Tax Revenue Loss Estimates For Consumer Remote Sales

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Executive Summary
April 2001

- Michigan Sales and Use Tax collections were $7.6 billion in FY 2000. Most of this revenue was used for schools and local government revenue sharing.

- Sales and use tax revenues are being eroded by remote sales (mail order and Internet sales). With the dramatic growth forecasted for e-commerce, taxation of remote sales is becoming a serious fiscal issue for state and local governments.

- Michigan's tax revenue losses from remote sales are estimated at $187 million in FY 2000. This revenue loss will grow to $349 million in FY 2005.

- Nationally, the sales and use tax revenue loss has been estimated to be over $20 billion in 2003. This estimate includes losses from business to business e-commerce.

- Resolving the issues related to taxation of remote sales will either involve voluntary compliance by remote retailers or require Congressional action to assure collection of the taxes due under current laws.

- Cooperative efforts to address these and other related issues are underway in the Streamlined Sales Tax Project between retailers, remote sales retailers, state and local governments, and national organizations.

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Introduction

Sales and use taxes comprise a large share of total Michigan state tax revenue. In FY 2000, total Michigan sales and use tax revenues were $7,633 million out of $22,865 million of total state tax revenue, or 33 percent. By the State Constitution, no local units in Michigan levy a sales tax. Nationally, FY 1997 state and local government finance data from the Bureau of the Census indicate sales and use taxes were 24.5 percent of total state and local tax revenue.

Increasingly, sales and use tax revenues are being eroded by remote sales (mail order sales and Internet or e-commerce), outdated sales tax bases and specific exemptions for formerly taxable goods such as food and clothing. With e-commerce predicted to grow dramatically in the future, the issue of taxation of remote sales is an even more serious fiscal matter for state and local governments. To help increase compliance, Michigan recently added a line on the personal income tax form for use tax owed.

The tax revenue loss estimates presented in this report are only for business to consumer remote sales. Because of business tax audits, direct tax payment agreements between Michigan businesses and the state of Michigan, voluntary compliance with tax laws and tax exemptions for business production inputs (industrial processing), the current revenue loss from business to business remote sales is small. However, due to the high-predicted volume of business to business transactions over the Internet in the future, small losses now could lead to greater losses if use tax law is not strongly enforced.

Current Law on Remote Sales

Mail order and Internet firms that do not have nexus with a state are not required to collect sales taxes from purchasers of that state. Nexus is defined as a minimum physical presence or link to a state that would require a business to collect and be subject to a state's tax system. A recent court case (*Quill v. North Dakota, 1992*) stated that it is a violation of the Commerce Clause to force businesses that do not have nexus to collect tax because of the undue burden of collection. However, this decision would allow the Congress of the United States to enact law that would remove the Commerce Clause barrier and allow states to force mail order and Internet firms to collect sales tax on purchases from their customers. Since the Quill decision, Congress has been unwilling to authorize states to compel mail order and Internet firms to collect sales tax.

To address the issue of undue burden, state governments have begun the Streamlined Sales Tax Project. This is a cooperative effort among the states to simplify sales tax laws and tax rates and to provide incentives for remote sales firms to voluntarily remit tax. Michigan is one of four states to enter a pilot program to begin collecting taxes from remote sales firms. If states can simplify tax law and collection, then the undue burden of collecting and remitting taxes would be eliminated. This would weaken the Commerce Clause argument for firms with no nexus from not having to collect tax.

In October 1998, the Internet Tax Freedom Act was signed into law, which provided a three-year moratorium prohibiting state and local governments from taxing Internet access. Multiple and discriminatory taxes on electronic commerce are also prohibited. However, the Internet Tax Freedom Act does not prohibit sales or use taxes on taxable e-commerce purchases in the 45 states with a sales tax.

Residents of a state with a sales tax that purchase taxable items by mail order or e-commerce and pay no sales tax are required to submit a use tax payment to their home state. Compliance rates are very low among consumers, most commonly due to lack of knowledge of use tax law and avoidance given that enforcement of the law is difficult.

Remote Sales Estimates

E-commerce sold to consumers is difficult to measure accurately. The Bureau of the Census now measures retail sales from e-commerce and Forrester Research conducts monthly surveys to measure e-commerce volume. The Bureau of the Census estimates that for calendar year 2000, retail sales from e-commerce totaled $25.8 billion. Forrester Research estimates retail sales of e-commerce at approximately $33 billion in 2000. In addition to retail sales, Forrester Research also measures other e-commerce such as travel purchases and concert/sporting event ticket sales.

