Institute for Policy Innovation IPI

Quick Study

A Policy Report Summary by the Institute for Policy Innovation

Should We Tax the Internet?

A Summary of IPI Policy Report #152

By Merrill Matthews Jr.

Should access to information on the Internet be taxed? Should e-commerce be taxed? If so, then how? Before taxing the Internet, policymakers need to take a close look at the impact taxes would have on the new e.conomy.

Growth of the New e.conomy

64.2 million adult Americans go online each month to obtain information or make purchases. Although business-to-consumer Internet sales are currently only about 2 percent of the $2.7 trillion retail industry, that figure is expected to grow to 6 percent by 2003. Business-to-business e-commerce is expected to grow to $1.3 trillion by 2003.

- 17 million households shopped online by the end of 1999, spending an average of $1,167 per household.
- By 2004, that number is expected to grow to 49 million households spending an average of $3,738 each.

Deloitte & Touche estimates that 49 of the top 100 retailers are capable of taking customer orders online. By next year 176 malls will be wired for high-speed Internet access.

According to the Center for Research in Electronic Commerce, the Internet economy created $301.4 billion in 1998 and was responsible for 1.2 million jobs. About a third of that amount, $102 billion, was a direct result of Internet commerce.

Can States Tax the Internet?

Issues surrounding taxing the Internet are the same ones that have plagued catalogue sales — estimated at an annual $57 billion — for years. In *Quill Corp. v. North Dakota*, the U.S. Supreme Court ruled in 1992 that the Commerce Clause bars states from requiring an out-of-state mail-order company to collect taxes on sales made to customers inside the state unless the company has a substantial presence (referred to as "nexus") within the state. Thus, the states' authority to collect taxes stops at their borders.

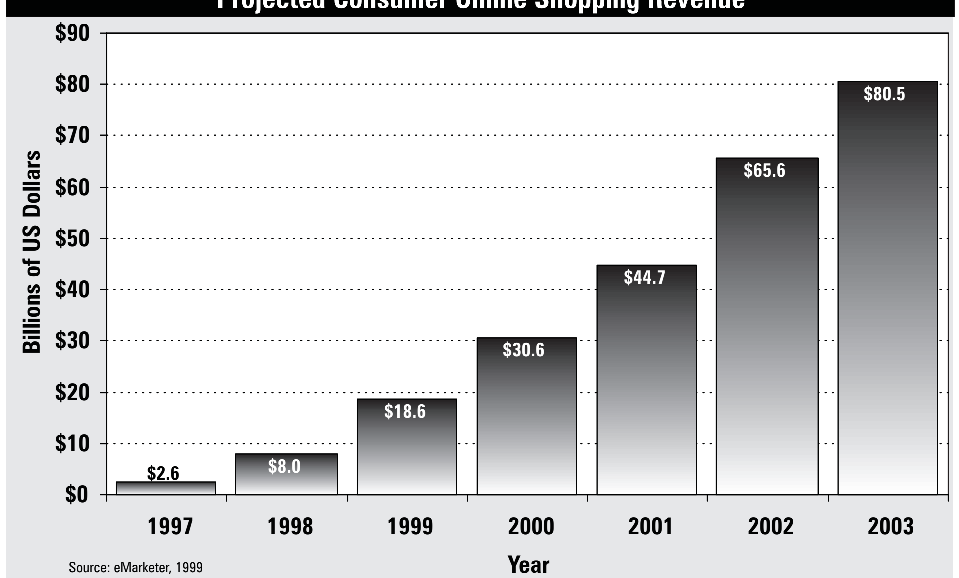
Internet Tax Options

Sales Taxes

A proposal by Sen. Ernest Hollings (D-S.C.) would impose a uniform Internet sales tax nationwide. Currently, there are some 7,548 taxing jurisdictions within the United States. Knowing which tax level to apply to whom and on which purchases — since states vary on what items they tax — is a difficulty this plan would avoid.

An option supported by the National Governor's Association (NGA) would require online vendors to collect sales taxes based on

Projected Consumer Online Shopping Revenue



the residence of the purchaser, not the vendor. This approach would use existing state and local tax structures, but is currently prohibited by the Commerce Clause. It would also create an administrative nightmare. Not only will vendors need to know where to ship the item, they will need to know which of the 7,500 taxing jurisdictions the customer lives in so they know how much tax to charge.

One seldom-discussed solution would require online vendors to impose the sales tax appropriate for its place of business, rather than the residence of the purchaser. In this case the nexus applies to the seller rather than the buyer, just as when a customer travels to another state and purchases something from a retail outlet. The vendor doesn't ask or care whether the buyer is from another state or not.

