

**S. 2255, A BILL TO AMEND THE INTERNET  
TAX FREEDOM ACT TO EXTEND THE  
MORATORIUM THROUGH CALENDAR YEAR  
2006**

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**HEARING**

BEFORE THE

**COMMITTEE ON COMMERCE,  
SCIENCE, AND TRANSPORTATION  
UNITED STATES SENATE**

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

APRIL 12, 2000

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SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

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WEDNESDAY, APRIL 12, 2000

U.S. SENATE,  
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,  
*Washington, DC.*

The Committee met, pursuant to notice, at 9:30 a.m. in room 253 of the Russell Senate Office Building, Hon. John McCain, Chairman of the Committee, presiding.

**OPENING STATEMENT OF HON. JOHN McCAIN,  
U.S. SENATOR FROM ARIZONA**

The CHAIRMAN. I am pleased to welcome all our witnesses this morning. We can expect diversity of views and opinions on one of the most important issues facing us this session: the future of the Internet and e-commerce transactions. I believe that we are at a critical juncture in determining the future regulatory scheme under which the new economy will either continue to grow and prosper or will be thwarted by government bureaucracy, taxation and shortsighted greed.

Our founding fathers certainly did not have the Internet in mind but nevertheless understood the potential dangers and pitfalls of States taxing and regulating interstate commerce. That is why our constitution reserves the power to regulate commerce among the several States. The purpose of Federal power over interstate commerce is to ensure that one or more States do not unduly burden the transaction of interstate transactions. The Internet is the epitome of interstate commerce. If each state and local jurisdiction attempts to impose its own business regulations and taxes to it, the opportunities presented by this new economic engine will be destroyed. It is important to look at the full picture of our economy as assessing the impact of taxation on the Internet and e-commerce.

The Internet is filled with websites of small businesses, businesses that are expanding in ways which would never before have been economically feasible. One of our witnesses today, Mr. Morse, will be able to give us a reality check as to how the Internet has afforded him an opportunity to compete with much larger companies. The Internet is the last frontier for the small business entrepreneur to develop a business and compete without massive amounts of investment capital. His or her small business, his small

business, which has historically had a limited market for its goods, now has a website that allows him to market and sell to people all over the country, even all over the world. Mr. Morse, like other small business men and women, benefit from the freedom of the Internet and the country benefits from their success.

When a small business increases its sales and revenues, it needs to hire more employees and it pays taxes on the increased revenues and the newly hired employees pay taxes on their wages. State and local governments benefit not only from the additional taxes paid on the revenues, but in the economic benefits of additional jobs and a growing economy. The potential burden of complying with tax regulations and the paperwork involved under current law for as many as 7,500 estimated taxing units in this country would overwhelm many businesses, especially small businesses. The cost of complying with multiple States filing and regulatory requirements would in many instances exceed the amounts collected and transmitted.

A multistate company currently files many tax returns. AT&T has informed the Committee staff that last year, it completed approximately 99,000 separate tax filings. Under current law, States can require businesses who have a nexus with the state to collect taxes, collect sales and use taxes. The moratorium does not disrupt this existing law nor would an extension of the moratorium. The Supreme Court has found that businesses, with a physical nexus to a state, have created a relationship with that state sufficient to submit themselves to the regulatory and taxing authority of that state. In essence, the business becomes a citizen of the state and its transactions with other citizens of that state are intrastate in nature. Thus there is no burden on interstate commerce.

By contrast, the essence of what the tax and spend advocates who oppose this legislation demand is 50 state jurisdiction over every Internet business, large and small, regardless of any other connection to each state. They advocate that a Vermont businessman such as Mr. Morse collects sales taxes and comply with the tax regulations of every state and local jurisdiction in the country.

Where does this expansive jurisdiction lead? Does such an expansive jurisdiction also result in potential liability in each state for noncompliance or miscompliance for state regulations? What about business licenses, occupational fees, occupational or retail licensing regulations, blue laws? How do we ensure that in the zeal to collect more money to permit even more expansive governments, we protect the privacy of the consumers? How does imposing more regulatory burdens affect competition in the marketplace? What impact does increasing the regulatory and tax burden on Internet commerce have on rural, handicapped and low-income consumers? How does it affect our trade opportunities with other countries?

We need to consider whether the macroeconomic benefits of the new economy will outweigh the potential losses in direct revenues. We must ensure a level playing field for all venues of commerce, not simply create a new remote sales tax system. We must simplify the overwhelming morass of tax rules, regulations and paperwork so that opportunities for new or small businesses are not lost in complex and archaic bureaucracies. We need to re-examine the level of services which the public wants to be provided by govern-

ment and determine how to provide necessary revenue to accomplish the people's will. We need to ensure that taxation is not simply imposed to increase government bureaucracy.

I am looking forward to hearing from the witnesses on all of these issues. It is clear that these are complex issues which will require extensive investigation, analysis and debate. The commission established by the Internet Freedom Act did not reach consensus, nor did it resolve the multitude of issues presented by the new framework of interstate commerce which the Internet presents.

I do not see how we can arrive at consensus on these critical issues between now and October of next year, which is why I proposed a 5-year simple extension of the current moratorium. Extension would not affect the current nexus rules. It would not affect the grandfather provisions. It is a simple extension of the status quo.

It had been my intent to include S. 2255, the 5-year moratorium extension legislation, on the Committee markup tomorrow. The advocates of increasing the tax burden on the public have prevailed in having it removed from tomorrow's agenda so that they can look into this matter further. However, I want to emphasize this is critical legislation. It is in the best interests of our nation's economic prosperity to bring it to the full Senate. Therefore, I intend to include it in a future markup and ensure that the Senate is permitted to debate these issues fully.

[The prepared statement of Senator McCain follows:]

PREPARED STATEMENT OF HON. JOHN MCCAIN, U.S. SENATOR FROM ARIZONA

I am pleased to welcome all of our witnesses this morning. We can expect a diversity of views and opinions on one of the most important issues facing us this session, the future of the Internet and e-commerce transactions. I believe that we are at a critical juncture in determining the future regulatory scheme under which the new economy will either continue to grow and prosper, or will be thwarted by government bureaucracy, taxation and shortsighted greed.

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Does such an expansive jurisdiction also result in potential liability in each state for non-compliance or mis-compliance with state regulations? What about business licenses, occupational fees, occupational or retail licensing regulations, "blue laws"?

How do we ensure that, in the zeal to collect more money to permit even more expansive governments, we protect the privacy of the consumers? How does imposing more regulatory burdens affect competition in the marketplace? What impact does increasing the regulatory and tax burden on Internet commerce have on rural, handicapped and low income consumers? How does it affect our trade opportunities with other countries?

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Senator Hollings.

**STATEMENT OF HON. ERNEST F. HOLLINGS,  
U.S. SENATOR FROM SOUTH CAROLINA**

Senator HOLLINGS. Mr. Chairman, the problem is not increasing the tax burden, the problem is decreasing the tax burden at the local level. Everyone would agree we shouldn't tax access to the Internet, and I do not know of anybody who has suggested taxing access to the Internet. What has really occurred is a pell-mell rush to identify the technology. Everyone is running around saying "oh, I have done something." One individual, of course, said he invented



the Internet. Others are hastening to try to identify with the technology, saying they are against or for a moratorium. We got to save the Internet, acting like the Internet is some sick chicken or needs Viagra, heck, we have a runaway animal here. You do not have to worry about saving the Internet. Even the Chinese are trying to block it, and cannot do it. So let us not get onto this bit about increasing the tax.

The problem is decreasing the tax. I had the privilege of working with Charles Conlin of the Federation of Tax Administrators in Chicago back in 1949 and 1950 when we wrote the sales tax. It was a sales and use tax. Incidentally, we more or less used the California and Ohio laws, and they have never been disturbed. We never really attempted to repeal it in the conservative legislature of South Carolina, or set it aside at the court level.

It says use. All the States, except two or three, have the use tax so that if I buy a jacket from L.L. Bean in Freeport, Maine, by telephone, by letter, or by Internet, I am subject to the use tax because it is bought in Maine for use in South Carolina.

The problem, of course, has been over the years that the bureaucracy entailed in trying to collect that use tax far exceeded any kind of benefit, so no one has bothered to really collect. On the other hand, with the volume of Internet sales everybody will buy their car on the Internet. That fellow Heisinger, he is running around putting these agencies everywhere. You are going to put every automobile dealer in your state and community out of business because they are just programmed. These big companies, General Motors, Ford, they will put the cars, about 30 of them at the most, which is better than 130 because they require those dealers to program some 130. They just look at what you want and the dealer itself will order it on the Internet and it will be delivered the next day. And you would save 500, 600 dollars on a car, plus the added less expense of actually programming all the automobiles out on the lot. It is a trauma to local business and to the local revenue system.

I had introduced a bill along that line that says look, we used to have what we call revenue sharing in February of 1967. We had it, and it worked extremely well up until when we senators were understanding we were financing everybody at the local level to run against us. We said wait a minute, we are giving them all the money and they are taking it and they are running against us at the local level. So with Howard Baker, myself and others, we just eliminated the revenue sharing. But with that approach, we ought really to just give a service to the States. We could waive the Interstate Commerce Clause, put in a 5 percent tax for the 50 States, and send it back to the States and let them fuss about how they are going to divide it up. We do not have to charge the States anything, but we can lessen the impact of this new technology at the local level.

That is the real problem. The real problem is not a moratorium. You cannot tax the Internet. Nobody wants to tax access to the Internet. But it is a problem at the local level of trying to maintain what is left of Main Street. Wal-Mart is going to close down half of it and this will close down the other half. So what we need to do is look at what Senator Dorgan and others have been working

on. They know the tax system. Let us provide a service for the States and get on with the problem and quit mounting these strawmen like somebody trying to ruin the Internet or interfere with the technology. You have no chance of doing it. Thank you very much, Mr. Chairman.

Senator McCAIN. Senator Stevens.

**STATEMENT OF HON. TED STEVENS,  
U.S. SENATOR FROM ALASKA**

Senator STEVENS. I do not have a prepared statement. I just want to endorse your statement, Mr. Chairman. I support this bill.

Senator McCAIN. Thank you.

Senator Wyden.

**STATEMENT OF HON. RON WYDEN,  
U.S. SENATOR FROM OREGON**

Senator WYDEN. Thank you, Mr. Chairman. I think Senator Hollings has identified the key issues, with the question of the impact of technology on local revenue. I would just like to begin by offering up a few facts about what we have seen with respect to the impact on local government since the Internet Tax Freedom bill was passed. In fact, I guess the *New York Times* summed it up this week when they said in a headline on page one, "A Resurgent Michigan Leads Newly Flush States." The fact of the matter is that local revenue is way up since the Internet Tax Freedom bill was passed, and in States where Internet usage is highest, local revenues are up the most.

For example, California sales tax collections were up 20 percent over 1998. The traditional bricks and mortar retailers had one of their best holiday seasons. They had a nearly 8 percent jump in sales over the previous year. The States and localities ended fiscal 1999 with a 35 billion dollar surplus. So this notion that technology is somehow devastating local revenues just is not borne out by the facts. The record clearly shows otherwise.

Now, the problems that States and localities are having with respect to collecting these sales and use taxes have nothing to do with the Internet. I am pleased that our co-author, Congressman Cox, is here today. He and I have pointed out, as the Chairman has repeatedly, that there is nothing in the Internet Tax Freedom bill that prevents a state from going out right now and putting in place a better and more cost-effective system of collecting sales and use taxes.

But the States, as we have heard, will not do it because they do not want the political heat. Governor Cellucci of Massachusetts put it very well when he recently came to the Hill and said, I cannot station a bunch of policemen on the Massachusetts border to run down folks coming over from New Hampshire and try and stick them with taxes.

So what we now have is a situation like that in which some of those opposed us so vehemently in 1997. I have gone back and looked at the record. It is an incredible record. The League of Cities, National Association of Counties and others said, and I quote, "that our moratorium would cause a virtual collapse in the state and local revenue base." They said, and I quote, "one of the gravest

concerns of this new electronic era will be the almost complete erosion or potential implosion in the sales tax.”

So all these folks who were proven wrong in the years since the Internet Tax Freedom Act are now saying that what the Congress ought to do is let local jurisdictions go out and impose a new tax on a merchant 2500 miles away from that jurisdiction who has no connection with the jurisdiction other than a website, and that new tax ought to be imposed without a vote of the U.S. Congress. That is really what is at issue here. The Internet Tax Freedom bill is about technological neutrality. It says that you can do anything you want on the Internet, as long as you do unto the offline world what you do to the online world.

I am anxious to work with these mayors and Governors and others who opposed us in 1997 and that oppose us now as we try to extend the moratorium. I think at some point, those who keep predicting these parades of horrors as a result of technology in our legislation have some obligation to offer a factual foundation for their position. I really urge my colleagues to look at the transcript, because it is extraordinary in terms of what they predicted.

What we have seen is just the opposite, record setting revenues in places where Internet usage is highest, and now these folks would like to go out and impose these new taxes without even a vote of the U.S. Congress. This is an important hearing, Mr. Chairman. I have talked with Senator Dorgan and others. I am anxious to try to find some common ground so we can move rapidly to a markup. We ought to extend at a minimum the ban on discriminatory Internet taxes. In fact, so that there would be clarity this time, Congressman Cox and I, in introducing our legislation, have renamed the bill. It is called the Internet Non-Discrimination Act so as to make it clear.

Senator McCAIN. That is a much better name.

Senator WYDEN. I hope. I hope. And I look forward to our testimony, and I have a full statement that I would just ask it be part of the record, Mr. Chairman.

[The prepared statement of Senator Wyden follows:]

PREPARED STATEMENT OF HON. RON WYDEN, U.S. SENATOR FROM OREGON

Three years ago, when Congressman Chris Cox and I introduced the Internet Tax Freedom Act (ITFA), we said you can't squeeze the new economy into a set of rules written for the smokestack industry.

Three years ago, opponents of our bill predicted retailers were going to vanish from Main Street. The National Governors Association predicted our bill would "have severe consequences on state and local economies" (Oct. '97), the National League of Cities, the National Association of Counties and the U.S. Conference of Mayors warned the moratorium on Internet taxes "would cause a virtual collapse in the state and local revenue base." The National League of Cities said "one of the gravest concerns of this new electronic era will be the almost complete erosion or potential implosion of the sales tax."

*The Denver Post* editorialized on November 16, 1997 that the Internet Tax Freedom Act would "make states and cities wave goodbye to their tax revenues," and that "services citizens expect of local government will decline drastically." "Democracy and federalism as America knows them could be zapped from the screen of history."

A front page story in this past Monday's *New York Times* paints a very different picture: "A Resurgent Michigan Leads Newly Flush States." The article begins: "Lawmakers here and in many other states, now in the throes of writing their budgets for the 2001 fiscal year, are witnessing the biggest of six consecutive years of rising revenues, inspiring inventive new ways to spend money and wave upon wave

of tax reductions.” It goes on to point out that “New York, California, Texas, Maryland, Minnesota, Indiana, Washington, Pennsylvania and Michigan have been amassing annual surpluses exceeding \$1 billion.”

In the 18 months since enactment of the ITFA:

- States and localities have continued to collect sales and use taxes, and state budgets ended fiscal 1999 with a \$35 billion surplus;
- Traditional bricks and mortar retailers had one of their best holiday seasons, recording a nearly 8% jump in sales over the previous year;
- In states where Internet usage is highest, revenues are up the most;
- California’s sales tax collections were up 20% over 1998; and
- ABC News reported that 74% of Main Street merchants now also do business online. Bricks and mortar have become clicks and mortar.

The Internet Non-Discrimination Act (INDA) that Rep. Cox and I introduced earlier this year is about one principle: you cannot stick it to the new economy. The Internet Non-Discrimination Act is about fairness and balance. The bill would continue current law that bans discriminatory taxes on e-commerce. No business gets any more favorable tax treatment by selling online, and no business gets any less favorable treatment by selling online.

I believe that a permanent ban on discriminatory taxes on the Internet is the way to go. I am willing to let the states and localities try their hand at developing a simplified sales and use tax system that doesn’t stick it to the Internet. But the Supreme Court set the bar high in the *Quill* decision. The states have a lot of work to do to make sure any new sales tax collection obligation they want to impose on remote vendors can satisfy the undue burden test. If the state simplification plan passes the undue burden test, it will not have any problem passing the non-discrimination test.

Senator McCAIN. Thank you very much, Senator Wyden. Thank you for your informed and very passionate effort on this very important issue.

Senator Abraham.

**STATEMENT OF HON. SPENCER ABRAHAM,  
U.S. SENATOR FROM MICHIGAN**

Senator ABRAHAM. Senator McCain, I will be brief. As you know, I am a cosponsor of your legislation. I would just make the observation today that I made a couple of weeks ago in the Budget Committee when we heard from several Governors and others talking about this issue. And that is that, I believe, that the ability today to predict the tax system of five or 10 years from now is very minimal.

I believe that the changes in behavior with respect to the way people live their lives, buy things for their home, purchase goods and services, run their companies, and so on, will be so dramatically affected by the high technology information age transition that we are going through that what we are debating today will, I predict, in five or 10 years seem to be a relatively innocent and somewhat perhaps even amusing debate in retrospect.

I think that the Internet and the changes that technology and the information age bring to human behavior will force tax reform in ways that think tanks, that political candidates, all of us combined in fact have been unable to accomplish because of the changes that will happen in society. I question, for example, as we, as the introduction of broad-band and high-speed Internet access becomes universal, how many companies will continue to build skyscrapers to house their employees under one roof. I believe we will

see dramatic changes in the number of people who in fact work out of their homes.

I think we will see changes in a variety of other ways that affect commercial transactions and as we pass legislation such as our e-signatures bill, we will see changes brought about by that as well and so while I do support the legislation, I just would say that I suspect we will be having many more hearings to address the issues of changes that technology brings about with respect to taxation and other various areas of government activity. I look forward to it. I think it is very exciting and I am sure under your leadership, we will continue to be on the cutting edge of these issues. Thank you.

Senator McCAIN. Thank you very much.

Senator Dorgan.

**STATEMENT OF HON. BYRON L. DORGAN,  
U.S. SENATOR FROM NORTH DAKOTA**

Senator DORGAN. Mr. Chairman, thank you very much. I support the moratorium, supported the legislation that called for it; although I must say to my colleagues that had we passed the legislation as originally written and introduced, we wouldn't have had much of a tax base in local governments for consumption taxes, but it was changed dramatically. I support it. I would support its extension as well. But I think its extension needs to be accompanied by a series of considerations.

This explosion of information technology and the Internet is exciting, dynamic and wonderful for our economy, and I agree that we should not have a tax system that would impose burdens upon it or injure it or injure the growth of this new exciting part of our economy. Having said that, we have a series of questions we need to answer. There are some principles here that are important.

One: despite all of the rhetoric, there is no new tax being discussed by anyone, no new tax. On these transactions, there is a use tax that a consumer has a responsibility to report to the state in which the consumption occurred. Of course, that use tax is seldom ever paid. It is far too complicated to have tens and tens of millions of Americans filing use tax returns, so the sales tax is generally the complementary piece of that and the tax is collected upstream rather than downstream.

Now, my colleague seems to suggest the States just do not have the wherewithal or the will to go out and collect this. That would suggest that he is proposing an army of more government agents and inspectors. I mean, I want less government, not more government. If you really want a use tax collected from tens and tens of millions of people through some regime, then you are talking about more government, more complexity. I am talking about less government and simplicity.

A tax exists on these transactions. The question is: How will it be collected? I think it is in our interest to find a simplified method, a very simplified method, simple for those who are Internet sellers. I think every state ought to be required to have one blended rate, only one, and a tax system, a tax base that is common, one rate, a common base. That is simplification.

Second: I think you have to be concerned about preserving a local tax base. Our schools are predominantly funded by the local tax base, especially the consumption tax. I think you have to be concerned about that in the long run. And third, I think there is a significant issue with respect to fairness to Main Street merchants with respect to the obligation of a tax on a transaction so, you know, all of these things need to be part of the balanced approach that we take.

Again, I support Senator McCain in extension of the moratorium. The moratorium on discriminatory taxes makes eminent good sense. I support prohibition on taxes on access, but I do think there needs to be more considered with respect to the other items I have just discussed. I want to end by saying that no one is talking about a new tax. No one.

There is no new tax involved. There is a consumption tax in this country that has complementary sales and use taxes. When a sales tax does not apply, a use tax does, but to suggest somehow to find a way to simplify the collection of a use tax as representing a new tax burden on the American people is just wrong. It is just not accurate. I hope that we can work together and find a way to resolve this issue and do it as we did a year and a half ago with respect to the bill we passed in the Senate.

If I might make one additional short comment. We put together a Commission in that piece of legislation, and in my judgment the Commission has failed. I understand that even though we provided that they would not make recommendations without a two-thirds recommendation on the Commission, I think this Commission largely has not achieved the goals that we would have liked.

Perhaps we need to find some other way of doing that. Thank you, Mr. Chairman.

Senator MCCAIN. Senator Burns.

**STATEMENT OF HON. CONRAD BURNS,  
U.S. SENATOR FROM MONTANA**

Senator BURNS. Thank you, Mr. Chairman, and thank you for elevating this hearing to a full Committee. I think it warrants full Committee. I am going to offer my statement for the record and add my name as a cosponsor. I think what we have done so far has worked very well and I think we ought to continue this, and I am looking forward to hearing from the witnesses.

Senator MCCAIN. Thank you. Your statement will be made part of the record without objection.

[The prepared statement of Senator Burns follows:]

PREPARED STATEMENT OF HON. CONRAD BURNS, U.S. SENATOR FROM MONTANA

Thank you, Mr. Chairman.

I commend the Chairman for holding today's hearing, as it concerns a topic of great importance to the future development of the Internet—how to make sure that our nation's tax policy keeps pace with rapid technological change.

The "Internet Tax Freedom Act" recognized that uniformity and common sense must be brought to taxation policy on the Internet. The Act placed a three-year moratorium on state and local taxes that discriminate against online transactions. I strongly supported this bill and welcomed its passage by the Senate in October of 1998.

In the short period since the Act's passage, we have seen a continuation of the explosive growth in electronic commerce. Companies ranging from garage startups

to multinational corporations are bringing their goods and services into the electronic realm at an ever-escalating rate. In my home state of Montana, companies such as Vanns.com and healthdirectory.com are taking advantage of the virtual markets provided by the Internet.

The Internet does not depend on physical geography or even the sale of physical goods. The virtual transactions that take place on the Internet may span hundreds or even thousands of individual taxing jurisdictions. Those states and cities that have decided that Internet commerce is subject to local sales taxes, even though the transaction occurs in cyberspace, created a paperwork nightmare for small businesses.

After witnessing the further growth of the Internet and electronic commerce, I am more convinced than ever of the folly of imposing a devastating patchwork of taxes on Internet transactions. I agree with the recommendation of the Advisory Commission on Electronic Commerce that we should extend the moratorium. Mr. Chairman, I would like to add my name as a co-sponsor to S. 2255, which will keep the Internet a "tax-free" zone and help foster the continuing growth of electronic commerce.

Both consumers and businesses will benefit from a reasoned Internet tax policy. Growth will create more revenue and an expanding tax base for the future. The empowering aspects of the Internet for small business—low barriers to entry and an immediate global reach—must not be allowed to be harmed by a heavy-handed government approach to Internet taxation.

Extending the moratorium on discriminatory taxes on Internet transactions will help to ensure that the nearly limitless potential of electronic commerce is realized. Thank you, Mr. Chairman.

Senator McCAIN. Senator Breaux.

**STATEMENT OF HON. JOHN B. BREAUX,  
U.S. SENATOR FROM LOUISIANA**

Senator BREAUX. Thank you very much, Mr. Chairman. Also thanks for having the hearing at the full Committee level. I think it is important enough. Let me just obviously make my position very clear from the outset. I think that Congress should give the States the authority to require the collection of a sales tax by businesses who sell products into a particular state over the Internet or any other means that they see fit to do so.

I think that there is something patently wrong with a situation that allows a person to walk downtown to Main Street and buy a pair of shoes and pay the locally imposed sales tax on that transaction which in most cases, as Senator Dorgan has said, goes to run the police protection, the fire protection, and the schools within that local community. Yet somehow if that person buys the same pair of shoes ordering it out of state or with the Internet, they somehow escape the legal liability of having the sales tax collected by the seller of the merchandise. It does not make any sense, and I think it is wrong. Congress should act in this area.

I congratulate Mike Leavitt and others who served on the Commission. Having some experience with being on a Commission that requires a super, supermajority, I know how difficult that happens to be, if not impossible to ever accomplish. The work that they did was very helpful and shows that there is a real interest in solving this problem. I would suggest that it is not a question of whether sales taxes increased at the local level last year. It is a question of what they are going to do in 5 years or 10 years or 20 years.

Of course, with a booming economy, sales taxes were up in most States. Mine was an exception and as more and more people look at this as a loophole to escape paying local sales taxes, in 5, 15, 20 years you are going to see a system that does wreak real hardships on local communities because of Congress' failure to act to

allow the imposition of what the local communities have already legally decided was appropriate sales tax.

As far as the connection, I mean, it seems to me that the only connection that the companies have outside of a particular state is a pipeline directly into the States sucking money out of local communities. They certainly have the right to sell their merchandise. They have a huge advantage because they are not located there. They do not hire people. They do not pay property taxes. They do not own buildings. Most times they do not contribute to local charities or become involved in local activities. They have a huge advantage selling in a local community.

Why say that we are going to carve out a special exemption and allow them to get away with not having to pay the local sales tax that the local people in that community say is appropriate and proper and is imposed upon themselves for important functions like schools and police protection and fire protection. Congress should act on this. I think a 2-year moratorium was appropriate. We should figure out a universal state sales tax so that one tax could be collected and submitted to the state and the state would distribute it to the local communities based on what is appropriate under the state rules and laws. Thank you.

Senator MCCAIN. Senator HUTCHISON.

**STATEMENT OF HON. KAY BAILEY HUTCHISON,  
U.S. SENATOR FROM TEXAS**

Senator HUTCHISON. Thank you, Mr. Chairman. I appreciate your holding this hearing. Certainly I think the Commission that was put together has looked at this issue very carefully, but it is a crucial issue for a state like mine that does not have a state income tax. I spilled some of my own blood in my state to avoid having a state income tax. And if we allow this inequity to continue to occur, I can see that we are not going to have the sales tax base that will support our state, and I can see a drumbeat beginning for a state income tax, which I would fight to the death. So I hope that we can take a responsible step. I am not sure that I agree with my colleague from Louisiana that collecting sales taxes at the federal level is the answer. I had hoped this Commission would bring forward a fair plan.

Senator BREAU. Would the gentlewoman yield on that point?

Senator MCCAIN. The Senator from Louisiana is not recognized.

Senator BREAU. She has the time. If she wants to yield, she can yield.

Senator MCCAIN. No, she does not. She is making an opening statement. I have ruled the Senator from Louisiana out of order. That is the ruling of the chair. Please complete your opening statement so that we can go forward with the witnesses.

Senator BREAU. She can't yield on her time?

Senator MCCAIN. Time is for opening statements, I say to the Senator from Louisiana. I thank the Senator from Louisiana for his courtesy.

Senator HUTCHISON. Let me say that perhaps I should not have mentioned a disagreement. We will have time to debate at another time, but I do believe that it is important for us to find the right answer. At the very least, we should not treat retail sales dif-



ferently on the Internet than they are from catalogues, and States have been able to pass laws that would require the collection of a sales tax from a consumer in a state if there is a catalogue purchase. I think we have got to look at this issue very carefully. I do not think we should tax the Internet itself, but I think the issue of a level playing field where a retailer pays taxes and supports the community, and should not have an unfair competitive disadvantage because you can buy something without paying a sales tax on a retail purchase from an Internet company.

So I think we have a very tough issue here, but we also need to realize that we have certain services that are done at the state and local level that are supported by retailers who invest in the community and by consumers who pay a sales tax so thank you, Mr. Chairman. I appreciate having this hearing. I hope we can do something responsible that does keep a level playing field for all of the businesses in our country.

Senator MCCAIN. Senator Bryan.

**STATEMENT OF HON. RICHARD H. BRYAN,  
U.S. SENATOR FROM NEVADA**

Senator BRYAN. Thank you very much, Mr. Chairman. In the interest of time let me say that I associate myself with some of the observations made by our distinguished colleague from Texas. I think the growth of the Internet has been a very positive thing for us in this country. I think it has helped to spawn a technology explosion that will put us well ahead of our competitors in the 21st century. Having said that as a former Governor, I am concerned about what the implications are for tax bases in state and local governments who are heavily dependent upon sales tax collections.

In my own state, one third of the revenue derived offered all the essential services of government, primarily education, in the state are dependent upon the sales tax, so I think we do have to look in terms of how we treat this issue in no way to penalize or to limit the opportunities for expansion, but to deal with the very legitimate concerns that state governments have.

Second thing I have is this inherent sense that there ought to be some equity and fairness. I mean, for many communities in my own state, and I am sure for that of my colleagues as well, local businessmen and women in Main Street America really form the hub and base of so much of what we do, whether it is the support of the little league or the Boy Scouts, the Girl Scouts, the Camp Fire Girls are done as a result of the involvement civically by those individuals who are active in the business community.

It seems to me that they are entitled in any kind of system to be treated fairly and equally, and so I think there is an equity issue as well, and I hope we might be able to address those two issues. And again, I thank the chair for convening this very timely and important hearing.

Senator MCCAIN. I thank you very much. I would ask the Honorable Christopher Cox of the U.S. House of Representatives and the Honorable Mike Leavitt to come forward. Congressman Cox, would you make your statement, followed by Governor Leavitt. Welcome to both of you before the Committee.

**STATEMENT OF HON. CHRISTOPHER COX,  
U.S. REPRESENTATIVE FROM CALIFORNIA**

Mr. COX. Thank you very much, Mr. Chairman, and members of the Committee. Thank you for inviting me to testify this morning as a co-author of the Cox-Wyden legislation, more popularly known as the Internet Tax Freedom Act, and I certainly appreciate the opportunity to join my co-author. It was this Committee, your Committee, Mr. Chairman, that held the first-ever hearing on the issue of Internet taxation.

I am also joined this morning at the witness table by the distinguished Governor of Utah, Governor Mike Leavitt, who served on the Internet Tax Commission created by the Internet Tax Freedom Act, and it was with Governor Leavitt that I spent many, many long hours a few years ago writing the legislation that created not only the Commission, but also the existing moratorium. We brought together very different points of view from the state governments, from local governments, from many municipalities all over the country, and we agreed on one very, very important principle, and that is that the Internet should not be singled out for special taxation, for multiple taxation or for discriminatory taxation.

It is important to get straight what the Internet Tax Freedom Act is and therefore what your bill, Senator McCain, which is co-authored by Senators Wyden, Abraham and Leahy, does when it extends that existing moratorium. Just 3 years ago, our purpose was to prevent tyranny of the parochial over the Internet, which is not just national in scope but global. There were already afoot a few years ago incipient efforts by some 30,000 potential taxing jurisdictions in this country alone to lay claim to a piece of the Net. There were news articles that talked to us about efforts by state and local governments to shake down the Net. People viewed this as a great cash cow that could be exploited, and perhaps exploited without notice.

Internet access services were a big target. This was long before politicians grabbed the issue of the digital divide as something that they wanted to prevent; rather, governments were talking about actually taxing Internet access. Multiple taxation was a big concern. That is because the Internet's very design, its packet-switched architecture made it especially vulnerable to taxation by multiple jurisdictions. And discriminatory taxation was also a real threat.

Just a few years ago, many academics, governments in Europe, and even the United Nations were talking, for example, about a bit tax, something specially designed to prey upon electronic commerce. It would have taxed every single bit, every zero and one of digital information in cyberspace—literally an information tax. The Internet Tax Freedom Act, which you are talking about extending here today, stopped such multiple discriminatory and technologically targeted taxation. That is exactly what it did.

It ensured that the Internet is not caught up in this tyranny, the parochial and 30,000 taxing jurisdictions.

What it did not do is protect Internet transactions from sales tax. That is an important issue that many people on this Committee that Governor Leavitt, many people across the country wished to discuss. That is not what this legislation is about. This legislation

is about protecting the Internet from discriminatory taxation. The two are very, very different. The Internet Tax Freedom Act does not create a preference for electronic commerce over bricks and mortar. The existing tax moratorium that this Committee helped write does not even mention sales taxes.

It stops multiple and discriminatory taxes on products ordered over the Internet, but it does not bar taxation of Internet commerce by state and local government. So whatever disagreements there might be on other aspects of this question, on sales tax, for example, on nexus, on physical presence, on the Supreme Court's decisions, there ought to be as a starting point agreement on this principle of Internet nondiscrimination.

As we all know, the version of the Internet Tax Freedom Act that became law lasts only 3 years. That is why this legislation is important. The temporary nature of the moratorium was something that many of us thought was an important compromise because it would give us a chance to see what happened, and as Senator Wyden pointed out in his opening statements, there were concerns that we were going to sail off the edge of the earth, that everything would fall apart, that there would be a big falloff in revenues. That did not happen. As we meet here today, not only is it true, as Senator Breaux said, that of course the economy is doing well and tax collections are up, but I think most economists are willing to tell us that the reason we are enjoying this prosperity is the new economy.

