State Taxation of Internet Activities:
What Role for the Federal Government?

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1. Introduction

It is difficult to recall any business-government argument over state tax matters, other than perhaps those raised by Container and Barclays, that has been as bitter as that surrounding state and local taxation of activities conducted over the Internet. Newspaper and magazine editorial pages have been replete with calls to tax or not tax the Internet, while governors, mayors, and state and local legislators have taken to the airwaves as well as editorial pages to warn that one of their central sources of state revenues, the sales and use tax, is seriously at risk.

Events leading up to enactment of the federal moratorium in 1998, and the establishment in the moratorium legislation of the National Advisory Commission on Electronic Commerce (ACEC) portended the possibility of business-government problem solving. However, the legislative details establishing the ACEC (no budget, a 2/3 super-majority needed to adopt recommendations, and the ability to receive ‘donations’ to finance its activities) also portended a difficult if not ugly process. Early litigation in federal court within the Commission over the composition of membership, and funding and staffing issues plagued the Commission, and vast differences over policy ultimately precluded the agreement in April, 2000 of any of the required supermajorities by the time the Commission’s report was due.

It comes as no surprise to this observer that those businesses, currently not obligated to collect and remit use taxes from out-of-state customers, and related business interests which are part of the New Economy, prefer upon first analysis this arrangement to any other. Indeed, if one believes in the primacy of short-run self-interest, it is difficult to envision any other response from the New Economy. Placing a majority or near majority of such businesses on a federal advisory group, coupled with others indebted to them, could only lead to the most likely result: protection of financial self-interest. Given their earlier success in achieving the federal moratorium, and recent success in forestalling agreement on practical yet principled solutions to the state tax problem, one might reasonably inquire what is next for the New Economy and those elected officials indebted to them?

Two fiscal objectives may now be within reach of the New Economy in light of recent successes in remaining immune to the obligation to collect and remit use taxes: (1) convincing Congress that the current federal moratorium should be made indefinite as well as enlarged, and (2) arguing that the time has now come to obtain through public budgets direct expenditure subsidies to strengthen the momentum of the New Economy.

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2 The history of 19’th century state economic development activities, especially related to the technological innovations posed by railroads, is replete with examples of not only public borrowing for private purposes, but also public spending for private purposes as well as the grants of substantial amounts of public lands to lubricate the wheels of progress. See, for example, Scheiber(1975), and Clay and Strauss(forthcoming) for a comparative treatment.
One can imagine the latter to be justified by the need to stabilize capital markets or smooth out the trajectory of the NASDAQ. Arguably, real aggregate consumer demand could collapse were adverse wealth effects large enough. Achieving these ambitious objectives could be justified by appealing to earlier fiscal largesse enacted in response to pleas for Keynesian pump-priming that moved a moribund world economy out of the Great Depression and got the American economy moving in the early 1960’s. Such New Economy calls for action will likely be accompanied by economic analysis and policy papers written on a fee-for-service basis by independent business consultants and the tax policy staffs of the major public accounting firms.

Readers with a concern for the public interest may find such predictions unduly glum, and agree with my evaluation that they amount to taking the tax policy football to the wrong goal-line. Perhaps the political economy question at hand involves identifying what set of economic forces might be sufficient for an about face in political momentum, and a run for the other goal-line which public finance economists and other moral philosophers might characterize as good tax policy. As is usually the case in such matters, much depends on how the interests of consumers, business, and elected officials get combined.

My optimism that political tides will turn is based on the occurrence of two possible scenarios.

---Scenario 1: Elected Officials Finally Recognize They Have Something New Economy Customers and Web Site Owners Increasingly Want: An Electronic Commercial Code

Even if bandwidth materializes so consumers can point and click to have common carriers deliver grass seed, bath soap, sunlamps and other items of daily life, the problems of customer-merchant trust and merchant-customer trust remain to be dealt with. Effross (1997) provides a comprehensive review of the commercial problems web businesses and their customers face in doing business on the web, and provides a rather complete checklist of commercial law issues for web site owners to address if they intend to stay out of trouble and to become profitable. On the customer’s side of the virtual bargain are a series of outstanding, awkward issues beyond the obvious one of privacy of their buying habits and financial affairs.

It is useful to remember that determining that the virtual purveyor is simply the owner of the web site or in fact claims to be a “merchant” is more than of passing interest to the customer, for the term “merchant” is a term of law which has associated with it a litany of responsibilities:

3 Historically, it may be worth remembering that after business lost Container and then Barclays, it became sufficiently energized to convince California to at least optionally allow business to elect out of the unitary tax scheme. Defeat in the courts energized legislative change. Whether or not the state and local sector will be able to, having lost before the Commission, to convince Congress to intercede on its behalf remains to be seen.
Face to face commerce and remote commerce which rely on paper communication and contracts long ago accomplished state by state agreement to a model commercial statute in the 1950’s, the Uniform Commercial Code (UCC), which operates to this day to organize most interstate commerce in tangible personal property. Code Article 2 of the UCC defines a “merchant” as

A person who deals in goods of the kind or otherwise by his occupation hold Himself out as having knowledge or skill peculiar to the practices or goods Involved in the transaction or to whom such knowledge or skill may be attributed By his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.

Such expertise brings with it expectations on the part of the customer as to what ordinary business dealings are, and creates a basis on which failure to act in accordance with such expectations constitutes grounds for litigation. Such expectations include, for example, that the merchant acts in “good faith.”

Virtual customers may be surprised to learn that their recourse over delivery disputes are not with the web purveyor/“merchant” who took their credit card funds, but rather with the common carrier who was to deliver the goods to the customer’s shipping address. Consider the following statement commonly found on Amazon.Com’s April 8, 2000 web page:

“RISK OF LOSS.--All items purchased from Amazon.com are made pursuant to a shipment contract. This means that the risk of loss and title for such items pass to you upon our delivery to the carrier.”

