Interstate Commerce Initiative

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Issue Brief

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BY ANDREW WILFORD

Post-*Wayfair* Sales Tax Laws No Budgetary Panacea for States

In the aftermath of the Supreme Court's decision in *South Dakota v. Wayfair*, which permitted states to assess tax liability on the basis of economic nexus with the state rather than physical nexus like a store location, one pervasive myth is that the decision opens up a gusher of previously untapped revenue for states to enjoy. In the midst of a pandemic-induced recession, an extra source of revenue, particularly one tied closely to e-commerce, may tempt state budget officials to thank their lucky stars for deliverance. They shouldn't — *Wayfair* won't come close to solving their problems.

In fact, all the evidence in the aftermath of the *Wayfair* decision points to a very minor revenue bump. In the context of a recession that has state and local governments begging for further federal aid even after receiving roughly $200 billion from Uncle Sam, *Wayfair* revenues appear to be modest at best.

A *Wayfair* Windfall?

That *Wayfair* was never going to produce vast amounts of revenues for states was apparent well before the first economic nexus laws went into effect. Advocates of these new sales tax rules argued that states were getting shortchanged by the shift to e-commerce, as they could not legally impose tax collection

Key Facts:

The pandemic has accelerated the growth of e-commerce, leading some to claim that sales tax laws passed after the 2018 Supreme Court decision in *South Dakota v. Wayfair* will salvage state budgets that have otherwise taken big hits in recent months.

While post-*Wayfair* laws do allow states to raise some additional revenue, the impact is marginal. Pre-pandemic projections estimated that such laws would raise about 0.7 percent of state general fund revenues, and most additional sales tax revenue realized since then was already taxable under pre-*Wayfair* law.

State lawmakers should keep in mind that post-*Wayfair* sales tax rules are no silver bullet. The small revenue benefits states stand to realize could be far outweighed by the harm to still-struggling businesses if they are not careful to minimize compliance burdens.

obligations on out-of-state e-retailers. Thus, the argument went, a great deal of sales tax revenue could be "unlocked" by allowing states to tax on the basis of economic connection to the state, rather than just physical presence.

But that argument ignored the situation on the ground. Most of the largest companies involved in e-commerce are hybrid businesses — businesses with brick and mortar outlets that have developed a thriving online retail business as well, including Walmart, Home Depot, Best Buy, and so on. These businesses already had nationwide physical presence, and were already liable for collecting sales taxes on online purchases.

Meanwhile, the clear leader in e-commerce sales, Amazon, had been entering into voluntary collection agreements with states for years before the 2018 *Wayfair* decision. Over a year before the Supreme Court case, Amazon was voluntarily collecting sales taxes for all 45 states with a sales tax.

With all of the largest players already collecting tax on sales they make all across the country, there wasn't much revenue left to be scrounged. Only smaller businesses that make up a modest portion of the e-commerce market weren't legally obligated to collect and remit sales taxes prior to *Wayfair*, and the relative benefit of the small amount of revenue to be gained from enforcing new tax obligations on these small sellers is arguably outweighed by the compliance burden of requiring businesses without extensive legal and accounting staff to collect and remit sales taxes across the country.

Excessive Revenue Optimism

Back in August of 2019, the National Taxpayers Union Foundation looked at the difference between the revenue amounts that advocates of economic nexus taxes promised and what state officials calculated after economic nexus rules had actually been drafted. NTUF found that post-*Wayfair* revenue projections ended up far lower than what had been estimated prior to the *Wayfair* decision.

NTUF was able to collect estimates of revenues gained from economic nexus rules from 32 states in the aftermath of the *Wayfair* decision. On average, post-*Wayfair* estimates of revenues to be gained from economic nexus rules turned out to be about a quarter of the amount the widely-cited projection of the National Conference of State Legislatures (NCSL), and about half of the Government Accountability Office's (GAO) estimates, both performed prior to the Supreme Court case.

In total, across these 32 states, NCSL had projected that states could gain a total of $19 billion in revenue from economic nexus taxes, while GAO's more measured estimate was that states could gain roughly $8.6 billion. In reality, official post-*Wayfair* estimates totaled just $3.6 billion — that's about 0.7 percent of these states' general fund revenues.

And though the COVID-19 pandemic has certainly shifted the balance of brick and mortar vs. online sales towards the internet, analysts should be careful not to assume that post-*Wayfair* law revenues will save the day. E-commerce has undeniably become more important in the context of social distancing and lockdowns, but the fact remains that the vast majority of commerce taking place online was taxable even prior to the Supreme Court ruling.

Some of the irrational exuberance regarding the *Wayfair* decision will save the day in the wake of COVID-19 is attributable to the same factors that led advocates to oversell the revenue new sales tax rules could generate in the first place: that most sales were already taxable under previous law, and that greater than 85 cents of every retail dollar is still spent in traditional brick-and-mortar retail establishments. Another factor, however, is the growth in transactions that are processed online but fulfilled in brick-and-mortar locations.

