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# Taxation of Interjurisdictional E-Commerce

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**"Taxation of interjurisdictional e-commerce."**

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1. Most writers and reporters in this new field accept state and local sales taxes as part of the ordained order of things. The predominant attitude is one of how to preserve and raise the state sales tax, by taxing purchases from "foreign" (out-of-state) sources, which the writers regard as an administrative nuisance and a leakage.

A. Academic sources.

Modern textbooks on public finance do not treat the general retail sales tax as the historical novelty that it is. They no longer mention that no state taxed retail sales until 1929 (GA)[1] and 1930 (MS), and most not until 1933 (when California joined the movement with a rate of 2%) and the mid-thirties, by which time half the states joined in. Few books give any weight to the fact that 5 states and one province (Alberta) have no sales tax at all: the states are Alaska, Oregon, NH, Delaware, and Montana. The academics treat these states as eccentrics and laggards, and trivialize them for their small populations, but the states in question, which have 10 U.S. Senators among them, do not see themselves that way at all. One of them, Oregon, in 1980 retired the powerful Chairman of the House Committee on Ways and Means, Al Ullman, because he

[1]Technically the GA tax was on gross business income. Most economists see that as functionally a sales tax.

championed a Federal VAT. Another, New Hampshire, plays a key role in screening presidential candidates. It is rather a matter of some local pride, not to mention commercial advantage. People speak casually about a uniform Federal standard for all states (and all cities and counties within states, over 7,000 taxing jurisdictions in all). But state taxes are a power reserved to each state; not one they will quietly abandon.

Few academics show much concern about its partiality and non-uniformity. They enumerate a few exemptions, but then favor it because it allegedly exempts capital formation.

Even some decentralists seem to favor federal action to promote state sales taxes. Here is the attitude of Charles McLure of the Hoover Institution, who wrote, "I believe sales taxes to be the most appropriate form of tax for state and local govts. to use." He adds, " ... the ridiculously unfair and distortionary de facto exemption of interstate sales by mail-order houses" should be banned by federal legislation. (Curiously, the main theme of McLure's article is in favor of intergovernmental tax competition, which would seem to rule out sales taxes. McLure is a bright and savvy economist, but he gives no support for his "belief.") McLure is currently active with ACEC, and, not surprisingly, is advising the states to find ways to tax e-commerce.

B. Even more surprising is the attitude of business sources. You'd think they'd show some delight that a new way has been found to undercut the sales tax. Instead, many of these works might as well be written by tax administrators. Their main concern may be making sure that other firms pay, too.

2. My viewpoint is the reverse. I am here to explore how e-commerce may work as a lever to lower or quash sales taxes, and to show how states may do that without making catastrophic quakes or waves.

3. The Commerce Clause.

The U.S. Constitution bans state taxes on interstate commerce. "The Congress shall have the power ... to regulate

Commerce with foreign Nations, and among the several States, and with the Indian tribes; ... " - (Article I, Sect. 8).

"No State shall, w/o the consent of Congress, lay any Imposts or Duties on Imports or Exports, ... (Article I, Sect. 10). This reinforces the commerce clause of Sect. 8.

The Commerce Clause has preserved interstate tax competition. W/o it, it is likely that state sales taxes would rise to 20% or more in short order, as the wholesome fear of interstate competition was stifled. It created and has preserved our domestic market, the greatest free trade zone in the world, an essential ingredient of American productivity and prosperity. It is not something to be thrown away lightly, especially not for the sake of something as baneful as the retail sales tax.

Sections 8 and 10 are there by design. James Monroe was the leading champion (T.J. Norton, p.51), so I shall herein call the Commerce Clause "The Monroe Doctrine" --one that did and does more for the greatness of the U.S.A. than the better-known doctrine of the same name (actually the work of J.Q. Adams, anyway). Media and academic pundits slight domestic trade, yet this is the basis of our greatness. They write and speak of "trade" and "commerce" and "specialization" as basic good things, but synonymous with international trade. (Look up "commerce" in The New Palgrave Dictionary of Economics: it says "see International Trade.") States and cities speak of their export industries as their "economic base," yet their internal trade is far more important (Jane Jacobs). Case of Erie Canal: it thrived and made money for 20 years based purely on internal trade, inside state of NY (Carter Goodrich, Philip Cornick).

