Why an online sales tax could be more trouble than it is worth

Julian Jessop
Economics Fellow, Institute of Economic Affairs
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Summary

- The UK Treasury has been consulting on the concept of an 'online sales tax', or OST, which could raise £1-2 billion annually to help pay for a reduction in business rates for physical retailers. This is a bad idea, for many reasons.
- First, there is little hard evidence that online retail is systematically undertaxed, or that this has played a significant part in the decline of traditional High Street shops. Where digital businesses do pay less tax, it is usually for good economic reasons, or as a result of tax breaks that governments themselves have promoted.
- Second, it is wrong to assume that the economic burden of taxes is borne by the companies that pay them. In this case, the additional tax on online sales would inevitably be passed on to real people, including to consumers, adding even more to the cost of living.
- At the same time, any associated reduction in business rates might simply benefit landlords, in the form of higher rents. The net effect would therefore be to transfer spending power from households to owners of commercial property.
- Third, an online sales tax could be a nightmare to administer. It would be hard to determine which transactions should be taxed, not least because many bricks-and-mortar businesses now have an online presence too.
- Any additional tax revenues could therefore be offset, at least partially, by relatively high administrative costs and distortions. And if the new tax disproportionately affects tech companies based in the US, it could also be challenged as a de facto international tariff.
- Indeed, the experience of the Digital Services Tax provides more evidence that an online sales tax could be more trouble than it is worth. Like the DST, an OST would be a clumsy solution to a problem that does not exist, or, at best, is wrongly diagnosed.
- Above all, there is no clear rationale for an online sales tax. The government says it is not intended to discourage people from shopping online. But if the only purpose is to raise more revenue in order to reduce business rates, this could be done in other, simpler ways.
- It would of course be preferable not to go down this route at all. It makes far more sense to focus efforts on making it easier to repurpose high street buildings - and let the market decide what use to make of them.
- In the meantime, applying an additional tax to new business models would send a terrible signal that innovations which benefit consumers are somehow to be feared, and penalised.
Introduction

HM Treasury (2022) has been consulting on proposals for an online sales tax (OST), which it describes as ‘an option to help rebalance taxation of the retail sector’. No decision has been taken yet on whether or not to proceed with an OST. Indeed, the consultation paper itself was clear that there are many potential problems.

An online sales tax would be an additional tax on transactions conducted over the internet, probably levied as a small percentage of the value of the transaction, or a lump sum charge for each online order. The new tax would be specifically aimed at raising money that would then be used to subsidise business rates¹.

This would be wider in scope than the existing Digital Services Tax, which is a 2% tax on the UK revenues of search engines, social media services and online marketplaces (HMRC, 2020).

This briefing will begin by reviewing the main arguments in favour of an online sales tax, which are based on some shaky economics. These calls often seem to be motivated by well-meaning but old-fashioned ideas about the High Street, or popular animosity towards the ‘tech giants’.

The paper will then summarise the economic arguments against an online sales tax, and the practical challenges in designing, implementing and administering an OST.

1. The case for an online sales tax

Supporters of an OST argue that bricks-and-mortar retailers are at an unfair disadvantage, because companies operating from High Street properties are likely to pay more in business rates (and possibly in other taxes) than their online competitors. At the very least, the shift towards online shopping has reduced the amount of revenue that the government raises from the retail sector, requiring a rebalancing of the burden simply in order to continue to finance local services.

There is a lot to unpick here.

For a start, there is no good reason to think that the traditional model of High Street retail is worth protecting in its own right. The reality is that the High Street is always evolving as consumer tastes, lifestyles and technology change.

For example, does anyone remember Blockbuster? In the early 2000s Blockbuster was a familiar brand on the high street, renting out videos and DVDs from more than 800 shops around the UK. Ten years later the business was itself ‘bust’, rendered obsolete by online streaming.

The government of the day might have tried to prevent this. It could have imposed an additional tax on the downloading of entertainment via the internet. It could have reduced the business rates charged on video rental shops. The government could even have paid for customers to enjoy discounted rentals on certain days.

But not many people would have thought that these forms of intervention were sensible. Blockbuster was a casualty of technological progress and changing consumer preferences. Few were sorry to see it go. The free market soon found other uses for the properties that it occupied – and other opportunities for the people that it employed.

This example is worth remembering whenever anyone proposes some grand new government plan to ‘save the High Street’. They would need to explain what exactly it is they are trying to preserve, and why.

Another poor argument for resisting change is the risk to jobs in High Street shops. The purpose of economic activity should be to provide consumers with the goods and services that they want, how and where they want them, and not to employ people in particular businesses (whether that is a Blockbuster video store, or your local Pret). And of course, people work for online companies too.

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¹ Business rates are devolved, so this would mean giving an additional pot of money to Scotland, Wales and Northern Ireland, to do with as they wish.
It may simply be that people may want to buy more goods online, and visit the High Street to spend on services (and ‘experiences’) instead. Online businesses also contribute to consumer welfare by reducing transaction costs, such as the need to visit multiple shops to compare prices and access a wider range of products.

As Chart 1 shows, the share of internet sales in total retail sales shot up during the pandemic, but the latest figure (27% in April) is only a few percentage points above the long-term upward trend (ONS, 2022). This trend is global, and not driven by the UK tax regime.

An online sales tax would be unlikely to change this. Indeed, the UK government does not expect an OST to raise a large amount of money anyway. In part this is because it is not intended to actively discourage people from shopping online, so would be set at a low rate.

