

**Statement of
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United States Senate Committee on Commerce, Science, and Transportation**

Hearing on Internet Taxation, April 12, 2000, 9:30 a.m.

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 taxation 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:

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.

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.

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 give 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.