4. How Congress might circumvent the Monroe Doctrine - but probably won't.

A. "The consent of Congress."

States may tax imports "with the consent of Congress." McGoldrick v. Berwind White (1940) established they might apply a sales tax if the seller has a nexus in the taxing state. Quill Co. v. N.D. 1992, seems to have established that Congress has the

power to enact legislation allowing states to levy sales and use tax on remote sales, including mail-order and electronic sales, without the current requirement of physical presence. Congress and the President have the power to require all online vendors (and all mail-order sellers) to collect sales and use tax on all sales to all states.

That's interesting, but Congress doesn't pass laws just because it may. It also has power to tax capital gains as they accrue, but it never has, and the leading case where the U.S.S.C. advised Congress it has this power is usually cited to show the opposite, because the Court told the Administration it needed the consent of Congress (Eisner v. Macomber, 1920). The very first power the Constitution enumerates for Congress is the power to levy a national land tax (Art. I, Sect. 2, Para. 3), but it hasn't since 1862.

Congress has not lacked for urging and lobbying by the States. The ACEC includes a large number of state representatives who keep asking for authority to tax remote sales, both electronic and traditional.

B. The Uniformity Requirement

Congress is bound by the constitutional mandate of uniformity. "... all Duties, Imposts and Excises shall be uniform throughout the U.S." (Art. I, Sect. 8). Many states are not so bound. There are over 7,000 sales tax jurisdictions (counting cities and counties), and constant flux in the rules. Then there are business license fees: in Riverside, California, for example, business license fees vary from business to business because the city uses 35 (sic) formulas to calculate the charge. Some fees are based on gross receipts, which would seem to make them city sales taxes, too. The chances of achieving uniformity seem remote, indeed.

One might object that many Federal taxes appear non-uniform, but "the uniformity of taxation throughout the U.S. is geographic, not intrinsic" (Bromley v. McCaughn, 1929; also the Head Money Cases, 1884). Thus, the U.S. may tax maple syrup and exempt cotton, but it must do so the same in every state.

Then there are the 5 states without any sales taxes at all. Can Congress get into helping enforce a Duty, Impost or Excise in 45 states while exempting five?

C. Zeitgeist

The spirit of the times is for Decentralization and "Devolution" - of power and responsibility from the Feds to the states. There are large cuts in Federal programs. Some old centralists, like Alice Rivlin, are still proposing a national sales tax or VAT to be divided among the states, but they are swimming against a current.

The EU and the OECD are centralist, but have hit major roadblocks in their drive for tax "harmonization" among all nations. Even in Europe, the "principle of subsidiarity" (Devolution) is written into the original Maastricht Treaty. Oskar Lafontaine is gone. The Commissioners of the EU have all been disgraced and replaced.

D. Double taxation

Retail sales taxation has always involved some double taxation, as businesses buy some of their inputs at retail, and then sell their products at retail. With e-products and services this problem grows more severe, because most e-commerce is business to business.

5. The novelty of e-commerce

A. Tendency to overstate novelty.

Every generation thinks it invented sex, and rewrites textbooks on physics, math, and English composition, as well as biology, even as the underlying disciplines remain much the same. Much literature on e-commerce overstates its novelty and underestimates the experience, imaginations and precedents of our forebears. Justice Marshall in Gibbons v. Ogden, 1824, clearly stated that "commerce" is a broad concept not limited to trade in

tangible commodities - he then applied it to ferrying passengers across the Hudson River. In Pensacola Telegraph v. Western Union, 1878, Justice Waite explained that transmitting intelligence via the new and intangible medium of electricity was commerce, in the Monroe Doctrine meaning, and "must not be encumbered by state legislation." The Radio Act of 1927 subjected all forms of interstate and foreign radio transmission to Federal control; the USSC upheld it in Federal Radio Commission v. Nelson, 1933.

Some novel intangible electronic products may now escape the tax net, it is true; but every retail sales tax is already riddled with exemptions, many of them far grosser than e-products are likely to be for some time to come. Distressing and damning as that is, it has not served to quash retail sales taxation, which legislators love for its revenue capacity; the addition of e-products is not likely to change that.

B. Secrecy, privacy, and evasion.

E-commerce allows greater secrecy in transmitting orders, making payments, and keeping records. To tax sales, a state must know the location of buyer, but this may not be known. Some addresses are merely domain names.

Furthermore, a seller who is found to have nexus in the high-tax state of a buyer may simply change his server location to another state with no sales or use tax.

C. Greater volume

E-commerce may generate a much greater volume of "foreign" purchases than does mail-order at present. It is easy to overanticipate this growth, just as buyers of ".com" IPOs are prone to overestimate future profits, but clearly this is something to watch, even if with a jaundiced and skeptical eye.

