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New.Economy@Old.Constitution:

Internet Taxes and the Constitution

By Lawrence A. Hunter
George A. Pieler

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Executive Summary

As the 21st Century dawns, few people doubt that something fundamental has changed in the American economy. The new economy is being fueled by a revolution in information technology and networking—the Internet. Today, more than 100 million American adults are using the Internet, and email already outnumbers regular mail by a ratio of 10 to 1.

The amount of commerce being conducted over the Internet is growing exponentially. Internet economy revenue should reach $1.2 trillion by 2002, rivaling health care as the nation's largest industrial sector. Forrester Research predicts that by the year 2003, a minimum of $1.8 trillion worth of business transactions will occur online.

Ronald Reagan characterized politicians' natural predisposition as, "if it moves, tax it; if it keeps moving, regulate it; and if it stops moving, subsidize it." The Reagan dictum still holds, it seems, even if "it" moves in data packets at the speed of light. Today politicians at virtually every level of government are looking for ways to tax the Internet.

At the federal level, the Internet provides a rich new tax base to which federal politicians would like to gain access, and a number of new "tax handles" to use to manipulate the American economy as they see fit. At the state level, the Internet provides a novel new means of overturning constitutional limits on state taxing authority that have long irritated state politicians. But even more fundamentally, the Internet has revived an age-old struggle between those who believe in political diversity, decentralization and tax competition among the states and those who would replace it with tax coordination and uniformity among the states.

Clearly, the reality is much more complex than a choice between making the Internet a "level playing field" and making it a "tax-free zone." For one thing, we must draw a distinction between constitutional and unconstitutional methods of taxing the Internet. Of course, everyone assents to the proposition that there should be no unconstitutional taxes on the Internet. But there is considerable disagreement about what is or is not constitutional.

Due Process constraints on state taxation means that the taxpayer must have some sort of physical presence in a state in order to be subject to its taxing authority. And while the standard of Due Process has been loosened by the courts, it hasn't been erased. And the Internet raises entirely new questions about "presence."

The Commerce Clause is the primary source of federal power over state and local taxation that involves cross-border issues, so its relevance to Internet issues is obvious. Less obvious, however, is the Confederation or Compact Clause, which sets the boundaries of what states can do collectively without requiring congressional approval. And while the Compact Clause normally prompts recollection of the Confederate States of America, cannot an Electronic Confederation be envisioned, where states enter into a compact to harmonize their policies on taxation, privacy, censorship, residency, voting standards, and the like, all geared to "residents" of cyberspace? Such collusion between states would cause a clear constitutional test.

The Madisonian model of government, as laid out in The Federalist Papers, is a model of competition, not collusion; friction, not harmony; a calculated division of power, not unification across all levels of government. The Internet is the most dramatic example yet of the power of markets, unencumbered by heavy-handed government intervention, to make the world a better place. How policy makers respond to the challenge of electronic commerce will help determine not only the future of the Internet, but also the continued relevance of constitutional governance.

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Direct all inquiries to:
Institute for Policy Innovation
250 South Stemmons,
Suite 215
Lewisville, TX 75067

(972) 874-5139 [voice]
(972) 874-5144 [fax]

Email: **ipi@ipi.org**
Website: **www.ipi.org**

New.Economy@Old.Constitution: Internet Taxes and the Constitution

By Lawrence A. Hunter
George A. Pieler

I. The Battle Lines

As the 21st Century dawns, few people doubt that something fundamental has changed in the American economy. This new economy is being fueled by a revolution in information technology and electronic networking—the Internet. By 1996, the Internet was producing dramatic boosts in productivity and was helping to pull the economy out of the mire of slow growth that began with the early 1990's recession and the 1993 tax increase.

The first inter-computer network, which was housed in the mainframe computers of four academic institutions—the Stanford Research Institute, the University of California at Los Angeles, the University of California at Santa Barbara, and the University of Utah—went "online" in 1969. This network was called "ARPAnet" after its creator, the Department of Defense's Advanced Research Projects Agency. The National Science Foundation's NSFnet, originally established in 1986 by linking together five supercomputers, eventually linked other academic institutions around the country to create small mini-networks that all linked to each other back through the supercomputers. This system replaced ARPAnet in 1990, and the Internet was born.

Now, networked systems like the Internet are taking over every part of our communications systems, our businesses and our government.

Today, more than 100 million American adults are using the Internet, up from 65 million in mid-1998 and 84 million at the end of 1998. As more and more people jump onto this speeding train, those networks will develop into truly life-changing technologies. Cisco Systems reports that every month, 18 million people around the world go online for the first time. Email already outnumbers regular mail by a ratio of 10 to 1.[1]

The amount of commerce conducted over the Internet is growing exponentially. According to a University of Texas study, Internet-economy revenues should reach $1.2 trillion by 2002, rivaling health care as the nation's largest industrial sector. Forrester Research, Inc. even more optimistically predicts that by the year 2003, a minimum of $1.8 trillion worth of business transactions will occur online. Illustrative of the explosion of e-commerce, the American Council of Life Insurance, which reports over $3 billion in term insurance sold online this year—a number it expects will double next year—estimates that within 10 years.[2]

Since 1970, Detroit's share of America's industrial production has ranged between four and six percent and now hovers at just below six. Silicon Valley's share of our nation's industrial output, however, has followed a steady upward path from just over one percent in 1970 to eight percent in 1998, having overtaken Detroit for good in 1995. Between 25 and 33 percent of America's economic growth in the 1990s has been due to the information-technology sector. Four-fifths of total business investment now comes from information technology investments.[3]

The Politician's Creed: Let No Good Deed Go Untaxed

The Internet is clearly a revolutionary—a transformative—technology, and politicians, no less than business firms and individuals, are struggling to come to grips with it. President Ronald Reagan characterized politicians' natural predisposition as, "if it moves, tax it; if it keeps moving, regulate it; and if it stops moving, subsidize it." The Reagan dictum still holds, it seems, even if "it" moves in data packets at the speed of light.

It's Moving: Tax It

After graphic user interfaces were introduced in 1994, the Internet became widely accessible and increasingly integrated into the nation's economic infrastructure. No sooner was the Internet a reality than efforts to tax it began: but this time, two Members of Congress themselves moved to forestall this knee-jerk reaction. Sen. Ron Wyden (D-OR) and Rep. Christopher Cox (R-CA) introduced and Congress enacted The Internet Tax Freedom Act of 1998 (ITFA), which contained a moratorium on new Internet taxation. The purpose of the legislation, in the words of Sen. Wyden, "is to try to figure out a rational Internet tax policy. This may mean no taxes at all, or it may mean tax equality for all transactions, no matter the technology."[4]

Contrary to a widely held misconception, the moratorium did not bestow any new privileges or advantages on cyberspace businesses. It merely put a stop to the unseemly rush to lard new taxes on top of taxes already affecting this new universe, i.e., to forestall bandwidth taxes, byte taxes, access fees, multiple and discriminatory taxes on the Internet itself and novel new definitions of "nexus," which would permit states to compel Internet companies to collect sales and use taxes on remote Internet sales even when those firms have no real physical presence within a state.[5] The moratorium allows for the imposition and collection of state and local sales and use taxes on electronic business at a rate no greater and no less, and under circumstances no different, than those currently imposed on phone- and mail order companies.[6] Because the authors of the moratorium legislation recognized that the Internet is inherently susceptible to multiple and discriminatory taxation in a way that commerce conducted in more traditional ways is not, the moratorium's main objective is to prevent the Internet from being singled out and taxed discriminatorily in new and creative ways.

Two distinct political dynamics are at play in the rush to tax the Internet. At the federal level, the Internet presents a rich new tax base to which federal politicians would like to gain access, not only to increase revenues flowing into the United States Treasury but also to diversify the number of "tax handles" they have on the American economy for both revenue and regulatory purposes. At the state level, potentially lucrative new sources of revenue are also at stake, as well as a novel means of overturning constitutional limits on state taxing authority that have long irritated state politicians. But even more fundamentally, the Internet has revived the age-old struggle between those who believe political diversity, decentralization and tax competition among the states are economically beneficial and politically desirable and the advocates of political centralization who would eliminate tax competition and replace it with tax coordination and tax uniformity among the states.

It's Still Moving: Regulate It

In addition to seeking new taxes on the Internet, politicians and interest groups also moved quickly to propose regulations on the Internet in the name of the public interest. Protecting children from downloadable 'adult content' proved to be the ideal entry point for politicians into cyberspace, and regulating obscenity gave them considerable leverage in their quest to gain suzerainty over this new domain. In 1996, Congress passed the Communications Decency Act (CDA), which criminalized the "knowing" transmission of "obscene or indecent" messages to any recipient under 18 years of age and specifically prohibited the "knowin[g]" sending or displaying to a person under 18 of any message "that, in context, depicts or describes, in terms patently offensive as measured by contemporary community standards, sexual or excretory activities or organs."[7] But the Supreme

Court intervened, ruling that "The CDA's 'indecent transmission' and "patently offensive display" provisions abridge 'the freedom of speech' protected by the First Amendment."[8]

In spite of this setback, politicians and interest groups continue their unabated, if lower profile, coordinated efforts to regulate Internet commerce in the name of the public interest (the concern over adult content over the Internet did not go away, however: ITFA itself contains exemptions for states that use taxes to regulate Web distribution of "material that is harmful to minors."). The regulatory arrow, however, is not always directed at the Internet *per se*.

For example, a new regulation being promoted by the National Association of Insurance Commissioners (NAIC)—dubbed "Triple X"—would prohibit insurers from guaranteeing policyholders a single rate for more than five years and require insurance companies to substantially increase their cash reserves. Currently, insurers can write term life policies for up to 30 years, locking customers into the same rate for the duration of the policy. According to NAIC, the Valuation of Insurance Policies Model Regulation was enacted because of the potential for insolvency in smaller companies. Advocates of "Triple X" contend that smaller firms are selling policies that are too long for rates that are too low, and therefore not maintaining sufficient financial reserves to pay the inevitable claims. According to the NAIC, most states are gearing up to adopt some version of the Triple X.

While Triple X is moving forward under the guise of consumer protection, a closer look at the proposal reveals it to be an effort by larger insurers to enlist the government to block smaller, highly competitive Internet-based insurers with special regulatory impediments. According to David E. Fowler, CEO of ratemasters.com, an Internet-based life insurance company, "It's not that the large companies aren't also on the Internet, it's just that because they were so big already, with much more staff and much more overhead, it's harder for them to compete with smaller, leaner insurers using the Internet as their primary sales tool. They feel as though they're losing out, and this may be their way of leveling the playing field." [9]

The collusion between state officials seeking to protect their power and revenue sources and traditional retailers attempting to protect their market niche is even more obvious in the case of the automobile industry. Forty-eight states currently have laws requiring that new vehicles be sold exclusively by franchised new-car dealers. This means that online auto companies still must buy their cars from freestanding dealerships, which artificially shelters the dealer system from direct online competition. In the past couple of years, dealership interests in 22 of those states succeeded in strengthening such pro-dealer rules, preventing auto manufacturers from selling directly to consumers online.

