ROLLING BACK DISCRIMINATORY BURDENS AGAINST DIRECT-TO-CUSTOMER INTER-STATE COMMERCE:

THE ECONOMIC IMPORTANCE OF A DE MINIMUS PHYSICAL PRESENCE TEST

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I INTRODUCTION

Madam Chair, Members of the Committee, I want to thank you for the opportunity to testify on the economic importance of reforming BAT. I am Peter Johnson, Vice President for Research Strategy and Platforms and Senior Economist of the Direct Marketing Association ("DMA"). I am in my seventh year serving the DMA in this capacity, having taught economic policy at Columbia University in New York City full time from 1991 to 2000.[1]

The DMA is the largest trade association for businesses delivering value to customers directly. Founded in 1917, the DMA today has over 4,700 member companies in the United States and 53 foreign countries. The membership of the DMA has had a long-standing interest in helping policy makers understand the legal and tax underpinnings of inter-state commerce. My research on the physical presence test in regard to the amount of uncollected sales or use taxes arising from Quill protections of Internet Commerce has been presented before other committees on several different occasions by my colleagues at the DMA, and cited by others before hearings at the state level in Florida, Illinois, Virginia and California, among others.

I wish to emphasize that I am neither a tax attorney nor a Government Relations professional. In today's testimony I hope to bring an economic perspective to the debate surrounding Business Activity Taxes. I hope these will encourage you to undertake these most needed reforms.

II. ARGUMENT IN BRIEF

Our tax counsel, George Isaacson, has made clear the DMA's position regarding these issues from the perspective of the Constitution and Federalism. Our position has been, and continues to be, that a clear physical presence standard for nexus is appropriate, whether in regard to BAT or transaction taxes. Without such a test, state tax policy risks

[1] I would particularly like to thank my colleagues Mark Micali, George Isaacson, Anne Frankel, Michelle Carrera, and Dr. Yory Wurmser in preparing this testimony.

running afoul of the Interstate Commerce clause, and becoming economically burdensome and discriminatory.

Speaking as the DMA economist, my purpose today is to make clear the economic implications of the physical presence test, and the reduction in discriminatory burdens to which we hope it will lead.

As I review the policy debate concerning BAT reform, I note most of it has focused on the size of tax loss to state treasuries. Opponents of HR 5267 and its predecessors point to the expected loss to state treasuries, and claim that without the right to levy BAT, local commerce will continue to pay tax, while inter-state commerce is asking for special treatment, and seeking to avoid shouldering its fair share of the costs of state services.

Framing the debate in terms of local commerce and inter-state commerce is terribly misleading. What this debate is really about is whether state tax policies should be used to divert interstate commerce through one set of marketing channels as opposed to another. The concern about losses to State revenues is only part of the story. The rest of the story is how Business Activity Taxes by their nature are economically rational for one type of interstate marketing, but represent a discriminatory burden for another.

Thus, in the remarks that follow, I intend to show first what these two types of interstate commerce look like from a marketer's perspective; second, how BAT fits with one but discriminates against the other; and third, the wider economic gains to be had by releasing direct marketing from these discriminatory burdens through a clear physical presence test.

III. TWO FORMS OF INTER-STATE COMMERCE: ORIGINAL MARKETING VS. DESTINATION MARKETING

To defend the claim that BAT is burdensome and discriminatory to direct marketing, one must consider not only the absolute level of taxes posed, but the relative impact on the underlying efficiencies of the business models involved.

From a historical perspective, interstate commerce begins on the demand side, with national manufacturing in the nineteenth century. The development of national transportation networks of canals, railroads, and then interstate highways and air transportation offered increasing returns to scale in the mass manufacture and shipment of physical products. This is, of course, fairly obvious, and not what is at stake in BAT reform.

What is at stake in BAT reform is how these nationally manufactured or distributed products would reach their end customer on the demand side, i.e., the households or small businesses scattered across what would eventually be an entire continent, divided into 50 separate states and thousands of sub-state jurisdictions. To bring their goods to their end customers across America's vast distance required national manufacturers to develop and use efficient marketing channels.

Let me be clear what I mean by marketing channels. These are the set of planned business activities undertaken to bring potential buyers and sellers into contact with each other, then facilitate transactions among those who wish to do so. In economic language, marketing channels seek to reduce both "search" and "transaction" costs.

