THE SKY IS NOT FALLING: WHY STATE AND LOCAL REVENUES WERE NOT SIGNIFICANTLY IMPACTED BY THE INTERNET IN 1998

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Ernst & Young Economics Consulting and Quantitative Analysis

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* This study was prepared for the eCommerce Coalition, a broad-based, national coalition dedicated to providing sound policy information on the taxation of electronic commerce. The Coalition members include America Online, Inc., Andersen Consulting LLP, Cisco Systems, Inc., FirstData Corporation, Intuit, Inc., Microsoft Corporation, Time Warner, Inc., Wal-Mart Stores, Inc.

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Executive Summary

Ecommerce, the purchase of goods and services by consumers over the Internet, is raising important tax policy issues for state and local governments, consumers and retail sellers. Many state and local officials have expressed concerns about potential erosion of the state and local retail sales and use tax base. Ecommerce firms are concerned about the administrative and compliance costs of different sales and use tax systems at different rates applied to different bases in 45 states and thousands of additional cities, counties and other local governments.

This study analyzes the potential erosion of state and local sales and use tax revenues from the growth of ecommerce. **The "revenue crisis" from Internet sales has not materialized. The Advisory Commission on Electronic Commerce, state and local governments, and Congress have time to carefully deliberate on the appropriate taxation of ecommerce.** The future sales and use tax system of state and local governments should be fair, minimize adverse economic costs, encourage economic growth, reduce taxpayer compliance costs, and minimize government administrative costs.

Key Findings:

- The impact on state and local governments' sales and use tax revenues from ecommerce retail sales must be considered in the context of the current state sales and use tax systems.

    - Interstate ("remote") sales are not subject to sales or use tax collection by companies without nexus (i.e., no physical presence in the taxing state) based on Supreme Court rulings.
    - Most services and intangible products are not subject to sales and use tax. Many tangible goods (e.g., groceries, apparel, prescription drugs) are also exempt from sales and use tax in many states.
    - Taxable purchases from remote sellers are subject to use tax, but states are not effectively enforcing their existing laws on their citizens.

- Although ecommerce retail sales have grown rapidly and are receiving wide-spread attention, the approximately $20 billion of business-to-consumer ("retail") sales over the Internet in 1998 represent less than three-tenths of one percent of total consumer spending.

- An estimate of the sales and use tax not collected in 1998 from the increase in remote sales due to the Internet is less than $170 million, or only one-tenth of one percent of total state and local government sales and use tax collections. This small effect is due to a number of factors:

    - An estimated 80 percent of current ecommerce is business-to-business sales that are either not subject to sales and use taxes or are effectively subject to use tax payments by in-state business purchasers.

- An estimated 63 percent of current ecommerce business-to-consumer sales are intangible services, such as travel and financial services, or exempt products, such as groceries and prescription drugs, which generally are not subject to state and local sales and use taxes.
- Substitution of ecommerce purchases for sales from other remote sellers (e.g., mail order and telemarketers) does not result in reduced sales and use tax. A conservative estimate of 60 percent of ecommerce purchases of tangible products that would otherwise be made by phone or mail further reduces the potential erosion.
- Some current ecommerce sales result in sales and use tax from ecommerce sellers remitting sales and use tax to states where they have nexus and some ecommerce buyers complying with use tax.
- Five states do not have state sales and use tax, and 19 states do not allow local governments to impose sales or use tax.

- Based on the factors above, approximately $2.6 billion or only 13 percent of total ecommerce retail sales have potential sales and use tax collection issues. **Applying state and local sales and use tax rates to the potential tax base results in sales and use tax erosion of less than $170 million in 1998. This is only one-tenth of one percent of total sales and taxes collected by all state and local governments.**

- The potential erosion of sales and use tax is not an erosion of tax *liability*. Although out-of-state sellers without physical nexus have no legal obligation to collect sales and use taxes from in-state consumers, the in-state consumers still have a use tax liability. The potential erosion of tax *collections* is due to lack of effective enforcement of the existing use tax by state and local governments.

- As further evidence that a “revenue crisis” is not at hand, state and local sales and use taxes continue to grow at the average growth rate experienced throughout this decade. And many state governments have record level budget surpluses.

