

Subj: Economic Impact: Perspectives of Americans For Tax Reform
From: Ron Nehring, 858 794 2338
Americans For Tax Reform (ATR)
To: Internet Caucus Advisory Committee

Don't Tax Cyberspace: Internet Fuels Economic Growth

By Ron Nehring, Washington Times, December 13, 1999

Tax the Internet? Now there's an idea only a politician could love. Nevertheless, when a Congressional commission meets in San Francisco next week, the agenda will be dominated by all kinds of proposals to saddle the Internet with new taxation schemes.

In 1998, Congress passed and the President signed Rep. Christopher Cox's Internet Tax Freedom Act (ITFA), which set a three-year ban on special taxes on Internet access and goods sold over the Internet (e-commerce). The law also created the Advisory Commission on Electronic Commerce to study the various tax issues surrounding the Internet, and make its recommendations to Congress by April 2000. The Commission is about to hold its second-to-last meeting, and its pro- and anti-tax factions are set for a high-tech showdown that will have a major impact on the California economy.

The stakes could not be higher. The Commerce Department reports that one-third of America's economic growth between 1995 and 1998 is directly attributable to our surging high-tech sector, with the Internet as its backbone. Falling prices for technology products reduced inflation by a full percentage point in 1996 and 1997. Jobs in high-tech pay an average of \$55,000 per year, compared to the national average of \$30,000.

For California, information technology is even more important to overall economic growth. The Golden State's high taxes and burdensome regulatory regime make it unfriendly to low-skill manufacturing when compared to other regions. High tech is one sector where California enjoys an advantage over other Western states, and Mexico. Growing technology enclaves in San Diego, Orange County and San Jose are driving property values and wages up, and unemployment down. Growth in high-tech spills over into other areas. The rising tide floats all boats.

All of this is put at risk by the new Internet tax collection schemes being floated by a group of governors, mayors, and other politicians. Unsatisfied with the unprecedented budget surpluses they now enjoy due to the growing economy, the politicians represented by the National Governors Association (NGA), National League of Cities, and other big-government groups are waging an intense lobbying and public relations campaign to create a national sales tax collect scheme for the Internet.

Austan Goolsbee of the University of Chicago Business School studied the question of just what would happen if existing sales taxes were applied to the Internet. His conclusion: forcing companies doing business online to collect sales taxes would force the e-commerce market to shrink by 24% or more. Many Internet startups are already operating on very tight margins, or to choose one high profile example, Amazon.com continues to lose millions every year. Making 1-in-4 online customers disappear would drive many of these Internet

ventures deeper into the red, or out of business altogether. Fewer vendors means diminished demand for programmers, web designers, technicians, graphic artists, and the servers, routers, PCs and networks they work on.

Besides the impact new tax collection schemes would have on the economy, the plans floated by the NGA and other groups pose Constitutional problems. Under established case law, no state may require companies without a presence in its borders to collect and remit its sales taxes, and the Constitution gives Congress sole authority to regulate interstate commerce. By empowering each state to export its tax collection schemes beyond its borders, the politicians rely on a view of interstate commerce that went out with the Articles of Confederation.

With Congress showing no interest in giving the states the expanded taxing authority they want, the politicians are planning to do what they often do when the American people don't support what they're up to: they turn to the courts. The U.S. Supreme Court reinforced limits on states taxing outside of their borders in *National Bellas Hess, Inc. v. Department of Revenue of Illinois* (1967), and *Quill Corp. v. North Dakota* (1992). The court reasoned that requiring a single vendor to comply with the sales tax laws of 6,600 separate taxing jurisdictions, each with its own tax bases, auditing and reporting requirements, would pose an unacceptable burden on interstate commerce. Knowing this, the politicians have now developed a plan to get around the court's reasoning in *National Bellas Hess* and *Quill* by shifting the tax collection burden from vendors to so-called "trusted third parties." Under the plan, vendors would report all sales to the "trusted third party" (which could be anything from a state revenue agency to the United Nations), which would then collude with your credit card company to layer a sales tax on top of all your Internet purchases. This plan, which some might have thought only George Orwell could concoct, lays the foundation for an effort to overturn more than 200 years of Constitutional law governing interstate commerce.

