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Hearing on H.R. 1860, the “Digital Goods and Services Tax Fairness Act of 2011”

Before the
Subcommittee on Courts, Commercial and Administrative Law
Committee on the Judiciary
U.S. House of Representatives

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Chairman Coble, Ranking Member Cohen and members of the subcommittee, I appreciate the opportunity to discuss the importance of creating a fair tax system that eliminates multiple and discriminatory taxes on digital goods and services. I commend you for addressing this important issue, and I want to applaud Chairman Smith and Ranking Member Cohen for bringing this measure forward.

I am the president and founder of the Information Technology and Innovation Foundation (ITIF). ITIF is a nonpartisan research and educational institute whose mission is to formulate and promote public policies to advance technological innovation and productivity. Recognizing the vital role of technology in ensuring American prosperity, ITIF focuses on innovation, productivity, and digital economy issues.

Across the nation, state and local governments are increasingly imposing taxes on the sale of digital goods and services. Unless Congress creates a national framework to ensure consistency and fairness in the tax code, there is a risk that digital goods purchased and downloaded in one state will be taxed at higher rates than related physical goods or that digital goods will be taxed multiple times by different tax jurisdictions, such as the state government of the buyer, the state government of the seller, and the local government tax authorities. With thousands of different tax jurisdictions in the United States—each with their own definitions and tax rates—buyers and sellers face an increasingly complex and unfair tax system.

While states and localities may look to discriminatory or duplicative taxes on digital content as a way to create short-term gains in tax revenue, these policies discourage investment in the digital economy, increase the cost of doing business online, lower national productivity, and ultimately hurt businesses and consumers. Congress is wise to consider legislation such as the Digital Goods and Services Tax Fairness Act of 2011 that would eliminate unfair and discriminatory regulations that would tax digital goods differently than physical goods. Such legislation would recognize the importance of digital goods and services to the national economy and help ensure a fair, consistent and non-discriminatory tax system.

Government Should Encourage, Not Discourage, the Sale of Digital Goods and Services

Digital goods and services account for an important, and growing, role in the U.S. economy. Digital goods are goods that are delivered electronically; digital services are services provided electronically, including access to digital goods. This testimony is about taxation of digital goods and services, such as music tracks downloaded off of iTunes, not physical goods and services purchased online, such as CDs ordered off of Amazon.com.

The sale of digital goods, such as downloadable software, music, movies, games, and books, continues to increase. In 2010, for example, U.S. online retailers sold 1.17 billion digital music tracks totaling \$1.5 billion in revenue. Similarly, e-book sales in the United States reached \$1 billion and are expected to almost triple by 2015.¹ Amazon carries almost 1 million titles available for download on its Kindle e-book reader and has found that when it carries both a physical and digital edition of a book, it sells six Kindle books for every ten physical books.² On mobile devices, U.S. consumers downloaded almost 1.6 billion free and paid apps in 2010 generating approximately \$1.6 billion in paid app revenue.³

The growing digital goods and services economy has significant benefits for the United States. Dematerialization—using bits instead of atoms—allows digital activities to be much less energy-intensive and have a smaller impact on the environment than creating, moving, and storing physical goods. For example, the CO₂ emissions associated with purchasing a CD from a retail store is approximately 3200g, compared to only 400g for an album purchased and downloaded online.⁴ Downloading music or movies instead of purchasing them at a store eliminates many energy consuming activities such as driving to a store, shipping from the wholesaler to the retailer, and producing the physical media and media cases.

