MINUTES OF THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT .

The meeting was called to order by Chairperson Bill Mason at 3:30 p.m. on February 11, 1999 in Room 522-S of the Capitol.

All members were present except: Representative Larry Campbell-E
                                     Representative Gerald Geringer-E

Committee staff present: April Holman, Legislative Research Department
                            Lynne Holt, Legislative Research Department
                            Darrell McNeil, Office of Revisor of Statutes
                            Rose Marie Glatt, Committee Secretary

Conferees appearing before the committee:
    Karla Pierce, Secretary of Revenue
    Chris McKenzie, Executive Director of League of Kansas Municipalities
    Natalie Bright, Director of Taxation and Small Business
    Rebecca Rice, Kansas Retail Liquor Dealers Association

Others attending: See Attached

Chairman Mason spoke of the growing concern regarding the tax issue of Internet sales as well as the impact of those sales on small businesses, industries and communities. Although there was no formal bill for consideration, they would hear presenters that would update them on these issues.

April Holman, Legislative Research Department, briefed the committee on the following issues: Impact of e-commerce on local "main street" businesses, loss of sales/use tax revenue and federal moratorium on taxation of Internet sales (Attachment 1).

Discussion followed regarding tax ramifications of Kansas companies selling their products through the Internet and the requirements for sales tax collection by companies.

Karla Pierce, Secretary of Revenue, briefed the committee on the current status of electronic commerce, Internet sales and taxes (Attachment 2). She defined electronic commerce and reviewed the following issues: Nexus, Internet Tax Freedom Act, National Tax Association and Kansas'conformity to recommendations coming from that association. She talked about the states' activities and the upcoming mid-state workshop. In summary she gave estimates of the tax loss through Internet sales and stated that this was a complex issue with many differing interests. The issue would grow as Kansans have access to more products than through regular catalogue marketing channels.

Discussion followed regarding clarification in the "nexus" area and the possibility of tying the tax liability and collection to a product warranty or consumer protection plan.

Chris McKenzie, Executive Director of the League of Kansas Municipalities, briefed the committee on the issue of electronic commerce and its possible effects on the shape of state and local finance in the future (Attachment 3). He talked about three issues: What state-local revenue trends might tell us, Changes in the economy that are affecting the debate and Where do we go from here. His testimony included reprinted newspaper and publication articles and a local fiscal policy.

Discussion followed regarding the problems of the retailers, expansion of business due to Internet sales and the ramifications of the technology age and subsequent changes such as relocating people from offices to homes.

Natalie Bright, Director of Taxation and Small Business, briefed the committee on five issues: Who is using the Internet, How are businesses responding to taxing the Internet, What is the business community willing to support, What are the concerns of businesses and the Barriers to online shopping. (Attachment 4). She distributed copies of "The Second Annual Ernst & Young Internet Shopping Study"(Attachment 5).

Rebecca Rice, Kansas Retail Liquor Dealers Association, spoke to the committee regarding a bill that the liquor industry had brought forward to Federal and State Affairs Committee last year, to deal with Internet alcohol sales (no written testimony). Although it is not a tax issue, they were trying to bring awareness to the Legislature that with the creation of the three tiered distribution system there are also inherent problems, i.e., the availability of any kind of liquor sales, via the Internet, delivered directly to homes. She cited the example of California wine sales directly to Kansas residents.

Discussion followed regarding the process of the bill in the Federal and State Affairs committee.

The Chairman thanked the presenters for the information and asked that they keep committee members informed.

Representative Gatewood moved that the minutes from the February 2nd and 4th meetings be approved. Representative Aday seconded the motion and the motion carried.

The next meeting is February 11.

The Chairman adjourned the meeting at 4:45 p.m.

HOUSE ECONOMIC DEVELOPMENT COMMITTEE
COMMITTEE GUEST LIST

DATE: February 11, 1999

NAME	REPRESENTING
Scott Schneider	MGA
George Peterson	Ks Taxpayers Network
Kelly Buttala	City of Overland Park
Rose Franche	KGE
Sk Sicilian	K.D. of Rev.
Erik Sartorius	Johnson Co. Board of Realtors
Greg Hill	Federico Consulting
Mabel Miller	Kansas Inc
Laverne Cole	Sen Tyson - Intern
Mark Barcellana	KDOC&H
Karla Pierce	KDOR
Jay Allbaugh	Multimedia Cablevision

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February 11, 1999

Presentation to House Economic Development Committee
By April Holman

Re: Internet Commerce Issues

The terms "electronic commerce" (e-commerce) and "Internet commerce" (I-commerce) are often used interchangeably to refer to commercial transactions which occur over the Internet.

There has been a sizeable growth in e-commerce overall in the past two years. According to the United States Department of Commerce, on-line sales estimates for 1997 average $3 billion, while estimates for 1998 average $9 billion, an increase of three times the 1997 level. A study done by Nielson Media Research disclosed that almost one quarter of all consumers who accessed the Internet in the first six months of 1998 made an on-line purchase.

The following issues are discussed below:

- impact of e-commerce on local "mainstreet" businesses,

- loss of sales/use tax revenue, and

- federal moratorium on taxation of Internet sales.

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Impact of E-Commerce on Local "Mainstreet" Businesses

There are a variety of reasons why it is difficult to quantify the impact of e-commerce on local "mainstreet" businesses. One very basic reason is that it is difficult, if not impossible, to track in a comprehensive way the location of Internet purchasers. In some cases this information can be discerned from the delivery address of goods purchased over the Internet. However, there are instances where there is no physical delivery of a product, as in the case of a purchase of software which is downloaded directly from the Internet. It is also possible that purchasers may have products delivered to an address other than their own.

Another impediment to determining the impact of e-commerce on local businesses is the availability of catalog sales and the phenomenon of "trade pull" in Kansas and the subsequent loss of local business to traditional retailers in retail centers in counties such as Ellis, Johnson, Sedgwick, Saline, and Shawnee.

The concept of "trade pull" is tracked by Kansas State University economist, David Darling, in a series of annual studies which measure the retail strength of Kansas counties and cities using an equation that aims to show which areas are capturing more retail trade than they are losing. This study is based on sales tax collections and population data.

According to the 1998 study, Ellis County had a pull factor of 1.85 on the high end and Kearney County, adjacent to Finney County, had a pull factor of .21 on the low end.

As a result of the retail pull, it is that much more difficult to isolate losses to mainstreet businesses due to the Internet.

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Another reason that it is difficult to quantify the impact of e-commerce on local businesses is that Internet sales levels have not been officially tracked in the past. The United States Department of Commerce has traditionally tracked Internet sales in conjunction with catalog sales. The good news on this front is that Secretary of Commerce, William Daley, announced last week that the Census Bureau would begin publishing figures on Internet sales separate from catalog sales.

I realize that the subheading on this section is somewhat misleading in that it might appear that I have identified the actual impact of e-commerce on local businesses. Unfortunately, for the reasons listed above, this information is not available at this time. However, there may be a loss of business to traditional retailers in Kansas due to Internet sales, even though that loss may not be quantified.

Loss of Sales/Use Tax Revenues

According to Kansas law, a sales tax is imposed on all nonexempt retail sales of goods and services within the state. While the tax is to be paid by the consumer, it is to be collected by the retailer. This creates an enforcement problem when the retailer is an out-of-state vendor. Unless the vendor has sufficient contacts, such as a presence (nexus) in the state, the state cannot require the vendor to collect the state sales tax. The state may define "nexus" in its statutes, but the due process and commerce clauses of the U.S. Constitution create limits on the state's ability to find nexus. For example, in *Quill Corp. v North Dakota*, 504 U.S. 298, 112 S.Ct. 1904 (1992), the United States Supreme Court found a company cannot be required to collect and remit sales tax if the company has no connection to the state other than through the

U.S. mail or common carrier. Although the United States Supreme Court has not specifically ruled on the issue of nexus in the context of collection of sales tax on Internet commerce, there is a close similarity to the issues involved in catalog sales on which the Supreme Court has ruled.

Because the state cannot enforce collection of the sales tax without nexus, a benefit of sorts is realized by out-of-state Internet retailers who do not have to include sales tax in the price of their goods and services and, therefore, have a competitive advantage over in-state retailers.

Note: Some companies selling goods and services over the Internet collect state and local taxes voluntarily, such as Microsoft.

Federal Moratorium on Taxing Internet Sales

Several states have attempted to recapture some of the revenue lost due to Internet sales by imposing a tax on Internet access. Unfortunately, a federal moratorium prevents additional states from instituting such a tax for three years.

In October of 1998, Congress enacted the Internet Tax Freedom Act. This legislation placed a three-year moratorium on the following state and local taxes:

- taxes on Internet access, unless such tax was generally imposed and actually enforced prior to October 1, 1998;

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- multiple taxes; and

- discriminatory taxes.

The statute defines a discriminatory tax as any tax generally imposed by a state or local government on electronic commerce that:

- is not generally imposed and legally collectible on transactions involving similar property, goods, services, or information accomplished through other means or at the same rate;

- imposes an obligation to collect or pay the tax on a different person or entity that in the case of transactions involving similar property, goods, services, or information accomplished through other means; and

- establishes a classification of Internet access service providers or on-line service providers for purposes of establishing a higher tax rate to be imposed on such providers than the tax rate generally applied to all other providers of similar information through other means.

The statutory definition of "discriminatory tax" also applies to taxes imposed by state and local governments that use the sole ability to access a site on a remote seller's out-of-state computer server as a factor in determining a remote seller's tax collection obligations.

The Internet Tax Freedom Act also established a 19-member Commission to conduct a thorough study of federal, state and local, and international taxation and tariff treatment of transactions using the Internet and Internet access and other comparable intrastate, interstate, or international sales activities.

The Commission has 18 months from the date of enactment to issue a final report to Congress and it is charged with studying the following issues:

- examination of barriers imposed in foreign markets on U.S. providers of property, goods, and services or information in electronic commerce and how those barriers impact U.S. consumers and the growth of the Internet;

- examination of the collection and administration of consumption taxes on electronic commerce in other countries and the United States, particularly comparing collection and administration of such taxes in transactions which are conducted over the Internet and when it does not;

- examination of the impact of the Internet and Internet access (particularly telephone use over the Internet) on the revenue base for taxes imposed under the IRS Code of 1986, Section 4251;

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- examination of model state legislation that would provide uniform definitions of categories of property, goods, services, or information subject to or exempt from sales and use taxes;

- examination of model state legislation that would ensure that Internet access services, on-line services, and communications and transactions using the Internet, Internet access service, or on-line services would be treated in a tax and technologically neutral manner relative to other forms of remote sales;

- examination of the effects of taxation, including the absence of taxation, on all interstate sales transactions, including transactions using the Internet, on retail businesses and on state and local governments; examination may include a review of the efforts of state and local governments to collect sales and use taxes on in-state purchases from out-of-state sellers; and

- examination of ways to simplify federal, state, and local taxes imposed on the provision of telecommunications systems.

States are somewhat limited as to what they can do to address Internet sales issues, at least to the extent that solutions may involve either leveling the playing field with local businesses through equal imposition of the sales tax or recapturing of lost sales tax revenue by means of an alternative tax.

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Office of the Secretary

BRIEFING PAPER

TO: **House Economic Development Committee**
            Representative Bill Mason, Chairman

FROM: **Karla Pierce**
            Secretary of Revenue

DATE: **February 11, 1999**

Electronic Commerce, the Internet and Taxes

Virtual shopping malls require only a click of the mouse to purchase your favorite merchandise from any where in the world. Electronic commerce is changing the way business is conducted globally. Existing state tax policies were designed for a different era of commerce. The use of the Internet to market and transact sales of taxable goods has turned main street business into an information superhighway.

Electronic commerce has been defined as the exchange of goods or services between two or more parties using electronic tools and techniques. One type of electronic commerce is for the business to advertise and accept orders over the Internet and deliver the goods through traditional means. This is very similar to mail order business. Another type of electronic commerce is to deliver digitized goods over the Internet, such as music, books, magazines, movies and computer software. All of these products, in traditional form, would be subject to Kansas Retailers' Sales Tax if purchased by a Kansas consumer from a Kansas business. However, the U.S. Supreme Court in its 1992 *Quill* decision said that a retailer must have a physical presence in a state before that state has the authority to require sales or use tax collections. This is called **"nexus."** Electronic commerce permits out-of-state electronic merchants to transact business without physically entering other states. Here in lies one of the major barriers to administering the current tax system in the world of electronic commerce.

Keep in mind, all of these products are subject to a 4.9% consumers compensating (use) tax that is to be reported and paid by the consumer. Many businesses consuming taxable products are reporting these purchases and paying the tax. County treasurers collect this tax on vehicles purchased from an in-state owner or out-of-state vehicle dealer not registered to collect Kansas tax. On other transactions, we have no systematic way of collecting this tax from individual consumers.

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Internet Tax Freedom Act
This issue has caught the eye of Congress, businesses and state and local tax professionals. As a result, Congress passed the Internet Tax Freedom Act in 1998. This act placed a three year moratorium on the imposition of taxes on Internet access and on multiple or discriminatory taxes on electronic commerce. A multiple tax is defined as a tax imposed by one state on the same electronic commerce that is subject to another tax imposed by another state without a credit for taxes paid to the other state. A discriminatory tax is defined as a tax not generally imposed and legally collectible by such State on transactions involving similar property, goods, services or information accomplished through other means or not generally imposed at the same rate as commerce transacted by other means. Kansas has none of these taxes and was not affected by this act.

Section 1102 of the ITFA created a 19 member advisory commission to examine trade barriers, collection and administration of consumption taxes on electronic commerce. The advisory commission is to write model state legislation, provide uniform definitions and examine the effects of taxation on all Internet sales transactions.

Members of the commission have been appointed. However, there is some concern that membership appointments do not meet the requirements of the act. The act provides for 8 business representatives, including a main street business owner, and 8 government representatives. There appears to be more electronic commerce business representatives and less government representatives appointed to the commission. The other three members are the Secretary of Commerce, the Secretary of Treasury and the United States Trade Representative. The commission has not held their first meeting. They have 18 months from the date of enactment (April 2000) to submit a report to Congress. Their recommendations must be approved by two-thirds of the members, be tax and technologically neutral and apply to all forms of "remote" commerce. Remote commerce include both direct marketers and electronic distribution.

Congressional action in the nexus area is a necessary first step for states to impose sales and use tax collections requirements on out-of-state retailers. This must be a part of the final Commission recommendations if the state and local governments are to protect the tax base and ensure a level playing field between remote and main street commerce.

National Tax Association
The National Tax Association (NTA) launched the Communication and Electronic Commerce Tax Project in mid-1997 to examine the issues involved in the application of state and local taxes to electronic commerce and develop recommendations to resolve relevant issues. This project grew out of a symposium on telecommunications and electronic commerce that was co-sponsored by NTA, Federation of Tax Administrators, the Multi-state Tax Commission and the National Conference State Legislatures. The membership of the project includes industry and government representatives.

This project's purpose has shifted because of the enactment of the Internet Tax Freedom Act. The current purpose is to provide input into the Advisory Commission. The NTA goal is to reach agreement on expanding the duty of retailers to collect use tax in exchange for tax simplification

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and uniformity for businesses. State NTA members do not believe a consensus will be reached. They are currently working on the administrative architecture and relying on Congress through the advisory committee to develop the policy architecture. As you know, this Committee's work is not binding on Kansas.

- Tax Rate - NTA members have agreed to one rate per state. To be constitutional, this rate could not be more than the lowest rate in Kansas. At this time that is 4.9% because not all locations have a local option tax.
- Tax Base - The objective is to define and classify goods and services according to a third party system to promote uniformity across states. Kansas would need clear policies related to digital products, such as music or videos delivered over the Internet.
- Sourcing - Sourcing determines what basis should used to assign the destination of a sale for determining where the transaction can be taxed. There have been three recommendations adopted:
  - Sales should be sourced to the state level only - there will be no sub-state sourcing.
  - Sales should be sourced to the state of destination when adequate information can be obtained in a practical, unobtrusive and efficient manner.
  - A default rule must be developed to deal with transactions where adequate information is not available.
- Administrative Simplification - The group has identified three options for reducing the administrative burden on retailers.
  - Base state of the seller would collect for all other destinations and then remit to other states. This is the way we administer Interstate Motor Fuel.
  - Real time tax administration by a state contractor-agent who collects information from the sales transaction and tax at the point of sale. These would typically be third party brokers or clearinghouse type operations. This would be a costly infrastructure to build with the costs being passed through to states contracting for the service. This also raises audit-ability and liability issues.
  - Central clearinghouse for returns and remittance processing would provide a processing operation for business registrations, data and remittance processing but allow each state to complete the audit, compliance and delinquent collections functions.
- Other Administrative Simplifications are being discussed to achieve uniformity across the states.
  - Standard exemption forms
  - Uniform vendor allowance
  - Direct pay provisions to allow purchaser to directly pay tax
  - Clear audit burden relief

The final report for this project should be completed in July 1999.

Kansas conformity with these recommendations
The tax collected on mail-order or Internet sales transactions would be a retailers' compensating use tax. This tax is 4.9% with no local option, except for vehicle and boat purchase or leases. We currently only allow a retailers discount for collecting the tax to retailers is located in Missouri, Nebraska, Colorado and Oklahoma per bi-state compacts. The Secretary has authority

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to establish compacts with other state retailers for collection of retailers' compensating use taxes. We do accept a standard exemption form and have direct pay provisions in our statutes.

This highlights the impact this form of commerce is going to have on local option sales taxes. By moving the transaction from Kansas Retailers' Sales Tax to Kansas Retailers' Compensating Tax local jurisdiction's lose their ability under current law to tax the transaction.

States' Activities
The northwestern states of Washington, Idaho and Utah have been working to make their definitions uniform and determine statutory changes to simplify their three states' sale tax. Washington has designed an Internet sales tax form that uses GIS to determine the tax rate of a location. If the retailer uses this form, they are relieved of some tax burden during audit.

I have visited with Missouri, Nebraska and Iowa Tax Commissioners. We are planning to hold a mid-states workshop on this topic. We would like to include legislators, local units of government and representatives of Chambers of Commerce to examine all of the issues that impact the mid-states region.

This workshop will focus on educating interested parties about the laws, trends and issues surrounding remote commerce. Each state needs to develop an understanding of the relationships between the Internet service providers and sellers. We also need to have clear policy on the taxability of information services and software and digital products. We all need to be better educated on constitutional nexus issues.

Summary
We have estimated that Kansas would collect $50 million annually in tax revenue from remote commerce if given the authority to require out-of-state retailers to collect the tax. If shipping and handling charges are exempted for simplification reasons, we would lose $17.0 to $27.0 million in tax revenue, for a net gain of $33.0 to $23.0 million. This includes any sales transactions that would be made over the Internet. I think it is reasonable to assume this will only grow as Kansans have access to more products than through regular catalogue marketing channels.

This is a complex issue with many differing interests. My goal today was to report on the national activities and point out potential problems down the road. Should Congress provide the states authority to require out-of-state businesses to collect and remit taxes, you will need to consider whether Kansas should adopt any subsequent uniformity provisions. Most uniformity provisions will probably need to apply to retailers' sales tax in order to avoid having the retailers' compensating tax become discriminatory. Stay tuned, this issue is only going to heat up.

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TO: **House Economic Development Committee**
FROM: Chris McKenzie, Executive Director
DATE: February 11, 1999
SUBJECT: Potential Effects of Electronic Commerce on State and Local Sales and use Tax Revenues

Thank you for this opportunity to visit with you today about the issue of electronic commerce and its possible effects on the shape of state and local finance in the future. I applaud the Committee for studying this important issue.

