 5, (December 1998): 1.

53. Nicholas W. Jenny and Elizabeth I. Davis, "Fiscal 2000 Tax Revenue Growth, Strongest of the Last Decade," Nelson A. Rockefeller Institute of Government, *State Fiscal Brief*, no. 61, www.rockinst.org/publications/fiscal_studies/FB_61.pdf .

54. David Broder, "States in Fiscal Crisis," *Washington Post*, May 22, 2002, p. A37.

55. Bob Herbert, "For Struggling States, All Solutions Point to Washington," *New York Times*, December 2, 2002, p. A21.

56. "States Want Federal Bailout, But Financial Help Unlikely," *Investors' Business Daily*, March 14, 2003, p. A18.

57. National Association of State Budget Officers, "Fiscal Survey of the States," November 2002.

58. See Edwards, Moore, and Kerpen, "States Face Fiscal Crunch after 1990s Spending Surge, Cato Institute Briefing Paper no. 80, February 12, 2003, pp. 2–3, www.cato.org/pubs/briefs/bp-080es.html.

59. Quoted in "States Want Federal Bailout, but Financial Help Unlikely," p. A18. For additional information on state spending and the question of a federal bailout, see Richard Vedder, *Should the Feds Bail Out the States?* American Legislative Exchange Council, February 2003. Vedder, an Ohio University professor of economics concludes, "during the prosperity of the 1990s, state and local government dramatically increased expenditures when there was a reduced need for some government spending, like public assistance," pp. 2–3.

60. Donald Bruce and William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," Center for Business and Economic Research, University of Tennessee, September 2001, p. 1.

61. Direct Marketing Association, "The Truth About Online Sales Taxes," www.the-dma.org/cgi/dispnewsstand?article=1012.

62. Cline and Neubig note: "An estimated 80 percent of current e-commerce is either business-to-business sales that are either not subject to sales and use tax or are effectively subject to use tax payments by in-state business purchasers." They add:

"Our experience, and that of the states, is that businesses are highly compliant with use-tax payments. They are audited too often, and the penalties are too high, not to do so." In effect, approximately $2.6 billion or only 13 percent of total e-commerce retail sales raise potential sales and use tax collection issues. The two economists also argue that applying state and local sales and use tax rates to the potential tax base might have resulted in sales and use tax erosion of less than $200 million in 1998. This represented merely one-tenth of one percent of total sales and taxes collected by all state and local governments. See Robert J. Cline and Thomas S. Neubig, " The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet," Ernst and Young Economics Consulting and Quantitative Analysis, June 18, 1999, www.ecommercecommission.org/document/skyIsNotFalling.pdf.

63. Section 1 of the Amendment reads: "No State shall make or enforce any law which shall abridge the privileges and immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." As Bernard Siegan has noted: "The importance of [the Fourteenth Amendment] derives from the fact that there are few other provisions in the Constitution that protect citizens or other persons against violation of their rights by the states . . . . The provision under discussion was designed to accord maximum protections for liberty at the state level. Each of its three clauses—privileges and immunities, due process, and equal protection—was directed toward this end, and collectively they constitute a formidable barrier against state excesses and oppression." Bernard H. Siegan, "Economic Liberties and the Consti-tution: Protection at the State Level," in *Economic Liberties and the Constitution,* ed. James A. Dorn and Henry G. Manne (Fairfax, Va.: George Mason University Press, 1987), p. 138.

64. *Bellas Hess* at 753.

65. *Quill Corporation* at 298.

66. House Committee on the Judiciary, p. 895.

67. See Jeffrey A. Eisenach, "The High Cost of Taxing Telecom," Progress and Freedom Foundation, *Progress on Point* 6.6, September 1999, www.pff.org/telecomtax.htm.

68. See Patrick Ross, "Internet Tax Moratorium Will Be Permanent This Time, Backers Believe," *Washington Internet Daily*, April 1, 2003, pp. 3–4.

69. Brian Krebs, "States to Vote Today on Internet Sales Tax Plan," Washingtonpost.com, November 12, 2002.

70. For the complete text of the final agreement, see "Streamlined Sales and Use Tax Agreement," November 12, 2002, www.streamlinedsalestax.org/FinalAgreementAdopted11-12-02.pdf.

71. The Willis Commission advocated similar sales tax simplification reforms almost 40 years ago, but few steps were taken by state or local governments to achieve this goal. Instead, the sales tax system grew far more complex. See House Committee on the Judiciary, pp. 879–95.