Virtual customers may also be surprised to learn that resolution of any disputes with a virtual purveyor are to be resolved in the state chosen by the virtual purveyor. Consider the following assertion of choice of law made by Amazon.Com on their April 8, 2000 Web Page:

“APPLICABLE LAW This site is created and controlled by Amazon.com in the State of Washington, USA. As such, the laws of the State of Washington will govern these disclaimers, terms, and conditions, without giving effect to any principles of conflicts of laws. We reserve the right to make changes to our site and these disclaimers, terms, and conditions at any time.“

4 See Armstrong(1991) for a retrospective on the development of the UCC. As early as 1995, the National Conference of Uniform State Laws proposed a counterpart to the UCC to deal with transactions of intangibles, especially through the use of computers. Article 2B which has existed in draft form since 1995 remains widely discussed, but not widely adopted by the states. Moreover, the model provision has been revised and evolved into the Uniform Computer Information Transactions Act(UCITA). Efforts are ongoing to obtain not only state-by-state adoption (Virginia recently adopted its variant of UCITA), but also Congressional adoption. To date, Congressional interest in such a far-ranging federal statute has been limited, and federal legislative interest is focused on the narrow issue of federal legislation governing digital signatures.
Another commercial law set of issues arise with regard to consumer use of automated shoppers or “intelligent agents.” To protect themselves as to the accuracy and completeness of information they find on behalf of an interested party, they assert various terms and conditions to avoid litigation and liability. Consider the following assertions from Price.com (which has somehow transmuted into PricePulse.com) found on April 8, 2000:

**TERMS AND CONDITIONS.** Although PricePulse.com goes to great lengths to provide useful information, PricePulse.com cannot possibly insure the accuracy of all of the information at all times. You should not rely on this information in situations where its inaccuracy would cause you to suffer any significant loss.

The information is provided by PricePulse.com "as is". PricePulse.com makes every effort to provide accuracy, but makes no representations or warranties of any kind concerning the accuracy, completeness, or suitability of the information, either express or implied, including without limitation any implied warranties of merchantability or fitness for a particular purpose.

The various products referenced on PricePulse.com are provided by third party vendors. PricePulse.com does not sell, resell, or license any of the referenced products, and disclaims any responsibility for or liability related to the products. Any questions, complaints, or claims related to any product should be directed to the appropriate vendor.

PricePulse.com is providing the information without charge for non-commercial purposes. Accordingly, PricePulse.com shall not be liable under any circumstances or under any legal theory for any direct, indirect, punitive, special, incidental, or consequential damages that may be suffered by you or any other user of the site in connection with or as a result of the information or the products, regardless of how much damages may arise and even if PricePulse.com has been previously advised of the possibility of such damages. And finally, have a good time, find an extraordinary price, and be happy!

Participants in business to business transactions likely will find the above circumstances to be unsatisfactory. One might expect to find growing customer and business pressure for the establishment of an electronic commerce code which the states could voluntarily adopt, or the federal government could enact that would protect parties to electronic commercial transactions in the same way they have been protected under the Uniform Commercial Code, state, and federal law. To date, state by state activity in
accomplishing this for electronic commerce has been sketchy, and limited primarily to the area of accepting digital signatures. Were pressure to grow for uniformity because web commerce growth was inhibited by the absence of such “rules of the road,” presumably some elected officials will argue that an expanded duty to collect and remit state use taxes would have to be part of this extension of government’s responsibilities. Creating an orderly virtual market place and access to state laws which contain a workable set of statutes ought to be traded for the related tax resources needed to finance the establishment of such new governmental responsibilities.

Pressure for state and/or federal legislation might also result from outcries over some of the more undisciplined aspects of the Internet. Beyond the ongoing concerns over pornography, there have been recent public outcries over minors obtaining dangerous web based pharmaceutical services. There have been some Congressional expressions of concern and concerns expressed from vendors about the need to devise mechanisms to prevent this in the future; such observations usually entail new federal laws. Difficult tradeoffs between free speech and expression, customer privacy, individual and children’s rights, and business autonomy need to be addressed should effective solutions be found. However, it is difficult for me to understand how credible safeguards can be put in place without federal as contrasted with voluntary state legislation. Safeguards without swift sanctions that have across-boundary reach will not stop some from engaging in illegal, unethical, or morally objectionable business practices.

Again, one can expect that further governmental regulatory activities could raise questions of finance, and a revisiting of what a reasoned set of tax policies should be for activities transacted across the net.

Scenario 2: Web Commerce Grows, Main Street Commerce Atrophies, and State and Local Sales and Use Tax Receipts Fall

Not withstanding some of the uncertainties and impediments to web commerce noted above, it seems equally likely that instead of growing slowly in the next several years, web commerce will instead grow geometrically. Further, under the growth scenario, much of traditional commerce could well move to the web, and that noticeable state and local fiscal adversity will result. Bandwidth to our residences is very much in progress, and trust, at least in terms of the security of pin numbers which encryption provides, is being addressed. The public’s geometrically growing thirst for connectivity and convenience will thus be met. Once worst case revenue fears become apparent, state and local elected officials will become sufficiently energized to not only complain in a credible fashion, but will do so to their federal brethren. State and local officials then may also take seriously their earlier promises to cleanse or rationalize their crazy quilt of sales and use taxes.

5 McBride, Baker and Coles, a Chicago law firm, maintains current of national and state by state descriptions of not only enacted legislation dealing with electronic commerce, but also pending legislation. See www.mcb.com/legis.
Second, the intense competition to Main Street retailers, which geometrically growing Web retailing will generate, will likely energize and force Main Street to seek similar taxation for identical and near-identical commodities and services now trafficking tax free over the Internet.

Third, the merging of virtual and bricks and mortar operations (e.g. the merging of AOL with both content providers and cable companies) which seems to be occurring in tandem with the growth in bandwidth will eliminate some of the current distance in thinking about tax policy between the New and Old economies. New Economy companies currently reluctant or recalcitrant about participating in the tax collection process may rethink their stance.

Fourth, New Economy companies who depend on public sector markets to sell their wares may find their public sector customers starting to complain publicly that legitimating such companies (and implicitly their stance towards use tax collection) by buying from them may be adverse to their own fiscal self-interest. Imagine the equivalent of domestic content laws arising as state and local governments begin to utilize their monopsony power in deciding which company’s software and hardware to buy.