On August 31, 1998 a group of Kansas municipal officials met with Senator Pat Roberts and Senator Sam Brownback to discuss the then pending "Internet Tax Freedom Act." At that time the bill before the Senate had a number of problems, and they are enumerated in the attached memo to Senator Roberts of that date.

To a person the city officials who discussed this issue talked about two things: (1) the inability of the state to collect taxes on electronic commerce could cripple local budgets which today rely as much on sales taxes as they do on property taxes; and (2) the growing unfairness of the sales tax will ultimately spell its demise if we do nothing. They also stressed that no one was interested in taxing Internet access. The issue was whether sales tax due on items sold over the Internet can be collected. Fortunately, the senators heard us and worked for a much fairer version of the bill. The *Wall Street Journal* article following to the memo to Senator Roberts really tells the story as clearly as it can be told.

Today I would like to focus on some trends in state and local finance that may be tell us something about where the impact of this problem may hit hardest. I also will share with you the executive summary of a recent publication on the challenges we face in keeping our tax systems in tune with the changing local economy.

WHAT STATE-LOCAL REVENUE TRENDS MIGHT TELL US. Many times we can't see where we are heading without looking a bit at the past. In its November 1997 publication, *Critical Issues in State-Local Fiscal Policy: A Guide to Local Option Taxes*, the National Conference of State Legislatures identifies some important indicators of change in the state-local fiscal system that bear watching and pondering. Two of those factors are:

- Fiscal centralization--growth in the state share of state and local tax revenue; and
- The diminishing role of the local property tax in state-local finance.

The effects of centralizing the power to raise and expend revenues in the hands of state government is illustrated in the attached Tables 1 and 2 from the report. Table 1 illustrates not only changes in state-local tax levels per $100 of personal income, but notice the inverse relationship between 1970 and 1996 between

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Attachment 3

the tax levels of local and state governments. The local tax level is declining while the state level is increasing, for the most part.

Table 2 tells the rest of the story, reporting by state the shift between 1970 and 1994 between states and local governments on raising revenues. As noted, states like Kansas have moved significantly toward centralization. No doubt our 1992 school finance plan had a lot to do with this.

Table 3 then illustrates the decline between 1970 and 1994 in the role of the property tax as a percent of total state and local tax revenues. In this time frame Kansas went from collecting 51% of its total state-local revenues from property taxes in 1970 to 31% in 1996.

It is probably safe to conclude a few things from this trend:

❶　　As state government shoulders a greater share of the load of financing state and local government functions, its revenue sources are probably more vulnerable to being affected by the growth in untaxed electronic commerce.

❷　　Despite the declining reliance on the property tax, cities and counties could experience revenue losses if commercial business districts experience business losses and declines in assessed valuation.

CHANGES IN THE ECONOMY THAT ARE AFFECTING THE DEBATE. Last year the National Governors Association, National Conference of State Legislatures, and the National League of Cities joined together to commission a major study by Thomas W. Bonnett on the potential threats to the current state-local tax structure. These groups were well aware of the emerging concerns about "untaxed" electronic commerce, and they wanted a study to begin to document these concerns.

Attached to this memo is a copy of the executive summary from Tom Bonnet's report, entitled "Is the New Global Economy Leaving State-Local Tax Structures Behind?" Bonnet points our that when the current state-local tax structure was developed, we were tightly bound by geography. Most people worked, shopped and lived in the same community. In such environments, collecting taxes was simply a matter of finding the income, consumption and other transactions and applying the appropriate rate.

In the emerging global economy, Bonnet suggests, that ideas, information and knowledge are much more mobile in the bast, and it is ideas (or services) that are forming a growing portion of the retail economy. Unfortunately, the current tax structure was developed based on an industrial economy model: i.e., one which applies taxes to the production of goods. We have not yet adjusted to a the new service based economy, and our inability to modernize our tax structure will leave us further behind.

In addition to these and other forces working to restructure our economy, Bonnet suggests electronic commerce is one of the major driving forces:

　　As we enter the digital age, the prospect of electronic commerce may be the most visible long-term threat to the existing state-local tax structure. The advent of electronic commerce

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liberates consumption from geography and heightens capital mobility. The mobility of firms forces interjurisdictional tax competition. These trends make it more difficult to fairly tax capital-intensive firms and business property. the new era of deregulating the telecommunications and electric industries poses extraordinary burdens on state and local governments.

Bonnet provides some estimates of the potential impact of state sales tax losses from electronic commerce that are also attached.

WHERE DO WE GO FROM HERE. I respectfully submit that there is no question that major changes in our economy call for major changes in our state and local tax systems. Rather than continue to provide exemptions from a sales tax that still is largely based on the sale of goods (not services), a critical rethinking of our sales tax system is in order. As part of that process we should work to simplify its administration, looking at ways to make it easier for retailers to collect and remit taxes. Finally, we need to remind the U.S. Congress that its failure to redefine nexus for sales tax purposes to include the collection of sales and use tax from remote electronic sales could seriously undermine the ability of the state and local governments to educate children and carry out its other essential functions, maintain the public infrastructure, and provide police protection.

Thank you.

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League of Kansas Municipalities

Issues Concerning the Fair Taxation of Electronic Commerce

Background. Electronic commerce produced 1/3 of the growth in the U.S. economy in the past five years. Consumers are expected to purchase $6.1 billion in goods electronically in 1998, and this figure is projected to grow to $20 billion (up 233%) by 2000. Online business between companies is expected to grow even faster, increasing from $15.6 billion in 1998 to $175 billion in 2000 (up 1,021%). <u>Source</u>: *TIME* Magazine cover story, 7/20/98, "Kiss Your Mall Goodbye--the Cyberspace Marketplace."

Discrimination Against Kansas Businesses. Current federal law on the collection of sales/use taxes from non-Kansas businesses discriminates against Kansas retailers that collect state and local sales taxes. When goods are purchased from non-Kansas merchants, the "compensating use tax" applies and consumers are required to remit to the state an amount comparable to the sales tax. This rarely happens unless the item is registered (e.g. boats or cars) because the U.S. Supreme Court has held that federal law allows non-Kansas retailers to avoid collecting the tax. The rapid growth in untaxed electronic commerce will only increase the competitive disadvantage of Kansas merchants, exposing them to the risk of business losses and closure. If this happens, property values in local business districts will decline, less sales and property taxes will be collected, and local units will have no choice but to cut services or raise property taxes at a time when commercial property values are declining. The importance of the sales tax to municipal budgets is underscored by the fact that in 1997 cities collected $312 million in sales taxes--equal to 96% of all city property tax collections that year.

Problems With Pending Legislation. At least four (4) versions of the "Internet Tax Freedom Act" have been considered in Congress, and the focus is now on the Senate where the Senate Finance Committee in late July reported a version of S. 442. It would impose a 2-year moratorium on taxes on Internet access and similar taxes by state and local governments (not the federal government) while a new advisory commission, composed of 5 federal representatives, 6 state/local representatives, and 6 representatives of the electronic commerce industry and consumers meet to study the issues. <u>No</u> local merchants who pay state and local sales taxes today are included, and the Commission would <u>not</u> be directed to make recommendations to end the discrimination against local merchants under current federal law as a result of untaxed catalog and electronic sales. In short, states and local units would get preempted with no possibility of real tax equity resulting.

Recommendations. Since no level of government can or wants to restrain the growth of electronic commerce, the question becomes how to treat it fairly for tax purposes. We urge support for legislation which contains the following ingredients:

❶ No moratorium or no more than a two-year moratorium applicable to all levels of government (including the federal government).

❷ A broad based advisory commission charged with achieving tax equity between in-state and out-of-state purchases. In other words, the Commission should submit recommendations "solving" the nexus problem for purchases from remote sellers, including electronic and catalog merchants.

❸ Incentives should be provided for states that simplify their sales tax system to make it easier for companies to remit sales and use taxes. Examples might be a single state/local rate on <u>remote</u> (not all) sales, with the state being responsible for determining the details of distributing the local share.

States Chafe as Web Shoppers Ignore Sales Taxes

By JOHN SIMONS
Staff Reporter of THE WALL STREET JOURNAL

What's the difference between a $3,000 personal computer purchased on the Internet and the same machine bought at a PC outlet and tucked in your trunk?

This isn't a joke, and states and municipalities hungry for sales-tax revenue

ONLINE

aren't laughing. The answer, in Rhode Island at least, is $210.

That's the 7% the state loses every time a consumer points and clicks through an Internet retail site like **Dell Computer Corp.**'s and makes such a purchase—unless the buyer reads and heeds the fine print near the bottom of Dell's invoice: "The purchaser is responsible for remitting any additional taxes to the taxing authority."

Believe it or not, the burden is on *you* to calculate and pay the state and local taxes on what you buy. But if you're like the overwhelming majority of Internet shoppers, you're likely to leave that tax unpaid.

With the current law on Internet-sales taxation murky and a three-year moratorium on new rules in effect, state tax collectors are breathless at the revenue slipping through their fingers. It isn't hard to understand their chagrin; U.S. sales rung up on the Internet register last year totaled nearly $8 billion, and the Web-shopping surge is looking robust. It all spells a serious tax-compliance problem.

In 1996, well before Internet commerce took off, a handful of states began drafting rules to govern Web taxation. A few even considered adding Internet-only levies to existing sales taxes. But the White House, generally favoring a hands-off approach to regulation of the Net, objected to the introduction of any new taxes. In 1997, White House adviser Ira Magaziner suggested that Congress implement legislation temporarily prohibiting them.

It did. Last October, the Internet Tax Freedom Act was passed, placing the three-year ban on new Internet sales taxes. A five- or six-year moratorium had been discussed, and the shorter term was offered as a concession to groups like the National Governors Association and the National League of Cities. But the ban effectively inaugurated a tax-free Internet shopping spree.

The nation's governors and mayors had long worried that Web shopping would siphon much-needed revenues from their tax coffers. Then last Christmas's Internet sales hit $3.2 billion, tripling the previous year's holiday receipts—and the officials' displeasure. All but five states have sales taxes, from which they derive half their revenue.

In most states and municipalities, the buyer is required to pay sales tax, but the seller isn't required to collect the tax unless the business has a corporate office, warehouse or other physical presence—a "nexus"—in the state where the sale occurs. The same laws govern the $48 billion catalog-sales business, and states and municipalities have fought unsuccessfully for two decades to overturn them. Internet sales are growing faster than catalog sales, though, and are due to overtake them within the next few years.

The laws are nearly impossible to enforce, and consumers know it. Michael A. Pitlock, executive director of the Nevada Department of Taxation, likens the situation to "putting a speed-limit sign on the road that says, 'By the way, police don't patrol here, and they never will.' "

Mr. Pitlock is particularly sensitive to any drain on revenue. Nevada, which doesn't have an income tax, depends on the state's 6.5% sales tax. "Looking at the national numbers, [Internet commerce] is now a significant concern," he says. His solution to the quandary: "Put a requirement on vendors to collect taxes for all products they ship to each state."

Not surprisingly, most online sellers don't want to play tax collector in each of the country's 30,000 tax jurisdictions. "It puts additional cost and responsibility on us," says Cathie Hargett, a spokeswoman for Dell, of Round Rock, Texas.

Naomi Lefkovitz, deputy general counsel at Web-based music seller **CDnow Inc.**, in Fort Washington, Pa., is blunter. "Consumers are supposed to pay the tax and report it, but we have no control over that," she says. "That's up to each person and their own honesty."

Most online entrepreneurs believe stricter sales-tax rules would slow the growth of digital commerce. Take away the bargain-basement aura of the Net, they say, and online buying loses some of its glow. University of Chicago economist Austan Goolsbee, who analyzed data on the buying decisions of some 25,000 Internet shoppers, says in a recent paper that applying existing sales taxes to Internet commerce "would reduce the number of online buyers by 25% and spending by more than 30%."

Under current tax law, Internet bookseller **Amazon.com**, Seattle, charges taxes only on purchases made by customers who give an address in the company's home state of Washington. Dell charges taxes only on Web sales made to consumers in Florida, Kentucky, Nevada and Texas, because it has warehouses, distribution centers or corporate offices there.

Amazon competitor **Borders Group Inc.**, of Ann Arbor, Mich., set up Borders Online Inc. as a separate operation to handle Internet sales. As a result, although Borders Group operates bookstores in all but 10 states, Borders Online charges tax in only two: Tennessee, where it has a warehouse, and Michigan, where it shares a corporate base with Borders Group.

Microsoft Corp. is one of the few companies that regularly factor in state and local sales taxes. As consumers type their addresses on an electronic sales form, the Redmond, Wash., company's billing system calculates the tax for that location. "But I can't say with 100% certainty that we tax everybody appropriately," says Bruce Reid, Microsoft's state and local tax director. An online buyer might have software mailed to a friend in a state with no sales tax, he says.

From the consumer's point of view, sales-tax obligations can be baffling. University of Michigan graduate student Bob Geier estimates that he spent close to $4,000 shopping online last year. He was "vaguely aware" that he was eventually supposed to pay taxes on most of those purchases, he says, but "like every other human being in Michigan, I dutifully ignore" the requirement.

October's Internet Tax Freedom Act ordered that state and local officials and Internet entrepreneurs participate in an advisory panel to hash out a uniform Internet-tax policy. The panel, with options ranging from recommending extension of the moratorium to calling for creation of a national system for taxing Internet sales, would have 18 months to issue a report. The committee's makeup was to provide a balance of views.
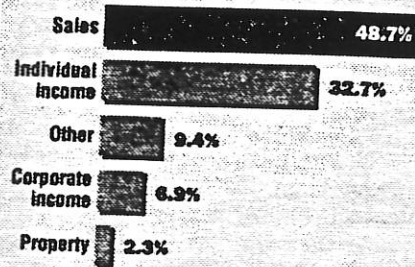
pointments were made in December; industry panelists include C. Michael Armstrong, chief executive of AT&T Corp.; Robert Pittman, chief operating officer of America Online Inc.; and Netscape Communications Corp. Chief Executive James Barksdale. But governors and state legislators complain that the panel is slanted toward industry, with nine business representatives and only seven state and local members. Congress is rethinking the board's balance and may expand membership to 22.

Last week, seven groups, including the Council of State Governments and the U.S. Conference of Mayors, sent a letter to President Clinton and members of Congress urging them to redress the panel's imbalance. The letter asked them to ensure that the committee "does not serve as a mechanism to harm or create a bias against local retailers" or "serve as a tax haven to drain vital resources critical to education, health care and public safety."

Seeking a Share of the Wealth

States Depend on Sales Taxes...
Sources of state tax revenue

Sales	48.7%
Individual income	32.7%
Other	9.4%
Corporate income	6.9%
Property	2.3%

And Want Their Cut of Web Purchases
Estimated business-to-consumer sales online, in billions of dollars

Sources: Forrester Research, U.S. Bureau of Census

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CRITICAL ISSUES IN STATE-LOCAL FISCAL POLICY

A Guide to Local Option Taxes

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	Total			State				
Fiscal Year	Combined	Local	State	General Sales	Personal Income Tax	Corporation Income Tax	Selective Sales	Other
1970	$11.31	$5.07	$6.24	$1.84	$1.19	$0.49	$1.70	$1.01
1971	$11.50	$5.26	$6.24	$1.87	$1.23	$0.41	$1.71	$1.02
1972	$12.24	$5.51	$6.73	$1.98	$1.46	$0.50	$1.76	$1.04
1973	$12.40	$5.43	$6.97	$2.03	$1.59	$0.56	$1.77	$1.02
1974	$11.94	$5.16	$6.78	$2.07	$1.56	$0.55	$1.64	$0.96
1975	$11.75	$5.09	$6.66	$2.06	$1.56	$0.55	$1.54	$0.94
1976	$12.01	$5.17	$6.84	$2.09	$1.64	$0.56	$1.54	$1.01
1977	$12.16	$5.17	$6.99	$2.14	$1.76	$0.63	$1.49	$0.97
1978	$12.09	$5.01	$7.08	$2.20	$1.82	$0.67	$1.44	$0.95
1979	$11.37	$4.46	$6.91	$2.19	$1.80	$0.67	$1.34	$0.92
1980	$11.00	$4.26	$6.74	$2.12	$1.83	$0.65	$1.21	$0.92
1981	$10.79	$4.20	$6.59	$2.04	$1.80	$0.62	$1.16	$0.97
1982	$10.52	$4.12	$6.40	$1.98	$1.80	$0.55	$1.12	$0.95
1983	$10.60	$4.25	$6.35	$1.99	$1.84	$0.49	$1.12	$0.91
1984	$11.20	$4.35	$6.85	$2.17	$2.05	$0.54	$1.16	$0.92
1985	$11.12	$4.34	$6.78	$2.19	$2.01	$0.55	$1.12	$0.91
1986	$11.05	$4.37	$6.68	$2.19	$1.97	$0.54	$1.10	$0.88
1987	$11.30	$4.50	$6.80	$2.19	$2.10	$0.57	$1.11	$0.84
1988	$11.43	$4.57	$6.86	$2.26	$2.08	$0.56	$1.12	$0.83
1989	$11.41	$4.55	$6.86	$2.25	$2.14	$0.58	$1.09	$0.80
1990	$11.33	$4.59	$6.74	$2.24	$2.15	$0.49	$1.06	$0.80
1991	$11.15	$4.61	$6.54	$2.17	$2.09	$0.43	$1.06	$0.79
1992	$11.35	$4.69	$6.66	$2.18	$2.12	$0.44	$1.12	$0.80
1993	$11.43	$4.66	$6.77	$2.20	$2.15	$0.46	$1.15	$0.82
1994	$11.46	$4.61	$6.85	$2.26	$2.16	$0.47	$1.15	$0.82
1995	N/A	N/A	$6.98	$2.31	$2.20	$0.51	$1.13	$0.83
1996	N/A	N/A	$6.89	$2.29	$2.21	$0.48	$1.09	$0.81
Average								
1970s	$11.88	$5.13	$6.74	$2.05	$1.56	$0.56	$1.59	$0.98
1980s	$11.04	$4.35	$6.69	$2.14	$1.96	$0.57	$1.59	$0.98
1990s	$11.34	$4.63	$6.78	$2.24	$2.15	$0.47	$1.13	$0.89

TABLE 1. STATE-LOCAL TAX LEVELS PER $100 PERSONAL INCOME, 1970-1996

Key: N/A = Not available

Sources: U.S. Census Bureau, *Government Finances in 1970 and 1996*;
U.S. Census Bureau, *State Government Finances in 1970 and 1996*;
U.S. Commerce Department, *Survey of Current Business*, Rev. Personal Income Estimates, October 1996.

Fiscal centralization

Fiscal centralization measures the percentage of combined state and local taxes that are collected by the state. Table 2 compares state fiscal centralization in 1970 and 1994. The table illustrates the dramatic variation in state fiscal structures. New Hampshire has a long history of strong local control and a weak state government that pays very little for education, which is a key state funding responsibility in most states. Hawaii is at the opposite end of the spectrum. Its schools are state financed and controlled, and the state

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funds a single payer health insurance system through payroll taxes. Delaware and New Mexico also are highly centralized.

