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ISSUE ANALYSIS

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Sales Taxes and the E-Commerce Revolution

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Elected officials in Georgia and throughout the country have been expressing their concern over the possible loss of state sales tax revenues as e-commerce grows on the Internet. Georgia State Revenue Commissioner Jerry Jackson told a joint meeting of the House and Senate Appropriations Committees that Internet commerce represents a future threat to state revenue and that "[a]t some point [it] will begin to have a major impact on sales tax collections."[1] Proponents of taxing Internet commerce believe that online sales are a substitute for "bricks and mortar" retail sales and that state sales tax receipts will decline as e-commerce increases. They also claim that exempting e-commerce from sales taxes is "unfair" to other retail merchants who have to collect sales taxes. The Georgia Municipal Association is warning that decreases in sales tax revenues due to e-commerce will result in increases in Georgia property taxes.[2] Local officials [3,4] assert that states and counties have a right to tax Internet sales.

Although many elected officials (including the president)[5] and organizations like the National Governors' Association believe that e-commerce should be taxed, there is currently a moratorium on the imposition of certain taxes on the Internet. It is not, however, a complete moratorium on sales taxes.

In 1998, Congress passed the Internet Tax Freedom Act ("The Act").[6] The Act imposed a three-year prohibition, until October 21, 2001, on the imposition of state or local taxes on Internet access fees (like the monthly charge paid by AOL or Mindspring users). The Act has a limited grandfather clause for some states that were already taxing Internet access when the law became effective. The Act also prohibits state or local governments from imposing taxes that would subject buyers and sellers of electronic commerce to taxation in multiple states. States were already prohibited by the U.S. Constitution's Commerce Clause and Supreme Court decisions from imposing sales taxes on retailers who have no physical "nexus" or presence in their state.[7] This prevents states from requiring mail-order retailers to collect taxes on most catalog sales; this logic applies equally to e-commerce retailers. The State of Georgia cannot force an online or mail-order retailer located in another state to collect taxes on sales to Georgia residents if the retailer does not have a physical presence in Georgia. However, this prohibition could be lifted by Congress.

Nothing currently prevents a state such as Georgia from imposing sales taxes on its own residents on any items they purchase through mail-order catalogs or over the Internet for delivery and use in Georgia unless the Internet purchase is for an item that is sold exclusively over the Internet with no comparable off-line equivalent.[8] Under Georgia law,[9] the State already imposes a 4 percent tax on "the first instance of use, consumption, distribution, or storage within this state of tangible personal property purchased at retail outside this state." As a practical matter, however, the Georgia Department of Revenue (DOR) has never collected such taxes from Georgia citizens on their catalog purchases and has no current method of doing so for e-commerce purchases. Other states, including Michigan and North Carolina, have recently changed their state income tax forms to require residents to total their out-of-state purchases, including items bought online, and pay a 6 percent sales tax.[10] Michigan's law dates back to 1937, although it has never been enforced. Such taxes are very unpopular: 70 percent of online users are opposed to sales taxes on Internet purchases.[11]

Under the Act, Congress also established a 19-member Advisory Commission on Electronic Commerce to make recommendations to Congress by April 21, 2000 on whether electronic commerce should be taxed. Conflicts have arisen on the Commission over this issue. For instance, Commission Chairman James S. Gilmore, governor of Virginia, wants to ban Internet taxes permanently whereas Ron Kirk, mayor of Dallas, wants state sales taxes automatically added to online sales by e-commerce retailers when a customer puts in his address.[12] Utah Governor Michael Leavitt, also a member of the Commission, recently revised a proposal by the National Governors' Association, which he heads, to expand tax collections to both Internet and mail-order sales. The revision dropped a controversial proposal that called for tax collections to be done by "trusted third parties" because of criticisms that this would intrude on taxpayers' rights. The revised proposal calls on state and local governments to enter into "partnerships" with retailers to simplify sales taxes "and experiment with meaningful voluntary collection systems."[13]