Or, consider the public relations potential were such current contradictions made public and harped upon. How could New Economy corporate officials ignore the pleas and protests by placard-carrying elementary school children in front of their corporate headquarters? Could AOL, Cisco Systems, Dell, Gateway, Microsoft, Oracle and other New Economy companies with anti-tax orientations continue to ignore the pleas of these children that such companies collect and remit use taxes to the states so their schools can afford to buy their New Economy goods and services to improve the quality of public education? What if images of these pleading children were digitally captured and sent world-wide around the Web to every AOL subscriber? Might not the CEO’s then buckle to public sentiment out of own self-interest?

Finally, when shareholders in the Old Economy figure out that the New Economy has shirked its fiscal responsibilities onto the Old Economy and thereby reduced the Old Economy’s after-tax return to capital, the Old Economy may force Congress to finally reverse field and move policy towards the proper goal line and a tax policy whose normative tenets are familiar to public finance economists.

Since Congress clearly can, if it chooses to, regulate state taxation of activities conducted across state boundaries on the Internet, the question about what might constitute reasoned public policy will need to be answered. My objective below is to analyze different ways our federal system might evolve to maintain the state and local

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4 Much still depends on whether or not various judges and their crack law clerks find it straight-faced plausible to differentiate between Borders.Com and the Borders Bookstore down the street when Borders.com claims that it is separate and apart from its virtual brother, and therefore has no duty to collect and remit use tax, irrespective of the fact that both parts of Borders are controlled by the same holding company.

7 For example, see Hellerstein(1998)
sector’s ability to finance public goods and services as we enter the new Millennium hand in hand with the New Economy.

What might one derive from first principles of public finance and federalism that might provide a coherent set of policies should Congress decide to intervene in what is an increasingly rancorous debate between the state-local sector and the New Economy? My objective is to attempt to answer this question in ways that have practical implications.

The paper is organized as follows: Section 2 discusses goals for a reformed sales and use tax regime, and the nature of a Grand Political Trade that has been discussed by government and business for the past several years; Section 3 analyzes extensively the federalism issues which arise with major approaches to reforming state sales and use taxes with special emphasis on the range of trust issues which arise from electronic commerce; Section 4 investigates in more detail some issues arising in reforming existing sales and use taxes and develops a new way to identify final consumption; and Section 5 concludes.

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8 By way of disclosure, I should note I remain a technological pessimist. See Peha and Strauss (1997).
2. Aspects of Reformed Sales and Use Tax Regimes

2.1 Goals of a Good Tax System for the New Millennium

A good tax system is typically described as one which: (1) generates revenues sufficient to finance agreed upon public goods and services without necessitating constant tax rate or base changes; (2) is easy and inexpensive to administer and comply with, (3) alters consumer and business choices as little as possible, and (4) compels tax payments from individuals and businesses consistent with agreed-upon distributional norms. To these desirata, one might also hope that this tax system would (5) match the nature of the service provided with an appropriate financing source, and (6) encourage accountability between elected officials and their electorate by being transparent.\footnote{While the notion of transparency, and the related issue of trust emphasized by Musgrave (1998), are usually reserved for public finance discussions in transition economies, I think there is substantial merit in applying the transparency criteria to fiscal institutions in mature economies.}

Since their inception, state and local consumption tax design has been essentially a three variable problem: (1) the nature of the activity subject to tax (the sale or lease of property or services by the vendor or purchase by the customer), (2) the geographic reach of the tax, and (3) the determination of whether or not the activity is taxable.

These legal considerations can also be recast in terms economic considerations. Table 1 omits any distinction between customer and vendor, but differentiates between final consumption vs. intermediate production, whether the transactions occurs intra (sales) or inter (use)-jurisdiction, and whether or not any good or service is taxable or exempt. Table 1 does not indicate whether origin or destination is a design decision. Once one recognizes the purpose for which the tax is levied, the financing of services for residents of the taxing jurisdiction, the destination principle, in my view, becomes the only intellectually defensible design decision.\footnote{For legal and administrative arguments on the other side of this issue, see Caldwell(1998) or Apple(1999).}

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Since each state can decide how much of final consumption or intermediate production can be taxed through complicated exemption schemes, and since each state can enable its local governments to also impose such sales and use taxes, complexity and non-uniformity across the states are assured. Constitutional scrutiny under the Commerce Clause is essentially limited to making sure that whatever decisions are made in the Sales
tax row with regard to exemption structure be mirrored in the definition of compensating Use taxes. Since customers who import across state boundaries are legally liable to pay use taxes, the argument over taxation of internet transactions reduces to whether or not remote sellers, like their historical mail order predecessors, are legally obligated to collect and remit on behalf of their customers. Current federal case law, *Bella Hess* and *Quill*, says they are not.

2.2 Major Features of the Great Political Trade

For the past three years, there has been widespread discussion of a Grand Political Trade: that would involve:

- legislatively overturning *Bella Hess* and *Quill* through an expanded duty on remote sellers to collect and remit use taxes to the jurisdiction of destination or use currently without such obligation

in return for

a vastly simplified sub-federal sales and use tax system that would eliminate intra-state diversity in sales and use taxation, and standardize administration across the states.

Under this grand trade, states would agree to move to one tax rate per state that was revenue neutral, and business would join with state and local government to find suitable legislative vehicles to make it a reality. Earlier this year, 170 public finance economists, including myself, signed a Manifesto and urged the ACEC to agree upon a somewhat more detailed version of the above grand trade in the form of a set of principles, and argued in effect that such an approach would meet the objectives of a good tax system outlined above.  

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In particular the statement of principles urged upon the ACED were:

1. Electronic commerce should not permanently be treated differently from other commerce. There is no principled reason for a permanent exemption for electronic commerce. Electronic commerce should be taxed neither more nor less heavily than other commerce.

2. Remote sales, including electronic commerce, should, to the extent possible, be taxed by the state of destination of sales, regardless of whether the vendor has a physical presence in the state. In limited cases, where it is impossible to determine the destination of sales of digital content to households, it may be necessary to substitute a surrogate system. In no case should taxation of remote commerce or electronic commerce be limited to origin-based taxation, which would induce a "race to the bottom" and, in effect, no taxation at all.