State governments' interest in online sales of automobiles is also evident. Some 20 percent of all state sales taxes are collected by automobile dealers. States fear that direct online sales of automobiles by manufacturers or online brokers would complicate the collection of sales taxes. In reality, it would be a relatively easy matter for states to convert their retail sales taxes on automobiles to a use tax or a one-time property tax, such as that levied in Maryland, which could be collected by the department of motor vehicles upon registration.

In some states, the regulatory effort has gone even further without legislative action. In Texas, for example, this year the state motor vehicles department implemented rules effectively preventing Internet companies from charging a fee to dealers and from setting prices while requiring that any new vehicles must be sold through dealers. These rules have the effect of preventing aggressive Internet companies like CarsDirect.com, CarOrder.com and Greenlight.com from doing business in the state of Texas.

The dot-com companies are fighting back in court, arguing that such rules violate the Commerce Clause by restricting interstate trade, since the automotive industry embraces much more 'commerce' than just the purchase of the automobile. Currently, there are no

state or federal laws preventing Internet companies from competing with dealers for finance and insurance revenue, which is a huge market. Nearly 94 percent of new-vehicle buyers finance or lease their cars or trucks. Finance and insurance accounted for 27.6 percent of the typical franchised new-vehicle dealership's profits in 1990. That share rose to 33 percent in 1999.[10]

It's Not Moving Fast Enough In Some Places: Subsidize It

The Internet bean counters in the Clinton-Gore administration have delved deeply into cross-tabulated demographic data and invented a so-called "digital divide" looming across the land (if you can't invent the Internet, at least you can manufacture some 'problems' with it). At a recent White House press briefing, administration officials expressed great concern over the fact that that 17 percent of white households with incomes in the $15,000 to $35,000 range are connected to the Internet compared to eight percent of African-American households.[11] A special assistant to the president also lamented the fact that in "our poorest schools in the last report, less than 40 percent of classrooms are connected, while over 60 percent in the wealthiest schools [are]." (Two weeks later, it was reported that virtually every public school in America is now connected to the Internet.)

Vice President Al Gore speaks fervently on the issue: ". . . it is imperative that we ensure that this [digital] division does not continue. We must begin this millennium not as a country technologically divided, but instead as one committed to creating digital opportunity for all our citizens."[12] Contrary to the Vice President's hyperbole, surveys reveal that because most users go online at work or school, there is virtually no remaining disparity in Internet *access* along racial lines. Nevertheless, Vice President Gore is playing the race card on the Internet: in a characteristic statement in Fort Dodge, Iowa in August 1999, Gore said "We will never make the most of the Information Age when the average black household is only two-fifths as likely to have home Internet access as a white household," as if the market were withholding its products from black households. He parses his words carefully by emphasizing a disparity in Internet access *at home* to imply that a growing "digital divide" exists between whites and blacks which the federal government must step in and close.[13]

The President and Vice President characterize different consumption patterns across income levels as "digital inequities," and they use them to justify an outpouring of federal subsidies for the Internet and information technology in general. In the president's FY 2001 budget, the administration proposes a cornucopia of new federal subsidies, including $50 million to expand home access to computers and the Internet for low-income families; $2 billion over 10 years in tax incentives to encourage private sector donations of computers, sponsorship of community technology centers, and technology training for workers; and hundreds of millions of dollars of new direct spending on teacher training.

The fact is, computers and the Internet have penetrated American households faster than any new technology of the past century, and total penetration will be complete within a very few years without any help from government.[14] Nevertheless, the spending die was cast a couple of years ago when Congress acquiesced to the Clinton Administration's spending billions of dollars to wire public schools to the Internet and the levying of a telephone tax to pay for it. Now that every school is online, and given the Clinton-Gore administration's demagoguery on the so-called "digital divide," the promise of "a laptop in every backpack" may be too tempting for politicians to resist. If so, one can also expect a push by politicians to pay for the Internet subsidies with special, earmarked taxes on the Internet and the information technology industry. The scheme used to finance the wiring of many public schools to the Internet—a stealth tax on telephone bills now bringing in $5 billion a year—provides a template for financing other schemes aimed at the so-called "digital divide" by levying future taxes on the Internet.[15]

What Does It Mean To "Tax The Internet"?

As portrayed in the media, the Internet taxation issue is a simple dichotomy. One side wants to prohibit all levels of government from taxing the Internet in any form and in any fashion, direct and indirect, now and forever. The other side is portrayed as seeking to do nothing more than "level the playing field" and prevent the Internet from becoming a "tax-free" haven of unbridled capitalism. Reality is considerably more complex.

"Leveling the playing field" has become a favorite excuse for politicians and private interest groups to advocate not only regulations on the Internet but also new taxes. For example, in making the case for levying new sales taxes on Internet commerce, state and local politicians and traditional brick-and-mortar retailers begin from the premise that most state and local sales and use taxes currently go uncollected from remote sales over the Internet. This fact rankles state and local officials who argue they're not getting all the revenue due them. It also irritates merchants who sell merchandise face to face out of a storefront and must collect the sales and use tax, because they feel put at a competitive disadvantage vis-à-vis online merchants.

This situation, however, did not newly arise with the Internet and is not a consequence of whiz-bang technology undermining states' ability to levy sales taxes. Rather, the situation derives from the United States Constitution. For more than 30 years now, state and local officials and representatives of the retail-sales industry have been frustrated when sales and use taxes levied on remote mail-order and phone sales are not collected due to well-established constitutional prohibition against states reaching beyond their borders to force firms with no "presence" in the state to collect its taxes. The advent of the Internet does not alter these constitutional considerations but it has provided the state-and-local-government lobby and their allies in the retail sales industry a fresh opportunity to reopen this old issue, even though the law in this area has been reasonably well-settled for a number of years. In effect, the state-and-local-government lobby has found a new pretext for taking away from companies engaged in remote sales—all remote sales, not just over the Internet—the legal and Constitutional protections against tax overreach by state and local governments.

As the sales tax example illustrates, there are a number of different dimensions involved in deciding whether, and if so how, to "tax the Internet." Therefore, before proceeding directly to a discussion of the pros and cons of "taxing the Internet," it is first useful to lay out a framework in which to consider these questions. The first step in defining what is meant by "taxing the Internet" is to categorize the different approaches to Internet taxation that have been suggested and then analyze how current law relates to the resulting categories.

The first useful distinction to draw is between constitutional and unconstitutional methods of "taxing the Internet." The reason it is necessary to belabor the obvious is that some of the most prominent proposals to expand sales tax coverage to all Internet commerce seek to avoid existing constitutional restrictions (e.g., by novel definitions of "nexus") or they involve new approaches to taxing the Internet that are themselves constitutionally suspect (e.g., state laws and interstate agreements designed to collect sales taxes that may run afoul of the Commerce Clause or other constitutional provisions).

It is also useful to sort Internet taxes by the tax base tapped. Some taxes under consideration treat the Internet *per se* as the tax base (e.g., byte taxes or web page excise taxes). Some taxes target activities unique to the Internet as the tax base (e.g., excise taxes on e-mail or Internet access fees). By far the largest category of Internet-related activities that government may seek to tax are activities that may be conducted on the Internet but are not necessarily unique to the Internet. Within this broad category, it is useful to combine income, payroll, real property and business activities into a single category and to treat sales and use taxes as a distinct category.

The framework that results from this typology is shown in Table 1.

Unconstitutional Internet taxes (black);
Constitutional taxes already being used to raise revenue from an Internet-related tax base (white);
New, arguably constitutional taxes the federal government and states might choose to levy on the Internet and Internet-related activities. (gray).

Table 1
The Internet Taxation Debate

- ☐ Constitutional and exonomically defensible
- ▪ (gray) May be constitutional but raise serious issues of both law and economic prudence.
- ■ Unconstitutional

1 Tax currently prohibited by the Internet Tax Moratorium.
2 Tax may be constitutionally suspect.

The Internet Taxation Debate				
TAX LEVIED ON	FEDERAL GOVERNMENT TAXES		STATE GOVERNMENT TAXES	
	Constitutional	Unconstitutional	Constitutional	Unconstitutional
Internet *Per Se*	Web Site Excise Tax[1] Byte Tax[1] Bandwidth Tax[1] Internet License Fees[1]		Web Site Excise Tax[1, 2] Byte Tax[1, 2] Bandwidth Tax[1, 2]	Tax Levied By: i. Unauthorized Interstate Compact; or ii. State Confederacy
Activities Unique to Internet	Internet Access Fees[1] E-mail Excise Tax[1] E-commerce Transactions Tax[1]		Internet Access Fees[1, 2] E-mail Excise Tax[1, 2] E-commerce Transactions Tax[1, 2]	Tax Levied By: i. Unauthorized Interstate Compact or ii. State Confederacy
Retail Sales & Use	Sales, Use and Excise Taxes Collected Directly From Consumer Mandated Collection of Sales and use Taxes by Internet Companies		Sales, Use and Excise Taxes on Internet Sales Collected Directly From Consumer Mandated Collection of Sales and Use Taxes by Internet Companies w. Nexus	Mandated Collection of Sales and Use Taxes by Internet Companies w/o Nexus Levied, Collected or Administered by i. Unauthorized Interstate Compact or ii. State Confederacy
Income, Payroll, Real Property & Universal Business Activities	Corporate Income and Payroll Taxes Levied On Internet Companies Income and Payroll Taxes On Wages & Salaries Earned from Internet Companies Property Taxes Levied on Internet Companies Business and License Fees Unemployment and Workers Compensation Taxes Collected From Internet Companies		Corporate Income and Payroll Taxes Levied On Internet Companies w. Nexus Income and Payroll Taxes On Wages & Salaries Earned from Internet Companies w. Nexus Property Taxes Levied on Internet Companies w.Nexus Business and License Fees Levied On Internet Companies w. Nexus Unemployment and Workers Compensation Taxes Collected From Internet Companies w. Nexus	Corporate Income and Payroll Taxes Levied On Internet Companies w/o Nexus Income and Payroll Taxes On Wages & Salaries Earned from Internet Companies w/o Nexus Property Taxes Levied on Internet Companies w/o Nexus Business and License Fees Levied On Internet Companies w/o Nexus Unemployment and Workers Compensation Taxes Collected From Internet Companies w/o Nexus

Table 1 provides a ready means to organize the Internet taxation debate as it stands today. Individual entries in the cells of the table consist of taxes that have been actively considered since the emergence of the Internet but one must assume that as this debate advances, advocates of taxing the Internet will devise additional ways to levy cyberspace charges.

How To Tax The Internet?

