E-Commerce and Taxation:
A Plan for California

Presented by

The Inaugural Class

Pepperdine School of Public Policy

Executive Summary

The inaugural class of the Pepperdine University School of Public Policy is proud to present the first capstone policy seminar project -- "E-Commerce and Taxation: A Plan for California." With this endeavor, this first group of students puts into practice techniques of policy analysis studied over the past two years. This report is the first of what is sure to be a long history of forward-looking policy studies put out by future classes of the School of Public Policy.

This project is an exposition in policy analysis addressing a critical, cutting-edge, and timely policy question. The tremendous growth of electronic commerce raises the question of what is the best method for taxing this new type of transaction. All actors in the policy arena-- government, private industry, and consumers-- have a stake in the outcome of this policy deliberation. Taxation of electronic commerce is currently a relatively unstudied issue. This proposal is submitted to aid, open, and spur debate toward a thoughtful and comprehensive solution.

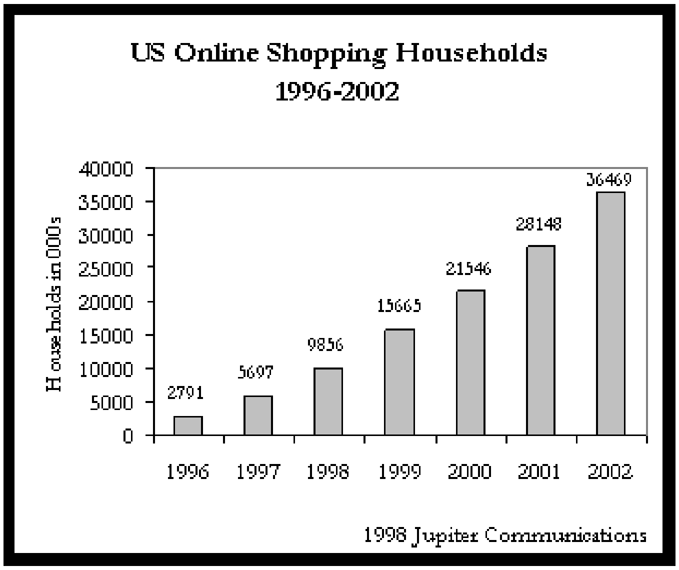
In a break from traditional ivory tower academic work, this report seeks to provide realistic recommendations for a complicated world. The class considered the interests of local, state, federal, and international players, but was specifically guided by the needs of its client – the State of California and its Electronic Commerce Advisory Council.

The inaugural class would like to thank many individuals for their assistance in the publication of this report. The group would like to acknowledge the guidance and leadership of our capstone seminar professor, Dr. Phillip Romero. We would also like to thank School of Public Policy Dean James Wilburn, and administrators Sheryl Kelo, Tami McKelvy, and Marie Ann Thaler for their guidance, patience, and hard work. Additionally, we gratefully acknowledge the individuals and families who have made donations to the School of Public Policy. This publication would not have been possible without such generosity.

Introduction

Like most fast-moving revolutions, the whirlwind development of e-commerce has inspired both hope and fear. Always pushing the workable limits of disintermediation, the past three years have seen phenomenal progress toward that oft-imagined, but never-realized goal of capitalist efficiency: the frictionless economy. The digital future has fast become the digital present. In the space of only three years, less time than it takes to plan and build one suburban mega-mall, almost 13 million additional consumer households will have become electronic shoppers, with another 21 million projected to join them by the end of 2002.

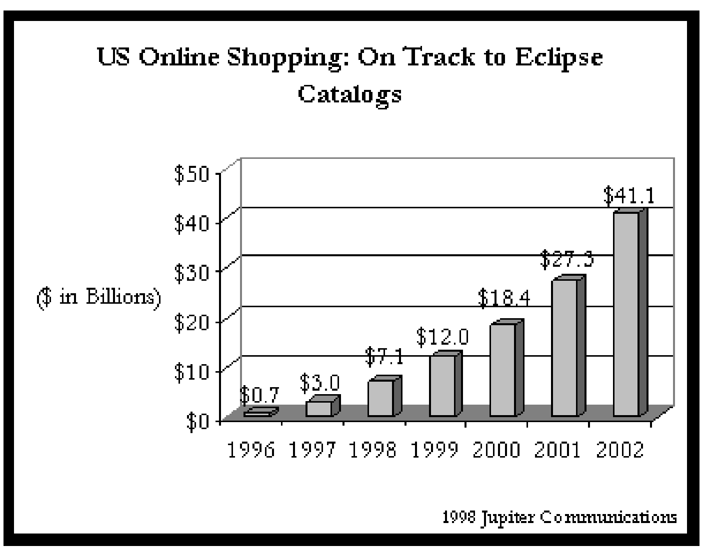
CHART 1



Even while cities-- driven by the need for sales tax revenues-- and developers build out enormous physical retail centers, hyping them as "Mega-Malls" or "Super Centers," the world's largest and fastest-growing retail center has actually been the online marketplace.

Indicators and analysts both suggest that this is only the infancy of a rapidly growing new center of commerce. Leading research firms, Jupiter Communications and Forrester Research, predict huge increases in e-commerce spending. Jupiter forecasts online spending growth to reach $41.1 billion by 2002 in the business-to-consumer market, very crucial to traditional retailers (*see chart 2*). Forrester's 2002 forecast for business-to-business e-commerce is in excess of $350 billion.

CHART 2



Such escalating numbers heighten debate about the future of e-commerce taxation. Opponents of internet regulation argue that Internet commerce must be allowed to grow unfettered by the drain of taxation, increasing the odds that an industry now bringing value to consumers will flourish, ultimately providing even greater economic gains. Proponents of Internet taxation—mainly state and local politicians who stand to lose revenues from the moratorium—counter with the argument that taxing online sales equally is a matter of fairness to traditional, brick-and-mortar merchants. It is also a matter of survival for the states and localities, fearful of the loss of millions of dollars in sales and use tax revenues as increasing amounts of commerce is conducted electronically. It is of particular concern to local governments in the state of California, which have relied heavily on sales tax revenues since the passage of Prop 13.

