

INTERNET SALES TAXES AND LOCAL GOVERNMENT REVENUE

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August 15, 2005  
Public Policy 101 Final Paper  
Tracy's Tuesday Section

## **Executive Summary**

Internet Sales are growing at an astonishing rate but the Supreme Court ruling *Quill vs. North Dakota* and the Internet Tax Freedom Act prevent states and local governments from being able to tax interstate online sales. The losses projected from these sales are substantial, as high twenty billion dollars. This loss in tax revenue impacts funding for local services such as police and fire departments and could ultimately corrode the power of these smaller governments.

This paper evaluates the five common policy alternatives to alleviate these problems and finds that the national flat-tax on internet sales provides the best policy outcome of the proposed plans. The other plans include the present moratorium, internet taxation based on the residence of the purchaser, taxes based on the location of the seller and a complete ban on all sales taxes. These policy alternatives are evaluated by applying criteria regarding revenue to state and local governments, equity between physical and electronic stores, technological difficulty, political feasibility, privacy concerns and economic efficiency.

The evaluation finds that the moratorium while attractive due to it's lack of major technological, privacy, political or economic problems is unable to address the vital issues revenue to government and equity between "brick and mortar" and virtual retailers. The residence based tax has large privacy, technological and economic problems but recoups nearly all of the lost taxes, encourages equity and is moderately politically feasible. Taxes based on the location of the retailer do little to provide additional revenue or equity but there simplicity allows them to avoid the technological, economic and privacy issues which plague residence based taxes. Complete elimination of the sales tax, decreases revenue and it politically infeasible but allows for stronger economic efficiency than any other program and has no privacy or technological problems. The recommended flat tax improves revenue and retailer equity but does complete address either. It has no privacy or technological problems but has minor economic inefficiencies.

## **Introduction And Information**

The rising number tax free of online purchases has effected revenue to state and local governments and this dearth of funds is impacting their abilities to provide local services. Services whose effective may be compromised by these lost funds include fire departments, police forces and schools (Matthews 11). This paper will examine methods of restoring these funds by altering the mechanisms for collecting sales taxes from internet companies, local merchants or both. These possible solutions will be analyzed by balancing a variety of concerns and criteria from both economic and social perspectives. Ultimately, this report will conclude that a national flat sales tax is the preferred alternative to restore government revenue while minimizing these social and economic problems.

Over the past few years, use of the internet for purchases has experienced an unprecedented growth in magnitude. Economist Austan Goolsbee, the author of, "In A World Without Borders: The Impact of Taxes on Internet Commerce", writes that the growth rate of internet commerce has exceeded even the growth in the number of Americans with internet access. Dr. Goolsbee cites Jupiter Communications data collected in 1998 which indicates an annual growth rate in internet shopping of 300% (Goolsbee 2). The Institute for Policy Innovation projects that by 2004 there will be 49 million households in the United States shopping online and these households will be spending an average of \$3,738 (Matthews 2). Interstate internet and mail-order sales may not be subjected to sales taxation due to the recently renewed Internet Tax Freedom Act and a Supreme Court ruling, *Quill vs. North Dakota*. For the next few years, online spending will remain a relatively small but significant portion of total national retail sales, between 2% and 6% (Matthews 1). However, the National Governor's Association and the U.S. Conference of Mayors estimate that state and local governments suffer losses between 10 and 20 billion dollars annually (Wiseman 90).

Today some internet transactions are taxed. The aforementioned Supreme Court ruling *Quill vs. North Dakota* in 1992 requires that retailers have a physical presence known as a “nexus” in a purchaser’s home state in order for that state to collect sales taxes. The Advisory Commission on Electronic Commerce, ACEC, estimates that approximately twenty percent of the dollar value of online sales was taxed under this ruling in 1999 (ACEC 18). It is important to note that no states collect taxes on items sold online by retailers in their states to purchasers in other states. However, when residents of one state enter another and makes purchases in physical establishments, the buyers pay the local sales tax at the local rate and the revenue goes to the local governments. For these “brick and mortar” stores, it would be difficult if not impossible to engage in transactions in any other manner. There are thousands of jurisdictions and hundreds of thousands of retailers in the United States so calculating the taxes owed to each jurisdiction and then transferring the funds to the respective governments would be extremely expensive and impractical. (Lukas 1)

