One Cheer For The "Marketplace Fairness Act"

The essential principle of "fairness" involves giving the same treatment to similar actions. On this count, the Marketplace Fairness Act, currently making its way through the U.S. Congress, is deserving of support for rectifying a longstanding inequity in the retail landscape, namely the sales tax exemption enjoyed by mail order retailers. The bill, which passed the Senate and is headed towards the House of Representatives, would enable states to collect sales tax on out-of-state purchases. Thus, if a California-based retailer shipped an instrument to a consumer in New Jersey, it would have to collect New Jersey's 7% sales tax and remit it to the state.

How much the sales tax exemption has contributed to the growth of online retailing is the subject of fierce debate. Brick-and-mortar retailers contend that it has had an enormous impact, and they offer up countless anecdotes about customers who tried out products in their store, only to go home and shop for a lower price online. The practice, now referred to as "showrooming," is so widespread, it's cited as the primary cause for the problems of electronics giant, Best Buy. Online merchants tend to dismiss these stories and argue that their competitive advantage derives from convenience and selection.

The evidence suggests that while the sales tax exemption has not been the only thing driving online sales growth, it has made a measurable contribution. To cite an industry example, when Guitar Center relocated its Musician's Friend subsidiary to California from Oregon and suddenly had to collect a 9.25% sales tax on shipments within the nation's largest market, it experienced an abrupt decline in revenues. Setting aside the argument, the fact remains that online merchants and brick-and-mortar merchants are engaged in the same activities—buying products, inventorying them for resale, and promoting them to the public—and as such, should receive the same tax treatment. As it is, state and federal governments effectively put a finger on the scale in favor of internet sellers, giving them a 6% to 12% price advantage. If the playing field is leveled with equitable taxation, we'll find out soon enough whether online merchants rely on selection or price. More importantly though, the state will get out of the business of favoring one type of business over another.

Before popping the champagne corks over the prospect of sales tax fairness, brick-and-mortar retailers, and every other business for that matter, should ponder some of the potential downsides of the pending legislation. Ever since the first sales tax was levied in Mississippi in 1937, competition between the states has provided some restraint on the growth of tax rates. But if states can readily collect tax on out-of-state purchases, those constraints will be reduced, and legislators being what they are, are more likely to jack up rates. To grasp the impact of ever-increasing sales tax, consider the European Union where music products are subject to value added taxes (another term for sales tax) that range between 18% and 24%. Per capita spending on music products is about 78% of current U.S. levels. Our industry's primary customer base doesn't reside in the most affluent demographics, and higher prices will have an adverse impact on gross sales and future growth prospects.

Opponents of the Marketplace Fairness Act claim that having to remit sales tax to the nation's 9,600 jurisdictions will create an undue administrative burden, particularly on smaller retailers. Those in favor of the bill dismiss the complaints citing the ready availability of software to automate the task. Brick-and-mortar retailers can justifiably say, "It's not my problem; the mail order guys have had a free ride for so long, let them deal with it." However, if states are entitled to collect sales tax from retailers who have no physical presence within their borders, expect a dramatic increase in cross-border enforcement efforts. Within the m.i. industry, the vast majority of brick-and-mortar retailers have websites with some purchase options, 60% of the Top 200 report selling on eBay, and a growing number use some form of "bricks-and-clicks" strategy. We suspect that enthusiasm for this bill will quickly fade the first time a brick-and-mortar retailer receives a past due bill for sales tax from a distant state capital.

A final criticism of the bill concerns the fact that it exempts businesses with under $1.0 million in online sales from out of state sales taxes. With this arbitrary demarcation point, the bill trades one inequity for another. Why should a business with revenues of $999,999 and one with $1,000,001 be treated differently? More importantly it creates a disincentive for growth. If your business did $950,000 last year, why invest to grow 10% when the extra sales will only increase your administrative costs and decrease your competitiveness?

While we think the above shortcomings are well within the range of probability, on balance we still support the legislation because it addresses an grievous imbalance. In a more perfect world, rather than just applying the same sales tax rates to all merchants and pocketing an additional $11.4 billion in revenues, our esteemed state and local lawmakers would use the expanded tax base as an opportunity to provide a real consumer stimulus in the form of reduced sales tax rates. But as the late economist John Kenneth Galbraith once observed, "politics consists in choosing between the disastrous and the unpalatable." With that, we offer conditional support for the pending legislation.

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