Dialogue on Virginia Policy

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Should Consumers Pay Sales and Use Tax on Internet Purchases?

Yes!

Read My Lips, No Industrial Policy: Let the Marketplace Work

By Robert v. L. Hartwell

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As a fiscal conservative, and anti-tax Republican, it is awkward for me to defend taxing anything. The worst part about the argument of whether to tax Internet sales or to allow state "use" taxes, is that it ends up pitting business against business; traditional "brick and mortar" retailers against high-tech firms and Internet "click and order" retailers. And when policymakers are not able to build a consensus on this issue, pro-tax advocates and government bureaucrats will make every effort to benefit.

Missed an Opportunity of the Advisory Commission.

It is particularly distressing that the Advisory Commission on Electronic Commerce chaired by one of my anti-tax heroes, Governor James S. Gilmore III (R-VA), failed to obtain the required majority on recommendations for Internet and electronic commerce taxation. Having long-time personal and political friends on that panel, I was hoping that they would reach a consensus and solve a complex problem facing the business community and all levels of government: How do we fix a state sales and use tax system that is broken, in a way that will ease regulatory and tax burdens on commerce, simplify commerce and tax policy for consumers and business, and yet ensure a level playing field for all retailers?

The Commission failed by two votes to gain a Congressionally mandated two-thirds majority of 13 votes. This heightened tension, controversy, and resulted in "unofficial" recommendations to delay addressing these critical issues for another five years. To be spe-

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No!

Let It Be, Let It Be, Let the Internet Be

By Scott E. Luellen

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Ronald Reagan characterized government behavior in society by these short phrases: "If it moves, tax it; if it continues to move, regulate it; if it stops moving, subsidize it." These maxims are still relevant today as governments' role in the Information Age is rearing its ugly head again with the notion of taxing the Internet.

The title question is challenging because it is a bit 'loaded.' Americans' overt sense of fairness and justice generally motivates them as lay people to immediately respond in the affirmative — "with liberty and justice for all," etc. The question also presumes that there currently exists some special tax-free carve out for Internet purchases where there is none.

That said, the direct answer is: No; consumers should not, at present time, have to pay sales and use taxes on Internet purchases, and for two good reasons. First, there is no demonstration of need — the catalyst behind all government revenues; there is also significant independent data showing the negative economic impact of taxes on e-commerce. The second reason is a simple matter of fairness. Online vendors (e-tailers) should expect the same rules as other remote sellers. Much to the regret of e-tax proponents, the US Supreme Court has upheld those existing rules with respect to their impact on interstate commerce. In short, the Court upheld the notion that, in order to be taxed, the taxpayer should have at least some connection or influence over the tax collector.

There are many ways to tax the Internet (e-taxes). This article focuses on the area e-tax proponents usually attack first, sales and use taxes on Internet pur-

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cific, 11 Commission Members issued unofficial "Majority Policy Proposals" to:

1. Extend the current moratorium on new and discriminatory taxes targeted at the Internet until year 2006.
2. Permanently ban Internet access taxes;
3. Prohibit sales taxes on American consumers who purchase goods and services over the Internet
4. Ban sales taxes on the sale of digital goods and services;
5. Eliminate the federal telephone tax (an immediate tax cut of $5 billion for American consumers);
6. Bridge the digital divide through targeted tax incentives for public and private partnerships and by authorizing states to use surplus welfare funds to provide needy families access to computers and the Internet.
7. Address consumer privacy on the Internet.

A Quick Critique of The Commission's Recommendations:

1. *A delay to 2006?* What a cop out! The Commission's life should have been extended and all members kept in the final meeting until a plan was agreed upon;
2. *A permanent ban on access taxes?* O.K., I'm for it, but just say "a ban" because nothing except death is permanent;
3. *Prohibit sales taxes on Internet purchases?* If the Commission advocated prohibiting sales taxes period, then maybe I'd support it. Sales taxes can be regressive; they can inhibit commerce and confuse consumers when imposed at different rates on different products. But if you do away with one revenue stream that funds critical activities such as schools, police or public health, then a responsible Commission would have suggested alternatives, and many of those alternatives are even worse;
4. *Ban sales taxes on digital goods and services?* What is the difference between digital sales and "normal sales' of goods and services, other than one is done electronically? Does this mean that all consultations or sales transmitted electronically should be exempt from taxation... and that intellectual property must be shared freely if

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chases. However, any e-taxes could have similar affects, changing the rules for sales and use tax punishing Internet purchasers is just one of them. Other e-tax strategies range from access fees to transactions fees for electronic material — i.e., documents and e-mails.