A common misconception about sales taxes is the belief that if a consumer purchases an item outside his home state via mail-order or on the internet, he is not forced pay local taxes. In fact many localities impose “use taxes”, which their residents are supposed to pay for goods purchased elsewhere, including the internet (Matthews 6). Unfortunately for local governments, few residents are even aware of the existence of these “use taxes” and even fewer bother to pay them. Local law enforcement budgets are consistently tight and the costs and difficulty of enforcing “use taxes” are high. As a result, these taxes are generally only enforced when the size of a purchase is substantial enough to warrant the effort.

Today, sales tax is applied to only the sales of physical products and not to consumer services. These services include but are not limited to construction and contracting, health care and transportation (Theirer 1). Today services make up 60% of consumer spending so local

governments have been forced to raise sales tax rates to make up for the dearth in income due to declining consumer spending on product sales (Lukas 1). This particular problem becomes quite important when related to internet commerce since there is a debate over the nature all-digital internet purchases.

Although the majority of online transactions involve physical products which can clearly be classified as physical goods, this is not true of a certain group of “intangible products” or “soft goods.” These products include movies, music and information purchased online for a fee. At first glance many Americans would quickly classify these products as goods but they are actually traditionally considered services (Mattoo 10/11) and would thus be exempt from sales taxes under most states’ laws. These completely electronic products also present their own unique set of taxation difficulties. For these goods, transactions can easily occur across national borders, between moving vehicles and travel through dozens of jurisdictions which might try to impose their own taxes or duties on these “sales”. What’s more, high strength encryption, electronic currency and the ease of forging or hiding data make gathering accurate information about these “intangibles” difficult. These electronic impediments will also render accurate enforcement of pure digital transactions very difficult (Maathius 166). For this reason, the World Trade Organization has imposed a moratorium on custom’s duties on pure electronic goods; this moratorium applies to all WTO member states (Mattoo 1). Fortunately, the market for these electronic goods is relatively small. Even if every good that conceivably be delivered electronically were delivered over the internet, these transactions would account for less than 1% of total world trade (Mattoo 5). Since the technical issues for “intangibles” are very complicated and the approach to this problem would be quite different from the approach to tangible goods problems this paper will not address them specifically in analyzing policies.

## **The Alternatives**

In investigating and attempting to solve this policy problem, there are five policy alternatives to attempt rectify this loss in tax revenue. These alternatives are:

- Continue with the present tax moratorium, which was extended by five years in 2000.
- Introduce a national flat tax on all internet sales which would be redistributed to the states and local governments based on some formula.
- Switch to a tax system where individuals purchasing goods online would be taxed at the rate in their home area and tax revenue would go to local governments.
- Implement a new tax system where businesses are taxed based on their own location, not the location of their customers.
- Eliminate the present state and local sales tax system in favor of other forms of taxation such as property or income taxes.

## **The Criteria**

The purpose of this paper is to examine methods for returning lost tax income to state and local governments. As a result, the most important benchmark for these suggested programs will be the amount of revenue they provide. In 1999, state and local governments received an average of roughly 25% revenue from sales taxes (ACEC 18). A significant decrease in these receipts may cause government services to be compromised and the power of localities diminished.

Another related and very important gauge is the equity of the “brick and mortar” stores and online retailers. This criteria asks if online retailers are able to use a sales tax advantage to take business away from local merchandisers. As mentioned previously, this tax inequality between online and physical sellers exacerbates the tax losses to local governments since Goolsbee’s research shows that a 1% increase in sales tax results in .5% increase in probability of

that area's citizens shopping online (Goolsbee 8). This means that consumers who would otherwise shop at local stores and pay sales taxes to the local government are drawn online by the difference in tax rates.

In analyzing any policy, feasibility must be taken into account. In the case of a policy regarding internet taxation, there are actually two kinds of feasibility to consider: the political feasibility of turning a plan into law and the technological feasibility of the plan actually working. In the case of the former, objections to plans may be raised by politicians and political operators at all three levels of government. In addition, some policies have constitutional or legal issues that would require substantial political effort to overcome and thus make these policies more difficult to implement. Technologically, taxation schemes can require large research and development efforts and might be particularly at risk of inaccurate or incorrect information causing taxes to be sent to wrong place or preventing orders from being processed and sent.