In addition, workers and consumers are benefiting from the increasingly digital U.S. economy. Among the 100 most popular websites in 2009, online-only companies comprised the overwhelming majority: 94 percent of the top web sites were for online-only companies versus only 6 percent were for “brick-and-clicks”.⁵ Most of these websites were for search, social networking, and entertainment sites. These sites receive billions of dollars in online advertising revenue and employ hundreds of thousands of employees. For example, in 2007, the top five search engines (Google, Yahoo!, AOL, Microsoft, and Ask.com) together employed close to

40,000 individuals and generated roughly \$30 billion in revenue.⁶ Yet employment figures do not fully capture the full value of non-retail Internet-only companies to the economy. These firms tend to have high revenue-to-employee ratios, meaning that they are able to create a disproportionate amount of value from their employees. For example, in 2007, the top five search engines generated \$790,000 worth of revenue per employee, far exceeding the revenue per employee ratios of the average firm.⁷

Digital content and services also cost less for consumers. Producing and distributing digital content can cost less for sellers, and these savings are passed on to consumers. For example, for books produced in digital form rather than in print, publishers can save by eliminating printing, storage, and shipping costs and reducing their design and marketing costs. Consumers have seen big savings: the average price of a hardback book is approximately \$26 compared to around \$13 for an e-book on the iPad or Kindle.⁸ Similarly consumers save on the purchase of digital music: the average price for a digital album is \$9.99 for a digital album on iTunes versus around \$14 for a CD.⁹ Since digital content costs less than the physical equivalent, some state and local governments may be tempted to impose higher taxes on these items.

Congress Should Not Let the Narrow Interests of States Outweigh the Broad Interests of the Nation

Across the nation, most states are facing a budget crisis as the recession has caused a steep decline in state revenue. Forty-eight of the fifty states faced a budget shortfall cumulatively totaling \$196 billion in 2010, or approximately 29 percent of overall state budgets.¹⁰ Not surprisingly, in the face of such fiscal woes, states are searching for new opportunities to increase state revenue and many have set their sights on the taxation of digital goods and services.

As shown in Figure 1, more than 20 states currently collect taxes on digital goods. These states have created these taxes either by statute or administrative changes to the tax code. Of these, 13 states have enacted sales tax statutes specifically to tax digital goods or services, including: Indiana, Kentucky, Mississippi, Nebraska, New Jersey, North Carolina, South Dakota, Tennessee, Utah, Vermont, Washington, Wisconsin, and Wyoming.¹¹ At least four states—Minnesota, North Dakota, Ohio and Oklahoma—have made it clear that they do not subject intangible items, such as digital goods and services, to sales tax in their tax codes.¹²

