



TESTIMONY

Submitted to the
COMMITTEE ON THE JUDICIARY
UNITED STATES HOUSE OF REPRESENTATIVES

ORDER FROM CHAOS: IS CONGRESSIONAL ACTION NECESSARY?

July 24, 2018

Jessica P. Melugin
Associate Director, Center for Technology and Innovation
Competitive Enterprise Institute

Dear Members of the Committee:

Thank you for the opportunity to submit testimony. I am Jessica Melugin, Associate Director of the Center for Technology and Innovation and the Competitive Enterprise Institute (CEI). CEI is a non-profit public policy research organization dedicated to advancing individual liberty and free enterprise with an emphasis on regulatory policy. We appreciate the opportunity to comment on this vexing question of interstate sales taxation.

The Supreme Court's recent decision in *South Dakota v. Wayfair* changed the default rule that dictates how states may tax remote purchases shipped to their residents in the absence of congressional action. It does not change Congress' constitutional authority to create rules for this part of interstate commerce. In fact, the Court's about face ruling makes it more imperative that Congress act to stem the chaos of unfettered expansion of state taxing power.

Specifics on which path Congress should take to address the growth of remote online sales will be discussed briefly at the end of this testimony. However, the harms from allowing states to act with only their self-interest as a guide will be detailed and they strongly



recommend a moratorium on state action.¹ Until Congress can make a more objective and evenhanded decision, balancing the needs of citizens of states with the desires of state governments, Congress should prevent states from charging ahead with unwise policy.

There Is No Rush; States Are Flush

The big winners from the Supreme Court's overturning of the physical presence standard are state tax authorities. As Max Behlke, Director of Budget and Tax, State-Federal Relations Department for the National Conference of State Legislatures, put it, "it's about the money."² That statement is both refreshingly honest and depressingly worrisome. It underscores the urgency of the need for Congress to act to stop states from acting with the singular priority of gaining more tax revenue and without giving due consideration to other affected parties and principles.

How much money is at stake here? State governments will reap anywhere from \$8 billion to \$26 billion by forcing out-of-state vendors to collect and remit sales taxes, depending on whose report you believe.³ A 2017 U.S. Government Accountability Office study found that potential revenues would be, "about 2 – 4 percent of total 2016 state and local government general sales and gross receipts tax revenues."⁴ That is hardly a silver bullet of revenue for state budgets.

¹ CEI has opposed much of the legislation introduced in Congress to address the taxing of interstate commerce online. For a more detailed discussion of these criticisms, see Jessica P. Melugin, "Online Sales Taxes Make Government Bigger and Undermine Federalism," *Web Memo* No. 42, Competitive Enterprise Institute, March 15, 2018,

<https://cei.org/content/online-sales-taxes-make-government-bigger-and-undermine-federalism>.

² Elaine S. Povich, "As High Court Weighs Online Sales Taxes, States Get Ready to Pounce," *Stateline*, an initiative of the Pew Charitable Trusts, March 13, 2018,

<http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2018/03/13/as-high-court-weighs-online-sales-taxes-states-get-ready-to-pounce>

³ United States Government Accountability Office, "Sales Tax: States Could Gain Revenue from Expanded Authority, but Businesses Are Likely to Experience Compliance Costs," GAO-18-114, November 2017, <https://www.gao.gov/products/GAO-18-114>.

For the higher end, see National Conference of State Legislatures and International Council of Shopping Centers, "Uncollected Sales & Use Tax from Remote Sales; Revised Figures, March 2017, <http://www.efairness.org/files/Updated%20Sales%20Tax%20Loss%20Report.pdf>

⁴ GAO.



Even with the disparity in what the actual amount will be and the small percentage it would represent, perhaps a more germane question to today's hearing is: What is the level of urgency for these funds to reach state treasuries?

The Pew Charitable Trusts recently reported that a, "decade after the start of the Great Recession, 34 states—the most yet—were taking in more tax revenue at the end of 2017 than before receipts plunged in the downturn, after accounting for inflation."⁵

A recent *Wall Street Journal* editorial opposing the related Remote Transactions Parity Act (H.R. 2193) noted that, "Contrary to political lore, sales tax revenues have been increasing steadily in states with healthy economies. Over the past five years, Florida's sales tax revenues have grown 27%. South Dakota's are up by nearly 30% since 2013."⁶

According to the U.S. Census Bureau, state and local governments brought in \$215.4 billion more than they spent in 2013.⁷ More recently, the Census Bureau found that state and local governments collected a record \$404.5 billion in individual income taxes in 2017.⁸

All of these data indicate that there is no funding emergency for most states and that the potential revenues from expanded remote sales tax collection would constitute a tiny fraction of states' overall budgets.

