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*A Tax System for an
E-Commerce Economy*

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by Murray Weidenbaum

The growing debate on taxing electronic commerce underscores the obsolescence of our current federal and state tax systems and the need to overhaul them fundamentally. Properly taxing the commerce resulting from rapidly changing technology is a special challenge to a federal form of government with interaction among a national tax structure and 50 state tax systems, which at times can be overlapping and competitive.

Moreover, the problems that result from trying to tax e-commerce by means of traditional revenue sources, notably a transaction-based sales tax, also underscore the continuing shortcomings of the existing tax structure. Thus, the perennial (and accurate) criticism of the convoluted nature of the current Internal Revenue Code is a constant reminder of the need to avoid adding to the Byzantine complexity of federal—as well as state—tax structures.

The current focus on the sales tax to extract revenue from e-commerce also brings up the larger question of how to deal with the major economic inadequacy of the dominant income tax: the heavy tax burden on saving in an economy that generates so little of the saving necessary to finance the nation's investments. If the conventional—and admittedly regressive—sales tax is not up to the task of efficiently collecting revenue from e-commerce, what alternative is available?

That leads us to what I believe is a sensible and effective response—the proposal for a saving-exempt income tax, which is described a little later in this report. Putting aside the intricacies inevitably accompanying any major tax legislation, what is needed is a modern tax system that can relate effectively to the dynamic and global economy of the new century and simultaneously meet the needs of the federal and state governments, while avoiding derailing progress toward a high-tech Internet-oriented society. That's a tall order, and some explanation is required to develop a workable and fair response.

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The Challenge of Taxing Electronic Commerce

Should the tax collector simply ignore the special characteristics of electronic commerce generally and Internet transactions specifically? Surely, trying to subject sales on the Internet to conventional sales taxes will run afoul of all sorts of practical problems, such as taking into account the ability of businesses to shift transactions across state borders and national boundaries. These obstacles to the work of today's sales tax collectors stem in good measure from the continually advancing technology used by this new form of marketing and its complex interaction with numerous governmental rules and regulations.

Using existing income and estate tax experience as a guide, taxpayers could expect a very substantial expansion in the existing regulations issued by the different state tax systems facing companies doing business in a variety of states. It seems unlikely that the various state legislatures will be able to design sales taxes that effectively and fairly cover e-commerce. The standard response—merely adding complexity to the existing tax structure—is neither efficient nor sustainable in the case of rapidly changing technology.

The high-tech community has raised another concern. Taxing business on the Internet during its formative period could reduce the prospects for its ultimate widespread use. Although the “infant industry” argument has been abused over the centuries, it is not totally devoid of merit. In view of the cross-border nature of so much of e-commerce, a race by state governments to maximize their revenues from this new economic activity will be particularly disruptive. It also would expand the role of a tax that falls disproportionately on the poor.

But, we must admit that there is a different way of looking at the question of taxing e-commerce—that is, from the viewpoint of the taxpaying competitors. On reflection, it does seem unfair to base the decision to tax a purchase solely on whether or not it is made through a conventional sales outlet. “Bricks and mortar” retailers do have a point when they object to their electronic competitors facing a lower tax burden. On average, sales taxes generate one-third of a state's total revenues. Therefore, if a rising portion of business transactions is exempt from existing sales taxes, state governments will attempt to meet their revenue needs by taxing other businesses and individuals more heavily. It is cavalier to ignore these concerns.

There is a way out of this dilemma. It requires making a critical examination of the entire governmental revenue structure. The controversy over the tax status of e-commerce provides an excellent opportunity to consider the matter of tax policy in the properly broader light of the future fundamental structure of governmental taxation in the United States. The shortcomings of the status quo in the U.S. revenue system extend far beyond—although they surely include—the ramifications of the growing use of the Internet. Yet, dealing with the fundamental issues turns out to be the most constructive way of answering the question of how to tax e-commerce.

The major shortcomings of the current tax system of the United States include (1) the complexity of the array of federal and state tax structures, (2) the negative effects on the macroeconomy, and (3) the lack of fairness in key components of the tax system.

