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Internet Purchases:
To Tax or Not to Tax, Here Are The Questions

Lawrence W. Reed

Analysis of Arguments for and against Taxation of Internet Consumers and Recommendations to Keep the "Cyber-Economy" Growing

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Executive Summary

A national debate is taking place that promises to intensify in coming months: Should government tax purchases made over the Internet? If not, why not? And if so, how? While the question of federal taxation is certainly alive, most of the focus to date has been on the question of state and local government taxation.

Governor Engler opposed federal efforts to create new taxes or interfere with states' rights to set their own tax policies, but he did endorse a proposal designed to extract more revenue from Internet purchases.

In February, Governor John Engler testified before the U.S. Senate that he favored improving collection of current sales and "use" taxes, which already technically apply to Internet, catalog, and 1-800 number purchases made by Michigan citizens, but which in practice are rarely paid. He emphasized the issue of tax "fairness," saying that it is unfair to tax traditional "bricks and mortar" businesses six percent on their sales while exempting sales over the Internet from the same sales taxes.

Engler was careful to oppose federal efforts to either create new taxes or interfere with states' rights to set their own tax policies, but he did endorse a proposal by the National Governors' Association (NGA) designed to extract more revenue from Internet purchases. The NGA plan would have states employ "trusted third parties" who would track information about consumers' purchases and location to determine the amount of tax due and ensure that the revenue is routed to specific state and local government bank accounts.

But two problems arise with the governor's position on Internet taxation. The first is that Engler's case for "fairness" in taxation undermines other taxation positions his administration has taken. For example, the Engler administration often has bestowed special tax breaks, favors, and even direct subsidies on certain businesses at the expense of fairness and uniformity. Such discriminatory tax policies are the hallmark of the governor's Michigan Economic Growth Authority (MEGA) and Michigan Economic Development Corporation (MEDC) agencies.

The other problem with the governor's position is his endorsement of the NGA plan itself. Policy analyst Adam Thierer of The Heritage Foundation explains the NGA plan is seriously flawed because it

- creates a new *de facto* national sales tax cartel;
- violates constitutional first principles regarding tax fairness and commercial union;
- upsets existing U.S. Supreme Court commercial jurisprudence;
- threatens America's federalist structure of government by discouraging jurisdictional tax competition;
- creates a "trusted third party" tax collection system that could compromise individual and corporate privacy;

- is unnecessarily complex and could be extremely costly to implement;
- is not "voluntary" as the NGA claims; and
- is at odds with the Clinton administration's proposed "global free trade zone" for international commerce and could threaten American sovereignty.

In 1998, Congress passed the Internet Tax Freedom Act (ITFA), which instituted a national, three-year moratorium on "multiple" and "discriminatory" taxes directed at electronic commerce. That moratorium is set to expire in October 2001, and the federal Advisory Commission on Electronic Commerce (ACEC), created by the ITFA, is scheduled to release its recommendations to Congress this April.

State and federal policy makers should take advantage of opportunities to eliminate burdensome or antiquated telecommunications taxes.

Meanwhile, interest groups are weighing in with their own recommendations. The NGA, the National Association of Counties, and the U.S. Conference of Mayors all support taxing Internet purchases. Others including Americans for Tax Reform, the National Taxpayers Union, and several governors including Virginia's James Gilmore argue against Internet taxation on the grounds that the benefits of leaving the Internet relatively tax-free far outweigh whatever "unfairness" may exist among states' current tax structures.

In fact, a large part of the reason "e-commerce" is enjoying robust growth is the fact that it is subject to little direct taxation. In this free-market atmosphere, Internet commerce totaled roughly $20 billion in 1999 and is estimated to increase dramatically in the years ahead. To ensure continued growth and Internet access opportunities for all citizens, this report offers state and federal policy makers the following recommendations:

- **Extend or broaden the current tax moratorium.** Congress should make permanent the ITFA's moratorium on "multiple and discriminatory" Internet taxation.

- **Adopt a clear and constitutional taxation standard.** Congress should legislatively endorse the U.S. Supreme Court's "physical presence test" for businesses, which makes it clear when and which state and local governments have the right to impose sales taxes.

- **Require that any sales taxes imposed on Internet purchases be "origin-based" so that they will be consistent with the U.S. Constitution and prevailing legal standards.** The ITFA and existing Supreme Court jurisprudence do not prohibit all forms of Internet taxation. If policy makers do adopt some form of sales tax, they should ensure it is collected at the source, or point of sale, instead of at the destination, or point of consumption.

- **Look for ways to make Internet access and other telecommunications technologies more accessible and affordable.** America's increasingly competitive communications sector also remains one of its most heavily taxed. Policy makers should take advantage of opportunities to eliminate burdensome or antiquated taxes including the three-percent federal telecommunications tax of 1898, discriminatory state taxes on interstate telecommunications, Internet tolls and access taxes, and massive state and local taxes on consumer telephone bills.

Internet Purchases: To Tax or Not to Tax, Here Are the Questions

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Introduction: To Tax or Not to Tax?

A large part of the reason "e-commerce" is enjoying robust growth is the fact that it is subject to little direct taxation.

A national debate is taking place that promises to intensify in coming months: Should government tax purchases made over the Internet? If not, why not? And if so, how? While the question of federal taxation is certainly alive, most of the focus to date has been on the question of state and local government taxation—specifically, should sales and use taxes apply to Internet purchases just as they do when, say, a consumer walks into a nearby department store and pays a sales tax when he buys a television set?

In general, businesses are forced to collect sales taxes on many goods they sell and sometimes on services they provide within the state where they are based. Stipulations as to the tax rate and which goods and services are included in or exempted from the sales tax differ in each state. A Michigan book dealer, for example, collects a six-percent sales tax when he sells a book in his store to another Michigan citizen.

If the same citizen were to buy the same book from an Internet vendor such as Amazon.com, Amazon.com would not assess him a Michigan sales tax (or any sales tax for that matter) because Amazon.com is neither based in Michigan nor does it have a physical presence here. A Michiganian who buys his book this way is supposed to declare the purchase to the state and pay a six-percent "use tax." However, few citizens bother to do so. Because the state of Michigan cannot force out-of-state companies to charge the tax and remit the revenue, the use tax goes largely unpaid and unenforced.

Of the use tax revenue that is collected, two-thirds goes to General Fund/General Purpose and one-third goes to the School Aid Fund. A new effort this year by the state of Michigan to collect the use tax by asking citizens to declare their out-of-state Internet, catalog, and 1-800 number purchases on their state income tax forms may yield some additional revenue, but no one expects widespread compliance.

In fact, a large part of the reason "e-commerce" is enjoying robust growth is the fact that it is subject to little direct taxation. A congressionally mandated three-year moratorium on "multiple" and "discriminatory" Internet taxation is set to expire in October 2001 and a special federal commission, the Advisory Commission on Electronic Commerce (ACEC), will report soon on what it thinks Congress and the states should do after that.

