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Online Sales Taxes in the Age of Amazon

"Don't tax you, don't tax me, tax that fella behind the tree." — Former U.S. Senator Russell B. Long, (La.)

By Ward Hanson

Introduction

Congress currently is debating a law — HR 3179 — that has much interest for holiday shoppers. Seeking to change tax policy, this law enables but does not require cash-strapped states such as California to force online retailers to collect sales tax for online purchases. Current law allows Web-only retailers, such as Amazon.com, to avoid sales tax for most purchases. This policy brief reviews the impact of technology on retailing, the online sales tax exemption, and why HR 3179 is a reasonable solution that balances competing interests.

Gift givers face no shortage of alternatives. Retailers expand their hours, promote aggressively, and dream up new ways to encourage shoppers. Downtown districts decorate streets, provide seasonal concerts and special events, and even waive parking fees.

In recent years online retailers joined the fuss surrounding Black Friday, offering special deals on shipping, gift wrapping, and creating Cyber Monday. As an alternative to long lines and bad weather, these online sellers enjoy even more success during the holiday season. E-commerce as a share of total retail (the unadjusted line seen in Figure 1) shows a marked fourth-quarter bounce each year. While only about 5 percent of annual retail sales occur online, more than 35 percent of Black Friday shoppers used online sites.[1] The seasonally adjusted line continues its steady rise

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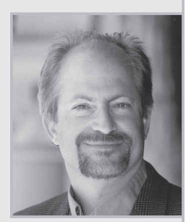
1 According to survey results of the *National Retail Federation,* November 27, 2011. While many of these shoppers were using the websites for information collection only, those making purchases online reported spending more than 37 percent of their weekend total online.

About the Author



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throughout the decade, showing the upward trend in the online retail share.

At the heart of this e-commerce growth is Amazon.com. Amazon has always been "first among equals," but in the past couple of years its growth has been especially striking. In 2010 Amazon grew by nearly $10 billion, reaching sales of $34.4 billion. To put this in context, Amazon's growth in 2010 roughly equaled the online sales of the number two online retailer Staples.com. U.S. sales exceeding $50 billion in 2011 are likely.

In carving out its strong position, Amazon is following a familiar path. Several times in the past century, new technological opportunities set the stage for the rapid rise of an innovative value-oriented retailer able to harness new technology and new operational procedures. This results in the demise of many established, smaller, and less efficient rivals. Retailing has played this role so strikingly that Joseph Schumpeter's classic analysis of creative destruction highlighted new retailing formats as a prototypical case:

> ***"In the case of retail trade the competition that matters arises not from additional shops of the same type, but from the department store, the chain store, the mail-order house and the supermarket which are bound to destroy those pyramids sooner or later. Now a theoretical construction which neglects this essential element of the case neglects all that is most typically capitalist about it; even if correct in logic as well as in fact, it is like Hamlet without the Danish prince."*** *— J. Schumpeter (1942), Capitalism, Socialism, and Democracy*