Over time, it has become clear that for national manufacturers to reach the full range of their end customers required the development of two distinct types of marketing channels. The first of these, mass marketing, invests in physical infrastructure of retail outlets that capture increasing returns to scale in transportation and communication channels to supply geographically-concentrated markets. The other form, direct marketing, capitalizes on increasing returns to scope in third-party communication and distribution channels to aggregate end-customers across geographically dispersed markets.

In principle the two forms of inter-state marketing complement one another. A fully efficient national economy would combine the two in ways that reflect the efficiencies scale and scope offered by the marketing channels at any given time. However, these marketing channels also represent revenue streams for taxing authorities. Tax policy decisions represent sticky investments by public authorities that tend to divert business activity towards one set of channels and away from another.

This facts concerns both national sellers and end-customers who find it more cost effective to use direct marketing to find each other like needles in the haystack that is the national economy of 250 million consumers and some 3 million or more businesses. And because finding each other requires them to cross so many legal jurisdictions, direct marketing sellers and end customers are uniquely vulnerable to the collective decisions of these thousands of taxing authorities.

Mass Marketing: Geographic Concentration From The Response Monopoly

Mass marketing is essentially a form of indirect marketing, in which the national manufacturer or seller is separated from the end-customer by business intermediaries of wholesalers and above all, geographically concentrated retailers. While this separation of ultimate seller from ultimate buyer is to some degree a natural by product of economies of scale in transportation costs, the extent of this separation is not, nor is the degree of economic concentration in mass retailing this now represents.

The twentieth century's large and increasing returns to scale of geographically concentrated retail channels is largely an artifact of the economics of mass communication media, particularly the domination enjoyed in the twentieth century by mass produced newspapers and electronic broadcast media. During this era, the economics of mass "one to many" communications" made it highly cost-effective for national manufacturers to generate publicity about the lower cost, reliability and availability of their products by making large purchases of advertising space in urban newspapers, and then large blocks of time on broadcast radio and television networks. Their goal is what marketers now refer to as “brand awareness”.

From an economic point of view brand awareness was really only a poor substitute for the thing that mattered: sales to end customers. Because neither newspapers nor electronic broadcast media offered two-way communications in much of the twentieth century, the end-customer’s primary (usually, their only) response channel (ie way of purchasing) was a local retail outlet.

It is their local monopoly as the response channel that ultimately shifted the economic balance of power away from national manufacturers and towards retailers. By making their own media buys, large retailers could advertise the fact they carried – and discounted – nationally manufactured brands. Because they bore the risks associated with unsold goods, and controlled the end pricing, proprietors of retail outlets soon discovered they enjoyed increasing returns to scale of their own, returns to scale that were often superior to those of national manufacturers or distributors.

To the returns to scale offered by their dominance of the response channel, retailers could further reduce transaction costs for their end consumer by locating in population centers with low cost transportation nodes. Together, these increased returns to scale promoted a progressive concentration of retail outlets, forcing local grocery and hardware stores to lose competitiveness to supermarkets and department stores, who in turn consolidated into city-wide retail chains. In turn, these urban supermarkets and department stores became less price competitive than suburban shopping centers, until ultimately, big box retailers emerged as the most price retail channels so far.

Destination-Based Marketing: Direct Marketing

For all the competitive price efficiencies achieved by mass-market retail channels, it is important to recognize there are inefficiencies inherent in geographically concentrated mass market retailing that even now are not fully appreciated.

In particular, demand from individual end-customers who share a specialized need or want must often be sacrificed by geographically concentrated mass marketing’s quest for economies of scale in transaction costs. So too must new products, or offerings from new national suppliers that do not fit the cost structures demanded by mass marketers.

Direct marketing’s comparative advantage over mass marketing lies in its ability to maintain the direct connection between a national or regional seller and their end customer. Given the superior economies of scale for mass marketing of commodities, however, direct marketers can generally only do so profitably by aggregating demand that is thinly dispersed across a wide number of separate geographic destinations into a pool that is large enough to be served economically.

Allow me to present this business model of serving dispersed end-customer markets in a little detail. To create such "virtual" markets of dispersed end-customers, direct marketing must invest heavily in reducing search-costs both for themselves and end customers, while asking end-customers to bear some of the cost and risk in transacting.

Direct marketers reduce search costs for themselves by first investing in lists of prospects or customers. These individuals will be selected for promotions based on their probable response behavior – i.e. a likelihood of buying a particular type of product or service, often as revealed by having bought a similar type of product in the recent past. Because communicating offers on this individualized basis expensive, direct marketers developed statistical and financial disciplines to reduce expenditure on promotions to potential buyers who are less likely to respond to their product offers, and concentrate only on those that are more likely.