Is Georgia losing tax revenue due to e-commerce sales? Other than Revenue Commissioner Jackson's prediction that Georgia will lose tax revenue at some point in the future, the Georgia Department of Revenue has not provided estimates of whether *any* sales tax revenue has been lost due to Internet sales. The DOR's Statistical Report for the fiscal year ending June 30, 1999, (see **Figure 1**) reflects that Georgia collected $4,479 million in general sales and use taxes in 1999, up 11.8 percent over 1998. Total tax revenues were up 8.8 percent. With some exceptions,[14] Georgia's revenues since 1988 from general sales and use taxes have increased steadily and have remained remarkably stable as a percentage of the total revenue collected by the State. In 1987, general sales and use taxes represented 34.3 percent of total tax revenue compared with 35.9 percent in 1999.[15]

Figure 1.
Georgia General Sales and Use Tax Revenues[16]

Year	Total in Millions of Dollars	Change
1999	$4,479	11.80%
1998	$4,006	1.50%
1997	$4,067	2.94%
1996	$3,951	8.37%
1995	$3,646	8.03%
1994	$3,375	9.29%
1993	$3,088	10.60%
1992	$2,792	0.80%
1991	$2,771	1.13%
1990	$2,740	29.70%
1989	$2,113	8.90%

At a time when elected officials like Governor Leavitt are complaining about lost revenue due to Internet commerce, almost all of the states, including Georgia, are awash in budget surpluses. The states collected $11.3 billion in revenue surpluses in 1998 and had $36 billion in "rainy-day funds."[17] Georgia's rainy-day fund is now $548 million.[18] From 1980 to 1995, state tax revenues across the country grew 227 percent and local government revenues grew 193 percent, with state revenues growing at almost twice the rate of inflation from 1992 to 1998.[19] The same is true for Georgia: the state has a $1 billion surplus this year that the Georgia General Assembly has voted to spend entirely without returning one penny to Georgia taxpayers. The General Assembly also voted to borrow an additional $530 million above and beyond the $1 billion surplus to finance additional state programs.[20] Since 1980, Georgia's budget has increased dramatically at a rate greater than the combined rate of increase of the state's population and inflation. Georgia currently is not experiencing a loss of sales tax revenue but rather a lack of fiscal restraint. There is no evidence that Georgia has experienced any loss of tax revenue due to e-commerce sales.

A recent study by Ernst & Young estimated that there was a total of $20 billion of business-to-consumer ("retail") sales in 1998 on the Internet.[21] This represents less than 0.3 percent of total consumer spending. Furthermore, "[a]n 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."[22] The Ernst & Young study also pointed out that: (1) an estimated 63 percent of Internet retail sales are intangible services such as travel and financial services or intangible products such as food and prescription drugs that are exempt from sales taxes in most states; (2) 11 percent of taxable e-commerce retail sales already result in taxes being paid by either vendors or consumers; and (3) 60 percent of taxable e-commerce purchases are of goods that would otherwise be purchased over the telephone or by mail from catalogs, sales that have always been exempt. As a result, the study concludes that only $2.6 billion or 13 percent of e-commerce retail sales in 1998 would have been subject to potential sales and use taxes. Thus, less than $170 million in sales and use taxes was not collected in 1998, amounting to only 0.1 percent of total sales and taxes collected by all state and local governments.[23]

Forrester Research, an e-commerce marketing research firm, predicts that the current $20 billion in e-commerce sales will grow to $184 billion by 2004. This compares with total retail sales in 1998 of $2.6 trillion. Applying the Ernst & Young analysis indicates that only $24 billion of e-commerce sales in 2004 will be subject to sales and use taxes. At an average tax rate of 6.5 percent, this will result in only $1.57 billion in total sales tax revenue losses by the states, a relatively small amount.