Internet-related taxes in the black-shaded categories of Table 1 must be rejected as unconstitutional. Internet-related taxes in the white-shaded categories are defensible both on constitutional and economic grounds with some important caveats discussed in Section II (The Constitutional Underpinnings) below. Internet-related taxes in the gray-shaded categories may be constitutional but raise serious issues of both law and economic prudence.

No Unconstitutional Taxes On The Internet

Unconstitutional taxes on the Internet are shaded black in Table 1. These taxes could only be levied on the Internet if the Constitution were to be amended, the Court were to reverse an earlier relevant opinion or Congress were to overturn the Court. Notice that all of

the taxes that fall into this category are state taxes. Although it is theoretically possible to devise a federal tax on the Internet that would run afoul of the Constitution, the authors know of no proposals currently under consideration that do so.

The general proposition that there should be no unconstitutional taxes levied on the Internet, of course, receives universal assent. As always, though, there is considerable controversy over certain Supreme Court interpretations of what is and what is not constitutional and over whether certain taxes that have not been tested by the Court fall into the red area. The authors are of the opinion that the plan put forth last year by the National Governors Association (NGA), which impels the states to devise a nationally uniform system for the extraterritorial collection of sales taxes on Internet sales and to eventually adopt a uniform state sales tax system nationwide on all forms of retail commerce, violates the Constitution and therefore should be placed off limits in the black. Obviously, the state and local government lobby and their allies in the retail sales industry disagree. They would put the NGA plan in the next column to the left and color it white. This controversy is taken up in detail in Section II below.

No *New* Taxes On The Internet, Constitutional Or Not

A category of new taxes that might be levied constitutionally on the Internet by the federal government and perhaps by the states is shaded yellow in Table 1. Gray shading is chosen to reflect the authors' opinion that these taxes, while probably constitutional in most cases, nevertheless should not be levied on prudential/economic grounds. The white bullet was selected for gray-shaded state taxes in the constitutional column to reflect the authors' opinion that some or all of these taxes may be constitutionally suspect. (See Section II below.)

The gray-shaded area in Table 1 also maps out the categories of taxes currently prohibited by the Internet tax moratorium. The case against these taxes on economic and prudential grounds is straight forward: They are not needed to raise revenue, and they would impose an unacceptable economic burden on the Internet without a compelling non-revenue justification (e.g., tax neutrality) to recommend their adoption.

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.

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

Table 2 PRODUCTIVITY GROWTH

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

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]

Table 3
STATE & LOCAL BUDGET SURPLUSES AS PERCENT GDP

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

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

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 though 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 fist 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.

The Principle of Fairness and Tax Neutrality.

The other excuse for levying new taxes on the Internet is that they are required to "level the playing field" between remote Internet sellers and traditional bricks-and-mortar retailers. For example, the advocates of extending the states' taxing authority beyond their borders argue that the current restrictions confer a competitive price advantage on firms that sell their products through e-commerce relative to retail businesses that sell directly to customers face-to-face out of a storefront and must collect the tax. This situation, it is argued, violates the principle of "tax neutrality," which holds that a tax system should not pick winners or play favorites but allow people freely to make decisions based on their own needs and dreams. In the words of the National Commission on Economic Growth and Tax Reform (TRC), "Taxes cannot help but raise the cost of everything they fall on. But

at least they should fall on things neutrally without penalizing one form of economic behavior and promoting another."[18]

In the eyes of retail merchants who feel they are at a competitive disadvantage and among state and local officials who feel deprived of tax revenue, allowing Internet sales to avoid the sales and use tax is viewed as "administratively inefficient" and "unfair" because it does not treat all merchants "neutrally." "How" a product or service is sold, they contend, is not relevant to whether or not the transaction should be taxed. Thus, they argue, government should take the steps necessary to "level the playing field" between retail and "e-tail" forms of doing business. In the case of sales and use taxes, doing so could require the Congress to overturn more than thirty years of judicial case law, perhaps even amending the Constitution and probably getting involved in helping state and local governments collect the tax, if not actually collecting the tax on their behalf.

The non-neutrality decried by the advocates of expanding states' taxing authority beyond their own borders, however, is not the kind of intentional bias the TRC had in mind when it inveighed against non-neutral tax code provisions. The disparity in tax treatment at issue here is a direct consequence of the constitutional design of American federalism and the checks and balances intricately woven into its fabric. While the American system of federalism invests states with an extensive and independent power to tax, it simultaneously limits that power by restricting the states' taxing authority to reach no further than its own geographic boundaries. While that limitation may doubtlessly prove frustrating to state and local public officials in their endeavors to raise tax revenue, especially when technological innovations such as the Internet suddenly alter the economic landscape in which they are accustomed to operating, frustration is not a legitimate justification for altering the constitutional order.

No "tax bias" favoring remote sales merchants can be found in any provision of the federal tax code nor in any other federal statute, and there is no "tax bias" resulting from a conscious policy decision by Congress to protect remote Internet sales, even at the expense of traditional store-front, face-to-face sales. Moreover, what the state-and-local government/retail sales lobbies characterize as "unfair non-neutrality" is not a phenomenon that can easily be remedied without large costs to innocent businesses and individuals and significant collateral damage to the overall economy. In other words, the tax disparity that has arisen between "e-tail" and storefront retail sales arises naturally as a consequence of technological innovation in a marketplace that operates in a legal framework of federalism. The only way to eliminate the disparate tax treatment would be for governments to take extraordinarily coercive and intrusive actions to collect a tax that is in practical terms uncollectable at a reasonable cost to individuals and society at large.

Second, as observed previously, the tax disparity complained of by the advocates of Internet taxation is neither new nor uniquely related to the Internet. It goes back more than 30 years to the rise in remote mail-order sales, which also escape most sales and use taxes, not as a result of electronic wizardry, but by virtue of the fact that the Constitution bars states and localities from forcing a person or firm not present in the state to collect their taxes for them. The fact that most sales and use tax revenue levied on remote mail order sales is seldom collected reflects the cold reality that while states and their subdivisions may possess the *authority* to levy a sales or use tax on any consumer within their boundaries, it does not necessarily follow that they possess the practical constitutional *means* by which to collect it.

Strawmen, Non-Problems And Real Problems That Solve Themselves

Utah Governor Michael Leavitt, speaking on behalf of the National Governors Association (NGA) at the National Press Club on November 16, 1999, acknowledged that uncollected sales and use taxes from Internet sales pose no fiscal problem currently. The Governors' concern is that as e-commerce expands, uncollected taxes will also increase and pose a revenue problem for state and local governments. This concern is misplaced, as

it arises from a static view of the relationship between a growing economy and government revenues. This static framework leads the state-and-local lobby to erroneously focus narrowly on the static "revenue loss" that supposedly occurs because states are constitutionally prohibited from forcing online companies outside their borders to collect sales and use taxes on remote e-commerce transactions. Ronald Reagan confronted the same kind of static mentality in cutting tax rates in the early 1980s.

Focusing exclusively on so-called "lost" sales tax revenues from remote sales when evaluating the Internet's impact on state treasuries is misleading. First, there is no evidence that the Internet has given rise to a zero-sum game between e-commerce and local-merchant purchases, and there is every reason to anticipate a positive-sum relationship. For example, the advent of the VCR did not mean that people stopped going to the cinema to view movies. People still value, and are willing to pay a fair amount to enjoy, the "theater experience." The overall movie industry today has never been stronger.

There is every reason to believe that if policy makers do not undermine economic growth with ill-conceived policies, the retail-sales industry will continue to evolve, adapt and thrive in this changing environment.

Governor Leavitt himself, ironically, offered a profound insight that undermines the pessimism espoused by his own organization. "In the century ahead, 'e-tailing' will not simply replace brick-and-mortar retailing. The two will converge in a new world of 'clicks and mortar.'" How right he is when he predicts that, "The successful retailer of the future will have a retail presence, a catalogue presence and an Internet presence." Where he goes astray, however, is in failing to see the implications of his own insight. He says, "convergence [between e-tailing and brick-and-mortar retailing] *demands* a level playing field as its first principle." But, convergence doesn't demand a level playing field *a priori*, and by implication with government policy to do the leveling. *The convergence itself will create the level playing field without government having to lift a finger.* The very retail-presence/storefront-locations that Governor Leavitt foresees will create nexus and solve the problem about which the NGA and her sister "public interest groups" are currently wringing their hands.

At least one established major bookseller with retail stores nationwide has attempted to sever nexus by establishing a completely separate online business operation, which not only sells an identical inventory as the bricks-and-mortar stores but also allows e-commerce customers to use local stores for the return and exchange of merchandise purchased over the Internet. When this type of arrangement is inevitably challenged, the courts are likely to pierce any 'corporate veil' of efforts by companies selling the same merchandise online and over the counter. To organize e-commerce operations into 'separate' legal entities to break the nexus for sales tax purposes will not stand—they will have to collect the sales and use tax.[19] As long ago as 1941, the Supreme Court ruled that Sears could not avoid Iowa taxation on its mail-order service when it had such a substantial physical retail presence in the state.[20]

Listen to Governor Leavitt's own prediction: "Amazon.com recently established six distribution centers throughout the country. This gives Amazon nexus to those seven states—the physical connection that triggers the obligation under the laws of those states and their municipalities [*sic* — what he really means is "under the Commerce Clause rulings of the Supreme Court"] to collect sales tax. *It means even Amazon.com will be subject to an Industrial Age sales tax system.*" If, as the Governor predicts, "savvy consumers expect to be able to integrate the Web with in-store shopping," which is quite likely, the problem of uncollected sales and use taxes solves itself.

Governor Leavitt constructs two straw men to create the impression of serious problems where none actually exist. In the first case he describes a single brick-and-mortar store with a cash register, a catalog mail order terminal and an Internet terminal allowing customers using both the catalog and Internet forms of ordering to avoid the sales or use tax

while the customer one aisle over paying at the cash register must pony up the tax. "Would this be fair?" he asks, not bothering to mention that not only would it not be fair it would most likely be illegal. Absent other factors, the very existence of the store front and the physical presence of the computer terminals in it should be sufficient to establish 'nexus' obligating the business to collect tax on purchases made from the store's catalog and terminals.

The second over-stated problem relates to what Governor Leavitt describes as a "campaign to prohibit state and local governments from creating tax systems in their own communities." The only effort that approaches this description consists of a single bill introduced by Senator John McCain and Rep. John Kasich, which would have the federal government preempt states from even collecting sales or use tax on Internet sales *within* the state. The state-and-local-government lobby misleads the public by taking an isolated instance of a bad idea (the McCain/Kasich bill), which is separate and distinct from the Internet tax moratorium currently in effect, and associate it in the minds of the public with the moratorium as a "campaign" to deprive states and localities of the sovereign right to tax. The irony is doubly rich when one considers the extraordinary extent to which Governor Leavitt's own NGA scheme erodes states' tax sovereignty.