It is the ability to track and predict customer response that is the main driver of efficiency in direct marketing. To take advantage of economies of scope in aggregating end-customers, communications channels need to direct observe response by the end-customer to the offer. To minimize responses diverted to retail channels and minimize lost response arising from unnecessary search costs borne by the end customer, it becomes economically necessary for direct marketer to shoulder their end-customers' search costs as well.

This capacity to track and analyze response is itself determined by the availability of communications channels that allow end customers to respond through channels other than retail middle-men. Unfortunately, for many years, the only nationally efficient network which allowed end customers to respond to them at an affordable price was the national postal network..[2]

The second major way in which direct marketers absorbed search costs was through the use of introductory offers for new customers. Because many buyers are unsure of the value of products offered them at distance from firms with which they were not previously acquainted, there is an implicit new customer 'discount' that had to be over come through special discounts not offered to previous buyers. Such subsidies to new customers were often a necessary loss that would recouped only from a certain fraction of such new customers who convert as repeat customers with a high life-time value (LTV), and for which rigorous financial analysis is required.

It is in how direct marketing addresses transaction costs for end customers, especially in fulfillment, that the virtual marketplace is at a relative disadvantage. Most obviously,

[2] Not until the deregulation of long-distance charges and the development of toll-free dialing (800 numbers) could direct marketers speed response time through electronic communications. This allowed marketers to introduce response-based advertising in print and broadcast, but only on limited basis for space and time that was sold in 'spot' markets. In fact, FCC regulations for many years actually required that such advertising spots only be made available merchants of products that were not available in stores; hence the famous phrase "not available in any store."

national vendors face shipping and handling costs that are on average substantially higher than is the case for mass marketers. To contain total transaction costs the marketer must be able to incur transportation and settlement charges on a variable cost basis. This means they must be able to engage the services of common carriers with increasing returns to scope in their delivery or fulfillment charges on an as-needed basis.

Even so, higher average transaction costs have historically placed strict limitations on the range of product offers which marketers could expect customers to respond to, and have delivered to them on a variable-cost basis. Initially, when the only addressable network was the Post Office, products that could be marketed in this way were often limited to small or content-based products, such as magazines, hobby and craft items, apparel, toys or credit-card offers, etc. that could be sent as printed matter or parcel post. (The exception was when the end-customer was so far distant from retail outlets that the high fulfillment costs represented a small fraction of the final price.)

Even given this limited range of products, the economics of the virtual marketers generally require the end-customer to bear a portion of the distribution and settlement costs and risks. This includes cost of shipment in the event of returns. This is something mass marketers generally do not. Indeed, doing so is often necessary to distinguish serious customers or prospects from those who are merely “window shopping.”

Economic Benefits From Direct Marketing.

Most obviously, the first beneficiary of this marketing method are end customers with specialized needs that are not met through mass marketing channels. By investing in lists and predictive analysis to identify prospects most likely to respond to their offers, absorbing their response costs, and by avoiding the overhead costs involved in physical infrastructure, direct marketers discovered they could identify and serve latent demand within widely dispersed markets that could not be efficiently served by traditional marketers’ focus on reduced transaction costs to geographically concentrated markets.

The second benefit accrues to small businesses. When fully integrated throughout the organization, direct marketing processes increase the organization’s overall efficiency, eliminating waste throughout the organization, leading to highly focused efforts in every area from initial product research and development decisions through final customer sales and service. With initial overhead investment in physical infrastructure minimal, and variable marketing costs, there are relatively low barriers to entry.

Historically, because of the response monopoly enjoyed by local retailers, efficiencies that could be achieved by investing in returns to scale in lower transaction costs greatly outweighed those available to direct marketers. At some point in the growth of direct marketing businesses, therefore, there often would come a point in which the volume of customers so constructed shifts the logic from direct to mass marketing. Many of today’s most famous multi–channel retailers (i.e., retailers with both retail stores, Internet websites, and, in some cases, catalog operations) began as pure-play direct marketers but who, once they achieved a certain sales threshold, found it more efficient to complement their direct sales by opening retail distribution networks.

What has changed over the years is that the relative returns to scope have improved relative to the increasing returns to scale. This is largely thanks to the proliferation of response-based channels, particularly the Internet, and databases that further increase the returns to scope in employing remote response channels.

