BBVA | RESEARCH

Economic Watch

United States

Houston, March 25, 2014
Economic Analysis

Michael Soni
michael.soni@bbvacompass.com

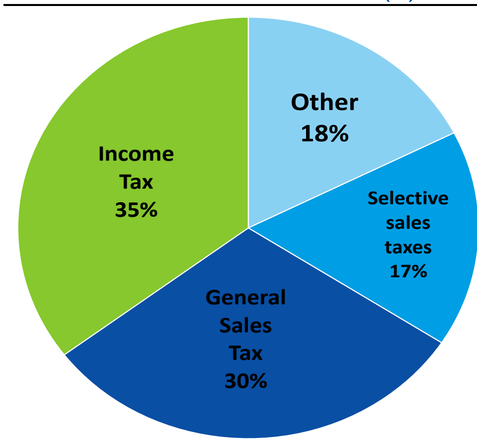
Is E-Commerce Taxation a Solution for State Revenues?

- Estimates suggest states are missing out on over $11bn a year
- Online sales projected to make up increasing share of total sales
- Marketplace Fairness Act would help states collect missing tax revenue
- The amount of revenue states stand to gain from tax will remain insignificant as a percentage of total state revenue and GDP

As the amount of revenue lost in online sales continues to grow, states are turning their attention to e-commerce and are debating whether they should enforce tax collection on internet sales. The National Conference of State Legislatures (NCSL) estimates that in 2012, state governments lost over $11 billion in revenue by failing to collect due sales taxes on internet purchases by consumers alone.

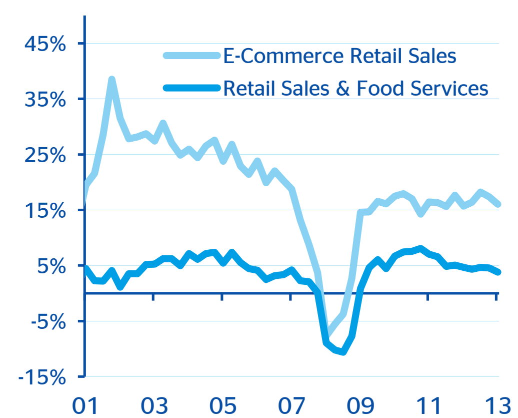
Online shopping has exploded over the last decade with the proliferation of smartphones, tablets and other portable electronic devices, and many businesses are utilizing the internet as a means of retailing. The growth and globalization of e-commerce has provided customers with a convenient way to shop. Since 2005, online retail sales in the United States have tripled from $72bn to $262 billion in 2013. In terms of total market share, in 2004, e-commerce sales were 1.9% of total retail sales and by 2013 e-commerce retail sales increased to 4.2%. Many companies are recognizing the opportunities to be gained from e-commerce and the significance of an online presence. Thus, online retail sales share of total retail sales will continue to increase in the future.

Chart 1
2012 State Tax Revenue Breakdown (%)



Source: Census Bureau and Haver Analytics

Chart 2
Retail Sales vs. E-commerce Sales Growth (YoY%)



Source: Census Bureau and Haver Analytics

Moreover, in a time when state balance sheets are strapped tight, legislators are looking for additional revenue to close the budget gap. A recent NCSL survey of state legislative fiscal officers concluded that between 2008 and 2013, states closed nearly $530bn in budget gaps through program reductions. Following the recession, state budget revenues have been slowed by weak economic growth; between 2Q08 and 2Q11, state revenues declined by an average of 1.5% YoY. However, state revenues have improved substantially over the past couple of years. From 2Q11 to 2Q13, YoY revenue growth increased by an average of 6.1%, relieving budgetary pressures. Still, the fiscal improvement has not been enough to close budget gaps, and states continue to search for alternative ways to improve their fiscal situations. Additionally, many state governments rely on general sales taxes for a significant portion of their revenue. In 2Q13, sales taxes accounted for over 31% of total tax revenue. If the issue of online sales tax collection is not addressed, states stand to lose an increasing share of sales tax revenue as e-commerce makes up an increasing share of overall retail sales.

