FUTURE MARKETPLACE
FREE AND FAIR

HANNS KUTTNER

HUDSON INSTITUTE

Future Marketplace: Free and Fair

by Hanns Kuttner

HUDSON INSTITUTE

© MAY 2012

Future Marketplace: Free and Fair

"

New technologies have brought broader choices and more competition. They have expanded the scope of the market. But when these technologies allow turning the sales tax difference into a price advantage that tips the scales from one seller to another, they confer special treatment.

In any market, buyers seek out the seller who offers the lowest prices and best terms. Government can distort markets by decreasing or increasing prices through subsidies, taxes or regulation. Compared to a free market, distortion means different sellers get the sale and at different prices.

Current federal policy on state sales taxes yields a distortion. The result is prices and pairing up of buyers and sellers that differ from the free market result. These distortions mean a loss of economic efficiency. Goods move more. Consumers respond to differences in price based on tax differences, not differences in how efficiently goods and services can be produced. These differences create a deadweight loss that burdens the economy. Changes in technology, many rooted in the Internet, mean this distortion will become larger in the future.

Forty-five states, home to 97 percent of the American people, have a sales tax. States may impose a sales tax but federal policy creates a loophole for out-of-state sellers. Sales tax often goes uncollected on sales across state lines. Imperfect collection results in a preference for buying from out-of-state. This distortion will effect the sale of up to $330 billion worth of goods and services in 2012.

The distortion stems from the price difference the sales tax can create when buyer and seller are in different states. States require in-state businesses to collect the sales tax owed on sales within the state. Federal policy does not allow states to make the same requirement of out-of-state sellers. The tax difference functions as a subsidy, putting a wedge between the true economic cost and the price paid by the buyer. A free market offers the highest possible level of efficiency. This wedge detracts from efficiency.

The implications of tax differences have grown as new technologies have made it easier for distant buyers and sellers to come together. The ways to reach customers across state lines have grown, as new technologies become available. Catalogs were once the state-of-the-art; today the Internet has that distinction.

New technologies have brought broader choices and more competition. They have expanded the scope of the market. But when these technologies allow turning the sales tax difference into a price advantage that tips the scales from one seller to another, they confer special treatment.

Buyers seek out the lowest price. That lowest price can be the actual lowest price or it can be the result of government distortion that favors one group of sellers. A market in which one seller collects the sales tax, and another does not, distorts the location of sales. Compared to the division that would prevail in a free market, out-of-state sellers get a larger share in a market where state governments must give a preference to out-of-state sellers.

The view that the Internet is a sales-tax-free zone is outdated. We estimate that sales tax is now collected on more than half of all Internet-facilitated sales which are subject to sales tax in the buyer's state. Two forces drive this conclusion. First, tax compliance via the use tax among businesses means high compliance for that portion of Internet sales. The use tax is the form of the sales tax paid by the purchaser when buying from out of state. Sales between businesses remain a much larger share of Internet sales than sales to consumers. Second, the growth in multi-channel sellers—those that sell through both the Internet and physical stores—has lead to more sellers collecting the sales tax for multiple states.

The subsidies and distortions that result from the loophole currently required by the federal government are longstanding. As developments in technology narrow the distance between buyers and sellers, more commerce will be "e-commerce." Thus the size of the subsidy and resulting distortion will grow, even if marketplace developments also lead to a larger share of sales occurring between parties who collect the sales and use taxes.

This report explains how this distortion and its subsidy for out-of-state sellers has come to be and how the federal government keeps the loophole from being closed. It also reviews policy options for addressing it. These range from ways to level the playing field to changing the sales tax from a tax on purchasers to a tax on sellers.

Subsidies as a Source of Distortion in a Free Market

In a free market, buyers and sellers come together and agree on a price. What it means to come together is changing. Over time, a declining share of market transactions involve face-to-face interaction, a trend that will continue, spurred by developments in communications technologies. A succession of new technologies has created alternatives to face-to-face dealings; Benjamin Franklin is credited with introducing the first mail-order catalog. Where the alternatives serve buyers better than face-to-face, buyers have embraced them. The alternatives have come to include catalogs, toll-free calls to call centers, and a variety of information technologies that can be gathered under the heading of e-commerce. Altogether these alternatives are the different forms of "remote selling."

Sales take place through either face-to-face interactions or through one of the forms of remote sales. The equilibrium between physical presence and remote sales in the market for each good or service reflects many factors. Some relate to the nature of the good or service being sold. Others relate to purchaser preferences. Together these forces determine the free market division between face-to-face and remote sales.

However, a distortion in the marketplace, whether from subsidies, taxes, or regulation, will change this division and cause a loss of efficiency relative to a free market.

Current policy makes the sales tax a distortion. Current policy has the effect of giving remote sellers a price advantage, allowing them to sell their goods and serv-

THE SALES AND USE TAX: A CONSUMPTION TAX, AMERICAN STYLE

The state and local sales tax in the United States is a type of consumption tax. Unlike taxes on income or capital, consumption taxes do not distort decisions to work, save, or invest. Taxes on sales are the most important revenue source for state governments, amounting to 48.9 percent of total state tax revenue in 2010.[1]

Each state (and in some cases, local government) decides what is subject to tax. Looking across what is and what is not subject to the sales tax, one sees that the tax base does not include many forms of consumption.

A larger share of goods than services is subject to the sales and use tax. States begin with the presumption that goods are taxed and then exempt some goods (with food for home consumption and prescription drugs the goods most frequently exempted.) With services, state law names particular services that are taxed.[2] As the American economy has grown and changed over time, services have become a larger share of the economy, and thus the share of purchases subject to the sales and use tax has fallen. Within consumption expenditures, the sales tax could be seen as an incentive to consume untaxed services rather than taxed goods.

