

“Internet Tax Simplification: Is It Really That Simple?”

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While the sales tax is a state and local tax base, efforts to impose collection responsibilities on out-of-state vendors automatically raise an interstate concern that warrants some degree of congressional oversight. While this debate is infused with endless talk of protecting federalism and “states’ rights,” it is important to understand what some parties mean when they use these terms. Many state and local officials and tax administrators seem to believe that “states’ rights” means that state and local governments should be free to apply any type of tax or regulatory regime to commercial activities, even if interstate activities are involved. Such an argument is based on a fundamental misunderstanding of the federal system the Founding Fathers designed in the U.S. Constitution.

Will the Real Believers in Federalism Please Stand Up. Federalism is a two-sided coin; the flip side of “states’ rights” is interstate commerce. It is important to recall that the U.S. Constitution was an explicit rejection of the Articles of Confederation. The disadvantages of untrammelled “states’ rights” were trade disputes, protectionism, and interference with the flow of interstate commerce. Consequently, the Founders wisely granted Congress the authority to take steps to regulate commerce among the states—that is, to keep open the channels of interstate commerce to ensure that free trade would win out over factionalism.

Applying the Founders’ vision to high-tech markets and technologies they could not have envisioned is tricky, but not impossible. In the debate over the taxation of electronic commerce it will mean that Congress will need to oversee state-led reform efforts to ensure that unconstitutional tax collection burdens are not imposed on “remote vendors” of interstate commerce. In addition to extending the current ITFA moratorium on “multiple and discriminatory” taxes as well as Internet access taxes, Congress will also consider whether to put its stamp of approval on a multi-state tax compact or collection agreement called the Simplified Sales Tax Project, or “SSTP.”

The SSTP is an effort to simplify and harmonize tax rates among the states in order to get around constitutional hurdles to taxing remote vendors. While simplification is a laudable goal, tax harmonization can also have a downside. Congress should be wary of collusionary tax compacts that would grant the states open-ended tax authority over the channels of interstate commerce, not only because of the potential constitutional issues it raises, but also because tax competition between and among the states might be negatively affected.

The system the SSTP envisions is not your Founding Fathers’ federalism; it is an EU-style federalism that stresses tax cooperation over tax competition. The Founder’s federalism was based on a tension between units of government to add more checks and balances to the system. A cozy good ol’ boy tax cartel like the SSTP is not consistent with that model.

There is more than one way to skin this cat. State and local lawmakers have several options when considering how to address the question of remote sales taxation, but ultimately they will be forced to choose between two systems of sales tax reform to “level the (tax) playing field.” The first option, which has strong support from state and local politicians, is a “destination-based” sales tax regime organized by a multi-state compact, which would give states the power to impose tax collection duties on vendors outside their jurisdictions after tax rates and product definitions had been sufficiently “simplified” to get around Supreme Court or congressional protections for interstate commerce. This is the SSTP model. It is antithetical to true American federalism and represents “taxation without representation” by imposing tax collection obligations on interstate vendors without nexus in many states.

A second option, which has received much less attention, is an “origin-based” tax regime, under which states would exercise their right to tax equally all sales inside their borders, regardless of the buyer’s residence or ultimate location of consumption. Under this reform, all sales would be sourced to the principal place of business for the seller and taxed accordingly. Although support for an origin-based or “seller-state” sourcing methodology has a growing number of proponents, it remains controversial and unpopular within political circles since many policymakers fear a “race to the bottom” in terms of competition among tax jurisdictions. Of course, for those who hold a deeper respect for the federalism the Founders envisioned in the U.S. Constitution, this option would be viewed as a race to the top since it would encourage jurisdictional tax competition and help keep taxes in check.

The Ultimate Choice. In the end, the debate over Internet taxation comes down to a question of which overarching tax philosophy will prevail in the future: tax competition or tax collusion. That is, the choice is between States remaining truly independent entities with protections for interstate commerce from burdensome and potentially unconstitutional extraterritorial tax schemes, or a collusive multi-state compact for interstate sales and use tax collection.