Public Service Commission of Wisconsin

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March 27, 2000

TO: Senator Rodney Moen

FROM: Joyce S. Mahan
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RE: Biennial Review of Universal Service Fund Rules in   1-AC-166
         Wis. Admin. Code Ch. PSC 160

This reflects the opinion of the Office of General Counsel and was the basis for the vote by the majority approving the rule language submitted to your committee.

RELEVANT LAW

47 U.S.C. § 254(f)

(f) ...Every telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, in a manner determined by the State to the preservation and advancement of universal service in that State...

Wis. Stat. § 196.218(3)(a)1.

(a)1. Except as provided in par. (b), the commission shall require all telecommunications providers to contribute to the universal service fund.....

47 U.S.C. § 332(c)(3)(A)

(A) ...no State or local government shall have any authority to regulate the entry of or the rates charged by any commercial mobile service or any private mobile service, except that this paragraph shall not prohibit a State from regulating the other terms and conditions of commercial mobile services....

Wis. Stat. § 196.202(2)

(2) A commercial mobile radio service provider is not subject to ch. 200 or this chapter, except a commercial mobile radio service provider is subject to s. 196.218(3) to the extent not preempted by federal law.....

Wis. Stat. § 196.218(3)(e)

(e) ...a telecommunications provider or other person may not establish a surcharge on customers' bills to collect from customers contributions required under this subsection.

QUESTION

Does the surcharge prohibition found in s. 196.218(3)(e), Wis. Stat. constitute rate regulation of commercial mobile radio service providers (CMRS) which is prohibited under federal law?

BRIEF ANSWER

No, the surcharge prohibition is not rate regulation.

DISCUSSION

In its *First Report and Order on Universal Service Issues* (May 8, 1997) the FCC stated that 47 U.S.C. § 332(c)(3)(A) does not prohibit states from assessing CMRS for universal service. It states that universal service contribution requirements are regulation of "other terms and conditions" of CMRS rather than of "entry or rates." This was repeated in the FCC's *Fourth Order on Reconsideration* (December 30, 1997).

In a declaratory ruling case[1] that was appealed to the DC Circuit Court of Appeals[2], the FCC refers to Congressional legislative history and cites a House Report where the meaning of "terms and conditions" was explained[3]. In that report the House Committee states that matters such as "...customer billing information and practices and billing disputes and other consumer protection issues..." are included in "terms and conditions."

While it is true that none of the recent court cases dealt specifically with a state statute that prohibited a surcharge, they did discuss related matters. For example, the DC Circuit Court of Appeals case cites the FCC's interpretation of the "rates charged by" language in 47 U.S.C. § 332(c)(3)(A).[4] The FCC interprets that language to "prohibit states from prescribing, setting or fixing rates."

Additionally, the DC Court of Appeals specifically dealt with the argument that assessment of CMRS providers is rate regulation because it impacts their cost of doing business, which could impact the rates charged to customers. The court stated:

> One might say the same thing about local siting laws or state consumer protection laws. Yet a House Committee cited these laws as examples of the variety of permissible regulation of the "other terms and conditions."....To equate state action that may increase the cost of doing business with rate regulation would, the Commission reasonably concluded, forbid nearly all forms of state regulation, a result at odds with the "other terms and conditions" portion of the first sentence [of 47 U.S.C. § 332(c)(3)(A)].[4]

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[1] *In the Matter of Petition of Pittencrieff Communications, Inc.* (October 2, 1997)
[2] *Cellular Telecomms. Indus. Ass'n. v. FCC*, 168 F.3d 1332
[3] *Pittencrieff* at par. 16
[4] *Cellular* at 1336

It is my opinion that the surcharge statute is not rate regulation since it does not prescribe, set or fix rates. It does not prohibit "the passthrough to customers of the universal service fund assessment." The surcharge statute regulates the billing method, not what may be billed. It only deals with how a customer is billed, not what a customer is billed. Billing practices are "other terms and conditions" and may be regulated by states. CMRS providers have complete freedom to recover the assessment through their rates or to choose not to pass the cost on to customers. The only thing they cannot do is use a surcharge mechanism. If they want to pass the assessment cost on to customers, they must do so through their rates. However, what their rates are is entirely up to them and is not regulated.

E-Commerce in the Context of Declining State Sales Tax Bases

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April 2000

ABSTRACT: This paper extends the quantitative estimates of sales tax revenue losses from electronic commerce in a variety of ways. First, we place the effects of e-commerce in the context of general sales tax base trends, arguing that e-commerce is only one of the factors reducing sales tax bases. Second, we take a forward looking view, estimating both the current losses and the expected losses several years hence. Third, we estimate the revenue-neutral increases in state sales tax rates that will become necessary to offset the base declines. Revenue loss estimates are prepared for every state with a sales tax. Our baseline estimates suggest that e-commerce will cause about $10.8 billion in additional tax revenue losses nationwide in 2003.

Introduction

Much has been said about the importance of e-commerce to state tax revenues, with particular attention to effects that interstate sales have on the ability of states to impose and collect sales and use taxes.[2] Estimates of the state and local government revenue losses for states, at least in general discussions, cover the spectrum from the expectation that state tax bases will be devastated to the contention that tax revenues will actually be increased by an economy that is invigorated by the internet.[3] The differences depend on the perspective taken on issues such as the role that taxes play in allowing the development of e-commerce, the time period analyzed, and forecasts of how rapidly e-commerce will expand. Nearly everyone agrees that the revenue losses-to-date have been relatively limited because e-commerce is still in its infancy. The important question from a policy perspective, then, is how the losses will grow in the near and longer term, since it is future rather than current losses that will be affected by policy decisions and which should be a factor in structuring policy. As with most issues, the probable reality of the revenue implications lies between the purported extremes.

A common assertion by those arguing that tax revenues will increase as a result of failure to impose the sales tax on e-commerce transactions is that the productivity enhancements stimulated by the Internet and electronic commerce will expand the economy and raise all states' tax revenues. A case has been made that new electronic technologies are allowing output quality to rise and production costs to fall (for example, see OECD, 1999). However, the productivity gains are only dependent on tax exemption if there is a network or information externality that requires a subsidy to achieve efficiency. Goolsbee and Zittrain (1999) argued that to the extent that any externalities exist they will be short lived and any tax exemption should also be short lived. It seems hard to imagine that the externalities would remain in the near future (and require subsidies equal to an average sales tax rate of 6.5 percent), given the expected magnitude of e-commerce transactions over the next several years. In the absence of externalities, the non-neutral tax treatment of e-commerce transactions may reduce rather than expand the economy, even though the overall presence of e-commerce expands the economy. If consumer

transactions are taxed differently on the basis of how commodities are obtained, efficiency losses are probable. Efficiency effects of sales and use taxes on business inputs are more difficult to evaluate because reduced taxation of business inputs is generally efficiency enhancing. However, the efficiency effects of exempting business inputs purchased via e-commerce, while taxing many business inputs obtained in other forms, potentially at higher rates, could increase efficiency losses.

This paper seeks to extend the quantitative estimates of sales tax revenue losses in a variety of ways. First, we place the effects of e-commerce in the context of general sales tax base trends, arguing that e-commerce is only one of the factors reducing sales tax bases. Second, we take a forward looking view, estimating both the losses today and the expected losses several years hence. Third, we estimate the revenue neutral increases in state sales tax rates that will become necessary to offset the base declines. Finally, estimates are prepared for every state with a sales tax.

Sales Tax Trends

State sales tax bases have been declining relative to state personal income for many years. For the average sales-taxing state, the tax base equaled 51.4 percent of the state's personal income in 1979, but had fallen to 42.8 percent in 1998 (see Figure 1).[4] The breadth of sales tax bases varied widely by state, from 27.6 percent of personal income in Rhode Island to 109.2 percent in Hawaii.[5] The base does not narrow every year, despite the overall trend. Immediately after a recession and in very strong consumption years like much of the latter part of the 1990s, the base rises as a share of income, but this cyclical pattern must be distinguished from the downward trend.

FIGURE 1—Sales Tax Base as a Percent of Personal Income, 1979-2003
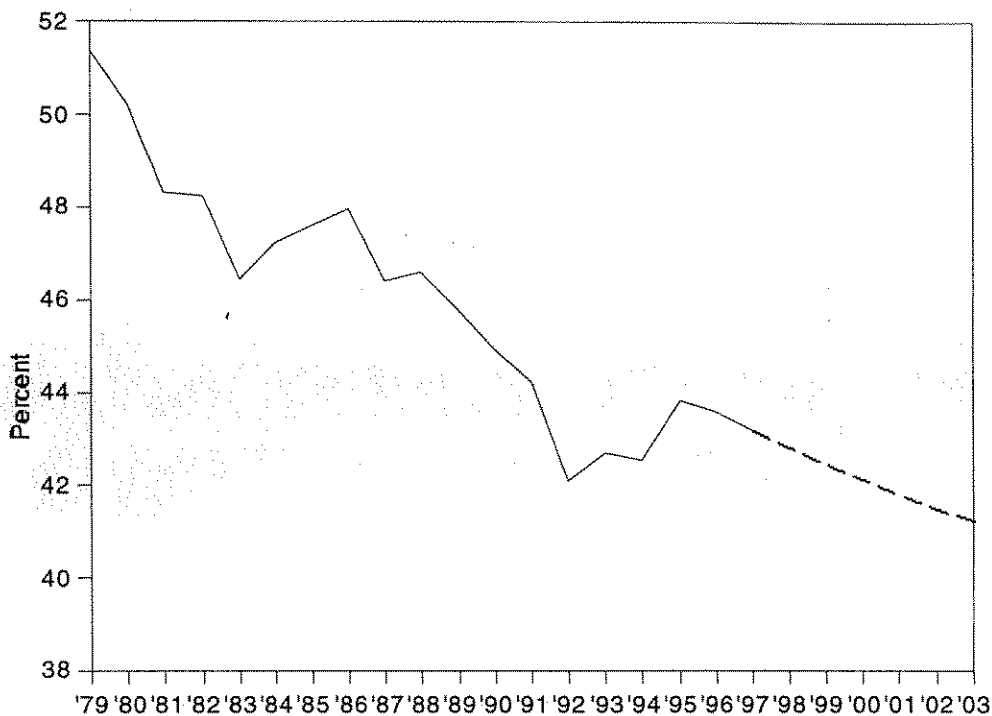
The narrowing of sales tax bases is attributable to three major factors. The first is remote sales, including e-commerce, catalog sales, and cross-state shopping, all of which have been rapidly expanding in recent years. Every state with a sales tax imposes a corresponding use tax on remote purchases, effectively intended to convert the overall tax structure to a destination basis.[6] Thus, to the extent that the base is shrinking because of remote purchases, tax evasion rather than avoidance or re-definition is generally the cause. Administration and compliance costs could be limited through collection of the use tax from vendors rather than buyers.[7] However, the U.S. Supreme Court in Quill v. North Dakota, 112 U.S. 298 (1992) ruled that states could only require firms with physical presence in the state to collect use tax on their behalf. As a result, the use tax frequently relies on voluntary compliance, which is very limited for individuals except for a small set of commodities such as automobiles and boats that must be registered. Use tax compliance is somewhat greater for businesses, but still falls far short of the

legislated burdens. The court's limitation of collection responsibility to firms with physical presence was based on the commerce clause, meaning that Congress has the authority to override the decision through legislation.