TABLE 2. PERCENT OF STATE-LOCAL TAX REVENUE RAISED BY STATES, 1970 AND 1994							
State	1994	1970	Change	State	1994	1970	Change
Alabama	70.6%	73.8%	-3.2%	Montana	69.5%	46.6%	22.9%
Alaska	63.5%	68.2%	-4.7%	Nebraska	57.7%	44.4%	13.3%
Arizona	63.8%	62.9%	0.9%	Nevada	69.4%	59.1%	10.3%
Arkansas	77.1%	72.6%	4.5%	New Hampshire	33.6%	38.6%	-5.0%
California	65.8%	49.3%	16.5%	New Jersey	53.1%	41.6%	11.5%
Colorado	50.7%	50.9%	-0.2%	New Mexico	78.6%	74.9%	3.7%
Connecticut	60.7%	50.5%	10.2%	New York	47.5%	51.4%	-3.9%
Delaware	82.0%	79.3%	2.7%	North Carolina	70.5%	75.3%	-4.8%
Florida	58.4%	60.3%	-1.9%	North Dakota	68.3%	52.4%	15.9%
Georgia	58.9%	65.8%	-6.9%	Ohio	58.0%	46.6%	11.4%
Hawaii	79.7%	77.3%	2.4%	Oklahoma	70.9%	64.1%	6.8%
Idaho	72.5%	63.0%	9.5%	Oregon	57.8%	51.5%	6.3%
Illinois	53.5%	53.0%	0.5%	Pennsylvania	60.7%	58.7%	2.0%
Indiana	61.3%	54.0%	7.3%	Rhode Island	57.7%	59.0%	-1.3%
Iowa	63.6%	51.0%	12.6%	South Carolina	68.2%	76.5%	-8.3%
Kansas	62.3%	48.6%	13.7%	South Dakota	50.3%	42.5%	7.8%
Kentucky	77.1%	73.0%	4.1%	Tennessee	63.0%	62.7%	0.3%
Louisiana	59.0%	69.6%	-10.6%	Texas	52.3%	55.8%	-3.5%
Maine	60.5%	55.0%	5.5%	Utah	66.0%	63.4%	2.6%
Maryland	57.0%	57.2%	-0.2%	Vermont	57.8%	64.6%	-6.8%
Massachusetts	64.3%	49.3%	15.0%	Virginia	56.8%	60.4%	-3.6%
Michigan	59.2%	58.0%	1.2%	Washington	70.2%	68.1%	2.1%
Minnesota	69.3%	60.7%	8.6%	West Virginia	76.2%	73.3%	2.9%
Mississippi	75.4%	74.1%	1.3%	Wisconsin	61.4%	59.3%	2.1%
Missouri	60.0%	51.2%	8.8%	Wyoming	61.8%	58.6%	3.2%
U.S. Total	59.7%	55.3%					

Key: States in **boldface** have moved significantly toward centralization (=7.5% increase); states in *italics* have moved significantly toward decentralization (=7.5% decrease); states in plain text have experienced little change in either direction.

Source: U.S. Census Bureau, *Government Finances in 1970 and 1994.*

Table 2 also shows the trend toward centralization during the last 25 years. New Hampshire and New York are the only states where local governments raised more tax revenue than state governments in 1994. In 1970, local governments in nine states raised more tax revenue than the states. The number of highly centralized states also increased from 10 to 12 between 1970 and 1994.

Figure 1 shows the percentage of taxes collected by the states during this period. The state share of state-local revenue increased from an average of 55 percent in 1970 to 61 percent

TABLE 3. PROPERTY TAX AS A SHARE OF STATE-LOCAL TAXES, 1970 AND 1994					
Region/ State	1994		1970		Percentage Point
	Percent	Rank	Percent	Rank	Change
New England	**44.0%**		**47.2%**		**-3.1%**
Connecticut	38.9%	9	49.2%	8	-10.3%
Maine	40.2%	7	45.7%	16	-5.5%
Massachusetts	34.7%	18	50.3%	7	-15.6%
New Hampshire	65.9%	1	62.3%	1	3.6%
Rhode Island	42.1%	5	40.5%	20	1.6%
Vermont	42.4%	4	34.9%	30	7.5%
Middle Atlantic	**30.0%**		**34.0%**		**-3.7%**
Delaware	14.9%	49	18.6%	49	-3.7%
District of Columbia	32.1%	23	32.7%	33	-0.6%
Maryland	27.2%	35	32.4%	34	-5.2%
New Jersey	46.1%	2	54.1%	4	-8.0%
New York	32.3%	21	36.4%	26	-4.1%
Pennsylvania	28.6%	31	29.5%	37	-0.9%
Great Lakes	**36.1%**		**43.8%**		**-7.8%**
Illinois	38.5%	10	41.2%	19	-2.7%
Indiana	34.9%	17	47.0%	13	-12.1%
Michigan	41.1%	6	40.3%	22	0.8%
Ohio	28.5%	33	47.2%	11	-18.7%
Wisconsin	37.2%	13	43.4%	17	-6.2%
Plains	**32.0%**		**47.6%**		**-15.6%**
Iowa	34.4%	19	48.9%	9	-14.5%
Kansas	31.4%	24	51.2%	6	-19.8%
Minnesota	29.2%	29	38.7%	25	-9.5%
Missouri	23.4%	39	40.1%	23	-16.7%
Nebraska	36.8%	14	52.6%	5	-15.8%
North Dakota	28.8%	30	46.6%	15	-17.8%
South Dakota	39.9%	8	55.0%	2	-15.1%
Southeast	**22.8%**		**24.9%**		**-2.1%**
Alabama	12.2%	51	15.2%	51	-3.0%
Arkansas	15.1%	48	25.8%	40	-10.7%
Florida	36.1%	15	34.0%	32	2.1%
Georgia	29.5%	28	30.5%	35	-1.0%
Kentucky	16.5%	46	22.9%	45	-6.4%
Louisiana	17.3%	44	19.8%	48	-2.5%
Mississippi	23.5%	38	24.1%	43	-0.6%
North Carolina	21.9%	41	25.3%	41	-3.4%
South Carolina	28.6%	32	22.4%	47	6.2%
Tennessee	22.8%	40	27.5%	39	-4.7%
Virginia	31.0%	25	28.3%	38	2.7%
West Virginia	19.5%	43	23.3%	44	-3.8%
Southwest	**24.2%**		**33.1%**		**-8.9%**
Arizona	30.7%	26	38.9%	24	-8.2%
New Mexico	12.5%	50	22.6%	46	-10.1%
Oklahoma	16.4%	47	30.5%	35	-14.1%
Texas	37.3%	12	40.5%	20	-3.2%
Rocky Mountain	**32.8%**		**43.4%**		**-10.5%**
Colorado	32.3%	22	42.7%	18	-10.4%
Idaho	26.2%	36	36.4%	26	-10.2%
Montana	42.7%	3	54.3%	3	-11.6%
Utah	25.6%	37	36.0%	28	-10.4%
Wyoming	37.4%	11	47.5%	10	-10.1%
Far West	**27.5%**		**34.2%**		**-6.7%**
Alaska	33.0%	20	24.4%	42	8.6%
California	27.3%	34	46.9%	14	-19.6%
Hawaii	16.6%	45	17.2%	50	-0.6%
Nevada	21.8%	42	34.4%	31	-12.6%
Oregon	36.0%	16	47.2%	11	-11.2%
Washington	30.1%	27	35.1%	29	-5.0%
U.S. Average	**31.5%**		**39.2%**		**-7.7%**

Source: U.S. Census Bureau, *Government Finances* in 1970 and 1994.

National Conference of State Legislatures

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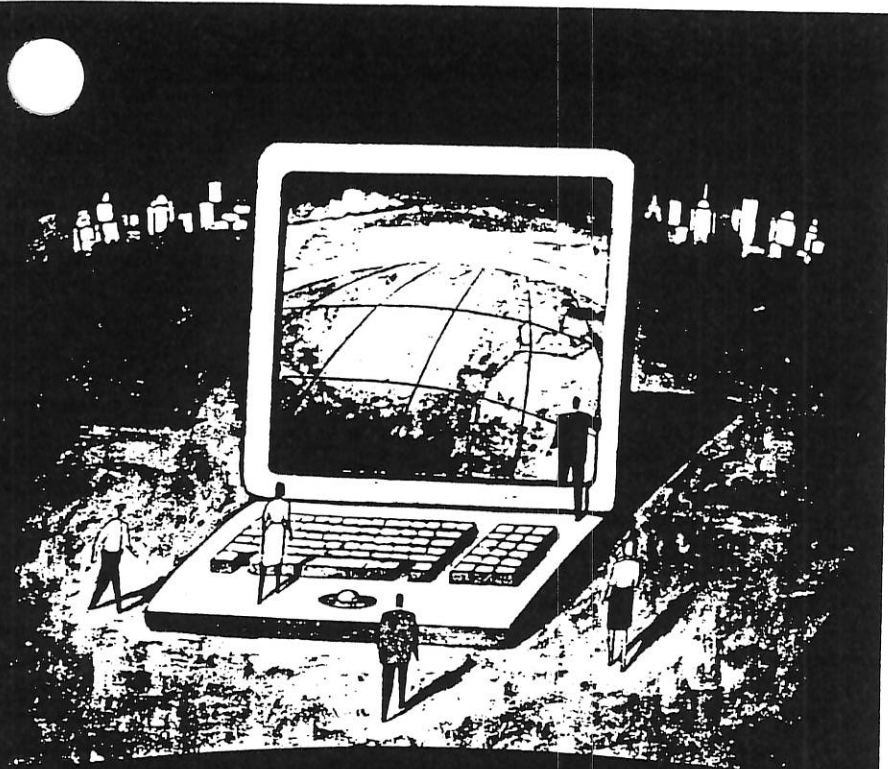
IS THE NEW GLOBAL ECONOMY

LEAVING STATE-LOCAL

TAX STRUCTURES BEHIND?

NATIONAL LEAGUE OF CITIES

NATIONAL CONFERENCE OF STATE LEGISLATURES

NATIONAL GOVERNORS' ASSOCIATION

EXECUTIVE SUMMARY

Prominent economic, social, demographic, and technological trends threaten to erode the tax revenues of states and cities. The mainstays of their tax systems are the income, property, and sales taxes. Together, they generated 75.9 percent of total state and local tax revenues in fiscal 1994. Each is a prominent revenue source for state and local governments: the property tax generated 31.5 percent, the sales tax generated 23.8 percent, and the personal income tax generated 20.6 percent of total state-local tax revenues in fiscal 1994.

The most significant fiscal trend over the past twenty years has been the declining share of federal support to state and local governments, which has placed a much greater burden on current state and local taxes. Federal grants-in-aid to state and local governments averaged 21.5 percent of their total spending over the 1990 — 95 period. This is well below the 26.5 percent peak that occurred in 1978. Consequently, state and local governments have had to rely much more upon their own tax revenue sources to generate sufficient revenue to provide the services required by the public. Further, the recent trend of Congress pushing more responsibilities to state and local governments will place additional burdens on the current state-local tax structure.

If these two trends continue, federal grants-in-aid support to state and local governments will remain at modest levels for some time and burdens will increase as well. Surely, that prospect increases the importance to state and local leaders of maintaining a state-local tax structure that will continue to generate adequate revenues with which to support valuable public services. The continued effectiveness of the tax structure is essential to maintain the autonomy of state and local governments. State and local leaders concerned with the independence and responsiveness of their governments should be sensitive to the stability of the state-local tax structure.

When the current state-local tax structure was constructed, most local and regional economies were tightly bound to geography. In that era, most people worked, shopped, and lived in the same community. In these "closed" systems, jurisdictions had a relatively easy time taxing income and consumption to raise sufficient revenue to support public services. The global economy today is an open system of economic production and consumption. The major vulnerability of the current state-local tax structure is its inability to adapt to increased mobility.

Capital has always been mobile, but in the global economy, it can speed from London to Hong Kong to New York in seconds. Ideas, information, and knowledge are mobile, and have become important factors of production in the new global economy. It is a cliche to talk about a shrinking world, but transportation and telecommunications costs throughout the world have plummeted in this century. International trade between 1980 and 1995 grew twice as fast as the growth in world output. In 1970, about 25 percent of the total world output was traded internationally; that figure is projected to be 50 percent in 2000.

The mobility of the factors of production in the modern economy has enabled global firms to comparison shop around the world for advantageous locations for new industrial plants. Job-hungry governments have responded by bidding for business. Decades ago, industrial recruitment was considered a regional competition — the sun belt versus the rust belt. Today, industrial recruitment is an international competition.

The mobility of capital has enabled business to aggressively seek tax preferences from state and local governments. The net effect has been a reduced share of tax revenues coming from business. Each level of government in this country collects a smaller share of its total tax revenue from business today compared to 1946. The challenge of taxing income and capital is a global problem, and one that grows more difficult each passing day.

The current tax structure was build decades ago when the industrial economy produced tangible goods. The shift to the new service economy is the best documented challenge to the current tax structure, but other social, demographic, and technological trends pose difficult challenges as well. The shift from a manufacturing-based economy, the changing nature of work, the shift to electronic commerce, the mobility of firms and interjurisdictional tax competition, the deregulation of telecommunications and electric industries, and the aging of America are trends that together could jeopardize the future viability of the current state-local tax structure. Each of these trends has important tax implications.

⦿ *Economic Transformation.* The magnitude of the shift over the last half century from an economy based on manufacturing goods to one dominated by knowledge-based and personal services is often not well understood, but it poses several challenges to current tax policies. In 1959, services constituted less than 40 percent of the Gross Domestic Product (GDP), while goods production constituted roughly half. In 1994, services were almost 65 percent of the GDP while goods production was approximately 37 percent. In short, there has been a dramatic shift in how the modern economy creates wealth. State and local leaders may ask, in this context, how well the current tax system matches the modern economy. Specifically, they may ask how the current sales tax system corresponds to the fastest-growing sector in the economy.

Two specific tax questions are posed: whether personal services should be included in the sales tax base and whether the property tax is biased against capital-intensive firms. There may be less rationale to limiting the sales tax to tangible goods while services — the growth sector of the economy — remain untaxed or are inconsistently taxed. Similarly, the continued reliance on the property tax as the primary source of funding for local governments may pose a heavy burden on goods-producing firms and capital-intensive industries. The effect of both policies may violate the notion of horizontal equity in taxation,

impose burdens on narrow tax bases, distort private economic decisionmaking, and hinder economic development. The issue of reforming the tax structure to achieve tax neutrality among firms and promote economic development will merit further study.

⦿ *Changing Nature of Work.* The increase in global competitiveness has led to major corporate downsizing; advances in computing and telecommunications technologies have enabled organizational restructuring such as telecommuting and decentralizing headquarter operations; and public sector innovation following this pattern of reengineering has fostered other changes in how work is being organized. Each of these developments has tax implications for state and local governments.

⦿ *Electronic Commerce.* Electronic commerce offers both boundless opportunities for, and grave threats to, the public sector. State and local governments may lag behind the private sector in implementing the latest information technologies that enable electronic funds transfer, electronic benefits transfer, electronic data interchange, digital signatures, and smart cards. An increasing number of public sector leaders understand that those technologies hold tremendous opportunities for improve services and achieve greater efficiencies. Implementing them in the public sector is a difficult task.

Electronic commerce also poses a long-term threat to the current tax system. The threat is that consumers will increasingly use electronic media for purchasing goods and services — circumventing conventional sales taxation — and shifting earned income to other jurisdictions, which would either minimize or evade conventional income taxation. Income and consumption are no longer constrained by geography.

The traditional definition of nexus for sales taxation — having a physical presence in a state — is rapidly becoming an antiquated concept as electronic commerce emerges in new markets. Unless Congress redefines nexus, electronic commerce will erode the revenue stream from state-local sales taxes. Although this potential threat is a very serious one, the recent discussions between the mail-order catalogue industry and the states presents an excellent model for resolving this political conflict, and a basis for measured optimism that this can be done with enlightened private sector leadership. Indeed, if the states can negotiate an agreement with the largest mail-order firms to collect sales taxes on purchases made across state boundaries, then electronic vendors could be persuaded to follow this path.

⦿ *Firm Mobility and Interjurisdictional Tax Competition.* State and local officials are under increasing pressure to grant tax preferences that erode tax neutrality among competing firms. That economic development trend has been bolstered by advances in telecommunications and information technologies, the increased

mobility of capital, the changing nature of work, and the ability of firms and individuals to locate wherever preferential tax treatment is provided.

Deregulation of the Telecommunications and Electric Industries. Allowing competitive entry in these regulated industries will end the practice of specialized taxation of monopoly providers. Achieving tax equity will force state and local governments to experience substantial tax shifting. Substantial hardship is expected for those taxing jurisdictions that rely heavily upon existing electric generating facilities to pay local property taxes.

- *The Aging of America.* This well-documented demographic trend may result in substantial shifts in aggregate consumption patterns (diminishing sales tax revenues) and create pressure for broad reforms in senior tax preferences. The growing elderly population may diminish public sector revenues because it tends to spend less than the average working population in general, and spends more on services such as health care, which are not often taxed. Furthermore, the political controversies over the vast array of senior tax preferences could become more divisive in the future.

In addition to those major threats, two immediate policy challenges to the current state-local tax structure loom on the fiscal horizon:

- *Federal Tax Reform.* The congressional proposals for a flat tax and a national retail sales tax would force the states to undertake major revisions of their sales and personal income tax systems. It is difficult to overstate the havoc that would be caused to the state-local tax structure if federal tax law eliminated the deductions for mortgage interest, state personal income taxes, and local property taxes.

- *Federal Preemption of State or Local Taxation.* Congress has been inconsistent in responding to the needs of state and local governments. Its Un-Funded Mandates Reform Act of 1995 has been lauded by state and local leaders. The devolution of domestic programs, such as the Temporary Assistance to Needy Families Act of 1996, has been viewed by some as a tremendous opportunity, by others as an insurmountable burden. In the area of federal preemption of state or local government authority, state and local leaders are clearly displeased by the current trend.

The Clinton administration's recommendation that Internet transactions not be burdened by new taxes and the strong congressional interest in the Internet Tax Freedom Act — which would preempt state and local taxation of electronic commerce via the Internet — threatens to erode the traditional sales tax revenue base.

Now in the seventh year of economic expansion — the national unemployment rate is 4.3 percent, the lowest since 1973 — the current state-local tax structure is generating an adequate revenue stream to fund essential public services. Yet, the long threats and immediate challenges to the existing tax structure are very serious ones.

The transformation to the new service economy should provoke thoughtful revision of the current tax system. The tax structure built in the industrial age not longer matches the modern economy, and the mismatch is growing wider. The changing organization of work from corporate downsizing, telecommuting, and public sector innovation represent opportunities as well as challenges to the leaders of state and local governments.

As we enter the digital age, the prospect of electronic commerce may be the most visible long-term threat to the existing state-local tax structure. The advent of electronic commerce liberates consumption from geography and heightens capital mobility. The mobility of firms forces interjurisdictional tax competition. These trends make more difficult to fairly tax capital-intensive firms and business property. The new era of deregulating the telecommunications and electric industries poses extraordinary burdens on state and local governments.

On the horizon, the aging of America will shift relative tax burdens among age cohorts. The growing elderly population will consume less than the working age population and spend a large share of their incomes on services, such as health care, which are often not taxed. In addition, the controversy over granting a full array of senior tax preferences will escalate as the demographic shift becomes more pronounced and the champions of generational equity gain more support among the working age population.

Taken together, these economic, social, demographic, and technological trends threaten to imperil the future viability of the state-local tax structure. If not confronted directly by state and local leaders working closely with Congress, the viability of the state-local tax structure could be undermined, jeopardizing state autonomy and municipal independence in the future.

what will happen in ten." [45] *Sales tax revenues are not in immediate danger of being eviscerated by electronic commerce, but it may become a long-term threat to state-local sales tax revenues.* The Internet has the potential to conduct a growing volume of electronic commerce, dramatically reducing the sales tax revenues traditionally collected by states and local governments.

