



Why A Digital Advertising Services Tax Will Undercut the Small Business Recovery: The Maryland Case

DR. MICHAEL MANDEL
CHIEF ECONOMIC STRATEGIST
PROGRESSIVE POLICY INSTITUTE

JANUARY 2021

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EXECUTIVE SUMMARY

As of November 2020, employment in Maryland was down more than 4 percent compared to a year earlier. Small businesses are suffering. Nevertheless, the state's revenues for the 2021 fiscal year are coming in better than expected in spring 2020, buoyed by federal stimulus and continued employment of white collar workers.

Under the circumstances, enacting a new tax that would be especially harmful to small businesses seems like a mistake. However, in spring 2020 Maryland state legislators approved a new tax on annual gross revenues derived from digital advertising services in Maryland, with the proceeds to be devoted to education. The bill, which broadly covered “advertisement services on a digital interface,” was vetoed in May 2020 by Governor Larry Hogan, with the veto potentially in line to be overridden by the state legislature in the session that began mid-January 2021.

In this paper we will explore the economics of digital advertising and the economics of a digital advertising services tax, with special attention to Maryland. We make four main points:

- The price of digital advertising has fallen by 42 percent since 2010 across the United States. This decline has fueled a sharp reduction in ad spending as a share of GDP.

- Our calculations suggest that the falling price of digital advertising is saving Maryland businesses and residents an estimated \$1.2 billion to \$2 billion per year, based on the size of the state's economy.
- Passing the digital advertising services tax is likely to reduce the cost benefits of digital advertising to Maryland businesses and residents. In particular, the tax will drive up the price of help-wanted ads in Maryland, making it harder to connect unemployed Maryland residents with local jobs. In addition, employers will rely less on public ads and more on personal connections with friends and family, disadvantaging less-connected groups such as minorities and immigrants.
- Raising money for education is a worthwhile goal. But the appropriate source of funds are broad-based taxes such as sales tax or an income tax, rather than a narrow and distortionary tax on one small but vital segment of the economy. In addition, moving to a combined corporate income tax framework could help reduce income shifting and increase tax revenues.

THE ECONOMICS OF DIGITAL ADVERTISING

Before discussing the particulars of the Maryland digital advertising tax, we'll consider the broader economics of digital advertising. Prior to the widespread use of the Internet, the legacy media--newspapers and local television and radio stations-- had a near-stranglehold on local advertising. Newspapers, especially, used that market power to raise advertising rates, because local retailers and other businesses had no other good alternatives if they wanted to reach nearby consumers. According to data from the Bureau of Labor Statistics, the average

price of newspaper advertising tripled between 1980 and 2000, rising far faster than the overall consumer price level (which doubled over the same period).¹

As a result, businesses had to pay increasingly large sums for consumer-oriented advertising in the pre-Internet days. For retailers, restaurants and other local businesses who wanted to reach new customers, there were few viable alternatives.

Equally important, local employers had to shell out for "help-wanted" ads in newspapers in order to find good workers. Newspapers could and did jack up the price of these employment ads because businesses--especially small businesses--had no other way to reach potential employees before the era of digital advertising.

When we look back to the era before digital advertising, it is stunning how newspapers used help-wanted advertising as a high-priced cash cow. Consider, for example, the price of help-wanted ads in the Washington Post before the widespread use of digital advertising. In 1980 the Washington Post charged potential employers \$1.98 for a single line in an employment classified ad, placed a single time in a daily edition.

By 1990 the price of that same single line in a Washington Post help-wanted ad had risen to \$6.70, a 240 percent increase. The price increases continued for the next decade, with the price of a line in a help-wanted ad rising to \$11.06 by 2000, another 65 percent gain, far exceeding the 34 percent increase of the consumer price index over the same period.²

These ads were expensive--running just one 5-line help wanted ad for just one week in 2000 would cost around \$85, without volume

discounts and including the more expensive Sunday edition. Small businesses who did not have their own HR departments, especially, had no other choice except to pay big bucks to the newspapers in order to hire.

Employers got huge price relief as the Internet became more important. Rather than being forced to run high-priced ads in newspapers, they could shift their help-wanted ads to online portals such as Craigslist, Monster.com and Indeed.com, which were both much cheaper and much easier for jobseekers to search. For comparison, today a Craigslist job posting in the DC area—which gives employers a full paragraph to work rather than just 5 lines-- costs \$45 for 30 days (Baltimore is priced at \$35 per ad).³

Since 2010, the overall price of digital advertising has fallen by 42 percent, according to the BLS. (That figure excludes print publishers such as newspapers.). By comparison, the price of newspaper advertising, both print and digital, is down by only 7 percent since 2010.

This drop in price for digital advertising has been a tremendous boon for businesses, especially small businesses like restaurants and retailers, who used to have a limited set of options for consumer advertising. Businesses of all types now find it much cheaper and easier to post help wanted ads and find qualified help.

On a macro level, businesses and consumers are benefiting from the lower cost of digital advertising. In 2019, advertising amounted to about 1 percent of gross domestic product (GDP). That's down from 1.5 percent in 2000, and an average of about 1.3 percent in the 1991-2000 period.⁴

In other words, the shift to digital advertising has lowered ad spending by about 0.3-0.5 percent of GDP. This is money that goes directly into the pockets of businesses and consumers.

