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Rethinking State and Local Reliance on the Retail Sales Tax:

Should We Fix the Sales Tax or Discard It?

*Charles E. McLure, Jr.**

I. INTRODUCTION

Electronic commerce (e-commerce) has appeared with the suddenness of a comet. Having first been detected as a tiny speck emerging from the constellation Geek less than five years ago, e-commerce is now upon us. E-commerce raises questions about many key fiscal institutions we take for granted, among them the use of the retail sales tax (RST) to finance state and local governments.¹ In part, questions about the RST arise because the tax, as it currently functions, is an anachronism that reflects its origins in the Industrial Age nearly 70 years ago; since the RST was created without a firm conceptual basis and “just grewed,” it is not surprising that it is defective—or that e-commerce magnifies its defects.² But the problem may be deeper than this; even if reformed, the RST may simply not be suitable to serve as the most important source of tax revenue of state and local governments in the twenty-first century.

This paper examines these issues. First, after briefly discussing tax policy objectives, it describes the defects of the typical RST, noting how e-commerce aggravates these defects. Then it examines ways that have been proposed to fix the RST system to accommodate e-commerce. Finally, it asks whether it would not be better to revamp the finance of state and local government, by substituting either a value added tax (VAT) or increased reliance on the income tax for

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1. Initially, while describing and discussing principles and problems of taxation, I refer only to “sales tax,” rather than to “sales and use tax.” Where necessary I distinguish between sales taxes and use taxes. The meaning should be clear from context. I employ the terms “remote commerce” and “electronic commerce” to refer to commerce that crosses state or national boundaries.

2. See Charles E. McLure, Jr., *Electronic Commerce and the Tax Assignment Problem: Preserving State Sovereignty in a Digital World*, 14 ST. TAX NOTES 1169 (1998).

the state and especially the local RST. Appendix A discusses fallacious arguments for exempting electronic commerce from sales and use taxation. Appendix B reproduces an "Appeal for Fair and Equal Taxation of Electronic Commerce" that has been signed by more than 170 academic tax specialists. Appendix C is the proposal for massive simplification of sales and use taxes I submitted to the Advisory Commission on Electronic Commerce in December 1999. Appendix D indicates how a state VAT could be implemented.

II. OBJECTIVES OF TAX POLICY

In order to identify defects in tax policy, it is necessary to have criteria against which to judge policies. The following is a list of commonly accepted objectives of tax policy. Because the conventional criteria of economic neutrality, equity, simplicity, and transparency are well-known and the purpose of writing this article is not to produce a treatise on tax policy, the discussion of those criteria is brief. I describe principles of tax assignment in greater detail, since they are not as well-known, but lie at the heart of the analysis that follows.

A. Conventional Tax Policy Criteria

Most textbooks describe the following criteria of good tax policy.

1. Economic neutrality

The case for economic neutrality is based on the belief that markets do fairly well in determining, *inter alia*, what to consume, what to produce, how to organize and finance production and distribution, where to locate economic activity, and whether to save and invest or consume.³ A tax is neutral if it does not interfere with these decisions. For example, a sales tax that applies equally to all consumption occurring in a given jurisdiction is relatively neutral (distorting only the choice of where to live, a decision not likely to be much affected by the level of sales taxation), whereas a tax on all production occurring in the same jurisdiction is less likely to be neu-

3. For reasons explained by the theory of optimal taxation, a neutral tax may not be optimal. A discussion of the theory of optimal taxation and its shortcomings as a guide to policy would take us far afield, but see Joel Slemrod, *Optimal Taxation and Optimal Tax Systems*, 4 J. ECON. PERSP. 157 (1990).

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tral, as it distorts the choice of where to locate production. A tax that applies selectively to only some consumption or some production distorts choices of what to consume or what to produce. Finally, a tax on capital goods discourages investment.

2. Equity

Equity is essentially a matter of what society believes to be fair. Equity can be placed in two categories. *Horizontal equity* involves collecting similar amounts of tax from those in similar circumstances. *Vertical equity* involves collecting differing amounts of tax from those whose circumstances, commonly measured by their income, differ; a tax satisfies this criterion if tax liabilities differ systematically in ways that society believes are appropriate. It is ordinarily agreed that taxes should not be regressive—that they should not take a larger share of income from those with lower incomes.⁴

3. Simplicity

Costs of compliance and administration should be reasonable, and certainly no greater than required to implement a given policy. If costs of implementing a particular policy are unreasonable, then the policy should be rethought.

4. Transparency

Taxation should not be imposed in ways that obscure its burden.

B. Principles of Tax Assignment

The “tax assignment problem” can be stated as “who (which level of government) should tax what, and how?”⁵

4. This characterization is almost certainly true of aggregate tax burdens. It is less compelling for specific taxes, especially those levied to pay for benefits provided to identifiable beneficiaries.

5. For a more complete discussion, and references provided therein, of tax assignment, see Charles E. McLure, Jr., *The Tax Assignment Problem: Conceptual and Administrative Considerations in Achieving Subnational Fiscal Autonomy* (March 16-27, 1998) (unpublished manuscript presented at the Intergovernmental Fiscal Relations and Local Financial Management Course, OECD Multilateral Tax Centre, Vienna, Austria) (on file with the author).

1. *Objectives of tax assignment*

In solving the tax assignment problem, it is necessary to consider several objectives that are not adequately captured in the conventional criteria listed above. Several are mentioned again here, despite being listed above, to emphasize their importance for tax assignment. These are clear enough to be stated with little elaboration.

a. Revenue adequacy. Revenues of subnational governments should be adequate to finance the appropriate functions of these governments.⁶

b. Fiscal autonomy. Subnational governments should be able to control the level of revenues they receive, so they can control their level of expenditures.

c. Relation of taxes and benefits. To the extent possible, those who consume services provided by subnational governments should pay for them.

d. Tax competition. Competition in the supply of public services and in taxation should be encouraged to discipline politicians and bureaucrats to be efficient and to provide the services citizens want.

e. Locational neutrality. Taxes levied by subnational governments should not distort the location of economic activity.

f. Avoidance of tax exporting. Burdens of taxation levied by subnational governments should not be borne by non-residents.⁷

g. Administrative feasibility. It should be possible to implement the taxes assigned to subnational governments without undue costs of compliance and administration.

2. *Issues of tax assignment*

The tax assignment problem can be divided into four sub-questions: (a) Which taxes should subnational governments be allowed to levy? (b) Which level of government should define the tax base(s)? (c) Which level of government should set the tax rate(s)? (d) Which level of government should administer the tax(es)?

I have argued elsewhere that the choice of tax rates is, by far, the most important decision for the fiscal sovereignty of subnational

6. Determining “the appropriate functions of these governments” is the expenditure assignment problem.

7. However, not all tax exporting is bad: taxes intended to serve as user charges should be exported if non-residents consume public services. In what follows, tax exporting refers only to situations that do not fall within the scope of this qualification.

governments because that choice determines the level of public services that can be provided. Moreover, tax competition between jurisdictions in the setting of rates helps citizens control the monopolistic tendencies of bureaucrats and politicians.⁸ By comparison, subnational choice of tax bases and administration can create unacceptable complexity and onerous costs of compliance and administration. Subnational administration may be important if subnational governments do not trust the national government to exercise diligence in administration of subnational taxes or to turn over revenues from subnational taxes.

3. Methods of revenue assignment

Depending on how the previous questions are answered, one can distinguish several methods of revenue assignment.⁹

a. Independent legislation and administration. First, individual subnational governments may choose which taxes to levy, define tax bases, set tax rates, and administer taxes, subject only to broad constitutional limitations, as in the United States. That is, there may be independent legislation and administration. This method provides the greatest fiscal autonomy for subnational governments, but also entails the greatest complexity and the greatest latitude for gaps and overlaps in the tax base, with consequent distortions and inequities. The current debate, triggered by the emergence of electronic commerce, suggests that, at least in its pure form, this approach is no longer satisfactory in the case of the state sales tax. The United States Supreme Court ruled in *Quill Corp. v. North Dakota*¹⁰ that the uncoordinated actions of individual states have created a system that is so complex that requiring remote vendors to collect use tax would place an unconstitutional burden on interstate commerce.

b. Tax sharing. Second, national governments may share revenues from particular taxes with subnational governments. Tax sharing minimizes complexity and inconsistency of subnational tax bases, but at the cost of complete loss of subnational fiscal sovereignty over tax rates, as well as the tax base. In the American context, where

8. See McLure, *supra* note 5. (Competition should not extend to the choice of base because of the complexity implied.)

9. I use the term “revenue assignment” because one of the methods (tax sharing) does not involve tax assignment. It is more like revenue sharing or grants.

10. 504 U.S. 298 (1992).

state sovereignty is highly prized, tax sharing is not appropriate, and is not likely to be politically acceptable.

c. Surcharges. Third, subnational governments can impose taxes on a base defined by a higher level of government. There are several administrative variants of this approach. First, subnational governments can impose surcharges that are administered by the higher level government; surcharges are widely used in Canada, for the income tax, and at the local level in the United States, for both sales and income taxes. Surcharges provide a combination of subnational fiscal autonomy, simplicity, and consistency. They may be optimal in many circumstances, such as in developing countries and countries in transition from socialism. State sales tax surcharges are also not a realistic alternative in the United States. After all, there is no federal sales tax on which to place state surcharges, and state and local governments would strenuously oppose federal entry into the sales tax area.¹¹

d. Subnational administration of taxes levied on a commonly defined base. Fourth, subnational governments can administer taxes levied on a commonly defined base; the base might be defined by the national government or by the states acting in concert. This is essentially the approach that underlies the value added tax (VAT) in the European Union.¹² If administration is uniform and consistent, this approach may also provide an attractive combination of fiscal autonomy, simplicity, and consistency. It is especially worthy of consideration in the United States, for reasons to be clarified below.

III. DEFECTS OF THE STATE RETAIL SALES TAXES

The retail sales taxes imposed by the states suffer from several defects. Some problems are inherent; others, while not inherent, are arguably more important. In order to understand these defects, it will be useful to describe, in turn, an “ideal” RST, problems in implementing the ideal, and the typical RST actually imposed in the United States.

11. At one time, federal legislation provided for federal collection of income taxes for any state that would conform its law to federal law. It was eventually repealed for lack of state interest.

12. See Appendix D.

A. The Benchmark: An Ideal RST

An ideal RST would be used to implement a *destination-based* tax on *consumption*. This simple statement requires justification, and it implies several corollaries.

1. The case for taxing only consumption

The ideal RST would apply only to purchases by households for purposes of consumption.¹³ It would exempt *all* purchases by businesses, capital goods, goods for resale, fuels and utilities, office supplies, or whatever. There are several reasons for this limitation. Taxing goods bought for resale creates pyramiding (repeated taxation of the same product) and creates incentives for vertical integration, as well as inequities (discrimination against those who buy products that are subject to multiple taxation). Taxing other sales to business has similar effects, although perhaps not as obviously, and is also likely to distort decisions on how to produce and distribute products. Taxes on business inputs also cause the perceived cost of government to be understated, because they are hidden and allow tax rates to be artificially low; taxation limited to consumption would make the cost of government more transparent. In addition to sharing these faults, taxation of capital goods purchased by business discourages investment. Finally, taxation of sales to business interferes with the realization of destination-based taxation.

2. The case for taxing all consumption

If a sales tax is to be economically neutral, horizontally equitable, and relatively simple, it should apply equally to *all* consumption spending. Thus there should be no distinction between tangible products, intangible products, and services and no distinctions based on methods of ordering or delivering products. Where alternative ways of achieving vertical equity are not readily available, as in developing countries, it may be thought appropriate to exempt products that figure especially prominently in the market basket of low-

13. Several qualifications are in order. First, it may reasonably be decided that selected business purchases (e.g., general purpose automobiles) should be taxed to prevent their tax-free diversion to household use. Second, I generally focus on the distinction between sales to households and sales to business, ignoring for the most part other sales, such as those to non-profit organizations, governments, and quasi-governmental organizations.

income households, such as cereal grains. In developed countries, fiscal devices such as progressive income taxation and family allowances (the earned income tax credit in the American context) makes this type of differential treatment unnecessary.

