Do you shop out of state to avoid the tax bite? A whole bunch of state legislators and governors would like to change that.

Under current case law, out-of-state vendors cannot be required to collect sales taxes unless they have a physical presence in the purchaser’s state. Such a requirement, the Supreme Court reasoned in a 1992 decision, would unduly burden interstate commerce. With the growth of e-commerce, however, state governments have become increasingly concerned about the loss of sales and use taxes on their residents’ out-of-state purchases.

Accordingly, most states with sales taxes have joined the Streamlined Sales Tax Project (SSTP), whose objective is to simplify and harmonize the relevant tax code provisions in order to convince Washington that interstate sales tax collection is no longer an undue burden. This effort has produced a multistate tax compact called the Streamlined Sales and Use Tax Agreement (SSUTA). As of
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September 2004, 20 of the 42 states participating in the project, along with the District of Columbia, had adopted SSUTA, and many others were considering it.

If SSUTA is ratified by a sufficient number of states and endorsed by Congress, it will override the Supreme Court’s 1992 decision and permit the states to impose tax collection responsibilities on out-of-state vendors. The Streamlined Sales and Use Tax Act, introduced by Representatives Ernest Istook, a Republican from Oklahoma, and William Delahunt, a Democrat from Massachusetts, would come into effect once at least 10 states with at least 20 percent of the U.S. population comply with the terms of SSUTA. It would then require sellers with annual receipts of more than $5 million to collect and remit taxes on sales to SSUTA states, whether or not the seller is located in a member-state.

COSTS AND BENEFITS

Not all states believe the SSTP agreement is in their interest. Those that don’t impose a sales tax — Alaska, Delaware, Montana, New Hampshire and Oregon — clearly have no incentive to join. And some that do may still worry about the loss of autonomy that membership in the compact entails, or fear a political backlash from voters resentful of anything that smacks of a tax increase. Thus far, three states with sales taxes — Colorado, Idaho and New Mexico — have chosen not to participate in the SSTP process.

Several researchers have written about taxing remote sales, but most of their studies do not include a solid analysis of the potential effects of SSUTA — particularly on states that may not want to participate. There have been widely differing quantitative assessments of the direct fiscal impact of the inability to collect sales taxes on remote purchases. More important, none of the research has examined the extent to which remote purchases by non-residents stimulate economic activity beyond that linked to the actual sales — the “multiplier effects” that are recognized in every study of, say, new construction projects or the benefits from tourism.

In a recent analysis for the Progress and Freedom Foundation (available at www.pff.org/issues-pubs/pops/pop11.16SSTP.pdf), we closed that knowledge gap by estimating the benefits and costs associated with SSTP membership, assuming that membership would be voluntary. This research required us to come to grips with several issues that had either been unresolved or unexamined in the policy debate. They include the extent to which remote purchases would actually be affected by SSUTA, the impact of adopting SSUTA on those purchases, and the fiscal and economic benefits accruing to states that participate — or, alternatively, decide to opt out.

WHAT WOULD BE TAXED

First, we took a fresh look at the extent to which various categories of sales would be affected by SSUTA. It is true that electronic commerce has grown dramatically in the past few years, and that future growth rates for online sales are expected to outpace overall economic growth. However, to assess the impact of SSUTA on state budgets and economies correctly, it is important to look at each major component of remote sales, determining the extent to which they are already subject to sales tax collection and estimating the extent to which remote sales would remain

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exempt from tax under SSUTA.

There are three distinct streams of remote sales potentially subject to sales tax: two in electronic commerce, which is divided into the business-to-business and business-to-consumer sectors, and one in the more traditional “off-line” remote sales driven by mail order and direct marketing. Most remote sales, it turns out, are business to business, rather than business to consumer; most business to business sales are not subject to sales tax, and in many cases, states have adequate tools to track the portions that are subject to use taxes by auditing company books.

Even within the business-to-consumer sector, we found that the majority of online transactions are in services or goods not typically subject to sales tax. We estimate that only 30 percent of 2001 business-to-consumer expenditures – or about $21 billion – would potentially be affected by SSUTA.

