CENTER FOR THE NEW AMERICAN CENTURY

Nine Problems with Taxing the Internet

Questions Governors and Legislators Must Consider

Nine Questions to Consider . . .

Is the SSTP revenue neutral?
No. The SSTP's goal of $440 billion in "new revenue" over 10 years would negate one-third of President Bush's federal income tax cut of 2001.

Will the SSTP simplify tax compliance for America's merchants, as its proponents suggest?
No. SSTP would preserve many of the current complexities of calculating and collecting sales taxes and add new ones. A merchant would be subject to up to 7,500 different tax rates on transactions with consumers.

Does the SSTP pose threats to consumer privacy?
Yes. The SSTP proposes one or more third-party tax collection agents, who will gain automatic access to confidential information about individual consumers and what they purchase.

Will the SSTP require your state and its local jurisdictions to forfeit sovereignty over tax policy in your state?
Yes. The SSTP creates the U.N. of state tax policy. It requires each state to submit its sales tax system to oversight of a "governing board."

Is the SSTP consistent with the Constitutional doctrine of federalism?
No. The SSTP would allow participating states to foist their tax and regulatory burdens upon out-of-state businesses and citizens.

Will the SSTP reduce tax policy competition between states?
Yes. The SSTP rewards the least competitive states by allowing them to "dumb down" the tax code.

Will the SSTP impede the success of the technology revolution?
Yes. Attaching tax burdens to each online transaction will inhibit people's access to and use of Internet content and stifle technological innovation.

Will the SSTP hurt certain citizens more than others?
Yes. New on-line transaction taxes will disproportionately punish rural, handicapped or even elderly buyers who cannot easily substitute on-line transactions with traditional purchases at brick-and-mortar retailers.

Will the SSTP create equity between brick-and-mortar and on-line retailers?
No. SSTP might create equal tax rates for on-line and brick-and-mortar transactions, but creates new inequities in compliance costs and in the availability of certain benefits.

By Bill Owens
Governor of Colorado

Introduction

Governors and legislators across the country are being asked to endorse a multi-state compact to impose taxes on Internet-based sales. Because no sales tax can be collected on catalog or on-line transactions that occur with out-of-state merchants, many officials here in Colorado and across the nation are making the case for a new, national taxing regime to capture those dollars from consumers.

Called the Streamlined Sales Tax Project, or SSTP, the new system would be formed by a compact among the states that is authorized by Congress. Its advocates say the new system will harness technology to create a "burdenless" sales tax collection system. The project, which would ostensibly "simplify" the myriad sales tax systems used by states and localities, aims to achieve two goals:

- to maintain the stream of sales tax revenues that are being "lost" as online sales become more prevalent; and
- to reduce a perceived competitive disadvantage between traditional "brick and mortar" retailers who must collect sales taxes on all purchases and remote retailers who must collect taxes only in limited circumstances.

While some states have already embraced the SSTP, much of the drafting of this sweeping change in America's tax system SSTP occurred out of public view. In order to let some sun shine in on this tax proposal, I asked policy-makers in my state to examine nine questions. The answers, provided below, raised significant concerns. Some of its policies are

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I believe wrong for Colorado. In other cases, SSTP policies or proposed implementation of the project just create entirely too much ambiguity or leave too much to chance when it comes to the taxes paid by Americans.

I fear the SSTP, while designed with some good intentions, could have serious and long-lasting negative economic effects for states that embrace and implement it. From a policy standpoint, the SSTP approaches the perceived problems with an unhealthy bent toward big government. The answers to these nine questions make a compelling case for the need for a public, national discussion before moving forward with the SSTP.

I. Is the SSTP revenue neutral?

No. SSTP will increase the tax burden on most American consumers. SSTP's supporters tout a study of sales and use taxes authored by two professors at the University of Tennessee that concludes state and local governments could collect an additional $440 billion in sales taxes from the American people over the next 10 years by expanding sales tax collection to all Internet commerce. Some experts believe the $440 billion figure overstates the windfall. Whereas the University of Tennessee professors count on $45 billion in new revenue by 2006, for example, a study commissioned by the Direct Marketing Association reports a figure of $3.2 billion over the same time period. Either way, SSTP is a tax increase. But if we accept supporters' estimate of $440 billion, SSTP could negate one-third of President Bush's $1.3 trillion federal income tax cut of 2001.