The second and perhaps foremost factor is the shift in consumption patterns towards greater consumption of services and less consumption of goods. Services are much less broadly taxed than goods, meaning the base shrinks relative to the economy as services become more prominent. As evidence of this shift in spending, services were 47.4 percent of consumption in 1979 but rose to 58.8 percent in 1998. The implications for base decline would be even larger except that much of the decline in goods consumption has been for food at home, which is exempt in most states.

Third, the continuing process of legislated exemptions has narrowed the base in essentially every state. To be sure, some of the recently legislated exemptions, such as for industrial equipment,[8] are consistent with good tax policy, but they still have the effect of lowering the taxable base. Other exemptions are intended to improve equity, such as the exemption of food for consumption at home and prescription drugs. These equity enhancing exemptions may come at a high price in terms of targeting and of administration and compliance, and improved equity may be better achieved in most states though direct taxes. Still other exemptions are given mostly for political reasons. These exemptions are often for business inputs, which should be excluded from a consumption tax, but they are given in a haphazard fashion that may not be efficiency enhancing. For example, the exemptions are often firm-specific or are very narrowly construed, and can lead to differential taxation within industries.

States have responded to the narrowing tax bases by raising tax rates, though the extent of a causal relationship has not been carefully studied. The median state sales tax rate increased from 3.25 percent in 1970 to 4.0 percent in 1980 and to 5.0 percent in 1990. Seventeen states now have rates at or above 6.0 percent. The rate increases have allowed states to slightly increase revenues as a percent of GDP since 1986. Local governments in 32 states are also permitted to impose sales taxes.[9] A pattern of rate increases appears to have occurred at the local level as well.

Revenue and Efficiency Losses from Sales Tax Patterns

The combined effects of the trend decline in demand for sales taxable commodities and e-commerce are summarized in Figure 2. D_1 is the demand for sales taxable commodities, which in this simple example can be thought of as in-state purchases of goods. Changes in tastes for non-taxed services and development of a non-taxed substitute commodity (through e-commerce) reduce demand for sales taxable commodities, as evidenced by movement of the demand curve to D_2. States lose tax revenue equal to $t_1*(S_1-S_2)$, at the initial tax rate t_1. Based on past patterns, states raise their tax rates to offset the lost revenues, which will reduce the tax base further (evidenced by S_2 to S_3), depending on the price elasticity for sales taxed commodities. States

FIGURE 2—Effect of Sales Tax Base Changes on Tax Revenues

PRICE

$P(1+t_2)$

$P(1+t_1)$

P

D_1

D_2

S_3 S_2 S_1 SALES TAX BASE
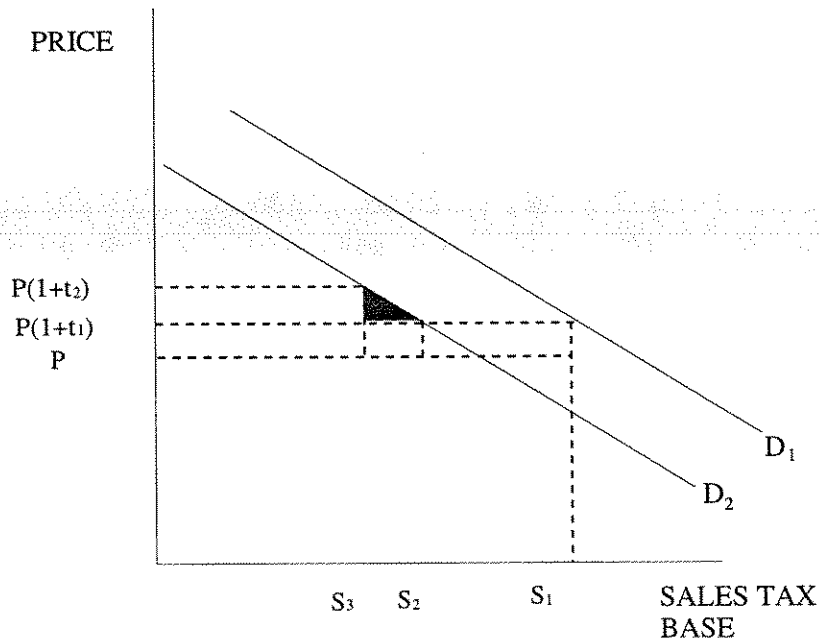
could increase their tax rate to t_2, where the additional revenue from the higher tax rate $((t_2-t_1)*S_3)$ equals the lost tax revenues from fewer taxable purchases $(t_1*(S_1-S_3))$.

Higher tax rates necessitated by both the trend reduction in sales tax bases and the development of e-commerce entail the usual efficiency loss as illustrated by the shaded area. If

the failure to impose sales taxes on e-commerce is viewed as the marginal impact, the share of the efficiency loss from e-commerce is particularly large, based on the well-known finding that the loss depends on the square of the tax rate increase.

Estimates of Revenue Loss

This section presents estimates of sales tax losses from e-commerce in the context of the broader decrease in sales tax bases. To accomplish this objective, we first estimate the trend reduction in sales tax bases that is occurring independent of e-commerce, and then estimate the loss from e-commerce. The focus in this paper is on an estimate of revenue losses for 2003, because the nascent state of e-commerce makes a current year estimate of limited value for policy purposes.

Estimating Trend Decreases in State Sales Tax Bases

The first step in our analysis involves calculating state level estimates of the trend decrease in sales tax bases as a percent of personal income. The process involves arithmetic calculations of state sales tax bases, panel model estimates of the relationship between the tax base and personal income, state by state estimates of personal income growth, and tax base forecasts as a function of the personal income forecasts. The first step, estimation of state sales tax bases, was accomplished by dividing each state's sales tax revenues by its sales tax rate.[10] Then a sales tax base equation was fit for all 45 sales-taxing states plus the District of Columbia, using panel data for 1979 to 1996. The equation was estimated through 1996 in an attempt to find the underlying relationships prior to any effect from e-commerce. Controls in this equation include state personal income and state fixed effects to account for differences across states in the underlying sales tax base and other state specific impacts. The growth in real GDP was used instead of fixed effects for time, presuming that differences across time are heavily dependent on the point in the business cycle. Results of the panel model are shown in equation (1). The key variable of interest is personal income, and the 0.85 elasticity on personal income is consistent with previous findings.[11] The finding of an elasticity below 1 results in the forecast of a trend decrease in the base as a share of the economy, consistent with the pattern generally observed

6

since 1979.[12]

$$\text{ln Tax base} = \underset{(7.96)}{1.94} + \underset{(61.62)}{.85} \text{ (ln personal income)} + \underset{(0.41)}{.097} \text{ GDP growth} \tag{1}$$

$$R^2 = 0.92$$

Equation (1) is used to forecast the state-specific sales tax base for each year through 2003, based on a forecast of personal income for each state. Personal income forecasts were developed using a time series equation for each state, relating state personal income to national personal income and the growth rate in real GDP.[13] The latter was intended to account for any state specific differences in the response to national business cycles. Then, state personal income estimates through 2003 were made based on WEFA's November 1999 forecast for U.S. personal income and growth in GDP.[14]

In Table 1, the tax base as a share of personal income is given for each state for 1996 and an estimate is provided for 2003.[15] All states are forecast to experience a reduction in the tax base during this time period. It should be noted that Table 1 does not include effects from the development of e-commerce. It is these effects to which we now turn.

Revenue Losses from E-Commerce

The revenue losses from e-commerce generally arise because e-commerce significantly expands the potential for remote sales causing a shift from collecting sales taxes at the point of sale to collecting use taxes for goods used, consumed or stored in the state. Compliance rates are much better for sales taxes than for use taxes. Also, use tax compliance, which even before e-commerce was less effective than sales tax compliance, is expected to fall because of e-commerce. There appears to be a feeling, at least among some taxpayers, that e-commerce transactions are free from sales and use taxes. The limited moratorium enacted through the Internet Tax Freedom Act may be one explanation for this misunderstanding. Further, taxpayers who generally comply with use taxes may be less willing to pay because of the perception that others are reducing their compliance. The revenue losses described here are generally the result

Table 1: Sales Tax Base as a Percentage of Personal Income, 1996 and 2003

State	1996	2003
AL	39.9	37.8
AR	64.9	61.7
AZ	47.8	45.3
CA	39.6	37.3
CO	45.1	43.0
CT	36.7	34.6
DC	44.0	41.6
FL	55.4	52.2
GA	56.7	53.6
HI	109.2	102.3
IA	46.4	44.5
ID	51.3	48.8
IL	32.2	30.7
IN	44.3	42.1
KS	48.7	46.4
KY	46.5	44.2
LA	64.7	61.9
MA	29.0	27.4
MD	35.8	33.7
ME	42.3	39.9
MI	47.8	45.5
MN	46.6	44.3
MO	48.1	45.7
MS	55.5	52.9
NC	45.8	43.3
ND	51.9	50.0
NE	43.1	41.1
NJ	29.1	27.5
NM	86.2	81.8
NV	58.4	55.4
NY	34.4	32.5
OH	38.8	36.9
OK	67.2	64.3
PA	32.2	30.5
RI	27.6	26.0
SC	52.6	49.7
SD	65.9	62.8
TN	51.0	48.3
TX	48.7	46.3
UT	61.8	58.9
VA	42.8	40.3
VT	41.6	39.3
WA	49.9	47.3
WI	45.5	43.3
WV	48.0	45.8
WY	71.5	68.9

Source: Authors' calculations.

of tax evasion, not tax avoidance, since the use tax is due even if the sales tax cannot be collected.

State and local revenue losses from e-commerce sales are measured here by estimating the reductions in the sales tax base and then multiplying the lost tax base by the state-specific

effective state and local sales tax rate.[16] Key inputs to estimating the tax base loss for e-commerce transactions are forecasts of e-commerce sales, identification of the sales taxable components of these sales, assumptions about what share of taxable sales could be collected in the absence of e-commerce, and estimates of the share of taxes due that can be collected.

E-commerce sales are drawn from Forrester Research Inc.'s annual forecasts for the years 1999 through 2003 for 24 categories of business to consumer (B2C) sales and 13 categories of business to business (B2B) sales.[17] Forrester anticipates a rapid compound growth rate of 83.7 percent annually through 2003.[18] B2B sales are expected to dominate e-commerce activity, representing 90.3 percent of the 2003 total.

Forrester's forecasts were adjusted to net out purchases by businesses and residents in non-sales-taxing states.[19] The assumption was that the share of e-commerce sales in these states is proportionate to their share of the national population.[20] The remaining transactions are assumed to be made by residents and businesses in sales-taxing states. Sales tax bases differ by state and the categories which Forrester uses are relatively broad, so it was necessary to make assumptions about the percentage of sales for each sales category that would be taxable on average across the U.S. For sales that are expected to occur through e-commerce, major exempt purchases on B2C transactions are for most leisure travel (which includes airline tickets purchased through e-commerce), much of the food and beverage purchases (at least 27 states exempt food for consumption at home), some health and beauty expenditures (medical expenditures are exempt in most states), and a portion of apparel (part of apparel expenditures are exempt in some states). Based on the specific assumptions adopted, 70.2 percent of forecast 2003 e-commerce B2C sales will be taxable. States are assumed to collect about 20.9 percent of the due revenues through either the sales or use tax, based on the assumptions that all liabilities on automobile sales are collected and 10 percent of liabilities on other categories are collected.[21]

Many categories of B2B e-commerce sales are exempt, but the largest categories of expected sales are computing and electronics and motor vehicles. The vast majority of both is taxable. Examples of exemptions in these categories are for custom software and computers used

for research in some states and for computers used directly in the manufacturing process. Paper and office products and pharmaceutical and medical purchases are examples of other categories where many purchases are taxable. In total, 52.5 percent of expected B2B sales are assumed to be taxable, based on reasonable assumptions about what percentage of each of Forrester's categories is taxable.