ESTIMATING THE IMPACT OF STATE SALES TAX REVENUE LOSSES FROM ELECTRONIC COMMERCE

Although the potential growth of tax-free electronic commerce represents a long-term threat to the existing state-local tax structure, no one can predict with any real confidence how great the public sector revenues will be, or how rapidly they will occur. In an effort to provide a range of estimates, the Federation of Tax Administrators prepared the following Table III, which shows the impact on state general funds from 10 percent and 20 percent reductions in sales tax revenues. Many local governments would experience substantial revenue losses as well. Four hundred cities, for example, received more than 40 percent of their total revenues from the sales tax. Mayor Smith of Greenwood, Mississippi — a jurisdiction that receives 55 percent of its budget from sales taxes — was quoted in the New York Times as saying, "If there's just a 2 percent drop in sales tax revenue, it means I have to lay off three of my fifty-three police officers."

Two important qualifications should be added: first, the estimates in this Table are not predictions or projections of revenue losses; and second, the data uses 1996 as the base year for comparison purposes. No one has any idea how much electronic commerce was conducted via the Internet in 1996.

A REVIEW OF "THE GREAT INTERNET TAX DRAIN"

Advocates of the Internet paint happy pictures of consumers shopping in a national/global marketplace. Little of this buying and selling will be subject to state and local sales taxes. This is good news for the consumer, but "a potential catastrophe for state and local governments that rely on sales tax revenues." States already lose at least $3.3 billion each year from retail sales that have migrated to mail-order businesses. Total retail sales on the Net added up to only about $200 million in 1994 — less than 0.1% of what was spent on mail-order shopping. But corporate America is turning to the Net as a dizzying pace, with the number of Web sites advertising businesses and products growing at about 12% a month. The trend is likely to accelerate as one of the key barriers to Net commerce — lack of security — starts to fall. The obvious response is to allow states to tax mail-order and Internet sales, but the courts have said no. Despite political winds favoring devolution, *"new information technologies call for more centralized revenue collection, not less."* (original emphasis) — Michael Marien, *Future Survey*, 19:3, March 1997, 6; review of Nathan Newman, "The Great Internet Tax Drain," *Technology Review*, 99:4, May-June 1996, 24-30.

TABLE III
POTENTIAL SALES TAX LOSSES FROM ELECTRONIC COMMERCE

STATES	Total Sales Tax Revenue 1996 ($million)	Potential Impact from 10% Decline		Potential Impact from 20% Decline	
		Revenue Loss ($million)	General Fund Loss (percent)	Revenue Loss ($million)	General Fund Loss (percent)
Less Populated States (< 2 million)	$7,170	$717	2.95%	$1,434	5.91%
Populated States (2-4 million)	$14,128	$1,413	3.09%	$2,826	6.19%
More Populated States (4-7 million)	$29,509	$2,951	3.27%	$5,902	6.53%
Most Populated States (>7 million)	$72,198	$7,220	3.45%	$14,440	6.91%

Less populated states: the District of Columbia and the following states: DE, HI, ID, ME, NE, NV, NM, ND, RI, SD, UT, VT, WV, and WY. [Alaska, Delaware, Montana, and New Hampshire are not included because they have no state sales tax.] **Populated states:** AZ, AR, CO, CT, IA, KS, KY, MS, OK, and SC. [Oregon is not included because it has no state sales tax.] **More populated states:** AL, GE, IN, LA, MD, MA, MI, NC, TN, VA, WA, and WI. **Most populated states:** CA, FL, IL, NJ, NY, OH, PA, and TX.

Source: Federation of Tax Administrators (FTA) calculations for various sources, U.S. Bureau of Census, National Association of State Budget Officers, October 1997.

February 11, 1999

Presentation before the House Committee on Economic Development
by

Natalie Bright
Director of Taxation and Small Business

During the last six months of 1998, on line sales grew by 200%, with the predictions that overall sales for the year would be between $10 and $13 billion. The percentage of retailers offering online shopping more than tripled in 1998 while manufacturers selling online grew by 65% in the same period. However, at the same time, only about 10% of all retail sales are made over the internet and less than 15% of Americans are shopping over the Internet.

I.   Who is using the Internet?

In order to better understand how states are losing a revenue dollars it is important to understand who makes up the tax base from which these revenue dollars are lost. In 1998, Ernst and Young conducted a survey of 1,363 and that each good would be taxed at the rate assessed by the destination state. consumers, 41 retailers and 74 manufacturers to find out just who is participating in electronic commerce. Of those surveyed, it was found that:

- Online shopping is not a mainstream activity, but is growing at a steady rate. Of the consumers participating in the survey, 43% owned personal computers in their homes. It is estimated that roughly 10% of U.S. households shop the Internet.

- Most retailers in the study are preparing for a world of electronic shopping. Retailers selling online to consumers more than tripled in 1997 from 12% to 39%, while the number planning to sell online jumped from 22% to 37%. In other words, the number of those selling or planning to sell online more than doubled from 34% to 76%.

- Most manufacturers are not yet selling directly over the Internet. 57% of manufacturers of consumer goods said they would not sell online to consumers, however, 28% of the manufacturers indicated they do plan to sell on the Internet. Studies indicate that most manufacturers currently selling over the Internet are small.

Economic Development
2-11-99
Attachment 4

II.   How are businesses responding to taxing the Internet?

In 1996, a group called the National Tax Association was formed and is comprised of industry and state representatives that are trying to find a taxing structure that is agreed upon by all parties. The goal of the industry is to develop a broadly available public report that identifies and explores the issues involved in applying state and local taxes and fees to electronic commerce as well as make recommendations to state and local officials regarding the application of such taxes. It is the goal of the group to put forth model legislation for the states to follow.

III.   What is the business community willing to support?

The business community is willing to support fairness amongst all taxpayers. The most popular solution to the state taxing issue of electronic commerce amongst businesses is for states to simplify our country's state and local use tax and fees. With over 50 states that each have their own sales tax rates as well as local sales tax rates, it would be too burdensome for any business selling via electronic to sell over the internet to try to correctly collect sales tax. The proposed solution calls for each state to assess on sales tax so that businesses would only have to keep tract of 50 different rates. What rate of tax the business would collect would be determined at the rate of the state that is the good's final destination. Businesses would then remit one lump sum of tax to the states and it would then be up to each state to divide the sales tax collected amongst local entities.   However, in order for this solution to be viable there must be some universal definition established for all goods sold over the Internet so that when businesses would know whether the good qualified as a taxable item.

IV.   What are the concerns of businesses?

The most crucial concern of the business community is the broadening of the nexus definition and the repercussions this may have if states attempt to expand their "power" to assess income and franchise taxes against businesses selling goods in their state via electronic commerce.   If the definition is broadened, current businesses which are not subject to state assessed income taxes because they have no physical presence in the state could find themselves paying income tax in all 50 states. Discussion amongst the members of the NTA concerning this issue have proven to be unsuccessful in reassuring businesses this expansion of a state's income base would not be attempted.

4-2

- By the year 2001, it is estimated that Internet sales will amount to about 9% of all retail sales while manufacturers project a rate of Internet sales to be around 7%.

- 1998 sales over the Internet were estimated to be between $10-13 billion, growing at an excess of 200% per year.

- Only 26% of American households have computers. 68% of those buying from the Internet are over 40 years old and only 11% are under 30 years old. Most are above average in wealth. Slightly more than 50% of those currently shopping on the Internet come from towns of less than 50,000 while only 2% come from major metropolitan areas.

- Largest volume items sold over the Internet include books, clothing, music, consumer electronics, and film equipment. Reasons provided for these items being the top sellers is attributed the demographics of the buyer, buyers comfort level with purchasing these items over the Internet, and these items have been sold the longest on the Internet.

- Consumers are shopping via the Internet because of lower prices (no over head cost included, no taxes), greater variety and convenience (24 hour availability).

- Consumers not shopping on the Internet are concerned with security issues (credit card information) and the difficulty of using the net and finding the items they want.

Barriers to online shopping

1. The majority of American households do not have computers. Of those polled, 57% did not own computers and of the 43% who do own computers only 52% of those are actually and only 38% of those actually have online services.
2. Consumers say they are fearful of giving out credit card information over the phone and not being able to see the product before they buy it.
3. Many consumers do use the online services through their work.
4. Manufacturers and retailers who are not using the Internet indicate it is because of a lack of corporate resources, alleviating consumers concerns for security and privacy and the complexities of linking their site to other business processes.

1999
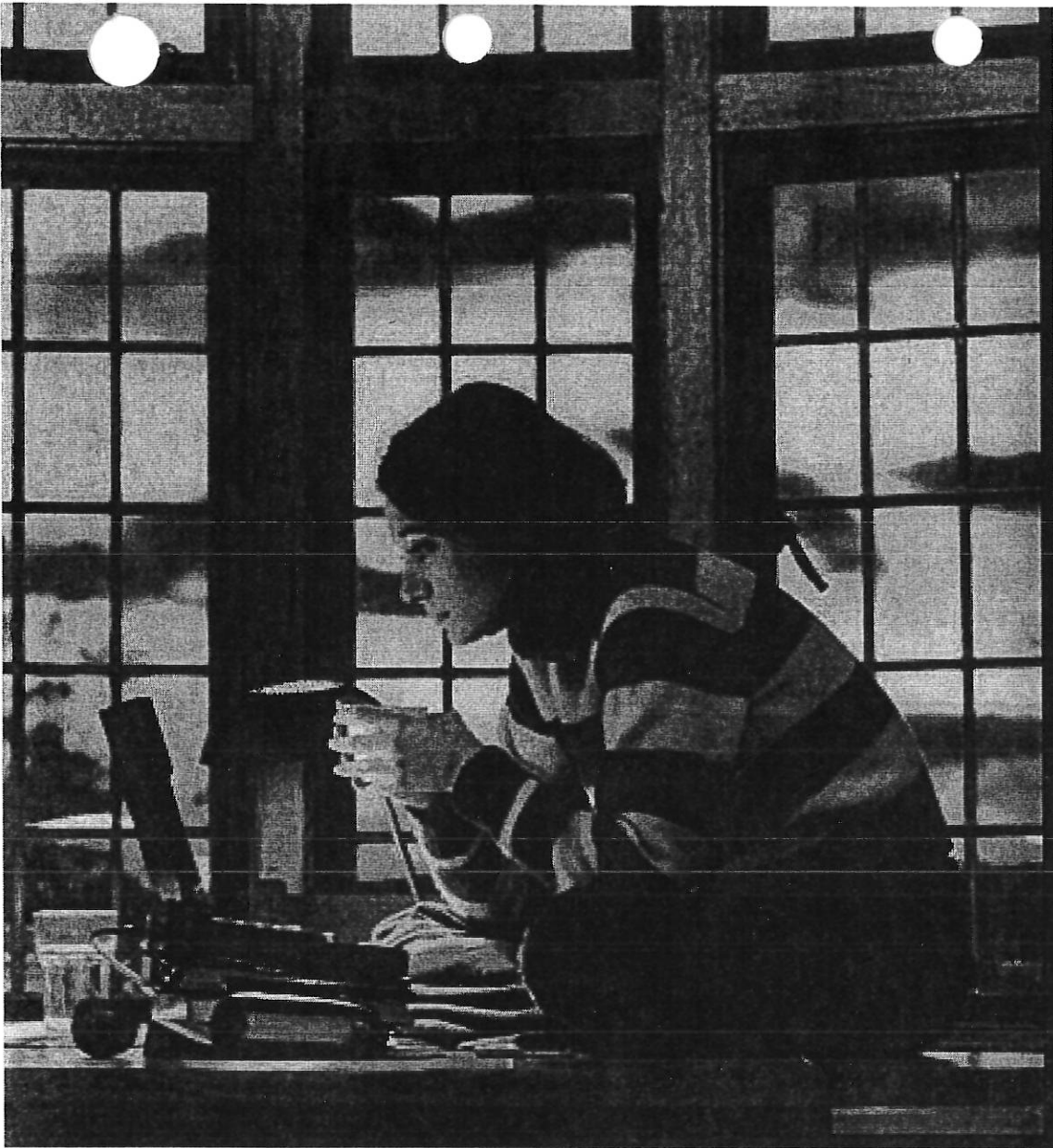
THE SECOND ANNUAL
ERNST & YOUNG
INTERNET SHOPPING STUDY

The Digital Channel Continues to Gather Steam

Sponsored By:

Table of Contents

Stephanie Shern
Vice Chairman, Marketing,
Chairman, International Retail and
Consumer Products Committee
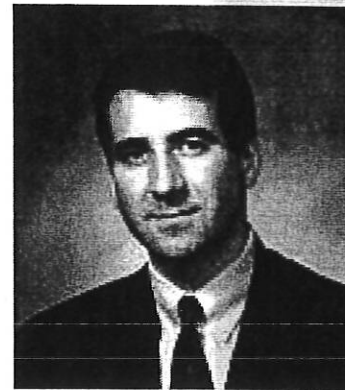
Fred Crawford
National Director
Retail and Consumer Products

Welcome to the world of cybershopping, a world where consumers are researching and purchasing their goods in stores from across the globe – all without crowds, parking, and check-out lines.

Consumer interest is high. Internet exploration is becoming mainstream. And online shopping is growing at exponential rates. In the last six months of 1998, online sales grew 200%, with predictions that overall sales for the year would come in at between $10 and $13 billion.

A few years ago, retailers could rightly state that the number of consumers connected to the Internet was too small to justify a major investment in cybershopping capabilities. That argument no longer holds water today. Consumer connection to the Web increases significantly each year, and now is just too influential for growth-oriented merchants to ignore.

The following report takes a hard look at this new sales channel from the perspectives of the consumer, retailer, and manufacturer. More than 1,300 consumers from across the country told us what they're doing on the Web, and what they'd like their merchants to provide. Their insights are provocative and instructive.

Retailers and manufacturers take heed. This new sales channel is not to be scoffed at!

What does it mean to be a merchant on the Web? How do traditional retail activities such as assortment, merchandising, pricing, and promotion translate to a world with no physical store? How do you leverage your brand in cyberspace? And how well does a company's infrastructure, such as information systems and supply chain management, support this sales channel?

A rapidly growing percentage of retailers and manufacturers are tackling these questions head-on. Our report shows that the percentage of retailers offering online shopping more than tripled in 1998. Manufacturers selling online grew by 65% in the same period.

Opening up this new sales channel is not without difficulties. In our report that follows, both manufacturers and retailers identify their biggest barriers to success in cyberspace. What does it take to succeed? Ernst & Young identified companies with above-average online success and found common traits of cybershopping leaders. These companies have strategic focus on this channel, management autonomy, strong brands, aggressive marketing campaigns, and well-designed sites.

Increased consumer demand for Internet stores will translate into strong growth in this channel. For many merchants, the Internet represents an excellent way to reach new markets and new customers. But along with growth comes challenge. Companies will succeed on the Net by turning challenges into opportunities and plans into rapid execution.

5-3

Introduction

The Internet is rapidly becoming a vibrant marketplace for buyers and sellers of a fast-growing pool of consumer goods and services. Though still a small slice of the total shopping pie, the World Wide Web in just four years has become a viable outlet for manufacturers and retailers of everything from clothes, food, and books to computers, toys, and travel arrangements.

Consider today to be akin to the 1960s, when regional malls, chain stores, and other novel retailing concepts were beginning to reshape consumer shopping habits. As the year 2000 beckons, the online shopping landscape – a blur for the last four years – is starting to take shape. Eventually, it will reconfigure the supply chain of many consumer goods and services – retailers, wholesalers, and other parties that come between producers and consumers. With vast digital retailing territory still to be won and fortunes still to be made, it's becoming more important by the day to understand why consumers are going to the Web and how pioneering manufacturers and retailers are satisfying online shoppers' buying needs – or leaving them frustrated.

This report, Ernst & Young's second on the topic in two years, is based on an extensive survey conducted with consumers, retailers, and manufacturers in the fall of 1998. It contains the insights of Ernst & Young's top experts on Internet commerce – professionals who are helping retailers and manufacturers devise Internet strategy, build Internet businesses, and prepare their organizations for the structural changes ahead in a world of electronic commerce.
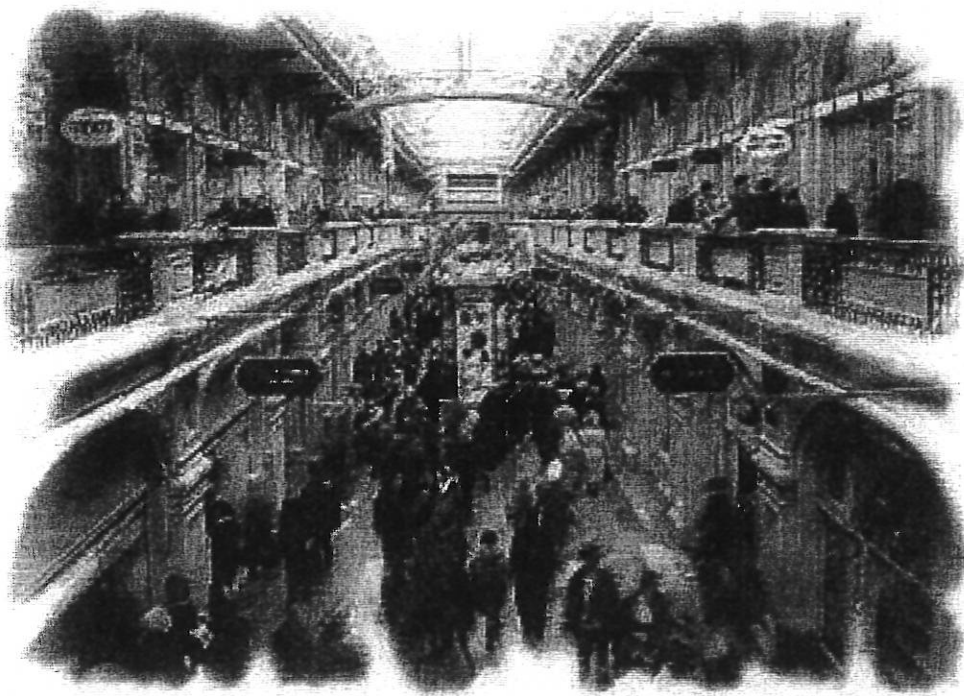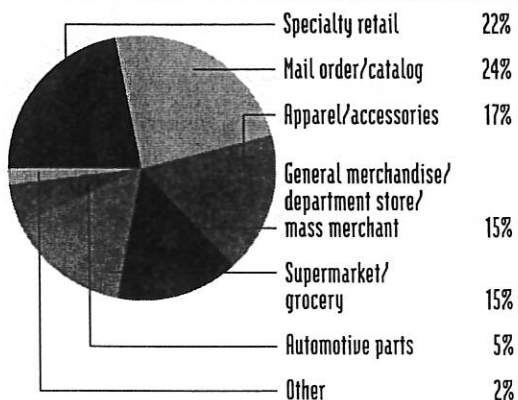
Survey Overview

Executive Summary

Shopping from home over the Internet – an activity of just one out of every 10 households in 1998 – is advancing rapidly. Ernst & Young's second annual survey of Internet shopping shows a strong increase in households shopping online and making more frequent and larger purchases over the World Wide Web. The percentage of retailers and manufacturers selling, or planning to sell, to consumers over the Net also rose dramatically.