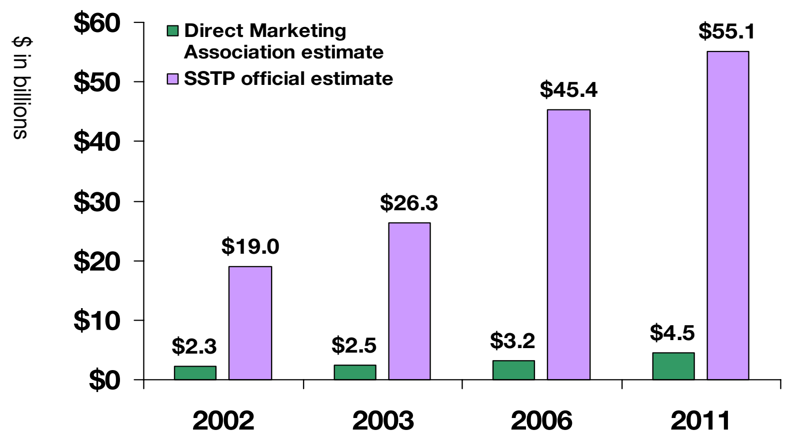
Because SSTP takes a broad view of taxable goods, additional hidden tax increases could lurk in the esoteric details of the SSTP. States that currently exempt certain goods from taxation could be forced to extend sales taxes to currently untaxed products, as an example. And all caps that limit sales tax liabilities would be eliminated. So while a farmer in North Carolina who purchases a piece of farm equipment is currently capped at $80 in total sales taxes, SSTP would fully tax the entire value of his purchase.

Minnesota provides another telling example of how taxes will subtly increase as states adopt SSTP uniform provisions. Prior to adopting the SSTP, Minnesota imposed sales taxes only upon the price of each product purchased from a vendor with nexus in the state. The SSTP defines "sales price" more broadly to include not only the price of the product, but also charges for shipping, handling and postage. Because Minnesota adopted the SSTP, not only do the people of Minnesota pay new sales taxes on purchases from out-of-state vendors, but they also pay higher taxes on purchases from in-state vendors.

If the prospect of unsuspecting voters learning of tax hikes isn't cause enough for fear, consider this: Some states could actually *lose* revenues under SSTP. Those states that do not currently reimburse in-state merchants for their costs of collection will be mandated to pay a uniform reimbursement rate for all merchants, whether in-state or out-of-state. The adoption of SSTP will, therefore, affect each state differently, and will add a new dimension of uncertainty to budget planning in the coming years.

How Much New Revenue Would New On-line Sales Taxes Really Generate?

Estimates of potential new government revenues vary widely



DMA estimate: Peter A. Johnson, Senior Economist, The Direct Marketing Association (March 2003). SSTP estimate: Donald Bruce and William F. Fox, Center for Business and Economic Research, University of Tennessee (September 2001).

II. Will the SSTP simplify tax compliance for America's merchants, as its proponents suggest?

No. The goal of simplifying tax compliance for businesses is laudable. As Governor, I frequently hear concerns voiced by retailers, particularly small businesses, regarding the complexity and cost of complying with the current tax system.

But SSTP would actually magnify these current problems. Most notably, SSTP foists national sales tax collection obligations upon each merchant in America while preserving for each local government in the country its own distinct tax rate. That means a merchant will have to calculate up to 7,500 different tax rates on transactions to consumers. Merchants will even be responsible for determining each customer's nine-digit zip code, since five-digit zip codes cross local jurisdictional boundaries.

These realities confound the initial promises made by SSTP sponsors. At the inception of the SSTP process, they promised that their efforts would produce a "burdenless" sales tax collection system so streamlined that it would be suitable for the Internet. They examined two solutions to promote simplicity and uniformity.