What about Maryland? According to the Bureau of Economic Analysis (BEA), Maryland's state GDP was roughly \$400 billion in 2019.⁵ Applying national figures, that suggests digital advertising is saving Maryland businesses and consumers about \$1.2-2.0 billion per year.

IMPACT OF DIGITAL ADVERTISING TAX

Keeping in mind the lower price of digital advertising, what economic impacts would we expect from the proposed digital advertising services tax? H.B. 732 proposed a new tax on the annual gross revenues derived from digital advertising services in Maryland. The tax rate would vary from 2.5% to 10% of the annual gross revenues derived from digital advertising services in Maryland, depending on a taxpayer's global annual gross revenues. To be required to pay the tax, a taxpayer must have at least \$100,000,000 of global annual gross revenues and at least \$1,000,000 of annual gross revenues derived from digital advertising services in Maryland.

Note that this is a tax on gross receipts, a type of state tax that has been judged by economists as intrinsically problematic.⁶ Gross receipt taxes are exceptionally sensitive to market structure, since the tax can be theoretically applied at each stage of the advertising production and sales process, which could lead to double (or multiple) taxation. In this case, the Maryland tax authorities will have to determine the "real" seller of the digital advertisements, which in many cases is not obvious.

Note also that the legislation does not actually specify what it means for digital advertising services to be “in Maryland.” That task is left up to the state’s Comptroller. But it seems clear that at a time when users are increasingly concerned about privacy, the legislation will effectively force advertisers to identify the location of people who view or click on digital ads. That is a move in the wrong direction, and might even violate the laws of some states or countries where the digital advertising companies are headquartered.

Because the digital advertising services tax, as proposed, is a tax on gross receipts rather than income, it has the potential to badly hurt profit margins. Consider Yelp, for example, the well-known company whose mission is to connect consumers with local businesses. As reported in Yelp’s 2019 annual report, the company has global revenues of \$1 billion, virtually all from digital advertising, and an after-tax profit margin of 4 percent. Since Maryland accounts for 2% of U.S. GDP, that suggests Yelp’s Maryland revenues are \$20 million, well over the threshold for applying the 10% tax rate in the proposed legislation.

The implication is that the proposed digital advertising services tax could turn Yelp’s Maryland business into a money-losing proposition. That’s insane. Yelp’s only options would be to either withdraw from the Maryland market or significantly raise its advertising prices.

Whether digital advertising companies raise their rates or withdraw from Maryland, it would be bad news for local businesses trying to recover from the pandemic recession, and bad news for consumers who would just be crawling out of their pandemic-induced depression. Using digital

advertising, owners are able to reach customers, showcase products, even confirm they are still open. Raising the price of digital advertising and reducing its availability could help slow those recovery efforts.

Or consider the impact of the proposed tax on “help wanted” postings. Since these ads have to identify a location of the job, it will be easy to connect the receipts to Maryland. Clearly what will happen is that Craigslist and other job sites will likely put a surcharge on Maryland-based help-wanted ads to account for the digital advertising services tax. The implication is that advertising for a job in Maryland will be more expensive than it was prior to the tax. That may even put Maryland employers at a disadvantage in attracting talented workers.

At the margin, Maryland employers will reduce their purchases of digital help-wanted advertising. In that way, the introduction of a digital advertising services tax will slow down the rate of hiring in the state.

The other likely effect is that employers will rely more on personal networks such as friends and family to fill positions, rather than advertising on the open internet. This is bad news for groups that are less well-connected, such as low-income workers, minorities and immigrants.

THE NEED TO RAISE REVENUE

Some people argue that taxing advertising to pay for education is a good trade-off for society. After all, the benefits of education are undeniable, while advertising is annoying to many people.

But advertising does have the virtue of allowing consumers to uncover cheaper and better goods and services, and aiding jobseekers in finding better employment opportunities. Recent economic research has actually looked

at the plusses and minuses of taxing or fining advertising and transferring the proceeds to low-income workers.⁷ Calibrating the model using real world numbers, they found that the “advertising equilibrium modeled is surprisingly close to being efficient.” The implication, at least from the initial research, is that taxing digital advertising doesn’t gain much.

What are the alternative sources of revenue for education in Maryland? There is now the possibility of additional state support packages from the federal government in 2021. And in terms of taxes, without delving deeply into details, economists believe that the best taxes are broad and non-distortionary. That would argue in favor of increasing the top tier of the Maryland income tax, now set at 5.75% for taxable income over \$250,000, especially since many high-income individuals have done well during the pandemic recession. Such an increase would raise revenues without imposing large deadweight losses on the state economy.

On the corporate income side, one possibility is for Maryland to shift to a system of “combined filing” for state corporate income tax. That would treat a parent company and its subsidiaries as one entity for state income tax purposes, according to the Center for Budget and Policy Priorities, “thereby helping prevent income shifting” and potentially raising money.⁸

By comparison, a tax on digital advertising would dampen the ability of Maryland businesses to reach out to customers precisely at the time when it is needed—coming out of the pandemic recession. Small Maryland businesses trying to regain their customers need as much access to digital advertising as possible. Putting a tax on digital advertising is like taxing the future—and that’s never a good idea.

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PROGRESSIVE POLICY INSTITUTE
1200 New Hampshire Ave NW,
Suite 575
Washington, DC 20036

Tel 202.525.3926
Fax 202.525.3941

info@ppionline.org
progressivepolicy.org