> ***Governments at all levels are already imposing sales taxes on Internet access, excise taxes on communications services and various other franchise fees on the American people.***

Surprisingly, all of these options are under serious consideration by many levels of US government. Governments at all levels are already imposing sales taxes on Internet access, excise taxes on communications services and various other franchise fees on the American people. Ironically, it's not just government that supports e-taxes. Select businesses and special interests do also, albeit few in number and even fewer outside of traditional retail industries.

To simplify the e-tax issue, let me make an analogy. Imagine you are a productive, contributing member of society, likely if you are reading this, and a vendor over-charges you $11 billion while having an extra $36 billion in the bank because they 'need the money.' Thereafter, they announce they will soon bill more because you are so successful. Oh, and by the way, it violates two Supreme Court rulings in addition to common sense and capitalist philosophy. Make sense? That in a nutshell, is what e-tax supporters are proposing for the immediate future and will expect you to happily comply, whether you like it or not.

In business, we use concise issue summarizations — 'business cases.' As such, let me state the 'business case' for continuing the ban on taxing the Internet in any of its various forms. The following can be factually and independently stated about e-taxes.

1) E-Taxes will Impede Progress and Growth, Negatively Impacting the Economy — The Digital Revo-

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transmitted digitally without protections and without taxation?

5. *Eliminate the telephone tax?* Yes, I agree. We need to streamline the ways in which politicians can get into our pocketbooks... but did you know that for many years the news media has been exempt from that tax while every poor American with a telephone paid it? I'm with you on this one, Governor Gilmore!
6. *Bridge the digital divide?* This is a good public purpose. But couldn't you just use the $5 billion from the telephone tax to directly subsidize low-income Americans who need to own a computer or gain access to America On-Line!
7. *Address consumer privacy on the Internet?* How? People need to know their personal information is safe and cannot be accessed via the Internet without their permission or direct involvement in waiving that right. A recommendation requiring Internet retailers to allow consumers to "opt-out" of having their names, addresses or any other information shared would have been helpful.

Tax policy should be neutral and not distort the marketplace...

As a married-with-children taxpayer and as a former top staff member to a staunch anti-tax Congressman, I have developed a perspective on tax policy similar to noted economist Milton Friedman's. Tax policy should be neutral and not distort the marketplace... unless it is directed at some positive *and critical* public purpose. Lowering consumption of products that are legal but dangerous to our health or the environment, improving public safety, stimulating economic growth or the education of young Americans all qualify. However, there should be proof that changing tax policy will have the intended effect or that distortions in the marketplace won't occur.

Concerns of the States and Retailers

In the case of the Internet, the inability of the states to develop a cohesive sales and use tax system is deplorable. In fact, it is almost as bad as the federal

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lution launching the Information Age has already had a more positive economic, social and national impact than the Industrial Revolution. The Internet has been a prime catalyst of this revolution. Simply put, regulations will prevent the Internet from reaching its maximum potential and could derail it. Moreover, companies advocating e-taxes are failing to transform their business model to accommodate the elements that have made the Internet so successful.

According to Dr. Austin Goolsbee, a University of Chicago researcher and economist, e-taxes will likely result in a 25-30% decrease in on-line purchasing activity; a key catalyst in fueling the Information Age's growth. A March 2000 on-line survey of 25,000 purchasers by BizRate.com showed nearly 66% of purchasers will decrease Internet activity in the presence of e-taxes.

Finally, according to the University of Texas' Center for Research in Electronic Commerce, the Internet economy realized approximately $507 billion in revenues in 1998. Growth since then has been dramatic and is nearing $1 trillion per year. Significantly diminishing a $1 trillion portion of the economy clearly quantifies the costs of e-taxes as extraordinary and destructive.

2)E-Taxes Will Diminish US Competitiveness — Unlike the Industrial Revolution, the Information Age requires fewer fixed assets. This means it is practically as easy to run an e-company from a foreign jurisdiction as it is from within the US. European customers, Irish banks and a free real-time interactive and multi-faceted communication systems (the Internet) make servers proximity virtually irrelevant.

A uniform global policy for any e-tax is impractical and politically infeasible. Subsequently, every jurisdiction will be different, creating immense regu-

E-taxes in the US will definitively make the US less competitive internationally and dampen Information Age growth.

