FLAWED SYSTEM: ONLINE SALES TAX COLLECTION

ECONOMIC IMPACT UPON CALIFORNIA BUSINESSES AND EMPLOYEES

Prepared for Taxpayers Advocate

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by

Richard A. Parker, Ph.D.
Rea & Parker Research
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EXECUTIVE SUMMARY

This report focuses upon lost sales and corresponding impacts upon economic activity, decreasing commercial real estate values, and lost jobs and payroll that are due to the lack of an effective method of collecting the Internet sales taxes in California.

In particular,

- An overriding finding is that the costs that California is presently experiencing in the components of the study are significant. However, no matter how substantial they are at present, these costs will mushroom over the course of the next decade.

- California retail establishments physically based in the State are losing $4.1 billion in sales presently (2010) to Internet retailers that would, instead, be made at stores physically located within California.

- The amount of growth in the $4.1 billion of California lost sales in 2010 will reach $7.7 billion in 2015 and $14.3 billion by 2020.

- Indirect and induced impacts brought about by these sales losses, will cause a total of $7.2 billion in lost economic activity in California in 2010. This loss of economic activity in California can be expected to reach $13.4 billion by 2015, and $24.9 billion by 2020.

- It is estimated that commercial real estate value decreases presently equate to another $1 billion loss for California. By 2020, that amount will increase to losses in commercial real estate value of $3.4 billion in California**.**

- Total full-time equivalent jobs that are lost to out-of-state online sales are 18,300 presently and will grow to 34,100 in 2015 and 63,400 in 2020.

- Payroll lost within California equates to $789.3 million at present, growing to $1.6 billion in 2015 and more than $3.3 billion in 2020.

INTRODUCTION

The State of California imposes a sales and use tax of 8.25 percent upon retail sales of tangible personal property in California. Examples of tangible personal property include such items as furniture, giftware, toys, antiques, and clothing. In addition, some service and labor costs are subject to sales tax if they result in the creation of tangible personal property. Local governments have, in most cases, added to the 8.25 percent for various local needs.

In some instances, retailers and consumers are to pay use tax at the same rate, rather than sales tax. The most common example of a purchase subject to the use tax is a purchase of an item for use in California from an out-of-state retailer. Out-of-state retailers who are engaged in business in California are required to collect the use tax, when applicable, from the consumer at the time of making the sale. If the out-of-state retailer is not engaged in business in California, then payment of tax technically falls upon the consumer, although collection of this tax is indeed rare. Consumers who live in a state that collects sales and use tax are technically required to pay the tax to the state even when an Internet retailer does not collect it.

The only difference between sales and use tax is which person -- the seller or the buyer -- pays the state. Theoretically, use taxes are just a backup plan to make sure that the state collects revenue on every taxable item that is purchased within its borders. But because collecting use tax on smaller purchases is so burdensome, states have traditionally attempted to collect a use tax only on expensive items that require licenses, such as cars and boats.

Finally, some sales and purchases are exempt from sales and use tax collection. Examples of exempt sales include, among others, sales of certain food products for human consumption, sales to the U.S. Government, and sales of prescription medicine.

The 8.25 percent sales and use tax rate is comprised of the following components:

- 6.00 percent to the State of California General Fund
  - This base rate was established in 1991, having increased from 2.50 percent at inception in 1933
- 0.25 percent to the State of California to pay off the Economic Recovery Bonds of 2004
- 0.50 percent to the State of California Local Revenue Fund to support local health and social services programs (began in 1991)
- 0.50 percent to the State of California Local Revenue Fund to support local criminal justice services (began in 1993)
- 1.00 percent to the local jurisdiction in which the sale occurred. This is known as the Situs Rule and originated in the Bradley-Burns Uniform Local Sales and Use

Tax Law of 1955. The law authorizes counties to impose the tax. Effective January 1, 1962, all counties have adopted ordinances for the State Board of Equalization to collect this local tax.

- Between 1972 and 2004, local jurisdictions received 1.25 percent instead of 1.00 percent, but 0.25 percent was taken by the State in 2004 to pay for the Economic Recovery Bonds in what has become known as the "triple flip." Other taxes were designated to replace the 0.25 percent for local jurisdictions.
- The 1.00 percent local jurisdiction sales tax funds are allocated 0.25 percent to the County where the sale occurred for transportation funding and 0.75 percent to the city or county (if the sale took place in an unincorporated area) general fund where the sale occurred for general operations.
- When the Economic Recovery Bonds of 2004 are paid in full, the 0.25 percent tax that the State receives will be returned to local jurisdictions under the Situs Rule, bringing the local tax back to 1.0 percent.

Local jurisdictions have the ability to pass additional sales taxes for various purposes, subject to a vote of the electorate, such that Los Angeles now has a 9.75 percent sales tax rate, San Francisco has a 9.00 percent rate, and San Diego has an 8.75 percent rate in total.

Sales taxes began in California in 1933 at a rate of 2.50 percent. That rate increased to 3.00 percent in 1935 (although temporarily returned to 2.50 percent from 1943 to 1949), 4.00 percent with the Situs Rule being adopted by all counties in 1962, 5.00 percent in 1967, 6.00 percent in 1974, 6.25 percent in 1989, and then increasing to 8.25 percent in accordance with the additions to the tax indicated above in 1991, 1993, and 2004.

Despite these increases in the sales and use tax rate and despite an economy that has grown significantly over the 27 years inclusive of 1977-78 and 2003-04, the amount of the State General Fund that was covered by sales and use tax declined from 37.3 percent in 1977-78 to 28.8 percent in 2003-2004. During the boom years of the mid-2000s, sales and use taxes grew back toward 1977 levels (34.6 percent) but have since retreated to 28.9 percent.