3. The case for destination-based taxation

A tax on transactions—e.g. the RST—can be levied consistently at the origin or the destination of transactions that cross jurisdictional boundaries.¹⁴ An origin-based tax applies to exports from the taxing jurisdiction, as well as to domestic production; it does not apply to imports, but value added after the import stage is subject to tax. In other words, an origin-based tax is a tax on production occurring in the taxing jurisdiction. It is imposed at the rate chosen by the jurisdiction of origin, which gets the revenue from the tax.

A destination-based tax is levied on the full retail value of imports, exports are exempt, and any tax collected before the export stage is refunded.¹⁵ A destination-based tax is levied on consumption occurring in the taxing jurisdiction. The jurisdiction of destination chooses the tax rate and receives the revenue.

A destination-based tax has several advantages. First, being a tax on consumption, a destination-based tax is not likely to distort the location of economic activity, except where cross-border shopping (buying products in one jurisdiction for consumption in another) in lower-tax jurisdictions and untaxed purchases from remote vendors are economic alternatives. Second, such a tax probably serves relatively well—and better than an origin-based tax—as a surrogate for user charges for the consumption of public services.¹⁶ By comparison, while simpler to implement, an origin-based tax would distort the location of economic activity and induce a “race to the bottom,” as states compete to attract footloose industry by lowering taxes.

14. There are, of course, an infinite number of ways to levy taxes that follow no consistent principle. However, the only such method discussed in this article is the extant RST.

15. Those familiar with the mechanics and terminology of the VAT will recognize that it would be more accurate to say that exports are zero-rated, exporters are allowed credits for VAT paid on purchases, and that tax collected before the export stage is refunded to the extent it exceeds VAT due on non-export sales.

16. An origin-based tax is also more likely to be exported to non-residents than is a destination-based tax. I do not emphasize this because tax exporting to non-resident consumers is likely to be important only when the taxing state dominates the market for taxed products—a relatively rare phenomenon, especially when a general sales tax is at issue. Exporting of an origin-based tax to out-of-state owners of productive assets is more likely.

4. *The need for uniformity*

The three characteristics of an ideal RST discussed above should guide the policy of any jurisdiction acting alone. More is required of a sales tax levied in a multijurisdictional setting. Except for rates, sales taxes should be essentially uniform across jurisdictions, both to avoid undesirable economic effects and—of special significance in the present context—to minimize costs of compliance and administration. Differences in rates must be allowed so that jurisdictions can exercise this most important element of fiscal sovereignty.

a. Identical tax base. The tax base should be identical (or very similar) in all jurisdictions. Otherwise, merchants operating in more than one jurisdiction, including remote vendors, must know the tax base in every jurisdiction where they make sales.¹⁷ The base would be identical under the ideal sales tax described above. It would consist of all sales to households and include no sales to business. If there were exceptions to these rules (e.g., an exemption for prescription medicine), all jurisdictions should adopt the same exceptions. Statutory language and regulations describing the tax base and administrative procedures would need to be identical.

b. Identifying legitimate business deductions. One of the most important features the ideal system must contain is a uniform means of determining whether a given transaction is a taxable sale to a household or an exempt sale to a business. There seems to be a relatively simple solution to this problem. First, eligibility to make purchases that are exempt from sales tax should be limited to purchasers with federal employer identification numbers.¹⁸ The purchaser would be required to provide this number when making tax-exempt purchases. Second, such potentially exempt purchasers should be allowed to make tax-exempt purchases only to the extent they are allowed a deduction for the expenditure in question for federal income tax purposes.¹⁹

There should be a uniform exemption certificate—which the

17. When I refer to “every jurisdiction where they make sales,” I ascribe the common-sense meaning to these words to refer to the state where customers are located and to which products are sent—not legal meanings such as the state where title passes.

18. A similar rule might allow only non-profit organizations that are registered with the IRS to make tax-exempt purchases.

19. Eligibility for sales tax exemption should be interpreted broadly to include, for example, eligibility for depreciation allowances.

purchaser should be able to transmit electronically—that is recognized by all states. The exemption certificate could be relatively simple; it need contain only two pieces of information: the purchaser's federal employer identification number and certification that the purchase is deductible for federal income tax purposes. The existence of information on the nature of products bought under each employer identification number would allow audit of the validity of purchases ostensibly made for business purposes.²⁰ This system would work only if (essentially) all sales to business are exempt, as they would be under the conceptual ideal; otherwise, cross-checking between income tax and sales tax records would be too complicated.

c. Identical administrative requirements and procedures. Administrative requirements and procedures (registration, filing, payment of tax, audit, appeals, etc.) should be identical (or virtually identical) across states. There is no reason for vendors that do business in more than one jurisdiction to need to comply with a different set of requirements and procedures in each state. Particularly important, joint audits should be performed on behalf of all states desiring audits.

d. Centralized compliance. To facilitate compliance, certain aspects of compliance and administration should be centralized, in a base state, a multistate organization, or a “trusted third party” (TTP). That is, forms and payments might be filed with the taxpayer's state of commercial domicile or a multistate agency, which would distribute the relevant information and money to the individual states.²¹ Alternatively, a TTP would assume responsibility for most of the burden of compliance. This is explained and discussed further below.

e. De minimis rules. Small businesses incur costs of compliance that are disproportionate to the amount of sales they make.²² Some states provide “vendors' discounts” intended to compensate for these costs, but the discounts are generally inadequate to fully offset costs. It may thus be appropriate to establish a de minimis amount of

20. Note that this compilation of information would pertain only to purchases for which a business exemption is claimed.

21. I intentionally use the term “taxpayer” inaccurately in the case of the use tax to refer to the vendor who collects the tax, rather than to the purchaser, who has the legal liability to pay the tax and for whom the vendor collects the tax.

22. For a discussion of compliance and vendor's discounts, see Robert J. Cline & Thomas S. Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers*, 18 ST. TAX NOTES 297 (2000). Note that compliance costs are especially high because of the existence of local sales and use taxes.

sales, below which there is no liability to collect sales or use tax. Different de minimis rules might be appropriate for intrastate and interstate sales. A de minimis rule is probably appropriate even under an ideal system of the type described above and, in fact, would be provided, de facto, by an adequate vendors' discount.

f. The question of local sales and use taxes. One of the trickiest issues is whether an ideal RST could incorporate local sales and use taxes. I tend to doubt it. If, however, there are to be local rates, certain things are implied.

g. Coincidence of ZIP codes and jurisdictional boundaries. Compliance with (and administration of) local use taxes would be greatly facilitated if the boundaries of taxing jurisdictions corresponded with postal ZIP codes. This would enable remote vendors to easily ascertain the local tax rate that should be applied to a particular sale and the local jurisdictions that should receive use-tax revenues. At this late date, this may be a counsel of perfection. It is possible that tax compliance software can handle the problem by mapping nine digit ZIP codes into jurisdictional boundaries.²³

h. Zero-cost compliance. Governor Michael Leavitt of Utah, on behalf of the National Governors' Association, has proposed that there should be zero cost of compliance for taxpayers.²⁴ This is a laudable objective, as costs of compliance can be quite high, especially for small vendors. A key to the zero-cost compliance proposal is the provision of tax compliance software at government expense. Because of the simplicity of the ideal system, the required software would be substantially cheaper to produce, maintain, and operate than under current law.²⁵

5. The simplicity of the ideal RST

Under the ideal system described above, the sales and use taxes of all states would be essentially identical, except where state sover-

23. See Dan Sullivan et al., *Submission by TAXWARE Int'l Inc.* (visited Mar. 1, 2000) <<http://www.ecommercecommission.org/library.htm>> (submitted to the Advisory Commission on Electronic Commerce, San Francisco, December 15, 1999).

24. See National Governors' Association, *Streamlined Sales Tax System for the Twenty-First Century* (visited Jan. 17, 2000) <<http://nga.org/internet/proposal.asp>> (presented to the Advisory Commission on Electronic Commerce, San Francisco, December 15, 1999).

25. It should be noted that compliance has zero cost for the taxpayer; however, it is not without cost to society. Under the proposal for zero-cost compliance, simplification would reduce the cost to government, as well as to society.

eignty is most important, in the setting of tax rates. There would be a single, uniformly defined tax base. Purchases by business would be exempt in all states, as long as they are eligible for deductions (or similar treatment) under the federal income tax. Laws, regulations, and administrative requirements and procedures would be the same throughout the nation. Centralized reporting and the use of compliance software would ease the burden of compliance. For firms with sales below the de minimis threshold, the only burden would be certifying the level of sales (and, of course, being prepared to prove eligibility for the de minimis exception).

B. Inherent Defects of the RST

The RST suffers from inherent defects, especially when imposed by subnational governments, even if all states levy the ideal sales tax described above. If inherent defects are important enough, perhaps state and especially local governments should not rely on the retail sales tax.

1. Inherent problems of implementing destination-based taxation

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.²⁶

a. Cross-border shopping. Cross-border shopping violates the principle that taxation should be based on the destination principle. Yet there is not much that can be done about it, if creation of a single market carries high priority. It is simply not acceptable to stop cars (or pedestrians, cyclists, and passengers on interstate planes, trains, buses, and boats) at state borders and perhaps search them for goods being taken across state lines without paying sales tax of the state where consumption will occur. In the case of goods being transported across the boundaries of local jurisdictions, implementation of a destination-based local tax would be essentially infeasible, as well as unacceptable on policy grounds.

Cross-border shopping across state lines is primarily problematic where major metropolitan areas straddle state lines, as in the case of

26. These problems are not unique to the RST; they also occur under the VAT.

New York City, St. Louis, and Kansas City. But cross-border shopping between local jurisdictions is endemic, given the fragmentation of cities. Furthermore, it cannot be assumed that the effects will be minor or benign. If consumers shop in regional malls, substantial amounts of revenue flow to the “wrong” jurisdiction (where people shop, instead of where they live), as judged by the criterion of the destination principle. If tax rates differ enough between jurisdictions and consumers shop where rates are lowest, there may also be significant distortions of decision-making.

b. Remote sales of tangible products. It is inherently more difficult for remote vendors to comply with a duty to collect use tax than for local vendors to meet sales tax obligations. Even if there is a uniform tax base, remote vendors must know the destination (the state and perhaps the locality) of their sales and the tax rate of every jurisdiction where they make sales. It seems, however, that sales of tangible products would not pose insurmountable problems under the ideal system described above since each such sale has a mailing or “ship to” address. The compliance problems of small remote vendors can probably be handled satisfactorily by providing a de minimis exemption for firms with sales below a certain level. For larger firms, tax compliance software can probably produce satisfactory results.²⁷

c. Sales of digital content. Remote sales of digital content (e.g. music, videos, software, and games) are especially troublesome. Anonymity is a key characteristic of the Internet. As the famous cartoon says, “On the Internet no one knows you are a dog.”²⁸ With anonymity goes the potential inability to determine the location of

27. There is one qualification and two exceptions to this optimistic assessment. First, since jurisdictional boundaries and ZIP codes do not coincide, states must be more forgiving when vendors make errors in identifying to the local level the destination of shipments. Under a TTP system such errors would be the responsibility of the TTP. Second, while a “software solution” works well when remittance is made by credit card (so the charge can be adjusted to reflect applicable taxes) or is made in real time (so the tax due can be calculated before the sale is consummated), it does not work if the purchaser wishes to pay with a check or money order and the tax due is not determined in real time; there is no convenient way to communicate the tax rates of thousands of local jurisdictions in a printed catalog. Third, it is necessary to decide how to treat gifts. Conceptually defensible arguments can be made for taxation by the jurisdiction where the donor lives or where the gifts are delivered. The former answer raises no new issues. The latter compounds the first problem identified above, because gifts are sent to multiple jurisdictions. Moreover, it may not be available if digital content is sent to multiple locations, for example, if the donor prepays for the donee’s access to a predetermined amount of digital content.