Since ecommerce combines complex new issues of interstate taxation and of legal definitions of what is taxable, it will be very difficult to address these issues through marginal adjustments in the current state and local tax laws. Instead of short-term, ad-hoc law changes, the Advisory Commission on Electronic Commerce, state and local governments, and Congress should consider longer-term, more comprehensive changes in the state and local tax structure. There is time to carefully construct a fair, efficient, and administrable tax system for state and local governments for the 21st century.

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I. Overview

The rapid growth in electronic commerce (ecommerce) over the Internet has raised concerns among state and local governments about possible adverse affects on sales and use tax collections and on economic competitiveness of in-state sellers. Ecommerce joins traditional forms of direct marketing as an important alternative retail channel for consumers to purchase goods and services from remote sellers. Since sellers in the Internet retail market can be located in a number of taxing jurisdictions, ecommerce transactions add another dimension to the complex issue of how to administer the sales and use tax on purchases from out-of-state sellers.

The retail sales and use tax, designed in an earlier era to tax primarily sales of tangible products, is not well-suited to effectively tax interstate transactions involving services as well as products. The interstate dimension of Internet sales is not a new phenomenon. Mail order catalog retail sales have posed a challenge to the collection of retail sales and use taxes that federal, state and local governments have struggled with since the mid-1960s. In addition, some states have been modifying their sales and use taxes to expand the tax base to include an increasing share of rapidly expanding consumer spending on services.

What is unique about ecommerce is that it is simultaneously blurring both the geographic boundaries between states and the definitional boundaries between goods and services. It is this combination, along with the growth in ecommerce sales, that has raised fundamental questions about the sales and use taxation of electronic commerce.

The objective of this paper is to provide estimates of the potential size of uncollected state and local sales and use taxes on ecommerce transactions between businesses and consumers and to compare these estimates to the current level of state and local sales and use tax collections. The paper also frames the issue of taxing retail ecommerce in the broader context of sales and use taxation of all goods and services, regardless of the method used to complete the transactions.

II. State and Local Sales and Use Taxes

The sales and use tax is an important state tax, accounting for one-third of all state taxes and one-fourth of total revenue raised by the states. The sales and use tax is less important as a local source of revenue accounting for approximately 11 percent of local taxes. For state and local governments combined, the sales and use tax provides one-quarter of all taxes.

As shown in Table 1, the importance of the sales and use tax varies significantly across states with five states (Florida, Nevada, South Dakota, Tennessee and Washington) receiving more than 50 percent of their taxes from the sales and use tax. At the other end of the spectrum, six states (Maryland, Massachusetts, New York, North Carolina, Vermont and Virginia) receive less than 25 percent from the sales and use tax. Five states do not have a state-level sales and use tax. This wide variation in reliance on the sales and use tax means that the revenue impact of not taxing remote sales also varies widely across states.

The sales and use tax generally applies only to tangible personal property with relatively few consumer services included in the tax base. As a result, the rate of growth in state and local sales and use taxes has been slowed by the shift of consumer spending away from tangible products (durable and non-durable) to personal services (e.g., personal care, personal business and recreation spending). In fact, over the last decade the rate of growth in consumer spending for services has exceeded the growth rate of durable goods consumption by 35 percent and the growth rate of non-durable spending by almost 50 percent. As will be discussed, a large component of Internet sales includes services, such as stock brokerage and travel transactions, that are generally not taxable regardless of the retail distribution channel.

The more rapid growth in consumer spending on services and other non-taxable goods has resulted in a steady decrease in the ratio of taxable consumer spending and total consumer spending. This is evident in Figure 1 that plots the percentage of U.S. consumer spending that we estimate is taxable under state and local sales and use taxes. With the exception of the early 1990s recession, the taxable share of consumption has been falling since 1985.

The important point to make in the context of sales and use taxation of ecommerce is that this “erosion” of the sales and use tax base has been going on for at least a decade prior to the advent of ecommerce. While increased remote sales over the Internet may result in some substitution of non-taxable for future taxable retail sales, as discussed in detail below, the changing composition of how consumers spend their money, not how they purchase their goods and services, has been the key factor contributing to the slower growth of state and local sales and use taxes.