We have it to thank for the Federal Government, for state governments and for local governments being awash in new tax revenues so far from the cataclysm in tax collections that was predicted by preventing discrimination against the Internet, and that is what this Committee did. We have protected and promoted the collection of taxes by state and local governments and by the Federal Government.

Brick and mortar sales are not down. They are up. And they are way up. The International Council of Shopping Centers reports that 1999 holiday sales the most recent holiday season were up 8 percent. Now, 8 percent growth in a mature industry that is enormously bigger than e-commerce is quite spectacular. The Internet has helped traditional retailers expand beyond Main Street to sell to new markets. Tax collections by state and local governments in part and consequence of this explosion in traditional commerce are also way up.

In my state of California, sales tax collections 1999 versus 1998 are up 11 percent, and for the fourth quarter they are up 20 percent. The growth in Internet commerce and taxable sales has fattened state budgets, which ended fiscal 1999 with a combined 35 billion dollars in state surpluses, and the Federal Government is a big beneficiary of this as well, even though we collect no sales taxes. Total Federal tax collections as a result of the economic growth spurred by this new economy were up 118 billion dollars in 1999 over 1998.

So I think the facts are in. We have learned from this moratorium. The results are conclusive. The new economy is generating tremendous new revenue. The current tax policy is working, and it ought to be extended. It is working not only for States, not only for

the Federal Government, but for counties and for cities whose power to tax has been protected by this legislation, but the national interest at the same time has also been protected and the global interest in this new medium exchange has also been protected.

I would like to conclude with a brief anecdote, if I might. About a century-and-a-half ago Michael Faraday became world renowned for his invention of the first electric motor, the Dynamo. He did this by rotating a current-bearing wire around a magnet. His invention came to the attention of King William IV, and he got an audience with the King, and Faraday described and demonstrated his invention, upon which the King said to him, "This is interesting, but of what use is it?" And Faraday replied, "Only time will tell; but of this I am certain: some day, sir, you will tax it." We are here today to discuss new ways to tax Faraday's invention.

I hope that this Committee will be wise in exercising that responsibility because the art of taxation has been compared wisely, I think, to plucking a goose. The object is to get the most amount of feathers with the least amount of squawking. If we want to protect this extraordinary expansion in federal and state and local revenues that we are experiencing, we would be wise to tread lightly in this area. I want to thank the Committee for your patience and your interest and your attention to this issue.

[The prepared statement of Mr. Cox follows:]

PREPARED STATEMENT OF HON. CHRISTOPHER COX,  
U.S. REPRESENTATIVE FROM CALIFORNIA

Thank you for allowing me to testify this morning on our common interest in protecting the digital economy—and the tax revenues it generates for federal, state, and local government budgets—from special taxation.

I'm here today to deliver my strong support for S. 2255, the legislation introduced by Chairman McCain, and sponsored by Senators Ron Wyden, Spence Abraham, and Pat Leahy to extend the moratorium on new, multiple, and discriminatory Internet taxes.

In the House, we hope to bring similar legislation to the floor of the House *before Memorial Day*.

I'm pleased to be back before the Commerce Committee, which three years ago held the first-ever Congressional hearing on the issue of Internet taxation. At the time, our purpose was to nip in the bud the incipient efforts of some 30,000 taxing jurisdictions to lay claim to a piece of the Internet. Back then, this was a very real threat. News magazines warned that tax collectors around the country were looking to "shake down the Net."

- Internet access services were a big target for taxes, as more and more Americans were connecting to the Internet.
- Multiple taxation was a big concern, given that the Internet's very design—its decentralized nature—makes Internet transmissions vulnerable to taxation by different jurisdictions.
- Discriminatory taxation was a real threat, too, as a number of academics were promoting the "bit tax," a tax system designed to burden only electronic commerce.

The Internet Tax Freedom Act stopped these special types of taxes, and ensured that the Internet would not be caught up in an inconsistent patchwork of taxes by the United States' 30,000 taxing jurisdictions.

The final tax moratorium that this Committee helped write does not overreach. It stops new taxes on Internet access, and multiple and discriminatory taxes on products ordered over the Internet—but does not bar all Internet taxes. This fundamental structure is ideally suited to become a long-term—if not permanent—policy. Whatever disagreements there might be on other aspects of the Internet tax debate, surely we can all agree—as a starting point—that the Internet should not be subject to new, multiple, or discriminatory taxes.

This principle makes sense independent of whatever rules Congress or the U.S. Supreme Court may adopt on “nexus”—whether we have the existing physical-presence rule, as outlined in the 1967 *Bellas Hess* case and the 1992 *Quill* case, or some new rule. Whatever the standard, surely there is agreement that all sellers should be subject to the same standard. None of us wants a regime that subjects the same seller differently if he sells by catalog or over the Internet.

As you all know, the version of the Internet Tax Freedom Act that became law lasts only three years—and then expires. The temporary nature of the moratorium was something that many of us accepted out of respect for the concerns of state and local government leaders, who issued dire warnings about the effect the bill might have on their budgets. But now, as we have reached the half-way point of the moratorium, the data is rolling in about the real effects that the moratorium has had:

- Internet sales are up, way up. For the 1999 holiday season alone, Americans bought \$10 billion worth of goods over the Internet.
- “Brick and mortar” sales are up, too. The International Council of Shopping Centers reports that 1999 holiday sales at shopping malls were up 8 percent over 1998. The Internet has also helped traditional retailers expand beyond Main Street to sell to new markets.
- Taxes collected by state and local governments are up—way up. In my State of California, sales tax collections for 1999 were up a whopping 11 percent from 1998.
- The growth in Internet commerce and taxable sales has fattened state budgets, which ended fiscal 1999 with a combined \$35 billion in surpluses.
- The federal government has benefited, too: Total federal tax collections grew by \$118 billion from 1998 to 1999.

The facts are in, and conclusively so: the Internet economy—the “new economy”—is generating tremendous tax revenue for federal, state, and local governments. The Internet is opening up new markets for Main Street businesses and contributing to new jobs, better wages, and a stronger economy—all of which boost tax receipts.

These are signs that the current tax policy *is* working—not only for consumers, but also for states, counties, and cities whose power to tax has been modestly constrained by the Internet Tax Freedom Act. Every level of government has a stake in ensuring that the Internet will continue to propel the new economy that is contributing to record tax receipts at every level of government.

I’d like to conclude with a brief anecdote:

*More than a century and a half ago, Michael Faraday invented the first electric motor—the Dynamo—by rotating a current-bearing wire around a suspended magnet. He became so well known for this invention that, one day, he was granted an audience before King William IV. After Faraday described what he had developed, the King looked at him and asked: “But, after all, what use is it?”*

*Faraday came back with a quick response. “Only time will tell, but of this I am certain: Someday, sir, you will tax it.”*

Developing new taxes for new technologies need not be an irresistible temptation. I commend the Chairman and the members of this Committee for their interest in showing that the government can indeed learn the lessons of the past, and that we can protect new technology—and the new economy—from the very real dangers of predatory taxation.

Senator MCCAIN. Thank you very much, Congressman Cox.  
Governor Leavitt, welcome.

**STATEMENT OF HON. MICHAEL LEAVITT,  
GOVERNOR OF THE STATE OF UTAH**

Governor LEAVITT. Just one housekeeping item. The testimony that I submitted to the Committee—as I reviewed the formal testimony, I recognized that a portion of that testimony was, had drawn not directly from my words, but from a group of words that were part of the Advisory Commission on E-commerce, and I would just like to acknowledge that, and I will submit a correction so that it is clear.

I would like to begin by just echoing what I have heard around the room today, and that is the Internet is the most powerful force of expansion that this planet has ever known economically. I would like to acknowledge the fact that Congressman Cox and I did work long hours and that the Internet Tax Freedom Act was a bill that I supported and that the Governors supported. We believed fervently then, and do now, that there should be no bit tax, there should be no, there should be no bandwidth tax, no access tax, no multiple tax, no discriminatory tax. The Internet simply should not be inhibited in any way by tax policy on its growth.

This debate, I believe, will focus really around three issues. The first is what should the relationship be between the state and the national government? Who ought to be making decisions on this and important issues related to education and roads and schools and how does the Internet change that?

Second, is the sales tax going to be a viable tool in the 21st century? It might not be. We might find out that because of the nature and changes that occur in the way we transact business, that it may not be viable. I would suggest unless we make some substantial changes, it probably will not be, and we need to begin to think about what the consequences would be and are we prepared to accept them?

The third issue is if we are to have a sales tax, will we adopt the philosophy that will create a level playing field where all sellers and all buyers are treated the same, or will we adopt the philosophy that says we are going to grant a special privilege to certain segments of our economy not to have to contribute to our schools or roads or law enforcement? As Congressman Cox pointed out, the existing moratorium is something that had my support and continues to have my support.

It is, at the proper time I would be very optimistic and pleased to see it extended. We still have 18 months left on the moratorium. There are a lot of things that have changed even since we enacted the first moratorium, the whole area of telephony, how we are going to deal with that. Many of those issues are just now emerging and the next 18 months will be an important time for us to be able to analyze those, but I would be very optimistic and willing to see it extended.

I would like to comment briefly, Mr. Chairman, on the Advisory Commission on Electronic Commerce. As was pointed out, we were not able to achieve the two-thirds that was required in order to put forward a report. A report is being advanced, but it did not require the—did not attain the statutory requirement. I feel some disappointment in reporting what I believe to be a lack of success—unnecessarily—in the Commission's efforts. We were so close, so close to what I think could have been a powerful statement of direction and recommendation to the Congress.

I would like to review with you the things on which we had virtual agreement. Out of 10 major areas, we had expressive agreement on eight. We simply had disagreement on two, and I would like to highlight both the agreements and the disagreements.

The first was our general acknowledgment of the power of this engine of economic expansion and that we ought to do nothing to inhibit it. We all agreed on that.

The second was that there should be no discriminatory taxes, no new taxes placed on the Internet. All agreed. Both those who voted in the majority and those who were not voting on the side of the majority. We agreed in our first meeting, 15 out of 19 commissioners, that the ultimate goal needed to be a level playing field. We also agreed that unless we had radical simplification, harmonization of the existing system, that it simply would not work in the 21st century. The current system is a mess and if it is not fixed it will not be compatible with the economy of the 21st century.

We agreed that the telecommunications industry was dramatically overtaxed as an industry, and that the tax system we had was far too complex and needed to be simplified. We agreed that these should all be revenue neutral that we were not in any way attempting to impose requirements on the Internet that would make it a tax collection vehicle, that anything we do should be revenue neutral. We also agreed that it should be zero burden to the seller, that if we did not meet the requirement of being able to essentially make this a zero burden to those who have to use the Internet as a collection means that it, that the sales tax likely would not be a viable vehicle in the 21st century.

We agreed that there needed to be protection for small firms that the tender chutes of Congress that are coming up to the soil ought to receive some special protection perhaps in the form of some sort of a de minimis rule where small firms would not have to be burdened in any way, but that once they reach a certain point, that in fact we ought to go, they ought to become full citizens and meet the requirements of corporate citizenship.

Now, where are the areas in which we did not agree? There were two. First, that the national government should preempt the capacity of state and local governments to control their own tax policy. The report clearly indicated that they should. We disagree with that. And second of all, that there should be some form of special tax privileges granted. We believe in a level playing field, so those are the only two areas in which there was disagreement.

Now Mr. Chairman, I would like to submit for the record today a letter from 40 Governors in this country asking that the conclusions of the report be rejected. Given the fact that they clearly call for preemptions of state authority, and second of all that they would not create a level playing field. I would also like to submit a letter from 170 of the country's most respected academic tax experts, who indicate that there is no rational basis to pursue a tax policy that does not include as its foundation a level playing field, and I would like to submit, if you would allow it, a copy of a report drafted by a minority on the commission.

Where do we go from here?

Senator MCCAIN. Without objection, all those documents will be included in the record.\*

Governor LEAVITT. Thank you, Mr. Chairman. The States are pursuing actively and aggressively through the Uniform Commission on State Laws the creation of a model state law that would standardize, harmonize and modernize the sales tax system. It would be our hope that in the next 2 years we can come to Con-

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\*The information referred to has been retained in the Committee files.

gress and ask them to authorize the creation of an interstate compact that States would have the option of moving into or facing certain privileges that would not be accorded them. We also believe that this can lead us, this is a pathway to a level playing field.

Mr. Chairman, I would like to just conclude today by making reference to a piece of legislation that the President recently signed that came from you as the Chairman. I think it is a tribute to your leadership and that is the Airport Investment and Reform Act of the 21st century. I would like to say in particular there is one thing I like as a fellow Westerner who has to travel from the west and endure that 1-hour drive from Dulles Airport, thank you for the flights going into National. That will be great.

Senator MCCAIN. Thank you very much.

Governor LEAVITT. That will be a great benefit to many of us. But the legislation also clearly included an increase on sales taxes collected over the Internet. The taxes, it would have been a terrible imbalance if it had not. There was not a single senator who stepped up to offer an amendment that would have changed that. It would have dramatically reduced the mechanism for collecting funds that go to improve airports that we all depend on. I can just imagine the fuss that would have been caused if suddenly state legislatures started passing laws saying you cannot collect taxes on the Internet with respect to airport or to airline tickets.

The Congress would have rushed to the Supreme Court saying that is a violation of interstate commerce and they would have been right. They would have said you are not allowing us to collect the dollars that are necessary from the proper people who are using it to pay for those services. It would have been seen as anti-Internet. It would be seen as—if the States were saying it is anti-Internet and pro-tax to be doing that, then I would like to suggest we are talking about the sales tax in the same way.

This boils down to just a couple of things. One, nobody likes taxes, but if we are going to have them they at least ought to be fair; and, second, a question of whether or not the sales tax is going to be a viable tool in the 21st century. If it is not, we need to begin to look at what the alternatives are. They are very clearly more income taxes and property taxes—something that I do not believe the people in this country are prepared to accept. And the third, where are we going to control basic decisions about our schools and roads and law enforcement? Those are traditionally and very clearly local prerogatives and best managed at the local level, and this issue very much reflects the question of whether or not local communities will continue to be able to do so. Thank you, Mr. Chairman.

[The prepared statement of Governor Leavitt follows:]

PREPARED STATEMENT OF HON. MICHAEL LEAVITT,  
GOVERNOR OF THE STATE OF UTAH

Mr. Chairman and members of the Committee, I am Michael Leavitt, Governor of Utah. I am here today not only as a member of the Advisory Commission on Electronic Commerce, but also on behalf of the National Governors' Association. Thank you very much for the courtesy that's been extended to me this morning.

No other innovation—no other way of doing business—has revolutionized our nation's economy faster than the Internet. It took generations for the Industrial Revolution to play out around the world. The Internet Revolution has unfolded before our eyes, in less than a decade. The speed of this change has been astounding. In the Industrial Age, as change took place, governments were able to react accord-



ingly. In the Internet Age, today's innovation is tomorrow's standard. Government must act on Internet time.

Congress, as well as state and local governments, need to function in this new economy by facilitating its continued expansion. In one area, we have an opportunity, if unencumbered by the federal government, to do just that—to create a radically simplified and streamlined sales tax system that eliminates the burdens from our current horse and buggy system.

And I believe we came close in the Commission to achieving a balanced approach, a fair approach with a level playing field. I remain convinced that the states are already moving rapidly in the right direction, and I remain convinced that the high tech industry, the nation's retailers, and states and local governments could reach consensus amongst ourselves.

Any thoughtful discussion on e-commerce must include the following key issues:

1. The proper relationship between the federal government and the states on issues of taxation, and which levels of government ought to bear the responsibility for determining and financing the needs of their citizens and businesses;
2. The necessity of keeping tax policy neutral so that neither traditional retailers nor remote sellers (catalog, Internet, or similar enterprises) are given an advantage based on tax policy; and
3. The need to stop erosion of essential revenue streams that support education and other key public services at the local level.

Governors are vitally concerned about any action that could negatively affect the vast majority of retailers—most of them small businesses, by the way—as well as their employees in our states, and erode the revenue source most important to the provision of education, public safety, and transportation services to the American people and businesses.

#### **Extending the Moratorium**

On behalf of the National Governors' Association, we oppose S. 2255, which would extend the provisions of the Internet Tax Freedom Act (ITFA) for an additional five years. Since the current moratorium does not expire until October of 2001, there is no compelling need to act at this time. This is particularly true since the technology is changing rapidly and creates substantial uncertainty with regard to unintended consequences. A rush to judgment on this matter could be detrimental to the Internet and electronic commerce industry, to Main Street America, as well as to state and local governments and all of our citizens who rely on government services every day.

Some of the technology issues that create uncertainty with respect to impacts include:

- *Bundled services;*
- *Discriminatory Tax Definition;* and
- *Internet Telephony.*

These issues have little or nothing to do with the sales tax collection issue that has dominated debate on extension of the ITFA. They are, instead, the result of the rapid pace of technological change and developments since the ITFA was originally enacted. We believe it is important to the Internet industry as well as state and local governments that you address these issues as part of any extension of the ITFA. Failure to address them is likely to mean that the ITFA does not meet the expectations of Congress.

#### **Future of the Sales Tax**

The Advisory Commission report very directly raises the issue of the future of the sales tax in our country—the single most important source of revenue in America for public education, and which level of government ought to be responsible for determining and meeting the education, public safety, transportation, and infrastructure needs of our citizens. The central issue between the states and federal government as it relates to e-commerce is not about new taxes on the Internet, but rather *how* the states will collect taxes already on the books, and whether states will remain sovereign in their right to collect those taxes.

In Utah and other states, we strongly oppose any *new* taxes on the Internet. We should not seek to enrich our state or federal coffers with new taxes just because of new technology and new methods of delivering goods.

There is no more fundamental responsibility for any of us elected to office than to that of representing our respective constituents and taxpayers. The concept of reciprocal immunity is an inherent part of our federal system, consistent with the basic sovereignty states retain under the 10th Amendment to the Constitution. For

decades the states have had the authority to enact and modify sales tax laws and their complement use tax laws. Use tax laws have been effectively enforced for decades as it relates to business purchases.

The ACEC report asking Congress to impose unfounded mandates on states and local governments in excess of \$30 billion annually through the preemption of existing taxes and creation of special privileges for certain kinds of companies through changes in state and local income, business activity, property, and sales and use taxes simply boggles any concept of our appropriate responsibilities to our respective citizens.

Is it possible that the federal government will override long-standing state policies in each of these areas that vary so dynamically from one state to the next? Once successful in this regard, will we see additional actions of the federal government? Will the federal government declare that income taxes can no longer be applied to the software engineers who build the websites involved? Will dot.com firms' warehouses be exempted from property taxes by action of the federal government?

Such an action would clearly violate the sovereignty of the states to enact and enforce sales and use taxes.

Imagine where that slippery slope leads in the years ahead—congressional tax cuts imposed by eliminating state taxes! The taste of enacting tax cuts that don't reduce federal revenue could, of course, easily prove to be addictive. What about the elimination of state use tax on equipment necessary to reduce environmental emissions? Why not override states authority to tax diesel fuel that is used to transport goods across state lines? How about an end to income taxes for teachers? Or firemen? The opportunity for mischief is unlimited.

Only with state action to efficiently collect existing taxes will our traditional main-street retailers compete with the new world of e-commerce on a level playing field, and will our funding base for critical services be preserved for the years to come.

There is no question that the federal government has the right to regulate interstate commerce. But it would be virtually unprecedented for the federal government to stomp on the most basic rights of the citizens and taxpayers of each and every state by determining how they may or may not raise revenues.

### **Creating a Level Playing Field**

Any action taken by this Committee should guarantee assistance towards achieving a streamlined sales tax system for the 21st century, a level playing field for all businesses, and no special privileges. In the face of the impending transformation of retail shopping, government tax policy must remain neutral. It is not the time to have government tilt competitive forces in favor of either traditional retailers or emerging electronic retailers. Unfortunately, without the states effective enforcement of our current laws—and with the passage of proposals like that proposed by the Commission—such government-sponsored special privileges will result.

We nineteen members of the Advisory Commission on Electronic Commerce (ACEC) gathered research, hearing and reviewing testimony from interested parties, sifting through proposals and debating varying perspectives; all in an attempt to form the basis of a balanced recommendation that addresses the most pressing issues raised by all parties and therefore could garner the requisite support of the Commission necessary to make a formal recommendation to Congress. We did not succeed.

Throughout the process some broadly held general views emerged and deserve to be articulated. They are the core concepts upon which any federal policies should be based.

Clearly our main task was intended to be the issue of the collection of taxes on remote sales over the Internet. We encountered a great degree of confusion about the current state of play in this area. The current rules for remote sales tax collection are guided primarily by the set of interpretations and practices emanating from the U.S. Supreme Court *Quill* decision, which essentially said that remote sellers are not responsible for collecting sales taxes for taxing jurisdictions where they do not have physical nexus. We have lived with this construct for decades and it has guided the tax policy of direct merchants and catalogue sellers for years. The reality is that sales taxes apply to electronic commerce conducted over the Internet and any seller that has nexus with a taxing jurisdiction is required to collect and remit such taxes today.

So why the current great debate? Today there is a view that the world is largely made up of electronic commerce companies and traditional brick and mortar companies. Inevitably, however, somewhere down the road, in 3, 5 or 10 years, take your pick, commerce will be intertwined with the cyberspace and physical worlds will merge and interact to meet the increasing demands of consumers. "Bricks and mor-

tar” retailers will pour millions into their online shopping offerings as they morph into “clicks and mortar” retailers. Clients will browse at home and order direct or head down to the store to “feel the fabric” or “swing the golf club.” Remote sellers will have contracts with local providers (who may or may not be legally affiliated entities) to provide service or accept returns.

*In a world like this, if remote sales over the Internet are taxed differently than intrastate sales we will have a system based upon a tangle of legal maneuvering that will create separations between local merchant and their Internet counterparts and a playing field that will be viewed as inherently unfair. Such unfairness, if left to fester, will bring contempt and non-compliance. It is hard to argue with the need for an enormous simplification of state and local sales taxes that can pave the way toward a level playing field that does not discriminate between methods of access.*

In reality, of course, taxes on remote sales are already due. They are called use taxes and the obligation falls on the consumers to calculate and pay them. While they exist in most states, with respect to individual consumers they are collected more by exception than by the rule. So while any new system that implements a way to collect remote sales taxes would not increase the theoretical taxes on the books of government, it would undoubtedly lead to increased revenues collected. This raises its own issues.

I am pleased to report to you this morning that we, the states, have already achieved substantial progress in moving to radically simplify state and local sales taxes. For those of you that remember the efforts of former President Reagan, Senator Packwood, and Rep. Rostenkowski; you can well understand and appreciate the challenge we have undertaken. I can report to you that substantial progress was made as 26 states gathered in a cooperative effort in Denver, Colorado on March 30–31, 2000, to continue discussions focusing on the implementation of a revolutionary streamlined sales and use tax system. The Streamlined Sales Tax System Project is a comprehensive undertaking in direct response to the widespread call for simplifying the sales tax. The states have enthusiastically embraced this unique opportunity to attain the fundamental simplification measures needed to maintain a viable sales tax system.

The states embarked on this mission in September 1999, by initiating discussions to develop and implement a simplified sales tax system. Two subsequent meetings were held prior to this most recent Denver meeting and continuing discussions are being conducted to resolve integrating the design elements of the new system. It is anticipated that a pilot project of the new system will be in place in Fall 2000.

Work Groups were established and charged with addressing a multitude of issues essential to successfully implementing the new system. The Work Groups are:

- Paying for the System, Technology, Audit, and Privacy Issues;
- Sourcing and Other Simplification Issues;
- Tax Rate, Registration, Returns, and Other Remittances; and
- Tax Base and Exemption Processing.

Several key issues received attention from the Work Groups, including:

- Ensuring that the use of technology does not breach the basic tenets of consumer privacy while simultaneously establishing a new benchmark of security measures designed to preserve the integrity of transactions;
- Developing straight-forward sourcing rules that can be easily implemented and adapted to an electronic environment;
- Implementing the use of existing technology that provides for the accurate mapping of tax rates to the appropriate taxing jurisdiction;
- Consideration of one local use tax rate for remote sellers and exploration of the available technology that will facilitate the administration of multiple tax rates; and
- Drafting uniform definitions, standardizing exemption processing procedures for use- and entity-based exemptions, and arranging for the use of a product coding mechanism that will provide a bridge between the tax base and the use of technology.

The Project States seek the input of both public and private sector groups, in addition to those companies and individuals willing to provide technical assistance to the Work Groups. A public comment period will be provided at each Project Meeting during which interested parties may comment on the Project’s design initiatives and accompanying issues with the Project States.

Electronic commerce is growing exponentially and only if we start the process today of developing a tax system that contemplates the burdens the new economy will place on our existing structures will we be prepared to face the challenge.

The burden and responsibility of reform lies with the state and local governments. Clearly, any tax system must not disproportionately burden remote sellers. However, if a system can be established that equates the burden of inter- and intrastate sellers, a level playing field could exist. Finally, in designing a process to produce this system, we, as Commissioners, recognized that while there is a national interest in creating an environment that fosters growth of electronic commerce and ensuring any taxing system does not unduly burden interstate commerce, we also recognize the need to be mindful of the sovereignty of state and local officials in setting policies for their electorate.

### **Closing**

Last week, Congress sent the President the Airport Investment and Reform Act for the 21st century. That legislation is a tribute to you, Mr. Chairman, and the members of this Committee. It is another important step to deal with not only critical safety issues, but also expanding the nation's ability to compete globally in this new economy.

The new legislation provides for an increase in taxes on the Internet. Not a single member of the House or Senate offered an amendment to exempt airline tickets purchased over the Internet from this tax increase. I believe we all understand how self-defeating such an amendment or policy would have been. It would have been terribly imbalanced. It would have sanctioned a double standard. And it most certainly would have led to significant erosion of the very funds this Committee has made such a leadership effort to ensure are available to meet the nation's needs.

Let us be clear. No Governor is looking to tax the Internet, any more than any Senator is trying to impose a special, discriminatory tax on the Internet.

The states' sales and use taxes are existing taxes, not new taxes.

All we are asking is to keep the right we now have as a state to determine our own revenue policies under the laws the people of our state have adopted and we are elected to implement. Most of these sales and use taxes have been in place for at least 50 years.

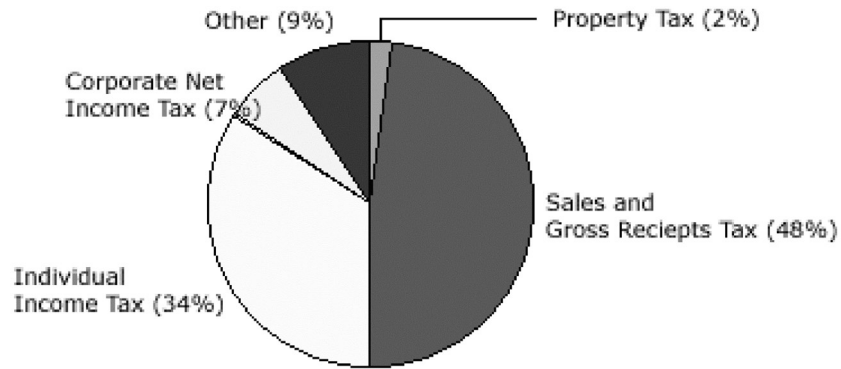
The largest revenue collections in the nation, even in the income tax states, are through state sales taxes. If Congress overrides states' tax policies by cutting our tax base, it will fundamentally upset both the states' and the nation's capacity to provide critical services to the people. The sales and use tax revenues belong to people and taxpayers of the states, not the federal government.

Finally, if we gravitate towards a tax system that creates a specific loophole for retailers that use the Internet, we risk creation of a federal policy that favors Internet vendors at the expense of Main Street stores and home-town merchants. We cannot adopt a tax policy in America that assists in harming traditional Main Street retailers.

Thank you for the opportunity you've given me to testify, Mr. Chairman.

**FACTS AND FIGURES**

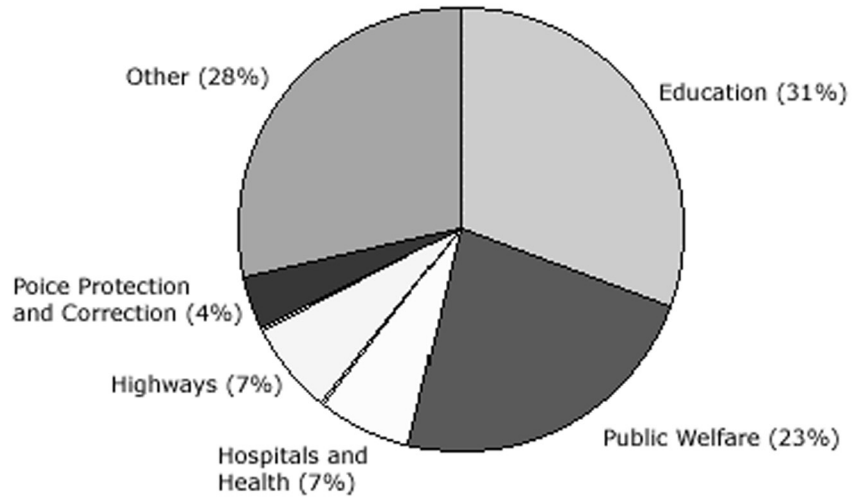
**Sources of State Revenue**



Source: Bureau of the Census

States rely heavily on sales taxes to provide essential public services.

**Percent of State Expenditure by Function**



Source: Bureau of the Census

Senator MCCAIN. Thank you very much, Governor Leavitt. The moratorium runs out in about 16 months. Do you have some confidence that this model state law can be agreed upon in that period of time?

Governor LEAVITT. I feel very confident that we are going to be able to have the model legislation developed before the Congress for the authorization of an interstate compact. Now, if sufficient progress has not been made by that time, then I think the Congress clearly ought to make a decision based in that framework. It may be that we will get to that point and conclude that a lot of progress has been made and at that point we would extend the moratorium. I would be in support of that.

Senator MCCAIN. I believe you stated that you supported the first moratorium, is that correct?

Governor LEAVITT. I did in fact. Yes.

Senator MCCAIN. We received letters from the National Governors' Association and many Governors. Did you weigh in at that time?

Governor LEAVITT. I think Congressman Cox had recognized in fact we did. We had grave concern about the first version of the moratorium which very clearly, very clearly would have ended local control of the sales tax as we know it today. Gratefully, substantial changes were made. We became not just supportive, not just comfortable with the moratorium, but supportive of it.

Senator MCCAIN. It seems to me your model would apply one rate of sales tax to Internet transactions and a different rate to local in-person transactions. Is that correct?

Governor LEAVITT. Not necessarily.

Senator MCCAIN. Not necessarily?

Governor LEAVITT. No. We are interested in coming up with a level playing field.

Senator MCCAIN. And every state in America is going to adopt that same model. Please, Governor.

Governor LEAVITT. There are many, Senator, there are many instances where that has occurred already. The fuel tax is one example. We have a model already where each state collects, and there is a process through which the States have cooperated. This is an issue that the States have grave interest in and it is very clear to me that when the interstate compact goes on the table that there is going to have to be incentives for the States to do it, some of them positive, some of them negative. If the States do not, Mr. Chairman, then I believe the Congress should, but the States in fact I believe will act and just need some time to pull this together. This is a problem that the States have to solve.

Senator MCCAIN. What progress have the States made in the area of taxation of mail order catalogue sales?

Governor LEAVITT. The States—I would suggest the Congress has not made much progress in the collection. If the States were allowed, they would have done very well.

Mr. COX. Mr. Chairman, I wonder if I might comment on this. I mentioned in my remarks that the Internet Tax Freedom Act itself does not address sales taxes. Any concerns about the collection of sales taxes or the counterpart to sales taxes, use taxes, are a function not of the Internet Tax Freedom Act, not of the existing

moratorium, which only prevents new taxes and discriminatory taxes and multiple taxes, but remember the Supreme Court decisions. What those Supreme Court decisions have decided, first in 1967 and then in 1992, can essentially be described in plain English as no taxation without representation. States have jurisdiction over the people who live there, and they can tax them. States do not have jurisdiction over people who do not live there, and they cannot tax them.

Therefore, if someone is doing interstate commerce, they are subjecting themselves to tax by entering the state and what the Supreme Court has said is that if you mail something into the state, that is not enough. If you set up a business there and you have people there, well then that is different, and the principle of no taxation without representation is not violated if you are taxed.

Are States left without recourse if they cannot collect a sales tax on a remote seller? Absolutely not. Every state in America that has a sales tax has a use tax which is identical in every respect, the same rate, the same application collected on the same transaction, so in economic effect it is exactly the same. States can tax the purchaser and the Internet, I submit, actually making this possible in ways that it was not before.

Now, I am not a big fan of adding taxes to commerce, even sales taxes that support state and local governments, but that is not a matter of my personal predilection. As a matter of power, States ought to have that power and they do, but what we are being asked to do in Congress is to change that federalism, to change that Federal-state relation and expand the power of States to tax so that the principle of no taxation without representation would be violated. That would be a terrible thing, so I agree with Governor Leavitt that States ought to have jurisdiction over the people who live there and over the transactions that take place in that jurisdiction, but that means that all they need to do is tax the transaction in exactly the same way that otherwise they would if it occurs on the Internet by taxing the purchaser. That is the person over whom they have jurisdiction. The amount is the same as sales tax, it looks and feels the same as sales taxes. Nobody would know the difference.