Once all the strawmen, non-problems and real problems that will correct themselves are swept aside, a dynamic view of the Internet economy reveals a much more optimistic outlook for state revenues in the upcoming Cyber Century than the state-and-local lobby would have us believe. Ernst & Young has produced an estimate of sales and use taxes not collected in 1998 as a result of the increase in remote sales from the Internet: $170 million. That is only one-tenth of one percent of total state and local sales and use tax collections. Anyway, eighty percent of transactions conducted online are business-to-business sales, which are either non-taxable or paid directly by in-state business purchasers, and most of the business-to-consumer transactions are non-taxable securities and information services, or airline tickets for which applicable taxes are in fact collected.

Furthermore, states are not as dependent on sales tax revenues as their lobbyists would have the world believe. While salivating over all the sales tax revenue "lost" to remote sales, state and local officials tend to overlook the fact that more aggressive efforts to coerce and/or entice companies to collect these taxes will set in motion reactions by consumers and online firms that will thwart the collection efforts.

Sixty percent of state revenue and 75 percent of state and local revenue combined comes from non-sales taxes, such as income and property taxes. A static estimate used by NGA puts the revenue "loss" from uncollected sales taxes at $10 billion in 2003. A more realistic study, which takes consumers' behavioral responses into account, estimates that the volume of sales over the Internet would decline 30 percent if sales taxes were collected on all remote Internet sales as consumers purchased less (anywhere from one-third to three-fourths less according to the empirical research). This study places the revenue "loss" from uncollected sales and use taxes at $2.6 billion in 2002.[21]

The reduction in overall GDP from more aggressive efforts to collect sales and use taxes on remote Internet sales would result from more than just reduced retail sales. A reduction would come about as the entire information technology industry contracted in reaction to the gloomier outlook for e-commerce. Right now, e-commerce is the tip of the Internet economy iceberg: only about 35 percent of all revenues in the Internet economy came from e-commerce in 1999. The remaining 65 percent came from the infrastructure, applications and intermediary companies that build and maintain the hard and soft framework and backbone of cyberspace. In the first quarter of 1999, the Internet infrastructure, application and intermediary companies generated $80 billion in revenue compared to $37.5 billion in e-commerce.

Economist Austan Goolsbee's research illustrates the fallacy of static framework employed by the state-and-local-government lobby. He found that if more aggressive efforts to collect these taxes on remote Internet sales reduced economic growth by no more than one-third of one percentage point, the dynamic revenue lost from other sources would offset any additional sales tax revenue likely to be collected. This does not include the additional collateral damage done to the Internet.[22]

II. The Constitutional Underpinnings

The taxation of electronic commerce brings together an unusual confluence of constitutional considerations, ranging from basic issues of federalism (state vs. federal power) to minute yet telling issues of factual interpretation (does a web server constitute a physical presence in a state?). But at the heart of the controversy over how to apply existing rules of taxation to commerce over the Internet is the oldest dispute in America politics: whether we are a unified nation and market as Hamilton envisioned, or are we an assemblage of states that retain sovereign authority over commerce within their physical boundaries, yielding only cross-state and foreign commerce to the national government (the Madisonian view).

Historically this dispute has been marked by wide swings of the pendulum in sorting out the respective powers of the states and the federal government, whether through constitutional interpretation in the courts or in the legislative process. But in the 20th century at least, the overwhelming trend was to build up federal power and reinforce the idea of a national marketplace, at the expense of state power. This result was perhaps a natural outgrowth of technologies that broke down transportation and communications barriers to the exchange of goods and services across the nation; but it also got a big boost in the political process, beginning with the Progressive Era and accelerating with the New Deal assumption of sweeping new federal powers over economic activity of all kinds.

Whether the 21st century will see a different approach remains to be seen, but already the emergence of electronic commerce has scrambled the traditional 'correlation of forces' that up to now has shaped federal-state relations in taxing and regulating economic activity. While states normally trumpet their autonomy and independence to legislate as they choose, where e-commerce is concerned, they demand the right to impose uniform rules across state lines and complain that the federal government is impeding them. While the federal government normally seeks to tap any new revenue source, where the Internet is concerned it has moved to restrain state taxation without stepping in to assert its own taxing power. And substantial elements of the business community, both high-tech and 'traditional' in nature, lean more towards the states' desire for uniformity than to the current federal preference for no (or minimal) taxation of the Internet.

How this will sort itself out no one can predict, but clearly a shift in economic power relations (and their constitutional parameters) between the states and the Feds is in the works. Before we speculate on what may happen, let us look at the most critical constitutional issues surrounding e-commerce today.

Due Process

For purposes of federal-state relations in the area of taxation, 'due process' means the requirement of the 14th Amendment to the Constitution barring states from depriving "any person of life, liberty, or property, without due process of law." While due process requirements are most familiar from areas such as criminal procedure and the property rights movement, their application to the subject of taxation is limited but important. In essence, they boil down to the idea of "no taxation without representation," not in the sense that they require the taxpayer to have voting rights in the taxing jurisdiction, but in requiring that the taxing authority have sufficient grounds for taxing a person or corporation not resident (incorporated) in the state, and that the taxpayer have a reasonable expectation or understanding that he or she is subject to the state's taxes.

In practice, due process for state taxation has been boiled down to the notion that the taxpayer must have some sort of physical presence in a state in order to be subject to its taxing authority. While the constitutional standards for such a presence (as decided by the Supreme Court) have evolved over the years, they loosened substantially in *Quill Corp. v. North Dakota ex rel. Heitkamp,* a case decided by the Court in 1992.[23] In that case the Court drew a clear distinction between Due Process jurisprudence and Commerce Clause jurisprudence, ruling that while due process required nothing more than certain minimum contacts with a state (not necessarily a physical presence) for purposes of taxation, the Commerce Clause imposed a more stringent standard against states (see discussion, below).

Why does this matter for electronic commerce? First, while the Due Process constraint on state taxation has been substantially narrowed by the courts, it hasn't been erased. The Internet, and the commercial transactions conducted over it, raises entirely new questions: Does a web server in the state constitute even a 'minimum contact' for Due Process purposes? Do freely-posted commercial web offerings, passively available to anyone with Internet access but not 'aimed' at any particular jurisdiction, constitute such contact?

The question may seem moot since, as we will see in discussing the Commerce Clause, it is hard to imagine a form of presence in a state that would pass the Commerce Clause test yet fail a Due Process test. However, since Congress has freedom to reinterpret the Commerce Clause via legislation (so long as it doesn't breach clear constitutional limits), it is not inconceivable that federal legislation, or some less formal type of federal-state accord, might ratify certain forms of Internet taxation that would nonetheless fail a 'minimum presence' test for Due Process purposes. That seems unlikely for now, but the law is constantly evolving, as legal commentators are always eager to remind us. In any event, given the (literally) ethereal and non-tangible nature of commercial activity conducted over the Internet, it is not inconceivable that Due Process jurisprudence in the field of state taxing jurisdiction could be revived: another reason to be wary of 'comprehensive' proposals for Internet taxation like the original NGA proposal.

In fact, a possible Due Process case is not difficult to find even now. As we have seen in Section I, the most critical area of dispute concerns the imposition of state sales and use taxes on electronic commerce. In that Section we also point out (see Table 1) that states could constitutionally collect sales and use tax directly from the consumer at point of sale. In response to frustration over their inability to collect taxes on remote sales (mail order as well as electronic) to their residents, however, some states (North Carolina, Michigan) have resorted to requiring taxpayers to report their "use tax liability" on state income tax forms. This is an important and novel development, because (1) the whole concept of use tax is to require vendors to collect and remit tax on items purchased for 'use' by residents of their states—switching the tax-collection burden to the residents themselves alters the very nature of the taxing relationship; and (2) the requirement that a state's residents know exactly which of their out-of-state transactions are subject to use tax assumes that those residents (for purposes of constitutional jurisprudence) know which companies they deal with out-of-state have an adequate 'nexus' to the state under the Commerce Clause rulings.

Placing the incidence of tax *and* the burden of collecting it on consumers puts them in the middle of a constitutional conundrum, and creates a sort of hybrid direct (on the consumer) and indirect (on the transaction) tax. Every taxpaying resident of these states could end up having to be a constitutional law expert, and have to conduct an in-depth survey of the corporate structure of his or her out-of-state vendors as well.

Not only is that a somewhat bizarre notion, it could stir up a new class of due process claims. If states try to assess use taxes on their residents using this self-reporting device, those residents could well end up paying tax on 'use' of items purchased from concerns that have no constitutional nexus with the state. That raises questions of fundamental

fairness, notice and certainty, and...yes...taxation without representation, all of them key due process considerations. It may be that the states experimenting with this device for collecting use tax really intend to (1) put pressure on their residents to hold out-of-state vendors accountable, and (2) create popular support for making those vendors directly liable for collecting use tax. Regardless of state intent, this new approach to the use tax collection issue could easily revive some aspects of due process jurisprudence regarding state taxation of cross-border transactions.[24]

Commerce Clause

The Commerce Clause of the U.S. Constitution, especially after the *Quill* decision, is the primary source of federal power over state and local taxation that involves cross-border issues. The enactment of ITFA itself is premised on Congress' power over interstate commerce, and over the years that power has been asserted (by private parties as well as the federal government) to limit the states' taxing power not just with regard to sales and use taxes, but income and excise taxes as well. For the current Internet tax debate, the Commerce Clause is where it's at.

As we have noted earlier, the relevance of Commerce Clause jurisprudence to the Internet is obvious. Electronic commerce brings a new level of complexity to the issue of taxing purchases by residents of a state from vendors whose retail facilities are located elsewhere: when orders are placed in cyberspace, who has jurisdiction? Obviously every business has a physical presence somewhere (offices, warehouses, shipping facilities), but that presence will seem increasingly insignificant as e-commerce grows and just-in-time order fulfillment using drop shipping becomes the norm.