72. Streamlined Sales and Use Tax Agreement, Fundamental Purpose.

73. Ibid., p. 42.

74. John L. Mikesell, "Remote Vendors and American Sales and Use Taxation: The Balance between Fixing the Problem and Fixing the Tax," *National Tax Journal* 53, no. 4 (December 2000).

75. Andrew Wagner and Wade Anderson, "Guideline for Establishing an Origin-Based Sales Tax," tax.org, 2000 STT 54-42, March 15, 2000, www.tax.org/federal/Federal_Readings/Fed_Readings_Frames.htm.

76. Streamlined Sales and Use Tax Agreement, Fundamental Purpose, p. 6.

77. Charles E. McLure Jr., "SSTP: Out of the Great Swamp, But Whither? A Plea to Rationalize the State Sales Tax," www.nga.org/cda/files/SSTP121701.pdf.

78. Fred L. Smith, "Rush to Tax Could Produce Net Loss," Competitive Enterprise Institute, C*EI Update*12, no.10 (November 1999): 9.

79. Lawrence A. Hunter and George Pieler, "New Economy @ Old Constitution: Internet Taxes and the Constitution," Institute for Policy Innovation Policy Report no. 153, March 2000, p. 21.

80. Michael Flynn, "The Rise of Cartel Federalism," American Legislative Exchange Council, *ALEC Policy Forum*, Winter 2002/2003, pp. 39–42.

81. Ibid., p. 42.

82. Jack Kemp, "Taxation and the Cyber-Frontier: A Framework for Economic Growth," Submission to the Advisory Commission on Electronic Commerce, December 14, 1999, pp. 14, 19. Kemp also noted in testimony before the Subcommittee on Commercial and Administrative Law of the House Committee on the Judiciary on April 1, 2003: "If you want an idea of the negative consequences of tax harmonization schemes simply look across the ocean to our European friends. Tax harmonization is nothing

more than a euphemism for high taxes and is a recipe for economic stagnation. These issues should be dealt with head-on and resolved decisively in favor of what is Constitutional; while focusing on economic growth and not increasing the tax burden; and safeguarding the proper roles of government." www.house.gov/judiciary/kemp040103.htm. Likewise, Lawrence Hunter and George Pieler note: "The Madisonian model of American government, as laid out in *The Federalist Papers*, is a model of competition, not collusion; friction, not harmony; a calculated division of power, not a unification of it across all levels of government. For different units of government to collude in their exercise of power is not just radically different than federalism, it tramples on the most basic protection of American liberty the founders envisioned: the allocation of power in different areas to different units of government, so that government could never achieve total authority over the individual citizen. Government collusion in the arena of taxation, therefore, is a very troubling concept and not something that should be countenanced except in the most extreme circumstances." Hunter and Pieler, p. 21.

83. See www.streamlinedsalestax.org/FinalAgreementAdopted11-12-02.pdf.

84. Kent Lassman and Anna Duff, "The Internet, Taxation and the Constitution," The Claremont Institute for the Study of Statesmanship and Political Philosophy, September 2001, www.claremont.org.

85. Charles E. McLure Jr. has written extensively on the benefit of the destination-based tax. See for instance, "Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix or Discard It?" or "Electronic Commerce, State Sales Taxation, and Intergovernmental Fiscal Relations," *National Tax Journal* 49, no. 4 (1997).

86. Austan Goolsbee, "In a World without Borders: The Impact of Taxes on Internet Commerce," *Quarterly Journal of Economics*, May 2000, pp. 561–76.

87. For instance, according to the U.S. Department of Commerce, more than 100,000 Canadians cross the Canada–U.S. border each week for what they consider to be shopping bargains: milk, butter, and eggs at at least 50 percent off what they pay at home and a wide selection of cheeses at up to 80 percent off.

88. Kaye Caldwell, "A Message to Main Street Merchants: Be Careful What You Ask For," CommerceNet, *The Public Policy Report: Electronic Commerce Core Series* 1, no. 9 (September 1999): 3.

89. We should mention that North Carolina has implemented an alternative method. Because the state government recognizes that if the retailer is located out of state and does not have a physical presence in North Carolina, the state cannot require the retailer to collect North Carolina's tax, it passed legislation requiring individuals to pay the use tax on their income tax returns. The Department of Revenue in North Carolina predetermines the amount of use tax due by each individual. This system, of course, also has a great cost for taxpayers. For one thing, if a taxpayer rarely make purchases from out-of-state vendors, the burden of proof will be on his shoulders to prove that he does not owe the tax. See www.dor.state.nc.us/faq/use.html.