In September 1998 we surveyed 1,363 consumers, 41 retailers and 74 manufacturers across the U.S. (see charts for demographic information). Consumers were polled through randomly dialed telephone calls to households across the country. We surveyed executives at retailers and consumer goods manufacturers, typically the senior-most marketing officer. The respondents could either complete the survey at a special Web site or fill out a paper version of the enclosed questionnaire (thus eliminating the potential to skew participation toward Web-oriented executives).

Some of the more significant findings are the following:

- Online shopping, while still not a mainstream activity, nonetheless is growing steadily. The percentage of U.S. households participating in the study that have purchased goods and services online rose from 7% in 1997 to 10% in 1998, as the number of households with PCs increased from 41% to 43%.

- Most retailers in the study are preparing for a world of electronic shopping. The proportion of retailers selling online to consumers more than tripled from 1997, from 12% to 39%, while the number planning to sell online jumped from 22% to 37%. As a result, in just one year the percentage of retailers either selling or planning to sell online has more than doubled, from 34% to 76%.

- While the majority of consumer goods manufacturers surveyed do not sell online and have no plans to, a growing number are preparing for direct electronic sales to consumers. The majority of manufacturers participating in the study (57%) said they don't – and won't – sell online to consumers. But others are not content to let retailers have the only electronic connection with consumers. Some 15% of the manufacturers reported selling online, up from 9% in 1997. And the number that plans to sell online in the future more than doubled, from 12% to 28%. Still, by far, it is mostly smaller manufacturers that said they are planning to become online merchants – not large companies that produce established brands sold through traditional retail channels.

- Online sales are expected to become a significant – although still minority – portion of total sales in the next few years for retailers and manufacturers. Today's online retailers expect the Net to account for a steadily increasing percentage of their revenue, from 1% of total sales today to 9% for fiscal year 2001. Manufacturers already selling online projected the Internet will represent 7% of their total revenue by their fiscal year 2001.

- As far as performance is concerned, most companies are far from satisfied with their Web efforts. Retailers and manufacturers alike believe that their Web sites must be easy to navigate, updated frequently, informative, and interactive. Yet, on average, they give their sites mediocre grades on these attributes. The companies with greater than average online success have sites that are more informative, intuitive, and current. In addition, they are better at providing a

Retailing respondents

Specialty retail	22%
Mail order/catalog	24%
Apparel/accessories	17%
General merchandise/ department store/ mass merchant	15%
Supermarket/ grocery	15%
Automotive parts	5%
Other	2%

5-5

Manufacturing respondents by revenue

>$1 B	18%
$400 M – $1 B	26%
$100 M – $400 M	40%
<$100 M	16%
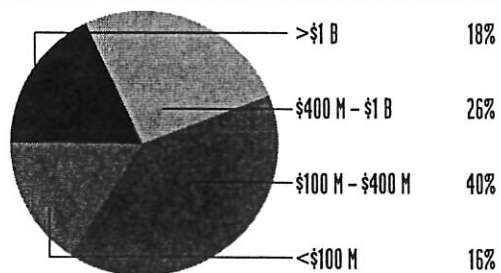
feeling of "community" (allowing visitors to share information with one another) and customizing the online experience.

The Barriers to Online Shopping

The market for goods and services sold to consumers over the Internet is estimated to be up to a $13 billion market this year, growing in excess of 200% per year over the next few years, according to a study released by shop.org and Boston Consulting Group. Yet despite the growing use of the Internet to buy computers, books, consumer electronics, airline tickets, cars, clothing, and other items, significant barriers prevent widespread online shopping by consumers.

The first, our survey found, is quite basic: The majority of American households don't have computers. Even with the recent advent of under-$1,000 PCs, 57% of all households polled in our survey lack a PC. And the presence of a PC is not a guarantee that its users are shopping on the Internet. Of households with PCs, only a slight majority (52%) are online, and only a

minority (38%) of households that are online (or "online households" for short) has bought something over the Net. Consumers who are online but don't buy through the Net cite two main reasons: the fear of giving out credit card information and the need to see the product before buying it. Even the majority of people who do buy online have, on occasion, done their research on the Web, only to buy the product at the store, fax in the order, or phone it in. Offsetting this barrier, of course, is the growing number of consumers who have Internet access through the workplace, many of whom use this access for household shopping.

Retailers and manufacturers have their own problems in making online shopping work. Those that sell or plan to sell online believe their biggest challenges are lack of corporate resources, alleviating consumer concerns for security and privacy, and the complexities of linking their site to other business processes. Web-minded manufacturers see barriers within their organization as taller than those outside of it.

Whatever the barrier, companies enjoying the most online success with consumers appear to be operating very differently from those that are struggling (see discussion on page 15). In the leading companies, managers regard the Internet as strategic to the company's future. They more clearly see the need to leverage the company's brand in cyberspace, and they spend far more on marketing to attract consumers to their Web site.
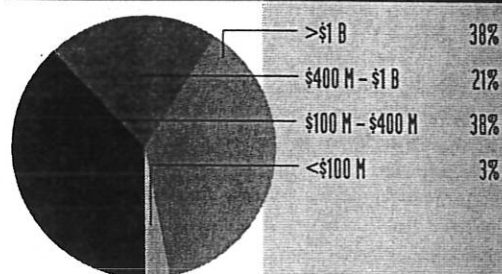
Retailing respondents by revenue

>$1 B	38%
$400 M – $1 B	21%
$100 M – $400 M	38%
<$100 M	3%

Manufacturing respondents

Food/beverage	22%
Other	21%
Health and beauty	13%
Home renovation supplies	8%
Apparel/textiles	7%
Computers & related products	7%

5-6
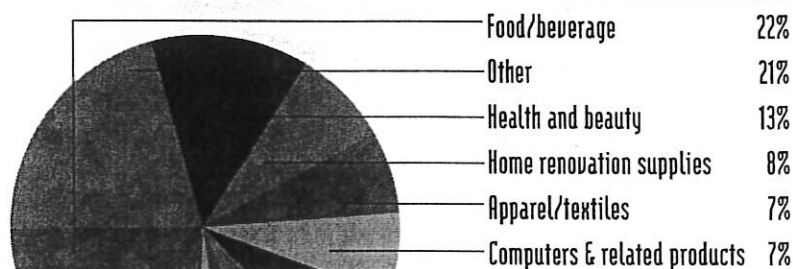
The Online Shopper

The pool is still small, yet is growing every year

While not nearly as popular as the mall, the Internet is rapidly becoming a medium through which consumers can browse and buy. The majority of online shoppers are male (although female shoppers represent an increasing percentage), better educated than the general population, and are in higher income brackets. Most also use the Internet to get information on products and services. The items they most frequently purchase online are computer-related products, books, clothing, recorded music, gifts, and consumer electronics.

Consumers participating in the study said that to keep them buying online or to get them comfortable with the activity in the first place, Internet merchants must, more than anything else, make their sites secure for credit card information and easy to navigate. And yet consumers give online stores mediocre grades on both counts.

The Rise of Online Shopping

Despite these hurdles, more and more people are shopping online. They are buying a greater range of products and services, spending more, and using the Web as a research tool for an increasing number of purchasing decisions. Some 10% of U.S. households now shop online, up from 7% when we polled consumers a year ago. Another 1% said they were "very interested" in shopping online in the future, while 7% were "somewhat interested."

A major reason only one out of 10 households shops online is that PCs are not ubiquitous, like TVs (in 98% of U.S. households) and telephones (96%). Despite strong computer sales in 1998, only 43% of American households have PCs, up from 41% in our 1997 survey. And only about one-quarter of U.S. households (26%) are online.

Yet the number of online households could be poised to increase dramatically. Seven percent of our respondents, both those with and without PCs, said they planned to hook up to the Internet through a PC during the next 12 months, which would push the percentage of online households to 33%. (The number of households with PCs that told us a year ago that they planned to go online – 5% – was nearly on target.) Another 2% of households without PCs said they planned to get on the Internet through a home electronics device such as a WebTV terminal or Internet screen phone. That would add another percentage point to the online household total. And the number of online households could rise even more with further reductions in PC prices, widening adoption of Internet access devices, enhancements in telecommunications

PC ownership, online use*

■ 1998 ▨ 1997

Households that own a PC
43%
41%

Households that are online
26%
20%

Households that have shopped online
10%
7%

*Percentage of responding U.S. households in past 2 surveys

Who is the online purchaser in the household?

Male head of household
49%

Female head of household
39%

Adult children 18 or older (not in college)
4%

Adult children 18 or older (attending college)
4%

Children up to 17
1%

Other adult family member
1%

Other
2%

bandwidth to the home, and more compelling Web sites, to name a few key forces. Considering the number of consumers with Internet access through the workplace, overall access increases dramatically.

"A few years ago, retailers could rightly state that the number of consumers connected to the Internet was too small to justify a major investment in cybershopping capabilities," noted Stephanie Shern, a vice chairman with Ernst & Young. "That argument, however, no longer holds water today. Consumer connection to the Web increases significantly each year, and now is just too influential for growth-oriented merchants to ignore."

The Profile of the Online Shopper

What kinds of people are buying goods and services through the Internet? The majority of online shoppers in our study are male heads of household (49%). Female heads of household represent 39% of online buyers, with another 8% being children 18 or over attending or not attending college (see chart). Some 68% of online buyers are 40 years old or older, and only 11% are under 30. On the whole, they are better educated than the average household (94% have had some college vs. 71% of all households). They also are wealthier, with 46% generating $50,000-plus in annual income vs. 17% for all households. Slightly more than half come from towns of less than 50,000, and only 2% are from major metropolitan areas.

The leisure-time pursuits of our study's online buyers are not much different from those of the average household (see chart). The largest differences showed up in movie attendance (37% of online shoppers go to movies frequently or regularly vs. 26% of the average household), recreational travel (42% vs. 32%), performing arts attendance (25% vs. 17%), and family-time pursuits (57% vs. 50%). A smaller percentage of online shoppers watch TV (61% vs. 65%). Otherwise, online shoppers are similar to all households in volunteer activities, gardening, gourmet cooking, photography, and attending sporting events. Our results echo a recent study that found that the general consumer population and Internet users are not much different in behavior, attitudes, and most purchasing habits.

The Internet as a Research Tool

Companies selling or contemplating selling online to consumers must regard the Internet in a broader context — as a medium through which people not only buy but also sort through their buying decisions. While 38% of online house-

holds actually purchased products or services through the Web, a much higher number (57%) researched products or services on the Internet, only to buy the item at a store or fax or phone the order in. In fact, of 12 online activities we asked online consumers about, only 10% of consumers said they used the Web often or all the time to purchase products or services, while 37% said they used the Web often or all the time to research items that they might purchase later. Much more frequently, consumers went online to send electronic mail to people they know (73% did this often or regularly) or to retrieve current news or specialized information (44%).

Consumers who use the Web to collect information for making purchasing decisions — but not

Education   ■ Online buyers   ▨ All households
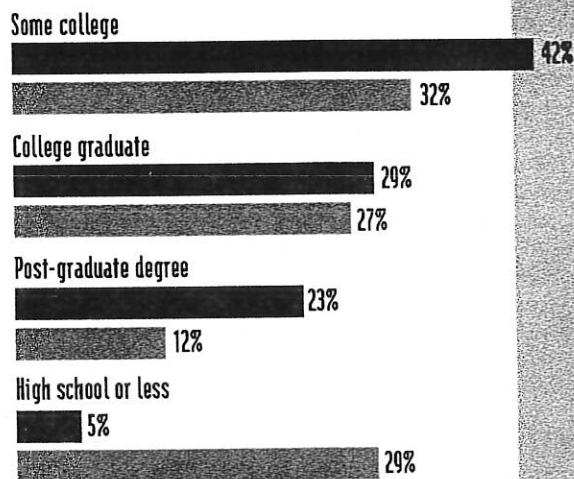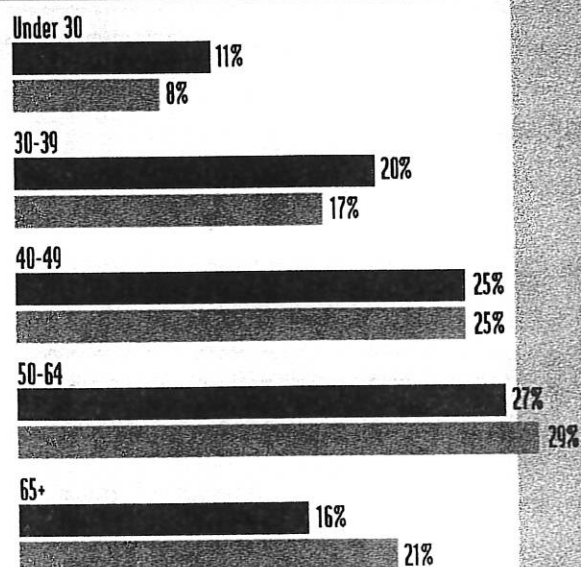
Some college
42%
32%

College graduate
29%
27%

Post-graduate degree
23%
12%

High school or less
5%
29%

Age   ■ Online buyers   ▨ All households

Under 30
11%
8%

30-39
20%
17%

40-49
25%
25%

50-64
27%
29%

65+
16%
21%

5-8

Income   ■ Online buyers   ▨ All households

Under $30,000
18%
31%

$30,000-50,000
36%
52%

$50,000-100,000
39%
16%

$100,000+
7%
1%

to make the transaction itself — buy a wide range of offerings (see chart on page 12). Computer-related products, books, and consumer electronics are the three most frequently mentioned products consumers said they researched online but bought elsewhere. Big-ticket items such as cars and boats were researched by 19% of the online shoppers but purchased online by only 2%. Even books, although purchased online by 39% of the online buyers we polled, were researched but not bought online by another 35%. Marketers in these industries — along with travel, clothing and apparel, music, large household goods such as furniture and appliances, movies and videos, and gifts delivered by mail — clearly have opportunities to inform and influence consumers, even if they aren't capturing their orders online.

"Companies that view the Internet as an 'either-or' proposition are missing the point," said Shern. "Yes, the Web can be an influential

Satisfaction rates of online buyers and non-buying online households*

	■ Online Buyers	▨ Online Households That Don't Buy Online
Number and variety of products available for purchase	3.90 [1]	3.60 [1]
Security of sending credit card over the Net	3.82 [2]	3.13 [8]
Getting latest product information and newest products	3.73 [3]	3.44 [3]
How well products and their use are described	3.65 [4]	3.38 [4]
Ease of finding your way around the site	3.59 [5]	3.20 [7]
Ability to do comparison shopping	3.50 [6]	3.25 [6]
Overall speed of process (screen downloads, etc.)	3.47 [7]	3.36 [5]
Merchandising/organization of products at sites	3.45 [8]	2.95 [11]
Lower prices than in traditional channels	3.42 [9]	2.88 [12]
How well products are pictured	3.41 [10]	3.51 [2]
Ability to have sales experience tailored to your needs	3.00 [11]	2.76 [13]
Ability to ask questions and get answers online	2.84 [12]	3.02 [9]
Ability to link to other Web sites with related information	2.71 [13]	2.97 [10]
Ability to share information with other online visitors	2.17 [14]	2.58 [14]

*Satisfaction measured on scale of 1-5 (1=not all satisfied and 5=very satisfied)

Where online buyers live

Major metro		2%
Suburb of major metro		23%
Medium-sized city/town		23%
Small city/town		51%
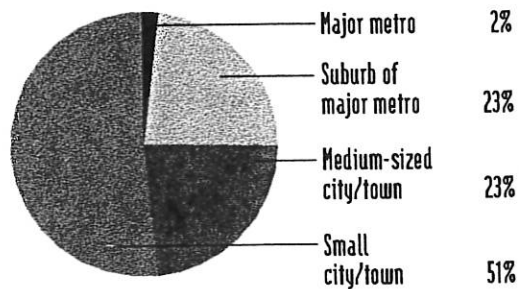
sales channel, but it also can be a powerful medium for driving purchases through more traditional channels. As our survey fi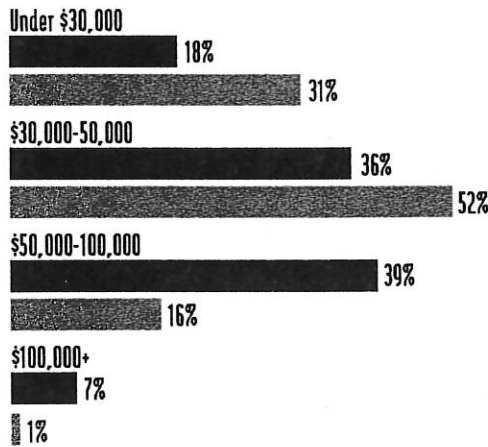gures show, it's really important for companies to avoid judging the success of their online presence simply in terms of sales generated through their Web sites."

The Hottest Selling Consumer Items on the Web

Several product categories have taken off in the stores of cyberspace: books, clothing/apparel, recorded music, gifts, consumer electronics, and filmed entertainment. The percentage of online shoppers who bought books over the Net nearly doubled, from 20% in 1997 to 39% in 1998. For clothing/apparel, the percentage rose from 10% of online shopping households to 21%. The percentage of online shoppers buying recorded music/CDs went up more than threefold, from 6% to 21%. Gifts delivered by mail or courier such as flowers and candy were purchased by 20% of all online shoppers, up from only 5% a year ago.

Why consumers didn't buy online*

1. Uncomfortable sending credit card data across Net	97%
2. Preferred to see product before purchased	53%
3. Couldn't talk to a sales representative	18%
4. Couldn't get enough product information to make decision	16%
5. Product too expensive relative to alternatives	15%
6. Couldn't get information or products suited to needs	13%
7. Couldn't talk to other buyers of product about their views	12%
8. Process took too long	11%
Had to download special software	11%
10. Web site was hard to navigate through	10%
11. Process was too confusing	8%
12. Product information or products were not current	6%

*Percentage of online households that didn't purchase via the Web

Consumer electronics are another popular item for online shoppers, purchased by 19%. And videos and other filmed entertainment were purchased frequently via the Web by 14% of online shoppers. Computer-related products (39%) and travel (14%) remain favorites of online buyers, with computers rivaling books as the most popular online purchases.

Why are computers, books, clothing, music, gifts, and consumer electronics among the most popular purchases of online shoppers? We believe that the ranking of the most popular items sold through the Web is a function of several things: the demographics of Web buyers; the attributes of products and services they are most comfortable buying through this new medium; and who has been selling the longest on the Web to date. It probably is no surprise, then, that consumers rate computers and books their most popular on-line purchases. In the case of PCs, to get online in the first place, online shoppers, of course, have to be computer aficionados. Buying books online has been spawned, probably more than anything else, by the launch of Amazon.com in 1995.

What do these products have in common?

Motivators of online purchasing*

Saving money/lower prices	75%
More convenience/less travel	50%
More choice/variety	48%
More fun than traditional shopping	29%

*Percentage of online buyers who rate it very important

What's in a brand? Quite a lot, say cybershoppers.

As in traditional retail establishments, brands appear to have a major influence on consumers shopping in virtual stores. Households with PCs – both online and not – stressed the importance of product and retailers' brands as factors in whether they would buy over the Internet. Some 82% said knowing the product's brand name would be important or very important in their decision to buy online. Another 79% said familiarity with their online retailer was important or very important. Eighty percent said it was important or very important in their buying decisions at a manufacturer's Web site. And, just over half (52%) thought it was important or very important to shopping in a mall-like Web site.