Meanwhile, interest groups are weighing in with their own recommendations. The National Governors' Association, the National Association of Counties, and the U.S. Conference of Mayors all support devising some mechanism to extract revenue from Internet purchases—involving a new "third-party" entity that would collect and distribute sales taxes on those purchases. Perhaps the most extreme pro-tax view came recently from South

Dakota Governor and ACEC member William Janklow. Janklow startled his audience when he announced that unless steps are taken to immediately tax online purchases, he may begin "sending out the highway patrol to start pulling over little brown trucks" delivering goods purchased via the Internet. He threatened to "disrupt interstate commerce" by sending out state highway-patrol officers to pull over delivery trucks, inspect packages for those originating out of state, and "following the packages" to their final destination to force his residents to pay the state's use tax.[1]

Other groups and policy makers including Americans for Tax Reform, the National Taxpayers Union, and several state chief executives including Virginia Governor James Gilmore argue against Internet taxation on the grounds that the benefits of leaving the Internet relatively tax-free far outweigh whatever "unfairness" may exist among states' current tax structures.

The best policy is one that leaves the modern technology of the Internet alone to develop its potential unhindered by ancient ways of exacting revenues for government.

In our view, the best policy is one that leaves the modern technology of the Internet alone to develop its potential unhindered by ancient ways of exacting revenues for government. To understand why, it is necessary to explore the issue in detail. This report provides further background information on this controversial issue and deals with the relevant, and often thorny, aspects of Internet taxation in a separate question-and-answer section, followed by a section of specific policy recommendations.

Governor Engler's Congressional Testimony on Internet Taxation

On February 2, 2000, Michigan Governor John Engler testified before the Budget Committee of the U.S. Senate on the subject of taxation of Internet commerce. His comments raised more than a few eyebrows because, as a man with a reputation for cutting taxes, he seemed to some to be calling for *new* taxes.

It should be noted that Governor Engler carefully separated himself from the rising chorus of government officials and others who indeed support the imposition of new taxes on the Internet or Internet commerce. He opposes new taxes on access to the Internet, such as a national surtax on telephone bills. He also reportedly opposes the idea of a new national sales tax imposed by Congress on e-commerce. But he opposes a congressional ban on the states' power to collect sales and use taxes on Internet purchases, arguing that such a ban "would be an intrusion on the rights of states to set their own tax policy." To his credit, he certainly did not echo the bellicose rhetoric of South Dakota's Governor Janklow.

Governor Engler sought to cast the debate as one involving states' rights and essential fairness or evenhandedness in taxation:

> The central issue between the states and the federal government as it relates to e-commerce is not about taxing the Internet; I am opposed to taxing the Internet. Rather, the question is how, in the future, will states collect taxes already on the books, and even more fundamentally, whether states will remain sovereign in their right to collect those taxes.

[1] Julie Foster, "Net Tax In Limbo," *WorldNetDaily* (www.wnd.com), December 17, 1999.

Legislation proposed by Senator John McCain (R-Arizona) and Representative John Kasich (R-Ohio) would permanently extend the three-year moratorium on Internet taxation approved by Congress in 1998. If this legislation should become the law of the land, then in Governor Engler's view,

> In effect, the federal government will be mandating this significant price differential to those who don't support local communities, create local jobs, pay local property taxes, and keep our cities and towns vibrant. Such a public policy is both unfair and counterproductive public policy. It is in essence, a double standard: good for clicks, bad for bricks.

That "price differential" to which the governor referred would be equivalent to the amount of sales tax that a state imposes on sales within its state and the zero-percent tax on Internet purchases that the McCain-Kasich legislation would mandate. In Michigan, that differential is currently six percent.

Governor Engler's position is that it is simply unfair to tax traditional "bricks and mortar" businesses six percent on their sales while exempting sales over the Internet from the same sales taxes.

TAX "FAIRNESS"

Governor Engler's position is that it is simply unfair to tax traditional "bricks and mortar" businesses six percent on their sales while exempting sales over the Internet from the same sales taxes. Essentially, this is the same sentiment the governor expressed in another context last November, when he vetoed a bill to exempt certain politically favored groups from a particular tax. He said then, "Tax policy is best which is simple and uniform, and which treats similarly situated activities in the same manner."

In the strictest sense, Governor Engler *does* oppose *new* taxes and especially new *federal* taxes on the Internet, but he clearly favors some mechanism whereby existing sales and use taxes are collected by the states from Internet commerce. Such taxes are rarely collected now because states do not have the means to calculate them and because companies and, in most cases, consumers do not report the purchases and submit the taxes. Governor Engler supports the view of the National Governors' Association, which is proposing that states employ "trusted third parties" who will be given information about a consumer's purchase and locality, which the third party will then use to determine the amount of tax due and ensure that the revenue is routed to specific state and local government bank accounts.

What Governor Engler may not realize is that basing his case for taxing Internet purchases on the "fairness" or "uniformity" argument undermines other taxation positions his administration has taken. For example, the Engler administration often has bestowed special breaks, favors, and even direct subsidies on certain businesses at the expense of fairness and uniformity, and then praised the policy as promoting Michigan's "economic development." That is what his Michigan Economic Growth Authority (MEGA) and his Michigan Economic Development Corporation (MEDC) engage in routinely.

For example, last December MEGA officials authorized a $23.4-million incentive package for Webvan Group, Inc., of San Francisco, California. Webvan runs the Internet Web site webvan.com, which operates as an electronic grocery store. The e-store receives orders over the World Wide Web and fills and delivers them to its clients free of charge.

The Webvan site claims that its prices, "on average, are up to 5 percent less than in local grocery stores." This clearly discriminatory policy violates Governor Engler's stated desire for fair treatment of all businesses, particularly in this case, Michigan's traditional "mom-and-pop" grocery stores.

The argument for equity, fairness, and uniformity was equally absent in 1996 when the administration sought to grant Borders Books a multi-million dollar tax abatement and a huge job-training subsidy. Mom-and-pop bookstores rightly wondered why they should pay their full tax bill only to see some of their money go to train the employees of one of their giant competitors.

MEGA's clearly discriminatory policy violates Governor Engler's stated desire for fair treatment of all businesses, particularly Michigan's traditional "mom-and-pop" grocery stores.

Likewise, the governor's "Renaissance Zones" set up small geographic regions within the state where taxes are much reduced or do not apply at all. A business can literally move a mile, into a Renaissance Zone, and enjoy a much lower tax burden than its nearby competitors.

One final example of administration policies that establish an uneven playing field: The MEDC offered an "incentive" package of $5.1 million in tax abatements and subsidies to New York-based Boar's Head Provisions, Inc., to establish a manufacturing presence in Holland Township last year. Meantime, a three-generation Michigan firm and a Boar's Head competitor based in Flint, Koegel Meats, pays full freight in taxes and takes no subsidies.

With each new abatement or handout from MEDC, Michigan's economic playing field is further shot through with inequities and unfairness. Governor Engler's core argument for taxing Internet purchases is greatly undermined by his administration's actions in these other areas. If he were to adopt a position that the Internet should be a tax-free zone for *everybody* and, at the same time, restore uniformity and equity by eliminating selective abatements and subsidies in all other areas, he would at once be both consistent *and* in support of the most beneficial approach for the economy.

The governor's position on applying sales and use taxes to Internet purchases is not an uncommon one nor is it, on its face at least, unreasonable. But, aside from the obvious inconsistency with his administration's behavior, does it really represent the best possible policy and is it based upon sound assumptions? An examination of the current state of tax law will help shed some light on these questions.