28. Peter Steiner, Cartoon, *NEW YORKER*, July 5, 1993, at 61.

customers, and thus the potential inability of vendors to apply the appropriate tax rates and remit revenue to the appropriate state and local jurisdictions, the inability of tax administrators to audit these transactions, and ultimately the ability of customers to purchase digital content, especially from suppliers located off-shore, without paying sales tax. Information currently being obtained to verify the identity of purchasers using credit cards to make payments may be adequate to identify the state and even the local jurisdiction of purchasers. But the widespread advent of digital cash—not to mention intentional routing of credit card bills through states that have no sales tax or even foreign countries—may make this information unavailable or inaccurate. Thus, advocating destination-based taxation of digital content may be a counsel of perfection, whether under the RST or the VAT. It may be necessary to retreat to a conceptually flawed compromise for sales of digital content by domestic suppliers, such as imposition by the states acting in concert of a nationwide use tax on digital content, with allocation of revenues among jurisdictions on the basis of a formula.²⁹

There is fear that an attempt to tax digital content would drive vendors offshore, where they could take advantage of the anonymity provided by the Internet to escape taxation. This risk may be overstated. Cooperation between the United States and other members of the OECD may cut off this avenue of tax evasion. It appears to be relatively simple to require foreign subsidiaries of domestic corporations (or of corporations headquartered in foreign countries willing to cooperate in administration of such a system) to pay the uniform use tax on sales of digital content.³⁰ There would be problems in the case of digital content sold by suppliers located in countries that are unwilling to cooperate. It is worth remembering, however, that the great bulk of digital content is bought by businesses and would not be subject to sales or use tax under the conceptually ideal system. The remaining gap would consist of sales of digital content to

29. This sentence raises a host of issues that cannot be examined in detail here. Such a scheme would almost certainly be unconstitutional without the Congressional seal of approval since the nationally uniform tax would exceed the tax on local sales in some jurisdictions. However, with Congressional approval, it would almost certainly be constitutional. States might choose to compensate consumers who pay use tax in excess of the local sales tax rate, but probably would not.

30. Because of the difficulty of identifying the location of purchasers, it may be necessary to employ a formula for this purpose.

households by independent suppliers, probably a small part of the potential sales tax base.

2. *Political defects*

The way the RST operates creates incentives for both governments and business to deviate from the ideal tax described above. This does not mean that the ideal tax does not have the benefits attributed to it—only that it is unlikely to be found in practice, or at least less likely to be found than is a conceptually pure VAT.

a. The incentive to seek exemptions. Under the RST, if a sale is exempt, that is the end of the story; the purchaser avoids the tax. Thus, there is an incentive to try to gain exemptions, and no reason not to do so. This stands in marked contrast to the VAT, where an exemption is advantageous only if sales are made to households. Even then, it is less valuable than under the RST because only value that is added at the retail stage escapes VAT. An exemption of pre-retail sales actually increases aggregate taxation under the VAT, since no credit is allowed for VAT paid on purchases by the exempt seller.³¹

b. The proclivity to tax sales to business. A retail sales tax yields the same revenue with lower tax rates if sales to business are taxed than if they are exempt. The tax on business inputs is hidden from public view. Therefore, politicians have an incentive to tax sales to business and not to eliminate such taxation if it already exists. Again, there is generally no such incentive under the VAT, as credit is allowed for tax paid on purchases by registered traders.³²

Potentially offsetting the incentive to tax sales to business is the adverse effect doing so has on the business climate of a state; a state will be a more attractive place to invest if tax is not levied on capital goods and/or other business inputs.³³ How the forces for taxing and not taxing business inputs will play out in a given state cannot be known *a priori*, but it seems safe to say that the present situation il-

31. Zero-rating has quite different effects: none in the case of pre-retail transactions and complete elimination of tax in the case of retail sales. See CHARLES E. MCLURE, JR., *THE VALUE ADDED TAX: KEY TO DEFICIT REDUCTION?* 72-75 (1987). Except for exports, zero-rating is quite rare in the EU.

32. If anything, there is an incentive not to provide exemptions of sales to business, for reasons noted earlier.

33. One of the most famous examples of the exit of investment caused by taxation of capital investment involves Intel's decision to locate a new microchip processing plant in New Mexico, rather than in California where it would have been subject to sales tax.

lustrates the tyranny of the status quo. Had sales to business never been taxed, it is unlikely that they would be taxed now because of the harm to the business climate. But for historical reasons, they are currently taxed. The tax on business inputs, which is hidden, is not likely to be rescinded in a revenue-neutral manner, because of the need to raise tax rates on the remaining taxable sales to maintain revenues.

C. Defects of the Actual RST

Besides the inherent problems described above, which are relatively minor, the actual RST exhibits explicit defects that are not inherent but are substantially more important. As state sales taxes operate in practice, they flagrantly violate all the primary criteria listed above (economic neutrality, equity, simplicity, and transparency). The complexity that plagues the sales tax “system” is especially important for present purposes because it stymies efforts to tax remote commerce, including electronic commerce.

1. Failure to exempt all business inputs

States commonly do not attempt to exempt all sales to business; rather, they provide exemptions on a selective basis.³⁴ All states exempt sales for resale, but the Multi-State Tax Commission’s (MTC’s) draft “Uniform Resale Exemption Certificate” is far from uniform. Most states also exempt products to be physically incorporated in a taxable product. Beyond that, policy on exemption of business inputs is haphazard; various states exempt industrial fuels, utilities, and agricultural inputs (e.g., fertilizer, seed, and farm implements). Even where exemptions are facially identical, they may not be similar. In short, the lack of a uniform exemption policy is the source of considerable complexity for vendors operating in more than one sales-tax state.

a. Certification of eligibility to make tax-exempt purchases: current practice. In order to make tax-exempt purchases under the RST, as it actually operates, a firm must file a resale (or similar) exemption cer-

34. This description is meant to indicate the nature of the problem; it is not intended to be comprehensive. For a comprehensive description, see JOHN F. DUE & JOHN L. MIKESSELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 59-74 (2d ed. 1994).

tificate with its supplier. In other words, to evade tax, a purchaser must be willing, in the first instance, to lie to a supplier. It must also be prepared to withstand audit—to show that the particular purchases are eligible for an exemption. But the primary attention of audits is on the vendor. There is no link to eligibility for federal income tax deductions, and cannot be, given the haphazard structure of exemptions for purchases of business inputs.

The situation is quite different under the VAT. All (non-exempt) sales are subject to tax, without regard to the nature of the buyer. Multiple tax on business purchases is avoided by allowing credits for VAT on business purchases to be taken against VAT on sales. Thus, the focus of audit is on the buyer, who must lie directly to the tax authorities to evade tax. For both conceptual and organizational reasons, the link to income tax administration is potentially much closer.

b. Certification of eligibility to make tax-exempt purchases: the proposal. The proposed system would tie exemption of business inputs to eligibility for deduction (or similar treatment) under the federal income tax; if the federal government allows a deduction for the expenditure, it would be exempt from sales tax. While there is some possibility of cheating by claiming federal tax deductions for what are actually personal expenditures, doing so would require providing a false employer identification number. Moreover, this type of cheating is likely to involve a relatively small amount of sales tax revenue. After all, ordinarily far more is at stake in lost federal and state income tax revenue than would be involved in failure to collect sales or use tax. Moreover, states would retain the right to audit purchasers claiming exemptions for business purchases.

2. Failure to tax all consumption

The typical state sales tax fails to tax all consumption; indeed, it may tax less than half. Again, besides being bad policy on economic grounds, the diversity of state practice creates needless complexity.³⁵

a. Exemption of services. The tax treatment of goods and services under the typical RST is quite asymmetrical. For the most part, goods are taxed, unless explicitly exempted. By comparison, services

35. See generally *id.*

are generally exempt, unless explicitly listed as subject to tax. (Intangible products are typically not mentioned, but it generally can be assumed that they are exempt.) While in theory the “exemption” approach applied to goods and the “enumeration” approach applied to services could produce the same result, in fact they do not. Generally, goods are taxed, with some relatively common exceptions (e.g., for food and prescription medicine), and most services are exempt.

b. Exemption of goods. States differ considerably in which tangible products they choose to tax. For example, many exempt food and some exempt clothing. Moreover, some states provide exemptions for clothes bought during a certain period of the year, to relieve the burden of taxation on school clothes.³⁶

c. Definition of exempt products. States do not define exempt products the same way. Differences in the way food and clothing are defined are legendary.³⁷

d. Determination of tax base by local jurisdictions/local filing. Of all the many features of a many system, perhaps the manyest of all is allowing local governments to define their own sales tax bases.³⁸ There is absolutely no excuse for allowing local governments to deviate from the state definition of the tax base; any gain in local autonomy is outweighed by the complexity inherent in this practice. The complexity would be extremely burdensome for a taxpayer operating stores in several localities in a given state;³⁹ it would be an intolerable burden on interstate trade if remote vendors were required to collect local use taxes.

Almost as absurd is the practice of requiring taxpayers to file sales and use tax returns with local governments. This does not even have the redeeming quality of contributing to local autonomy; it merely creates needless costs of compliance. All states should do what most do: provide that local sales taxes be imposed as surcharges on the state taxes, so that liabilities to local governments are reported to the state, which distributes revenue among the local governments.

36. See Cline & Neubig, *supra* note 22.

37. See, e.g., Cline & Neubig, *supra* note 22.

38. See DUE & MIKESSELL, *supra* note 34, at 277-318.

39. See *Advisory Commission on Electronic Commerce: Third Meeting*, at 231 (visited Mar. 1, 2000) <<http://ecommercecommission.org/sanFran/tr1215.htm>> (statement of David Bullington, Vice President of Tax, Wal-Mart) (asserting that complying with the sales tax requirements in two states required more resources than complying with the requirements of 10 other states).

3. *De facto exemption of remote sales*

Because of the complexity of the present system, the Supreme Court, in *Quill*, ruled that remote vendors cannot be required to collect use tax in states where they do not have a physical presence.⁴⁰ While understandable, this decision produces results that violate common sense, as well as accepted norms of tax policy: remote vendors are favored relative to local merchants, horizontal and vertical equity are violated, and the tax base is undermined. Neutrality between electronic commerce and traditional remote commerce would require that the *Quill* doctrine be extended to the former. The fear that this judicial doctrine might be applied to electronic commerce causes considerable apprehension on Main Street and in state capitals.

D. The Impact of Electronic Commerce

The advent of electronic commerce has called attention to the defects of state sales and use taxes, especially the tax's complexity and its failure to tax remote commerce. In the first instance, loss of revenues has been the primary concern; state and local government officials fear that revenue will vanish into cyberspace, as commerce shifts to the World Wide Web.⁴¹

Remote commerce—and thus electronic commerce—cannot be taxed, as long as the system is so complicated. It is impossible to create “technological neutrality” because of the structure of the existing system. Should electronic commerce be taxed, like many sales on Main Street, or should it be exempt, like most remote commerce?⁴² The key to a solution of these problems is enough simplification of

40. See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). See also Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425 (1997).

41. See NATHAN NEWMAN, PROP 13 MEETS THE INTERNET: HOW STATE AND LOCAL GOVERNMENT FINANCES ARE BECOMING ROAD KILL ON THE INFORMATION SUPERHIGHWAY (Economic Democracy Information Network Report, Center for Community Economic Research at U.C. Berkeley ed., 1995) (on file with author). Newman was an early doomsayer. See Robert J. Cline & Thomas S. Neubig, *The Sky Is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998*, 17 ST. TAX NOTES 43 (1999) for a more realistic assessment. See also Austan Goolsbee & Jonathan Zittrain, *Evaluating the Costs and Benefits of Taxing Internet Commerce*, 52 NAT'L TAX J. 413 (1999).