90. Caldwell, p. 3.

91. See McLure, "Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the Sales Tax or Discard It?" p. 84.

92. See Charles Adams, *For Good and Evil: The Impact of Taxes on the Course of Civilization* (Lanham, Md.: Madison Books, 1993).

93. Lee Goodman, "National Sales Tax Reform Raises New Customer Privacy Issues," in *Privacy in Focus*, May 2002, p. 3.

94. As Kaye Caldwell concludes: "The message for Main Street is: That level playing field you want so badly? It will be much more level than you have yet imagined. You too will get to participate in the massively burdensome and costly use tax system, imposed on you by governments in other states where neither you nor your employees even get to vote." Caldwell, p. 4.

95. Wagner and Anderson," "Origin-Based Taxation of Internet Commerce," p. 189.

96. For the North Carolina system, see www.dor.state.nc.us/faq/use.html, and for Michigan, see www.michigan.gov/treasury/1,1607,7-121-1750-5929–,00.html.

97. Saba Ashraf, "Virtual Taxation: State Taxation of Internet and On-Line Sales," *Florida State University Law Review* 24, no. 3 (Spring 1997): 611.

98. Quoted in Joyce E. Cutler, "State, Local Governments Fear Tax Ban Will Threaten Revenues, Sovereignty," *BNA Daily Report for Executives*, December 16, 1999, p. GG-1.

99. Quoted in Richard Wolf, "Status of Use Tax Likely to Rise," *USA Today*, April 11, 2000, p. A4.

100. Lathrop, p. 2.

101. Goolsbee, pp. 561–76.

102. The New Economy Tax Simplification Act, S.

2401, 106th Cong., 1st sess.

103. Andal.

104. For additional details see Adam D. Thierer, "After the Net Tax Commission: The Gregg-Kohl Nexus Solution," Heritage Foundation Backgrounder no. 1363, April 25, 2000.

105. Nonna A. Noto, "Internet Tax Legislation: Distinguishing Issues," CRS Report for Congress: RL30667, November 24, 2000, www.ncseonline.org/NLE/CRSreports/Economics/econ84.cfm?&CFID=6067239&CFTKEN=4325961#Back33.

106. The Internet Tax Reform and Reduction Act, H.R. 4267, 106th Congress, 1st sess.

107. Frieden, p. 64.

108. A far more extensive discussion of origin-based taxation is contained in Michael S. Greve, "If It Ain't Broke, Why Is Everyone Trying to Fix It? Taxing E-Commerce in a Destination Based World," in *Who Rules the Net? Internet Governance and Jurisdiction*, ed. Adam Thierer and Clyde Wayne Crews Jr. (Washington: Cato Institute, 2003), pp. 269–95.

109. Michael S. Greve, "E-Taxes: Between Cartel and Competition," *AEI Federalist Outlook*, no. 8, September 2001, www.federalismproject.org/outlook/9-2001.html.

110. Ryan and Miethke, p. 884.

111. William F. Fox and Matthew W. Murray, "The Sales Tax and Electronic Commerce: So What's New?" *National Tax Journal* 50, no. 3 (September 1997): 573.

112. Wagner and Anderson, "Origin-Based Taxation of Internet Commerce," p. 188.

113. Frieden, p. 182.

114. Lathrop, p. 1.

115. Paul J. Gessing, "The Race to Cyberspace: Internet Taxation and State Tax Competition," NTU Policy Paper 103, November 21, 2000.

116. Frieden, p. 182.

117. *Oklahoma Tax Commission v. Jefferson Lines*, 514 U.S. 175 (1995).

118. "In reviewing sales taxes for fair share, however, we have had to set a different course. A sale of goods is most readily viewed as a discrete event facilitated by the laws and amenities of the place of sale, and the transaction itself does not readily reveal the extent to which completed or anticipated interstate activity affects the value on which a buyer is taxed. We have therefore consistently approved taxation of sales without any division of the tax base among different States, and have instead held such taxes properly measurable by the gross charge for the purchase, regardless of any activity outside the taxing jurisdiction that might have preceded the sale or might occur in the future." Oklahoma Tax Commission.

