Statement of

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before the

Committee on Finance
United States Senate

on

Tax Equity and Sovereignty for States in the Digital Age

on behalf of

The National Governors Association

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Good morning, Mr. Chairman. I appreciate the opportunity to present testimony to the committee this morning with regard to issues relating to taxation and the Internet. The nation's Governors want to ensure the country will be competitive in a global economy in which the dominant source of social wealth is knowledge and information. Governors understand that the traditional state-local structure of property, sales, and income taxes does not reflect the elimination of borders in this new borderless economy or the knowledge forces driving the national economy. The Governors recognize there must be structural changes for a new state-local tax structure that matches this information age. That will require the cooperation and insight of our national leaders in the private sector, academia, and public sector. They look forward to your leadership and support in making this a joint effort.

Governors understand that these changes must address:

- What should be taxed in the future as production and consumption become disconnected from the geography;
- How to create a fair, neutral tax system, one that does not discriminate for or against new technologies that improve productivity and enhance opportunity;
- How to address a growing, long-term structural gap between the investment needs of state and local governments—especially in education and health care by states—and current state revenues; and
- How to preserve state and local autonomy at a time when the networked economy pushes society toward uniform standards and common protocols.

Two years ago, the Governors, at their annual meeting in St. Louis, discussed whether to initiate work on a new state-local revenue system to replace the sales tax, or whether to develop a twenty-first century sales tax that can achieve fairness for all forms of sales: Main Street, mail order, and Internet. The Governors recognized that the current system simply does not function efficiently or fairly in a global economy. The Governors determined that a streamlined sales tax with simplified compliance requirements would ensure that states are prepared to support the global electronic marketplace of the next century.

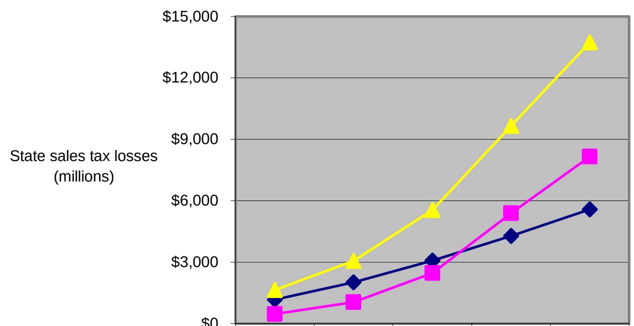
At the federal level, the Governors strongly support the proposal by Senators Dorgan, Voinovich, Graham, Enzi, and others, S. 512, to provide states with the authority to require remote sellers to collect state and local sales taxes combined with an extension of the Internet Tax Freedom Act. Such changes could provide a far more efficient economy and significantly reduce the burden on sellers. Florida and Texas are the 2 most recent of the 16 states that have enacted streamlined sales tax laws this year. The Governors believe that the 32 participating states in the Streamlined Sales Tax Project have a unique opportunity to work together with Congress to enact a twenty-first century sales tax that will ensure states are prepared to support the global electronic marketplace. With estimates that one-third of the $8 trillion national economy could be conducted electronically over the course of the decade, we believe that all parties should compete—as they do under the federal Internet tax system—on a level playing field, just as Representative Cox, Robert Comfort of Amazon.com, and Governor Engler recommended in testimony before the House Judiciary Committee.

Background

Currently, Internet-based merchants are not required to collect sales and use taxes, which places them at a significant advantage over traditional retailers. This inequity could have a profound negative impact on not only retailers but local communities because it risks states' ability to collect the revenue needed for education, police, and other essential services, and could lead to increases in state property or income taxes.

Nearly 40 percent of all state revenues come from the sales tax; it is the single most critical source of funding for public education in the United States. But, unless Congress moves to restore a level playing field, current industry and academic studies project States will lose between $10-20 billion in sales tax revenues by 2003.

Figure 1: eCommerce Sales Tax Loss Will Grow to $13 Billion By 2004



	2000	2001	2002	2003	2004
Business-to-consumer (B2C)	$1,169	$2,022	$3,079	$4,274	$5,580
Business-to-business (B2B)	$468	$1,042	$2,465	$5,389	$8,156
TOTAL (millions)	$1,637	$3,064	$5,544	$9,663	$13,736

Figure 1, Source: Forrester Research, November, 2000.

Many believe—incorrectly—that the Internet Tax Freedom Act (ITFA) passed by Congress in 1998 made the Internet tax-free. It did *not.* Businesses and consumers are charged taxes on Internet purchases from companies that have nexus in their state, and they are supposed to pay use taxes on the rest of their online purchases. The ITFA merely prevents states from adopting new Internet-specific taxes. But absent federal action, states may not require remote sellers to collect the taxes owed on transactions.

