Subj: Internet Taxes: Perspectives of Robb Watters
From: Robb Watters <rwatters@jeffersongr.com, (202)626-8512>
To: Internet Caucus Advisory Committee

We are at a historic juncture where Congress must decide how to ensure that the Internet and electronic commerce continue to grow. If states and local governments are allowed to set up a tax system targeting remote vendors, the end result will be to hinder one of the most rapidly growing sectors of the economy. Many are opposed to any such tax system that is discriminatory or burdensome on interstate commerce.

When the Internet Tax Freedom Act (sponsored by Sen. Ron Wyden of Oregon and Rep. Chris Cox of California) was passed in 1998 it created: a moratorium on new Federal Internet or Internet-access taxes; a declaration that the Internet should be free of international tariffs and other trade barriers; a three year prohibition through October 21, 2001 on new taxes imposed on Internet access and on multiple or discriminatory taxes on electronic commerce; and established the Advisory Commission on Electronic Commerce (ACEC) to study international, federal, state and local tax issues related to the Internet.

This legislation created a moratorium on the application of all taxes that were not already being imposed or enforced prior to October 1998. Because this tax moratorium expires after three years, Congress has only a limited window of opportunity to head off state and local taxes that will interfere with the growth of electronic commerce. The on-line world is not seeking to escape taxation all together. In fact, on-line businesses pay all the taxes that traditional businesses pay. There are presently taxes imposed on telecommunications channels; e-commerce companies pay income and other direct taxes; sales taxes are collected on in-state purchases; and state income taxes capture a generous share of the personal wealth generated by electronic commerce. For these reasons, it seems that states are merely trying to expand their authority over out of state businesses by seeking to impose sales taxes on Internet transactions.

The effect of state-imposed taxes on Internet transactions is potentially devastating. A recent Bizrate.com public opinion poll revealed that nearly 60 percent of on-line buyers would make fewer purchases if they had to pay a sales tax on all transactions. In addition to public opinion, eminent scholars have also concluded that taxing the Internet would have a disastrous effect on on-line buying. For example, University of Chicago economist Austan Goolsbee has shown that applying existing sales taxes to the Internet would reduce the number of on-line transactions by almost 25% and reduce on-line Internet spending by as much as 30%. In addition to the direct costs of Internet taxes, there are the huge compliance costs associated with multiple taxes from a seemingly endless number of state and local municipalities. Ernst and Young tax economists Robert Cline and Thomas Neubig noted that: " high compliance costs result directly from complexities built into each component of the tax system: definitions of what is taxable, multiplicity of tax rates, numerous exemptions for specific buyers or uses, overlapping jurisdictions, filing requirements and audit procedures."

The effect of such taxation would not only devastate the Internet but also harm the economy as a whole. A survey of about 1,500 traditional "brick and mortar" businesses showed that 74 percent of these establishments have gone on-line. In addition, 20 to 40 percent of these businesses' sales are a direct result of the Internet. Traditional brick and mortar businesses are becoming "click and mortar" businesses. This shift in the business paradigm will result in more income for these "click and mortar" businesses and an increased tax base for the states and local municipalities where they are located. Thus, taxing the Internet would not just damage e-commerce but harm everyone, including those who would collect such new taxes.

The ACEC report being submitted to Congress this April must allow the Internet to continue to grow and thrive. It must not impose burdensome new taxes that inhibit the entrepreneurship and record levels of economic growth coming from this sector. The imposition of the current system of state and local taxes would create a significant compliance burden on multi-state sellers. The present tax system is unwieldy and out of step with the demands of e-commerce.

By reining in the tax reach of states and local municipalities, Congress has the opportunity to uphold the principles of interstate competition, due process, and fairness, while allowing e-commerce to be free to serve as the growth engine of tomorrow's economy.

Washington's goal should be to protect the Internet from unfair restrictions. Commerce on the Internet has transformed the traditional standard of business -- especially business-to-business interaction, entrepreneurship, and consumer service. Only in the absence of unnecessary government regulation can the Internet continue to mature and prosper.

If Congress acts, it should be to block the extraterritorial taxation of electronic commerce in both tangible and intangible products. That would ensure that states and municipalities tax only those firms with a physical presence in their jurisdiction. Congress should firmly refuse to give in to demands for new taxing authority.

The tax treatment of sales over the Internet is an extremely complicated issue and one that has many factions fighting to ensure that the outcome produces a fair and equitable system. While we await Congress's action, some steps should be taken to protect consumers in the meantime. We should all support the latest effort by Rep. Cox and Sen. Wyden (the Internet Non-Discrimination Act --INDA), a bill to make permanent the temporary moratorium on new, special and discriminatory Internet taxes originally imposed under Cox-Wyden II in 1998.

It is also advisable also that for the Internet to reach it fullest potential, the moratorium needs to be expanded to include an outright ban on sales and use taxes, as well as eliminating "grand fathered in" Internet access taxes and the 3 percent telephone excise tax. (The 3 percent telephone excise tax was enacted to fund the Spanish American War over 100 years ago as a temporary luxury tax on the telephone.)