The benefits of electronic shopping to consumers are significant and continue expand. Wider selection, always-open stores, deeper discounts, and extensive product information are all available in the comfort of one's own home. As columnist Norman Ornstein puts it, "Internet shopping has accelerated astonishingly, and it's not hard to understand why. You don't have to look for a parking space, look all over a store, deal with surly or ignorant clerks, or wait in long checkout lines. And one other big plus: You don't have to pay any sales taxes."

This last "big plus" is keeping state and local treasurers awake at night. The untamed and untaxed nature of Internet commerce has led to a growing dispute among lawmakers, Governors and local politicians of every rank and stripe. Which state government should be able to tax an electronic purchase when the purchaser is in New York, the company is in Seattle, Washington, and the commerce server (the computer that completes the transaction) is in San Jose, California? Even if the jurisdiction is determined, how can tax collectors grab their piece when digital money is so craftily elusive? In deciding this question, billions of tax revenue dollars are at stake.

An explosion of previously unavailable information is now at the fingertips of consumers everywhere, forcing merchants to compete in an arena of near-full disclosure. One class of merchant feeling the effects of this new paradigm is the traditional car dealership. California Internet companies Autoweb.com and Auto-by-tel.com, just two of a handful of leading comparison shopping sites for car buyers, have given consumers the upper hand in negotiating the purchase or lease of a new vehicle. Recent successful IPOs will ensure that this trend continues. Dealers, already feeling the effects of the newly empowered and informed consumer, are scrambling to adjust. Forrester predicts that the Internet will influence 8 million U.S. auto-purchasing decisions in 2003.

Projections (and fears) are largely focused on the domestic market but, unlike brick-and-mortar retail, e-commerce sales taxation is a global concern. Electronic transactions erase the geographic borders that nations have long taken for granted. The governments of Germany and Canada are among the many which have begun to address this growing international policy issue. Over 1000 government officials assembled in Ottawa, Canada in October of 1998 to discuss and debate the future of e-commerce regulation, including the core topic of taxation.

In the United States, legal battles loom, especially regarding the definitions of "nexus" and "physical presence" in a virtual marketplace. Prior to the advent of the Internet, in *Quill Corp. v. North Dakota*, the Supreme Court established that an out-of-state seller only has nexus (and, therefore, the requirement to collect sales and use taxes) if it has substantial *physical* presence in that state. Since voluntary compliance with use tax laws is virtually non-existent, state and city officials are looking for ways to insure that buyers do not escape tax-free. The U.S. Conference of Mayors and the National Association of Counties are not waiting to see what the federally appointed Advisory Commission on Electronic Commerce (ACEC) will decide. Feeling underrepresented on the commission, they have filed a lawsuit to block the ACEC from meeting until its membership is more evenly balanced.

Regardless of the outcome of the lawsuit, the Commission's focus is likely to be on sales and use tax, and the ability of states to require out-of-state vendors to collect that sales and use tax. a power that Congress may grant this power to the States, providing the ACEC makes recommendations favoring such delegation. This decision would dramatically alter the e-commerce landscape.

Mayor Bob Knight, of Wichita, Kansas, Vice President of the National League of Cities, representing 15,000 U.S. towns, says, "E-commerce will be the NLC's top priority over the next few years." Utah Governor Michael Leavitt, bemoaning the competitive landscape on behalf of his Main Street retailers, says, "It's inequity, unfair, and it needs to be changed."

Any changes in Internet taxation will affect more than just e-commerce sales. Recent research by Professor Austan Goolsbee of the University of Chicago concluded that the introduction of sales tax to shopping on the Internet would decrease the number of electronic shoppers by 25%. Goolsbee states that an argument could be made for creating another category known as non-geographic sales that would take into account not only Internet sales, but also mail order and home shopping.

Responding to the early swirls of disagreement over such issues, California Governor Pete Wilson formed the California Electronic Commerce Advisory Council to address these concerns. Home of some of the World Wide Web's marquis companies—Yahoo!, Excite!, GeoCities, E-Trade, @Home, and Cisco, just to name a few—California has been the leader in the development of the online marketplace, and the frontrunner regarding public policy issues related to the rise of the Internet as a force shaping the state's future.

In this respect, the business community has applauded the efforts of California's policy-makers and legislators. The American Electronic Association (AEA) recently released its 1999 California High-Tech Business Climate Report Card. Evaluating California's climate for Electronic Commerce, the AEA gave the state an "A" grade, an improvement from last year's grade of "A-." This high mark is largely due to the significant contribution of the Internet and e-commerce to the growth of California's economy. Credit was also given to California for leading the way for the U.S. Congress by passing the Internet Tax Freedom Act and thus prohibiting any new or discriminatory taxes on or in connection with the Internet and interactive computer services for the next three years.

However, three years passes quickly. The debate over e-commerce taxation is only just beginning. This class committed itself to the task of analyzing the many facets of this increasingly complex issue, and for the purposes of the project created a policy consulting firm—MPP Consulting—with the California Electronic Commerce Advisory Council as our "client." All research and analysis was filtered through the lens of California's interests concerning the taxation of e-commerce. After multiple revisions and many debates, we present the following product. It is an early volley in what may prove to be a long match. Our hope is that this project will prove useful in fostering educated discussion among the many groups that will be affected by this issue.

Introduction to Quantitative Methods

Forewarning

Due to the youth of e-commerce as a mode of selling, there is not a lot of historical data available. As a result, forecasting for the growth in this "industry" is very challenging and inexact. However, conscientious examination of the trends can lead to a meaningful analysis of different policy recommendations for the fledgling industry. Through our quantitative analysis we will attempt to study the major impacts of potential policies involving the taxation of electronic commerce in the future.