I am not encouraging the expansion of use taxes or use tax collection because I personally think it is nice to have a modest level of taxation. But as a matter of power, I cannot disagree with the Governor, States ought to have that power and they do, and Congress should not go any further and expand the power of States to collect taxes.

Governor LEAVITT. Mr. Chairman, it is very clear to me, and I think to Governors and state and local officials that if we do not fix the existing tax system that the capacity to collect the sales tax will, will not be there in the future. E-commerce is growing at such a rate, and we are encouraging it, doing all we can to encourage it to grow. It is growing at such a rate that ultimately in order for people to be competitive, they are going to have to remain using e-commerce. And our purpose is simply to say this: set up a hurdle for us to meet. The hurdle is zero burden on sellers.

If we cannot create a system where the burden is virtually zero on those who sell over the Internet, then it is likely that the sales

tax is not a viable tool in the future because the field will no longer be level and those who ultimately sell with bricks and mortar will be so disadvantaged that ultimately we will be required by fairness and economic policy to eliminate the sales tax altogether and that may be where we want to go in this country, but if it is, we need to analyze what the consequences are. The Senator from Texas has indicated very clearly what they would be in Texas.

Senator MCCAIN. Senator Burns?

Senator BURNS. I am not next, am I?

Senator MCCAIN. Yes, sir.

Senator BURNS. I have one question, I guess, through this whole thing on what you agreed on and what you did not agree on. What do we do, Governor, with States who have no sales taxes and, I live in one of those States?

Governor LEAVITT. We would simply, under the proposal we are making, we would simply have a standardized national system and Montana, which does not have a sales tax, would simply be able to say we do not impose it, we are not going to collect it, we would have a zero rate. It would have no impact on you. I will point out that the majority report that was issued by the Commission would have quite an impact on Montana because it would have interfered with your capacity to collect income and property taxes from certain vendors. It would have made the playing field unlevel in those areas, but it would have no impact on sales tax.

Senator MCCAIN. Senator Wyden.

Senator WYDEN. Both of you have been very helpful. Governor, let me start with you. There is not a word in the Internet Tax Freedom Act that prevents Utah or any other state from going on out today and improving its system of collecting sales and use taxes, and I think we agree on that. Governor Cellucci came and he told us the reason we do not do it is because there is too much political heat. I cannot track people down running from New Hampshire.

Same is true in the State of Washington. My friend Senator Gorton is here. They could go out and collect these taxes that are owed. They do not do it because of the political heat. Now, you all have come forward with a proposal for simplifying taxes. I do not happen to think it is very workable. But I am anxious again to try to find common ground, and supposing we go forward with a markup in Committee next week that looks like this.

We extend the moratorium on discriminatory taxes on the Internet. I would like to make it permanent. Maybe we say 5 years. We will work with you on the time. But we also say we direct NUCSL or one of the other groups involved in the state and local tax area to work with the Governors and the mayors and the cities on the proposal for tax simplification, and we would commit to giving you all a vote within say 180 days of the time NUCSL comes forward with the recommendation so that that way we could have a debate about whether it is actually workable. I do not think you all have come up with something that is workable yet.

Maybe there is a technological fix out there that would not impose any burdens on remote sellers. But supposing we went to a markup next week with those two provisions at the heart of the legislation—an extension of the moratorium on discriminatory



taxes on e-commerce, and by the way, Governor Engler came to another Committee and told me he would support a permanent ban on discriminatory taxes on e-commerce. We have that on the record. We would make that the first provision of the bill, but then we would direct NCSL or some other group that you all feel comfortable with to go forward with their tax simplification proposal, and the Congress commits to giving you an up-or-down vote after we have the hearings and look at whether it is workable and we pass legislation out of this Committee in the next few weeks, what is your reaction to that?

Governor LEAVITT. Senator, as you know, I did support and continue to support moratoriums on discriminatory taxes on the Internet. We have 18 months left on the existing moratorium. We are very anxious to bring to Congress model legislation having been developed by NCSL that could form the basis of an interstate compact. That interstate compact would be the solution put forward that you are looking for.

I am the first to tell you if we cannot come up with that system not only do I believe we will not be able to collect a remote sales tax, I believe within a period of three to five to seven years that the sales tax as we know it will no longer be a viable tool. The point is the States have an enormous incentive to get this fixed. Now, with—we need to put the fix up. The States need to put the fix up. And if we cannot, then we need to get on with the analysis of the alternatives. This is clearly on the plate of the States and local governments. If we cannot fix this system, and it is a mess, then the sales tax as we know it will not be a viable tool in the 21st century.

Senator WYDEN. So what would be wrong with our moving forward with what I proposed? You all have already said that you are not for discriminatory taxes on e-commerce, so that would be the first plank and second, we would commit to giving you all a vote. You would get the vote that you wanted in the Congress on your proposal. What would be wrong with going forward with that?

Governor LEAVITT. We went down that road before, and we became buried with it. I think no one knows better at this table that part of the moratorium was the incentives that it created for everyone to come to the table and solve the problem. It also became very clear that the insurance of a vote could not be enforced under Senate rules, and certainly in the House, and it was far too complex to be able to see that as the solution. What we are proposing is we want to have a couple of years to bring back a solution. If we cannot, our world is not going to—

Senator WYDEN. Governor, we can write in a law a fast-track process that commits to a vote, and I guess what troubles me is I am trying to reach out and extend the olive branch. You all were proven wrong in 1997, and it was not just before the bill that you all predicted all of these problems. There has been a drumbeat ever since the enactment of the law about how this is going to erode all these revenue bases. I cannot find one state, not one in America, that has seen its sales tax base eroded as a result of the Internet Tax Freedom Act, and your reluctance to go along with something that I think is at least trying to meet you halfway is an indication

that what you all really want, the real goal here is frankly to let the moratorium expire.

Then we will let all these jurisdictions go out and start doing their own thing and to me, that undermines your view that you all really are committed to a nondiscriminatory approach on e-commerce. So I hope that you will work with us on this because I think that Chairman McCain and I and others on both sides of the aisle would like to find common ground, but we are not going to let you be like grease going through a goose, subject these out-of-state remote sellers to new, what appear to be, bureaucratic requirements for collecting taxes without our having at least a chance to examine it and what I am offering to you I think shows a reasonable common ground position that I hope you look at.

Governor LEAVITT. Senator, let me respond. First of all, we are sincere and were sincere in our support in the, in support of the moratorium. We will continue to do so, but I think it is important that we recognize that when we started talking about a moratorium in 1997, it was not the same moratorium we are talking about today. Period. And it would have had every consequence that was pointed out by state and local government then and it would now. This is a good economy. The States have had an average increase in the growth of their tax revenues of 5.2 percent.

The Federal government, I might add, has had one of 7.7 percent during that exact same period. I pointed out earlier that Members of the Congress and the President supported the bill I suggested on national airports. It included a clear increase in Internet taxation. I didn't see a single United States Senator stand up and say let us not tax the Internet on this one because you needed the revenue and you wanted to have a system that was balanced and provided a level playing field. That is all we are asking for here. Give us a chance to fix a system that is dramatically broken and that will not be compatible with the 21st century.

We are reaching out saying we'll bring the solution to the table. If we can't, let us all recognize we have to get on to the next option, which is property tax and income tax.

Senator WYDEN. I just offered you a proposal that is in line with what you say you all support. That you say you are for a ban on discriminatory Internet taxes. That is what Governor Engler said. You said you would support an extension of the moratorium on Internet taxes. I have just offered you a proposal that is a middle ground and—

Senator MCCAIN. Senator Wyden.

Senator WYDEN. Can I ask one additional question.

Senator MCCAIN. Please make it brief. The other members—and we have another panel.

Senator WYDEN. You have a seller 2500 miles from a local jurisdiction. They have no presence other than a website. They use no services, no water permits, plants, nothing. All they have is a website. How do you envision that person getting a fair shake under your proposal?

Governor LEAVITT. First of all, the tax is not on the Internet seller. It is on the person who lives in the state who does use the roads and sewer and water. The issue is not whether or not the taxes are owed, but rather who do we place the burden on to collect it. If we

put a burden on a new firm that does not have the capacity and sophistication to do it, that would be wrong and we ought to have a de minimis rule.

Second, if we ultimately put any kind of a substantial burden on any business, be it K-Mart or Wal-Mart or any business, then the system will not work and if we cannot bring back a system that creates zero burden to those who have to collect it, we would have failed. It is going to be unviable in general on bricks and mortar because this country will not stand for the kind of unlevel playing field that would be created where you can go into a store and buy one thing and go to a kiosk outside the store and buy it on the Internet and have taxes collected on one and not the other. It will not work.

Senator MCCAIN. Before I recognize Senator Gorton, sir, we have ample precedent for fast-track authority that requires a vote on an issue. You are incorrect in that response that we do not have that kind of authority.

Senator Gorton.

**STATEMENT OF HON. SLADE GORTON,  
U.S. SENATOR FROM WASHINGTON**

Senator GORTON. Thank you, Mr. Chairman. I suspect that this is an issue on which almost every member of this panel, if not every member, has made up his mind, and I would just like to make a couple of comments, one to my good friend Chris Cox.

I argued cases like this in the Supreme Court, Congressman Cox, and it is not true to say that the Supreme Court rule is no taxation without representation. That is a total distortion of the Supreme Court decisions. We tax the people of the District of Columbia without representation. Senator Wyden's state taxes my Washington residents without representation if they so much as cross over the state line in the course of doing any of their work.

The decision of the Supreme Court is that there is no taxation without presence, which is quite different from representation. And they have determined that the catalogue seller in one state does not have a tax presence without Congress authorizing them to do so, which is why this issue is before us. It has also been very clear from the Supreme Court that it would, that it would regard an act of Congress as perfectly within our power over interstate commerce, and I think it is the implication of those decisions that we ought to do it, but in order to create the very fairness that Governor Leavitt is speaking about, I think we should be extremely cautious at setting policies for other people.

Boy, is it easy for Congress to say that someone else should not impose a tax and that is what we are doing even, even with the moratorium, we are doing that.

We are saying Congress should say someone else should impose a tax, but just yesterday we voted on whether Congress ought to impose a tax that we collect and we spend. We had a vote on whether or not we ought to temporarily suspend a 4 cent gasoline tax and we voted rather overwhelmingly against it. Why? Because members of the Senate got up and said we cannot do that. We will not be able to build roads if we do not continue to impose this tax,

but evidently, we do not care whether or not States can fund schools.

Now, in connection with what Senator Wyden had to say, of course the tax base has been eroded. It has been eroded to exactly the extent that sales take place without a sales or use tax being collected. We have States that are doing pretty well now and haven't directly suffered as a result of it, but their tax base has been eroded. Presumably, in many of their cases, their sales taxes would be lower on everything if they had, if they had a broader base. And for anyone to say well, it is perfectly easy just to collect the use tax on the resident when it arrives, that has been the law in the United States in every state with the sales tax for 50 or 100 years and you cannot for all practical purposes collect that use tax, except on an automobile or something that is so large that it has to be registered.

In my view, which is different from some of the others in this connection, it is easy. Once a state has agreed that it is going to only impose a single rate of sales tax on all sales, there is no burden whatsoever in requiring the out-of-state seller to collect that from the buyer and submit it to the state. Personally, I think Governor Leavitt gives up too much in the argument that he makes to us here. But the answer to Senator Wyden is, those of us who believe in fair treatment, and I think the fairness to retail sellers is the overwhelming argument here, not to mention the proposition that we should not be determining state tax policies, the argument is overwhelming. If we have a vehicle that we can get a hearing on, we ought to use that vehicle.

Governor Leavitt says it a little more politely than I do, but that is the beginning and the end of it and this is a fascinating hearing but I think members have made up their minds. In non-sales tax States like Oregon you are not losing a dime telling Washington that it cannot collect tax when someone sells something from Oregon into the State of Washington. It does not cost you a dime.

Senator WYDEN. Would the gentleman yield?

Senator GORTON. If I were the Senator from Oregon, I would take that point of view. Sure.

Senator WYDEN. I am taking the position on the Internet Tax Freedom Act for the same reason I worked with you on the Y2K legislation. I thank the gentleman for yielding.

Senator GORTON. I agree with that. We have a year and a half. If Governor Leavitt's group does not come up with an answer a year from now, then we ought to extend it, but it is perfectly appropriate to vote on both of these closely related issues at the same time. I am sorry I was late.

Senator MCCAIN. Thank you very much, Senator Gorton. Could I give both our witnesses a chance to respond to your comments.

Representative COX. I very much appreciate that, because I think, Senator Gorton, that you and I agree on some big principles.

Senator GORTON. We certainly do.

Representative COX. That is the allocation of responsibilities between state and local governments. I come from Orange County, California which has more people than 17 States and no Senators and so every time we send our money to Washington we get short-changed. We have to share our senators with 34 million others and

we recognize, for example, when it comes to the gas tax, the 18.4 cent per gallon tax on gasoline that we pay the Federal Government, that goes in the Highway Trust Fund and we have an expectancy that we are going to get Rhode Island's. But good luck. Rhode Island has  $\frac{1}{3}$  fewer people than Orange County but gets more money than we do.

Senator MCCAIN. I have some affection for Rhode Island.

Representative COX. Particularly as a fiscal conservative and as a Republican and also as somebody who lives in a place that gets cheated by this Federal system on a daily basis. I do not want to send power, influence, and money to Washington. I want the county supervisors and States to have this authority. I strongly agree with you. The reason that I have co-authored the Internet Tax Freedom Act in the first place was that we have to recognize the possibility with the Internet of the tyranny and the parochial. There is too much of a good thing here.

I want my local people involved, but I do not want the local city council in some neighboring state and all 50 States to be taking a piece of a transaction because electrons are running through their state. All we have done is put together legislation that bans discriminatory taxes, multiple taxes, new taxes and what is being said here this morning is that everybody agrees on that. Yet some people are willing to take this bill, which would simply keep in place the ban on multiple and discriminatory taxes, take it hostage and hold up support for what is right and what they agree is fair so that they get to vote on something else which is somewhat related.

It is the same general topic as the Internet, but I don't think that on the merits anybody can object to a ban on new taxes, technologically targeted taxes, multiple taxes, tell me everybody here is in favor of it. I have heard none.

The Supreme Court is concerned. I think you recognize when I say no taxation without representation is what cities are about, that I don't believe that that sentence is written into the constitution. Instead, those decisions were based upon Article 1 Section 8 of the Constitution, the Interstate Commerce Clause and the earlier decision also on a separate ground, due process. But we have to ask ourselves why is that Interstate Commerce Clause in the Constitution? Why did the founders fear discrimination against one state?

Senator MCCAIN. We wanted you to respond.

Representative COX. They have good reason to do so. The essential genius of the Interstate Commerce Clause is that it gives the national government jurisdiction over preventing the tyranny of the parochial. That is all we are doing here, and that is a very important thing to uphold. I did not hear anything in any of the senators' or Governor's comments that we should somehow discriminate against electronic commerce. The Internet Non-Discrimination Act moving forward in the House, which is essentially the same as Senator McCain's bill that many of you sponsored, does that. I think because these issues are coming up in 18 months, we ought to take a look at and not confuse them.

Senator MCCAIN. Governor Leavitt.

Governor LEAVITT. The Supreme Court very simply said you can't expect 7500 taxing jurisdictions to respond and people to re-

spond to all of them. They said either you bring back a system that has zero burden on sellers or we are going to impose a limit on your ability to do that, and what we are proposing to do is figure out that system, and if we cannot, it is clear we will continue to suffer the same problem.

I would like to comment on one point that you made related to Senator Wyden's comments. Let me begin by expressing a story. My mother is the grandmother of 29 grandchildren and on a December morning last year she came to my home on her way to the mall, and it was snowing, and she knew the crowds were going to be there and I said why do you not do it on the Internet.

She had never shopped on the Internet. We sat down for an hour and a half and she bought a gift for all 29 of her grandchildren and not only—she was thrilled. She did not have to fight the crowds. She did not have to—and then they packaged them for her and mailed them to her grandchildren and she was done. Now, I kept track as we went through that just because of my own curiosity to make sure my mother paid her use tax. There was 2,400 dollars spent that day and all but 400 dollars of it was not subject to taxation. 400 of it was because they had nexus in the state. Now, my mother would still owe that, and I am confident she will take care of it, but the point is this, people are not shopping on the Internet to avoid the sales tax. They are shopping because it is convenient and because it is a very good thing and our economy is booming, yes, because of the new economy, but we should not be making tax policy decisions on the basis of a temporary economic expansion.

We ought to be dealing with tax policy that creates a level playing field that will endure forever. I invite anyone in this room who has made a purchase on the Internet to ask themselves: why did they do it? Did they do it because it was 1 o'clock in the morning and they did not want to go to the mall and it was not open, or did they do it because they wanted to avoid the sales tax? I would submit to you in your heart it is pretty clear what it is.

Senator MCCAIN. Senator Dorgan.

Senator DORGAN. Mr. Chairman, thank you very much. Governor Leavitt, my colleagues Senator Wyden and Congressman Cox indicated the state should really just collect the use tax if they want to. Having been a tax administrator and actually administered a state sales and use tax, I can tell you it is impossible to collect a use tax on a broad basis, but as a Governor, can you describe for me what kind of burden this imposes on the taxpayer, No. 1, and No. 2, what kind of additional employees would the State of Utah need to collect a broad-based use tax throughout the State of Utah?

Governor LEAVITT. Well, it has simply been impossible in the past, as the Chairman pointed out, on remote sales of any sort, to do that. It would be an imposition in many cases. We do in certain cases where it can be tracked, collect a use tax mostly on business, but as you know, when you go to a catalogue and it says if you live in the State of Maine or Virginia or Utah or South Carolina, you have to calculate it, it is being collected today, but only where there is a nexus, so we are doing our best, but what we are proposing is a system that would be zero burden to anyone and it is not just zero burden to remote sellers. We think we can redesign the system to save billions of dollars in inefficiency and friction that is

currently in the system that can go to the benefit of the American economy and be a very substantial benefit to taxpayers.

Senator DORGAN. My point was if you did really try to collect the use tax across the board, you would have to hire thousands of people. You would impose new burdens on virtually all of your constituents because they would have to file individual use tax returns and declare a use tax on small amounts of goods they have purchased, so the point is it is an impractical thing to do to say well let us just collect the use tax. That is not a solution. It is totally impractical.

Governor LEAVITT. As your neighbor Governor Janklow recently said, we would have to put—have to start stopping men in brown suits in little brown trucks and we would have to hire armies of policemen and it would be just impractical. It would be unreasonable. People would not accept it. It is not a solution.

Senator DORGAN. And a better solution is one that has inherent simplicity and removes the burden effectively from the consumer and removes the burden from the seller. And that is what you are talking about.

Let me ask a couple of additional questions. One, the contention is that, gee, this really does not mean anything. The States have growing economies and are collecting more money. The Internet sellers, I am told, last year sold 13 billion dollars through the Internet and it is expected in the next 10 years to grow to 1 trillion dollars. Is there any, any reason that one can say this will not have an impact on a state sales tax or use tax base?

Governor LEAVITT. Those would argue this is not going to be a burden or not going to affect States' capacities to deliver services, simply ignore reality. On the one hand we say we want to grow without any inhibiting force. On the other hand, we say it is not going to have an impact. Those two are inconsistent. It is having an impact. I would challenge anyone to go to a state that has a sales tax, talk to the people who are estimating revenue and despite the fact that in most states we are seeing increases you will find that almost every tax commission who estimates revenue will have a category for Internet sales and it is a negative.

Senator DORGAN. Governor, you have heard discussion of some here who say they want to impose new taxes describing this debate. These are not new taxes, are they?

Governor LEAVITT. They are not new taxes. And that is political rhetoric.

Senator DORGAN. Are you aware of anyone who wants to impose new taxes here?

Governor LEAVITT. I know of no one who wants to impose a new tax on the Internet. There may be a few but we are not among them.

Senator DORGAN. Congressman Cox, you indicated that prior to the moratorium that there were a range of governments, local governments attempting to develop discriminatory taxes. Can you give us some examples of that?

Representative COX. Sure. Takoma.

Senator DORGAN. What was Takoma trying to do?

Representative COX. They were trying to levy a tax directly on Internet access.

Senator DORGAN. And did they do that?

Representative COX. I believe they were either successful in getting it started or we nipped it in the bud.

Senator DORGAN. Are there a range of others?

Representative COX. Indeed we have a website, the Internet Tax Freedom website, that can be accessed through my website and it lists many of them. It was not just the United States as I mentioned. This is also something that was also going on around the world.

Senator DORGAN. One final question. Governor Leavitt, my understanding is that some of the largest retailers who are going to be involved in Internet selling—because they feel they must from news reports—I am told that they are intending to organize in a way and incorporate in a way that they will have an Internet sales component that will be able to sell without a responsibility to collect the local sales tax. If that occurs on a widespread basis, I assume that will also exacerbate the problem with the local tax base.

Governor LEAVITT. Major retailers in this country—and we are talking about the Wal-Marts and K-Marts who are perfectly capable of speaking for themselves—are clearly moving into a dot com mode because it is the most efficient way of selling. And they should. And they will. They are suggesting, “just give us a level playing field. Define the rules for us.” It is very clear from their actions and their words they would prefer a level playing field but if in this country we define the playing field as creating special privileges for a certain component of it, they will be forced by the competitive atmosphere in which they are in to move to that point.

They will have kiosks outside of shopping malls, of stores, they will hook their cash registers to the Internet they will find whatever ways they have to within the carve-outs that we define to move to that point, and that is the point I suggest that the sales tax generally does not become viable or another thing occurs. People say we cannot stand this inequity. We need to have a balanced system that is a level playing field so let us have a national system and the IRS will stand on their tiptoes and say we are national, we will collect it for you and I will be willing to bet there are those in Congress who say if the IRS is collecting it we ought to be appropriating it.

And suddenly you will have revenues that have been collected and appropriated by state and local jurisdictions for schools and roads and for law enforcement will now be appropriated by the Congress and collected by the IRS because the inequality of one having to collect it and one not simply will not be allowed to stand in the long term.

Representative COX. I should point out that kind of tax is banned in the Internet Tax Freedom Act that we are trying to extend here.

Senator DORGAN. The Interstate Commerce Clause is actually why we are discussing this. It gives Congress the authority to do this, and the other genius in the Constitution is 640,000 North Dakotans have two senators.

Representative COX. That is one part of the Constitution that is not amenable even under Article V.

Senator DORGAN. I want to work with Senator McCain, Senator Wyden, Senator Breaux and other colleagues to respond to this



area. I support an extension of the moratorium. I support it for an eternity. I don't support discriminatory taxation. There are other things we need to balance as we do this and that is the reason for the questions. Mr. Chairman, thank you.

Senator MCCAIN. Thank you.

Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. I apologize for having to leave, but I have heard both of your testimonies and we appreciate you being here. I have two points, I guess. Governor, I would like to once again thank you for serving on that Commission. It can sometimes be a thankless task, particularly when you have a two-thirds requirement to get an agreement. If we do extend the moratorium for 5 years or what have you, it would seem to me that it takes a great deal of the pressure off for you folks to come to any kind of a consensus or agreement on what to recommend. Do you agree or disagree with that?

Governor LEAVITT. As I indicated that, I supported the Internet Tax Freedom Act and the moratorium that is there and I am prepared to support its extension. I do believe we have 16 or 18 months left on it. We have much to be done during that period.

Senator BREAUX. And then if you are not able at that time, I take it from your testimony, you would support an extension that would at least give you the time to see if you can do it during this period.

Governor LEAVITT. In the last 12 months we have seen dramatic changes. We will see dramatic changes in the next 12. I would suggest that one of those will be that we will start to see the clear shaping of a national model that could provide a zero burden system for the development of taxation on commerce.

Senator BREAUX. I apologize if you have gone into detail on explaining those, but can you give me some indication so I can better understand what you all are attempting to do with regard to getting an agreement on a unified sales tax to be collected for Internet sales transaction—and we are not talking about the Congress determining what each state's sales taxes would be, or amount would be, as I understand it. Can you give me some more elaboration on what you are all recommending?

Governor LEAVITT. I think what you are asking me is what would a zero burden system look like if we were to be able to develop it? We set a very high hurdle for ourselves. It would have centralized one-stop registration. You would not have to go to fifty different states. You would go to one website, register and you are registered in all 50 States. It would have uniform tax definitions so that what was a peanut in one state would be a peanut in another. It would have uniform and simple sourcing rules. In other words, we would have a standardized set of rules as to who was obligated to pay and who had the obligation to collect. We would have uniform exemption rules for those who have tax exempt status. It would do away with the tax audit as we know it. It would essentially have software that could be embedded in the software of a website that would completely eliminate and remove from the seller any responsibility for this. This would be a boon to those who are currently involved in commerce at the bricks and mortar level.

Senator BREAUX. This recommendation which you just described would come to the Congress for Congress to take action on?

Governor LEAVITT. We would bring it to the Congress for them to authorize an interstate compact among the States and with it I believe would be a group of benefits for those who adopt it and some sanctions for those who do not. It is clear to me that the States have an enormous amount of incentive to adopt this. If we do not, we are going to be completely left behind and the sales tax as we know it will no longer be a viable tool. We have to solve this problem.

Senator BREAUX. What would the process be by which the States participate in making this recommendation?

Governor LEAVITT. The NUCSL process, which is the Uniform Commission on State Laws—each state sends representatives to the process and they also include other stakeholders. They go through an exhaustive process to develop a model state law. It is then taken back to each state and passed in each state legislature as such.

Senator BREAUX. The amount of each state sales tax under that recommendation could be different. It would not necessarily be all the same. Louisiana could have five sets, 5 percent. Texas could have whatever Texas has. California could have whatever.

Governor LEAVITT. There are those who argue that a single rate in every state would benefit. In my own state in this last legislature we authorized a single rate for remote sales. There are those who also argue that the technology will not make that necessary. Those who argue would not be necessary say that the technology exists today to be able to disseminate where it goes and that we ought to use the existing. That will be part of the debate that will occur during the next 2 years.

Senator BREAUX. I think you are attempting to accomplish something that is very, very helpful—obviously to Congress, if we can get that type of a recommendation. I think that you all have done terrific work and we appreciate it. Chris, I appreciate your position. We have some disagreements on it but hopefully in the end we can come together and find a solution that everybody can work with. Thank you.

Senator WYDEN. Would it be possible to ask one additional question?

Senator MCCAIN. Only one.

Senator WYDEN. Thanks. And—

Senator MCCAIN. Short one, please.

Senator WYDEN. I ask it only because the point that Senator BreauX makes I think is right at the heart of our getting the bill out in the next few weeks and my concern is if the moratorium ends without action, we can go back to letting all these local jurisdictions have at it. And my question would be, Governor Leavitt, if you support what you all say you are for, which is an extension of a moratorium on discriminatory taxes, I will support your getting a vote on the fast-track that the Chairman was talking about of something I am very skeptical of, which is you can come up with a workable system. Can you all look at that over the next few weeks and get back to the Chairman and Senator Dorgan, Senator BreauX and me so that we can see if at least that can be examined.

Governor LEAVITT. We are always willing to talk, as both you and Congressman Cox know from our previous successful discussions that culminated in the Internet Tax Freedom Act.

Senator WYDEN. Thank you, Mr. Chairman.

Senator MCCAIN. Thank you both for being here this morning. I apologize for the length that you had to remain in the docket, but I appreciate the very important testimony you have given the Committee. Thank you both.

Our next panel is Dr. John Berthoud, who is the President of the National Taxpayers Union; Dr. Donald Bruce, Professor, Center for Business and Economic Research at the University of Tennessee; Mr. David Bullington Vice President of Taxes at Wal-Mart Corporation; Mr. Burr Morse, who is the President of Morse Farm Sugar Works in Montpelier, Vermont; Mr. Jonathan Zittrain, who is from the Berkman Center for Internet and Society at the Harvard Law School. Mr. Berthoud, thank you very much for being here and we'll begin with your opening statement.

**STATEMENT OF DR. JOHN BERTHOUD, PRESIDENT,  
NATIONAL TAXPAYERS UNION**

Dr. BERTHOUD. Thank you, Mr. Chairman. Thank you for correctly pronouncing my name! It is a pleasure to appear before your Committee and you, who are a repeat winner of the NTU Friend of the Taxpayer Award year after year.

It is a pleasure to talk with you this morning on behalf of our 300,000 members nationwide. I come before you to state our views on Internet taxation and your legislation S. 2255, which would extend the moratorium through 2006. The National Taxpayers Union strongly supports your efforts, Mr. Chairman, and encourages the Committee to act favorably on this bill.

While proponents of more taxes on the American people have lobbied to establish taxes on Internet commerce, a close examination of the facts reveals no justification at all for creating taxes on Internet access, creating discriminatory taxes on the Internet or perhaps most importantly forcing vendors to collect taxes for cities and States in which they are not located, proposals such as Governor Leavitt outlined previously.

I will briefly examine and refute the claims of the pro-taxing crowd and make the case why it is important to keep the destructive power of government as far as possible from the Internet. First we hear that failure to establish a tax regime such as the NGA is proposing will lead to underfunding of critical services and let me quote from some of the NGA scare stories on their web page and this is a quote, "state and local governments can lose nearly 10 billion dollars by 2003 in uncollected sales tax revenues in Internet and mail order sales. If this problem is not addressed, America would have 200,000 fewer teachers and police officers educating our children and keeping our communities safe."

However, facts and a brief review of state and local revenues and how states collect the revenues will quickly dispel this type of hysteria. State governments, as has been recognized, are flush with money and in my testimony you have a figure that shows based on OMB numbers, state and local tax receipts have grown by over 30 percent—a stunning amount in just the past 5 years. Many states

such as New York, California, Texas, Maryland, Pennsylvania and others have seen year after year of surpluses exceeding 1 billion dollars.

The fact is that states have so much money, they are creating endless new programs. In fact, there was a state senator from Michigan who admitted to the *New York Times* that they have new programs coming out of the weeds and he said only some of them have merit. This was in the *New York Times* just a couple of days ago. The fact that the States have so much money that they are creating myriad new programs, again some legislators are making the admission that they have little merit, seems to clearly disprove the scare tactics of the NGA and others. Make no mistake, Mr. Chairman, as you wisely know, part of the reason for this boom in revenues is the Internet e-commerce and the high-tech sector.

Because governments at all levels have so far wisely left the Internet, e-commerce and indeed the entire high-tech sector alone, it has been able to flourish. In turn, these businesses have returned massive amounts of revenue to states and localities via the taxes currently in place. Adding new taxes to the Internet would adversely affect e-commerce and in turn stifle this revenue growth that the States are luxuriating in.

A 1999 study by the National Bureau of Economic Research concluded that applying existing sales taxes to the Internet would slash the number of online buyers by 25 percent and plummet purchases by 30 percent or more. Proponents—and perhaps “fairness” is a word that has been used by almost every person testifying before the Committee this morning—proponents of new tax regimes say that it is unfair that Internet businesses are not subject to sales taxes and other taxes and that they are supposedly escaping their obligation to fund “needed government services.” Again, nothing could be further from the truth.

Anyone who knows about state and local taxes knows that all businesses, large and small, face myriad other taxes beyond the sales and use tax. They pay corporate income taxes, employees pay personal income taxes, property taxes, and literally hundreds of different types of fees. When Governor Leavitt was recounting his story about all the sales tax revenue that was lost by his grandmother’s purchases, he of course did not mention that States and localities gained literally hundreds, perhaps thousands of dollars through other taxes that were collected based on those sales.

Rather than figuring out new taxes to add on to businesses, Congress and the States should be focused on the ways to lower the old ones. For those businesses that currently do not have an Internet presence and who feel that fairness dictates the establishment of new taxes on e-commerce, our message is simple. Government is never the solution to your competitive problems. More government always ends up hurting commerce and we would advise them to look instead to getting into the Internet or expanding an Internet presence themselves.

Mr. Chairman, we share your vision of equity and the issue of equity and fairness has been fundamental to debates over NGA’s type of tax regime. The question is, is it fair to brick and mortar businesses if we do not have an NGA type regime on Internet commerce? We would argue that every business in America has the op-

portunity to sell on a tax-free Internet, and what could possibly be more fair than that?

As you well know, Mr. Chairman, the debate over taxes has been central to the 2000 election cycle. While you and others have offered wise and sensible plans for reducing the Federal tax burden and returning some of the Federal tax overpayment (what is also called the surplus) to its rightful owners, the American taxpayers, the issue we are talking about today is perhaps of greater long-term significance to taxpayers. We thus strongly support your legislation and indeed we urge Congress to go further and adopt your legislation S. 1611 which would amend the Internet Tax Freedom Act to broaden its scope and make the moratorium permanent. We have also endorsed in the House H.R. 3252, the Internet Tax Elimination Act sponsored by your colleague, Congressman Kasich which would bar sales and other types of taxes permanently on e-commerce.