"Consumers online reinforce what leading consumer goods companies have known for many years: there is a lot of equity in brands, whether it's the company or product brand," said Fred Crawford, national director of retail and consumer products at Ernst & Young. "This simple fact does not really change just because the shopping vehicle is a PC rather than a physical store. In fact, because of consumers' concerns about online security, having an established brand or selling well-known products is likely to be a major advantage for a company setting up shop on the Internet – at least in the early going. But as Amazon.com has demonstrated, the 'brand edge' is short-lived and vulnerable to the efforts of innovative and nimble competitors. So the message really is that while brands can help you get a foothold in cyberspace, they're not enough – on their own – to sustain competitive advantage."

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The six most popular categories share several attributes. First, they are mostly "considered" purchases (as opposed to impulse purchases), done after at least some thought and information-gathering, which means they all require some information in order to make a good decision. In fact, the majority of online buyers (52%) don't use the Net to make spontaneous purchases, while only 12% said they do so frequently or regularly. (Some 42% of online buyers plan their purchase and know what brand they want and/or the merchant they want to buy from.) None of the six product categories needs to be touched and felt to buy (although many clothing purchases must be made in person – i.e., to try on the item). And each product often requires sorting through massive amounts of inventory for the buyer to find the right one.

Regardless of what they are buying, online shoppers in 1998 are purchasing more frequently and spending more than they did a year ago (see charts on page 13). More than half (51%) purchased something online on at least five occasions, up from 17% a year ago. And the percentage of online shoppers who spent at least $300 rose from 26% in 1997 to 35% in 1998.

Online Shopping: Motivators and Barriers

Cost savings, greater variety, and convenience attract consumers to Internet stores (see chart on page 11). The potential of lower prices motivates a large majority of online shoppers to purchase over the Web (i.e., 75% of them said saving money/lower prices is a very important motivator), while convenience was cited by 50% of respondents as a reason to shop online. From a convenience standpoint, the Web's

Products researched on the Internet but purchased through others means*

1.	Computer-related products	49%
2.	Books	35%
3.	Consumer electronics	34%
4.	Travel reservations	28%
5.	Cars, boats	19%
6.	Clothing and apparel	18%
	Recorded music, CDs	18%
8.	Larger household goods (furniture, major appliances)	15%
9.	Filmed entertainment, videos	13%
10.	Gifts delivered by mail (e.g., flowers, candy)	12%
11.	Publication subscriptions	8%
	Investment or financial services	8%
	Food and drink	8%
14.	Artwork, posters, etc.	4%
15.	Other	13%

*Percentage of online buyers researching each product category on-line then purchasing elsewhere

Frequency of researching online but purchasing elsewhere*

Never	41%
Once	8%
2-4 times	30%
5-10 times	14%
10+	6%
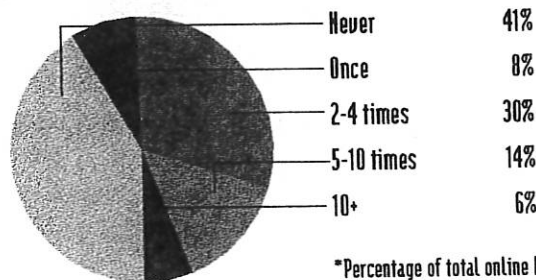
*Percentage of total online households

hours can't be beat. As an example, outdoor goods retailer REI, whose online sales have been growing a reported 20% to 30% a month, is said to generate 35% of its online orders between 10 p.m. and 7 a.m. (when its stores and mail-order operations are closed).

Variety, cited by 48% of online buyers as a motivation for shopping on the Web, also is unparalleled in cyberspace. This is one of the key factors in the ascension of Amazon.com. The company positions itself as the "World's Largest Bookstore" – the place to go for that difficult-to-find book. Similarly, published reports have said that online toy retailer eToys

hopes to have a greater selection of items than toy retailing giant Toys R Us by the end of 1998. Even Wal-Mart's Web site reportedly offers more items than its stores.

"Today's consumer typically juggles so many things day to day that they generally have little time left to shop," noted Ernst & Young's Stephanie Shern. "The Web fits perfectly into that active and time-stressed, two-income family that is always on the go, striving to spend more time together, and not wanting to drive from store to store looking for the best products at the lowest prices."

On the other hand, there are two factors that are keeping nearly two-thirds (62%) of online consumers from purchasing over the Net: the fear of sending their credit card information over the Net and the difficulty of navigating their way around a Web site (see chart on page 14).

We asked both online buyers and online consumers who don't buy over the Net about the factors behind their purchasing decisions, and how satisfied they were with the online shopping experience. Important factors for both groups include how well products are pictured, how well they are described, and the ability to do comparison shopping. And while the prospect of finding lower prices may attract them to the Web, online consumers who hold back from buying online do not place the utmost importance on lower prices. It ranked ninth in importance to them. More important is getting the latest product information and products, the ability to link to related Web sites, and the ability to ask questions and get answers online.

Still, consumers who do not buy online were, on the whole, less than satisfied with merchants' Web sites (see chart on page 10). They gave them less than average marks in five areas: the ability to link to other sites; the way products are merchandised and organized; prices compared to traditional buying channels; having tailored sales experiences; and the ability to share information with other online visitors.

Internet shopping patterns: Frequency and amount spent in past year

	1998	1997
Once	14%	33%
2-4 times	34%	50%
5-10 times	34%	13%
>10 times	17%	4%

	1998	1997
<$100	34%	45%
$100 – 299	28%	29%
$300 – 499	16%	13%
$500+	19%	13%

What they're buying online*

	1998	1997
Computer-related products	39%	40%
Books	39%	20%
Clothing	21%	10%
Recorded music	21%	6%
Gifts	20%	5%
Consumer electronics	19%	NA
Travel	14%	16%
Movies, videos	14%	NA
Subscriptions to online publications	11%	6%

*Percentage of households that have purchased products online

There are two factors keeping consumers from purchasing over the Net: security and Web site navigation challenges. But if a consumer has purchased over the Net, fears go down dramatically.

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Online buyers, like online households that don't buy over the Web, point to credit card security and ease of navigating Web sites as their two most important factors in purchasing over the Net. However, online buyers were more satisfied with the state of security, finding their way around the sites, online prices, and other aspects of Web sites than non-buyers were. They were less than satisfied with the extent to which Web stores let consumers ask questions and get answers online, their links to related sites, and how they let online visitors share information.

"Consumers are finding that online shopping isn't as targeted as it needs to be," commented John Jordan, director of electronic commerce research at Ernst & Young's Center for Business Innovation. "Companies' Web sites often reflect an inward-looking perspective of the organization rather than a customer-focused experience. The dissatisfaction is one of many instances in which market expectations are outstripping internal capabilities and outlooks."

One company that is attempting to allay consumer concerns over security and ease of use is Excite Inc. The Web portal recently announced the creation of Excite Express Order, an online shopping initiative that brings together hundreds of products offered by a variety of retailers. Excite pre-screens all participating merchants for customer service, prompt notification and delivery of purchases, and a trusted environment for credit card information. One of the principal benefits of the program is its need to capture consumer billing and shipping information only once, thus eliminating the need for shoppers to enter the same data each time they shop. According to Andy Halliday, vice president of commerce at Excite, the program is simplifying the online shopping process by "bringing together great retailers, a wide selection of products, and a fast, easy, and secure ordering system in order to give consumers a more streamlined shopping experience."

Most important factors in purchasing over the Internet*

	■ Online Buyers	▨ Online Households That Don't Buy Online
Security of sending credit card info over the Net	4.65 (1)	4.70 (1)
Ease of finding your way around the site	4.20 (2)	4.31 (2)
Ability to do comparison shopping	4.02 (3)	3.98 (5)
How well products and their use are described	3.98 (4)	4.05 (4)
How well products are pictured	3.85 (5)	4.09 (3)
Ability to ask questions and get answers online	3.71 (6)	3.85 (8)
Number and variety of products available for purchase	3.69 (7)	3.56 (10)
Merchandising/organization of products at sites	3.69 (7)	3.54 (11)
Lower prices than in traditional channels	3.67 (8)	3.83 (9)
Ability to link to other Web sites with related information	3.65 (9)	3.89 (7)
Getting latest product information and newest products	3.29 (10)	3.91 (6)
Overall speed of process (screen downloads, etc.)	3.26 (11)	3.29 (12)
Ability to have sales experience tailored to your needs	2.54 (12)	2.85 (13)
Ability to share information with other online visitors	2.31 (13)	2.62 (14)

* Importance rated on scale of 1-5, where 1=not at all important and 5=very important

Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
Apparel							
Blair Corp.	www.blair.com			•			
Brooks Brothers	www.brooksbrothers.com	•	•	•	•	•	
Brown Group, Inc.	www.browngroup.com		•	•	•	•	•
Bugle Boy	www.bugleboy.com	•		•	•	•	
Burlington Coat Factory Whse. Corp.	www.coat.com	•	•	•	•		
Eddie Bauer	www.eddiebauer.com	•	•	•	•	•	•
FootStar, Inc.	www.footstar.com				•		•
Fossil	www.fossil.com	•	•	•	•	•	
Gap, The	www.gap.com	•	•	•	•		
J. Crew Group	www.jcrew.com	•	•	•	•		
L.L. Bean	www.llbean.com	•	•	•	•	•	
Lands' End, Inc.	www.landsend.com	•	•	•	•	•	•
L'eggs Brands	www.onehanesplace.com	•			•	•	
Limited, The	www.limited.com				•		
Liz Claiborne	www.lizclaiborne.com		•	•	•	•	
Newwatch Company	www.newwatches.com	•		•	•		
NIKE	www.nike.com		•	•	•	•	
Nine West Group, Inc.	www.ninewest.com	•	•	•	•	•	
Payless Shoe Source	www.paylessshoesource.com		•	•	•		
Reebok International	www.reebok.com		•	•			
Ross Stores, Inc.	www.rossstores.com			•	•		•
Spiegel, Inc.	www.spiegel.com	•		•	•	•	•
TJX Companies, Inc.	www.tjx.com		•	•	•		
VF Corporation	www.vfc.com		•	•	•		
Books/Office Supplies							
Amazon.com	www.amazon.com	•		•		•	
Barnes & Noble	www.BarnesandNoble.com	•				•	
Borders Group Inc.	www.borders.com	•	•	•	•	•	•
Mead	www.mead.com	•	•	•		•	
Office Depot, Inc.	www.officedepot.com	•		•		•	
OfficeMax, Inc.	www.officemax.com	•		•	•	•	•
Quill Corp.	www.quillcorp.com	•	•	•		•	•
Staples, Inc.	www.staples.com	•		•	•	•	
U S Office Products Co.	www.usop.com	•		•	•	•	•
Viking Office Products	www.vikingop.com	•	•	•	•	•	•
Computer-Related Products							
Beyond.com	www.beyond.com	•	•	•		•	
Buycomp	www.buycomp.com	•	•	•		•	
Buysoftware	www.buysoftware.com	•	•	•		•	
CDW Computer Centers, Inc.	www.cdw.com	•	•	•		•	
Compaq	www.compaq.com	•	•	•	•	•	•
CompUSA	www.compusa.com	•	•	•		•	
Computer Discount Warehouse	www.cdw.com	•	•	•		•	
Creative Computers, Inc.	www.cc-inc.com	•	•	•		•	
Cyberian Outpost	www.outpost.com	•	•	•		•	•
Dell Computer Corporation	www.dell.com	•	•	•		•	•
Egghead	www.egghead.com	•	•			•	•
Gateway	www.gateway.com	•				•	

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Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
Global Directmail Corp	www.globalcomputer.com	•	•			•	•
Greet Street: Home of E-greetings	www.egreetings.com	•	•			•	•
IBM	www.ibm.com	•		•			
Insight Enterprises Inc.	www.insight.com	•	•			•	
Micro Warehouse	www.warehouse.com	•	•			•	
Multiple Zones Intl., Inc.	www.zones.com	•	•	•		•	
Necx	www.necx.com	•	•	•		•	
PC Connection	www.pcconnection.com	•	•	•		•	•
Ubid Online Auction	www.ubid.com	•	•				

Consumer Goods Non-Durables Manufacturers

Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
American Greetings Corp.	www.amgreetings.com	•				•	
Avon Products	www.avon.com	•	•	•		•	
Clorox	www.clorox.com		•	•		•	•
Colgate-Palmolive	www.colgate.com		•	•		•	
Dial Corp.	www.dialcorp.com		•	•		•	
Fort James Corp.	www.fortjames.com		•	•		•	•
Kimberly-Clark	www.kimberly-clark.com		•	•		•	
Procter & Gamble	www.pg.com	•	•	•	•	•	•
Revlon, Inc.	www.revlon.com			•		•	

Electronics

Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
Avnet, Inc.	www.avnet.com		•	•	•	•	•
Best Buy Company, Inc.	www.bestbuy.com	•	•	•	•	•	•
Cellstar Corp.	www.cellstar.com		•	•		•	•
Circuit City Stores	www.circuitcity.com		•	•	•	•	•
Comcast Corp.	www.comcast.com		•	•	•		•
Damark Intl., Inc.	www.damark.com	•	•	•		•	
Marshall Industries	www.marshall.com		•	•			•
Newark Electronics	www.newark.com	•	•	•		•	
Pioneer-Standard Electronics, Inc.	www.pios.com			•			•
Tandy Corporation	www.tandy.com			•			•

Food/Beverage Manufacturers/Processors

Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
Anheuser-Busch	www.anheuser-busch.com			•	•		
Archer-Daniels-Midland Company	www.admworld.com			•		•	•
Bestfoods	www.bestfoods.com			•		•	•
Brown-Forman	www.brown-forman.com			•		•	•
Campbell Soup	www.campbellsoups.com	•		•		•	•
Chiquita Brands International, Inc.	www.chiquita.com			•	•		•
Coca-Cola	www.cocacola.com			•			
ConAgra	www.conagra.com			•	•		
Cybermeals	www.cybermeals.com	•	•			•	•
Dean Foods	www.libertydairy-deanfoods.com				•		•
DiGiorgio Corp.	www.whiterose.com			•			
Dole Food	www.dole.com			•		•	
Earthgrains	www.earthgrains.com			•		•	
Farmland Industries	www.farmland.com			•	•		•
General Mills	www.generalmills.com			•		•	
Godiva	www.godiva.com	•			•	•	
H.J. Heinz	www.heinz.com			•		•	•
Hershey Foods	www.hersheys.com			•		•	
Hormel Foods	www.hormel.com			•		•	
IBP	www.ibpinc.com			•	•	•	•
International Multifoods	www.multifoods.com			•			
Kellogg	www.kelloggs.com			•	•	•	

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Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
McCormick & Company	www.mccormick.com		•	•		•	
PepsiCo	www.pepsico.com			•		•	
Pilgrim's Pride	www.pilgrimspride.com			•			
Quaker Oats	www.quakeroats.com		•	•			
Ralston Purina	www.ralston.com		•	•			
Richfood Holdings	www.richfood.com		•	•			•
RJR Nabisco Holdings	www.rjrnabisco.com		•	•			
Sara Lee	www.saralee.com			•			
Seaboard	www.seaboardcorp.com			•			•
Tyson Foods	www.tyson.com		•				
Virtual Vineyards	www.virtualvinyard.com	•	•			•	
Wm. Wrigley Jr. Company	www.wrigley.com		•	•		•	

General Merchandise

Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
Ames Department Stores	www.AmesStores.com	•	•			•	•
Bluefly.com	www.bluefly.com	•	•				•
Bradlees, Inc.	www.bradlees.com		•				•
Dayton Hudson Corp.	www.dhc.com		•				•
Dillard Department Stores, Inc.	www.dillards.com		•				
Dollar General Corporation	www.dollargeneral.com		•	•			•
Family Dollar Stores	www.familydollar.com			•			
Heilig-Meyers Company	www.heiligmeyers.com						
J.C. Penney Company	www.jcpenney.com	•		•			
Kmart Corp.	www.kmart.com	•		•			
Kohl's Department Stores	www.kohls.com		•	•			
Neiman Marcus	www.neimanmarcus.com			•		•	•
Nordstrom	www.nordstrom-pta.com	•	•	•		•	•
Macy's	www.macys.com	•	•	•		•	•
May Department Stores	www.maycompany.com		•	•			
Proffitt's Department Store, Inc.	www.proffitts.com		•	•			
QVC	www.iqvc.com	•	•	•		•	
Sears, Roebuck and Co.	www.sears.com	•	•	•			
Service Merchandise	www.servicemerchandise.com	•	•				
Value City Department Stores, Inc.	www.valuecity.com			•		•	
Wal-Mart Stores, Inc.	www.wal-mart.com	•				•	

Drug

Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
CVS Corporation	www.cvs.com				•	•	•
Longs Drug Stores	www.longs.com	•	•	•			•
Rite Aid	www.riteaid.com		•	•		•	•
Walgreen	www.walgreens.com	•	•	•		•	

Grocery Retail/Wholesale

Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
Albertson's, Inc.	www.albertsons.com		•	•			•
American Stores Company	www.americanstores.com		•	•			•
BJ's Wholesale Club, Inc.	www.bjswholesale.com		•			•	•
Certified Grocers of California Ltd.	www.certifiedgrocers.com		•	•			
Costco Cos., Inc.	www.costco.com		•	•		•	•
Dominick's SuperMarkets	www.dominicks.com		•	•		•	
Fleming	www.fleming.com		•	•		•	
Food 4 Less Supermarkets, Inc.	www.ralphs.com		•	•		•	
Fred Meyer	www.fredmeyer.com		•	•		•	•
Hannaford Brothers	www.hannaford.com		•	•		•	•
Ingles Markets, Inc.	www.ingles-markets.com		•	•		•	•
Jitney Jungle Stores of America, Inc.	www.jitneyjungle.com		•	•			•
Kroger	www.kroger.com		•	•			

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Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
Marsh Supermarkets, Inc.	www.marsh.net		•	•		•	•
NetGrocer	www.netgrocer.com	•	•				
Peapod, Inc.	www.peapod.com	•		•			
Quality Food Centers, Inc.	www.fredmeyer.com		•		•	•	
Roundy's	www.roundys.com				•		•
Safeway Stores	www.safeway.com	•					
Smart & Final, Inc.	www.smartnfinal.com		•	•	•	•	•
Spartan Stores, Inc.	www.spartanstores.com			•	•		•
Supermarkets General Holdings	www.pathmark.com			•			
SuperValu, Inc.	www.supervalu.com		•	•	•		•
United Grocers, Inc.	www.ugweb.com		•	•	•		•
Whole Foods Market, Inc.	www.wholefoods.com			•	•		
Winn-Dixie Stores	www.winn-dixie.com		•		•		

Music/Videos

Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
CDnow	www.cdnow.com	•	•			•	
Harman International Industries, Inc.	www.harman.com			•		•	
K-Tel Express	www.ktel.com	•				•	
Music Boulevard	www.musicblvd.com	•	•			•	
N2K, Inc.	www.n2k.com	•	•	•		•	
Movielink	www.movielink.com	•	•			•	
Reel.com	www.reel.com	•	•			•	
Videos Now	www.videosnow.com	•				•	

Toys

Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
eToys	www.etoys.com	•				•	
FAO Schwarz	www.faoschwarz.com	•		•	•		•
Hasbro	www.hasbro.com		•			•	
Mattel	www.mattelmedia.com		•			•	
Toys 'R' Us, Inc.	www.toysrus.com	•				•	

Other Notables Selling On-Line

Company	Web Site	Sell Online	Links	Company Info.	Store Locations	Product Info.	Employment Info.
1-800-FLOWERS	www.1800flowers.com	•	•			•	
Autoweb	www.autoweb.com	•	•			•	
CarPoint	www.carpoint.com	•	•			•	
Clinique	www.clinique.com	•		•	•	•	
Coldwater Creek, Inc.	www.coldwater-creek.com	•	•	•	•	•	
eBay	www.ebay.com	•	•			•	
Fingerhut Companies	www.fingerhut.com	•		•		•	
General Nutrition Center	www.gnc.com	•		•		•	
Harry and David	www.harryanddavid.com	•			•	•	
Ibaby	www.ibaby.com	•		•		•	
Lillian Vernon Corp	www.lillianvernon.com	•		•		•	
Microsoft Expedia	www.expedia.com	•				•	
National Media Corp	www.quantumtv.com	•		•		•	
NetMarket (CUC International)	www.netmarket.com	•	•			•	
ONSALE, Inc.	www.onsale.com	•	•			•	
Preview Travel	www.previewtravel.com	•	•			•	
Shopping.com	www.shopping.com	•	•			•	
SkyMall	www.skymall.com	•	•			•	
Sportsmans Guide, Inc.	www.sportsmansguide.com	•				•	
Spree.com	www.spree.com	•	•			•	
Valuevision Intl., Inc.	www.vvtv.com	•		•		•	
Virtual Emporium	www.virtualemporium.com	•	•			•	
WebAuction Warehouse	www.webauction.com	•	•			•	

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Comparing the Leaders and Laggards in Online Shopping

To try to discern some of the secrets to selling online, we compared the responses of 12 retailers and manufacturers that reported greater-than-average online success (which we designate as "leaders") with nine retailers and manufacturers reporting less-than-average online success ("laggards"). A higher percentage of leaders' sites are profitable (46% of leaders vs. 13% of laggards), have more visitors (who spend more time at the site), and have a greater percentage of visits that led to sales transactions.

