INTRODUCTION

Several years ago I published a paper on the nuttiness of state and local taxes (McLure, 2002). These are among the many nutty characteristics of state sales and use taxes:

- Many services are exempt;
- Internet access is exempt;\(^1\)
- Many business purchases are taxed;
- The sales tax system is incredibly complex, in large part because of interstate differences in tax bases, product definitions, and administrative practices, but also because of the existence of local taxes; and
- A state cannot require a vendor to collect its use tax unless the vendor has a physical presence in the state.

Nuttiness also permeates the state corporate income tax:

- Not all states provide for combination of unitary businesses;
- States that do provide for combination do not necessarily define a unitary business the same way;
- Even when states use the same apportionment factors to divide the business income of multistate corporations, they do not all assign the same weights to the various factors;
- The current trend is to place a disproportionate weight on the sales factor in an effort to attract economic activity;
- States do not use identical definitions of the apportionment factors, especially sales; and
- The existence of substantial sales in a state does not imply taxable nexus, even if the state employs only sales to apportion income.

\(^1\) I do not actually discuss this nutty feature in McLure (2002), but do so in many other places, including Hellerstein and McLure (2004), which provides further references.
Finally, it is absolutely nutty that states should be allowed to employ targeted tax incentives in a beggar-thy-neighbor effort to attract economic activity.

Much of this nuttiness, the part related to lack of uniformity and consistency across states, the legal inability to implement policies that would make good sense, and the part that involves state beggar-thy-neighbor tax policies, such as sales-only apportionment and the failure to require combination of unitary businesses, is rooted in our system of government. As my title says, the individual states have both too much sovereignty over tax policy and not enough. I will use the lack of coordination of corporate income taxes and of sales and use taxes to illustrate the problem. For this purpose I will use the term “coordination” to refer to uniformity of tax bases and administrative procedures and cooperation in administration, but not to harmonization of tax rates, which should be under state control and not necessarily uniform.

THE EXERCISE OF STATE TAXING SOVEREIGNTY

The US Constitution provides the legal framework for the exercise of sovereignty by the states. We are accustomed to saying that the states are sovereign. But the Tenth Amendment to the Constitution does not only assure substantial state sovereignty; it says explicitly that state sovereignty may be limited by other provisions of the Constitution, and it says implicitly that the Congress can limit state sovereignty through the exercise of its considerable constitutional powers. The amendment says, “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people (emphasis added).” For the present purpose the most important limitations on state sovereignty are those inherent in the Due Process Clause, those implied by the so-called Dormant Commerce Clause, and those imposed by the Congress, pursuant to its exercise of the powers granted to it by the Commerce Clause. States cannot legally do anything that violates due process, that interferes with interstate commerce, or that is prohibited by federal legislation. Otherwise they can do pretty much what they want in the tax area. The judiciary, especially the US Supreme Court, determines whether state actions violate the Constitution or federal law.

We are all familiar with how this has played out in practice:

- The independent exercise of sovereignty by individual states has resulted in the lack of uniformity and the complexity described earlier.

- The U.S. Supreme Court has responded to the complexity of the sales and use taxes with the physical presence test of nexus, first in National Bellas Hess (386 US 753, 1967) and then in Quill (504 US 298, 1992).

Pursuant to its Commerce Clause powers, the Congress has also imposed federally mandated nuttiness, that is, nutty limitations on the exercise of state taxing authority:

- In the income tax field, P.L. 86–272 prohibits state assertion of nexus for income tax purposes if all the potential taxpayer does in the state

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2 State taxing authority is also limited by the Equal Protection Clause of the Constitution, which I do not consider in the present discussion. Congress also has the power, which it has sometimes exercised (for example, in forbidding states from taxing income from certain federal obligations), to preempt state taxing authority with respect to the federal government and its instrumentalities.