Indeed, as can be seen from the accompany tables 1 and 2, direct-marketing based non-store retailers represents a small fraction of total retail commerce – roughly 5% of the total number of firms, and slightly larger proportion of total sales in this sector. Yet non-store direct sellers are significantly smaller and more efficient. This trend is increasing, as mass marketers continue to consolidate, and direct marketers continue to embrace new market entrants.

In fact, even before the emergence of Internet commerce, the non-store retail sector the average number of employees was about 10% less than in the traditional retail sector, and for each employee, these small direct marketing businesses achieved about 25% more sales. As the Internet has increased direct marketing's ability to compete nationally, by offering more customer response opportunities, the trend to smaller businesses in non-store retailing has intensified. The average number of employees in mass marketing retail firms can be estimated to be about 14.1 in 2007, a 12% increase in average size.

Today, average return on investment in direct marketing channels is over $11; in mass, it is in the vicinity of $6.

Secondarily, more and more product for sale via interstate commerce is "content"-based that can now be transmitted digitally rather than shipped in bulky analog format. Even in the age of Google, direct marketers are investing heavily in both paid and organic "search" by customers.

For all these reasons, large geographically based mass marketers are increasingly concerned about their long-term competitiveness. And they should be. The number of non-store retailing firms has continued to decline, dropping an estimated 3% in the last decade. While their total sales increased 52% in this period, total sales in the non-store sector increased in the same period, by my calculations, by about 130%.

So while mass marketers are clearly not suffering in terms of absolute growth, they are clearly losing competitiveness in relation to the smaller and more nimble competition fostered by direct marketing. It should nor surprise us, therefore, if many of traditional mass retailers see a potential competitive burden on their smaller direct competitors from state and local tax structures as not a bad thing.

<u>THE PHYSICAL PRESENCE TEST IN INTER-STATE COMMERCE</u>.

As I hope is clear from the broad-brush picture I have just painted, direct marketing is not different because it is interstate – mass marketing retail distribution is also. Nor is direct marketing synonymous with inter-state retail distribution of tangible consumer goods. In fact, thanks to the proliferation of addressable communications and distribution channels, increased efficiencies in data measurement and analysis processes, and the proliferation of content-rich products and services, direct marketing is increasingly utilized at the local and regional level also.

What is crucial is direct marketing's ability to bring end customers and sellers together directly. But because some direct marketing efficiencies can only be realized by aggregating customers from across all 50 states, and 30,000 sub-state jurisdictions, these efficiencies are acutely vulnerable to taxes imposed at the sub-national level. To put the BAT controversy in context, it must be recognized that the physical presence test originated in the arena of transaction taxes as protection against administrative policies tailored with the economic efficiencies of geographically concentrated marketing in mind.

<u>Origin of the Physical Presence Test: Transaction Taxes.</u>

By the twenties, mass marketing advantages enjoyed by broadcast media created a boom in transactions in tangible goods available for sale in supermarkets, department store, franchises, and dealerships. State and local tax authorities found it economically rational to shift more of their total tax revenues to consumers by levying transaction (sales) taxes.

As a matter of law, transaction taxes are levied on the purchaser, and are owed to the jurisdiction where the purchaser resides. However, because of the large number of transactions involved and the accompany regulatory issues between taxable and exempt products, excluded transactions, filing requirements, audit arrangements and appeal procedures, such a pure "destination" basis would have raised transaction costs substantially. Such a policy would have undercut the basic economic logic of the origin-based marketing model.

So, as a matter of tax administration, these transaction taxes were converted to Business to Government ("B-to-G") taxes payable by the retailer, who could use their economies of scale to collect the tax much more efficiently at the point of sale as a "C-to-B" tax. Thus, what in law began (and technically still remains) a 'destination' sourced tax became, from the point of view of administrative convenience, de facto origin-sourced.[3]

Because of the economies of scale involved, this burden on local retailing was far less than if consumers were asked to bear the compliance costs directly. Moreover, the tax was compensated for in other ways. Retailers increasingly came to seek, and states and localities, to grant, substantial tax breaks and incentives such as tax increment financing,

[3] This can be seen in the fact that local retailers are ultimately liable to the state for transaction taxes owed, even if they chose not to collect them from their end-customers.

to encourage them to locate stores within the relevant jurisdiction. In addition, indirect subsidies have increasingly been provided to large chain store retailers by states and localities in the form of municipal bond financing, infrastructure construction, and even the use of eminent domain.[4] All these policies are consistent with traditional retailers' overall competitive strategy of increased sales through lower transaction costs.