D. Problems with business taxes

Many states, like California, apply a "unitary" system to dividing the profits of MNC businesses among jurisdictions.

Without it, taxes on business income are a travesty. With e-commerce, however, the old allocation formula is hard to implement. Under the standard allocation formula, the state calculates the world profits of the MNC, and then takes its cut based on its share of three elements: sales, payroll, and property.

Sales: where does the sale occur?

Employees: where do they count, if they live in India and supply a service in California, transmitting the semi-finished product by e-mail. At what stage do you tax it? What if it is re-exported in a final product?

Property: a lot of the assets are intangible. These include parts of the inventory; fixed assets in licenses, copyrights, and frequency allocations. A lot of the assets are highly mobile, like satellites. So, to be sure, are ships and aircraft, but the ships, at least, often escape the tax net. Will there next be flags of convenience for satellites?

Finally, there is encryption. Government security agencies have made great strides in breaking codes and intercepting messages, seeking out keywords, but the code-breakers have a priority in national defense matters, and we may surmise that encryptors are constantly racing to be a step ahead, so this is to be an endless cat and mouse game of growing cost and uncertainty, with substantial loss of revenue.

6. Net result.

Look forward to a new world in which forms of taxation must change substantially. There must be more emphasis on immobile assets. That is not necessarily a bad thing: we've been there and done that, and it wasn't half bad. Professor Wallace Oates, Univ. of MD, writing in the current Review of Economic Literature, refers his readers to his study of Pittsburgh, where he and a colleague found that a shift to a more immobile tax base, land, may have caused a rise in building activity. I cite Prof. Oates because he and Prof. Robert Schwab approached their

subject in the most cautious imaginable way, and their conclusions are about as soft-pedaled as is humanly possible from the data they present.

7. What would happen in California if we eliminated the sales tax, and replaced it by raising the property tax?

A. No catastrophe

1. Five states and the Province of Alberta already get along nicely with no sales tax, so it must be possible.

2. No state at all had a retail sales tax before 1929 (GA). California opened its gates in 1933 with the Riley-Stuart Act, and so did several other states. It was sold as an "emergency measure," at a rate of 2%. As late as 1977 it was 4.75%. Now it is 7.25% statewide, with many cities, counties and transportation districts adding their tolls to the total, but for most of our state's existence we got along nicely with either no sales tax, or much lower rates than today.

3. The Property Tax rate would rise to a level lower than it was before Prop. 13. California sales tax revenues are currently 1.19% of the Assessed Value (A.V.) of taxable property.[2] Add that to the current 1%, and get 2.19%, compared to 2.7% before Prop. 13 - except that the 2.7% was applied to actual value, while today's assessed valuations are far below that.

The A.V. value of land is probably about 1/3 or so of market value; buildings are closer to market.

B. Greater equity.

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[2]Data are from 1993-94. See \mtrls\salestax.-av. Sales tax revenues est. $22b; A.V. is $1.86t.

The distribution of the tax burden would shift from poor counties to richer ones. Thus, in the poor inland counties of Fresno, Tulare, Imperial, and Stanislaus, sales tax revs are about 1.5% of A.V.s. In rich coastal and suburban counties of Sta. Barbara and Marin, sales tax revenues are about .75% of A.V.s.[3] Thus, the state sales tax takes a lot more money from the poor counties than it would cost them to replace the services from local taxes; the rich counties, with the high property tax bases, are contributing less to the common pool than they are saving in property taxes.

Within counties, by extension and analogy, I am reasonably certain that a careful study will show that the burden would shift from poorer cities and districts to richer ones. Again, among individuals, I believe we would find the same. One of these days, God willing, I will find the time and money to conduct or sponsor such a study.

The relevance here of this equity question is that most states and provinces have complex and expensive systems and formulae for "power equalization," and the like, designed to shift resources from rich counties to poorer ones. One reason such programs are needed is to offset the effects of the very same state sales taxes used to finance them. There are great savings to be realized by quashing this cross-hauling of public funds.

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[3]See note 1

**This response to John Mikesell was published in State Tax Notes, April 3, 2000**

# More on Clarifying Sales Tax History

**Mason Gaffney**

I welcome Prof. John Mikesell's joining this dialogue on sales taxation. He could contribute to a history that is becoming most timely as sales taxation becomes a hot current issue, pro and con. His present letter, however, supplies less of the promised clarity than a jumble of detail, some of it trivial and tangential. He fails to marshal much of the detail behind his two theses, or to relate these to each other.