In some states, certain sales of tangible personal property are taxable but sales of a digital counterpart are not. For example, all states tax pre-packaged software, but 16 states do not tax software if it is downloaded (State Taxation Institute, 2000). No explicit adjustment is made to account for changes in form that alter taxability of transactions, except as assumptions are made about the extent to which certain types of sales are assumed to be taxable. At most one-seventh of e-commerce sales appear to reasonably fit into the category where they might become non-taxable in some states because they are sold in digitized form. (for example, software, music, books, etc.).[22] The resulting estimates are overstated (assuming that states do not alter the tax base to reflect this trend) to the extent that this shift reduces the tax base, but most states could be expected to react quickly to such base erosion and redefine the base to include many digitized sales.

Revenue losses from e-commerce equal taxes due minus use taxes collected. Further, an incremental loss from e-commerce occurs only to the extent that taxes on the transactions would have been collected without e-commerce. These two factors must be combined to obtain the final loss estimate. No precise estimates are available on the extent to which use taxes are being paid on B2B transactions. Discussions with state revenue officials suggest 40 to 50 percent compliance is the current average, except for motor vehicles where compliance should be much better. The baseline estimates used here assume 50 percent use tax compliance for all items, except for vehicles where the compliance rate is 100 percent. This results in a weighted average 65.2 percent compliance rate.[23] This would appear to be an upper bound on compliance for e-commerce sales. Also, the baseline assumption used in this analysis is that 50 percent of the B2B revenue loss and 35 percent of the B2C revenue loss would have occurred even without e-

commerce transactions (because of failure to collect sales and use tax in a non-e-commerce environment).[24]

Based on the assumptions, forecasts of the incremental revenue loss from e-commerce sales are shown in Table 2 for 1999 through 2003. The incremental loss is estimated to be $10.80 billion in 2003.[25] The incremental loss is the amount that would not have occurred without e-commerce, after recognizing the substitution of e-commerce sales for other remote sales.

Table 2: Estimated Sales Tax Revenue Losses from E-Commerce					
(Billions)	1999	2000	2001	2002	2003
Total Business-to-Business[1]	106.59	244.87	486.63	821.80	1,297.80
Less Exempt Sales	-47.54	-105.05	-208.76	-369.81	-616.45
Less B2B on which sales/use tax collected	-34.07	-80.96	-164.77	-281.59	-444.24
Equals B2B Base Loss	24.98	58.87	113.09	170.40	237.11
Less substitution for other remote sales	-12.49	-29.43	-56.55	-85.20	-118.55
Equals Incremental B2B Base Loss	12.49	29.43	56.55	85.20	118.55
Approximate Revenue Loss from B2B	0.80	1.88	3.61	5.44	7.57
Total Business-to-Consumer[1]	19.75	37.79	62.59	98.62	140.19
Less Exempt B2C	-8.32	-15.34	-23.53	-32.74	-41.78
Less B2C on which sales/use tax collected	-1.14	-2.60	-5.51	-10.54	-20.57
Equals B2C Base Loss	10.29	19.85	33.55	55.34	77.85
Less substitution for other remote sales	-3.60	-6.95	-11.74	-19.37	-27.25
Equals Incremental B2C Base Loss	6.69	12.90	21.81	35.97	50.60
Approximate Revenue Loss from B2C	0.43	0.82	1.39	2.30	3.23
Approximate Incremental Revenue Loss	1.23	2.70	5.00	7.74	10.80

1. Sales taxing states only.

Source: Authors' calculations based on E-Commerce forecasts provided by Forrester Research, Inc.

The dominant role that B2B is expected to play in e-commerce sales means that the ability to collect revenues on B2B transactions is very important to the revenue loss for state and local governments. B2B is responsible for 70.1 percent of the expected incremental revenue loss in 2003, with the other 29.9 percent coming from B2C sales. Economists have argued that exemption of B2B sales is consistent with structuring the sales tax as a consumption tax. This could lead some to conclude that loss of revenues on B2B transactions is a good thing. However, exempting B2B transactions acquired through a specific means may not be welfare enhancing. Elimination of the B2B sales from the base should be part of broader policy reform.

State-specific estimates of the revenues lost from e-commerce were prepared based on the 2003 calculations. The distribution between states was approximated based on two factors. First, each state's taxable e-commerce sales were assumed to be proportionate to the state's share of the combined sales tax base for all states. Estimates of each state's sales tax base were drawn from the calculations described in the section on trend base losses. Second, each state's tax base was weighted for the propensity of residents to shop via e-commerce depending on the state and local sales tax rate. Goolsbee (1999) found that each one-percent increase in the sales tax rate led to a 0.5 percent increase in the probability of buying something online. Thus, differences across states in the share of the national loss from e-commerce are a function of the breadth of the states' sales tax base (a determinant of the state's existing share of the combined base), the states' income growth (determining the forecasted growth in the general sales tax base) and differences in state sales tax rates (determining the relative propensity to purchase through e-commerce).

Table 3 lists the 2003 state and local government revenue losses from trend narrowing of the tax base, total e-commerce loss, incremental e-commerce loss, and the total revenue loss. The total revenue loss shown in column 4 is $23.86 billion. This includes trend base erosion and e-commerce losses. An estimated 45.2 percent of the revenue loss comes from incremental e-commerce sales. This is a surprisingly large share, given that the trend sales tax base losses over the past several decades appear to have been driven more by shifts to consumption of

Table 3: Combined State and Local Revenue Losses in 2003 (Millions)

(1) = Revenue Loss Without E-Commerce
(2) = Total Revenue Loss Due to E-Commerce
(3) = Incremental Revenue Loss Due to E-Commerce
(4) = Total Combined Revenue Loss

State	(1)	(2)	(3)	(4)
AL	177.2	269.7	144.8	322.1
AR	113.9	188.6	101.3	215.1
AZ	218.7	341.4	183.4	402.1
CA	1,964.4	2,780.2	1,493.2	3,457.6
CO	167.5	290.7	156.2	323.6
CT	201.5	288.0	154.7	356.2
DC	38.6	55.1	29.6	68.2
FL	1,006.8	1,403.0	753.6	1,760.4
GA	419.6	620.7	333.4	752.9
HI	127.0	158.6	85.2	212.2
IA	82.4	162.7	87.4	169.8
ID	39.9	67.1	36.0	75.9
IL	497.7	844.8	453.7	951.5
IN	202.1	324.6	174.3	376.5
KS	112.3	189.5	101.8	214.1
KY	145.3	238.6	128.2	273.4
LA	239.2	453.9	243.8	483.0
MA	207.6	303.6	163.1	370.7
MD	215.9	294.1	158.0	373.8
ME	56.7	78.5	42.1	98.9
MI	460.7	757.5	406.8	867.6
MN	254.3	408.6	219.5	473.8
MO	243.8	395.0	212.1	456.0
MS	119.9	206.1	110.7	230.6
NC	300.1	444.9	239.0	539.1
ND	17.7	38.6	20.7	38.4
NE	59.4	105.6	56.7	116.1
NJ	360.0	510.7	274.3	634.2
NM	119.8	191.1	102.6	222.4
NV	122.8	191.1	102.7	225.5
NY	1,073.1	1,581.3	849.3	1,922.4
OH	411.4	671.4	360.6	772.0
OK	155.5	298.3	160.2	315.7
PA	427.6	666.8	358.2	785.7
RI	39.5	55.5	29.8	69.3
SC	158.6	231.4	124.3	282.9
SD	33.8	57.7	31.0	64.8
TN	361.1	545.6	293.0	654.2
TX	1,039.5	1,735.9	932.4	1,971.9
UT	91.9	158.2	85.0	176.9
VA	262.6	363.8	195.4	458.0
VT	22.4	31.8	17.1	39.5
WA	422.0	646.2	347.1	769.1
WI	193.5	320.1	171.9	365.4
WV	57.9	104.7	56.2	114.1
WY	16.9	38.5	20.7	37.6
US	13,060.3	20,109.9	10,801.0	23,861.4

Source: Authors' calculations.

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services than by increases in remote sales. The incremental revenue loss of $10.8 billion is shown in column 3. The incremental losses from e-commerce are estimated to range from $17.1 million in Vermont to $1.49 billion in California. The dollar losses are highly correlated with state population (0.98) and the state and local tax rate (0.48).

The incremental loss should not be interpreted as the taxes that states would collect if Congress enacted legislation establishing nexus for firms with economic rather than physical presence. Rather, it is simply the additional effect of e-commerce beyond any losses already occurring from inability to collect sales and use taxes. Column 2, the total e-commerce revenue loss of $20.1 billion, is the estimate of the total revenues from collecting all taxes due on e-commerce transactions.[26] This estimate assumes 100 percent compliance with the sales and use taxes.

The share of total tax revenues that each state loses is a useful way to measure the importance of the loss to specific states. For purposes of this calculation, each state's total tax revenue is assumed to be the same percentage of personal income in 2003 as in 1996.[27] The loss to state governments is given in Table 4 and the loss to local governments is in Appendix Table 1. Note first that, in 2003, the state-level share of the national *incremental* e-commerce loss will amount to 1.52 percent of total state taxes (in sales-taxing states only), while the state-level share of the national *total* e-commerce loss is 2.84 percent and the combined loss is 3.37 percent. These national estimates mask wide variation across states, however. Of course, there is no revenue loss for the five states without a sales and use tax. For the states with sales and use taxes, the incremental (total) loss from e-commerce ranges from a low of 0.90 (1.68) percent of state tax revenues (setting aside D.C.) in Massachusetts to a high of 2.62 (4.88) percent in Texas. The combined loss ranges from 2.05 percent in Massachusetts to 5.83 percent in Florida. The estimated incremental revenue loss as a share of tax revenues is positively correlated with the importance of the sales tax to states' pre-e-commerce tax structures (0.87), the breadth of states' sales tax bases (0.52) and states' tax rates (0.25).