Similarly, local retailers also encouraged states to impose this origin-based administrative system on direct marketers by requiring them to collect and remit taxes also. On appeal, the Supreme Court consistently held that such an arrangement was, from the point of view of both due process and the inter-state commerce clauses, both unfair and economically burdensome. Most obviously, out–of–state companies had no way to influence the state and local tax burdens that are imposed on them. Moreover, the compliance burden placed on sellers that was resolved for mass marketers by the administrative convenience of origin-based administration produced the opposite effect when magnified across all 30,000 jurisdictions with the authority to levy transaction based taxes.[5]

Thus was born the physical presence test. In this test, the court originally stipulated that an out of state retailer could not be required to collect and remit transaction taxes unless it had at least one retail outlet within the borders of the taxing jurisdiction. In the realm of transaction taxes, the physical presence test prevents the administrative solution that serves local retail interests in reducing transaction costs from disproportionately burdening its destination-based business model, even to the point of annihilating it.

Evolution of the Physical Presence Test.

The court recognized that interstate commerce continued to grow as a share of state and local economic activity, and that state taxes needed to accommodate this. In subsequent holdings regarding the physical presence test over a number of years the Court did two things which allowed interstate commerce to grow organically, and state transaction revenues to grow with it.

First, the court broadened the physical presence test to incorporate more types of physical presence. What once required retail stores came to include other physical infrastructure as well: warehouses, distribution centers, offices, permanent sales forces, trucking facilities, and so on. All these were consistent with an appropriate state interest in making inter-state commerce pay its fair share of local and state service which it was physically present to enjoy.

Indeed, the perceived "problem" of internet vendors not collecting use
tax has proven to be largely self–correcting. As remote sellers grow, most of them

[4] Needless to say, these are benefits that are not available to out-of-state merchants. For example, one large, well–known retail chain recently secured tax breaks of upwards of $40 to $50 million in each of several states where it proposes to open a store, an enormous tax advantage not available to remote sellers.
[5] Currently, more than 7,500 of the 30,000 have chosen to impose transactional taxes, and the number grows every year

embark on a multi–channel sales strategy, which includes not only opening more retail stores, but warehouses, distribution centers, and the like. Thus, numerous direct marketers began to collect state sales/use taxes naturally, as their organic business growth led them to acquire nexus in more and more jurisdictions.[6]

Simultaneously, however, the Court accompanied this widening of the physical presence test by the preservation of a de minimus threshold. The presence had to be physical, not merely transactional or economic; and the presence could not be indirect, such as through the use of communication networks to solicit business, nor the mere use of common carriers to fulfill orders. In this way, the physical presence test standard which allowed state and local authorities to tax the growing amount of interstate commerce, but in ways that were consistent with the two basic marketing relationships involved.

<u>Physical Presence Test and Business Activity Taxes.</u>

Despite this naturally balanced approach struck by the physical presence test doctrine in the realm of use taxes, the application of the physical presence test to other tax streams has been unsettled. States and their constituencies of geographically concentrated mass marketers have grown concerned by the erosion of their base in transaction taxes. As a result, they have sought to expand their revenue streams by imposing so-called business activity taxes.

As with destination-based taxation of transaction, revenue based transactions on direct marketing relationships in themselves are not only procedurally unfair but violate the spirit of federalism. To quote the DMA's tax counsel, George Isaacson, "Federalism does not work, however, when a state (or locality) attempts to export its tax system across state borders. At that point, the state is visiting its experiment on businesses that have no connection – or nexus – with the taxing state."

BATs have two principal features of concern here. In both features, BAT taxes penalize direct marketers for investing in serving geographically dispersed markets.

First, such taxes may involve a state or locality assess "revenue" taxes on the evidence of a mere economic presence, such as promotion marketing activity into a given locality.

Taxes levied on a revenue basis across multiple jurisdictions without a physical presence test risks is an invitation to arbitrary assessments as to what portion of a firms' revenue is actually attributable to a given jurisdiction. Since the marketer will be liable for the full amount of income taxes owed to the jurisdictions it is domiciled or has other physical presence, there is a significant risk of double-taxation. In BATs, there is no inter-state reconciliation process to avoid double taxation, as there is among states and personal income tax.