3 The independent exercise of sovereignty has also produced the undesirable treatment of services and sales to business described earlier.
is solicit for orders for tangible property to be shipped from outside the state; and

- The Internet Tax Freedom Act (ITFA) prohibits state taxation of Internet access, very broadly defined.4

These limitations on state taxing powers produce results that can only be characterized as nutty—the physical presence test of National Bellas Hess/Quill because it places local merchants at a competitive disadvantage, relative to remote vendors;5 P.L. 86–272 because it does not mesh with the inclusion of sales in apportionment formulas and thus facilitates the generation of “nowhere income;” and the ITFA because it discriminates in favor of Internet access, including Internet telephony. And, of course, all three deprive states of badly needed revenues.

SOURCES OF NUTTINESS IN STATE TAX POLICY

It is useful to distinguish two type of nuttiness in state tax policy, aside from the federally mandated nuttiness described earlier.

Unilateral nuttiness. First are nutty policies that affect purely intrastate businesses, as well as interstate businesses. These include indefensible refinements in tax bases, such as excessive distinctions in the tax treatment of a particular kind of product (e.g., peanuts or orange juice), and needlessly onerous administrative rules, as well as the irrational treatment of services and sales to business. Bad as these problems are, I do not discuss them further, because they are primarily intrastate problems that are well within the power of individual states to fix, if they have the will.

Failures of coordination. The second type of nuttiness affects primarily multistate firms and businesses engaged in interstate commerce—or would affect them, in the absence of safe–harbors such as Quill. By their very nature these issues defy resolution by individual states acting unilaterally; they represent failures of coordination. Many of these nutty features involve complexity caused by differences in state tax policies (e.g., the tax base) and administrative requirements; the complexity of the state sales and use tax “system” is the poster child for this type of problem, which we might call “failures of uniformity.”

State taxes can also be inconsistent from an economic point of view, even if differences in state policies pose no particular compliance problems and the policies of individual states pass constitutional muster if considered alone.6 Perhaps the best example of such “failures of consistency” is the fact that states may use different apportionment formulas and employ different definitions of a unitary business if

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4 These are not the only federal statutes that limit state taxing powers; they are the ones that are relevant for these remarks. The ITFA also prohibits “multiple and discriminatory taxes” on electronic commerce. Since few (and perhaps no) such taxes existed or were seriously being contemplated when the legislation was enacted, I do not consider this aspect of the ITFA.

5 This is not to say that National Bellas Hess and Quill were wrongly decided. Complexity does place an unreasonable burden on interstate commerce. Moreover, had the Supreme Court found in favor of the states in those cases—and had the states not been frightened by the specter of revenue disappearing into cyberspace, particularly after initial passage of the ITFA—there is little reason to believe that the states would have ever taken action to simplify their sales and use taxes. There is no comparable justification for the overly broad strictures of P.L. 86–272 or the federally mandated sales tax exemption of Internet access.

6 Thus an apportionment formula that considers only sales would be internally consistent, as it would not produce multiple taxation if it were utilized by all states. It may also be deemed to be externally consistent, in that it does not result in a tax that “reaches beyond that portion of value that is fairly attributable to activity within the taxing state” (Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 US 175, at 185, 1995). Of course, such a formula would be economically inconsistent with formulas used by other states that assigned less than 100 percent of the weight to sales.
they require unitary combination. Since the U.S. Supreme Court has refused to sanction any one formula or definition of a unitary business, both under- and over-taxation can occur, and states can place excessive weight on sales as part of an economic development strategy.

The two types of failure of coordination can occur together or independently. Thus it may not be difficult to comply with provisions that are economically inconsistent, because they require apportionment based on sales only in one state and on three equally weighted factors in another. Similarly, two states may adopt tax policies that appear to be mutually consistent, but implement them in such different ways as to cause overwhelming complexity for multistate businesses.

THE LACK OF SATISFACTORY COORDINATING MECHANISMS

The U.S. Constitution does not provide satisfactory mechanisms to avoid or overcome failures of coordination. All extant mechanisms are either badly flawed or politically difficult to implement.

Judicial decision-making. First, the US Supreme Court has consistently—and justifiably—refused to assume a positive legislative role in the interest of uniformity and consistency. That is, the Court has said what states cannot do (e.g., require a remote vendor that lacks an in-state physical presence to collect use tax), but has refused to say what states must do (e.g., adopt the then-standard equally-weighted three-factor apportionment formula). It has said that if there is a problem that the states have not fixed or cannot fix, it is up to the Congress to fix it.

