# Chapter II
# Electronic Commerce and the State Sales Tax System: An Issue of Tax Fairness

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## EXECUTIVE SUMMARY

This article examines the relationship between electronic commerce and the U.S. state sales and use tax system. A framework of a high-quality tax system is used in this study, and it is applied to taxing electronic commerce sales. The first part of this article analyzes nine principles of an effective tax system and divides these principles into the categories of adequacy of revenue, fairness of revenue, and management of revenue. In the second part of this article, these principles are tested to determine what impact electronic commerce taxation has on an effective revenue system. The results of these initial tests suggest that taxation of electronic commerce was associated with fairness in the tax system. In particular, the results suggested that states that had fairer tax systems were more likely to rely less on a sales tax and more on taxing Internet access. Management and adequacy of the revenue systems of states were not found to have a significant bearing on taxing electronic commerce. These results reinforce the existing public finance and legal theories that argue that the sales tax is not a fair revenue stream and that it should be reevaluated, especially in light of the contentious issue of taxing electronic commerce.

## INTRODUCTION

Taxing of electronic commerce is one of the most pressing tax policy issues that U.S. state governments face in the 21st century. This article examines how electronic commerce affects the sales tax system and its adherence to the standards of a high-quality tax system. This study uses several principles to devise measures of revenue capacity, or the ability of state governments to have a high degree of adequacy, fairness, and management in their revenue systems. Revenue capacity is different from tax capacity; the latter represents the ability of a government entity to finance its public services (Berry & Fording, 1997). Revenue capacity is broader, encompassing not just state revenue raising ability but also the management of the revenue system and equity issues.

This study attempts to discern how states deal with taxing electronic commerce, particularly if they have a high-quality revenue system. Specifically, areas such as taxing Internet access, having a state sales tax, taxing digital downloads, and participation in the Streamlined Sales Tax Project (SSTP) (an effort created by state governments to simplify and modernize sales and use tax collection and administration) are examined.

The study is notably different from existing empirical work, in that it examines how the taxing of electronic commerce affects revenue capacity. This article qualitatively applies nine principles of an effective tax system, dividing them into the categories of adequacy of revenues, fairness of revenues, and management of revenues to the taxation of electronic commerce. These three categories then are tested quantitatively to determine the impact that taxing electronic commerce has on revenue capacity. The key question is: *For states that are less reliant on taxing electronic commerce sales, will they have higher levels of revenue capacity?*

## Taxing Electronic Commerce and Information Systems (IS) Research

A common argument for not taxing Internet sales is that the Internet is viewed by some as an infant industry that requires protection. In information systems (IS) research, we would like to know whether taxing Internet sales would lead to less use of this communication media because of the higher price. There are potentially positive spillover effects arising from the size of the Internet. The idea is that aiding the Internet early will yield large benefits to future generations (Goolsbee & Zittrain, 1999). Furthermore, as the number of Internet transactions rises, the value of Internet commerce rises, as well. There is some empirical evidence that supports a ban on taxing Internet sales in the short run (Goolsbee & Zittrain, 1999) and other evidence suggesting that it makes no difference to sales if Internet access is taxed (Bruce, Deskins, & Fox, 2004).

Another common argument in favor of banning taxes on the Internet relates to a "digital divide" in Internet access in America. The Internet and other information technologies are more prevalent among wealthier people than among lower income individuals (Bruce et al., 2004). Therefore, taxing Internet sales will affect the poor more than the rich in the United States. Lower income individuals will not have as much Internet access in order to take advantage of purchasing online and potentially avoiding paying sales tax. These two arguments are especially pertinent to IS research and are explored in more detail later in this article.

This article is divided into three parts. The first part of the study looks at how the existing system of sales taxation adheres to the standards of a high-quality revenue system and how electronic commerce affects this relationship. The second part of the study uses the information presented in the first part to build hypotheses and to test relationships of how the presence of electronic commerce and taxation affects the revenue capacity of states. The third part presents recommendations, limitations, and avenues for future research on taxing electronic commerce sales.

## PRINCIPLES OF HIGH-QUALITY STATE TAX SYSTEM APPLIED TO SALES TAXES ON ELECTRONIC COMMERCE

There are nine principles of a high-quality state tax system that can be applied to the taxing of electronic commerce. The comparison is based upon criteria outlined in the 1992 document titled

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