When consumers buy things or services subject to the sales and use tax, they pay the tax. Businesses also pay the tax, a feature that makes the American sales tax different from the consumption tax in many other countries. While states typically exempt goods purchased for resale from wholesalers or inputs used by manufac-turers, businesses pay sales tax on things they use, such as office supplies. These costs carry forward into the prices businesses charge for the goods and services they produce, making this component of the sales tax one that is also ultimately paid by consumers.

The sales tax is both a transparent tax and an invisible tax. Consumers receive receipts that show just how much sales tax they paid on that purchase. The invisible portion of the sales tax is the amount that sellers pass forward to purchasers as part of the price of the good. This invisible part is much smaller than it would be if large classes of sales, such as those by wholesalers to retailers, were not exempt.

The largely-visible sales tax administered by states in the US compares to "value-added" style consumption taxes that are included in the price of the good or service in many countries.

1. Cheryl J. Lee, Robert Jesse Wilhide, and Nancy I. Higgins, "State Government Finances Summary: 2010," GI0-ASFIN, December 2011, Washington: Census Bureau.
2. For example, see the spreadsheet prepared by the Federation of Tax Administrators listing the state-by-state status of 184 services. http://www.taxadmin.org/fta/pub/services/btn/0708.html

ices without collecting the sales tax owed by the purchaser. This price difference functions like a subsidy. It distorts the allocation between the two forms of selling. The subsidy from not collecting tax due means a larger share of sales will take place remotely than would occur in a free, undistorted market.

The sales at stake are largely in the retail market for goods. Some services, such as hotel and motel rooms, fall within the scope of the sales tax base in many states. Most services, including hospital and medical services, tuition, personal services such as hair treatment, and the services of lawyers and other professionals, are not subject to sales tax in most states. The Census Bureau surveys retailers about their sales; **Figure A** breaks down the retail market by type of seller. This provides a sense of the retail market, although not one that tracks perfectly to the sales tax base (for example, food for home consumption is taxed in only some states.)[1]

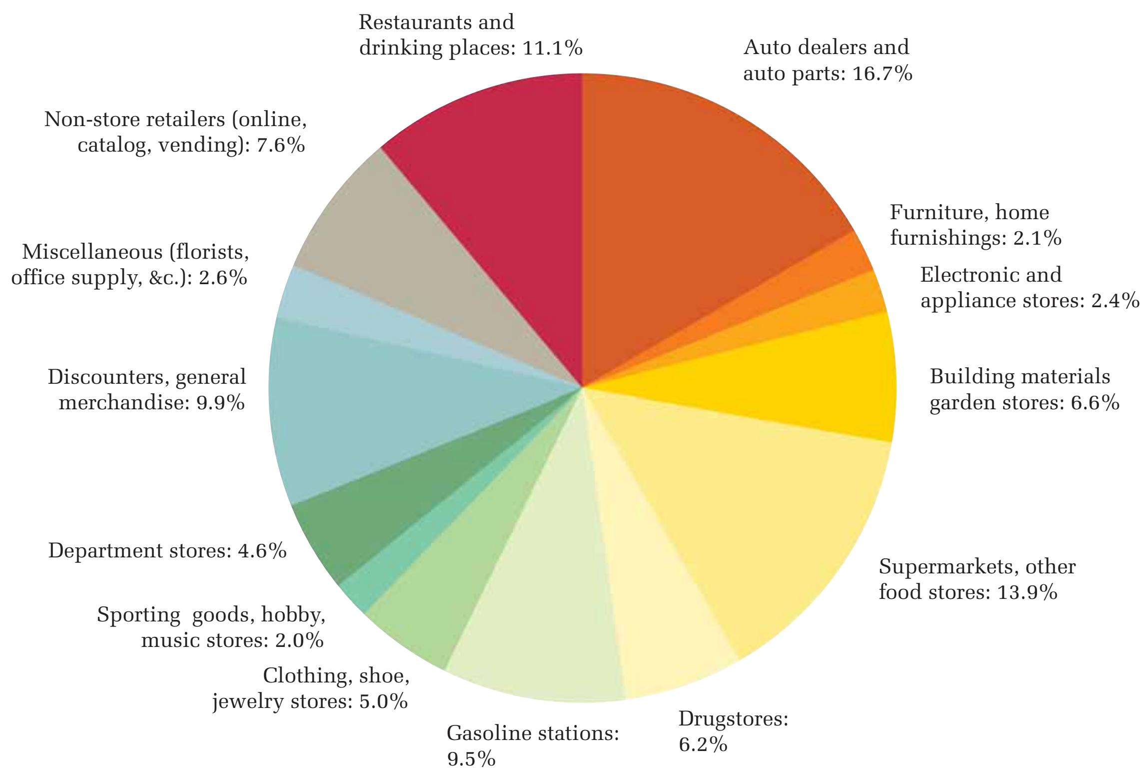
The difference in the face-to-face/remote split under a free market and a market with distorting subsidies varies according to the nature of the good or service. Four factors that influence the efficient allocation between face-to-face and remote sales are:

- **Standardization**. Products that have standard descriptions or characteristics make it less important for the purchaser to assess goods in person before buying. Standardization increases the potential share of purchases made without face-to-face interaction. The availability of standards for many industrial commodities (grades

FIGURE A

Total: $4.1 trillion

Retail and Food Service Sales, 2009



Source: U.S. Bureau of the Census, "Estimated Annual Sales of U.S. Retail and Food Services Firms by Kind of Business: 1992 Through 2009," March 2011, http://www.census.gov/retail/

of steel, standards for purity of chemicals) helps explain why "business to business" sales dominate the dollar volume of e-commerce.