Total U.S. remote sales to consumers are estimated to grow from $279.2 billion in 2001 to $429.0 billion in 2005 (see Exhibit 1, 2 & 3). For 2001, consumer mail order sales are estimated to be $216.7 billion and grow to $264.7 billion in 2005 (see Exhibit 1). Future growth rates from mail order sales are estimated to be lower in the next few years due to a slower growing economy and a substitution effect with e-commerce. Consumer e-commerce is projected to grow sharply higher in the next few years from $62.5 billion in 2001 to $164.2 billion in 2005 (see Exhibit 1). These figures include consumer e-commerce from leisure travel.

Forrester Research estimates e-commerce by category of consumer purchase. In 2000, the main consumer purchases were travel related (airline tickets, etc.) and personal computer hardware and software (see Exhibit 4).

Tax Loss Estimates

Michigan's use tax revenue losses from remote sales are estimated to be $187 million in FY 2000. This loss will grow to $349 million in FY 2005, primarily due to the growth of e-commerce (see Exhibit 5 and Exhibit 6). Over this period, the revenue loss from traditional mail order sales continues at a moderate pace. The forecasted revenue loss in Michigan from mail order sales is expected to increase from $149 million to $188 million (see Exhibit 5). This estimate assumes that mail order retailers collect Michigan sales tax on one-third of sales to Michigan residents. Due to the explosion in the growth of e-commerce, the expected revenue loss will also increase for Michigan. The revenue loss due to consumer e-commerce is forecasted to increase from $37 million in FY 2000 to $160 million in FY 2005 (see Exhibit 5).

Michigan sales tax revenue is earmarked differently than the Michigan use tax. Most sales tax revenue is earmarked to the School Aid Fund at 73.3 percent with local revenue sharing receiving 24.2 percent of the sales tax. The remaining sales tax is distributed to the General Fund except for a portion of auto-related sales tax, which is earmarked to the Comprehensive Transportation Fund. Use tax revenue is mostly earmarked to the General Fund at 66.7 percent with the remaining 33.3 percent of use tax revenue earmarked to the School Aid Fund.

While forecasts for total consumer e-commerce may vary, this medium is becoming more accepted by consumers for making retail purchases. As technology improves, security fears are subsiding and the ease of electronic shopping will most likely continue to make the Internet an increasingly popular way to shop. This trend is a major concern for state and local governments that have a sales and use tax.

An Advisory Commission on Intergovernmental Relations report, *Taxation of Interstate Mail Order Sales Estimates 1994 Revenue Estimates*, provides a methodology to determine the revenue impact from mail order sales. The same methodology can be applied to e-commerce estimates. Other studies such as the General Accounting Office's *Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain* look at the possible range of tax loss estimates from remote sales. A study by the Center for Business and Economic Research at the University of Tennessee estimated the sales and use tax loss of e-commerce at over $20 billion in 2003. This study included the revenue loss from business to business e-commerce.

Beginning with tax year 1999, Michigan added a line on the personal income tax form for taxpayers to include use tax due on remote sales to make it easier for Michigan income tax filers to pay use tax that they may owe. Taxpayers have the option of reporting actual use tax due or using a table provided in the income tax form that estimates use tax liability based on income. For any single purchase over $1,000, the actual use tax due must be reported. For tax year 1999, 64,650 taxpayers submitted $2.9 million of use tax on their Michigan income tax returns. This amount is a great improvement over the previous year's voluntary use tax collections without the line on the income tax form. State officials hope that as more taxpayers become educated on their use tax responsibility, compliance will increase.

Summary

The revenue loss to state and local governments due to remote sales is a serious problem. As e-commerce becomes more familiar to people and more households have access to the Internet, the revenue loss will grow.

If projects such as the Streamlined Sales Tax Project are successful in improving compliance from remote sales, then sales and use tax revenue will continue to be a viable component for most state and local tax systems. Otherwise, without federal intervention, the tax loss from remote sales may doom the future of sales and use taxes as a consistent revenue stream for state and local governments.

