50th Anniversary
1961-2011

ECONOMIC POLICY / BRIEFING PAPER

Hudson Institute

Future Marketplace: Free and Fair

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November 29, 2011

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A free market provides buyers with the best terms and lowest prices. When that price reflects the actions of third parties, like government, the result is a distortion away from the efficient, free market price. Government actions that distort a free market include taxes, subsidies, and regulations that prefer one form of economic activity over another.

Current federal policy treats different sellers differently. States may set a sales tax but federal policy then creates a loophole for out-of-state sellers. The general sales tax used in 45 states, home to 97 percent of the American people, interacts with state lines and federal policies to create a preference for buying from out-of-state. This distortion between the share of sales that go to in-state versus out-of-state sellers will effect the sale of up to $330 billion worth of goods and services in 2012.

This distortion reflects the price difference between purchases from in-state and out-of-state sellers. Federal policy allows states to compel in-state businesses to collect the sales tax owed by the final consumer. It does not allow them to impose the same requirement on out-of-state sellers who sell by catalog, toll-free numbers, electronic data exchange, and, to a growing extent, over the Internet, unless the seller has a physical presence in the state. These out-of-state sales can become "no state" sales, with the sales tax of no state collected on them. This special treatment gives "no state" sellers a price advantage, an advantage they can use to gain a larger market share than they would have in a market without government distortion.

In a free market, buyers get the lowest price. That lowest price can be the truly 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 subsidies and distortions that result from the loophole currently required by the federal government are longstanding. Changes in the technology of buying and selling are increasing the size of the distortion. Information technology is narrowing the distance between buyers and sellers even though the physical distances remain the same. As a result, the size of the subsidy and resulting distortion will grow over time.

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 abandoning the general sales tax as unworkable in the 21st century to keeping it and using technology to simplify the complexity of complying with the sales tax laws of multiple states.

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 smaller share of market transactions involve face-to-face interaction. 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"

Many sales can take place through either face-to-face or through one of the forms of remote sales. Competition in many markets shows some of the market goes to sellers who interact with buyers face-to-face and some to sellers who sell remotely. 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 an remote sales.

However, if there is a distortion in the marketplace, whether from subsidies, taxes, or regulation, there will be a different division between face-to-face and remote. This difference is a loss of efficiency relative to a free market.

Distortions from government action can have an impact on the share that is face-to-face compared to remote. Current policy makes the sales tax a distortion. Current policy gives 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. 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 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 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 make sure the product offered by two sellers is the same. A consumer can gather information from a variety of sources: walk into store, look at the websites of online sellers. From this a consumer can decide which product is best. The information contained in a few pieces of information -- brand, make, model number -- is enough to allow comparing price across and between physical and online sellers, confident that the product is the same.

- **Product comparability**. A restaurant that buys a five gallon container of cooking oil obtains a comparable product whether the container comes across state lines or from a local vendor. With services, immediacy is often an important component. Further advances in logistics would be required for remote sellers to erode the strong advantage of physical sellers. Again, 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 some 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. Transportation costs represent a large share of the cost of stone and other building aggregates delivered to a construction site. Rock aggregates are an example of a category where the price difference from the sales tax does little for remote sellers. 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	Medium	High
Convenience purchases	Appliances	Books
Gasoline	Furniture	Clothing
Motor vehicles	Insurance	Consumer electronics
Personal services		Music recordings
Restaurant meals		

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 third quarter retail "e-commerce" sales were 4.6 percent of all retail sales.[1] 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 define the Internet buying experience increase 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 of late in 2011. Applying the sales taxes which are imposed in the states where those customers are produces a sales tax amount of $23.3 billion. Table 2 shows the amount of sales and sales tax involved in each of the states which imposes a sales tax.

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[1] US 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 does 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.