First was to create one sales tax rate per state. Participants in the National Tax Association's Communications and Electronic Commerce Tax Project (consisting of major state and local government associations) unanimously agreed in their final report, issued September 7, 1999 (pp. ii & 3): "There should be one rate per state which would apply to all commerce involving goods or services that are taxable in that state."

But drafters of the SSTP ran into a political roadblock: efforts to achieve simplicity and uniformity were undercut by efforts to preserve some semblance of local control. They were therefore forced to reject the idea of one-rate per state and allow municipalities to establish varying rates.

The second goal for easing the burden of tax compliance involved the development of new technology. SSTP sponsors promised to develop and demonstrate a "third-party" tax collection software package that could be seamlessly integrated into the business systems of each merchant in America and that would perform all tax calculation, collection and remittance functions. I enthusiastically support the efforts of the SSTP to develop technology to ease the burden of tax compliance. Whether the SSTP moves forward or not, this is a worthwhile goal.

But even if the ideal system is invented, adopted and implemented across the nation (and there are significant doubts that such a system can be successfully deployed in the near future), SSTP would still result in new burdens and threats to America's merchants. An Internet or catalogue merchant that opts to perform tax collection functions itself will be subject to 46 different audits by 45 different states and the District of Columbia each year to ensure the merchant is properly collecting and remitting its taxes.

Even in states that opt not to participate in the SSTP, merchants will be at risk if its supporters succeed in convincing Congress to authorize the compact. A merchant in Colorado who sells goods across state lines will be audited for compliance not only with his own state's tax code but also for compliance with the SSTP. If an auditor concludes that the merchant under-collected a state or local government's due share, the merchant will have two options – pay the difference or pay a lawyer to litigate.

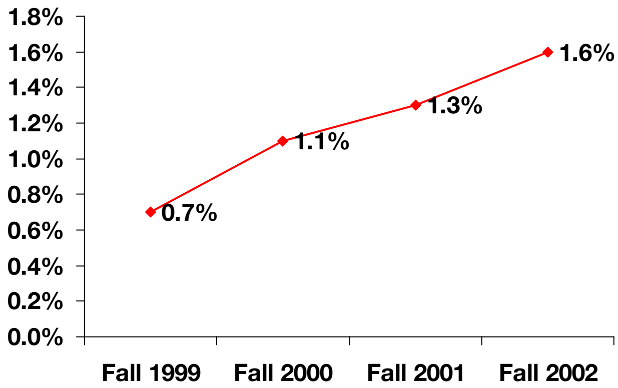
SSTP participants started out with the worthy goal of promoting simplicity in tax compliance. But the only true way to ensure simplicity – a uniform tax rate for each participating state – was rejected. And the promise of new technology has instead acted as cover for a multitude of new complexities. Thus, one of the best arguments in the SSTP's favor rings hollow: instead of simplification, SSTP is an exercise in tax compliance complexification.

III. Does the SSTP pose threats to consumer privacy?

Yes. Consumer privacy has become a major issue in Colorado and across the nation in recent years. In Colorado, our Legislature passed and I signed legislation to crack down on e-mail spam and to create a no-call list for telemarketers. In 1999, one of the state's vendors began collecting data regarding Colorado consumers from our automobile license database. The public outcry was understandable. This is why ensuring consumer privacy is an indispensable component of any national sales tax collection effort.

The SSTP's authorization of one or more third-party tax collection agents that integrate their tax collection software into the mainframes of each merchant

E-Commerce as a Percent of Total Sales



Source: U.S. Department of Commerce, U.S. Census Bureau

creates substantial questions about the protection of consumer privacy. At the time of a transaction, the software would calculate the tax due and remit the tax to the destination state and locality, keeping a portion of the tax as its fee. In the process, however, the collection agent would gain access to information about individual consumers and what they purchase.

What protections are there for the consumers? The SSTP is internally inconsistent on this issue. On the one hand, it instructs third-party tax collectors to "respect" the "precept of anonymity" in their tax collection functions. On the other hand, the SSTP provides that "[e]ach member state's laws and regulations regarding the collection, use and maintenance of confidential taxpayer information remain fully applicable and binding" in the implementation of the SSTP.