Congressional decision-making. Until recently the Congress has also generally not presumed to legislate state tax policy. The Internet Tax Freedom Act, which (like P.L. 86–272) deprives states of revenue with little sound economic justification, makes one wish that federal inaction had continued.

7 In Moorman (437 US 267, 1978) the Supreme Court refused to invalidate sales-only apportionment and thus sanction the equally weighted three-factor formula, which is no longer the most commonly used formula. Similarly, it sanctioned diverse state definitions of a unitary business when it said in Container (463 US 159, 1983, at p. 167) that “the definition of a unitary business is, so to speak, not unitary.”

8 Justice Frankfurter observed nearly 50 years ago:

At best, this Court can only act negatively; it can determine whether a specific state tax is imposed in violation of the Commerce Clause. Such decisions must necessarily depend on the application of rough and ready legal concepts. We cannot make a detailed inquiry into the incidence of diverse economic burdens in order to determine the extent to which such burdens conflict with the necessities of national economic life. Neither can we devise appropriate standards for dividing up national revenue on the basis of more or less abstract principles of constitutional law, which cannot be responsive to the subtleties of the interrelated economies of Nation and State. The problem calls for solution by devising a congressional policy. Congress alone can provide for a full and thorough canvassing of the multidimensional and intricate factors which compose the problem of the taxing freedom of the States and the needed limits on such state taxing power.


9 For more on my views of the ITFA, see, for example, McLure (2000) and Hellerstein and McLure (2004). Consideration of the Willis Committee’s proposals (U.S. House of Representatives, 1965) might also lead some to applaud Congressional inaction. While some of the Willis Committee’s proposals may have been problematic, adoption of its recommendations for corporate income taxes would probably have been a positive step. The Committee proposed, inter alia:

• Formula apportionment of all income (that is, elimination of the distinction between apportioned business income and specifically allocated non-business income);

• An apportionment formula that accorded equal weight to payroll and property (and thus disregarded sales);
There are a number of reasons that federal legislation of state tax policies is generally likely to be a bad idea. First, the members of Congress are unlikely to have the incentives, the interest, the expertise, or the time to make good state tax policy. The lack of incentives deserves particular attention. In a sensibly structured democratic society, responsibility for raising public funds and for spending them is commonly—and wisely—lodged in the same body, at least at the margin. Decision-makers in such a system must weigh the political benefits of cutting taxes against the political costs of cutting public services or raising other taxes. When the Congress usurps the power to make state tax policy, this link between taxes and benefits is severed. Its members reap the political benefits of cutting taxes (perhaps bestowed by lobbyists, whose contributions can help win reelection), while state legislators and governors are left with the politically unpopular task of cutting services or raising revenues from other sources. It is hardly surprising that this asymmetrical constellation of costs and benefits can lead to undesirable restrictions on the taxing powers of the states, as in the case of the ITFA.

Even if there were no incentives for the Congress to act counter to the interests of state and local governments, there is also little incentive for it to act in a manner that protects or furthers those interests. Moreover, the limitations of interest, expertise, and time are serious. Merely legislating federal policy in other areas, including federal tax policy, is a gargantuan task that requires access to, and sophisticated appraisal of, large and complex bodies of knowledge. Many do not think Congress performs that task very well. There is even less reason to expect it to legislate wisely for state and local governments.

A nexus standard that would permit taxation by any state to which the apportionment formula assigned income.

While market states might reasonably complain about the loss of tax base (which the Willis Report said would be relatively small for most states), this system has notable advantages. It would eliminate the most troublesome apportionment factor and with it many arguments over what constitutes nexus, as well as the possibility of “sales only” apportionment and “nowhere income.”