Table 4: State Revenue Losses as Percentages of Total State Taxes, 2003

(1) = Revenue Loss Without E-Commerce
(2) = Total Revenue Loss Due to E-Commerce
(3) = Incremental Revenue Loss Due to E-Commerce
(4) = Total Combined Revenue Loss

State	(1)	(2)	(3)	(4)
AL	1.37	2.09	1.12	2.49
AR	1.81	3.00	1.61	3.42
AZ	1.80	2.82	1.51	3.32
CA	1.87	2.65	1.42	3.30
CO	1.28	2.22	1.19	2.47
CT	1.75	2.50	1.34	3.09
DC	1.06	1.51	0.81	1.87
FL	3.33	4.64	2.49	5.83
GA	2.01	2.97	1.59	3.60
HI	2.67	3.33	1.79	4.46
IA	1.35	2.66	1.43	2.78
ID	1.55	2.60	1.40	2.95
IL	1.74	2.95	1.58	3.32
IN	1.70	2.73	1.47	3.17
KS	1.69	2.85	1.53	3.22
KY	1.60	2.63	1.41	3.01
LA	1.94	3.68	1.98	3.91
MA	1.15	1.68	0.90	2.05
MD	1.77	2.41	1.29	3.06
ME	2.01	2.78	1.49	3.50
MI	1.76	2.90	1.55	3.32
MN	1.75	2.81	1.51	3.25
MO	1.70	2.76	1.48	3.19
MS	2.25	3.86	2.07	4.32
NC	1.34	1.99	1.07	2.41
ND	1.28	2.79	1.50	2.78
NE	1.56	2.78	1.49	3.05
NJ	1.70	2.41	1.29	2.99
NM	2.27	3.62	1.94	4.21
NV	2.82	4.39	2.36	5.18
NY	1.16	1.72	0.92	2.09
OH	1.58	2.58	1.38	2.96
OK	1.77	3.40	1.83	3.60
PA	1.61	2.51	1.35	2.96
RI	1.71	2.41	1.29	3.01
SC	2.07	3.02	1.62	3.69
SD	2.57	4.39	2.36	4.93
TN	3.08	4.65	2.50	5.58
TX	2.92	4.88	2.62	5.54
UT	1.89	3.26	1.75	3.65
VA	1.61	2.22	1.19	2.80
VT	1.81	2.57	1.38	3.19
WA	2.24	3.43	1.84	4.08
WI	1.37	2.27	1.22	2.60
WV	1.54	2.79	1.50	3.04
WY	1.49	3.39	1.82	3.31
US	1.85	2.84	1.52	3.37

Source: Authors' calculations.

States have demonstrated a propensity to raise tax rates to offset previous base reductions, and it is reasonable to expect states to respond to further base narrowing with additional rate hikes. As rates are increased, the sales tax base will be narrowed further as purchasers substitute non-taxable items and use remote purchasing to evade the tax. Sales tax rate increases necessary to replace the lost revenues were calculated for each state and are given in Table 5. Washington (0.91 percentage points) will need the largest rate increase and Wyoming (0.45 percentage points) will need the smallest increase to offset the total base decline (column 4 of Table 3). The tax rate increases are correlated with tax rates (0.94), population (0.47), breadth of the initial tax base (-0.30), and the percent of revenues raised from sales taxes (0.29).

Policy Implications

The sales tax base erosion that is stimulated by e-commerce is part of a downward trend in the tax base that has been underway for many years. However, e-commerce has accelerated the trend that otherwise appeared to have been slowing in the middle 1990s. The revenue loss estimates provided here, totaling nearly $24 billion in 2003, suggest that the combination of the trend decline and e-commerce will significantly alter state tax structures during the next several years unless states increase their sales tax rates. State and local governments will be confronted with several choices: they must either cut expenditures, increase sales tax rates, or shift to another tax source, such as the property or income tax. Each choice has important implications. The effects of the first option, shrinking government, depend on the choices that are made. For example, reducing education and infrastructure spending could lower the economy's growth potential.

If the size of government is not cut, the issue comes down to the way in which state and local governments are to finance themselves. With these decisions goes the full range of implications regarding taxation, including equity, administration and compliance, and behavioral incentives. From a public policy perspective the issue is whether state and local governments are better financed with the triad of sales, property, and income taxes, or whether the sales tax base

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Table 5: Sales Tax Rate Changes Necessary in 2003 to Maintain Constant
Revenue

(1) = Without E-Commerce
(2) = Total Due to E-Commerce
(3) = Incremental Due to E-Commerce
(4) = Total Combined Rate Change

State	(1)	(2)	(3)	(4)
AL	0.40	0.67	0.36	0.76
AR	0.29	0.53	0.29	0.58
AZ	0.38	0.65	0.35	0.73
CA	0.47	0.72	0.39	0.86
CO	0.30	0.57	0.31	0.61
CT	0.37	0.58	0.32	0.69
DC	0.35	0.55	0.30	0.66
FL	0.39	0.60	0.33	0.72
GA	0.33	0.54	0.29	0.63
HI	0.28	0.38	0.21	0.48
IA	0.23	0.50	0.27	0.50
ID	0.26	0.48	0.26	0.52
IL	0.39	0.72	0.39	0.78
IN	0.27	0.48	0.26	0.53
KS	0.31	0.57	0.31	0.62
KY	0.32	0.58	0.31	0.64
LA	0.36	0.74	0.40	0.75
MA	0.30	0.48	0.26	0.56
MD	0.32	0.48	0.26	0.58
ME	0.38	0.58	0.32	0.70
MI	0.32	0.58	0.31	0.64
MN	0.36	0.64	0.34	0.71
MO	0.33	0.58	0.31	0.64
MS	0.36	0.68	0.37	0.73
NC	0.31	0.50	0.27	0.58
ND	0.22	0.52	0.28	0.50
NE	0.29	0.57	0.31	0.60
NJ	0.37	0.58	0.32	0.69
NM	0.34	0.59	0.32	0.66
NV	0.39	0.67	0.36	0.75
NY	0.45	0.73	0.40	0.85
OH	0.32	0.57	0.31	0.63
OK	0.30	0.62	0.33	0.63
PA	0.35	0.59	0.32	0.67
RI	0.44	0.68	0.37	0.82
SC	0.31	0.49	0.27	0.58
SD	0.27	0.50	0.27	0.54
TN	0.47	0.78	0.42	0.89
TX	0.40	0.72	0.39	0.79
UT	0.30	0.57	0.31	0.61
VA	0.27	0.41	0.22	0.50
VT	0.31	0.48	0.26	0.57
WA	0.47	0.79	0.43	0.91
WI	0.28	0.50	0.27	0.55
WV	0.29	0.58	0.31	0.61
WY	0.19	0.48	0.26	0.45

Source: Authors' calculations.

should be allowed to continue shrinking and the focus increasingly shifted toward other broad-based taxes. Replacement of the lost local sales tax revenues with higher property taxes and the lost state revenues with higher income taxes would change the overall revenue mix. In our baseline scenario, the sales tax would fall from 25.1 percent to 22.6 percent of revenues between 1996 and 2003 if there were no rate hikes. In order to recover this loss in a revenue-neutral fashion, the personal income tax would have to rise from 21.2 to 23.2 percent of total taxes and the property tax would have to rise from 30.2 percent to 30.6 percent. These are large structural changes in the short window examined here, and the shifts could be much larger over the next decade.

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Appendix Table 1: Local Revenue Losses as Percentages of Total Local Taxes. 2003

(1) = Revenue Loss Without E-Commerce
(2) = Total Revenue Loss Due to E-Commerce
(3) = Incremental Revenue Loss Due to E-Commerce
(4) = Total Combined Revenue Loss

State	(1)	(2)	(3)	(4)
AL	2.15	3.27	1.76	3.91
AR	1.28	2.11	1.13	2.41
AZ	1.01	1.57	0.85	1.85
CA	0.86	1.22	0.66	1.52
CO	1.36	2.36	1.27	2.63
CT	0.00	0.00	0.00	0.00
DC	0.00	0.00	0.00	0.00
FL	0.15	0.21	0.11	0.26
GA	1.18	1.74	0.94	2.11
HI	0.00	0.00	0.00	0.00
IA	0.10	0.19	0.10	0.20
ID	0.00	0.00	0.00	0.00
IL	0.36	0.61	0.33	0.69
IN	0.00	0.00	0.00	0.00
KS	0.58	0.98	0.52	1.10
KY	0.00	0.00	0.00	0.00
LA	2.34	4.44	2.38	4.72
MA	0.00	0.00	0.00	0.00
MD	0.00	0.00	0.00	0.00
ME	0.00	0.00	0.00	0.00
MI	0.00	0.00	0.00	0.00
MN	0.03	0.05	0.03	0.05
MO	1.13	1.83	0.98	2.11
MS	0.01	0.01	0.01	0.01
NC	1.04	1.54	0.83	1.86
ND	0.25	0.54	0.29	0.54
NE	0.36	0.64	0.34	0.70
NJ	0.00	0.00	0.00	0.00
NM	1.88	2.99	1.61	3.48
NV	0.31	0.49	0.26	0.58
NY	0.88	1.30	0.70	1.58
OH	0.37	0.61	0.33	0.70
OK	1.78	3.42	1.83	3.61
PA	0.04	0.07	0.04	0.08
RI	0.00	0.00	0.00	0.00
SC	0.13	0.20	0.10	0.24
SD	0.81	1.38	0.74	1.55
TN	1.56	2.36	1.27	2.83
TX	0.60	1.00	0.54	1.13
UT	0.84	1.44	0.77	1.61
VA	0.51	0.70	0.38	0.88
VT	0.00	0.00	0.00	0.00
WA	1.15	1.76	0.95	2.10
WI	0.12	0.21	0.11	0.24
WV	0.00	0.00	0.00	0.00
WY	0.59	1.34	0.72	1.31
US	0.57	0.89	0.48	1.05

Source: Authors' calculations.

ENDNOTES

[1] The authors wish to thank Matthew Murray and two anonymous reviewers for very helpful comments on an earlier draft.

[2] See Fox and Murray (1997) for a discussion of various issues surrounding the taxation of electronic commerce.

[3] See Cline and Neubig (1999) and Goolsbee and Zittrain (1999), for examples.

[4] These percentages are weighted averages for sales taxing states.

[5] The combination of Hawaii's broad taxation of consumer purchases and taxation of certain business inputs results in a base that exceeds personal income.

[6] Tax base definitions for the sales and use taxes are very similar (see Due and Mikesell, 1994).

[7] Multi-state vendors would probably experience higher compliance costs associated with collecting and remitting sales and use taxes than single state vendors. However, if the choice is between collecting use taxes from multi-state vendors or from individual consumers, higher costs would be expected for the sum of state governments and all individual consumers than for the sum of state governments and the multi-state vendors.

[8] Today, most states exempt industrial equipment, but machinery is fully taxed in some states, partially taxed in others, and taxed at a lower rate in others.

[9] The Census of Governments reports local sales tax revenues in 32 states.

[10] In some cases Census sales tax data include revenues from sources other than the general sales tax and exclude revenues from special levies normally included in the sales tax. For example, the Washington business occupations tax is included and the Maryland tax on motor vehicles and boats is excluded (see Due and Mikesell, 1994). Also, some states use multiple tax rates. For example, the District of Columbia has a 5.75 percent general tax rate, a 13 percent tax on hotel rooms, a 12 percent tax on parking, a 10 percent tax on food and drink for immediate consumption, and an 8 percent tax on beer, liquor, and wine for off premises consumption. John Mikesell used painstaking means to develop a more accurate data series on sales tax bases for 1995-1998, and has graciously provided the data for this study (see Mikesell, 2000). Census-derived sales tax bases were adjusted from 1979 to 1996 to match the difference between Mikesell's 1996 data and the 1996 data drawn directly from the Census. It should be noted that this correction only affects the intercept terms for states and not the slope coefficients. No data are available to measure the time trend effects.

[11] For example, see Fox and Campbell (1984) who find the income elasticity varies from 0.15 to 1.0, depending on the category of goods, and Mikesell (1991) who finds the elasticity varies from 0.76 to 1.22, depending on the state.