119. In general, see Arthur Angstreich, James R. Fisher, and Eric J. Meithke, "Jefferson Lines as the Ticket to Cyberspace? A Proposal for the Taxation of Electronic Commerce Services," *State Tax Notes*, June 22, 1998, pp. 1993–96.

120. Fox and Murray, p. 573.

121. "Unlike with a market-state rule, there is no need in a vendor-state rule to identify precisely where a company's customers are using its services. Whether a company's customers are located in 5 jurisdictions or 25 jurisdictions does not change the outcome. Even if it is difficult to identify a customer's location, because of the use of a Web address and/or the involvement of a financial intermediary in the transaction, nothing changes." Frieden, p. 247.

122. Michael S. Greve, "E-Taxes: Between Cartel and Competition," p. 3.

123. See Charles E. McLure Jr., "Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the Sales Tax or Discard It?" p. 84.

124. "In general, when a purchaser contacts a florist by telephone, telegram, or other means of communication for delivery of flowers or other merchandise to another city or state, the sales tax is based on the location of the florist who initially received the order. The florist who delivered the goods to the consumer is not subject to tax." Ryan and Miethke, "The Seller-State Option: Solving the Electronic Commerce Dilemma," *State Tax Notes*, October 5, 1998, p. 883, f. 11.

125. See Frieden, pp. 156–61. Frieden notes: "Given the practical difficulty of the point-of-consumption approach, an increasing number of states take a vendor-state-oriented approach and now tax the cards at the point of sale of the card from the retail outlet. . . . The place of sale for local sales tax purposes will be the location at which the retailer transfers possession of the card to the customer, not where the customer actually uses the telecommunications service." Ibid., p. 158.

126. Under the Mobile Telecommunications Sourcing Act of 2000, Congress established the following sourcing rule for the tax treatment of cellular telecommunications services: "All charges for mobile telecommunications services that are

deemed to be provided by the customer's home service . . . are authorized to be subjected to tax, charge, or fee by the taxing jurisdictions whose territorial limits encompass the customer's place of primary use, regardless of where the mobile telecommunication services originate, terminate, or pass through, and no other taxing jurisdiction may impose taxes, charges, or fees on charges for such mobile telecommunications services." For more information, see Michael S. Greve, "Opportunity Rings: New Cellphone Law Shows Way on Internet Taxation, Competitive Enterprise Institute, *CEI On Point*, no. 72, September 14, 2000.

127. Ryan and Miethke, p. 883.

128. Hal R. Varian, "Forget Taxing Internet Sales. In Fact, Just Forget Sales Taxes Altogether," *New York Times*, March 8, 2001, p. C2.

129. Ibid, p. C2.

130. For example, see Murray Weidenbaum, "A Tax System for E-Commerce Economy," Center for the Study of American Business, *Policy Brief* no. 205, June 2000, http://wc.wustl.edu/csab/CSAB%20pubs-pdf%20files/Policy%20Briefs/pb205-mlw%20e-comm%20tax.pdf; Stephen J. Entin, "Tax Reform to Handle the E-Tax Controversy," Institute for Research on the Economics of Taxation, *Congressional Advisory* no. 104, May 15, 2000, www.iret.org/pubs.html; Bruce Bartlett, "Tax Reform Resuscitation?" *Washington Times*, June 21, 2000, p. A18; Varian, p. C2. Also, during the 2000 presidential election, candidate John McCain flirted with such a proposal thanks to efforts by American Enterprise Institute economist Kevin Hassett, who helped him formulate his tax policy. As *Weekly Standard* reported at the time: "The best regime, Hassett believes, would place almost no tax burdens on savings. Instead it would tax consumption (George W. Bush's tax plan in Texas in 1997 also shifted the burden to consumption). Hassett says that if you give middle-class people more reason to save, you will unleash more capital for investment than you would by reducing the top marginal rate on income. . . . This is a step toward a consumption tax. Since income minus savings equals consumption, Hassett says, if you reduce the tax on that portion of income that goes to savings, you are shifting the burden onto consumption. This is a better way of taxing consumption than the old-fashioned way, a sales tax collected at the cash register. In the age of e-commerce, he says, it doesn't make sense to try to impose an old-fashioned consumption tax at the point of sale. Better to collect it up top, at the point of income." See David Brooks, "The McCain-Bush Tax Wars," *Weekly Standard*, January 24, 2000, p. 10.

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