In another sense, though, e-tailing of goods and services is no different (for constitutional purposes) than mail-order and phone sales, which have been going on for some time. Mail-order sales were the issue in *Quill*, after all, and the Court's action striking down North Dakota's attempt to impose use tax on such sales did not provoke a wave of concern that state and local revenues would be gutted, the way e-commerce has. E-commerce seems to be such an unknown quantity to state and local tax collectors, with tremendous but hard-to-predict potential, that it leads to extravagant claims about how different the commercial world of the future will be. Before considering the differences, let's look at some of the similarities between e-commerce and other forms of cross-state transactions.[25]

Both forms of commerce involve a resident of a state contacting (or being contacted by) a vendor who is not 'located' in the same state in order to purchase goods or services, which then are shipped to the resident from a location determined by the vendor. If the vendor ships from a warehouse in the resident's state, or also does business from a physical location in the resident's state, there is little question that sales and use tax is owed to that state. As the *Quill* Court said in reaffirming existing criteria for determining taxable 'presence' in a state for Commerce Clause purposes, "we affirmed the continuing vitality of Bellas Hess' 'sharp distinction' … between mail-order sellers with [a physical presence in the taxing] State and those … who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business."[26]

The problem for states and localities arises, of course, where they cannot demonstrate a 'substantial nexus' between an out-of-state vendor (e-tailer or mail-order) and their jurisdiction. 'Nexus' means a physical presence of some kind in the state (or locality), but exactly what that constitutes remains open to judicial refinement as new fact situations present themselves. Importantly, nexus is necessary but not sufficient for states to impose sales and use tax: under existing jurisprudence they also must not discriminate against interstate commerce, must apportion tax fairly, and tax in a manner related to services the State provides to firms selling into their jurisdiction.[27]

Obviously states, who have had limited practical success in collecting use tax from out-of-state mail order firms, are concerned that electronic transactions will be even more difficult to collect tax on. That is why Gov. Leavitt and his colleagues in the National

Governors Association have proposed a systematic new scheme for coordinating sales and use tax policy (including collections) among the various states and with the private sector (at least, that is the *stated* reason). But the main difference between mail order and electronic sales is the means of placing the order. Tracking down transactions that may be subject to sales and use tax is not necessarily any more difficult in cyberspace, and software innovations might actually make it easier in the future. The real problems states face, with regard to both mail orders and Internet sales, are privacy concerns (government prying into people's buying habits is unpopular, to say the least) and wariness of treading on federal power over interstate commerce.

There is substantial reason to believe, then, that Gov. Leavitt and his allies seek to use the flurry of interest in e-commerce as an occasion to muster support for the more 'rational' approach to sales and use taxation they prefer: similar rules among the states, an agreed-upon technical means for all states to collect and share taxes 'due' on cross-state transactions. While Leavitt and his like-minded colleagues will continue to refine and modify their proposals to build political support, one thing is clear: to accomplish what these states want would require a substantial change, or at least clarification, of what constitutes 'nexus' in the meaning of the Supreme Court's Commerce Clause rulings. That change could be accomplished two ways: Through congressional action (which the *Quill* court invited Congress to undertake if it chose to), or through a series of adjudications more favorable to the Leavitt position.[28]

No doubt, it is for this reason that the Number One concern of the Leavitt group seems to be to head off congressional action redefining 'nexus' in a way that would restrict their efforts to subject more interstate economic activity. Several proposals to do that have been made, including some from the business community (which does, after all, want common standards if it can get them) and one submitted to the Advisory Commission on Electronic Commerce by Commissioner Dean Andal. In fact, the Governors would probably prefer to live with ITFA for the foreseeable future (since ITFA does not interfere with existing constitutional jurisprudence on 'nexus' but only restricts Internet access fees and 'multiple or discriminatory' taxation) than have it replaced by a tightly-drawn federal definition of what does and does not constitute 'nexus'.

Is there a bottom line here? Probably so. First, since there is no state/local revenue crisis on the horizon (see our discussion in Section I), there is no urgent need to 'clarify' the Commerce Clause to facilitate state collections of sales and use tax. It may indeed be useful to legislate some clearer standards of 'nexus' consistent with the existing physical presence test, which is what Commissioner Andal, among others, proposes to do. But that is a policy determination, not a legal one: it would certainly be desirable in the interest of facilitating the growth of electronic commerce, which is a major factor in generating the revenue boom that both states and the federal government are enjoying. But as the Supreme Court has said, Congress is free to legislate pursuant to the Commerce Clause or leave a substantial gray area to be clarified by future adjudications.

Second, while there is no immediate threat that state sales and use taxes will be seriously undermined by e-commerce, it is certainly possible that as commercial habits and relations evolve, the concept of taxation at point of sale, coupled with a 'use' tax on purchases by residents from out-of-state vendors, may become obsolete and ineffective. For that reason alone, it is certainly prudent for states and localities to be thinking about alternative revenue sources and restructuring their tax bases for the future. In the long run, any adjustment in state taxing authority as it affects Internet (or mail-order) commerce will require a hard-fought political accommodation with the federal government. That, after all, is what the federal power over interstate commerce is all about. If commerce evolves in such a way that it is difficult or impossible to prove a 'nexus' or physical presence in most states, then states will need federal backing (if only legislative acquiescence) for any substantive redefinition of those terms (not to mention the ability to withstand a court challenge). If commerce does evolve as dramatically as Gov. Leavitt and some of his colleagues

seem to think it will, it would be much more prudent of them to reexamine their internal tax structures from top-to-bottom rather than continuing to chase after the marginal tax dollar from cross-border transactions. Thanks to the Commerce Clause, they are not dealing from a position of strength in this area, relative to the federal government.

Third, it does not follow from the supremacy of federal power over interstate commerce, and the increasingly nationalization of market activity driven by telecommunications, growing wealth, and mobile populations, that federalism as we know it is dead, or that states will (or should) become dependent on the federal government for revenue to perform their functions. There is a tendency to view the natural evolution of markets as a reason to suddenly alter the governmental structure, usually in favor of greater centralization and more power over the economy. In the 1970's, the mantra was that with the growth of multinational companies and business conglomerates, economic activity had become too 'complex' for a limited-government, low-tax approach to work. The Reagan Revolution should have proved how wrong that was, but memories are short.

The new mantra is that nationalization and globalization of markets requires 'harmonization' of tax and regulatory structures across state (and national) boundaries. That, for instance, is what the European Union is all about. But neither complexity nor globalization should drive changes in the constitutional structure, which has served America quite well indeed for over two centuries. The Constitution and its Commerce Clause envision a sort of matrix system in which states are free to innovate within their boundaries, subject to mediation by the federal government and federal preemption when necessary to keep goods and services flowing smoothly across state borders. That paradigm is as valid today as ever, and adapting tax systems to the world of cyberspace need not disrupt the federal system. But that adaptation will require great imagination and innovation on the part of policymakers, something that many of our Governors seem unwilling or unable to supply. But when they have to, they will.

The Interstices of Federalism

While the federal system encourages states to innovate (and indeed compete) within their borders, the Constitution gives less-clear guidance as to what states can do acting together, rather than individually. After all, the federal government is supposed to express the collective will of the states (as well as the people) in legislative and policy matters: the U.S. Senate itself was created to represent "the states" in the national government. In very extreme circumstances, collective action by a group of states split the nation in two (the Confederacy), resulting in a bloody war to settle the issue of national power and unity.

But short of that extreme case, there are many areas in which states cooperate or coordinate policy, ranging from law enforcement to land-use planning, without disturbing federal-state relations. They are free to do so insofar as they do not run afoul of Article I, Section 10 of the Constitution, which says in pertinent part that "No State shall enter into any Treaty, Alliance, or Confederation;" and that "No State shall, without the Consent of Congress, … enter into any Agreement or Compact with another State …". Over the years the Supreme Court has interpreted these provisions to allow states to collaborate in most normal 'housekeeping' or police power matters without express Congressional approval: examples include exchange of crime records, regional transportation agreements, coordination of health warnings or quarantines, and so forth.

For purposes of our analysis, however, the issue is possible joint-state efforts in the field of taxation to coordinate or 'harmonize' policies, practices, and procedures in the interest of maximizing their revenue take and clamping down on cross-border 'evasions' of what they see as taxes rightly due them. While there is no system or accord in place now in the field of Internet taxation that raises issues under the Confederation Clause or the Compact Clause (as the above-reference provisions are commonly referred to), there most certainly are proposals on the table that, at a minimum, test the boundaries of what states can do collectively without requiring congressional approval. The original proposal by Gov. Leavitt and the National Governors' Association, for example, would have gone so far as

to revive the ancient and despised use of "tax farmers" by channeling tax-collection information to private sector entities ("trusted third parties") for the purpose of analyzing tax liability and divvying up the proceeds of sales and use taxes among the states. It also would have imposed penalties on states that declined to "harmonize" their sales and use tax policies to minimize e-commerce leakage.

While the Governors' proposal is still evolving (the 'trusted third party' feature has been dropped, and a less coercive means of harmonization seems to be in the works), the issues it raises under the Constitution are very much alive. In interpreting the Compact Clause the Supreme Court has made it clear that 'substance over form' is the order of the day: the issue is not the degree of formality with which states enter into agreements, but "the essence and the substance of things … It would be but an evasion of the constitution to place the question upon the formality with which the agreement is made."[29] The Court has determined that the real issue under the Compact Clause is "the formation of any combination tending to the increase of political power in the States, which may encroach upon or interfere with the just supremacy of the United States."[30]

This 'political power' standard is a highly subjective one, and it may not be immediately obvious why this standard differs from federal control over interstate commerce under the Commerce Clause. The answer is that the Compact Clause pertains to much more than commercial relations across state lines; and that the very notion of agreements among the states raises issues of constitutional structure that the Commerce Clause ignores. In essence, the Compact Clause as interpreted by the courts goes to the fundamental question of states joining together to, *de facto*, create a new political entity that is neither state nor federal in nature, but something in between. Such entities, when found, are prohibited when they intrude on the 'just supremacy' of the United States.

Applying the Compact Clause in the area of taxation is therefore a tricky matter, because the Constitution does not bar the states from any *source* of taxation except insofar as it interferes with interstate commerce (a tariff, for example), as we saw in our discussion of the Commerce Clause. In fact, the leading Supreme Court case on state taxation agreements, *U.S. Steel Corp. v. Multistate Tax Commission,* 434 U.S. 452 (1978) found no Compact Clause bar to an agreement that helped determine and apportion state income tax liabilities for businesses with income-producing activity in multiple states, including (*inter alia*) apportionment formulas and auditing requirements enforced by the Commission. The Court concluded, in brief, that "Any State's ability to exact additional tax revenues from multistate businesses cannot be attributed to the Compact; it is the result of the State's freedom to select, within constitutional limits, the method it prefers."[31]

At face value the *Multistate* decision appears to validate the notion that states may join together to harmonize their tax policies, and even tax collection procedures such as audits, without congressional approval, notwithstanding the Compact Clause. That would be a hasty conclusion. First, the types of accords the Governors seem to be contemplating in the area of Internet taxation include such measures as common collection agents for the states; penalties on states that do not adopt certain types of harmonization legislation, such as definitions and audit rules that would apply uniformly to on-site, mail-order, or Internet sales; and surrendering their sovereign right to act unilaterally on such fundamental issues of tax administration as classifying products and deciding when and how to change their own laws concerning sales and use taxes (after all, you can't have 'harmony' and 'certainty' if states retain too much independence!).