So why go through all the trouble of devising a new, constitutionally questionable national sales tax collection scheme that could have severe economic implications for workers, consumers and taxpayers? Ronald Reagan understood the answer to this long before the Internet became a household word when he explained that the liberal worldview is one of, "if it moves tax it, if it keeps moving regulate it and if it stops moving subsidize it." The advocates of big government see the Internet and new telecommunications technologies growing and they are anxious to muscle in on this action.

Ron Nehring is Director of National Campaigns for Americans for Tax Reform. More information is available on the Internet at www.e-freedom.org

Subj: Economic Impact: Perspectives of IPI: Center for Technology Freedom
From: Bartlett Cleland <bcleland@ipi.org, (972) 874-5139>
 Institute for Policy Innovation
To: Internet Caucus Advisory Committee

Table 3

STATE & LOCAL BUDGET SURPLUSES AS PERCENT GDP	
Year	Percent GDP
1993	1.3
1994	1.4
1995	1.7
1996	1.6
1997	1.7
1998	1.7

Source: The Federal Budget for Fiscal Year 2000, Historical Tables.

Table 2

PRODUCTIVITY GROWTH	
YEAR	PERCENT
1993	0.1
1994	1.3
1995	0.7
1996	2.9
1997	2.2
1998	2.8
1999	3.0

Source: Economic Indicators, January, 2000, published by the President's Council of Economic Advisers for the Joint Economic Committee.

Budget Surpluses As Far As The Eye Can See.

Despite what the public might have been led to believe, companies that do business on the Internet carry their own weight. There are no additional legal and constitutional protections extended to them that traditional "bricks-and-mortar" businesses do not already enjoy.

Furthermore, neither the federal government nor the states are in need of additional revenue that would justify placing new taxes on the Internet. Productivity growth and the stock market have soared since the introduction of the Internet, and with it capital gains tax revenues, income tax revenues and sales tax revenues all have surged, putting an end to the myth fostered, in part, by the Internet tax moratorium that the Internet is getting special treatment and a tax-free ride. In fact, it is becoming clear that the untaxed Internet has actually been the source of much of the revenue surge flowing into Washington and state capitals.

If revenues continue coming into the federal Treasury at their current pace, this year will mark the eighth consecutive year in which the growth of federal revenues has outstripped

the growth of gross domestic product. Indeed, from 1994 to 1998, revenues rose at an average rate of 8.3 percent a year, much faster than GDP. Consequently, revenues as a percentage of GDP increased from 18.1 percent in 1994 to 19.9 percent in 1998. Although revenue growth slowed to 6.1 percent in 1999, it still exceeded GDP growth and boosted the ratio of receipts to GDP to a postwar high of 20 percent. The Congressional Budget Office (CBO) projects that even if productivity growth slows from the torrid 6-percent annual rate chalked up in the fourth quarter of 1999 and if average economic growth falls below three percent a year, revenues will remain near 20 percent of GDP for years to come.¹⁶

As a result of the economy's Internet-driven performance, the federal government is facing large budget surpluses as far as the eye can see. The CBO projects total surpluses of \$3.152 trillion over the next ten years.

State governments also enjoy flush fiscal times. Total state revenues from all sources—including taxes on businesses, individual income, sales, and property, and other excise taxes and fees—also have been rising consistently throughout the first few years of the Internet era. State and local revenue growth from 1996 through 1998 averaged 5.6 percent a year. Combined state and local revenues as a share of GDP hit an all time high of 11 percent in 1995 and remain near that high point today at more than 10.7 percent. As a result of this healthy revenue growth, states are in surplus, and that surplus continues to grow.