Internet Purchases and Current Law

If 7,500 jurisdictions with sales and use taxes were to apply their own tax collection regimes to the Internet, America would experience tax pandemonium. This is largely what has logjammed the effort to tax the Internet in the first place: Current law does not provide a clear idea how to go about it.

(Imagine, by the way, what collection chaos would ensue if all 87,453 units of government in America were to adopt sales or use taxes—all 3,043 counties, 19,372 cities, 16,628 townships, 13,726 school districts, and 34,683 special districts—and then tried to impose those taxes upon each other whenever residents made Internet purchases from outside their respective jurisdictions!)

This is why, in 1998, Congress passed the Internet Tax Freedom Act (ITFA), which instituted a national, three-year moratorium on "multiple" and "discriminatory" taxes directed at electronic commerce.

The U.S. Supreme Court has ruled that states cannot require out-of-state companies to collect taxes for them, since this would interfere with interstate commerce. Under the ITFA and Supreme Court precedent, states and localities may only require companies with a "substantial physical presence" or "nexus" in their state to collect sales taxes. For example, a company with facilities in Florida may be required to collect taxes on sales to Floridians. But a Montana company with no "nexus" in Florida cannot be required to collect taxes on the goods it sells to Floridians.

The U.S. Supreme Court has ruled that states cannot require out-of-state companies to collect taxes for them, since this would interfere with interstate commerce.

This situation is extremely frustrating to state and local government officials constantly on the lookout for new sources of revenue. It creates a virtual tax-free zone for consumers. But bear in mind: State and local officials are not upset because they are "losing" revenue. They are upset because they are missing out on a *new* source of revenue: Internet sales. Like anyone, they appreciate anything that makes their jobs easier or brings them more money, and are frustrated when they cannot have it.

Ron Nehring of Americans for Tax Reform gives the example of 800.com, an online consumer electronics vendor based in Oregon, a state with no sales tax. The company has no presence in any other state. As a result, 100 percent of purchases from 800.com are free of sales tax collection. Consumers in states with sales taxes are technically responsible for reporting their purchases to their local taxing authority and paying a "use tax." This is, of course, rarely if ever done.

"Many state and local politicians detest a system which allows consumers to avoid paying sales taxes by going online or, as is more common, purchasing from a catalog," says Nehring. That is why nonprofit lobbying groups representing government officials have converged on Washington in recent years: to fight for the extra revenue they believe Internet commerce has deprived them of.

With the Clinton administration on their side, state and local officials succeeded in establishing, as part of the deal for passing the ITFA, the Advisory Commission on Electronic Commerce (ACEC), which has been holding meetings across the nation and will make its recommendations before its statutory April 21, 2000, deadline. Instead of examining the issue objectively and questioning whether the Internet ought to be taxed at all, the Commission's goal has been, in Nehring's words, to "change the law and institute a national sales tax collection system for all Internet and catalog remote sales."

According to a recent analysis, state governments are "awash in tax revenues," with a total surplus this year in the neighborhood of $36 billion.

Answers to Common Questions about Internet Taxation

If it has yet to be determined *whether* the Internet should be taxed, then arguments over *how* to tax it are premature. Below are several questions and answers designed to inform the "whether to tax" issue.

Has the growth of tax-free Internet sales hurt state revenues or education funding?

There is no sign of it. At the time of this writing, Michigan is enjoying a budget surplus in excess of $1 billion, after enacting numerous tax cuts in previous years. Governor Engler, in his State of the State Address on January 19, even called for further tax cuts. State spending is expected to rise in the next fiscal year at twice the rate of inflation and the budget is anticipated to remain in surplus after additional tax cuts this year. The "Rainy Day Fund" has grown so large—well in excess of a billion dollars—that the governor is proposing spending some of it on new programs. Moreover, Michigan's School Aid Fund is at record levels. Spending per pupil in Michigan public schools has never been higher.

A recent analysis by Dean Stansel and Stephen Moore of the Cato Institute[2] reveals that Michigan's budget experience mirrors that of other states. State tax collections grew at nearly twice the inflation rate between 1992 and 1998. State governments are "awash in tax revenues," with a total surplus this year in the neighborhood of $36 billion. *Investor's Business Daily* notes that state revenues grew 227 percent and local revenues grew 193 percent between 1980 and 1995.[3] A report by Michael Flynn of the American Legislative Exchange Council finds states to be "in their best financial health in over a decade."[4]

Predictions about "lost" future revenues if the Internet remains untaxed are almost always vastly inflated. Typically, such forecasts include business-to-business sales as well as business-to-consumer sales even though business-to-business sales are mostly exempt from sales taxes—and they comprise a much greater portion of Internet deals than do those by businesses to consumers.

Factoring out that and other dubious assumptions built into the inflated forecasts, two economists—Austan Goolsbee of the University of Chicago and Jonathan Zittrain of Harvard Law School—figure that nationwide, the tax revenue "lost" in 1998 totaled about $430 million. That amounts to "less than one quarter of one percent of total state and local sales tax revenues." Goolsbee and Zittrain calculate that the revenue "lost" over the next five years will be about $3.5 billion, which is still less than two percent of the sales taxes state and local governments are expected to collect.[5]

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[2] Cited in Adam Thierer, "Internet Taxes Could Crash the System," Washington, DC: The Heritage Foundation, November 3, 1999.

[3] *Ibid*.

[4] *Ibid*.

[5] Cited in "Taxing the Net," *Investor's Business Daily*, July 7, 1999, p. A4.

Cato's Aaron Lukas adds that

> In an era of almost no inflation, state budgets grew by 5 percent in fiscal year 1997 and by more than 6 percent in fiscal year 1998. The last fiscal year ended with about $21 billion more in tax collections than originally anticipated. It appears that states will enjoy a sizable revenue windfall this year as well. If electronic commerce is undermining state revenues, it's an undetectable trend."[6]

Is it "unfair" for sales over the Internet not to be taxed while other sales are taxed?

No. In fact, it would be blatantly unfair to tax out-of-state vendors that do business in a state over the Internet. Taxes pay for services, such as police and fire protection, roads, and parks. As Adam Thierer of The Heritage Foundation has pointed out, ". . . out-of-state vendors of electronic commerce, though subjected to the same tax burdens that Main Street vendors must bear, would receive none of the benefits for the taxes they paid to state and local governments where they did not reside. This amounts to a form of taxation without representation."[7]

"Out-of-state vendors of electronic commerce, though subjected to the same tax burdens that Main Street vendors must bear, would receive none of the benefits for the taxes they paid to state and local governments where they did not reside."

One reason many people assume Internet sales should be taxed is because without realizing it, they have absorbed the mentality of those who believe in taxation of almost anything as a matter of principle. Instead, taxation is actually a practical matter involving the limited powers the American people grant to government.

There is no underlying assumption in the American system that says everything should be taxed just because it's "out there." Under the American system, the people grant to government the limited powers that it wields, including taxation. Those powers are limited by the federal and state constitutions, and as long as the people do not expand the government's power to tax, the fact that a new sort of commerce comes along creates no moral, legal, or economic sanction for expanding that power to the new commerce.

