TAX FOUNDATION

TAX FEATURES

www.taxfoundation.org *November 1998 Volume 42, Number 10*

Mismatch Between Old Tax Law and New E-Commerce Has Governments Scrambling

Taxation of Electronic Commerce is Foundation Conference Theme

What is electronic commerce? How is it being taxed now? How might it be taxed in the future? These are the questions that will be answered at the Tax Foundation's 61st annual conference, Thursday, November 19th.

The rapid growth of Internet usage has opened up a 24-hour virtual global marketplace for goods and services that is creating a revolution in the way businesses operate. This swiftly changing technology has the potential to fundamentally alter the nature of marketing, ordering, invoicing, billing, and customer service. Because the costs of entry are relatively low, it is accessible to both small retailers and global conglomerates.

How big is electronic commerce? Electronic commerce is in its infancy and hard data is difficult to come by. Industry estimates vary widely. According to a survey by Nielson Media Research and CommerceNet, almost seventy-nine million people over the age of sixteen used the Internet in the first six months of this year, up 58 million from only nine months ago. Of those users, 20 million made online purchases—double the figure from nine months ago. Globally, there were more than four hundred thousand active commercial websites in January 1998, more than double the number in January 1997.

By far the largest component of electronic commerce is business-to-business trade. U.S. business-to-business sales of goods using the Internet will top $17 billion this year—more than double the 1997 figure, and they are expected to exceed $300 billion by 2002.

Existing tax policy was written for a world in which most commerce was in sales of manufactured goods. This raises a number of issues in the application of tax policy to electronic commerce:

♦ Current sales and use taxes at the state and local levels in the United States apply primarily to tangible products. They are selectively applied to services on a widely varying basis. Services are a growing fraction of consumer expenditures, and the growth of electronic commerce will only increase the fraction of commerce that escapes sales and use taxation as more consumers go online to purchase services and intangible products. Should services and intangibles (digital goods) be included in the sales tax base? How?

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FRONT & CENTER

Tax Reform and the Consumption Tax: Getting the IRS Out of the Individual Lives of All Americans

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Foundation's *Taxpayer's Guide to Federal Spending* Joins *Facts and Figures* on the Nation's Reference Shelf

Keeping the public informed about national, state, and local finances was one of the primary purposes for the launch of the Tax Foundation in 1937. As the budget the President submits every February to the Congress has become longer and more unapproachable, the Tax Foundation decided in 1995 to publish a one-volume companion to each year's budget. Titled *A Taxpayer's Guide to Federal Spending,* the volume distills the federal budget into a working document, with the fiscal year's projected expenditures organized by department, agency, program area, and individual expenditure account. Pie charts throughout the book offer a concise picture of how each department divides its budget among component agencies and major program areas.

For example, a reporter or taxpayer interested in the IRS's budget could tell at a glance that the agency still spends more on enforcement than it does on processing returns and taxpayer assistance, but that spending on enforcement is trending down, while spending on taxpayer assistance is up. In fact, processing and taxpayer assistance is up from $1.9 billion in FY'97 to $3.2 billion in FY'99, while enforcement spending is down from $4.1 billion to $3.2 billion. Meanwhile, the agency will spend $143 million to administer the Earned Income Tax Credit.

A Taxpayer's Guide to Federal Spending joins the venerable *Facts & Figures on Government Finance* as annual books published by the Foundation. First published as *Tax Facts and Figures* in 1941, *Facts & Figures on Government Finance* brings together in one convenient and concise handbook scattered facts on tax collections, public expenditures, and public debt.

Readers of that first volume could pick up one reference book and see that federal tax collections between 1913 and 1940 had jumped from $668 million to $4.73 billion (or 607%) — and that state tax collections had climbed even more, from $300 million to $3 billion (or 909%). (Several tables later, they could learn that unemployment compensation taxes were the primary reason for the soaring state tax burden.)

