New York City Independent Budget Office

Fiscal Brief

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E-Commerce: Eroding City's Sales Tax Revenue

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SUMMARY

NEW YORKERS, LIKE MOST CONSUMERS IN OTHER CITIES AND STATES, have grown accustomed to not paying sales taxes on many of the purchases they make online, although in New York and many other places taxes are actually due. The rapid growth of e-commerce—online retail sales and electronic services—is making many state and local officials concerned about the erosion of an important part of their tax base.

In June, New York State passed a law that would force the collection of taxes on certain electronic purchases. Often called the "Amazon" tax, the law is already being challenged in court.

In addition to providing an overview of the tax policy issues at the heart of the debate over e-commerce this report presents IBO's estimates of Internet sales activity by city residents, the share of e-commerce that tax is collected on, and the level of tax revenue lost to online sales. Among our findings:

- Roughly $2.2 billion of the $4.4 billion in e-commerce sales generated by New York City residents in city fiscal year 2007 is taxable.
- These online sales should yield about $173 million in tax revenues—$91 million for the state and $82 million for the city.
- From July 1, 2006 through June 30, 2007, more than $50 million of combined state and local taxes on Internet sales generated by the city's consumers went uncollected, including $29 million in lost city revenue.

The report also notes that in recent years the sales tax has comprised a declining share of total city tax revenues. Rising levels of untaxed Internet sales is likely one of the reasons for this decline.

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INTRODUCTION

In recent years, the rapid growth of electronic commerce (e-commerce) has presented New York City and many other localities and states with a serious challenge in collecting the appropriate sales taxes on that business. New Yorkers, like most consumers in other cities and states, have grown accustomed to not paying sales taxes on many of the purchases they make online, although in most cases—at least in New York—taxes are actually due.

State and local officials have been concerned that the rise of the e-commerce on the Internet may severely erode state and local tax bases. Their concerns may well be warranted: IBO estimates that from July 1, 2006 through June 30, 2007 the city and state combined lost nearly $50 million in sales taxes due to Internet sales.

On June 1, a new law went into effect in New York State that attempts to force collection of sales taxes on certain electronic purchases. The state has projected that it will collect nearly $50 million this fiscal year in additional tax revenues from what has become known as the "Amazon" tax for the name of country's biggest Internet retailer and a strong opponent of the state's tax collection initiative. In subsequent years, the changes are expected to result in increasing revenues, growing from $70 million in state fiscal year 2009–2010 to nearly $100 million by 2011–2012.

With the city's sales tax piggybacking on the state's, the state estimates that city coffers would also receive about $27 million in the city's current fiscal year if the new law survives the court challenges that have already been filed. The state projects that the city will see a revenue increase of more than $40 million in the next fiscal year, and that in city fiscal year 2012 the revenue gain will amount to more than $60 million.

In an effort to inform the ongoing discussion on the effects of e-commerce and to provide relevant city specific estimates, this report provides an overview of the tax policy questions at the heart of the e-commerce debate and an estimate of how much of Internet transactions generated by city consumers currently go untaxed, as well as the amount of sales tax revenues the city failed to collect from Internet sales in city fiscal year 2007.
The report is structured as follows: after reviewing the general challenges created by the rise of e-commerce, the report focuses on New York specific aspects and history of sales taxation and tax collection efforts and then presents our estimate of revenue losses, including the methodology, data, and assumptions the estimate is based on.

THE CHALLENGES OF INTERNET SALES TAXATION

The general anxiety surrounding the fiscal problems stemming from e-commerce—an unease that has persisted for years—was captured in the title of a 1995 report by Nathan Newman for the Center for Community Economic Research at the University of California: *How State and Local Government Finances Are Becoming Road Kill on the Information Superhighway*.

Based on a 1992 ruling by the Supreme Court in *Quill v. North Dakota*, a state may not require an out-of-state retailer to collect sales tax on sales to its residents, unless the retailer also has some physical presence or *nexus* in the state. One consideration in *Quill* was that the sheer number of sales tax jurisdictions—more than 8,000 of them in the U.S.—meant that compliance with local tax regulations was a hindrance to interstate commerce.

Attempts to deal with the problem by creating a more unified framework for sales taxation have so far been unsuccessful. In 1998, Congress passed the Internet Tax Freedom Act that established a commission to study Internet sales tax issues. After working for several years the commission failed to reach a consensus. More recently, a group of states has initiated the Streamlined Sales Tax Project in an effort to enhance interstate conformity of the base and administration of the tax. The participating states hope that a harmonized system of sales taxes would encourage Internet vendors to collect sales taxes voluntarily.