Besides, as Aaron Lukas writes,

> . . . it's not fair to force out-of-state firms to act as tax collectors when they don't benefit from state services. When a [Michigan] business collects sales taxes, there is a clear linkage between the taxes paid, the services provided, and legislative representation. After all, local firms benefit from police and fire protection, roads and waste collection and other state services, so it is proper that they help cover those costs. And local

[6] Aaron Lukas, *Tax Bytes: A Primer on the Taxation of Electronic Commerce*, Washington, DC: Cato Institute, December 17, 1999.

[7] Adam Thierer, "Internet Taxes Could Crash the System," Washington, DC: The Heritage Foundation, November 3, 1999.

> firms can make their voice heard directly through lobbying and membership in groups like the Chamber of Commerce.
>
> Remote sellers, on the other hand, don't enjoy any of those advantages. If the state wants more of the taxpayers' money, it should collect it itself and not try to push the burden onto out-of-state businesses.
>
> Finally, differentiated tax rates create healthy competition that helps keep local rates under control. For example, some residents of Manhattan drive to Delaware to avoid sales taxes—an option that has undoubtedly curbed the profligate fiscal habits of New York politicians. Electronic commerce similarly guards against excessive taxation. When sales tax rates get too high, it's important that [Michiganians] have a shopping alternative.[8]

Every state's sales tax system is already riddled with exemptions and exceptions that treat different goods and services "unfairly."

Heritage's Thierer notes that the "fairness" argument simply misses the point entirely:

> . . . state and local businesses pay sales (and other) taxes because they can take advantage of the government programs or public services provided with those funds, such as roads, schools, parks, and police and fire protection. Remote vendors engaging in interstate electronic transactions do not benefit in a similar way either from these taxes or from the programs or services these taxes fund. Moreover, Internet vendors are tangible "bricks and mortar" businesses that will continue to pay routine corporate income and property taxes where they reside. Even a permanent Internet tax moratorium would not prevent states and localities from imposing equal sales tax rates on companies within their own jurisdictions.[9]

John R. LaPlante, managing editor of the Heartland Institute's *Intellectual Ammunition*, cites scholars at the University of Texas who estimate that "in 1998 alone, the Internet was responsible for over 1.2 million jobs—representing more income for workers, and for governments, more taxes. By contrast, University of Chicago and Harvard researchers estimate that less than 2 percent of sales tax revenues will be 'lost' to unreported Internet transactions."[10]

The National Governors' Association is fond of citing a poll which found that 72 percent of Americans believe it is unfair that local businesses must collect sales taxes while online sellers do not. But the very same poll also shows that 85 percent of Americans do not approve of a tax to make up for any shortage in revenues due to the rise of untaxed e-commerce.[11]

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[8] Aaron Lukas, *Ohio Doesn't Need to Tax the Net*, Washington, DC: Cato Institute, April 1, 1999.

[9] Adam Thierer, *The NGA's Misguided Plan To Tax The Internet And Create A New National Sales Tax*, Washington, DC: Heritage Foundation, February 4, 2000.

[10] John R. LaPlante, "Save the Internet From Death By Taxes," *Intellectual Ammunition*, Heartland Institute, February 2000, p. 18.

[11] Julie Foster, "Net Tax In Limbo," *WorldNetDaily* (www.wnd.com), December 17, 1999.

Finally, governors and mayors who argue for taxing Internet purchases for reasons of "fairness and equity" cannot have their cake and eat it, too. Every state's sales tax system is already riddled with exemptions and exceptions that treat different goods and services "unfairly." Most states do not apply sales tax to food or clothing. Many exempt services. Some exempt agricultural equipment, and so on.

Would imposing new taxes on the Internet do serious damage to the ability of this new form of commerce to thrive?

Yes. For starters, simple economics dictates that if Amazon.com is required to collect a five-percent tax on its products, it will probably have to lower its prices slightly to maintain sales volumes. Even if it holds prices steady, it will sell fewer books at the after-tax price, thus suffering a loss of sales revenue. All e-commerce is likely to suffer such shrinkage in order to reach economic equilibrium following imposition of a new Internet tax.[12]

On the demand side, a recent study by economists Austan Goolsbee and Gordon Zittrain estimates that taxing remote electronic commerce would reduce the number of online buyers by 25 percent and total spending on Internet transactions by more than 30 percent. The study suggests that these sales would not be replaced by ordinary retail sales, since the Internet is probably a net trade creator, generating business that would not otherwise have occurred.[13]

One recent study estimates that taxing remote electronic commerce would reduce the number of online buyers by 25 percent and total spending on Internet transactions by more than 30 percent.

As Adam Thierer states, "The explosive rise of the Internet and electronic commerce has created an unprecedented level of entrepreneurialism and innovation in America, and this technological renaissance has been the driving force behind America's recent strong and sustained economic growth."[14]

In other words, it is the very surge of entrepreneurialism and innovation through the Internet that has led America's unprecedented prosperity over the past decade, benefiting not only families and businesses but also state and local governments. As Raymond J. Keating, chief economist for the Small Business Survival Committee pointed out in testimony before the ACEC in September of last year, "federal, state and local governments have lost no revenues to expanding e-commerce, but have gained revenues due to economic growth driven in part by information technologies."

[12] Aaron Lukas, *Tax Bytes: A Primer on the Taxation of Electronic Commerce*, Washington, DC: Cato Institute, December 17, 1999.

[13] Cited in Austan Goolsbee, "In a World without Borders: The Impact of Taxes on Internet Commerce," Washington, DC: National Bureau of Economic Research, Working Paper No. 6863, November 1998.

[14] Adam Thierer, *The NGA's Misguided Plan to Tax the Internet and Create a New National Sales Tax*, Washington, DC: Heritage Foundation, February 14, 2000.

Yet state and local governments, their coffers overflowing with cash from the benefits of the information technology explosion, want to kill—or at least do serious harm to—the goose that's laying all the golden eggs.

What's wrong with the Internet taxation proposal of the National Governors' Association (NGA) favored by Governor Engler?

As analyst Adam Thierer explains,[15] the NGA plan is seriously flawed because it

By enabling state governments to extract taxes beyond their geographic boundaries, the NGA plan would completely undermine the original constitutional design regarding free interstate commerce.

- creates a new *de facto* national sales tax cartel;
- violates constitutional first principles regarding tax fairness and commercial union;
- upsets existing U.S. Supreme Court commercial jurisprudence;
- threatens America's federalist structure of government by discouraging jurisdictional tax competition;
- creates a "trusted third party" tax collection system that could compromise individual and corporate privacy;
- is unnecessarily complex and could be extremely costly to implement;
- is not "voluntary" as the NGA claims; and
- is at odds with the Clinton administration's proposed "global free trade zone" for international commerce and could threaten American sovereignty.