States are currently unable to efficiently collect out-of-state online sales tax revenue due to a 1992 ruling *Quill v. North Dakota* that placed the burden on sellers instead of buyers for out-of-state online retail transactions. As part of the ruling, sellers are only required to collect sales tax if they have a substantial physical presence, such as a warehouse or factory, within that state. However, the ruling took place in an era when e-commerce was a non-issue, so at the time, online sales tax collection was not a concern.

Presently, 45 states administer a retail sales tax and as a result of the 1992 decision, the responsibility is placed on the consumer to self-report their purchase in the form of a use tax. However, according to a study by the Minnesota House Research Department, less than 2% of taxpayers report a use tax in states where they are required to report, which suggests that states are not capturing this source of revenue as they should. In addition, the Sales Tax Advisory Council noted that many consumers are unaware of the requirement to self-report the use tax, and that collecting a small amount of taxes on each individual consumer who makes an out-of-state purchase is costly.

In May 2013, the Senate passed the Marketplace Fairness Act (MFA). The proposed law forces out-of-state retailers with revenue of $1 million or more or who have a physical presence in their state to collect sales tax on out-of-state purchases. States would only be given authority to enforce collection if they have simplified their tax laws, either by agreeing to the Streamlined Sales and Use Tax Agreement (SSUTA) or abiding by specific simplification requirements described in the bill. The bill has passed the Senate but is currently held-up in Congress. Opponents of the bill regard the online sales tax enforcement as an additional tax; however, considering that buyers are already supposed to be paying a use tax, the argument is difficult to defend. Additional criticism stems from the extra burden on retailers of coordinating several tax rates across different states. The MFA attempts to address the issue by requiring that all states agree to the SSUTA, but the effectiveness of the mandate has yet to be seen.

Overall, the MFA would assist states in collecting tax revenues due on internet sales and contribute in closing state budget gaps. By providing state governments with the rights to enforce sales and use tax laws, states would be able to attain revenue which goes largely unreported. Another suggested system in collecting the online sales tax is an origin base collection system, in which the retailer abides by the tax laws of the state in which it is located. However, this would cause companies to locate in states that have low sales tax or no sales tax at all, so the issue of tax collection would still be unresolved.

According to our estimates, e-commerce sales will more than double by 2018, from $262bn to around $551bn. Put as a percentage of total retail sales, e-commerce sales would make up over 9% in 2018, up from 4.2% in 2012. In the absence of any changes to the law, our estimated tax loss for states would reach about $27bn in 2018. Even under these assumptions, the estimated tax revenue lost from internet sales would represent just over 1.1% of total state revenues by 2018 and only 0.1%

of United States GDP in the same year. Thus, the amount of revenue states will be losing out is small relative to total revenues and gross domestic product, and the effort required to enforce laws for online tax collection weigh down on the benefits. In other words, states may be better served to look for other sources of revenue, such as cutting spending, increasing tax collection or improving spending efficiency, as means to balance their budgets and increase their bang for the buck. In the end, the relatively small share of estimated revenues losses from online sales does not seem to represent a high risk to state finances, states' creditworthiness and the country's long-term fiscal stability.

Bottom Line

Thanks to the rapid growth of technology and innovation, e-commerce growth continues to make up a larger share of the overall retail sales pie. As a result, states are targeting online sales as a means of collecting sales tax revenue which are already due. By adopting the Marketplace Fairness Act, collecting taxes on out-of-state online purchases would be made easier for states. However, the revenue gained from out-of-state online tax revenue represents a small portion of the state revenue pie and will not be a significant gain for state budgets in the future. In the end, even if attempts to collect sales tax revenue on online purchases do not succeed, state finances and overall economic growth will remain unaffected.