Exhibit 1

Estimated National Remote Sales to Consumers

millions

Year	Consumer Mail Order Sales	Percent Change	Consumer E-Commerce Sales	Percent Change	Total Remote Sales	Percent Change
1999	$192,963	7.6%	$29,314	87.1%	$222,276	14.2%
2000	$208,787	8.2%	$42,222	44.0%	$251,009	12.9%
2001	$216,720	3.8%	$62,528	48.1%	$279,247	11.2%
2002	$228,516	5.4%	$85,242	36.3%	$313,759	12.4%
2003	$240,767	5.4%	$110,198	29.3%	$350,965	11.9%
2004	$252,682	4.9%	$135,885	23.3%	$388,567	10.7%
2005	$264,706	4.8%	$164,273	20.9%	$428,978	10.4%

Sources: National Mail Order Association, Forrester Research Inc., Bureau of the Census and Michigan Department of Treasury

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Filename: F:\orta\Taxes\Sales\InternetCommerce&MailOrder\2001Report\[ReportTables.xls]Exhibit1
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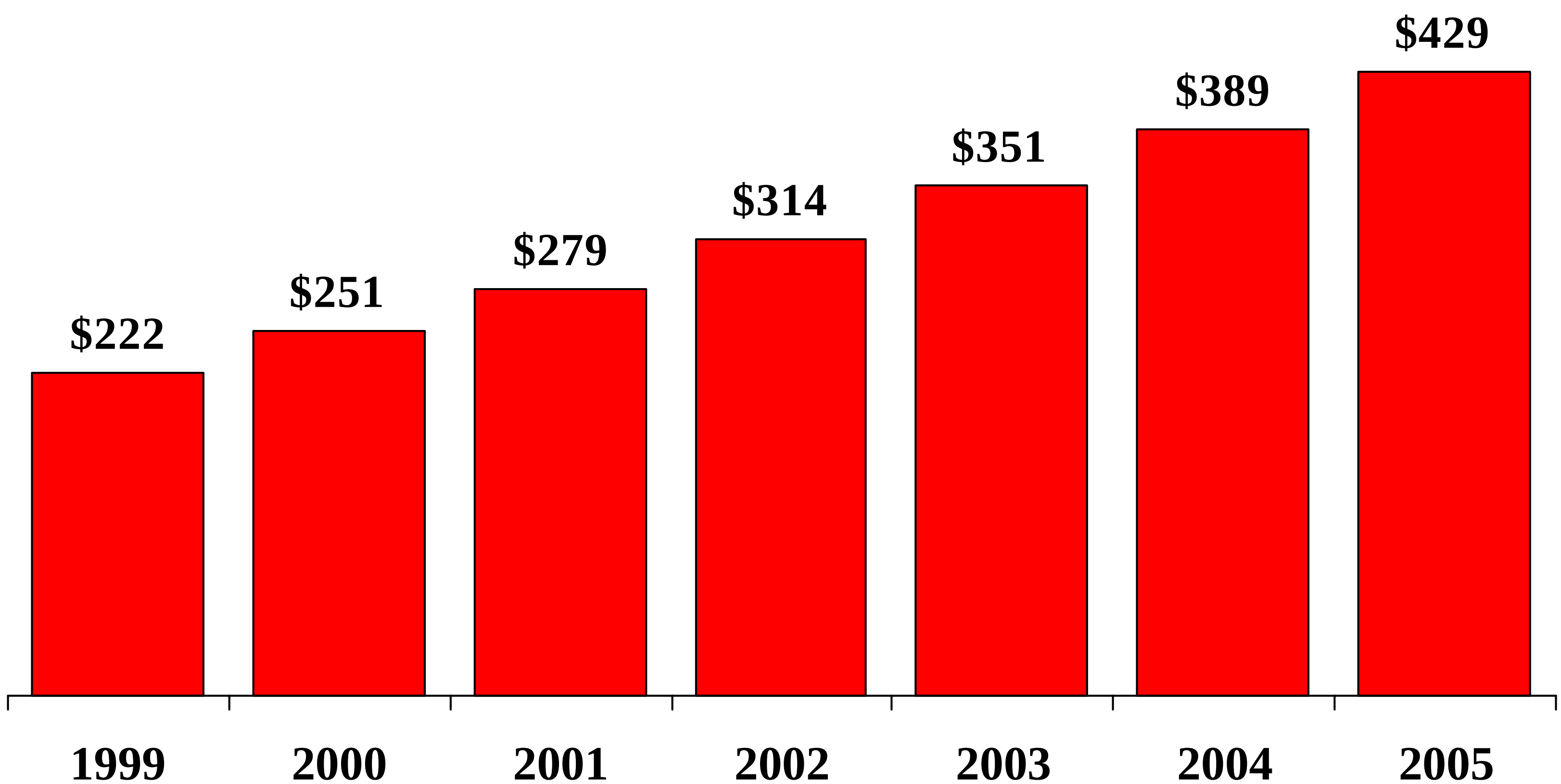
Exhibit 2
U.S. Remote Sales to Consumers
billions