What are these Internet shopping leaders doing that the laggards are not—or not to the same extent? Based on their responses, we found the following to be the biggest differences between the two camps:

- *In the leaders, Internet strategy more often drives business strategy than it does in the online laggards.* Three of the 12 leaders said Internet strategy in part drives business strategy, but none of the nine laggards said this was the case.

- *Leaders stress brand.* Some 79% of the leaders, but only one-third of the laggards, said a strong company brand or offering well-known branded products is a very important factor in selling online to consumers.

- *Leaders' Web initiatives typically are not run at the corporate level.* The leaders appear to be further from corporate oversight than the laggards. Web sites in the majority of laggards (six out of nine) operate at the corporate level, while the same is true for only two of the 12 leaders. In fact, four leaders operate their company's consumer online initiative in its own business unit, while only one out of the nine laggards do. In addition, leaders are much more likely to operate within another business function such as marketing or advertising.

- *Leaders more aggressively market their Web sites.* Leaders spend more on marketing their Web site than laggards, with two leaders shelling out more than $100,000 and three $1 million-plus. None of the laggards indicated that it spent more than $100,000. And leaders market their Web sites differently. They are more likely to use TV advertisements, print ads, ads on other Web sites, and relationships with search engines/portals/Web communities than laggards—and use them effectively.

- *Leaders' Web sites are more educational, easier to navigate, more current and community-oriented, and offer more customization capabilities.* Leaders place much greater emphasis on designing a Web site that fosters "community" (enabling visitors to share information with one another) and customization. Leaders also reported being better at providing knowledge online for product decisions and making their sites easy to navigate. And leaders update their sites more frequently than the laggards do.

"These results really underscore the need for companies to focus on three key areas to help ensure online selling success: strategy, marketing, and branding," explained Ernst & Young's Fred Crawford. "You can't treat your Web initiative as some foreign entity that's disconnected from the rest of the business, just as you don't develop stores independent of your overall business and branding strategies. And similarly, if no one knows about your site and capabilities, your online store will be a truly lonely outpost on the cyberspace landscape."

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Retailers and Internet Shopping

Attraction of the Web is proving irresistible

The year 1998 will be seen as a time when retailers caught Internet shopping fever. The percentage of retailing survey respondents who said their companies were either selling or planning to sell through the Web more than doubled, to 76% from 36% in 1997. The minority of respondents are holding back because of worries about the Net's impact on their investments in stores, and inadequate technology and distribution infrastructure for home delivery.

Ringing up the cyber cash register is not the only goal for retailers with Web stores or plans to build them (all of which had consumer Web sites). In fact, they placed equal importance on attracting new customers and penetrating new markets. Promoting the company's brand and improving customer retention are two other major goals.

Of the 10 online goals we asked retailers about, participants disclosed achieving more than moderate success with only four: brand promotion, generating online sales, boosting customer retention, and attracting new customers.

So what's the problem? Retailers said the three biggest obstacles to progress are insufficient corporate resources, consumer fears about security and privacy, and the difficulty of integrating their Web sites with their company's other business processes.

Online revenue projected as percentage of total revenue through 2001*

	% of total sales
Most recently concluded FY	1.0%
FY 1999	2.3%
FY2000	5.6%
FY2001	9.3%

*Estimates by respondents currently selling online

On the positive side, retailers noted that having a well-designed, easy-to-use site is the most important factor in achieving online success. Having a strong company brand and well-known branded products are also highly rated, as are linking with the right Web search engines, portals, or Web communities, and marketing the Web business.

Despite all the hype about online retailing, though, Web sales represented only about an average of 1% of retailers' revenue for the most recently concluded fiscal year. However, retailers that sell or plan to sell via the Web projected Internet revenues would reach a significant 9% of total revenue by the fiscal year 2001. If that

Reasons for not selling online to consumers*

Conflicts with our investments in physical stores	67%
Lack necessary technology infrastructure	67%
Lack necessary distribution network	50%
Don't believe investment is worth the expected return	33%
Product not appropriate for online sales	17%
Don't believe consumers will buy our products online	17%
Legal/regulatory reasons	9%
Other	9%

*Percentage of respondents that are not selling to consumers through the Net and have no plans to in the future

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Goals and success rates for retailers*

	Importance**	Success***
1. Attract new customers/penetrate new markets	2.87	2.07
Generate online sales	2.87	2.14
3. Promote company's brand	2.71	2.21
4. Improve customer retention/increase sales to existing customers	2.64	2.08
5. Improve after-sale customer service	2.00	1.50
6. Boost customer traffic to stores	1.92	1.83
Cut costs of sales transactions	1.92	1.75
8. Accelerate inventory turns	1.67	1.60
9. Cut general advertising and promotion costs	1.54	1.83
Cut costs in after-sales customer service	1.54	1.50

*Currently selling to consumers online

**Importance rating based on 1-3 scale (1=not a goal; 2=somewhat important; 3=very important)

***Success rating based on 1-3 scale (1=low; 2=moderate; 3=high)

Retailers selling on the Web

	1998	1997
Yes	39%	12%
Plan to	37%	22%
No plans	24%	54%
Unsure	0%	12%

turns out to be the case, the Internet – while by no means becoming the dominant distribution channel for consumer goods and services – will have become a significant force.

Who will rule the land of cyberspace shopping? Who do retailers fear most in cyberspace? None other than the growing number of startup companies whose storefronts exist only in the digital world – companies with no physical investments to protect, no channel relationships to massage, and comparatively less internal corporate politics with which to contend. Internet-only retailers were rated the biggest online threats to traditional retailers. On the other hand, consumer products manufacturers ranked fourth, behind store-based retailers selling competing products, and catalog companies.

Retailers on the Web

A clear majority (69%) of the retailers that filled out our questionnaire and that planned to sell online said they would do so during the next year, while 31% said they would do so within three years. If these numbers are realized, nearly two-thirds (65%) of the retailers surveyed will be selling online to consumers sometime in 1999 – a dramatic increase from the 12% that sold online in 1997. Indeed, an increasing number of traditional store-based and catalog retailers are beginning to sell online – whether it's experimenting with a few items or offering their entire product lines. Apparel cataloger Lands' End, for instance, recently noted that it is pegging a good deal of its future growth on online sales efforts. The Great Atlantic & Pacific Tea Co. became the first grocery chain to offer online ordering of prepared meals from its delis and bakeries. And even Starbucks, the ubiquitous coffee retailer whose stores never seem to be more than a block away, announced in October the launch of a Web site for selling coffee and propagating the "Starbucks experience."

Of course, there still are retailers that are not sold on the Internet as a shopping medium: nearly one-quarter (24%) of retailers participating in the survey had no plans to sell their products through the Web. These holdouts, whose ranks declined percentage-wise by nearly half in just one year

Reporting, Budgeting, and Direction-Setting

Very few (3%) of participating retailers' consumer-oriented Internet initiatives operate as a separate business unit. Most function at the corporate level (58%), with 31% existing within another business function (almost always the marketing/advertising department). Funding follows a similar path: two-thirds (63%) are funded either by corporate or a department.

Direction-setting for the majority of retailers' consumer Internet activities comes from a high level: 33% identified chief executive officer, chief operating officer, or business unit general manager as the primary "driver" of their initiative. With direction coming from on high, it is no surprise that the majority of respondents (65%) said the company's business strategy drives their Internet strategy, and not the other way around (only 16%).

"The attention that Internet initiatives are getting from senior executives is very encouraging, and means that the executive suite no longer sees the Internet as a technology tool for the systems department," noted Fred Crawford, national director of retail and consumer products at Ernst & Young. It's also good to learn that there is at least some connection between business and Internet strategies in most companies.

"One caution: don't develop your business strategy without considering the possibilities presented by the Internet. Understand the new business models that are possible – and the new markets that are reachable – via the Web. The Internet's ability to influence the development of business strategy still is vastly under-appreciated in most companies."

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Profitability of retailers' online stores*

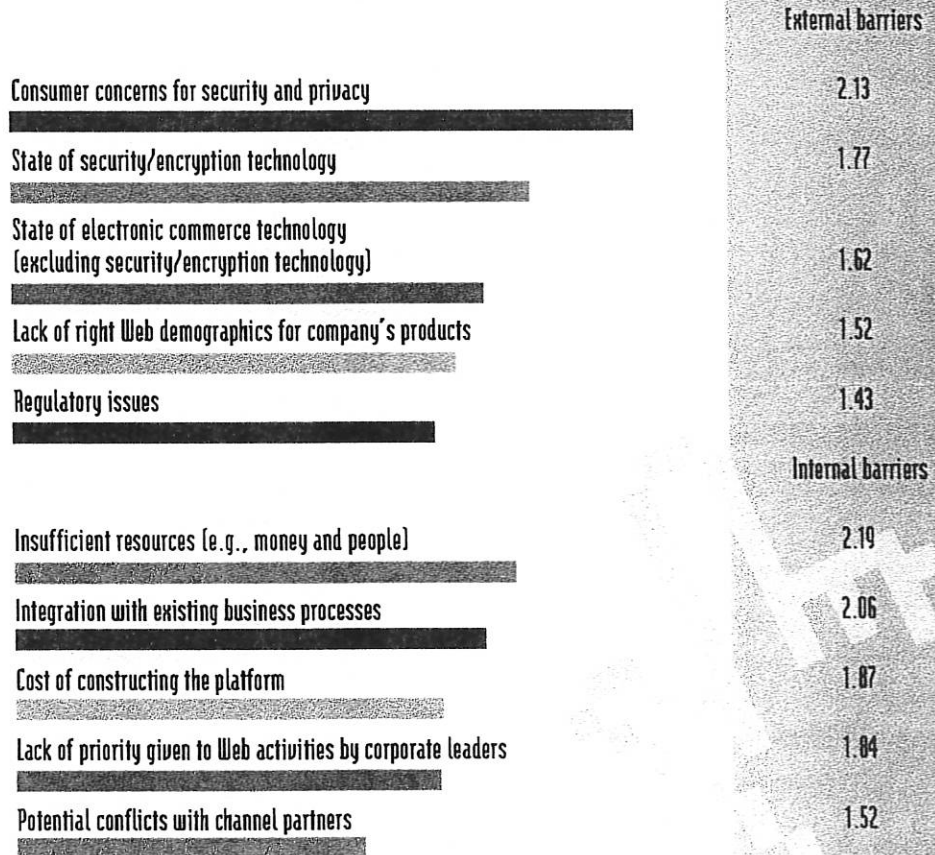|	
Currently	46%
Within 1 year	15%
Within 2 years	31%
Not expected to be profitable	8%
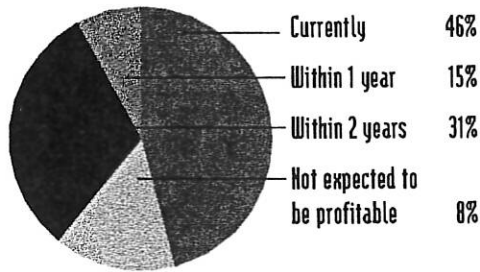
*Percentage of retailers selling online

(54% of last year's retailers had no plans to sell online), indicated several reasons why they wouldn't sell online. The most frequently cited reasons are a conflict between an online store and their investments in bricks-and-mortar stores; the absence of the necessary technology infrastructure; and the lack of the essential distribution network (see chart on page 20). Very few (17%) said that their product was not appropriate for Internet selling or believe that consumers would not buy their products online.

Why They're on the Web

To understand how retailers are faring, we asked only those already selling online to indicate the importance of 10 strategic goals and their progress in meeting them (see chart on page 21). Two goals are tied for first: generating online sales and attracting new customers/entering new markets. In third place is promoting the company's brand, followed by improving customer retention/ increasing sales to existing customers. Cost-cutting is low on the priority list, whether in sales transactions, general advertising and promotion, or customer service. Accelerating inventory turns also is not a primary objective for most online initiatives.

Setting goals is one thing; achieving them is an entirely different matter. As a group, online retailers report having mixed success with their goals. On only four of the 10 strategic objectives we asked online merchants about did they rate themselves as more than moderately successful: promoting the company's brand, generating online sales, improving customer retention, and attracting new customers. Improving customer service, accelerating inventory turns, and cutting costs all earned low marks for success by those for whom they were goals.

Biggest barriers to selling to consumers through the Web*

	External barriers
Consumer concerns for security and privacy	2.13
State of security/encryption technology	1.77
State of electronic commerce technology (excluding security/encryption technology)	1.62
Lack of right Web demographics for company's products	1.52
Regulatory issues	1.43
	Internal barriers
Insufficient resources (e.g., money and people)	2.19
Integration with existing business processes	2.06
Cost of constructing the platform	1.87
Lack of priority given to Web activities by corporate leaders	1.84
Potential conflicts with channel partners	1.52

*Based on 1-3 scale (1=not a barrier; 2=somewhat a barrier; 3=major barrier)

Success factors in online selling to consumers*

Factor	Score
Having a well-designed, easy-to-use site	2.97
Having a strong company brand	2.81
Selling well-known branded products	2.50
Being allied with the right search engines, portals, or Web communities	2.48
Aggressively advertising/promoting the site	2.45
Being a fast-follower	2.35
Having strong executive leadership	2.29
Offering more competitive prices online	2.10
Being a first-mover	1.87

*Most important success factors ranked on scale of 1-3 (1=not important; 2=somewhat important; 3=very important)

Profitability, however, appears to be a brighter spot, as 46% of respondents currently selling online said their sites are already profitable. Another 15% expect profitability within one year, and another 31% after one year but before two years.

Sales volume, as well, is an area of optimism. Retailers already selling to consumers online said their online businesses would grow fast. In fact, they projected online sales as a percentage of total revenue – currently 1% – to approximately double every year through fiscal 2001 (see chart on page 20). By that year, respondents said, their Web sales are expected to represent an average 9% of revenue.

James M. Zimmerman, chairman and chief executive officer of Federated Department Stores, echoed many of the study's findings in announcing the creation of Macys.com as a separate subsidiary dedicated to capitalizing on Internet opportunities.

"The Internet represents a strategically important complement to our department stores in an era when convenience is becoming a more important component of the value equation for customers," said Zimmerman. "While the sales volume for department store-type goods on the Internet is relatively small today, we believe it is a phenomenon that will continue to grow. Aside from generating incremental sales, Macys.com will be invaluable for testing new concepts within Federated's private brands, building interactive relationships with customers, and attracting customers who live in areas not served by our stores."

Keys to Success

With such high expectations for online sales in the near future, retailers are carefully considering a number of factors that could contribute significantly to their success. For instance, we asked merchants that sell or plan to sell online to rate the importance of a number of issues in selling successfully to consumers through the Web (see chart above). The two most highly rated factors are having a well-designed, easy-to-use site and a strong company brand. On ease of use, retailers appear to be listening to Web users, who rated it second only to credit card security as conditions for purchasing over the Net. The issue of brand came up twice: having a strong retail brand scored highly, as did selling well-known branded products. Other factors in the top five are relationships with key Web destinations – namely, search engines and other portals (such as browsers), and related Web communities – which finished fourth in importance, and marketing the Web site, which is fifth (see sidebar at right).

On the other end of the spectrum are factors such as prices and entry strategy. In general, retailers see competitive pricing online to be less important to their success. And being a first-mover to the Net finished at the bottom of the list. In fact, being a "fast-follower" – i.e., learning from the success and failures of the innovators before taking the plunge – was viewed as more important. This attitude, according to John Jordan, director of electronic commerce research at Ernst & Young's Center for Business Innovation, is a dangerous one.

Solving the Fulfillment Challenge: Critical to Online Success?

The effective and efficient movement of goods is critical in the consumer goods supply chain, whether the point of contact with shoppers is the store shelf or a computer screen. Yet for many retailers and manufacturers, distribution historically has involved large shipments on pallets to a few locations rather than small mixed lots in overnight packages to thousands-resulting in the need, in many instances, to create an entirely new distribution infrastructure to handle online selling.

That's why it is surprising that such a small percentage (15%) of manufacturers in the study that are not currently selling online cited the lack of an appropriate distribution infrastructure as a barrier to successful Internet selling. A larger percentage of retailers see distribution as a significant challenge, but still view others as more pressing (such as overcoming conflicts with their investments in physical stores). Could this opinion be short-sighted? Perhaps it is, as Christmas 1998 demonstrated. The exponential growth in online traffic and sales during the holiday shopping season tested many companies' fulfillment mechanisms – including their ability to accurately forecast demand-and resulted in many first-time online shoppers being frustrated by out-of-stocks and late shipments.

"Just as is the case in the physical world, success in the virtual shopping arena requires an effective fulfillment organization – to both anticipate and fulfill consumers' needs," notes Walter Loeb, president of Loeb and Associates in New York. "If you don't completely think through how your Web site links to your technical and logistics infrastructures, you risk alienating entire legions of Web shoppers who once frustrated-may not give you a second chance."

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Biggest online threats to retailers*

Internet-only retailers	3.03
Store-based retailers (selling competing products)	3.19
Catalog companies	3.30
Consumer products manufacturers	3.84
Store-based retailers (not currently selling competing products)	4.28
Auction Web sites	5.37
Information providers/recommenders	6.04

*Based on averages of company types respondents were asked to rank, from 1 to 7, with 1 being the biggest threat

"Apparently, the lessons of Amazon.com, Dell Computer, CDnow, Charles Schwab, and other online innovators are being taken too lightly," Jordan said. "Amazon.com got a two-year head start on barnesandnoble.com, whose quarterly sales are a tenth of Amazon's. Dell Computer was one of the first PC companies to sell through the Net. Today it sells close to $10 million worth of computer-related goods a day through its Web site and has been quoted as projecting half of its total sales will come via the Web by 2000. Many early movers in Internet commerce have mounted a substantial lead in their categories — whether they started with a strong brand or not. Brand alone is not proving to be enough to play catch-up."

