



PUBLIC POLICY REPORT

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Federalism: Should Congress Take a More Active Role in Restraining the States from Interfering in Interstate Commerce?

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The Origins of American Federalism

From 1777 to 1788 America was governed by the Articles of Confederation - a form of decentralized government that was the diametric opposite of the strong national government of Britain that the states had just defeated in the American Revolution. The Confederation consisted of a loose grouping of independent sovereign states. However, in ten short years under the Articles of Confederation, state protectionism rose to such a level that interstate commerce was nearly impossible. Historians characterized the period as one of "commercial war" between the states. It was that environment in which the U.S. Constitution was drafted and adopted, and it was that environment that led to several provisions of the U.S. Constitution establishing federal oversight of the states. Primary among those provisions is the Commerce Clause, Article I, Section 8, Clause 3, granting to Congress the power to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes".

In the debate surrounding the writing and ratification of the U.S. Constitution, the minority who opposed a stronger centralized government (the Anti-Federalists) prevailed upon the majority (the Federalists) to provide some additional protection for the people and to limit the power of the central

government by creating the Bill of Rights¹. The promise to create the Bill of Rights was essential to the ratification of the Constitution by seven of the states. In fact, their ratification was made specifically dependent upon the creation of the Bill of Rights.

Consistent with the promise extracted in exchange for ratification, Congress passed twelve amendments to the Constitution, sending them to the states for approval. The states approved ten - thus appending the Bill of Rights to the Constitution in 1791. The Tenth Amendment specifically states that "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."

Thus was born a government of powers shared between state and federal governments - the system of federalism we have today.

Federalism Today

Since the adoption of the Constitution the meaning of federalism has been reversed. Whereas during the drafting, debate, and ratification of the U.S. Constitution the term Federalism referred to a strong centralized government with significantly more power than under the Articles of Confederation, the term Federalism is today frequently used synonymously with the phrase "states' rights", the position historically held by the Anti-Federalists. But as Clint Bolick of the Institute for Justice states in *Grass Roots Tyranny: The Limits of Federalism*², "The very notion of states' rights is oxymoronic. States don't have rights, States have powers. People

¹ An early proposal for an even stronger national government, one with the power to veto state laws, was rejected in the early stages of the discussion at the Constitutional Convention.

² Cato Institute, 1993, p. 17.



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have rights. And the primary purpose of federalism is to protect those rights.” Both Bolick and Adam Thierer³ of the Heritage Foundation interpret the Constitution as intending to protect consumers against oppressive and unjustifiable state actions that adversely affect interstate commerce and therefore adversely affect the consumers’ interests.

Commerce Clause Interpretation

The Commerce Clause was added to the Constitution for exactly that purpose - to protect against oppressive and unjustifiable state actions that adversely affect interstate commerce. In 1829, James Madison, one of the signers of the Constitution, stated in correspondence⁴ that the need for the Commerce Clause “grew out of the abuses of power by the importing States in taxing . . . , and was intended as a negative and preventative provision against injustice among the States themselves”. Former Judge Robert Bork wrote in 1991⁵ that “everyone agrees that the historic central function of the commerce clause was to empower Congress to eliminate state-created obstacles to interstate trade”. Indeed the Supreme Court itself has explained that “our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them. Likewise every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any.”

In interpreting the commerce clause the Supreme Court has constructed the concept of the "dormant" or "negative" aspect of the Commerce Clause, interpreting the grant of power to Congress to regulate "commerce among the states" as implicitly mandating a policy of free interstate markets, such that local economic measures that have not been

outlawed by Congress are nonetheless unconstitutional if they unduly burden interstate commerce.⁶ Unfortunately, a judicially constructed concept is rather less effective than legislation specifically enacted by Congress.

The Need for Congressional Exercise of Commerce Clause Powers

Protecting consumers by utilizing its powers under the commerce clause is exactly what Congress needs to take more seriously. Congress’ use of these powers has been relatively infrequent. For example, while there are some federal laws controlling state application of income, sales, and use taxes on interstate transactions, those laws have clearly not gone far enough to actually stop the imposition of unconstitutional taxes on interstate commerce⁷.

