



National Economic Trends



Taxing Electronic Commerce: Boon or Boondoggle?

The recent economic slowdown—combined with pervasive state tax cuts in the 1990s—has hit state budgets hard. State tax collections, particularly income taxes on capital gains, were down by nearly 8 percent in FY 2002 and are expected to continue falling during FY 2003. States' budget deficits for FY 2002 totaled \$37 billion. Even with over \$17 billion in states' rainy day funds, estimates for FY 2003 forecast a collective budget deficit of nearly \$50 billion.¹

Many state policymakers believe that taxing electronic commerce—retail purchases conducted via the Internet—offers a partial remedy for their current fiscal crises. The U.S. General Accounting Office has estimated that the potential annual sales tax revenue to states from online taxation is \$13 billion. In 1992, however, the U.S. Supreme Court ruled that—under current law—merchants cannot be required to collect sales taxes unless they have a physical presence in the state where the customer is located. At the same time, the Court also ruled that Congress has the authority to amend the law and permit states to require that remote sellers collect and remit sales taxes.

Recently, policymakers from 30 states agreed to a proposal to simplify their sales tax laws and to encourage voluntary collection of online sales taxes. Named the Streamlined Sales Tax Project, this proposal would take effect when ten states representing 20 percent of the U.S. population have amended their laws to begin the program. Participating states would then ask Congress to vote in favor of a mandatory nationwide online sales tax collection program. The proposal would require states to adopt uniform definitions for various taxable goods and implement a statewide tax rate for each good. Online sellers would be required to purchase software that computes

the appropriate tax rate for the buyer's location. Sellers would then remit the collected sales tax to the corresponding state's treasury. Although states claim they would gain much-needed revenues and that online taxation would achieve more equitable tax treatment across Internet and local retailers, online retailers argue that costs from compliance and tax collection for over 7,000 different tax jurisdictions in the United States would be enormous.

Despite the possible costs, is taxing electronic commerce a permanent solution to states' budget problems? History suggests not, as states have continually sought new sources of revenue. Many states adopted sales taxes in the 1950s and 1960s and many have increased rates nearly 200 percent since that time. States receive hundreds of millions of dollars annually from lotteries and casino gambling taxes. States are now dipping into their tobacco settlement revenues to fund programs not remotely related to health care and smoker education. Finally, all but nine states have adopted rainy day funds, although many states have balances less than 5 percent of general fund revenue. None of these revenue sources has prevented the current budget problems.

During economic booms, such as the 1990s, state lawmakers cut tax rates while tax coffers are flush and make additional expenditure commitments that they have difficulty keeping when the economy slows. As economic conditions improve, states will again see rising revenues. If the past is a guide, these revenues will be committed to ongoing spending programs or tax rates will be cut. The single step of taxing electronic commerce is no panacea to the procyclical spend/cut pattern of state governments. Regardless of whether states end up taxing electronic commerce, state lawmakers could moderate spending growth and tax cutting during favorable economic conditions and contribute more surplus revenues to rainy day funds.

—Thomas A. Garrett

¹National Conference of State Legislatures, *State Budget and Tax Actions 2002*, and House Research Organization, Texas House of Representatives, *Interim News*, 25 March 2002.

