May 15, 2012 TEF Series - Volume 36

There's a Hole in Our Sales Tax

There is a hole in our sales tax that costs states billions in revenue every year. Some states are doing something about it, by leveling the playing field for local businesses and providing vital revenue for education.

What's the Problem?

Sales taxes are collected on tangible goods that are sold in local retail stores, and those taxes are sent to the state to use for funding vital public services like schools, roads, safety, and Medicaid. When Internet commerce emerged, consumers began purchasing goods from retailers that did not have any contact with any particular state. In 1992, the U.S. Supreme Court ruled that, because the established tax laws only allowed states to collect sales tax on retailers that had sufficient contacts with a state, there was no legal mechanism to collect sales tax on "remote sellers" (on sellers that had no contacts with the state). A state's inability to collect sales tax on Internet sales—an ever-growing percentage of all sales—costs states and local governments billions of dollars a year, making it almost impossible to fund critical public services and education at even existing levels.

What Are the Social Costs?

Obviously the main problem is that valuable revenue is escaping taxation because of antiquated sales tax laws, making funding for public schools and other services harder. But there are other costs associated with the failure to tax remote sellers. Lower-income households pay a higher share of all sales tax because more affluent consumers can avoid most sales tax by shopping online. Failure to tax remote sellers also creates an unlevel playing field for a community's local businesses. Remote sellers are afforded a 5% to 10% price advantage over community businesses because of the absent sales tax. That can mean the entire profit margin for a small business, and could explain the relative extinction of many local retailers. Finally, it is good policy to require those using public services to play a part in paying for those same public services. Remote sellers benefit greatly from a state's public services, such as roads for shipping goods, police and fire protection for goods in transit, consumer protection services that provide a trust in the remote market, and the court system to address disputes. There is no question that remote sellers are benefiting from public services the state provides, and as a result they should play a part in paying for those services.

What Can a State Do in Response?

All states should introduce and advocate for laws that attempt to level the Internet sales playing field. Some states have already taken up the challenge and, recently, Rhode Island and New York passed laws intended to capture Internet sales tax. Seven other states have introduced similar proposals commonly called "Amazon Laws," because Amazon.com is the nation's largest Internet retailer. New York's law is already raising tens of millions of dollars a year, providing much needed revenue for education, police, fire protection, and health care.

How Does the Law Work?

As was best explained in an article by the Center for Budget and Policy Priorities, "[the Amazon] laws rely on the fact that many such out-of-state retailers enlist independent in-state websites known as 'affiliates' to promote sales. Affiliates place links to the retailer's site on their websites and receive a commission when someone follows the link and buys something from the retailer. The states determined that this relationship with affiliates satisfies the requirement set down by the U.S. Supreme Court that states can require sales tax collections only from retailers with in-state property, employees, or independent sales representatives. A New York court has already upheld the law, and the Tennessee attorney general has issued a formal opinion that a version introduced there was constitutional." Because most of the largest Internet retailers operate affiliate programs, the Amazon laws are proving to be quite successful in capturing the lost sales tax revenue.

Over

There's a Hole in Our Sales Tax *(cont.)*

Why Should States Act Now?

Internet retailers can avoid the new Amazon laws by discontinuing their affiliate programs. However, if enough states enact Amazon laws and begin to collect Internet sales tax on the largest retailers they will be reluctant to discontinue the affiliate programs for fear of losing market share to local merchants or to online sellers that either voluntarily collect the sales tax or that are required to because of their physical presence in the state. For instance, without affiliate programs in numerous states Amazon could lose market share to Barnes and Noble, a retailer that is required to collect sales tax online because of stores located in the state. Market share has proved to be more important than the continued avoidance of collecting sales tax. Furthermore, a comprehensive solution is needed for all states, and so far Congress has been reluctant to act. As a policy indicator, if enough states pass Amazon laws, it could encourage federal lawmakers to respond in kind. States desperately need the revenue, and standing up for the policy change is the first step.

Until Congress acts to change the outdated tax laws that govern Internet sales, states should protect their tax base—which provides the valuable revenue for public services—and the competitiveness of their local businesses by passing Amazon laws.

For more information contact TEF@nea.org.

nea
NATIONAL EDUCATION ASSOCIATION
nea.org
Great Public Schools for Every Student