Table 2 shows a shorter-run view of the recent growth in state sales and use tax collections. It shows that the rate of growth of state sales and use taxes have actually increased over the last three years. The fiscal year 1998 growth rate, 5.6 percent, almost matches the compound growth rate of 5.7 in the decade of the 1990s. Although these figures have not been adjusted for tax rate or tax base changes, they provide no evidence of a slowdown in the rate of growth of state sales and use tax collections. In fact, state sales and use tax collections have grown faster than total retail trade during the past eight years, including 1997 and 1998.

III. Ecommerce Impacts on State and Local Sales and Use Taxes

In this section we present preliminary estimates of the revenue impact of ecommerce in terms of potential reductions in state and local sales and use tax collections.

Methodology for Estimating Sales and Use Tax Impacts

The following questions must be answered to accurately assess the impact of ecommerce on state and local sales and use tax revenues:

- What transactions are included in the definition of ecommerce?
- What is the estimated size and composition of ecommerce transactions in 1998?

- What categories of ecommerce retail sales are subject to state and local sales and use taxes under current law?

- For the ecommerce transactions that are subject to sales and use tax, what proportion of the sales are expected to produce sales and use tax payments under current law and administrative practices?

- For taxable ecommerce transactions that do not generate sales and use tax payments, what percentage of these sales are substitutes for sales that were not paying sales and use tax, and what percentage are sales that result in reduced sales and use tax collections?

- How does the estimated reduction in state and local sales and use tax collections attributable to ecommerce compare to the amount of actual collections in 1998?

Each of the steps in the estimation process is explained in the following sections. The basic approach we are using is to 1) determine the percentages of estimated Ecommerce transactions that fall into each of the above categories, and 2) to apply these percentages to aggregate estimates of Ecommerce transactions to determine sales and use tax impacts. The next section explains how we determine the key percentages.

Ecommerce Sales Subject to State and Local Sales Taxes

Total ecommerce sales can be divided into business-to-business sales and business-to-consumer sales. We estimate that 80 percent of total ecommerce transactions are business-to-business sales, while 20 percent are business-to-consumer sales. The business-to-business sales are an extension of electronic data exchange systems that have been in use for some time.[1]

A significant share of business-to-business transactions are not taxable under retail sales and use taxes because 1) they are exempt under sales-for-resale provisions and various manufacturing exemptions, or 2) they are non-taxable business services. For business-to-business sales that are taxable, if the seller does not collect the tax, the purchasing firms are subject to a use tax that is paid directly to tax agencies.[2] For large business taxpayers, use tax payments are subject to frequent and on-going compliance review.

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[1]Estimates of the distribution of total ecommerce sales are based on information from the Organization for Economic Co-Operation and Development, *The Economic Impact of Electronic Commerce*, 1999.

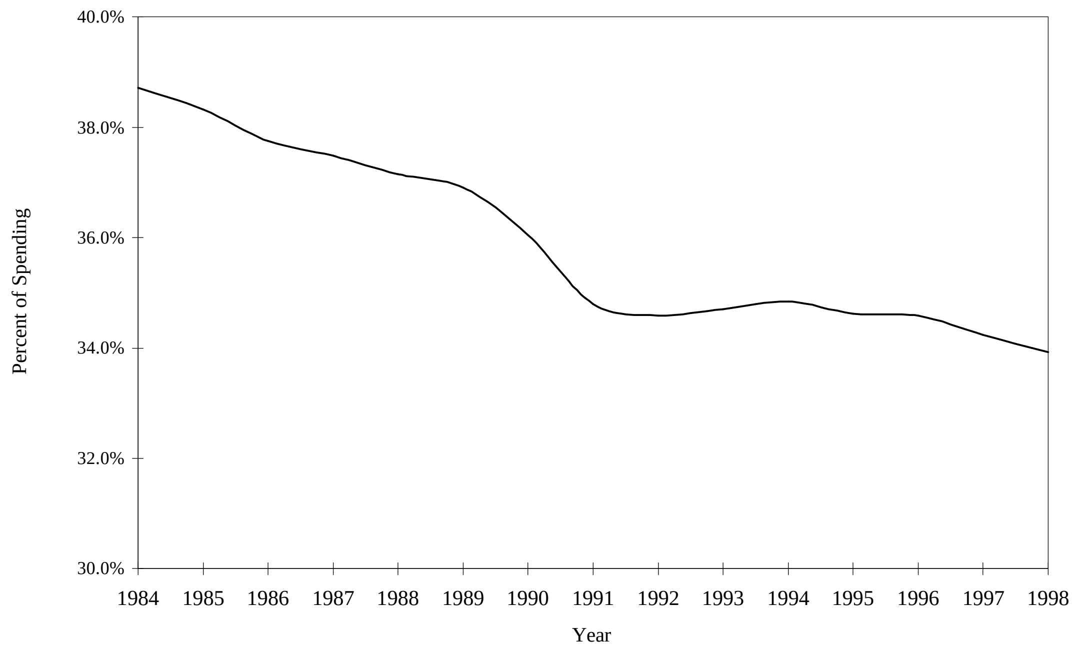
[2] Under the retail sales and use tax in most states, if the seller does not collect a tax on taxable sales, the purchaser is liable to pay a use tax at the same rate as the sales and use tax. Use tax collections, primarily paid by businesses on taxable inputs that they purchase free of sales and use tax, are significant in total. It has been estimated that use taxes average roughly 10 percent of reported sales and use tax collections. (John F. Due and John L. Mikesell, *Sales Taxation: State and Local Structure and Administration*, Urban Institute Press (1994), p. 246.)