As a proportion of personal income, sales and use taxes in California have declined significantly. Every 1 percent of the sales tax rate produced revenues equal to 0.52 percent of personal income in 1960, but this declined to 0.34 percent in 2007-2008. If taxable purchases accounted for the same share of personal income in 2007-08 as they did in 1966-67, the state would have collected an additional $16.4 billion in sales tax revenues.[1] Inasmuch as the Governor's 2010-2011 Budget

[1] http://www.cbp.org/pdfs/2009/0902_Californias_Tax_System.pdf

contains a $19 billion deficit, this decline in the relative share that sales and use taxes represent is quite substantial and, indeed, very serious.

The upshot of this is that a growing economy and higher rates have not enhanced the relative contribution of sales and use taxes to the State of California budget, and with the present economic decline, sales and use tax contributions are hovering at historically low contributions to State revenue. Much of this is because, when the law was originally passed, sales were made almost exclusively by "brick-and-mortar" retail establishments. There did not exist the huge number of catalog sales then as there are now. In 1995 (the year that Netscape made the Internet widely available) catalog sales represented 2 percent of all retail sales in the United States.[2]

Presently, with the Internet becoming more and more important in retail sales, Goldman Sachs has estimated that online shopping will increase from $134.9 billion (8 percent of equivalent product retail sales and 4.4 percent of all retail sales) to $624.2 billion in 2020 (approximately 4½ times to 17.1 percent of retail sales). Since 2000 web sales have more than tripled to achieve a 19 percent compound annual growth rate. Over the next ten years Goldman Sachs projects online growth to be five times the rate of growth for traditional retailing. It has forecast that the number of Internet buyers will grow at a 7 percent rate and spending per buyer will grow 8 percent over the same period. That puts online revenue at a 15 percent compound annual growth rate over the next decade, compared to traditional retail's 3 percent.[3] Amazon.com sales of $24.5 billion in 2009 are forecast to reach $32 billion in 2010 and $39 billion in 2011. That volume of growth is the equivalent of annually absorbing all the business done by Barneys New York, Neiman Marcus Inc. and Saks Inc.[4]

Also contributing to the relative decline of sales tax in California, services are not taxed by California sales and use taxes. Again, when sales and use taxes were initiated, the economy was much less service oriented. Only looking at the ten-year period between 1999 and 2008, service sector revenues in the United States grew by 60.9 percent[5]--approximately 5 percent annually and 1.67 times the growth rate of traditional retail. It is in this environment of budget crises,

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[2] http://www2.census.gov/retail/releases/benchmark/annpub96.pdf

[3] http://www.internetretailer.com/2010/06/17/web-sales-grow-so-should-spending-technology-report-says and Halkias, Maria, "States Consider Taxing Internet Sales to help Boost Revenues," Dallas Morning News, April 14,2010

[4] http://www.dallasnews.com/sharedcontent/dws/bus/industries/retail/stories/DN-InternetTax_14bus.ART.State.Edition1.3dae195.html

[5] http://www2.census.gov/services/sas/data/Historical/sas-08.pdf and http://www2.census.gov/services/sas/data/Historical/sas99.pdf

exacerbated by declining sales taxes, many states have turned to exploring the collection of online sales taxes, and California is just one of several to do so.

REVIEW OF STATES' LEGISLATION

In the preceding discussion, it was indicated that out-of-state retailers who are engaged in business in California are required to collect sales and use tax from the consumer at the time of making the sale. This has been a significant legal issue in federal courts for many years.

The landmark case is a 1992 decision, *Quill v. North Dakota*, in which the U.S. Supreme Court opined that the Commerce Clause of the U.S. Constitution prohibits a state from collecting sales and use taxes on an out-of-state retailer unless that retailer had a substantial physical presence, or "nexus," within the state. In this case, the Supreme Court overturned a lower court decision that said computer software that allowed customers to place orders was sufficient to establish that presence. When the Quill case was decided, online commerce via the Internet had not yet taken hold. The Quill case applied to mail-order businesses, but since the growth of the Internet, Quill has been interpreted as applying to online retail sales. In its ruling, the Court specifically noted that Congress has the authority to change this policy and could enact legislation requiring all retailers to collect sales taxes without running afoul of the Constitution.

There are two primary strategies that states are pursuing to move toward a tax system in which all retailers are subject to the same sales tax and collection requirements. One involves persuading Congress that collecting sales taxes for numerous state and local jurisdictions is no longer a burden for remote sellers. Software makes complying with state and local sales tax rules much simpler than when the Supreme Court issued its 1992 ruling.

To further standardize sales and use taxes, the National Governors Association established the Streamlined Sales Tax Project, a multi-state effort to simplify and align sales tax policies. As of July 2010, 44 states and the District of Columbia had approved an interstate agreement that established uniform sales tax rules and definitions, and 23 states had taken the next step of passing implementing legislation. Those 23 states are: Arkansas, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming.[6]

[6] http://www.streamlinedsalestax.org/index.php?page=faqs

Under this legislation, states and cities still have the authority to determine what goods are taxed at what rate, but they must adhere to rules governing such things as how and when they can change tax rates, as well as adopting uniform definitions. Having aligned and greatly simplified their sales tax policies, states are hoping to persuade Congress to pass the Main Street Fairness Act. Rep. William Delahunt, D-Mass., introduced a bill in July, 2010 calling for a national solution to ease states' online sales tax collections. Labeled the "Main Street Fairness Act," it would allow states that agree to streamline their sales tax systems to collect taxes from out-of-state retailers, whether or not they have a physical presence in the state.

The second strategy states are pursuing does not rely on Congressional action, but instead uses existing state authority to clarify what constitutes "nexus" for the purposes of sales tax liability. In the past, many national chains, despite having nexus in every state by virtue of their stores, claimed their e-commerce sites were distinct legal entities, unrelated to their bricks-and-mortar stores and therefore were exempt from collecting sales taxes. This practice is known as "entity isolation."