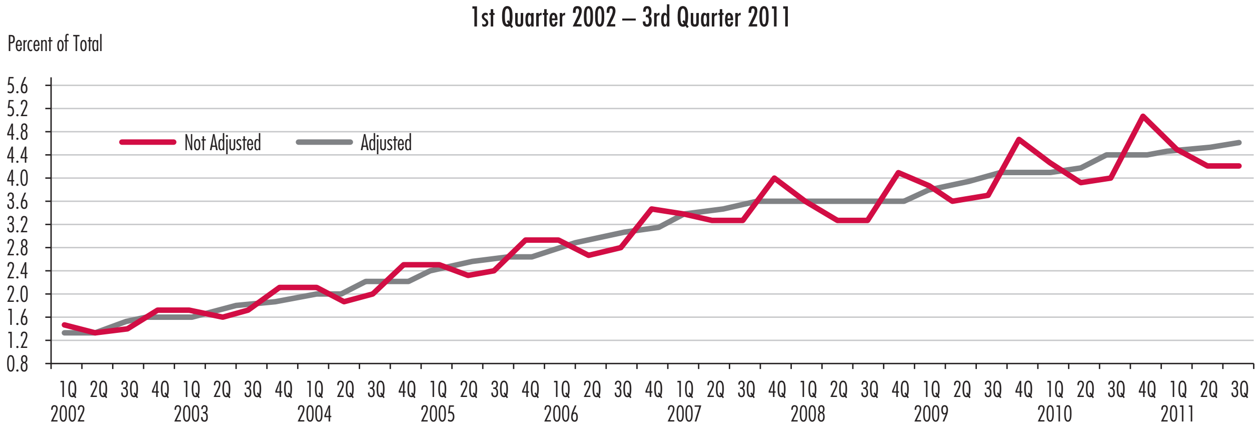
Along with this creative destruction often comes a political response seeking to limit competition and lessen the pain of less viable firms. This sometimes leads to regrettable policies that protect incumbents at the expense of consumers. HR 3179, called the "Marketplace Equity Act of 2011," provides another policy debate in this long line. HR 3179 would overturn the exemption from state and local sales and use taxes that online-only retailers enjoy. A number of states, including New York and California, have also recently passed initiatives seeking to tax online sales. With so much history of retail conflict and self-interested policy, new laws should receive careful scrutiny.

Technology and Retailing

Retailing and its associated supporting industries, such as wholesaling and trucking, are major employers in all advanced economies. Changes in technology that support new retailing methods can

Figure 1: The Steady Rise in U.S. Retail E-Commerce

Estimated Quarterly U.S. Retail E-commerce Sales as a Percent of Total Quarterly Retail Sales:
1st Quarter 2002 – 3rd Quarter 2011



Source: U.S. Census Bureau

cause large economic and employment consequences. In high-unemployment times such as these, the closing of traditional stores raises concerns in many quarters.

A&P

During the early 20th century, the A&P grocery chain symbolized state-of-the-art retailing. The A&P brought many retailing innovations to the U.S. market.[2] Although tiny by today's standards, as late as 1930 a typical A&P Economy Store of 1,800 square feet was the "big box" of its day. These stores could count on a national communication network, vertical integration, centralized buying of goods, and the threat of introducing house brands to discipline the pricing of national manufacturers. Run for decades by the Hartford brothers George and John, A&P's philosophy was to use high volume to drive down costs.

The rise of A&P led to some of the most problematic policies of the New Deal. So-called "fair trade" laws allowed manufacturers to set minimum retail prices for a wide category of products, despite the downward pressure caused by soft demand and more efficient retailing systems. The Robinson-Patman Act in 1936 restricted wholesalers offering quantity discounts to retailers, unless supported by a simplistic cost analysis. Various political jurisdictions tried zoning to restrict entry by the A&P, and both state legislatures and the Congress introduced bills to levy a chain- store tax on entities with more than nine stores. In 1941 the federal government accused the A&P of violating the antitrust laws through the use of monopsony power.

The most important policy lesson from the A&P experience is the difficulty of simultaneously protecting consumers and easing the transition between retail technological regimes. Following the introduction of the anti-chain-store legislation, A&P finally responded with lobbying and its own political activity to repeal or reduce anti-chain activities. It managed to hold off many of the specific taxes, although ultimately lost its antitrust case.

Wal-Mart

The second half of the 20th century, and especially the last two decades, saw the global emergence of another highly successful value retailer. Wal-Mart's integrated logistics, massive buying power, and global sourcing create advantages that small retailers find extremely challenging. Low price and large selection again provide the core value proposition, with another round of destruction of local retailers and merchants.

"W-Day" strikes fear in established retailers and city officials alike, as they confront the hollowing out of downtown centers and the switch to big-box retailers located on the city perimeter.[3] Restrictive zoning legislation in some states, such as Massachusetts and California, sought to slow market entry. Contrary to the experience of the A&P days, these policy efforts have been much less widespread or publicly supported. Partly this is due to measured benefits occurring to consumers. The latter part of the 1990s saw rapid productivity gains, and some studies attribute as much as half of these productivity gains to the retail sector.