Analysis

There is a concern expressed by several entities over the disappearance of sales tax revenues resulting from sales over the Internet. The groups most concerned are the main bodies who would be receiving this "lost" sales tax revenue, the state and local governments. E-commerce sales are not currently taxable under the rules of the Internet Tax Freedom Act. The exception is that those companies with nexus are required to collect and remit sales tax to the appropriate collection agency. Currently it is difficult to determine what percentage of e-commerce sales both originate and terminate within California. This factor is important when examining the amount of sales tax revenues that could be gained if e-commerce was to be taxed.

California maintains a sales tax rate in which the state gets 6.25 cents and cities receive 1 cent per taxable dollar. Sales tax revenues can make up over 30% of both the state and cities' operating revenues.

If e-commerce were taxed, there would be an effect on the overall purchases made online. What must be addressed in this matter is the price-elasticity effect. This effect is equal to the change in quantity purchased relative to the change in the price level. A study by professor Goolsbee at the University of Chicago estimates that the price-elasticity of demand in the case of e-commerce would be 30% or higher depending on the tax rate. In the case of California, a state with one of the highest sales tax rates, this effect may top the 30% mark. This is a very important fact when examining how much sales tax revenue may be currently lost. For our analysis, we have accepted a more cautious elasticity of 20%.

Another factor to be addressed concerning the nexus issue is how much of current e-commerce sales are already taxed? This number probably does not exist. Most companies when paying their sales tax to the state of California do not differentiate between which sales were made via brick and mortar stores and which were result of an online purchase. Thus we can only speculate how much of e-commerce sales, which taking place in California, are actually taxed. For our purposes we incorporate a 10% level.

As mentioned earlier, the two major research firms monitoring electronic commerce are Jupiter Communications and Forrester Research. Both have provided forecasts for e-commerce sales through the year 2002. Most of the numbers available from Forrester include business-to-business sales, while the numbers provided by Jupiter Communications are focused on business-to-consumer sales. Our quantitative analysis is based on the business-to-consumer numbers. Although the business-to-business sales figures represent the greatest portion of online commerce, they have been set aside because they primarily represent purchases of intermediate goods. Also, capital purchases transacted through the Internet have a use tax attached, which requires the purchasing company to remit regardless of whether it was purchased through traditional means or the Internet.

On a final note, the fact that there really is no physical presence for the Internet may lead to generally higher costs of implementation and enforcement of any tax policy on Internet sales. Such numbers have not been included in the quantitative analysis, but should be kept in mind when examining the issue.

Considering the Tax Moratorium

All of the clamoring about what to do when the current congressional and state moratorium on new Internet taxes ends has generated a great deal of grumbling, but very little in the way of substantive recommendations. This project is intended to offer a beginning point in the governmental, commercial, and academic discussion of how to best navigate the rapidly changing landscape of e-commerce. When the current moratorium ends, there may very well be great benefit in buying still more time to further develop the discussion on what will work best for the future of e-commerce taxation. Whether the debate takes the shape of the recommendations proposed in this project, or that of some other idea, the State of California and the nation as a whole will benefit from seeing the moratorium extended by a minimum of two additional years.

With this extension, sufficient time will have been provided for policy makers to generate a more uniformly agreed upon decision as to what will work best for the nation, the individual states, private industry, and individual consumers alike with regard to Internet taxation, specifically e-commerce tax policy. During the extended moratorium, further studies will explore exactly what effect taxation of electronic commerce will have on job markets, e-commerce revenues, and the overall economy of California in general. Additionally, California's intergovernmental financing structure needs to be reevaluated in light of the changing economic structure in the state.

The analysis contained in this report recognizes the reality that at some point the moratorium will end and the "rubber will meet the road" in terms of enacting a policy for e-commerce transactions. We advocate strongly that California not act ahead of its competitors – the other 49 states – so as to put itself at a competitive disadvantage in terms of business growth, job retention, and consumer transactions. However, the state needs to have considered all possible alternatives when the day of reckoning comes and policy formulation begins.

Presenting the Alternatives

In the course of our study we came up with three alternative policies that could be enacted with regard to taxation of electronic commerce. As has been previously stated, it is not realistic to think that a tax moratorium will continue forever, especially considering the amazing growth rate of electronic commerce. Therefore, a complete absence of all taxation on e-commerce was not considered a viable alternative policy for California to pursue. In addition to considering the best interests of our client, the alternatives were judged on the criteria of liberty, efficiency and equality, defined in the following ways:

> <u>Liberty</u> - A policy encourages liberty by allowing the most choice and sovereignty for the individuals, groups, and institution that the policy affects.
>
> <u>Efficiency</u> - A policy is efficient if it achieves its objectives of the greatest benefit with the least effort and expense.
>
> <u>Equality</u>- A policy is deemed equal if all individuals and groups are affected the same way.

With this in mind, the three policies that are presented are the national sales tax policy, the freedom of states policy, and—our recommendation—the state sales tax extension policy.

<u>Alternative 1—THE NATIONAL SALES TAX</u>

Under a national sales tax the federal government would have the authority to set all definitions and rates surrounding the further taxation of electronic commerce. The policy, as studied, works as described below.

The national sales tax policy is figured at 4.765 percent, because it is the average of the sales tax rates in all the 50 states combined. There are three categories of sales and purchases for physical and nonphysical goods: (1) regular goods and services such as books and travel, (2) intermediary goods and (3) international sales and purchases.

