ISSUE BRIEF

No. 4855 | MAY 29, 2018

When It Comes to Taxation, Borders Matter—Europe and the U.S. Should Act Accordingly

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The European Commission (EC) and certain U.S. states are renewing their efforts to expand taxing authority beyond their borders. These efforts will provoke a battle over the proper reach of government tax systems, with wide-ranging consequences for the power and scope of governments at all levels.

In Europe, the EC is seriously considering a "digital-transactions tax" to increase revenue from large multinational technology companies based on the location of their customers.[1] In the U.S., South Dakota—along with 30 other states—is expanding the obligation to report and collect local sales taxes from businesses not physically within the state. The EC and South Dakota claim that the rise of the Internet has fundamentally changed the way taxes should be assessed. In the past, a corporate tax or sales tax could be levied and collected on a business based on their physical location. Their argument, in essence, is that the Internet has rendered physical location an antiquated and economically inefficient standard.

Policymakers in Washington see a European digital-transaction tax and an expansion of domestic sales taxes across state lines as separate issues. However, the two policies have the same principle at their core. Destination-based tax proposals limit tax competition and expand the extraterritorial reach of distant politicians into local affairs. When a government is no longer constrained by its borders, individual liberties are put in jeopardy.

Background on Extraterritorial Taxation

As international trade grew through the 1950s and 1960s, multiple countries claimed taxing rights to the same corporate profits. Countries around the world regularly extended their tax systems beyond their borders to tax profits originating in other countries. Multiple taxing claims resulted in pervasive double taxation of corporate profits, an unfortunate barrier to global trade.

The minimization of international corporate double taxation took concerted efforts and a series of international tax treaties to institutionalize a system that rests on the physical presence of the business.[2] Opposition to extraterritorial taxation has not been universal—with the U.S. itself often enacting extraterritorial policies. Through 2017, the U.S. maintained a worldwide corporate tax system and recently included broad international minimum taxes in the new quasi-territorial regime. However, most developed countries moved to territorial tax systems, and those who still maintained worldwide taxes allowed certain tax liabilities to be deferred and provided credits for taxes paid elsewhere.

Why Europe Should Preserve International Constraints on Taxation

The current international tax system is imperfect. It allows for tax planning and does not tax 100 percent of corporate profits, but, for the most part, these are features, not flaws. The existence of tax havens and a generally porous international tax sys-

This paper, in its entirety, can be found at
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tem has fostered international pressures that keep business taxes relatively low—a boon for economic growth and investment.[3]

Tax competition has facilitated economic growth and international trade with benefits for consumers around the world and with no harm to the ability of nations to generate revenue. Tax competition has forced corporate tax rates among Organization for Economic Co-operation and Development (OECD) countries to fall from above 45 percent to below 25 percent over the past three decades.[4] Lower business tax rates benefit workers through higher wages and help the broader economy through increased investment.[5] The pressures of tax competition have resulted in more tax revenue. Corporate tax revenue as a percentage gross domestic product has increased across the same countries over the same period.[6]

The European Commission Proposal Breaks with the Consensus

The EC's digital tax proposal is the most recent of numerous projects to break with international consensus on limiting the harms of extraterritorial taxation.[7] The EC proposes a new 3 percent tax on revenues from online advertising, sale of user data, and facilitated user interactions.[8] Revenue-based taxes are economically problematic in their own right because firms could have no net income in the taxing jurisdiction and still be subject to tax. Levying a revenue tax on a destination basis only further compounds the economic inefficiencies of the new tax proposal.

Background on Extraterritorial Taxation in the U.S.

Forty U.S. states are similarly working to overturn limits to their taxing authority. The increasing popularity of catalogue sales in the 1980s presented a challenge for states who wanted to levy sales tax on goods shipped into their state by businesses without a physical presence in the consumer's state. A series of Supreme Court rulings, most recently *Quill v. North Dakota* in 1992, prohibit states from compelling out-of-state businesses from collecting and remitting distant sales taxes—a burdensome administrative procedure.[9] Under current precedent, Congress must explicitly authorize extraterritorial state taxes as they are impediments to interstate commerce.[10]

The rise of Internet retail has renewed efforts to expand state taxing powers. States are challenging the ruling in *Quill*; several congressional proposals are aimed at expanding state governments' taxing powers beyond their borders.[11] Much like the European efforts to tax digital revenues based on the destination of users, states are attempting to require businesses to collect sales taxes based on customer