State action in recent years has sharply curtailed the number of so-called "bricks-and-mortar" retailers using entity isolation to skirt collecting sales taxes on their online operations. In 2001, California became the first state to issue an administrative ruling against the practice of entity isolation when the Board of Equalization ruled that Borders.com was not a separate entity, but, rather, an online extension of the chain Borders Books & Music, which, therefore, must collect sales taxes on sales to California residents.

In the following years, several states amended their sales tax laws to clarify that the e-commerce arms of national chains still have nexus and that entity isolation does not absolve them of their obligation to collect sales tax. Increasingly concerned about the threat of court action by states and the potential liability, as well as the complexity and inefficiency of attempting to treat the e-commerce side of their operations as a separate company, several national chains have brokered deals with the states in which they were forgiven all of their back taxes in exchange for collecting sales taxes online from that point forward.

New York State passed a law (Amazon Law—2008) maintaining that physical presence in New York was established by online retailers such as Amazon.com and Overstock.com through their affiliates. Rhode Island, Hawaii, and North Carolina followed with much the same laws as New York. Indiana and Arkansas have also sought to more clearly define the concept of nexus for sales tax purposes. Affiliates are state residents who advertise the retailers on the residents' personal websites. It is believed that Amazon.com, for example, may derive as much as 40 percent of its business from affiliate referrals.[7] Affiliate programs are intended to encourage websites to send potential customers to the e-commerce sites by paying commissions or referral fees. For example, Amazon.com's "Associate Program" allows its "associates" to offer books and other products on their websites, through special links to Amazon. When a customer comes to the associate's website, he or she is transported to Amazon's site through a link. If the customer makes a purchase, Amazon commits to the "associate" a commission or referral fee, generally between 5 and 15 percent of the purchase price.

As a result of the passage of the laws in New York, Rhode Island, North Carolina, and Hawaii, Amazon fired its North Carolina, Rhode Island, and Hawaii affiliates;[8] in New York it filed suit against the State but to date the courts have sided with the State. In New York, Amazon is collecting the sales tax while the legal cases proceed through the court system.

New York's Amazon Law creates a rebuttable presumption that an Internet seller that contracts with a New York resident to refer potential customers to it on a commission basis has a physical presence in the State if sales from such referrals to New York residents exceed $10,000 during the preceding four quarterly periods. Physical presence in the State of New York imposes an obligation on the vendor or seller of tangible personal property or services subject to sales tax to collect and remit sales tax to the appropriate taxing jurisdiction in New York.[9]

What made the New York Amazon Law unique is that it specifically provides that a referral by a link on an Internet website of a resident representative to the website of the Internet seller creates a presumed nexus obligating the Internet seller to collect sales taxes on sales to residents of the State of New York. The New York State Department of Taxation and Finance has ruled that the presumption of nexus will be deemed rebutted if the seller can establish that the resident with

[7] Goodland, Marianne, "Lawsuit Filed over Recent Internet Sales Tax Bill," Colorado Statesman, July 9, 2010
[8] Birchall, Jonathan, "Online Retailers Defy Tax Move," Financial Times of London, July 3, 2009.
[9] Sonnier, Blaise M. "The Amazon law: Will You Pay Web Sales Tax?" Journal of Corporate Accounting and Finance, November/December, 2009.

whom the seller has an agreement did not engage in any solicitation in the State on behalf of the seller. To rebut the presumption, regulations require that (1) the Internet seller's contract with each resident representative expressly prohibit any solicitation by the resident representative on behalf of the Internet seller in the State of New York and (2) the Internet seller obtain annually from each resident representative a signed certification stating that the resident representative has not engaged in any prohibited activities in New York State at any time during the previous year.

Colorado initially attempted to take that same approach. The original version of its bill (HB 1193) used the nexus of affiliates in order to require online retailers to collect and remit sales taxes. Colorado legislators, however, fearing that Amazon and others would do to Colorado affiliates what they did in North Carolina and other states—namely terminating their affiliate agreements, amended the bill to require online retailers to inform their customers of the sales taxes owed to the state. If the retailer refused to collect the sales tax or inform the customer, the law would require the retailer to provide the Department of Revenue with the customer names and the amount of the purchase subject to State sales taxes, at which time the customer would be liable for use taxes.

The passage of HB 1193, and its subsequent signing by the governor was not enough to assuage Amazon.com. Despite the amended bill removing all references to affiliates, Amazon terminated all of its Colorado affiliate agreements on March 8, 2010.

Tennessee introduced legislation in its 2010 session to adopt a law based on the Colorado model but the bill died when the Tennessee Legislature adjourned June 10. Nexus legislation is being considered in Illinois, Maryland, Nevada, Oklahoma, Vermont, and Virginia. Many other states have begun to explore this revenue option, including New Mexico and Mississippi. [10]

In California, ABX8-8 is a bill that was originally introduced in the State Assembly as AB8; it was passed in the Assembly and then sent to Senate. When first introduced the bill's purpose was to address the financial emergency declared by Governor Schwarzenegger, who had previously in 2009 vetoed an attempt to secure taxes from Internet sales (AB178) under threats from Amazon.com and Overstock.com that local affiliate agreements would be terminated.

When ABX8-8 moved to the Senate, amendments were added that parallel the New York, Rhode Island, and North Carolina laws and it passed the Senate in February, 2010. ABX8-8 includes in

[10] http://affiliateadvocacy.com/2010/nexus-legislation-updates/

the definition of a "retailer engaged in business in this State" that engagement in the State includes any retailer entering into agreements under which a person in the State, for a commission or other consideration, directly or indirectly refers potential purchasers, whether by a link or an Internet website or otherwise, to the retailer, provided the total cumulative sales price from all sales by the retailer to purchasers in the State that are referred pursuant to these agreements is in excess of $10,000 within the preceding 12 months. The bill moved out of Assembly Rules Committee in February but the special session ended on March 11, 2010 with the bill having not been acted upon by the full Assembly. It will require reintroduction later in the year.[11]

ECONOMIC IMPACT ON CALIFORNIA BUSINESSES AND EMPLOYEES

The discussion thus far has focused upon revenue generation for the States and local jurisdictions. A report out of the University of Tennessee estimated state and local sales tax losses arising from e-commerce for 46 states and the District of Columbia to grow to $11.4 billion-to-$12.65 billion by 2012 for a six-year total loss (2007-2012) of $52 billion-to-$56.3 billion.[12] The report estimated that California's losses would reach approximately $9 billion in foregone taxes over those 6 years—an average of $1.5 billion per year.