Table 1
State Sales Tax Revenue, Fiscal Year 1998

State	State Sales Tax (millions)	Percent of Total State Taxes	Percent Change 1997 - 1998
United States	$150,609	36.7	5.6
Alabama	1,584	29.3	4.7
Alaska	---	---	---
Arizona	2,368	48.0	7.1
Arkansas	1,492	41.6	3.2
California	21,260	37.4	6.4
Colorado	1,536	31.2	8.7
Connecticut	2,762	34.5	6.3
Delaware	---	---	---
Florida	11,838	70.0	7.0
Georgia	4,143	37.2	1.6
Hawaii	1,425	50.0	-2.2
Idaho	653	32.9	5.0
Illinois	5,312	32.8	5.6
Indiana	3,279	32.9	4.2
Iowa	1,515	33.9	3.7
Kansas	1,537	39.9	9.7
Kentucky	1,981	34.6	5.2
Louisiana	2,012	38.5	1.6
Maine	791	40.0	19.4
Maryland	2,161	29.9	3.2
Massachusetts	2,963	21.2	3.0
Michigan	6,713	35.3	3.9
Minnesota	3,697	36.5	8.3
Mississippi	2,035	44.8	6.3
Missouri	1,706	26.7	-0.4
Montana	---	---	---
Nebraska	804	38.2	6.3
Nevada	1,656	80.2	4.2
New Hampshire	---	---	---
New Jersey	4,766	33.7	8.0
New Mexico	1,121	44.6	4.7
New York	7,308	21.2	3.5
North Carolina	3,255	28.3	4.1
North Dakota	316	41.4	1.5
Ohio	5,266	37.1	6.0
Oklahoma	1,328	32.4	4.4
Oregon	---	---	---
Pennsylvania	6,152	34.6	1.9
Plains	9,962	35.3	5.7
Rhode Island	530	33.2	8.4
South Carolina	1,742	37.3	6.6
South Dakota	388	71.5	5.8
Tennessee	4,070	60.3	4.6
Texas	14,706	59.1	10.0
Utah	1,252	38.8	0
Vermont	202	25.1	10.0
Virginia	1,919	21.9	5.1
Washington	4,964	52.6	5.9
West Virginia	878	34.7	2.9
Wisconsin	3,047	32.3	6.4
Wyoming	175	39.6	10.5

Source: *State Tax Notes*, "Another Banner Year for State Tax Collections in Fiscal 1998," May 12, 1999.

Figure 1
Falling Share of Consumer Spending
Subject to Sales and Use Taxes



Source: Authors' calculations from, *Survey of Current Business,* U.S. personal consumption expenditures.

Table 2
State Sales and Use Tax Collections

Fiscal Year	State Sales Tax Collections (millions)	Percent Annual Growth Rate in State Sales Tax	Percent Annual Growth Rate in Total Retail Trade
1998	**155,300**	**5.6**	**5.1**
1997	**147,069**	**5.5**	**4.3**
1996	**139,363**	**5.4**	**5.7**
1995	**132,236**	**7.5**	**4.5**
1994	**123,006**	**7.3**	**7.5**
1993	**114,635**	**5.4**	**6.3**
1992	**198,734**	**5.4**	**5.2**
1991	**103,166**	**3.5**	**0.6**
Compound growth rate, 1991-1998		**5.7%**	**4.9%**

Source: US Bureau of Census, *Governmental Finances*, 1991-1997., US Bureau of Census, *Monthly Retail Trade Survey*, 1991-1997. 1998 taxes estimated by applying the 1998 growth rate from K.M. Landers and D.J. Boyd, *Another Banner Year for State Tax Collections in Fiscal 1998* to 1997 collections.