[6] In other words, recent history shows that successful Internet retailers will grow their businesses by adopting a parallel retail store strategy, and, upon doing so, commence sales and use tax collection on all sales (including Internet sales) to residents in states where the stores are located.

This is especially significant, given that for many direct marketers net income cannot be directly inferred from the volume of revenues flowing from current year marketing efforts. As noted earlier, many current-year customers are newly acquired customers that incur loss. For state tax authorities unfamiliar with direct marketing business models, it will simply not be possible to ascertain those which are actual sources of net income simply by noting the volume of responses. Usually, the firm itself can only ascertain this after the elapse of time, and across the full sum of its marketing efforts, using life-time value accounting.

Second, they can involve imposing taxes on common carriers and other parts of the national distribution network that are indispensable if direct marketers are to operate efficiently on a variable costs basis. By imposing out of state revenue taxes on the third-party infrastructure necessary to variable cost pricing of delivery, particularly imposing revenue taxes on common-carriers, revenue taxes raise the average cost of fulfilling orders to end customers, a fact that is particularly damaging to this business model.

To both of the above direct burdens must be added the question of compliance costs.

As we have seen, direct marketing firms are typically smaller, and the number of jurisdictions to which they must market in order to achieve economic efficiency are more numerous. Thus, the number of discrete jurisdictions for which they will have to incur BAT compliance costs for which there are not economies of scale is large. These costs and the associated risks of audits and litigation are proportionately higher. In the remote sales tax area, we have seen these compliance costs are typically four times higher, on average than for mass marketers, representing up 10% of total value owed, in comparison with the large mass retailers, whose costs represent somewhat more than 2%.

What is the likely economic gain from a bright line physical presence test?

The starting point for an economic impact analysis of tax reform legislation is the amount accruing to state budgets. According to assessments of an earlier version of this legislation undertaken by the Congressional Budget Office, the National Governors Association, and Ernst and Young, there could be some $400m to $4bn of revenues in state and local coffers arising from unreformed BAT taxes in the near and short term.

The second step in estimating the gain to the economy is to know what portion of it is derived from the burdened industries. Of this amount, I estimate that an initial $1.25 billion represents the value that would be returned to direct marketing-based interstate commerce thanks to a clear physical presence test.

To arrive at this figure, I relied upon the Ernst and Young study to estimate the discrete impact effects of the bill's principal provisions. However, in determining the amount derived from "remote" sellers, the E and Y study used federal data from 1992 – i.e, a version of the landscape that is now fifteen years out of date. Thus, I adjusted their break down by estimating a more current estimate of the distribution of remote marketing activity across industry groups. This more current amount still fell within the lower range of estimates for 2005 losses from the three studies.

This figure I adjusted downwards by about one-third, reflecting what I take to be the net effect of modifications recently introduced in HR 5267. To update the original 2005 estimate for the year 2008 I then estimated an overall increase arising from changes in nominal GDP, and a slight trend increase in state and local application of BAT to operations without nexus.

The figure of $1.25 billion represents only the initial tax relief. To calculate total relief, I next estimated the value of compliance costs that would not be incurred. These I assumed to be 7.6% of total taxes paid, which adds a further $95m in relief, bringing the immediate relief to $1.345bn.

The next step is determine what effect the transfer of this sum money from the state sector to the direct marketing sector would have. Within the context of the economic analysis I have outlined above, this total tax relief represents a net cost reduction for direct marketing channels, making them more attractive at the margin relative to mass marketing.

Taking into account current price elasticities of demand by national marketers between mass and direct-marketing, a net reduction in state-imposed costs to direct marketing will mean that $755 million dollars in expenditure that is currently uneconomic thanks to BAT will be spent. As is summarized in the accompanying table 3, because of direct marketing's overall more efficient return on investment in the sectors concerned, this would result in at least $8.9 bn in additional revenue to US firms in 2008, and $11.5 bn in 2012. This additional economic activity would involve an incremental employment gain throughout the economy for one year of 44,000 jobs, which would increase to 49,000 jobs within 5 years.

Conclusion

Although preliminary estimates that cannot take into account the provisions of the final legislation, these numbers suggest that a clear physical presence test, along the lines envisioned by HR 5267, represents an opportunity to help small business, strengthen America's immediate economic output, and secure its long-term economic growth rate. Direct Marketing will bring wider economic benefits to US economic output, growth, employment, and the small business sector.