Exploring the critical issue of site design further, we see that retailers selling or planning to sell over the Web seem to be in synch with consumers on the most important aspects of Web site design. Making the site intuitive (i.e., easy to navigate), current (updated frequently), and educational (giving customers knowledge on products and their use) were rated by retailers to be the most important design factors in attracting and retaining visitors to a Web site (see chart on page 25). Consumers rated intuitiveness second in importance to credit card security (which is not a design issue). Interactivity — the ability to ask and answer questions online and provide feedback — was high in importance for both consumers and retailers.

On the need to educate visitors on products and their use (an attribute we refer to as "knowledge"), retailers appear to be in tune with consumer desires. Retailers ranked knowledge the third-most important factor in designing a Web site that will attract and retain visitors. In their survey, consumers ranked three knowledge-related issues highly: how well

products are pictured, the ability to do comparison shopping, and how well products and their use are described. Keeping the Web site up to date (an attribute we call "currency") is also very important to retailers and consumers. And both retailers and consumers, on average, said it is less than important for Web sites to be customized to different visitors' tastes and interests or to be an online community in which visitors can share information.

Despite appearing to understand what it takes to attract and keep visitors to their Web sites, retailers did not give their own sites high marks on any of the six criteria on which they were polled. (Consumers did not give online stores high marks, either.) Retailers, on average, rated themselves to be between average and good in making their sites intuitive, current, knowledgeable, and interactive. And they graded themselves between poor and average in offering customization and community.

Online Threats and Barriers

The survey shows that retailers clearly are getting serious about using the Internet as a sales channel. In just one year, the number of merchants that sell or plan to sell online has gone from a minority of retailers to the majority. However, there are many obstacles with which online-oriented merchants must contend — both in the form of competitive threats and significant challenges to creating successful online shopping capabilities.

Competition, of course, is something all retailers understand. But online, the form of competitors is far from familiar. As they enter a new era of online shopping, the companies retailers worry about most on the Internet are those without physical assets, pre-existing channel

Most-valued Web site attributes, and how online retailers stack up*

Attribute	Importance of attribute ■ (scale 1-3)	Self-Rating ▨ (scale 1-4)
Intuition (Is easy to navigate through)	2.86	2.61
Currency (Material is updated frequently)	2.76	2.43
Knowledge (Educates visitors on products and their use)	2.69	2.41
Interactivity (Offers visitors the ability to provide feedback, ask questions, etc.)	2.45	2.32
Customization (Enables visitors to tailor content and information representation)	2.07	1.44
Community (Allows visitors to share information with other like-minded visitors)	1.83	1.41

*Rating of importance of six attributes on scale of 1 to 3 (1=not important; 2=somewhat important; 3=very important) and how respondents rate themselves on those attributes on scales of 1-4 (1=poor; 2=average; 3=good; 4=excellent)

relationships, and name recognition — namely, Internet-only retailers (see chart on page 24).

Retailers see their second-biggest online threat to be their traditional competition: store-based retailers selling competing products. The third-most significant threat are catalog companies, whose existing direct-to-consumer business model and fulfillment machine make them a natural fit for Internet selling. Consumer products manufacturers are fourth, followed by store-based retailers not currently selling competing products, auction Web sites (whose ranks of 150-plus are growing by the day), and information providers.

The threat of Internet-only merchants also can be seen in data on the company to which retailers pointed most frequently as being "best practice" in interacting with consumers through the Net: Amazon.com. The number-one online bookseller (in revenue) was mentioned as "best practice" by 53% of retailers that sell or plan to sell online. No other online merchant came close. The second-most admired online retailers are The Gap, Lands' End, and Eddie Bauer — all well-known retail brands. Each was named "best practice" by 13% of respondents.

Besides competition, other potential challenges exist for retailers selling online — some more imposing than others (see chart on page 22). Unlike the threat of competitors, two of the most-significant barriers cited by retailers are internal conditions: namely, drumming up sufficient corporate resources and integrating the online store with the company's existing business processes.

Interestingly, the state of electronic commerce and security/encryption technology was not seen as a great stumbling block, revealing divergent opinions between retailers and consumers.

As mentioned earlier, nearly every consumer (97%) in the survey who told us why he or she didn't buy through the Net cited discomfort with putting credit card information online. Yet retailers, on average, rated consumer concerns for security and privacy to be only "somewhat a barrier" to online commerce.

"Retailers are right to view concerns over Internet transaction security increasingly as a non-issue," noted Robin Hutchinson, a senior manager in Ernst & Young's Information Systems Assurance and Advisory Services practice. "The technology exists to make online commerce as secure as any traditional information exchange. The real issues here are misperception and education. Retailers that sell or plan to sell through the Internet have much work to do to change consumers' perceptions of the safety of shopping online if they hope to gain consumers' confidence — and business."

"Retailers that sell . . . through the Internet have much work to do to change consumers' perceptions of the safety of shopping online . . ."
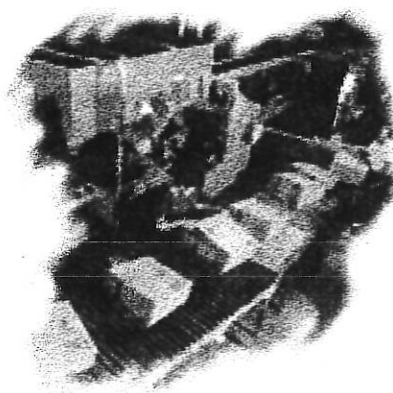– Robin Hutchinson, Ernst & Young

"Many early movers in Internet commerce have mounted a substantial lead in their categories – whether they started with a strong brand or not."
– John Jordan, Ernst & Young

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Manufacturers and the Online Consumer

Lots of interest, but little action – so far

Manufacturers of consumer products got more aggressive about selling direct to consumers through the Internet in 1998, yet the majority still do not sell online today and have no plans to do so in the future – particularly those with annual sales of more than $1 billion. The percentage of manufacturers either selling or planning to sell online doubled to 43% from 21% in our year-earlier survey (see chart), although the ones oriented to selling online tend to be smaller companies. Three-quarters of the manufacturers currently selling online to consumers have less than $200 million in annual sales. Of manufacturers with annual revenue of at least $1 billion, only 11% are selling online, and just another 7% planned to do so.

Not surprisingly, manufacturers cited two principal reasons for their lack of interest in selling over the Net to consumers: they believe their product is not right for online sales and they are not willing to risk their relationships with wholesalers and retailers.

But what is somewhat surprising is the fact that manufacturers with online stores already operating do not place generating online sales at the top of their list of goals. Instead, they view activities such as providing information, promoting brands, and answering customer inquiries as more important benefits of their Web presence.

As far as barriers are concerned, manufacturers' biggest constraints in selling online to consumers are more internal than external ones – led by lack of sufficient corporate resources and the difficulty of linking their Web store to the company's existing business processes (the same as those expressed by retailers). Manufacturer respondents also said that having a Web site that's easy to use and has strong relationships with other Web players (search engines and other portals and Web communities) are their most important success factors. And, like retailers, they rated intuition, currency, and knowledge to be of highest importance in the design of a Web site. But they gave themselves only mediocre marks on these and other design attributes.

In the future, we'll likely see more manufacturers selling online. However, manufacturers already selling online project that the Internet will constitute a smaller percentage of their total sales than online retailers do. Still, consumer goods producers that sell through the Net today predict that online sales would account for an average 7.3% of their total sales in four years.

What They're Doing on the Web

Between last year and this, there has been some growth in the percentage of manufacturers with consumer-oriented Web operations: those selling online to consumers grew from 9% in 1997 to 15% in 1998, while the number planning to sell online more than doubled from 12% to 28%. But most consumer products manufacturers – particularly large ones – are not selling direct to consumers over the Net and have no plans to in the future. While there are multiple reasons, two were cited more frequently than the others: the belief that their products are not conducive for an Internet purchase, and the fear of risking relationships with other partners in the supply chain (see chart at left). Curiously, few said they were hampered by the lack of a distribution network to the consumer, or by information technology. Only 9% believe the investment would not be worth the expected return.

But this doesn't necessarily mean that manufacturers are Web-phobic. Nearly all manufacturers (94%) have or plan to have a Web site with information on themselves and their products (see chart on page 27). Some 29% said they have an electronic catalog of their products

Manufacturers selling on the Web

	1998	1997
Yes	15%	9%
Plan to	28%	12%
Don't plan to	57%	71%
Unsure	0%	8%

Reasons for not selling online to consumers*

Product not appropriate for online sales	53%
Not willing to risk channel relationships	38%
Don't believe consumers will buy our products online	21%
Lack necessary technology infrastructure	15%
Lack necessary distribution network	15%
Don't believe investment is worth the expected return	9%
Legal/regulatory reasons	9%
Other	9%

*Percentage of respondents that are not selling to consumers through the Net and have no plans to

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online, but with no ability to process orders and accept payments. And another 26% plan to put an electronic catalog of their products online. Furthermore, in the packaged foods sector, a growing number of manufacturers are augmenting their relationships with store-based supermarket chains by selling to consumers through online grocers like Peapod, Streamline, and NetGrocer.

Ethan Allen Inc., the international home furnishings manufacturer and retailer, typifies the manufacturer that recognizes the power of the Web, yet stops just short of offering full online shopping capabilities. The company recently announced that its new interactive product catalog is now available on its Web site. Using this feature, consumers can shop and gather specifications for anything from rugs, furniture, upholstery, and accessories. When finished shopping, consumers then print out their merchandise list and take it to their nearest Ethan Allen store for purchase.

"Realizing that today's consumer leads an extremely busy lifestyle, we wanted to make the furniture shopping experience a more relaxed and enjoyable one," noted M. Farooq Kathwari, chairman and chief executive officer of Ethan Allen. "Our online shopping guide allows our customers to pre-shop, then walk into our store knowing what they want and how much they're going to spend."

Results to Date: Success is Mixed

For manufacturers selling through the Internet, the most important goal of their Web site is

to provide useful product information to consumers. Of course, manufacturers hope that this information will influence the purchase decision, whether made online or not. The other top goals are related to brand: promoting specific product brands, increasing brand awareness in existing markets, and promoting brands in new markets. Significantly, generating online sales – although still an important goal – finished fourth. Much less important are accelerating

What manufacturers are doing online

	Present	Planned
Web page with company/product info	71%	23%
Electronic catalog	29%	26%
Catalog + order processing + payment	15%	27%

Online revenue projected as percentage of total revenue through 2001*

	% of total sales
Most recently concluded FY	0.9%
FY 1999	2.6%
FY2000	4.7%
FY2001	7.3%

*Percentage of respondents currently selling online

Goals and success rates for manufacturers currently selling to consumers online

Goals	Importance*	Success**
1. Provide useful product information	2.88	2.25
2. Promote specific product brands	2.55	1.89
3. Field consumer inquiries	2.45	1.90
4. Generate online sales from consumers	2.27	1.90
5. Increase brand awareness in existing markets	2.18	2.00
6. Promote brands in new markets	2.09	2.29
Drive consumers to retail outlets	2.09	1.38
7. Accelerate inventory turns	1.55	2.25
8. Cut general advertising and promotion costs	1.36	1.67

*Importance based on 1-3 scale (1=not a goal; 2=somewhat important; 3=very important)

**Success based on 1-3 scale (1=low; 2=moderate, 3=high)

"Realizing that today's consumer leads an extremely busy lifestyle, we wanted to make the furniture shopping experience a more relaxed and enjoyable one."

— M. Farooq Kathwari, Ethan Allen

inventory turns and cutting general advertising and promotion costs.

And how are they meeting these goals? Much like retailers: with mixed success. Manufacturers believe that their Web stores do well in promoting their brands in both new and existing markets. They also claimed to be more than moderately successful at providing useful product information and accelerating inventory turns. However, most notably, these companies' rated their Web operations as less than moderately successful at generating online sales, and gave themselves low marks for promoting specific product brands, fielding consumer inquiries, driving consumers to retail outlets, and cutting marketing costs.

But despite the challenges in achieving their online goals, manufacturers selling online are optimistic about their operations. Nearly two-thirds said that their Web initiatives are either currently profitable or will be within two years. Another 18% said profitability would come by year three, and just 18% said their Web site was not expected or designed to be profitable ever.

Such profitability is anticipated to come from increasingly larger sales volume. For manufacturers already selling online, Web sales are expected to be a small but growing portion of overall revenue: from 0.9% in the most recently concluded year to 7.3% in fiscal 2001 (see chart on page 27). That is somewhat less than retailers' projections but, nonetheless, a significant share of overall revenue.

A prime example of the type of manufacturer with large Web aspirations is Medina, Ohio-based candle maker A. I. Root Co. With $25 million in annual revenues (growing at a 10% clip for nearly a decade), the company recently announced plans for a redesigned Web site geared to selling direct to consumers. Company executives view this new foray as a means of expanding its customer base in areas unserved by its distributors, and to do so more cheaply and quickly than by opening stores in those regions. Additionally, the site will direct visitors to stores in their area that carry Root products

Profitability of manufacturers' online stores*

Currently	18%
Within one year	18%
Within two years	27%
Within three years	18%
Not expected to be profitable	18%

*Percentage of respondents currently selling online

Most significant barriers to selling online to consumers*

	External barriers
Consumer concerns for security and privacy	1.87
State of electronic commerce technology (excluding security/encryption technology)	1.73
Lack of right Web demographics for company's products	1.57
Regulatory issues	1.47
State of security/encryption technology	1.43

	Internal barriers
Insufficient resources (e.g., money and people)	2.52
Integration with existing business processes	2.26
Potential conflicts with channel partners	2.13
Cost of constructing the platform	2.07
Lack of priority given to Web activities by corporate leaders	1.97

*Responses for companies selling or planning to sell online.
Based on scale of 1-3 (1=not a barrier; 2=somewhat a barrier; 3= major barrier)

so that Root's longtime dealers will not view the site as a threat to their business.

"Clearly manufacturers have a long way to go to fully capitalize on the potential of the Internet market," noted Ernst & Young's Fred Crawford. "Consumers have confirmed the importance of brand in their online shopping. It is time for manufacturers to more fully include this sales and marketing vehicle in their overall brand strategies. I think then we will begin to see greater success."

Managing the Web Initiative

Manufacturers' Web initiatives appear to have more autonomy than retailers'. Some 26% of manufacturers selling online or planning to sell online to consumers said their Web activity is in its own business unit. More often (in 45% of the companies), though, the initiative functions at the corporate level. In another 26% of the respondents, the Internet initiative operates within another business function, usually a marketing-related one.

Funding of the Web initiative is split as well. Most monetary support comes either from different departments pooling their resources (30% of the cases) or a single department's budget (30%). In 20% of the respondents, the Internet initiative is funded at the corporate level, while at 17% of respondent companies the Web site has its own separate budget.

Like retailers, direction-setting for these Internet initiatives is most often supported by either senior corporate executives or the top-level marketing person. In 38% of the manufacturers, the CEO, COO, or a business unit general manager drives Internet strategy; in 34% of the companies, the head of marketing is responsible for developing the organization's Internet direction. In 9% of the companies, the CIO is the chief Internet strategist.

Barriers and Contributors to Online Success

What is the biggest barrier in manufacturers' efforts to sell to consumers online? To paraphrase the famous quote, the enemy is within. Manufacturers, more than retailers, rated barriers internal to their companies as more significant than hurdles outside the organization. The biggest perceived barriers are insufficient corporate resources and integration with existing business processes. Two other internal barriers rated as more than "somewhat a barrier": potential conflicts with channel partners and the cost of constructing the platform.

Regarding external issues, consumer concerns for security and privacy finished first among manufacturers — even though it was rated to be less than "somewhat a barrier." As is the

> *"Clearly manufacturers have a long way to go to fully capitalize on the potential of the Internet market."*
>
> – Fred Crawford, Ernst & Young

Success factors in online selling to consumers*

Factor	Score
Having a well-designed, easy-to-use site	2.94
Being allied with the right search engines, portals, or Web communities	2.61
Having a strong company brand	2.52
Aggressively advertising/promoting the site	2.42
Selling well-known branded products	2.39
Being a first-mover	2.26
Being a fast-follower	2.10
Having strong executive leadership	2.03
Offering more competitive prices online	1.77

*Most important success factors ranked on scale of 1-3 (1=not important; 2=somewhat important; 3=very important)

case with retailers, manufacturers seem to view security and privacy as less of an issue than do consumers.

For manufacturers hoping to overcome various internal and external barriers, attention should be given to Web site navigation and linkages. Manufacturer respondents rated ease of use and alliances with the right Web partners as the most critical factors in online sales to consumers (see chart on page 29). Like retailers, they almost universally believe in the need to have Web sites that are easy to navigate. They also believe that brand is king in cyberspace — both the company and individual product brands. Unlike retailers, however, manufacturers place higher importance on being a first-mover than a fast-follower. Like retailers, they downplayed the need for lower prices on the Net; competitive pricing finished last on the list.

Web Site Design Issues

With Web site ease of use named a critical factor for online success, one would expect manufacturers' site design philosophies to emphasize navigation. And that's precisely the case. Like retailers, manufacturers said ease of use was more important than any other design attribute, followed by knowledge and currency. Interactivity was fourth. Both customization and community were rated less than "somewhat important" in attracting and retaining Web site visitors. Asked to rate themselves, manufacturers gave between average and good marks to the

intuitiveness, knowledge, currency, and interactivity of their sites, but they gave themselves poor marks on customization and community. Interestingly, only 16% of the respondents said they update their Web sites at least weekly; the majority (51%) said they update their sites less often than monthly. One-third update their sites monthly.

One reason for the average to poor marks on Web design could be the lack of customer input to their Web designs. Half of manufacturer respondents said customer comments impacted the design of their sites to a minor degree or not at all. Only 14% said it influenced design to a great degree, and 37% said to some degree.

To attract visitors to their Web sites, manufacturers rely primarily on four marketing channels: print media, references on catalogs, links to other Web sites, and references on packages. The latter was rated the most effective source of generating Web traffic (equaled by TV), followed by direct mail and print media. No manufacturer reported generating more than 5,000 customer visits per day. Forty percent said they received between 1,000 and 4,999, and 47% said they had fewer than 1,000.

Not surprised by these numbers, Ernst & Young's Crawford commented, "Overall these design issues and traffic statistics reinforce what is intuitive to most consumer goods marketers: Messages must be targeted, fresh, and relevant to capture and retain the consumer."

Like retailers, manufacturers said ease of use was more important than any other design attribute, followed by knowledge and currency.

Most-valued Web site design attributes and how respondents stack up*

	Importance of attribute	Self-Rating
Intuition (Is easy to navigate through)	2.97	2.52
Knowledge (Educates visitors on products and their use)	2.80	2.69
Currency (Material is updated frequently)	2.77	2.03
Interactivity (Offers visitors the ability to provide feedback, ask questions, etc.)	2.47	2.07
Customization (Enables visitors to tailor content and information representation)	1.87	1.31
Community (Allows visitors to share information with other like-minded visitors)	1.90	1.29

*Rating of importance of six attributes on scale of 1 to 3 (1=not important; 2=somewhat important; 3=very important) and how respondents rate themselves on those attributes on scales of 1-4 (1=poor; 2=average; 3=good; 4=excellent)

The National Retail Federation is the retail industry's largest advocacy organization which advances the industry through professional seminars, trade conferences, publications and educational activities, and influences the development and content of legislation and public policy affecting retailing and the consumer.

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