Individual consumers also buy standardized products. Make and model numbers allow consumers to know the product offered online is the same as what they see in stores.

- **Product comparability**. A pad of paper is just as useful if it comes from a local vendor or a vendor several states away. With some goods, but especially with services, having to wait two days is not as valuable as having something now. Immediacy can be an important component of some purchases. Further advances in logistics would be required for remote sellers to erode the strong advantage of physical sellers. Restaurants offer an example. A remote seller offering a meal that will be delivered tomorrow and which must be warmed upon arrival is a weak competitor to a restaurant that offers a meal served within the hour.

- **Cost of transportation**. The additional cost of sending goods hundreds of miles can be a small share of the final sale price for some goods and a large share for others. This effect can undo the price advantage of a remote seller who does not collect the sales tax. Garden mulch is an example of a category where the price difference from not collecting the sales tax does little for remote sellers. Transportation costs represent a large share of the cost of mulch for landscaping. Software represents the opposite case. Software can be downloaded via the Internet. The transportation cost does not vary with the distance the product travels.

- **Consumer preference**. The conditions of a competitive market often leave little room for factors other than price and objective characteristics to influence business-to-business sales. That does not hold for sales to consumers. Each consumer has a different attitude towards the shopping experience. Some enjoy giving close personal examination before buying. Others do not enjoy shopping and would be willing to pay more for the privilege of not going to a store to buy. Even at the level of the individual consumer these attitudes can vary from product category to category.

The size of the distortion, measured as the difference between the share that occurs in a subsidized and a free market, depends on how sensitive sales are to the price difference the subsidy creates. Where price is the first, last and only criterion in the purchaser's decision making process, the gap is larger. Goods and services with a high degree of standardization, comparability between local and remote sale, and low cost of transportation are most likely to have a larger gap between the efficient and the subsidized division between face-to-face and remote sales. **TABLE 1** shows categories where there is a low, medium, and high potential for distortion because of the subsidy.

TABLE 1.

Potential for Remote Sales

Low

Convenience purchases
Gasoline
Motor vehicles
Personal services
Restaurant meals
Hotel and motel rooms

Medium

Appliances
Furniture
Insurance

High

Books
Clothing
Consumer electronics
Music recordings
Office supplies

TABLE 2
SALES VENUE IN PLAY

	Total Untaxed Out-of-State Sales ($, billions)	Average Sales Tax Rate (%)	Sales Tax Due ($, millions)
Alabama	4.21	8.25	347.7
Alaska	0.22	1.40	3.0
Arizona	8.69	8.15	708.6
Arkansas	2.86	8.25	236.3
California	50.73	8.20	4159.7
Colorado	5.51	6.40	352.6
Connecticut	2.40	6.35	152.4
District of Columbia	1.21	6.00	72.5
Florida	22.31	6.65	1483.7
Georgia	12.05	6.95	837.6
Hawaii	2.82	4.35	122.5
Idaho	1.70	6.05	103.1
Illinois	13.40	7.90	1058.8
Indiana	5.70	7.00	398.8
Iowa	2.64	6.85	181.0
Kansas	4.65	6.00	279.2
Kentucky	2.57	8.75	224.5
Louisiana	16.17	5.00	808.3
Maine	1.09	6.00	65.4
Maryland	6.02	6.25	375.9
Massachusetts	4.47	6.00	268.0
Michigan	4.01	7.20	289.0
Minnesota	6.50	7.00	455.2
Mississippi	4.18	7.25	303.3
Missouri	7.17	6.00	430.2
Nebraska	1.50	7.85	118.1
Nevada	4.96	6.95	344.9
New Jersey	6.31	6.55	413.4
New Mexico	2.91	8.45	246.0
New York	25.80	6.85	1767.0
North Carolina	7.46	5.85	436.5
North Dakota	0.46	6.80	31.3
Ohio	7.67	8.20	628.6
Oklahoma	4.63	6.40	296.3
Pennsylvania	12.84	5.50	706.2
Rhode Island	1.01	7.00	70.4
South Carolina	3.56	7.15	254.3
South Dakota	1.11	5.50	60.8
Tennessee	7.92	9.45	748.5
Texas	22.21	8.00	1777.1
Utah	2.70	6.70	180.7
Vermont	0.74	6.05	44.8
Virginia	8.45	5.00	422.
Washington	6.15	8.80	541.0
West Virginia	1.72	6.00	103.3
Wisconsin	5.30	5.45	289.0
Wyoming	1.14	5.40	61.7
Total	329.84		23260.0

Sources: Sales tax due: National Conference of State Legislatures
Sales tax rates: The Sales Tax Clearinghouse (rate is sum of state and average local (city and county) rates).

Electronic interchange has made tremendous inroads in how businesses come together to buy and sell. The purchasing agent working with a stack of product catalogs on his or her desk has given way to a purchasing agent going to a web site, perusing the electronic version of the paper catalog, and placing an order.

The four factors that influence the share of sales that are face-to-face versus remote make it not surprising that "business to business" ("B2B") sales dominate e-commerce. At this point in the evolution of the marketplace, remote selling has obtained a far greater share of the B2B market than sales by businesses to consumers ("B2C"). The Census Bureau estimated that in the third quarter of 2011, retail e-commerce sales were 4.6 percent of all retail sales.[2] While about triple the level of about a decade ago, it is still far below the level that it could reach as both the technologies that allow access to e-commerce and those that define the Internet buying experience increase their capabilities.

How Much Subsidy is There?