In a parallel effort, a bill was introduced in Congress last summer that would obligate remote sellers to collect sales tax for states that are members of the Streamlined Sales and Use Tax Agreement. Although New York State is not a member of the agreement, its official representatives have taken an active role in the project. So far, the complexity of coordinating a near complete overhaul of sales taxation in multiple states and a lack of enthusiastic Congressional support has slowed the project's progress toward a simplified framework of sales taxes.

Recently, New York State has taken up the challenge by enacting a statue that renders New York-based affiliates of Internet vendors equivalent to employees. This, the state argues, creates sufficient nexus to require collection of the state's sales tax by out-of-state sellers. If the state is successful in enforcing the law—which is already being challenged in the courts—the City of New York stands to gain from this initiative as well because online retailers would also have to collect the city's sales tax if the customer is a city resident.

BACKGROUND: NEW YORK CITY SALES AND USE TAXES

The use of sales taxes by states can be traced back to the Pennsylvania mercantile license tax introduced in 1821. This tax and those that followed were selective, goods-specific taxes and were not as broad based as what is now referred to as a general sales tax. The first general sales tax in the United States was enacted by the state of Mississippi in 1932. New York adopted a statewide general sales tax in 1965. From the very beginning, sales taxes were conceived as a levy on retail sales with sellers serving as collection agents. Currently, 45 states and the District of Columbia levy a general sales tax imposing their own tax rates and choosing their own definitions of the base of goods and services to which the tax applies. (The five states without a general sales tax are Alaska, Delaware, Montana, New Hampshire, and Oregon.) Many states—including New York—allow local governments (municipalities, school districts, and counties) to levy their own sales taxes in addition to the state tax. Typically, most services and intangible products, such as medical, financial, educational, and legal services are excluded from the base of the tax.

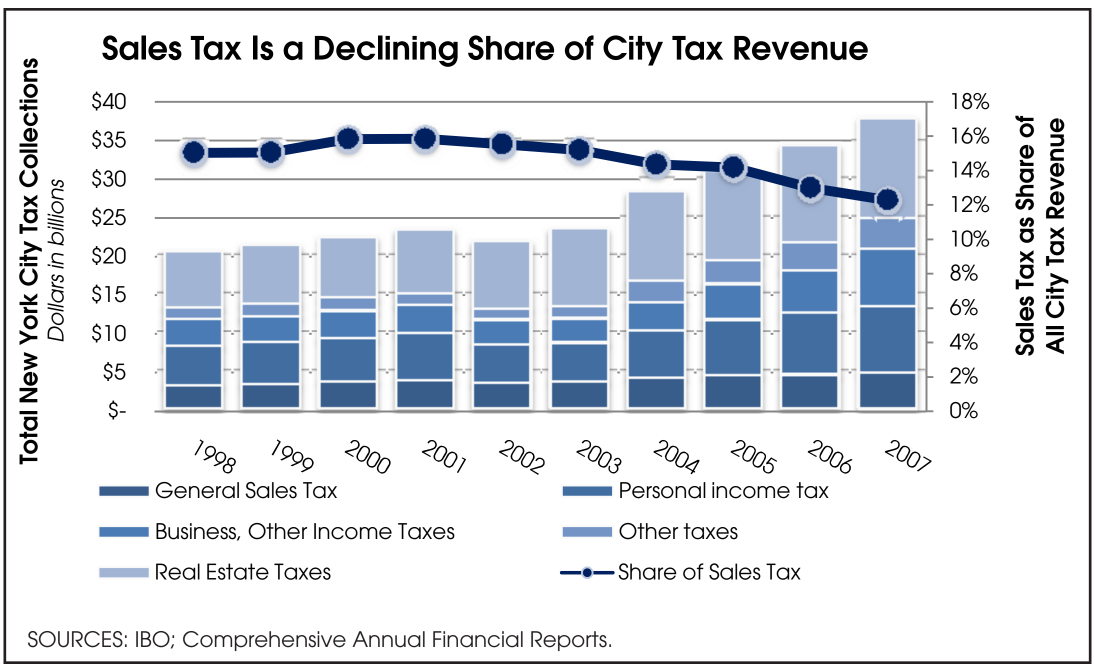
The city's sales tax was first enacted in 1934 and is imposed on sales of tangible personal property and selected services. The state administers the tax for the city. Currently, the city sales tax rate is 4.0 percent, the same as the state's rate. An additional 0.375 percent sales tax is collected for the Metropolitan Transportation Authority in the 12 counties the authority serves (sometimes called the Metropolitan Commuter Transportation District). This makes the total sales tax rate in the city 8.375 percent. Exemptions—designed to make the tax less regressive—include food, rent, prescription and nonprescription drugs, textbooks for college students, and public transportation. New York State recently also exempted shoes and clothing from the base.