Use Taxes

The state of residence can impose a use tax on items bought from other states. The out-of-state seller is required by federal law to report the name and address of the buyer to the buyer's state of residence. The state of California, for instance, recently sent 3,200 residents a tax bill for cigarettes purchased online from out-of-state vendors.

Access Taxes

The Internet Tax Freedom Act prohibits states from imposing new taxes on the Internet, but taxes that were already in effect were permitted to remain. Several states have already turned to "access taxes," which tax access to the Internet through service providers such as America Online. By March 1998, 10 states, Washington D.C. and several local governments were taxing Internet access.

Miscellaneous Taxes

Most products purchased online have to be delivered. As a result, some have proposed requiring delivery services to collect a tax, thereby indirectly taxing Internet sales. States or cities might also impose a tax when a home installs a second phone line. High-speed access lines could be targeted as well.

Internet Tax Proposals

Senator Hollings' Federal Internet Sales Tax

Senator Hollings' "Sales Tax Safety Net and Teacher Funding Act" (S. 1433) would impose a 5 percent sales tax on all retail sales over the Internet and through mail order. Money collected from the tax would be deposited in the "Sales Tax Safety Net Trust Fund." That money would ultimately be distributed to the states and used primarily to increase teachers' salaries.

Hollings' proposal has minimal privacy problems because the buyer's residence is irrelevant; however, it would represent a new and unprecedented federal incursion into state activities. The money also comes with strings attached, as it must be used on education.

National Governors' Association

The NGA plan, a "Streamlined Sales Tax System for the 21st Century," would simplify the way states collect sales and use taxes by making them more uniform. States would contract with "trusted third parties" (TTPs), independent organizations created to process sales taxes, which would monitor their client organizations' sales, collect the taxes and distribute the appropriate amount to the various municipalities. Software would compute the tax based on the residence of the purchaser but would not transfer that information to the TTP.

While the NGA's desire to simplify the sales tax system is laudable, there may be an underlying motive to eliminate competition. Uniform sales taxes would give companies no incentive to look to another state for lower taxes or less restrictive regulations.

Advisory Commission

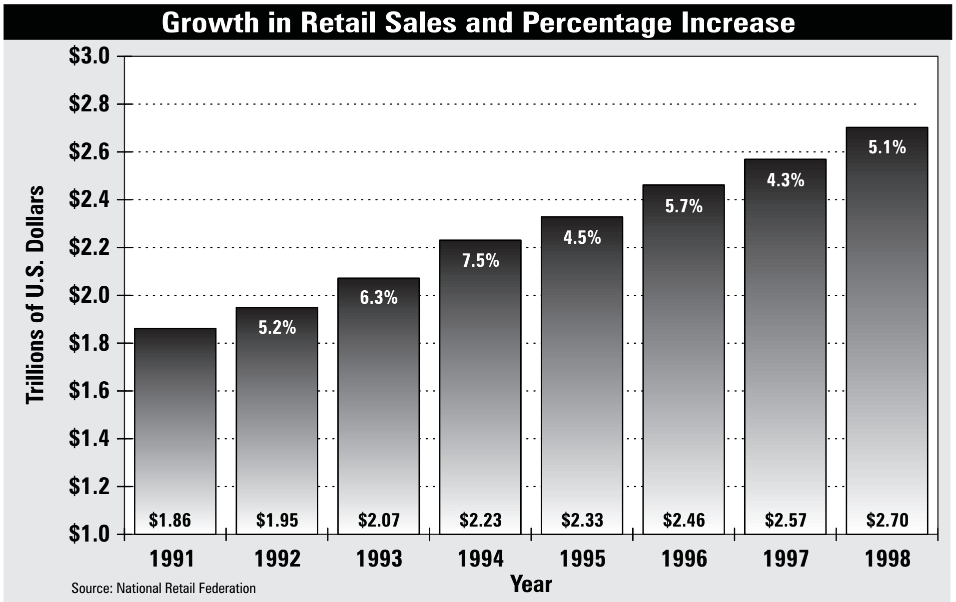
The Advisory Commission on Electronic Commerce (ACEC) is a congressionally appointed committee charged with undertaking "A thorough study of federal, state and local, and international taxation and tariff treatment of transactions using the Internet and Internet access and other comparable intrastate, interstate and international sales activities."

