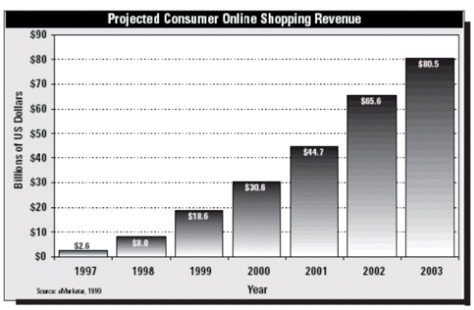
Internet Sales and Government Revenue

Problem: The rise in internet sales has prevented state and local governments from being able to capture sales taxes on goods sold to their residents. This loss of revenue impacts the local governments' abilities to provide vital services to their residents.

Facts about Internet Shopping and Taxes

- ◇ There is an intense debate over the actual loss in revenue to governments as a result of internet sales. Estimates range from $20 billion to a few hundred million dollars.
- ◇ Researchers agree that growth in both internet use and online sales have been very high in recent years. Estimates in sales growth are as high as 300% annually.
- ◇ The Internet Tax Freedom Act (ITFA) was recently renewed. ITFA in conjunction with the Supreme Court ruling *Quill vs. North Dakota* (1992) prevent states from enacting interstate internet sales taxes.
- ◇ The *Quill* ruling requires that mail-order (and thus internet) retailers have a physical presence known as a "nexus" in a state in order for their sales to be taxed.
- ◇ The *Quill* ruling is has lead "brick and mortar" retailers such as Barnes & Noble to spin off separate online companies to avoid making their customers pay sales taxes.

Some Graphs (from IPI)



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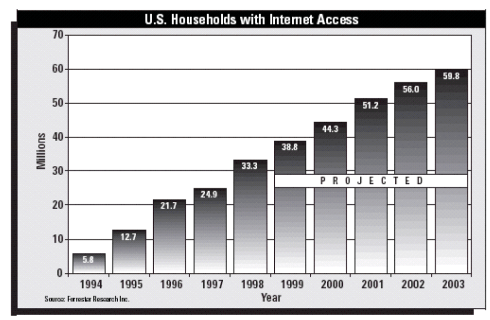
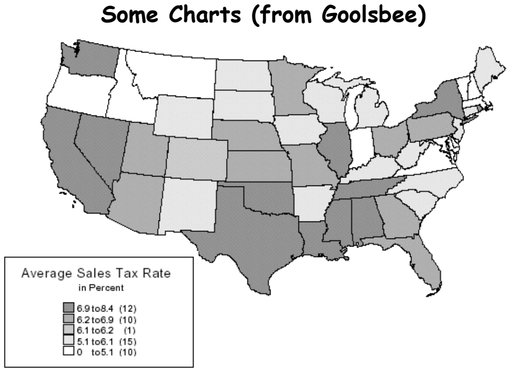


Some Charts (from Goolsbee)



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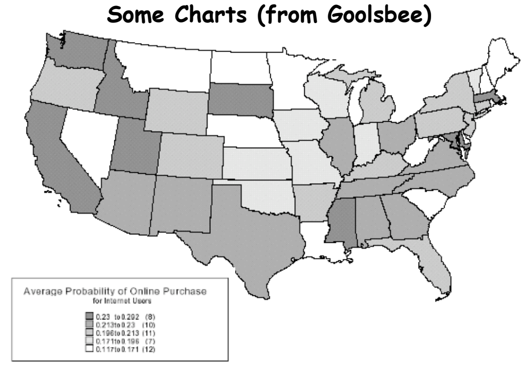

A few more facts

- Localities often have “use taxes”, taxes which are charged to residents who buy goods elsewhere. However, local law enforcement always has limited resources and most residents are not aware of these taxes. As a result, these are very rarely paid.
- Most sales taxes deal only with physical goods, not services. However, US consumer spending has shifted from goods to services over the course of the last century.
- This shift in consumer spending has caused local governments to increase sales tax rates to make up for the loss in revenue.
- A special case for taxation are “intangibles” or completely electronic products. These are traditionally classified as services but governments are trying reclassify them as goods so they can be taxed.
- These “intangibles” are a very small portion of total e-commerce.
- The WTO has already banned member states from collecting customs duties on “intangibles.”
- “Intangibles” create some very difficult enforcement problems, so this report will not attempt to address “intangibles” directly.

The Alternatives

These are the five most commonly mentioned alternatives in scholarly works.