A close but not identical problem to technological feasibility is the economic efficiency of a policy alternative. Many of the proposed policies artificially alter market conditions and thus might cause inefficient or non-optimal outcomes. Schemes which require large technological solutions will often incur additional transaction costs and might have a negative impact on the economy as a whole. Other schemes may be technologically feasible but have a wasteful design or great implementation costs. In addition, some plans, while technologically simple contain other mechanisms which cause them to have negative economic impacts.

Lastly, some policies may require personal information be collected and provided to government entities or third party businesses. Other programs may force retailers to engage in activities which compromise the privacy of purchasers. These privacy issues can result in a decrease in trust of online shopping and may be construed as a violation of consumers' rights.

One notably absent criteria from this list, but one which is mentioned quite frequently in

political circles, is whether a policy encourages growth of the “infant internet industry.” This suggestion has several significant problems which cause it to be excluded from this list. One rebuttal to this argument lies in the growth which has already occurred in this industry. Many new companies such as amazon.com and buy.com join older established corporations such as Barnes and Noble and Target as nationally recognized online stores. Another arguments stems from research regarding the economic ramifications of sheltering new industries. Economist Charles McLure demonstrates that “infant industries” can rarely be weaned from policies designed to assist their development once they have “grown” (Wiseman 92). Former Intel executive Andrew Grove stated that he did not see any reason for an internet tax exemption on these grounds (Wiseman 92) and none of the economic or policy analysis works used in this report provide a thorough argument for this criteria.

### **The Outcomes**

The most apparent policy option is to continue with the present trend of not taxing internet sales. This plan was recently extended by congress when the Advisory Commission on Electronic Commerce was unable to reach the supermajority it needed to create a final recommendation. Using a simple majority vote, this commission recommended extending the moratorium for an additional five years (Wiseman 88-91). After some debate, Congress agreed decided to follow the simple majority’s recommendation. This plan’s primary flaw, lies in its inability to provide revenue to state and local governments and the glaring inequity between local retailers and their electronic counterparts. Of course, this plan allows local governments to enforce “use taxes” but the aforementioned problems with these taxes prevent this alternative from seriously providing revenue or creating equity between local and online businesses. This scheme’s advantages lie in its simplicity because it avoids any technological or privacy problems that arise in complicated tax schemes, and it incurs only the slight economic costs related to



having physical and internet retailers operating at different tax rates. At present, the moratorium enjoys a large share of political popularity, but it may lose support as revenue losses to local governments mount.

The NGA supports a taxation scheme in which purchases are taxed at the rate in the buyer's jurisdiction. This option is supported heavily by local politicians but Congress appears considerably less receptive to this plan. Despite the *Quill* ruling, this plan could be made legal because the Constitution allows Congress to permit states to collect interstate taxes. Article I, Section 10 states, "No state shall, without the consent of Congress,...enter into any agreement or compact with another State . . . ." This alternative would exactly equalize tax rates between online retailers and local merchants, and it would dictate that the income to individual localities be exactly the same for online and off-line purchases. Unfortunately, this plan is extremely technologically and economically complicated. It requires mechanisms to calculate taxes in approximately 30,000 jurisdictions (Wiseman 90) for every one of hundreds of thousands of internet retailers. This actions would require significant funding and effort on the part of retailers and governments alike. Additionally, locating and verifying the residence of each purchaser would also require substantial technological effort, result in additional costs and represent a substantial privacy violation.

Another of the proposed methods, suggested by the Cato Institute, is to tax sales based on the location of internet retailers and not residences of the consumers to whom they sell. As mentioned earlier, such a plan would actually mirror the present situation for retail sales in which a buyer traveling from a different jurisdiction pays the local sales tax. On the surface this policy might seem to be a good idea but online retailers would probably just relocate to areas with no or limited sales taxes, making this alternative essentially indistinguishable from the present moratorium. This option has few economic or technical costs and it causes no privacy issues

because any given retailer would simply collect taxes at one rate. However, as retailers flee to areas with lower taxes, it would fail to return revenue lost to the internet in most jurisdictions or normalize competition between “brick and mortar” businesses and online stores. These defects in this plan could be easily realized by politicians so it would probably be met with political skepticism at all levels.