The states have enacted a plethora of laws and regulations designed to benefit local merchants at the expense of interstate commerce. Some of those laws directly benefit local vendors to the detriment of out-of-state sellers and thus to the detriment of consumers who are left with less choice and a less competitive marketplace. Other legal rules have their adverse effect by the sheer volume of differing state and local laws and regulations that a nationwide seller must deal with. The costs of dealing with those laws and regulations are passed on to the consumer in product and service prices. And woe be to those interstate companies that must actually maintain some sort of presence in their customers’ jurisdictions in order to serve those customers. Those companies are frequently subject to enormous tax and regulatory burdens, many of which, especially in the tax area, are unconstitutional. Rather than the people owning their government, the governments have seized ownership of the people and are charging admission fees, in the form of illegal taxes, to businesses that wish to have access to the market of local citizens. The costs of those illegal taxes are passed on to the taxing state’s consumers, a pernicious form of hidden taxation that


³ Adam Thierer, *The Delicate Balance: Federalism, Interstate Commerce and Economic Freedom in the Technological Age*, Heritage Foundation, 1999, p. 9, p. 21 (as clarified in e-mail dated 4/26/99 to the author of this article).

⁴ Correspondence with J.C. Cabell.

⁵ Robert H. Bork, “Federalism and Federal Regulation: The Case of Product Labeling,” Washington Legal Foundation, *Critical Legal Issues*, Working Paper Series no. 46, July 1991, p. 10.

⁶ See Philip P. Frickey, *The congressional process and the constitutionality of federal legislation to end the economic war among the states*, 1996 at: <http://woodrow.mpls.frb.fed.us/sylloge/econwar/frickey.html>

⁷ See: CommerceNet Public Policy Report article *States Behaving Badly*, June 1999.

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is frequently not even seen by the citizens, let alone voted on or approved.

Electronic commerce is inherently national, if not global, in scope. Therefore many, if not most, of the laws, regulations, and taxes imposed by state and local governments have a particularly negative effect on electronic commerce. Among those laws are:

- ◆ State laws prohibiting manufacturers of automobiles from selling direct to consumers if they have dealers in the state.
- ◆ State laws requiring shipments of wine to first be delivered to local distributors before being transshipped to customers in the destination state, or worse, completely prohibiting the shipment of wine to individuals resident in the state
- ◆ State laws requiring use of a specific font (12-point bold, for example) in consumer notices which, as they differ from state to state, make use of a single form for all customers impossible.
- ◆ Tax collection forms, rules, and filing requirements imposed on sellers that are different for each state. Fortunately the U.S. Supreme Court has denied the states the right to impose sales and use tax collection obligations on many, but not all, out-of-state sellers.
- ◆ Taxes, and frequently hidden costs and fees, imposed on specific forms of communications services.
- ◆ Barriers to interstate commerce involving state specific regulation of insurance, financial services, utilities, and other industries.
- ◆ State professional licensing requirements that do not recognize the licenses issued by other states.

By far the most immediate need for uniform national standards is in state and local tax policies. Although discrimination against interstate commerce is unconstitutional under the U.S. Supreme Court's jurisprudence interpreting the Commerce Clause of the U.S. Constitution, the unfortunate fact is that the

current legal environment provides little real remedies to the taxpayer against the imposition of unconstitutional forms of state and local taxes. Examples of decade long litigation to obtain refunds of illegally imposed taxes are not uncommon. (See the June 1999 CommerceNet Public Policy Report article *States Behaving Badly*.)

The Courts and the Constitution - Judicial Review has Simply Not Been Effective in Preventing the Imposition of Unconstitutionally Discriminatory Taxes

Several factors combine to make challenging a tax on constitutional grounds a long, arduous, and even when successful, unrewarding process, not the least of which is the potentially enormous fiscal impact of refunding past taxes which makes states unwilling to acquiesce without battling the issue to the bitter end.

First of all, some state and local governments require that in order to challenge a tax, that tax, and any associated penalties and interest, must first be paid. These are commonly known as pay-to-play rules. Then all administrative remedies - appeals within the tax agency - must be exhausted. Only then can the case be taken to court. The Tax Injunction Act⁸ restricts the power of federal courts to prevent collection or enforcement of state taxes, stating that:

The district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State.