42. See Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Law*, 52 TAX L. REV. 269 (1997); Charles E. McLure, Jr., *Achieving a Level Playing Field for Electronic Commerce*, 14 ST. TAX NOTES 1767 (1998).

the sales and use tax that imposing an expanded duty to collect use tax on remote vendors is not unreasonable.⁴³

IV. PROPOSED SOLUTIONS TO THE PROBLEM OF TAXING ELECTRONIC COMMERCE

Suggestions of how to tax electronic commerce depend on the objectives sought. Some proposals, though motivated by the desire to exempt electronic commerce, would exempt all remote commerce. Others are targeted more narrowly at electronic commerce. An exemption could be either permanent or temporary. While some would exempt electronic commerce only from use tax, others would exempt it from sales tax. While I strongly oppose both a sales tax exemption for electronic commerce and a permanent use tax exemption, I believe a temporary use tax moratorium is both inevitable and desirable. Such a moratorium would allow the states time to simplify their sales tax systems so that an expanded duty to collect use tax is not unreasonable. But I do not believe such a moratorium should be legislated.

A. Proposals to Exempt Electronic Commerce Permanently

A permanent exemption of electronic commerce is advocated for a variety of identifiable reasons, none of which I find convincing.⁴⁴

Some seem to believe that e-commerce is imbued with mystical—almost magical—properties that justify exemption. Advocacy of an exemption for e-commerce smacks of central planning—the view, largely discredited since the demise of the Soviet Union, that politicians and bureaucrats (and industry spokespersons and editorialists in this case) do better than markets in choosing what to produce and how to produce and distribute it.⁴⁵ There is little convincing evidence or argumentation that external benefits, which cannot be

43. See National Tax Association Communications and Electronic Commerce, *Tax Project Final Report* (visited Feb. 12, 2000) <<http://www.ntanet.org>>.

44. Advocates of exemption commonly parade a litany of fallacious arguments to support their position. My refutation of many of them, from Charles E. McLure, Jr., *The Taxation of Electronic Commerce: Background and Proposal*, in PUBLIC POLICY AND THE INTERNET: PRIVACY, TAXES AND CONTRACTS (Nicholas Imparato ed., forthcoming 2000), is included as Appendix A.

45. I find it anomalous that the editorial page of the *Wall Street Journal* is the most prominent situs of this *dirigist* view of the world. See, e.g., *The E-Grinch*, Editorial, WALL ST. J., Nov. 29, 1999, at A28.

captured by the private sector, exist and are important enough to justify a permanent exemption.⁴⁶ If external benefits do not exist or are not important, an exemption would cause undesirable distortions in the conduct of business, for example, by encouraging uneconomical methods of distribution. Thus, I agree with what Ronald Reagan said in 1981, that “[t]he taxing power of government must be used to provide revenues for legitimate government purposes. It must not be used to regulate the economy or bring about social change.”⁴⁷

Another (somewhat cynical) view is that a permanent exemption would force politicians to reduce sales taxes in response to complaints from Main Street merchants about unfair treatment. However, a permanent exemption would impose windfall losses on Main Street merchants. No matter how much one desires lower tax rates, I do not think it appropriate to sacrifice Main Street on the altar of sales tax reduction.

Just before the San Francisco meeting of the Advisory Commission on Electronic Commerce (ACEC) on December 14–15, 1999, a small group of tax specialists, fearing that the Commission might advocate a permanent exemption for e-commerce, sent e-mails to a hurriedly assembled list of academic tax specialists asking them to support an appeal to the Commission to oppose a permanent exemption.⁴⁸ By the time the appeal was submitted to the Commission in fewer than three business days, fifty-five academic tax specialists had expressed their support for it. Support has continued to grow, and by early February 2000 more than 170 academic tax specialists and two recipients of the Nobel Prize in economics (Kenneth Arrow and James Tobin) had endorsed the appeal. Particularly noteworthy is the fact that, with three easily-explained exceptions, every Deputy Assistant Secretary (DAS) of the Treasury for Tax Analysis (the highest tax policy position normally held by an economist) since 1975, as well as one Assistant Secretary and two DASs for Tax Policy (posi-

46. It is quite common for advocates of exemption to cite the work of Austan Goolsbee, although Goolsbee is quite clear that he supports, at most, a temporary exemption. See Goolsbee & Zittrain, *supra* note 41.

47. Address Before a Joint Session of the Congress, 17 WEEKLY COMP. PRES. DOCS. 131, 137 (Feb. 18, 1981).

48. The “Appeal for Fair and Equal Taxation of Electronic Commerce,” including the list of signatories as of December 29, 1999, is included as Appendix B to this paper. Besides urging the ACEC not to propose a permanent exemption for electronic commerce, the appeal advocates destination-based taxation of sales, simplification, and elimination of compliance burdens on vendors making small amounts of sales.

tions held by tax lawyers) support the appeal.⁴⁹ It is clear that a permanent exemption of electronic commerce has virtually no support among academic tax professionals.

1. Codification/extension of Quill

Under current judicial interpretation of the U.S. Constitution, e-commerce in tangible products would benefit from the protection of *Quill*. Although there is some uncertainty whether the *Quill* doctrine would also apply to remote sales of digital content, most seem to believe that it would. If *Quill* does cover these sales, nothing need be done to create an effective exemption of electronic commerce that crosses state boundaries; *Quill* will be the law of the land unless and until it is overturned. Yet some are not content with the status quo; they would like to codify *Quill* and perhaps broaden the protection it provides.

a. Codification. Codification of *Quill* would have the advantage of converting tax evasion to tax avoidance; those who do not pay use tax on purchases from remote vendors would no longer be breaking the law. But codification has an enormous disadvantage. Whereas the Supreme Court could conceivably overturn its decision in *Quill*, if the states were to simplify the sales taxes, it seems extremely unlikely that the Court would overturn a codification of that decision, which the Congress would presumably enact pursuant to powers granted by the Commerce Clause of the Constitution.⁵⁰ Thus, failing legislative repeal of the codification, the nation would be left with an indefensible but permanent exemption of remote commerce, even if the sales taxes are simplified dramatically. Since a moratorium should be only temporary, until the states simplify their sales and use taxes, it would be a mistake to codify the *Quill* decision.

b. Extension. Dean Andal, a member of the ACEC, has advocated legislation that would extend the protection provided by *Quill* in several ways.⁵¹ It would substitute “substantial physical presence” for

49. Only one DAS for Tax Analysis who did not sign is an academic; he says he does not sign anything. Relatively few of those who have held the positions of Assistant Secretary or DAS for Tax Policy are academics.

50. In *Quill*, the Court urged Congress to substitute its own nexus test if Congress did not like the Court’s decision. See *Quill Corp. v. North Dakota*, 514 U.S. 298, 318 (1992). Codifying *Quill* could be reasonably interpreted as answering that challenge.

51. See Dean Andal, *A Uniform Jurisdictional Standard: Applying the Substantial Physical Presence Standard to Electronic Commerce* (visited Feb. 12, 2000) <<http://www.ecom->

the “physical presence” bright-line test of “substantial nexus” in *Quill*, list specific activities that would not be deemed to constitute nexus, and extend the protection of *Quill* to business activities taxes (essentially corporate income taxes).

Andal’s approach would be even worse than mere codification of *Quill*, the faults of which it shares. First, raising the threshold for nexus to “substantial physical presence” would lead to a flood of litigation, as taxpayers test the limits of this new standard. Second, some of the activities in Andal’s “safe harbor” list clearly should constitute nexus; the presence of a corporate affiliate in the taxing state is one.⁵² In short, the Andal proposal should be rejected.

2. Exemption of “electronic commerce”

Senator John McCain (R-Ariz.) has introduced legislation that would amend the Internet Tax Freedom Act (ITFA) to provide that state and local governments could not impose “sales or use taxes for domestic or foreign goods or services acquired through electronic commerce.”⁵³ Congressmen John Kasich and John Boehner (both R-Ohio) have proposed a virtually identical prohibition, which they call the “Internet Tax Elimination Act” (I-TEA).⁵⁴ These two proposals would exempt all electronic commerce, even if conducted by a vendor that has nexus in the state.

One can examine these proposals under two scenerios: first, under the naïve assumption that what we now think of as electronic commerce is all that would be exempt and second, under the more realistic assumption that business practices would adjust to take account of the exemption of electronic commerce.

a. The naïve view: getting the economics wrong. Some want to exempt electronic commerce because they believe it to be the source of increased productivity. But the logical implication of this belief is not that all electronic commerce should be exempt, but that all sales to business should be exempt. Consider Figure 1, which shows a four-way division of commerce among (a) electronic and traditional

mercecommission.org/document/andaluniformstd.pdf>.

52. See Michael J. McIntyre, *Taxing Electronic Commerce Fairly and Efficiently*, 52 TAX L. REV. 625 (1997) (the defects of “entity isolation”—the view that what I call “nexus by affiliation” is not automatic). I do not comment on the extension of *Quill* to business activities taxes, as doing so would take me too far afield.

53. S. 1611, 106th Cong. (1999).

54. H.R. 3252, 106th Cong. (1999).

commerce and (b) sales to business and sales to households. Cell 1, business-to-business transactions in electronic commerce—sometimes called B2B—is where most electronic commerce is occurring. It is also the source of most of the gains in productivity attributable to electronic commerce. By comparison, electronic sales to households in Cell 3 are relatively small and not likely to be the source of great gains in productivity.

This figure assists in understanding the difference between my proposal and the proposal to exempt all electronic commerce. I would exempt all sales to business—the first row of the figure—while an exemption for all electronic commerce would apply to the first column.

Although exemption of all electronic commerce would avoid impeding B2B transactions in electronic commerce, it would discriminate against Main Street merchants making sales to either businesses or consumers. The conceptually correct solution of exempting all sales to business achieves the primary objective of allowing B2B commerce to develop tax-free, but without discriminating against traditional sales to either business or households.

Figure 1
Four-way Division of Commerce

	Electronic Commerce	Traditional Commerce
Sales to business	1. Electronic sales to business	2. Traditional sales to business
Sales to households	3. Electronic sales to households	4. Traditional sales to households

b. The realistic view: gutting the sales tax. The definition of electronic commerce in legislation providing an exemption is crucial. Since the McCain bill and I-TEA would amend the Internet Tax Freedom Act (ITFA), they rely implicitly on the definition of electronic commerce contained in Section 1104 of the ITFA: “Electronic commerce.—The term ‘electronic commerce’ means any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property,

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goods, services, or information, whether or not for consideration, and includes the provision of Internet access.”⁵⁵ It appears that, under this definition, all that is required for classification as electronic commerce is interposition of a connection to the Internet between the order and delivery of a product. For example, a customer in a department store might identify a product in a showroom and use a terminal sitting on the counter to order the product over the Internet for pickup at the check-out counter a few minutes later. As far-fetched as this example seems, it was approved by Chris Wysocki, the advocate of the I-TEA before the San Francisco meeting of the ACEC on December 14, 1999.⁵⁶ If enacted, such a proposal could essentially eliminate the sales tax. This, it appears, is the objective of some who support his approach.⁵⁷

B. A Temporary Exemption for Electronic Commerce: Reliance on Quill

One can identify at least two arguments for a temporary exemption for electronic commerce: First, a temporary exemption would provide a chance for this potentially vital industry to grow. Second, a temporary exemption would allow time for development and implementation of a rational long-run tax policy toward e-commerce, which would require simplification of the state sales and use taxes.

I do not believe that exemption is needed to spur growth of an industry that is growing more rapidly—and producing billionaires more quickly—than any in history. On the other hand, given the currently disastrous complexity of the state sales taxes, a temporary moratorium for e-commerce that crosses state lines is probably inevitable, as well as appropriate. The Supreme Court is not likely to require remote vendors engaged in electronic commerce to collect use taxes that reflect the current complexity of the sales taxes, nor

55. Internet Tax Freedom Act § 1104(3), 47 U.S.C. § 151 (1998).

56. See *Advisory Commission on Electronic Commerce: Third Meeting*, at 253-55 (visited Feb. 12, 2000) <<http://www.ecommercecommission.org/sanFran/tr1214.htm>> (statement of Chris Wysocki, President, Small Business Survival Committee).