This asymmetry can be traced in part to the Seventeenth Amendment to the U.S. Constitution, which provides direct election of senators. The Constitution (in Article 1, Section 3) originally provided that the legislature of each state would elect the state’s two senators. Senators that are directly elected can be expected to represent state interests generally, along with the national interest, and to reflect the views of their party on partisan issues, but they may not represent the interests of their state as a political jurisdiction. That is, responding to lobbyists for special interests, a senator may vote for policies that undermine the fiscal well-being of their home state, as in passage of the ITFA. It seems reasonable to believe that senators would have been less likely to vote for measures that unreasonably restrict the taxing powers of the states, if doing so would make life more difficult for the legislators that elect them, as under the original constitutional arrangement. Whether or not this assessment is accurate, it seems unlikely that we will soon see a return to indirect election of senators.

The federal Unfunded Mandates Act was intended to protect states from burdens imposed on them by federal legislation without providing for funding of such burdens, but it has not prevented Congress from adopting legislation restricting state taxing powers.

It must be admitted that state and local governments are not entirely blameless in this episode. It is hard to know whether the ITFA would have gained traction had some state and local governments, seeing a bonanza in taxing Internet transactions, not adopted misguided tax policies and threatened to adopt others.

The situation is quite different in the European Union, where decisions on direct taxation require the unanimous vote of all member states. The unanimity rule protects the sovereignty of individual member states, by giving each veto power in EU tax matters. This is both good and bad. It makes it difficult for the EU to enact desirable tax legislation, as well as helping prevent undesirable legislation.

Although state income taxes generally conform to the federal income tax, the states, especially those faced with limitations on borrowing, are often reluctant to adopt provisions that would lose large amounts of revenue and thus “decouple” from federal law. Since not all choose to decouple in the same way, frequent changes in the federal income tax have also given rise to lack of uniformity of state laws and is thus a further source of complexity.
P.L. 86–272 illustrates this problem. This statute was originally intended to be a stop–gap response to the Supreme Court’s 1959 decision in Northwestern States Portland Cement (358 US 450), which allowed states to tax the apportioned income of nondomiciliary corporations engaged exclusively in interstate commerce. The Willis Report (U.S. House of Representatives, 1965, p. 8), says, “[B]oth Houses viewed this provision as a temporary measure designed to hold the line pending the completion of the thorough study which was considered necessary to achieve a permanent solution.” A comprehensive study was completed, but there was no further legislative action.

One can cite many possible reasons for Congressional inaction: Other concerns crowded out Congressional reconsideration of the nexus standard of P.L. 86–272, it was relatively easy for business lobbyists to hold the political high ground established by that legislation, and the states had difficulty agreeing on the contours of alternative legislation. Whatever the reason, we are stuck with a nexus standard that can readily be combined with sales only apportionment to produce nowhere income, especially in the absence of unitary combination.14

Finally, the states have rarely come to the Congress with a plan to deal effectively with failures of coordination, just because it is the right thing to do. By this I mean that they have (almost) never asked Congress to approve a plan to rationalize either sales and use taxes or corporate income taxes. Rather, my impression is that they would like to see Congress simply overthrow the nexus standards of National Bellas Hess/Quill and P.L 86–272, without such rationalization—clearly not a good idea on policy grounds in the first case, as well as politically unrealistic in both. When they have come to Congress it has commonly been in response to a judicial decision, as in National Bellas Hess, or the threat of pre–emptive federal legislation such as P.L. 86–272 or the ITFA, but again without proposing to undertake fundamental reform that would rationalize the system.15 In short, when confronting the threat of federal legislation, the states often have spoken with one voice only to the extent of saying, “Leave us alone.” They have wished to exercise sovereignty without interference, even though they have not exercised sovereignty responsibly in the past.

State decision–making. This, then, leads to the question of whether it is reasonable to expect the states to act cooperatively to overcome failures of coordination. If the states are to reduce significantly the lack of uniformity and consistency and thus the resulting complexity and undesirable economic effects that are at issue, they must be willing to surrender some of the sovereignty that has produced the problem in the first place. That is, individual states must be willing to sacrifice sovereignty in order to increase the collective sovereignty of all states. They must, at the very least, be willing to cooperate with other states to rationalize the state tax system. Moreover, given the restrictions on state policies inherent in Quill and P.L. 86–272, it may be necessary for the states to ask Congress to approve some of their

14 See also McLure (2002) and Hellerstein and McLure (2004), which address the possibility that the assertion of nexus may be further restricted.