In fact, for any given level of taxes accruing to treasuries from BAT, a disproportionate level of burden is placed on direct marketers than if theoretical and empirical economic reasons to believe the cumulative impact is more discriminatory to direct marketers than to mass marketers. In turn, because direct marketing is now economically more efficient than mass marketing, these discriminatory taxes placed on direct marketing are more burdensome to the economy than if an equivalent level of taxation had been imposed on other forms of marketing.

As the provisions of this bill are debated and amended, the specific economic impact will likely change. This makes future cost-benefit analyses attached to any particular bill dependent on the framework of the debate itself. As a nation, we are now a decade into a national conversation about how best to tailor the economics of tax regimes to capture the economic virtues of the virtual marketplace.

As we have seen, the physical presence test cuts across BAT reform and other policy domains. Because the economic theory of this virtual marketplace has been too little understood, we have had a debate that has focused too much on symptoms, such as lost to specific state revenue streams, rather than overall state tax revenues; and debated the issues indirectly, such as by focusing on legal precedents, rather than directly, by attempting to understand what works for the overall competitiveness of the economy.

A clear understanding of the comparative economic advantages of these two types of inter-state commerce, one virtual, one physical, help place the importance of the physical presence test in its proper context. A clear bright-line *de minimus* physical presence test is appropriate across a range of policy domains. In the case of BAT, it will lead to reforms which can be expected to liberate a more efficient way of doing business from backward-facing tax policies. Their ultimate result, unintentionally or not, is a short-sighted effort to restore the competitiveness of brick and mortar interstate commerce, not by making it more efficient, but by making direct marketing less so.

In liberating the virtual economy from tax structures designed for the physical era of interstate commerce does not privilege any particular industry or segment of the population. It will allow direct marketing to help a wider range of small businesses and customers find each other at a time when mass marketing increasingly stands in their way.

Table 1: Traditional Retail Economic Performance

Traditional Retail (Excluding Non-Store)	1997	2002	2007 (Est'd)	97- 07 % Chg
Number of Firms	1,073,965	1,056,062	1,038,159	-3.3%
Sales ($1,000)	$2,347,765,853	$2,880,817,657	$3,574,176,765	52.2%
Average Revenue ($1,000)	$2,186	$2,728	$3,269.7	49.6%
Total Employees	13,485,110	14,051,790	14,618,470	8.4%
Average Employees	12.6	13.3	14.1	12.1%
Efficiency ($1000 Sales/Employee)	$174.1	$205.0	$244.5	40.4%

Source: DMA Analysis of US Census Bureau Data.

Table 2: Non-Store Retail Economic Performance

Non-Store Retailers	1997	2002	2007 (Est'd)	97- 07 % Chg
Number of Firms	44,482	54,921	65,360	46.9%
Sales ($1,000)	$113,120,159	$172,864,966	$260,547,323	130.3%
Average Revenue ($1,000)	$2,543	$3,148	$3,752.0	47.5%
Employees	505,993	571,438	636,883	25.9%
Average Employees	11.4	10.4	9.7	-14.3%
Efficiency ($1000 Sales/Employee)	$223.6	$302.5	$409.1	83.0%

Source: DMA Analysis of US Census Bureau Data.

Table 3: BAT Reform Impact Estimates

	2008	2009	2012
Ad Spending Impact			
Baseline ($000)	$ 183,149	$ 193,493	$ 227,758
Less BAT Tax Burden	$ 183,904	$ 194,291	$ 228,698
Difference	$ 755	$ 798	$ 939
% Difference	0.4%		
Sales Impact			
Baseline ($000)	$ 2,158,634	$ 2,303,296	$ 2,791,406
Less BAT Tax Burden	$ 2,167,535	$ 2,312,793	$ 2,802,917
Difference	$ 8,901	$ 9,498	$ 11,511
Ad Employment Impact			
Baseline	1,660,930	1,698,161	1,811,815
Less Tax Sim 1	1,667,779	1,705,164	1,819,287
Difference	6,849	7,003	7,472
Seller Employment Impact			
Baseline	9,206,257	9,462,400	10,219,965
Less Tax Sim 1	9,244,220	9,501,418	10,262,108
Difference	37,963	39,018	42,143
Total Employment Impact			
Baseline	10,867,187	11,160,561	12,031,780
Less Tax Sim 1	10,911,999	11,206,582	12,081,395
Difference	44,812	46,021	49,615