Table 2. Sales at Stake

	Sales Tax Due ($, millions)	Average Sales Tax Rate (%)	Total Untaxed Out-of-State Sales ($, billions)
Alabama	347.7	8.25	4.21
Alaska	3.0	1.40	0.22
Arizona	708.6	8.15	8.69
Arkansas	236.3	8.25	2.86
California	4159.7	8.20	50.73
Colorado	352.6	6.40	5.51
Connecticut	152.4	6.35	2.40
District of Columbia	72.5	6.00	1.21
Florida	1483.7	6.65	22.31
Georgia	837.6	6.95	12.05
Hawaii	122.5	4.35	2.82
Idaho	103.1	6.05	1.70
Illinois	1058.8	7.90	13.40
Indiana	398.8	7.00	5.70
Iowa	181.0	6.85	2.64
Kansas	279.2	6.00	4.65
Kentucky	224.5	8.75	2.57
Louisiana	808.3	5.00	16.17
Maine	65.4	6.00	1.09
Maryland	375.9	6.25	6.02
Massachusetts	268.0	6.00	4.47
Michigan	289.0	7.20	4.01
Minnesota	455.2	7.00	6.50
Mississippi	303.3	7.25	4.18
Missouri	430.2	6.00	7.17
Nebraska	118.1	7.85	1.50
Nevada	344.9	6.95	4.96
New Jersey	413.4	6.55	6.31
New Mexico	246.0	8.45	2.91
New York	1767.0	6.85	25.80
North Carolina	436.5	5.85	7.46
North Dakota	31.3	6.80	0.46
Ohio	628.6	8.20	7.67
Oklahoma	296.3	6.40	4.63

Pennsylvania	706.2	5.50	12.84
Rhode Island	70.4	7.00	1.01
South Carolina	254.3	7.15	3.56
South Dakota	60.8	5.50	1.11
Tennessee	748.5	9.45	7.92
Texas	1777.1	8.00	22.21
Utah	180.7	6.70	2.70
Vermont	44.8	6.05	0.74
Virginia	422.7	5.00	8.45
Washington	541.0	8.80	6.15
West Virginia	103.3	6.00	1.72
Wisconsin	289.0	5.45	5.30
Wyoming	61.7	5.40	1.14
Total	23260.0		329.84

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)

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 that come in from out-of-state. 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.

<u>Changing technology and changes in the efficient division between in person and remote sales</u>

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

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 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.

In the market for some products a very large share of transactions has already become "e-commerce." 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.

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 possibilities have intrinsic limitations that will never be overcome. 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 the natural province of 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 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 giving a new meaning to "24/7." At the time of the Internet boom in the late 1990's, 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 and having the time to sit down and place an order.

Other changes are blurring the line between physical presence and remote sale. 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.

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, imposed on all sales to final consumers. By 1950, 30 states had general sales taxes; by 1969, the number was 45, 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 36 cents or more.

States that adopted the sales tax also adopted another tax called the use tax. The combined sales and use tax allowed states to treat purchases equally, whether made from an in- or out-of-state seller. The sales tax applied to purchases of goods within the states. Naturally, states did not want to create incentives for their citizens to make out-of-state purchases to avoid the sales tax. The concept of a use tax addressed those incentives. While sellers would collect the sales tax, the use tax was collected by 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.

The size of subsidy depends on 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 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. One reason for the lower compliance is obvious: the seller is under no legal obligation to collect the tax, leaving the tax to the purchaser. Large and sophisticated organizations, again, 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. As sellers, firms specialize. They have reason to be familiar with the nuances of definitions of what is and what is not in the sales tax base. As buyers, they are more likely to be buying a more disparate bundle, buying 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. They buy cleaning supplies, replacement parts for their vehicle fleet, computers and software, paper for use in the computer printers.

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, which imposes a 7 percent sales tax, who purchases an appliance in Massachusetts, where the sales tax is 5 percent, is obligated to pay the two 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 desperate financial circumstances of the Great Depression by adopting a general sales tax, they recognized that a sales tax on purchases in 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 a practical failure. 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 a trying to create relationships with a vast number of businesses, many of which would have no or few sales to the state. It would not be cost-effective to pursue many of the out-of-state sellers.

Thus states adopted a different strategy to collect and remit the tax due on sales to their residents from out-of-state. 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 suggests that compliance is far from perfect.