The fact that different business models may mean that some firms pay less in business rates is not necessarily a problem, either. For example, an online retailer might be able to gain a perfectly legitimate competitive advantage, including but not limited to a reduction in their business rates, by operating from a more efficient out-of-town warehouse rather than a shop on a congested city-centre High Street. This is not something that that the tax system should seek to ‘correct’.

What’s more, online businesses may face higher costs in other areas, such as delivery networks, which might also increase their liability for other taxes, such as fuel duties.

There is a perception that online businesses do not pay their ‘fair share’ of other taxes too. Unfavourable comparisons are often made between the sales that companies like Amazon make in the UK, and the corporation tax that they pay here. But this is misleading, because corporation tax is paid on profits, not on turnover. Online marketplaces might see a lot of business transacted between third parties on their websites, but still be working on small profit margins, or even at a loss.

Finally, where digital companies do pay less tax, this is often as a result of tax breaks that governments themselves have promoted, including the favourable treatment of R&D spending, software developed in-house and other intangible assets, or tax breaks for employee share ownership schemes.

2. Who would pay, and who would benefit?

It is also wrong to assume that the economic burden of taxes is borne by the companies that pay them. In this case, the additional tax on online sales would inevitably be passed on to consumers, adding to pressures on the cost of living.

This risk could be minimised by setting the tax at a very low rate. However, that would also minimise the amount of money raised. If the tax does work (a big if), there would inevitably be a temptation to raise the rate in future.

At the same time, any associated reduction in business rates might simply benefit commercial landlords, in the form of higher rents. As Adam (2019) explains, economic theory, and plenty of evidence, suggests that business rates are mostly reflected in rents. The net effect of using the additional revenues from an online sales tax to reduce business rates would therefore be to transfer spending power from households to owners of commercial property.

What’s more, turnover taxes have particularly large deadweight costs and are a major deterrent to investment (at a time when the UK already has a productivity problem). An online sales tax would penalise firms that have innovated and adapted in response to changing technology and consumer tastes.
3. How would it work?

An online sales tax could be a nightmare to administer. It would be hard to determine which transactions should be taxed, not least because many bricks-and-mortar businesses now have an online presence too.

The Treasury’s own consultation paper identified a long list of potential problems, including:

i. how to define an online sale, and whether this should extend to cover ‘remote’ sales made by phone or post;

ii. whether there should be exemptions, for example for ‘click-and-collect’ sales, or for particularly sensitive goods, such as food (business rates do not depend on the type of goods sold);

iii. how to treat digital products, such as e-books or newspapers, which compete with purchases of print publications sold by physical shops;

iv. whether the tax should only cover goods, or also services (bearing in mind that many transactions have elements of both);

v. how to treat sales that cross international borders.

Any additional tax revenues could therefore be offset – at least partially – by relatively high administrative costs and distortions. The consultation paper notes that a tax rate of 1% on online sales of goods from to consumers, or one alternative of a flat fee of £1 per order for deliveries, might raise around £1 billion. These are relatively small amounts of money in return for the hassle of introducing a brand new tax.

Finally, there are some potential obstacles in international law. This came up in the context of EU proposals for digital services taxes that were more or less explicitly targeted at large US-based firms. As Hufbauer and Lu (2018) explain, this appeared to be a de facto tariff in breach of WTO rules. An OST could therefore be an additional complication in negotiations on a US-UK trade deal.

Indeed, the experience of the UK’s own Digital Services Tax (DST) shows that an online sales tax would be more trouble than it is worth. The DST is expected to raise about £700 million in 2022-23 (OBR, 2022). However, the DST was only ever intended as a stopgap until an OECD deal on global taxation of multinational companies can be implemented (see OECD, 2021). The OECD deal will be a big enough challenge on its own, for both policymakers and businesses, without diverting energy to developing a brand new online sales tax.

In the meantime, there is ample evidence that the DST has been passed on to consumers in the form of higher prices, including by Amazon2. Like the DST, an OST would be a clumsy solution to a problem that does not exist, or, at best, is wrongly diagnosed.

Conclusions

In short, there is no clear rationale for an online sales tax. The government says it is not intended to discourage people from shopping online. The consultation document also recognised that there will have to be a new tax system, with extra costs to government and additional compliance costs for businesses.

Business rates themselves are also a mess and a fundamentally bad tax, partly due to their inflexibility and problems in the valuation process. But if the only purpose of an OST is to raise more revenue to finance a reduction in business rates, this could be done in many other, probably better ways. Options here include increasing VAT or extending its scope, introducing some form of land value tax, or raising corporate income taxes. However, it would of course be preferable not to go down this route at all.

As Shackleton (2022) discusses in more detail, applying extra taxes to new business models cannot be the right answer. It would send a signal that innovations which benefit consumers are somehow to be feared, and penalised.

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2 The DST is not payable on products that Amazon is selling on its own behalf, but only when acting as an online marketplace for other businesses. An OST would presumably apply to all sales on the platform
In particular, the High Street has already changed dramatically over the years. The high street most of us remember - largely branches of retail and banking chains - was really only a product of the 1960s and 1970s. There was much more varied use in the 19th century, including housing and workshops.

The upshot is that policymakers should not try to freeze urban land use, even though this is what so much of our planning system attempts to do. It makes far more sense to focus efforts on making it easier to repurpose high street buildings - and let the market decide what use to make of them.

References


ONS (2022) Retail sales (April 2022) Available at https://www.ons.gov.uk/businessindustryandtrade/retailindustry/bulletins/retailsales/april2022