The subsidy is the sum of the price advantage that out-of-state sellers get from being able to offer prices that do not include the sales tax in the customer's state. Using the most recent estimates from the National Council of State Legislatures (NCSL), the total amount of sales with sales tax not collected will be $330 billion in 2012. The average state and local sales tax rate in the sales tax states is 7.05 percent under tax rates that applied late in 2011. Applying the sales tax rates to these sales produces a sales tax amount of $23.3 billion. **TABLE 2** on the opposite page shows the amount of sales and sales tax

involved in each of the states which imposes a sales tax.

The $330 billion in sales is a measure of the distortion from the current loophole that keeps states from collecting tax on sales to their residents. It shows the maximum amount of sales that could change sales mode if the loophole closed. The extent to which sales would change from remote to local if states collected tax on the remote sale depends on how much sales respond to changes in price. Some sellers who have used the tax differential as a way to charge higher prices may lower their prices to keep the sale.

Changing Technology and Efficient Division between in Person and Remote Sales

The level of sales that benefits from the favorable treatment enjoyed by out-of-state sellers reflects both long-standing technology and more recent innovations.

Remote selling is not new. Montgomery Ward and Sears, Roebuck and Co. pioneered mass catalog selling in the 19th century, long before any state imposed a general sales tax.

Each successive innovation in technology has brought new opportunities for remote selling. Toll-free numbers advertised on radio and television created new opportunities for sellers to find customers across state lines. A steady decline in the real price of computing power has enabled catalog sellers to buy and exchange lists, mining data to target their mailing to customers who are most likely to buy.

Electronic interchange has made tremendous inroads in how businesses come together to buy and sell. The purchasing agent working with a stack of product catalogs on his or her desk has given way to a purchasing agent going to a web site, perusing the electronic version of the paper catalog and placing an order. In other cases, where volumes are larger and processes more integrated, the purchasing agent has been replaced by software. One company's production planning system electronically interacts with the supplier's software to place an order. In the case of multiple vendors, the production planning system may electronically request bids, receive those bids, and apply algorithms the purchaser has developed to decide which bid to accept. Efficiency explains much of why electronic interchange has made inroads in how businesses interact with one another.

The movement to e-commerce has been uneven across markets. While the average consumer is more familiar with remote selling and e-commerce in the form of catalogs and merchant web sites, the dollar amounts are much greater in proprietary electronic data exchange relationships between businesses. For example, among manufacturers, 42 percent of the dollar value of shipments in 2009 involved a sale that took place via e-commerce. Among wholesalers, beverage and tobacco products had 59 percent of the dollar value of shipments take place as a result of an e-commerce sale. The retail sector lags far behind: only 4 percent of retail sales involved e-commerce; the overwhelming majority still take place in face-to-face sales.[3]

The consumer market (referred to as "business to consumer" or "B2C") lags the "business to business" (or "B2B") market. While it has lagged, the B2C side also has many more possibilities for future growth.

Even as growth proceeds more rapidly on the B2C side, some possibilities appear unlikely. Standardization, comparability and transportation costs mean many products have intrinsic limitations that make e-commerce unlikely. Many services, whether restaurant meals or a massage, are in this category. The small quantities in which consumers buy many products give an advantage to physical sellers who realize scale economies by taking shipments in a case. Buying a pack of gum will remain a transaction that only takes place through physical sellers.

However, advances in technology are rapidly changing the efficient allocation between physical and remote sales. Changes in telecommunications technology are rapidly shifting the equilibrium point between physical and remote sales. The speed at which consumers are able to access the Internet has gone up. The term "Cyber Monday," referring to a rush of Internet sales when consumers returned to work on Monday after Thanksgiving, had its origins in a time when workplaces typically had much faster Internet connections than homes. Broadband's growing availability has made the average at-home Internet upload and download speed much higher.

Other changes in telecommunications technologies are increasing the opportunities for consumers to buy remotely. The omnipresence of access to the Internet is giv-

ing a new meaning to "24/7." At the time of the Internet boom in the late 1990s, buying something over the Internet meant sitting down at a desktop computer with an Internet connection. The emergence of smartphones and tablet computing has put individuals within reach of the Internet for more of their waking hours. The thought of buying something over the Internet need not be deferred until arriving at home or the office to sit down in front of a computer and place an order.

Other changes are blurring the line between physical presence and e-commerce. Sellers that have both web sites and physical stores already offer the opportunity to order products on the web site and pick them up in a physical store. Cell phone apps offer the potential for a consumer to visit a store, identify the product he or she wants to buy, but decide he or she wants to have a different color. The in-store merchandising could show the range of colors available. The consumer could decide to buy a color not on display and use a cell phone app to order the preferred color to be shipped to his or her house.

With the retail sector so far behind other sectors of the economy in the share that is e-commerce, the balance between physical presence and e-commerce seems almost certain to shift further towards e-commerce. Sales from manufacturers to wholesalers and wholesalers to retailers are largely exempt from the sales tax, which falls mostly on sales made by retailers. In this sector, the sales tax will be another factor at work that will influence the pace and features of the further rise of e-commerce.

Subsidies Administered Through the Sales Tax System

Among the consequences of the Great Depression was a crisis in public finance. State governments were both financially pressed and subject to requirements in state constitutions that they balance their budget. From this combination emerged the sales tax. In 1933 alone, twelve states made the decision to impose a general sales tax.

States had long imposed taxes on particular articles (for example, alcoholic beverages.) In contrast to taxes on particular items, the new sales taxes were general taxes that began with the assumption that all sales were subject to tax and particular classes were exempt. By 1950, thirty states had general sales taxes; by 1969, the number was forty-five, where it remains to this day. Alaska has no statewide tax, but some local governments impose a sales tax. Even in states without a general sales tax, there are particular sales taxes. New Hampshire, for example, has a 9 percent rooms and meals tax that functions like a sales tax but is applied only to hotel rooms and restaurant meals that cost thirty-six cents or more.