Regular goods and services that are bought and sold within the territorial boundaries of the United States are subject only to the 4.765 percent sales tax. Intermediary goods are component goods that are used to make a final product. Such goods bought and sold within the territorial boundaries of the United States will continue to be taxed under the existing tax structure which does not allow for sales tax to be added to the good. International sales and purchases (imports) that are bought in the United States and sold from a foreign country will be charged a three percent infrastructure fee, in order to encourage other nations to trade with the United States. The infrastructure fee is remitted to the federal government for purposes of infrastructure maintenance only. Since these goods are transported using the federal interstate highway system, exporters are required to pay for their use. This would include the manner in which a "good" is delivered such as interstate highways, airports and ports.

Exported goods and services from the United States will be charged a three-percent infrastructure fee and a 4.765 percent national sales tax. The reason the national sales tax is added to exported goods/services is due to their use of state resources in production.

All other import/export duties will be waived for goods and services bought through e-commerce consistent with free trade agreements such as NAFTA. However, the United States reserves the right to add "special fees" on those nations that threaten U.S. political/economic interests. The purpose of retaining this right is to secure that the U.S. government maintains the ability to respond to discriminatory trade policies, and is able to act when vital interests are being threatened from abroad.

The national sales tax revenues will be distributed to the state where the point of sale occurs. The point of sale is considered to be the state from which the seller receives the buyer's order for the good/service. In addition, a special provision will be included in order to protect the rights of consumers.

Projecting the Impact of a National Sales Tax on Revenues

The following is an analysis using numbers forecasted by Jupiter Communications in regard to business-to-consumer Internet sales of goods for the upcoming years. Granted these are forecasts, but we believe that these numbers will be accurate upon assessing the past history of Internet sales growth and under economic stability. Please note that these forecasts are for goods only, and not services. Forecasts for services vary too widely to be considered at this time.

Table 1-1 exhibits the projected sales tax revenue from the 4.765% national sales tax rate for the years 1998 – 2002. Based on the estimated internet sales revenues as projected by Jupiter Communications, the United States could gain over $1 billion in revenues by the year 2001. In 2002, the United States could garner almost $2 billion in tax revenue.

As explained above, imports and exports would also be affected. Exports from the United States would have the 4.765% sales tax rate levied in addition to the 3% infrastructure fee. Two examples are shown in Table1-1. Assume that a foreigner purchases a good that has a listing price of $100 from a company in California. This good would be subject to the 4.765% tax rate. An infrastructure fee of 3% of the list price of the good would also be charged to the foreigner. The total cost to the foreigner is $107.77 with $4.77 of that cost being sales tax revenue to the federal government. If the list price was $200, the federal government receives $9.53 in sales tax.

Any import to the United States would not be charged the 4.765% sales tax rate since the good was not purchased within the U.S. borders. Only the 3% infrastructure fee to cover the shipping and transportation costs would be levied. This fee would add $3.00 to every $100 worth of goods purchased. On a $100 purchase by a domestic consumer from a firm in Germany, $3.00 would be charged bringing the cost to $103.00 to the domestic consumer.

TABLE 1-1

E-Commerce national sales tax

Year	Sales Tax Rate	Estimated sales revenues*	Percent Increase from previous	Sales Tax Revenue
1998	4.765%	$7,100,000,000	0%	$338,315,000.00
1999	4.765%	$12,000,000,000	69%	$571,800,000.00
2000	4.765%	$18,400,000,000	53%	$876,760,000.00
2001	4.765%	$27,300,000,000	48%	$1,300,845,000.00
2002	4.765%	$41,100,000,000	51%	$1,958,415,000.00

*Source: Jupiter Communications

Imports/Exports with Infrastructure Fee of 3%

Export from United States

List Price of good	Federal Sales Tax Rate	Infrastructure Fee	Final Cost to Foreign Consumer	Tax Revenue
$100	4.765%	3%	$107.77	$4.77
$200	4.765%	3%	$215.53	$9.53

Import to United States

List Price of good	Infrastructure Fee	Final Cost to US Consumer
$100	3%	$103.00
$200	3%	$206.00

While Table 1-1 shows the added revenues for the country as a whole, we must remember that we are considering the best policy recommendation for California. When you look at Table 1-2 you will see that California would be a net loser with a national sales tax versus being able to implement their current sales tax rate on e-commerce.

TABLE 1-2

Tax Revenue Collected by California at 7.25% and other Rates

California
(all figures in $ Billions)

Year	CA On-line Sales	Taxes Collected at Current Rate: 7.25%	Taxes Collected at 4.77%	Deviation from Current Rate
2000	$ 2.32	*0.168*	0.111	-0.057
2001	3.44	*0.249*	0.164	-0.085
2002	5.18	*0.376*	0.247	-0.129
2003	7.77	*0.563*	0.371	-0.192
Total	$ 18.71	1.356	0.893	-0.463

Assessing the Alternative

The standards for measuring the effectiveness of the national sales tax policy are consistent with the principles of equality, liberty, and efficiency. Economic equality, understood as the necessity for equitable taxation, requires consistency in taxation methods. Because the federal government will collect taxes, it ensures that all 50 states will be justly compensated with the revenue owed to that particular state. In addition, it will curb the likelihood of states creating individual tax rates or discriminatory tax rates levied against "particular goods." This would be consistent with the existing Internet Tax Freedom Act, which includes a non-discriminatory clause. Naturally, some inequalities will inevitably arise. For example, a customer purchasing a good from a state with a lower tax rate than the national average will be paying more under this system of uniform taxation than if they had purchased the good via more traditional means.

Having discussed issues of equality, it is important to assess whether this policy conforms to ideas of liberty. With federal imposition of taxes, the rights of consumers and vendors from state and local entities will be protected to a greater degree. The federal government will ensure that state officials will not mismanage funds in order to protect the sole interests of that particular state, or use e-commerce as a "cash cow." Because the success of small businesses is vital for a thriving economy, instituting a strict yet constructive tax structure will encourage the growth of small businesses. It should be noted, however, that various cities might perceive the policy set forth as a limitation on their liberty, because it requires sole reliance on the state in remitting taxation funds owed to the city. Establishing a uniform sales tax presupposes that state and local entities will be deprived of their right to determine the amount received and how the funds will be disbursed.