The vast majority of the city's sales tax revenue is collected by retailers from customers who make their purchases on-site. This method allows for relatively low administrative costs and has a high rate of successful tax collections. Remote sales, including online purchases, are more difficult to monitor and tax. At one time, remote sales consisted mostly of mail order catalog purchases and telephone sales, but recently online sales have become predominant.

When a remote retailer does not collect the New York sales tax on purchases by New Yorkers, either due to a lack of nexus with New York, ignorance, or complicity in tax avoidance, the purchaser is responsible for paying the equivalent amount in use tax. The city and state use taxes exactly mirror the city and state sales taxes and are supposed to be paid directly by consumers if the appropriate sales tax was not paid. Unlike the taxation of local sales, use taxes are inherently more difficult to administer and have low collection rates.

The sales tax continues to be an important source of tax revenue for the city, although it has decreased in recent years as a share of total tax revenues. From 1998 through 2003, sales taxes on average made up 15.4 percent of all city taxes. In 2006, sales tax collections slipped as a share of city tax revenue to 13.0 percent. It slipped again in 2007 to 12.3 percent of all tax revenues, or $4.6 billion of the $37.8 billion in taxes collected that year.

A recent report by Tax Policy Center using data from the U.S. Census Bureau's State and Local Government Finances data found that the share of general and select sales taxes in other states and localities has also declined slightly from about 21 percent in the early 1990s, to 19 percent of all tax revenues in 2005. Rising levels of e-commerce are assumed to be one cause of the decline in the sales tax as a share of state and local taxes. Other factors include the long-term rise in purchases of services rather than goods, growth in personal income, and the recent boom in business income taxes.



SHOULD INTERNET SALES BE TAXED?

The emergence of Internet and electronic commerce has sparked an intense debate among policy makers at various levels of government and, not surprisingly, local taxation of Internet sales has been strongly opposed by some Internet vendors. The question at the heart of this debate has remained the same: should the states and localities be able to extend their sales tax regimes to include purchases over the Internet.

Fairness in tax treatment is the most frequent argument for collecting the sales tax on electronic purchases. Transactions by "brick and mortar" retailers are subject to sales tax, as are those made on Web sites of retailers that have nexus in a given jurisdiction. Thus online-only retailers enjoy the privilege of selling lower priced goods by avoiding collection of sales taxes. Local stores, or stores with local representatives, are at a competitive disadvantage due to the current policy that favors e-commerce transactions.

The fairness argument can be extended to consumers. Although Internet access is widespread, a portion of the population has no or only limited access to the World Wide Web. Consumers in lower income groups may have fewer opportunities to take advantage of untaxed purchases. This contributes to the regressivity of state and local sales taxes.

The other primary argument for taxing e-commerce is the need to preserve the tax base of state and local governments. If Internet sales continue to grow relative to traditional retailing while remaining beyond the reach of state and local taxes, sales tax collections will erode. Particularly for localities that rely on sales and property taxes rather than income taxes, this trend may threaten an important source of tax revenues and undermine state and local efforts to provide goods and services.

Online vendors point to the fact that the sheer number of states and localities with differing sales taxes on drastically different tax bases, and frequently changing sets of exemptions make it all but impossible for Internet businesses to keep up with the task of charging the proper sales tax on goods shipped to a particular locality. Traditional retailers dismiss this argument by pointing out that today's computer technology can easily address the challenges of figuring out the appropriate tax rate. In fact, many multistate retailers with nexus in one or more states already have Web sites that automatically calculate and apply the appropriate sales taxes on Internet purchases.

THE STREAMLINED SALES TAX PROJECT

As an alternative way of encouraging sales tax collection by Internet vendors, a group of states has initiated a project that aims to harmonize sales taxes across the nation. The effort—known as the Streamlined Sales Tax Project—would simplify state and local sales taxes and make them more uniform across the country. The states' attempts at streamlining sales tax administration have as their chief purpose the improvement of sales tax collection on e-commerce, mail order, and other kinds of remote sales. By reducing state-to-state differences in sales tax bases and rates, participants hope to remove some of the objections to having vendors collect the tax.