1. Maintain the present moratorium on internet taxes (ITFA).
2. Implement a national flat tax on all internet sales, redistribute revenue to the states using “some formula”.
3. Devise a system in which internet sales taxes are the same as the taxes in a purchaser’s area of residence and paid to those local governments.
4. Tax purchases based on the location of seller. Local governments would collect taxes from the internet businesses located inside their jurisdictions.
5. Completely eliminate sales taxes for both online and physical merchants and use other methods to collect revenue.

The Criteria

1. Increased Revenue: To what extent does the alternative recover revenue lost to internet sales?
2. Equity Between Retailers: Is the system “technologically neutral”, that is, are online retailers given an advantage over their “brick and mortar” counterparts?
3. Privacy: Does this plan require governmental bodies or companies to have access to personal information?
4. Technological Feasibility: Does the alternative require complicated technological mechanisms to implement?
5. Political Feasibility: How easy would it be politically and legally to implement this program?
6. Economic Efficiency: Does a particular plan place a large fiscal overhead on transactions? Are there costs that could make implementation expensive?

Alternative #1: The Moratorium

1. It is still possible to collect “use taxes” and tax internet transactions within a particular state. However, these generally do not provide much revenue.
2. Online retailers have substantial advantages over their physical counterparts. They avoid sales taxes for most transactions.
3. Since their is no tracking or other government intervention, there are no privacy concerns or technological challenges.
4. At present this moratorium is favored politically but as more revenue is lost to online sales, it may lose political approval.
5. Since there is no tax, this plan causes no extra costs to be incurred on internet retailers. However, there is a slight economic inefficiency because internet retailers may use the tax inequity to draw consumers away from otherwise superior local businesses.

Alternative #2: Residence Based Sales Tax

1. This program compensates localities exactly for the lost sales tax to internet purchases.
2. Local retailers and their internet counterparts pay the same taxes for everything so neither has an advantage anywhere. They are exactly equal from the tax perspective.
3. This program requires extensive tracking of customer locations and a good deal of tax related information would have to be provided to governments or third party tax collectors. These raise major privacy issues.
4. In order to calculate sales tax, a large amount of technology must be developed and deployed. Mistakes would be relatively easy to make.
5. Although it is proposed by the NGA, Congress appears much less responsive to this proposal.
6. The cost of calculating the sales tax, and passing the tax to the respective local governments (30,000 jurisdictions) is very substantial. Even if the process is highly automated, it will still require significant expenditure on technology.

Alternative #3: Retailer Based Taxes

1. Although these taxes appear to increase revenue, they will probably encourage internet businesses to move to low tax areas, making net revenue low in most localities.
2. The taxes on internet retailers are not proportional to the taxes on local companies. Internet retailers can move so they will probably maintain a substantial advantage.
3. Since all retailers in a locality pay a specific tax, this plan has no technological or privacy problems.
4. Politically this plan is probably less feasible than most others. Elected officials realize internet companies would likely follow the lowest taxes.
5. This plan is quite economically efficient. Since taxes are collected only in the locality, there are no major overheads (similar to the overheads seen by physical stores). The same enforcement mechanisms can be used for all sales in a particular jurisdiction.

Alternative #4: Eliminate All Sales Taxes

1. This plan actually decreases revenue substantially to state & local governments.
2. No one pays any taxes so local and online stores are on equal footing.
3. Since no one has to report sales, there are no privacy concerns.
4. This idea is more technologically simple than another other because local stores do not even need a mechanism for collecting sales taxes.
5. This is probably unconstitutional since it would require the federal government to ban sales taxes. Such a ban violates the principle of federalism. Even if this program were legal, it would face fierce political opposition from governors and mayors.
6. This plan is the most economically efficient of all the plans. No one has to put any effort into calculating sales taxes and government does not need to audit sales taxes since there aren't any.

Recommended Proposal: Flat Online Sales Tax

1. Although it does not provide perfect compensation to each jurisdiction this plan does provide substantial revenue to state & local governments.
2. In any given jurisdiction either internet retailers or local merchants may have the advantage. However, the tax rate could be set so there is an equilibrium nationally.
3. Since this plan uses a flat tax, no personal information needs to be gathered and no major technological problems need to be addressed.
4. Of the plans that use taxation, this is the most politically feasible. It is a compromise between the residence based plan tendered by the NGA and the present moratorium.
5. This plan would incur some economic costs. Although individual retailers would not have to spend much money since the tax is a flat rate, the federal mechanisms for collection and distribution have to funded.