Having addressed both issues of equality and liberty, we shift now to efficiency. Establishing a uniform national sales tax rate will create greater efficiency in tax collection by creating a tax system for only three categories. By maintaining uniformity the point of sale is automatically definable. States will be able to regain revenues lost through the use-tax system, which would otherwise be impossible to collect. The inefficiencies of the national sales tax policy are in placing the primary responsibility under the auspices of the federal government. There is bound to be considerable administrative drain on revenues as they are collected at the federal level and make their way to the lower levels of government. Ultimately, this fact, combined with the lost revenues that California faces by the enactment of a tax rate that is lower than its own (see Chart 3), prevent this proposal from being in the best interest of the state of California.

Alternative 2—FREEDOM OF STATES

The "Freedom of States" policy would give taxing authority and regulation of e-commerce to the individual states. Each state would be able to adopt whatever policies it deemed appropriate, at whatever rates it felt were sufficient. This is a scenario much like what exists with sales taxes in the states currently. This might seem a natural fit for e-commerce taxation because it is a tax on consumption, very similar to sales taxes. Although in general we are in favor of policies that grant the most localized control, the unique nature of e-commerce makes this a problematic approach.

In all research done on this subject there were two principles that were demanded by consumers, private industry, and government—uniformity and non-duplicity. The very fact that 50 states could enact 50 different tax policies with 50 different definitions of nexus violates both of these tenets. It is quite likely that a consumer living in California purchasing a good in Nevada with a server based in Texas might have to pay taxes on three different occasions. States would enact policies that maximized their advantages. States with low populations, who attract businesses with incentives, would define nexus by the presence of the seller. High population states with low concentration of technology companies would define nexus by the address of the consumer. The fact that such large volumes of transactions would occur across state lines means duplication of tax collection and confusion. This situation violates the criteria for our analysis.

On the surface, this policy might benefit California and its liberty. The state would be able to collect taxes through its existing sales tax structure and would have the freedom to set whatever rates and policies it deemed were in its best interests. However, California would likely see a drain in both its businesses and its transactions base. Consumers and businesses will go to the states that can afford to minimize taxes on electronic commerce. As a greater proportion of commerce is conducted electronically, the "Freedom of States" policy would place California, with its high infrastructure costs and high population, at a competitive disadvantage.

Recommendation For California—SALES TAX EXTENSION POLICY

To reiterate, it can be assumed that the current tax moratorium will not be extended ad infinitum. Therefore, when the moratorium finally ends, there will be a need for e-commerce tax policy that promotes equity in its effects upon the concerned parties, efficiency in its long term application and initial implementation, and liberty of economic choices to the extent that they are upheld in the current system of taxation. The alternative that the MPP Consulting Group recommends for the State of California accomplishes these objectives.

The Internet creates a significant method of purchasing that defies traditional means of determining tax collection. In order to accommodate this new mode of trade, we propose California take the lead in supporting a federally regulated tax policy allowing states to collect taxes on all goods, regardless of the method of transaction. The strategy behind this federal basis of regulation is to avoid the dilemma of double taxation that threatens when different states have not only different rates of taxation, but completely different policies in general. Our recommendation is to persuade Congress to allow each state to tax its constituency on goods that are bought and sold on the Internet. This can be achieved by simplifying the troublesome nexus question to a standard sales tax policy. This sales tax policy would allocate taxes to states based on the consumer's billing address. In redefining the nexus from the traditional physical presence requirement, Congress can free the states to collect taxes based on a standard sales tax rate. This is efficient, equal, and protects liberty.

The federal regulation will need to be initiated in the form of congressional legislation for all non-traditional commerce. Such a bill will include the proposed sales tax laws for e-commerce, catalog sales, television shopping, and all other taxable commerce. This legislation ensures that all commerce falls under one umbrella of taxation, thus promoting equity of commercial enterprises regardless of the mode of transaction. The State of California will not have to fear the possibility of placing itself at a unique competitive disadvantage with other states due to vastly differing e-commerce tax policies. The broad encapsulation of the federal guidelines will help California continue to thrive in the new economy in spite of the potential detriment of sales tax on Internet commerce.

How the Policy Can be Implemented

California can use the current sales tax system as the mode to collect Internet taxes. Implicit in this model is that nexus will occur at point of purchase. Taxes will be collected at the current 7.25% level by the Board of Equalization. The system will involve the following elements:

I. **Enforcement:** The State of California, through the Board of Equalization, will expand its current taxation power to include a jurisdiction on all tangible goods purchased. The Internet taxation will be collected by businesses, as in the current system, and eligibility will be based on the billing address of the resident.

II. **Enforcement under the Board of Equalization consistent with current tax laws:** The Board of Equalization will be empowered to collect taxes imposed on California residents from non-California companies through the perpetuation of the current Reciprocal Tax Collection Agreement. Forty-five states, all those with sales tax, presently have statutes which make foreign companies (anyone with a nexus outside the state) liable for state taxes incurred outside of its jurisdiction. This agreement will simply be extended to Internet commerce. It will produce a uniform collection process, even in the midst of a variable state Internet taxation, in two ways:

A. States will be empowered to collect revenue owed to them from companies operating outside of their boundaries.
B. The mass fluctuation of companies to "tax haven" states will be remedied. Through reciprocal agreements, companies are liable for taxation wherever they operate in the United States.

I. **Nexus:** The Supreme Court has ruled that states have taxing jurisdiction only over those out of state sellers of tangible personal property who have nexus (sufficient physical contact) within the state. However, recent State Supreme Court rulings have shown increasing state authority to define Internet commerce nexus. In this vein, California will redefine nexus as the purchaser's billing address.