A different study by the University of Tennessee Center for Business and Economic Research, whose authors are strong proponents of Internet taxation, gives a much larger estimate of total state sales tax revenue losses: from $1.2 billion in 1999 to $10.8 billion by 2003.[24] The study predicts a tax loss of $333.4 million in Georgia in 2003, or 1.59 percent of the State's total tax revenues.[25] Since 1989, Georgia's general sales and use tax revenues have been growing at an average rate of 8.19 percent per year. It should be also noted that the possible reduction in tax collections is "due to lack of effective enforcement of the existing use tax [on residents] by state and local governments."[26]

The great difference between the University of Tennessee study and the Ernst & Young study illustrates the unpredictability of the future of the e-commerce marketplace and what the actual effect on sales tax revenues will be. Given these uncertainties and the fact that sales tax revenues have been steadily increasing,[27] there is no need for Congress or the states to rush to tax Internet sales without long consideration and review of the economic effects of imposing new taxes on the information revolution that has been fueling our economy.

It is important to note that none of these analyses of possible sales tax revenue reductions take into account tax revenue generated by e-commerce growth. There is no doubt that tax revenue from new e-commerce businesses has helped fuel the state revenue surpluses that exist throughout the country. Nearly 400,000 new e-commerce jobs were created in 1999, for a total of 2.3 million Americans employed in the Internet economy. Total Internet economy revenues of $301 billion in 1998 were expected to reach $507 billion in 1999, bypassing the airline industry ($355 billion).[28] E-commerce retailers and businesses such as Amazon.com and EarthLink (formerly Mindspring), which is headquartered in Atlanta, and their employees pay property, income and all other applicable state and local taxes. Thus, they are paying the taxes that support local budgets for roads, police, fire and all of the other services and infrastructure that state and local governments provide wherever those businesses and their employees are actually located. When an e-commerce retailer is not located in Georgia, the state has no equitable basis for asserting that a company should have to pay sales taxes to support infrastructure it does not use.

It is also argued that not taxing e-commerce is unfair to "bricks and mortar" merchants. This ignores the fact that 70 percent of the nation's retailers have established online operations.[29] The line between e-commerce retailers and traditional retailers has become increasingly blurred as retailers are taking advantage of the benefits of Internet transactions. At a time of tax revenue surpluses, it would be more equitable to discuss reducing sales taxes on all retailers, rather than seeking to extend them to e-commerce and mail-order vendors. Median state sales tax rates have steadily increased from 3.25 percent in 1970 to 5 percent in 1990, with 17 states today having rates at or above 6 percent.[30] When federal, state and local taxes are combined, Americans are paying near-record levels of taxes.

Proposals to force e-commerce retailers and mail-order companies to collect sales taxes would also be very difficult to establish given our current tax structure. Forty-five states and the District of Columbia impose sales taxes. It is estimated that almost 7,500 jurisdictions in the United States have local sales taxes; when special-purpose tax districts such as downtowns are included, there may be more than 30,000 different sets of sales tax rules.[31] National firms that are responsible for collecting taxes in all states with sales taxes have compliance costs that range from 14 percent of sales taxes collected by large retailers, to 48 percent for medium retailers, to 87 percent for small retailers.[32] This compares with compliance costs for single-state retailers that range from 1 percent for large retailers, to 3.7 percent for medium retailers, to 7.2 percent for small retailers.[33] Until and unless the states and local jurisdictions simplify their sales tax structures, applying such taxes to e-commerce sales will pose significant administrative difficulties and substantial compliance costs for e-commerce retailers at a time that the e-commerce retail market is still in its infancy. In addition to such compliance costs, one study has also estimated that applying existing sales taxes to e-commerce would reduce the number of online buyers by 25 percent and spending by more than 30 percent.[34]

Another factor that recommends against Georgia moving to tax e-commerce sales (assuming that Congress does not extend the Internet tax moratorium) is the effect such a tax could have on the State's efforts to attract industry to Georgia. Georgia's "Yamacraw Mission" is a state plan to spend $100 million to attract high-technology companies and turn Georgia into a new Silicon Valley.[35] Governor Roy Barnes has also proposed a $56 million package of tax credits in the 2000 General Assembly session to spur rural economic development and lure high-tech firms by providing a sales tax break for computer or high-tech purchases of up to $15 million.[36] Another bill was introduced in February that would authorize Georgia's Seed-Capital Fund to invest in start-up, high-tech firms.[37] These efforts illustrate the importance the State's leaders place on creating conditions that will encourage the information revolution to take root in Georgia and help sustain our continued economic growth. There is no doubt that e-commerce entrepreneurs and high-tech business executives would see any move to impose taxation on e-commerce as hostile to their businesses. For Georgia to be in the forefront of such tax policy would damage the State's extensive efforts to attract new industry and develop a high-technology base. The imposition of such taxes by other states could also hurt e-commerce start-ups headquartered or located in Georgia.