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income tax system, except there is only one federal government and fifty states. In terms of sales taxes, the states collected about $150 billion in 1999, equaling almost a third of their total revenue. Lost sales taxes due to Internet purchases were estimated to have cost government only a small portion of that total... about $525 million. However, some estimate that a huge growth in Internet retailing could result in a sales tax loss of as much as $10 billion by 2003.

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Of particular concern to traditional retailers and state and local governments, including prominent conservative Republican Governors Michael O. Leavitt (R-UT) and John Engler (R-MI), is the lack of a level playing field proposed by the Commission and lost revenues to the states. Governor Gilmore argues that the Commonwealth of Virginia is creating thousands of jobs and billions in new tax revenues thanks to our growing technology industry. His claims are valid but, to the extent these companies are basing their Virginia investments on retail sales they generate and taxes they don't pay, Governor Gilmore's logic is misplaced.

The miracle of the Internet is information and communication, not its role as a sales engine. The public will always be wary of purchasing goods they can't see or touch from people they don't know or can't locate in person. Brick-and-mortar businesses recognize the value of customers coming into their stores, gaining the expertise of sales personnel they can talk to and get to know, or people who seek medication advice from their neighborhood pharmacist they know and trust. Internet sales don't offer this.

It just makes plain common sense that if our states garner one-third of their revenue from sales taxes and decide to impose them, that all retailers, whether selling via catalogs, telephone, showrooms or the Internet should pay the same tax rate. But why didn't this argument take hold with the Commission? For one,

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latory complexity for consumers and businesses. E-taxes in the US will definitively make the US less competitive internationally and dampen Information Age growth. Moreover, equal enforcement would be nearly impossible and a law which cannot be equally enforced damages the population governments are obligated to protect.

Economists say we are only in the early years of a many-year economic cycle, diminishing international competitiveness early in the cycle has dramatic long-term consequences.

3) E-Tax Supporters Mischaracterize the Issues & Benefits — The e-tax supporters fundamental arguments are 'fairness,' and lost revenue governments need. Each of these cornerstones is fatally flawed and in direct opposition to the facts. Specifically:

- Internet retailers (e-tailers) are treated the same as any company making catalogue sales**:** specifically, they must have a physical presence in a state (the legal term is "nexus") to charge sales tax. The only difference is the Internet empowers e-tailers to be more successful than traditional catalogue retailers. Subsequently, the e-tax advocates believe this advantage is, somehow, 'unfair.'
- Fairness dictates any tax must be reasonably related to the services provided by the government. But, e-tailers, like catalogue sellers, do not make use of the public resources like roads, sewers, police and fire services in the states where their customers reside.
- When consumers purchase products and are not required to pay sales tax, there is an archaic levy called a 'use tax' that some jurisdictions ask consumers to pay voluntarily. However, as Virginia Governor James Gilmore recently noted, it is usually ignored by both consumers and governments and is difficult, if not impossible, to enforce. This is true with e-commerce as well as with traditional, brick and mortar sales. Fairness is not the issue; an out-of-date and silly tax is the issue.

Now, let's review the tax revenue issue.

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the retail industry was not really represented. Retailers are often too busy with massive chores of buying and maintaining inventory, marketing and selling their products, while fighting to earn a measly 2% to 4% profit margin on huge sales volume. The Internet Tax Freedom Act passed by the Congress in 1998 also played a major role. The Act set up the Commission and as a result, criteria for appointments led to it being pretty well stacked with high-technology business operators and politicians. ***In fact, while the underlying statute called for small business or retail representation on the Commission, none was appointed.***

A Commissioner and former Capitol Hill colleague, Stan Sokul, presented a more critical reason why the states did not hold sway during Commission deliberations. He now represents the Association for Interactive Media and argued that, "if the states can simplify, they would gain a lot more credibility when they argue that they should get nationalized tax power." In essence, the inability of state governments to reach a consensus over the years on harmonizing their various tax laws and coming up with a simplified way to track and fairly tax cross-border transactions, neutralized their ability to sway a majority of the Commission.

One clear example of this gridlock is the "use tax." This tax exists in over 40 states and requires taxpayers purchasing goods from businesses in other states to pay use taxes to their home state when the goods exceed certain values. The Commission "unofficially" failed to recommend repeal of this tax that almost every American fails to pay. Governor Gilmore was quick to use this point in speeches about Commission deliberations, justifiably stating that, "I want to decriminalize the American people who are buying goods and services over the Internet."

