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Keep the Internet Tax-Free!

by Lawrence W. Reed

Summary

Michigan Governor John Engler supports a plan by the National Governors' Association that would apply existing sales taxes to purchases made over the Internet. But the plan could invade consumers' privacy as well as severely hamper the fledgling Internet economy that is leading the way to new growth and prosperity.

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Will the Internet continue to be an engine for America's economic growth, or will it become just another cash cow for tax-happy state and local governments? Congress will now decide.

In March, after 10 months of deliberations, the federal Advisory Commission on Electronic Commerce endorsed a plan that would extend the current ban on new Internet taxes until 2006. Unfortunately, the commission was unable to muster the two-thirds majority necessary to make this its official recommendation to Congress, where the final decision on this issue will be made.

Congress could follow its commission's advice, or it could enact another Internet tax proposal favored by the National Governors' Association and Michigan Governor John Engler. This plan would apply existing sales taxes to virtually all Internet purchases and create a "third-party entity" to collect and distribute those taxes. This is neither the best policy, nor is it grounded in sound premises.

The National Governors' Association plan to apply sales taxes to virtually all Internet purchases and create a "third-party entity" to collect and distribute those taxes is not the best policy nor is it grounded in sound premises.

In all but a handful of states today, businesses are forced to collect sales taxes on many goods they sell within the state where they are based or have outlets. The Supreme Court has ruled that states and local governments cannot require out-of-state companies to collect taxes for them, since this would interfere with interstate commerce. States and localities may only require companies with a "substantial physical presence," or "nexus," in their state to collect sales taxes.

Imagine what collection chaos would ensue if even a small portion of the 87,453 units of government in America were to adopt sales taxes and then try to apply them to Internet sales. It was to prevent such chaos that Congress in 1998 instituted the three-year moratorium on new Internet taxes—a ban the Advisory Commission would extend five more years.

One of the main points of contention, raised by Engler in congressional testimony, is that it's not "fair" for traditional "bricks-and-mortar" businesses to collect sales taxes while Internet businesses are free of such taxes. But this argument is undermined by tax policies followed by Engler and other state administrations.

It so happens that Michigan's tax structure is riddled with unfair "special favors"—even, in one case, for an Internet company. Last

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December, for example, state officials authorized a $23.4 million "incentive" package for Webvan Group, Inc., of San Francisco, California. Webvan operates as an electronic grocery outlet, receiving orders over the Internet and delivering them at prices it advertises as "up to 5 percent less than in local grocery stores."

Likewise, Michigan's "Renaissance Zones" set up small geographic regions within the state where taxes are much reduced or don't apply at all. A business can literally move a mile, into a Renaissance Zone, and enjoy a much lower tax burden than its nearby competitors.

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Ironically, it is the governors' plan to tax Internet commerce that would be blatantly unfair. Taxes are supposed to pay for services governments provide, such as police protection. Out-of-state vendors with no physical presence in a state would receive none of the benefits for taxes they would pay to state and local governments where they do not reside. Internet tax freedom therefore maintains a level playing field for all retailers, regardless of where they have a physical presence.

Besides, state governments are awash in tax revenues, with a total surplus this year in the neighborhood of $36 billion. Michigan currently has a huge budget surplus, a "Rainy Day Fund" in excess of $1.2 billion, a bulging School Aid Fund, and record per-pupil spending in the public schools.

A healthy economy fueled by Internet technology is an important factor in the current boom that is filling government coffers. In fact, a recent study by economists from the University of Chicago and Harvard University estimates that applying sales taxes to electronic commerce would reduce the number of online buyers by 25 percent and total spending on Internet transactions by more than 30 percent. The study suggests that these sales would not be replaced by ordinary retail sales, since the Internet is probably a net trade *creator*, generating business that otherwise would not have occurred.

The Internet represents a new world of enterprise, increasingly easy for both buyers and sellers to access. Rather than looking for ways to take a chunk of it, politicians should see it as a means to a more promising future for everyone and let it be.

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