Approved: 3-11-99
Date

MINUTES OF THE SENATE ASSESSMENT AND TAXATION COMMITTEE.

The meeting was called to order by Chairperson Senator Audrey Langworthy at 11:15 a.m. on March 4, 1999, in Room 519-S of the Capitol.

All members were present except:

Committee staff present: April Holman, Legislative Research Department
Shirley Higgins, Committee Secretary

Conferees appearing before the committee: April Holman, Legislative Research Department
Karla Pierce, Secretary, Kansas Department of Revenue
Chris McKenzie, League of Kansas Municipalities
Natalie Bright, Kansas Chamber of Commerce and Industry

Others attending: See attached list.

The minutes of March 2,1999, were approved.

Senator Langworthy called upon April Holman, Legislative Research Department, for a presentation on Internet commerce issues. Ms. Holman distributed copies of a memorandum which she originally wrote for the House Economic Development Committee when it requested information on the impact of Internet commerce on local main street businesses. She noted that the memorandum also contains an overview of some of the basic issues of Internet commerce. Ms. Holman discussed the following issues: (1) the impact of e-commerce on local "main street" businesses, (2) loss of sales/use tax revenue, and (3) the federal moratorium on taxation of Internet sales. (Attachment 1)

Secretary Karla Pierce, Kansas Department of Revenue, followed with her presentation entitled, "Electronic Commerce, the Internet and Taxes." She stated that electronic commerce is changing the way business is conducted globally and noted that existing state tax policies were designed for a different era of commerce. Secretary Pierce discussed the following topics: (1) the Internet Tax Freedom Act passed by Congress in 1998, which placed a three year moratorium on the imposition of taxes on Internet access and on multiple or discriminatory taxes on electronic commerce; (2) the National Tax Association's goal to reach agreement on expanding the duty of retailers to collect use tax in exchange for tax simplification and uniformity for business; and (3) Kansas and other states' activities concerning Internet sales. (Attachment 2)

Chris McKenzie, League of Kansas Municipalities, commented on the possible effects of electronic commerce on the shape of the state and local finance in the future. He called attention to data in an attachment to his written testimony indicating that, over the last twenty years, there has been increased centralization towards state government of responsibility for financing local government. He further noted that there has been a trend toward diminishing the role of property tax in state-local finance. In this regard, he called attention to another attachment entitled, "Is the New Global Economy Leaving State-Local Tax Structures Behind?". In conclusion, he emphasized the importance of state and local governments standing together in restructuring the sales tax system. (Attachment 3)

Natalie Bright, Kansas Chamber of Commerce and Industry (KCCI), said businesses have always appreciated the free market, and the Internet currently is a free market. There are concerns from the "main street" members of KCCI; however, there are also members that now have access to markets that they were never able to access before. She commented that approximately 140 billion people are currently using the Internet market, and that number will continue to grow because of the popularity of Internet shopping. As a business community, KCCI acknowledges that the issue of sales tax needs to be addressed. The National Tax Association is the leading group that is looking at the issues surrounding Internet sales. That group believes there is an agreement on the nexus issue for sales tax. However, businesses fear that, once the nexus jurisdiction is opened up and expanded to allow taxation of businesses that do not have a physical presence in the state, it may branch out into income taxation to which they were not previously subjected. She

concluded that simplification of definitions is a key to resolving the taxation issues in addition to equity and fairness. She compared the impact of the Internet market to the Industrial Revolution. The effect of Internet sales necessitates a change in the tax structure. She emphasized that the restructuring should be done efficiently and effectively without stifling a market that has opened up a whole new avenue for the business community internationally.

The meeting was adjourned at 12:05 p.m.

The next meeting date is to be announced.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

SENATE ASSESSMENT AND TAXATION COMMITTEE
GUEST LIST

DATE: March 4, 1999

NAME	REPRESENTING
Shirley Sicilian	KS of Revenue
Karla Pierce	"
Don Schnacke	KIOGA.
Marilyn L. Nichols	Register of Deeds
Mike Reecht	AT&T
Dena Hatthews	Western Resources
Bob Vancrum	Midland Properties

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March 4, 1999

To: Senate Assessment and Taxation Committee

From: April Holman, Research Analyst

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:

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

2. loss of sales/use tax revenue, and

3. federal moratorium on taxation of Internet sales.

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Attachment 1

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.

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;

- 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;

- 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.

STA OF KANSAS
Bill Graves, Governor

DEPARTMENT OF REVE
Karla J. Pierce, Secretary

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Office of the Secretary

BRIEFING PAPER

TO: **Assessment and Taxation Committee**
Senator Audrey Langworthy, Chairman

FROM: **Karla Pierce**
Secretary of Revenue

DATE: **March 4, 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 collection requirements on out-of-state retailers. If the state and local governments are to protect the tax base and ensure a level playing field between remote and main street commerce, the Commission's final recommendations must include a change to Public Law 86-272.

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 of State Legislatures. The membership of the project includes business 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

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 commission to develop the policy architecture. As you know, NTA'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

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.

League of Kansas Municipalities

PUBLISHERS OF KANSAS GOVERNMENT JOURNAL 300 S.W. 8TH TOPEKA, KS 66603-3896 (785) 354-9565 FAX (785) 354-4186

TO: **Senate Committee on Assessment and Taxation**
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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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 than in the past, 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 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.