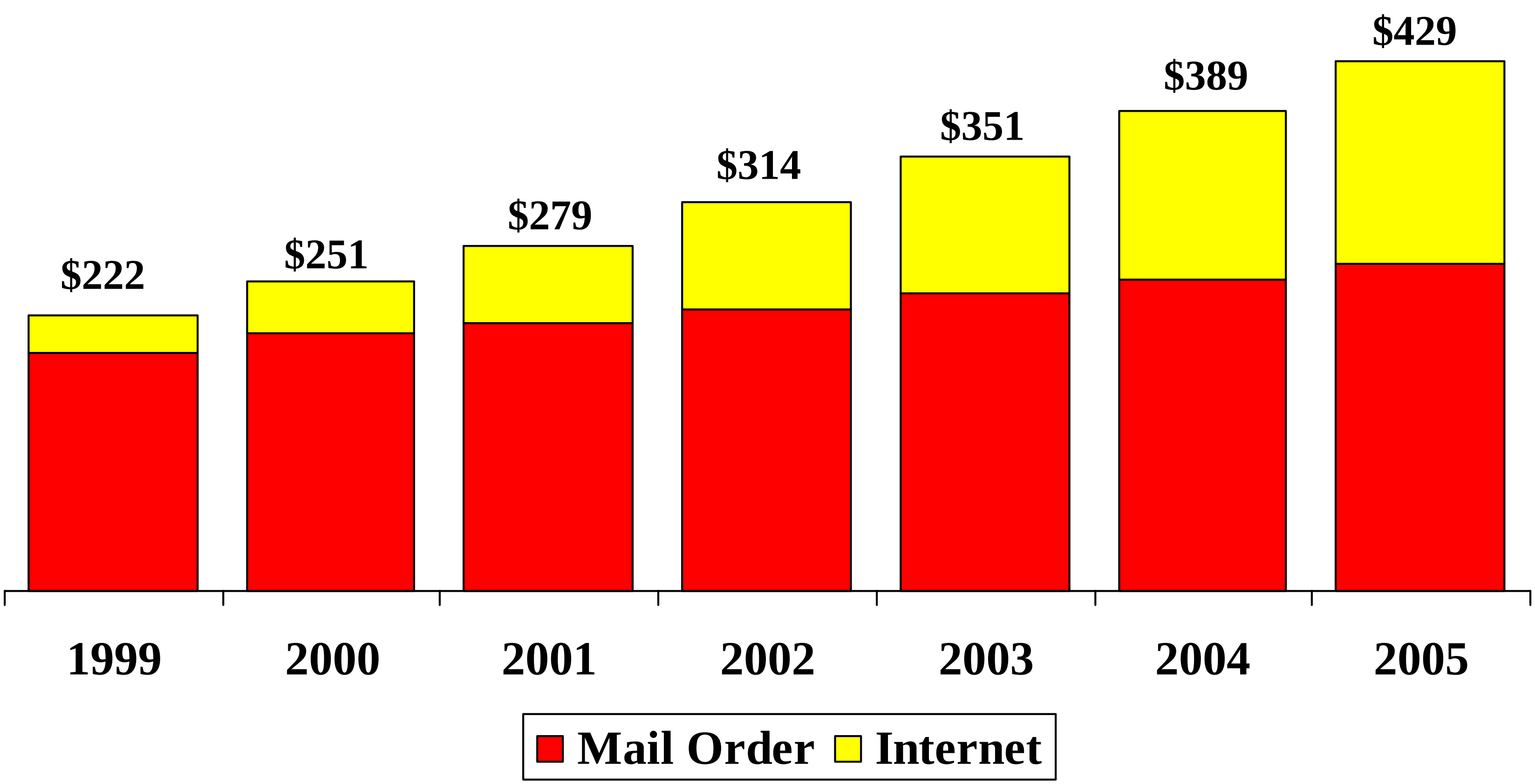


Sources: Bureau of the Census, Forrester Research and Michigan Department of Treasury