1. European Commission, "Fair Taxation of the Digital Economy," https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en (accessed April 3, 2018).
2. Organization for Economic Co-operation and Development (2012), *Model Tax Convention on Income and on Capital 2010* (Paris: OECD Publishing, 2012), http://dx.doi.org/10.1787/9789264175181-en (accessed May 11, 2018).
3. Chris Edwards and Daniel J. Mitchell, *Global Tax Revolution: The Rise of Tax Competition and the Battle to Defend It* (Washington, DC: Cato Institute, 2008), p. 188.
4. Organization for Economic Co-operation and Development, "Corporate Income Tax: Corporate Income Tax Rates," OECD Tax Statistics Database, 2018, http://dx.doi.org/10.1787/7cde787f-en (accessed May 16, 2018).
5. Adam N. Michel, "The High Price That American Workers Pay for Corporate Taxes," Heritage Foundation *Backgrounder* No. 3243, September 11, 2017, https://www.heritage.org/taxes/report/the-high-price-american-workers-pay-corporate-taxes.
6. Jason J. Fichtner and Adam N. Michel, "The OECD's Conquest of the United States: Understanding the Costs and Consequences of the BEPS Project and Tax Harmonization," Mercatus Center Research, March 2016, https://www.mercatus.org/publication/oecd-beps-project-tax-harmonization-consequences (accessed April 11, 2018).
7. For a review of the OECD's campaign to harmonize international taxes, see Andrew P. Morriss and Lotta Moberg, "Cartelizing Taxes: Understanding the OECD's Campaign against Harmful Tax Competition," *Columbia Journal of Tax Law*, Vol. 4, No. 1 (2012), https://taxlawjournal.columbia.edu/article/cartelizing-taxes-understanding-the-oecds-campaign-against-harmful-tax-competition/ (accessed May 11, 2018).
8. European Commission, "Fair Taxation of the Digital Economy."
9. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
10. Adam N. Michel and Elizabeth Slattery, "Do Borders Matter? The Supreme Court Reviews Internet Sales Taxes," Heritage Foundation *Legal Memorandum* No. 231, April 12, 2018, https://www.heritage.org/courts/report/do-borders-matter-the-supreme-court-reviews-internet-sales-taxes.
11. See *South Dakota v. Wayfair, Inc.* argument on April 17, 2018, and H.R. 2193, Remote Transactions Parity Act of 2017.

location—even when the business has no physical presence in the state.[12]

Why the U.S. Should Preserve Limits on Interstate Taxation

Constraining the reaches of governments tend to result in lower taxes and greater economic freedoms. The incentives of individual governments will tend to push for greater authority to tax the desired tax base completely, but allowing such power undermines important pressures that keep taxes from rising.

The current restrictions on states may be keeping state sales taxes relatively low, similar to the pressures of international tax competition. The European Union (EU) levies a similar consumption tax, called a Value Added Tax (VAT), determined on a destination base, and all member countries are compelled to have a similar tax scheme with prescribed minimum taxes. The EU tax cartel and enforceable destination-based tax rules remove certain competitive pressures to keep the tax rate low. The *lowest* standard VAT rate in the EU is 17 percent.[13] The *highest* U.S. combined state and local sales tax rate is 10 percent.[14] Lower sales tax rates decrease the tax cost of the goods and services purchased by Americans.

Freedom First, Not Economic Efficiency

The pursuit of economic efficiency is often used to further the case for expanding the reach of tax collectors beyond their borders. In the textbook world of perfect tax policy, taxes are equally applied to a broad consumption base.[15] When taxes are applied unevenly, they create inefficiencies by favoring the untaxed and penalizing the taxed. The proposed digital transaction tax and expanded state sales taxes both seek to connect taxes collected by businesses to the destination of the consumer rather than the locations of the business. In principle, destination sourcing is intended to better capture all transactions and better approximate an evenly applied tax.[16] However, most VAT and state sales taxes are far from textbook consumption taxes.[17] By one measure, state sales taxes only cover about 23 percent of the optimal consumption tax base because most services and many physical goods are exempt.[18] State lawmakers would be better served by first expanding the tax base within their jurisdiction rather than exporting their tax collection duties to out-of-state third parties.

Under the current physical presence-based sales tax regime, about 20 percent of remote sales go untaxed, a loss of less than 1 percent of state tax revenue.[19] This de facto exemption introduces an economic inefficiency with an economic cost. However, these costs must be weighed against the alternative of potentially expanding the base of state sales taxes by 20 percent (without an offsetting rate reduction) and limiting future competitive pressures to keep tax rates from rising. The economic losses from high tax rates are significant and can increase exponen-

