What's wrong with Internet sales tax

By: Daniel J. Mitchell – May 7, 2013

Let's assume you live in Utah, Hawaii or South Carolina, and you go to Nevada for a vacation. While in Las Vegas, you spend some money in the casinos.

Gambling is illegal in the state where you live, so should the cops in your home state be able to track your activities and arrest you for what happened in Nevada?

The answer, needless to say, is no. Or at least it should be no. Common sense tells us that state laws should only apply to things that happen inside a state's borders.

But this sensible principle is being tossed out the window by the U.S. Senate, which has approved a proposal that would give states the ability to impose their taxes on out-of-state sellers.

Many people think this is a debate about "taxing the Internet," but that's a misleading characterization.

If a merchant in your state makes an online sale to you or your neighbor, that seller will collect the sales tax levied by your state.

And if a merchant in another state makes an online sale to you or your neighbor, that seller is subject to any taxes imposed by the state where it is based.

But some governors and state legislators don't like this system because many states don't bother imposing any tax on sales to out-of-state consumers. And even if states levied taxes on sales to out-of-state consumers, what about the five states that don't have any sales tax? Wouldn't those states become "tax havens" for Internet sales?

For these reasons, some politicians fret that the Internet will put competitive pressure on them to keep their sales tax rates from getting too high.

These concerns are overblown. People generally shop online because of convenience, not tax savings. But it's also a good thing when states are forced to compete with each other.

States with no payroll income taxes, such as Nevada, Florida, Tennessee, Texas and New Hampshire, help restrain the greed of politicians in states that have punitive income tax systems, such as California, Illinois, New York and Massachusetts.

And if politicians in the high-tax states refuse to adjust their bad tax policies, then people should have the freedom to escape and earn income in other states.

The same principle applies to sales taxes. If politicians in, say, Arizona are worried that consumers will go online or travel across the border to avoid the punitive sales tax, then they should reduce their sales tax rate.

Politicians can choose to maintain uncompetitive tax systems, of course, but they also should be prepared to accept the consequences. I don't think California and Illinois should try to become the France and Greece of America, but that's something for the voters of those states to figure out for themselves.

In any event, they shouldn't have the right to force out-of-state sellers to act as deputy tax collection officials if they decide to impose bad tax policy.
But this debate isn't just about tax policy and the proper limits of state government power.

The bill still must go through the U.S. House, where the GOP is divided on the issue. If politicians in Washington approve the so-called Marketplace Fairness Act, they'll not only be authorizing extraterritorial tax enforcement, they'll also be setting in motion the creation of a database that will erode privacy for consumers and create opportunities for identity theft.

This is because the legislation only can be enforced if governments set up some sort of system for tracking where consumers live, what they buy and how much it costs. With 9,600 sales tax jurisdictions in the United States (cities and counties also impose sales taxes), this is a compliance nightmare.

And it means that your personal and financial details will be collected and stored in a database that will be a magnet for criminals and hackers from all over the world.
To be blunt, a sales tax cartel is bad news for tax policy and bad news for privacy. Let's limit the power of state governments so they can only screw up things inside their own borders.