The Fundamental Question of Tax Reform

Many economists believe that the current composition of our tax system is one of the reasons that the United States is a low-saving economy. In that view, the nation would benefit from shifting the primary focus of taxation to consumption instead of income. That change in the basis of taxation would provide an incentive to increase the nation's saving at a time when the shortfall of domestic saving is generating major repercussions in an increasingly global marketplace.

It is becoming quite clear that the gap between domestic saving and the much larger total of domestic investment is closely connected with this nation's excess of imports over exports. Although the relationships may seem arcane to the average citizen, the fact is that the inflow of foreign funds that finance the trade deficit also help close the investment gap. If we financed more of our domestic investment via domestic saving, we would wind up with a lower trade deficit and we would need a smaller supply of foreign funds.

With a rapidly rising international deficit (the current account deficit for the year 2000 is widely expected to be in the neighborhood of \$400 billion), interest is beginning to focus on ways of closing that gap in a benign manner—that is, to avoid resorting to protectionist measures that would directly curtail imports or to macroeconomic restraints that would generate recession and thus bring down the trade deficit the hard way. The benign approach is to increase domestic saving

and thus reduce this nation's dependence on foreign funds.

Here is where the two seemingly disparate considerations—deciding on the tax treatment of e-commerce and reducing the trade deficit—combine in terms of focusing on a single overriding solution. That single solution is to shift from the current mélange of federal and state income and sales taxes to a comprehensive “top-down” consumption tax. The special kind of consumption tax that is proposed here has been described by a variety of labels—a consumed income tax, an expenditure tax, a savings-exempt income tax, the USA tax, and the Nunn-Domenici tax reform proposal.

Contrary to widespread belief, a top-down consumption tax does not share the common shortcoming of sales taxes. It is not regressive nor does it require the individual taxpayer to pay a tax on each of the multitude of purchases that a typical consumer makes in the course of a year. Moreover, in contrast to the existing income tax system, the proposed alternative would encourage saving because the tax would be levied only on the portion of income that is currently consumed.

States converting their sales tax systems to a top-down consumption tax—and likely combining it with any existing income taxes—would provide a positive message to businesses considering locating within their borders. Such a tax reform would be a clear signal that the state government had opted for a modern type of tax system, one designed to encourage electronic commerce and other innovative forms of economic activity as well as to stimulate business investment generally.

Should the federal government and some states adopt a version of the USA tax, the efficiency benefits would be substantial. Because many states piggyback the collection of their income taxes on the federal tax return, they would have full opportunity to base their revenues on the revised (i.e., net of saving) income data reported to the Internal Revenue Service by their citizens.

A New Basis for Taxation

The most detailed proposal for a “top-down” consumption tax to replace the current federal income tax was offered in 1995 by Senators Sam Nunn and Pete Domenici as the USA Tax (USA refers to the key feature of the plan, the Unlimited Savings Allowance). An analysis of that proposal shows how it also can be an effective response to the specific issue of how to tax e-commerce.

The basic economic rationale for exempting saving from the income tax is that to do so en-

courages thrift and enterprise. *Saving* sounds so esoteric until you stop to think about it. So many references to saving go on to add the phrase “for the future.” Of course, people save for the future, and for many reasons—ranging from providing for that proverbial “rainy day” to preparing financially for retirement. The economic importance of saving is that it provides the money to invest in a more productive and competitive economy, with a higher rate of job formation. Under the Nunn-Domenici tax plan, the economic incentive to save is enhanced by relying on a simple and basically positive concept: the basic way to cut a person’s tax—legally—is to save more. In contrast, in order to minimize income tax liability under the current federal tax system, the taxpayer generally has to earn less, which reduces the incentives to work, save, and invest.

Moreover, saving is inherently a positive concept. That money does not sit idle. It works for the saver by being invested in stocks, bonds, and bank accounts—which provide interest or dividends from proceeds of the investments being financed—and in homes that provide shelter over a period of time. In the process of saving and investing, the economy generates the forces that create more production of goods and services, increased employment, and higher living standards. More capital formation will also enhance a nation’s competitiveness in an increasingly global marketplace. All this is why encouraging saving is so important.