[12] The personal income elasticity is significantly different from 1.0 at the 0.99 level of confidence. Estimated t-statistics (for the null hypotheses that the coefficient equals zero) are in parentheses.

[13]Correcting these equations for auto-correlation yielded forecasts for state personal income that differed from prior expectations in some cases. Consequently, we used uncorrected results. The coefficient estimates, which are still unbiased and consistent, yielded very similar overall conclusions.

[14]All estimates were corrected for jump-off error in 1996, presuming that the model fails to adequately account for shifts in the tax base during the last two years. Had this correction not been made, the main effect on the empirical estimates provided here would be to more than double the trend decline in base shrinkage without e-commerce. Nonetheless, the primary conclusions regarding the losses from e-commerce are essentially unchanged as a result of making this correction.

[15] Analysts have not separated the sources of sales tax base shrinkage—legislated changes, the shift to services, and increased remote sales—for all of the states. The forecast of continued shrinkage provided here implicitly assumes that the combination of all three factors would remain important. There are practical limits on the extent to which these factors, and particularly legislated changes, can occur, but there is no reason to presume that the aggregate of states is nearing the limits. States have continued to legislate or consider legislating base narrowing. Additional states have recently exempted food from the base (for example, Georgia) and other states have given it serious consideration (for example, Tennessee). A number of states are granting sales tax holidays for clothing, and the list of new exemptions continues.

[16]The estimated tax rate is the sum of the legislated state rate and a weighted average local rate defined as local sales tax revenues divided by the state sales tax base.

[17] Forrester's detailed estimates are proprietary.

[18]Forrester's estimates used in this paper were made prior to the rapid creation by large bricks and mortar based firms of parallel corporations (with very similar names) that operate through e-commerce, and may not have nexus in most states. These developments could result in even faster sales growth. The Boston Consulting Group (2000) has recently estimated e-commerce sales of $2.0 trillion in 2003, versus the less than $1.5 trillion estimated by Forrester, and used in this paper. Forrester recently prepared a new forecast and significantly increased its B2B e-commerce forecast.

[19]The five states without sales taxes, Alaska, Delaware, Montana, New Hampshire, and Oregon, comprise 2.48 percent of the U.S. population.

[20]The percentage could have been adjusted for the expected differences in the propensity to purchase over the internet, but the simple population weighted assumption was chosen as a more conservative option.

[21]As with many of the parameter assumptions used in this study, empirical guidance is either very limited or nonexistent. No studies are available, for example, on use tax collections from individual consumers. The assumption used here is comparable to assuming that consumers randomly purchase from firms that have nexus in states representing 10 percent of the U.S. population. This assumption is of surprisingly little consequence in the calculation of overall

revenue losses. For example, doubling the use tax collection assumption from 10 to 20 percent on non-automobile purchases (or from 20.2 to 29.7 percent on total sales) would only decrease the incremental loss from e-commerce from $10.8 billion to $10.5 billion.

[22] Potentially digitizable B2C categories (software, books, music, videos, and toys/video games) and B2B categories (computing and electronics) make up slightly less than 28 percent of total e-commerce in 2003. Our assumption is that at least half of this represents tangible, non-digitizable goods.

[23] Again, very little analysis of use tax compliance for business to business purchases is available. The State of Washington undertook a study of use tax compliance of registered taxpayers in 1991 and found 19.9 percent non-compliance for the use tax, the highest non-compliance rate of any tax. The Washington study can be expected to understate non-compliance for remote sales, however. Audit rates are generally very low, and normally well below 3 percent (see Due and Mikesell, 1994), and the ability to uncover non-compliance through audit is certainly far less than perfect. Many firms, and particularly out of state firms, may not register for tax purposes. Also, use tax compliance in the study is a combination of compliance on remote purchases (which is probably not as good) and compliance for items purchased with a resale certificate but which are taxable. Further, non-compliance may be expected to grow with e-commerce. Tennessee offers a good example of use tax behavior. Use tax collections were 4.4 percent of 1998 sales and use tax collections, but use tax collections on remote sales were less than 2.3 percent of revenues. Based on Ring's (1999) estimates of the consumer share of the sales and use tax, only about 6.1 percent of taxes paid by business come from use tax paid on remote sales. This suggests either that firms buy few inputs from outside the state or that compliance is relatively low.

[24] The combination of 65.2 percent compliance with the B2B use tax and this 50 percent reduction for previous non-compliance can be interpreted as a combined 82.6 percent "compliance" rate. With this alternative interpretation, incremental revenue losses in column 3 rather than total e-commerce losses in column 2 in Tables 3 through 5 are the relevant indicators of loss to the extent that the additional 50 percent subtraction is seen as further compliance.

[25] The assumptions on compliance and incremental loss were each increased by 10 percent and decreased by 10 percent. This resulted in a range of estimates from $9.8 billion on the low side to $11.8 billion on the high side. Also, as mentioned earlier, doubling the B2C compliance on non-automobile purchases (increasing overall B2C compliance to 29.7 percent) would only decrease the loss to $10.5 billion.

[26] Also, states would collect a somewhat lower amount if Congress created nexus on the basis of economic presence, but with a *de minimus* rule excluding small firms.

[27] To be sure, there has been a slight upward progression in taxes as a percent of personal income. State tax revenues grew from 6.10 percent of personal income in 1979 to 6.53 percent in 1996 and local tax revenues rose from 3.94 percent to 4.22 percent during the same time period. If revenues continue their upward trend, the revenue loss estimates will represent slightly smaller shares of total state taxes.

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**Week of
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Editorial

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Comment

No Internet tax means more taxes elsewhere

On Internet Taxes Tom Somodi

Any business person who believes you can have something for nothing has probably not been in business very long. Yet this is what proponents of a "no Internet sales tax" policy would like you to believe.

The idea of no sales tax on Internet commerce sounds great. Just don't ask the question of how state and local governments will fill the void created from lost revenues. It's an amount projected to be as much as $15 billion in the year 2003, according to a December 13, 1999 article in The Industry Standard.

Of course, most American business people know such a shortfall is unlikely to be offset by a reduction in government spending. Instead, history tells us the shortfall will be compensated for through a different set of taxes. Given the political climate and robust economy, the most likely shift will be to business income and property taxes.

So what is the net result? A reduction in the consumer based sales tax for an increase in business-based taxes.

While a "no Internet sales tax" policy will definitely create a reallocation of resources, it unfortunately will probably yield no real overall net dollar benefit. Of course, this immediately leads to the next question. Is there an overall benefit through the reallocation of resources that will occur?

It seems most people agree that the current "no Internet sales tax" policy favors heavily funded national and offshore Internet business enterprises that distribute nationally via a handful of strategically

placed distribution centers. In other words, the current reallocation of resources creates a disadvantage for business operations with a local presence. It is estimated that consumers spend 80 percent of their money locally. It is not surprising that a January 2000 USA Today/CNN/Gallup Poll showed 65 percent of the respondents indicated that people should be required to pay the same sales tax for purchases made over the Internet as they would if they had bought items in person at a local store.

That's right. Even the average American consumer recognizes there is no long-term advantage to a "no Internet sales tax" policy. Instead of penalizing local businesses and merchants with an arbitrary government influenced policy, Internet commerce and ultimately business and consumers will be better served through a standardize method of sales tax on Internet commerce.

Let's be real. These taxes will be collected one way or another. We should seize this opportunity to create a simplification and standardization in the sales tax systems among the various taxing authorities. Internet commerce is the wave of the future because it has inherent cost saving advantages, is convenient and expands the opportunities of choice to the consumer. A policy of no Internet sales tax provides a competitive advantage to a few businesses that can capitalize off of a specific organizational structure while hurting many businesses and merchants providing service at a local level.

The old adage still holds true. There is no such thing as a free lunch, and you cannot get something for nothing through a "no Internet sales tax" policy.

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CRS Report for Congress

Received through the CRS Web

Internet Transactions and the Sales Tax

Updated May 3, 2000

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ABSTRACT

The purpose of this report is to describe state sales and use taxes and the potential effect of Internet transactions on the administration and revenue generation of the tax. Pending legislation will not be reviewed in depth. Topics covered include state and local tax rates, state tax base, efficiency and equity of differential sales taxes, and sales tax revenue data for the fifty states and the District of Columbia. The moratorium on new Internet taxes as part of the Internet Tax Freedom Act of 1998 (ITFA) is discussed briefly as is the proposed extension and expansion of the legislation. The Advisory Commission on Electronic Commerce, formed as a part of ITFA, is a source of additional information on the taxation of electronic commerce. This report will be updated as legislative events merit.

Internet Transactions and the Sales Tax

Summary

The creation and subsequent activities of the Advisory Commission on Electronic Commerce has focused attention on the issue of Internet taxation. The debate generally focuses upon the administration of the sales tax and electronic commerce. Under present law, interstate vendors that do not have 'substantial nexus' in the state of a purchaser's residence are not required to collect the sales and use tax on Internet transactions. In most cases, the state requires the purchaser to voluntarily remit a use tax to their home state. However, voluntary compliance with this requirement is quite low. Thus, states feel that the growing share of Internet transactions relative to traditional retail transactions will lead to a deterioration of their tax base and thus revenue. This report examines the sales and use tax in general, provides state by state sales tax revenue reliance estimates, and lists state and local sales tax rates. This report will be updated as legislative events merit.

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List of Tables

Internet Transactions and the Sales Tax

Introduction

This report serves as an introduction to the economics of the sales and use tax and the growth of electronic commerce. Presently, forty-five states (and the District of Columbia) require that retail outlets add a fixed percentage to the sales price of all taxable items (inclusive of federally imposed excise taxes). In addition to the states, there are numerous localities and special taxing jurisdictions comprising an estimated 6,400 different sales tax rates in the United States.[1] For transactions physically taking place at the store or retail outlet, collection of the sales tax is straightforward. The vendor simply applies the appropriate tax rate. However, with the expanding acceptance of the Internet as an alternative to traditional retail transactions, the collection of the sales and use tax has become an issue of significant importance to vendors, sub-national governments, and consumers.

There are currently seven bills addressing the taxation of Internet based commerce awaiting congressional action.[2] Three of the bills would extend the moratorium (generally for five years after the current moratorium expiration in October of 2001) on multiple or discriminatory taxation of internet sales: S. 2255 (McCain), S. 2028 (Wyden), and H.R. 3709 (Cox). A fourth bill, H.R. 4267 (Hyde), extends the moratorium and incorporates most of the recommendations of the Advisory Commission on Electronic Commerce. Yet another bill, H.R. 3252 (Kasich and Boehner), makes the moratorium permanent. A sixth bill, S. 2401 (Gregg and Kohl), codifies nexus standards which are currently defined primarily by Supreme Court rulings. And a final bill, S. 1433 (Hollings), introduces a federal sales tax of 5% on all Internet and mail order sales. The proceeds from this tax would be collected by the federal government then redistributed to the states by an apportionment formula loosely based on population and poverty rate. For a more in-depth review of pending legislation, see CRS Report RL30412, *Internet Taxation: Bills in the 106th Congress.*

The first section explains the operation of the sales tax from the tax administrator's point of view. The second section provides an overview of the economic aspects of sales taxes and how Internet transactions, or 'Internet taxes,' have changed the role of the sales tax in state and local government finance.