The Internet's potential is not limited to our domestic economy. Thus, the recently passed Global Internet Tax Freedom Act (Cox-Wyden III) urged the United States to seek a global consensus supporting a moratorium on tariffs and special, multiple, and discriminatory taxation of electronic commerce. The United States should play a leading role in ensuring the future of the Internet is global.

The Internet is the ultimate global marketplace and how we act at home could set the standard for those around the world.

Subj: Future of Taxation: Perspectives of IPI: Center for Technology Freedom
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To: Internet Caucus Advisory Committee

For years supply-siders and other proponents of economic dynamism and limited taxation have complained about static concepts of revenue generation, in which tax policy and tax rates are assumed to have little or no impact on the actual economic activities that generate revenues for the government. In the budget process this static notion has impeded tax reduction by underestimating the revenue take, simultaneously feeding the growth of government in an era of anti-debt mania. In the world of the tax collector this same misbegotten concept has made every technological, marketing, and pro-consumer innovation look like a new 'loophole' that must be closed lest the revenue base be 'gutted'.

Consider for a moment why public officials complain about the Internet destroying their revenue base at a time when they have more revenue than they need. One reason is that those 'rational administrators' who dominated the 20th century forgot what we knew as far back as Alexander Hamilton, who observed that sales and excise taxes 'contain limits to their own burden:' that is, at some level of taxation they reach a point of diminishing returns. An 18th century Laffer Curve, as it were. As Hamilton put it in Federalist 22, "taxes on articles of consumption … prescribe their own limit, which cannot be exceeded without defeating the end proposed—that is, an extension of the revenue. … If duties are too high, they lessen the consumption; the collection is eluded; and the product to the treasury is not so great as when they are confined within proper and moderate bounds."

It may be that these types of self-limiting taxes are more appropriate to the national government, where citizens (including corporations) have few opportunities to 'vote with their feet' as they do at the state level. Income taxes, which are not so abruptly responsive to changes in the rate (and which may be modified at the taxable base as well), may be more in need of the 'citizen exit option' to keep them under control, and for that reason may be more appropriate at the state than federal level. Hamilton recognized that direct taxes, such as those on property and wealth as well as income, lack the self-limiting nature of indirect taxes on consumption. That is why he urged explicit constitutional constraints on direct taxes, and why (prior to the 16th Amendment) the Constitution barred direct federal taxes that could not be 'apportioned' among the states, so that the federal government would be obliged to rely on self-limiting indirect taxes.

It is also worth noting that if the Internet expands as many predict, state sales taxes may indeed become obsolete unless either

1. levied and collected at the point of origin, i.e. in the 'seller state'; or
2. made nationally uniform to facilitate collection at the point of purchase.

It is this conundrum that has no doubt led many Governors to find a constitutionally dubious middle ground of nationalizing the sales tax ***de facto*** without nationalizing it in law.[41]

That kind of exchange of taxing authority needs long thought and careful consideration of how it might ever be implemented without violating the guidelines we have set forth above, particularly how to do it without increasing the overall tax burden and producing a multiplicity of revenue sources at each level of government. The business community, which is interested in a simple, consistent, certain tax regime with which they can live nationwide, certainly does not want that result. But neither should it want a state of tax harmony at the cost of harmonizing the tax burden relentlessly upward. Not every form of simplicity is good for business.

But there is another way to apply the static/dynamic dichotomy to tax policy in the Internet era. One reason the 'rational administrators' have been reluctant to embrace lower tax rates and allow 'gaps' in the tax base is that they are wedded to the notion that they, as experts, are responsible for producing and protecting a rational, consistent, seamless revenue system, with the administrators themselves the arbiters of fairness and balance. But as we have seen with regard to income taxation in recent decades, what the tax collector (or legislator) thinks is 'fair' and ' rational' may be nothing of the kind. If the Reagan tax cuts proved anything, they showed the output-maximizing income tax rate is less (sometimes much less) than the revenue-maximizing rate. What politicians and bureaucrats calculate may be 'best' for the public (i.e. the government) may not really be good for the country at all. For a bureaucrat to acknowledge that letting go some of his or her power over revenues (by helping let the market find the output-maximizing rate) would be sacrilege, the ultimate surrender of authority—something Public Choice theory tells us (rightly) that bureaucrats will not do.

We don't know yet where the output-maximizing point for Internet commerce may lie, but for once we have a chance to let the market determine that without bureaucratic or political interference. That the Internet's economic dynamism is cranking out income, payroll, and even sales tax revenues for all levels of government — even if (or because?) there may be some inherent slippage in collections due under ideologically-pristine theories of taxation — is undisputed. By all means let's follow the mantra of " Don't Tax the Internet", if we interpret that to mean "let' s let the Internet work its magic in creating jobs, revenues, and new markets before we try to throttle it with obsolete 20th century theories of taxation and bureaucratic management." The Internet is not the ultimate tax shelter, not the cyberspace tax haven the tax professionals decry. It is, or can be, the ultimate catalyst of economic activity, and the most dramatic example yet of the power of markets, unencumbered by heavy-handed government intervention, to make the world a better place. This experiment in freedom needs to go forth and prosper, and it is incumbent on our public officials to hold their fire.