15 Regarding precursors to the Streamlined Sales Tax Project (SSTP), Swain and Hellerstein (2005) note, “[T]hese earlier efforts were limited largely to the elimination of the physical presence nexus test without pursuit of a concomitant reduction in compliance burden.” When I was Deputy Assistant Secretary of the US Treasury Department during the “unitary wars” of the 1980s, several states, via staff–level representatives on the Worldwide Unitary Taxation Working Group, offered to give up worldwide combination in exchange for the administration’s support for legislation that would over–ride Quill. I do not recall that they offered to address the complexity that had motivated the Supreme Court’s decision in that case.
cooperative arrangements, in order to loosen those restrictions. Indeed, it may even be desirable for the states to ask the Congress to limit their individual sovereignty, in order to increase their collective sovereignty—that is, to require them to participate in the cooperative endeavors needed to rationalize the system.

History does not provide much reason for optimism on this score. The Uniform Division of Income for Tax Purposes Act (UDITPA) has existed for almost 50 years, but not all states with income taxes have adopted it, some states that have adopted UDITPA deviate from it in significant ways or interpret its provisions differently, and UDITPA does not even address many key issues, in particular, nexus standards, the need for combined reporting, or the definition of a unitary business. Similarly, not all states have adopted the Multistate Tax Compact, and the Multistate Tax Commission (MTC), the body created to administer the Compact, only has the power to issue non-binding regulations. A key question is how to gain more widespread adoption of a uniform and perhaps updated version of UDITPA and greater state participation in the activities of the MTC. Beyond that is the question of whether and how to make adoption of UDITPA and participation in the MTC mandatory. I hope that the discussion at the 2004 National Tax Association Symposium, stimulated by the paper by Hildreth, Murray and Sjoquist (2005) will address these questions.

If the Streamlined Sales and Use Tax Agreement (SSUTA) is widely adopted and is implemented in a common form, it will greatly simplify compliance. It deserves to be enacted. But, even if enacted, SSUTA will leave compliance substantially more complicated than is necessary or sensible. The Uniform Sales and Use Tax Administration Act requires 15 pages and the SSUTA another 70 plus pages. Moreover, Walter Hellerstein and John Swain (2004) have devoted more than 130 pages to explaining SSUTA. Something that requires this much explication may be “simplified,” but it is not simple.17

My impression is that the SSUTA attempts to provide only enough simplification to get the Congress (or perhaps the Supreme Court) to override Quill.18

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16 For descriptions of UDITPA and the Multistate Tax Compact, see Hellerstein and Hellerstein (1998), Vol. I, Appendices A and B.

17 By comparison, a sensible sales tax would have only four fundamental principles. These are:

1. Tax all sales to consumers;
2. Exempt all sales to business;
3. Treat sales by remote vendors and local merchants the same;
4. Simplify the system enough that implementing the third rule does not unreasonably burden interstate commerce. This would require, inter alia, identical statutory language, regulations, and forms in all states, one-stop registration for all states, and uniform administrative procedures (audit, appeals, etc.).

I suspect that a statute that codified these rules and an interstate agreement that implemented them would take only a few pages, and that not much explanation would be required. For further discussion, see McLure (2000). The existence of local use taxes complicates matters. Clearly, state and local tax bases should be identical and states should collect local taxes, as (for the most part) provided by SSUTA. A question that threatens to stymie the SSTP is whether local taxes on sales made across jurisdictional borders within states should be based on the conceptually preferable destination principle or the more easily administrable origin principle, which is currently more common. This reconfirms the view that sales taxes are not well-suited for use by local governments.