Thus, establishing that there is no urgent need for increased state revenue leads us to another question: What is the level of regulatory pain that results from letting states expand their tax powers online?

There Are Significant Harms to Online Sellers if States Proceed to Tax Them Unchecked

If states proceed to tax them without restraint, online retailers may be forced to comply with the requirements of 10,000 distinct taxing jurisdictions—each with its own base,

⁵ Pew Charitable Trusts, "Fiscal 50: State Trends and Analysis," June 20, 2018, <http://www.pewtrusts.org/en/research-and-analysis/articles/2014/05/19/fiscal-50-state-trends-and-analysis>.

⁶ Editorial Board, "The GOP Internet Tax," *The Wall Street Journal*, March 15, 2018, <https://www.wsj.com/articles/the-gops-internet-tax-1521153858>.

⁷ United States Census Bureau, "State and Local Government Finance Snapshot," July 2016, <https://www2.census.gov/govs/g13-alfin.pdf>.

⁸ Terence P Jeffrey, "State and Local Income, Sales and Property Taxes All Hit Records in 2017," CNSNEWS, March 22, 2018, <https://www.cnsnews.com/news/article/terence-p-jeffrey/state-and-local-income-sales-and-property-taxes-hit-records-2017>.



rates, exemptions, and hundreds of changes every year—and remit taxes to the 46 jurisdictions—45 states plus the District of Columbia—that impose sales taxes. This presents the danger of regulating small firms out of existence with compliance costs and out-of-state audits.

Proponents of tax expansion often dismiss compliance cost concerns by pointing to “free” calculating software from state governments, but a study by the group True Simplification of Taxation estimates implementation costs of \$80,000 to \$290,000 and yearly maintenance costs of \$57,500 to \$260,000 for midsized retailers.⁹ Apparently, “free” means something else to tax authorities. Additionally, there are serious concerns with the performance of tax calculating software. Few considerations have been made in legislation to address costs associated with testing or integrating these systems.¹⁰

Unrestricted state tax expansion also subjects smaller retailers to invasive audits by states where they have no physical presence. A Texas retailer could be audited by California, New York, or New Jersey tax authorities simply for selling to somebody in one of those states. A business could be audited in multiple states simultaneously. The time and money spent on appearing in other state’s courts may prove lethal for some businesses.¹¹

Twenty-one states have already passed economic sales tax nexus models. Of those, only South Dakota and Maine have included language that prevents those economic nexus laws from being applied retroactively.¹² The threat of vendors being forced to pay back sales taxes is another layer of cost and uncertainty for online sellers.

Many brick-and-mortar retailers claim they are victims under the admitted inequities of *Quill’s* regime, but imposing unprecedentedly high compliance costs on online retailers will not balance the scale of justice between them and online retailers; it will only tip it the

⁹Larry Kavanagh and Al Bessin, “The Real-World Challenges In Collecting Multi-State Sales Tax,” True Simplification of Taxation, September 2013, http://truesimplification.org/wp-content/uploads/Final_TruST-COI-Paper-.pdf.

¹⁰Grant Gross, “Study: Internet sales tax software will be costly to implement,” PCWorld, September 25, 2013, <https://www.pcworld.com/article/2049412/study-internet-sales-tax-software-will-be-costly-to-implement.html>.

¹¹Ben DiPietro, “What Are Compliance Costs for Online Sales Tax?” *Wall Street Journal*, May 7, 2013, <https://blogs.wsj.com/riskandcompliance/2013/05/07/what-are-compliance-costs-for-online-sales-tax/>.

¹²Ryan Prete, “Many State Sales Tax Laws Leave Door Open for Retroactivity,” *Bloomberg Tax*, July 3, 2018, <https://www.bna.com/state-online-sales-n73014477104/>.



other way.¹³ Traditional sellers will continue to tax according to their location, not their customer's, while online sellers will be burdened with calculating for 10,000 tax jurisdictions. No one can seriously think that is fair.

There Are Harms to Principle and Precedent too

The principle of federalism among states is at stake here, and it is Congress' job to protect it. While this may sound like a problem only for theorists and constitutional scholars, the real-world consequences of ignoring it will be very real for taxpayers. And those consequences will not be limited to sales taxes. Allowing states to proceed unrestrained will set a dangerous precedent in other fields of taxation.

We all understand and value the benefits of *vertical* federalism that separates our federal government from our state governments. Yet equally important is the *horizontal* federalism that places states in competition with each other, to the benefit of their citizens. George Mason University Law Professor (and CEI board member) Michael Greve explained it to a Senate Committee like this in 2001:

States' rights, like individual rights, must end where another's rights begin. Federalism means that states may regulate and regiment their own citizens—but not the citizens of other states. The imposition of use tax obligations by each state on foreign entities amounts to mutual regulatory aggression on other states' corporate citizens. That is not federalism but very nearly its opposite.¹⁴

The long-term effect of ignoring this aspect of federalism and letting states tax extraterritorially would be to lessen the beneficial downward pressure on taxes that arises from competition between jurisdictions.