3. There must be enough simplification of sales and use taxes to make destination-based taxation of sales feasible. Such simplification might include, for example, unification of the tax bases across states, unification of tax rates within states, and/or sourcing of sales only to the state level, as well as simplification of administrative procedures.

4. A means must be found to eliminate burdens of compliance on sellers making only small amounts of sales in a state. These might include software-based systems made available at state expense, more realistic
supporting this proposal is to eliminate the offensive cascading in all state sales and use taxes which Ring(1999) puts at about 50%.

2.3. Some Comments on the Efficiency Issues of Sales and Use Taxes in A Second Best World and Why Taxing Final Consumption Makes Sense

While a supporter of the grand political trade identified above, and a signatory of the Manifesto, I would be remiss if I did not clarify that one’s support for eliminating cascading, local sales and use taxes, and moving to a nationally defined sales and use tax base, but allowing each state to vary the rate of tax, can not be on economic efficiency grounds alone, and perhaps not at all. The reason for this conclusion is quite simple. Unless one proposes eliminating sales and use taxes and moving to lump sum taxation, the economic welfare or efficiency gains are not empirically obvious. Current sales and use taxes put us initially in a second-best world of various Harberger triangles scattered across consumer and producer supply and demand curves throughout the economy. Whether the areas under the new set of Harberger triangles that result from imposing sales and use taxes on only final consumption are larger or smaller than the current areas of triangles requires empirical confirmation.

The primary reason to insist on taxing final consumption has less to do with economic efficiency gains that might be hoped for than with the improvements in political transparency that will result. Since taxpayers under a final consumption scheme will know more readily how much taxes are being levied by the states, they will be able to insist more effectively that the monies be used wisely in the production of public services. When elected officials engage in hand wringing over what might happen if business inputs were no longer taxed, they are not expressing concern about the possibility that economic welfare may fall because dead weight losses may rise rather than fall under a simplified sales and use tax system that would be levied just on final consumption. Rather, they are wondering how voters will feel once they see how much taxes must be on final consumption to achieve the same level of budgetary revenues.

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vendor discounts, and/or de minimis rules.

12 I am indebted to Marcus for (repeatedly) reminding me of this matter.
3. Federalism and Tax Harmonization Issues Raised by Electronic Commerce

The absence of face to face confirmation of activities and the elimination of written records in an e-commerce world generate a series of “trust” issues. How the states and federal government resolve these will affect not only the pace of e-commerce growth but also the extent to which greater sales and use tax uniformity can be achieved.

3.1 Developing Trusted Third Parties for Financial Record Keeping Purposes

Trust and verification issues arise under net commerce, not only between customer and seller over the security of the payment mechanism, but also arise for other, related third party purposes.

The historical mechanism by which the veracity of claims about financial or economic events are proven involve the notion of an independent audit, and the use of an independent notary for separate confirmation and independent records maintenance of certain classes of commercial events. It is common in the case of tangible property for a governmental organization to maintain the official record of title of ownership. We take it for granted that in the case of automobiles, ownership and certificate of title are confirmed by a state agency (typically a state department of transportation) that maintains the records and also administers various license and fees associated with current use as well as the transfer of title. Elaborate safeguards have developed over the centuries in Western economies to eliminate any uncertainty over ownership of real or personal property, and the standards for record keeping of such property are publicly set, regulated, and enforced. Notaries today are typically supervised in each state by the Secretary of State who is also responsible for maintaining original records of incorporation. The development of such public responsibilities and procedures are a central part of our system of private property rights.

In each of the above examples, a trusted third party is necessary to confirm the veracity of a claim to a level of accuracy that is satisfactory for the purpose at hand. Investors and owners trust the results of an audit because the auditor is independent of the entity which is audited, and therefore financially disinterested in the outcome. Separate accrediting agencies exist to set standards of independence, and procedures and definitions for performing the audit. Auditors are not immune from liability for their assertions, and in fact insure themselves against litigation from investors who may sue over audit results not being accurate with regard to how an entity in fact performed. Much of the oversight of auditors, and therefore audit results stems from the activities of their insurers seeking to be certain about their insurance liability exposure.

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13 In the middle ages, the notary function was often performed by a religious institution which set the standard for record keeping, and also maintained the records. Even today, marriage, death, and birth records are typically recorded by a religious institution and a governmental entity.

14 It will be interesting to see how those who insure the accounting profession plan to limit their liability in a world of purely electronic record-keeping.
Consider the circumstance in financial accounting when there are paper records of orders or journal entries of outlays. The rendering of an audit opinion, required for companies whose shares are publicly traded, necessitates a check of controls, and ultimately a signed, written assertion, that the summary of financial results that are disclosed by the auditor after examination of the books and records of the entity, they fairly represent the financial position of the firm. Both the highly scripted assertion by the auditor, and limited disclosure of results shown in an aggregate balance sheet and statement of operations are traditionally based on paper records and checking various kinds of controls. These findings are essential to potential investors as well as actual owners.

Without paper backup of time stamped written orders, bills of lading to demonstrate delivery and arrival of purchases, and cancelled checks for outlays etc., the independent auditor is driven to other, highly indirect methods to prove the validity of revenue and cost claims. One way is to test the integrity of the software used for order taking and the general ledger on a separate machine and simulate activity which gets summarized by the target entity. Confirmation of when a transaction event takes place, and who in fact the parties are becomes more problematical when there are no paper, time-stamped forms that underlie digital data.

A currently active part of electronic commerce involves the development of private, electronic notary services which for a fee will time stamp a transaction and maintain a partial or entire record of the event or property. In order for such digital transactions to occur privately and be recorded across the net, some form of encryption is employed and confirmation between parties to actual identities obtained. In order to demonstrate that such records have not subsequently been altered, there is a necessity to write the record on a once-writable CD or otherwise non-alterable form of digital media. I do not believe the states have yet begun to actually promulgate standards for such electronic notaries. In a sense, because such activity is motivated by the necessity to address issues which are independent of local or regional geography and occur without traditional paper trail, one can expect that state policy in this area will be slow and heterogeneous.

