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Why Congress Should Not Authorize a State Sales Tax Cartel

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Fearful of competition, some politicians in high-tax states want to stop their residents from saving money by purchasing products where taxes are lower. Using the excuse that they want to "streamline" and "simplify" retail sales taxes so that there will be a "level playing field" between Main Street merchants and e-commerce, these state and local politicians are asking Congress for unprecedented power to impose taxes on transactions that take place outside their borders.

The issue is not whether to tax Internet sales. States already have that power. Instead, the debate is about whether Congress should pass a law that allows taxation without representation. Should there be a national law, for example, allowing Utah to compel a Colorado business to collect and remit Utah taxes if that business sells something to a Utah resident?

The U.S. Supreme Court already has ruled that states may not tax companies that have no presence (or "nexus") inside their borders. State and local politicians want to overturn this decision by getting Congress to approve a state sales tax cartel and attach legislation authorizing the cartel to a bill extending the Internet tax moratorium.

Requests to establish this *destination-based* tax authority should be denied. Such a regime would create an anti-consumer sales tax cartel for the benefit of profligate governments. It also would undermine privacy by requiring the collection of data on individual purchases. And it would violate important constitutional principles by giving state and local governments the power to impose their own taxes on businesses in other states.

Proponents of a destination-based sales tax regime who claim that it would level the playing field ignore a crucial fact: The current inequity exists only because state and local governments have chosen not to tax the sales of in-state companies on purchases sent to out-of-state buyers. The issue is not the Internet. The issue is reducing competition from low-tax jurisdictions.

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The Threat to Competition. Both the National Governors' Association (NGA) and the National Conference of State Legislatures (NCSL) support the sales tax cartel. In their view, people should not have the freedom to shop where taxes are lower. This activity, they argue, creates a "race to the bottom" because states would be forced to lower their tax rates to remain competitive. But governments should not be allowed to act like monopolists. The possibility that taxpayers might shift economic activity to a lower-tax jurisdiction is a useful form of fiscal discipline. Tax

competition forces politicians to be more responsible, much as competition among banks, pet stores, and car companies results in lower prices and better service.

A Threat to Privacy. In addition to being bad tax policy, the destination-based regime is a threat to privacy. The system envisioned by the NGA and NCSL would require merchants to verify the residence of every customer and then impose the state and local taxes that apply in that locale. For this system to work, however, state and local bureaucrats would have the right to inspect records of transactions. At best, this approach means that personal financial information and buying patterns would cease to be private. On a more ominous note, this type of system would dramatically increase opportunities for such crimes as identity theft and credit card fraud. Proponents assert that "trusted third parties" could act as intermediaries to guard against these problems, but cosmetic gestures will not deter hackers and others who misuse private information.

A Dangerous Precedent. Advocates of the state sales tax cartel may not realize their regime also could undermine America's interests in the international arena. High-tax European governments are upset that many of their consumers avoid their punitive value-added taxes (a form of national sales tax) by purchasing goods and services from U.S. companies. In an effort to weaken America's competitive advantage, these states want to compel U.S. companies to collect taxes on their behalf.

To its credit, the Bush Administration is resisting this effort to make U.S. firms subservient to foreign law, but the President's moral authority to defend American interests will evaporate if state and local politicians are able to impose domestically what European politicians seek to impose internationally. Simply stated, it is important to defend the principle that sales taxes should be imposed where a transaction occurs, not where a consumer lives.

Real Tax Equity. Because of the shipping and handling fees that accompany on-line and mail-order purchases, consumers rarely make out-of-state purchases to avoid paying sales tax. But if state and local lawmakers are truly concerned that local merchants are being disadvantaged, there is a solution that would allow tax competition, preserve consumer privacy, and respect constitutional principles: States could level the playing field by taxing all in-state sales at the same rate, regardless of whether the purchase is made in person, over the phone, or by using the Internet.

This *origin-based* or "territorial" approach is based on the common-sense notion that there should be a link between taxes and government services. A Texas-based business, for instance, should pay taxes to the Texas government. That business, after all, uses Texas roads and relies on Texas fire and police protection. Having that business pay taxes to another state, by contrast, would be a form of taxation without representation.

Another benefit of "territorial" taxation is that it can level the playing field without special congressional approval. States merely have to apply their sales taxes on a non-discriminatory basis. Indeed, because a more broadly based sales tax would generate additional tax revenue, legislators should take advantage of this opportunity by using the extra revenues to lower state income tax rates or reduce the overall sales tax rate. This type of tax reform would improve state economic performance by boosting wages, creating new jobs, and attracting business.

Conclusion. A destination-based sales tax cartel would be bad for taxpayers. It would damage competition and privacy, erode fiscal discipline, and lead to higher tax burdens. It would threaten personal privacy by allowing third parties to examine financial transactions and buying patterns. And it would harm the President's ability to defend America's economic interests when dealing with Europe's welfare states. Rather than authorize a state sales tax cartel, Congress should encourage state and local governments to work together to implement origin-based or territorial sales tax reforms that would ensure that all purchases are treated fairly.

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