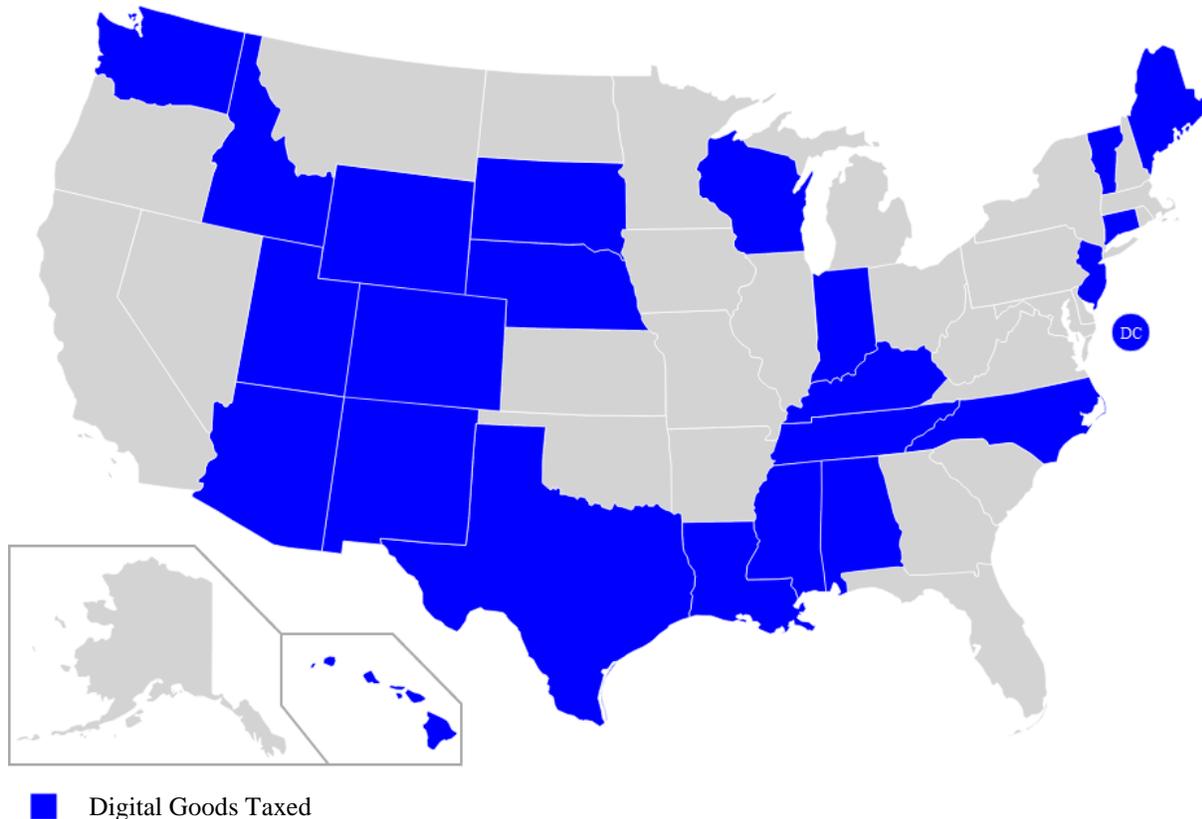


Figure 1: States Taxing Digital Goods, 2010

States and local governments that choose to tax digital content should not see this as a potential windfall for their tax bases. Tax rates on digital content should be equal to taxes on physical goods sales. State and local governments may argue that tax rates should be *higher* than on non-digital goods because digital goods cost less. Or they might argue that without a higher tax rate states might lose revenue. But this logic is fundamentally flawed. As agricultural productivity soared over the last fifty years and food prices have declined, states did not assess higher taxes on food in order to make up for lower tax revenues on food. If tax policy penalizes high-productivity industries, overall productivity and U.S. standards of living will increase more slowly.

Indeed, taxing digital goods increases the cost of online commerce and decreases the value of the Internet economy in the United States. The Internet economy is currently estimated to contribute approximately \$300 billion annually, or around 2 percent of GDP.¹³ States could impose discriminatory taxes because there is an asymmetrical distribution between the costs and benefits of taxes on digital goods. When states tax digital goods, they receive all of the financial benefit of the tax, but, because of network externalities, the nation as a whole suffers the net social cost of more expensive digital content and services.

Network externalities are the effects on a user of a product or service of others using the same or compatible products or services. Positive network externalities exist if the benefits are an increasing function of the number of other users. The classic example is telephone service, which becomes more valuable to a user if more people are connected. Indeed, telephone network externalities have long been recognized and have been a major rationale behind universal service policies. Similar network externalities exist with digital goods and services. In this case, as taxes increase the cost of digital goods and services, these price increases will lower demand and thus lower the supply of digital goods available to consumers and raise the price. It lowers the supply of digital goods because higher prices lower consumption which in turn lowers digital goods industry revenues. It raises prices because digital goods are characterized by extremely low marginal costs (e.g., the costs of providing one additional copy to a consumer). With fewer consumers, average costs must be higher to cover fixed costs of producing the product.

It is important to enact this legislation now while these state tax statutes are relatively nascent, as once states begin to create discriminatory or multiple tax laws for digital goods, Congress will find the situation increasingly difficult to remedy. For example, states may try to game the system by creating discriminatory or multiple tax laws that will be grandfathered in, giving them special tax advantages. We have seen similar problems in the past with state tax laws on Internet access.¹⁴

Policymakers Should Promote a Fair and Non-Discriminatory Tax System

Policymakers should avoid erecting unfair or unreasonable barriers to the growth of the Internet and the digital economy. The Digital Goods and Services Tax Fairness Act of 2011 would prevent states and local governments from jeopardizing our national interests in promoting a healthy digital economy to create a short-term boost in state and local tax revenue. The legislation does not compromise states' rights. States are still free to tax digital goods under the proposed legislation; however, state and local tax jurisdictions would adhere to a common framework which would prevent them from imposing multiple or discriminatory taxes on digital goods.