Facts and Figures contains much historical data that government agencies have discontinued but that scholars need. The 33rd edition, edited by Scott Moody, will be available in early 1999.

Please use the order form below to subscribe to these books today, and ask for a catalog of other Tax Foundation publications.

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New Foundation Research Highlights Importance of Capital Flows

In a new study, Tax Foundation executive director and chief economist J.D. Foster explores ramifications of international capital flows for revenue estimating, with attention to the estimates necessary for fundamental tax reform.

Appearing as Number 27 in the Tax Foundation's Background Paper series, and entitled, The Open and Closed Case for Capital Flows, the study reconciles the champions of perfect capital markets and those who find the notion of infinitely responsive international capital flows implausible.

Foster shows that one can posit perfect capital markets and still find significant restraints on the ability of the economy to increase net capital inflows. The restraining mechanism is the balance of payments since a country cannot increase its net capital imports faster than it can increase its net deficit in trade of goods and services.

Even for the United States, one of the most open economies in the world, there is disagreement regarding the extent to which the economy is open to capital flows and the incentives that drive them.

Gauging the Effects of Fundamental Tax Reform

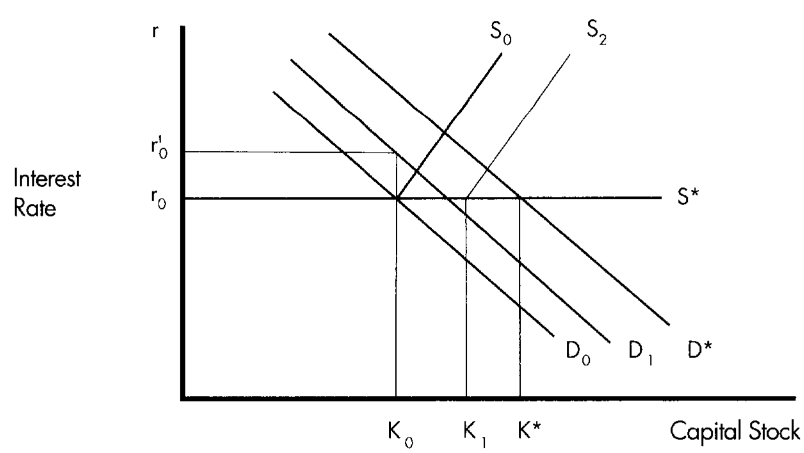
How freely capital flows across the nation's borders is key to understanding how fundamental tax reform would affect the U.S. economy and therefore federal tax receipts. This is one conclusion from the Joint Tax Committee's examination of economic models of the U.S. economy capable of accurately assessing the effects of tax reform.

International capital flows could play a critical role as the economy reacts to a change in tax policy. If the economy is closed to these flows, then a change in policy increasing the demand for capital or decreasing the net of government receipts over expenditures must be met with an increase in domestic saving. If domestic saving is unresponsive, then interest rates will rise, thereby dampening the stimulative effect of the policy. However, if the economy is open and international capital is plentiful, then the shortfall in domestic saving is made up by imported saving. Interest rates then remain largely unaffected and the economy would enjoy the full stimulative effect of the policy change.

Trade flows respond relatively slowly to changes in the economic environment, such as a change in the real exchange rate. A change in policy encouraging an increase in net capital inflows would likely increase domestic interest rates and, thereby, increase the exchange value of the dollar. This, in turn, would tend to make foreign goods more expensive to U.S. buyers and U.S. goods more expensive to foreign buyers.

The resulting increase in the trade deficit would permit an increase in net capital flows, which would, in turn, allow U.S. interest rates to once again decline. Thus, the economy can be completely open in the sense that capital markets operate perfectly, and yet its ability to import large amounts of saving from abroad in response to a change in tax policy is limited by the speed with which the net trade deficit can increase.