II. **Relationship between state and local:** Given the present sales tax model used, this relationship will remain unchanged. The state will continue to get 6.25% of all sales tax on all tangible goods and cities and counties will receive 1%.

III. **Taxable Items:** Sales tax will be levied only on those tangible goods which are taxable under current regulations, if bought at retail establishments that are purchased electronically.

IV. **Non-taxable items:**

A. *Intangible goods:* The state of California will not tax intangible goods due to the following factors:

  a. The Supreme Court has ruled that only tangible goods are taxable.
  b. Under California Bill 1502(f)(1) intangible goods, including software, are non-taxable.

A. *Access:* In keeping with California Bill 1502(f)(1), Internet access will not be taxed in any form.

Revenue Generation

In order to predict the revenues that would be generated by this policy, we conducted a sensitivity analysis to determine the range of estimated revenues for California under this policy. The results are seen in Table 2. The analysis was conducted with various levels of elasticity and current percentages of taxed items, and encompasses the high and low estimates for revenue generation.

TABLE 2 (See Appendix 1 for detailed analysis)

Expected E-commerce Sales Tax Revenues for the years 2002 - 2003 (for California)
(Figures reported in Millions of dollars)

	Lowest Range	Most Likely Range	Highest Range
At a 7.25% tax rate	**$530 - $770**	**$640 - $930**	**$890 - $1,300**
	30% Elasticity	20% Elasticity	0% Elasticity
	15% Already Taxed	10% Already Taxed	0% Already Taxed
At a 4.765% tax rate	**$350 - $510**	**$420 - $610**	**$590 - $850**
Appendix 1 Source	Table 4	Table 3	Table 5

Additionally, the Table demonstrates the lower levels of revenue to California under a national sales tax policy implemented at the average rate of the 50 states. As this analysis shows, in the most likely range California stands to gain between six hundred and nine hundred million dollars with a 7.25% rate, more than two-hundred million dollars more than if the rate were set at the average of 4.77%.

Policy Evaluation

This proposal is selected over the other alternatives because it demonstrates superior results in our analysis of efficiency, equality, and liberty. The upcoming section examines the exact meaning of these three criteria, and their effects within the framework of the key players involved—the State of California, consumers, and private industry. All benefit from this policy's implementation.

LIBERTY

A policy encourages liberty by allowing the most choice and sovereignty for the individuals, groups, and institution that the policy affects.

STATE OF CALIFORNIA

The most important gain in the area of liberty that this policy initiates benefits the state of California. California government regains the sovereignty to dictate its own commercial regulations and e-commerce taxation policies, rather than being restrained by the moratorium of the U.S. Congress. It is only restricted by the uniform definition of nexus as established by Congress, which is an ultimately benefit. Regardless of which pro-active policy the state chooses to adopt, the very freedom to act, rather than being upheld by the Congressional moratorium, expands the liberty that the state enjoys.

CONSUMER

Virtually any sales tax hinders the liberty of consumers. This recommendation is no exception to that rule. However, the consumers' liberty is not compromised any more than the current system has compromised it in the traditional venues of commercial transaction. It merely maintains consistency of taxation, rather than extending the encroachment on the economic liberty of the consumers and private sector alike by hiking the sales tax rates above their current 7.25% level.

PRIVATE INDUSTRY

Private industry does not find its economic liberty directly deterred by the implementation of the proposed policy. Critics of this proposal might raise the point that businesses no longer have the opportunity to move their operations to other states in order to avoid the sales tax problem due to the federal guidelines of this policy. However, businesses will still have the option to relocate into the states which have no sales tax, leaving them virtually unaffected by the continuation of sales tax rates into e-commerce transactions.

EFFICIENCY

A policy is efficient if it achieves its objectives of the greatest benefit with the least effort and expense.

STATE OF CALIFORNIA

The State of California's tax collection becomes a far easier task with the advent of this automatic technology. Plus, the timeliness of the tax collection potentially gives a greater sense of flexibility to the state budget each year. Rather than waiting for quarterly or annual statements on tax revenues, there will be an almost real-time account of what is coming in, and what in turn can go out to the tax payers. There will be less need to use tax dollars to support the Board of Equalization's payroll as the efficiency-stimulating effects of the automated system take effect. This economic flexibility could help California respond to immediate needs in a more timely or substantive fashion than under the system held in the status quo.

CONSUMERS

One of the most important facets of the recommended policy is its easy sell to consumers, or more aptly stated in political terms, the voters. The consumers are able to bypass most of the frustrating confusion that characterizes any change in the tax code. The current sales tax rate is merely applied to the Internet's purchasing venue in the same fashion that it is applied to stores in that state. Furthermore, the basic elimination of the potentially confusing question of nexus determination among the fifty states, one district, and handful of territories, as well as the international arena, makes this recommendation all the more efficient for the consumers. In addition, the billing address point of taxation helps California consumers even more. The tax revenues that they generate go to Sacramento's coffers rather than to those of the state where the purchased good is shipped from. Californians receive the infrastructure investment and social services that come from their e-commerce transactions.

PRIVATE INDUSTRY

The segment of California's private industry that is involved in Internet sales tax will inevitably oppose the implementation of any sort of sales tax. However, the stark reality is that e-commerce will not operate in a totally tax-free world forever. Therefore, in an attempt to make the best of the inevitable, the private sector will benefit from quicker and easier intrastate tax reporting for California businesses.

Rather than sifting through fifty separate stacks of paper work for tax collection, as the status quo requires, businesses will be able to take advantage of the automatic transaction recording software. This computer application will report the transaction, the account numbers of the purchaser and the business, and process the tax statement for the business' quarterly payments. The system will even be able to conduct automatic transfers of funds from the banking institution of the business and the state's tax collection agency, the Board of Equalization. The logistics behind this proposal actually simplify more than just e-commerce. Non-Internet companies will be able to take advantage of such computer applications. While the traditional tax collection system would be maintained for the stray businesses that do not use computerized bookkeeping systems, the private sector as a whole will discover a much more efficient flow in its tax reporting and payment.