States that adopted the sales tax also adopted another tax called the use tax. The sales tax applied to purchases of goods within the states. Naturally, states did not want to create incentives for their citizens or businesses to make out-of-state purchases to avoid the sales tax. The use tax addressed those incentives. While sellers would collect the sales tax, responsibility for the use tax belonged to the purchaser who faced the burden of self-assessing the tax obligation and remitting it to the state.

Both the sales and use tax apply to final purchasers. Both businesses and consumers can be final purchasers. Only a portion of purchases by businesses are final purchases. Wholesalers do not pay sales tax on goods they buy from manufacturers to sell to retailers. Wholesalers do pay sales tax on the warehouse trucks and office furniture they buy if those items are subject to the state's sales tax. Manufacturers are in the same position.

The subsidy amount reflects the degree of compliance with the sales tax law. If there are two sellers, one who collects the sales tax and one who does not, the uncollected sales tax is a subsidy that could wind up being split to a varying degree between the buyer and seller. The amount of sales tax creates a wedge between the seller who collects the tax and the seller who does not. What happens to the wedge depends on the relative bargaining power of buyer and seller. At one extreme, the buyer loses the entire wedge to the seller and the seller pockets all of the subsidy. At the other, the seller bargains away the price difference and the subsidy goes to the buyer. Repeated interactions, as between two businesses that have a customer-supplier relationship, offer an opportunity for buyers to get more of the wedge. In "take it or leave it" interactions that individual consumers have with sellers, sellers are much better positioned to hold on to the price difference.

There can be less-than-perfect compliance with state

Current policy has the effect of giving remote sellers a price advantage, allowing them to sell their goods and services without collecting the sales tax owed by the purchaser. This price difference functions like a subsidy. It distorts the allocation between the two forms of selling.

revenue laws for both in-state and out-of-state purchases. Enforcement studies show that there generally is a high degree of compliance with the sales tax, especially when the buyer, the seller, or both is a large and sophisticated corporation which has a staff that has as its primary task making sure the company complies with the tax laws. Lower levels of compliance occur among less complex businesses. Some failure to comply may be driven by complexity in the sales tax laws. Both types of sales and categories of purchases can be exempt. An examination of the frequency with which a state's sales tax collection agency gets mention in bankruptcy petitions filed by small businesses shows not remitting the sales tax collected can be a form of "desperation finance."

With out-of-state purchases, where the applicable tax is the use side of the sales and use tax, compliance is much lower.[4] Lower compliance reflects differences in specialization between buyers and sellers. As sellers, firms specialize. They have reason to be familiar with the nuances of definitions of which goods and services they sell are subject to sales tax and which are not. As buyers, they are more likely to be buying a more numerous set of goods and services. They must buy both the primary inputs for their product as well as a broad variety of goods and services that allow the firm to do all the things that are ancillary to their primary business. While a manufacturing company's purchases may be dominated by purchases of components for what it manufactures, it also buys cleaning supplies, replacement parts for their vehicle fleet, computers and software, and paper for use in the computer printers.

Compliance also reflects scale. Washington state found smaller firms had higher rates of noncompliance. Large and sophisticated organizations may understand their obligation to pay the tax, but even they suffer from the asymmetry of being in the position of a buyer versus that of a seller.

Individual consumers face the same set of challenges as businesses without the benefit of a tax department to help them figure out the details of use tax compliance. The low degree of compliance with the use tax begins with low levels of awareness that there even is a use tax. It is fed by the burden of compliance. One part of the burden is recordkeeping. Another is applying the correct tax concept to each receipt gathered in the recordkeeping process. For example, a consumer in Rhode Island, a state that imposes a 7 percent sales tax, who

purchases an appliance in Massachusetts, where the sales tax is 5 percent, is obligated to pay the 2 percent difference as a use tax to Rhode Island.

Why is There an Out-of-State Sales Tax Loophole?

When the first states responded to the difficult financial circumstances of the Great Depression by adopting a general sales tax, they recognized that a sales tax on purchases by residents of the state collected by sellers in the state would not reach purchases that their residents made out-of-state.

Their response to out-of-state sales was intellectually cohesive but practically flawed. This response was the use tax. For purchases in the state, the state could designate or create a revenue collection agency that would work with businesses in the state to collect the tax and remit it to the state. Trying to collect from businesses outside the state presented both legal and practical problems. From a legal perspective, it was unclear how a state could position itself to collect in other states. From a practical perspective, a state would be looking at trying to create relationships with a vast number of businesses, many of which would have few or no sales in that state. It would not be cost-effective to find many of the out-of-state sellers.

Thus states adopted a different strategy to collect and remit the tax due on out-of-state sales to their residents. States created a parallel tax to the sales tax called the use tax. Instead of the seller, the use tax would rely on self-reporting by purchasers.

As noted above, self-reporting by businesses does happen. About 10 percent of the revenue collected by state and local government as sales and use tax is use tax. Almost all of it is payments made by businesses. However, estimates of the size of the out-of-state sales loophole suggest that compliance is far from perfect.

The practical challenges of enforcing the use tax from individuals shows that as the compliance cost per unit of revenue increases, revenue is less likely to be collected. To comply with the use tax, a taxpayer faces the burden both of recordkeeping and applying a complex body of law.