The State of California Board of Equalization, in their analysis of AB178, estimated that online taxable sales to California residents and businesses that are not presently generating sales tax revenue were $1.661 billion in 2008-09.[13] This amount of sales would generate approximately $150 million in sales tax revenue annually for the State, which is a much lower estimate than in the University of Tennessee study. The difference between these estimates, which is enormous (the Tennessee estimate is ten times higher), is in the Tennessee study's inclusion of business-to-business sales that the report indicates to account for 93 percent of total e-commerce.[14] Given the sophistication and thoroughness of the Tennessee study and its inclusion of business-to-business sales, the determination of sales lost in the Tennessee study will be utilized in the study that follows.

[11] http://www.cj.com/downloads/tax/chrono_tax.pdf
[12] Bruce, Donald; Fox, William, and Luna, LeAnn, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce," Streamlined States Governing Board, April, 2009.
[13] http://www.boe.ca.gov/legdiv/pdf/ab0178-1sw.pdf
[14] Bruce, Donald; Fox, William, and Luna, LeAnn, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce," Streamlined States Governing Board, April, 2009, p. ii.

What is missing in the analyses by both the authors of the University of Tennessee study and by the State Board of Equalization is an analysis of the impact that the absence of such laws has upon the State economy—not just tax revenue. The balance of this study seeks to address the following additional economic impacts in California that are associated with the lack of collection of sales taxation on Internet sales. In particular, the following will be addressed:

1. Loss of business revenue to out-of-state companies
2. Decline in real estate values that accompany a decline in retail sales
3. Impact on California employment
4. Potential relocation of California businesses to other states

Loss of Economic Value to Out-of-State Retail E-Commerce

Applying a 9 percent average sales tax rate to the $1.5 billion in lost taxes (the study also identified that, in California, approximately 25 percent of all taxable sales are not collecting sales or use taxes [15]), leads to an estimate of $17 billion per year in untaxed sales annually in California.

Certainly, some Internet users make purchases based on convenience or time-related issues vis-à-vis price, and there have been some noteworthy studies that estimated price-sensitivity of Internet purchases .In economics, the degree to which demand for a product changes as the price of the product changes is known as price elasticity. This report will continue to use the more descriptive term—price sensitivity. It cannot, therefore, be argued that all of this $17 billion in online sales is due to the absence of sales tax collection. The key issue in estimating the loss that is ultimately incurred by California businesses caused by sales that are lost to these out-of-state retailers is to determine the price sensitivity of online buyers.

A seminal study in Internet purchase price sensitivity was done by Austan Goolsbee in 2000.[16] In that study Goolsbee estimated that 24 percent of Internet buyers and 30 percent of online purchases would be shifted in response to the imposition of sales taxes. These estimates of price sensitivity were from a study of purchasing intentions using data from the late 1990s, before the

[15] Bruce, Donald; Fox, William, and Luna, LeAnn, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce," Streamlined States Governing Board, April, 2009, pp. 3-9
[16] Goolsbee, Austan, "In a World Without Borders: the Impact of Taxes on Internet Commerce," Quarterly Journal of Economics, vol. 115, no. 2, May 2000, pp. 561-576

majority of Americans were Internet users and before the majority of Internet users had begun to make online purchases: however, these sensitivity measures are consistent with cross-border sales tax impact studies that have been conducted since.[17]

Despite this consistency, Goolsbee later thought that, because Internet buying had become much more prevalent, some adjustments to these initial estimates were required to account for the increasingly higher proportion of consumers who made online purchases. In so doing, the price sensitivity was found to have declined by 50 percent to 12 percent and 15 percent, respectively. In his second study, Goolsbee found that experienced Internet users (those online for more than two years) were about 80 percent more likely than the average Internet buyer to be affected by changes in the tax price, and the incorporation of this effect offset the 50 percent decline and established a remote sales elasticity of 24.3 percent. Goolsbee's research was corroborated by a study by Jupiter Research, which found that nine percent of those who were aware of the possibility of avoiding sales taxes online "always" looked to avoid the tax, while another 30 percent of those "sometimes" did so.[18]

In 2007, a study in Canada found that applying a provincial average sales tax of 14 percent to all Internet sales in Canada would reduce the number of online buyers by as much as 44 percent.[19] An earlier study found that 80.7 percent of mail-order buyers would probably order $50 worth of merchandise at a 2-percent tax for a $1.00 total tax. However, at the 2-percent tax on $500, with a tax bill of $10.00, the percentage of probable orders dropped to 60.6 percent. Using a $100 purchase amount as an example, at the 2-percent sales tax, 79 percent of the respondents would probably order. At an 8-percent tax on the $100 purchase amount, only 20.5 percent would probably order.[20]

Applying Goolsbee's 24.3 percent price sensitivity factor to $17 billion in sales indicates that retail establishments physically based in the State are losing $4.1 billion in sales this year to Internet retailers that would, instead, be made at the stores affected.

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[17] Lenard, Thomas and McGonegal, Stephen, "Taxation of Online Sales: Competing with the Streamlined Sales Tax Project," Progress Freedom Foundation, September, 2004

[18]"Jupiter Research Reports U.S. Online Retail Will Reach $65 Billion in 2004, Press Release, New York, January 20, 2004 cited in Lenard and McGonegal.