While the states are again trying to simplify their intrastate tax policies, each month that goes by without success justifies another month of the current Internet tax moratorium. There is plenty of blame to go around for the failure of the Commission to gain a real consensus.

Finding a Solution

Whether a consumer purchases goods or services via a telephone, a catalogue, the Internet, or in person at Kmart, sales taxes should be levied and col-

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- The National Governor's Association (NGA), an e-tax advocate, reports states collectively took in $11 billion more than they needed in 1998, and additionally, had $36 billion in surplus cash. Since 1988, sales tax revenues have continued to increase. Governments are already over-collecting while surpluses continue to rise. The Federal government's surpluses are even larger. When governments knowingly and constantly have surpluses, they are engaging in profit making.

Approximately 80% of Internet transactions are business-to-business (B2B) which are predominantly sales-tax exempt meaning any e-tax will generate less than 1/100 of 1% of increase for state and local governments.

- Approximately 80% of Internet transactions are business-to-business (B2B) which are predominantly sales-tax exempt meaning any e-tax will generate less than 1/100 of 1% of increase for state and local governments. *E-Commerce Advisor*, an industry on-line publication, predicts this market share will not change significantly in the near future. Further, according to the US Department of Commerce, on-line business-to-consumer (B2C) sales accounted for a scant .64% of all retail sales in the fourth quarter of 1999, in other words, 99.32% of all B2C retail transactions are still with brick & mortar companies.

Of that .64% of retail that is on-line B2C, 72% are non-taxable or already taxed exchanges including on-line banking, airline tickets, hotel reservations and/or stock transactions, according to the *Greenfield Online Digital Consumer Shopping Index*. This means the total target size of on-line B2C transactions for e-taxes is .18% of all retail sales.

Sixty-percent of all persons who will not consider making an on-line B2C purchase avoid it because of

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lected via consumers and all retailers equally.

Let me warn my Internet no-tax friends that while many of the policies they articulate make sense, a sleeping giant may awake one day if prodded and cajoled by state and local government. America's retailers have the huge but largely untapped potential to ensure that every American visiting a grocer, department store or pharmacy is presented with information on how "unfair tax policy is endangering our neighborhood safety and schools." If you choose to take on the traditional retailers, the economic backbone of every American neighborhood, and the state and local governments are right there with them discussing education, fire and police spending reductions, you may well lose the freedom from regulation and taxation you have enjoyed thus far.

> ***Whether a consumer purchases goods or services via a telephone, a catalogue, the Internet, or in person at Kmart, sales taxes should be levied and collected via consumers and all retailers equally.***

Somewhere in those Commission deliberations there was a compromise that made sense. Somehow, whether due to politics, rigid philosophy, or simply the make-up or lack of balance in the Commission, this compromise failed to materialize. While the Internet is a hugely successful tool in society, it does not yet hold sway with the majority of Americans who wish to purchase consumer goods at traditional stores and who are funding essential public services.

As this policy stalemate continues, the rhetoric will deepen and the ultimate decisions will become even more politicized and risky. At some point, especially if Internet retail growth projections becomes reality, brick and mortar retailers will take strong exception to unequal tax policy. As Governor Leavitt stated, "They're going to storm Capitol Hill with one phrase on their lips: level the playing field!"

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security concerns. If governments begin tracking consumer sales and automatically collecting e-taxes, confidence in a secure transaction will further decrease, dampening the role of the Internet in commerce and furthering the infamous 'digital divide;' the growing social and economic differences between those involved in the Information Age and those not.

Finally, according to a study by Hewlett Packard, over 65% of on-line B2C purchasers are under age 35, a group already among the most heavily taxed relative to median income.

So where is the "need" for an additional tax?

4) **E-Taxes are a Slippery Slope** — History of how governments tax shows when governments chose to collect revenue on a tangible item, collecting revenue on associated intangible items is usually not far behind. In other words, once the Pandora's box of e-taxes is opened, it will likely be difficult to control the bureaucrats' ambition in devising new e-taxes to increase the quantity and scope of their power and influence.

5) **E-Tax Supporters have Misleading Motivations** — If not 'fairness' or 'need,' why are some businesses e-tax supporters? Generally, e-taxes are supported by companies which are traditional in nature ('brick & mortar') and do not have a well-developed business strategy for the Information Age and e-commerce — an e-strategy. Fears based on an out-dated business model and the absence of an e-strategy are magnified by the exponential revenue and valuation growth enjoyed by e-tailers and e-companies.