In closing, I would like to quote from one of the great political philosophers of the 20th century, former President Ronald Reagan, who observed the government's view of the economy could be summed up in a few short phrases, "if it moves, tax it; if it keeps moving regulate it; and if it stops moving subsidize it." Now is the time, Mr. Chairman, to put a stop to schemes to tax the Internet to keep it moving and growing, so government one day does not have to step in and regulate it or subsidize it. This is the challenge before you and the distinguished members of this Committee.

[The prepared statement of Dr. Berthoud follows:]

PREPARED STATEMENT OF DR. JOHN BERTHOUD, PRESIDENT,  
NATIONAL TAXPAYERS UNION

### **I. Introduction**

Mr. Chairman and Members of the Committee, my name is John Berthoud. I am President of the National Taxpayers Union, a nationwide grassroots lobbying organization of taxpayers with 300,000 members.

I come before you today to state our views on Internet taxation and Chairman McCain's legislation, S. 2255, which would extend the moratorium on Internet taxation through 2006. The National Taxpayers Union strongly supports this effort and encourages the Committee to act favorably on this bill.

### **II. The Moratorium Should Be Extended**

A moratorium is a prohibition on action. We believe government should not act—through taxation, spending, or regulation—unless there is a clear and compelling reason for it to do so. While proponents of more taxes on the American people have lobbied hard to establish taxes on Internet commerce, a close examination of the facts reveals no justification at all for a) creating taxes on Internet access; b) creating discriminatory taxes on the Internet; or c) forcing vendors to collect taxes for states and cities in which they are not located.

I will briefly examine—and refute—the claims of the pro-taxing crowd and make the case why it is important to keep the destructive power of government as far as possible from the Internet.

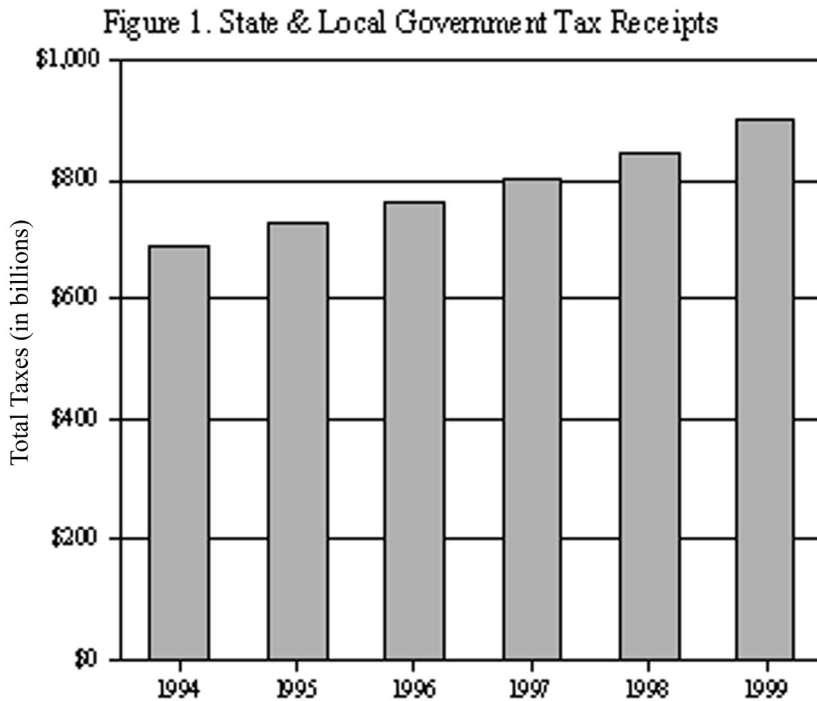
### **III. Claim: Failure to Tax the Internet Will Lead to "Under-Funding of Critical Government Services"**

Repeatedly, we hear from the pro-tax side that without a new tax regime on the Internet, "critical government services" will have to be cut. The pro-tax National Governors' Association (NGA) argues that if the NGA Internet tax plan is not adopted, "States and local governments could lose more than \$10 billion per year by 2003 in uncollected sales tax revenues on Internet and mail-order sales . . . . If this prob-

lem is not addressed, America would have 200,000 fewer teachers and police officers educating our children and keeping our communities safe.”<sup>1</sup>

NGA’s scare tactics about laying off police and teachers are repeated by other big government advocates who argue in favor of similar tax schemes. However, the facts quickly disprove this type of groundless hysteria.

State governments are flush with money. Total state taxes, including traditional sales taxes, have grown at almost twice the rate of inflation and population for the past six years. Figure 1 shows that state and local government tax receipts grew by over 30 percent between 1994 and 1999.



Many states—such as New York, California, Texas, Maryland, Minnesota, Indiana, Michigan, Washington, and Pennsylvania—have seen year-after-year of surpluses exceeding \$1 billion.<sup>2</sup> One Michigan State Senator commented that as a result of the year-after-year surpluses in that state, “we have programs coming out of the weeds—groups with something warm and fuzzy, and *some of them have merit*”<sup>3</sup> (*italics added*).

Meanwhile, the federal government’s share of the economy has reached a postwar high. In FY 2001, the Office of Management and Budget projects the federal government will collect 54 percent more revenue than it did just ten years ago (adjusting for inflation).<sup>4</sup>

And make no mistake—a substantial part of the reason for this boom in revenues is the Internet, e-commerce, and the high-tech sector. Because governments at all levels have so far mostly left the Internet, e-commerce, and indeed, the entire high-tech sector alone, it has been able to flourish. In turn, these businesses have re-

<sup>1</sup>“Sales Taxes and the Internet—Myths and Facts,” National Governors’ Association web site, <http://www.nga.org/Internet/Facts.asp>.

<sup>2</sup>Peter T. Kilborn, “A Resurgent Michigan Leads Newly Flush States,” *The New York Times*, April 10, 2000, Page A1.

<sup>3</sup>Ibid, Page A16.

<sup>4</sup>Office of Management and Budget, Historical Tables of the Budget of the United States Government—Fiscal Year 2001, Table 1.3.

turned massive amounts of revenue to states and localities through the taxes currently in place.

Adding taxes to the Internet would adversely affect e-commerce and in turn stifle the revenue growth that we have seen in most types of state and local taxes. A 1999 study by the National Bureau of Economic Research concluded that applying existing sales taxes to the Internet would slash the number of online buyers by 25 percent and plummet purchases by 30 percent or more.<sup>5</sup>

#### **IV. Claim: E-Commerce Businesses Are Escaping Taxation**

Proponents of more taxation argue that it is unfair that Internet businesses are not subject to new types of Internet tax plans—they are supposedly “escaping their obligation” to fund “needed government services.” Nothing could be further from the truth.

Businesses in America—those on the Internet or those not yet on the Internet—are already overtaxed through a great variety of levies. Some of the more prominent ones include:

- corporate income taxes
- personal income taxes
- sales taxes
- use taxes
- property taxes
- literally hundreds of different types of fees

The small business sector would once again be hit hardest by Internet taxation. Their smaller size means that the compliance burdens would be proportionately greater. Chris Wosocki, President of the 50,000-member Small Business Survival Committee, testified to the Advisory Commission on Electronic Commerce that, “Allowing the taxation of e-commerce would jeopardize the growth of the new digital economy and hamper the ability of entrepreneurs across America . . . The burdens that would be imposed are simply unacceptable.”<sup>6</sup>

Rather than figuring out new taxes to add onto businesses, Congress and the states should be focusing on ways to lower the old ones.

For those businesses who don't currently have an Internet presence and who feel that “fairness” dictates the establishment of new taxes on e-commerce, our message is simple: government is never the solution to your competitive problems. More government always ends up hurting commerce. Look instead to getting into the Internet yourself.

The situation with non-Internet retailers pursuing taxes on those with an Internet presence is analogous to the situation where some businesses have lobbied the U.S. Department of Justice to pursue Microsoft in the hopes of achieving a competitive advantage. Any short-run advantage to these firms is clearly outweighed by the longer-run costs of government intrusion. Nobel Laureate Milton Friedman made this point very eloquently in a dialogue with us last year:

Business, in general, has something of a suicidal instinct. It often proposes laws in its own self-interest which destroy the underlying basis of the whole private enterprise system. I believe that is what has been happening recently in the computer industry. Silicon Valley is suicidal in calling government in to mediate in the disputes among some of the big companies in the area and Microsoft. The end result will be that an industry that up to now has been able to proceed at a marvelous pace with little or no government regulation—it has been a wonderful example of the efficiencies of a strictly free private-market—that industry is now going to have government all over it. It's going to spend in legal fees over the next ten or twenty years, money which society would benefit from much more if it were spent in the kind of research and development that has brought us the many miracles in the area of Internet, in the area of home computers, industry computers, and all the rest.<sup>7</sup>

#### **V. Why Do Proponents of Internet Taxation Want to Add Internet Taxes?**

It is quite clear why advocates of Internet taxation have lobbied hard for Congress and state legislatures to either establish special taxes on the Internet or else create new tax regimes to snare e-commerce in the web of state sales tax collectors. They

<sup>5</sup>“A World Without Borders: The Impact of Taxes on Internet Commerce,” National Bureau of Economic Research Working Paper No. 6863, 1999.

<sup>6</sup>“Fed Panel Urged To Keep Web Tax Free,” The Associated Press, December 15, 1999.

<sup>7</sup>“Dr. Milton Friedman Talks with National Taxpayers Union President John Berthoud,” Spring 1999—San Francisco, California.

want lots more money from taxpayers to fund their plans for even bigger government.

One of the clearest examples is that of America's teacher unions. One of the strongest voices for more taxes—on the Internet and everything else—America's teacher union leaders are pushing an agenda that would add \$906 billion to the existing mountain of federal spending.<sup>8</sup> That's each and every year. To enact an agenda of this size would require a staggering tax increase of \$7,490 per taxpayer.<sup>9</sup>

Advocates of Internet taxation are advancing this idea to help fund their dreams for a massive expansion in government. This agenda is bad news for taxpayers and America's future.

#### VI. Practical Considerations

Mr. Chairman, your legislation extending the moratorium makes sense for all the reasons noted previously. But even if Internet taxes wouldn't add a huge burden to businesses and even if states weren't already overflowing in revenues, there are more practical reasons to continue the moratorium. For example, we have yet to hear a sensible argument on who would be owed a tax if a resident of Arizona, using an Internet Service Provider located in Utah, ordered a product from a company headquartered in Delaware, but whose main office is in Maine, and who ships their goods from New York. Absent a moratorium, we would expect to see state or local legislation that could lead to taxes being paid to a variety of these jurisdictions, meaning multiple taxation placed on a single sale.

And we would anticipate that it will be very difficult for tax and regulatory laws to keep pace with technological change as it occurs. We don't want to put laws in place that will quickly be made obsolete. As the respected magazine, *The Economist* argues, "The Internet is so new that the direction of technological change is fiendishly hard to predict. By contrast, tax rules are precise and inflexible, and take a long time to change."<sup>10</sup>

#### VII. Conclusion

As you well know Mr. Chairman, the debate over taxes has been central to the 2000 election cycle. While you and others offered wise and sensible plans for reducing the federal tax burden and returning some of the current federal tax over-payment (what is also called the surplus) to its rightful owners, the American taxpayers,<sup>11</sup> the issue we are talking about today is probably of even greater long-term significance to taxpayers.

We thus strongly support this legislation and indeed, we urge Congress to go further and adopt your legislation S. 1611, which would amend the Internet Tax Freedom Act to broaden its scope and make the moratorium permanent. We have also endorsed H.R. 3252, the Internet Tax Elimination Act sponsored by House Budget Committee Chairman John Kasich, which would bar sales taxes and other taxes on e-commerce.

In conclusion, I want to quote one of the great political philosophers of the Twentieth century, former President Ronald Reagan, who observed, "Government's view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it." Now is the time, Mr. Chairman, to put a stop to schemes to tax the Internet—to keep it moving and growing, so government one day doesn't have to regulate it or subsidize it. This is the challenge before you and the Members of this Committee.

Thank you.

<sup>8</sup>Jared Adams, "What About the Children? The Legislative Agenda of the National Education Association and the Politics of New Unionism," NTU Foundation Policy Paper 122, October 19, 1999, Page 1.

<sup>9</sup>Ibid.

<sup>10</sup>"Why the taxman fears the Internet," *The Economist*, January 29, 2000.

<sup>11</sup>Contrary to the opinion of many "Inside-the-Beltway" experts, Americans believe they are overtaxed and want to see federal tax dollars returned to them rather than spent on more government programs. This was brought out in polling by John Zogby last September:

Q. Statement A says that tax refunds should be returned to those who were overtaxed.

Statement B says tax refunds should be kept to shore up effectiveness of government programs.

Respondents who agreed with:

Statement A—64%  
Statement B—27%  
Neither—6%  
Not Sure—3%

(Source: "Zogby Poll Sets New Course for America," *The O'Leary Report*, Vol. IV, Issue V, September 1999, Page 3.)



Senator MCCAIN. I thank you for that informed statement, but also I want to thank you for the great job your organization has done for many years in informing the American people and being of assistance and providing me with additional information and knowledge over many years. I would like to, before I call on Dr. Donald Bruce, at this time to enter a letter into the record from the Governor of Pennsylvania, who supports the extension of the current moratorium on access, multiple or discriminatory taxes.

In fact, he points out he proposed the legislature approve the repeal of Pennsylvania sales taxes on computer services as well as tax prohibition on Internet access charges. There are some states and some Governors who I must say I think are more enlightened on this issue than others but we will leave that to others to judge.

Dr. Bruce, welcome. Thank you for being here. I want to thank all the witnesses for your patience while we interrogated the first panel. Thank you, Dr. Bruce.

[The information referred to follows:]

COMMONWEALTH OF PENNSYLVANIA,  
OFFICE OF THE GOVERNOR,  
*Harrisburg, PA, April 12, 2000*

Hon. TRENT LOTT,  
*Majority Leader, U.S. Senate,  
Washington, D.C.*

Hon. J. DENNIS HASTERT,  
*Speaker of the House, U.S. House of Representatives,  
Washington, D.C.*

Dear Senator Lott and Speaker Hastert:

I understand that Congress may soon consider proposals addressing the Internet Tax Moratorium set to expire next year. Technology has been a central focus of my administration since I took office 5 years ago. From education to public safety, our commitment to information technology is helping Pennsylvania to remain competitive in the global economy and preserve the high quality of life in the Commonwealth. Internet based commerce is changing the face of how we do business in Pennsylvania and providing rapid access to a whole new world of information.

To foster the electronic boom I support an extension of the current moratorium on access, multiple, or discriminatory taxes. The Internet has been growing at a record pace and I believe the moratorium has facilitated that process by assuring that commerce over the Internet is not singled out and taxed in new and creative ways. That is why I proposed and the Legislature approved a repeal of Pennsylvania sales taxes on computer services as well as a tax prohibition on Internet access charges. More recently, in my 2001 budget, I have proposed a Sales Tax Holiday for Commonwealth residents who buy personal computers.

Pennsylvania is rather unique because we continue to manufacture goods. Thus, technological advances are often applied to many of those goods produced in Pennsylvania. Decisions on the taxation on Internet commerce therefore, are very complex and must balance the needs of both Internet and Main Street based businesses.

The report submitted by the ACEC Business Caucus to the Advisory Commission on Electronic Commerce acknowledged that "In addressing whether and how the Internet should be subject to taxation, a major priority should be reducing or removing access barriers to perhaps the most advanced and useful medium of communication and commerce yet devised." I concur.

I also agree with the Caucus position that the system taxation of remote sales should be simplicity, efficiency and fairness—and that "(o)ur system of federalism mandates that the burden to produce such a system falls on the states."

My concerns with the report include their preemption of the state role, albeit for allegedly a period of five years, during which time the Caucus recommends that Congress pass laws preempting state sovereignty. We, state and local elected offi-

cials, are best suited to reach a consensus on what changes need to be made to our sales and property taxes without creating a competitive disadvantage for *any* of our businesses. The magnitude of the undertaking is only equaled by its importance. States must work with local governments and its stakeholders—consumers, telecommunication and other remote businesses as well as our Main Street business to address these challenges.

As Congress considers legislation on Internet taxation, I hope that a guiding principle will be fair competition between Main Street businesses and Internet businesses. An extension of the moratorium will provide us more time to assess the situation and ensure that we do no harm to either side. I strongly urge that when considering the impact of electronic commerce on our economy, any changes to the state tax structure should be done gradually and with consultation of all stakeholders.

Sincerely,

TOM RIDGE,  
*Governor*

**STATEMENT OF DR. DONALD BRUCE, PROFESSOR,  
CENTER FOR BUSINESS AND ECONOMIC RESEARCH,  
THE UNIVERSITY OF TENNESSEE**

Dr. BRUCE. Good morning, Mr. Chairman and thank you so much for this opportunity to present these remarks on behalf of myself and my colleague Dr. William Fox, who is also at the University of Tennessee. We appreciate this opportunity. Let me just begin by stating that we are in agreement with the basic theme of this Act. That taxes should be levied in a nondiscriminatory way is absolutely fundamental.

Our objection to the Act's extension is that it represents a failure to act on an issue of such monumental importance. It places us on a policy trajectory that prevents meaningful cooperative action to solve the actual problems.

First, it erodes the ideal of tax neutrality. The notions or decisions to produce or purchase a particular good or service should not be made on the basis of differential tax treatment. Second, it perpetuates reliance on a court determined standard of nexus that is based on physical rather than economic presence. A consequence of this is that future efforts toward simplification and improvement of sales and use taxes becomes even more difficult and state and local governments end up losing significant amounts of tax revenue.

The primary issue, however, in the great debate is that of tax neutrality. Essentially the tax treatment of a particular good or service should not depend on how that good or service is obtained for final consumption. Differential taxation affects not only consumer decisions of where to buy but also business decisions of where to produce and in this electronic world both sides will go wherever they get the better deal and taxes can make the difference thereby disadvantaging many regions of the country and many traditional businesses in the process. This idea is presumably at the heart of the original act. Discriminatory taxes on Internet sales should be prohibited.

However, nondiscrimination must go in both directions. In other words, the tax treatment of Internet sales must not discriminate against local bricks and mortar establishments. Subsidizing Internet firms through apparent non-taxation places a direct comparative disadvantage on local retailers inevitably forcing some of them out of business forever. Now a key component of the Act is its implicit acceptance of a definition of nexus that is based on physical presence, effectively limiting each state's ability to enforce collec-

tion of use taxes on remote sales. Extending the moratorium through 2006 will only make it more difficult for States to collect the sales and use taxes that are legally owed.

Our research, which we have submitted in its full form for the record, shows that revenue losses to state and local governments, while not particularly large in the immediate term, will grow dramatically under the status quo. Admittedly, state and local sales tax bases were already eroding prior to the development of the Internet. E-commerce will only accelerate this historical trend and will result in our estimation of an additional revenue loss of 10.8 billion dollars in 2003.

It has been argued in defense of this act that States have enjoyed strong revenue growth in recent years, and we must note, however, that this is a cyclical phenomenon. Long-term revenue growth is not excessive. Similarly, the robust growth of e-commerce is a result of things like convenience, price, quality of service and the like and cannot be attributed solely to this act. Taxing remote sales like their local counterparts would certainly not kill the golden goose.

To be clear, our position is neither for nor against big government. We are merely advocating the neutral non-discriminatory tax treatment of all types of commerce such that state and local governments can finance their activities as they see fit. The primary question then seems to be whether or not the sales tax should be preserved as a source of state and local revenue. Extending this act will permit the continued erosion of sales and use tax bases and state and local governments will have no choice but to turn away from our nation's primary consumption-based tax system, toward higher taxes on income and wealth. As it generates nearly  $\frac{1}{3}$  of all state tax revenues, we are of the opinion that the sales tax should be preserved with the following general modifications.

First, Congress should replace the outdated definition of nexus with one that is more in line with the modern economy based on economic rather than physical presence. Firms that significantly exploit a particular state's market should be expected to withhold sales and use taxes for that state regardless of whether or not the firm has physical presence.

Second, in exchange for this broader definition of nexus, States should be expected to implement substantial simplification measures. Included in this would be each state's adoption of a single sales and use tax rate and a state specific definition of a set of taxable goods and services presumably drawn from a uniform nationwide set of product definitions. These simplification measures would enable a more streamlined and less burdensome collection process for remote vendors. More importantly, production and purchasing decisions would be based on economically relevant factors rather than on differential sales and use tax treatment.

It has been said that the sales tax is a dying tax and that e-commerce is just the thing to push it to an early grave. Our contention is that e-commerce could provide the incentive for Congress to work with the States to improve our system of consumption taxation such that sales and use taxes can continue to be stable and significant sources of revenue. Thank you, Mr. Chairman.

[The prepared statement of Dr. Bruce follows:]

PREPARED STATEMENT OF DR. DONALD BRUCE, PROFESSOR, CENTER FOR BUSINESS  
AND ECONOMIC RESEARCH, THE UNIVERSITY OF TENNESSEE

### **Introduction**

Good morning, and thank you for this opportunity to address whether the Internet Tax Freedom Act (henceforth referred to as the Act) should be extended through 2006. Let me begin by stating that we are in agreement with the basic theme of the Act. That taxes should be levied in a nondiscriminatory way is absolutely fundamental.

Our objection to the Act's extension is that it represents the failure to act on an issue of monumental importance. It places us on a policy trajectory that prevents meaningful cooperative action to solve the problems at hand. First, such a policy erodes the ideal of tax neutrality—the notion that decisions to produce or purchase a particular good or service should not be made on the basis of differential tax treatment. Second, extending the Act perpetuates reliance on the Court-determined standard of nexus that is based on physical rather than economic presence. A consequence of this is that future effort toward simplification and improvement of sales and use taxes becomes even more difficult, and state and local governments lose significant amounts of tax revenue.

### **Tax Neutrality**

The primary issue in the greater debate is that of tax neutrality. Essentially, the tax treatment of a particular good or service should not depend on how that good or service is obtained for final consumption. Differential taxation affects not only consumer decisions of where to buy, but also business decisions of where to produce. In this electronic world, both sides will go wherever they get the best deal—and taxes can make the difference, thereby disadvantaging many regions of the country and many traditional businesses.

This idea is presumably at the heart of the original Act—discriminatory taxes on Internet sales should be prohibited. However, nondiscrimination must go in both directions. In other words, the tax treatment of Internet sales must not discriminate against local bricks-and-mortar establishments.

To illustrate, consider the following parallel with local infrastructure investments. A city that decides to renovate a downtown street will inevitably subject a number of businesses—and their customers—to tremendous inconvenience. Potential patrons will be less likely to visit these establishments during the construction period, and the businesses may have to close their doors as a result. These businesses probably will not reopen after the completion of the construction.

In a similar manner, the Act represents an investment in the Internet as a transaction mechanism. Nonetheless, subsidizing Internet firms (through non-taxation) places a direct comparative disadvantage on local retailers, inevitably forcing some of them out of business forever.

### **Nexus and Revenue Implications**

A key component of the Act is its implicit acceptance of a definition of nexus that is based on physical presence—effectively limiting each state's ability to enforce collection of use taxes on remote sales. Extending the moratorium through 2006, while delaying any cooperative effort between the Federal and state governments toward sales and use tax simplification, will only make it more difficult for states to collect sales and use taxes.

Our research shows that revenue losses to state and local governments, while not particularly large in the immediate term, will grow dramatically under the status quo. Admittedly, state and local sales tax bases were already eroding as a result of the growth of all types of remote sales, greater consumption of untaxed services relative to taxed goods, and the continuation of legislated exemptions, long before the development of the Internet. E-commerce will only accelerate this historical trend, and will result in an additional revenue loss of \$10.8 billion by 2003.<sup>1</sup>

It has been argued in defense of this Act that states have enjoyed strong revenue growth in recent years. It should be noted, however, that this is a cyclical phenomenon—long-term revenue growth is not excessive. Similarly, the robust growth of e-commerce is a result of convenience, price, quality of service, and the like, and cannot be attributed solely to this Act. Taxing remote sales like their local counterparts would certainly not kill the “golden goose.” To be clear, our position is neither for nor against larger government—we are merely advocating the neutral, non-

<sup>1</sup> Donald Bruce and William F. Fox, “E-Commerce in the Context of Declining State Sales Tax Bases,” Center for Business and Economic Research, University of Tennessee, April 2000.

discriminatory tax treatment of all types of commerce such that state and local governments can finance their activities as they see fit.

### **Policy Options**

The primary question, then, seems to be whether or not the sales tax should be preserved as a source of state and local revenue. Extending this Act will permit the continued erosion of sales and use tax bases due to the expansion of e-commerce, and state and local governments will have no choice but to turn away from our nation's primary consumption-based tax toward higher taxes on income and wealth. As it generates nearly one-third of all state tax revenues, we are of the opinion that the sales tax should be preserved, with the following general modifications.<sup>2</sup>

First, Congress should replace the outdated definition of nexus with one that is more in line with the modern economy—nexus should be based on economic rather than physical presence. Firms that significantly exploit a particular state's market should be expected to withhold sales and use taxes for that state, regardless of whether or not the firm has physical presence.

Second, in exchange for this broader definition of nexus, states should be expected to implement substantial simplification measures. Included in this would be each state's adoption of a single sales and use tax rate and a state-specific definition of the set of taxable goods and services, presumably drawn from a set of uniform product definitions. Whether a bag of honey-roasted peanuts is "food" should be determined by a national standard, while the decision of whether or not it is taxable (and at what rate) should still be left to each individual state.

These simplification measures would, in the process of restoring significant lost revenues, enable a more streamlined and less burdensome collection process for remote vendors. More importantly, production and purchasing decisions would then be based on economically relevant factors rather than on differential sales and use tax treatment.

### **Conclusion**

It has been said that the sales tax is a dying tax, and that e-commerce is just the thing to push it toward an early grave. Our belief is that e-commerce can provide the incentive for Congress to work with the states to improve our system of consumption taxation, such that sales and use taxes can continue to be stable and significant sources of revenue.

Senator MCCAIN. Thank you very much, Dr. Bruce. Mr. Bullington.

### **STATEMENT OF DAVID BULLINGTON, VICE PRESIDENT OF TAXES, WAL-MART CORPORATION**

Mr. BULLINGTON. Mr. Chairman, members of the Committee, thank you for including a voice from the broader retail community in today's hearing. Sound economic policy in a free enterprise economy requires equal tax treatment of the different channels of retail distribution. The existing state sales tax rules, as constrained by Supreme Court decisions issued well before e-commerce, have created two fields of retail competition.

On one playing field, brick and mortar retail stores, both large and small, are required to collect sales tax on behalf of States and localities. On the other, the largely unenforceable rules applicable to remote sales do nothing more than encourage consumers to voluntarily pay the use tax equivalent of a sales tax. As we all know, the use tax is easily ignored. Only across the board collection of this existing tax will level the playing field and rationalize our tax policy.

We believe it is now up to Congress to resolve this issue fairly, so that all channels of retail distribution are treated the same. Brick and mortar retailers are now at a competitive "pricing" dis-

<sup>2</sup>For a broader discussion of these issues, see William F. Fox and Matthew N. Murray, "The Sales Tax and Electronic Commerce: So What's New?" *National Tax Journal* 50(3): 573-592.\*

\*The information referred to has been retained in the Committee files.

advantage because, unlike many of their Internet and other remote selling counterparts, they must collect sales tax on most in-store sales. And, unless they take drastic steps to separate their Internet business from their brick and mortar businesses, they must collect sales tax on their own remote sales as well.

Furthermore, customers who do not have access to the Internet, often lower income individuals who can least afford the burden of taxes, must pay sales taxes, while Internet shoppers in most cases do not. Access aside, the issue of credit availability is a much larger impediment to lower income individuals.

We are greatly concerned about the effect the existing tax structure, if not fixed, will have on our communities. We share everyone's concern with the tax burden issue, and in no way do we want any additional tax burdens placed on consumers. Without across-the-board sales and use tax collection, revenues will actually decrease, and many States will be forced to raise sales taxes or introduce tax increases in other areas such as property taxes. In these circumstances, States will have fewer taxing options and will, as a result, have less control over their tax policy. As we all know, sales tax revenues are critical to the funding of public services such as schools, city streets, police and fire protection.

We believe the Congress may fairly require Internet and other remote sellers to collect and remit sales or use taxes and that simplification is the key, coupled with technology. We emphasize that even with simplification any across the board collection requirement must allow for suitable de minimis thresholds below which mom-and-pop websites and other small businesses need only concern themselves with the filing requirements of their own state as required by current law.

Additionally, appropriate collection allowances should be provided to compensate those remote sellers above the de minimis threshold for their cost of collection. There was general agreement in the Advisory Commission on Electronic Commerce as to the requirements for simplification. We believe that the States are willing to work together to implement these types of simplification. It will not work, however, to just say to the States "go simplify yourselves and then come back and talk to us." More is required, a framework, a direction and a simplification threshold beyond which States may require collection.

In inviting me you asked that I address specifically the consequences of extending the moratorium. If Congress extends the current tax moratorium, without at the same time approving legislation to achieve a level playing field for all retailers, future resolution of the issue will be seriously jeopardized. Already, many consumers have been led to mistakenly believe that the existing moratorium precludes sales tax on Internet purchases.

I do not know who believes it will be any easier to resolve. I don't know anyone who believes it will be any easier to resolve the issue in five or six years. We urge Congress not to extend the existing moratorium without creating the framework within which those States that continue to move forward on simplification can aim for a threshold or date certain, after which collection can be required for those States that have simplified. Thank you, Mr. Chairman.

Senator MCCAIN. Mr. Bullington, it is rare that I interrupt a sequence of witnesses, but I am now. I have defended your organization when it came to Cottonwood, Arizona, and everybody is driven out of business because of what some view as predatory pricing and the enormous advantages that you have. And here you are talking about the ensuring of a level playing field. I am really, it is remarkable. It is one of the more remarkable comments that I have heard in all my years as a member of this Committee.

Mr. BULLINGTON. May I respond?

Senator MCCAIN. No. Sure. I am sorry. Certainly respond.

Mr. BULLINGTON. Senator, we do represent tough competition for anyone. Many of our best customers are small businesses and they turn to us to buy goods for the same efficiencies of distribution that, Sam's Club and even our Wal-Mart stores, the same pricing reasons that they turn to the efficiencies in the Internet and for other reasons.

Senator MCCAIN. If some of those small businesses that had to shut down when you come into these communities' representatives were here they would have a very different view of your impact on them and their economies and their lifestyles but, which may be one of the reasons why there has been so much controversy associated with your locating in some parts of the country. I have always defended your right to do that. Now we have a technology that gives an enormous opportunity to so many people to acquire goods and services at a lower price and you are here in that position.

Mr. BULLINGTON. Not at all. We look forward to being part of that expansive Internet economy that is out there.

[The prepared statement of Mr. Bullington follows:]

PREPARED STATEMENT OF DAVID BULLINGTON, VICE PRESIDENT OF TAXES,  
WAL-MART CORPORATION

Mr. Chairman, Senator Hollings, members of the Committee, thank you for including a voice from the broader retail community in today's hearing. Sound economic policy in a free enterprise economy requires equal tax treatment of the different channels of retail distribution. The existing state rules, as constrained by Supreme Court decisions issued well before the superhighway of technology was introduced, have created two fields of retail competition. On one playing field, brick and mortar retail stores, both small and large, are required to collect sales tax on behalf of states and localities. On the other, the unenforceable rules applicable to remote sales do nothing more than encourage consumers to voluntarily pay the use tax equivalent of a sales tax. As we all know, the use tax is easily ignored. Only across-the-board collection of this existing tax will level the playing field and rationalize our tax policy.

We believe that it is now up to Congress to resolve this issue fairly, so that all channels of retail distribution are treated the same. brick and mortar retailers are now at a competitive "pricing" disadvantage because, unlike many of their Internet and other remote selling counterparts, they must collect sales taxes on most in-store sales. And, unless they take drastic steps to separate their Internet business from their brick and mortar business, they must collect sales taxes on their own remote sales as well.

We are greatly concerned about the effect the existing tax structure, if not fixed, will have on our communities. We share everyone's concern with the tax burden issue, and in no way do we want any additional tax burdens placed on consumers. Without across-the-board sales and use tax collection, revenues will actually decrease, and many states will be forced to raise sales tax rates or introduce tax increases in other areas, such as property taxes, to offset the loss of sales tax revenue. In these circumstances, states will have fewer taxing options and will, as a result, have less control over their tax policy. Sales tax revenues are critical to the funding of public services such as schools, roads, police, and fire protection.

Furthermore, customers who do not have access to the Internet—often lower income individuals, who can least afford the burden of taxes—must pay sales taxes, while Internet shoppers in most cases do not. Access aside, the issue of credit availability is a much larger impediment to lower income individuals.

Wal-Mart and the International Mass Retail Association (IMRA)<sup>1</sup> are among the founding members of the e-Fairness Coalition—a coalition that advocates fairness for businesses and consumers, and that supports a level playing field, including fair and efficient collection of the existing tax already applied to remote sales. The e-Fairness Coalition very firmly believes that Congress must not extend the existing moratorium—which does not expire until October 2001—without resolving this sales tax collection issue.

### Background

The issue of whether remote sellers should be required to collect and remit sales taxes is certainly not new, but the spectacular growth of the Internet and the opportunities for increased sales that most businesses see on the Internet have refocused attention on the issue.