18 Some might contend that the Agreement would need to be approved by Congress. This does not seem to be correct. Note first that SSUTA makes collection of use tax voluntary. The Compact Clause of the U.S. Constitution, which says (in Article I, Section 10, Clause 3), “No State shall, without the Consent of Congress, . . . enter into any Agreement or Compact with another State . . .” might at first glance seem to be a greater impediment. But the U.S. Supreme Court has determined that the Compact Clause “is directed to the formation of any combination tending to the increase of political power in the States, which may encroach upon or interfere
It deals primarily with arcane, albeit important, essentially non-policy questions of definition and tax administration and not with the big policy issues of what the tax base should be; moreover, it side-steps almost entirely the treatment of sales to business. It relies on the “carrot” approach to gain participation by both states and multi-state vendors—holding out the hope that states will want to participate in SSUTA in order to gain revenues from use taxes collected voluntarily by remote vendors who currently have no collection obligation. Of course, without bringing greater uniformity to the tax base, including a uniform exemption for business purchases, there is a limit to the simplification that can be achieved.

SSUTA is much longer and more detailed than UDITPA, in part because it provides details that would not be required in a more logical sales tax (see note 17). It also provides an institutional structure that is substantially different from that of UDITPA and the Multistate Tax Compact. UDITPA is merely a “uniform act” or model law, and the MTC has no “teeth.” By comparison, it appears that the Governing Board established by SSUTA might actually exercise some semi-legislative power over participating states. I hope that the discussion will address such issues as how to get the states to go beyond adoption of SSUTA and engage in radical simplification (perhaps along the lines of note 17), whether the participating states are likely to cede power to the Governing Board, and whether it would be desirable for Congress to make simplification mandatory—granted a contentious issue that is not very likely to be endorsed in the current political environment.

It is reasonable to ask whether the International Fuel Tax Agreement (IFTA) provides any guidance in the effort to rationalize corporate income taxes and sales and use taxes. Unfortunately, I doubt that it does.19 The IFTA was adopted in an environment that included these favorable characteristics:

1. A relatively simple tax levied on a per unit (gallon) basis on a few types of motor fuels and collected at the wholesale level;
2. An obvious if imprecise link between taxes and the benefits of highway use, as measured by miles driven in a state;
3. An increasingly sophisticated system for tracking the whereabouts of trucks;
4. An undisputed obligation to pay motor fuel taxes;
5. A desire by truckers to rationalize the assessment and collection of motor fuel taxes.20

The trucking industry was able to gain Congressional approval of legislation mandating greater uniformity and simpler compliance. Neither corporate income taxes nor sales and use taxes exhibit all the characteristics that made a political solution possible in this case. Both are highly complex, the link between benefits and taxes is much less clear, collecting use taxes would be complicated and burdensome, and in some cases there is currently no obligation to pay (or collect) taxes. (For a more complete description of IFTA and a comparison of it and the SSTP, see Denison and Facer, 2005).


19 Swain and Hellerstein (2005) cite the Mobile Telecommunications Sourcing Act as example of federal legislation supported by both industry and the states. The problems it was designed to solve also have little in common with the task facing the SSTP.

20 This description is oversimplified. Truckers wanted to eliminate ton–mile taxes and states were losing court cases on the legality of some types of taxes, especially flat fees.
While many in business have supported the SSTP, many will fight steps to rationalize either state sales taxes or state income taxes that increase taxes or the obligation to collect them.

CONCLUDING REMARKS

In closing I would like to leave you with several questions to be considered within the context of our constitutional arrangements:

- How can the states be encouraged to cooperate and thus avoid failures of coordination, not only by reducing lack of uniformity that causes needless complexity but also by avoiding mutually inconsistent policies that cause undesirable economic results? In particular:
  - How can the states be induced to adopt UDITPA, perhaps in an expanded form that considers unitary combination, and participate in the MTC?
  - How can the states be induced to go beyond SSUTA to adopt even simpler and mutually consistent sales taxes and to eliminate features that have undesirable economic effects?
  - How can the Congress be encouraged to sanction sensible state policies such as UDITPA and the SSUTA and—at least as important—how can it be dissuaded from adopting policies that are inimical to the fiscal health of state and local governments, as well as constituting bad economic policy for the nation, such as the ITFA?

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