The starting point for fundamental reform is the conversion of the traditional federal income tax into a comprehensive consumption tax. This means that the taxpayer deducts all the saving made during the year when reporting taxable income. Using the truism that income equals consumption plus saving (income less saving thus equals consumption), the new savings-exempt income tax structure effectively becomes a tax on consumption.

The Tax on Individuals

The USA individual income tax is a variation of the current income tax—with an unlimited deduction for saving. It differs fundamentally from sales taxes and other “bottom up” types of consumption taxes that are regressive because they focus on taxing each purchase a consumer makes. The proposed USA tax system collects the money owed the government by means of a standard annual tax return. Differential rates on specific products are not permitted, simply because they are not feasible.

In the case of the USA tax, use of a rate table gives the legislature great flexibility in designing the tax. Like the existing income tax, the new tax could be made as progressive as tax writers wish. Alternatively, a single proportional rate can be used, similar to the proposals for a flat tax. Simplicity is attained by eliminating a great variety of special treatments to certain transactions and taxpayers, which are not necessary in taxing consumption on a cash-flow basis.

In contrast to the current individual income tax, the USA version possesses the following unique characteristics:

- It permits a full and unlimited deferral of the portion of income that is saved. No tax is due on “rollover” (i.e., reinvested) capital gains. The tax is paid only when the principal and earnings are withdrawn from savings and devoted to consumption.
- It treats all income equally for tax purposes, eliminating the current differentiated treatment of “earned” and “unearned” income. The distinction drawn is not on the source of income, but between the portion consumed and the part saved.
- It exempts from taxation the consumption out of previously taxed savings (these funds have already been included in taxable income and subject to the current income tax). Thus, a retiree who is drawing down previously taxed savings, accumulated prior to the USA Tax Plan, can live on that savings tax free.

Compared to a national sales tax or a “postcard” form of flat tax, the USA tax would be collected much as income taxes are now, relying primarily on the annual return submitted by each taxpaying unit. A fuller view of the revised individual income tax can be gained by showing how the tax is calculated. The following three steps contain the essence of the plan:

Step 1. Calculate Gross Income

Gross income is the sum of wages and salaries plus financial income such as interest, dividends, and amounts received from sales of stocks, bonds, and other assets. This step is similar to the current procedure.

Step 2. Subtract Deductions

Step 2A. Deduct Exemptions

First deduct a family allowance. Second, deduct a standard amount for each taxpayer, spouse, and dependent. This is similar to the current procedure.

Step 2B. Subtract Unlimited Savings Allowance

Deduct the total amount of income saved during the year. Include deposits in savings accounts, purchases of stocks and bonds, and start-up capital contributed to one's own small business. This step, in effect, constitutes the creation of an unlimited Individual Retirement Account, without the current paperwork and restrictions.

Step 2C. Subtract Three Existing Deductions

Deduct home mortgage interest, charitable contributions, and alimony paid. All other current deductions are eliminated, including state and local taxes.

Step 3. Calculate Tax Liability

After making the allowed subtractions from gross income to compute taxable income, the taxpayer applies a new rate table to compute the tax liability. The rates in the Nunn-Domenici proposal are designed to maintain roughly the same tax burden in each income class as is imposed by the current system. Within each class, however, the high savers experience a lower tax and the low savers a higher tax.