Deciding whether remote sellers should be required to collect taxes rests with the Congress, under the U.S. Constitution's Commerce Clause. The Supreme Court's 1992 decision in *Quill Corporation v. North Dakota* held that the Constitution prevents states from requiring use tax collection by out-of-state sellers without a physical connection to the state, but that Congress has the power to require such out-of-state sellers to collect the taxes. As the Court pointed out, only Congress has the authority to regulate interstate commerce. The best and most thoughtful course of action for Congress would be to give those states that undertake specified simplification steps the authority to require remote sellers to collect. This would resolve any concerns about burdening interstate commerce and would put all retailers, at least in those states that simplify, on a level playing field.

### Simplification

We believe that Congress may fairly require Internet and other remote sellers to collect and remit sales or use taxes on all taxable business to consumer sales, and that simplification is the key. Much has been made of the thousands of different taxing jurisdictions across the nation and of the other elements of state sales taxes that add to the current complexity. And at present it is a complex patchwork of systems that causes even the largest and most efficient retailers great headaches. While technology has made tremendous progress, it is not yet by itself a silver bullet that can entirely eliminate the burden of collecting. Technology coupled with simplification is the answer.

We emphasize that even with simplification, any across-the-board collection requirement must allow for suitable de minimis thresholds below which Mom-and-Pop web sites and other small businesses need only concern themselves with the filing requirements of their home state, as required by current law.

Recently there has been a tremendous amount of discussion about sales and use tax simplification. While there is by no means universal agreement on exactly how simplification should proceed, there is broad agreement on a number of items that we believe should make up the basis of Congressional legislation to provide collection authority for states.

Simplification should include a centralized, one-stop, multi-state registration system for sellers; uniform definitions for goods or services that may be included in the tax base; uniform and simple rules for attributing transactions to particular taxing jurisdictions; uniform rules for the designation and identification of purchasers exempt from sales and use taxes, including a database of all exempt entities and a rule ensuring that reliance on such database shall immunize sellers from liability; uniform procedures for the certification of software that sellers rely on to determine state and local use tax rates and taxability; uniform bad debt rules; uniform tax returns and remittance forms; consistent electronic filing and remittance methods; state administration of all state and local sales taxes; uniform audit procedures; reasonable compensation for tax collection that reflects the complexity of an individual state's tax structure, including the structure of its local taxes; an exemption from use tax collection requirements for sellers falling below a specified de minimis threshold; appropriate protections for consumer privacy; and any other features that

<sup>1</sup> IMRA is an alliance of retailers and their product and service suppliers that is committed to bringing price-competitive value to the world's consumers. IMRA represents over 200 retail companies, which operate more than 133,000 stores worldwide and have sales of over \$450 billion annually. IMRA represents over 600 supplier companies with sales totaling over \$600 billion per year. Together, IMRA's membership represents over \$1 trillion in sales and employs millions of workers.



the states deem warranted to promote simplicity, uniformity, neutrality, efficiency, and fairness. We believe that many states are willing to work together to implement these types of simplification.

To encourage simplification, Congress should give states the authority to adopt a single state-wide use tax rate, which would be a blended rate of the various state and local sales tax rates. Current Commerce Clause judicial restrictions limit a state's ability to create a single blended rate applicable only to remote sales.

Some in Congress are already working on legislation to allow states to enter into an interstate compact to implement the simplification described above. This legislation would allow states that join the compact and meet the simplification goals (upon certification by the General Accounting Office) to require businesses selling into their state (remote sales) to collect and remit the proper tax. We commend this effort to the members of the Committee. The compact arrangement removes from Congress the decision of whether states impose and collect the tax and returns it to the states, where sales tax administration properly belongs.

#### **Consequences of Extending the Moratorium Without Addressing Sales Taxes**

If Congress extends the current Internet tax moratorium without at the same time approving legislation to achieve a level playing field for all retailers, future resolution of the issue will be seriously jeopardized. I don't know anyone who believes it will be any easier to resolve the issue in five or six years. In fact, I can almost guarantee you that it will be nearly impossible, because absent a solution, most brick and mortar businesses that also sell on the Internet will have been forced to reorganize their corporate structure in order to remain price competitive. Companies will, as Wal-Mart has already, restructure their Internet business as a separate subsidiary with nexus in only a handful of states and collecting sales tax in only those states. While Wal-Mart has taken this step for reasons in addition to tax collection, I respectfully suggest that this is not the result Congress should be seeking. Congress should not force businesses to alter their corporate structure simply to remain price competitive.

Rather, Congress should take this opportunity to level the playing field for sales tax collection. A level playing field, where all retailers are treated equally with regard to tax collection duties is the only rational policy available. Simply put, government should not be meddling in the marketplace. By perpetuating the status quo—extending the moratorium without fixing the problem—Congress would be giving Internet and other remote retailers a de facto tax subsidy, while at the same time making it much more difficult to resolve the issue in the future. Internet retailers do not need, nor should they be given, a tax preference. All retail businesses should compete on the traditional bases of price, selection and service. Tax preferences are bad tax policy and bad economic policy, and Congress must take this opportunity to encourage and eventually allow the states to bring this unintended tax subsidy to an end.

#### **Conclusion**

Senator McCain, you have long been a champion of ending corporate welfare and closing down special interest loopholes. Surely you cannot have intended to give a special tax subsidy to Internet retailers. By all means, keep the Internet free from taxes on access and do not let the Internet be burdened by special levies or regulations targeted solely at the Internet. Just as there is no justification for singling out the Internet for discriminatory treatment, there is no reason to perpetuate a deficient, outdated system that gives Internet retailers preferential treatment. Internet commerce will continue to flourish as more and more brick and mortar retailers take advantage of it. It need not be propped up at the expense of others.

Senator McCAIN. I thank you. Mr. Morse, Senator Leahy has been here a couple of times in his desire to introduce you. He is so proud of you and everything you have done and on behalf of Senator Leahy may I say that we welcome you and Senator Jeffords, we welcome you and we welcome your testimony today and thanks for being here.

[The prepared statement of Senator Leahy follows:]

PREPARED STATEMENT OF HON. PATRICK J. LEAHY, U.S. SENATOR FROM VERMONT

Chairman McCain and Senator Hollings, I want to commend the Commerce Committee for holding this hearing on taxation of electronic commerce. I am proud to

be a cosponsor of S. 2255, Senator McCain and Senator Wyden's legislation to extend the present moratorium on discriminatory taxes on Internet goods and services for an additional five years.

I am also proud that the Committee has invited Burr Morse to testify here today. Burr Morse is a seventh generation Vermonter who owns and operates the Morse Farm Sugar Works in Montpelier, Vermont. He has been part of the Morse Farm organization, a front runner in the field of Agri-Tourism, since graduating from the University of Vermont in 1971. His interests include a desire to preserve small business in America and family farms.

I am also proud to note that Mr. Morse is the grandson of the late Vermont Senator George Aiken. I have the honor to serve in the same seat as Senator Aiken. I am sure that Burr Morse will prove to be a wise owl, just as Senator Aiken was for some many years here in the Senate.

#### **STATEMENT OF BURR MORSE, PRESIDENT, MORSE FARM SUGAR WORKS**

Mr. MORSE. Thank you, Senator McCain. Thanks for having me come, a small businessman from a small state which incidentally has two senators. I am Burr Morse. My business is the Morse Farm Sugar Works in Montpelier, Vermont. I am a diversified farmer and maple sugar maker with roots back to the late 1700's. In central Vermont diversification is necessary because maple sugar making is a seasonal activity that lasts but 1 month out of 12 and that is on a good year. To supplement the income derived from gathering and boiling down 40 gallons of sugar maple sap to get one single gallon of Vermont maple syrup, I grow crops and I host tourists in my sugar house.

In any given year, 1 to 4 percent of our 50,000 visitors become mail order customers by placing orders over the phone and by mail from our annual catalogue or newsletters. In 1999, we expanded our sales program into the electronic media market by publishing a web site to increase the reach of our print and broadcast advertising. The site required an investment of \$6,000 and incurs monthly fees of a minimum of \$225. The response to the quality and uniqueness of our site has been overwhelming.

This is what brings me to these proceedings today. I have been able to document visits to the Morse Farm that have resulted directly from the web and we are enjoying some success with on-line orders. In real terms, however, our web presence is a long-term investment and not a panacea for the uneven cash-flow generated by a seasonal business like ours.

I encourage you all to visit [www.morsefarm.com](http://www.morsefarm.com) on the Internet, but please recognize that it is not a dot com business that is likely to appear on the Nasdaq charts one day. It is a way for me to better serve my customers to ensure their loyalty to my Vermont product. It is a new crop, if you will, in a field that without time to grow will not provide a harvest.

I submit that a moratorium on taxation of Internet sales until 2006 is the very minimum of what traffic will bear. My business is threatened daily by megamergers in the food, travel and mail order industries. Big business has won the battle and without an affordable way to communicate with customers who want traditional products, I cannot compete. If afforded the opportunity of nurturing this new field, that is the Internet, I might be able to recoup my original investment and find a little stability in a dynamic marketplace. And when I make money on my investments,

I pay taxes on those profits. Talk of taxing sales over the Internet affects me times two.

My father told a story once about sending his hired man out into the woods one day to check on how fast the sap was dripping. When he returned, he exclaimed, "Mr. Morse, I counted 18 drops between the end of the spout and the bottom of the bucket." Now, either he was seeing drops that just weren't there or he could surely count faster than a Pentium chip. Anyone who supports the concept of taxing sales made over the Internet is seeing imaginary profits or drops and could for short-term gains stifle a new and up-and-coming market. No, it will still take 40 gallons of sap to create one naturally sweet gallon of maple syrup in the year 3000, but if taxed 40 ways, nobody will be recognizing the taste and nobody will be recognizing the taste that came out of New England all those years ago. Thank you very much.

[The prepared statement of Mr. Morse follows:]

PREPARED STATEMENT OF BURR MORSE, PRESIDENT, MORSE FARM SUGAR WORKS

Thank you for allowing me to testify today. My name is Burr Morse and my business is the Morse Farm Sugar Works in Montpelier, Vermont. I am a diversified farmer with roots back to the late 1700s in Central Vermont. Diversification is necessary because maple sugar making is a seasonal activity that lasts but one month out of twelve, and that is on a good year. To supplement the income derived from gathering and boiling down forty gallons of sugar maple sap to get one single gallon of Vermont maple syrup, I grow crops and host tourists in my sugar house.

In any given year, one to four percent of our fifty thousand visitors become mail order customers by placing orders over the phone and by mail from our annual catalog or newsletters. In 1999 we expanded our sales program into the electronic media market by publishing a web site to increase the reach of our print and broadcast advertising.

The site required an investment of \$6000.00 and incurs monthly fees of a minimum of \$225.00. The response to the quality and uniqueness of our site has been overwhelming and brings me to these proceedings today. I have been able to document visits to the Morse Farm that have resulted directly from the web, and we are enjoying some success with on-line orders. In real terms, however, our web presence is a long term investment and not a panacea for the uneven cash flow generated by a seasonal business like ours.

I encourage you all to visit [www.morsefarm.com](http://www.morsefarm.com) on the Internet, but please recognize that it is not a dot-com business that is likely to appear on the Nasdaq charts one day. It is a way for me to better serve my customers to assure their loyalty to my Vermont product. It is a new "crop," if you will, in a field that without time to grow, will not provide a harvest. I submit that a moratorium on taxation of Internet sales until 2006 is the very minimum of what traffic will bear.

My business is threatened daily by mega-mergers in the food, travel, and mail order industries. Big business has won the battle and without an affordable way to communicate with customers who want traditional products, I can not compete. If afforded the opportunity of nurturing this new field that is the Internet I might be able to recoup my original investment and find a little stability in a dynamic marketplace. If and when I make money on my investments, I pay taxes on those profits. Talk of taxing sales over the Internet affects me times two. My father told a story about sending the hired man out into the woods one day to check on how fast the sap was dripping. He returned to exclaim, "Mr. Morse, I counted eighteen drops between the end of the spout and the bottom of the bucket!" Now either he was seeing drops that were not there or he could count faster than a Pentium chip. Anyone who supports the concept of taxing sales made over the Internet is seeing imaginary profits and could, for short term gain, ruin a new and up-and-coming market.

No, it will still take forty gallons of sap to create one naturally sweet gallon of maple syrup in the year 3000, but if taxed forty ways, nobody will be making the effort and nobody will even recognize the taste that came out of New England all those years ago.

Addendum to oral testimony:

**Report: Customer loyalty is e-commerce king**

A report by Mainspring Communications and Bain & Co. finds that building customer loyalty is key to long term profitability on the Web. <http://www.computerworld.com/home/print.nsf/CWFflash/000331D006>

The study found that retailers on the web have to retain a customer for 12 months to break even on that customer and online grocers have to hang on to a shopper for 18 months to recoup the \$80.00 customer acquisition cost.

Average repeat shopper at an apparel site spent 67% more in months 31 to 36 than in the first six months of shopping at the site.

Conclusion based on research and actual experience at the Morse Farm Web site: Web shoppers are as price conscious as traditional shoppers. The shipping and handling costs past on to Web shoppers are a definite consideration and in many cases, deterrent to actual purchasing. Any additional charges incurred through a potential taxation of Web sales would increase the deterrent factor and place Web shopping at a distinct disadvantage over "counter" shopping. The above statistics indicate that Web merchants are presently in a period of debt with their Web sites and the payback period is measured in multi-years.

Senator BREAUX. Thank you very much. Mr. Zittrain.

**STATEMENT OF JONATHAN ZITTRAIN, BERKMAN CENTER FOR INTERNET AND SOCIETY, HARVARD LAW SCHOOL**

Mr. ZITTRAIN. Thank you. Senator Breaux, Senator Wyden, good morning. My name is Jonathan Zittrain. I am the executive director of the Berkman Center for Internet and Society for Harvard Law School, where I teach classes on Internet law, and have done some research on the taxation of the Internet, including co-authoring an article with Austan Goolsbee of the University of Chicago for the National Tax Journal on the impact of a moratorium on Internet commerce on state coffers and other aspects of the economy.

First, the bill in question today, the Internet Tax Freedom Act—apparently now renamed the Internet Anti-discrimination Act—is relatively uncontroversial and relatively modest. This is an act that is meant to proscribe multiple and discriminatory taxes. So far as I know, there are no states clamoring to impose either multiple or discriminatory taxes. The only place I see it, actually, is in Europe, which appears to be on the cusp of imposing a 7 percent tax on goods, or for instance in Germany, a 16 percent tax on services. They then define digitally-delivered goods and services, and suddenly a newspaper that is on paper is taxed at a much lower rate than a newspaper delivered digitally. This may be because many of the sources of digital goods and services are thought to come from the United States—and that may be then a tax to worry about. Within the United States, however, there simply aren't any taxes that fit into that category, so it seems perfectly harmless to restrict fares further. To whatever extent there is a subsidy to access—thanks to a restriction on new taxes on Internet access, such as restriction on charges by AOL or Mindspring—this also seems to be a general benefit, because the more people we can get onto the Internet more quickly—at least while it is in its infancy—the sooner we can all benefit. You will get more web sites which will in turn draw more customers, etcetera.

But it seems also true to me—I should also add, by the way, that Wally Hellerstein has written a nice piece that highlights some ambiguities in the current phrasing of the Internet Tax Freedom Act and suggests some ways to tighten it up. Those might be worthy of some consideration. The real issue is: what is in essence an effec-

tive moratorium on collection of state sales tax that has been imposed through an interpretation of the Commerce Clause. That is a moratorium, as you have said today, that comes not from the Internet Tax Freedom Act but simply from Supreme Court precedent and that awaits Congressional action to be lifted, and that is the moratorium that we are all, I think, really here today worried about in terms of impact on state coffers.

Professor Goolsbee and I tried in our paper to make an estimate. Out of a total of \$193 billion of sales tax collected by state and local governments in 1998, we estimate that only \$430 million, that is a quarter of 1 percent, was actually lost thanks to Internet commerce that caused new transactions to happen interstate. To put that into perspective, one way of making up the shortfall would be to raise the average state sales tax rate from 6.33 percent to 6.35 percent; so currently, I think, everybody agrees this is not a big impact on state coffers.

As you move forward it is just a question of when, from what we can tell, that this will be a big impact on state coffers. Professor Bruce just mentioned his study showing that there may be \$10.8 billion in lost revenue in 2003. I should just flag a significant discrepancy between his study and ours, which are, interestingly, based on exactly the same numbers. We differ by about \$7 billion as to the actual costs in 2003. We estimate that there is only \$3.5 billion in sales lost, still less than 2 percent of the state coffers, and the reason from what I can tell for that huge disparity is a different calculation of how easy it is to collect use tax on business-to-business sales. Professors Bruce and Fox say it is not that easy to do. We actually believe it is the consumer sales that pose that problem, and that businesses do pay their taxes. It is thought that 90 percent of Internet commerce will be business-to-business stuff by 2003. So there is not, right now, a big impact on state coffers, and we do not think that most Internet sales—those that are business-to-business—will evade an applicable state sales tax.

There are these network externalities to consider; I talked about things that make something like eBay much more valuable to people who use it because you are much more likely to find the item you want or find the price you want—even better. So the more people we can get on quickly, the better it is for everyone.

That all said, however, in the long haul it seems that fairness must reign and I define fairness as equivalent treatment for interstate and intrastate transit of goods. It is clear that revenues are up. I say lower sales tax across the board, if that is how states want to return the surplus to the people—not have an essentially “swiss cheese” framework where some stuff gets taxed and other stuff does not because of increasingly arbitrary lines determined by whether the item was ordered electronically or by walking up to a store counter.

My bottom line is the moratorium is perfectly unobjectionable. There is no reason not to extend it from a policy statement. The moratorium that is *de facto* in place—thanks to the Supreme Court’s decision in *Quill*—is something relatively harmless to state commerce and is in fact having positive effects. But sooner or later—it is just a question of when—the piper will have to be paid and we will have to come up with a tax simplification scheme of

the kind that Governor Leavitt was talking about, and any help that Congress can give to the states to encourage them to simplify their tax bases and structures and lower the burden on out-of-state merchants would be sensible. The clock is ticking. It is just a question of when time will run out and whether we will have to abandon sales tax or roll back *Quill* and Congressional action.

[The prepared statement of Mr. Zittrain follows:]

PREPARED STATEMENT OF JONATHAN ZITTRAIN, BERKMAN CENTER FOR INTERNET AND SOCIETY, HARVARD LAW SCHOOL

Chairman McCain, Ranking Member Hollings, Members of the Committee:

My name is Jonathan Zittrain, and I am the executive director of the Berkman Center for Internet & Society at Harvard Law School, where I also teach on Internet-related subjects as a lecturer on law. Among my research interests is the taxation of Internet commerce, and last year I wrote an article (attached) for the National Tax Journal on the subject with Prof. Austan Goolsbee of the University of Chicago.

Today the Committee considers S. 2255, which is Chairman McCain's proposal to extend through 2006 the moratorium on certain kinds of taxes set in place by the Internet Tax Freedom Act. I will try to touch on the economic implications of S. 2255 (and thus of the Internet Tax Freedom Act), as well as on other, more significant forms of "Internet taxation" to which the Act does not speak.

My bottom line: The moratorium of the Internet Tax Freedom Act is not objectionable, because the moratorium is so limited in scope that it has little consequence for state tax revenues—it does not apply to sales tax for physical goods bought over the Internet. The moratorium may also help the Internet's growth at an important time. However, the real issues still lie ahead, particularly because while the Internet Tax Freedom Act is silent on state sales tax for online commerce, a Supreme Court decision has itself imposed an essential moratorium on such taxes. It thus falls to Congress to decide what the boundaries of state taxation power are in this area, and what research I have done in this area suggests that this more significant moratorium may be helpful now, but should be lifted later. I will first speak to the peripheral taxes covered by the ITFA moratorium, then to the more central taxes covered by the Supreme Court's moratorium, and finally to some guiding principles that might help sort out what the ultimate policies should be.

**Why the Internet Tax Freedom Act's moratorium is not harmful to state revenue interests and is helpful to Internet growth**

The scope of the Internet Tax Freedom Act's moratorium is quite modest. It restricts states' abilities to impose discriminatory or multiple taxes on Internet commerce, and it prohibits new taxes on Internet access.

One example of a discriminatory tax might be a surtax on products ordered through the Internet (for example, a state assessing a 10% tax on books ordered online when it only demands a 5% tax on books bought in a bookstore). Another would be claims by multiple states to collect tax for a single transaction with a buyer in one state and a seller in another, thus doubly taxing. Each of these examples is hypothetical; I know of no major attempts by states to impose discriminatory or multiple taxes on Internet commerce, and thus no substantial state money at risk if this revenue stream were clearly marked off-limits. By its very terms, this aspect of the moratorium seems at best sensible and at least unobjectionable.

Examples of the prohibition on new taxes on Internet access are taxes on monthly subscription fees for America Online, mindspring.com, or any other service that provides Internet access. This moratorium may impact the coffers of states that wish to tax Internet access but did not have corresponding legislation on their books before the moratorium came into force. The category of taxable commerce affected here is small compared to the revenue to be gleaned from the broad swath of traditional goods typically covered by sales tax.

While the impact on state coffers may be small, the subsidy to Internet usage and to all the economic progress that flows from it could be large. This is because the Internet is subject to positive "network externalities," which is to say that it becomes more useful to everyone as more people use it. (This is a general phenomenon of networks; compare how useful a fax machine might be to someone when only ten others own one versus when millions of others own one.) Such networks can grow exponentially once they reach critical mass, and signing more people on at a given time—thanks to an ability to offer comparatively lower access rates—amounts to a

boost to future economic activity generally, at least to the extent that new Internet commerce need not simply be drawn from competition with existing retail stores. Further, any lessening of Internet access fees might help bridge the “digital divide” by making Internet access that much more accessible. A five or six percent difference might not seem like a lot, but there will be some group of people on the margin for whom it would make the difference between signing on and not signing on.

To be sure, once the Internet has reached a natural saturation point among potential users, there is less reason to treat its provision any differently from any other transaction subject to sales tax. Thus the infant industry protection represented by the “no new access taxes part” of the moratorium may not need to become ensconced as established industry protection.

**The bigger controversy, unaffected by the Internet Tax Freedom Act: Taxation of Internet commerce**

More notable than what the ITFA moratorium covers is what it *doesn't* cover. The moratorium does not preclude the application of state sales tax for physical goods ordered through the Internet. The meat and potatoes of state sales tax revenue comes from the sale of physical goods generally, so this is the source of revenue that states are most concerned about losing to tax-free sales of goods over the Internet.

If the moratorium creates no boundary, why the worry? Because there is another boundary out there: one that separates in-state from out-of-state merchants. Sales tax is a tax technically imposed on a consumer—when we buy something we fork over a little extra money to cover the tax—but it is enforced and collected by the merchant. In its landmark *Quill* decision,<sup>1</sup> the Supreme Court made it clear that it was Congress's province to decide the extent to which one state could force a merchant located elsewhere to collect a sales tax, even if the buyer, located in the first state, is clearly subject to the tax. Since Congress has been silent on the issue, states can only force out-of-state merchants to collect sales tax on items they sell to people living there if the merchants have other “contacts” with the state: so-called “nexus.” In practice, out-of-state merchants can usually avoid creating that nexus, so many distant merchants (whether they receive customer orders through the Internet, mail order, or telephone) cannot be forced to, and do not, collect sales tax.

According to the Census Bureau, sales tax amounted to \$193 billion of state and local tax revenues in 1998. How do transactions placed through the Internet fit in? The best estimate Prof. Goolsbee and I could make on state sales tax revenue lost to out-of-state merchants receiving taxable orders through the Internet for 1998 is \$430 million on total sales of \$7.3 billion, or 0.2% of the collected tax kitty. Failure to pay tax on Internet-generated sales is thus not currently significantly denting state coffers.

What makes sales tax on goods purchased through the Internet such an issue then, despite the ITFA moratorium's silence on the subject and the relatively small revenues currently at stake?

I can offer two reasons. First, *Quill* provides its own effective moratorium on sales tax on most Internet-driven sales unless Congress rescinds it, and everyone has big expectations for the growth of the proportion of sales taking place through Internet commerce. The most recent figures from the Census Bureau estimate \$5.3 billion in online commerce sales for the fourth quarter of 1999, and Forrester Research estimates \$108 billion per year in online retail sales by 2003. Predictions beyond 2003 are due to be quite speculative; perhaps between 2004 and 2007 revenue loss from online, interstate transactions for which *Quill* blocks sales tax collection could amount to ten percent of total sales tax revenue, if more interstate, sales tax-exempt trade happens overall thanks to the added ease of Internet ordering.

A second reason for the current worry over an inability to apply sales tax to goods purchased across state lines has to do with a desire not to unduly distort markets with arbitrarily applied taxes. Tax experts may have differing personal views as to whether taxes should be raised or lowered generally, but they tend to be in agreement over the idea that one should tinker with rate rather than scope when seeking to adjust the public's tax burden. Over the short term, at least, *Quill's* moratorium on out-of-state tax collection will likely encourage more people to use the Internet for shopping, just as the ITFA's moratorium on new access charges will encourage more people to sign up for Internet access in the first instance. But as the use of the Internet matures and the benefits of the network externalities I discussed earlier are reaped, distinctions such as “in-state/out-of-state” or “ordered through Internet/ordered in a store” become truly arbitrary. Differences in tax rates should be made on the basis of the substance of a sales transaction, not on where or through

<sup>1</sup>See *Quill Corporation v. North Dakota*, 504 U.S. 298 (1994).

what medium it takes place. Local merchants, themselves in many instances limited to margins of 4 or 5% on their wares, should not forever pay a sales tax while their online and/or out-of-state counterparts do not.

Further, the enforcement costs of imposing taxes on goods ordered and paid for over the Internet could drop over time. Thanks to authentication and encryption technologies under development in the private sector—technologies to ensure that when one orders a dozen pizzas through the Internet, one cannot repudiate the bargain by saying someone else actually placed the order—it may become quite easy to know who is buying what from whom, to know where the buyer is, and then to collect the appropriate tax. This raises serious privacy issues, particularly if the scope of state sales tax varies so much that one must know and verify the nature of the item purchased in order to actually assess and account for the tax. But in a simplified scheme where the various states can agree on common definitions if not rates—something sorely needed and long overdue—one could actually imagine the collection of sales tax as second nature in online transactions, far easier than the corresponding calculation, collection, and remittance by local merchants in a traditional transaction. Indeed, structured properly, the collection of tax could come straight from the user, converting “sales tax” collected from the merchant into a corresponding “use tax” collected from the buyer, and in such a way that the buyer would not revolt. (Current use taxes, owed by consumers whenever they have managed to avoid having their merchants collect sales taxes thanks to *Quill*, remain largely uncollected, presumably because consumers would not take well to having to maintain accounts of everything they have purchased and what tax they might owe on it.)

In the current political climate it seems difficult to imagine Congress enabling states’ collection of sales tax from out-of-state merchants, so the revenues will only be obtained—if at all—through creative electronic collection schemes that can manage to only minimally burden both seller and buyer, or through reciprocal state tax collection agreements, through which New York, say, could ask a New York merchant to collect and remit New Jersey sales tax for its New Jersey customers. Neither of these solutions is particularly appealing, nor are they easy to implement, though they well emerge as alternatives to Congressional action to allow states to collect sales taxes across state borders.

Again, over the long run, state boundaries seem odd and unhelpful lines to draw on sales tax collection, as do boundaries between electronic and physical means of ordering. The legal and technical status quo whereby some transactions avoid the tax while others do not should, in the long run, be traded in for a more comprehensive tax reform that offers uniform tax relief (perhaps in tax rates) while enabling or maintaining other revenue streams in as simple and direct a way as possible.

### **Digital goods**

So far I have interpreted “Internet commerce” to cover the purchase of physical goods ordered via a computer network instead of a telephone call or visit to a store. I do see this as the core of the Internet tax controversy, because a lot of money will sooner or later be at stake through such channels, and because there exist bricks and mortar merchants who sell identical products and for whom differential tax treatment seems, over the long run, unfair.

But the Internet also enables the sale of digital goods: e-books and software, for example. Depending on one’s reading of the Internet Tax Freedom Act, these purchases may not be taxed by the states, whether the purchase is inter-state or intra-state. Since the distribution of wholly digital goods is especially in its infancy, even more so than the online purchase of physical goods, this would be an auspicious time for a moratorium on taxes of such goods.

Indeed, we may see the creation of new markets where individuals can sell cookie recipes or bedtime stories one at a time, for 25 or 50 cents each. To insist on collection and calculation of sales tax on such transactions might produce an administrative barrier that would preclude the development of such a “small fry” sellers’ market.

It is also important to ensure that other countries do not impose onerous or discriminatory taxes on digital Internet commerce, especially as they might perceive that digital merchants on the Internet are disproportionately American vendors.

### **Conclusion**

The Internet Tax Freedom Act does not speak to the taxes that really fill state coffers—and hit consumers’ pocketbooks. What few taxes it does preclude deserve to be precluded, and thus an extension of the Act’s moratorium seems perfectly appropriate, if not particularly efficacious. But in passing this Act, it’s important to note that much more work remains to be done. In particular, the convening of the



commission that the Act chartered has helped focus attention on a long-simmering issue for which the growth of the Internet is turning up the heat: the fact that states require Congress's formal assent before they can readily collect most of the taxes they wish to on goods purchased by in-state consumers from out-of-state merchants. A long-term compromise might be the easing of states' ability to collect such taxes in exchange for a serious simplification and harmonization of the substantive scope and administrative burden associated with the respective state sales tax regimes.

An extension of the moratorium should be accompanied by efforts to broaden the difficult conversation begun in earnest by the Advisory Commission on Electronic Commerce and among officials representing state and local governments, attempting to agree on the fairest and most practical ways to enjoy economic growth and freedom while paying the piper for the common services from which we benefit.

Attachment

EVALUATING THE COSTS AND BENEFITS OF TAXING INTERNET COMMERCE

Austan Goolsbee, University of Chicago, G.S.B.,  
American Bar Foundation, and N.B.E.R.

Jonathan Zittrain, Berkman Center for Internet and Society,  
Harvard Law School

*National Tax Journal*, May 1999

**Abstract**—*Current tax law makes it difficult to enforce sales taxes on most Internet commerce and has generated considerable policy debate. In this paper we analyze the costs and benefits of enforcing such taxes including revenue losses, competition with retail, externalities, distribution, and compliance costs. The results suggest that the costs of not enforcing taxes are quite modest and will remain so for several years. At the same time, compliance costs and the benefits of nurturing the Internet diminish over time. When tax costs and benefits take this form, a moratorium provides a natural compromise.*

**Introduction**

Existing sales tax law treats goods sold over the Internet the same way it treats goods sold from catalog companies. This means, roughly, that any company without a physical presence in a state (known as nexus) cannot be required to collect that state's sales tax even if the customer lives in the state. If a buyer in Boston, for example, orders a book from Amazon.com (located in Washington state), although the buyer technically owes a use tax (equivalent to the sales tax) on the purchase to Massachusetts, the state cannot require Amazon.com to collect the tax because Amazon.com has no nexus in Massachusetts. Instead, states must rely on self-reporting and payment by the customers, making enforcement almost nonexistent except in special cases such as for goods like automobiles that must be registered. In this sense, the Internet is a virtually tax-free sales channel.

While most of the tax issues raised by the Internet are the same as those raised in the earlier battles over the taxation of mail-order sales (ACIR, 1986), the rapid growth of online commerce has ignited a major debate as to how Internet commerce should be treated. Sheppard (1998) has declared the issue of taxes and electronic commerce to be "the hottest topic in multistate taxation." On one side, state governments and the National Governors Association have noted the potential revenue losses from online transactions and called for immediate enforcement of sales taxes. On the other, Internet advocates have argued that cyberspace is still fragile and its future uncertain; to tax it now, they say, might seriously damage its growth (Wyden, 1997; Anddal, 1997; Stephenson and Zeisser, 1998).

In 1998, Congress passed the Internet Tax Freedom Act (ITFA) placing a three-year moratorium on new taxes on the Internet. The ITFA, however, does not restrict the right of states to apply sales and use taxes to online commerce (these are not, after all, *new* taxes). Instead it primarily prevents states from applying new taxes to Internet access. Its primary effect regarding sales taxes is to prevent states from either applying sales taxes to categories of electronic services or goods with no physical counterpart or applying discriminatory sales taxes on Internet commerce that do not, for example, apply to catalog sales.

Though the ITFA itself did not change the sales tax status quo, it did call for Congress to appoint an advisory commission to come up with recommendations about how the tax system should treat online commerce. The panel's work is taken seriously enough that the National Association of Counties and U.S. Conference of May-

ors, fearing that the panel was stacked against local governments, filed suit to prevent the advisory Commission from meeting to draft recommendations.

On the basic issue of weighing the costs and benefits of enforcing taxes on the Internet, most of the discussion has taken place in the political arena rather than academic research (Graham, 1999; Smith, 1999). Most of the existing academic literature on the subject of Internet taxes has been conceptual discussions and legal analyses.<sup>1</sup> Because the area is so new there has been very little empirical work.<sup>2</sup> Most of the explicit discussions weighing the costs and benefits of tax policy toward Internet commerce has taken place in the popular press and has been more political.