The NGA proposal recommends the eventual expansion of its new "third-party" collection system to all retail transactions, including not only Internet commerce and interstate catalog or mail order sales, but also all traditional forms of "Main Street" retail sales. Thierer rightly warns that this "would be an unprecedented expansion of the existing sales tax system and possibly one of the biggest tax increases in American history." It would function as "a state-based tax cartel, with governors essentially agreeing to collude and tax electronic commerce, and eventually all interstate transactions, according to similar rates and standards." The plan of the NGA "with one Machiavellian blow would undermine the authority of Congress to legislate over these matters while instituting a stealth national sales tax on the American people."[16]

By enabling state governments to extract taxes beyond their geographic boundaries through third-party agents, the NGA plan would completely undermine the original constitutional design regarding free interstate commerce. It even does violence to the time-honored American concept of "no taxation without representation" because it would allow states to tax businesses in other states—businesses with no physical presence within the taxing state and no voice in its democratic process. Citizens in Michigan and across America, moreover, should also be concerned that overzealous tax collectors carrying out the NGA scheme would have unprecedented access to private, personal information.

[15] *Ibid*.

[16] *Ibid.*

Why does Virginia Governor James Gilmore oppose the National Governors' Association (and Governor Engler's) approach to taxing the Internet?

Governor Gilmore says the only explanation for the behavior of his fellow chief executives is that they have an insatiable desire "to tax anything that moves." The editors of *The Wall Street Journal* agree: "The drive to squeeze every last tax dollar out of Internet shopping isn't about voters, fairness, simplification, harmony or financing highways. It is about public power. Right now, the Governors and their friends at the National Association of Counties and the U.S. Conference of Mayors have a lot of power, a good share of it derived from sales tax revenues. Naturally, they want more."[17]

"Government has sound public policy reasons to free the Internet and the commerce it generates from taxes and the regulatory burdens and privacy intrusions necessary to enforce a sales tax system."

We, like Governor Gilmore, second the *Wall Street Journal*'s recommendation, made in that same editorial: "As long as we as a nation do not embed in federal law a general limit to the public-sector's tax take, we will constantly be fighting off money grabs like the Governors'. How about a commission on the proper role—and size—of government in the 21st century?"

Governor Gilmore explains his perspective this way:

> By burdening Internet consumers with new tax burdens, by imposing new tax collection millstones upon Internet-based entrepreneurs, or reporting all sales transactions to third-party tax collection agents of the government who would view the private purchases of each consumer, the evidence is clear that government would severely inhibit the economic growth of the Internet economy and particularly impact small Internet entrepreneurs and consumers.
>
> University of Chicago Professor Austan Goolsbee presented to the [Advisory] Commission [on Electronic Commerce] compelling evidence that the volume of sales over the Internet would decline 30 percent if sales taxes were imposed on Internet commerce. That impact is confirmed in survey after survey . . . .
>
> In return for inhibiting the growth of the Internet economy, governments would increase their sales taxes by approximately 1 percent of the sales tax base over the next four to five years. Professor Goolsbee estimates that by 2003, sales taxes on Internet-based sales would amount to no more than 1.4 percent total sales taxes collected nationally. To the extent many on-line consumers are switching from catalogues to the Internet, the 1.4 percent largely reflects a revenue-neutral shift for state and local tax collectors.
>
> But the costs of impeding the Internet economy's growth and the public and private benefits attendant to that growth could be far greater than an addition of 1.4 percent in sales tax collections for governments. Therefore, government has sound public policy reasons to free the Internet

[17] "Governors' Internet Grab," *The Wall Street Journal*, December 20, 1999, p. A26.

and the commerce it generates from taxes and the regulatory burdens and privacy intrusions necessary to enforce a sales tax system at its inception . . . .

Professor Goolsbee estimates that a substantial portion of on-line shoppers are new shoppers and concludes that, at present, research 'does not seem to point to intense competition between retail and online commerce at present—consistent with the notion of Internet as trade creator.' Thus, there is little evidence that shopping malls and Main Streets will be put out of business by the Internet in the same way malls put Main Streets out of business over the last three decades. According to the evidence, it is just as likely that purchases in stores will continue to increase. It is equally evident that sales taxes on purchases in stores will continue to increase and that proposals to tax Internet commerce represent an effort to tax new commercial activity (or at least commercial activity shifting from catalogues to the Internet).

All businesses will compete equally when they compete on the Internet.

In any event, tax freedom on Internet-based transactions regardless of where a business has physical nexus will create an even playing field for all retailers, even those national chains that adapt to a 'click and mortar' model. All businesses will compete equally when they compete on the Internet.

Failure to provide tax-free trade over the Internet within the United States will necessarily lead to businesses locating offshore to gain an advantage over domestic businesses, especially in the service, digital goods and information sectors . . . . Congress should consider the probability that some Internet merchants, especially those who sell digital goods, would simply locate off-shore somewhere in a place that doesn't require them to ask consumers questions about where they live or to collect sales taxes.

For all of these reasons, American public policy should embrace the Internet and the borderless economy it creates rather than impose old ways of thinking and antiquated locus-based tax structures upon it.[18]

Massachusetts Governor Paul Cellucci joined Governor Gilmore in taking a similar position when he testified on February 2 before the Senate Budget Committee.

Does the growth of online shopping pose a threat to traditional "bricks-and-mortar" retailers?

The most pertinent answer to that question is yet another question: Do catalog sales pose a threat to "bricks-and-mortar" retailers?

Like Internet sales, catalog sales involve greater convenience for the shopper: No trip to the store or the mall. And they have been a reality in America for decades. Yet, catalog

[18] James Gilmore, "No Internet Tax." Proposal to the Advisory Commission on Electronic Commerce, November 9, 1999, available at http://www.state.va.us/governor/newsre/nitprop.htm.

sales have not devastated traditional retailers. Why? Because both catalog sales and e-commerce have—and always will have—a decisive disadvantage in relation to traditional retail sales: the inability of the consumer to examine hands-on the goods to be bought.

The latest figures available bear out this counsel of common sense. E-commerce, while thriving, still only constitutes a tiny fraction—about three-tenths of one percent—of all retail sales. E-commerce poses no danger of large income losses for traditional retailers and indeed, the Web offers new sales opportunities for every business. Because of the relatively low cost of setting up and maintaining a Web page, this is especially true for small firms.

Moreover, in the words of Cato's Aaron Lukas,

> Because they cater to a customer's desire for a hands-on experience, local stores don't charge for shipping and offer immediate gratification and so will probably always dominate retailing. What's more, shopping is for many people a pleasurable social experience that cannot be duplicated online. Thus, Internet sales won't destroy 'real' retailers, just as catalog sales haven't.[19]

Besides, if e-commerce really posed a threat to traditional retailers, as proponents of taxing the Internet believe, this would simply provide the strongest sort of economic incentive for those retailers—who always are looking for ways to keep up and surpass their competition—to get their own Web sites up and running.

Already, the very existence of Web commerce, opening as it does a new venue for sales, with the potential for reaching a wider circle of customers, has inspired the more competition-minded retailers to set up their own Web sites. If competition from e-commerce were to intensify, this would merely increase the economic incentive for retailers to get on the Internet. A more intensified level of competition would ensue, with benefits going to customers who buy more and retailers who sell more and better products.

As Citizens Against Government Waste wrote in a recent report:

> . . . traditional retailers and Internet sellers are not mutually exclusive. Many traditional retailers have established an Internet presence, which allows them to avoid the burden of high taxation when they sell to customers outside their state. To claim that taxing the Internet will protect traditional retailers is reminiscent of the claim that the Berlin Wall protected East Berliners.[20]

Conclusion: No one has anything to fear—and we have everything to praise—about the effect e-commerce is having and will have on retail commerce in America.