Therefore a state tax challenge based on the U.S. Constitution must be taken to state court rather than to the federal courts. State courts of course are frequently funded by the very tax which they are being asked to rule illegal. In the state courts the case must find its way through multiple levels of the state judicial system, sometimes as many as three, before it reaches the state's Supreme Court. Each level typically has the ability to overrule the lower court decision in part and remand it back to the lower court for further consideration, from which that subsequent ruling may then be appealed once again back to the higher level court. Only once the

⁸ 28 USC §1341.



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case is finally decided by the state Supreme Court, or the state Supreme Court declines to review it, may it be appealed to the U.S. Supreme Court, which may or may not decide to review the case. Obviously this process can easily take several years, even a decade.

But that's not all! Once the tax is ruled unconstitutional, it's time to start litigation over the appropriate remedy for having illegally collected that tax. Now the state legislature gets into the act. They need to repeal the unconstitutional tax and replace it with one that is constitutional. In addition, they may try to revise their tax laws to create a non-refund mechanism, such as tax credits, to provide the necessary remedy for previously collected taxes that have now been ruled unconstitutional. Even though the U.S. Supreme Court has ruled that changing the refund rules after the tax has been paid is similarly unconstitutional, states, at least Alabama and Washington, have or seem likely to continue to engage in what the Supreme Court has called a bait and switch tactic with respect to refunds. Needless to say, the more important the tax, the less the state wants to actually refund it. A state that has imposed a discriminatory tax may have relied for years on income primarily from out-of-state corporations to fund its government. In a recent Alabama case⁹, the tax ruled unconstitutional was enormously discriminatory in that in-state corporations paid only 1/5 as much taxes as out-of-state corporations. The state is now faced with providing a remedy for over a decade of illegally collected taxes.

Once the legislature gets involved there are now two more "opportunities" for litigation on the very same tax. The first is over the issue of whether the remedy for illegally collected taxes is constitutional, the second is whether the new tax scheme is itself constitutional. States have been known to amend a tax ruled unconstitutional and replace it with another tax scheme that is itself also unconstitutional.

To summarize, the process of seeking relief from an unconstitutional tax involves: pay the tax, then appeal the tax to the tax agency, then, in some states, appeal the tax in the state tax court, then appeal the

tax to the district court, then the appeals court, and then the state supreme court, then appeal the case to the U.S. Supreme Court. Then appeal denial of a refund to the state courts, and once again to the U.S. Supreme Court. Then start all over again when the legislature replaces the unconstitutionally discriminatory tax with another tax that, although different, is still unconstitutionally discriminatory. Keep in mind that as an out-of-state corporation, none of the officers or employees of your corporation can even vote in the state in question. Also keep in mind that the U.S. Supreme Court has ruled¹⁰ that federal law¹¹ granting individuals and corporations private rights of actions against state officials for violation of constitutional rights does not apply to make available awards of attorney's fees in tax cases.

It is hard to imagine an area of state law that calls out more loudly for Congressionally imposed uniformity.

The National Tax Association's Electronic Commerce Taxation Project

CommerceNet has been participating, as a voting member, in the National Tax Association's Communications & Electronic Commerce Tax Project¹². The Tax Project's original goal was for industry and the states to develop a broadly available public report that identified and explored the issues involved in applying state and local taxes and fees to electronic commerce, and that included recommendations to state and local officials regarding the application of such taxes. Organizers expected that the report would also include model legislation designed to implement the recommendations of the project.


That Project is now coming to a close, with a final report expected to be issued within the next few months, if the Project's Steering Committee members are able to agree on the contents of the report. Far from reaching the goal set out at the outset of the project, the report is expected to detail the issues involved, but will include no

⁹ For details, see the June 1999 CommerceNet Public Policy Report article *States Behaving Badly*.

¹⁰ National Private Truck Council, Inc. v. Oklahoma Tax Commission, 515 U.S. 582 (1995).

¹¹ 42 USC §1983.

¹² See <http://www.nhdd.com/nta/ntaintro.htm#pagetop>

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recommendations to state and local officials, let alone any model legislation designed to implement recommendations. State and local government representatives were simply unable, or perhaps merely unwilling, to reach agreement with industry on a reasonable tax system to apply to electronic commerce.