57. Witness the following exchange between Mr. Pincus, the Commerce Department representative on the ACEC, and Mr. Wysocki:

“Mr. Pincus: . . . [W]ouldn’t every store owner of any size in America have integrated the Internet into their business in a way that there wouldn’t be any sales tax?”

Mr Wysocki: It would be a good idea.”

Id. at 254-55.

should it. If, however, sales and use taxes can be simplified to the point that collection of use taxes is not an unreasonable requirement to impose on remote vendors, either the Supreme Court or the Congress may—and should—overturn *Quill*. In short, until overturned either judicially or legislatively, *Quill* provides a de facto moratorium against use tax on electronic commerce that crosses state lines.

Quill does not provide a satisfactory long-run solution. Besides producing a result that is undesirable on economic grounds, it creates a nation of scoff-laws. Under the *Quill* doctrine, the use tax is a tax on honesty, and individuals are forced to choose between breaking the law and feeling they are the only ones who do not. Reliance on *Quill* may, however, be a reasonable short-run strategy. It avoids at least two risks: (a) that a temporary statutory exemption would become permanent and (b) that an exemption statute would be poorly drafted, either by inadvertence or by design, creating undesirable and perhaps unintended consequences.

C. Proposals to Tax Electronic Commerce by Tinkering with the System

Some would simplify the existing system enough to gain voluntary compliance by vendors who lack nexus under *Quill* or either Congressional approval or judicial sanction of a requirement that remote vendors collect use tax. The National Governors' Association (NGA), in its submission to the ACEC, has proposed a package of reforms that it believes would elicit voluntary collection of use tax. Its package includes the following: (a) a menu of potentially taxable products, based on state adoption of uniform definitions of products. This approach avoids the need for states to adopt a uniform tax base, and thus preserves substantial state sovereignty over the tax base; (b) menus for the tax treatment of various items when bought by business firms or non-profit organizations. Given that different industries make different uses of various things they purchase, the menu for business purchases might have refinements not found in the menu for sales to households; (c) administrative simplification, such as joint audits; (d) use of trusted third parties (TTPs), which would be responsible for ascertaining tax liabilities, depending on the product and the characteristics and location of the buyer; (e) state compensation for the cost of compliance, including the cost of obtaining and

maintaining compliance software from TTPs.⁵⁸

I believe this approach does not go far enough; when the NGA proposal mentions “uniform laws,” it apparently means uniform definitions and menus, not a uniform and rational tax base or truly uniform laws and regulations. While a uniform menu of what might be taxable would clearly be an improvement over the present system, which lacks even uniform definitions, this approach forswears the massive simplification that would result from exempting all business purchases and taxing all consumption spending by households.⁵⁹ There could be as few as a dozen items or as many as 10,000 items (or more) in the menu, depending on the level of aggregation in constructing the menu.⁶⁰ Of course, the more aggregation, the closer the system is to a uniform base, the simpler the system, and the more incursion into state fiscal sovereignty. Conversely, the less aggregation, the more complex the system will remain.

The NGA proposal is rather sketchy in its description of the TTP approach. One thing is certain: the compliance software the TTPs would need is far more complicated and costly than if the tax were simplified along the lines of the ideal system.⁶¹ The NGA proposal for elimination of the compliance burden shifts avoidable social costs of compliance to state governments, rather than eliminating them, as under the proposal for fundamental reform.

Noticeably missing from the NGA proposal is the unification of local use tax rates, which business contends is essential. Adoption of “one rate per state” would greatly simplify compliance and administration. But it would also seriously undermine local fiscal autonomy if extended to sales tax rates.⁶² A compromise might be to allow local determination of sales tax rates, but require a uniform use tax rate in each state. Unless the use tax rate were set to equal the lowest sales tax rate in the state, this would require congressional approval, as there would be otherwise unconstitutional discrimination against

58. See National Governors’ Association, *supra* note 24.

59. I would liken this to giving a pair of crutches that are too short to someone with a broken leg; they may be able to walk, but only bent over, haltingly, and not far; the only satisfactory solution is to set the broken bone and let it heal, so the patient can walk normally.

60. The Final Report of the National Tax Association Project describes the menu approach in greater detail. See *Final Report*, *supra* note 43.

61. Concern has also been expressed that the TTP system would create an unacceptable threat to privacy.

62. Some local governments have pledged sales tax revenues to the service of debt incurred to finance capital projects, such as stadiums.

interstate commerce in local jurisdictions where the use tax rate exceeded the sales tax rate.

D. Fundamental Reform of the Sales Tax

I have advocated a significantly different approach—one that addresses the need for simplification by proposing adoption of the conceptual ideal. Given the discussion of Section III.A, as well as the description and justification of the system in Appendix C, I can be brief.⁶³ The proposed system would have these features:⁶⁴

- Exemption of all sales to business
- Taxation of all sales to households
- State and local autonomy over tax rates
- Identical administrative requirements and procedures
- Centralization of compliance, probably in the vendor's state of commercial domicile
- A *de minimis* rule to eliminate the compliance burden on small vendors

Once a sufficient number of states (or states representing the lion's share of the market for sales by remote vendors) have adopted the uniform system, it would be appropriate to petition Congress to allow any state adopting the uniform system to require remote vendors to collect use tax. An alternative, but riskier, strategy would be for states to adopt the proposed system and challenge the Supreme Court to revisit *Quill* by attempting to impose a duty to collect. The voluntary approach espoused by the NGA could probably also be employed to implement this system.

63. This is my proposal to the ACEC, presented at its meeting in San Francisco on December 15, 1999. See Charles E. McLure, Jr., *Radical Simplification of State Sales and Use Taxes: the Prerequisite for an Expanded Duty to Collect Use Tax on Remote Sales: A Proposal to the Advisory Commission on Electronic Commerce* (visited Feb. 12, 2000) <<http://www.ecommercecommission.org/library.htm>>.

64. I describe the pure system. If there are to be exceptions to the proposed tax base, the exceptions should be adopted by all states, so that the tax base is uniform, if not ideal. Use of something like the TTP might also be needed.

V. ALTERNATIVE WAYS OF FINANCING STATE AND LOCAL GOVERNMENT

Although the sales tax is the most important source of tax revenues for state governments, and an important source for local governments, it is not the only possible source. This section considers two: a switch from the RST to the VAT and replacement of revenues from the RST with revenues from the income tax.

A. The "Other" Sales Tax: the VAT

Some have suggested that the conceptually pure sales tax I have proposed sounds a lot like a value added tax. Actually, this is not true. The intent and effects of the VAT and the RST system I have proposed are similar, but the techniques by which they would be achieved are different. In the interest of completeness, I briefly describe in Appendix D how a state VAT might be implemented. I do not include a description in this text because I do not believe the VAT to be a viable option for the American states and do not want to divert attention to it.⁶⁵

Substitution of a VAT for the state RSTs would be an extremely radical proposal—much more radical than my proposal for adoption by all states of an RST that is uniform in all respects except tax rates. The mechanics of the VAT and the RST are quite different. (Whereas the RST uses exemptions to eliminate tax on business purchases, the VAT uses tax credits.) As a result of the need to introduce new methods of accounting and to retrain personnel involved in both compliance and administration, this is not a change that should be undertaken lightly. Moreover, it would be difficult—and probably impossible—to impose local surcharges on the state VAT. A state VAT is not something I am ready to propose.⁶⁶

65. See Charles E. McLure, Jr., *Implementing Subnational Value Added Taxes on Internal Trade: The Compensating VAT (CVAT)*, INT'L TAX & PUB. FIN. (forthcoming) [hereinafter McLure, *CVAT*]; see also Charles E. McLure, Jr., *Implementing a State VAT: Breaking the Logjam in Tax Assignment*, 1999 NAT'L TAX ASS'N (forthcoming) [hereinafter McLure, *Breaking the Logjam*].

66. Thus, The Economist is simply wrong when it says I favor a European-style value-added tax. See *The Happy E-Shopper*, ECONOMIST, Jan. 29, 2000, at 14.

B. Another Alternative: Expanded State and Local Taxation of Income

Some have suggested that the individual income tax may be a more satisfactory source of revenue for state and local governments than the sales and use tax.⁶⁷ This section examines that possibility.⁶⁸

1. Substitution of income tax for state and local sales taxes

Individual income taxes can be an attractive way to finance state and local governments. This is often overlooked by those who think of income taxes in terms of income distribution and macroeconomic stabilization, functions that must be discharged primarily at the national level. Income taxes can also act as a form of benefit tax, financing the generalized benefits of public services provided by subnational governments. Since individuals are likely to consume public services—and to vote where they live, and not where they work—income taxation should be levied primarily by the state of residence, not the state of employment. A residence-based income tax is similar to a destination-based sales tax in this regard.⁶⁹ The question, then, is whether residence-based taxation of income by subnational governments is feasible.

Experience in forty-four states clearly shows that a residence-

67. See Hal Varian, *A Proposal to Eliminate Sales and Use Taxes* (visited Feb. 14, 2000) <<http://www.ecommercecommission.org/library.htm>>; Charles E. McLure, Jr., *Electronic Commerce and the State Retail Sales Tax: A Challenge to American Federalism*, 6 INT'L TAX AND PUB. FIN. 193, 202 (1999) (“[T]he case for subnational use of sales taxes is not as clear as has sometimes been suggested. This is especially true in the case of use by local governments, which would better be financed by residence-based surcharges on individual income taxes, as is common in Europe.”).

68. This discussion ignores almost as many questions as it addresses. First, if state and local governments were to abandon the sales tax, it might be appropriate for the federal government to move into that field. In that case, a federal VAT would probably be preferable to a federal RST. See MCLURE, *supra* note 31. Second, this discussion pertains only to the individual income tax; there are many good reasons why the corporate income tax is not a good state tax and is a horrible local tax. See McLure, *supra* note 5. Third, there is no suggestion that the income tax should not continue to be used by the federal government. Elimination of the federal income tax would pose serious problems for implementation of the state and local taxes. See Robert P. Strauss, *Administrative and Revenue Implications of Alternative Federal Consumption Taxes for the State and Local Sector*, 14 AM. J. TAX POL'Y 361 (1997). Lastly, whereas the federal income tax would presumably have graduated rates, the subnational income taxes might be levied at a single rate. Moreover, lower tax thresholds might be appropriate for the subnational taxes, for reasons explained in the text.

69. It might be noted in passing that an income tax tends automatically to eliminate the taxation of business inputs, which are deductible, and differential taxation based on the composition of the household's market basket.

based state income tax is feasible. Moreover, experience in more than a dozen of those states indicates that a residence-based local income tax is also feasible. Local income taxes are commonly levied as surcharges on state taxes, which rely heavily on administration of the federal tax. Indeed, it is vastly simpler to collect residence-based income taxes than to collect use taxes based on the destination of sales of tangible products, let alone digital products. Moreover, the income tax does not suffer from defects equivalent to cross-border shopping in the sales tax area.

The primary reason for not favoring substitution of state and local income taxes for the sales and use tax is the tyranny of the status quo; such a wholesale switch in tax policy would cause wrenching adjustments. At this late date it seems better to attempt to reform the sales and use tax along the lines outlined earlier than to pursue this even more radical option.

A further problem with greater state and local reliance on the income tax is the fact that, as currently structured, the typical state income tax is not a mass tax related roughly to benefits of government services, which is required for responsible government, as the sales tax is. The great bulk of the federal income tax is paid by those in the top ten percent of the income distribution.⁷⁰ Even though the tendency toward less highly graduated rates in state taxes reduces the concentration of tax liabilities, the concentration still exists. Liability for state and local income tax is not likely to be closely related to benefits, unless tax thresholds are lowered substantially, a change many would find objectionable on distribution grounds. A system with two-thresholds, one for federal tax and one for state and local taxes, would also complicate compliance and administration.⁷¹

2. A hybrid: substitution of income tax for only local sales taxes

Another combination of reforms is worth considering: continued use of the sales tax by the states, combined with abandonment of the sales and use tax, in favor of expanded use of the income tax by local

70. See Table 7: Individual Income Tax Rates and Tax Shares, SOI BULLETIN, Spring 1999, at 37.

71. Note the difference in these two policies, which could be structured to have equivalent distributional consequences: (a) providing transfers to the poor, who then pay sales tax on their purchases, and (b) exempting the poor from payment of income tax. In the first case, the poor face the tax price of government services, but in the second case they do not.

governments.⁷² Under this scenario, states would employ the ideal sales tax. Without the need to attribute sales to local jurisdictions and collect and remit local use taxes, compliance would be much easier for remote vendors than under current law.⁷³ This variant would eliminate the problem of cross-border shopping between local jurisdictions, where it is most troublesome.

