Chapter XIV
E-Commerce and Sales Taxes in the United States:
Adequacy, Fairness, and Management

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ABSTRACT

This chapter examines the relationship between electronic commerce and the U.S. state sales and use tax system. A framework is used in this study of a high-quality tax system and it is applied to taxing electronic commerce sales. The first part of this chapter analyzed nine principles of an effective tax system, and divided these principles into the categories of adequacy of revenue, fairness of revenue, and management of revenue. In the second part of this chapter, 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 which argue that the sales tax is not a fair revenue stream, and it should be re-evaluated 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 U.S. state governments face in the 21st century. This chapter 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 system. 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 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) are examined. (The SSTP is an effort created by state governments to simplify and modernize sales and use tax collection and administration.)

The study is notably different from existing empirical work in that it examines how the taxing of electronic commerce affects revenue capacity. This chapter 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 are then tested quantitatively to determine the impact that taxing electronic commerce has on revenue capacity. The key question asked 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 which 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 rise, 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 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 chapter.

This chapter 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 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 en-

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