Exhibit 3

U.S. Remote Sales to Consumers

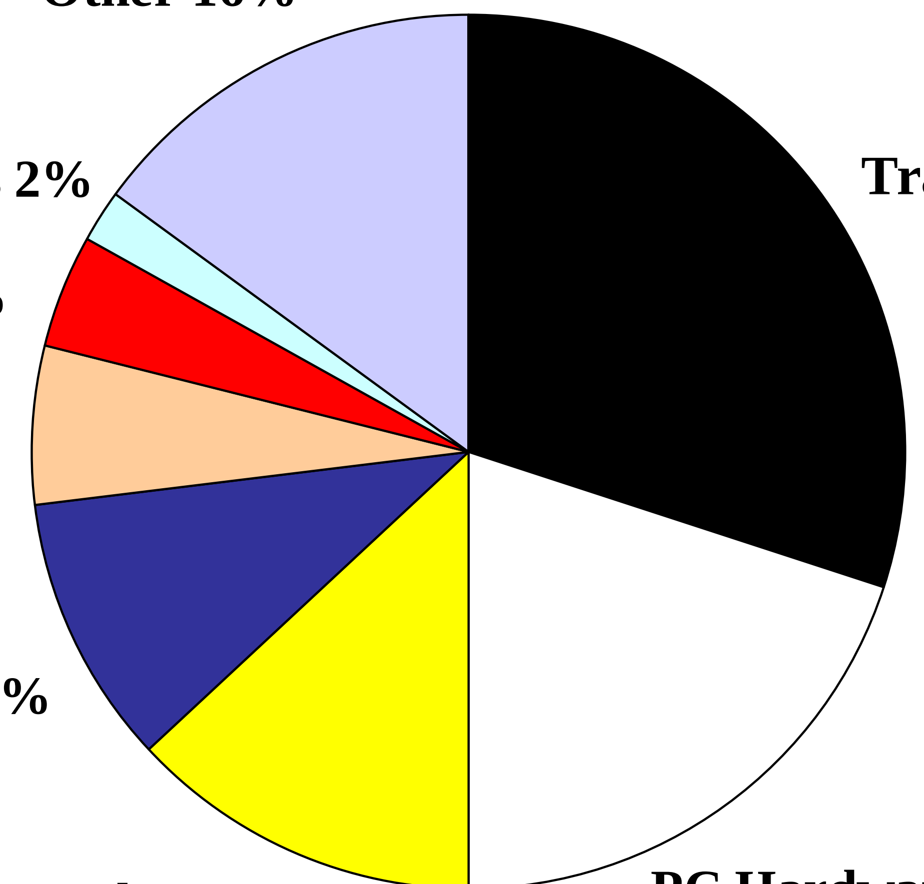
billions



Sources: Bureau of the Census, Forrester Research and Michigan Department of Treasury

Exhibit 4

Consumers' Online Purchases 2000



Source: Forrester Research

Exhibit 5
Michigan Sales and Use Tax Revenue Loss From Consumer Remote Sales
millions

	Revenue Impact					
Year	**Traditional Mail Order**	**Percent Change**	**E-Commerce**	**Percent Change**	**Total Remote Sales**	**Percent Change**
FY 1993	$56.7	NA	NA	NA	$56.7	NA
FY 1994	$74.8	31.9% (1)	NA	NA	$74.8	31.9%
FY 1995	$104.4	39.6%	NA	NA	$104.4	39.6%
FY 1996	$112.8	8.0%	NA	NA	$112.8	8.0%
FY 1997	$123.0	9.0%	$7.2	NA	$130.2	15.4%
FY 1998	$131.7	7.0%	$14.0	94.1%	$145.7	11.9%
FY 1999	$138.8	5.4%	$25.1	79.6%	$163.9	12.5%
FY 2000	$149.3	7.6%	$37.3	48.4%	$186.7	13.9%
FY 2001	$156.2	4.6%	$53.9	44.4%	$210.1	12.5%
FY 2002	$163.6	4.8%	$76.0	41.0%	$239.6	14.1%
FY 2003	$172.0	5.1%	$101.5	33.5%	$273.4	14.1%
FY 2004	$180.2	4.8%	$128.9	27.0%	$309.1	13.0%
FY 2005	$188.4	4.5%	$160.3	24.4%	$348.7	12.8%