Peha(1999) describes a system design composed of: (1) independent, electronic notaries, (2) separate, independent electronic verifiers of e-commerce parties’ identities, and (3) public and private encryption keys which permit the maintenance and recall of simple or complex records of transactions or documents across the net in a simple, private fashion. Central to the integrity of such a system is public accreditation, regulation and oversight of the electronic notary and verifier, and likely correlative standard setting for record maintenance and secure transmission so that such records can be suitable for third party uses as described above.

Because electronic commerce readily leads to purely electronic record-keeping, questions naturally arise about whether standard setting and supervision of record keepers, e.g. auditors and notaries, might better be accomplished through or assisted by a federal agency rather than state secretaries of state in the case of notaries, and an amalgam of professional associations of accountants and the IRS and the Securities and
Exchange Commission in the case of accounting standards and accounting practice. Currently, financial accounting standards are promulgated by the federal Securities and Exchange Commission for firms subject to Regulation 10-k disclosure requirements. Federal tax accounting standards are set by the Internal Revenue Service. While there is growing interest by the American Institute of Certified Public Accountants, a voluntary professional group, in electronic record keeping issues, I think it is fair to say that there does not yet exist a coherent federal strategy for dealing with entirely digital financial records. The General Services Administration, which supervises all federal agency purchasing, has various efforts underway to bring federal purchasing practices to the electronic world. However, GSA is not realistically in a position to dictate standards of electronic recording keeping and verification in a way that would effectively permeate the economy because much of the private sector does not deal with the federal procurement process.

There are two other, ubiquitous federal agencies: the Federal Reserve Board and the U.S. Postal Service. The Fed reaches to the entire economy through its contact with the national banking system; however, it does not directly contact the private sector at the establishment level. The postal system has contact with virtually every business in the economy by virtue of its near monopoly over postal services rather than direct regulator role. Should the US Treasury and IRS continue their reluctance to provide leadership to the private sector in terms of standard setting, and to the state-local sector in not being part of any grand political trade, one can imagine that either the Federal Reserve Board or the Postal Service could be chosen by the Congress to become the certifier of electronic notaries and electronic verifiers, and even maintain the records in part or whole as a trusted third party. Both are federal institutions with extensive physical presence, and both have excellent records on privacy and security matters. The Post Office is beginning in small ways to engage in some elements of this.

To date there does not appear to be either federal legislative or executive branch recognition that a federal role in certification, standard setting and some form of regulation of electronic record-keeping services would, as standard setting usually does, facilitate more rapid development in the private sector. The disinterest by private interests in a public role here seems somewhat contradictory, since the net would not historically exist had not the Defense Department obligated itself and its contractors to utilize a standard protocol or format in the transmission of electronic communication. The standardized nature of the format also explains why any email can be read by a third party able to attach to a device called a router whose purpose is to direct these standardized packets along the net to its

15 We take it for granted that to securely transmit something, typically for legal purposes, that we can send a letter or notice via certified or registered mail. To provide or supervise secure transmissions of such digital information, and or to devise national standards for, say, electronic notarization and digital signatures, may not be conceptually that far afield from what the Post Office does. The Japanese postal system which also supervises telecommunications is evidently taking on such responsibilities.

16 The standardized nature of the format also explains why any email can be read by a third party able to attach to a device called a router whose purpose is to direct these standardized packets along the net to its.
Achieving harmonization across the states in the regulation of electronic recording thus becomes in effect an issue of federalism, and one whose solution will need to be accomplished if state taxation of remote sales is to become practical.

Irrespective of whether or not there should be federal rather than state standards and certification for electronic notaries, because there is always a link between federal financial and tax accounting and reporting standards (e.g. Schedule M-1 and M-2 of an 1120)\textsuperscript{17}, there are necessarily subsequent links of such standards to state tax systems, record keeping, and accounting requirements. In my view, there is a need for national financial and tax record keeping and accounting standards for purely electronic records to evolve promptly to assist the private sector and state tax authorities to deal realistically with each other.\textsuperscript{18}

During the NTA Project, there was considerable sensitivity about whether or not there should be some form of audit of remote sellers to ensure destination states that there was a proper turnover of funds. Agreement was essentially reached that there should be no liability to a remote seller (or his payment agent) for purchasers’ providing misleading or fraudulent information about the identity or location of the purchaser\textsuperscript{19}. I think it is clear from the above discussion that the issue of underlying supervision of electronic recording keeping for purely private sector financial purposes, let alone federal or state tax purposes is one which will have to be addressed as paperless record keeping becomes increasingly widespread.

### 3.2. Direct Federalism-Trusted Third Party Issues Raised by An Expanded Duty to Collect

A second broad set of federalism-trusted third party issues arise as one begins to contemplate: (1) how remotely collected use tax monies might be remitted to the proper destination state, (2) how the details of a standard state sales and use tax regime might evolve, and (3) how compliance might be accomplished in a world of expanded duty to collect and remit. These relationships among the states and the national government and/or tax collector are typically described as tax harmonization issues. The basic orientation of the NTA Project in this area was to try to devise cooperatively a set of principles and rules that might characterize federal legislation making the grand political trade.

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\textsuperscript{17} Which drives which is a classic chicken-egg problem. I think a reasonable case can be made that, because taxation demands the immediate surrender of money, that federal tax accounting standards drive financial accounting standards. Financial reporting affects capital market decision-making, but that is extra-organizational and somewhat more removed than today paying the government.

\textsuperscript{18} FTA is developing cooperative statements on business to business electronic transactions through its EDI working group. This is, however, only one aspect of a very complex set of issues which purely electronic recording keeping engenders.

\textsuperscript{19} This becomes important when exemption certificates to, say manufacturers, or wholesalers are provided to avoid sales or use tax pyramiding.
While I consider myself a friend of the sub-federal sector, I see merit in any federal legislation, that makes permissible the taxation of remote sellers without a physical presence, to lay down a very clear template so that there is no confusion about what remote sellers must do in terms of consumption tax base and rate as well as the myriad of other details (forms, registration, remittance, etc.).