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[1] Goolsbee, Austan and Jonathan Zittrain, "Evaluating the Costs and Benefits of Internet Transactions," *National Tax Journal*, vol. 52, no. 3 (September, 1999) p. 413-428. In addition, research by *Vertex Inc.*, a private company that collects and sells jurisdiction tax data to vendors, found that over the last six years an average of 639 jurisdictions implemented tax rate changes a year.

[2] The probability of additional bills being introduced after the publication of this report is relatively high.

The Administration of the Sales and Use Tax

State and local governments that impose a general sales tax on transactions typically calculate the tax as a fixed percentage of a retail good's purchase price. In theory, the sales and use tax is seen in part as a benefits received tax on businesses and consumers for state and local expenditures such as fire protection, road maintenance, education, and police protection. Most states require monthly remittance of the sales tax and often offer discounts to businesses that pay early or have total sales exceeding a given amount.[3] Many states require that vendors with a substantial nexus maintain an active sales tax revenue account with the state revenue department.[4]

Sales Tax Pyramiding. However, not all transactions are taxed. Business to business transactions are in some cases not subject to the retail sales tax with the understanding that the purchaser is using the good as an input to production. Including business to business transactions leads to 'pyramiding' of the sales tax. For example, a coffee shop that pays a retail sales tax on the purchase of their wholesale coffee beans, then imposes a retail sales tax on coffee brewed for the final consumer, the total sales tax paid for the cup of coffee would exceed the statutory rate.

In addition to some business purchases, many individuals and organizations are exempt from the sales tax. Entities wishing to claim the sales tax exemption are often issued a certificate indicating their tax-free status and are required to present their verification at the point of transaction. Non-profit organizations, such as those whose mission is religious, charitable, educational, or promote the public health, are often the beneficiaries of sales tax-exempt status.

Substantial Nexus. Out-of-state businesses without substantial nexus in the taxing state are not required to collect state and local sales taxes on transactions involving customers in the home taxing state. The United States Supreme Court has held that a state has no jurisdiction to require a vendor to withhold that state's sales and use taxes unless the vendor has a "substantial nexus" with the taxing state.[5] The residence of the purchaser is not a sufficient nexus. However, the Court has also held that Congress, under its power to regulate interstate commerce, could grant jurisdiction to the states to require the collection of use taxes.

Because interstate Internet transactions do not have the sales and use tax added to their price by out-of-state vendors, Internet retailers and catalogue retailers are thought to have a competitive advantage over traditional 'bricks and mortar' vendors who are required to collect the tax. The equitable treatment of all vendors is the

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[3] Seventeen of the forty-five states with a sales tax do not offer a vendor discount. A gross receipts tax is similar to a general sales tax.

[4] Generally, substantial nexus means physical presence.

[5] There are two decisions that clarified the taxation of out-of-state vendors. In *National Bellas Hess v. Illinois Department of Revenue* (1967) the court established the substantial nexus argument. In *Quill v. North Dakota* (1992) the court upheld the nexus argument and further specified the physical presence standard for substantial nexus.

objective of many of the proposed changes to the administration of the sales and use tax.

In short, the sales and use tax is collected by vendors if the vendor has substantial nexus in the (non-tax-exempt) purchaser's home state. Usually, the vendor must remit all sales taxes monthly and often receives a discount for timely payment. Or, in the case of very large retailers, a rebate is offered to encourage accurate and timely reporting. If the vendor does not have substantial nexus the *consumer* is required to remit a 'use tax' to their state government. All states with a sales tax also impose a use tax though compliance is very low. Thus, contrary to what some observers say, Internet purchases are not 'tax free.'[6]

The Economics of the Sales and Use Tax

In 1932, Mississippi was the first state to impose a general state sales tax.[7] During the remainder of the 1930's, an era characterized by declining revenue from income and corporate taxes, twenty-three other states followed suit and implemented a general sales tax to compensate for the lost revenue.[8] At the time, the sales tax was relatively easy to administer and could raise a significant amount of revenue with a relatively low rate.[9] Given the relative success of the sales tax, almost all other states added the sales tax to their tax infrastructure by the late sixties. Use taxes are in practice analogous to the sales tax though the tax is on the *use* of the product purchased rather than the transaction. The last of the forty-five states to enact a general sales tax (along with a use tax) was Vermont in 1969.

The revenue a sales tax generates depends upon the chosen rate and the base to which the rate applies. The more narrow the base the higher the rate must be to raise an equivalent amount of revenue. States often have somewhat similar consumption expenditures included in their tax base, however, they are far from uniform. Tax rates also vary considerably from state to state depending in part on their reliance on other revenue sources. Following is a brief economic analysis of the sales tax and the challenges electronic commerce poses for the administration of the tax.

Efficiency. A commonly held view among economists is that a 'good' tax (or more precisely, an efficient tax) is one that does not significantly distort behavior. Broadly speaking, individuals should make the same relative choices before and after

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[6] The much discussed moratorium on Internet taxation applies to any multiple or discriminatory taxes targeted explicitly at Internet retailers. The sales and use tax is not a new tax.

[7] The *use* tax, the companion to the sales tax, was added in 1938. In the early years of the sales tax, states began with general sales then added the use tax to capture revenue from sales made out-of-state. Eventually, states adopting a sales tax included the use tax in the initial legislation.

[8] Fox, William F., ed., *Sales Taxation: Critical Issues in Policy and Administration, Sales Tax Trends and Issues*, by Ebel, Robert and Christopher Zimmerman (Westport, CT: Praeger, 1992), p. 3-26.

[9] The highest rate in 1934 was 3%. At the time the 3% rate was considered quite high.

a tax is imposed. The greater the distortions in behavior, the greater the economic welfare loss.

Products purchased over the Internet, which escape use taxation (i.e., the consumer does not remit the required use taxes), are generally preferred to the products offered at traditional retail outlets that are required to collect the tax. However, if the transaction costs associated with the Internet purchase, e.g. shipping and internet access, exceed the sum of the traditional transaction costs (time and transportation) and the applicable sales tax, the consumer will choose the traditional means of transaction. Note that the shipping costs added to Internet purchases are analogous to the transactions costs associated with traditional 'main street' shopping, not to the sales taxes imposed.

Equity. The sales tax has often been criticized as a regressive tax, or a tax that disproportionately burdens the poor.[10] Assuming the Internet shopper is relatively better off and does not remit use taxes as prescribed by state law, they can avoid paying tax on a significant portion of their consumption expenditures.[11] Those without Internet access at home or work, on the other hand, are not afforded the same opportunity to 'evade' the sales and use tax. In this way, electronic commerce may actually exacerbate the regressiveness of the sales tax, at least in the short run.

Tax Base. In theory, the base of a comprehensive consumption tax should include all income that is not saved.[12] The sales tax, which is often thought of as a consumption tax, is perhaps better identified as a transaction tax on tangible personal property. Most states only tax tangible goods purchased at the retail level. Services, such as legal and medical, are expenditures often omitted from the sales tax base.[13]

Ideally, the sales tax base is broad enough to avoid drastic fluctuations in the revenue stream. Given that state budgets must be balanced annually, a consistent revenue stream is important for fiscal stability engendered by a broad base sales tax. With the shift in the United States from an economy based on transactions of tangible personal property to intangible products and services, the sales and use tax base will continue to narrow.[14] It is then likely that sales tax revenue will also begin to show greater volatility.[15] However, the move from arms-length transactions to Internet

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[10] A regressive tax collects a smaller percentage of personal income as income increases.

[11] Goolsbee and Zittrain (1999) found that the average Internet user had on average two more years of education and $22,000 more in family income than non-Internet users.

[12] A common identity in the economics of income accounting is the following: C=Y-S. Or, consumption (C) equals income (Y) less saving (S).

[13] Only two states tax medical services, Hawaii and New Mexico.

[14] Bruce, Donald and William Fox, "E-Commerce in the Context of Declining State Sales Tax Bases," (February, 2000). Mimeo, University of Tennessee, Knoxville.

[15] States without groceries in the sales tax base, considered a relatively constant expenditure, are more vulnerable to cyclical shocks to the sales tax base.

transactions for services, such as financial, legal, or medical services, does not portend a large loss in state and local sales tax revenue.[16]

Table 1 presents a rough estimate of the *potential* sales tax base for the fifty states, their localities, and the District of Columbia.[17] Unfortunately, reliable estimates of consumption expenditures at the state level are not available. Thus, we offer state personal income in 1998 as a proxy for the potential base of the consumption tax. The last column is the tax rate on unadjusted personal income (in addition to any existing personal income taxes) that would be necessary to achieve the revenue produced by the current state sales tax.

Tax Rate. Sales tax rates low enough to avoid altering consumer behavior create fewer distortions than do high rates. However, state sales tax rates vary considerably as do the local rates piggy-backed onto the state levy. Mississippi and Rhode Island have the highest state sales tax rate of 7%. Oklahoma and Louisiana have the highest potential combined state and local rate of 9.5%. The higher rates in these states create and even larger wedge between those that must collect the sales tax and those that do not. Clearly, residents in the high sales tax jurisdictions gain more from Internet purchases (and tax evasion) than do those in small low tax states.

Table 2 presents the sales tax rates for the fifty states, their localities, and the District of Columbia. Also reported in Table 2 is the reliance on the states on the general sales (and gross receipts) tax (as measured by CRS). The Bureau of Economic Analysis (BEA) also collects data on excise taxes and selective sales. We do not report these receipts because they are typically collected at the wholesale stage, not at the point of retail transaction. For example, the gasoline excise tax is typically paid by the carrier (tanker truck) at the point of collection (the end of the pipeline), not retail sale. Even though gross receipts taxes have more in common with traditional business taxes, the BEA combines them with general sales taxes. Six states, indicated by italics in Table 2, identify their retail sales tax as gross receipts or general income tax. The base of the gross receipts is sometimes broader than the retail sales tax. Depending on the vendor, revenue generated by Internet transactions with out of state purchasers may or may not fall under the gross receipts tax.

Sales Tax Reliance. Based upon our calculations, the states most reliant upon general sales and gross receipts taxes, with over 57% of total revenue derived from the tax, are Tennessee, Washington, and Florida. This result is not surprising: these states do not have a personal income tax. In fact, the top six states in terms of reliance upon the general sales tax do not have a personal income tax.

States without a personal income tax are identified in italics. Alaska is dissimilar from all other states given the absence of personal income taxes and sales and use taxes. States without a sales and use tax are represented in bold. Ordinal rankings in terms of reliance appear in the last column of Table 2.

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[16] According the Boston Consulting Group, sales of financial services were second to sales of computer goods in the first six months of 1998. Goolsbee and Zittrain (1999).

[17] Assuming all states had a uniform base, which they do not.

A permanent ban on sales and use taxes on Internet sales would affect states proportionately to their reliance on the sales and use tax for revenue. States that rely heavily on the sales tax also have generally higher rates which exacerbate the difference between the after sales tax retail price and the Internet price. Alternatively, states with low rates (and in turn less reliance) would tend to have a smaller 'wedge' between the two means of transaction. Returning to the efficiency discussion earlier, residents in the high rate-high reliance states would tend to recognize the greatest welfare loss given their expected change in behavior.

If sales taxes were eliminated entirely, states may turn to an additional tax on personal income to help balance their budgets. Assuming this course of action is pursued, i.e total elimination of the sales tax, Table 1 offers the minimum personal income tax rate necessary to yield equal revenue. The calculation also assumes that all personal income is included in the income tax base.