The participants in the project have drafted an agreement that addresses the many aspects of sales taxation. The agreed upon requirements shape a tax structure that member states would have to adopt. The agreement promotes tax rate simplification and imposes uniform sourcing, exemption, and tax holiday rules. As a part of the agreement, member states would eliminate the tax caps and thresholds currently prevalent in many states.[1]

In order to become members, some states have already incorporated the provisions of the Streamlined Sales and Use Tax Agreement. Presently, 18 states are sufficiently compliant with the agreement to have been accepted as full members. Four other states are at the associate member level, indicating that they have achieved substantial compliance with the agreement.

In order to conform to the agreement, counties and cities of New York State would have to adopt a number of the statutory changes. The state's localities, including the City of New York, would be bound to levy sales tax on a unified base, thereby eliminating the use of local sales tax exemptions. The state's existing system allows counties and cities to opt-in to exemptions for clothing or residential solar energy equipment. There is also an array of personal services that are only taxed in the City of New York. Among local exemptions that do not currently conform with the rules of the agreement are the following: sales tax on the services of beauty salons, barber shops, health salons, massage, gymnasiums, saunas, and credit bureaus; the city's exemption for interior decorating and design services; the city's unique standard exempting permanent residents from its tax on hotel occupancy; the tax treatment for energy used in the production of gas, electricity, refrigeration or steam; and sales tax on property used at qualified marine terminal facilities.

A 2006 report by the New York State Department of Taxation and Finance provides estimates of possible trade-offs associated with joining the Streamlined Sales and Use Tax Agreement. For example, New York City currently imposes a tax on fuels used to produce electricity and gas. In order to comply with the agreement's requirement of uniform tax bases, either the city would have to repeal its tax or the tax would have to be imposed in the rest of the state. This tax raises more than $30 million per year for the city. Other New York localities would face their own challenges should the state decide to conform to the agreement's requirements.

The state, which administers the city's sales tax, would also be required to change some administrative aspects of its sales tax. The state in its report lists some of these provisions: offering a tax amnesty, allowing businesses to use a state-certified software system to perform their sales tax collection responsibilities, acceptance of electronic sales tax returns, and permitting sellers to collect tax based on the ZIP code of the purchaser.

These compliance and administration issues related to the Streamlined Sales and Use Tax Agreement, as well as possible tax revenue trade-offs, explain why New York has limited its role to that of an "observer" in the Streamlined Sales Tax Project and has not become an associate, let alone full, member of the agreement.

It is worth noting that, neither voluntary compliance nor tougher enforcement of the use tax can be expected to result in the city receiving all of currently uncollected revenue. For New York, full or near full recovery of lost revenues would, at a minimum, require effective enforcement of the new state legislation or Congressional action that would require out-of-state vendors to collect sales tax or a Supreme Court reversal of *Quill.*

ESTIMATING REVENUE LOST BY THE CITY AND STATE

This section offers a review of the methodology, assumptions, and data used to obtain the estimate of the local fiscal impact of electronic commerce. From July 1, 2006 through June 30, 2007 IBO estimates that a loss of more than $50 million in combined state and local sales taxes can be attributed to Internet sales.

The main methodological challenge in estimating city revenue losses due to untaxed remote electronic sales is quantifying the level of out-of-state electronic commerce generated by city consumers. IBO's estimation procedure can be summarized as follows: 1) estimate the share of electronic sales attributable to the city from existing measures of national sales generated by e-commerce; 2) net out sales exempted from the tax base; 3) apply the appropriate sales tax rate to the estimate of the city's electronic sales; and 4) subtract the amount of Internet sales taxes already collected, to arrive at the measure of revenue losses due to electronic commerce.

At the base of all calculations in IBO's estimates is the data compiled by the U. S. Census Bureau on e-commerce transactions for retail and selected services. These data, known as E-Stats, offer annual information from 1998 to 2006, as well as quarterly data on retail trade through the first calendar quarter of 2008. Information for 2007 total sales and shipments by the manufacturing, wholesale, and selected services sectors will only become available in 2009.

For the purposes of this report only consumer purchases are considered. The report adopts the Census Bureau's assumption that all retail sales plus receipts from selected services are business-to-consumer transactions. An estimate of tax revenue losses due to business-to-business Internet sales, some of which are also subject to sales tax in New York, is beyond the scope of this report. In general, however, firms are more tax compliant than individuals in their dealings with other companies.

Although national data is available on e-commerce retail sales for 2007, similar data for selected services is only available for 2006. Based on the Census Bureau's E-Stats data, total retail e-commerce sales in the U.S. exceeded $127 billion in 2007. IBO's estimate of $62 billion in national e-commerce services for 2007 was based on the assumption that these services increased 8 percent from 2006 to 2007, the average rate of growth for these services over the period 2002-2006.