[19] Shamin Ahmed and Tony Wirjanto, "The Impact of Sales Taxation on Internet Commerce — An Empirical Analysis" Policy Analysis Unit, Research Department, Bangladesh Bank, Bangladesh, Department of Economics, University of Waterloo, Ontario, Canada

[20]Michael L. Klassen, Karen Glynn, Kathleen Porter "Sales Tax Effects on Mail Order Customer Purchasing Decisions," Journal of Direct Marketing, Volume 8, Issue 3, Date: Summer 1994, Pages: 21-29

Online sales have grown significantly in recent years and Goldman Sachs has predicted that online sales will continue to grow by 15 percent until 2020.[21] Forrester Research predicted 10-14 percent growth to 2014.[22] The University of Tennessee study showed approximately 15 percent growth through 2012.[23] Various other online marketing and research websites quote growth rates between 17.5 percent and 24.7 percent.[24] Assuming a compromise/average growth of online retail sales at the lower end of these estimates (12.5 percent), the amount of growth in the $4.1 billion of California lost sales would reach, $7.7 billion in 2015, and $14.3 billion by 2020.

There does exist a partial offset to these losses—affiliate commissions, which, according to the Performance Marketing Association (the trade group for Internet retailers and affiliates) totaled $202.7 million in 2008 for 25,000 affiliates.[25] As such, affiliates earn approximately $8,000 per year for their part-time participation. Giving full credit to the trade group estimate, this would very modestly reduce the net loss of business activity in the State currently from $4.1 billion to $3.9 billion for 2010. Applying the 12.5 percent growth factor to this net loss, the net losses grow to $7.3 billion in 2015 and $13.6 billion by 2020 **(Chart 1).** What is most pronounced in this chart is the rapid decline in economic activity that will occur as e-commerce sales continue to grow during the coming decade. This growth in e-commerce will more than triple the losses in local sales between 2010 and 2020.

Economic impact does not stop at the retail sale stage, money that now leaves the State (except for the affiliate's small commission) would be spent and re-spent within the State were the sale to take place at a physical store. Multipliers are used to capture the secondary effects of spending in a region. There are two basic kinds of secondary effects:

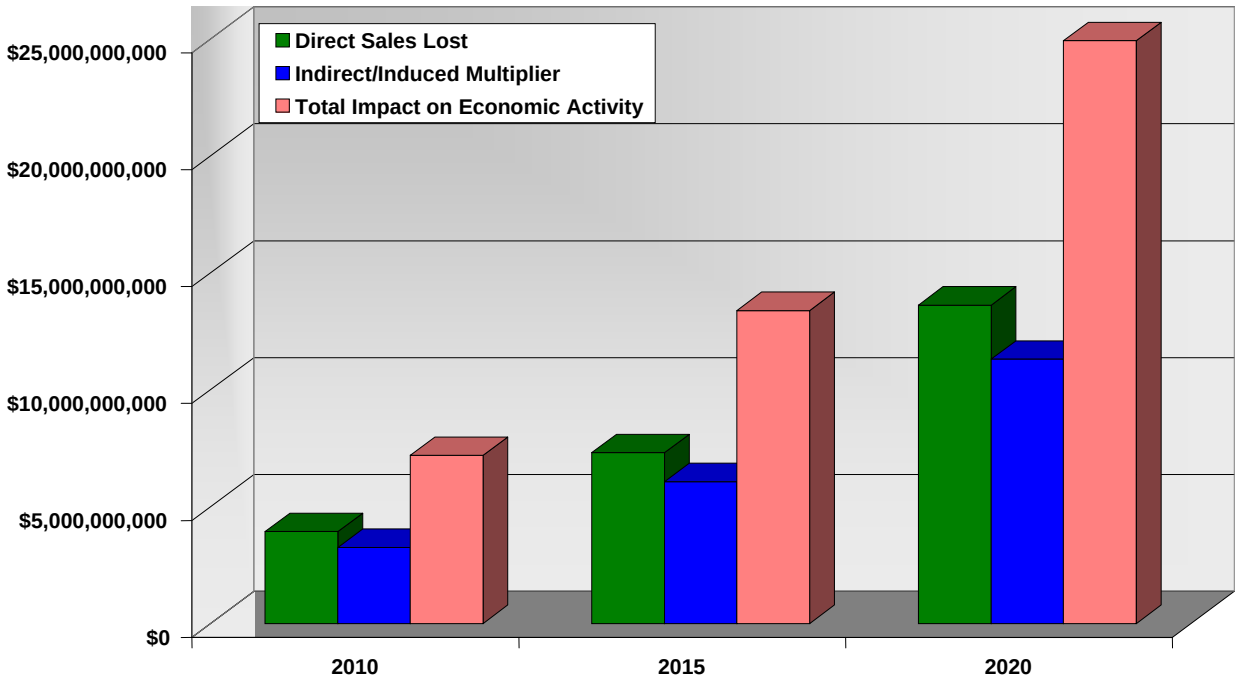
1. Indirect effects are the changes in sales, jobs and income within backward-linked industries in the region, i.e., businesses that supply goods and services to

[21] http://www.internetretailer.com/2010/06/17/web-sales-grow-so-should-spending-technology-report-says and Halkias, Maria, "States Consider Taxing Internet Sales to help Boost Revenues," Dallas Morning News, April 14,2010
[22] http://techcrunch.com/2010/03/08/forrester-forecast-online-retail-sales-will-grow-to-250-billion-by-2014/
[23] Bruce, Donald; Fox, William, and Luna, LeAnn, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce," Streamlined States Governing Board, April, 2009, pp.8-9.
[24] http://www.highbeam.com/doc/1G1-198422799.html and http://www.internetretailer.com/2007/05/21/annual-growth-rate-for-web-sales-to-drop-to-17-5-report-predic
[25] http://articles.sfgate.com/2010-02-24/news/17953603_1_sales-tax-state-income-tax-e-tailers

retailers. Each business that provides goods or services to retailers benefits indirectly from this spending. These indirect effects are captured by Type I multipliers (sometimes also called secondary impacts).

