



Online Taxation

In a recent report, the Federal Trade Commission analyzed the economic implications of the Internet.* A major issue is online taxation. Currently, the Internet allows out-of-state vendors who do not pay sales tax to compete with local brick-and-mortar stores that are subject to sales taxes levied by local and state governments. It seems natural to call for a level playing field on equity and efficiency grounds. However, in this respect, it is not all that straightforward what a level playing field means.

In the debate on online taxation, theoretical arguments and empirical evidence are brought forward on either side. The “infant industry” argument figures prominently. According to this reasoning, a developing industry should receive protection from competition until it is “mature” and able to compete on equal footing; otherwise, a market failure may result with the industry not being able to fully utilize its comparative advantages. E-commerce could be viewed as such an industry. Opponents of online taxation point to network externalities that deserve to be subsidized via tax exemption. Generally, a good possesses network externalities if it becomes more valuable to the consumer as the number of users increases. Thus, the marginal consumer generates benefits for all the existing consumers without being compensated. If e-commerce generates such an externality, a tax exemption on online purchases is a way to correct for it. Proponents of Internet taxation, however, point out that “infant industry” policies rarely produce the desired outcome. Once a developing industry enjoys protection, it has little incentive to become competitive.

Empirical research in the area of e-commerce offers some insights into the pros and cons of online taxation. Current empirical evidence points out three key findings. The first is that consumers who live in areas with high sales taxes are more inclined to purchase online than consumers in areas where sales taxes are low. A sec-

ond finding is that governments do not lose a sizeable portion of tax revenue through e-commerce due to the still relatively low volume of business-to-consumer Internet transactions. For 1998, it is estimated that the tax exemption amounted to \$170-430 million based on a business-to-consumer Internet sales volume of \$2.5-2.6 billion. Even a projected loss in sales taxes by the year 2002 of around \$2.5 billion is less than two percent of projected sales tax revenue.

The third finding concerns the burden that tax collection would represent to online retailers. Currently 46 states and almost 7,500 local governments impose sales taxes of various forms, differing across goods and jurisdictions. With online taxation, Internet retailers would have to determine which tax rate applies for every good and destination, and would be responsible for tax collection. A field study conducted by the Washington State Department of Revenue among brick-and-mortar retailers in Washington and Oregon indicates that the burden on online retailers for collecting and remitting sales taxes would be significant. This study estimated that the cost of tax collection and processing to retailers amounts to about 4.23% of total state and local sales taxes. Thus, the cost of compliance already is high, even though brick-and-mortar retailers only deal with one set of tax codes pertaining to their place of business.

In summary, Internet taxation remains a challenging issue. Given the small volume of business-to-consumer transactions, the government is in no hurry to act. As the Internet grows in importance, however, the tax issue will not remain in the background. A uniform tax rate for online sales would help minimize the cost of compliance, but it might prove difficult for state and local governments to coordinate on this solution.

* Alan E. Wiseman, July 2000, Economic Perspectives on the Internet, Federal Trade Commission.

—Judith H. Hazen
—Frank A. Schmid