

Impact of Electronic Commerce on the Iowa Sales Tax Base

Executive Summary

Introduction

Much discussion has been generated over the past few years regarding the impact of electronic commerce on state and local tax revenues. In September 2001 the Institute for State Studies issued a report estimating that nationwide state and local governments would experience losses totaling \$13.3 billion during 2001 and that the losses would increase to \$45.2 billion by 2006 and to \$54.8 billion by 2011. This study's estimates for sales and use tax revenue losses by Iowa State and local governments equal \$118.8 million for 2001, \$335.9 million for 2006, and \$486.9 million for 2011.

As an expression of its concern regarding issues associated with the growth of electronic commerce, the Iowa General Assembly during its 2000 session established the Electronic Commerce Task Force. The Task Force, which consisted of both legislators and citizen members, was charged with investigating three primary issues:

- The impact of electronic commerce on sales and use tax revenues,
- The appropriate treatment of digital and other electronically delivered products under State tax law, and
- The costs associated with and criteria for granting "discounts" to merchants against the sales and use taxes they collect for the State.

The Task Force met once on October 4, 2001. During that meeting presentations focused on the status of the federal Internet access charge tax moratorium and on the national Streamline Sales Tax Project. In addition, questions were raised regarding the validity of the Institute for State Studies' estimates of the current and future impacts of electronic commerce on state and local sales and use tax revenues. In particular, the issue was raised regarding what appeared to be an inconsistency of those estimates with the electronic commerce estimates released quarterly by the U.S. Census Bureau.

In an effort to resolve the perceived conflict between the Institute for State Studies' and the U.S. Census Bureau estimates of electronic commerce activity, the Iowa Department of Revenue and Finance has completed an evaluation of both estimates. In addition, the Department has completed its own estimates of the impact of electronic commerce on Iowa State and local tax revenues for the same years as those presented in the Institute for State Studies report. Finally, the Department has estimated the fiscal impact for FY 2003 of extending or making permanent the sales and use tax exemption for digitally and other electronically delivered products.

Institute for State Studies and U.S. Census Bureau Electronic Commerce Estimates Comparison

The two estimates of electronic commerce activity appear to be inconsistent because they do not measure electronic commerce the same way. The major differences between the two approaches are:

- The U.S. Census Bureau's estimates of electronic commerce include only business-to-consumer activity, whereas the Institute for State Studies estimates cover both business-to-consumer and business-to-business activity. Business-to-business activity currently accounts for over 90 percent of total electronic commerce activity.
- The Institute for State Studies estimate includes both traditional remote sales (i.e., catalog and telephone sales) as well as sales made over the Internet and by other electronic means. The U.S. Census Bureau estimate includes only the Internet and electronic component of remote sales.
- The Institute for State Studies estimate includes the impact of the transition of the national economy from goods based to services based. Consequently, that estimate reflects a long-term trend contraction in the sales tax bases of state and local governments because most do not tax as great a share of services transactions as they do goods transactions.
- The Institute for State Studies estimate reflects past law change impacts on state and local tax bases and anticipates continuation of this trend of increased sales and use tax exemptions.

Taking into consideration the above described differences in the methodologies used by the Institute for State Studies and by the U.S. Census Bureau in estimating the scale of electronic commerce activity, we conclude the two estimates are consistent for business-to-consumer sales. The U.S. Census Bureau estimate for this category of electronic commerce activity for 2001 is between \$1.6 billion and \$2.0 billion. The comparable Institute for State Studies estimate equals \$1.9 billion.

The source of both the business-to-consumer and the business-to-business electronic commerce estimates used in the Institute for State Studies report is Forrester Research. This organization is generally considered the national expert on electronic commerce activity. In the past estimates of future electronic commerce activity have proved to be somewhat low. The Forrester Research electronic commerce activity estimates used as the basis for the Institute of State Studies report are consistent with Internet usage and Internet purchases estimates made recently by the National Telecommunications and Information Administration.

Iowa Department of Revenue and Finance Sales and Use Tax Revenue Losses Estimates

Starting with the Forrester Research estimates of business-to-consumer and business-to-business electronic commerce activity, the Iowa Department of

Revenue and Finance has prepared estimates of State and local sales and use tax revenue losses for the years 2001, 2006, and 2011. The Department's estimates are for electronic commerce, non-electronic commerce, and total remote sales. The estimates derived by the Department are as follows:

Component	2001	2006	2011
E-Commerce	\$26.0 million	\$142.7 million	\$203.6 million
Non-E-Commerce	\$23.5 million	\$124.6 million	\$177.6 million
Total Remote Sales	\$49.5 million	\$267.3 million	\$380.2 million

The Department's estimates differ from those presented in the Institute for State Studies report for three major reasons.

- The Institute for State Studies estimates include a trend revenue loss component that factors in the continued shift of consumer and business purchases from goods to services and the continued erosion of the State's tax base due to the passage of additional sales and use tax exemptions. The Department's estimates do not factor in these trend losses.
- The Institute for State Studies estimates reflect national averages in terms of the shares of business-to-consumer and business-to-business transactions that are subject to sales and use taxes. The Department's estimates reflect Iowa specific shares equal to 55.7% for business-to-consumer sales and to 17.4% for business-to-business sales.
- The Department's estimate assumes taxes are already being collected on 35.0% of remote sales due to many large retailers having nexus in Iowa.

Iowa Department of Revenue and Finance Estimate of the Impact of Exempting Digital and Other Electronically Delivered Products from State and Local Sales and Use Taxes

The final section of the paper estimates the fiscal impact associated with extending or making permanent the temporary two-year exemption from State and local sales and use taxes for digital and other electronically delivered products enacted by the 2000 General Assembly. This estimate was derived by first estimating the value of products most likely to be converted to digital or other electronic form. These estimates were based on information obtained from the U.S. Census Bureau's Economic Census for 1997 and from various trade association and consulting company Internet sites. The types of products so identified include books, prerecorded tapes and CDs, published music, published databases and dictionaries, and computer software.

Then using additional information from various Internet sites, estimates of the shares of different categories of products that would likely be converted to digital or other electronic form were estimated. The resulting full year fiscal impact estimates for FY 2003 equal a reduction of \$6.4 million in State sales and use tax revenue and a reduction of \$1.2 million in local option sales and services tax revenue.