First, the proposed legislation would clarify which jurisdiction has the right to tax digital goods and services. Without clear guidelines, multiple tax authorities can impose taxes on a single transaction. Imagine the following scenario: a traveler from Houston downloads a movie in the Denver airport from Amazon.com, a company headquartered in Seattle. In this example, at least three states—Texas Colorado and Washington—all could claim that they have the right to tax this transaction. Resolving this dilemma fairly and consistently requires a national framework for “sourcing” the sale of digital goods and services (i.e. determining where the sale is taxable). The proposed legislation would clarify that a particular transaction is attributable only to a single physical address (and corresponding tax authority).

The Digital Goods and Services Tax Fairness Act does not address whether an out-of-state seller is required to collect sales tax. In 1992, the U.S. Supreme Court ruled in *Quill Corp. v. North Dakota* that states cannot require a retailer to collect sales and use taxes for in-state customers unless the retailer has “nexus”, e.g., a physical presence in their state.¹⁵ The Supreme Court reasoned that with over 6,000 different tax jurisdictions in the United States, taxes on out-of-state businesses “might unduly burden interstate commerce.”¹⁶ State and local governments would like to require out-of-state sellers to collect and remit sales taxes on e-commerce transactions (of both physical and digital goods). In an effort to gain Congressional approval for taxing out-of-state e-commerce sales, states have made a concerted effort to develop a streamlined taxing system. In 1998, the National Governors Association adopted a policy that expresses the willingness of states to simplify their sales taxes with the expectation that, in exchange, the federal government would provide these states with the authority to require larger out-of-state sellers, including Internet vendors, to collect sales taxes for the states. In November 2002, 44 states and the District of Columbia approved the Streamlined Sales and Use Tax Agreement (SSUTA), a framework for a simplified state sales and use tax system. The SSUTA includes uniform tax definitions, uniform and simpler exemption administration, rate simplification, state-level administration of all sales taxes, and uniform sourcing (e.g., where the sale is taxable).¹⁷ As of May 10, 2010, twenty-three states—comprising 33 percent of the country’s population—have passed SSUTA legislation and legislation was pending in at least 10 other states.¹⁸ Congress is correct to address the issue of nexus in separate legislation.¹⁹

Second, the proposed legislation would prohibit states from imposing discriminatory taxes on digital goods and services. This provision is needed to ensure that states do not impose protectionist taxes that limit e-commerce by unfairly raising the price of digital goods and services. Imposing higher taxes on digital goods—which are often consumed from out-of-state sellers—distorts the market by encouraging consumers to purchase physical goods (which are often consumed from in-state sellers and normally costs more than digital goods) instead of digital goods. This fear is not unwarranted. All states at one point or another have given in to pressure from brick-and-mortar businesses and have passed legislative or regulatory provisions that limit the right of consumers to purchase certain products and services online. For example, it is illegal in all 50 states for a consumer to purchase a car directly from the manufacturer, including over the Internet. States have also imposed restrictions on the ability of consumers to purchase contact lenses online. Such laws have been put in places in many states in response to the pressures from many in-state industries. The goal of public policy should not be to protect or insulate any business or industry from changes in the marketplace. Public policy should certainly focus on ensuring that individuals who lose their jobs have access to skills training and other assistance to transition into new jobs, but it should not try to erect barriers to protect existing businesses that may lose out to digital competition.

Conclusion

The Digital Goods and Services Tax Fairness Act of 2011 would set a national framework to ensure fair and equitable taxation of digital content by creating consistent rules for determining which jurisdiction has taxation authority, disallowing multiple and discriminatory taxes, creating consistent definitions, and ensuring that other taxes, such as those applied to telecommunications services, cannot be inappropriately extended to cover digital goods and services. By creating a fairer and more consistent tax system for digital goods, this legislation will help promote and sustain our growing digital economy.

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