What's the Problem

When the nation was founded and before there was a federal government, land in that agrarian society was the dominant source of wealth. Both state and local governments relied upon the property tax for public revenue. As the industrial economy matured, the sales tax was created in the 1930s to partly capture the growing appetite of mass production and consumption. The sales tax fit nicely to a consumption system within easy geographic access. It led to the evolution of today's 7,500 state and local governments with authority to levy sales taxes. Not surprisingly, these sales tax systems have evolved over the last 60 years in response to their own unique political pressures. This combination functioned well in the industrial era when both production and consumption functions were predominately local ones. Today, the production of goods, services, and intellectual property can occur anywhere in the world. Knowledge workers are mobile, because their jobs are portable. Similarly, consumption has been detached from the traditional federal, state, and local concepts of borders. In the last 30 years, the purchase of services has risen from about 45 percent of personal expenditures to nearly 60 percent, a relative increase of one-third in generally non-taxable expenditures. The sales and use taxes have become a relic of the depression era, applying almost only to the sale of tangible personal property. This antiquated system faces the following problems:

- ***The elimination of borders.*** U.S. Supreme Court rulings prevent states from requiring sellers that do not have a physical presence in the state from collecting existing and legally owed taxes on sales made into a state. With the advent of electronic commerce and the drastically increased ability to engage in remote marketing, the amount of uncollected revenue increases each year. Congress has steadfastly refused to grant states the authority to require remote sellers to collect these taxes, even though the Court has said it is squarely within their prerogative to do so.
- ***Inequity and non-neutrality.*** The status quo means that remote sellers are not required to collect the state and local sales/use taxes except where they have a physical presence. The Mom and Pop retailer on Main Street or in the mall is required to charge, collect, and remit sales taxes to their respective governments. National retailers, which have a physical presence in most states, must collect these taxes in their many stores, and through other ways (catalog, telephone, or Internet). Wal-Mart, Inc. files 10,000 different forms with various taxing jurisdictions across the country each year. E-tailers are exploiting this peculiar tax advantage in an industry with notoriously tight margins.
- ***Preservation of state and local autonomy.*** The Internet Tax Freedom Act applies only to state and local—not federal—taxes on the Internet. It marks an extraordinary intrusion by Congress into one of the most fundamental aspects of federalism: the responsibility and accountability of elected officials to the citizens who elected them. Some in Congress now may feel that micromanaging the state tax system has become part of its policy terrain.
- ***The current system can no longer bridge a growing gap.*** While the short-term fiscal outlook for states is bleak, the long-term outlook is far more serious. A population surge for the school-age population and the aging of the nation will create enormous pressures on the largest drivers of state budgets—education and Medicaid. The states raised $192 billion from the sales tax in 1998. But, absent changes, federal policies will exacerbate these structural, driving forces of these spending changes. At the same time, the current tax and revenue structure of states and local governments is becoming increasingly obsolete. It is inadequate to meet these surging budget demands. Again, federal actions threaten to exacerbate this problem rather than provide the states opportunities to restructure and reform their revenue laws and systems to meet a fundamentally altered economic time and the structural forces that will drive unique demands on state budgets over the next decade.
- ***Meeting the nation's competitive needs.*** The dominant driving force in the world economy today is knowledge and information. It is a networked economy with enormous pressure for common standards, definitions, and rules. These pressures will require both substantial investment by states in public education, especially post-secondary education, to ensure that young Americans are equipped to lead. It will require states to achieve tax reform that achieves horizontal equity across industries.
- ***The erosion of this most important source of revenue will accelerate.*** Congressman Cox has wisely acknowledged that exempting domestic and international airline tickets purchased over the Internet from the federal taxes would lead to accelerated transfer from over-the-counter to over-the-Internet purchases—with consequent repercussions for the Airport and Airway Trust Fund and the federal budget. Similarly, the growth and penetration of broadband and all public and private data demonstrate the increased erosion of state sales taxes. Not long ago, Bill Gates predicted that within five years from

25 percent to 30 percent of all U.S. homes will be connected to broadband services of some sort. That such changes have implications for the viability of the state sales tax should be apparent to everyone who understands the growth and potential of electronic commerce. Business analysts with IBM estimate that as much as one-third of the $8 trillion national economy could be conducted electronically within the coming decade. The Internet is not a temporary phenomenon. In short, given the nature of continuing economic trends and the accelerated movement to remote selling, the state and local retail sales and use tax will fail to keep pace with economic activity unless some substantial changes are made in the near term. Absent that, only rate increases are likely to enable the tax to play an increasing role in the state-local finance system

The Federal Role – The Internet Tax Freedom Act

Electronic commerce has been an important component of the national economy since Marconi invented the telegraph and Alexander Graham Bell invented the telephone. Every credit card use involves the electronic transfer of data; the electronic transfer of accounts between banks is another form. No one has ever suggested that there was something so unique about these forms of electronic commerce that the federal government should prohibit the states from imposing taxes on transactions using these forms of electronic commerce.