Not only have total state and local revenues risen but state sales tax collections in particular have risen consistently since the advent of the Internet. In 1994, the year Netscape made the Internet browser famous, states collected \$123 billion in sales taxes. By 1995 when the first real e-commerce transactions had been registered, states collected \$132.2 billion in sales taxes. As Internet use and e-commerce proliferated, sales tax revenues did not shrink but continued to rise. States collected the following amounts of sales tax revenue: \$139.4 billion in 1996, \$147.1 billion in 1997, and \$155.3 billion in 1998. A recent CATO Institute study showed that state sales tax revenues grew at nearly twice the rate of inflation between 1992 and 1998,¹⁷ and they grew at an even faster pace last year: 7.3 percent in the last quarter of 1999, over the same period in 1998.

Subj: Economic Impact on States: Perspectives of IPI: Center for Technology Freedom
From: Bartlett Cleland <bcleland@ipi.org, (972) 874-5139>Institute for Policy Innovation
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Would States Lose Revenue?

When consumers choose to buy a product or service online rather than in a retail outlet, in most cases they avoid any applicable sales taxes, which means a state loses that revenue. A retailer selling a \$1,000 computer might have to charge a purchaser, say, \$80 in sales tax, while that same customer might be able to buy the computer tax free over the Internet—thus saving the customer \$80, less shipping costs, and costing the state \$80 in revenue.

Tax proponents contend that over time and as e-commerce grows, states will lose significant amounts of revenue, threatening essential services that the public has come to want and expect. For example:

* Economist Henry J. Aaron of the Brookings Institution has written, "Whatever its strengths, however, e-commerce hasn't eliminated the need for schools, fire departments, police forces, parks, libraries, health care and other government services and for the revenue to maintain them." The implication, of course, is that without an Internet sales tax, these services would be threatened.

* Joseph Brooks, a councilman for the city of Richmond, Virginia, speaking on behalf of the National League of Cities, National Association of Counties, U.S. Conference of Mayors, National Conference of State Legislators, National Governors' Association, Council of State Governments and International City/Council Management Association, has said: "We believe the lost revenue from tax-free online shopping will be significant—between \$9 and \$11 billion by 2004. If our sales taxes shrink dramatically or even disappear because of tax-free online shopping, we will be forced to raise taxes in other areas to provide essential public services like police and fire protection and public education."

* "None of us wants to pay taxes," Dallas Mayor Ron Kirk, a member of the Advisory Commission, has said with regard to taxing the Internet, "but you certainly don't want the phone to go unanswered when you have a fire, or when you have a need for police."

The assumption behind this argument is that if online sales increase, state revenues will decrease. That is not necessarily true. Both retail sales and state sales tax receipts have continued to grow during the decade of the 1990s, even with the growth of Internet sales.

How can sales tax revenues continue to grow while more people buy online? Several reasons.

1. First, although people like to point to aggregate online sales, many of these purchases would not be taxed if bought in-state. For example, online pharmaceutical sales have been growing rapidly, but prescription drugs are not generally subject to the sales tax. In addition, many people purchase such items as airline tickets online, which are not typically subject to state sales taxes.

2. States have various ways of collecting at least some of the sales and use taxes for out-of-state mail order and online purchases. California is collecting taxes on out-of-state cigarette purchases. And Texas collected \$1 billion in use taxes in the last budget year, according to the state comptroller's office.

3. There is an assumption that there is a direct trade-off between an online purchase and a lost retail sale. However, online consumers are just as subject to impulse buying as those shopping retail—perhaps moreso in certain areas such as technology products. They might never have bought the product if they had to get in a car and go to the store. In other words, a retail outlet didn't necessarily lose the sale because the consumer had no intention of going to a retail store to buy it.

4. Finally, online sales have a "multiplier effect" that spurs sales both online and in retail stores, and thus spurs economic growth. For example, online sales are helping to keep inflation down which generates more economic activity. Economists Ethan S. Harris and Joseph T. Abate of Lehman Brothers found that Internet prices average 13 percent lower than retail stores even with the shipping costs. In addition:

- Prescription drugs, which would not be subject to sales taxes, averaged 28 percent cheaper online;
- Alcohol and tobacco are 28 percent cheaper, but states have ways to collect those taxes;
- The savings for electronic products was only 4 percent;
- While toys and hardware actually cost more online than in retail stores.