Precisely what sort of harmonization mechanism seems advisable or politically acceptable to this end depends initially on where stakeholders agree to be in the continuum describing the tradeoff between state sovereignty and ease of administration for taxpayer and tax collector(s), e.g. McLure (1998a). To this characterization I would add the consideration of actually getting some meaningful tax dollars in fact remotely collected and remitted.

Sales tax skimming is nothing new, and if my analysis of why much of traditional retailing may move to the net is correct, the possibilities for it to increase are not small. Moreover, a new, federal obligation to collect use tax creates opportunities for significant use tax skimming. Without a meaningful way to encourage and monitor remote seller collection and remittance conduct, the states will merely have a constitutionally permissible hunting license, but be in the dark as to where to look for their fiscal prey. All sub-federal parties who continue to negotiate over the grand political trade would do well to engage in reflection about what fiscal hunting in the dark really means. For sellers already with a physical presence intra-state, permitting this sort of midnight fiscal hunt in the dark could simply mean the level of their tax burden will simply continue.

Federal collection and remittance, the pure piggyback approach, was not something that representatives of the state and local sector or even the business community seemed ready to discuss in the NTA Project. Peha and Strauss (1997) mention this as one of several long-term approaches to dealing with the ultimate fungibility of destination assertions.  

Of course, there are more complex variants of piggybacking, such as piggybacking with restrictions on the extent of federal legislative changes in the tax base or requirements for state concurrence in federal tax base changes, which could be fashioned in conjunction with direct incentives (e.g. counter-cyclical federal block grants-in-aid to the states), that might overcome sovereignty concerns. Undoubtedly one can structure federal piggybacking with safeguards and financial incentives so that governors and state legislators find this approach more attractive than simply being individually enabled to urge remote sellers to collect and remit.

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20 Whether or not the states will continue to rule out federal piggybacking as McLure (1998a) predicts remains an open question. However, their lack of interest in the opportunity to piggyback on the federal personal income tax during the period 1972-1990 when it was available cost free suggests it would be difficult to accomplish without further incentives.

21 Or, one might statutorily require Congressional supermajorities to approve changes in the definition of a federally mandated tax base definition to forestall erosion of the base through the granting of exemptions.
An important macroscopic federalism design issue involves whether or not the federal government would help administer an expanded duty to collect use taxes in conjunction with its own national retail sales tax. Even if piggybacking does not occur *per se* (federal collection from remote sellers and remittance), the presence of a federal revenue generating template might readily force the states to fashion their sales and use taxes along the lines of the federal template and thereby achieve greater uniformity, and as well as engage in information exchange to administer the sales and use tax. We have seen this form of cooperation and state dependence on a federal template evolve in both personal and corporate income taxes.

Several points that raise questions about whether this is now a good idea for the federal government are, however, worth making. First, the state local sector continues to view consumption taxation as their preserve, and a national sales and use tax would have far-reaching political, let alone fiscal repercussions.

Two national arguments are typically advanced in favor of moving from our current hybrid federal income and wage tax system to a national retail sales tax: (1) improved economic performance that might be expected or hoped to result from a national consumption tax, and (2) administrative simplification at the federal (i.e. IRS) level. Without recounting an earlier analysis²², let me simply observe that the economic performance argument, at least defined in terms of real economic growth, is not nearly as persuasive today as it was in the early 1990’s.²³ We simply have been doing quite well economically with our hybrid system once fiscal policy became more balanced. If one is left then to argue for a national sales tax merely in terms of simplifying federal tax administration, I think the history of the ill-fated 1932 federal manufacturers excise tax is informative and argues against such a radical change in federal tax policy.²⁴ Also, it is difficult after reviewing the Canadian experience with their sales tax to conclude that simplification and compliance increased there.

If direct federal participation in a standardized, state by state sales and use tax regime via piggybacking is not desirable, and a national retail sales tax without piggybacking is also not warranted on its own merits, how might the federal government otherwise encourage compliance and ensure that a Congressionally mandated grand political trade was indeed honored? Two kinds of compliance are of interest: compliance by state governments to adopt and implement *intra*-state whatever regime Congress were to define as an acceptable grand political trade, and compliance by remote sellers to actually collect and remit according to the newly enacted federal rules.

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²³ There continue to be legitimate concerns about the low *rate* of private savings in the US economy. Whether a national consumption tax will do much to alter this remains an area of disagreement among at least academic economists.
²⁴ *Op cit.*, pp. 401-404.
²⁵ There could readily be constitutional conflicts over the Congress trying through federal statute to assert how the states should apply sales taxes to *intra*-state commerce. That is, if the federal use template were mandated for *intra*-state sales purposes to all states, there would be adverse reaction from at least the five non-sales tax states which the US Supreme Court would notice and uphold. However, any state which sought to indulge in ingenuity *intra*-state that varied from the federal use tax template and that also sought
There are both direct, and indirect approaches to accomplishing both kinds of compliance. The direct approaches involve federal grants-in-aid policy, and the indirect approaches involve state-federal tax relationships.

With regard to grants and governmental compliance, one can envision positive or negative incentives being effective. Two broad kinds of financial incentives may be envisioned: (1) a system of grants conditional on state adoption and implementation intra-state of what Congress were to enact with regard to inter-state use tax structure, and/or (2) the withdrawal of other, historical federal aid to the states that would be triggered by non-compliance by the states (which have sales and use taxes).

An in-kind variant of the second approach would be to condition continued state access to federal income tax return information on the state having in place the federally desired sales and use tax. Historically, Congress required that the states enact non-disclosure requirements parallel to those in the Internal Revenue Code and that states sign bilateral exchange agreements to continue to benefit from the exchange of federal tax return information for state tax administration purposes. Even non-income tax states enacted the necessary non-disclosure statutes, and signed up for the federal-state information exchange program.

Assuring compliance by remote sellers to collect and remit state use taxes also poses challenges were the federal government not involved itself in administration of a national sales and use tax. How to get remote sellers to in fact collect, and then remit to the destination state of use if federal piggybacking is not viable, and the IRS does not administer the use tax without a federal consumption tax being collected? Seller compliance was not something which the NTA Project identified as an issue to grapple with, but is extremely important for the meaningful implementation of an expanded duty to collect.

