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Online Sales Taxes Aren't a 'Money Grab'

Josh Barro | Aug 13, 2012

The Cato Institute's Dan Mitchell has an article for U.S. News arguing against the Marketplace Fairness Act, a proposed federal law to require online retailers to collect tax on sales to buyers in states where they don't operate. Echoing Ben Boychuk of City Journal, and many other conservative critics, Mitchell describes the proposal as "a money grab."

Mitchell and Boychuk both argue that online sales taxes are bad because they provide revenue to state governments. This shows you the thinness of arguments against online sales taxes. In fact, requiring tax collection for online sales is the only way to ensure that sales taxes continue to be a workable way to finance government -- which is a good thing.

First, some background on the history of sales taxes to help understand why this isn't a money grab. State and local tax receipts are remarkably stable -- From 1977 to 2008 they never exceeded 10.9 percent of GDP or fell below 10.0 percent.

And general sales taxes -- that is, taxes on the sales of most goods, not special taxes on items like gasoline and cigarettes -- have made up a stable share of those revenues, rising from 21 percent of all state and local taxes in 1977 to 23 percent by 2008.

But while sales tax revenues have been stable, sales tax rates haven't. In 1970, the mean state sales tax rate was 3.5 percent. That rose to 5.2 percent in 2003 and 5.6 percent by 2011.

Rates have been rising because the sales tax base has been shrinking. In 1979, the total sales tax base (the sum of all taxable sales) was equal to 59 percent of GDP. Now, the figure is closer to 37 percent. As the sales tax base has shrunk, governments have responded by raising tax rates to keep revenues stable.

Why is the sales tax base shrinking? For most of the last few decades, the principal story has been economic shifts: Most states tax most goods and few services, and the economy increasingly consists of services.

But in the last decade, online sales have become an important part of the problem. William Fox, an economics professor at the University of Tennessee, estimates that $24 billion a year in sales tax that is due for online activities goes unpaid. That's significant compared to the $291 billion in actual state and local general sales tax collections in 2009.

When states look to tax online sales, they're simply trying to stop the erosion of the sales tax base so that they can continue collecting revenues proportionate to those they collected in the past, and so that consumers face the same tax treatment whether they buy from online or brick-and-mortar retailers.

Some conservatives, including Ramesh Ponnuru writing for Bloomberg View, have advocated for an "origin sourcing" approach to online sales. This would mean that sales would be taxed according to the location of the seller, not the buyer.

Such a reform would enshrine and expand the current practice of many online sales going untaxed by the buyer's jurisdiction. Today, retailers with physical operations in a given state must collect tax on online sales to buyers in that state. If Best Buy Co. has a store in your state, it has to collect your state's sales tax when you buy through BestBuy.com. Under origin sourcing, they wouldn't.

Like the Marketplace Fairness Act, origin sourcing would create a level playing field of sorts: All kinds of retailers would be taxed according to their locations. But this level playing field would create a pernicious kind of tax competition, where state and local governments would engage in a race to the bottom on sales tax rates.

Some tax competition is good. You want states to try to offer taxpayers good value for their money and also to offer a menu of public policy options: Some states can adopt a high-tax, high-service model and see how it compares to a low-tax, low-service model. But it is important to make taxpayers choose: In order to get low taxes, you have to get your services from a jurisdiction that collects low taxes.

Sales taxes are consumption taxes, and the economic incidence of a broad-based sales tax is borne by consumers, not retailers. Under an origin-sourcing regime, consumers could buy products that are shipped from sales tax havens, while continuing to draw services from their home jurisdictions which might have high sales taxes. In other words, origin sourcing would make sales taxes inconsistent with the benefit principle of taxation.

As sales increasingly move online, origin sourcing would make sales tax a decreasingly workable mechanism to finance government. States and localities would have to shrink government spending as a share of the economy, and/or adopt higher taxes on income and property. The stability of state and local taxes over the last 35 years suggests the adjustment would come mostly on the tax side.

Ponnuru sounds like he's OK with this outcome since he is not a fan of the sales tax. But all taxes have their pros and cons. Property taxes tend to generate tremendous political resistance; income taxes appear to be more economically damaging than sales taxes. I think it would be a distinctly bad development if sales tax were gradually removed as a tool for state and local finance.

When I wrote in favor of comprehensive online sales taxation a couple of months ago, my article received heated criticism from some conservatives and libertarians. On Twitter, Veronique de Rugy of the Mercatus Center responded to my claim that origin sourcing leads to bad tax competition by saying that there is no such thing as bad tax competition because the government spends too much money.

If you take the Leviathan view of state and local government and think any development that reduces tax receipts is good, then you should celebrate the erosion of the sales tax base and oppose efforts like the Marketplace Fairness Act to make online sales taxes collectible.

If you think state and local governments need the ability to levy broad, efficient taxes with low rates to finance themselves, then you should favor bills like the Marketplace Fairness Act and oppose origin sourcing.

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