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Save the Internet from Death by Taxes

John R. LaPlante

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Should states and local governments be given new ways of taxing the Internet? To the contrary, they ought to *cut* the taxes they already impose on the Internet and e-commerce.

Forrester Research estimates that e-commerce will take in $1.3 trillion by 2003; state and local officials fear they will lose the tax revenues that might be due on those transactions. The growth of e-commerce, some argue, will mean that essential public services will suffer, as out-of-state transactions are not taxed. And then there's the fairness issue: why should interstate transactions be taxed differently from intrastate ones?

Those arguments are familiar, having been sounded during the growth spurt of the mail-order catalog industry. They are also false.

Problems with Taxing E-Commerce

There's no need for the money. The National Governors Association proclaims that without a "streamlined sales tax with simplified compliance requirements," there will be fewer teachers and police to serve the public.

The cries of desperation ring hollow, however, when one considers the financial condition of states today. State coffers, Dean Stansel and Stephen Moore write for the Cato Institute, are "awash in tax revenues." Michael Flynn, of the American Legislative Exchange Council, estimates that states have enjoyed surplus tax revenues of nearly $75 billion over the past four years.

Scholars at the University of Texas estimate that in 1998 alone, the Internet was responsible for over 1.2 million jobs--representing more income for workers, and for governments, more taxes. By contrast, University of Chicago and Harvard researchers estimate that less than 2 percent of sales tax revenue will be "lost" to unreported Internet transactions.

State and local officials need to find more creative ways of responding to a changing marketplace than calling for more taxes. If the governors want to improve education, for example, many more effective and less costly measures--such as contracting out services and funding schools through a voucher system--are available.

They should also appreciate the political and economic value of any tax avoidance that the Internet breeds. Tax rebellion, of course, was one motivating force behind the American revolution. In a less dramatic fashion, tax competition among states contributes to economic growth. The growth in the Sunbelt, for example, was due in part to people escaping high taxes in the Midwest. After improving its competitive climate, "the Rust Belt" by some measures enjoys the strongest economy of the country.

It's unconstitutional. Under the U.S. Constitution, only Congress has the authority to tax interstate commerce. The U.S. Supreme Court has affirmed this in various cases, most recently (1992) involving the mail-order office supply firm Quill. Congressional leaders, fortunately, are in no mood to change the Constitution.

Fairness is elusive. The argument most likely to lead to e-commerce taxes is the fairness and economic efficiency argument. Shouldn't a Main Street retailer and an Internet retailer be required to collect the same tax?

Given the vagaries of sales taxes, though--the definition of what is and is not "food" is the most humorous portion of many state's tax codes--it's absurd to argue that any sales tax can be "fair." And unequal treatment may not be as much of a problem as we think. As established retailers gear up for e-commerce, the distinction between e-commerce and "bricks-and-mortar" business is becoming less important. The Internet, in other words, is becoming simply another tool for businesses to use, and recent sales data suggest that even on the Internet, shoppers are turning to established brand names (with a taxable, physical presence in their state).

Fairness in taxes is not in itself a good thing--not if it's brought about in a way that violates personal liberties and compromises limited government. Consider that under our present national income tax system, the effort to ensure compliance has brought about many overbearing tactics by the IRS. Do we really want to open the door to something like that when it comes to sales taxes? The privacy implications of the databases implicit in some of the enforce-Internet-taxes proposals are frightening.

Cut Taxes, Don't Raise Them

Lost in the middle of concern over "lost" taxes is the fact that e-commerce is already subject to tax. Consumers are already subject to sales tax in those transactions where the business and consumer reside in the same state. Moreover, most e-commerce is conducted over either phone lines or cable television lines, which are taxed at various levels of government.

Policymakers should keep in mind that we inevitably get less of what is taxed more. Given the dynamic growth of the Internet and its tremendous potential, Internet-related taxes should be *cut*, not raised.