The benefits to Georgia of being in the forefront of taxing e-commerce sales are clearly outweighed by the costs. There is no evidence that e-commerce is reducing traditional commerce in the state or sales tax revenues. It is also difficult to justify any extension of sales taxes to out-of-state retailers who do not benefit from local services, especially in light of a $1 billion budget surplus and the 11.8 percent increase in general sales and use tax revenues in 1999. Without simplification of the nation's very complex tax system, such taxation would be a substantial administrative and cost burden on e-commerce retailers and the majority of traditional retailers who are setting up e-commerce operations. While the e-commerce retail sales market is still relatively small, the overall Internet economy is making major contributions to job creation and our current sustained economic growth. If Georgia wants to continue to attract high-tech industry and establish itself as an attractive location for new e-commerce start-ups, it should not impose a tax policy that discourages the development of e-commerce, is opposed by a majority of online users, and would create the image on the Internet of a state with a hostile regulatory climate. Georgia should oppose state sales taxes on e-commerce and encourage its Congressional representatives to support a continued national moratorium on such taxes.

This Issue Analysis is also available at www.gppf.org.

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Endnotes

[1] "Slowdown predicted for tax collections," *The Atlanta Journal-Constitution*, January 19, 2000, page B5.

[2] "Annual Financial Impact of City/County Millage Assessment for Every Percent in Georgia Sales Lost to Tax-Free Internet-Based Transactions," Georgia Municipal Association, www.gmanet.com.

[3] On February 23, 2000, the Georgia Senate passed Senate Resolution 538 sponsored by Senator Eddie Madden, which calls on Congress to allow taxation of Internet sales. It cites the increase in consumer sales over the Internet from $7 billion to $143 billion by 2003 apparently under the mistaken belief that 100 percent of Internet transactions would normally be subject to sales taxes if not for the national moratorium. The House passed a similar resolution on March 9; see H.R. 973.

[4] "DeKalb CEO Liane Levetan: Counties need a tool," *The Atlanta Journal-Constitution*, February 27, 2000, page C4.

[5] "Clinton Backs Web Sales Taxes," Charles Babington, *The Washington Post*, February 29, 2000, page E04.

[6] Public Law 105-277 (October 21, 1998).

[7] *National Bellas Hess, Inc. v. Illinois*, 386 U.S. 753 (1967); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[8] Internet Tax Freedom Act, Public Law 105-277 (October 21, 1998).

[9] O.C.G.A. Section 48-8-30.

[10] "New Taxes: States want you to pay," Margaret Kane, MSNBC, December 21, 1999; "Internet sales tax hunt is on," Charlie Cain and Mark Hornbeck, Detroit News Lansing Bureau, detnew.com, November 30, 1999.

[11] "plan Internet Poll Indicates Internet Taxation Could Be Major Issue in Upcoming Presidential Election," PRNewswire, January 31, 2000. This opposition cuts across political parties with 63 percent of Democrats, 76 percent of Republicans, and 73 percent of Independents against Internet taxation.