VI. CONCLUDING REMARKS: A SUMMARY EVALUATION

To clarify thinking about tax policy, academic tax specialists sometimes consider what type of tax system they would propose in a colony to be established on Mars.⁷⁴ Given that assignment, I would rank the systems considered thus far for the finance of state and local government as follows, dividing them into three groups, with problems listed under each:

Acceptable systems:

1. Residence-based state and local income taxes.

Problems: Potential failure to serve as benefit-related tax at low income levels.

2. The conceptually ideal destination-based RST described in Section III.

Problems:

- a. Cross-border shopping.
- b. Complexity of compliance with local sales and use tax surcharges.

72. In states where there is no income tax, local income taxes could be imposed as a percentage of a measure of income taken from the federal income tax return. While federal adjusted gross income might seem to be the most logical choice, for reasons suggested above, that choice would require many who have incomes below the federal tax threshold to file local tax returns. Thus, the use of taxable income as the base for local income taxes in these states seems almost inevitable.

73. Perhaps I should state emphatically that this splitting off of the local tax should not be used as an excuse to retain the current, horribly complicated, and irrational state sales tax; the proposed reforms should be enacted, even in this case. On the other hand, under this scenario, the state VAT looks somewhat better.

74. They might also ask what they would propose for the American colonies, if they were on the Mayflower and knew then what they know now. That is something of a stretch, as it is hard to imagine knowing about the Internet while on the Mayflower.

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- c. Difficulty of destination-based taxation of digital content.
- 3. The hybrid state sales tax/residence-based local income tax considered at the end of the previous section.

Problems:

- a. Potential failure of the income tax to serve as benefit-related tax at low income levels.
- b. Difficulty of destination-based sales taxation of digital content.

Acceptable for less developed countries (LDCs) and countries in transition from socialism, but not the United States:

- 4. A destination-based state VAT implemented by use of CVAT (described in Appendix D).

Problems:

- a. Impossibility of local surcharges.
- b. Cross-border shopping.
- c. Difficulty of destination-based taxation of all remote sales to households.

Deeply flawed and unacceptable systems:

- 5. The “simplified” RST system that would result from adopting proposals to tinker with the present system (described in Section IV.C).

Problems:

- a. Same as the conceptually ideal RST (#2 above):
 - Cross-border shopping.
 - Complexity of compliance with local sales tax surcharges.
 - Difficulty of destination-based taxation of digital content.
- b. Taxation of many business inputs.
- c. Exemption of much consumption spending.
- d. Wasteful cost of complexity is shifted to governments, not eliminated.

6. The present RST system.

Problems:

- a. Same as the simplified RST (#5 above):
 - Cross-border shopping.
 - Complexity of compliance with local sales tax surcharges.
 - Difficulty of destination-based taxation of digital content.
 - Taxation of many business inputs.
 - Exemption of much consumption spending.
- b. Onerous and wasteful cost of compliance.
- c. Avoidance of tax on much remote commerce, due to *Quill*.

7. An RST system that codifies and extends *Quill*.*Problems:*

- a. Same as the present RST (#6 above):
 - Cross-border shopping.
 - Complexity of compliance with local sales tax surcharges.
 - Difficulty of destination-based taxation of digital content.
 - Taxation of many business inputs.
 - Exemption of much consumption spending.
 - Onerous and wasteful cost of compliance
 - Avoidance of tax on much remote commerce, due to *Quill*.
- b. Improper extension of *Quill* protection.
 - Where a corporate affiliate of a remote vendor is present in the state.

8. An RST system that exempts all electronic commerce.

Problems: Essentially eliminates the sales tax by making it voluntary.

Since I have not been reticent in my condemnation of the last four systems, I do not consider them further, except to note that no responsible adviser would propose any of them for adoption *de novo*. The only advantage they have is that they take the existing system as their starting point—admittedly not an inconsiderable advantage. Given the question posed in the title of this paper—and quixotic optimism appropriate for the imminent start of a new millennium—I limit myself to the first three options, assuming that radical reform of the sales tax is possible. Because the VAT is not conducive to use as a source of local revenue and employs tax sharing, rather than destination-based taxation, for remote sales to households, I classify it as inappropriate for use in the United States, but perhaps not in less developed countries and countries in transition from socialism.

For reasons described briefly at the end of the last section, for the colony on Mars I would rank the state and local income tax slightly above the conceptually ideal RST I have proposed. The income tax avoids the troublesome problems of cross-border shopping and use taxes, especially on digital content, that plague even a conceptually pure RST. Since the status quo ante on Mars would be an empty page, there would be no problems of transition. The primary problem with the income tax is the difficulty of making those with low incomes aware of tax prices of public services. The hybrid, in which states employ the ideal sales tax and local governments employ the income tax, would also work, especially if the states also imposed income taxes.

But we are not on our way to Mars; we are merely on the way to 2001 on Earth. Thus we cannot blithely ignore the status quo. States already rely on the RST for about one-third of tax revenue, and abandoning that tax in favor of greater reliance on the income tax would cause wrenching adjustments. This leads me to rank the conceptually pure RST above the state and local income tax, despite its clear problems. In short, I believe we should fix the state sales tax, not discard it. But the “fix” requires radical reform; tinkering will not suffice. Finally, consideration might be given to the hybrid solution involving continued state use of the sales tax and increased reliance on the income tax by local governments, since many of the most serious remaining problems of sales and use taxation (cross-border shopping and the difficulty of attributing sales to local jurisdictions) involve the local tax, not the state tax.

APPENDIX A

Fallacious Arguments for a Permanent Exemption for Electronic Commerce⁷⁵

“Remote vendors do not consume services.” Some argue that remote vendors should not be required to collect use taxes because they do not consume public services provided by the market states. This view reflects a misunderstanding of the benefit principle of taxation. The sales and use tax is levied primarily to finance services provided to households, not to finance services provided to business firms doing business in the taxing state. Thus it should apply equally to all taxable goods and services consumed in the state, not only to those sold by local merchants. (The invalidity of the argument cited above can be seen by replacing reference to the sales and use tax with reference to an excise on tobacco products used to finance health care for smokers. No one would seriously suggest that cigarettes sent by mail order from another state should not be taxed, just because they are sold by a vendor that receives few services in the taxing state.⁷⁶)

“Shipping and handling compensate for the lack of use tax.” Some argue that the need to pay charges for shipping and handling, which are higher for shipments to individual customers than for bulk shipments to local merchants, compensates for the lack of use tax on remote sales.⁷⁷ This argument is obviously invalid in the case of digitized content; there are no shipping and handling charges to offset the lack of use tax. But it is equally invalid in the case of tangible products. The easy case involves a comparison of two remote vendors, one with nexus and one without. Shipping and handling costs

75. This Appendix is taken from McLure, *supra* note 44; *see also* Charles E. McLure, Jr., *How—and Why—the States Should Tax Electronic Commerce* 18 ST. TAX NOTES 129 (2000).

76. An admittedly unrealistic example illustrates the argument. Suppose that it were possible to sell motor fuel in a state without having a physical presence there. Suppose further that a tax on motor fuels consumed by motorists in the state is used to finance the construction and maintenance of roads and highways in the state. Should fuel sold in the state by a remote vendor be taxed? Of course it should; the tax is intended to charge for the in-state motorist's use of highways.

77. Given the attention paid to the difficulty of returning merchandise to e-commerce vendors following the Christmas of 1999, one can expect that difficulty to be added to the costs e-vendors incur that offset the sales tax advantage. Of course, the reasoning is fallacious, for reasons stated in the text.

may be comparable, but one collects tax and the other does not. Finally, consider the more difficult case: comparison of a remote vendor and a Main Street merchant. If costs are higher for remote commerce, the ability for remote vendors to compete successfully because of *Quill* is *prima facie* evidence that the de facto tax exemption induces economic inefficiency; costs are being incurred that would not exist if tax policy were neutral.

The previous two arguments (involving lack of services to remote vendors and shipping costs) may not be convincing to non-economists. But consider the following. Suppose someone suggested that sales (or use) tax should be collected if Americans buy foreign-made cars from American merchants, but not if they order the cars directly from a foreign manufacturer—or that sales tax should be collected on cars made in the United States, but not on cars made abroad. Few would think these suggestions make sense. Yet they are exactly analogous to arguments that purchases from out-of-state vendors should not be taxed: that is, foreign merchants and car manufacturers do not consume services provided by the American states and they incur substantial shipping costs getting their products to American markets. Yet we do not consider either fact in deciding whether to collect sales or use tax on foreign-made cars.

“Main Street merchants are going on-line.” There are at least three reasons not to draw solace from the fact that many Main Street merchants are joining the stampede to electronic commerce. First, this is small comfort to local merchants that do not establish an on-line presence, likely to be the smallest and most vulnerable. Second, unless local merchants that go on-line place the electronic commerce aspects of business in a separate subsidiary incorporated in another state, they must charge sales tax. The need to isolate online business in a separate out-of-state corporation distorts business operations, for example, because accepting refunds at the Main Street location is likely to create nexus for the e-commerce affiliate. Third, if the on-line strategy is successful, revenue losses will be far greater than the optimistic scenarios that assume that not much taxable consumption spending shifts to the Internet.

“Taxing electronic commerce would hinder the growth of small e-commerce firms.” No sensible proposal to impose an expanded duty to collect use tax would negatively affect small e-commerce vendors. First, there would be a de minimis exemption that would eliminate the duty to collect for small vendors. Second, the author’s proposal

to eliminate tax on sales to business implies that taxes on such vendors would be lower, not higher.

"The European Union is shifting to origin-based taxation." Some suggest that it would be appropriate to apply origin-based taxation to electronic commerce because the European Union (EU) is shifting from destination-based taxation to origin-based taxation under the value-added tax (VAT). Nothing could be further from the truth.⁷⁸ The EU has recently determined that digital content downloaded from the Internet should be taxed as a supply of services. For historical reasons, services have been subject to origin-based taxation in the EU. (They have not been exempt, as in the typical American states sales tax.) But, the EU has also recently decided to move to destination-based taxation of services, in large part to prevent the loss of revenue implied by origin-based taxation. Thus, like goods and other services, digital content will be subject to destination-based taxation in the EU.

"It is not necessary to tax electronic commerce, because the states have surpluses." This assertion reflects an implicit assumption that taxation of electronic commerce would be the source of additional revenue—that taxing electronic commerce would increase taxes. (This assumption is encouraged by the lament of state and local officials that revenues will drop if electronic commerce is not taxed.) I believe that this is not the way to frame the issue—that it makes much more sense to discuss the taxation of electronic commerce in a revenue-neutral context. In that context, the existence of a surplus is irrelevant; rates could be lower if e-commerce is taxed than if it is not.

"The development of electronic commerce is driving the recent economic expansion." Some attribute the recent expansion of the American economy to the development of electronic commerce. However, no evidence is offered to support the proposition, other than the fact that the two phenomena are occurring simultaneously. Electronic commerce may indeed be one factor that is fueling the expansion. But parsing out its contribution requires careful econometric analysis that attempts to control systematically for other influences that are occurring simultaneously, a difficult enterprise that would challenge

78. See *Advisory Commission on Electronic Commerce: Third Meeting*, *supra* note 56, at 25-34 (statement of Michel Aujean, Director of Tax Policy, European Commission) (dispelling any remaining doubts on this score).

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the best econometricians; it is not something that can be achieved by casual observation.