In this paper we use the best available data in an attempt to evaluate some of the costs and benefits claimed in the debate about Internet commerce. The lack of systematic data sources means that, on many important points, the evidence is more qualitative and suggestive rather than definitive. In our discussion, we emphasize the importance of distinguishing between the short and the long run when thinking about Internet commerce. The timing of Internet tax policy is crucial. For example, most of the major benefits from taxing the Internet, such as preventing revenue losses or eliminating competition with retail stores, are unlikely to become important for several years, while the importance of the costs of taxing Internet commerce, including enforcement costs and lost externalities, are likely to fall over time. A cost/benefit structure such as this naturally lends itself to a moratorium as a compromise position.

The first five sections of the paper evaluate the main costs and benefits of taxing Internet commerce. These include revenue loss from Internet commerce, competition with retail trade, distribution, enforcement costs, and externalities. The final section concludes with a discussion of the potential for compromise and the future of tax policy.

#### Revenue Loss from Internet Commerce

The most important presumed cost of not enforcing taxes on Internet commerce is the potential revenue loss. Sales taxes are, obviously, quite important to state and local government finance. As Table 1 shows, in fiscal year 1995–6, general sales taxes raised almost \$170 billion. This was second only to property taxes as an overall source of tax revenue and was the largest source of revenue for state governments. Given this importance, it is understandable why policymakers are concerned about the issue and decry the potential narrowing of the sales tax base. As Newman (1995) rather colorfully put it, “state and local government finances are becoming road kill on the information superhighway.” The National Governors Association has quoted forecasts that by 2002 there may be more than \$300 billion of commerce and concluded that this will cost up to \$20 billion in lost tax revenue (*Boston Globe*, 1998). Similar numbers are often cited by advocates of enforcing Internet taxation (for example, Graham, 1999).

Table 1. Total State and Local Tax Revenue in the U.S.

(in millions of \$)

Type Of Revenue	1995–96 (FY) State and Local	1995–96 (FY) State	1995–96 (FY) Local
Total tax revenue	689,038	418,390	270,602
General sales taxes	169,071	139,363	29,709
Property taxes	209,440	9,973	199,467
Individual income taxes	146,843	133,548	13,296
Corporate income taxes	32,009	29,315	2,693
Selective sales taxes (total)	79,922	66,751	13,123
Other taxes and charges (total)	51,753	39,440	12,313

Source: Bureau of the Census, *United States State and Local Government Finances 1998*. Washington, D.C.: Government Printing Office

As best we can tell, the standard calculation in these revenue loss estimates is made by multiplying total sales by the average tax rate and calling that the loss

<sup>1</sup>Examples of the existing literature include Fox and Murray (1997), Hellerstein (1997a; 1997b; 1997c), Horner and Owen (1996), McLure (1997; 1998; forthcoming), Aui-Yonah (1997), Murray (1997), and Steele and Hellerstein (1994).

<sup>2</sup>One exception is Goolsbee (1998), who empirically examines the question of how current sales tax rates influence the likelihood of consumers to buy over the Internet.

in revenue. For several reasons, however, this is highly inaccurate. First, the predicted amounts of commerce seem to include business-to-business sales as well as business-to-consumer. The business-to-business is largely exempt from sales tax or else the buyers actually pay the use tax. Forrester Research, the leading market research company regarding the information economy, has estimated that business-to-business sales will be (and are) much larger than the business-to-consumer (McQuivey et al., 1998; Erwin et al., 1997). Second, the predicted revenue losses ignore the possibility of trade creation. Products that might not have been purchased in a store were it not for the Internet, such as online greeting cards, should not be counted for lost revenue. Third, even if we assume that electronic commerce is entirely diversionary and that all of the commerce will be business-to-consumer, the calculations still have serious flaws by failing to account for the types of products being sold.

Table 2A, for example, presents data from the Boston Consulting Group (BCG) report on Internet business-to-consumer sales by type of product in the first quarter of 1998 (1998). Notice that several of the categories, including financial services, travel, automotive, and, in some states, food and apparel, do not result in lost sales tax revenue for the states either because no sales tax applies (travel and financial) or because, although taxable, seller's nexus is likely even if the Internet is used to make purchases (automobiles and groceries). Together, the obviously nontaxed categories account for more than 40 percent of total online sales in this period (about \$2.3 billion).<sup>3</sup>

Table 2A. Estimated Online Consumer Sales  
by Sector  
(first 6 months of 1998)

Sector	Amount (in millions of \$)
Computer goods	1,510
Financial services	1,429
Auctions	898
Travel	848
Books and entertainment	366
Gifts	138
Consumer goods	138
Apparel	92
Food and wine	67
Automotive	28
Home and garden	27
Total	5,541

Source: BCG (1998).

Of the remaining 60 percent of sales that may qualify as revenue losers, computer goods alone account for almost half. When calculating the incremental revenue loss from the growth of the Internet, however, computer goods raise several important issues. First, many computer sellers online already pay sales taxes. Having in-state repair services, for example, can create nexus for the seller (Multistate Tax Commission, 1995), and one of the largest online sellers, Gateway, does charge sales tax.

Second, for those without nexus, it is important to note that not every computer bought over the Internet would have been purchased in a store if the Internet did not exist. Computer goods have had a brisk mail-order business for many years (well before the Internet began). Forrester Research's *Technographics* data (described in more detail in the Appendix) suggests that about 20 percent of computer owners purchased their latest machines directly from the manufacturer (while a bit less than two percent bought them over the Internet). It is doubtful that a customer who today buys from Dell online, for example, would buy a computer in a store if there were no Internet when she could instead buy from Dell directly by telephone. If Internet sales cannibalize nontaxed catalog sales rather than retail store sales, the growth of Internet commerce does not imply any additional revenue losses to state governments.

Although it is hard to find data to make an industry-wide argument, Dell is an important example. Our estimates indicate that in the first six months of 1998, Dell

<sup>3</sup>In this calculation we ignore the fact that in some states food and clothing are exempt from sales tax. This would make the number even larger.

may have sold around \$435 million online to consumers (more than one-quarter of the computer goods in the BCG sample).<sup>4</sup> Few of those sales were taken away from stores. If not for the Internet, they would have likely gone to Dell's mail-order business.

Taken together, we believe that much of the computer goods category should not be considered a revenue loser. For simplicity, then, let us assume that one-half of computer goods sales consumers did not pay the sales tax but would have if the law were changed. The true number is probably much lower. This assumption would imply that another 15 percent of online retail sales did not cut into local revenues.

After eliminating all of the non-applicable sales, there were about \$2.5 billion of sales that may qualify as revenue losses to state governments (if we make the somewhat implausible assumption that all auction transactions would have paid sales tax if they had taken place through newspaper classified ads, and so on). The weighted average sales tax rate in the United States is about 6.33 percent (Goolsbee, 1998), so the actual revenue loss in the first six months of 1998 was on the order of \$157 million. Even with a 213 percent annual growth rate, the total revenue loss for the 1998 entire year was a bit more than \$430 million. The same analysis using more detailed data from Forrester Research listed in Table 2B puts the total revenue loss for 1998 at around \$210 million (McQuivey et al., 1998).<sup>5</sup> With overall sales tax revenue growing at 6 percent nominal rates (as indicated in Bureau of the Census, 1997, 1998), the revenue loss in 1998 using either measure amounted to less than one-quarter of one percent of total state and local sales tax revenue (or 0.05 percent of total tax revenue).

Table 2B. Online Revenue by Category in 1998 and 2003  
(in millions of \$)

Category	Estimate: 1998	Forecast: 2003
Total U.S. revenue	7,826	108,031
Software	665	3,179
Books	630	3,002
Music	187	2,495
Videos	151	1,346
Event tickets	115	2,572
Apparel	530	13,510
Flowers	212	906
Greetings	36	320
Specialty gifts	63	544
Toys	68	1,481
Sporting goods	56	1,918
Tools and garden	63	1,021
Travel	3,073	29,447
Computer hardware	1,090	14,965
Consumer electronics	84	6,132
Appliances	17	2,275
Household goods	83	3,446
Food and beverage	235	10,836
Health and beauty	213	6,294
Miscellaneous	255	2,342

Source: Forrester Research, Inc. (1998).

<sup>4</sup>This estimate is calculated as follows: At the end of 1998/start of 1999, Dell announced online sales at a rate of \$14 million per day or \$1.25 billion per quarter (Dell, 1999). Because this is after a substantial growth rate over the course of the year we assume that Dell's revenue over the year grew at the 213 percent annual rate (33 percent per quarter) estimated in the BCG (1998) report for total commerce that Dell's online sales were divided the same way as their total sales (according to Dell (1998), this was about 65 percent to government, big business, and educational users). With total sales of \$1.25 billion in the last quarter of 1998, this would imply sales of \$531 million and \$707 million in the first two quarters of the year, and if 35 percent of these sales were to individuals, this would total \$435 million for the period.

<sup>5</sup>This assumes one-half of computer software and computer hardware currently do not require payment of sales taxes but would under a rule change. It also assumes that flowers and food satisfy the nexus requirements and thus do not result in revenue losses when purchased online. Event tickets and online greetings are assumed to be untaxed.

Looking to the future, Forrester estimates that, from now to 2003, online retail spending will grow almost 70 percent per year when it will total more than \$108 billion. Their prediction includes estimates by category. Doing the same calculation on the five-years-out projection yields a revenue loss of \$3.5 billion—still less than two percent of sales tax revenue even after a half-decade of rapid growth.<sup>6</sup> With average growth rates of general sales taxes, the Internet revenue losses will, even after several years of dramatic growth, amount to less than two percent of sales tax revenue.

To put these revenue numbers in perspective, note that the Census Bureau's *Monthly Retail Sales* suggests that mail-order sales topped \$55 billion in 1998, and this is likely to be significantly understated, as explained in ACIR (1986). The existence of untaxed catalog sales has not bankrupted state budgets and, for the next several years, online sales are likely to be considerably smaller than mail-order sales were even decades ago.

Alternatively, consider the numerical question of how much the sales tax on retail goods would have to rise in order to cover the revenue shortfalls generated by the Internet sales.<sup>7</sup> Based on the Forrester forecasts, to keep revenue constant, the average tax rate on sales would need to rise from 6.33 percent to 6.35 percent in 1998. Five years later, in 2003, to keep revenue constant would require an increase from 6.33 percent to about 6.40 percent. These small changes may imply that the costs of enforcement might not be better applied elsewhere in the short run. For example, the estimates in Slemrod (1999) concerning the revenue generated in Michigan from a simple crackdown in cigarette smuggling imply that this had a substantially greater impact on Michigan state tax revenue than aggressive enforcement of Internet taxation would have had.

In some sense, the modest costs of not enforcing taxation on Internet sales numbers illustrate why the advocates of immediate enforcement consistently invoke revenue loss projections from well into the future. Only after an extended period of rapid growth will the issue become substantively important. If the growth rate of online retail commerce continues at 70 percent per year after 2003, by 2007 the revenue loss would amount to as much as 10 percent of total sales tax revenue. If Forrester were significantly too conservative and online retail commerce doubled every year, the revenue losses would amount to as much as ten percent of sales tax revenue as early as 2004. It is the possibility of these extreme losses, albeit well into the future, that makes the issue of enforcement so politically sensitive today. The states want to ensure that online sales will be taxed before they become important rather than after. When Internet sales account for, say 10 or 20 percent of total retail sales, the states believe it may be difficult to put the genie back in the bottle. The data suggest, however, that for the next several years, at least, there is little revenue to be gained from enforcing taxes on Internet sales.

### Internet Competition With Retail Stores

Another basic benefit claimed by advocates of enforcing taxes on Internet commerce is to eliminate the unfair disadvantage that uneven tax enforcement puts retail stores at relative to their online (and out-of-state) counterparts. Presumably, there is some notion about tax-induced distortions. If consumers, for example, would prefer to buy from a local store but buy online only to avoid taxes, the tax is creating an inefficiency.<sup>8</sup>

Evaluating the competition with retail is really asking whether Internet purchases are being diverted from retail purchases or are wholly new transactions. This is very much like the trade creation versus trade diversion arguments about bilateralism found in the international trade literature (Viner, 1950). Thus far, Internet sales are so small that no one has addressed the question.

To properly answer it would require panel data on the retail and online buying habits of individuals over time. No such data exist. Instead, we use cross-sectional data from Forrester studies conducted at the end of 1997, compiled in *Technographics '98* and described in the data Appendix. This random survey of

<sup>6</sup>Repeating the analysis in the interim years yielded a revenue loss of \$470 million in 1999, \$880 million in 2000, \$1.4 billion in 2001, and \$2.3 billion in 2002. The last number is 15 to 20 times smaller than the estimates quoted by advocates in the popular press for the same year.

<sup>7</sup>This is assuming no behavioral responses on the part of retail sales of raising the sales tax.

<sup>8</sup>Note that optimal tax theory does not necessarily call for the rates to be equal on the two types of commerce. While the well-known results of Cortlett and Hague (1954) suggest that we should tax similar goods similarly, if the price elasticities of Internet customers and retail customers are very different, it may actually be efficient to allow those with high elasticities to have lower rates. This is the finding of Sandmo (1981) in a different context. In some sense, the least distortive tax would be the one with high rates on those people who would not change their behavior.

110,000 people yielded approximately 25,000 users of the Internet. Each of these individuals was also asked to give a qualitative ranking of how frequently they shop in certain types of retail stores (OFTEN, SOMETIMES, RARELY, NEVER). We aggregate their answers for discount retailers, wholesale clubs, upscale department stores, moderate department stores, and other department stores in two ways. First, we choose the maximum level of shopping in the five categories as the measure of retail shopping (i.e., if they report rarely shopping at an upscale department store and often shopping at a wholesale club, they would count as shopping often). Second, we rank each of the categories numerically (0 for NEVER, 1 for RARELY, and so on) and sum them across the five store types to get a measure of total retail shopping.

To test for the competition between Internet and retail commerce, we estimate equations for the amount of retail shopping done by an individual controlling for that person's education, income, age, race, gender, marital status, presence of children under 18, use of a computer at work, running of a business from home, and ownership of a computer in the year before the survey. In addition to these controls, we also include whether the person has bought online. If online buying comes at the expense of retail buying, we would expect a significant negative coefficient. We do not list the coefficients on the controls for reasons of space, but they are generally not surprising.

Because this is not panel data, of course, this regression may suffer from bias due to unobservable, individual-specific traits. This bias could go either way. There could be an upward bias if the people who, beyond their observables, shop online are people with higher consumption levels who shop more in every venue. There could be downward bias if the people buying online are people who, for example, have little access to retail stores. In either case, the estimated substitution pattern between retail and the Internet will not reflect the true pattern but instead will reflect the distribution of unobservable traits across people. Despite these potential limitations, these are the only data that exist.

Column 1 of Table 3 shows the results from an ordered logit estimation, where the dependent variable is the maximum amount of shopping (four categories) across the five store types. The results indicate that people who have bought online are more likely to shop frequently at some type of retail store, controlling for individual characteristics. The same is true in column 2, where we conduct an ordered logit of the aggregated measure of shopping (20 categories). There is, again, a small but significantly positive coefficient on buying online for the amount of retail shopping. Finally, in column 3, we do a linear regression of the aggregated measure but include state-metropolitan area dummies to account for correlated unobservables, differences in sales tax rates, and so on. The results do not change much.

Evidence like this is only suggestive, but it does not seem to point to intense competition between retail and online commerce at present—consistent with the notion of Internet as trade creator. As time progresses, however, and the Internet becomes a larger fraction of total retail, the competition may become more intense.

Table 3. Impact of Online Buying on Retail Shopping Frequency

Indep. Var.	(1)	(2)	(3)
Bought Online	0.153 (0.034)	0.183 (0.029)	0.248 (0.039)
Other Controls	11 variables	11 variables	11 variables
Dummies	none	none	metro-state
Estimation	ordered logit	ordered logit	OLS
$n$	24,412	22,465	22,465
$R^2$	—	—	0.08

Note: The dependent variable in (1) is the maximum amount of shopping reported in the five categories, as described in the text. The dependent variable in (2) and (3) is the summation of the five categories, also as described in the text. Standard errors are in parentheses. The included control variables are not listed to save space. They are the same variables as those in Table 5. The estimation method is listed at the bottom of the column.

### Distributional Considerations

Not enforcing taxes on the Internet, as argued in the popular press, does have particular distributional effects (see, for example, Gillmor, 1999). The incidence is not random. The argument is that online purchasers are disproportionately wealthy so failing to collect tax on Internet commerce then represents an indirect transfer to the rich. If online purchases are not taxed, anyone with enough money to buy a computer can avoid sales tax, while less well-off individuals cannot.

A general lack of data has prevented much analysis of the issue, but it seems intuitive that online individuals would be better off than those not online. The Forrester data (listed in Table 4) confirm the significant difference in terms of income and education between wired and non-wired customers. The average Internet user has almost two more years of education and \$22,000 more family income than the average nonuser.

Table 4. Income and Education of Internet Users

	Income	Education
Internet Access	57.2	14.9
No Internet Access	35.6	13.0
Internet 3+ years	61.4	15.6
Internet 2-3 years	61.4	15.2
Internet 1-2 Years	58.4	14.8
Internet <1 year	52.2	14.3
	Percent Online	Percent of Online Users Having Bought Online
Income <25,000	0.11	0.17
Income 25-50,000	0.22	0.21
Income >50,000	0.41	0.23

Source: Authors' calculations using data from Forrester Research, Inc.

The regressiveness, however, is becoming noticeably less pronounced over time. Dividing the Internet users by when they first started going online, we see that newer users have significantly lower levels of education and income than existing users. Because the number of Internet adopters is accelerating dramatically over time, the data suggest that the distributional issues seem to be lessening.

Furthermore, the data are not consistent with the broader claim that online buying is primarily serving as a way for the rich to avoid paying sales taxes. As the bottom panel of Table 4 shows, while richer people are more likely to have online access than poorer people, even among those in the highest third of income (more than \$50,000 per year), most do not have Internet access. The second column shows, as well, that of those with access, slightly more than one in five has actually bought something online, and these rates do not vary much by income level. In addition, the calculations in Goolsbee (1998) and Krantz (1998) suggest that, even for those with access who choose to buy, the amount they spend is fairly modest.

### Enforcement Costs

One frequently mentioned potential cost to taxing Internet commerce is the difficulty of enforcing such taxes (*The Economist*, 1997). Basic theory suggests that tax rates should be low on activities where enforcement is difficult or costly. The potential enforcement problems of Internet taxes are numerous. First, in a reprise of the original argument establishing the nexus requirement for taxing mail-order business, opponents argue that, with more than 6,400 different tax rates in the United States (Rappaport, 1994), simply calculating and remitting the applicable taxes to every jurisdiction from which a customer orders could be quite burdensome, particularly for the smaller, "pushcart" type sellers thought to populate the Internet marketplace. Complex tax regulations enforceable on a mature market might eliminate entire classes of small, less sophisticated Internet sellers.

Practically speaking, however, the importance of this enforcement problem has fallen over time. Calculation of taxes for each particular jurisdiction may be tedious, but such a task is well-suited to an electronic environment. Companies such as Vertex or Taxware International have produced databases that can calculate the amount of tax to be collected if given the address of the purchaser and the amount

of the purchase, data known to the merchant for transactions involving the shipment of physical goods. In the unlikely event that private companies price this software beyond the reach of most smaller merchants, state governments would have incentives to invest in a low-cost or even free system fully linked to popular electronic commerce platforms.

Some administrative aspects of remittance still remain. For some products the tax base differs across jurisdictions. Also, sales may entail pre-registration with certain state tax authorities and a significant amount of paperwork. Some commentators have suggested the creation of a single national clearinghouse to streamline the ministerial aspects of tallying and remitting tax on transactions made by small firms with customers in multiple jurisdictions (Eads et al., 1997). Here, again, states have a strong incentive to take up simplifying recommendations to make collection easy. Many proposals, for example, would simplify collection by having only a single rate per state. Also, the BCG (1998) report suggests that online sales are actually somewhat concentrated among a small number of sellers. About half of all sales come from the top ten sellers and more than three-quarters come from the top 50. Thus applying a *de minimis* rule would probably not result in much reduction in revenue.

A second set of potential enforcement difficulties concerns the difficulty of identifying individuals or even transactions in the electronic environment. At the extreme, if both merchant and consumer can be anonymous online (giving no indication of their physical location) and can transact in untraceable "e-cash," enforcing the sales tax online could have serious problems.

At present, we do not believe that this difficulty is as relevant as has been portrayed in the popular debate. For now, online commerce is dominated by credit card payments, and credit card verification often hinges on whether one can confirm the billing address of the account. Given this zip code and address information, simple software could immediately calculate the tax and send payment for most transactions involving physical goods sold online. Merchants with nexus already make such calculations regularly.

There still remains the potential problem of verifying location of the buyer for transactions involving electronic goods. Note, however, that such transactions are not typically subject to sales tax as they often do not have physical counterparts. This is, then, largely a question of whether sales taxes should apply to this new category of goods. This issue is no different than existing discussions about whether sales taxes should apply to services (McLure, 1997). Such issues are certainly beyond the scope of this paper and are likely beyond the scope of the ITFA advisory commission, as well.

In the future, however, non-credit card payment mechanisms such as incentive-based scrippike systems (e.g., "Cybergold"), where members earn and trade "points" redeemable through participating merchants or micropayment systems (e.g., Cybercash and Echarge) may become increasingly important and would seem to re-restore the problems of anonymous customers. This assumes, however, that the Internet of tomorrow will be similar in the relevant respects to the Internet of today. It is conceivable that compliance and enforcement may actually become easier as the architecture of the Internet evolves to better suit electronic commerce—perhaps even easier than they are for non-Internet-based transactions. Further, government policy decisions themselves will likely have a major influence on the "code" underlying the Internet and its transparency to government policy (Lessig, 1998).

Network effects, for example, are likely to narrow the payment mechanisms to a small number of choices. As long as there is general centralization at some key point among Internet payment schemes, the government will have a way to collect taxes from most transactions. If policymakers, for example, simply attach their reporting requirements to the most popular payment schemes, they could calculate, collect, and remit sales tax on transactions without requiring the merchant to do much work. An extra charge representing a sales tax would be applied, collected, and electronically remitted as an integral part of each instance of payment. Apart from payment mechanisms, server-side e-commerce software could be revised to incorporate sales tax. Government tax rules could give incentives to those controlling the payment mechanism software to ensure that their products incorporate calculation, collection, and remittance of tax at the moment of sale. Those wanting to evade tax collection and remittance would have to develop nonstandard software to handle customer payments (and do so in a way that could not be easily detected by state governments).

More generally, the advent of digital signatures to enable trusted commerce means that the respective states could themselves become common to a transaction, freely verifying the residence of someone wishing to buy something. Merchants with consumers who are unable or unwilling to offer residence verification from any juris-



diction could be assessed some sort of tax then allocated in a “throwback” way to the jurisdiction in which the merchant operates, or among the known jurisdictions in which the merchant sells (see Eads et al., 1997). (Klassen and Shackelford (1998) analyze the economic effects of throwback rules in the retail context.)

The essence of any effort on enforcement is not to spend resources in an effort to eliminate every single instance of fraud. This standard is unrealistic even for retail sales taxes. Rather, the goal is to make compliance easy and evasion difficult so that the problem is limited. In this sense, in the short run, there may be some problems with trying to enforce sales taxes online, but looking forward, these problems are likely to lessen in importance.

### Externalities and Under-Provision

A final set of costs associated with taxing Internet commerce relate to the potential existence of externalities. According to the results in Goolsbee (1998), if taxes were applied effectively to Internet purchases, there would be a significant reduction in the amount bought online. If there are important externalities, this reduction could be a significant social cost. Many of the arguments in the political arena that we should protect or nurture the Internet at an early stage of development are in this spirit. Here, we evaluate two potential sources of social under-provision: network benefits and information problems.<sup>9</sup>

The first problem is the potential positive spillovers arising from network externalities—that the benefit to each Internet user rises with the size of the overall network. The idea is that seeding the Internet early will yield large benefits in the future. There is very little empirical evidence concerning the magnitudes of network benefits associated with either the Internet in general or Internet commerce specifically.<sup>10</sup> In the case of online commerce, the potential spillovers may involve local learning spillovers (e.g., a friend explains which websites are useful or that using credit cards online is safe), demand side economies of scale (e.g., with a big enough potential market, a merchant will be willing to incur fixed costs to enter various niche markets or develop additional features), or direct network benefits (e.g., if auction sites can create networks of otherwise thin markets, both buyers and sellers benefit). In each case, as the number of Internet customers grows, the value of Internet commerce rises. It is important to note, however, that for network externalities to justify, essentially, infant industry protection of the Internet, electronic commerce must do more than simply divert sales from retail stores, as discussed above.

We first ask if there is any empirical evidence favoring the existence of spillovers associated with Internet commerce. Does getting a person to buy online actually lead others to follow suit? Existing data are largely inadequate to answer this question precisely, but for the individuals in our data, we have some qualitative information on the topic. In addition to reporting demographic information, people with online access also provide information about the share of their friends and family who buy things online. They can answer ALL (<1 percent), MOST (2 percent), SOME (17 percent), VERY FEW (46 percent), or NONE (35 percent).

Because this is a single cross-section that lacks further information, we cannot deal with the obvious potential problem of unobserved common traits among friends beyond the observables and location dummies as, for example, Goolsbee and Klenow (1998) do in their study of network benefits; nor can we show that spillovers are actually externalities in the spirit of Leibowitz and Margolis (1994). Given that these are the only data available, however, we attempt to examine what correlations exist in them.

We do a standard probit regression of whether an individual with online access has bought something online. In it, we include the same individual control variables as before (income, age, education, gender, race, marital status, the presence of children, the use of a computer at work, the operation of a business from home, whether the individual already had a computer in the year preceding the survey, and dummy variables for the metropolitan area of residence). In addition, we include dummy variables for the share of friends buying online. If there are network spillovers, having more friends and family buying online should make the individual more likely to purchase. As shown in Table 5, people are more likely to have bought on the Internet the greater the share of their friends that have done so. Moving from hav-

<sup>9</sup>There is a third potential source relating to retail market power, but we do not consider it in detail here. If local retailers have market power, Trandel (1992) shows that having a tax-free outside option can reduce this market power and actually improve consumer welfare. Given that we have no data on market power, we will just assume that markets are competitive.

<sup>10</sup>Goolsbee and Klenow (1998) show that there seem to be significant local spillovers from using the Internet and using e-mail.

ing no friends buying online to having most buying online, for example, raises the probability of purchase by more than 0.40. This is a large and significant coefficient and is consistent with local spillovers (although also consistent with common unobservables among friends).

At the same time, it is important to think about the size of future network externalities. The major network externalities are likely to exhaust or at least diminish once the Internet achieves major scale. Too often, infant industry protection turns into established industry protection. Further, we expect that eventually there will be an important negative network externality at work (to the extent it is not already) in increasing Internet congestion due to the prevalence of zero marginal cost pricing.<sup>11</sup> The congestion problem is likely to get worse as the Internet grows and argues against subsidizing the growth rate through tax policies.

Table 5. Influence of Friends on the Probability of Buying Online

Variable	(1)
All friends buy online	0.470 (0.049)
Most friends buy online	0.408 (0.021)
Some friends buy online	0.333 (0.007)
Very few friends buy online	0.147 (0.006)
Income	0.003 (0.001)
Education	0.005 (0.001)
Age	-0.002 (0.001)
Female	0.061 (0.005)
Single	0.025 (0.006)
Children under 18	-0.041 (0.006)
Asian	-0.011 (0.018)
Non-white minority	-0.009 (0.007)
Use a computer at work	0.005 (0.006)
Run a business from home	0.044 (0.007)
Owned a computer in 1996	0.110 (0.007)
Dummies	Metropolitan Area
<i>n</i>	24,059
<i>R</i> <sup>2</sup>	0.14

Notes: The dependent variable is a variable equal to one if the respondent reports having bought something online in the past three months. Standard errors are in parentheses. The equation is estimated using a probit.

The second externality-type argument regards the information problems associated with the security of Internet transactions. In reality, credit card security on the Internet is extremely high. There are no direct calculations of the incidence of online fraud, but experts generally agree that it is much more likely to have one's credit card number stolen over the phone, for example, than online, yet over-the-phone use is common (Fraza, 1998). Further, even if one's credit card is stolen, there is a \$50 limit on the amount of charges for which the consumer is liable.

The Forrester *Technographics '98* data asked the 80 percent of Internet users who have not bought online why they have not done so. By far the most common answer, accounting for 45 percent of the responses, was that they did not want to give out their credit card information over the Internet. When asked to give their opinions of the level of security of credit card information given out over the web (rated from one to ten with ten being extremely secure and one being not at all secure), the respondents' average rating was only a 2.9. The overall safety and the limited risk associated with Internet purchases do not appear to be widely understood by Internet users. Once they buy something, however, the repurchase rates are very high.

With the apparent asymmetric information on the part of new consumers about security, there may be justification for encouraging people to try shopping online. In the social sense, there may be too little Internet commerce. Qualitatively, this is a cost of taxing Internet commerce, though, again, this is a strictly short-run jus-

<sup>11</sup>Some important early discussions of congestion can be found in Mackie-Mason and Varian (1995; 1996), Bohm et al. (1994), and Gupta et al. (1995).

tification. Once Internet commerce is established as a conventional sales channel, there is no reason to give a benefit.

### Conclusions

In this paper, we have examined the costs and benefits associated with enforcing taxes on Internet commerce. The results suggest several things. One, because of its limited size relative to retail and because of the type of products being purchased, aggressive enforcement of taxes on Internet commerce would raise only a small amount of revenue over the next several years. Two, Internet commerce does not seem to be primarily fueled by diversion from retail sales. Third, not enforcing taxes on the Internet does disproportionately benefit higher income and highly educated people, but this effect has lessened substantially in the last two years. Fourth, the costs of complying with taxes on Internet commerce are unlikely to be very large for most online transactions. Fifth, there is suggestive evidence of spillovers and of information problems that should be considered costs of aggressively applying taxes. These benefits are primarily restricted to the short run, however.

Given that the costs of maintaining the status quo are small and the benefits of nurturing the Internet seem to be somewhat concentrated in the short run, a natural compromise position might be a moratorium on enforcement of Internet sales taxes in the short run followed by equal treatment once the conditions change. This is not quite the same as the ITFA. The ITFA is a moratorium only on new and discriminatory taxes and leaves the broader question of sales taxes to be resolved in the future upon the recommendations of an advisory commission. Hopefully, results such as those in this paper will encourage advocates and policymakers on both sides to give more empirical thought to the tax issues raised by the Internet.

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## Appendix

Forrester Research is a leading market research company whose specialty is the information economy. In their *Technographics '98* program they conducted a major consumer survey about technology in which they asked more than 110,000 people

about their characteristics and their ownership of technology (the field work was done by the NPD Group). A greater description of the survey can be found in Goolsbee (1998).

The individual variables we use are income, education, age, gender, marital status, race, children under 18, ownership of a computer in 1996, use of a computer at work, and running of a business from home. We turned the series of dummy variables for education, age, and income into continuous variables. If income was stated as between \$35,000 and \$40,000 for example, we imputed an income of \$37,500. For top-coded variables, we tried various values, but changing them had almost no impact on the results. Similarly, just including the variables as dummies gave the same results.

Though the sampling methodology is proprietary, it is meant to make the survey nationally representative and the data is both widely respected and very expensive for private sector companies. It also matches up somewhat well with government sources such as the Current Population Survey on obvious variables like income, gender, and so on.

The survey also presents data about whether individuals owned a computer, when they got their computer, what type of computer they bought, whether they had access to the Internet, and many other questions of this nature. For those who reported having online access, they were also asked how long they had been online, whether they had bought something online, what share of their friends and family are online, and what share of their friends and family have bought something online. These are variables we use in our analysis.

Senator BREAUX. [presiding]. Our Chairman has had to step away. He will be recognized when he returns. Thank all of you for coming. This has been a terrific discussion on a very interesting and very, very important issue that really cries out for some resolution.

Dr. Berthoud, I know that have you never met a tax you liked, no matter what shape, size or form it happens to be in. But let me ask you to, sort of philosophically, I mean, what is wrong with a case where in my hometown of Crowley, Louisiana, the city fathers and the citizens of that community determine that it is appropriate to levy a five percent sales tax on purchases. They are going to use it for police protection and fire protection and some of it will go to schools, and yet have a situation where some local citizen buys a pair of shoes at the local shoe store he pays that five percent sales tax and goes for those purchases. What is wrong with saying that if that same person orders a same pair of shoes over the Internet for someone who is not located there that somehow they should not have to pay the five percent sales tax?

Dr. BERTHOUD. Senator, you ask a very important question. This really is the heart, I think, of the debate as these panelists and the previous panelists have gotten to. That ultimately is the issue—should we impose sales taxes on remote sales. That ultimately is the public policy question. We would again argue that we would reverse the logic, if you will, and rebutting those who suggest it is unfair for one type of business not to pay a tax and one to pay it, we would say that any business can begin e-commerce. This is the ultimate in economic democracy, we believe, and that is the beauty of the Internet, for any business can get on and their customers shop sales tax-free.