12. Every state with a sales tax currently has a "use tax" which the consumer is obligated to pay on goods purchased out of state. In almost every state, use taxes are largely unenforceable and go unpaid.
13. European Commission, "VAT Rates Applied in the Member States of the European Union, Situation at 1st January 2018," https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_en.pdf (accessed April 3, 2018).
14. Jared Walczak and Scott Drenkard, "State and Local Sales Tax Rates 2018," Tax Foundation *Fiscal Fact* No. 572, February 13, 2018, https://taxfoundation.org/state-and-local-sales-tax-rates-2018/ (accessed May 18, 2018).
15. Taxes on consumption can take various different forms, but, in the abstract, they all get to the same answer. See David R. Burton, "Four Conservative Tax Plans with Equivalent Economic Results," Heritage Foundation *Backgrounder* No. 2978, December 15, 2014, https://www.heritage.org/taxes/report/four-conservative-tax-plans-equivalent-economic-results, and Alan J. Auerbach, "The Choice Between Income and Consumption Taxes: A Primer," National Bureau of Economic Research, No. W12307, 2006, http://www.nber.org/papers/w12307 (accessed April 3, 2018).
16. In the case of the digital-transactions tax the ideal tax base is unclear.
17. Tax Policy Center, *Briefing Book*, "What Would Be Taxed Under a VAT?" http://www.taxpolicycenter.org/briefing-book/what-would-be-taxed-under-vat (accessed April 3, 2018).
18. Nicole Kaeding, "Sales Tax Base Broadening: Right-Sizing a State Sales Tax," Tax Foundation *Fiscal Fact* No. 563, October 24, 2017, https://taxfoundation.org/sales-tax-base-broadening/ (accessed April 3, 2018).
19. U.S. Government Accountability Office, "States Could Gain Revenue from Expanded Authority, but Businesses Are Likely to Experience Compliance Costs," GAO-18-114, November 2017, https://www.gao.gov/assets/690/688437.pdf (accessed April 2, 2018).

tially with the rate.[20] When the state enlists businesses as their tax collectors, the tax collection is best connected to the business location. Divorcing the location of the business from tax collection creates unnecessary administrative burdens, especially for small retailers.

The precise nature of the economic efficiency trade-off between more complete taxation versus higher tax rates and increased revenue is debatable. However, this trade-off should not come at the expense of political protections. Expanded tax powers extend the reach of every state capital and European parliament beyond their natural political borders. The freedom of a small e-retailer in sales-tax-free Oregon from California sales tax collection requirements cannot be directly weighed against the potential economic efficiency of a 50-state sales tax cartel, enforced by the federal government. Limits on state power must be a bedrock principle, even in the face of claims for economic efficiency. Although economists can provide convenient cover for expanding taxes, the political motivations are driven by government's desire for additional revenue.

Conclusion

When governments are constrained by their borders, individual liberties are best able to flourish.[21] Government taxing authority is the most straightforward case for limited state powers, even at the cost of some revenue loss and possible small economic inefficiencies. Indeed, the economic inefficiencies created by gaps in tax codes are the engine that drives tax competition, keeps political pressures from raising taxes, and keeps the goods and services we buy from including larger tax costs.

The international campaign to roll back the natural limits to government taxing authority is gaining steam in the U.S. and across Europe. Secretary of the Treasury Steven Mnuchin has stated that the "U.S. firmly opposes proposals by any country to single out digital companies."[22] The Administration and Congress should uniformly apply their skepticism to similar state efforts to tax interstate transactions—a policy that the White House supports.[23]

The limits on state tax systems and the international tax norms that prevail will have ramifications beyond what the revenue governments can collect. A more broadly applied U.S. sales tax or a European digital-transactions tax will irreversibly expand the scope and power of governments at all levels.

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20. John Creedy, "The Excess Burden of Taxation and Why it (Approximately) Quadruples When the Tax Rate Doubles," New Zealand Treasury *Working Paper* No. 03/29, December 2003, https://treasury.govt.nz/sites/default/files/2007-10/twp03-29.pdf (accessed May 11, 2018).
21. Dan Mitchell, "The Fight Over 'Internet Taxation' Is Really a Proxy for an Important Battle on Whether Government Power Should Be Constrained by Borders," International Liberty blog, March 23, 2018, https://danieljmitchell.wordpress.com/2018/03/23/the-fight-over-internet-taxation-is-really-a-proxy-for-an-important-battle-on-whether-government-power-should-be-constrained-by-borders/ (accessed May 18, 2018).
22. News Release, "Secretary Mnuchin Statement On OECD's Digital Economy Taxation Report," U.S. Department of the Treasury, March 16, 2018, https://home.treasury.gov/news/press-releases/sm0316 (accessed May 11, 2018).
23. Brief For The United States As Amicus Curiae Supporting Petitioner, *South Dakota v. Wayfair, Inc. et al*, https://www.supremecourt.gov/DocketPDF/17/17-494/37747/20180305180114702_17-494tsacUnitedStates.pdf (accessed April 3, 2018).