To illustrate, consider this thought experiment. Driving your car across the D.C. border to Virginia to fill up with lower Virginia gas taxes keeps at least some downward pressure on D.C. tax rates. If D.C. made the rate high enough, then everyone would exit and fill up in Virginia. But if online extraterritorial taxation by states were applied, it would mean that

¹³ Big box retail stores like Target, Best Buy, and Walmart support new state tax powers, which would burden small competitors, potentially putting some out of business. Even Amazon, which used to oppose these tax expansion efforts, has switched sides now that it owns warehouses across the country to improve delivery times, which triggers sales tax compliance requirements in many states.

¹⁴ Dr. Michael S. Greve, "Internet Sales Taxation," Testimony to the United States Senate Committee on Finance, August 1, 2001, https://cei.org/sites/default/files/2001_Greve_IST.pdf



when you pull into that Virginia gas station, the station attendants would look at your D.C. plates and charge you the D.C. gas tax rate. There is no exit. Consumers will wear their home jurisdiction like a tax albatross when they shop online.

This is the opposite of horizontal federalism and its beneficial tax competition; it is a de facto cartel among the states.

The recently overturned physical presence standard protected business owners from what amounts to taxation without representation, since a state could not impose its sales tax on purchases if the seller has no store, warehouse, or office located in the state. But that default safeguard was wiped away with the Supreme Court's reversal of decades of precedent in *South Dakota v. Wayfair* earlier this summer.¹⁵

This protection was in line with one of the most important aspects of competitive federalism: protecting individuals from overreaching states and states from each other. Of course the Constitution does not bar state Internet sales taxes; it permits them so long as Congress passes federal legislation or approves a multi-state agreement.

If Internet sales taxes are really in the public interest, Congress should establish some reasonable rules of the road. States should not be able to act independently, wreaking havoc on interstate commerce and citizens' pocketbooks. In the meantime, Congress should impose a moratorium on state online taxing activity until it can provide a more circumspect and thoughtful regime.

To that end, Congress should consider enacting—or approving, if agreed upon via multistate compact—an *origin-based* online sales tax system. Under this system, online sales taxes would be assessed based on the point of purchase—for example, an online seller located in South Dakota would be subject to that state's tax, just like brick-and-mortar sellers in that state. Vendors selling remotely, just like those selling in out of a storefront, would remit to their own home tax authority.

In short, online and brick-and-mortar sellers would be treated identically. Most importantly, such an approach would promote healthy competition among the states and keep politicians accountable to those they tax. A state that imposed a very high tax on sellers located within its borders would risk losing those businesses to lower-tax states. This benefits taxpayers and provides a check on the growth of government.

¹⁵ United States Supreme Court, *South Dakota v. Wayfair, Inc.*, Docket No. 17–494. Argued April 17, 2018—Decided June 21, 2018, <http://www.scotusblog.com/case-files/cases/south-dakota-v-wayfair-inc/>.



By contrast, if states are allowed to tax extraterritorially and unrestrained, it will lead to the destruction of many small, online businesses and impose a de facto tax hike on Americans, leaving citizens with less money in their pockets and fewer choices online.

Additionally, allowing states to charge forward, ignoring the physical presence standard, sets a dangerous precedent in other areas of taxation. The previous nexus requirement was a shield of protection from overzealous tax collectors and was a fundamental tenet in American tax policy for decades. If Congress does not act to reinstitute this protection, or one similar, business earnings and individual income taxes could expand to unprecedented degrees.

Conclusion and Recommendation

An origin-based online sales tax regime is the best available option. Congress should consider this approach as it's a politically accountable way to allow states to meet the revenue challenges posed by the growth of online commerce. Its opposite, a destination-based taxing regime is a bad idea, especially if states institute it 46 different ways. It is also a bad idea as proposed in Congress, in the form of the Marketplace Fairness Act (S. 976) or the Remote Transactions Parity Act (H.R. 2193).

Congress has the opportunity to find a better solution to balancing federalism, economic efficiency, and tax equity.¹⁶ At minimum, Congress should give itself time to do so and institute a moratorium on states acting on their own to expand remote online sales taxes. Congress needs to act in the best interests of online entrepreneurs and taxpayers.

¹⁶ See the eloquent, constitutional solution to the remote taxing question here: https://cei.org/sites/default/files/2001_Greve_IST.pdf