And I would remind you that if that consumer purchases that item locally or purchases that item remotely, some government somewhere in America is still getting taxes, be it as I said property taxes, income taxes, corporate income taxes, or individual income taxes. There are plenty of taxes on every single purchase that we make, whether there is a sales tax—Senator Wyden's State does

not have a sales tax, but every single purchase, whether you see it or not at the register, has myriad taxes and indeed every American pays 35 percent to 40 percent of their income in taxes. So we are, we are not in any danger, if we exempt that purchase from sales tax, of governments running out of money. And indeed we have heard testimony about the revenue loss, but I have not seen in any projection for any State—despite the growing prevalence of e-commerce—in five years, to be collecting less revenue than they are today.

Senator BREAUX. I go back to the point we were discussing with Senator Hutchison. Her State does not have an income tax.

Dr. BERTHOUD. Very wisely.

Senator BREAUX. But her State still generates revenues through the sales tax for all these important purposes. I totally agree with her that if all of a sudden people start saying I am going to avoid a five cent or five percent sales tax on everything I can buy and get it almost as quickly by ordering it on the Internet, it is going to put a tremendous pressure to make up those lost revenues by establishing something that you also do not like, which is an income tax on a State level.

Dr. BERTHOUD. That would certainly be correct, Senator.

Senator BREAUX. You do not like that tax either.

Dr. BERTHOUD. No, but Texas is among the States that has had over a number of years a billion dollars in surplus. We see for the foreseeable future that state over-spending is a far greater threat and I would reference you to the article cited in my testimony in the *New York Times*. States have so much money now.

Senator BREAUX. Let me make sure you do not include mine. We have a \$600 million deficit. We can talk about why. Most States have a substantial deficit.

Dr. BERTHOUD. Most States have a substantial surplus. They are creating programs. Some of them have merit, but apparently most of them do not and that seems to us as the far greater threat to taxpayers, and again the great State of Texas, for the foreseeable future, it is projecting, despite the expansion of e-commerce, it is projecting revenue growth at the State level and indeed there is, according to Texas' own projections, there is no threat to the Texas revenue source.

Senator BREAUX. My final question if I might, Mr. Bullington of Wal-Mart. If I was a smart fellow and wanted to really compete against your chains, I take it that under this scenario that we are currently under that you got a Wal-Mart in my local town that sells all the wonderful things that you do and I got to go to Wal-Marts about once a week for a Wal-Mart fix, but I could establish Easy Mart and locate Easy Mart maybe in Maine. And I could survey everything and every Wal-Mart store in my State and put every single thing that you have in your Wal-Mart and put it in Easy Mart located in Maine; establish a web site that clearly spells out everything that you have in your Wal-Mart store that I have in my Easy Mart up in Maine; buy billboards and advertise the hell out of it all over my State that say: See it, feel it, touch it at Wal-Mart, but buy it at Easy Mart, and encourage people just to go through your store and see it, feel it and touch it and then come

out and just go right out there and say I'll buy it from Easy Mart. And Easy Mart would not collect the sales tax.

I mean, that is a hypothetical. If I was really smart and I thought this was going to be the current situation for the indefinite future, I would do that. Not me personally. I do not have enough money to establish anything, but somebody might do that. I mean, would that be possible?

Mr. BULLINGTON. It is certainly possible. We welcome that type of competition. Just do not tie one arm behind us with a six to eight percent pricing range.

Senator BREAUX. So that is fine for Wal-Mart and most retailers that are in your type of business as long as there is not a discriminatory assessment or nonassessment of a local sales tax?

Mr. BULLINGTON. Absolutely. We might be very well doing Wal-Mart whatever, side by side, selling on the Internet the same way.

Senator BREAUX. From your perspective, discrimination, I agree we should ban and put a moratorium ad infinitum on discriminatory taxes. I think they are illegitimate. Thank you.

Senator MCCAIN. Thank you very much. Senator Wyden.

Senator WYDEN. I just have two questions for this panel, one for you, Mr. Zittrain. You have heard about the Governors' proposal with respect to tax simplification and you heard about it again today. What is your assessment of what it would cost the typical small business to collect and remit these remote sales taxes? We have gotten projections that for every dollar you would collect, the burden on the small business person would be very substantial. What is your assessment on that point vis-a-vis the Governors' proposal?

Mr. ZITTRAIN. Is that under the way things currently work?

Senator WYDEN. No. Under the proposal that they have been talking about. As you know, and it was described again today, the centralized kind of system and the like.

Mr. ZITTRAIN. What I would want to know first is when the proposal talks about a de minimis exemption, for example if you are just selling a few cookie recipes over the Internet, do you have to comply with 50 States' tax codes? The higher that de minimis exemption is, the more that businesses who are Mom and Pop doing small amounts, just getting started, do not have to worry about compliance. So one question would be: How big is the de minimis exemption going to be?

Another question would be, can Governor Leavitt see the states actually unifying their tax bases? And by that I mean, if you are selling blankets, you would not need to know whether the blankets are covered in Nevada or Texas. You would know whether or not with respect to all 50 States that you have actually got something coming under the tax. As far as actually calculating the rate and doing remittance, if in fact Governor Leavitt's group can produce a system whereby it is one-stop registration, one-stop calculation as far as actually figuring out how much to collect and where to send it, that could make it quite easy. There are companies like Taxware International where it says this is how much you owe and away you go and with microtransactions it would then be easy to remit the tax.



Senator WYDEN. We are just skeptical that that can be done. You heard me say I am trying to meet him halfway and approach this along the lines of giving him a vote on a date certain with respect to doing this. It is just that some of the leading accounting firms in the country have done an estimate of what it would cost for the Governors' proposal and for the typical small business person, I mean, relative to each sales tax dollar collected, the burden would be very, very great.

I mean, as you know, you have to distinguish between cookies in one State and candy and profit-making organizations and non-profit-making organizations and I think your first point was very, you know, very correct, which is we have to see what the de minimis exemption is. And of course the higher you make it the less likely you are to flatten Mr. Morse there. And that is what is very important and I appreciate it.

I am also going to put into the record the studies that have shown that as of now, based on what the Governors have said, the cost for the average small business to collect and remit the sales tax is very, very high.

Mr. Morse, one question for you. We are so glad that Senator Leahy pushed to have you come because I think you are really the face of the new economy. This has been portrayed now for 3 years as sort of bricks and mortar vs. folks who are online and they are going to be in this bloody sort of battle, but Senator Leahy has really brought to our attention that in a sense you are the integration of these two worlds. You have this traditional business, so-called bricks and mortar business, have an online economy and I and others called this sort of bricks and clicks. And my sense is that this has accelerated much more rapidly than we ever thought when we wrote the original law.

There was one study that showed since the Internet Tax Freedom Act, 74 percent of the Main Street retailers are like you. They have set up a serious online kind of operation and that leads me to believe that if and when our country has economic problems again, it is not going to be because of the Internet, it is going to be because of all kinds of other considerations, maybe it will be oil prices. Maybe it will be interest rates. It could be a variety of things but it will not be because of the Internet.

My question to you is based on your involvement as a Main Street retailer, is it your sense that a lot of your colleagues on Main Street are going to go the route that you have and sort of integrate these two worlds because that is how you see your future?

Mr. MORSE. Yes. I believe that they will. I know of many cases where that has happened. I had the good fortune to be interviewed by ABC World News back before Christmas.

Senator WYDEN. I saw the show.

Mr. MORSE. You saw that show. Small world. The—subject matter was Main Street USA and was presented prior to Christmas over the Internet and there were several Montpelier businesses that stood to be interviewed by them, small businesses like mine and did not, were not interviewed, but I just feel like it is the new way coming down for businesses, large and small.

Senator WYDEN. When you say it is the new wave, I think that really sums it up. This is not going to be bricks and mortar versus the online world. This is going to be an integration of the two.

We are really glad that Senator Leahy pushed to have you come and I appreciate your coming. All of you have been very helpful. We have worked with almost all of your organizations and will continue to do so.

Senator DORGAN. Let me thank all of the panel. I regret that I had to go for a meeting with Senator Daschle in the middle of your presentations but I have read much of what you had to say and I appreciate your being here and your willingness to testify. Mr. Zittrain, my understanding from your response to Senator Wyden is that there are circumstances under which the simplification of a collection of a sales or use tax would not impose a burden and if that were the case, you would not oppose that. Is that what I understand you to mean?

Mr. ZITTRAIN. That is correct. If there is a strong administrative burden imposed on those out of state trying to collect it, that is good reason not to bother collecting the tax, as our article explains. On the other hand, if there is a way to make that burden go away over time, it is another reason why imposing a moratorium now, but being sure to lift it later, actually makes sense.

Senator DORGAN. The piece of legislation that actually passed a Subcommittee in the U.S. House probably 15 years ago now in the Ways and Means Committee, dealing with remote sellers—in this case it was catalogue sales—included a \$10 million de minimis. That is businesses that were not at a \$10 million revenue threshold would not be required to be involved. Mr. Morse, would your business meet that test?

Mr. MORSE. Yes, it would.

Senator DORGAN. I do not quite understand, is it below \$10 million?

Mr. MORSE. No. It is below.

Senator DORGAN. The reason that was included is there needs to be, if we are going to simplify here the collection of what is now a use tax, there must be genuine simplification in the requirement that the States impose a single rate against remote sellers, a single sales tax rate, a common sales tax base. And in addition there needs to be a de minimis that will allow smaller businesses not to get caught in the net.

So I think in any event, when the compact is created among the States, it will include all three of those circumstances and I do not know what the de minimis would be, but I will just say to you that what it was 15 years ago with catalogue sellers in the House, recognizing the compliance issues which then would not be radically simplified but now I think would be simplified by technology, the de minimis was \$10 million. And I want to say that, Mr. Morse, for your comfort because I think all of us understand those who are starting out, you do not want to impose upon them significant burdens.

In the State sales tax bases, most sales tax administrators will create de minimis levels, but their de minimis levels are normally the people doing \$1,000 a year or \$2,000, crocheting doilies with magnets to hang on refrigerators and putting some brand name

and making \$1,000 or \$2,000 a year. Those are normally excluded. That is a relatively low de minimis. With respect to this, the de minimis would have to be more significant.

Dr. Berthoud, I was interested in your testimony. You are obviously well versed in all of these issues and you talk about the pro-tax side. There in fact is not a pro- or anti-tax side in this debate, is there; because we are not talking about a new tax. A tax exists on these transactions, so when you talk about the pro-tax side what are you referring to?

Dr. BERTHOUD. An example of that would be the type of regime that Governor Leavitt is talking about creating.

Senator DORGAN. But would that result in the imposition of a tax that does not now exist?

Dr. BERTHOUD. Well, it would result in already high State tax collections going even higher, yes.

Senator DORGAN. So he is pro-tax because he advocates the collection of a tax that already exists?

Dr. BERTHOUD. He is pro-tax because he is advocating higher taxes on already overburdened taxpayers.

Senator DORGAN. How is it a higher tax if a dollar transaction imposes a current use tax and Governor Leavitt suggests the simplification of its collection, how is Governor Leavitt advocating a higher tax?

Dr. BERTHOUD. Senator, we at the National Taxpayers Union look at it this way. The average American has to turn over 35 percent of their income to the government. The average American, by the way, supports taxes at 25 percent or less. 75 percent of Americans across all demographics support that. The adoption of what Governor Leavitt is proposing would increase that. It means more taxes for States. It is more taxes paid by taxpayers.

Senator DORGAN. Do you view tax compliance as an increased tax burden?

Dr. BERTHOUD. We view more taxes as more taxes.

Senator DORGAN. Would you admit this: that the current use tax that exists on a transaction, if it exists, is not going to be increased by its collection through some other mechanism?

Dr. BERTHOUD. Absolutely.

Senator DORGAN. And if it is not going to be increased, how then do you suggest that someone who suggests collection is pro-tax?

Dr. BERTHOUD. Tightening enforcement mechanisms, creating a tax regime which would potentially climb above the \$10 million threshold is adding taxes and adding a burden to both small businesses and to individuals. I would also add that it would be very, very hard to create an exemption for businesses. Or let me just say it seems to be a huge loophole where there would be a \$10 million threshold.

Senator DORGAN. I am talking about the folks above who would be collecting a tax that is already owed. I graduated in a high school class of nine, I was in the top five. I am not the quickest on all of this. But my sense is that if you do not support the payment of taxes that are owed, then you must support the non-payment of taxes or nonenforcement of existing taxes.

Dr. BERTHOUD. Let me try and clarify. We do not support the creation of an Internet compact for Internet sales taxes such as Governor Leavitt is proposing.

Senator DORGAN. You would not oppose Governor Leavitt deciding we are going to collect every dollar of use tax in his State?

Dr. BERTHOUD. That certainly is his right.

Senator DORGAN. Would you encourage the filing of returns of every Utah resident that complies with the requirement that exists in the law?

Dr. BERTHOUD. We would not support that.

Senator DORGAN. I think I made my point. When you use the word pro-tax, I don't think you are using it properly. I was not born into this world to defend Governor Leavitt. We are not even of the same political party, but he is not a pro-tax Governor. He is here talking about collecting a tax that is currently owed and a mechanism to do that that is simple, effective, fair, and does not obliterate your tax base. I mean, we disagree on that, but I just wanted to make the point, I think throwing around this notion of new tax, pro-tax and so on is unfortunate because I do not think it fairly describes this debate.

Dr. BERTHOUD. If I may, Senator, I would argue on the other side. I think it is terribly unfortunate for groups like the NGA to say if we do not adopt their proposed regime, to use these scare tactics such as the forced firing of firemen and teachers and policemen. I think that is just as unfortunate.

Senator DORGAN. What taxes do you support, Dr. Berthoud? Can you describe what kind of taxes you do support?

Dr. BERTHOUD. We support a lower tax on all Americans. We do not advocate zero taxation but we think the current level of taxes at 35 to 40 percent on every single American is far too high.

Senator DORGAN. But tax rates above zero then would require a need to describe a certain kind of tax system. What would you prefer? Sales tax or income tax? Property tax?

Dr. BERTHOUD. It is up to the States what type of tax system that they have. Income taxes are the most pernicious types of taxes. I think our message here is an effort to say that the aggregate level of taxes is too high and it should be lowered. If the States want to have one type of tax or another, that is their business.

Senator DORGAN. I do not mean to single you out but you use the word pro-tax which I think is horribly inappropriate in this debate and I wanted to straighten that out.

Mr. Bullington, you represent Wal-Mart?

Mr. BULLINGTON. Yes.

Senator DORGAN. Is Wal-Mart going online? I read your testimony. Wal-Mart is going online to be an e-tailer on line?

Mr. BULLINGTON. Have been for sometime. Yes.

Senator DORGAN. Are you separately incorporated to do that?

Mr. BULLINGTON. Effective early this year, yes.

Senator DORGAN. What is the result of that with respect to your tax base?

Mr. BULLINGTON. We only collect State taxes of California, Utah and Arkansas.

Senator DORGAN. You did that for what reason?

Mr. BULLINGTON. Well, we did it because California is certainly a magnet as far as things going on, Silicon Valley and that industry and we brought in venture capital.

Senator DORGAN. I am not talking about the three States, I am talking about the decision to separately incorporate.

Mr. BULLINGTON. Because of the reasons to attract outside management investment capital and to deal with the competitive issue as it relates to sales tax collection.

Senator DORGAN. If you had not done that you would be one of the larger merchandisers in the country with brick and mortar in every State and on the Internet, but being on the Internet would require you to collect sales taxes and your competitors would not?

Mr. BULLINGTON. As a division of Wal-Mart stores we collected sales tax from every jurisdiction where we delivered product to.

Senator DORGAN. Mr. Morse, congratulations. I am one of the great maple syrup fans in America and we do not produce any of it in our State so to the extent that I am able to access it, it has to be through the Internet, catalogue sales or in the grocery store. Bring those prices down just a little bit, if you will, but maple syrup is one of the great substances, as far as I am concerned.

Thanks to the rest of you for sharing your thoughts with us. This is not an easy issue at all. It is complicated and difficult, and contrary to what some believe, I think the stakes are very, very high here, and this should be done thoughtfully and done promptly. I am not someone who wants to injure the Internet. I want it to grow and flourish and I want to work with my colleagues to find a way to solve all of the problems and there are several problems here, not just the issue of preventing discriminatory taxation which I will join in doing.

We should not allow discriminatory taxes. That is one issue. There are two or three other issues. Let us solve that at the same time. Let us not believe that one has more weight than the others. Let us address this as a group of problems that we can come together on and do good things. I say the Chairman feels very strongly about this. I have great respect for him and when we provided the previous moratorium on the floor of the Senate, we worked together to reach an agreement on it and I will again support him on extending the moratorium.

I hope, however, that we can work in a way that adds some things to the extension that will create some balance to addressing the other sides of these issues. I would say the same with respect to my colleague, Senator Wyden, who also feels strongly about it. Again, thank you for being with us. This Committee is adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]



## APPENDIX

PREPARED STATEMENT OF HON. MAX CLELAND,  
U.S. SENATOR FROM GEORGIA

Mr. Chairman, thank you for holding this hearing today on the important issue of Internet sales tax policy.

As a former state official, I believe that the sovereignty of states must be a closely held and protected authority. However, Congress has pre-empted the state's authority to develop its own tax policy with regard to Internet sales since 1998. State and local officials in Georgia and elsewhere went along with this plan with the understanding that after three years there would be some direction on this issue from the Advisory Commission on Electronic Commerce (ACEC). However, the Commission did not reach the statutorily required two-thirds majority necessary to make a recommendation, and instead of working together to reach a valid recommendation, they submitted to Congress a simple "findings". Thus, unfortunately, the ACEC failed in this assigned mission of consensus-making.

Some in Congress contend that the state and local sales tax system is too cumbersome, and, therefore, Internet sales should be exempt from sales taxes. This may be the case, and I encourage state officials to evaluate their tax policies. However, in today's society, where the "new economy" leaders survive by filling voids, there are companies that have developed software that enables an on-line seller to assess the appropriate local sales tax. For example, Taxware, in Salem, Massachusetts, licenses their software to on-line retailers who also have nexus in states, requiring the collection of local sales taxes.

On the other hand, some traditional bricks and mortar stores have established separate, independent on-line businesses that do not collect sales taxes because as separate businesses they do not technically have nexus in as many states as the "bricks and mortar" stores by the same name. How would the Supreme Court have interpreted this business arrangement if it was hearing the *Quill* case today? And, I would question if this was the intent of Congress when it passed the Internet Tax Freedom Act.

Additionally, is Congress in the business of rewarding stores that only choose to offer products on-line? Or, punishing stores whose owners only choose to offer goods to consumers who visit their store? Barring outside intervention, I believe that the most efficient form of commerce will prevail. Congress should not favor one form of commerce over another, whether in tax or other forms of public policy, but rather must allow the businesses to compete equally for customers.

Finally, some of our colleagues in Congress would like to make this into an anti-tax versus pro-tax issue. This is not the issue. Sales taxes are not new taxes and are not imposed by the federal government. This tax policy is developed at the most local level to support local services—education, emergency services, local healthcare, and infrastructure development. In Georgia, tax policy decisions are even more localized than elected officials. Proposed sales taxes must be put to the voters in a referendum for their choice. Are my colleagues asking me to support denying my constituents the right to vote for a sales tax to improve their local school?

I look forward to the testimony today and hopefully to having some of the questions I have raised in my statement addressed.

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RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JOHN MCCAIN  
TO BURR MORSE

*Question 1.* How many employees work for you?

Answer. 18 employees.

*Question 2.* How many employees do bookkeeping/accounting or tax work for you?

Answer. 1 employee does bookkeeping/accounting.

*Question 3.* How much does your maple sugar sell for? How much does someone usually order at a time? Do you charge for shipping and handling? How much is the shipping charge for a typical order?

Answer. We sell a full range of sizes and grades of maple syrup from 1.7 oz. (nips) to gallons. Our gallons average about \$40.00 and our nips are \$1.49. We also sell cases of ½ pts., and qts. Our average order is about \$38.00 for the syrup and \$10.25 for the shipping and handling. Yes, we charge for shipping and handling. Maple syrup is a heavy, bulky, liquid and slightly perishable product. Carriers like UPS do not like several of the above qualities. Many sizes of syrup have to be double boxed with special packing material. Again, our average shipping charge is \$10.25.

*Question 4.* Do you collect sales tax on sales within Vermont? Do you know how much sales tax would be charged on your market in Salt Lake City, Utah? How would you go about collecting a sales tax on a can of maple syrup you sell and ship to a customer in Moses Lake, Washington?

Answer. Within Vermont, maple syrup is considered a grocery item and groceries are not taxable in Vermont. I have no idea about the tax repercussions in Salt Lake City or any other municipality in the U.S. In some, no doubt, maple syrup would be considered a luxury product and taxable. In others, groceries may be taxable. For the Moses Lake order, we would probably have to purchase software that would list Moses Lake tax code. We would then have to pay the Moses Lake tax, by mail, out of our pocket, or collect an amount of tax on every container of syrup to create a pool for paying taxes when due. (Would this even be legal—charging tax to every one where only some were liable?) I doubt if here is presently software available that would categorize every product as taxable or not taxable for every municipality and then electronically add the tax to any given order. My point is, for the Moses Lake order, I think there would be considerable manual labor in handling the taxation.

*Question 5.* Do you have competitors in your business? Are they large or small companies? What effect has the Internet had on your ability to compete with your competitors?

Answer. Maple syrup is a pure product that is very labor intensive to produce on an extremely seasonal level. There is no such thing as a national brand of pure maple syrup. Our competitors are relatively small companies. On “over the counter” orders, we feel a minimum of grief over competition. Traditional mail order brings minimal competition because we all tend to have our own exclusive customer lists. Internet, in my opinion, is getting to be the most competitive means of selling maple syrup because we are all competing on the search engines to be top on the list.

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RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MAX CLELAND TO  
DR. JOHN BERTHOUD

*Questions.* Georgia’s state and local leaders strongly support technology advances and the opportunities offered by electronic commerce. Georgia is home to corporations, such as EarthLink, iXL, and UPS, which are carving the path to the new economy. Why should the federal government extend a moratorium that prevents local leaders from establishing local tax policy to serve these corporations and their employees?

In Georgia, citizens must vote by referendum to impose sales taxes on products they purchase. Why should Congress limit local citizens’ ability to determine how they wish to tax themselves?

As we know, e-commerce is experiencing tremendous growth. Each transaction taking place on-line translates in to a loss of revenue for state and local services, and this amount will continue to grow. Services like police protection and ambulances will still be needed to support their local community. The revenue lost will have to be made up somewhere. In Georgia, the Governor and General Assembly have developed a tax policy that includes reducing property taxes for our citizens. Do you support a bill that may force local lawmakers to alter this popular tax policy change and actually increase property taxes to make up the lost revenue to support emergency services?

Isn’t it true that the ability to set revenue policy to deliver necessary public services is a fundamental authority of state and local government?

Answer. It is perhaps the ultimate irony that opponents of the Internet Tax Moratorium have, on occasion, invoked the argument of “freedom” to support their point of view. Throughout the history of mankind, the single greatest threat to freedom has been from overreaching government. The Internet Tax Moratorium simply blocks the establishment of new and discriminatory taxes on the Internet. Senator Cleland’s question seems to imply that Senator McCain’s Internet Tax Moratorium



is a threat to freedom. With due respect to Senator Cleland, that is absolutely backwards: Senator McCain's legislation expands the freedom of individuals by blocking government.

Regarding the line of questioning on how limitations on Internet taxes may supposedly force Georgia to raise other taxes, as I stated in my testimony, the far greater threat to Georgia residents right now is from runaway spending. Legislators at all levels of government, instead of turning surplus dollars back to the people who have earned them, are creating hundreds of new programs and dramatically expanding the old ones.

The well-respected Georgia Public Policy Foundation perfectly captures the real problems in Georgia:

Georgia collected \$4,479 million in general sales and use taxes in 1999, up 11.81 percent over 1998, plus another \$646 million in sales taxes on fuels, alcohol, and tobacco. Total tax revenues were up 8.81 percent over the prior year. With the exception of 1998 when food sales became exempt, Georgia's revenues since 1988 from general sales and use taxes have increased steadily and have remained remarkably stable as a percentage of the total revenue collected by the State. Moreover, most of the states, including Georgia, are awash in budget surpluses: \$11.3 billion in 1998, with \$36 billion in "rainy day funds." Georgia's rainy day fund is now \$548 million. Georgia has a \$1 billion surplus that the General Assembly has voted to spend entirely plus borrow an additional \$530 million. Georgia is not experiencing a loss of sales tax revenue but rather a lack of fiscal restraint.<sup>1</sup>

For those with a concern about Georgia's fiscal future, the paramount threat comes from irresponsible politicians. Blocking the ability of politicians to get their hands on at least a few of the dollars that Georgians earn should be applauded, not condemned.

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RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MAX CLELAND TO  
DR. DONALD BRUCE

*Questions.* In your publication "E-Commerce in the Context of Declining State Sales Tax Bases," you state several options for recouping lost revenue that may be used by local officials. Is there one option you see as more optimal than others? What effect do you see these policies having on local citizens?

*Answer.* Local officials will have several options for recouping revenue lost to untaxed e-commerce sales. Generally, these choices include cutting government expenditures, increasing sales tax rates, or turning toward a different tax source such as the property or income tax. To be sure, many local governments are enjoying revenue surpluses and will be able to maintain current expenditure levels without additional taxation, at least for a few years. For many other municipalities, tax increases will be necessary to maintain budgets that have already been trimmed to the limit.

The most probable option will be an increase in property taxes, which currently represent the vast majority of local tax revenue. Consequently, a small rate increase could generate a large amount of revenue. This is perhaps the optimal policy choice since local governments currently have the administrative structure in place. An increase in property tax rates would be less costly and easier to administer than most of the other options.

Alternatively, localities could increase sales taxes in states where local options are available. However, it must be noted that such a policy reaction would work against other state and local simplification measures. The perpetuation of differentiated local add-on rates only makes the existing system more complex.

Other options include local income taxes (which are extremely rare), special excise taxes or user charges, or other miscellaneous local fees. Inevitably, the optimal choice will be municipality-specific, as no particular revenue solution will be perfect for all local governments.

As with any situation involving a budget cut or a tax increase, there will be winners and losers among the local citizenry. The particular reform that is chosen must minimize the adverse impact on the losers while maintaining a sufficient and stable level of public services. It is important to keep in mind that the localities with the largest revenue losses—those that will require the largest tax increases due to revenue losses from e-commerce—are the very localities that are currently avoiding the

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<sup>1</sup>Hans A. von Spakovsky, "Sales Taxes and the E-commerce Revolution," The Georgia Public Policy Foundation, [www.gppf.org/pubs/commentaries/2000/etax.htm](http://www.gppf.org/pubs/commentaries/2000/etax.htm).

most taxes by shopping online. To the extent that property, sales, or income taxes are increased to replace lost revenue, then, there will be no net tax increase.

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RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MAX CLELAND TO  
DAVID BULLINGTON

*Question.* Why did Wal-Mart establish a separate company to run its on-line business as opposed to a subsidiary of the parent company?

*Answer.* By way of the outside equity participant, Wal-Mart wanted to gain access to additional Internet expertise within the Silicon Valley area as well as the management recruiting ties offered by this equity participant. Additionally, this structure offers the opportunity to do a public offering of stock of the Internet company. Further, it allowed for direct pricing competition with those remote sellers that do not collect the sales tax.

*Question.* Should your on-line stores have a tax advantage over your bricks and mortar stores?

*Answer.* No.

*Question.* If there is a level playing field among all forms of commerce, I believe consumers will be the winners by having new options when entering a traditional "bricks and mortar" store like Wal-Mart. For instance, if an item is not in the store, the consumer can go to a terminal and order it on-line. Do you agree that there will be more options for consumers if there is a level playing field among all forms of commerce? Has Wal-Mart discussed ways to incorporate its on-line business in to its stores if these two businesses are treated equally?

*Answer.* Yes, we agree that numerous options will be created by way of a business model that allows complete integration with store operations. Wal-Mart has and continues to study ways by which store and web operations can be leveraged off each other. For example, the ability to allow in-store web site access to a customer combined with a cash payment option at an adjacent register would facilitate Internet purchasing by customers who do not have credit cards.

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RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MAX CLELAND TO  
HON. MICHAEL LEAVITT

*Question.* Unfortunately, we are holding this hearing the same morning as the formal release of the Advisory Commission on Electronic Commerce's report, and I and my colleagues have not had the opportunity to read and evaluate this report. Many people opposed to allowing states to determine their own tax policy claim that current tax policy is too cumbersome. However, apparently software currently exists that takes into account the tax laws for all jurisdictions. Was the Advisory Commission on Electronic Commerce aware that such software exists? And, is there any mention of this in the report?

*Answer.* Senator, because no retailers were appointed to the Advisory Commission on Electronic Commerce, no one with the practical experience who currently uses software to determine sales taxes in every jurisdiction served on the panel. However, Tax Ware, a company which provides such software was permitted to testify at one of the commission meetings. To the best of my knowledge, there is no mention of the availability of the software in the report.

*Question.* The Internet is providing a more convenient way to purchase goods for consumers. However, I am interested in whether the Advisory Commission on Electronic Commerce found that tax avoidance was leading consumers to online purchasing?

*Answer.* Senator, the Commission did find that current federal policy permitting tax avoidance is reducing revenues to state and local governments. Clearly, this finding demonstrates both the inequity for Main Street vendors and that—all other factors being equal—being able to purchase the same item at the same price, without paying taxes is one factor in this inequity.

*Question.* Is the ability to set revenue policy to ensure the deliverance of essential public services a fundamental authority of state and local lawmakers?

*Answer.* There is no more fundamental tenet of our country's federal system than the ability and authority of state and local elected leaders to determine the revenue policies necessary to balance their budgets and meet the needs—federally mandated and otherwise—of the people.

*Question.* Major corporations like AT&T, MCI Worldcom, Gateway, and others have implied that they might support tax on goods sold over the Internet if there is a continued ban on taxes on Internet *access* and provisions for making state and local sales taxes simpler and more business friendly. In hearing from my constituents over the years and by being a member of the Small Business Committee, I have heard that they too are interested in simplifying the sales and use tax systems. As a state elected official who shapes Utah's tax policies, do you have a recommendation on a way to minimize complexity, improve compliance, and remove the burden from the retailer or "e-tailer"?

*Answer.* Senator, I believe we need to develop and implement a 21st century, streamlined state and local sales tax system. Because of my strong commitment on that front, and that of many of my colleagues, for the past year we have embarked on an undertaking to do just that; to eliminate the burden on remote and electronic retailers by enacting a radically simplified and streamlined system. I am pleased to note that 27 states have formally acted to join in this challenge. In fact, we intend to hold a hearing in Chicago on September 29th specifically to obtain public feedback on our Streamlined project proposals.

The project expects to release a majority of the work that has been done so far by the Tax Rates, Returns, Registration, and Remittances Work Group; recommendations on the treatment of state exemption certificates by the Tax Base Work Group; and a majority of the proposals from the group dealing with technology, audit, privacy, and system funding issues.

Major draft proposals completed so far include:

- a uniform sourcing rule for all transactions;
- uniform required notice and limited frequency of rate changes;
- minimal sales tax returns or reporting requirements for participating sellers;
- simplified exemption administration;
- uniform treatment of bad debts;
- voluntary registration not a factor in determining nexus for income or other taxes;
- minimal seller exposure to audits; and
- state compensation for the system.

Some areas, including all but the most essential taxing definitions and the concept of coding products to make administration easier, will be deferred until Phase II of the project, after model state legislation is developed and unveiled in December.

The system we are developing is focused on reducing the burden on sellers. In the audit and technology area, a linchpin of the system would allow retailers to contract with certified service providers (CSPs) to take care of all their tax collection and remittance responsibilities. Other models under the system would allow the use of certified software systems that would provide retailers significant protections from audit and from the consequences of any errors resulting from good-faith use of the systems.

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RESPONSE TO WRITTEN QUESTION SUBMITTED BY HON. MAX CLELAND TO  
BURR MORSE

*Question.* Mr. Morse, I note that you are an "e-tailer" of your Vermont products. I am sure you have experienced growth in your sales as a result of your website, which is a wonderful tool to promote your products. Do you believe there are advantages in allowing your local elected officials to develop tax policy for Vermont?

*Answer.* I do not believe there are advantages in allowing our local elected officials to develop tax policy for Vermont as it relates to web sales. I think that web sales should not be taxed and the origin of legislation toward this end makes no difference, nationally or locally. Either way would be a mistake. I enclose the following addendum to further support this question. Thank you very much.

*Addendum*

Vermont has a tax policy that already impacts all tailers, e-, re-, whatever; it is an income tax. There are also sales taxes in Vermont that must be collected whenever sales occur in our state (phone, fax, on-site, mail order, or WWW), and I believe that is the case in most states already.

Happily, one very positive aspect of a strong economy and the expansion of the information highway (the World Wide Web), is that Americans are again discovering America. They can easily plan customized holidays that take them to businesses like the Morse Farm Sugar Works where they can learn about Vermont's most tradi-

tional occupation (maple sugaring), and farm life in our state while shopping for regional crafts and specialty foods in our Country Store. We think as many as half of the visitors to our website will eventually make their way to our state capital and the Morse Farm, where they will pay taxes on fuel, meals, purchases, and accommodations. Here in New England at least, where we once started a revolution over taxes, I doubt that state or federal taxes on web sales would be well-received.

