

NAVIGATING THE INTERNET TAX DEBATE

Several state-oriented organizations such as the National Governors' Association, the National Conference of State Legislatures and the U.S. Conference of Mayors contend that as e-commerce grows, states stand to lose a significant amount of revenue. In response, they are promoting a new "simplified" state sales tax system and other changes to facilitate state collections of e-commerce taxes.

While their efforts have led to a debate focused on taxing Internet sales, the issue is much more complicated and multifaceted but ultimately is fostered by some states' desire to tax citizens of other states. The debate touches many issues and inspires many arguments; a discussion of the most important follows.

ACCESS TAXES

An access tax is a tax on the fee a customer pays an Internet service provider such as America Online. Although Congress has imposed a moratorium on *new* access taxes, several states had the taxes in place before Congress acted. Now, there seems to be an emerging consensus that a tax on Internet access is a tax on information, and even states that had imposed such a tax are moving away from it.

Nevertheless, an extension of the moratorium or a move to make it permanent would send all states a powerful message that taxing access to information is unacceptable because it could constrain Internet use by those least able to pay.

SALES TAXES

Contrary to popular belief, the current moratorium does not affect the ability of states to collect sales and use taxes on electronic commerce. It only prohibits states from imposing multiple and "discriminatory taxes." For example, the moratorium prohibits taxing the delivery of

online newspapers, which in most places are exempt from sales and use taxes if delivered over the counter. If Congress does not act, the states will once again be free to levy discriminatory taxes.

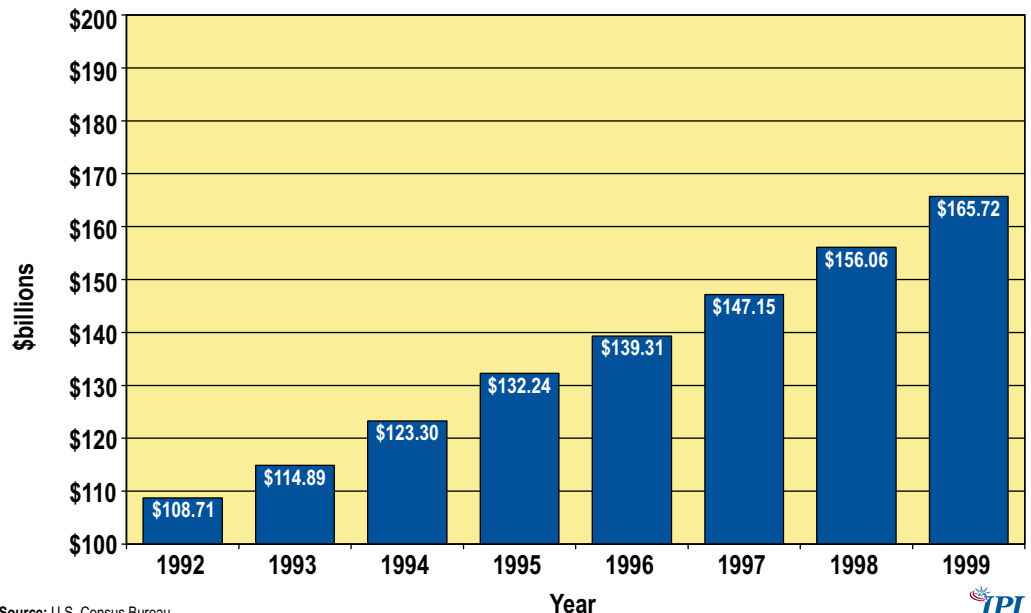
Currently, business-to-consumer (B2C) online sales that normally would be subject to a sales tax are still relatively small, only \$17.3 billion (1999) in a \$6 trillion economy, according to Jupiter Research. And the recent "dot com" shakeout has raised doubts that online B2C sales will grow rapidly in the near future. Although some types of e-commerce have continued to grow, primarily airline ticket purchases (\$5 billion in 1999) and business-to-business (B2B) sales, these transactions are seldom subject to a sales tax. As a result, simplifying state sales tax methods would do little to increase state coffers, now or in the foreseeable future.