The Case of A Partially Open Economy



The curve S represents the long-run supply of domestic saving plus net capital inflows. The desired domestic supply of saving prior to and after tax reform is given by S_0 and S_1, respectively, and the initial, post-tax reform desired stock of capital curve is given by D_1 and the equilibrium curve is given by D*. An increase in the desired flow of investment in new plant and equipment produces a temporary increase in interest rates to r'_0. The increase in the interest rate lessens the increase in the rate of investment, spurs on an even more accelerated rate of additional saving than would tax reform alone, and it creates an incentive for foreign capital inflows.*

As domestic saving accumulates and net financial capital flows continue, the stock of plant and equipment increases until it reaches its new equilibrium at K. This is the equilibrium capital stock the economy would attain, though more quickly, if it had the benefit of full and instantaneous cross-border capital flows.*

Tax Reform and the Consumption Tax: Getting the IRS Out of the Individual Lives of All Americans

by Rep. Bill Archer (R-TX)

How much would you pay never to have to deal with the Internal Revenue Service *ever again*? Most people respond they would pay hundreds of dollars a year, about the sum they spend to hire a professional tax preparer. Some go even further: Last year a woman from Connecticut jokingly testified before the Ways and Means Committee she would give up her first-born child if it meant freedom from the IRS. Jokes aside, people living in the freest nation on Earth should never have to feel this much disdain for an agent of their government.

Americans dislike the current income tax with good reason. It's complicated, burdensome and unfair. When the federal income tax was established in 1913, the new law was a mere 16 pages long. Today, the income tax code takes up 17,000 pages. The 8 billion pages of forms the IRS sends out every year is enough paper to circle the earth 28 times.

There will always be complications when we use income — meaning work, savings and investment — as the basis of taxation. For example, the IRS must ask 42 questions just to figure out whether an individual taxpayer is the head of a household. As someone who still does his own taxes, I know that the current income tax system is a huge headache for most Americans.

Taxpayer compliance costs are also a huge drain on our economy. Americans spend an estimated $200 billion on income tax compliance costs each year. The IRS estimates that adds up to about $8.67 on every $100 paid in taxes.

Complications inevitably lead to errors by both the IRS and innocent taxpayers. In 1993, the IRS gave out 8.5 million wrong answers to taxpayers seeking help with their income tax. But the IRS is not alone.

Money magazine hired 45 professional tax preparers to fill out a hypothetical family's 1996 tax return and they gave 45 different answers for how much that family owed in taxes. In fact, only a quarter of the tax preparers came even within $1,000 of the actual taxes due.

In addition to the difficulties of filing a return, most Americans live in fear of the consequences of inadvertently filing an incorrect return. According to a survey, more Americans would prefer a root canal than an IRS audit. Another survey found that the most feared phone message in America is, "This is the IRS calling."

I want to get the IRS out of the individual lives of all Americans and eliminate all the loopholes in the tax code, creating a new, fairer system. The only way to achieve this is by replacing the income tax with a tax on the consumption of goods and services.

These fears are well founded. In 1993, one taxpayer was fined $46,806 for an alleged underpayment of 10 cents! A Delaware contractor paid $50,000 in unowed taxes simply because it was cheaper than getting justice.

These problems are symptoms of the disease: income tax will always lead to intrusive, burdensome and complex tax code. I want to tear the income tax out by its roots so it can never grow back again. I want to get the IRS out of the individual lives of all Americans and eliminate all the loopholes in the tax code, creating a new, fairer system. The only way to achieve this is by replacing the income tax with a tax on the consumption of goods and services.

A consumption tax is the only tax that gets the IRS out of the individual lives of all Americans because as long as you tax income, you will always have the complex question, "What is income?" And you will always have the IRS invading your privacy and freedom in an attempt to figure out exactly what your income is.

In 1986, we tried to reform the income tax by going to a system with a tax of just two basic rates. But sure enough, in just a few short years, the income tax has grown back with a vengeance.