On the other hand, contributors to the information highway, who are helping Americans re-discover the traditional arts, crafts, and way of life that made this country so unique should be nourished and encouraged to continue to bring their businesses to this expanding new audience who has become so used to filling day to day needs at Wal-Mart, Walgreens, and McDonalds!

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RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MAX CLELAND AND  
HON. JOHN MCCAIN TO JONATHAN ZITTRAIN

*Question 1.* What is a discriminatory tax?

Answer. Prof. Walter Hellerstein succinctly defines a discriminatory tax in his article analyzing the provisions of the Internet Tax Freedom Act. Hellerstein writes:

A discriminatory state tax is ordinarily understood to be an exaction that singles out one class of taxpayers, activities, or property for disadvantageous treatment by comparison with the treatment accorded another class of taxpayers, activities, or property, when the distinction between the two classes is one that the law does not tolerate as an appropriate basis of classification (e.g., the conduct of interstate commerce or the exercise of First Amendment rights).

See Hellerstein, "Internet Tax Freedom Act Limits States' Power to Tax Internet Access and Electronic Commerce," (90 *Journal of Taxation*, 5 January 1999).

*Question 2.* In an effort to simplify state taxes, would it be sufficient for each state to simply establish a state "remote sales" rate, that is a tax rate, which might be different from the sales tax rate a person would pay during an "in person" sale?

Answer. If a state were to have one sales tax rate for a purchase made through the Internet, and another for the same transaction entered into in person, the difference would amount to a discriminatory tax, discriminating on the basis of mode of ordering. It is difficult to imagine a valid long-term justification for such discrimination from a policy standpoint, particularly if the remote sales tax rate were higher than the in-person rate.

State sales tax simplification for the purposes of reducing burdens on out-of-state sellers, and thus making a good case to Congress for a liberalization of *Quill's* restrictions on applying tax to sellers with no appreciable in-state presence,<sup>1</sup> should focus on administrability (for example, arranging a single point of registration and remittance for merchants for all state sales taxes collected) and scope (for example, harmonizing definitions of "juice" across states; Wisconsin currently taxes any beverage which is not 100% juice, while Pennsylvania allows exemption so long as the beverage contains 24% or more juice). These alone are daunting tasks, especially since states' respective idiosyncratic exemptions may reflect long-settled local political dynamics. Harmonizing sales tax rates from one state to the next is not necessary so long as the tax is grounded on where the goods or services are consumed rather than sold, and indeed may be undesirable. Such "simplification" across states at the cost of creating intrastate tiers of tax based on mode of ordering or location of seller would be even worse.

There are some states that allow local subdivisions to impose their own additional taxes to state sales tax at a point of sale. As a result, the tax on a given product might amount to 6% in one town and 6.5% in another, even with both towns in the same state. One could imagine a state seeking to create a single, blended tax that averaged across all subdivisions to make calculation easier for remote sellers while retaining the complications for local merchants and consumers. However, the Supreme Court has made it clear that such schemes aren't allowed without Congressional assent so long as the remote rate ends up higher in comparison to that of any state subdivision. See *Associated Industries of Missouri v. Lohman*, 511 U.S. 641 (1994). This casts doubt on any attempt to create a remote rate that differs from an in-state rate, even if done for the purposes of simplification.

*Question 3.* In Georgia, citizens vote by referendum to place sales taxes on products they purchase. Why should Congress limit local citizens' ability to determine how they want to tax themselves?

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<sup>1</sup>See *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).

Answer. There are many reasons to want to leave the determination of state sales tax to the discretion of the respective states, each in turn accountable to its citizens. Under the legal status quo, states are indeed free to set their own consumption tax rates. They can demand of their citizens the remittance of a tax on particular goods and services that they purchase (no matter where purchased), and they can demand that merchants collect that tax on behalf of in-state consumers, so long as the merchants themselves are in-state.

The problem arises in collecting tax through physically remote merchants for transactions involving in-state consumers. In such instances in which a state's citizens wish to tax themselves via external parties, and the Supreme Court has held in cases like *Quill* that those out-of-state parties may be unduly burdened by a requirement that they calculate, collect, and remit taxes for distant jurisdictions. The worry inheres not in the fact of state citizens choosing to tax themselves, but rather in a requirement that out-of-state entities participate in the tax scheme. As a result, states are prohibited from requiring physically remote merchants to serve as the instruments of collection of otherwise-legitimate taxes. Congress can relax this requirement if it chooses, so one might suggest that this is a "Congressional limit" even though it has been imposed in the first instance by the Supreme Court.

An ideal solution might see the states working together to present a scheme to Congress for approval that would minimize the tax-collecting burden on out-of-state merchants while still having those merchants collect sales tax. That way, over the long term, the states would not have to choose among (1) allowing the distortion and lost revenues that come from a failure to collect tax on remote sales, (2) seeking to enforce the politically and logistically difficult collection of corresponding use tax from their citizens when no sales tax is paid in a transaction, or (3) giving up the sales tax entirely.

To be sure, a harmonization across states of the scope and definitions of goods and services covered by state sales tax might be an important part of simplification; as my answer to question two suggests, differing interpretations of such matters as what constitutes "juice" could contribute to burdensome confusion among retailers as to whether their goods fall under a given state's tax regime. Thus simplification could require some measure of compromise: Georgia might be compelled to alter its own definition of, say, "juice" as part of a process to create common definitions among states, thereby lowering tax collection burdens on physically remote vendors and eliminating any reason to remove such vendors from states' reach.

*Question 4.* Goods and services ordered over the Internet are delivered to consumers on the roads everyone uses. Roads are subject to wear and tear each time they are used, and the states are receiving no revenue from the delivery causing the damage. However, the state and local leaders are responsible for the upkeep of these roads. Is this an unfunded mandate?

Answer. Generally speaking, a Congressional restriction or preemption of state taxing ability may well be an unfunded mandate under the Unfunded Mandates Reform Act of 1995, which erects certain procedural hurdles in the path of Congressional legislation that seeks to impose certain costly duties on states without providing funds to pay for their execution.<sup>2</sup> Indeed, it appears that the drafters of the original Internet Tax Freedom Act's proscriptions on state taxes contemplated that they could fall under the UMRA. Elements of S. 2255's extension may, if resulting in a large enough loss to state coffers, also represent unfunded mandates covered by the Act, as might a Congressional narrowing of the definition of "nexus" such that merchants additional to those covered by *Quill* were free from state tax collection obligations. However, the current specific restriction on states' abilities to force physically remote merchants to collect sales tax comes not from the Internet Tax Freedom Act or other affirmative Congressional legislation, but from Supreme Court cases like *Quill*, grounded in the Commerce Clause of the Constitution.

As a result, it is difficult to see how *Quill's* restrictions are unfunded mandates covered by the UMRA, despite the UMRA's inclusion of court decisions in the definition of "Federal mandates" generally.<sup>3</sup> The technical definitions of the UMRA aside, however, one might view an inability to effectively collect tax on out-of-state products delivered to in-state addresses as an unfunded mandate in colloquial terms: states are providing certain necessary infrastructure and services while being restricted in their efforts to have those who benefit from them contribute a share. This is why, ultimately, it would be desirable to create a system whereby out-of-state

<sup>2</sup>See Tracy A. Kaye, "Show Me the Money: Congressional Limitations on State Tax Sovereignty," 35 *Harvard Journal on Legislation* 149 (1998); Pub. L. 104-4, 109 Stat. 48 (1995) (codified in scattered sections of 2 U.S.C. (1995)).

<sup>3</sup>See 2 U.S.C. § 1555 (1995).

purchases can be treated similarly to in-state purchases. This is true even as, for the next few years while the burgeoning Internet remains an infant industry, the serendipitous restrictions on out-of-state tax collection—a rough proxy for collection of tax on items ordered through the Internet—may be helpful to the economy without great cost to state coffers.<sup>4</sup>

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PREPARED STATEMENT OF THE AMERICAN FEDERATION OF STATE,  
COUNTY AND MUNICIPAL EMPLOYEES (AFSCME)

The American Federation of State, County and Municipal Employees (AFSCME) submits the following statement for the hearing record in opposition to the amendment to the Internet Tax Freedom Act (S. 2255) to extend the moratorium through calendar year 2006.

The originally-enacted Internet Tax Freedom Act (47 U.S.C. 151) imposed a three-year ban, ending September 30, 2001, on any new state and local taxes on Internet access and multiple or discriminatory taxes on electronic commerce. The practical effect of this law has been to exacerbate the existing de facto tax-exempt status of most such remote sales that result from the inability of states to collect sales taxes from purchases made by state residents from Internet and catalog sales. As a result, AFSCME respectfully urges that the moratorium be allowed to expire in September 2001 and *not* be extended through calendar year 2006 for the following reasons:

- The current moratorium does not expire for nearly 18 months. This provides time for the states to continue their work to simplify their sales tax systems, using a combination of technology-based software systems and administrative systems. The states are demonstrating that they can attack this challenge in a constructive and cooperative fashion. Congress should not arbitrarily constrain these efforts.
- State and local governments already may be losing on the order of \$5 billion in sales tax revenues annually from their inability to tax most mail-order sales. With Internet sales growing rapidly, these governments could be losing an additional \$10 billion annually by 2003 if Internet purchases remain effectively tax-exempt.<sup>1</sup> Revenue losses would continue to mount thereafter, as Internet sales grow over time.
- The loss of revenue will significantly impair the ability of states and localities to meet demands for education funding and other critical services. This scenario is particularly troubling in the context of education. There is agreement that primary and secondary education in the United States is in need of constant improvement so that our children receive the foundation that will allow them to fill the demand for high-skilled, well-educated workers in the information economy. Improving the education system requires investment. In fact, state education budgets consume 35 to 40 percent of state revenues. It is ironic that the Internet, the very tool fostering today's high-tech explosion, stands to play a pivotal role in the states' inability to fund the desperately needed improvements in the education system.
- Main Street retailers will be at risk of losing considerable business to remote sellers so long as they must add sales tax to their prices at the cash register while Internet and mail-order merchants can sell tax-free. There is evidence that this tax advantage is already distorting retail competition by compelling large retail chains to reorganize their operations solely to be able to compete with their tax-exempt Internet rivals.

For these reasons, AFSCME opposes the extension of the moratorium and supports enforcement and active collection of existing sales tax due on remote purchases.

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PREPARED STATEMENT OF THE COMPUTING TECHNOLOGY INDUSTRY ASSOCIATION

The Computing Technology Industry Association is pleased to submit our suggestions regarding the taxation of electronic commerce. We endorse the majority recommendations of the Commissioners of the Advisory Commission on Electronic Commerce. The majority of Commissioners voted to:

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<sup>4</sup>See Goolsbee and Zittrain, "Evaluating the Costs and Benefits of Taxing Internet Commerce," 52 National Tax Journal 413 (1999).

<sup>1</sup>Center of Budget and Policy Priorities (February, 2000).

1. Reduce consumers' tax burden by repealing the Federal three-percent excise tax on communications services;
2. Forge a meaningful pathway to simplification of states' sales and use tax systems;
3. Permanently prohibit states or localities from taxing Internet access subscription charges;
4. Extend the current Internet tax moratorium legislated by the Congress on multiple and discriminatory taxation; and
5. Clarify nexus standards that impact the obligation of businesses to collect and remit state and local taxes on remote transactions.

The Commission's Final Report recommends to Congress the need to bridge the "Digital Divide" to permit all Americans to participate in the Internet economy. It addresses the issue of privacy concerns, noting that any tax administering system for e-commerce should be developed in a manner that minimizes disclosure of consumers' personal information, and should contain sufficient security to protect that information. The Commission recommended that the appropriate committees of Congress should explore privacy issues associated with the collection and administration taxes on e-commerce.

We believe that the first priority should be to extend the current Internet tax moratorium legislated by the Congress on multiple and discriminatory taxation and address growing public concerns regarding privacy of personal data. We believe the appropriate approach to the latter is to appoint an independent commission with ample representation of individual taxpayers, the IT sector and public interest groups to simultaneously assess options to address public concerns as well as progress and the outlook for adoption of voluntary standards by Internet vendors.

CompTIA disagrees with the assessment of the issue as well as solutions proposed by some representatives of state and local government. At the same time we are heartened by positive steps of state and local government leaders which we believe will greatly enhance the effectiveness in collecting from their constituents the sales and use taxes owed to state and local governments.

The actual scope of the problem of noncompliance by taxpayers with their state and local sales tax laws is not presently known. Surveys have shown that many taxpayers are unaware of their obligation to pay appropriate state and local taxes not collected by vendors in other states.

Several states have initiated aggressive programs to educate their citizens of the obligation to pay any state and local taxes that were not collected by Internet vendors. Other states need to follow their example. This effort will undoubtedly reduce noncompliance. Once this task is accomplished the scope of revenue losses due to deliberate noncompliance will be known.

The Internet community also has an ethical responsibility not to mislead the public. Internet retailers should avoid statements that suggest that purchases made over the Internet relieve consumers of any obligation to report and pay any appropriate state and local taxes on those purchases.

The recognition by state and local government associations of the need to simplify and rationalize the many thousands of inconsistent state and local tax laws is a laudable goal in its own right. It will also pave the way for increased voluntary support of state and local governments by Internet vendors located outside their jurisdiction.

CompTIA disagrees with a few state and local government leaders who argue that a major expansion of the definition of nexus is good policy, fair, or necessary. CompTIA believes the state representatives who were Constitution's authors were wise in precluding other state governments from imposing any of their respective state laws, whether they relate to taxes or regulations, on businesses or individuals in other states.

The question of what constitutes nexus should be reviewed, because new business models have posed legitimate questions and clarification would benefit all parties. However the review should be approached narrowly, from the perspective framers of the Interstate Commerce Clause. If Internet vendors with an actual physical presence in the state substantially benefit from the programs and services funded by state and local sales and use taxes, then requiring them to support the state's sales tax system is appropriate. If their "presence" is *de minimis*, and they receive no real benefit from the programs and services funded by state and local sales and use taxes, then they should not be required to provide tax collection services for that state.

Requiring Internet vendors to provide free state and local tax collection services for other jurisdictions is not fair to companies that receive no direct benefits from those states and have chosen not to physically locate in those states. It would undermine the healthy competition between states to balance the benefits of a business friendly environment with other priorities of the state and local governments.

CompTIA believes the Streamlined Sales Tax System for the 21st century may well provide a framework that can provide the incentives necessary to enlist the assistance of Internet vendors in the collection of state and local taxes for governments outside of their home state. Most businesses find it necessary on occasion to use outside debt collection services themselves. They recognize that this is a necessary process and entirely appropriate for use by state and local governments. The Streamlined Sales Tax System for the 21st century contemplates a technology oriented business model utilizing trusted third parties to protect the privacy of purchasers and vendors.

At the same time the creators of the Streamlined Sales Tax System for the 21st century should recognize that they are asking the Internet vendors to provide debt collection services. Fees for commercial debt collection services are determined by supply and demand. Similarly, support by the Internet community will be determined by the compensation package offered to participating vendors. We believe that over time the program's developers will develop a package that will lead to participation by the majority of Internet vendors.

Aggressive consumer education programs will result in increased sales and use tax collections by state and local governments. Effectively implemented, the Streamlined Sales Tax System for the 21st century will result in the collection of the majority of the remaining state and local taxes. In combination CompTIA believes that the bulk of the sales and use taxes on Internet sales will ultimately be collected.

CompTIA, the Computing Technology Industry Association, is a not-for-profit trade association, founded in 1982. Today it represents over 8,000 computer hardware and software manufacturers, distributors, retailers, e-tailers, resellers, VAR5, system integrators and training, service, telecommunications and Internet companies in over 50 countries worldwide. Over 1,000 industry professionals are represented in the association's new individual membership category.



AMERICAN ASSOCIATION OF STATE COLLEGES AND UNIVERSITIES,  
*Washington, DC, April 7, 2000*

Hon. JOHN MCCAIN,  
*Chairman, Senate Committee on Commerce, Science, and Transportation*  
*Washington, DC 20510*

Hon. THOMAS J. BLILEY, JR.,  
*Chairman, House Committee on Commerce*  
*Washington, DC 20515*

Dear Senator McCain and Representative Bliley:

On behalf of the undersigned higher education associations, I write to urge Congress not to pursue measures such as a permanent federal ban on e-commerce taxation, which has been proposed by members of both the House and the Senate.

As you are probably aware, the law establishing the Advisory Commission on Electronic Commerce (Public Law 105-277) clearly stipulated that a "supermajority" vote (two-thirds of the members) would be required for the Commission to issue its findings/recommendations to Congress. The Commission failed to achieve this, which signifies a lack of consensus on fundamental issues, including the neutral tax treatment of e-commerce relative to other forms of remote sales.

In light of this failure, Congress should refrain from taking any action that could adversely impact state and local tax systems. Additionally, AASCU's analysis of trends in state and local taxation strongly suggests that any decision to ban taxation of e-commerce should be weighed carefully against the likely fiscal ramifications. Over the past 30 years, the state portion of state and local taxes has grown significantly, and sales tax proceeds as a portion of all state-local tax proceeds has grown as well. More recently, however, the shift from goods to services and information as the focus of economic activity and the changing consumption patterns of an aging economy are eroding the sales tax base of many states and localities. As a result, many states will be forced to confront the issue of tax reform in the very near future. State-level reform discussions should not be pre-empted by a federally legislated ban on the taxation of e-commerce, especially when those advising Congress on these issues could not arrive at a meaningful consensus.

In sum, we urge Congress to act carefully and thoughtfully with respect to the issues considered by the ACEC. Failure to do so could destabilize state and local revenue systems, which in turn would have an immediate and adverse impact on public services such as higher education. As always, our organizations and our member institutions are prepared to help facilitate the policy conversations on this vital issue.

With warm regards,

CONSTANTINE W. CURRIS,  
*President, American Association of State Colleges and Universities*

On behalf of:  
*American Association of Community Colleges*  
*Association of American Universities*  
*National Association of State Universities and Land-Grant Colleges*

TRAVIS REINDL,  
*Policy Analyst, American Association of State Colleges and Universities*

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JOINT PREPARED STATEMENT OF LAWRENCE A. HUNTER, CHIEF ECONOMIST,  
 EMPOWER AMERICA, AND GEORGE A. PIELER, ADJUNCT FELLOW,  
 COMPETITIVE ENTERPRISE INSTITUTE

Mr. Chairman and Members of the Committee, we are pleased to offer our support for the Chairman's bill, S. 2255, to extend the existing moratorium on many forms of Internet taxation (the Internet Tax Freedom Act of 1998, or ITFA) through the year 2006. We would just like to explain why we support this approach and suggest a few useful avenues of inquiry for the Committee to consider as it explores this complex but extremely important issue.

First, we should say at the outset that although each of us is affiliated with organizations that do work on Internet policy (Dr. Hunter is Chief Economist for Empower America, Mr. Pieler an Adjunct Fellow with the Competitive Enterprise Institute), the views expressed in our statement to the Committee are strictly our own. They are based on the work we did in preparing *New.Economy@Old.Constitution*, a study of some of the practical and constitutional issues surrounding Internet tax-

ation recently published by the Institute for Policy Innovation's new Center for Technology Freedom (a copy of that study is submitted herewith for the Committee's consideration).

#### **The Work of the ACEC**

Mr. Chairman, we believe the congressionally-mandated Advisory Commission on Electronic Commerce, which recently completed its work under the outstanding leadership of Virginia Gov. James Gilmore, did an excellent job of framing the issues involved with Internet taxation from the perspective of protecting the taxpayer, advancing economic growth, and balancing the interests of the states and the national government with due regard for our constitutional structure. The Commission's conclusions, which have been laid before Congress, lay out a thoughtful blueprint for Congress to consider in asserting its power to define the scope of state authority to tax cross-border transactions. The Commission also made abundantly clear by majority vote that the Internet must not be viewed as an easy way to both raise taxes and increase the number of revenue sources that states (or the federal government, for that matter) can tap. Electronic commerce does open up entirely new fields of commercial endeavor, but at heart it is simply a new, dynamically productive way of doing business.

As such, the Internet deserves neither special tax burdens nor unique tax privileges. The Commission appears to agree, although there are several areas in its attempt to define 'nexus' with a state for (constitutionally permitted) taxation of cross-border transactions where it may step a bit over the line in limiting state power. At the same time, the Commission lays out an agenda for 'harmonization' and 'simplification' of state sales and use taxes that threatens to go too far in the opposite direction by creating the framework for a de facto national sales tax for which the federal government or the states would be accountable to the taxpayer. While we discuss these issues at some length in the attached paper, for present purposes we simply suggest that the weighty political issues and controversies (even among sincere tax professionals) involved in the broader agenda laid out by the Commission make it unlikely that Congress can hammer out an equitable, constitutional, and pro-taxpayer agreement in time for the expiration of the ITFA moratorium in October, 2001.

For these reasons we urge the Committee and Congress to study the work of the Commission carefully, since there is much to be learned from its outstanding effort. But as a practical matter, the wisest course for the Congress is to extend the existing moratorium on Internet taxation as set forth in S. 2255.

**Why It Matters.** Mr. Chairman, you have made it abundantly clear by your initiatives on the Internet tax issue over the years that you understand this is a topic with very high stakes for America. It is universally understood that electronic commerce over the Internet is a major driving force behind our economic expansion, cutting costs for both businesses and consumers and creating whole new markets that are only just beginning to emerge. The Internet, not coincidentally, is helping break down barriers to trade, investment, and employment, as well as facilitating the exchange of ideas and interests across national boundaries as never before in history.

None of this, however, explains why the Internet poses such unusual challenges—and opportunities—for tax policy. Much of the interaction between our tax systems and the Internet is purely conventional: companies involved in e-commerce have payrolls, generate income, and make investments, and those companies already pay the taxes every other company pays as a consequence. Why, then, the allegation that so-called 'e-tailing' gives Internet companies an undue competitive advantage and erodes the state and local tax base?

One answer is that states and localities are using the Internet tax issue to reopen the old debate over taxing mail-order sales, a debate they have lost in the past when they sought federal backing for their efforts to mail-order sales in a comprehensive way. A corollary to this, however, is that many jurisdictions in the U.S. really do fear the advent of electronic commerce because it upsets their long-standing notions of how and what to tax; because they don't feel they have control over the situation; and because they don't know how to plan for a 21st century economy in which physical, geographical location is the least important factor for buyers, seller, investors, and innovators.

There are grounds for being sympathetic to these concerns, but as Gov. Gilmore's work on the Advisory Commission demonstrates, the evolution of commerce in cyberspace can give responsible, innovative policymakers a head start in revolutionizing tax policy. Tax policy no longer need be confined to 20th century notions of comprehensive, cradle-to-grave taxation of wealth and income, redistribution of income, and tax-based industrial policy. We have a fresh, unique opportunity to craft tax rules that are economically neutral, clearly visible to the taxpayer, and generate

a fair share of our national income to public purposes without being as prone to short-term political manipulation as our present tax structure—state, local, and federal—most assuredly is.

Whether lawmakers choose to shift to broad-based consumption taxes, user fees, transaction taxes, or devices not yet thought of is something legislators and tax administrators at every level of government will have to decide. But the fact that they have the opportunity, the challenge, the obligation to rethink tax policy from the ground up is ultimately why the debate over Internet taxation matters so much. It is critically important, however, that our tax systems evolve in a way consistent with the constitutional order crafted by the Founders and produce revenue-collection mechanisms that are truly better for the taxpayer, and not just for the tax collector.

**A Few Watchwords.** To that end, Mr. Chairman, let us conclude by suggesting a few Rules of the Road for anyone working in the area of Internet taxation to consider, and hopefully to follow:

1. *Be Constitutional.* As the Advisory Commission reports, and as our paper discusses, the Constitution defines clear, unambiguous constraints on the power of states to collect taxes beyond their borders (the Commerce Clause) and on their ability to act in concert to ‘enhance’ their power to collect such taxes (the Compact Clause, and in extreme cases, the Confederation Clause). It is vitally important that this Committee and this Congress avoid falling into the trap of legislating, or given credence to, the notion that interstate harmonization, indeed uniformity, of tax policy is a good thing. States on their own may do as they please, but there is a real danger that the desire for simplicity and uniformity on the part of the business community, coupled with the state and local eagerness for enhanced revenue authority, could create an anti-Constitutional tax structure that is neither federal nor state in nature, but a ‘third layer’ of government unaccountable to the people. At the same time it is appropriate to warn against federal overreaching in this area via excessively prescriptive rules on what states can and cannot do within their sovereign boundaries. Remember the 10th Amendment, and the fact that we are a union of states, and you should have no trouble striking the proper balance.

2. *Keep an Eye on the Tax Burden.* While most discussion of Internet taxation focuses on disparate effects on different states, different businesses, and different forms of retailing, our key ultimate objective must be to ensure that electronic commerce does not become an engine for increasing the overall tax burden on the American people, whether imposed directly or indirectly (as by pass-through taxes imposed on corporations). This is not entirely within the power of the federal government to prevent, of course, but a minimum the Congress should commit to ensuring that any new tax on the Internet, on e-commerce, or in any related sector be offset dollar-for-dollar elsewhere in the revenue-raising scheme. The same pledge should be undertaken by every state and local official in America. And to the extent that scrutiny of e-commerce from a tax standpoint produces bold new tax reform proposals, it should be crystal clear that Americans expect any major new revenue source to be a substitute for, not an addition to, an existing tax authority. If you’re going to create a new tax code you’ve got to scrap an old one, lock, stock and barrel.

3. *Don’t Ignore Fiscal Federalism.* Each of us has worked in the past in the area of federal-state fiscal relations, including both tax policy and grantmaking authorities. We are not insensitive to the constraints states and localities face due to the overwhelming presence of the federal government in the economy and in the field of taxation, and we do believe there is room for a diminished federal role in many areas of domestic policy, which would leave states and localities more freedom to innovate and take charge. What we must all guard against, however, is the kind of massive ‘final solution’ to public policy problems that too often takes center stage: e.g. the feds give up the income tax, the states give up the sales tax. There is no way to enforce that kind of bargain absent constitutional amendment, and there is a great risk that any grand bargain on tax and fiscal policy between the states and the federal government would in the end produce bigger government at all levels. Just as Internet taxation should not be an excuse for increasing the tax burden, so it should not be a back-door way of increasing the role and power of government. To this end we suggest that this Committee and the Congress consider a simple rule of thumb: any measure that increases the power or wealth of one sector of government should be offset with countermeasures to restore the balance. For example, if Congress chooses to give states any enhanced power to collect sales and use taxes, it should require states to forgo an equivalent share of federal aid in the form of categorical or matching grants. If the many Governors who have spoken

out on this issue are serious in what they say, they aren't seeking to increase their wealth overall, merely prevent it from eroding. If that is true, they should have no objection to an exchange they gives them more revenue authority (which they control) in return for less federal aid (which Washington controls).

These, then, are the matters we submit as most worthy of the Committee's consideration in the field of Internet taxation. Again, we applaud the initiative you and your Committee have taken, Mr. Chairman, in seeking to extend the moratorium on unwarranted taxation of the Internet, and we look forward to a stimulating and productive debate over tax policy and fiscal federalism in the months ahead.

Thank you.

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PREPARED STATEMENT OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

The International Council of Shopping Centers (ICSC) appreciates this opportunity to present its views to the Senate Committee on Commerce, Science, and Transportation on the need to apply existing state sales and use taxes to electronic commerce.

ICSC is the global trade association of the shopping center industry. Its 39,000 members in the United States, Canada and more than 70 other countries around the world include shopping center owners, developers, managers, investors, lenders, retailers and other professionals. The shopping center industry contributes significantly to the U.S. economy. In 1999, shopping centers in the U.S. generated over \$1.1 trillion in retail sales and over \$47 billion in state sales tax revenue, and employed over 10 million people.

Simply stated, ICSC believes that all goods, regardless if they are purchased over the Internet, via catalog or in traditional retail stores, should be subject to the same state and local tax collection requirements. One form of commerce should not receive preferential tax treatment over another. Unfortunately, existing tax law is structured to favor electronic commerce over sales made in local retail stores.

Contrary to popular belief, it is not the existing moratorium on Internet taxes that precludes states from requiring out-of-state retailers to collect sales and use taxes on their behalf. Instead, it is a 1992 Supreme Court case, *Quill v. North Dakota*, that held that remote merchants are not required to collect sales and use taxes for states in which they do not have substantial physical presence or "nexus." The moratorium—which expires in October, 2001—applies only to access charges and new, multiple and discriminatory state sales taxes. However, because many Internet retailers are not collecting the existing sales and use taxes, a long-term extension of the moratorium will make this practice an accepted way to do business.

ICSC does not support the enactment or implementation of Internet access charges, or new, multiple or discriminatory taxes on electronic commerce. Instead, we believe that existing sales and use taxes should be collected uniformly on all types of retail sales. The taxes which states should be able to require remote sellers to collect are not new taxes. Instead, they are existing use taxes which buyers are currently obligated to remit to their state and local governments. However, as a practical matter, most individuals are either unaware of their tax obligations, or simply don't bother to comply.

ICSC supports electronic commerce and believes it should be fostered. In fact, many traditional brick and mortar retailers are incorporating Internet commerce into their businesses in order to obtain new customers and better serve existing ones. However, as a matter of fairness and sound tax policy, Internet-based retailers should not receive a competitive advantage over traditional brick and mortar merchants simply because electronic commerce is a new and growing form of transacting business.

Although the extent to which Internet sales will displace traditional retail sales is unknown at this time, the competitive tax advantage that Internet-based retailers currently have could negatively affect many local retailers, shopping centers and their communities in the near future. Not only would traditional retailers generate reduced sales, but their employees would suffer from reduced working hours, wages or layoffs.

In addition, state and local governments would receive less sales tax revenues that go to provide essential public services (i.e., education, police and fire protection, road repairs). Governments that rely heavily on sales tax revenues would either have to cut back on such services or increase other taxes on local businesses and residents, such as property and income taxes. If governments decide to increase sales tax rates to make up for lost revenues, lower-income individuals would have to pay an even higher disproportionate share of their income on sales taxes since they are less likely to own computers and purchase products on-line.

It is this reason why many state and local governmental organizations support a level playing field for all types of retail sales. These government groups include the National Governors Association, Council of State Governments, National Conference of State Legislators, U.S. Conference of Mayors, National Association of Counties, National League of Cities and International City and County Management Association.

Our critics claim that electronic commerce is a new and growing industry and, therefore, it should not be saddled with "old world" sales tax collection requirements. They say we should not kill the goose that lays the golden egg. Our response is that, while electronic commerce is certainly a growing and important part of our economy, subjecting it to the same sales tax collection requirements that traditional merchants have been subject to for decades would not harm its growth or vitality. Electronic commerce will continue to flourish, regardless of whether or not sales and use taxes are imposed on it.

These critics also claim that forcing Internet retailers to collect sales and use taxes for the thousands of state and local taxing jurisdictions across the country would be too burdensome on electronic commerce and just can not be done. We agree that all businesses, especially small businesses, should not be overburdened by sales tax collections and that state and local governments need to simplify their sales tax systems. However, inexpensive software exists today that assists retailers in determining how much state and local taxes needs to be collected on their sales.

Another argument that is made by our opponents is that states and localities are flush with cash and do not need to tax electronic commerce. While it is true that most state and local governments are currently enjoying budget surpluses, there is no guarantee that this economic prosperity will last indefinitely. (In fact, Kentucky and Tennessee are two states that are currently experiencing a deficit crisis. Their Governors strongly believe that the collection of this existing tax would be beneficial.) If and when our economy softens, many state and local governments, as well as traditional merchants, could suffer financial harm, especially if electronic commerce continues to displace traditional sales.

ICSC is disappointed that the Advisory Commission on Electronic Commerce failed to reach agreement that all retailers should be on a level playing field with regard to state and local sales taxes. Even more so, we are disappointed at the process of the Commission itself. To begin with, even though a traditional local retailer was supposed to be represented on the Commission, no such individual was appointed.

Second, the Commission sent a report to Congress that was agreed to by only 10 out of 19 Commissioners, clearly short of the 13 votes that was required under the Internet Tax Freedom Act. Third and most importantly, the majority report fails to address the level playing field issue. Instead, it recommends (although not "formally") that Congress extend the current moratorium, repeal the 3-percent telecommunications excise tax, establish special "nexus" carve-outs for Internet businesses, and create sales tax exemptions (such as those on "digitized" goods and their "non-digitized" counterparts) that would directly benefit the "business caucus" companies.

ICSC does not oppose the substance of the current moratorium (e.g. its ban against access charges and discriminatory taxes). However, we are deeply concerned that the longer the moratorium is extended, the more difficult it will be for Congress to address and take action to level the playing field among retailers.

The U.S. Supreme Court has recognized Congress' authority to enact legislation that would allow state and local governments to require out-of-state retailers to collect sales and use taxes. Therefore, we urge Congress to enact legislation that would level the playing field among Internet-based and traditional retailers.

Thank you for this opportunity to express our views on this very important matter.