In Brief: Should State and Local Governments Tax E-Commerce?

The growing role of e-commerce raises many policy issues, including privacy and consumer rights. The concern addressed by this paper is whether state and local sales taxes should be applied to e-commerce.

Currently, 45 states impose sales/use taxes. The sales tax provides about 25 percent, on average, of state and local tax revenues. These taxes go uncollected on many Internet and catalogue sales, however. This is because the Supreme Court has placed limits on the states’ ability to require certain out-of-state merchants to collect the tax. Moreover, consumers have failed, by and large, to carry out their legal responsibility to submit the sales tax to their home states, although all states that collect the sales tax require their citizens to do so when the retailer has not already collected the tax.

As a result, under the existing system of laws related to the sales tax, identical products may be taxed differently, depending on whether they are purchased over the Internet, through a catalogue, or in a traditional, “mortar-and-bricks” store. Traditional retailers charge that this situation confers a price advantage on catalogue and Internet retailers.

In addition, an important equity concern arises from the fact that older people, minorities, and people with lower incomes are likely to pay the sales tax more frequently than other individuals, because they face certain barriers to Internet shopping. These groups are less likely to have Internet access, credit cards, or a secure place to receive goods delivered through the mails.

State governments are concerned that their financial situation will suffer as a result of untaxed Internet commerce. This could imperil the many state-provided services to seniors and low-income residents. Eventually, states might be forced to seek additional revenues from the property tax, which weighs more heavily on seniors.

Many arguments have been levied against the existing sales tax system. Some of the criticisms are unjustified, for example the charge that the sales tax amounts to “taxation without representation.” Other criticisms are of dubious merit, such as the argument that the Internet is an “infant industry” that must be protected in order to allow it to develop.

Probably the strongest argument to be made against applying state sales and use taxes to the Internet is that the administrative burden could overwhelm small retailers. It is often argued that the sales tax places an onerous burden on both catalogue and Internet firms, because it requires them to collect the tax under vastly different state sales tax regimes. Currently, the compliance burden facing an Internet or catalogue firm that is required to collect the sales tax in 46 jurisdictions, because it has a physical presence in each of those jurisdictions, is no
different from the compliance burden facing a national retail chain with stores in each of those jurisdictions. Under current law, the very smallest Internet retailers, those run out of households, only have to collect the sales tax on sales within their home state. But efforts to expand merchants’ duty to collect the sales tax have the potential to affect even the very smallest household firms. For this reason, most proposals to expand the duty to collect the sales tax contain *de minimus* thresholds.

Current policy proposals vary greatly in their approach. During the 106th Congress, several proposals would have prohibited the application of the state sales tax to Internet sales. Other proposals would reform the current system, however, by expanding merchants’ duty to collect the sales tax, for example.

The administrative burden facing Internet retailers could be greatly reduced through a combination of technology and a dedicated effort on the part of states to reform their systems. In particular, thirty state and local governments have combined their efforts to develop a “streamlined” sales tax system that combines specialized software with simplification of state sales tax regimes. This two-pronged strategy has the backing of some well-known commentators. Skeptics counter that the states are unlikely to agree on the necessary reforms. Whether this skepticism is justified remains to be seen.

Most of these problems are not new. For over thirty years, state and local governments have been concerned about the revenue impact of uncollected sales taxes due to purchases from out-of-state catalogue and mail order firms. The states have brought numerous court cases to litigate out-of-state merchants’ responsibility for collecting the sales tax.

In some cases, the opposing views have deep, philosophical roots. This divergence of views has given rise to some fairly high-flying rhetoric. For supporters of the sales tax, the key issue is the need to preserve state and local government sovereignty by defending state and local sources of revenue. Of course, many critics of the sales tax are pursuing a broader anti-tax agenda, and this group sees a solution in abolishing the sales tax altogether.


A copy of the full report can be obtained at http://research.aarp.org, or write for PPI Issue Paper 2001-08, Public Policy Institute, AARP, 601 E Street, NW, Washington, DC 20049. May be copied only for noncommercial purposes and with attribution; permission required for all other purposes.