> ***Traditional businesses... have not yet determined their precise role in the Information Age and subsequently, act to protect and preserve the old way of doing business.***

Successful traditional businesses and many Republicans supporting e-commerce taxation share a common trait: they have not yet determined their

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Also remember the words of former House Speaker "Tip O'Neil that "all politics are local." I'm not looking forward to a splintered and weakened business community, or a dangerous cat-fight between retailers and high tech companies. But when it eventually comes via unfair competition or the inability of state and local governments to simplify and streamline sales and use taxes, let's just hope that those who would use it as an excuse to levy even more onerous taxes or devise new taxes don't step in and ruin it for everyone.

The excesses, rhetoric and missed opportunities of the Commission on Electronic Commerce may result one day soon in the proverbial "throwing the baby out with the bathwater." That often happens when government is asked to step in and take charge. Lets hope that the miracles of the Internet and our new technological freedom are not crippled by trying too hard, to do too much, too quickly, for one new, innovative and favored sector of our business community and economy. This is "industrial policy" at the federal level pure and simple ... something conservatives have opposed for decades. It is sad to see some of our conservative leaders now promoting "industrial policy." What industry will be next? And what will these "good conservatives" say in opposition? "Oh, the Internet is different!" It simply won't wash.

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precise role in the Information Age and subsequently, act to protect and preserve the old way of doing business.

Pragmatically, two special-interest groups have formed an odd coalition: businesses without an e-strategy wanting protection and state and local governments which, with limited analytical resources, perceive the Information Age and e-commerce as a way to further fill their coffers.

In reality, each group will be better off dealing with the healthy competition capitalism creates and using e-commerce as a catalyst for new, more creative directions. If businesses supporting e-taxes devoted as much time and energy on creating and executing an e-strategy, they would be much better off. If governments devoted as much time, energy and money reducing surpluses, fostering environments that allow the Information Age to continue to flourish and replacing 100-year old policies with modernized, Information-Age friendly policies, citizens would be better served. Governments must adapt to an Internet-based world and Information Age economy to even modestly fulfill their moderate-term objectives.

In summary, the benefits of any decision, including tax decisions, should out-weigh the costs. The Internet has been a primary catalyst in the Digital Revolution launching the Information Age. The economic and social impacts have been monumental on the history of mankind. Yet, we are far from maximum potential. The magnitude of change has only begun. Threatening the greatest economic boon to mankind in its infancy with two of the most dreaded tools of government, taxes and regulation, is akin to the Biblical story of ancient Pharaohs executing all male infants under the age of two because one of them might change the status quo.

"Dialogue on Virginia Policy" is a publication of the Thomas Jefferson Institute for Public Policy, a non-partisan foundation concentrating on issues confronting the state of Virginia.

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Thomas Jefferson Institute for Public Policy

"If we can prevent the government from wasting the labors of the people, under the pretense of taking care of them, they must become happy." ... Thomas Jefferson 1802

The Thomas Jefferson Institute for Public Policy is a non-profit, non-partisan foundation dedicated to participating actively and creatively in the public policy debates in Virginia.

This Institute examines issues confronting state and local government and suggests possible solutions focused on what is best for the citizens of Virginia based on a clear philosophy of limited government, free-market economics and individual responsibility.

Areas which are of particular interest to the Jefferson Institute include reforming government and how it works; economic development; health, public education and welfare; criminal justice; and legislative analysis on a non-partisan basis. These issues are promoted through research, studies, conferences, op-ed pieces, and other activities of the Jefferson Institute.

There is no political bias to the Jefferson Institute, although there is a philosophical basis to the activities conducted by this foundation: limited government, free markets and individual responsibility.

This foundation has been endorsed by a cross-section of political leaders in our state including Governor Jim Gilmore, Lt. Governor John Hager, Senator John Warner, Congressman Tom Davis, Senate Democratic Leader Richard Saslaw, former Lt. Governor Don Beyer, and others. The Board of Directors of the Thomas Jefferson Institute is bi-partisan as well.

The Jefferson Institute develops relationships with the political, business, academic and non-profit leadership in our state so that its educational work becomes part of the problem-solving discussions that take place.

This prospectus outlines in more detail the purpose, philosophy, programs and leadership of the Thomas Jefferson Institute for Public Policy.

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