Thus, the disparate and often confusing laws of 50 different states and the District of Columbia supersede any SSTP "precept," and, since nobody has any experience with the new national sales tax collection scheme, it's anybody's guess what protections a consumer in my state can count on when her favorite vendor in a participating state gets audited or subpoenaed in a tax dispute. Will her personal information and purchase choices be protected under Colorado law, where she lives, or under the law of the state where her vendor operates? SSTP has not answered this fundamental question.

IV. Will SSTP require your state and its local jurisdictions to forfeit sovereignty over tax policy in your state?

Yes. Check the SSTP statute.[1] Oversight and implementation of a significant portion of your state's tax policy would be ceded to and dictated by a board of unelected and unaccountable out-of-state tax bureaucrats. SSTP essentially creates the U.N. of state tax policy.

To resolve disputes, SSTP requires each state to submit its sales tax system to oversight of a "governing board" comprised of four representatives from each participating state, with each state getting one vote on the board. This governing board will be vested with administrative, legislative and judicial powers over each participating state's tax policy. It can amend the SSTP with 60 days notice upon a three-quarters vote of its members, thereby altering each state's tax laws.

Worst of all, this governing board will interpret the SSTP and resolve disputes brought to it like a court of law. It even can sanction participating states it deems not "substantially compliant." (What "substantially compliant" means remains a mystery. The SSTP's governing board will define it on a case-by-case basis.)

V. Is the SSTP consistent with the Constitutional doctrine of federalism?

No. SSTP would allow participating states to reach across state lines and foist their tax and regulatory burdens upon out-of-state businesses and citizens conducting business on the Internet. The goal of SSTP proponents is to get a number of states to pass SSTP and then seek Congressional authorization to force merchants – including those that operate in states choosing not to adopt the SSTP– to collect and remit sales taxes in compliance with the laws and regulations and audits of the adopting states. Businesses, in other words, would be subject to the SSTP's scheme even if their home state democratically chooses not to join the uniform tax regime. This implicates profound practical and theoretical federalism concerns.

For example, a state that was unable to foster a significant information technology industry in the 1990s might adopt SSTP in an effort to force the many software and online content providers of California's Silicon Valley to become their tax collectors of choice, even if California receives nothing in return from businesses in that state.

But SSTP's threat to state and local control extends beyond the theoretical. Many states, Colorado included, have constitutional or statutory limitations on tax increases or revenue collections. Adopting SSTP in Colorado would therefore require a vote of the people. And what if voters in a local jurisdiction vote down the tax change? How will states reconcile voter inspired referenda and initiatives with an SSTP that values national uniformity and limits individuality?

In my home state of Colorado, and in most other states, citizens pride themselves on local control. Many of our counties and cities have obtained "home rule" status, giving them significant constitutional autonomy in their taxing decisions. While certain items are subject to local sales tax in one Colorado city, therefore, they might be exempt in another. Even if Colorado's state legislature agrees to accept SSTP in concept, therefore, compliance with this new, national tax regime would be extremely difficult.

VI. Will the SSTP reduce tax policy competition between states?

Yes. The SSTP rewards the least competitive states by allowing them to "dumb down" the tax code, resulting in a less favorable technology business environment across the country. By nationalizing a significant portion of the tax code historically reserved to the states, the SSTP effectively undermines the notion of states as "laboratories of democracy." As Governor, I've always embraced the notion of constructive competition between the states. Competition spawns innovation and creativity, and we learn from the successes and mistakes of other states.

The SSTP, however, rewards the least competitive states. It hypothetically allows 10 participating states to piggy-back on the economic investments of 40 other (non-participating) states. It attempts to coerce all states into following minority policy – a virtual "tax cartel." But allowing non-competitive states to "dumb down" the tax code will ultimately hurt all states.

VII. Will the SSTP impede the success of the technology revolution?

Yes. Attaching tax burdens to each online transaction will dampen enthusiasm for Internet usage and stifle technological innovation. Some people will inevitably log off rather than fill out the requisite tax form to purchase music or read an online book. Indeed, studies show that a significant number of online shoppers would not participate in electronic commerce if taxes are imposed. According to Prof. Austan Goolsbee's 1999 study, the extension of existing sales taxes to Internet purchases could reduce the number of online buyers by as much as 24 percent.