Thomas Jefferson made it one of his career goals to eliminate any direct contact between the American taxpayer and federal tax collectors. In his second inaugural address, he considered this his most important achievement. He spoke to the nation with these electrifying words, "Now, it is the pleasure and pride of every American to ask, 'What farmer, what mechanic, what laborer ever sees a tax gatherer of the United States?'"

It is my hope that we can soon make that same statement again. Jefferson saw clearly the moral issue at the root of taxation: where should the government levy the disincentive of taxation?

Today, Americans are caught in a tax trap. The harder you work, the more you save, the more you are taxed. It should not have to be that way. It should be the more you spend, the more you pay.

We need a tax code that achieves

six basic objectives. It must promote fairness, simplify compliance, attack the underground economy, encourage savings and investment, improve the balance of trade, and stimulate economic growth.

In my opinion, a brief examination of each objective shows why a consumption-based tax code is the only system that can accomplish all six.

Fairness. Under a consumption tax, every American would bring all of his or her paycheck home without losing a cent to income tax withholding. You would decide how much you would be taxed by how much you spend; those who buy a Geo Metro would have a smaller tax than those who buy a Rolls Royce. We can get rid of all tax loopholes and create a fair tax code that includes protections for low income Americans.

Simplification. Under a consumption tax, no individual would ever have to file an income tax return with the IRS ever again. No tax forms or even postcards. You cannot get much simpler than that.

A tax collecting agency would still be necessary to administer the collection of federal revenues from the sales of goods and services, but it will become far smaller and less intrusive than the IRS. In fact, a consumption tax would reduce the number of collection points from the current 170 million to less than 2 million.

The Underground Economy. Tax evasion costs U.S. taxpayers at least $200 billion a year in lost revenues. Honest taxpayers are paying an additional 10% - 15% in taxes to make up for those who cheat the income tax system.

Under a consumption tax, every Ferrari a drug dealer buys would be taxed. Everyone would have to pay their fair share of federal taxes on all their purchases.

Savings & Investment. The current system punishes anyone who saves and invests by taxing them twice — once you pay income taxes and again when you pay taxes on interest, dividends and the profits of saving. The income tax discourages people from investing in child care, health care, education or saving for retirement. We can help ease many Americans' concerns with Social Security's stability and planning for retirement by making our tax system more savings friendly.

Under a consumption tax, there would be no tax on savings. Every country that has increased its national savings rate has seen a corresponding increase in its standard of living.

America would become a sponge for savings, causing interest rates to decline and thereby reducing the prices of homes, automobiles and all items consumers buy on credit. By ending the double taxation on savings and encouraging investment, a consumption tax would energize the U.S. economy, lift stagnant wages and create jobs.

Trade. Just imagine how many companies around the world would want to build their factories here if they could reduce their operating costs by relocating to the US. This would create a boom in the demand for American workers and thereby help raise American wages.

No product made in the USA and exported to other markets around the world would be subject to the consumption tax. If all taxes were removed from production costs, you could expect the price of American products to drop.

This improved competitiveness for U.S. exports would undoubtedly lead to a surge in U.S. exports. All imports would be subject to the consumption tax just like any other product sold in the U.S. This border-adjustability, completely legal under World Trade Organization rules, would give us a fair advantage in the global marketplace.

Economic Growth. Dale Jorgenson, Chairman of the Economics Department at Harvard University, testified before the House Ways and Means Committee that a consumption tax could increase the projected overall size of the U.S. economy under the current income tax immediately by 13 percent and then remain at 9 percent above current economic forecasts.

The tremendous surge provided by a consumption tax would mean more work for American businesses and more jobs for American workers.

It would be inaccurate to assume that a consumption tax would increase the price of all products. It is easy to forget that for every television set, car or note pad we buy, the cost of federal income taxes is built into the final price. A consumption tax would merely offset the hidden price of the income tax in today's products. In addition, the income tax would no longer be withheld from a worker's paycheck.

However, real tax reform is a massive undertaking that will only be successful with strong, national, grass-roots support, and that support is growing. Grass-roots organizations are forming in all 50 states in support of abolishing the income tax, and I expect to see a growing national consensus in support of such a move.