In fact, the bulk of potentially taxable remote sales are not online, but from traditional off-line retail categories like direct mail, catalog sales and telemarketing. Overall, out of the $1.15 trillion in remote sales in 2001 (the most recent year for which complete data were available), only $123 billion would have been affected by adoption of SSUTA. The remaining remote sales were either exempt or already taxed.

FISCAL BENEFITS OF PARTICIPATION
The price sensitivity of Internet shoppers is well established. Recent studies have confirmed that added costs, such as sales taxes and shipping charges (which are typically higher for remote sales than for in-state purchases), significantly affect online buying decisions. It is therefore reasonable to
expect that businesses and consumers would shift purchases from remote sellers who are required to collect sales taxes, so long as they can make purchases from competing sources unencumbered by SSUTA. Even under the Istook-Delahunt bill, where the obligation to collect sales taxes would not be confined to states with SSTR membership, tax-free remote purchase opportunities would be offered by sellers located outside the United States.

Studies of online purchasing (as well as of off-line purchases in areas close to state borders) have shown that such switching could limit the fiscal benefits to states that adopt SSUTA. Research conducted by Austan Goolsbee, an economist at the University of Chicago’s Graduate School of Business, using data from the late 1990s, shows that these shifts are potentially large (see gsbwww.uchicago.edu/fac/austan.goolsbee/research/intertax.pdf). Moreover, the most tax-sensitive buyers in his studies – Internet users who have used the Internet for more than two years – account for an increasingly large proportion of Internet buyers (see gsbwww.uchicago.edu/fac/austan.goolsbee/research/tpe.pdf).

More recently, Jupiter Research found that 9 percent of those who were aware of the possibility of avoiding sales taxes online always sought to avoid the tax, while another 30 percent of those sometimes did so.

As a baseline, we estimated the benefits to SSTR membership under the assumption that all the sales-tax states would join the agreement. Taking into account current levels of online sales and Internet user experience, we estimate that about $29 billion (just over 24 percent of the $123 billion in potentially affected 2001 remote sales) would shift to the zero-sales-tax states. The lost sales are largest for states like California and Texas, which have both large economies and relatively high sales tax rates. California consumers alone would shift more than $4 billion in remote purchases to non-SSUTA states.

Nationally, we estimate the maximum increase in total sales tax revenues – assuming that all states with sales taxes adopted SSUTA – at $4.8 billion, which represents less than 2 percent of the $258 billion in sales and excise taxes collected by states in 2001. Even this modest projected fiscal benefit would be eroded substantially when the impact of economic activity supported by the remote wholesale and retail sectors is taken into account. States that lost remote sales to non-resident businesses would experience reduced sales and income tax collections from those who do business with, work for and buy from firms in these sectors. As each additional dollar of demand works its way through the economy, it has a multiplier effect on output, earnings and employment.

A demand shift from SSUTA states to non-SSUTA states would induce a negative multiplier effect in the losing states, which would have a further negative effect on economic activity. This would ultimately translate into lower tax revenues. Once these multiplier effects (due to the loss of business in SSUTA states) are taken into account, the projected 2001 increase in sales tax revenues from adopting SSUTA is considerably smaller than $4.8 billion. We estimated the extent of this reduction in cases studies of Virginia and Colorado below.

**Benefits to Nonparticipants**

Assuming that participation in SSTR remains voluntary, states that opt out stand to benefit from increased sales to non-residents by existing remote sellers, as well as increased rates of business creation in this sector. The value of this economic activity should not be viewed solely in terms of tax revenues, but
also in the larger context of economic growth, resident incomes and jobs.

We estimated these effects for a tax-free zone consisting of the five zero-sales-tax states, using multipliers from the Commerce Department's Regional Impact Modeling System data, available from the Bureau of Economic Analysis. Our calculations indicated that the $29 billion in shifted sales translates directly into $9.4 billion in earnings and more than 200,000 jobs. Once the indirect multiplier effects on other state businesses are fully factored in, shifted sales could produce an aggregate economic benefit of $25 billion in earnings and more than 530,000 jobs to the states that capture the remote wholesalers and retailers making these sales. For states contemplating adoption of SSUTA, this analysis implies that capturing even a small share of shifted remote purchases would generate enough tax revenues from increased economic activity to more than offset the revenues foregone by opting out of the agreement.