No one can say for certain that some of the proposals for coordinating and regulating state tax policy concerning e-commerce would be found to violate the Compact Clause if adopted without congressional approval. We can and do say, however, that these proposals go directly to the issue of enhancing state power at the expense of the national government. This is exactly what the Compact Clause, according to the Supreme Court, was designed to address. Indeed, the issue of taxing the Internet has inspired states to argue that

in order to protect their sovereignty, they have to surrender their sovereignty—but to some intermediate authority or coordinating system, not to the federal government. Knowing that Congress has historically resisted legislating solutions to state revenue collection problems, many of the Governors appear to be taking advantage of the emergence of e-commerce to effectively 'legislate' their own solutions, bypassing Congress altogether. If the Compact Clause has any bite at all, this is where it should come into play.

In addition, and in the realm of pure speculation, it can be argued that the *Multistate* case was wrongly decided and might come out differently today. In his dissent in that case Justice White made a strong argument that the Court adopted the proper standard of looking to the impact of an agreement on federal-state power relations, but then failed to apply that standard accurately to the facts of the case. Justice White particularly cited the Multistate accord's audit enforcement powers and rules for apportioning income, concluding that "It is pure fantasy to suggest that 21 States could conceivably have arrived independently at identical regulations for apportioning income, reciprocal subpoena powers, and identical interstate audits of multinational corporations, in the absence of some agreement among them."[32] White dismissed the Court's finding that whatever the Multistate agreement provided, states could each have done on their own, pointing out that "it cannot be disputed that the action of over 20 States, speaking through a single, established authority, carries an influence far stronger than would 20 separate voices."[33]

Justice White's remains a minority view, but it is worth pointing out that the *Multistate* decision was handed down long before the advent of e-commerce, and without Congress having expressed its will as it has done in enacting ITFA. The message of ITFA clearly is that the federal government is occupying the field of e-commerce and Internet taxation for now, subject to the sovereign authority of states acting on matters within their borders. Any compact or agreement undertaken by the states (even if done without an express accord, since the Supreme Court is interested in substance, not form) would have to be more closely scrutinized under both the Commerce Clause *and* the Compact Clause in light of this unambiguous expression of congressional intent. As a matter of practical politics, the states will not be able to coordinate action effectively in this area without congressional acquiescence, unless they resort to the courts and succeed in breaking significant new ground in the field of constitutional jurisprudence.

Similar concerns apply under the Confederation Clause of Article I, Section 10, although here the issues are more cut-and-dried. While that Clause was invoked as an objection to the secession of the Confederate States, its linkage in Article I with the concept of "treaties" means that most constitutional jurisprudence under this section deals with limits on the power of states to delve independently into the realm of foreign relations. While a Confederation Clause objection against any state compact on Internet taxation may seem novel, it raises some very interesting questions. For example, in the emerging era of e-commerce, should we really be so concerned about alliances based on geography (which is what the Framers clearly were thinking of), or alliances and accords based on power and interest? The futurists among us predict not just an explosion of e-commerce, but an accelerating shift of social relations, interest group activities, political speech, entertainment, and even civic activity (cybervotes) to electronic 'space'. If that proves true, does a confederation barred by Article I Section 10 really have to be based on geography, as was the Confederate States of America?

Perhaps not. An Electronic Confederation can easily be envisioned, embracing the kinds of tax harmonization sought by many Governors, but also including common standards of privacy, censorship, residency, voting standards, welfare requirements, and much more, all geared to 'residents' of cyberspace who only incidentally are also geographical residents of the states who form the Confederation. This is no more an exercise in the imagination than the arguments of tax collectors and regulators who see cyberspace as a massive threat to their authority, a sort of Cayman Islands of the ether. After all, the same technological advantages available to private citizens are also

available to all levels of government: if a group of states crafted a 'virtual secession' via the Internet, how would Washington stop them?

Whatever the future of the Confederation Clause as a regulator of state-to-state agreements, it is worth remembering that this Clause has one critical distinction from the Compact Clause: Congress cannot legislate out of it. Whereas compacts can always survive if approved by Congress, the Constitution gives Congress no power to 'approve' a Confederation, or an unauthorized treaty action by any state or states. Confederations are found by the courts only in extreme cases, but they are absolutely barred where found.

Electronic Space: Where Is It?

As can be seen from the preceding discussion of constitutional constraints on state and local taxing authority, 'where' economic activity takes place (or is deemed to take place) has tremendous consequences. This is especially important in the field of electronic commerce, since cyberspace has the potential to confuse the situation by making it possible to split up functions like order-taking, corporate headquarters, warehousing, delivery, and finance more than ever before. As we have also seen, though, the Internet does nothing to change the fact that every customer is resident in some political jurisdiction, as is every vendor. The real concern of state and local governments is, or should be, that cyberspace makes it harder to track transactions to their point of origin and to the final customer. Technology may solve that problem quite handily, however, provided that suitable privacy protections can also be developed.

Boiled down, there is not enough imminent 'danger' to state and local revenue sources from e-commerce to justify meddling with the constitutional structure we have just reviewed. There is, however, one real concern that is properly the province of the states: the possibility of electronic transactions being conducted between companies with proper nexus to a state (as defined by the Supreme Court or subsequent federal legislation) and residents of the same state. This can occur already in the mail-order situation, and voluntary tax compliance on the part of vendors has been the main answer (and a fairly effective one, at least for larger vendors). But there is little dispute that the Internet opens many new possibilities for in-state tax avoidance.[34] Here again, there may be a technological solution, and there may be a need for some exchange of information across borders to facilitate compliance (not exactly a groundbreaking idea).[35] It is, however, hard to see why this particular problem requires or justifies novel and constitutionally questionable accords and compacts among states.[36]

Thinking of cyberspace as an overlay of U.S. geography that has independent legal, practical, or constitutional significance is probably wrong. It provides an electronic forum, a means of communication, a boundless source of information, and a catalyst for commerce. But it may not have such profound meaning and consequences for revenue-generation and tax-collection as many commentators seem to think. The Internet is no more the determinant of *where* economic activity occurs than are factors such as, say, a favorable climate, abundance of natural resources, or easy access to recreational facilities.

All of these are important 'quality of life' factors affecting the location of economic activity, yet no one looks upon them as factors creating unique problems for tax collectors (if people flee New York for Florida, New York doesn't seek to apportion tax revenues generated by its former residents[37]). There is no issue in state or local taxation concerning the growth of electronic commerce that cannot be resolved quite handily under existing constitutional jurisprudence. And there is no need for states and localities to 'over-innovate' with public policy in order to enhance their power over commerce simply because it is moving to the Internet. There's plenty of reason for constitutional caution here, and plenty of time to craft constitutionally appropriate solutions for problems when they arise. That time is not here yet.

III. Down To Earth: Practical Federalism For The 21st Century

We have seen that the debate over Internet taxation is fundamentally a debate over principles of fiscal federalism: How to balance the state's independent taxing powers against their need for coordination in some areas; the virtues of cooperation and harmony versus competition and tension among states in the field of taxation; and the relative powers of the states relative to the federal government as a whole. Arguments over what constitutes a 'level playing field', and what constitutes 'revenue adequacy', and what administrative remedies are appropriate, all must be framed within this context.

For many years these issues and many others were the province of political scientists, public administrators, and economists specializing in public finance. All of these folks tended (and still tend) to operate within a 'rational planning' paradigm, an offshoot of the Progressive Movement and its emphasis on administrative efficiency, 'scientific' management, and centralized administration. As a corollary, this planning paradigm stresses cooperation and bureaucratic coordination in tax policy in order to reduce or eliminate 'destructive' tax competition and supposed administrative chaos. The old saw is that units of government will conduct a 'race to the bottom' if they have to compete, reducing public services as much as possible in a bidding war to attract business.

The Public Choice school of analysis, which rose to prominence in the 1970's lead by Nobel-prize winning economist Dr. James Buchanan, effectively smashed the planning paradigm by demonstrating (1) that competition among taxing authorities both maximized efficiency in delivering public services and enhances citizen welfare by constraining government growth, and (2) planners not subject to *some* kind of market discipline become a class unto themselves, primarily concerned with maximizing their own welfare under the guise of exercising a public trust.

Too many proposals for dealing with Internet taxation, and electronic commerce in general, revert to the assumptions of the rational planning model, as though the Public Choice revolution had never happened. The original National Governors' Association plan, as marketed by Gov. Leavitt, was sold on the basis that it protected fundamental principles of federalism and the rights of states. In fact it is rational planning *par excellence*, and, as former Tax Reform Commission Chairman Jack Kemp said, "the very antithesis of American federalism."

Whatever mode of analysis you prefer, there is always going to be a necessary tension between the goals of easing tax collection and protecting individuals' rights and freedoms. The example of remote sales being conducted over the Internet may be a leading indicator of the future, and foretell vexing problems for government in dealing with cyberspace in other forms of taxation as well. For example, it is not far fetched to imagine that electronic money will soon advance to the point where a consumer can just slip his fingerprinted smart card into a reader attached to his cell phone or computer keyboard and pay cash for anything he desires without the seller or anyone else knowing who or where he is. Combining digital payment systems with the use of mail-forwarding services, the government would not easily be able to locate either the seller or the consumer in such transactions.[38] But, the novelty of the Internet should not mislead one into thinking that the tax evasion it stimulates is unique. To the contrary, the Internet should revive the universal and timeless principle of taxation that "only what can be taxed efficiently should be taxed at all."[39]

It is hard to imagine a scenario, at least in a free society, where there was *not* tension between the tax collector and the individual. The obligation of policymakers is to make an unbiased judgement as to when the pendulum has swung too far one way, or the other. The case that it has already swung too far in protecting the individual in the case of Internet sales is far from proven. And before the judgement is made that it has, either now or sometime in the future, we must carefully weigh the costs of trying to improve tax collection at the expense of further limiting personal freedoms. Before that route is taken, policy makers would be well advised to think about reconstructing the system of taxation from the ground up in a fashion that is more compatible with a free society.

Everything in life is unfair to someone, and scientific innovations like the Internet clearly advantage those businesses and individuals best situated to exploit them, and disadvantage those who lag behind. A society that encourages the "creative destruction" of free markets must also understand the resentment of those who (at least temporarily) are disadvantaged in market competition. At the same time, it is wrong to let that temporary resentment be exploited by interested parties to drive the political process toward government (federal or state) intervention that undercuts the natural, socially beneficial operations of the market. Indeed the worst result, from the standpoint of the neutrality principle as articulated by the Tax Reform Commission, would be federal intervention to *de facto* impose a tax penalty on technologically advanced merchants in order to 'protect' their less-advantaged competitors from the salutary effects of creative destruction.

The Problem of Collusion

All governments, federal, state or local, want to collect taxes as quietly and painlessly as possible, and routinely resort to such devices as third-party collections: using an intermediary to collect taxes, rather than going directly to the taxpayer. This device is not limited to vendors collecting sales and use taxes, but also includes employer withholding of income and payroll tax, collection of excise tax by manufacturers, and fee collection by service providers (ticket taxes, excises, telecommunication service taxes, etc.). In the extreme case governments require taxpayers to publicly display a mark of having paid taxes, such as property tax stickers to be displayed on the windshields of vehicles, so that, *inter alia*, can be deployed to monitor tax compliance.