Congress must continue working to keep the momentum building. I am confident that all of us who support tax reform will eventually rally behind one central plan.

With its economic advantages and ultimate simplicity, the consumption tax is the best choice for those who want real tax reform. Timid people may say that it is too bold. But I believe that the consumption tax is the fairest way to collect federal revenues while respecting the American principles of privacy and individual liberty.

The Tax Foundation invites a national leader to provide a "Front and Center" column each month in Tax Features. *The views expressed are not necessarily those of the Tax Foundation.*

FOUNDATION MESSAGE

Social Security Reform: Crisis versus Leadership— It's Your Decision

J.D. Foster, Ph.D.
Executive Director &
Chief Economist
Tax Foundation

Washington, D.C. denizens like to talk about what people are thinking "outside the beltway." As in many cities, a heavily traveled highway called, naturally, the "beltway," encircles Washington. Along the southern side, where the highway meets the Potomac river, drivers cross the Woodrow Wilson bridge. Recently, a sad soul threatened to throw himself off the bridge, neatly timing his threat with the evening rush hour. Already outrageous, traffic in Washington was thrown into chaos. The jumper is reviled today, but he demonstrated how vital this bridge is to traffic in Washington. And that was a great service because the Woodrow Wilson bridge is expected to fall into the Potomac in a few years.

"Social Security reform remains a hot topic because there are leaders who recognize the colossal crisis in the distance."

Authorities have long known the old bridge was in trouble. Like most roads in the nation's capital, it carries far more traffic that it was designed for. Nevertheless, lacking real leadership, the authorities were never able to get their act together to plan a replacement. Until now. Now, the bridge is about to collapse. Now, there is a crisis. Crisis has replaced leadership and, finally, there is a plan and some funding.

Crises have often replaced leadership as the political tool of choice. In this respect, Social Security may be just like the Woodrow Wilson bridge. In the past election, many candidates promised to protect Social Security, by which they meant protecting it against change. These are the anti-leaders. The kind of officials who hope to bob, weave, and demagogue, and then leave the tough problems to their successors to solve. The kind who, for example, would wait until the bridge falls into the river before committing to action.

Despite their short-sightedness, Social Security reform remains a hot topic because there are leaders who recognize the colossal crisis in the distance and they know we cannot and must not wait. President Clinton saw this last year, and so he shocked the policy community with his call to "Save Social Security First" in his 1998 State of the Union message.

The Woodrow Wilson bridge will be replaced because it will collapse. Social Security will change because it will go broke when the baby-boomers retire in force. Even before it goes broke, it would require huge amounts of new federal borrowing. And reform will happen because, even if it could be propped up, Social Security offers participants a horrendous return on their taxes.

With the campaign over, the President and the Congress must now come up with a realistic plan they can sell to the American people. While the process remains fraught with political dangers, Social Security reform must yield a solvent system, and it must yield a system where participants receive market rates of return on their contributions. (Thus, a tax increase to bail out Social Security is not a solution because, while possibly solving the insolvency problem, it would exacerbate the rate-of-return problem.)

Social Security reform will require some combination of out-year reductions in Social Security outlays plus additional revenues into the Social Security plan. Fortunately, politics aside, the decision process is fairly straightforward, as demonstrated by the decision tree presented to the right and described below, beginning with:

"Reform will combine out-year reductions in Social Security outlays with additional revenues into the Social Security plan. Fortunately, politics aside, the decision process is fairly straightforward, as demonstrated by the decision tree presented to the right."

Number 1

Will the welfare component of Social Security continue to be funded by payroll taxes or by general revenues?

1a) If general revenues, what other spending will be cut or taxes raised to fund this shift in budgetary responsibility?

1b) If general revenues, then future demands on the Social Security Trust Funds are reduced by the same amount.