Nevertheless, Congress enacted the Internet Tax Freedom Act (ITFA) in 1998. This legislation established a three-year moratorium on the state and local taxation of Internet access and "multiple or discriminatory taxes on electronic commerce." The ITFA provided "grandfather" protection for the states that were already applying these taxes on Internet access at the time of enactment. There were four aspects of this legislation that are troubling from the states' perspective:

- The first is that it preempted the states in determining whether Internet access should be subject to state taxation. The sales tax has been a mainstay of the state-local revenue structure for 65 years. For most of that period, Congress had the good sense to not mess with this revenue source. From a federalist perspective, the states should be making the decision about taxing Internet access.
- The second is that it has contributed to the myth that Internet transactions are tax-free. This, of course, is not true. Any seller with a presence in a state must collect the sales or use tax on transactions—in traditional stores, via mail-order, or from its website. Staples has a physical presence in 48 states, and it must collect the sales tax on purchases made by the residents of each of those states. Its affiliate, Staples.com, uses software to compute location-specific sales taxes. Only remote vendors that lack a physical presence in a state enjoy the advantages of not collecting the sales tax when residents of that state make remote purchases.
- Third is the troubling aspect of the vagueness of the definition of Internet access. With all the recent news about proposed purchases and mergers between cable and telecommunications firms, these developments raise the potential for the new firms to become dominant providers of Internet access. Would this be Internet access, cable, or telecommunications service? Would the service provide long distance phone calls, movies on demand, cable TV, movies on demand, and broadband Internet access? Governors believe that Internet content and services should not be exempted from state and local taxes. Governors believe it important for the committee to carefully evaluate the definition of access and maintain the current grandfather for the ten states that have continued their taxes. As we all know, the industry is moving to both bundle services such as television programs, games, books, music, and motion pictures into one fee, as well as to adapt rapidly changing technology.

- The fourth, and most troubling, aspect of the ITFA is what appears to be exacerbating an increasing tendency of Congress to ignore its own house and intrude upon the responsibilities of states. There are multiple bills pending in the House and Senate today to interfere with existing state and local authority, regulations, and current revenues on Internet transactions. There are no comparable bills to limit federal taxes or authority.

Despite a widespread perception that states are fiscally healthy, the speed with which states have been spending down their accumulated surpluses has been stunning. This has been especially sobering because of the number of states that have been forced to tap their reserves in the absence of a recession—especially at a time when the national economy is still growing. Indeed, there is growing evidence that an exuberant national economy covered up structural cracks in state economies in recent years—cracks that are now surfacing. So while the federal government has experienced revenue growth that has far exceeded state revenue growth in each of the last six years, states have, at the same time, been forced to confront structural problems on both the spending and revenue sides. This disparity has been aggravated by a federal misperception and a growing tendency to interfere with the ability of states to restructure their own programs and economies.

Technology convergence and globalization have important implications for the role of states. States are, and always have served as, critical laboratories for the nation. But a common response to this emerging global economy from much of government at the federal level and industry has been to respond with a one-size-fits-all federal fix instead of rethinking how governments can restructure themselves to be flexible, innovative, and responsive in meeting changing needs and expectations of citizens and businesses. This response can create federal authority to set the rules and undercut state and local resources—threatening to erode the flexibility and innovative nature of the states, as well as accountability. Those efforts compromise innovation and reduce responsibility and accountability. They introduce shocks to the system.

Shocks to the system affect state and local economies. They affect the delivery of federal and state programs and services. They affect not just state and local economies, but, inevitably, the national economy and the nation's competitive capacity. Health care in America today is so interwoven between federal and state responsibilities that a shock administered by the federal government to states, intentionally or not, will have immediate and lasting repercussions for the federal government. Similarly, inability to comprehend the structural costs of education to the states over the next decade will have serious impacts in our knowledge-based economy on the U.S. role in the global economy.

What are the States Doing?

The Governors are committed to work differently and that states must work hard to achieve tax reform by striving for equity across industries and reforming state tax systems. Most Governors understand this second task will require more effort and more cooperation among the leaders of Congress and the private sector than the incremental reform initiatives of the past. Key steps states are taking include:

- A year ago, President Clinton signed the Mobile Telecommunications Sourcing Act into law. The effort culminated nearly three years of negotiations between states, local governments, and industry. The new law preserves state and local rates, but it sets common definitions, and, importantly for the wireless telecommunications industry, it sets common rules for state and local taxation in an era where more and more Americans make wireless calls while passing through multiple jurisdictions. The new law slightly reduced revenues in some states and increased it in others. It marked a radically new way for states to do business. The bill passed Congress without a dissent.