Hard-fought political battles over efficient retail are ongoing around the world. India is in the midst of a politically charged debate. In the past month there have been riots in the streets in different Indian cities, with India's Prime Minister Manmohan Singh and his Congress party facing a serious challenge over Wal-Mart and other big-box retailers' entry into the Indian market. Government officials see retail productivity as a key initiative in restoring a high Indian growth rate. At loggerheads are many of the 175

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2 A useful and comprehensive look at the A&P history appears in Marc Levinson (2011), *The Great A&P and the Struggle for Small Business in America,* Hill & Wang, New York.

3 W-Day is the entry of Wal-Mart into a region. For a deeper discussion of this, see my chapter "Discovering a Role Online: Brick-and-Mortar Retailers and the Internet," in *The Internet and American Business,* edited by William Aspray and P. Ceruzzi, *MIT Press,* 2008. For further information on the productivity impacts of Wal-Mart and other retailers, see especially William Lewis (2004), *The Power of Productivity,* University of Chicago Press.

million Indian farmers seeking better prices for their output and lower prices for their inputs against the 25 million Indians employed in small retail stores.[4]

Amazon.com

The current battleground for U.S. retailing efficiency is the Internet. As the retailing leader of the Internet age, Amazon.com appears to be cementing its position. It is far and away the largest online retailer, once again with a high-volume, low-price-point focus. Key innovations include (1) an effective website that seamlessly merges a very wide assortment of internal and external sales, (2) logistics able to pick, pack, and ship cheaply and rapidly, (3) sophisticated personalization and recommendation methods, and (4) innovative digital platforms such as the Kindle to transform physical purchases to instantaneous delivery. While still a small fraction of Wal-Mart's total sales, Amazon is disrupting sellers in several categories. The toll on traditional booksellers has been especially notable.

Sales Tax and the Internet

Decided on the eve of the commercial Internet, the Supreme Court in 1992 ruled that states could not compel catalog retailers without a physical presence in a state (or "nexus") to collect sales and use tax.[5] As online retailers share the same distant nature as mail order, they too are except from collecting state tax. Hybrid companies like Staples or Office Depot, with physical stores scattered across the country, have nexus in all of these states and must charge tax for their online sales. Amazon, lacking nexus and operating online exclusively, collects sales tax only in Washington (where it is headquartered) and in states where it has a distribution center.

Gone are the days when e-commerce was so new that its costs were high, all participants were startups, and Schumpeterian experimentation could justify special tax treatment. State and local governments now often label their efforts to levy an e-commerce tax as "Amazon taxes." This reflects a change in both public perception and the political dynamic. The sales tax exemption increasingly seems an example of corporate favoritism rather than the beneficial stimulation of entrepreneurial activity.

Almost all economists now agree that the current Quill sales tax exemption lacks justification. There is little reason why a hybrid retailer, such as Staples or J.C. Penney, should be forced to collect sales taxes online when an Amazon or Blue Nile does not. In their textbook on taxation, Slemrod and Bakija have stressed three basic principles for evaluating a tax: It should be fair, simple, and enforceable.[6] The Quill decision seems unfair when comparing these differing versions of online sellers, as it does when comparing an Amazon.com against a small independent bookseller.

Current proposals go a long way to making online e-commerce simple to administer as well. Efficient taxes have low transaction and administrative costs. Complexity comes mostly from the exemption of products from the tax base and varying tax rates. A reasonable compromise between e-commerce vendors and local governments is to require each state to choose its own single taxation level and payment destination. For example, each month Amazon could then transfer its collected taxes on California purchases to state officials in Sacramento and New York purchases to Albany. This would reduce the number of e-commerce taxing authorities in the country from an estimated 6,000 to 50.[7] If an individual state allows local authorities to levy regional sales taxes, to support an individual city or a sports stadium, this would have to be parceled out by each state

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4 Vikas Bajaj, "Wal-Mart Debate Rages in India," *New York Times,* December 6, 2011. Notably, the article mentions that only about 6 percent of Indian retail is accomplished through organized retail stores compared with 20 percent in China, 36 percent in Brazil, and 85 percent in the United States. This 6 percent in India is comparable to the share of online retail in this country.