For all of the above reasons, state and local government officials have not expressed concern about business-to-business ecommerce, but have focused on business-to-consumer sales. The estimate of total 1998 business-to-consumer sales used in this study is $20 billion.[3] This is the segment of ecommerce that is causing the most concern in terms of retail sales and use tax administration and compliance and is the figure we use to estimate the retail sales and use tax impacts of ecommerce.

The first step in deriving sales tax impacts is to divide total business-to-consumer sales into taxable and non-taxable sales. Based on estimates of the amount of ecommerce sales to consumers by type of spending and identification of taxable sales categories by state, we estimate that 63 percent of consumer ecommerce purchases are not subject to retail sales and use taxes. Figure 2 identifies the types of business-to-consumer sales that are not taxable, as well as the categories that are taxable.

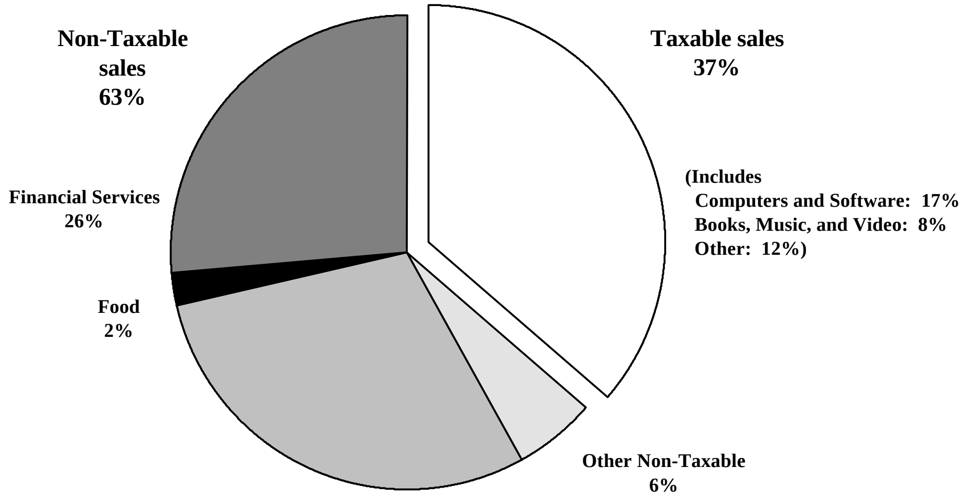
While the definition of the sales and use tax base varies substantially from state-to-state, ecommerce products and services generally not taxable include: personal financial services (electronic banking, bill paying, stock broker services and insurance), interactive games, travel tickets and services, groceries, on-line subscriptions to newspapers and Internet gambling. Because current retail sales and use taxes exclude most forms of intangible services, a significant portion of business-to-consumer ecommerce transactions will not be taxable without a significant restructuring of the current-law sales and use tax-base.

As shown in Figure 2, we estimate that only 37 percent of projected total ecommerce retail sales to consumers are subject to retail sales and use taxes. Included in this category of current retail goods and services provided to consumers over the Internet are: jewelry and gifts, flowers, electronic products, shoes and clothing, books, tapes and compact disks, alcohol and household products.[4] Figure 2 shows the distribution of the major taxable categories. This relatively small set of total ecommerce transactions is the potential source of sales and use tax collection erosion that is the concern of state and local governments.

[3] This is a total revenue estimate on the high-end of a wide range of estimates that are being produced by industry experts, academics and private consulting firms. The large variance in estimates is due partly to the lack of detailed data from traditional federal data sources and to differences in the definition of what is included in business-to-consumer sales. The $20 billion estimate for business-to-consumer Internet retail sales is consistent with the recent estimates of total ecommerce sales in the U.S. in 1998, $102 billion published by the University of Texas, Center for Research in Electronic Commerce (www./internetindicators.com, June 1999). Forrester Research, Inc. figures for online retail sales in 1998 are $8 billion, but exclude financial services. Research estimates reported by Boston Consulting Group and shop.org show 1998 retail online revenues of $13 billion.