Recordkeeping for individual taxpayers who intend to comply begins with a separate shoe box for receipts from out-of-state purchases. Processing those receipts starts with identifying whether the sales tax has already been collected.Those out-of-state sellers who have a physical presence in the buyer's state already collect the sales tax, meaning no use tax is owed. The next step would be to separate which purchases are subject to tax and which are not, a task that requires both knowing the general categories of purchases exempt from tax (in many states, groceries) and the state's revenue rulings over the years that have spoken to whether a particular good or service qualifies under the exemption. For example, is chocolate ordered from an out-of-state specialty company subject to the sales tax?

One approach that has been taken by some of the states is to look for use tax compliance in the income tax return. Twenty-three states that impose both a sales and an income tax try to collect the use tax on the income tax return. Eleven states include something on the income tax return that has to be completed about potential use tax liability. Nine states provide a table which taxpayers can use to find an estimated use tax liability appropriate to the taxpayer's income.

Despite these measures, only 1.6 percent of taxpayers report use tax in the eleven states that make an effort to collect use tax as part of the income tax return. The state with the highest share of returns showing use tax liability is Maine, where 11.3 percent of taxpayers reported use tax obligation on their 2007 tax returns. That may reflect the presumption that Maine had made the use tax liability 4 percent of income if the taxpayer did not report some other amount, a practice which ended in 1999.[5]

Why Don't States Fix the Loophole?

The impracticality of the use tax had fewer consequences when states first adopted sales and use taxes. At that time the largest distortion might have been along state borders. Buyers could order goods from sellers across the state line to be delivered or sent by mail. If the

THE SUPREME COURT AND STATE POWER TO TAX

The commerce clause of the Constitution enumerates authority to regulate interstate commerce as a power of Congress (Article I, Section 8): "The Congress shall have Power ... to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." Congress has said little about how states' sovereign power to tax relates to the commerce clause. Federal courts have played a more active role in spelling out the relationship of state sovereignty and state tax power.

In the years before states created general sales taxes, the Supreme Court saw the commerce clause as a source of sharp restrictions on state and local taxes that touched interstate commerce. In the 1880s, the Supreme Court considered a city business license tax imposed on a telegraph company operating under a provision of federal law. The Supreme Court struck down the tax, saying "no State has the right to lay a tax on interstate commerce in any form" (*Leloup v. Port of Mobile*, 127 U.S. 640, 648).

This was the legal context when states adopted general sales taxes beginning in the 1930s. They had to be mindful that the federal courts might say the tax interfered with interstate commerce, so they created a tax on sales to residents of their states, both individuals and corporations, with two sides. With intrastate sales, states required sellers to collect the sales tax. With out-of-state sales, states required purchasers to collect the tax from themselves, naming the tax a use tax.

An early question was the status of the two big retailers who both operated stores and sold by catalog, Sears Roebuck and Montgomery Ward. Did they have to collect sales tax on their catalog sales? In a pair of cases decided in 1941, the Supreme Court held that they did, even though items ordered through the catalog might be shipped from an out-of-state warehouse (*Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359; *Nelson v. Montgomery Ward & Co.*, 312 U.S. 373).

Changes in the marketplace allowed the Supreme Court to consider new types of selling patterns in 1967 in *National Bellas Hess v. Illinois*. National Bellas Hess was a mail order house in Kansas City, Missouri, which specialized in clothing. Unlike Sears, Roebuck and Co. and Montgomery Ward, it did not have stores in Illinois, yet Illinois wanted it to collect the state sales tax. The U.S. Supreme Court looked at the company's relationship to Illinois and noted that it did not have an office, place of business, or telephone listing in that state, nor did it advertise in Illinois newspapers or on Illinois radio or television stations.

National's connection with the state was through mailed catalogs and flyers. That, the Supreme Court decided, was not enough to disturb its bright line defining which sellers could be required to collect the sales tax. Anyone who had a store in a state could be required to collect sales tax on catalog sales. Sellers that did not have physical locations or personnel in a state could not.

seller had no physical presence on the buyer's side of the border, the seller would be unlikely to collect the tax owed by the buyer. The prototypical problem might have been Virginians going into North Carolina to buy furniture. The Virginia address on the invoice would show a North Carolina state tax auditor that no tax was required. Absent voluntary self-reporting by the Virginian who purchased the furniture, Virginia revenue authorities would never know about the purchase and use tax obligation.

As selling technology changed, states made efforts to keep the administration of their tax laws up to speed with those changes. The courts responded to these state initiatives by clarifying what key concepts in the U.S. Constitution implied for administering a sales tax. (See Box opposite: The Supreme Court and Limits to State Power to Tax.)

Catalog sales raised a range of issues. A decade after states began to impose general sales taxes, the Supreme Court decided that sellers who both had stores and catalogs could be required to collect sales tax on catalog sales, even when the merchandise was shipped from out-of-state and not the in-state store. The Court has hewed to the view that a seller must have a store or other physical facility in a state before the seller can be required to collect the state's sales tax, affirming its position in *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967) and *Quill v. North Dakota*, 504 U.S. 298 (1992), both cases that involved catalog sellers.

The Supreme Court decisions have been the work of one branch of the federal government to preserve federal prerogatives. The Court has noted that the legislative branch might also set policy on whether requiring out-of-state sellers to comply with state sales tax laws is an undue burden on interstate commerce. As the Court wrote in its *Quill* decision, "Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes."

Since the 1992 decision, new possibilities have emerged. In addition to selling through stores and catalogs, sellers have an additional hybrid strategy, offering consumers a choice of buying at a physical store or online. These hybrid sellers have no choice but to collect the sales tax on their online sales.

When companies that sell remotely have acquired physical presence in more states, they lose their ability to ignore the sales tax in those states. The Sears purchase of Lands' End offers an interesting example of what current federal policy implies. Before being bought by Sears, Lands' End had a small physical footprint, focused on one state: Wisconsin. However, its new parent, Sears, has stores in every state. The result is that Lands' End now collects the sales tax on behalf of all the sales tax states.