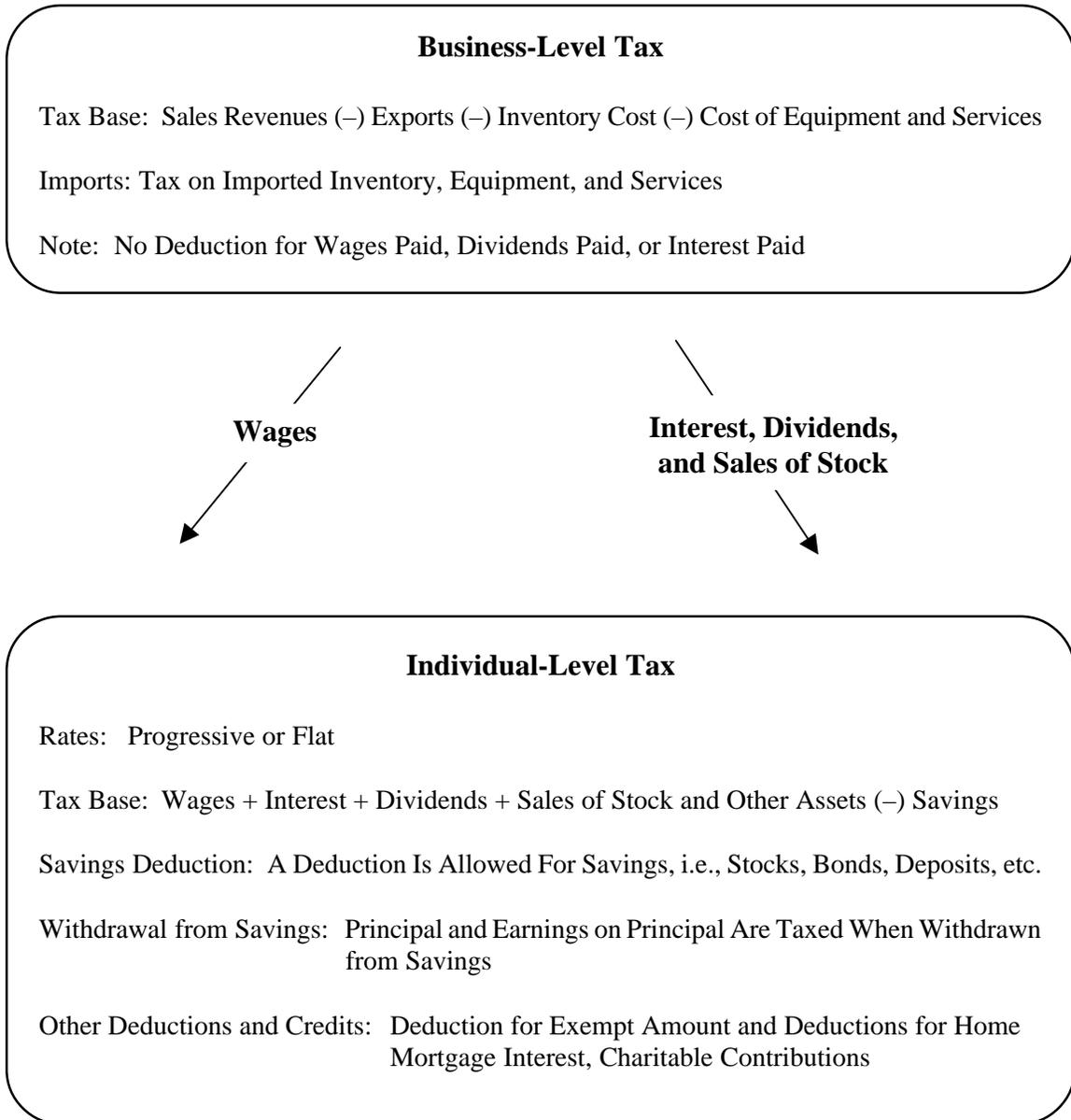
To the typical taxpayer, the USA Tax Plan will be similar to filling out the current IRS annual form (1040). The two big changes are the inclusion of what amounts to a universal but simplified IRA, and using a different rate table (see Figure 1 for the relationship between the individual tax and the business tax under the USA Tax Plan).

The Tax on Businesses

In the Nunn-Domenici USA Tax Plan, all businesses, whether incorporated or not, are taxed at the same flat rate on their annual gross profit. There is no tax advantage in shifting to or from the corporate form or any special version (such as subchapter S corporations).

In calculating its gross profit, a business starts with its total revenues from the sale of all goods and services in the United States. It then subtracts the amount paid to other firms for the goods and services bought from them, including plant and equipment as well as inventory, parts, supplies,

Figure 1
The USA Tax



Source: Adapted from Ernest S. Christian, *The Tax Restructuring Phenomenon: Analytical Principles and Political Equation*, May 1995.

outside services, and utilities.