[4] The sale of motor vehicles is, in a number of states, subject to the retail sales and use tax. The collection of this tax, regardless of how the vehicles are purchased, is effectively ensured through state and local registration systems. For this reason, motor vehicle purchases are not included in the estimate of taxable business-to-consumer ecommerce sales that may not pay sales or use tax. It should also be noted that the percentage of taxable retail ecommerce sales shown in Figure 2 is higher than the estimated percentage of all consumption spending that is taxable as shown in Figure 1 due to differences in the composition of spending.

Figure 2
Business-to-Consumer Ecommerce Sales,
Taxable and Non-Taxable



Estimates of the Sales and Use Tax Not Collected on Retail Ecommerce Sales

The final step in the estimation process is to determine what the net effect of the estimated taxable Internet sales had on state and local sales and use tax collections in 1998. This step is a complicated one that has to consider compliance issues, as well as possible substitutions between ecommerce sales and retail sales through more traditional retail channels, such as mail-order sales, that do not result in sales or use tax collections.

Figure 3 illustrates how we divided the 37 percent of business-to-consumer sales that are subject to sales and use taxes into three categories: sales generating taxes, sales substituting for other sales not generating taxes, and sales resulting in reduced tax collections.

As shown in Figure 3, we estimate that 4 percent of taxable business-to-consumer ecommerce sales result in sales and use tax payments.[5] These payments would be made primarily by in-state ecommerce firms or out-of-state firms that have sufficient nexus in a state to be required to collect and remit sales and use taxes. A relatively small additional percentage would be paid as use taxes by individual consumers. There is no loss of state and local sales and use taxes associated with this category of taxable ecommerce sales.[6]

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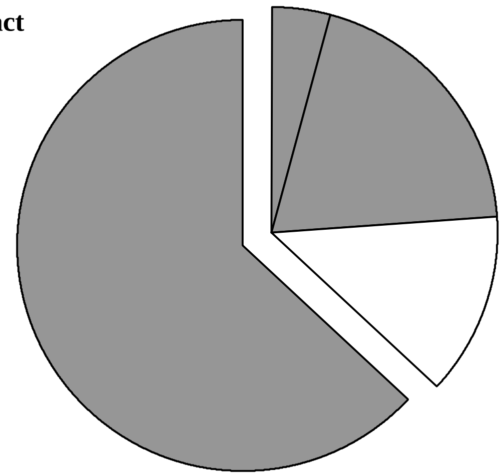
[5] The estimated percentage is conservative compared to the 16.5 percent estimate reported in U.S. Advisory Commission on Intergrovenmental Relations, *Taxation of Interstate Mail Order Sales: 1994 Revenue Estimates* (May 1994), which did not include Sears, J.C. Penney and Speigel, which collected sales and use taxes in all states.

[6] The estimate of the percentage of taxes on taxable sales paid by vendors is based on an informal survey of several state tax agencies and prior studies. The potential positive effect of additional taxes paid by ecommerce vendors on new taxable sales is not included in the revenue impact estimates.

Figure 3
Tax Treatment of Ecommerce Business-to-Consumer Sales



The second category of taxable ecommerce retail sales identified in Figure 3 are sales that do not reduce sales and use tax collections because they substitute for other taxable remote sales that are not currently generating sales or use taxes; both types of sales result in non-payment of sales and use taxes. We estimate that this category accounts for 20 percent of business-to-consumer sales. The displaced sales, for example, could come from multi-channel retailers that replace mail or telephone sales with online retail sales over the Internet.[7] These may be out-of-state retailers that do not have the required nexus to collect sales and use taxes from in-state consumers.[8] The substitution figure is probably on the low side. Research suggests that specific categories of online retail sales, such as computers, are very close substitutes for other direct marking sales by mail or telephone.[9]

[7] The shop.org/Boston Consulting Group study of 127 online retailers found that "Although there is a proliferation of retailers selling online, revenues are still concentrated in only a few mature sites." Further, "Multichannel retailers, like Dell, Schwab, Eddie Bauer and Lands End, account for 59% of online revenues."