There is a general solution to this part of harmonization problem that involves federal participation but one that stops a bit short of federal piggybacking. The solution lies in constructing a tentative (federal) tax which may be offset by a credit for other “qualified” (state) taxes that the seller collects and remits directly to the states. Failure to collect and remit means loss of the credit, and the payment of the tentative tax to the federal government rather than in effect zeroing it out with the payment of the state tax. Since there is a tentative federal tax, there will necessarily be a federal review of books and records (federal audit), and oversight of the remittances so they go to the proper state.

In July, 1999 Senator Hollings introduced S1433 whose purpose was to impose a federal tax on internet or catalog sales at a rate of 5%, but which could be offset by a credit for collection and remittance of state and local sales and use taxes at rates of up to

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\text{Fulton}\text{ analysis. The likely net result for such a state would be the reward for such ingenuity would be to impose its own intra-state sales tax and hope for the best on use tax issues with essentially Bella-Hess and Quill limitations on taxing remote sellers.}
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5%. The bill creates the construct of sales by a “local merchant” to which the tentative tax and credit would not apply. The net federal proceeds of such an approach would go into a trust fund whose proceeds would be used by the Secretary of the Treasury to make grants, based on a population and poverty allocation formula, to each state and the District of Columbia to supplement salaries of primary and secondary public school teachers.

The Hollings mechanism puts extreme pressure on the states to adopt use tax rates at 5%. This arguably will have a chilling effect on state sovereignty that might be far worse than pure piggybacking because most piggyback models permit state discretion in tax rate, but use a purely federal collection mechanism.

A second variant of this type of harmonization, and one that I believe is much more workable, is to utilize an existing well harmonized federal-state tax instrument. What I have in mind here is to utilize the historical harmonization of federal and state unemployment taxes as a vehicle for assuring that the new duty to collect and remit use taxes is in fact honored. The idea would be to amend eligibility for the FUTA tax credit to require positive agreement by an employer to participate in the collection and remittance of the newly enabled use taxes. Remote sellers of any consequence have employees, and are thus necessarily involved in existing federal and state unemployment compensation programs. As a result, they are already subject to audit and regulation by both IRS and the US Department of Labor and their state counterparts.

Under this scheme, qualification to take the historical credit for state unemployment taxes against the tentative federal unemployment tax would simply entail a new responsibility, namely demonstrably agreeing to collect and remit use taxes enabled under the grand political trade. One would amend current FUTA tax reporting requirements to include reporting about all sales and the use tax remittances to aid in administration and audit. Under this approach, the states retain control over their use tax rates, get remittances directly from remote sellers, and IRS would perform some audit and oversight functions, but not deal with each transaction. This approach would also allow remittance mechanisms to evolve as technology develops, and the market place provides software solutions to remote sellers. It is reasonable to expect that some form of vendor discount be made available to amortize the costs of such software investments.

Two other tax harmonization issues necessarily arise if one uses in some new way a federal tax apparatus to administer or help administer an expanded duty to collect and remit use taxes. The first issue involves state standing to examine audit federal records to be assured of compliance and the determination of the geographic allocation of remittances. The second issue involves conflict adjudication systems from appeals to a court in which disputes, which inevitably will arise, get resolved. Presumably mechanisms can be devised, which follow our experience with FUTA, to resolve both matters satisfactorily.

26 The bill is silent on whether or not there are limitations on or qualifications for teachers to receive such supplements. Federal financing of teacher merit pay might bring together some currently divergent political forces.
3.3 Intra-governmental Trust Issues

Not too many years ago, California, the most populous state in the nation, resorted to issuing script because it could not agree on a budget by the start of its fiscal year. In the course of that budget difficulty, which has happened in other states (although without resorting to script), state cash transfers of school and other aid were interrupted. Local control over an elastic revenue source such as the sales tax, at least in terms of rate if not rate and base, gives local governments a level of confidence about being able to address their own fiscal destiny which a regime of one rate per state necessarily interferes with. Movement to one rate per state and the end of intra-state diversity in sales and use taxation, where permitted, creates a series of trust issues between state governments and their constitutional children, local governments.

Mechanisms such as a local sales and use tax depository trust fund can alleviate some but not all anxieties. Even if a state devises a trust fund into which a statewide portion of sales and use taxes are automatically transferred, and even if the trust fund is administered by a board of local governmental officials to ensure that the timely transfer and equitable allocation of the trust fund are accomplished, problems can occur. First, the elimination of local sales and use tax reporting means that subsequent allocation on a source or destination basis will not be readily possible. Without information about where sales are made or shipped to from vendors, municipal and county claims to be kept fiscally whole can be hard to honor. One solution is for a state to assure, at least on a dollar basis, that monies returned will be at least that collected under the old, intra-state regime. However, this approach will not track relative changes in shopping patterns that might reflect migration, or the development of new housing or shopping facilities.

Since these changes will also lead to growth in local and regional public service needs/demands, there will be claims to expand earlier programs on the basis of the earlier source of funding.

Population statistics, and population statistics weighted by income, help inform the states about such changes in living patterns (but not necessarily about locations of purchases) and they can be elements in an allocation formula. At the county level, there are periodic federal reports about retail sales, but not below the county level. The states may have to periodically survey retailers and perform studies to estimate how sales activity has changed; the federal statistical community may also be engaged to address these data needs.

The other aspect of the trust problem has to do with the elimination of fiscal discretion. The upward trend in average city sales and use tax rates shown in Figure 2 above do not reflect random events; they reflect political decisions which undoubtedly were not popular at the time they were taken. While it is true that in most states discretion over the local property tax rate will remain, where that discretion is fully utilized and public service needs remain, they will go unmet unless other sources of finance are found.
State revenue sharing and/or state assumption of a greater share of the costs of local services would appear to be a corollary to moving to one sales and use tax rate per state. Finally, the states can alleviate cyclical concerns by establishing state funded local rainy day funds with draw down or borrowing rights for local governments.