The practical challenges of enforcing the use tax from individuals show that it falls afoul of Colbert's (17th century French tax minister, not 21st century television figure) maxim that the challenge of taxation is to collect the maximum number of feathers with a minimum of hiss. To comply with the use tax, a taxpayer faces the burden both of recordkeeping and applying a complex body of law.

Recordkeeping would require a separate shoe box for receipts from out-of-state purchases. Processing those receipts would begin by identifying whether the sales tax has already been collected. Some sellers already participate in the Streamlined Sales Tax process. 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 out-of-state a grocery not 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 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 that use tax liability was 4 percent of income if the taxpayer did not report some other amount, a practice which ended in 1999. [2]

<u>Why don't states fix the loophole?</u>

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 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 US Constitution implied for administering a sales tax. (See NOTE: "The Supreme Court and Limits to State Power to Tax" at end of report.)

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* (1967) and *Quill* (1992), both cases that involved catalog sellers.

The Supreme Court decisions have been the work of one branch of the federal

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[2] Nina Manzi, "Use Tax Collection on Income Tax Returns in Other States." Policy Brief, Research Department, Minnesota House of Representatives, June 2010.

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. 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, had stores in every state. The result is Lands End now collects the sales tax on behalf of all 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, Circuit City.com is liberated from the burden of collecting sales tax for states other than where it has a distribution center.

<u>Future directions in the technology that brings together buyers and sellers</u>

From the perspective of the 1990's, 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. There are many possibilities on the consumer side that technology has not yet reached but could.

Some possibilites:

- **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.

<u>Reducing the burden of compliance</u>

When 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 collect the sales tax of multiple states.

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. 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.

<u>Policy options</u>

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 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” time purchases of clothing are an example.

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 figment that there is a use tax. Taxpayers would be made more honest and state revenues only the tiniest bit smaller.

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.

NOTE:

The Supreme Court and State Power to Tax

The sales tax has presented many questions over the years about the implications of the Commerce Clause of the Constitution (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;")

In the years before states created general sales taxes, the Supreme Court saw the Commerce Clause imposing sharp restrictions on state taxes, holding in 1888 that "no State has the right to lay a tax on interstate commerce in any form." (*Leloup v. Port of Mobile* 127 US 640, 648).

This was the legal context against which states adopted general sales taxes beginning in the 1930's. They imposed a sales tax on intrastate commerce, with the in-state seller responsible for collecting the tax and a use tax on those who were within the state, bought from interstate commerce and used the good or service within the state.
An early question was the status of the two big retailers who both operated stores and sold by catalog, Sears Roebuck and Montgomery Ward. In a pair of cases decided in 1941, the Supreme Court held that a seller than maintained local retail stores meant the seller would have to collect sales tax on catalog sales in the state. (*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 changes in selling patterns in a 1967 case, *National Bellas Hess v. Illinois*, 386 U.S. 753. National Bellas Hess was a mail order house in Kansas City, MO that specialized in clothing. Unlike Sears, Roebuck and Co. and Montgomery Ward, it did not have stores in the state which wanted it to collect the sales tax. The US Supreme Court looked at National's relationship to Illinois, and noted that it did not have an office or place of business there, no telephone listing in Illinois, nor did it advertise in Illinois newspapers or on Illinois radio or television stations.

National's connection with state was through mailed catalogs and flyers. That, the Supreme Court decided, was not enough to disturb its interpretation that anyone who had a store in a state could be required to collect sales tax on catalog sales but for sellers who did not have instate stores, requiring them to collect the sales tax violates the Commerce Clause.

Given the opportunity to revisit its view of what runs afoul of the Commerce Clause, the Court, in its 1992 *Quill* decision, declined.

Since then the whole field of Internet selling has arisen. The jurisprudence that applies remains that of the 1992 case: the Commerce Clause should be interpreted to allow only sellers who have physical presence to be required to collect state sales tax. However, in that 1992 decision, the Court said it was speaking only because Congress had not. As Justice Stevens wrote for the Court: “This aspect of our decision is made easier by the fact 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. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions.”