Circuit City Stores shows one more possibility: leaving selling through stores and selling only through the Internet. Following Circuit City Stores' bankruptcy and subsequent liquidation, an entrepreneur purchased the rights to the Circuit City name, allowing for the resurrection of Circuit City as an online-only seller. In its new form, CircuitCity.com is liberated from the burden of collecting sales tax for states other than where it has a distribution center.

Future Directions in the Technology that Bring Together Buyers and Sellers

From the perspective of the 1990s, the possibilities of buying and selling that have become available would be surprising. Time of day and distance from seller have become irrelevant constraints. No doubt the world of twenty years hence will bring its own surprises in the technologies that bring together buyers and sellers.

Physical limitations will remain important in many categories. Sales at gasoline stations, which were just under 10 percent of all retail sales in 2009, offer an example of how physical limitations will limit change. Gasoline's weight relative to its sale price and the scale economies in transporting it by tanker truck make it unlikely to be something that would ever be sold remotely, at least in the volumes bought by the typical household. Remote sellers would find it difficult to match a characteristic consumers value about the non-gasoline items sold by gas stations: immediate availability.

Standard setting for products sold "business to business" long preceded the rise of information technology and the possibilities that opened for remote selling.

No matter whether a sale occurs face-to-face or remotely, the information technology supporting any transaction is more capable today than it was a generation ago.

There are many possibilities on the consumer side that technology has not yet reached but could.

Some possibilities:

- **Clothing.**

More standard setting and more parameters in standards. Men's shirts are available not just in Small-Medium-Large but also in two-parameter sizing: neck and sleeve length. Multiple parameters, combined with computer-controlled made-to-order processes, could tilt more of the clothing market towards remote purchases.

Technologies that combine pictures of individuals with particular clothing styles, fabrics, or colors could increase the sensory richness of the online shopping experience.

- **Sensor-driven purchasing**.

Refrigerators and home pantries can be equipped with sensors using RFID tags that track household inventories. Consumers could set inventory alerts that could also be set to access the Internet and automatically order more when supplies run low. While many grocery items are exempt from sales tax in many states, other kitchen items (e.g., plastic bags) are not.

Reducing the Burden of Compliance

Since the Supreme Court last stated federal policy on sales tax compliance, in the 1992 *Quill* decision, advances in information technology have reduced the burden faced by sellers who must already collect the sales tax for multiple states.

Regardless whether a sale occurs face-to-face or remotely, the information technology supporting any transaction is more capable today than it was a generation ago. Compared to the real-time analytics applications used by the most sophisticated sellers, the software module required to determine if a sale is subject to sales tax and calculate the correct amount is trivial. A seller which does not have some information technology supporting

the sales process is rare. Sellers can turn to either customized applications or off-the-shelf software that can calculate the sales tax for any jurisdiction in the country. They can also turn to third parties to do compliance for them. For example, Amazon will collect sales taxes for all jurisdictions for those who use Amazon to sell as Amazon Marketplace clients for a 2.7 percent fee.

Choices made by state and local governments add to the burden of complying with the sales tax. Rates can change at any time of the year. A city or county government can subject different items to tax or exempt certain items.

Policy Options

Many tools could be put to use to implement approaches that would make the future marketplace a fair one in which tax policy does not distort sales away from the most efficient location.

They differ along several dimensions, including:

- **Federalism**. Some options have no role for the federal government, relying on state action. They include leveling the playing field down and reducing the range of goods subject to the sales tax.

Other options involve federal pre-emption or a new bureaucratic role for the federal government. Moving to an origin-based sales tax, for example, would require federal pre-emption of state laws and an ongoing federal role to administer the sales tax, as would a national "e-commerce sales tax" as an alternative to collecting the sales tax of the state where the consumer is located.

- **Degree of change**. Some options involve incremental change and others involve radical departure from current practices. Ending the general sales tax on categories of goods which are most likely to be sold remotely leaves the general structure of the sales tax in place and adds to the current list of exemptions. Shifting from a destination-based to an origin-based sales tax would be a large conceptual change in what the sales tax is, from an approximation of a consumption-based tax to a tax on business transactions.

1. Reduce the Scope of the General Sales Tax.

The playing field could be leveled between in-state and out-of-state up or it could be leveled down. State and local governments could look at the potential for remote selling and apply the general sales tax only to goods and services which are not likely to be sold remotely.

Some states accomplish this already on a time-limited basis through sales tax holidays. These holidays allow purchase of some goods with no sales tax for a certain period of time. "Back-to-school" purchases of clothing are an example.

Pro

—Creates a level playing field for sellers in different states.

—Provides a rationale for cutting taxes.

Con

—The long-term trajectory of the sales tax has led to a tax base which is a smaller and smaller share of the economy and upward rate creep. This would add to pressure for higher rates on goods subject to tax.

—Allows a loophole to drive tax policy.

2. Get Rid of the Use Tax on Purchases by Individuals.

Only a small share of people make an effort to comply with the use tax. Ending the tax on purchases by individuals would end the status of a use tax on out-of-state purchases by individuals as a legal fiction.

Pro

—Compliance costs are large relative to amount owed.

—Individuals pay only a small share of use tax receipts. Eliminating the legal liability for use tax would mean only a trivial loss of state revenue.

Con

—In-state and out-of-state purchases would continue to have different treatment under state sales tax laws.

—Treats purchases of the same goods by individuals and businesses differently, as businesses would continue to pay the use tax.