APPENDIX B

Appeal for Fair and Equal Taxation of Electronic Commerce⁷⁹

We the undersigned academic specialists in tax policy, having no direct interest in the outcome of the deliberations of the Advisory Commission on Electronic Commerce, are concerned that the Commission may make recommendations for the tax treatment of electronic commerce that are contrary to the public interest. We therefore respectfully suggest that any recommendations the Commission makes regarding the sales and use tax should satisfy all four of the following general principles, which are consistent with a variety of specific proposals:

1. Electronic commerce should not permanently be treated differently from other commerce. There is no principled reason for a permanent exemption for electronic commerce. Electronic commerce should be taxed neither more nor less heavily than other commerce.

2. Remote sales, including electronic commerce, should, to the extent possible, be taxed by the state of destination of sales, regardless of whether the vendor has a physical presence in the state. In limited cases, where it is impossible to determine the destination of sales of digital content to households, it may be necessary to substitute a surrogate system. In no case should taxation of remote commerce or electronic commerce be limited to origin-based taxation, which would induce a "race to the bottom" and, in effect, no taxation at all.

3. There must be enough simplification of sales and use taxes to make destination-based taxation of sales feasible. Such simplification might include, for example, unification of the tax bases across states, unification of tax rates within states, and/or sourcing of sales only to the state level, as well as simplification of administrative procedures.

4. A means must be found to eliminate burdens of compliance on sellers making only small amounts of sales in a state. These might include software-based systems made available at state expense, more

79. The author presented this appeal to the ACEC during his invited statement before the Commission on December 15, 1999. See *Advisory Commission on Electronic Commerce: Third Meeting*, *supra* note 56, at 59-69. At that time there were forty-nine signatories.

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realistic vendor discounts, and/or de minimis rules.

[This statement does not represent the position of the institutions with which the signatories are associated.]

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Charles de Bartolome	University of Colorado at Boulder
Larry DeBoer	Purdue University
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William Dumcombe	Syracuse University
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William F. Fox	University of Tennessee
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J. Fred Giertz	University of Illinois at Urbana Cham- paign
Malcolm Gillis	President, Rice University
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Austan Goolsbee	University of Chicago
Roger H. Gordon	University of Michigan
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APPENDIX C

Radical Simplification of State Sales and Use Taxes:
The Prerequisite for an Expanded Duty to Collect
Use Tax on Remote SalesA PROPOSAL TO THE ADVISORY COMMISSION ON ELECTRONIC
COMMERCE⁸⁰**Preface**

The existing state sales and use taxes are a product of their time—a time when *local merchants* sold primarily *tangible products* almost exclusively to *local customers*. They are not suited to the twenty-first century, when *services and intangible products* will be much more important than tangible products and *remote sales* of tangible products and *digitized content*, especially via *electronic commerce*, will be increasingly important. The most obvious problem is complexity:

- Each of forty-six states (including DC) chooses its own tax base, with no requirement that the base—or even what might be in the base—be uniform across the nation.
- Each state decides what should be exempt when bought by business.
- Each state sets its own administrative requirements and procedures, including registration, filing of tax returns, payment, audit, and appeals.
- Roughly 7,000 local jurisdictions also levy sales and use taxes.
 - Most local jurisdictions levying sales taxes choose their own tax rates.
 - Local jurisdictions in some states do not follow the state definition of the tax base.

80. Footnotes 82 to 88 have been added; they do not appear in the proposal to the ACEC.

- Boundaries of local jurisdictions do not correspond to postal ZIP codes.
- Local governments change their tax rates from time-to-time, making it difficult for taxpayers⁸¹ to know the current rate.

Because of this complexity, the U.S. Supreme Court, in 1967 (*National Bellas Hess*⁸²) and again in 1992 (*Quill*⁸³), ruled that a remote vendor could not be required to collect use tax on sales to customers in a state where it lacks a physical presence (nexus). The result is loss of state and local tax revenue, unfair competition for Main Street merchants, and discrimination against those who patronize those merchants, instead of remote vendors—problems that the growth of electronic commerce will aggravate. Sound public policy demands that remote vendors, including those engaged in electronic commerce, collect use tax on their sales, if those sales exceed a de minimis amount. As Ronald Reagan said in 1981, “The taxing power of government must be used to provide revenues for legitimate government purposes. It must not be used to regulate the economy or bring about social change.”⁸⁴ But an expanded duty to collect makes sense only if there is radical simplification of the state sales and use tax “system.” This proposal describes a system that would meet this objective and (in the Annex) indicates how the proposed system meets the criteria proposed by the Advisory Commission on Electronic Commerce (ACEC).⁸⁵ The proposal is intended to be revenue neutral in each state and locality; tax rates would be raised or lowered, as required to maintain revenues, but not increase revenues.

81. The term “taxpayer” is used (somewhat inaccurately) for both vendors who are legally liable for sales taxes and vendors who (actually or potentially) collect use taxes that legally are due from their customers.

82. *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967).

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

84. Address Before a Joint Session of the Congress, 17 WEEKLY COMP. PRES. DOCS. 131, 137 (Feb. 18, 1981).

85. The annex containing the required certification that the proposal satisfies the criteria announced by the ACEC is omitted.

THE PROPOSAL: SUMMARY STATEMENT

This section summarizes the proposals, which are described in detail and justified in the next section.

1. There would be a single uniform nation-wide base for sales and use tax.
 - a. The base would consist of all consumption spending by households.
 - Tangible products, services, and intangibles would have the same tax.
 - Local merchants and remote vendors would collect the same tax.
 - b. All business purchases would be exempt in all states.
 - There would be a nationally uniform exemption certificate.
2. Compliance would be simplified and made less costly for vendors (two options):
 - a. Forms and payments would be filed with one state (base-state approach).
 - De minimis rule would eliminate the duty of some to collect use tax.
 - Realistic vendors' discounts would facilitate "zero-cost" compliance.
 - b. Trusted third parties (TTPs) would calculate/remit tax (TTP approach).
 - Taxpayers would be subject to joint audits on behalf of all states.
3. Software would be used to determine the situs of sales and state and local tax rates.
 - a. States would certify software and provide it without charge to vendors or TTPs.
 - b. A "hold-harmless" clause would protect vendors who rely on the software.

In addition to these “primary proposals” there are several “fallback positions” that some may find more politically realistic. The primary proposals provide a benchmark against which to judge other proposals the ACEC may receive, as well as the fallback positions. Because the proposed system is vastly simpler than conceptually defensible alternatives, the need for simplification may drive decision-makers toward it, despite the conventional wisdom that it is politically unrealistic.

THE PROPOSALS: DETAILED DESCRIPTION AND ANALYSIS

The Tax Base: General

Proposal A. All states would define the tax base identically. All sales to households in a state would be subject to tax, whether sold by local merchants or remote vendors, unless there were agreement among all states to exempt certain items (e.g., prescription drugs). Services and intangible products would be subject to tax, when bought by households. Special taxes on telecommunications would be eliminated.

Rationale. The *tax base would be defined uniformly* in all states to simplify compliance and administration. Remote vendors would need to deal with only one definition of the tax base, instead of forty-six (or more, considering local taxes). *All sales to households would be taxed* to prevent erosion of the tax base, simplify the system (e.g., no need to distinguish taxable and exempt food or clothing), avoid distortion of consumer choices, and treat those who buy from local merchants like those who buy from remote vendors. The enormous difficulty in gaining agreement on what should be in the uniform tax base suggests acceptance of the conceptually correct solution: taxing all consumption spending. Worth special note is the avoidance of “indistinct distinctions,” such as those between certain tangible products (e.g., shrink-wrapped software, music CDs, and video cassettes) and virtually identical intangible products (software, music, and videos) downloaded from the Internet. Such distinctions complicate compliance and administration and have no economic justification. Including services and intangible products in the tax base would allow reduction of tax rates. There is no justification for special taxes on telecommunications.

Discussion. Problems with the proposal are primarily political. In addition to the loss of state fiscal sovereignty implied by a uniform

tax base, there would be serious opposition to taxation of services and intangible products, even in a revenue-neutral context.

Fallback A1. States might be allowed to choose their own tax bases, but be required to define what is or is not subject to tax identically. (Conceptually there would be a “menu” of commonly defined products, beside which each state writes “taxable” or “exempt.”) Computerized “look-up tables” would indicate whether each product is taxed in each state. Bar codes could indicate the product category into which most tangible products fall. To be practical, there should be only a few well-defined product categories—perhaps no more than a dozen. Local jurisdictions should not be allowed to deviate from the state tax base.

Rationale. The primary proposal involves a radical departure from present practice, in which states choose their own tax bases. The fallback combines greater uniformity than current law with greater state fiscal sovereignty than the primary proposal.

Discussion. A menu of potentially taxed products might contain about 10,000 products—more or fewer, depending on the degree of aggregation of products. Look-up tables with 460,000 cells (one for each of 10,000 items in forty-six states) are conceptually feasible, but perhaps impractical; they would certainly be impractical for catalog sales if the purchaser desires to know the tax due when placing an order. Unless categories were chosen extremely carefully, “indistinct distinctions” and attendant problems would remain.

Fallback A2. It may be politically expedient to provide an exemption for Internet access purchased by households. (Purchases of Internet access by businesses would be exempt under the conceptually correct tax treatment of business purchases, considered below.)

Discussion. There is little justification for exempting Internet access by households. An exemption would complicate compliance and administration, because Internet access is commonly bundled with other (presumably taxable) products, and would have adverse distributional implications.

The Tax Base: Exemption of Business Purchases

Proposal B. The conceptually correct way to treat business purchases is for all states to treat them identically by exempting them. (Exemption achieves the same result as under the value added taxes used in the European Union, where businesses receive a credit for tax paid on purchases.) A uniform exemption certificate should be

used throughout the nation.⁸⁶

Rationale. Uniform treatment of business purchases would simplify compliance and administration; remote sellers would need to know only one set of rules, not forty-six. (The “uniform” exemption certificate drafted by the Multistate Tax Commission is not uniform, because state laws are not uniform.) Sellers would not need to judge the eligibility of their customers to make tax-free purchases, depending on the use of the product, as now. *Exemption of business purchases* would eliminate defects of the present system: discrimination among products, distortion of production decisions, incentives for vertical integration, and a tax cost that cannot be recovered on exports. While exemptions for business purchases (initially available only for resale) have been expanded over time, they remain far from comprehensive. Thus the purchases of some sectors are taxed, while those of others are exempt. The proposal would eliminate all such discrimination.

Discussion. Problems with the proposal are primarily political. In addition to the loss of state fiscal sovereignty, elimination of all business purchases from the tax base would necessitate increasing tax rates to maintain revenue in a revenue-neutral context.⁸⁷

Fallback B. States could continue to decide whether or not to exempt various types of business purchases, but be required to define the various types of business purchases that might be exempt identically. (Conceptually there would be a menu of commonly defined types of business purchases, beside which each state writes “taxable” or “exempt.”) Computerized “look-up tables” would indicate tax treatment in each state. To be practical, there should be only a few well-defined categories—perhaps no more than a half-dozen. Use of “direct pay” by business customers should be expanded.

Rationale/discussion. This alternative achieves much—but not all—of the simplification of the conceptually ideal proposal, without as much loss of state sovereignty or reduction of tax bases. The ad-

86. Eligibility for exemption of business purchases could be based on federal income tax law: a purchase would be exempt from sales and use tax if (and only if) it qualifies for a federal income tax deduction (or depreciation allowance, etc.). Since this eligibility is all that need be addressed in a uniform exemption certificate, eligibility could be certified simply by checking a box on a paper order form or clicking on a box in the order form on a website and providing the purchaser’s employer identification number.

87. If that were the only change, average rates would rise substantially. Taxing services would create an offsetting tendency for rates to fall.

verse economic effects of the present system would remain, but each state would have the option of exempting all categories of business purchases to attract business. Direct pay, which would not be needed under the primary proposal, would reduce the need for vendors to determine whether sales to businesses are for exempt uses.

Sourcing/Situsing of Sales and Local Tax Rates

The situs of remote sales determines the local tax rate to be applied and the jurisdiction that receives tax revenue from a sale. It is thus convenient to consider local tax rates together with the situs of remote sales.

