Chapter II
Electronic Commerce and the State Sales Tax System: An Issue of Tax Fairness

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EXECUTIVE SUMMARY

This article examines the relationship between electronic commerce and the U.S. state sales and use tax system. A framework of a high-quality tax system is used in this study, and it is applied to taxing electronic commerce sales. The first part of this article analyzes nine principles of an effective tax system and divides these principles into the categories of adequacy of revenue, fairness of revenue, and management of revenue. In the second part of this article, 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 that argue that the sales tax is not a fair revenue stream and that it should be reevaluated, 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 that U.S. state governments face in the 21st century. This article 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 systems. 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 also 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. Specifi-
cally, areas such as taxing Internet access, having
a state sales tax, taxing digital downloads, and
participation in the Streamlined Sales Tax Project
(SSTP) (an effort created by state governments to
simplify and modernize sales and use tax collect-
ion and administration) are examined.

The study is notably different from existing
empirical work, in that it examines how the taxing
of electronic commerce affects revenue capacity.
This article 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 then are tested quantitatively to deter-
mine the impact that taxing electronic commerce
has on revenue capacity. The key question 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 that 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 spill-
over 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 rises, 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
in order 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 article.

This article 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 to test
relationships of how the presence of electronic
commerce and taxation affects the revenue capac-
ity of states. The third part presents recommenda-
tions, 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 titled
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