2. Induced effects are the changes in sales, jobs and income in the region resulting from household spending of income earned either directly or indirectly from consumer spending. Employees in retail and backward linked industries spend their income in the local region creating additional sales and economic activity. Reduced income in the area results in reduced spending that will further affect retail stores and other businesses that depend on household spending. Type II multipliers capture both indirect and induced effects (also known as tertiary or quaternary effects).

Chart 1
Lack of Collection of E-Commerce Sales Tax:
Impact on Sales and Related Economic Activity in California



The size of the multipliers depends on three basic factors:

1. The overall size and economic diversity of the region's economy: Regions with large, diversified economies producing many higher order goods and services

will have high multipliers as households and businesses can find most of the goods and services they need locally.

2. The geographic extent of the region and its role within the broader region: Regions of a large geographic extent will have higher multipliers, all other things being equal, than will small areas as transportation costs will tend to inhibit imports. Regions that serve as central places for the surrounding area will also have higher multipliers than more isolated areas.
3. The nature of the economic sectors under consideration: Multipliers vary across different sectors of the economy based on the mix of labor and other inputs and the propensity of each sector to buy goods and services from within the region.

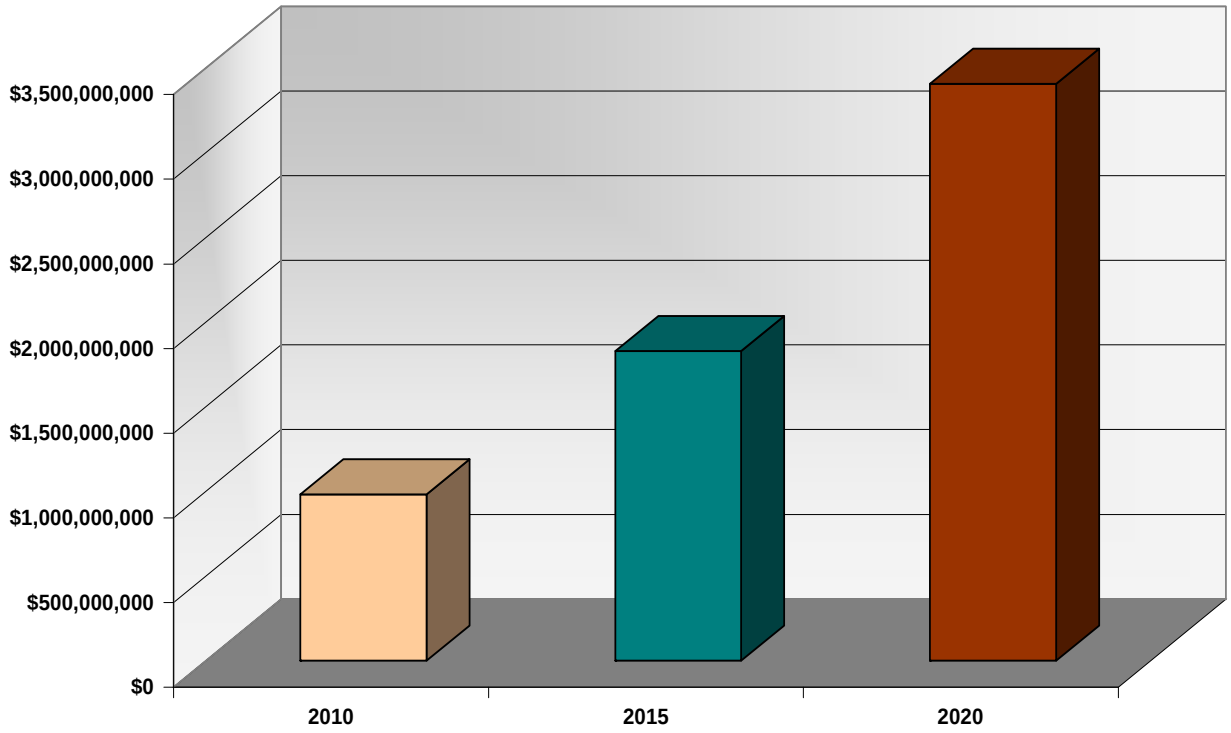
Generally, retail sales in California have demonstrated a multiplier of 1.83.[26] As such, the loss of $3.9 billion in sales carries with it an overall economic loss of $7.2 billion (1.83*$3.9 billion). This loss of economic activity in California, again multiplied by the 12.5 percent growth factor, can be expected to reach $13.4 billion by 2015, and $24.9 billion by 2020. **(Chart 1)**

John Baen (University of North Texas) over a decade ago explored the impacts that e-commerce could impose upon commercial real estate values.[27] He offered the scenario that e-commerce would reduce sales at "brick and mortar" stores, thereby driving down their ability to pay rent and reducing real estate values, with further Multiplier impacts on real estate commissions and management fees. What is important to address is the valuation issue, especially in view of the current economic downturn that was triggered in part by declines in real estate values.

Baen theorized that the $31.2 billion in sales that were being garnered by e-commerce in 1998, led to a 2 percent reduction in rents at shopping centers, which equals $624 million in lost commercial rents. Capitalizing these lost rents at 8 percent, the value losses were estimated to be $7.8 billion in 1998. Fast forwarding to 2010 in California and the $3.9 billion in sales lost to Internet retailers because of the lack of sales tax, this would equate to another $1 billion loss to California in the form of real estate value declines. By 2020, that amount can grow to $3.4 billion in California real estate value declines **(Chart 2).** The State, local governments, and school districts will lose the corresponding property taxes of approximately $34 million.