Because Congress is looking to the commission for recommendations, its findings will likely have a significant impact on the Internet tax debate. It is scheduled to release its report and recommendations to Congress in April 2000. So far, the

State Access Taxes

State	State Rate	Local Rate
Connecticut	6.00%	
D.C.	City	5.75%
Iowa	5.00%	Up to 1.00%
New Mexico	5.00%	Up to 1.25%
North Dakota	5.00%	Up to 1.00%
Ohio	5.00%	Up to 2.00%
South Carolina	5.00%	Up to 1.00%
South Dakota	4.00%	Up to 2.00%
Tennessee	6.00%	Up to 2.75%
Texas	6.25%	Up to 2.00%
Wisconsin	5.00%	Up to 1.00%

Source: National Conference of State Legislatures, "Which States Tax Internet Access?" March 25, 1998



draft report specifically states that "At this time, it does not appear that there is any compelling reason to impose taxes exclusively targeted at electronic commerce," and that "Governments should keep tax burdens on American consumers and businesses as low as possible."

Arguments for and Against Taxing the Internet

Would States Lose Revenue?

Tax proponents contend that as e-commerce grows, states will lose significant amounts of revenue, threatening essential services like police and fire protection. According to a coalition of government-oriented associations such as the NGA and the U.S. Conference of Mayors, not taxing e-commerce will cost state and local governments between $9 billion and $11 billion in lost revenue by 2004.

It is not necessarily true that if online sales increase, state revenues will decrease. State sales tax receipts have continued to increase during the 1990s, even with the growth of Internet sales. How?

- Many Internet purchases — for example, prescription drugs — would not be taxed if bought in-state.
- States have ways of collecting some of the sales and use taxes for out-of-state mail order and online purchases.
- Because online consumers are just as subject to impulse buying as those shopping retail, there is not a direct trade-off between online purchases and lost retail sales.
- Online sales have a "multiplier effect." For example, online sales are helping to keep inflation down and so spurring economic activity in retail stores. 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.

The Fairness Argument

Brick-and-mortar businesses must charge a price that is effectively between 3 to 7 percent more than online businesses—and that doesn't include local sales taxes. From an economic efficiency standpoint, the increased price penalizes traditional retailers through no fault of their own.

The problem with the fairness argument is that it only wants to go one way – increasing taxes. If fairness were really the issue, retailers would be indifferent as to whether state and local governments imposed an equal sales tax rate on e-tailers, eliminated sales taxes on retail stores, or somehow split the difference.

As for government officials, it is clear that their real concern is increased revenue. If it is unfair to tax retail sales and not online sales, then fairness proponents should oppose all schemes that give tax breaks to one business and not another.

The Economic Impact of Taxing the Internet

Access Taxes

Fortunately, there is a growing recognition that the Internet's primary value is as a source of information, and that taxing information, or access to information, is wrong in principle. As a result, several states have suspended their laws that implemented the tax, and there seems to be little desire to make it the Internet tax of choice.

Sales Taxes

Austan Goolsbee of the University of Chicago's Graduate School of Business and the National Bureau of Economic Research has found that "enforcing existing sales taxes on Internet purchases could reduce the number of online buyers by as much as 24 percent." 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.

Should the Internet Be Taxed?

According to the National Conference of State Legislatures, based on responses provided by 44 states: "Conservative revenue forecasting and prudent fiscal management have left states in their best financial condition in decades.… Thirty-two of the reporting states ended FY 1999 with a balance exceeding 5 percent…Seventeen of these states ended with balances exceeding 10 percent."

And with regard to tax cuts, the NCSL says, State legislatures in 1999 lowered taxes for the fifth consecutive year, approving a net reduction of:

Year	$billions	Percent of prior year tax collections
1999	$5.5	1.2%
1998	$7.1	1.6%
1997	$2.6	1+%
1996	$4.0	1+%
1995	$3.3	1+%

(Source: National Conference of State Legislatures)

Were states struggling for revenue, the NGA's concerns about the loss of public services might make sense. But what reason is there to create a new tax while states are trying to cut and eliminate already existing taxes?

There Are No Fair Taxes.

Politicians are increasingly pushing sweetheart deals by giving one business a tax break and not its competitor. Clinton's $350 billion tax cut package provides targeted tax cuts to a wide range of individuals, families, businesses, organizations and special interests. If associations like the NGA *really* wanted tax fairness, they would be supporting a flat income tax and the elimination of all other taxes and tax breaks. They are doing just the opposite.

So the states don't need the additional revenue and there is no fair tax. That being the case, there is no justification for taxing Internet access or sales.

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Want More Info?

This study is a summary of IPI Policy Report # 152, *Should We Tax the Internet?*

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