This third-party liability option—effectively concealing the cost of government actions from those who truly bear that cost—has grown in disturbing new ways in recent years, as state governments, and state officials, collude with one another or with Washington in order to achieve regulatory and legal objectives they would never be able to accomplish through the normal legislative or administrative process—objectives that impose serious costs and burdens on private parties. State attorneys general have joined together to extort money from the tobacco industry that they would probably not have been able to access individually. The same group eagerly fell in line when they saw the federal government's initial success in stalking Microsoft, an obvious source of easy money.

It's hard not to see the states' effort to 'harmonize' tax policy with regard to the Internet as cut from the same mold. But this time the collusion threatens fundamental changes in the nature of American government, just so politicians can access Americans' wallets more easily. This is not federalism: it is a new creature in the American system, whereby states, facing obstacles to collection or enforcement actions for practical reasons or due to implicit constraints on their power, join together (with or without assistance from Washington) in order to siphon still more revenue from legitimate taxpaying enterprises on which they depend for revenue. This is indeed ironic when you consider that this emergence of "collusive federalism" has arisen during the same period that there has been a revival of political rhetoric (frequently from the same colluding politicians) aimed at alleged collusive, predatory, anti-competitive, or fraudulent behavior on the part of the *private* sector.

Perhaps we need a set of antitrust and racketeering laws addressing collusion in the *public* sector that harms the public interest. Or do we already have them? After all, the constitutional order calls for both separation of powers within the federal government, a national government of enumerated and limited powers, and clear lines of demarcation between what is properly a federal power and what is reserved to the states. The fact that those lines of demarcation have been radically adjusted over the years thanks to both 'evolving' jurisprudence and changing economic circumstances doesn't alter these basic truths.

The Madisonian model of American government, as laid out in *The Federalist Papers*, is a model of competition, not collusion; friction, not harmony; a calculated division of power, not a unification of it across all levels of government. For different units of government to collude in their exercise of power is not just radically different than federalism, it tramples on the most basic protection of American liberty the founders envisioned: the

allocation of power in different areas to different units of government, so that government could never achieve total authority over the individual citizen. Government collusion in the arena of taxation, therefore, is a very troubling concept and not something that should be countenanced except in the most extreme circumstances.

A World of Choice

Such circumstances do not exist in the area of e-commerce and Internet transactions. In fact, as we discussed earlier, the emergence of electronic retailing gives savvy states and localities a unique opportunity to rethink not just their tax systems, but their mission in a 21st century economy. There are many, many options out there: in the state of Virginia alone, bills have been introduced by Republicans and Democrats alike repealing the state's 4.5% sales tax, on the ground that it works against traditional vendors who are competing against cyber-merchants. After all, if the states are principally concerned about a 'level playing field', it's much easier to level it with a low-tax policy than with massive new revenue enhancement powers. It is perhaps not surprising that a growing number of lawmakers in Virginia, which styles itself the Internet capital of the world (over half of all cybertraffic crosses its borders), have concluded that the sales tax may not deserve to survive the Internet Age.

While Virginia is one of the less sales-tax-reliant states, it does derive 22 percent of its revenue from that source, so this is not a minor revenue issue. Yet Delegate Frank Wagner (R-Virginia Beach) has concluded that the state sales tax has become a "nonfunctional form of collecting revenue." One reason is that Virginia's coffers are overflowing with income tax revenues, producing a large surplus (estimated at $2.4 billion this year) largely driven by growing payrolls at America Online and other Virginia-based Internet companies. Delegate Harry Parrish (R-Prince William Co.) chairs the tax-writing committee of the Virginia House of Delegates, and predicts the state will end its sales tax in a few years, the difference being made up by adjustments in the income tax.

Whether Virginia or any other state wants to tax income, sales, property, or something else is the right of Virginia to decide. But were Virginia to agree with ten other states to tax sales and use, to do it in a specified manner, and to adopt a formula and an administrative structure for divvying up the proceeds, clearly that would be a large step towards a *de facto* interstate ('national') sales tax—without the imprimatur of the federal government, and without any input from the voters. That is a troubling concept for many reasons, and in essence it is what the National Governors Association has been seeking to do. As ACEC Commissioner Grover Norquist (President of Americans for Tax Reform) points out, "It [the NGA plan] would lead to a national sales tax and completely obliterate consumer privacy because the government will have a computer filled with everything you've ever bought in your life. And it will lead to higher taxes."

A strong case can indeed be made for shifting federal taxation to sales or consumption, and state and local taxation more to income, and not just because of electronic commerce.[40] But even if everyone agreed with that premise, such 'global solutions' inherently require major cooperation and indeed collusion among governments. Both Public Choice theory and Madison's analysis of the play of interests in the political realm tell us to be wary of these kinds of 'total solutions.' Governments always want to collect more revenue, and how does one enforce, say, a pledge by the federal government to stay away from taxing income, or by states to end all sales taxes? A constitutional amendment is one answer, but then we are talking about a long-drawn out process of public review, revision, and comment before anything could be done. That is what our constitutional system calls for. To try to engineer such fundamental changes piecemeal, as the Governors seem to want, and away from public scrutiny, is not right. The likely result, as Commissioner Norquist points out, is likely to be higher taxes in every potential revenue area. If that's what the people want, they have a right to it: but they also have a right to know what is going on.

A Few Pointers

Whatever the ultimate outcome of the ACEC's deliberations, the issues surrounding electronic commerce and Internet retailing (not just the tax issues, but privacy and regulatory concerns) are with us to stay. Since the ACEC was created to guide policymakers, and since policymakers need all the guidance they can get, here are a few guidelines we can suggest based on our review of the state-of-play in electronic commerce under ITFA:

No Rush to Judgment. Internet retailing of goods, services, and digitized products is still in its infancy, and given the flood of revenues pouring into the states as well as the federal government in recent years, clearly there is no urgent need to clamp down on the Internet in the interest of 'tax compliance.' As this form of commerce continues to evolve and grow, imaginative analysts and lawmakers will have ample opportunity to craft particular solutions tailored to particular enforcement problems. There is absolutely no reason to anticipate that these solutions will require fundamental changes in the tax laws, in constitutional jurisprudence, or certainly in the structure of federal-state relations as they affect the rights of citizens. If state and local tax enforcers ever do need such radical remedies, they should rethink the way they tax from the bottom up, rather than tamper with legal rights and institutional relationships that have served the nation well for over two centuries.

No Taxation without Representation. This particular clarion call is highly relevant to the issue of taxing e-commerce, because so many of the proposals being bandied about tend to bypass the normal legislative process and minimize the impact of the popular will on very critical issues of taxation and governmental power. Commissions, coalitions of tax administrators, trusted third parties, state-sponsored trade associations, and expert panels all have their place and can be useful, but it is extremely dangerous (particularly in the field of taxation, the most critical interface between the citizen and the state) when they make, as opposed to comment on, public policy. The original NGA proposal clearly goes beyond the bounds in that regard, seeking to forge a coordinating body with real power over state actions but no accountability to their citizens (the same phenomenon is increasingly familiar in the international sphere, with U.N.-sponsored and other bureaucracies making decisions that have a major impact on our citizens without having to account to them). But the same objection can legitimately be made to various hybrid proposals, many of them supported by the business community and by ACEC members otherwise sympathetic to the cause of low taxation. Setting up a formal process for harmonizing state tax policies and procedures is troublesome in itself, unless you have a current, demonstrable problem in tax collections that is not amenable to case-by-case resolution or state-to-state negotiations. Any proposals for taxation in the field of electronic commerce should be responsive to the public's wellbeing first, the needs of the tax collector second, and thoroughly aired in the political process.

No New (Net) Taxes. The Congress in passing ITFA has gone firmly on record against new Internet-based taxes, and it should be encouraged to stick with that principle. The ITFA moratorium on 'new' Internet taxes should be made permanent, which in no meaningful way constrains state and local actions: it does nothing to undermine state enforcement of sales and use taxes where there is a constitutional nexus, and while it does bar such innovations as 'access fees', as a policy matter most states foreswear those anyway; and the ban is an appropriate policy exercise to give the Internet as free a reign as possible without imposing special burdens on it just because it is such a potent source of economic growth. Let's keep the growth going, and go a step further, with a congressional commitment to ensure that *any* new revenue sources or enforcement actions geared to the Internet impose *no net increase in the tax burden*. If the official concern about the Internet is that it could drain existing revenue sources, there should no objection to a guarantee that neither will it be used as a pretext to raise taxes overall: federal, state, or local.

Balance of Power. Even though today the federal government is the champion of the low-tax Internet and the states are proponents of expanding Internet-based taxation, there is no reason to think that is a permanent condition. As e-commerce

evolves and both states and the I.R.S. rethink their approaches to revenue-raising, the situation could change, even to the point of reversing completely. The interests of the taxpayer are best-served by continuing tension between the states and the federal government with regard to tax policy, so long as that tension does not get to the point of disrupting normal, legitimate government operations. There is no sign of that happening, and while the federal moratorium on Internet taxation under ITFA is a legitimate expression of federal power, it would be unwise to trust the feds to be permanent guardians of a low-tax Internet. Taxpayer vigilance against each level of government will be vitally important in e-commerce as in any other issue in taxation, and never-ending effort to restrain government spending and limit the tax burden will be more important than ever if the Internet continues to be such a powerful engine of revenue-generation. Taxpayers, keep your powder dry.

Epilogue: A New Tax Paradigm

All of the above are practical suggestions for guiding public policy responses to issues of taxation in an era of electronic commerce. But in the long run it may be more important to rethink some of our fundamental concepts of taxation, at least as they evolved (and in our view, became frozen in the New Deal) in the 20th century.

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.

Endnotes

1 Source: Nielsen/NetRatings

2 David E. Fowler, CEO of an Internet-based insurer, told WorldNetDaily that he understood the concern over potential small company insolvency, but expressed doubt as to the industry's true motivation for "Triple X." Fowler believes the regulation came as a result of the larger insurers' inability to compete with smaller, mostly Internet-based companies. Though they "sold the NAIC on the concept of needing to protect consumers," Fowler thinks they were more interested in protecting their own bottom line. "It's not that the large companies aren't also on the Internet," he said, "It's just that because they were so big already, with much more staff and much more overhead, it's harder for them to compete" with smaller, leaner insurers using the Internet as their primary sales tool. "They feel as though they're losing out, and this may be their way of leveling the playing field."