He opens by charging me with having "caused some confusion in the media" about the history of sales taxation, so it is fitting that I respond to that. He ends by shifting to a second thesis, that he disfavors all kinds of income taxation - a subject I never mentioned, nor will I now. In leading up to his second thesis, Mikesell ignores most of mine, which therefore stands unchallenged.

Mikesell draws a circle around "sales tax scholars, including myself" - an unfortunate dialogue-stopper that would exclude most of us, if we let it. My source is Professor Harold Groves of Wisconsin, a respected figure in public finance, and the beloved mentor of Joseph Pechman and Walter Heller, among other leading tax scholars. He in turn cites Haig and Shoup, and Nelson, Blakey and Blakey - a scholarly lot, on the whole (Financing Government, rev. 1946, p.309). They were closer to the events of the 1930s than we are now.

I follow Professor Groves in folding in Georgia's 1929 tax (on gross business income) with sales taxes. He saw it as a variant form of sales tax because its base was gross sales, like a sales tax. Like most tax scholars, Groves taught that the true economic incidence of such a tax depends on elasticities of supply and demand, independent of its nominal legal "impact," (i.e. whether on the seller or the buyer). I surmise that Mikesell, and most economists, would agree - that is standard stuff in the field.

There is no great difference between the essential facts cited by Groves and Mikesell. It is rather that Groves telescopes his treatment, as I did, to get to the nub of the matter. Mikesell piles on many details and variations, to no clear purpose. I do welcome his data about West Virginia, though. In my telescoped remarks I left out West Virginia's 1921 tax because it seemed like a temporal outlier, not a trend-setter. Now we learn from Mikesell that it was more of a severance tax than a retail sales tax, anyway. That makes it a tax of another genus. Many states have long had severance taxes as a crude way of taxing rents from minerals, assuming the sellers are price-takers (as most of them are) who cannot pass the tax along.

It doesn't much matter today whether Georgia was first in 1929, or Mississippi in 1930, and I do not understand why Mikesell wants to cavil about it: dissecting each tree distracts us from scoping out the forest. The major trends of 20th Century sales tax history that I would stress are two.

First, states adopted sales taxes not so much to raise more revenue as to lower property taxes: "property tax relief" was, and is, the main slogan of sales-taxers (as though no one, or no one of consequence, carries the sales tax burden). The rocketing rise of sales taxes after 1930 was matched by a meteoric fall of property tax rates, base, and revenues. By 1920 most states had come to rely heavily on property taxes for both state and especially local revenues. Rates were high, relative to earlier and later years, as a product of rapid urbanization, public schooling, and the Progressive Movement's emphasis on local funding for public goods. In my reading of history, the single-tax movement's emphasis on the unearned nature of land values also contributed to the popularity of property taxation then. The waning of Progressivism during the Andrew Mellon era (1921-31) set the stage for the rise of sales taxation.

Second, the southeastern states generally took the lead in raising sales taxes. That was not unrelated to the fact that the most obvious targets of regressive taxation, poor blacks, were then disenfranchised in those states, and remained so until very recently. It does not seem to me that a tax shift pioneered under those conditions should serve as a model for the nation today. Neither am I impressed by the economic development or rate of capital formation in Mississippi, Alabama, and some other southeastern states under their regimes of low property taxes and

high sales taxes. I do not make this a regional issue, for it is less and less so today, but again I invite your attention to New Hampshire, which continues to prosper outstandingly with meager natural resources, high property taxes, no sales tax, and no income tax worth mentioning. The facts speak volumes. New Hampshire contrasts starkly with California, whose national standing by many economic and social measures has dropped like a stone since it passed Prop. 13 in 1978.

I welcome, of course, Mikesell's support for land taxation. Here he is wearing the hat of a professional economist. However, he immediately changes to the hat of an amateur political scientist, and dismisses it for its lack of much standing among state legislatures. Such qualified support is not worth many legions in combat. No idea, good or bad, will get far once its supporters decide they will tell legislators only what these already believe, and want to hear again. Mikesell's bottom line is his continuing support for sales taxation. On this point I respectfully disagree.

Professor Mikesell praises the sales tax because it grew "on an extremely fast track for a fiscal innovation." Elsewhere he speaks of its many antecedents, so one wonders if he likes its novelty or its long history. Either way, those do not seem to be good criteria by which economists should evaluate a tax. I keep a growing list (available on request) of about 30 political leaders whom the public retired, and in some cases shot or beheaded, after they identified themselves with sales taxation. Judging a tax by its apparent popularity is a hazardous business. Better we should analyze its economic effects, allocative, distributive, and macro-economic.