[26] http://www.labor.ca.gov/panel/pdf/Multipliers.pdf
[27] Baen, John, "The Effects of Technology on Retail Sales, Commercial Property Values and Percentage Rents," Journal of Real Estate Portfolio Management, International Council of Shopping Centers, April, 2000.

Chart 2
Decline in Commercial Real Estate Value Due to Lower Sales Volume



Including real estate value losses with the sales impacts discussed above pushes the annual economic impact in 2010 to $8.2 billion and by 2020 that impact can be expected to increase to $28.3 billion. **Table 1** depicts these economic losses that are and will be suffered by California if the State continues not to pass fair Internet retailers sales tax.

Table 1 **Sales, Multiplier and Commercial Real Estate Value Impact (in $ billions)** **Of Lack of Collection of E-Commerce Sales Tax**			
	2010	**2015**	**2020**
Direct Sales Lost	**$3.93**	**$7.32**	**$13.62**
Indirect/Induced Multiplier Effect	**$3.26**	**$6.07**	**$11.31**
Real Estate Value Decrease	**$0. 98**	**$1.83**	**$3.41**
Total	**$8.17 billion**	**$15.22 billion**	**$28.34 billion**

Loss of Jobs and Payroll to Out-of-State Retail E-Commerce

With the loss of direct revenue of over $3.9 billion to California-based retailers at present and $13.6 billion to physically-based retailers in California by 2020, it is clear that the disappearance from the State of these annual sales must impact the number of jobs that will be available in California—retail and others that are generated by the Multiplier.

In 2008, the United States had one full-time equivalent retail sales job at a physical store location for every $350,000 in annual sales.[28] These losses due to the absence of the lack of collection of e-commerce on taxes, therefore, are costing California 11,200 direct full-time retail jobs in 2010 ($3.9 billion/$350,000), 20,900 full-time retail jobs in 2015, and will grow to 38,900 full-time jobs by 2020 as Internet sales continue to expand.

The retail employment Multiplier in California is 1.63:1.[29] This causes another 7,100 full-time jobs in 2010, 13,200 full-time jobs in 2015, and 24,500 full-time jobs in 2020 to be lost to indirect and induced effects. Total full-time equivalent jobs that are lost, therefore, to out-of-state online sales because there is no collection of sales tax on such activities are 18,300 presently (one job for every $400,000 of economic activity), and will grow to 34,100 in 2015 and 63,400 in 2020. **Table 2** shows these job losses in California that are caused by out-of-state online sales that are not taxed.

In 2009, the average full-time retail worker in California earned $38,810 for the year.[30] All statewide workers earned an average of $49,550. Applying the retail earnings of $38,810 to the 11,200 lost retail jobs and $49,950 to the 7,100 indirect/induced lost jobs results in payroll losses in California in 2010 of $789.3 million due to the loss of jobs caused by the lack of collection of an e-commerce tax.

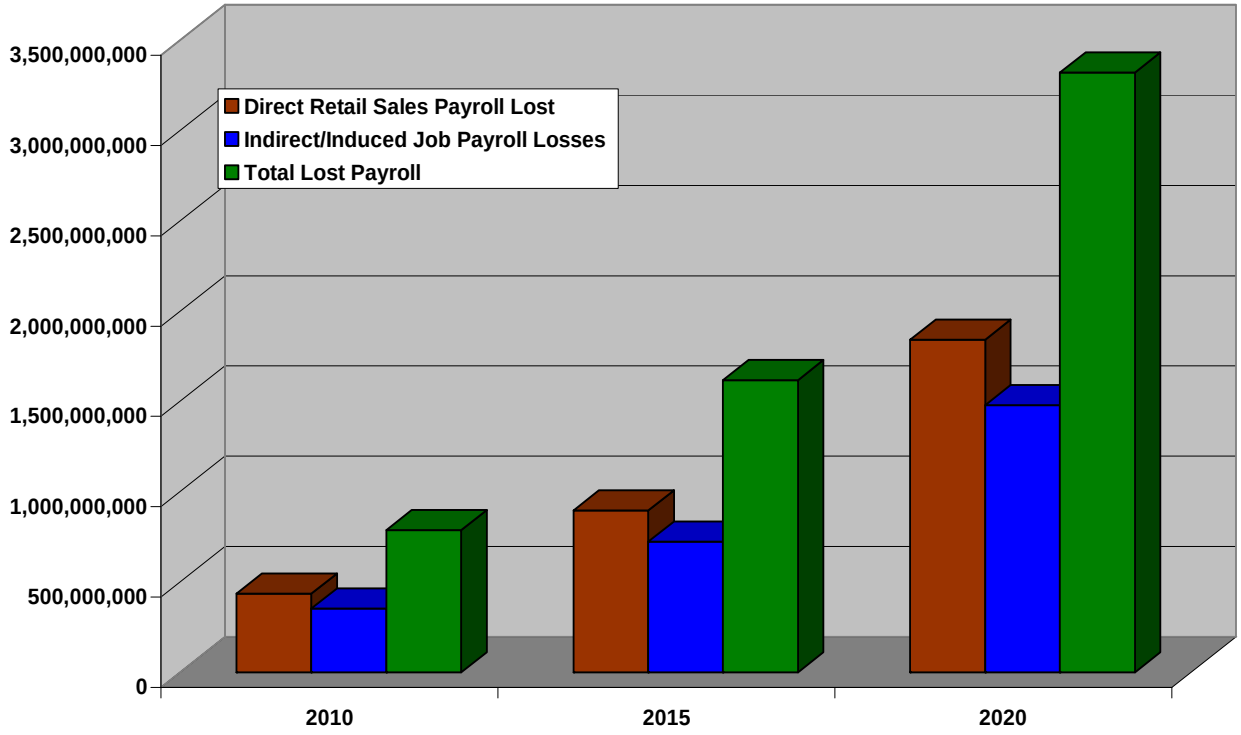
Table 2
Full-Time Jobs Lost in California
Due to Sales Leakage Caused by Lack of Collection of Internet Sales Tax