[8] The U.S. Supreme Court in the 1967 *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois* case clearly established the legal principle that out-of-state catalogue sales companies do not have to collect and remit a use tax from customers in a state where the companies do not have legal nexus for sales and use tax purposes. The U.S. Supreme Court's position was reaffirmed in the 1992 *Quill Corp v. North Dakota* case dealing with the definition of in-state sales for a mail-order firm.

[9] In a recent study of online retail transactions, the author found that online computer sales and mail-order sales are very similar in terms of responses of purchasers to tax rate differences. This suggests that there may be a high degree of substitution between mail-order and online computer sales. (Austan Goolsbee, *In a World Without Borders: The Impact of Taxes on Internet Commerce,* National Bureau of Economic Research, November 1998.) It should be noted also that total direct marketing sales are estimated to be $1.4 trillion dollars in 1998 (Direct Marketing Association, *Economic Impact: U.S. Direct Marketing Today*, *1998*, February 1999). A significant portion of these sales provides an opportunity for ecommerce sales substitution.

The final category in Figure 3 is the one that results in a loss of sales and use tax collections. This category, an estimated 13 percent of taxable business-to-consumer ecommerce sales, is the only sales category resulting in a loss of state and local sales and use tax revenue. The loss comes from taxable ecommerce sales, not generating sales taxes, that substitute for tax-paid sales under traditional retail channels. An example of transactions that may displace tax-paid sales include the purchase of a book from an out-of-state seller over the Internet, rather than from a local bookstore, that is delivered by common carrier without either the seller or the buyer paying the use tax.

To estimate the size of this revenue loss in 1998, we applied the estimated percentage of taxable ecommerce retail sales not paying sales and use tax (13 percent) to the estimate of taxable ecommerce business-to-consumer sales ($7.4 billion) to derive an estimate of the total U.S. taxable ecommerce sales base that is not paying sales and use taxes ($2.6 billion). We then distributed this sales and use tax base by state, including states without sales and use taxes, in proportion to state personal income. This distributed base was then adjusted for major differences in the scope of sales and use taxation of services for selected states. The resulting state-by-state sales and use tax bases were then multiplied by the 1998 combined state and local sales and use tax rates in each state to estimate aggregate sales and use tax losses.

The sales and use tax revenues at issue in 1998 from business-to-consumer ecommerce transactions for all state and local governments are an estimated $170 million, only one-tenth of one percent of total sales and use tax collections.

Table 3 provides a summary of each of the key steps in deriving the estimated 1998 revenue impact of $170 million.

Table 3
Summary of Ecommerce Sales and Use Tax Impacts, 1998

Steps	Percent of Sales	Amount (millions)
Total Business-to-Consumer Sales	100	20,000
Less: Percent Non-Taxable	63	-12,600
Equals: Taxable Sales	37	7,400
Less: Sales Tax Paid	4	-800
Less: Sales Substituting for Other Remote Sales, No Tax Collected	20	-4,000
Equals: Sales, No Tax Collected	13	2,600
Times: Average State and Local Tax Rates		6.5%
Equals: Estimated Sales Tax Loss		**$170**

Since the sales and use tax impact is only one-tenth of one percent in 1998, even if ecommerce sales doubled annually for the next three years, the revenue impact would still be less than one percent of state and local sales and use tax revenues. As a percentage of total state and local tax revenue, the impact would be less than two-tenths of one percent.[10]

Comparisons With Estimates of Sales and Use Tax Losses From Mail-Order Sales

The small impact of business-to-consumer ecommerce on state and local sales and use tax collections in 1998 can be put in perspective by comparing the ecommerce estimate to estimates of state and local sales and use tax revenue losses from mail-order sales.

The problem of collecting sales and use taxes on taxable consumer purchases from out-of-state suppliers is similar for both ecommerce and mail-order sales. States have been dealing with mail-order sales and use tax administration and collection issues for some time, and there have been on-going efforts to estimate sales and use tax revenue losses associated with mail-order sails.

[10] Austan Goolsbee and Jonathan Zittrain, *Evaluating the Cost and Benefits of Taxing Internet Commerce*, May 1999, find 1998 sales and use tax revenue impact from retail ecommerce that are similar in magnitude to the findings in this study.