3 Source: Bureau of Economic Analysis, U.S. Department of Commerce.

4 U.S. Senate floor statement by Senator Ron Wyden on the introduction of the Internet Tax Freedom Act, March 13, 1997.

5 For purposes of constitutional jurisprudence 'nexus' means a number of things, including at a minimum some form of physical presence (stores, shipping facilities) in the state seeking to collect tax. The underlying concept is that taxes should only be imposed on entities with enough tangible ties with a jurisdiction that fundamental fairness is served and interstate commerce not impeded. See our discussion in Section II of this paper.

6 Section 1101(b) of the Internet Tax Freedom Act states: "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."

7 Title 47 U.S.C.A. §223(a)(1)(B)(ii) (Supp. 1997).

8 *Reno, Attorney General of the United States, et al. V. American Civil Liberties Union et al*., 511 U.S. 96.

9 Dougherty, Jon E., "Higher rates, shorter-term policies; New life insurance regulation goes into effect in 2000," 1999 WorldNetDaily.com.

10 Interview with Jordan Hymowitz, an e-commerce auto industry analyst for the investment banking firm of Roberston Stephens Co., a subsidiary of Fleet Boston Financial Services, as reported in Brown, Warren, "Internet Putting Car Buyers in Driver's Seat: Dealers Feel Impact of Online Research," *The Washington Post*, February 28, 2000, p. A01.

11 Press briefing by National Economic Advisor Gene Sperling and Special Assistant to the President Tom Kalil on the Digital Divide, February 2, 2000.

12 Press Release, Office of the Vice President, February 2, 2000.

13 Jacob Sullum summarizes the current situation succinctly: "These claims [of a digital divide] were based on a July 1999 report from the Commerce Department, 'Falling Through the Net,' which said that 'minorities will continue to face a greater digital divide as we move into the next century.' But . . . that conclusion was based on outdated and misleading information. The Commerce Department relied on results from a 1998 survey that did not consider Internet access away from home. . . . Forrester Research had found [1998] that Hispanics were already more likely to have Internet access than whites (36 percent vs. 34 percent). Although black households were [then] still lagging, Forrester projected that they would close the gap by the end of 1999, when Internet access for all three groups would stand somewhere between 40 and 44 percent." "Political-digital divide," *The Washington Times*, February 19, 2000.

14 It took 46 years for household electricity to penetrate just 25 percent of the market. It took 35 years for the telephone to do the same. Television and radio took 26 and 22 years, respectively. It took 15 years for the personal computer to penetrate a quarter of the market and 13 years for the cellular telephone. It took only seven years for the Internet to penetrate 30 percent of the market, and according to Forrester Research Inc., a leading tracker of Internet traffic, more than 43 percent of all American households today own a PC, and more than three-fourths of them (33 percent of all households) are connected to the Internet. In some places, on-line connections already have reached as high as 50 percent, and Forrester predicts that on-line penetration will reach 56 percent of all North American households by 2003. See The Forrester Report, January, 1999.

15 The monies used to wire about half the public schools in America to the Internet were raised by a phone tax levied by bureaucratic fiat at the Federal Communications Commission under authority given to it in the Telecommunications Act of 1996 in which it was given broad discretion to mandate access to telecommunications services for schools and libraries." The FCC's mandate took the form of a telephone excise tax on long-distance calls—levied on telephone companies but immediately passed forward to consumers—but was euphemistically called a "universal service contribution."

16 *The Budget and Economic Outlook: Fiscal Years 2001-2010*, The Congressional Budget Office, Washington, DC, January, 2000.

17 Lukas, Aaron, *Tax Bytes: A Primer on the Taxation of Electronic Commerce*, CATO, Washington, DC, December 17, 1999.

18 *Unleashing America's Potential*, The National Commission on Economic Growth and Tax Reform, January, 1996, p. 20.

19 Information of a propriety nature also has come to the attention of the authors that another nation-wide chain of retail outlets recently considered a similar organizational setup to avoid having to collect sales taxes but decided that the probability of it being struck down in the courts was too great to take the risk.

20 *Nelson v. Sears, Roebuck & Co*, 312 U.S. 359 (1941).

21 Goolsbee, Austan, "In a World Without Borders: The Impact of Taxes on Internet Commerce," National Bureau of Economic Research *Working Paper* No. 6863, November 1998.

22 Ibid.

23 112 S.Ct.1904. *Quill* is probably the most-cited case in discussions of taxing electronic commerce, primarily for its affirmation of Commerce Clause constraints on state taxation of remote (in this case, mail order) sales.

24 In theory there might also be an ITFA objection to such modifications in use tax adopted after the enactment of ITFA, on the ground that it constitutes a "discriminatory tax" defined in ITFA as including "an obligation to pay the tax on a different person or entity than in the case of transactions involving similar property, good, services, or information accomplished through other means". In this case the change in use tax obligation has the same impact on e-tailing and mail-order sales, but differs from in-state sales tax collections. The issue would probably come down to definitional questions (are sales and use taxes equivalent, constituting a 'tax continuum' for purposes of this section of ITFA).

25 It's important to keep in mind that with regard to sales and use taxes, we are talking about sales of tangible goods and services. Intangibles (e.g. downloadable software) generally are seen in the U.S. as not reachable by such taxes; but not so in the European Community, which is considering way to tax downloadable software and music that 'originates' in the U.S. "Europe Plans to Collect Tax on Some Internet Transactions," New York Times, March 2, 2000.

26 The reference is to *National Bellas Hess, Inc. v. Department of Revenue of Ill.,* 386 U.S. 753 (1967), an earlier case involving mail-order sales in which the Court similarly ruled against state imposition of tax on out-of-state sales, but without distinguishing Commerce Clause rules from those applicable under the Due Process clause.

27 This four-part standard was set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

28 Even if some version of the Governors' plan were adopted 'voluntarily' by a group of states, without congressional action, it would be subject to court challenge to the extent it strays from existing standards of 'presence' in a state.

29 *Holmes v. Jennison*, 14 Pet. 540 (1840).

30 *Virginia v.Tennessee,* 148 U.S. 503 (1893) (concerning a boundary agreement between those states).

31 434 U.S. at 475.

32 434 U.S. at 491.

33 434 U.S. at 488.

34 At least one "total solution" dot-com company already provides what it calls a "risk assumption" service that works as follows: The nanosecond before a retail sale is executed, the "total solution" company steps in electronically, unbeknownst to the customer, and purchases the article wholesale from the seller at a discount, which means the sale is untaxed. The "total solution" company then turns around at the speed of light and completes the retail sale to the customer and keeps as its profit the margin between the "wholesale" and retail price. Unless the "total solution" firm has a nexus in the state in which the retail customer resides, no sales tax is collected. The "total solution" firm has nexus in a single locality in the United States and thus, theoretically, could provide a means by which cross-state or even cross-town sales could be made from a retailer to a consumer sales-tax free.

35 Plans already are under consideration at one dot.com "government portal" company, which puts various government services and tax/fees payments systems online, to develop a service aimed at the private sector that would automatically detect whether an Internet seller has a nexus for purposes of the sale about to occur. Whenever a nexus is detected, the software would calculate the tax due and collect the tax as a seamless part of the sales transaction. Rather than relying on a "trusted third party" to collect the tax, thus exposing the firm and its customers to prying by the government and its agents, the software, which would be sold to private firms on a propriety basis, would automatically make an electronic transfer of any tax due directly to the government on the receiving end. Such a system truly would be voluntary and would vastly improve the collection of sales and use taxes that e-tail firms are legitimately required to collect.

36 It is worth noting that while Congress has ample power under the Commerce Clause, it is highly questionable whether it could restrict state and local taxation of within-state transactions just because they are conducted over the internet. Rights still *are* reserved to the states, and it is hard to see how a deal becomes interstate commerce just because web-server is involved. For this reason, the McCain-Kasich legislation barring *all* taxation of e-commerce probably would not withstand a legal challenge.

37 However, as this paper is being written, there is a movement afoot in the U.S. House of Representatives to enact legislation (H.R. 3099) to deem all property of a United States expatriate as sold for its fair market value on the day before the expatriation date so that the federal government can expropriate through taxation a significant share of the wealth of any U.S. citizen who decides to renounce his or her citizenship.

38 See Reynolds, Alan, "The Futility of an Internet Sales Tax," *American Outlook*, Winter, 2000.

39 For an insightful speculation on what taxation in the digital age will be like, see Richard W. Rahn, *The End of Money*, The Discovery Institute, Seattle, Washington, 1999, Chapter VII.

40 Professor Charles E. McLure Jr., a senior fellow at the Hoover Institution at Stanford University and deputy assistant secretary of the Treasury for tax analysis from 1983 to 1985, said in a recent *Washington Post* roundtable on Internet taxation: "If we were starting from scratch, knowing what we know now, it would probably be better to use the individual income tax, rather than the sales tax, to finance local government and perhaps state government." February 20, 2000, p. B2.

41 It is also why several witnesses and white papers before the ACEC proposed moving the state sales tax to a 'seller state' model. Cf. Terry Ryan and Eric Miethke, "The Seller-State Option: Solving the Electronic Commerce Dilemma."

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About the Authors

Dr. Lawrence A. Hunter is Chief Economist at Empower America. He served as a member of Presidential candidate Bob Dole's Task Force on Tax Reduction and Tax Reform. During the 103rd and 104th Congresses, Dr. Hunter served on the staff of the Joint Economic Committee, first as Republican Staff Director and later as the Chief Economic Advisor to the Vice Chairman where he was the lead staff person in charge of putting together the economic growth and tax cut component of the Contract With America. Prior to joining the JEC staff in 1993, Dr. Hunter was with the U.S. Chamber of Commerce for five years where he served first as Deputy Chief Economist and later as Chief Economist and Vice President. Dr. Hunter received his Ph.D. from the University of Minnesota in 1981.

George Pieler is Washington representative for the National Tax Limitation Committee and a free-lance writer. Mr. Pieler was born in Chicago, Illinois and is a graduate of Princeton University and Columbia Law School. He has worked in a variety of government and public-policy related positions since moving to Washington, D.C. in 1976, beginning with a stint in bank regulation with the Legal Division of the Federal Reserve.

In the early 1980s Mr. Pieler served on the tax staff of the Senate Finance Committee under the leadership of Ranking Member (and then Chairman) Robert J. Dole. In 1985 Senator Dole asked him to join in the Office of Majority Leader as Deputy Counsel, a position Mr. Pieler held through the end of 1986.

Mr. Pieler also has served as a government relations consultant on a wide range of regulatory and tax-related issues, and in the Department of Education under the Reagan and Bush administrations. In 1993 he co-founded The Washington Scholarship Fund, which raises money to enable needy families in Washington to send their children to private elementary and secondary schools.

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Contacting IPI

IPI's mailing address is: **250 South Stemmons Frwy., Suite 215**
Lewisville, TX 75067

(972) 219-0811 [voice]
(972) 874-5144 [fax]

IPI's email address is: **ipi@ipi.org**

You will find IPI's home page at: **www.ipi.org**