Conclusion

The Advisory Commission on Electronic Commerce submitted their final report to Congress in early April of 2000. The final report included three recommendations or findings: 1) to close the digital divide, 2) to explore internet privacy issues, and 3) to support making permanent the international tariffs at the earliest possible date. However, the commission did not arrive upon the necessary two-thirds vote for six additional 'policy proposals'. The six 'policy proposals' included a five year extension of the moratorium on multiple and discriminatory taxes and clarification of nexus rules.

Ultimately, eliminating the sales and use tax on a select type of transactions and not others will likely lead to distortions in consumer behavior. These distortions would be minimized by taxing all transactions, regardless of mode, at the same rate (perhaps even zero). Whether this can be achieved with the current sales and use tax structure is an open question.

Table 1. Potential Sales and Use Tax Base of the Fifty States

State (*italics* =no personal income tax) (**bold**=no sales tax)	GSGR[a] State Tax Revenue 1998 ($000's)	Clothing in Base (in 2000)	Groceries in Base (in 2000)	State Personal Income 1998 ($000's)	GSGR Tax as Percent of Personal Income 1998
(a)	(b)	(c)	(d)	(e)	(f)
Alabama	1,570,650	Y	Y	93,566,943	1.68%
Alaska	0	n/a	n/a	15,823,391	0.00%
Arizona	3,050,111	Y	N	108,086,511	2.82%
Arkansas	1,513,673	Y	Y	51,762,820	2.92%
California	21,301,860	partial	N	900,899,903	2.36%
Colorado	1,530,832	Y	N	114,449,124	1.34%
Connecticut	3,031,699	partial	N	123,430,960	2.46%
Delaware	0	n/a	n/a	22,257,563	0.00%
District of Columbia[b]	855,000	Y	N[d]	19,525,661	4.38%
Florida	12,923,644	holiday	N	386,654,430	3.34%
Georgia	3,993,493	Y	N	191,864,830	2.08%
Hawaii	1,425,352	Y	Y	31,268,323	4.56%
Idaho	652,843	partial	Y	25,901,148	2.52%
Illinois	5,596,046	Y	Y[e]	349,029,419	1.60%
Indiana	3,166,706	partial	N	143,362,349	2.21%
Iowa	1,528,824	Y	N	68,719,683	2.22%
Kansas	1,619,246	Y	Y	65,854,217	2.46%
Kentucky	1,981,290	Y	N	84,833,878	2.34%
Louisiana	1,981,231	Y	Y[f]	93,429,786	2.12%
Maine	830,758	Y	N[d]	28,619,679	2.90%
Maryland	2,161,233	Y	Y	154,163,998	1.40%
Massachusetts	2,962,535	partial	N	202,252,119	1.46%
Michigan	7,572,789	Y	N	255,038,802	2.97%
Minnesota	3,243,611	partial	N	130,736,634	2.48%
Mississippi	2,034,804	Y	Y	52,283,212	3.89%
Missouri	2,627,839	Y	Y[e]	132,955,487	1.98%
Montana	0	n/a	n/a	17,826,735	0.00%
Nebraska	919,750	Y	N	41,211,643	2.23%
Nevada	1,771,955	Y	N	47,794,729	3.71%

State (*italics* =no personal income tax) (**bold**=no sales tax)	GSGR[a] State Tax Revenue 1998 ($000's)	Clothing in Base (in 2000)	Groceries in Base (in 2000)	State Personal Income 1998 ($000's)	GSGR Tax as Percent of Personal Income 1998
New Hampshire[c]	0	n/a	n/a	34,625,867	0.00%
New Jersey	4,766,195	partial	N	275,531,478	1.73%
New Mexico	1,454,913	Y	Y	24,753,112	5.88%
New York	7,615,370	holiday	N	575,767,817	1.32%
North Carolina	3,272,774	Y	Y	182,035,666	1.80%
North Dakota	309,139	Y	N	13,854,813	2.23%
Ohio	5,531,207	Y	N	282,920,265	1.96%
Oklahoma	1,328,295	Y	Y	70,469,389	1.88%
Oregon	0	n/a	n/a	81,309,693	0.00%
Pennsylvania	6,313,056	partial	N	322,705,796	1.96%
Rhode Island	525,672	partial	N	26,614,157	1.98%
South Carolina	2,162,858	Y	Y	82,039,415	2.64%
South Dakota	442,549	Y	Y	16,388,045	2.70%
Tennessee[c]	4,027,787	Y	Y	128,244,293	3.14%
Texas	12,474,161	holiday	N	494,543,763	2.52%
Utah	1,277,126	Y	Y	44,297,177	2.88%
Vermont	194,501	Y	N	14,309,450	1.36%
Virginia	2,225,021	Y	Y	186,685,782	1.19%
Washington	6,909,239	Y	N	159,673,674	4.33%
West Virginia	856,276	Y	Y	35,086,721	2.44%
Wisconsin	3,047,406	partial	N	131,546,684	2.32%
Wyoming	335,383	Y	Y[g]	11,169,256	3.00%

Sources: Columns (b) and (e): Bureau of Economic Analysis. Columns (c) and (d): State Tax Handbook 2000. Column (f): author's calculations.

Notes: [a] General sales and gross receipts tax (GSGR). [b] General sales and gross receipts data are from the annual report of the District of Columbia municipal government which is not directly comparable to the other states. [c] Only capital income is included in the personal income tax. [d] Snack food excluded from exemption. [e] Subject to a reduced rate. [f] Exemption is partially suspended. [g] Some snack foods are taxable.

Table 2. Reliance of State and Local Governments on the Sales and Use Tax

State (*italics*=gross receipts tax) (**bold**=no local tax)	State Rate 2000	Total Potential State & Local Combined Rate 2000	Total State Tax revenue 1998 ($000's)	GSGR[a] State Tax Revenue 1998 ($000's)	GSGR Tax as Percent of Tax Revenue	Reli-ance Rank
(a)	(b)	(c)	(d)	(e)	(f)	(g)
Alabama	4	5 to 8	5,734,128	1,570,650	27.39%	37
Alaska	0	0	1,186,235	0	0.00%	47
Arizona	5	5.5 to 6	6,949,270	3,050,111	43.89%	9
Arkansas	4.625	6.125 to 8.125	4,056,582	1,513,673	37.31%	13
California	6	7.25 to 8.25	67,713,433	21,301,860	31.46%	27
Colorado	3	4 to 6.75	5,898,349	1,530,832	25.95%	39
Connecticut	6	6	9,393,604	3,031,699	32.27%	23
Delaware	0	0	1,981,473	0	0.00%	48
District of Columbia[b]	5.75	5.75	2,444,800	855,000	34.97%	16
Florida	6	6 to 7.5	22,513,115	12,923,644	57.41%	3
Georgia	4	5 to 7	11,589,495	3,993,493	34.46%	20
Hawaii	4	4	3,176,246	1,425,352	44.88%	8
Idaho	5	5 to 7	2,057,378	652,843	31.73%	26
Illinois	6.25	7 to 8.75	19,771,284	5,596,046	28.30%	34
Indiana	5	5	9,747,426	3,166,706	32.49%	22
Iowa	5	6	4,802,531	1,528,824	31.83%	25
Kansas	4.9	5.9 to 7.4	4,647,921	1,619,246	34.84%	19
Kentucky	6	6	7,115,149	1,981,290	27.85%	36
Louisiana	4	7 to 9.5	6,082,026	1,981,231	32.58%	21
Maine	5*	5	2,369,820	830,758	35.06%	15
Maryland	5	5	9,190,482	2,161,233	23.52%	42
Massachusetts	5	5	14,488,496	2,962,535	20.45%	45
Michigan	6	6	21,692,742	7,572,789	34.91%	18
Minnesota	6.5	6.5 to 7.5	11,503,928	3,243,611	28.20%	35
Mississippi	7	7	4,343,435	2,034,804	46.85%	7
Missouri	4.225	4.725 to 7.475	8,222,326	2,627,839	31.96%	24
Montana	0	0	1,331,895	0	0.00%	49
Nebraska	5	5 to 6.5	2,633,216	919,750	34.93%	17
Nevada	6.5	6.5 to 7	3,228,206	1,771,955	54.89%	4

State (*italics*=gross receipts tax) (**bold**=no local tax)	State Rate 2000	Total Potential State & Local Combined Rate 2000	Total State Tax revenue 1998 ($000's)	GSGR[a] State Tax Revenue 1998 ($000's)	GSGR Tax as Percent of Tax Revenue	Reli-ance Rank
New Hampshire	0	0	1,008,518	0	0.00%	50
New Jersey	6	6	15,604,971	4,766,195	30.54%	30
New Mexico	5	5.125 to 6.9375	3,574,537	1,454,913	40.70%	10
New York	4	7 to 8	36,154,533	7,615,370	21.06%	44
North Carolina	4	6	13,869,426	3,272,774	23.60%	41
North Dakota	5	6 to 7	1,078,375	309,139	28.67%	32
Ohio	5	5.5 to 7	17,642,836	5,531,207	31.35%	28
Oklahoma	4.5	5 to 9.5	5,300,829	1,328,295	25.06%	40
Oregon	0	0	4,999,091	0	0.00%	51
Pennsylvania	6	6 to 7	20,629,483	6,313,056	30.60%	29
Rhode Island	7	7	1,783,913	525,672	29.47%	31
South Carolina	5	5 to 6	5,683,148	2,162,858	38.06%	12
South Dakota	4	5 to 8	833,662	442,549	53.08%	5
Tennessee	6	7 to 8.75	6,996,120	4,027,787	57.57%	2
Texas	6.25	6.75 to 8.25	24,629,000	12,474,161	50.65%	6
Utah	4.75	5.75 to 7.5	3,457,679	1,277,126	36.94%	14
Vermont	5	5	957,656	194,501	20.31%	46
Virginia	3.5	4.5	10,542,966	2,225,021	21.10%	43
Washington	6.5	7 to 8.6	11,806,170	6,909,239	58.52%	1
West Virginia	6	6	3,011,990	856,276	28.43%	33
Wisconsin	5	5 to 5.5	11,149,754	3,047,406	27.33%	38
Wyoming	4	4 to 6	855,716	335,383	39.19%	11

Sources: Columns (b) and (c): Federation of Tax Administrators. Columns (d) and (e): Bureau of Economic Analysis. Column (f) and (g): author's calculations.

Note: [a] General sales and gross receipts tax (GSGR). [b] General sales and gross receipts data are from the annual report of the District of Columbia municipal government which is not directly comparable to the other states.

CRS Report for Congress

Received through the CRS Web

State Sales Taxation of Internet Transactions

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Summary

There are at least two common misconceptions in the area of State taxation of Internet transactions. Contrary to popular opinion, (1) States do have the power to impose a sales tax on sales that are accomplished via the Internet even after the enactment of the Internet Tax Freedom Act in 1998 and (2) States do have the power to tax transactions where the seller is located outside of the State and has no real connection with the State. The Internet Tax Freedom Act placed a three year moratorium only on imposition of **new** taxes on "Internet access services" (existing taxes on access services were grandfathered) or any "**multiple or discriminatory** taxes on electronic commerce" by State or local governments, not on application of a general sales tax to such transactions. H.R. 3709, which would extend the moratorium for five years and repeal the grandfather provision for existing taxes on Internet access services, was passed by to the House on May 10, 2000.