- Now the Governors, state legislators, and other state organizations have worked hard on a compromise effort to break the stalemate on taxing retail electronic commerce. At the 2001 NGA Winter Meeting, policy EC-12, Streamlining State Sales Tax Systems, was reaffirmed. The policy calls for joint industry/government development of a simplified sales tax system, including streamlined administration and audit requirements, and uniform definitions of the goods and services that may be taxed. States retain the authority to determine what is taxed and at what rate. The policy establishes incentives for states to streamline and simplify their sales tax systems by calling on the federal government to restore fairness in the sales tax by requiring remote sellers to collect sales taxes for states that simplify their taxes. A minimum level of sales would be established; companies that made sales in the past year above that de minimus level would be required to collect and remit the sales tax to qualified states.

- Last January, the participating states in the Streamlined Sales Tax Project (SSTP) voted unanimously to adopt the multistate streamlined sales and use tax agreement that set the parameters for states to participate in a joint effort to simplify and modernize sales and use tax administration to substantially reduce the burden of tax compliance. Governors are now working with state legislators to set a meeting for the participating states to reach consensus on the requirements for states to join, or be ejected, from a multistate system, a system that provides for uniformity in state and local tax bases, a central electronic registration system, simplification of state and local sales tax rates, and terms for certified service providers. The new system will include a number of uniform definitions, including for food and clothing, and set forth states' policy for the protection of privacy. Since January, 16 Governors have signed streamlined enabling legislation into law.

- The project launched a pilot in four states in November to test the capabilities of tax-collection software under current law. The pilot will provide valuable information about how software programs could be adjusted to conform to a new tax-collection system. The participating states are North Carolina, Kansas, Michigan, and Wisconsin.

A Partnership for Tax Equity and Sovereignty for States in the Digital Age
Governors recognize, Mr. Chairman, that the transformation of the patchwork state and local sales tax system to streamline it for the new economy cannot be accomplished by states alone. The federal government must be a partner in encouraging and providing incentives for this unprecedented undertaking—one that will be far easier to block than enable. For that reason, the Governors strongly support the proposal by Senators Dorgan, Voinovich, Graham, Enzi, and others, S. 512, to provide states with the authority to require remote sellers to collect state and local sales taxes combined with an extension of the Internet Tax Freedom Act. Such changes could provide a far more efficient economy and significantly reduce the burden on sellers. The Governors believe that the 32 participating states in the Streamlined Sales Tax Project have a unique opportunity to work together with you in Congress to enact a twenty-first century sales tax that will ensure states are prepared to support the global electronic marketplace. With estimates that one-third of the $8 trillion national economy could be conducted electronically over the course of the decade, we believe that all parties should compete—as they do under the federal Internet tax system—on a level playing field.

The Governors know that states cannot succeed in this effort on their own, but rather want to work in a partnership with the private sector and the federal government to ensure the flexibility for states to structure a 21st century revenue system that could be the underpinning of this new, knowledge-based economy.

Thank you.

The Streamlined Sales Tax Project’s Agenda

States want to radically simplify and streamline the sales tax
to create significant efficiencies into the new economy and provide a level playing field.

SSTP	Challenge	Timetable
• Initiated at the NGA Annual Meeting in 1999, the project was established in March 2000 • Made up of 30 participating states and 9 observer states	There are more than 7,500 tax jurisdictions in the United States. The Supreme Court has ruled that it is an undue burden for remote sellers to collect taxes, maintain records, and remit taxes to multiple jurisdictions.	• December 2000: participating states voted unanimously to adopt the project model state legislation and agreement • 2001: complete pilot project • 2001: complete recommendations • States begin to enact

How

1. Craft model legislation to be adopted by each state that would modernize sales tax systems by simplifying state and local sales and use tax codes and tax administration processes uniformly across the United States.
2. **Reduce the collection burden placed on remote sellers enough to convince Congress to mandate that remote sellers collect and remit use taxes to states.**

Critical Issues to be addressed

Audit
Exemption administration
Privacy policy
Rounding rules
Vendor compensation
Tax rates
Technology models
Uniform definitions
Uniform rules for bad debts

Next Steps

Although the project's goal is admirable and momentum seems to be building, the real work lies ahead: getting individual states to pass the model legislation that will ultimately come out of the project, getting those states to fashion an interstate agreement on simplification, and getting the legislation to implement that agreement enacted in each of the participating states.