(1) Michigan Sales/Use tax rate increased from 4 percent to 6 percent on 5/1/94

Sources: National Mail Order Association, Forrester Research, Bureau of the Census & Michigan Department of Treasury

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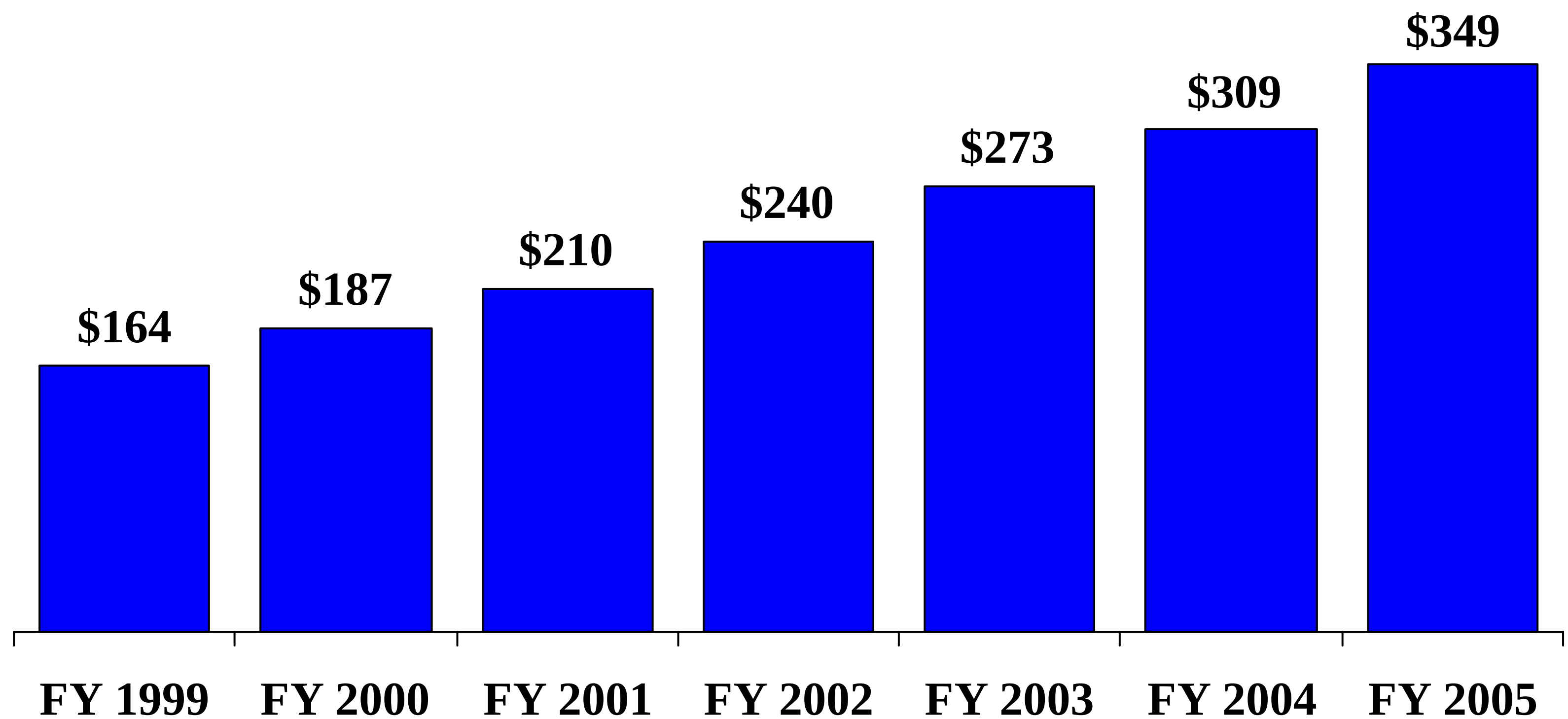
Exhibit 6

Michigan Revenue Loss from Remote Sales to Consumers

millions



Source: Michigan Department of Treasury