Under current law a State may tax a transaction if there is some connection of the transaction to the State. Thus if the seller or the buyer is located in the State, the transaction may be subject to the State's sales tax. The important question in the out-of-State seller context is not the State's power to tax the transaction, but rather does the out-of-State seller have sufficient nexus to the State so that the State can require the out-of-State seller to collect the sales tax from the purchaser. H.R. 3709 does not address the nexus issue.

This report briefly examines two common misconceptions in the area of State taxation of Internet transactions. These misconceptions are: (1) the Internet Tax Freedom Act of 1998[1] placed a moratorium on a State's power to impose a sales tax on sales that are accomplished via the Internet; and (2) States may not tax transactions where the seller is located outside of the State and has no real connection to the State.

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[1] The Internet Tax Freedom Act comprises Titles XI and XII of Division C of the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999, P.L. 105-277, 112 Stat. 2681 (1998).

Moratorium

The Internet Tax Freedom Act placed a three year moratorium on imposition of new taxes on "Internet access services" or any "multiple or discriminatory taxes on electronic commerce" by State or local governments.[2] In other words, States may not (during the moratorium period) enact a sales tax which applies only to Internet transactions or taxes Internet transactions at a different rate than other transactions. It may apply a sales tax which is imposed on sales equally without regard to the medium (face to face, mail order, or internet). The Act specifically states that:

> .....nothing in this title shall be construed to modify, impair, or supersede, or authorize the modification, impairment, or superseding of, any State or local law pertaining to taxation that is otherwise permissible by or under the Constitution of the United States or other Federal law and in effect on the date of enactment of this Act.[3]

H.R. 3709, which would extend the moratorium for five years and repeal the exemption for existing taxes on Internet access services, was reported to the House on May 4, 2000[4] and passed the House on May 10, 2000.[5]

Out-of-State Sellers

A State may tax a transaction if there is some connection of the transaction to the state. Thus if the seller or the buyer is located in the State, the transaction may be subject to the sales tax. The important question in the out of State seller context is not the State's power to tax the transaction, but rather can the State require the out of State seller to collect the sales tax from the purchaser.[6]

The Due Process[7] and Commerce[8] Clauses of the United States Constitution limit a State from imposing tax liability or collection responsibilities on a business concern unless there is a substantial nexus or in-state contact established with the State. There is currently no statutory authority and scant case law on the subject of nexus and the internet, but the Supreme Court has given considerable guidance in the analogous area of taxation of mail order sales. The two major Supreme Court decisions in this area are *National Bellas Hess, Inc. v. Illinois Department of Revenue*,[9] and *Quill Corp. v. North Dakota.*[10]

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[2] *Id.* at § 1101(a). The moratorium expires on October 21, 2001.

[3] *Id.* at § 1101(b).

[4] H.Rept. 106-609.

[5] 146 CONG. REC. H2821 (daily ed. May 10, 2000)(record vote no. 159).

[6] Several States impose a duty on the in-State buyer to report the purchase from an out-of-State seller and remit the sales tax. Needless to say, compliance with these requirements is very low.

[7] U.S. Const. amend. XIV § 1.

[8] U.S. Const. art. I § 8, cl.3.

[9] 386 U.S. 753 (1967).

[10] 504 U.S. 298 (1992).

In *National Bellas Hess* the Supreme Court held that the State of Illinois could not require an out of State mail order sales company to collect a use tax from Illinois customers. Bellas Hess's only contact with the State was via the mails or common carriers. This contact was found to be insufficient to establish nexus under either the Due Process or Commerce Clause. The Court utilized a physical presence standard for nexus for both of these clauses.[11]

In the twenty-five years between *Bellas Hess* and *Quill* the Supreme Court had clarified the Commerce Clause's four part test in *Complete Auto Transit, Inc. v. Brady.*[12] For a state tax to be applied to an activity there must be substantial nexus with the taxing State. The tax must be fairly apportioned. It must not discriminate against interstate commerce. The tax must be fairly related to the services provided by the State.[13]

This clarification became even more significant in the mail-order sales area in the *Quill* decision. In *Quill* the Court, in a case factually similar to *Bellas Hess*, dropped the physical presence test for nexus under the Due Process Clause, requiring only that the seller's efforts be "purposefully directed toward the residents of the taxing State."[14] Therefore the Due Process Clause was no longer an impediment to requiring tax collection by the out of State seller. However, the physical presence standard or substantial nexus requirement of the Commerce Clause was reaffirmed.[15] Therefore the practical out come of the case was the same as *Bellas Hess*. The State could not force the seller to collect the tax absent a substantial nexus.

The removal of the Due Process Clause as a road block did open a door for Congress, under its commerce powers, to legislatively empower the States to require the collection of these taxes. The Supreme Court, in *Quill*, specifically invited Congress to act in this area. To date, Congress has chosen not to enact legislation in this area.

Other CRS Products

CRS Report RL30431, *Internet Transactions and the Sales Tax*, by Steve Maguire. (May 3, 2000).
CRS Report RL30412, *Internet Taxation: Bills in the 106th Congress*, by Nonna A. Noto. (May 5, 2000).
CRS Report 95-655 C, *Taxation of Mail Order Sales: A Fact Sheet*, by Arnold Solomon. (May 26, 1995).
CRS Report 92-487A, *Quill v. North Dakota: The Mail Order Tax Case*, by Thomas B. Ripy. (June 8, 1992).

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[11] 386 U.S. 753 (1967). Generally, the Due Process Clause relates to the fairness of the tax burden and whether a business has minimum contacts with the taxing jurisdiction. The Commerce Clause is concerned with the effect of the tax on interstate commerce. Walter Hellerstein, *Supreme Court Says No State Use Tax Imposed on Mail-order Sellers...for Now*, 77 J. Tax'n 120, 120 (Aug. 1992).

[12] 430 U.S. 274 (1977).

[13] *Id.* at 279.

[14] *Quill* at 312.

[15] *Id.* at 317.

H.R. 4462
The Fair and Equitable Interstate Tax Compact Simplification Act of 2000
Summary

Introduced on May 16, 2000 by Spencer Bachus (R-AL), Karen McCarthy (D-MO), Ernest Istook (R-OK), and Bill Delahunt(D-MA), the bill provides for the simplification of sales and use taxes on interstate commerce and ensures that the taxes are applied equally.

The legislation recognizes as a matter of economic policy and basic fairness, similar sales transactions should be treated equitably, without regard to the manner in which sales are transacted, whether in person, through the mail, over the telephone, on the Internet or by other means. It also recognizes Congressional authority, based on the Supreme court decision in Quill vs. North Dakota, to authorize States to require out-of-state sellers to collect taxes on sales to in-State residents. The legislation finds that once states have adequately simplified their tax systems, they should be authorized to collect taxes on sales of goods or services delivered in-state.

Key Sections Analysis

SECTION 3. EXTENSION OF INTERNET TAX FREEDOM ACT

This section extends the Internet Tax Freedom Act moratorium on Internet access taxes, and multiple and discriminatory taxes on electronic commerce for five years from its original expiration date.

SECTION 4. STREAMLINED SALES AND USE TAX SYSTEM.

This section describes a uniform, simplified sales and use tax system that is designed to alleviate the burdens currently imposed on interstate commerce by state and local sales and use taxes. Only broad minimum requirements for this system are prescribed. It is left to the states to work together to develop a streamlined system.

The greatest burden on remote sellers under the current system relates to the calculation and remittance of taxes for thousands of taxing jurisdictions. Under section 4(a)(9), only states would administer such taxes, immediately eliminating much of the current administrative complexity. Further, under various other paragraphs of section 4(a), states would adopt consistent electronic filing and remittance methods, uniform returns and remittance methods, a centralized registration system, uniform tax base definitions, uniform bad debt rules, and uniform audit procedures. The development of software on which sellers may conclusively rely on for calculations is also a prinicpal component of the streamlined system. Section 4(a)(5) prescribes uniform procedures for the approval of software.

Section 4(a)(4) addesses the need for a central database of entites exempt from the payment of sales and use taxes. The provision is based on the need for sellers to be able to rely on database, and should not be burdened with evaluating the legitimacy of purchasers' claims for exemption on a transactional basis.

Section 4(a)(11) addresses the need for reasonable compensation for sellers who collect sales and use taxes. Sellers should not be forced to bear the costs of assisting states with the collection of taxes imposed by those jurisdictions.

Section 4(a)(12) includes in the streamlined system a de minimus threshold, so that small-volume remote sellers cannot be required to collect use taxes.The specific threshold is left to the states. (*note: this is different from the Senate bill in that the Senate specifies a $5 million threshold*)

SECTION 5. INTERSTATE SALES AND USE TAX COMPACT.

This section provides Congressional authorization and consent for an interstate compact for states that agree to adopt a streamlined sales and use tax system as long as the compact is formed before January 1, 2004.

SECTION 6. AUTHORIZATION TO SIMPLIFY STATE USE TAX RATES THROUGH AVERAGING.

States with sales tax rates that vary by locality may adopt a single use tax rate that is a weighted average of those sales tax rates.

SECTION 7. AUTHORIZATION TO REQUIRE COLLECTION OF USE TAXES.

For states that have adopted and participate in the streamlined system prescribed by the Compact is authorized to require sellers to collect and remit use taxes on remote sales in that state.

The authorization is in effect once 20 member states have streamlined and entered into the Compact prior to January 31, 2004. In addition, the President must submit a report to Congress that the streamlined system has met the simplification requirements. Congress then has 90 days to disapprove the system.

....
(Original Signature of Member)

106TH CONGRESS
2D SESSION
H. R. 4462

IN THE HOUSE OF REPRESENTATIVES

Mr. BACHUS (for himself, Ms. McCARTHY of Missouri, Mr. ISTOOK, and Mr. DELAHUNT) introduced the following bill; which was referred to the Committee on _____

A BILL

To provide for the simplification of sales and use taxes on interstate commerce and to ensure that such taxes are equitably applied.

1   *Be it enacted by the Senate and House of Representa-*

2   *tives of the United States of America in Congress assembled,*

3   **SECTION 1. SHORT TITLE.**

4   This Act may be cited as the "Fair and Equitable

5   Interstate Tax Compact Simplification Act of 2000".

1 **SEC. 2. FINDINGS.**

2   The Congress finds that—

3   (1) the moratorium of the Internet Tax Free-

4 dom Act on new taxes on Internet access and on

5 multiple and discriminatory taxes on electronic com-

6 merce should be extended;

7   (2) States should be encouraged to simplify

8 their sales and use tax systems;

9   (3) as a matter of economic policy and basic

10 fairness, similar sales transactions should be treated

11 equitably, without regard to the manner in which the

12 sales are transacted, whether in person, through the

13 mails, over the telephone, on the Internet, or by

14 other means;

15   (4) Congress may facilitate such equitable tax-

16 ation consistent with the Supreme Court's decision

17 in *Quill Corp. v. North Dakota*, 502 U.S. 808

18 (1992), which based its decision not to extend

19 States' collection powers in significant part on its

20 view that Congress has, by virtue of its constitu-

21 tional power to regulate interstate commerce, the

22 ability to authorize States to require out-of-State

23 sellers to collect taxes on sales to in-State residents;

24   (5) States that adequately simplify their tax

25 systems should be authorized to correct the present

26 inequities in taxation by requiring sellers to collect