That on-line transaction taxes would impede utilization of the Internet is cause enough for concern. But even more troubling is that the proponents of a new national sales tax on the Internet are busily working to craft a policy for imposing state and local sales taxes on what they view to be "digital goods." SSTP participants seem to be moving toward a policy that equates online content with tangible goods. The proposed SSTP law already defines "tangible personal property" to include software delivered electronically and uploaded on one's computer.

Clearly, the SSTP's bias is toward what is best for government, not necessarily what's best for consumers, taxpayers or the economy. In the view of SSTP's advocates, tax-free Internet transactions jeopardize the growth rate of government revenues. But why not instead (or at least in addition) look at the situation through the lens of commerce and economic development? The growth of the digital economy, and the family-sustaining jobs spawned by it, could clearly be placed in jeopardy by a system that expands taxes on their entrepreneurs.

VIII. Will the SSTP hurt certain citizens more than others?

Yes. New on-line transaction taxes will disproportionately punish rural, disabled or even elderly buyers who cannot easily substitute on-line transactions with traditional purchases at brick-and-mortar retailers.

The Internet facilitates commerce in places and between parties unimaginable just 10 years ago. Rural communities and transactions involving disabled citizens are just two examples of beneficiaries of Internet transactions. A farmer in western Iowa hundreds of miles removed from any major metropolis can log on and purchase music, clothes, or even farm supplies and equipment via the web. (He saves money on certain transactions in which taxes are not collected, but some if not all of these savings are typically cancelled out by delivery costs.)

By taxing all on-line transactions, individuals who cannot easily substitute on-line transactions with traditional purchases will be hurt the most. The SSTP will therefore have the effect of widening the so-called "digital divide." Urban and suburban dwellers will substitute more expensive on-line transactions with trips to the nearby mall. Rural dwellers and others who cannot easily substitute one transaction for another will face the greatest burden.

IX. Will the SSTP really promote equity between brick-and-mortar and on-line retailers?

No. One of the most compelling arguments I hear on behalf of the SSTP is the case for equity: why should no tax be collected on transactions with out-of-state merchants while brick-and-mortar transactions are taxed?

But if equity is truly the ultimate objective, other variables need to be considered, too. What about compliance costs? If SSTP moves forward, on-line merchants would be forced to calculate and comply with literally thousands of different tax rates across the country. These enormous compliance costs would put on-line merchants at a competitive disadvantage vis-à-vis brick-and-mortar retailers.

Likewise, on-line merchants are not eligible for the many benefits governments sometimes offer traditional retailers. Many brick-and-mortar retailers take advantage of enterprise zones, tax breaks or various direct or indirect government subsidies.

The rhetorically strong argument for "equity," therefore, falls short when other variables are considered.

Conclusion

Transforming the way that state and local governments levy taxes on consumer purchases is one of the central public-policy issues facing Governors and State Legislatures. If successful, the effort to tax all remote purchases will affect every state, county and municipality that levies sales taxes. It will affect virtually every American consumer who makes a purchase by mail, over the phone or online.

Simply put, the headlong rush to accomplish this sea change in American tax policy, often without a detailed public debate and outside the glare of media and taxpayer scrutiny, must be slowed. Significant questions – including the nine asked here – must be faced, discussed and adequately answered in each state.

The growth and expansion of the digital economy, and the innovations and consumer conveniences that have come with it, are transforming and improving lives in America and around the globe in the 21st Century. Companies that were little more than a dream just a few years ago today employ thousands of our fellow Americans – and generate tax dollars for our states. Our goal must be to ensure that government takes no steps that will needlessly stem this growth or unfairly penalize online entrepreneurs.

How we answer the nine questions about taxing the Internet will shape our economic future. We must be well informed, and we must choose wisely.

[1] See, for example, the "Streamlined Sales and Use Tax Agreement," Page 43, Line 28: "If a member state is found to be out of compliance with the Agreement, the governing board may consider sanctions against the state."