In order to estimate e-commerce sales in New York City, IBO assumed that the city's share of U.S. e-commerce sales mirrors its share of U.S. personal income. Since the city accounts for about 3.5 percent of total U.S. personal income, IBO estimates that the city's consumers generate $4.4 billion in electronic retail sales and $2.2 billion in electronic sales of selected services annually

Tax Exemptions. Using detailed industry data from the Economic Census compiled by the Census Bureau and from the New York State Department of Taxation and Finance's annual reports of taxable sales by industry for the counties (boroughs) of New York City, it is possible to estimate taxable sales for the city's major industries in fiscal year 2007. With these estimates we can then adjust the estimated city share of retail e-commerce sales for the narrower tax base in New York.

Accounting for various tax exemptions, IBO estimates that about $2.2 billion out of the $4.4 billion of e-commerce retail transactions generated by city consumers are taxable. The combined state and local sales tax of 8.375 percent due on these sales would yield $173 million in tax revenues. The city's portion of that sales tax revenue would total more than $82 million.

Similarly, for a group of selected services that are taxed under the local tax law and for which Census Bureau data is available, IBO estimates that almost $800 million of e-commerce revenues are taxable, and $67 million would be due under the combined state and local sales tax.

Estimating the Share of E-Commerce Currently Taxed. A share of these taxes is already being voluntarily collected by some Internet vendors and another portion is paid in the form of use taxes by city consumers, although the use tax portion is likely to be small. Empirical guidance on just how much of the Internet taxes are already being collected is not readily available. According to Forrester Research, an Internet market research firm, multichannel retailers—those with both brick-and-mortar stores and e-commerce affiliates—account for more than 75 percent of online sales. New York State's Department of Taxation and Finance has arrived at a similar estimate. In its 2006 report *Streamlining New York's Sales Tax* the department states that "the vast majority of large retailers that have a brick-and-mortar retail presence and a Web presence are already registered to collect tax in New York," a conclusion that can be explained by the fact that the City of New York has historically served as a center of national commerce.

Fiscal Impact. Using the state's assumption that as much as three-quarters of Internet sales are already being reported and taxed, IBO estimates that during a period that corresponds to city fiscal year 2007, more than $50 million of combined state and local taxes on sales generated by city's consumers went uncollected.[2] Of them, as much as $43 million were due on retail sales generated by city's consumers and the remaining $17 million on electronic services acquired by city residents. The fiscal impact on the city amounted to $21 million of losses in city's sales tax revenue that was due on retail sales, and nearly $8 million that should have been collected on selected services.

Once again, these findings should be interpreted with care. The lack of exact data, methodological choices and assumptions used in this study may have contributed to slight divergence from the true, but unobserved, levels of both e-commerce and lost tax revenue. The estimate of total Internet purchases generated by city's consumers is based on personal income, and does not account for other possible factors: for example, the city's geographical location. Unlike, say, residents of Hawaii, New Yorkers have the advantage of living in a historic transportation hub and consequently lower shipment charges on their Internet purchases that may make online shopping more attractive. These kinds of unaccounted biases may have resulted in an estimate that falls short of the actual amount of lost revenue.

E-COMMERCE AND OTHER LOCAL ECONOMIC EFFECTS

The economic influence of e-commerce extends beyond its fiscal impacts. Electronic commerce, still in its developing stages, has altered important sectors in the city's economy such as finance, communication, and retail trade. Moreover, some of the resulting changes are positive for the city, with new industries and employment opportunities emerging. The most critical effects may be associated not with obvious results but with less visible, but perhaps more pervasive, effects on routine business activities such as paying bills, managing office supplies, targeted marketing, and estimating demand. That is, e-commerce is changing the way businesses and other economic agents interact with each other.

Unfortunately, measuring the extent to which e-commerce has affected the city is problematic due to the lack of data and the inability of currently available statistical information to differentiate between traditional and Internet related activities. Despite being a focus of policy and academic discussions for many years, e-commerce has remained a vaguely defined phenomenon with a dearth of official measurements and economic statistics.

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ENDNOTES

[1]The streamlined agreement covers many aspects of sales tax administration, including centralized registration; monetary compensation; and uniform rules for the use of direct pay permits, tax rounding, tax returns, recovery of bad debt, customer refund procedures, and tax amnesty.

[2]The assumption adopted here that only 25 percent of taxes are being lost is quite conservative. A recent study by W. Fox assumes that as much as 65 percent of sales taxes due on consumer transactions go uncollected. Were we to accept this parameter, the estimate of combined state and local sales tax revenue losses on electronic retail and service purchases by New York City consumers would total $156 million in fiscal year 2007.