5 Quill Corp. v. North Dakota, 504 U.S. 298 (1992). The Court explicitly recognized that Congress had the right to overturn this decision should it choose to.

6 Joel Slemrod and Jon Bakija, *Taxing Ourselves,* MIT Press, 2008, Fourth Edition.

7 Plus Washington, D.C., and territories. Of course, some states do not have a sales tax and could be ignored.

from its block payment.

There are some situations where the choice of applicable state tax might be somewhat arbitrary. One example would be the delivery of an e-book to a traveler with a tablet. Rather than worry about the exact location of the traveler, the purchase might simply be taxed according to the normal home address. Physical gifts, such as a Christmas present to a relative, might more reasonably be based on the shipping destination. Coordination of these choices is desirable, as none is perfect and differing choices across states might well be confusing to consumers and complicated during the checkout process.

Forcing online retailers to collect sales taxes would improve the enforceability of the tax system. Currently, some states attempt to impose use taxes on purchasers for online purchases. These are difficult to collect, misunderstood by taxpayers, and widely ignored. Collection by online retailers would enhance compliance dramatically.

HR 3179 provides a reasonable bipartisan compromise. As the congressional summary states, it "Authorizes states to require all sellers making remote sales to collect and remit sales and use taxes with respect to such sales into the state, without regard to the location of the seller, if such states implement a simplified system for administration of sales and use tax collection for remote sellers. Requires such a system to include, at a minimum: (1) an exception for remote sellers with gross annual receipts in the preceding calendar year from remote sales not exceeding $1 million in the United States or not exceeding $100,000 in the state, (2) a single sales and use tax return for use by remote sellers and a single revenue authority within the state with which remote sellers are required to file a tax return, and (3) a uniform tax base throughout the state."

HR 3179, currently in committee, seeks to reverse Quill and empower the states to treat online sales in a very similar manner to retail sales within traditional stores or online stores with nexus.

Passage of HR 3179 would also reduce wasteful state-level political battles and lobbying. Facing a severe budget crisis, California in 2011 passed a law making all online retailers responsible for collecting California sales tax when selling to California customers. Similar actions occurred in other large-population and high-sales-tax states, such as New York. Amazon responded aggressively to these initiatives. It announced the elimination of California and New York "Amazon affiliates." These are businesses, organizations, and individuals that refer online visitors to Amazon and receive compensation if this referral makes a purchase. It did this to reduce its legal connection to the state. This distorts what is an effective and useful advertising system and small business activity.

Amazon also launched a California initiative referendum drive seeking to constitutionally block state revenue officials from imposing the tax. Even in referendum-happy California this was unusual and a major escalation of corporate lobbying.

At the end of the summer, the parties declared a truce. California would refrain from imposing its "Amazon tax" for a year. Amazon would drop its referendum funding and agree to begin collecting California sales tax in 2012. In the meantime, efforts began at the national level to solve this problem in a more unified manner.

Summing Up

In many ways, HR 3179 and its Senate counterpart simply push the problem of e-commerce taxation down to the states. This is actually one of its strongest benefits, "a feature not a bug." State-level fiscal policies vary widely across the country, with states choosing widely different sales tax rates. HR 3179 enables this federalism without an artificial wedge caused by a retail channel distortion. Congress should reverse the Quill decision and enable states to levy sales taxes on e-commerce purchases.

The bigger point of the sales tax debate is the strategic role in the economy played by the retail sector. While the "last mile" is a term commonly associated with Internet access, the last mile of goods and services is the retail sector's connection to consumers. This is a large and important part of the economy, with winners and losers in the creative destruction introduced by new technology.

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