A complete ban on all sales taxes is an interesting but more extreme option which is suggested by Maathuis, Alan Wiseman of the Brooking Institute and the Cato authors Lukas and Thierer. This plan seems to be the easiest way to solve many of the problems created by the difference in tax rates between online and physical stores but it also introduces some insurmountable difficulties. As mentioned earlier in this paper, 60% of consumer spending is on services, not the purchases of physical products (Lukas 1). These statistics mean that governments have been forced to raise tax rates to make up for the lost revenue. Since economists generally believe that low but broad taxes are most economically sensible, the mere existence of sales taxes create some economic inefficiency (Thierer 1). This plan would completely resolve the tax inequity between physical and internet businesses as no taxes would be collected from either. Without the collection and auditing necessities of other alternatives no technological hurdles or privacy concerns arise. Unfortunately, this plan creates an even larger revenue shortfall for local governments since absolutely no sales taxes would be collected. This policy also raises federalism issues which would prevent it from being easily politically implemented. Under this plan, the federal government must force state and local governments to discontinue all sales taxes and use other means of taxation such as income and property taxes. Such a law is probably unconstitutional as it violates the principles of federalism. Even if this proposal were legal, it would undoubtedly encounter strong opposition from almost all nonfederal elected officials making its passage and the political futures of its proponents dubious.

The recommended policy alternative is the implementation of a flat sales tax such as Senator Holling's proposal in which the federal government collects a 5% tax on internet purchases and redistributes the funds to the state and local governments based on "some formula" (Matthews 8). This formula would undoubtedly be statistically complex and deal with the number of purchases made by residents of certain areas, but it would not require an exhaustive count of the sales to specific jurisdictions because these numbers could be easily and cheaply approximated. Although any taxation proposal might appear politically infeasible, Congress is did only approve the temporary moratorium, not the permanent ban advocated by Representatives Wyden and Cox and Senator McCain (Wiseman 90), indicating that Congress remains open to passing a tax on internet sales. Additionally, Congress routinely passes laws which revolve around complicated formulas, most notably the formula used to calculate the number of House seats allocated to each state. History shows that it would not be overly difficult to pass such a law. Perhaps the strongest argument for this method is that it has fewer and less pronounced problems than the other alternatives. This proposal would be technologically simple since retailers would simply send some fixed percentage of their total sales to the federal government. No tracking or complicated region specific calculations would be involved. Likewise consumer information is not needed to calculate local tax rates, so there are no privacy concerns. Of course as with any form of taxes, there would be some economic inefficiencies due to tabulation process and the hiring of federal auditors and bureaucrats to distribute the funds. However, compared to the inefficiencies of other plans these are relatively small expenses. Of course, this tax would not completely make up for the loss of revenue to all governments since sales taxes vary widely from region to region. In some areas, local merchants would have tax advantages and in others internet stores would have tax benefits. However, a rate for the flat tax could be chosen so that on the national level, local stores and their online

counterparts pay the same average taxes. Such a national tax rate might also encourage state and local governments to adjust their rates toward the internet rate, making difference between physical and online retailers less pronounced.

### **Concluding Remarks**

The United States is a nation with tens of thousands of different taxable jurisdictions, and 6,400 different possible sales tax rates (Goolsbee 6) so any tax system which requires taxes to be distributed based on residence would be extraordinarily difficult to implement and error prone. If we continue with present trends, the dollar value of untaxed sales will continue to increase resulting in larger declines in state and local government tax revenue while continuing inequality between “brick and mortar” and online businesses. Other plans such as taxing the businesses based on their physical location instead of the residences of their customers or eliminating sales taxes altogether do little to recoup these revenue losses. Of the present proposals, the only one which returns revenue to these governments while maintaining economic efficiency, technological and political feasibility and avoid privacy violations is a nationwide flat-tax on internet sales. While such a system is imperfect, it allows fair competition between local and internet retailers on a nationwide basis and provides local governments an achievable means of receiving revenue which would otherwise escape their coffers.

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