Immediate expensing of all investments in capital equipment is a substantial simplification compared to the current system. It also encourages investment in durable business assets. Coupled with the new saving incentive contained in the individual income tax, the result is a substantial boost to the entire capital formation process. Financial transactions are excluded from the calculation of gross profits. The business neither includes interest and dividends received nor deducts interest and dividends paid. Furthermore, compensation of employees is not deductible from sales revenues.

This new type of cash-flow on gross profits is superficially similar to a VAT to the extent that both use a tax base of sales minus purchases. However, the business cash-flow tax differs from the VAT in several important respects. First, the tax is intended as a replacement of the corporate income tax, not as in Europe as an additional sales tax. Second, the cash-flow tax lacks the administrative complexities of a VAT, which requires firms to track on an invoice-to-invoice basis the amount of tax attributable to each transaction.

Indeed, the Nunn-Domenici cash-flow tax drastically simplifies the current business tax structure. Firms will devote fewer resources to complying with tax regulations (and to devising creative methods to minimize their tax burden). More resources will be available for productivity-increasing investment. The Nunn-Domenici business tax eliminates bizarre, complicated tax provisions such as the “amortization of intangible expenditures,” a procedure that depreciates purchases of patents, licenses, and other intangibles. Such complicated law contributes to the high costs of tax compliance. The simplifications would particularly aid new and small businesses.

The USA Tax Plan also introduces a new tax treatment of international trade, which is designed to help reduce the trade deficit. Amounts received from exports are excluded from the calculation of gross profit. Correspondingly, a special import tax is imposed on the sale in the United States of goods and services from abroad. Thus, a foreign business that manufactures outside the United States but sells its products in the U.S. market will pay the import tax.

In tax parlance, the USA business tax is territorial. Businesses do not include in gross profits the proceeds from sales made or services provided outside the United States and they cannot subtract amounts paid for the purchase of goods or the provision of services outside the United

States. Nor will businesses be taxed on dividends paid by foreign subsidiaries. Foreign businesses include in reportable gross profit only the amounts they receive for goods and services provided in the United States.

Analysis of Impacts

The United States uses consumption taxes to a far lesser degree than most other developed Western nations. Economists have offered several basic justifications for shifting the primary base of taxation from income to consumption in an effort to achieve greater equity as well as economic efficiency. Consumption-based taxes put the fiscal burden on what people take from society—the goods and services they consume—rather than on what they contribute by working and saving, as do income taxes.

In the nineteenth century, classical economist John Stuart Mill made this point in advocating the exemption of saving from taxation. Mill contended that the only “perfectly unexceptionable and just” principle of income tax was to “exempt all savings.” In the 1940s, American economist Irving Fisher argued that the income tax involved double taxation of saving and distorted the choice of individuals in favor of consumption. Thus, in this view not only is the income tax unjust, but it encourages consumption and leisure at the expense of thrift and enterprise. People should be taxed on what they take out of society’s pool of resources, not on what they put into it.

The U.S. Treasury actually proposed a “spending tax” in 1942 as a temporary wartime measure to curb inflation. The proposal was quickly rejected by Congress. Economist Nicholas Kaldor suggested an “expenditure” tax in 1955. A major argument against such a tax, then and now, is that the exemption of saving favors the rich, since they are better able to save large portions of their incomes. Some believe that this would lead to great concentrations of wealth in the hands of a few. Proponents of a “top-down” consumption tax (one, like the USA tax, that is based on an annual taxpayer return) respond that it can be made as steeply progressive as desired. The recent trend in income taxation in the United States has been away from progressive and toward a flatter, more proportional revenue structure.

Under a consumption-based tax system, saving — and investment — is encouraged at the

expense of current consumption. Over a period of time, society is likely to achieve higher absolute levels of both saving and consumption because the added investment, by generating a faster-growing economy, will lead to a bigger income “pie” to be divided among the various participants in economic activity.