For example, the percentage of Top 500 retailers offering curbside pickup has grown from 6.9 percent at the end of 2019 to 43.7 percent in August of this year, not to mention many smaller outlets such as restaurants. But those sales would have of course been taxable in the absence of *Wayfair* — to offer curbside pickup, after all, a business must have a physical location, which would subject it to sales taxes collection requirements, Supreme Court case or not.

For these reasons, budget officials should be wary of assumptions that increases in web-processed sales are of the same magnitude as increases in sales taxable only with an economic nexus standard on the books.

Looking at a basic comparison between economic nexus states and non-economic nexus states, one might be tempted to conclude that *Wayfair* kept the decline in sales tax revenues from being more drastic. For instance, one analysis found that Florida (a state without economic nexus rules) saw Florida's sales tax collections were down more than 19 percent, compared to Texas (a state with economic nexus rules in place) which only saw sales tax collections drop by about 6 percent.

But in this case, correlation is not the same as causation. More so than Texas, Florida relies heavily on its tourism and hospitality industries for its sales tax revenues, and those industries have unsurprisingly been greatly impacted by the pandemic. Lost revenue from these sectors could not have been recouped by economic nexus rules.

Digging deeper into the data, it becomes clear that nearly all the sales tax revenue Florida lost is attributable to declining tourism and hospitality revenue.

And as Florida began to tentatively reopen, the gap closed rapidly. In September, the gap between its sales tax collections compared to September 2019 had closed to just 6.8 percent, essentially mirroring Texas. By October, Florida had actually collected 3.4 percent *more* sales tax revenue than it had in October 2019. In that same month, Texas's sales tax revenues were still down 5.8 percent compared to the same month last year.

It's also a mistake to assume that economic nexus revenue was entirely non-taxable beforehand. Pandemic lockdowns have made e-commerce more important in the retail space, but the giants of it aren't new to paying sales taxes. Amazon's total revenues increased by 40 percent to $88.9 billion, as its web services, grocery delivery, and retail operations all saw revenue increases, but the company had already been collecting sales tax for every state in the country.

And the data bears this out. Even with economic nexus rules in place in 43 out of the 45 states with a sales tax, year-over-year sales tax collections are still down by 0.5 percent compared to last year according to the National Association of State Budget Officers (NASBO), a marked decline considering that sales tax revenue was projected to *increase* by 5 percent at the beginning of 2020. In other words, revenue fluctuations have been tied more to macroeconomic conditions than to changes in sales tax collection rules.

Not only are sales taxes decreasing, they are generally not the biggest issue for states in the midst of a recession. State individual and corporate income tax revenue declined by two and three times more, respectively, than state general sales tax revenue during the Great Recession, and a similar trend held true in 2020. NASBO estimated that state individual income tax collections would decline by 3.7 percent in 2020, while state corporate income tax revenue would decline by 9.5 percent.

Economic nexus rules don't have the power to compensate for reduced state sales tax collections alone, and they certainly can't hope to make up for revenue losses elsewhere. Clearly, counting on economic nexus taxes to return state budgets to solvency is doomed to fail. *Wayfair's* impact on state budgets will be middling at best.

The Consequences of Overestimating *Wayfair* Revenues

Overenthusiasm for economic nexus tax revenue is more than just misguided optimism. The myth of a *Wayfair* windfall has led to some poor policymaking decisions as state officials trip over themselves to take advantage. Numerous states have dispensed with the need for legislation to implement such a sweeping change to their sales tax landscapes in order to get at the new revenue source as fast as possible. Instead, these states have allowed their revenue departments to change tax policy through administrative fiat.

As we've seen, bypassing the legislative process can have some serious consequences. Not only does doing so fail to allow people and businesses affected by the changes to voice their concerns, but it can result in decidedly suboptimal rulemaking, as in the case of Kansas.

The Sunflower State is just one state that went the administrative route for implementing economic nexus rules, but in doing so, it created one of the worst sales tax problems in the country. After the legislature had laws with economic nexus provisions vetoed for unrelated reasons, the state's Department of Revenue took it unto itself to impose economic nexus rules on out-of-state businesses. In doing so, it failed to include any exception for small sellers, even though the Supreme Court had specifically mentioned a small-seller exception in South Dakota's law as being an important element of the law's constitutionality in *Wayfair*, and every other state has included a small seller exception.

Kansas's Department of Revenue claims it failed to include a safe harbor because it would be an "exemption," and only the state legislature was empowered to implement exemptions. Not only does this claim beg the question of why the state's administrative apparatus is empowered to impose new tax obligations but not important exemptions, but it also highlights exactly why the legislature should be the sole source of new tax policies in the first place.

Conclusion

States rushed to implement economic nexus rules on the basis of faulty estimates of what revenues could be realized by such changes, and in certain notable cases, it led to poor policymaking. Mistaken beliefs about the importance of *Wayfair* to state budget crises in the context of the pandemic only serve to validate such rushed policymaking and encourage it in the future.

About the Authors

Andrew Wilford *leads the Interstate Commerce Initiative at the National Taxpayers Union Foundation (NTUF), a project which seeks to protect taxpayers from the pernicious effects of states attempting to exercise power outside their borders.*

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2021 National Taxpayers Union Foundation
122 C Street NW, Suite 650, Washington, DC 20001
ntuf@ntu.org