(4)

League of Kansas Municipalities

Presented to Senator Pat Roberts---August 31, 1998

PUBLISHERS OF KANSAS GOVERNMENT JOURNAL 300 S.W. 8TH TOPEKA, KS 66603-3896 (785) 354-9565 FAX (785) 354-4186

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%). Source: *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. No local merchants who pay state and local sales taxes today are included, and the Commission would not 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 remote (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.

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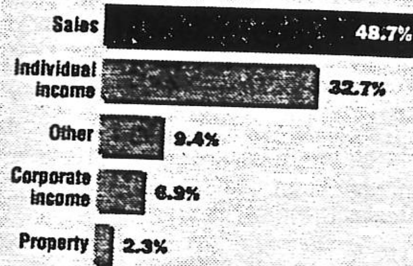
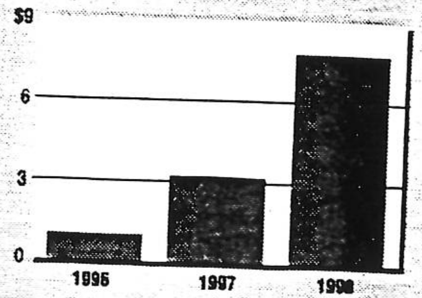
...ointments were made in December; industry panelists include C. Michael Armstrong, chief executive of AT&T Corp.; Robert Pittman, chief operating officer of **America Online** Inc.; and Netscape Communications Corp. Chief Executive James Barksdale. But governors and state legislators complain that 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





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

Foundation for State Legislatures
and
National Conference of State Legislatures

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November 1997

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

Fiscal Year	Total Combined	Total Local	Total State	State General Sales	State Personal Income Tax	State Corporation Income Tax	State Selective Sales	State 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	$1.13	$0.89
1990s	$11.34	$4.63	$6.78	$2.24	$2.15	$0.47	$1.11	$0.81

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

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.*

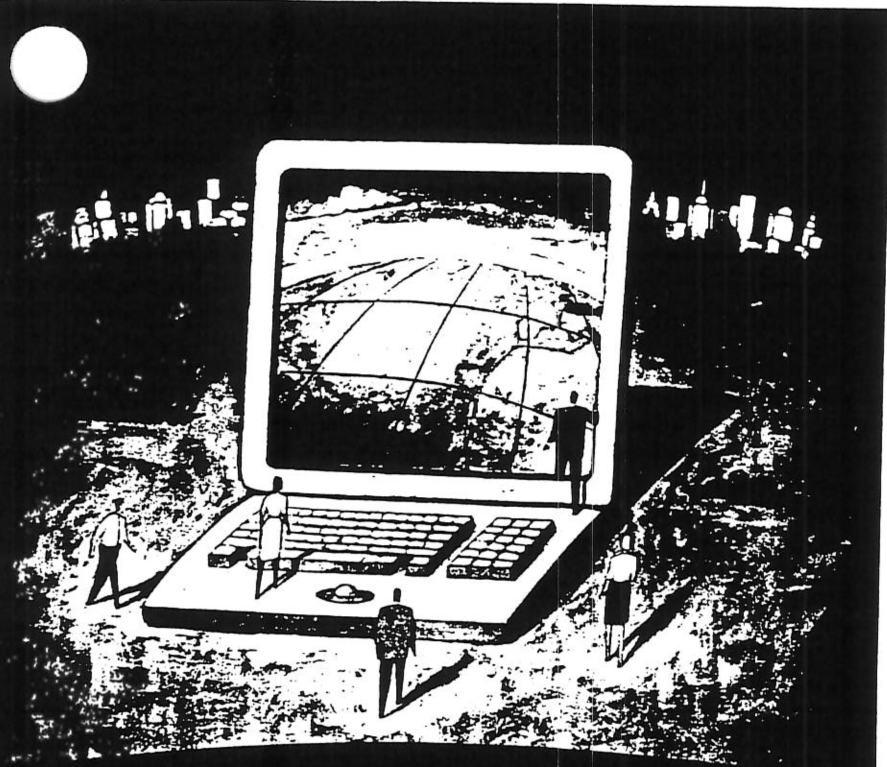
Table 2 also shows the trend toward centralization during the last 25 years. New Hampshire and New York are the only states where local governments raised more tax revenue than state governments in 1994. In 1970, local governments in nine states raised more tax revenue than the states. The number of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



Is the New Global Economy Leaving State-Local Tax Structures Behind?

National League of Cities

National Conference of State Legislatures

National Governors' Association

3-11

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.

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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 in[illegible] l plants. Job-hungry governments have responded by bidding for business. T[illegible] des 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 [illegible]y burden on goods-producing firms and capital-intensive industries. The [illegible]ect of both policies may violate the notion of horizontal equity in taxation,

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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

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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 rev-
[illegible] base.

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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-term 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 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.

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.

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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 ($million)	Potential Impact from 10% Decline: Revenue Loss ($million)	Potential Impact from 10% Decline: General Fund Loss (percent)	Potential Impact from 20% Decline: Revenue Loss ($million)	Potential Impact from 20% Decline: 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, MI, NJ, NY, OH, PA, and TX.

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