A host of factors determine firms’ decisions about where to locate. Fixed costs, connections to an area, and moving expenses may all limit the number of businesses whose locations would be affected by SSUTA. Relocation and start-up choices depend on tax and regulatory policy, levels of work-force education and compensation, and executive residential preferences. However, research by Minchul Kim, a graduate student at Yale, confirms that two factors particularly relevant to remote sales operations – sales tax and shipping costs – have a measurable effect on the geographic profile of Internet retailer locations (an abstract is available at www.econ.yale.edu/graduate/placement/2002-03/kim-m.htm).

**OPTING OUT**

We computed the costs and benefits of opting out (in terms of economic activity and jobs as well as tax revenues) for two states, Virginia and Colorado. Both are technology leaders (Virginia and Colorado ranked fifth and third, respectively, in the Milken Institute’s 2004 State Technology and Science Index) whose leaders are interested in attracting online businesses that may be quite sensitive to tax considerations.

Virginia currently participates in the SSTP, but has not yet enacted legislation bringing its tax code in compliance with SSUTA. Our research indicates that enacting such legislation would come at a substantial cost to the state in the form of lower levels of both overall economic activity and state tax collections.

Virginia would forego an estimated $97 million in revenues from the application of sales taxes to the remote purchases of its residents if it decided not to become part of SSUTA. Offsetting this, the state would avoid the adverse impact of losing remote sales. Incorporating multiplier effects, this avoidance-of-loss would be considerable: almost $2.4 billion in sales for Virginia businesses, $1.9 billion in personal income, nearly 15,000
STREAMLINED SALES TAX

jobs, and about $100 million in sales and income tax revenues. Thus, even before considering the new businesses that would be attracted to Virginia, a decision not to join SSTP would generate net gains to the state treasury.

More important, if Virginia opted out, it would be part of the tax-free zone and would gain a portion of the sales that are shifted from SSTP participants. Were the state to capture only 1 percent of the sales shifted from SSUTA states it would gain $860 million in output, $700 million in wages and salaries and 5,400 new jobs. And each percentage point of shifted sales would produce $37 million in new revenues. These factors were part of the reason a Virginia legislative study committee recently recommended that the state not adopt SSUTA.

For Colorado, a state that does not participate in SSTP, our research suggests that a decision to join would produce substantial losses in both state tax collections and economic activity. If Colorado adopted SSUTA, it would increase receipts by $53 million. On the other hand, Colorado businesses would initially lose some $500 million in sales shifted to the tax-free zone. With multiplier effects, this would cost Colorado $1.5 billion in lost economic activity, $1.3 billion in lost wages and salaries, 9,700 jobs, and $60 million in lost sales and income tax revenues – more than the $53 million in increased sales tax receipts directly attributable to SSTP participation.

Again, Colorado would also lose the opportunity to attract a share of the new business by being part of the tax-free zone. The numbers here parallel those for Virginia. If Colorado were to capture only 1 percent of the new business shifted from SSTP states, it would gain $880 million in new economic activity, $720 million in income, and 5,500 jobs. The tax revenues associated with this new economic activity would be $34 million.

VOLUNTARY SSTP EQUALS A MANDATORY SSTP

These case studies make clear that states choosing not to join will enjoy a competitive
advantage vis-à-vis SSUTA states. The new businesses attracted through a favorable tax policy will stimulate economic activity, job growth, incomes and tax revenues in the non-SSUTA states. For many states, the potential beneficial effects of opting out are substantial.

We should note that the potential costs and benefits of opting out vary from state to state, with those that collect little sales tax having relatively little to lose – and potentially a lot to gain – from declining to join SSTP. Similarly, states that are disproportionately exporters of goods to retail customers in other states would forego less tax revenues from opting out. States that are disproportionately importers would lose more.

We did not have data to incorporate all the factors that influence the gains and losses from participation. However, it is almost certain that the number of states with comparatively more to gain from opting out of SSTP is relatively large, and the number with relatively more to lose from not joining is much smaller. States with relatively small domestic markets stand to gain as much as larger states from shifted purchases from nonresidents, while foregoing smaller levels of tax receipts on remote purchases by state residents if they opt out of SSTP. Because residents of six states (California, New York, Texas, Florida, Illinois and Pennsylvania) account for more than 42 percent of all U.S. sales, the conditions are ripe under a voluntary SSUTA for what the late Mancur Olson of the University of Maryland, termed “the exploitation of the great by the small.” Accordingly, we expect that a voluntary SSUTA would be able to retain only a handful of states at best.