[19] Aaron Lukas, *Ohio Doesn't Need to Tax the Net*, Washington, DC: Cato Institute, April 1, 1999.

[20] Thomas A. Schatz, quoted in a news release from Citizens Against Government Waste, "Control, Alt, Delete: How Taxation Threatens to Shut Down Commerce on the Internet," February 16, 2000.

Why does the 300,000-member National Taxpayers Union (NTU) oppose Internet taxation?

In support of Massachusetts' Governor Paul Cellucci's statement opposing Internet taxation before the U.S. Senate Budget Committee, NTU noted

> Internet businesses and 'servers' can be located anywhere, and can respond to taxation by moving out of the U.S. Attempts to tax Internet services or to put up 'tax gates' on millions of Web sites under thousands of government jurisdictions would lead to administration nightmares beyond those created even by Value Added Taxes.
>
> A study last year by the National Bureau of Economic Research concluded that applying existing sales taxes to the Internet would slash the number of online buyers by 25 percent and plummet purchases by 30 percent or more—thereby damaging one of the leading sectors in America's booming economy. Even the Federal Communications Commission agrees with this sentiment, recommending a 'hands-off' approach in a recent report.[21]

High sales taxes are a major detriment to the poor simply because poor households spend a larger portion of their earnings on consumption.

Does tax-free Internet shopping disproportionately hurt the poor?

No, it is at worst neutral toward the poor but far more likely a genuine help. And applying taxes to the Internet would, in any event, not help the poor at all.

The pro-tax argument goes like this: Since low-income individuals are the least likely to have Internet access, they are the least able to shop on-line. The poor will end up paying the lion's share of sales taxes as wealthier citizens escape sales taxes through untaxed Internet purchases.

To begin with, high sales taxes are already a major detriment to the poor simply because poor households spend a larger portion of their earnings on consumption and are thus more sensitive to sales tax rates. That is why most states, including Michigan, exempt purchases of essential items from sales taxes. Aaron Lukas points out that

> If such exemptions work, then low-income households won't be affected by the growth of online shopping since most of their purchases are already tax-free. If the exemptions are ineffective, then the Internet at least offers a chance for the poor to escape punishingly high sales tax rates.[22]

In Michigan, the sales tax burden at six percent today is 50 percent higher than it was before Proposal A hiked it from four percent in 1994. Making sure the poor cannot escape

[21] National Taxpayers Union, "Nation's Largest Taxpayer Group Praises Governor Cellucci's Support for a Tax-Free Internet," news release, February 2, 2000.

[22] Aaron Lukas, "A Poor Excuse for Internet Taxes," Washington, DC: Cato Institute, January 4, 1999.

paying six percent by imposing sales taxes on Internet purchases may assuage some egalitarians' troubled consciences, but it hardly extends a helping hand to anybody.

Does the Internet hold much appeal or promise to the poor, to inner-city residents, or to minorities?

Cato's Lukas and many other experts say yes. Lukas argues as follows:

> The Internet is especially valuable to inner-city residents. Lower-income urban shoppers can go online to find goods and services not available in their own neighborhoods, which often aren't served by traditional stores. A recent study conducted by PricewaterhouseCoopers and the Initiative for a Competitive Inner City (ICIC) concludes that inner-city residents with access to computers and the Internet use the Web as often as, and sometimes more frequently than, does the general U.S. population. Catalog shopping has long been popular among inner-city residents; the Internet merely expands the mail-order option.
>
> As Carl Steidtmann, chief retail economist at PricewaterhouseCoopers, notes, 'Bricks-and-mortar retailers have virtually ignored the inner cities, so it is natural that consumers there would look for other places to shop. The Internet opens doors for these people that they never saw before.'
>
> Affluent households shop more online only because they are more likely to have access to a computer. The ICIC study found that 30 percent of inner-city shoppers have computers at home compared to 50 percent of the general population.
>
> But that too is changing. As far back as 1996, a survey by Wirthlin Worldwide found that Internet use by people earning less than $15,000 per year had increased by as much as 160 percent. And this year the Commerce Department reported that from 1994 to 1998, computer ownership by whites increased 72 percent, while ownership by blacks increased 125 percent. Such trends have led Novell's Eric Schmidt to predict, 'At the current rate of growth every man, woman, and child on the earth will be connected to the Internet by 2007.'
>
> Given that 98 percent of Americans have color televisions, and 88 percent have VCRs—technologies that once were prevalent only in upper-income households—Schmidt's prediction is almost certain to come true. Families that don't have computers now are going to have them soon, and they're going to use them for shopping.[23]

[23] Aaron Lukas, "A Poor Excuse for Internet Taxes," Washington, DC: Cato Institute, January 4, 1999.

While privatization of many government functions is often a good idea, tax collection is probably one function of government that should not be privatized.

Would widespread taxation of Internet transactions threaten personal privacy?

Quite possibly. There are good reasons to be concerned about the threat to privacy from proposals to tax e-commerce, especially the proposal of the National Governors' Association.

This year, the state of Michigan, in an effort to collect "use" taxes, inserted a line (Line 30) in 1999 state income tax forms which specifically requests that citizens report their total online and interstate catalog purchases and pay the six-percent tax. It is highly unlikely that Michigan citizens will suddenly begin to tally the transactions they made last year via the Internet, catalogs, mail order, or 1-800 numbers and pay the tax, but the very insertion of Line 30 introduces a fundamentally new element in sales and use tax collection. It strips away the traditional anonymity of the taxation of personal purchases.

Heretofore, one of the positive features of a sales tax (or a use tax, for that matter) has been that it is a fairly anonymous tax. When you make a purchase in a store, you pay the tax to the vendor and then leave the store. No information is collected about the consumer and the state does not attempt to track individual purchases by citizens. That could all change now with the state's new emphasis on collecting so-called "use" taxes through Line 30 of state income tax forms. We may have even more to fear if Michigan adopts a "trusted third party" tax collection system as proposed by the National Governors' Association.

The NGA plan would effectively deputize third-party tax collectors to carry out the government's business of tax collection. Governor John Engler has been all too eager to volunteer Michigan citizens as guinea pigs to test out such a system. While privatization of many government functions is often a good idea, tax collection is probably one function of government that should not be privatized. Citizens are rightly concerned about private parties having access to their credit card numbers and personal buying habits without their express authorization.

Policy Recommendations

If government doesn't tax Internet purchases, what alternative policies make sense? Constructive alternatives have been proposed by Adam Thierer who, in addition to his position as a policy analyst for The Heritage Foundation, is an adjunct scholar with the Mackinac Center for Public Policy. In his own words, Thierer proposes the following:

1. Extend or broaden the current tax moratorium.

Members of Congress have introduced legislation which would make permanent the Internet Tax Freedom Act's current moratorium on Internet taxation. It is important to stress, however, that while extending or making permanent this moratorium makes sense, it would not necessarily prohibit the imposition of all forms of taxation of the Internet, especially sales taxes. The Internet Tax Freedom Act prohibited "multiple and discriminatory taxes," as well as "access taxes," but did not outlaw all forms of Internet taxation.