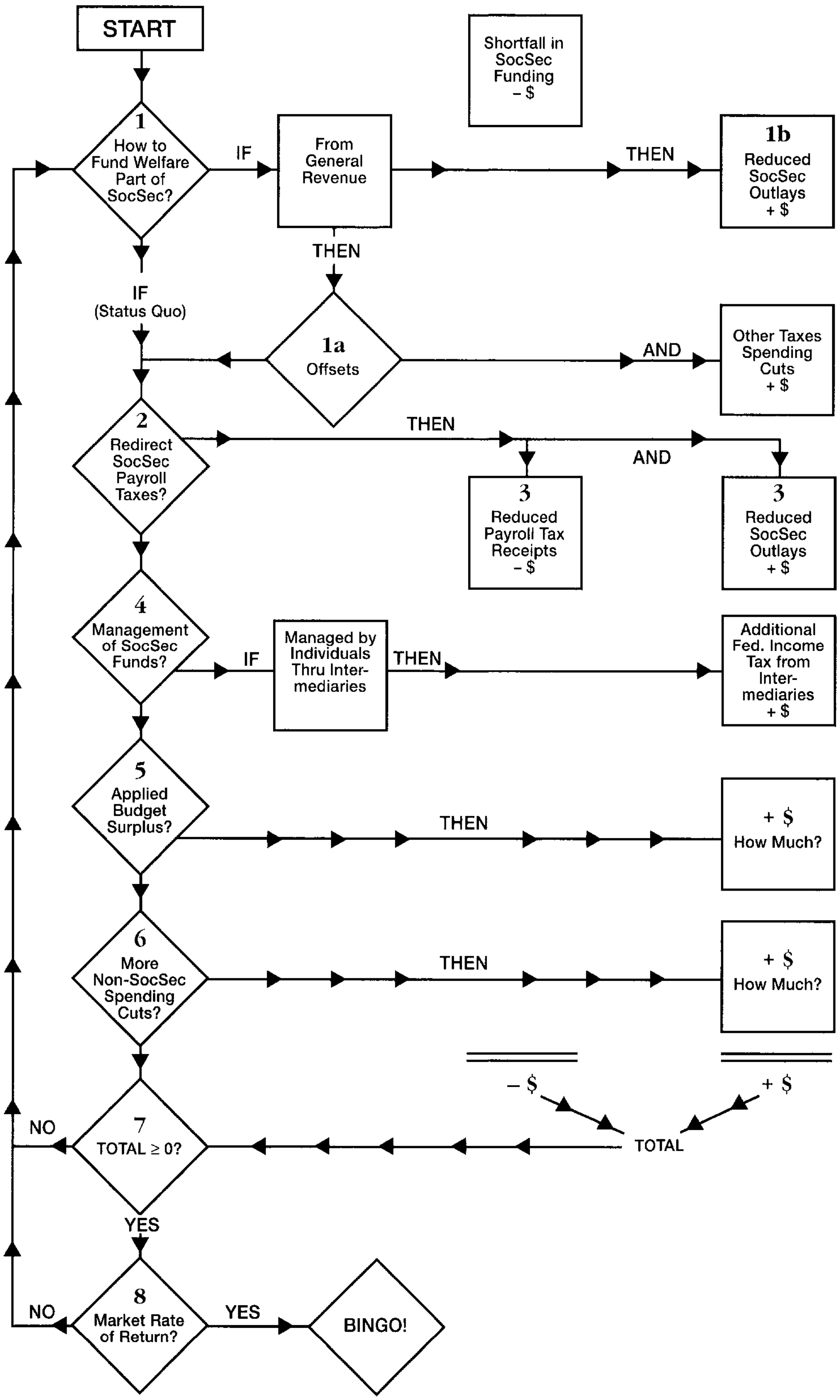
Number 2

Of the payroll taxes not funding the welfare element, how much should be turned over to individual accounts?

Number 3

If payroll taxes are returned to the

Social Security Reform Decision Tree



taxpayers, how will this reduce future outlays from the Social Security Trust Fund?