Prefatory discussion. State sales taxes are based on the destination of sales—or would be, if remote sales were taxed and business inputs were exempt. Unlike origin-based taxation, destination-based taxation avoids distortion of the location of economic activity. Moreover, private consumption is generally a reasonable proxy for the consumption of public services. The conceptually correct way to determine the situs of remote sales is thus to attribute them to the state and locality of destination of the sale.

Proposal C. Software would be used (a) to determine the state and local tax rates that should be applied to remote sales of particular products and (b) to prepare the reports containing the information needed by states to channel revenues to the appropriate local jurisdictions. Such software would contain rules—to be applied uniformly across the nation—needed to determine the situs of sales not involving tangible products (e.g., for services and telecommunications).

Discussion. The proposal implements destination-based taxation and provides local governments with autonomy over the tax rate, which would be applied to both sales by local merchants and remote sales. Several qualifications are appropriate. First, states should certify software and enact “hold harmless” rules to protect remote vendors from relatively minor and unintentional errors resulting from good-faith reliance on such software, including those that result from the software vendor’s failure to update rate tables. (Local governments should bear the burden of informing providers of software of changes in rates.) Second, such software can be used only for sales to customers that are willing to allow the vendor to calculate the tax and add it to the bill. A special regime may be needed for those who remit by check or money order when placing an order. It might be based on the “one-rate-per-state” fallback position discussed below.

Fallback C. Business representatives argue that remote sales should be attributed (“sourced”) only to the state level, claiming that it is impossible to determine accurately the local situs of remote sales. Local governments could set *sales tax* rates, but there would be only one *use tax* rate per state, and states would be responsible for allocating revenue from use tax among their local jurisdictions.

Discussion. The fallback would retain local autonomy over local *sales tax* rates, but eliminate autonomy over local *use tax* rates. Local jurisdictions would receive revenues from taxes on sales by local merchants, but depend on sharing of revenues from the statewide local use tax. This arrangement would allow local jurisdictions to meet their obligations under debt covenants that dedicate revenues from local sales tax to debt service. Local governments imposing sales tax rates well below the statewide local use tax rate might compensate local residents for excess use tax on remote purchases. Where local sales tax rates exceed the statewide use tax rate, discrimination against local merchants would remain.

Unallocable Sales

Proposal D. Remote sales that cannot be allocated to a state (because remote vendors do not know the location of a buyer of digitized content) and remote sales that fall below the de minimis threshold (see below) would be subject to a national “substitute” use tax, revenues from which would be shared among the states, perhaps on the basis of estimated consumer spending in the state.⁸⁸

Rationale/discussion. It is not satisfactory to attribute unallocable sales to the state of origin of remote commerce; doing so creates an incentive to locate operations in states with no sales tax. Billing addresses can be used to determine the location of some customers, but not all. The need for the national substitute use tax is one advantage of having a nationally uniform state sales tax base, which would be used as the base of that tax. States that have no sales tax (or rates well below the national tax) could refund the national tax (or the difference in rates) to their residents. Technological developments may make this provision unnecessary.

88. The substitute use tax would be implemented by the states, not the federal government. In the text I have substituted “among” for “with,” which might give the impression that the substitute use tax would be imposed by the federal government.

Administrative Aspects

Administration of state sales and use taxes should be simpler and more uniform throughout the nation. Two options deserve attention.

Proposal E1: the Base State Approach. Taxpayers would collect use tax in all states where sales exceed de minimis amounts. But they would file a single form to register in all states and another to pay tax due in all states. Forms might be filed in the state in which the firm has its commercial domicile (the “base state”) or with a multistate agency. The base state or multistate agency would forward revenues to states where sales occur, which would divide revenues among local jurisdictions, on the basis of information provided by taxpayers. There would be joint audits on behalf of all states and a common appeals process.

Discussion. Tax authorities in each state would need to know the tax laws of all other states. This system would thus work best if there were a common definition of the tax base. It would not work in the absence of a common menu of potentially taxable products.

Proposal E2: Use of Trusted Third Parties. This approach would shift compliance from the vendor to a trusted third party (TTP). The TTP would calculate tax and remit it to states where sales are made, with an indication of the division of revenues among local jurisdictions.

Discussion. Further analysis is needed to determine whether the base-state approach or the TTP approach is more promising.

Zero-cost Compliance

Proposal F. Implementation of a destination-based sales tax requires remote vendors or TTPs to use sophisticated and expensive software. State governments should provide the software at no cost. (There is precedent. When Canada introduced the VAT, it subsidized purchase of new cash registers.) Under the base-state approach vendors’ discounts should be set to defray costs of compliance. (They might not be needed under the TTPs approach.) These costs can be quite high, as a percentage of revenues, for small vendors.

De Minimis Rule

Proposal G. It may be desirable to have a de minimis rule; vendors with total remote sales below a certain level would be relieved of the need to participate in the base-state system or utilize a TTP.

Discussion. From an economic point of view, making sales in a state, rather than physical presence, should be the test of nexus. Yet, it may be unreasonable or uneconomical to require firms with small remote sales to participate in the regular system. (There might be relatively little need for a de minimis rule if all the primary proposals made here were adopted.)

Concluding Remarks

Because the proposals made here form a package, comments on the entire package are appropriate.

The Integrity of the Proposals

Taken together the primary proposals would radically simplify state sales and use taxes and make it reasonable to impose an expanded duty to collect use tax. If proposed changes are omitted or replaced by the fallback positions, there would be substantially less simplification—so much less that an expanded duty to collect might become questionable.

If there were a menu of taxable products, instead of a uniform and comprehensive base, the software needed to implement use taxes would be more complicated and expensive, classification of products would be more controversial and onerous, state certification of software and a “hold-harmless” provision would be problematical, the base-state approach and use of TTPs might be infeasible, and the de minimis threshold would need to be higher. The severity of problems would depend on the level of aggregation of the menu. Moreover, it is unlikely that technological neutrality would be maintained in constructing the menu. If there were not even a uniform menu from which states would choose their tax base, it seems unlikely that enough simplification could be achieved to justify an expanded duty to collect.

The Question of State Sovereignty and Local Autonomy

Some will attack some of these proposals (e.g., the proposal for a uniform tax base) as an unwelcome intrusion on state fiscal sovereignty. That view loses sight of the larger picture. The state sovereignty that was possible when local merchants sold primarily tangible products almost exclusively to local customers is no longer possible, or at least not a realistic alternative, as it implies enormous complexity for remote vendors and thus the legal inability to tax remote sales, including those in electronic commerce. The proposals represent an attempt to craft a compromise between the need for revenue and the

power to set state tax rates—arguably higher orders of state sovereignty—and control over the tax base, arguably a less important aspect of sovereignty. They also attempt to retain local autonomy over local sales and use tax rates.

The Need for Federal Legislation

In theory, it might be possible for the states to act cooperatively to implement a system such as that proposed here, without federal legislation. If they did, the Supreme Court might eliminate the physical presence test of nexus. In fact, history does not inspire confidence that the states would act in this way, and the Court might not respond as predicted, even if they did. In any event, there would be unacceptable uncertainty. Thus, it seems almost certain that federal legislation would be required to implement the proposals made here. Rather than requiring that states adopt the proposals (the “stick” approach), legislation could allow an expanded duty to collect only for states that adopt the proposals (the “carrot” approach).

APPENDIX D

Implementing a State VAT

The following is brief description of the mechanics of one way to implement a state VAT.

1. The basic mechanics of the VAT⁸⁹

Under the standard VAT of the type used in the European Union (and virtually everywhere else) tax is collected on all sales, whether made to businesses or to households. Business taxpayers are allowed to offset (credit) tax paid on their purchases against tax due on sales.⁹⁰ The only tax that is not offset is that on sales to households. Thus, the credit for tax paid on business purchases achieves exactly the same purpose as the exemption of sales to business under the conceptually pure RST.⁹¹

2. VAT on interstate trade⁹²

Under the destination principle, VAT is collected on imports and rebated on exports, so that the effect is the same as under the ideal RST, which also applies to imports, but not to exports. The VAT treatment of exports is called “zero-rating.” A rate of zero is applied to exports, credit is allowed for any VAT exporters have paid on their purchase, and excess credits are refunded, so that exports occur tax-free.

VAT on international imports is ordinarily collected at the border. Within the European Union (EU) business imports are not taxed at the border; since credit will be allowed for tax paid by business, there is no need to collect tax at the border. This tax treatment is called “deferred payment,” since tax on imports is deferred until products produced using the imports are sold.

It has long been thought that a subnational VAT is too complicated to be feasible. It now appears, however, that this is not the

89. See MCLURE, *supra* note 31. To simplify exposition, I do not consider exemptions or sales to or by non-profit organizations, governments, or quasi-governmental agencies and lump unregistered traders together with households.

90. In this simple description I lump registered traders together with households.

91. The coverage of sales to households under the VAT is also much more comprehensive than that of the typical RST. This is not inherently the case. But, as noted in Section III.B.2, the functioning of the VAT creates political forces that encourage taxation of most goods and services that might also be sold to businesses.

92. See McClure, *CVAT*, *supra* note 65; see also McClure, *Breaking the Logjam*, *supra* note 65. Those papers do not consider the local VATs.

case—that a state VAT may be feasible. The issue involves the tax treatment of interstate trade: how can a destination-based tax be imposed, without border controls between states (thought to be needed to implement the refund of taxes imposed in the exporting state and collection of taxes of the importing state) or complicated clearinghouse arrangements (needed to channel revenues collected by origin states to states of destination)? If zero-rating and deferred payment is employed on interstate sales, how can households be prevented from masquerading as business purchasers? This issue continues to vex the EU.⁹³

Quebec has shown that a subnational tax is feasible in the context of a system of dual national/subnational VATs.⁹⁴ The need to comply with the Canadian federal VAT prevents abuse of the system of zero-rating/deferred payment employed by the province. But what if there is no federal VAT, as in the United States?

It appears that the use of a uniform “compensating VAT” (CVAT), to be imposed jointly at a uniform rate by the states on all interstate exports and allowed as a credit by business purchasers of interstate exports, combined with zero-rating/deferred payment under the ordinary state VAT, allows a relatively satisfactory resolution of the problem at the *state* level. Tax on business purchases (whether the ordinary VAT or the CVAT) is eliminated by tax credits. Sales to households that pass through a retail outlet in the destination state are subject to the VAT of that state. By comparison, remote sales to households are subject only to the CVAT, instead of the state VAT, with CVAT revenues from such sales being distributed among the states by formula. (There is no net revenue from CVAT on sales to business.) In other words, there is nothing analogous to the state use tax. Nor can there be local surcharges, even for sales made by Main Street merchants.

I originally advocated the CVAT system as a means of allowing subnational governments in less developed countries (LDCs) and

93. For an alternative to the system described below, see Michael Keen & Stephen Smith, *The Future of the Value Added Tax in the European Union*, 23 *ECON. POL'Y* 375, 375-411, 419-20 (1996). Space does not allow a full discussion of the relative merits of the two systems. See, however, Michael Keen, *CVAT, VIVAT, and All That: New Forms of Value-Added Tax for Federal Systems* (1999) (unpublished manuscript, on file with author); See also McLure, *CVAT*, *supra* note 65.

94. See Richard M. Bird & Pierre Pascal Gendron, *Dual VATs and Cross-Border Trade: Two Problems, One Solution?*, 5 *INT'L TAX AND PUB. FIN.* 429 (1998).

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countries in transition from socialism (CITs) to have access to revenues from a sales tax. The subnational VAT (with CVAT) would work better than the subnational RST in that context, since most national governments in LDCs and CITs already impose VAT and it would be a mistake to suggest a combination of national VAT and subnational RST. Moreover, in LDCs and CITs the issue of local sales taxes arises relatively rarely. Of course, in the United States there is no federal sales tax, but there are local sales taxes. In that context it seems more sensible to reform the state and local RST along the lines proposed than to make the radical switch to a state VAT, which apparently can accommodate neither state use taxes nor local sales (and use) taxes.