The most comprehensive state-by-state estimates of the sales and use tax revenue loss from mail-order sales were prepared by the U.S. Advisory Commission on Intergovernmental Relations. The study estimated that mail-order sales resulted in an aggregate revenue loss of $3.3 billion in sales and use tax collections in 1994.[11] This was approximately 2.4 percent of total sales and use tax collections for all states. If this percentage is applied to the 1998 level of state and local sales and use tax collections, a conservative estimate of the uncollected sales and use taxes related to mail-order sales is $4.5 billion.

IV. Conclusions

The preliminary estimates presented in this paper suggest that the revenue impact from ecommerce is very small in both dollar amounts and relative to the revenue erosion caused by the economy's growth of services and other forms of remote sales, including mail-order sales. For all state and local governments, the collections at issue in 1998 are estimated to be $170 million, less than one-tenth of one percent of state and local sales and use tax revenues.

The current $170 million impact of ecommerce on state and local and use tax collections <u>contrasts</u> sharply with the concerns expressed by some officials:

> *Nevada Department of Taxation Executive Director Michael A. Pitlock: "Looking at the national numbers, (Internet commerce) is now a significant concern." (January 31, 1999, Las Vegas Review-Journal)*
>
> *"The National Association of Counties said Wednesday that the Internet-related loss of state and local sales and use tax revenue is estimated to be anywhere between $15 billion and $50 billion a year nationwide by 2005." (The Buffalo News, April 1 ,1999)*

The small impact of Internet taxation on state and local tax revenues in 1998 should also be compared to the states' budget situation. According to the latest *Fiscal Survey of the States*, the continuing strong economy produced general fund budget surpluses in almost all states in fiscal year 1998.[12] In the aggregate, end-of-year balances reached $36 billion, 8.8 percent of general fund expenditures in fiscal year 1998. These balances remained after tax cuts passed during the year. Twenty-one states had balances of 10 percent or more of expenditures.

Although ecommerce sales are growing rapidly and are receiving wide-spread attention, there is only a small current negative impact on sales and use tax collections for several important reasons:

- 80 percent of all ecommerce sales are business-to-business sales that are either nontaxable or on which businesses pay a use tax. These business-to-business sales are much less of a compliance issue because of well-established sales and use tax audit procedures for in-state businesses.

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[11] Due and Mikesell, *Sales Taxation*, have noted that the methodology used by ACIR in their original estimates in 1991 overstated the revenue loss from mail-order sales by not adequately including use tax revenue collected by registered in-state firms and out-of-state firms that have nexus to collect the tax or that are voluntarily collected use tax.

[12] The National Governor's Association and the National Association of State Budget Officers, *The Fiscal Survey of the States*, December, 1998

- 63 percent of business-to-consumer ecommerce sales are intangible services and exempt products that are not taxable under most state and local sales and use taxes.

- 11 percent of taxable ecommerce retail sales result in taxes being paid by either vendors or consumers.

- 60 percent of the taxable business-to-consumer sales are substituting for other sales that do not generate sales and use taxes and do not result in new sales and use tax losses.

It should be noted that the potential erosion of sales and use tax is not an erosion of tax *liability*. Although out-of-state sellers without physical nexus have no legal obligation to collect sales and use taxes from in-state consumers, the in-state consumers still have a use tax liability. The potential erosion of tax *collections* is due to lack of effective enforcement of the existing use tax by state and local governments.

An important implication of this study's findings is that states have sufficient time to carefully evaluate alternative options for taxing ecommerce. In addition, the problems associated with collecting retail sales and use taxes on ecommerce business-to-consumer sales must be discussed within the broader context of how to effectively tax services, as well as remote transactions, under sales and use tax systems designed in an earlier era to tax in-state, tangible personal property.

In summary, the sales and use tax "crisis" from Internet ecommerce transactions is not at hand. The Advisory Commission, state and local governments, ecommerce firms and Congress have time to carefully deliberate on the most appropriate, long-term method for effectively taxing ecommerce transactions. The solution will be found in coordinated changes to the current tax system that recognize the much broader issue of effectively taxing interstate sales under a simpler, more uniform tax system.

In addition, the restructured tax system will have to simultaneously address additional tax policy goals of fairness, economic efficiency and uniformity, long-term revenue responsiveness, and reduced taxpayer compliance and government administration costs. This is a challenging, complex task that will require much more than marginal adjustments in current sales and use taxes. Fortunately, this study suggests that there is sufficient time for the stakeholders to carefully consider the alternatives.