EQUALITY

A policy is deemed equal if all individuals and groups are affected the same way.

STATE OF CALIFORNIA

The very fact that federal guidelines define the nexus, the symmetry of sales tax rates, and the term of the moratorium makes this recommendation inherently equal for the state of California with regard to other states. Some states may still have a lower overall sales tax, but there will not be a discrepancy of rates between e-commerce and traditional commercial transactions within each given state. Thus, strangely positioned and unequal economic advantages from one state to the next is avoided. Sacramento will be operating on the same playing field as in years past, which is no less level than before.

CONSUMER

There is a major discrepancy in the equality of the current sales tax system. E-commerce shoppers are not subject to the same sales taxes that traditional brick and mortar store shoppers are. Therefore, the most obvious way to establish equality in this policy proposal was either to eliminate sales taxes from both of these venues or to equalize the rates paid at both venues. Working from political reality this proposal seeks equality for consumers with an equal rate in both venues.

Goods available for sale on the Internet are equal to goods available anywhere else with the application of this equal sales tax. A tax-free Internet gives economic benefits to those who have computers and Internet access. This policy recommendation eliminates the de facto bias against consumers who are unable to access Internet shopping. This is a major stride toward increased equality for consumers in that many of the very people who are most pinched by taxes will no longer be left taxed in the only commercial venue to which they had access.

PRIVATE INDUSTRY

The current standards for in-state physical presence with regard to commerce and taxation would be overturned in this policy recommendation. Therefore, artificial geographical preferences would be effectively eliminated upon its implementation. The economic playing field is made more equal as a result of such implementation. The comprehensive nature of this recommendation will help California businesses maintain equality with those of other states. Since the sales tax of each state would be applied to e-commerce in that state, the private sector will not find itself battling inequality resulting from the varying policies of each state. Finally, the cries of the brick and mortar, non-Internet private sector, that e-companies are being favored over in the present system of taxation, will subsist. Equality of taxation will prevail in this model, particularly in the case of businesses within the state lines.

The Global Picture

It is worthwhile to note that the international ramifications of the recommended policy are very significant, given the global nature of the Internet and e-commerce. The globalization factor that the Internet raises makes the residence-based sales tax an ideal circumstance for effective negotiation of the international commerce question. Just as the state of California should lead the way in shaping e-commerce policy for the U.S., the U.S. should in turn continue to lead the world in shaping its collective policies on the Internet and e-commerce as well. E-commerce should be given particular attention from international trade organizations and in U.S. international trade agreements, as its rapidly changing environment poses an all new set of challenges for solid economic and taxation policy.

Recommendation on General Trends in Taxation

As was demonstrated earlier, the implementation of a tax on electronic commerce will increase the tax revenue for California drastically. Consequently, the state should look to restructure its taxing scheme to adapt to the changing reality of its revenue stream. Should California adhere to our recommendation and implement a sales tax on electronic commerce, the state needs to consider its competitive environment

At present, California taxes capital –corporate income, capital gains, and interest – at a substantially higher rate than the national average. Many economists refer to capital as the "seed corn" of the economy and downward pressure on rates of taxation on capital will help retain businesses and grow California's economy. Additionally, as the leader in the technology industry, many of the jobs created by the growth in the Internet will be created in California. Since many of the jobs that are created will be high paying jobs, income tax revenues per capita should rise. This expanding job base and growing tax base should create downward pressure on income tax rates.

In the new economy, it will be imperative that modes of taxation are grounded in the principles of efficiency, liberty and equality. California should find that taxation on consumption of tangible goods will be in the state's best interests, and that high levels of taxation on capital and income may very well hamper growth and be difficult to enforce. It is therefore recommend that the state move to lower taxes in these two areas while it places the sales tax structure on e-commerce.

Implementation Strategy

At the intersection of taxation and electronic commerce is an obscure, nuanced and largely uninvestigated public policy debate. The issue gained some generic public exposure in 1997 and 1998 – largely due to the recently enacted, "Internet Tax Freedom Act," (IFTA) sponsored by Rep. Chris Cox, R-Ca., and Sen. Ron Wyden, D-Ore. However, for the most part, our base of information on the impact of electronic commerce is underdeveloped and under-circulated in all but the most circumscribed policy networks.

The relatively small community of interest for electronic tax policy questions – so far limited largely to a few legislative leaders in Congress and the States, local government officials, and industry associations – makes the job of implementing our public policy recommendations both easier and more difficult in certain respects. The task is made easier because we have an easily definable universe in which to work, and all our key players have clear ideological approaches to the issues. The task is harder because the topic is so difficult to communicate in layman's terms, and because relatively few persons in the general public have strong opinions about -- or experience with -- this topic.

Therefore, to support implementation of these public policy recommendations several project participants were assigned various information distribution and persuasion duties. Known as the Communications Team, the purpose of this group is to drive the enactment of the policy recommendations through strategic marketing, government relations and media relations.

Marketing

Duties include report production and distribution, presentation event logistics, polls and interest group surveys

Government Relations

Responsible for building a coalition capable of driving legislative action towards adoption of policy recommendations, enlisting support for key legislative leaders and government officials, drafting necessary legislation, monitoring floor activity, and countering legislative opposition

Press Relations

Tasks include developing coalition message, producing key written materials, organizing the publication of opinion-editorials, convening press conferences and on-line policy chats, maintaining coalition Web pages, monitoring the media for relevant stories, and overseeing the uniform distribution of message throughout the coalition

Communications Strategy

PHASE ONE – PRODUCING THE RECOMMENDATIONS

After the policy team completed the research and determined the public policy recommendations, the real work of implementation began. In the interest of product quality and objectivity, we decided to dissuade early publicity, choosing instead to let the policy team do their work without outside interruption.