The fact is that online retail sales have not impaired the states' ability to collect sales taxes, which have grown steadily for years. [See Figure]

TELECOMMUNICATIONS TAXES

Telecommunications taxes are complex and multilayered, and they add to the cost of Internet access. Many are

TOTAL GENERAL SALES TAXES COLLECTIONS BY STATES AND LOCALITIES



Source: U.S. Census Bureau

imposed directly on the users of telecommunications. Others are less direct, appearing on users' bills as higher fees or per-minute charges for telecommunications services. Simplification of e-commerce taxation will be incomplete without rationalization of telecommunications taxes.

THE RATIONALE FOR DIVERSITY

The primary problem with any proposed plan to simplify state taxes through a compact or through federal government encouragement is that there is nothing simple about it. The Founding Fathers recognized that states would differ significantly in their approaches to taxes and considered that difference to be a good thing. To them, competition between the states meant that an American citizen who was unhappy with the policies of one state could move to another.

As the states experimented with different policies, the Founders believed that each would determine what was appropriate and acceptable to its own population. Most states have a sales tax, but some do not. Most states have an income tax, but some do not. The simplified plan ignores the Founders' wisdom by substituting a uniform tax policy that is both anticompetitive and antithetical to a federalist system.

THE LIMITS OF STATE SOVEREIGNTY

The real purpose behind the simplified system is to allow one state to impose a tax on citizens of other states, sidestepping the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*. That decision barred states from requiring an out-of-state mail order company to collect taxes on sales made to customers inside the state unless the business had a substantial presence, or "nexus," within the state. Otherwise, states would be able to tax citizens of other states, and those citizens would have no democratic (electoral) recourse. In addition, the Court found the state tax schemes too complex for remote sellers and thus barriers to interstate commerce.

One of the most persistent myths during the course of the debate about Internet tax has been that the moratorium on discriminatory taxes has somehow precluded states from collecting sales and use taxes. The states have always been able to collect sales and use taxes within their borders. Every state that has a sales tax also has a use tax; the latter requires residents to pay their state sales tax on out-of-state purchases. That most Americans evade this law is a compliance problem, not a justification for adopting a new and constitutionally questionable tax system.

Further, despite the insistence of some involved in this debate, who should control the future of state tax schemes is not the issue. States have taxing authority within their borders. What they have asked for is authority to require remote merchants to collect sales taxes and remit the taxes to

their states. This is a dramatic expansion of state government power.

CONSTITUTIONAL CONCERNS

While extending the Internet tax moratorium or making it permanent is the right thing to do, it does nothing to resolve another issue. Some former champions of a tax-free Internet such as Sen. Ron Wyden (D-Ore.) have attached to their moratorium extension bills provisions for a massive overhaul of state and local sales and use taxes that would move the states forward in creating their simplified plan.

This may sound harmless but it isn't. The National Governors' Association has been pressing for this power for several years, despite constitutional restrictions on forcing businesses to collect sales taxes on purchases by residents in states in which the business has no presence.

Even more questionable, Sen. Byron Dorgan (D-N.D.) and Rep. Ernest Istook (R-Okla.) are proposing that Congress preauthorize a compact among states needed by the streamlined-sales tax coalition. The compact would continue in perpetuity unless Congress affirmatively voted to reject it within 120 days. The legislation asserts it would by definition be consistent with the Constitution's Commerce Clause. But of course that is for the Supreme Court, not Congress, to decide.

A BETTER SOLUTION

Better proposals exist. For example, a bill by Sens. George Allen (R-Va.) and Conrad Burns (R-Mont.) would make the Internet tax moratorium permanent and block future efforts by state cartels to fill their coffers by taxing residents of other states.

Congress faces a stark choice. Extending or making permanent the current moratorium will preserve and even encourage Internet access and e-commerce. And it will maintain the federal system intended by the Founding Fathers. The states' desire to adopt a simplified plan will have the opposite effect.

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