It is unlikely that the report will clearly identify the issue which the author of this article (who is CommerceNet's representative on the Project) believes was the real bone of contention that prevented industry and the states from reaching agreement. With regard to collection of sales and use taxes, a major effort of the project was focused on determining what kind of a tax system would be needed for the industry representatives to agree that collection, under that system, of sales and use taxes on interstate sales was not an unconstitutional burden on interstate commerce. However, one vital issue was so contentious that discussions of it between state and local governments and industry representatives had to be discontinued after only one conference call. That issue was the imposition of income, franchise, and other business activity taxes, by the buyer's state, on sellers that registered to collect use taxes, on behalf of the buyer's state, from buyers located in that state. Industry wanted explicit standards that would protect sellers in interstate commerce from additional types of discriminatory taxes. States were unwilling to consider any such real protections. While the current use tax system is so administratively burdensome that the U.S. Supreme Court has ruled that collection obligations cannot be imposed on companies with no physical presence in a state, that system is still much less of a nightmare than the imposition of unconstitutional forms of income, franchise, or business license taxes on each and every e-commerce business. Between the states' rejection of a centralized use tax collection system¹³, and their rejection of standards for imposition of business activity taxes, it became clear to this participant that the state and local governments' intentions are to require every e-commerce seller to register with every tax agency in

¹³ A centralized sales/use tax collection system would have relieved taxpayers of the necessity to register, as use tax collectors, in every state. This could have deprived states of the opportunity to obtain a list of companies on which to impose additional types of state and local taxes.

every state, while retaining complete and unchecked discretion to impose discriminatory state and local taxes upon those out-of-state businesses.

Possible Federal Remedies

The need for effective protection against the imposition of unconstitutionally discriminatory taxes is abundantly obvious, given:

- 1) the current egregious imposition of unconstitutional state and local taxes, and
- 2) that the likelihood that any changes in federal law *enabling* states to impose sales and use tax collection obligations on electronic commerce companies will result in the imposition by state and local governments of even more unconstitutional taxes.

There are several remedies that Congress could implement to ensure that state and local governments do not impose unconstitutional forms of taxes on e-commerce companies.

The most pressing need is to provide some sort of remedy that actually works to prevent the collection of unconstitutional taxes. Clearly the states can, and do, abuse the current system, thereby managing to deny refunds of illegally collected taxes for decades.

Possible remedies might include:

- ◆ Federal legislation providing that in state or local jurisdictions with pay-to-play or bond-to-play rules, the taxpayer has the option of having the case heard in federal, rather than state, courts.
- ◆ Federal legislation overturning the U.S. Supreme Court decision denying attorney's fees in tax cases where the tax is found to be unconstitutional. Since those attorney's fees can be awarded against individual state tax officials, this could provide a major incentive for state tax officials to ensure that their state legislatures refrain from passing unconstitutional taxes.
- ◆ Federal legislation to actually ensure the refund of taxes which have been declared unconstitutional. Such legislation might, for example, withhold the tax refunds from federal funds paid to the states and then



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refund, out of funds withheld, the taxes to the taxpayer that is owed the refund. In the case of local taxes the states could then withhold the amounts from the state funds paid to the local jurisdiction that owes the refund.

- ◆ Federal legislation to specify that certain tax schemes are constitutional, thus encouraging states to enact those tax schemes in order to avoid having their tax laws overturned in constitutional challenges.

Conclusion

The states have perfected their abuse of federalism to a high degree, particularly in the area of state and local taxation of interstate commerce. It is time, indeed past time, for Congress to step in and enable the nation-wide economy to perform without the hindrances imposed by state and local commercial protectionism. The U.S. Constitution gave Congress the power to regulate interstate commerce for that very reason and Congress must step up to their responsibilities by enacting legislation that overturns protectionist state and local laws. While there are many minor areas that need uniformity, in order for electronic commerce to develop to its fullest potential and provide consumers with the maximum benefit from the low cost Internet marketplace, the most significant area where a national standard is needed is state and local taxation of interstate businesses.

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