Number 4

Should individuals or the government manage the accounts?

4a) If individuals, then financial intermediaries (Citigroup, Goldman Sachs, etc.) will be paid for services. This means taxable income to the intermediaries and an additional source of federal income tax receipts.

Number 5

How much of the projected federal budget surplus should be applied to Social Security reform?

Number 6

How much other federal spending should be cut to supplement the budget surplus in funding Social Security reform?

Number 7

Is the sum of :

the additional income tax receipts from financial intermediaries (step 4a),

+

the applied portion of the budget surplus (step 6),

+

additional spending cuts (step 6),

+

the reduced outlays (step 3),

greater than or equal to:

the projected cumulative shortfall in Social Security funding

+

the reduction in federal payroll tax receipts?

If no, return to step 1 and try again. If yes, then the plan is viable and go to step 8.

Number 8

Can taxpayers earn market rates of return on their new mandatory savings accounts?

If no, then return to step 1 and try again. If yes, then congratulations! The plan's a winner and you may henceforth be known as the savior of Social Security!

TAX FEATURES©

Tax Features© (ISSN 0883-1335) is published 10 times a year by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia. Annual subscriptions to the newsletter are $15.

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Taxing E-Commerce *from p. 1*

♦ Even before the emergence of electronic commerce, the growth of mail order was increasing the fraction of commerce performed by remote merchants. Because states are legally prohibited from compelling vendors who operate only out of state to collect sales and use taxes on products and services sold to their residents, local merchants are at a competitive disadvantage. The Internet will certainly exacerbate this problem for conventional in-state vendors. Should remote commerce be subject to sales and use tax collection requirements?

♦ The Internet blurs the links between economic activity and location. In the borderless world of the Internet, where does a transaction take place? Is it at the customer's computer? At the company's website? The server that houses the website? The seller's computer?

Efforts at addressing these and other issues regarding the taxation of electronic commerce are underway globally at all levels of government. The OECD has recently concluded a conference that addressed (in part) the global tax issues connected with electronic commerce.

The U. S. Government has issued a white paper containing the federal government's primary concerns regarding electronic commerce. And a compromise version of the Internet Tax Freedom Act (ITFA) was signed into law on October 21, 1998 as part of the omnibus budget reconciliation package.

The Tax Foundation's conference on the taxation of e-commerce will be another step in the clarification of this new and challenging field of taxation. It will begin with a keynote address from Harris Miller, President, Information Technology Association of America, who will give an overview of electronic commerce and how taxing authorities are approaching it. Andrew Sernovitz, President & CEO of the Association for Interactive Media, will follow with insights on the future of electronic commerce.

Two panel discussions will follow. The first panel will focus on the government perspective on the tax issues related to electronic commerce. Because electronic commerce by its nature can cross both global and interstate boundaries, international, state and local governments are actively seeking agreement on how to apportion the income generated by these transactions and the sales and use taxes among taxing jurisdictions to avoid subjecting electronic commerce to onerous multiple layers of taxation. Speaking to this will be Michael Hardy, Senior Advisor on Fiscal Affairs and Electronic Commerce from the Organization for Economic Cooperation and Development; Joann Weiner, Ph. D., Economist at the Office of Tax Analysis, Department of the Treasury; and Harley Duncan, Executive Director, Federation of Tax Administrators.

Finally, on the last panel, representatives of industry and congressional staff will impart the business perspective on the evolution of tax law as it applies to electronic commerce and in particular the issues of complexity and compliance with the law as it exists and as it is evolving. Speakers will be Dina S. Shapiro, Vice President, Citicorp; Carla Howard, Tax Counsel, Electronic Data Systems; Pat Nugent, Director of Tax Legislative Affairs, MCI WorldCom; Brigitta Pari, Tax Counsel, Senate Finance Committee; and John Harrington, Tax Counsel, House Ways & Means Committee.

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