In fact, Section 1101(b) of the ITFA went so far as to preserve state and local tax sovereignty by stating explicitly that

> Except as provided in this section, nothing in this title shall be construed to modify, impair, or supersede, or authorize the modification, impairment, or superseding of, any State or local law pertaining to taxation that is otherwise permissible by or under the Constitution of the United States or other Federal law and in effect on the date of enactment of this Act.

Therefore, even though "multiple and discriminatory" or "access" taxes would still be prohibited under an extended ITFA moratorium, Congress would have to do one of two things to keep a plan like the NGA's from taking effect: either prohibit all sales and use taxes on electronic commerce or Internet activity, or codify and clarify current Supreme Court jurisprudence regarding taxable nexus.

The Internet Tax Freedom Act prohibited "multiple and discriminatory taxes," as well as "access taxes," but did not outlaw all forms of Internet taxation.

Representative John Kasich (R-Ohio) and Senator John McCain (R-Arizona) have introduced legislation (H.R. 3552, S. 1611) that embodies the first option. However, although their approach has great appeal and would end the debate over Internet taxation, it also raises several concerns.

First, the Kasich-McCain bills would prohibit only sales taxes imposed on electronic commerce. But what about mail order, catalog, direct phone (1-800), or other current or future forms of interstate retailing? Failure to grant these forms of interstate commerce similar protections would represent a serious breach of tax equity or regulatory parity.

Second, the Kasich-McCain approach could be found unconstitutional. The Supreme Court recently has held Congress to a higher standard when federal legislators have tried to preempt state and local authority under the Commerce Clause.[24]

University of Georgia law professor Walter Hellerstein has argued that "these [Supreme Court] decisions do not seriously inhibit the extensive power that Congress plainly possesses to deal with the broad range of problems raised by state taxation of electronic commerce."[25]

Nevertheless, an argument can be made that the Kasich-McCain approach is too broad and would infringe on the sovereign rights of state and local governments to determine tax policies within their own jurisdictions.

[24] See, for example, U.S. v. Lopez, U.S. 93-1260 (1995) and *Printz* v. *United States*, U.S. 95-1478 (1997).

[25] Walter Hellerstein, "The Law of Sales Taxes in a Cyber Economy," presentation to the Advisory Commission on Electronic Commerce, Williamsburg, Virginia, June 22, 1999.

2. Adopt a clear and constitutional nexus standard.

A better approach would be to clarify and codify constitutional and Supreme Court precedents regarding the taxation and regulation of interstate commerce. Congress could do this by adopting an unambiguous nexus standard that conforms to existing Supreme Court jurisprudence and constitutional objectives. Both Governor James Gilmore, chairman of the Advisory Commission on Electronic Commerce (ACEC), and Dean Andal, ACEC member and vice chairman of the California State Board of Equalization, have made presentations to the commission that embody this approach.

The fact that an electronic transaction passes through a network of wires, computers, servers, or wireless satellite dishes that may be located within a given state does not by itself mean that a company has a substantial physical presence within that jurisdiction.

Andal's "Uniform Jurisdictional Standard" asks the ACEC to lend its formal support to the Supreme Court's physical presence test, which makes it clear when state and local governments have the right to impose sales taxes.[26]

Specifically, it would modify an existing federal law, Public Law 86-272, which deals with state income taxation of companies engaged in interstate commerce. The Andal proposal would broaden Public Law 86-272 to cover all forms of state and local taxation of interstate commerce, not merely income taxes, and clearly define what constitutes a "substantial physical presence" in a state or locality and when that test is not satisfied.

For example, the fact that an electronic transaction passes through a network of wires, computers, servers, or wireless satellite dishes that may be located within a given state does not by itself mean that a company has a substantial physical presence within that jurisdiction. Furthermore, the fact that a firm's Web page is advertised or promoted within a state or locality does not necessarily mean that the company is physically present within that jurisdiction.

Many state and local officials and tax officials have tried to replace traditional nexus standards with new theories, such as "attributional," "representational," or "agent" nexus that attribute physical presence to a company in cases such as those discussed above. It is vital that the ACEC and Congress reject these new definitions. As Saba Ashraf, an associate with the New York law firm of Winthrop, Stimson, Putnam & Roberts, notes, "By changing and expanding the definition of physical presence, and in effect equating nonphysical presence in a state with physical presence, the state legislative bodies would be writing the constitutional requirement of physical presence out of existence."[27]

Physical presence must mean what most rational individuals take it to mean: the actual, tangible presence of a company's buildings, employees, and related property within the boundaries of a state or locality.

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[26] Dean Andal, *A Uniform Jurisdictional Standard: Applying the Substantial Physical Presence Standard to Electronic Commerce.* Presentation to the Advisory Commission on Electronic Commerce, September 15, 1999, revised November 5, 1999.

[27] Saba Ashraf, *Virtual Taxation: State Taxation of Internet and On-Line Sales*, p. 628. For an excellent overview of these new nexus theories, see Karl A. Frieden and Michael E. Porter, *The Taxation of Cyberspace: State Tax Issues Related to the Internet and Electronic Commerce*, Part IV: Nexus Issues, December 1996, at http://www.caltax.org/andersen/contents.htm.

3. Require that any sales taxes imposed on Internet sales be origin-based so that they will be consistent with the U.S. Constitution and prevailing nexus standards.

State and local leaders may fear that extending the Internet Tax Freedom Act and codifying a nexus standard would prohibit them from collecting any sales taxes on electronic transactions. As mentioned above, however, the ITFA and existing Supreme Court nexus jurisprudence do not prohibit all forms of taxation. What they do prohibit, respectively, is "multiple" or "discriminatory" Internet taxes and extraterritorial taxation of remote vendors of commerce in general—exactly the sort of burden that would be imposed by the NGA plan.

Adoption of an origin-based (or "seller-state") system of sales tax administration "technically would take care of a lot of these problems," argues ACEC member Gene Lebrun, former president of the National Conference of Commissioners on Uniform State Laws. "I think we've got to think outside the box to resolve these issues."[28]

Vendors would not be required to remit taxes to states or localities outside their home territory, where they have no physical presence.

Commissioner Lebrun is correct, because under an origin-based system, sales taxes would be collected at the source, or point of sale, instead of at the destination, or point of consumption. All commercial vendors (including Internet vendors and mail order companies) would be required to collect the sales taxes owed to governments within the state or location where they have a substantial physical presence. They would not be required to remit taxes to states or localities outside their home territory, where they have no physical presence.

Terry Ryan, director of state and local taxes for Apple Computer, and Eric Miethke, a partner with the Sacramento-based law firm of Nielsen, Merksamer, Parrinello, Mueller, & Naylor, have detailed the many advantages an origin-based system would have in practice.[29] According to Ryan and Miethke, an origin-based or seller-state system would

- **minimize the burden on sellers** by requiring sellers to know and abide by only the tax rates and regulations within their principal place of business;
- **maximize the amount of tax collected for states** by making compliance easier and incorporating activity (such as foreign shipments) that currently are untaxed;
- **remove nexus uncertainty and constitutional concerns** by taxing only companies within a state or local government's borders;
- **eliminate the threat of double taxation** by imposing taxes only once, at the point of sale;

[28] Quoted in "Sales Tax Calculation, Compliance a Heavy Load for Internet Businesses," *Electronic Commerce News*, Vol. 4, No. 37, September 13, 1999.