**MANDATING SSTP PARTICIPATION**

Because the benefits of SSUTA to the participating states decline as additional states opt out, some of its proponents have proposed that states – even if they choose to opt out – should still be required to collect taxes for SSTP members. Under the Istook-Delahunt bill, states could require remote sellers to remit taxes for sales to customers in member-states. So, for example, a seller in Virginia would be required to collect taxes on the software it sold to Texas residents and to remit those taxes to Texas – even if Virginia had opted out of SSUTA and therefore was not receiving taxes on the Texas computers sold to Virginia residents.

The potential costs and benefits of opting out vary from state to state, with states that collect little sales tax having relatively little to lose – and potentially a lot to gain – from declining to join SSTP.

If SSUTA enjoyed universal participation, its geographic impact would be clear: interstate purchases would become more expensive relative to in-state purchases, and consumers would shift some purchases to both off-line and online sources in their home states. In terms of direct sales tax revenues, states would be indifferent to the extent of this shifting because they would receive taxes on sales by both instate and remote retailers. The extent of the shifting would depend on how consumers value non-tax attributes of the various alternatives, like the convenience of Internet shopping versus the ability to
examine merchandise in person, as well as the shipping costs associated with remote purchases.

As we noted above, the extent of this fiscal benefit would still be modest compared to overall state sales tax collections. Even if consumers were unable to shift any purchases to tax-free areas (a scenario that would require eliminating any small business exemption and enforcing compliance by foreign sellers), we estimate that SSUTA would have increased state sales and excise tax collections in 2001 by only 2.5 percent. Contrary to the predictions of some analysts, this share is not projected to rise dramatically in the foreseeable future. Under reasonable assumptions about the future growth of remote sales and state fiscal structure, SSUTA receipts would still represent less than 5 percent of state sales and excise tax receipts – even projecting out as far out as 2008.

Economists can point to an additional potential benefit from enforcing compliance with SSUTA: elimination of the tax-induced wedge between the prices paid for local purchases and remote purchases of the same product or service. While this argument is frequently couched in “bricks versus clicks” terms, in-state online and remote off-line sellers would be equally affected.

However, while we did not focus our attention on mandatory SSTP participation in our research, there are a number of important reasons to be concerned about this proposal. First, requiring businesses in nonparticipating states to collect sales taxes could prove quite burdensome. Businesses in zero-sales-tax states would be obliged to purchase and use tax-collection software where none was needed before. Businesses in sales-tax states might well have to use two software systems – one for their own state and one for SSUTA states – or face the expense and uncertainty associated with converting their existing tax collection systems to ones that accommodate SSUTA-mandated remissions.

Second, mandating state compliance with SSUTA would accentuate some tax-induced economic distortions even while attenuating others. In particular, the presence of substantial populations in areas close to state borders warrants consideration. Currently, remote purchases represent one option for these consumers sensitive to sales taxes. With this option foreclosed by mandated SSUTA compliance, buyers in relatively high-sales-tax states could be expected to increase purchases from nearby states with lower (or nonexistent) sales taxes.

Most important in our view, mandating SSUTA compliance would be tantamount to a requirement to adopt SSUTA. If states must bear all the costs of SSTP membership, regardless of whether they join, and are deprived of the benefits of opting out – i.e., the ability to attract new businesses – they will likely choose to join so they can at least get some benefits. If such a requirement were extended to the tax-free states (which is likely), it might even induce them to enact sales taxes because the benefits of being a tax-free state would diminish.

Such a requirement would seriously erode the benefits of tax competition that are an important part of our federal system. Currently, states are able to compete for businesses in a variety of ways, including through their tax codes.

This competition represents an important check on the tendency of states to institute tax systems that distort economic incentives and reduce economic efficiency. In our view, eliminating this restraint would be detrimental not just to a subset of states, but to the economic health of the whole country.