[12] "A pitch for tax-free e-commerce," Elliot Zaret, MSNBC, September 14, 1999; "Deal May Bar Internet Access Tax," Curt Anderson, The Associated Press, December 16, 1999; "Why an Internet-tax moratorium is needed," sv.com, April 26, 1999; "The Net Changes Everything, Except Politicians," Paul A. Gigot, *The Wall Street Journal*, November 12, 1999.
[13] *Bloomberg News*, February 23, 2000.
[14] The loss of sales tax revenues in 1998 is due to the exemption of food that was phased in beginning on October 1, 1996, and became 100 percent effective on October 1, 1998. Georgia Department of Revenue, Sales & Use Tax Regulations, Chapter 560-12-2-.104(c).
[15] Table H-3 – Trend in Georgia's Total State Tax Revenues by Major Sources 1988-1999, 1999 Statistical Report, Georgia Department of Revenue, page 10. By comparison, sales taxes as a percentage of total tax revenues range from a high of 59 percent in Washington to a low of 20 percent in Massachusetts and Vermont. Forty-five states impose sales taxes, collecting over $150 billion annually. "Dependence on sales tax," *The Atlanta Journal-Constitution*, February 27, 2000, page C4.
[16] Table H-3. The figures for general sales and use taxes do not include revenues from sales taxes on motor fuels, liquor, beer, wine, cigars and cigarettes that amounted to $646 million or 5.2 percent of total revenues in 1999.
[17] "The Net Changes Everything, Except Politicians," Paul A. Gigot, *The Wall Street Journal*, November 12, 1999.
[18] "Slowdown predicted for tax collections," *The Atlanta Journal-Constitution*, January 19, 2000, page B5.
[19] "Why Congress should Counter efforts to Tax Internet Commerce," Adam D. Thierer, The Heritage Foundation Executive Memorandum No. 628, October 5, 1999.
[20] "Party line vote OKs midyear spending plan," *The Atlanta Journal-Constitution*, February 25, 2000; see H.B. 1162.
[21] "The Sky Is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998," Robert J. Cline and Thomas S. Neubig, Ernst & Young Economics Consulting and Quantitative Analysis, June 18, 1999, page i.
[22] Id. Forrester Research estimates that 90 percent of annual Internet sales are business-to-business sales or $176 billion in 1999. "Internet taxation question headed for Congress again," Jim Nesbitt and Jim Barnett, Newhouse News Service, *The Kansas City Star*, February 27, 2000.
[23] Cline and Neubig, page ii and 12.
[24] "E-Commerce in the Context of Declining State Sales Tax Bases," Donald Bruce and William F. Fox, Center for Business and Economic Research, University of Tennessee, February 2000. Dr. Fox believes e-commerce should be taxed the same as purchases from conventional businesses because unfair tax advantages can upset the economy. "E-Commerce Cuts into State Tax Revenues," University of Tennessee Press Release, January 27, 2000.
[25] Bruce and Fox, page 14 and 16; "E-Commerce," *The Wall Street Journal*, February 2, 2000, page S1.
[26] Cline and Neubig, page 12.
[27] Although the rate of growth in state and local sales and use taxes has increased over the last three years, the growth rate has slowed over the longer term. Since 1985, there has been a steady shift of consumer spending away from tangible products and goods to personal services that are generally not taxable, and state governments have been steadily increasing the goods exempted from taxation. Cline and Neubig, page 2, and Bruce and Fox, page 4.
[28] "Huge E-Commerce Growth Fuels Hot Internet Economy," Jeff Fletcher, National League of Cities, November 9, 1999, www.gmanet.com.
[29] Forrester Research, cited in Nesbitt and Barnell.
[30] Bruce and Fox, page 4.
[31] "Will buying on the Net remain TAX FREE?" Marilyn Geewax, *The Atlanta Journal-Constitution*, February 27, 2000, page C1.
[32] "Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers," Robert J. Cline and Thomas S. Neubig, Ernst & Young Economics Consulting and Quantitative Analysis, September 8, 1999, page iii.
[33] Id. at ii.
[34] "In a World Without Borders: The Impact of Taxes on Internet Commerce," Austan Goolsbee, National Bureau of Economic Research Working Paper no. W6863, December 1998.
[35] "One State's Big Gamble on Future in Chips," Greg Jaffe, *The Wall Street Journal*, November 23, 1999, page B1.
[36] "Capitol Insider," *The Atlanta Journal-Constitution*, February 25, 2000, page F7; H.B. 1510.
[37] H.B. 1629.