The report and recommendations saw first public airing at a presentation before the immediate university community. At this event our recommendations faced a "murder board," or group of electronic commerce and tax policy experts from a wide variety of backgrounds. These panelists were given advance copies of our report and asked to comment on our recommendations. The purpose of this review was to – in essence – test market our product before our community of interest to define strengths and weaknesses.

After our "murder board," the paper and recommendations went to university leaders for circulation and further comment. The "newness" of the issues – and the relative lack of solidly researched scholarly opinion on electronic commerce – requires that we take extra care before publicly releasing a finished document with associated policy recommendations.

PHASE TWO - BUILDING THE COALITION

Our "client" for these policy recommendations—recalling the introduction—is the State of California and the Governor of California, Gray Davis. In February 1999, Davis was reported by news sources as a supporter of the Internet taxation moratorium—but Davis had also expressed concerns about the long-term sustainability of his position. In light of Davis's ambivalence, we decided to begin building our coalition in the Legislature and private sector. We believed Davis could be convinced of the correctness of our recommendations, but that initial support would likely come from leaders in the legislature until the airtight case was made.

In 1998, the state legislature had overwhelmingly passed AB 1614, by Assemblymember Ted Lempert, D- Palo Alto. Lempert's bill mirrored the federal rules enacted by IFTA, establishing a three-year state moratorium. However, the initial principles stated by the bipartisan, bicameral, California Legislative Internet Caucus, include language indicating an openness to appropriate taxation. Further, in news accounts some digital industry reps have appeared accepting of taxation – at issue are questions of rates and timing. For their part, state and local government associations have been outspoken tax moratorium opponents. We think they would readily join a pro-tax coalition, though our timing recommendations might affect support from this key group.

All key players on this issue seem to accept the taxation of electronic commerce as inevitable. The critical issue is the design of a balanced, well-thought-out system – exactly what our recommendations facilitate. Obvious opponents, however, are anti-tax lobbyists, and possibly state Republican legislators – who stand to gain from painting Democrats with the traditional "tax-and-spend" message at the next election. For this reason, it will be important to pass our policy recommendations early in an off -year, and before electronic commerce becomes commonplace enough to affect large portions of the population.

PHASE THREE – SPREADING THE WORD

Once the core coalition has been established, we will rely on the network of press teams and public leadership for communication of our policy position. Prior to introduction of legislation, we would circulate opinion-editorials and fact sheets throughout the coalition. Coalition members would be directed to target opinion-editorials at newspapers with statewide readership, and newspapers in the legislative districts of fence-sitting or opposing legislators. Our specific recommendations would not be mentioned, but the principles leading to our policy decisions would be stressed.

At the introduction of our bill(s), we would hold a press conference featuring our most prominent coalition members in which we would outline our specific policy proposals. We would point the public and press to our Web page – complete with links to supporting documents, press releases and coalition member contact information. During the legislative process, opinion-editorial distribution would continue at a higher intensity level, particularly during critical legislative junctures, and we would assist coalition members with the preparation of floor and other speeches. To support our champions in the legislature, we would publicly praise their accomplishments in their districts and to their colleagues, with advertisements in various publications and mention in all press contacts. Our goal is implementation – however long it takes. If we are not successful in enacting our policy recommendations at first try, we will analyze our message and delivery – benchmarking success, defining points of failure and negotiating where necessary. Then, we will return to the fray.

Message – Two for One Special

Framing the issue is the most important part of any policy debate—our keyword is "balance." Our policy recommendations set the tone for business-government cooperation in the new economy by establishing a working balance between the legitimate—but seemingly divergent—requirements of digital markets and 21st century government. Savvy business people understand that governments need resources. Smart governments do not strangle markets. Together, business and government build the strong communities that make the American dream possible. Together, clear-sighted business and government balance their competing interests and build sustainable neighborhoods—real places with real people, real needs, and appropriate compromise.

Conclusion

As we mentioned in the introduction to this report, our hope is that this is one of the first volleys in the long match that will be the debate over taxation of electronic commerce. Policy makers and industry leaders can not afford to bury their heads in the sand known as the tax moratorium for too much longer. Soon enough, policy formulation will have to occur within the state and across the nation. When it does, policy makers will be wise to heed the principles of equality, liberty, and efficiency, and to recognize the enormity of what is at stake. In such understanding, the MPP Consulting recommendations will be a very appropriate and attractive policy option.

APPENDIX 1

Tables 3-5 are all related to the expected amount of sales tax generated for California resulting from taxation of e-commerce. Table 3 figures represent the most likely case for California Revenue from taxing e-commerce. Important factors in Table 3 that differ from Tables 4 & 5 are the price-elasticity and percentage of Internet sales already taxed under current laws. Those numbers are 20% and 10% respectively for Table 3. Table 4 is the low-end estimate for e-commerce sales tax revenues in California. Within this table, a price-elasticity figure of 30% and a level of already taxed e-commerce goods of 15% were used in order to reflect the pressures which are present that may cause revenues to be lower than expected. Table 5, which is the high end estimate, omits the effects of elasticity and does not account for sales that are currently taxed. This was done in order to create a benchmark for the highest expected outcome.

Within each of Tables 3-5 is a comparison of two factors. One of those is the projected sales made over the Internet. Part B of Tables 3-5 includes a higher forecasted sales figure as provided by Forrester Research for comparison to sales figures in part A, which encompasses sales figures generated by Jupiter Communications. The second factor used for comparison is a lower tax rate of 4.765%, the average rate among the 50 states.

Table 6 has been included as a reference guide to see the forecasted sales numbers of Jupiter Communications. The year 2003 was forecasted by our group using a 50% growth rate closely approximating the average of the previous several years used by Jupiter.

APPENDIX 2

MPP CONSULTING GROUP

Pete Montgomery – President

Policy Team	Communications Team	Quantitative Analysis
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