Indeed, people expect to find lower prices online. According to KPMG, 60 percent of online shoppers expect to pay less when they buy something online than if they buy it in a retail store. Only 37 percent expect to pay about the same.

The price competition created by Internet sales is keeping prices down for both retail and online sales, and that spurs economic growth. Of course, this type of competition might be short-lived, and there is some evidence that online and retail sales prices might be converging. But without that competition, prices would be higher and sales would be lower—which would cost the states money.

Sales Taxes

Assessing the economic impact of taxing Internet sales is a daunting task because there is very little to compare it to and almost no previous scholarly analysis. Fortunately, Austan Goolsbee of the University of Chicago's Graduate School of Business and the National Bureau of Economic Research has managed to make an assessment of the economic impact of Internet taxes.

Goolsbee's first task was to determine the consumers' tax sensitivity (i.e., how willing they are to substitute an item with little or no tax for one with a higher tax). This type of work has already been done in border regions, where people have the opportunity to easily cross a border, say, into the next state, in order to pay a lower sales tax. Research has shown that people living in border areas are highly sensitive to taxes, according to Goolsbee.

The next step was to look at online sales in high-tax areas. "Controlling for individual characteristics, people who live in high sales tax locations are significantly more likely to buy over the Internet The estimated tax price elasticities of Internet commerce are large and resemble those found in previous studies of taxes in geographical border areas. The magnitudes suggest that enforcing existing sales taxes on Internet purchases could reduce the number of online buyers by as much as 24 percent."

Thus, Goolsbee thinks effectively imposing the current state sales and use taxes on Internet purchases could slow e-commerce by a quarter. Based on the projection that business-to-consumer sales, left unhindered, are predicted to reach about \$108 billion by 2003, that would mean a reduction of \$27 billion in the economy. And remember, people may not necessarily go to a brick-and-mortar store to buy the product if they can't get a good price on the Internet. Some of that \$27 billion will be lost economic growth.

Internet Taxation Part 2: Economic Impact of Net Taxes

Subj: Economic Impact on States: Perspectives of University of Tennessee
From: The E-Fairness Coalition, 202-789-2111
To: Internet Caucus Advisory Committee

Projected Annual Revenue Losses for States

The University of Tennessee published a report in early February that projects how much money states will lose per year by 2003 if businesses are not required to collect the use taxes that are owed by purchasers on electronic commerce.

State	\$ in millions
Alabama	269.7
Arkansas	188.6
Arizona	341.4
California	2,290.8
Colorado	290.8
Connecticut	288.0
Florida	1,403.0
Georgia	620.7
Hawaii	158.6
Iowa	162.7
Idaho	67.1
Illinois	844.8
Indiana	324.6
Kansas	189.5
Kentucky	238.6
Louisiana	453.9
Massachusetts	303.6
Maryland	294.1
Maine	78.5
Michigan	757.5
Minnesota	408.6
Missouri	395.0
Mississippi	206.1
North Carolina	444.9
North Dakota	38.6
Nebraska	105.6
New Jersey	510.7
New Mexico	191.1
Nevada	191.1
New York	1,581.3
Ohio	671.4
Oklahoma	298.3
Pennsylvania	666.8
Rhode Island	55.5
South Carolina	231.4
South Dakota	57.7
Tennessee	545.6
Texas	1,735.9
Utah	158.2
Virginia	363.8
Vermont	31.8
Washington	646.2
Wisconsin	320.1
West Virginia	104.7
Wyoming	38.5
Total	20,109.9

"E-Commerce in the Context of Declining State Sales Tax Bases"
 By Donald Bruce, Assistant Professor Center for Business and Economic Research; and William F. Fox, Director, Center for Business and Economic Research; The University of Tennessee, Knoxville, Tennessee, February 2000