[29] Terry Ryan and Eric Miethke, "The Seller-State Option: Solving the Electronic Commerce Dilemma," *State Tax Notes*, October 5, 1998.

- **preserve local jurisdictional tax rights** instead of adopting a harmonization proposal like the NGA plan, which would create a de facto national sales tax;

- **respect privacy rights** by not requiring that any special information be collected about a buyer and by not empowering a third party tax collector to collect information about buyers;

- **respect federalism principles and preserve jurisdictional tax competition** by permitting each state to determine its own tax policies and encouraging healthy state-by-state tax rivalry; and

- **be more politically feasible**, since it remains unlikely that Congress will alter existing nexus standards and allow extraterritorial taxation by state and local governments.

There is no need to impose a confusing, top-down system of sales tax collection on America.

Andrew Wagner, staff director of tax law with the FDX Corporation, and Wade Anderson, former director of tax policy for the Texas Comptroller of Public Accounts, have submitted a formal proposal to the commission that outlines how such an origin-based system would work.[30]

Though their proposal is tailored to the sale of digitized products sold over the Internet, they argue that an origin-based system could be applied to all types of sales.

Wagner and Anderson also conclude that an important advantage of an origin-based system is that it "represents a bottom-up approach to the question rather than a top-down approach." There is no need to impose a confusing, top-down system of sales tax collection on America when state and local governments could move directly to a much more straightforward, bottom-up system of origin-based sales tax administration on their own.

Many state and local officials continue to fear that an origin-based system of sales taxation would cause a "race to the bottom" by encouraging some states or localities to lower tax rates, or even to create tax-free "tax havens" to attract commercial vendors to their jurisdictions. The question is: Why should this sort of vigorous jurisdictional tax competition be considered such a lamentable development?

Indeed, this is exactly what the Founders hoped would occur in the federalist system of government they created. By allowing states and localities to tailor their tax systems to their own needs and simultaneously allowing companies and consumers to "vote with their feet" by shopping around for favorable tax and regulatory environments, an origin-based system of sales taxation would enhance and reinvigorate federalism in the United States. If "race to the bottom" fears persisted, a revenue-sharing compact could be arranged among the states to redistribute revenue more evenly.

[30] Andrew Wagner and Wade Anderson, *Proposal of an Origin Based Tax Solution for the Possible Taxation of Digitized Products Sold Over the Internet*. Proposal to the Advisory Commission on Electronic Commerce, November 8, 1999, at http://www.ecommercecommission/org/proposal.htm.

Arguments for destination-based "use" taxes on interstate commerce and against an origin-based sales tax system are parochial attempts to protect in-state vendors and avoid rigorous jurisdictional tax competition. As Dean Andal appropriately concludes, "The use tax is not a surrogate consumption tax as some would suggest. It was a device conceived to protect in-state merchants."

4. Address broader telecommunications tax issues.

America's increasingly competitive communications sector also remains one of its most heavily taxed. As Progress and Freedom Foundation President Jeffrey A. Eisenach asks,

> . . . in a world in which building out the telecommunications infrastructure is policy goal Number One—why would we place discriminatory taxes on telecommunications? And we're not talking about small taxes, either. We're talking about levels of taxation between 20 and 40 percent, depending on the state and the locality . . . . We're talking about a level of complexity that is just stunning. There are 38 different kinds of taxes paid by telecommunications companies just in the telephone business . . . . The tax structure that we have is not only too high, it's also regressive. Virtually all of the taxes that we levy on telecommunications providers are excise taxes or line taxes, line charges, equivalent of poll taxes. And so they go directly against our objective of making Internet access and the information revolution available to people regardless of their income.[31]

America's increasingly competitive communications sector also remains one of its most heavily taxed.

Among the taxes that most deserve the attention of Congress and members of the ACEC are the following:

- **The federal three-percent excise tax on telecommunications.** Put in place during the time of the Spanish-American War of 1898, this tax is an anachronism and should be repealed immediately.

- **Discriminatory *ad valorem* taxation of interstate telecommunications.** Fifteen states tax telecommunications business property at rates higher than other property, driving up costs for consumers. Federal protections against such taxes—already in effect for railroads, airlines, and trucking—should be extended to telecommunications.[32]

- **Internet tolls.** These new taxes and fees levied on telecommunications providers and their customers when cable is installed along highways and roads can run up to

[31] Jeffrey A. Eisenach, "Speech Before Winter Meeting of the National Governors' Association," February 21, 1999, at http://www.pff.org/NGA_speech_by_JAE_990221.htm.

[32] See also Dean Andal, *A Prohibition on Discriminatory Ad Valorem Taxation of Interstate Telecommunications: Encouraging Investment in Internet Infrastructure through Equitable State Tax Treatment.* Proposal to the Advisory Commission on Electronic Commerce, December 15, 1999.

five percent of gross receipts. They drive up costs for consumers and should be abolished. Congress should make clear that the 1996 Telecommunications Act intended only that state and local governments be reimbursed for actual costs incurred in managing public right of ways.

- **High state and local telecommunications taxes and complicated auditing and filing procedures.** Many governments are using consumer telephone bills as cash cows, imposing multiple high taxes on services. Such taxes should be cut to a single tax per state and locality, and filing and auditing procedures should be streamlined.

- **Internet access taxes.** The temporary federal ban on Internet access taxes should be made permanent. States and localities that imposed such taxes before the ban took effect should repeal any taxes on access to keep costs down for consumers.

Politicians should view the Internet as what it is: a means to a more promising future for everyone.

Even if the ACEC and Congress do not reach agreement on the issue of Internet sales taxation in the short term, they should, at a minimum, undertake immediate action to eliminate or reform these costly telecom industry tax burdens.

Conclusion

The economic case for keeping the Internet tax-free is compelling. To begin with, states do not need the money. State governments are awash in tax revenues, with a total surplus this year in the neighborhood of $36 billion. Michigan is cutting taxes while it enjoys a huge budget surplus, a "Rainy Day Fund" in excess of $1.2 billion, a bulging School Aid Fund, and record per-pupil spending in the public schools.

A healthy economy fueled by Internet technology is an important factor in the current boom that is filling government coffers. The Internet represents a new world of enterprise, increasingly easy for both buyers and sellers to access. Rather than looking for ways to take a chunk of it, politicians should view the Internet as what it is: a means to a more promising future for everyone.

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Reed is author of over 800 columns and articles which have appeared in newspapers and magazines including *The Wall Street Journal*, *Investor's Business Daily*, *Policy Review*, *The Detroit News*, the *Detroit Free Press*, and dozens of other publications in the U. S. and abroad. In addition, he has written or edited five books and delivered over 800 speeches in 40 states and 10 foreign countries. His interests in political and economic affairs have taken him as a freelance author to 56 countries on six continents since 1985.

Reed is currently serving a third year as chairman of the board of trustees of the Foundation for Economic Education (FEE) in Irvington, New York. He is a regular columnist for FEE's monthly journal, *Ideas on Liberty*.

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