It is useful to note what is absent from the USA tax. It does not select any specific sector of the economy to receive especially favorable tax treatment through traditional loopholes nor does it discourage any category of activity through tax penalties. Thus, the proposed tax code is far more neutral than the present system. An added benefit is the simplicity of the resultant tax system. All this should be particularly welcome to new high-tech companies and to small firms generally.

By making saving generally deductible from gross income, there is no need for the paperwork and other overhead expenses now required to establish and maintain IRAs, Keoghs, SEPs, and other “tax favored” accounts. Nor need the taxpayer be concerned with staying within the arbitrary limits now required under these specialized savings incentives. Moreover, consumption-type taxes do not require complicated corrections for inflation because the tax base is inherently based on current cash flows.

Similarly, by expensing all real investment, the taxpayer no longer has to estimate the useful life of assets or choose from an array of complicated depreciation systems. Also, there is little incentive to fuss with the conversion of ordinary income into capital gains because only the income actually consumed winds up in the tax base. Tax is deferred on capital gains, dividends, interest, and other forms of income that remain in the pool of savings.

Likewise, because interest and dividends are subject to the same tax treatment, there is no longer any tax incentive to leverage a company’s financial structure or to convert dividend payments into interest payments. The result will not be an end to the current merger and acquisition boom. Rather, business decision makers will make such choices on the basis of underlying economic advantage rather than responding to tax considerations.

The fairness of a tax system, like beauty, is mainly in the eye of the beholder. Economists tend to view the subject in terms of horizontal equity and vertical equity. Horizontal equity is simply

jargon for “equal treatment of equals.” The idea is that taxpayers with similar incomes should generally pay the same tax.

The Nunn-Domenici USA Tax Plan moves to greater horizontal equity in many ways. For individual and family taxpayers, virtually all types of income are treated the same. Likewise, virtually all forms of saving are treated identically. The movement to horizontal equity is even more apparent in the case of businesses, where all enterprises—corporations, partnerships, and individual proprietorships—become subject to a single tax system. Likewise, virtually all capital investment is treated equally, as is the return on financial investment (e.g., interest and dividends).

As for the issue of vertical equity, a progressive rate structure is usually—but not universally—proposed as the appropriate instrument for achieving this aspect of fairness. Some fairly esoteric assumptions underlie the proposition that it is fair for taxpayers with higher incomes to pay a higher *percentage* of their income than do those with lower incomes. A considerable literature is devoted to such questions as the diminishing marginal utility of income as the individual ascends the income scale and the difficulties in making interpersonal utility comparisons.

A significant number of public finance specialists, however, has concluded that the case for a progressive income tax structure is questionable or “uneasy.” That line of reasoning supports a proportional tax system, whereby the government assesses all taxpayers the same percentage of their income. To my knowledge, there is no professional support for the adoption of a regressive tax structure—whereby the upper brackets pay a smaller percentage than the lower brackets. If the case for progressive taxation is “uneasy,” surely the case against regressive taxation remains “easy.” In recent years, support has grown for a proportional or “flat” tax structure. A “top-down” consumption tax can be adopted to fit any of these alternative views of vertical equity.

Conclusion

Even if Congress continues to prevent the establishment of a special federal tax on electronic commerce, it is likely that individual states will attempt to gain revenues from what seems to them to be a new and attractive business source. Many state governors have been urging Congress to pass legislation that would make it possible for the states to tax out-of-state sales. Whether at the state or

the national level, it would be highly undesirable for any new tax to expand the shortcomings of the current revenue structure.

In this spirit, simply increasing the coverage of state sales taxes to include purchases on the Internet would be highly undesirable. Because of the flexibility of e-commerce, the attempt to collect such a tax would increasingly result in enforcement policies that would further complicate an already complex if not Byzantine tax system. Yet, the alternative of selectively taxing one set of retail transactions and not another simply because of the nature of the middleman is patently unfair.

The way out of this conundrum is to see the shortcoming in current efforts to tax Internet transactions as part of the broader need to overhaul and modernize the nation's tax structure. Substitution of a "top down" consumption tax for the existing array of income and sales taxes would simultaneously deal with the specific question of Internet purchases as well as the broader concerns of enhancing the economic impact and the fairness of the American tax system.

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