3. Close the loophole.

Congress could accept the invitation from the Supreme Court to articulate a standard for an undue burden on interstate commerce. The simplification framework developed by the states in the Streamlined Sales and Use Tax Agreement offers an example of a standard that Congress could endorse.

Pro

—Gives same treatment to purchases from in-state and out-of-state sellers.

—Does not require an ongoing federal role in the sales taxes imposed by state and local governments.

Con

—Requires congressional action.

—Without a "smaller seller exemption," compliance burden relative to amount of tax collected would be relatively higher for some sellers.

1992: THE MOST RECENT WORD FROM THE SUPREME COURT

A quarter-century after the *National Bellas Hess* case, the Supreme Court returned to the same issues in *Quill v. North Dakota*. The Court affirmed its bright line test, requiring some physical connection between a state and a seller—some kind of physical premises in the state or employees based in the state—before a state could require the seller to collect the state's sales tax.

North Dakota had amended its definition of a seller who must collect the state's sales tax to include "every person who engages in regular or systematic solicitation" of business in the state. Quill was then a catalog seller, selling office supplies via printed catalogs mailed to businesses in North Dakota and other states. It had warehouses in Illinois, California, and Georgia. It had no facilities in North Dakota, nor did it have any employees there.

The state supreme court argued that "the tremendous social, economic, commercial and legal innovations" since the Supreme Court had decided the *National Bellas Hess* case in 1967 meant that the decision was obsolete.

The U.S. Supreme Court differed. The bright line in *National Bellas Hess* would remain its standard for interpreting the commerce clause. And as a result, North Dakota could not require Quill to collect the North Dakota sales tax on office supplies shipped to North Dakota.

The court noted that "like other bright line tests, the *Bellas Hess* rule appears artificial at its edges," but it established clear boundaries. Since Congress had not spoken, the Supreme Court would.

The court pointed to Congress to provide more guidance, noting that "the underlying issue is not only one that Congress may be better qualified to resolve but also one that Congress has the ultimate power to resolve."

At the time, the idea of a graphical user interface and a world wide web were less than three years old and the web accounted for less than 1 percent of Internet traffic.

The world has changed, not only for the marketplace, but for Quill itself. Quill no longer benefits from the Supreme Court's affirmation of its position. The company was acquired by Staples in 1998 and continues today as Quill.com. Because Staples has physical stores across the country, Quill.com now collects sales tax on sales to all states, including North Dakota.[1]

[1] Staples 2010 Annual Report, April 2011.

NOTES

1. Thirty-one states and the District of Columbia exclude food purchased for home consumption from their sales tax; seven tax food but at a lower rate than the general sales tax; five tax food but offer a tax credit for lower-income households meant to offset part or all of the tax; two tax food at the same rate as all other purchases. Center on Budget and Policy Priorities, "Which States Tax the Sale of Food for Home Consumption in 2009?," Washington: 2009. http://www.cbpp.org/cms/?fa=view&id=1230

2. U.S. Census Bureau, "Quarterly Retail E-Commerce Sales 3rd Quarter 2011," CB11-186, November 17, 2011 http://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf. The Census Bureau defines retail sales by the nature of the seller, not who buys, thus this definition includes both business-to-consumer sales as well as some business-to-business sales. E-commerce is one part of remote sales by out-of-state sellers which also includes catalog sales and calls to toll-free numbers spurred by radio and television advertising and direct mail. The Census Bureau data also do not break down e-commerce sales between in-state sellers who are already required to collect the sales tax and out-of-state sellers who are not.

3. U.S. Census Bureau, "E-Stats," May 26, 2011. www.census.gov/econ/estats/2009/2009reportfinal.pdf

4. The State of Washington Department of Revenue looked at compliance in a sample of audits in conducted between 2005 and 2008. The audits covered returns of excise taxes collected by businesses. It found sales tax compliance was 99 percent; that is, the amount remitted was 99 percent of tax liability. Use tax compliance was 77 percent. State of Washington Department of Revenue, "Department of Revenue Compliance Study," Department of Revenue Research Report #2010-4.

5. Nina Manzi, "Use Tax Collections on Income Tax Returns in Other States." Policy Brief, Research Department, Minnesota House of Representatives, June 2010.

HANNS KUTTNER

Hanns Kuttner is a Visiting Fellow at Hudson Institute. His career spans the policy and research world. During the presidency of George H.W. Bush, he was part of the White House domestic policy staff with responsibility for health and social service programs. Most recently, he was a research associate at the University of Michigan's Economic Research Initiative on the Uninsured. He has also worked for the federal agency which runs the Medicare and Medicaid programs and advised the state of Illinois on restructuring its human service programs. He has written extensively about issues relating to Americans' health insurance status and the potential for improving the American health care system.

Kuttner comments widely in the media on health care, economics, and government innovation.

HUDSON INSTITUTE

Hudson Institute is a nonpartisan, independent policy research organization dedicated to innovative research and analysis that promotes global security, prosperity, and freedom.

Founded in 1961 by strategist Herman Kahn, Hudson Institute challenges conventional thinking and helps manage strategic transitions to the future through interdisciplinary studies in defense, international relations, economics, health care, technology, culture, and law.

With offices in Washington and New York, Hudson seeks to guide public policymakers and global leaders in government and business through a vigorous program of publications, conferences, and policy briefings and recommendations.

Hudson Institute is a 501(c)(3) organization financed by tax-deductible contributions from private individuals, corporations, foundations, and by government grants.

www.hudson.org

1015 15TH STREET, N.W., SIXTH FLOOR, WASHINGTON, D.C. 20005

HUDSON INSTITUTE

TELEPHONE 202-974-2400 WWW.HUDSON.ORG