	2010	2015	2020
Retail Sales Jobs Lost	**11,200**	**20,900**	**38,900**
Indirect/Induced Job Losses	**7,100**	**13,200**	**24,500**
Total Lost Jobs	**18,300**	**34,100**	**63,400**

[28] http://www.census.gov/compendia/statab/2010/tables/10s1025.xls
[29] http://www.labor.ca.gov/panel/pdf/Multipliers.pdf
[30] http://www.bls.gov/oes/current/oes_ca.htm

Allowing earnings to grow by 2 percent per year, the 34,100 jobs lost in 2015 will cost California workers $1.6 billion and the 63,400 jobs in 2020 will deny workers in the State more than $3.3 billion **(Chart 3)**. The State would lose its share of income taxes on these funds in addition to the sales taxes discussed above. With an effective income tax rate of 1.4 percent on $50,000 of income, these foregone payroll amounts equate to lost income taxes of $46.5 million dollars per year in 2020.[31]

Chart 3
Payroll Lost by California Workers



Potential Relocation of California Businesses to Other States:

Traditional location theory identifies a number of key issues in determining business location choices. In general, access to markets, access to raw materials and specialized labor, and labor costs dominate both theory and practice. Location decisions are comprised of a balancing of the costs associated with each of these components. In typical scenarios additional issues such as cost of utilities and local taxes become factors only after these key issues are settled. For

[31] http://www.lao.ca.gov/2001/tax_primer/0101_taxprimer_chapter2.html

example, an automobile manufacturer may choose to locate in the southern United States for labor and access to market issues but then choose the southern state that offers the most attractive tax incentives or utility rates.

Consistent with this location theory discussion, a recent study of international comparative advantage in taxation by KPMG (*Competitive Alternatives 2010 Special Report: Focus on Tax)* found that "Income taxes typically represent up to 12 percent of location-sensitive costs. This cost is relatively low compared to other costs, such as labor (46–85 percent of location-specific costs), facilities (2–18 percent), and transportation (5–18 percent)."[32]

The issue that is important for this report is whether, and to what extent, the lack of collection of e-commerce on taxes on out-of-state online retailers in California serves as an incentive or disincentive to locate within the State. Again, labor costs and transportation costs will dominate the regional location decision, but taxes can have a significant place in intra-regional location decisions. Logic would dictate that the lack of collection of e-commerce on taxes would discourage business locations for two reasons:

1) A "bricks and mortar" store that must charge sales taxes will suffer a competitive disadvantage against out-of-state Internet sales operations that do not operate under the same rule.
2) A large Internet-based retailer, such as Amazon, would have to pay sales taxes in California—a very large market—if it were to locate physically within the State.

The impact on physically-located stores will be substantial. This report details that economic activity in California will decline by almost $25 billion annually by 2020. That clearly involves store closures and movements to states that might have adopted collection of Internet sales taxation, thereby removing that competitive disadvantage for store locations. More will surely follow as these economic impacts spread. These impacts are indicated in the sales and economic activity damage that has been estimated in this report.

What this report has yet to address, however, are location decisions that would have been made in California's favor but were not because sales taxes are imposed on some merchants and not

[32] http://www.competitivealternatives.com/highlights/taxfocus.aspx

others. If an Internet retailer, for example, determines that transportation costs to market are vital and needs to be near a large market such as California, the lack of collection of e-commerce on taxes for out-of-state online retailers in California might make Arizona or Nevada attractive locations for distribution centers to access California and still pay no California taxes. An e-commerce tax collected for these California sales would offer no advantage to locating out of the state for tax reasons—taxes would be due no matter the location of the distribution facility—and California might prove to be a location with an advantageous proximity to markets vis-à-vis neighboring smaller states. This not only costs California but costs the economy in general. The lack of collection of e-commerce on taxes in this event would have caused a business to choose a less efficient site than it might otherwise have chosen.

In 2003, the Congressional Budget Office (CBO) published a CBO Paper entitled, "Economic Issues in Taxing Internet and Mail-Order Sales." In this publication, the CBO summarized these economic inefficiencies as follows:

> Consumers may be willing to purchase a good remotely even if the total cost of production and delivery exceeds the comparable instate cost because the money they save in taxes compensates them for the money they pay in shipping costs. Similarly, producers may be willing to construct facilities in locations where production and shipping costs are high to avoid nexus and the need to charge their customers sales taxes. The more unevenly a tax is applied, the more producers and consumers waste resources in efforts to avoid it—thereby reducing economic efficiency. And if a greater fraction of sales escapes taxation over time, states may seek to maintain the same level of receipts by raising tax rates, which would increase the tax system's excess burden.[33]

[33] CBO, Economic Issues in Taxing Internet and Mail-Order Sales, p. vii

REPORT AUTHORS

Richard A. Parker, Ph.D., President of Rea & Parker Research, is the principal author of this study. Rea & Parker Research is a survey and market research and economic consulting firm based in San Diego, California, with facilities in Los Angeles and Orange County. It was founded by Louis M. Rea, Ph.D., and Richard A. Parker, Ph.D., in 1984. Dr. Parker is a professor in the School of Public Affairs at San Diego State University. Dr. Parker is the co-author of a highly successful book, Designing and Conducting Survey Research: A Comprehensive Guide, published by Jossey-Bass Publishers in 2005 (third edition). In addition to his survey research work, Dr. Parker has conducted numerous economic and fiscal studies throughout Southern California for both private and public sector clients.

Scott Barnett formed Taxpayers Advocate, a private company that conducts studies on local government spending policy, in 2003. Mr. Barnett has almost three decades of political and public policy experience, including a term on the Del Mar City Council from 1984-1988, where he was the city's representative on the SANDAG and North County Transit Boards. Mr. Barnett was executive director of the San Diego County Taxpayers Association from 1995 through 2001. See www.taxpayersadvocate.org for more information.