4. Defining Taxable Goods and Services and Final Consumption

4.1 The Classification Problem of Defining Taxable Goods and Services

Early on, a major tenet of the NTA Project’s discussions was that the choice of what should be taxable, and what should be exempt is a matter of state sovereignty, and should not be a matter of federal interest. To administer this continued freedom in a world of web commerce with an expanded duty to collect by remote sellers would require the development of a classification system for current goods and services which would be adopted by each state. Each state would then have to make public periodically whether or not, for example, it allowed the sales of men’s shoes to be taxed, or new automobiles, etc.

As is well known extant sales and use taxes in the US address vertical equity concerns by according exempt status to deserving commodities or services (the transaction), and address tax pyramiding concerns by characterizing the use of the good or service in construction of other goods or services. The states vary considerably in whether or not they tax under their sales and use taxes, for example, clothing, food, medicine, electricity, telephone service, newspapers, and books.

If sales and use tax reform entails taxing only final consumption, the question remains how to get from current state practices to the economist’s dream which typically makes it no farther than the classroom blackboard and a final exam question. From an economic perspective, final consumption can be measured by excluding from sales and use taxes items used for “production.” The term “production,” of course, harkens back to days when manufacturing was the primary form of commerce and does not deal with items used to produce services.

Due and Mikesell (1994, Chapter 3) observe that carving out a safe haven for production inputs can be achieved by defining a taxable sale to exclude many inputs, specifically exempting particular items regardless of use, and following the technique in credit-invoice VAT’s provide a credit to the purchaser for the tax in the purchase price.

Operational solutions involve applying the sales and use tax for sales at retail (and not to sales for resale). Statutory language has evolved over time to exclude from sales and use tax items which are combined, altered or transformed into another product. Issues arise in the case of items used in the conjunction with the performance of services, and whether or not an item facilitates production, but is not a physical part of it. Professor Due observes in a personal note that he tried to convince California, as it was first

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27 See Due and Mikesell(1994).
28 See Due and Mikesell(1994), Chapter 4.
developing its sales and use tax language in the early 1950’s, to exclude any item whose purchase price is reflected in the cost of production. Regrettably, the administrator in charge was a lawyer, and preferred to make verbal distinctions or bright lines rather than functional distinctions which had the predictable result of subsequent litigation and confusion.

4.2 Solving the Classification Problem and Defining Final Consumption: A Proposal

Were the federal government to devise a national template which the states would administer, and whose use component would be watched closely in conjunction with the operation of the FUTA tax, there would be an opportunity to address this age old classification problem. One way to do this is to reverse the way sales and use tax laws are typically drafted, and to introduce a new construct for sales and use tax purposes, the “taxable person.”

Under the taxable person approach, sales and use taxation is an exception to a general prohibition on the taxation of anything. The exception is for anything purchased for or purchased or by a “taxable person” for “non-business use”. What is a “taxable person”? A “taxable person” is any natural person (and thus not a corporation or other recognized legal form of a business or government). Purchase or use would cover any consumer purchase or rental. This concept is quite broad; for example, consumer services would be automatically covered under this definition since they are paid for by a natural person who is not a business. The first phrase, “purchased for” is necessary for sole proprietorships, and for closely held businesses, and more generally to avoiding passthroughs from businesses to persons as a way to circumvent the sales and use tax.

How might such a system work in the world of web commerce? Unless a purchaser had a registration certificate, any purchase, main street or remote, would be taxable at a single state rate. Provision of the business registration number by the agent for the company making the purchase would preferably be in a uniform format (a single national registration form with a single structure to the registration number) and provided in a secure (encrypted) form to the seller. Just as a seller has to confirm the authenticity of a credit card number and any other identifying information prior to agreeing to the sale, the seller would confirm the business registration certificate number to a regional or central clearinghouse that would maintain this information in a secure fashion. To ascertain whether or not the purchase is a pass through for personal use, the purchaser would have to be queried about this, and the proper response noted and recorded. The final issue involves the destination of delivery or use, and the application of the correct state sales and use tax rate. Again, the purchaser would need to be queried as to this and the seller would have to record it.

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30 Third party payments (e.g. health insurance) are a gray area but would seem to be an example of a business pass through to an individual which would thus be taxable to the third party (regardless if it was tax exempt or not). Anything purchased for personal use would be covered by the non-business use.
31 Evidently the new Russian Federation’s Regional Sales Tax appears to be structured in a similar manner. See Mikesell(1999).
The duty to collect would, of course, be on the seller, but the structure would move towards an economic or economist's definition of what we economists think is "final consumption."

The classification system focuses sales and use tax administration at the last stage of a chain of transactions. It would not eliminate the necessity for sole proprietorships and closely held businesses to be registered for exemption purposes along with manufacturing corporations and others which now benefit from such exemption. The seller (and tax administrator) would ultimately still have to make a determination of whether the purchase was for personal use, but it would significantly simplify the administration of retail sales and use taxes, and, move their application much closer to what economists consider final consumption. It would, however, also narrow the current state sales and use tax base by eliminating (unless policy were made and intervened to the contrary) current multiple taxation through the taxation of business inputs. By including all forms of consumer purchases (including food, clothing, and medicine), it would heighten vertical equity concerns which would have to be addressed through liberalization of income maintenance programs as well possible refundable sales and use tax credits administered through state personal income taxes.32

5. Conclusions

The purpose of this paper has been to review varying roles for the federal government once state taxation of activities on the Internet becomes a desired public policy. If web commerce growth does not materialize as fast as hoped because the states are unable to enact uniform statutes governing electronic commerce which accord customers and merchants enough protection to generate requisite levels of trust, one can envision a federal role in devising a uniform template which states voluntarily or Congress enacts. In such event, it is imaginable that such enlarged governmental responsibilities be accompanied by a fiscal mechanism to help pay for it. Alternatively, if very rapid growth occurs, then it is likely that state consumption tax revenues will be adversely affected, and the need to finally overturn Bella Hess and Quill will be seen.

As electronic transactions replace traditional paper and face to face commerce, there are a variety of issues involving state and federal regulatory and tax institutions which will require alteration. Commercial record keeping ultimately depends on standard setting requirements that are set by each state. One can readily envision the need for the development of a electronic notary function to arise, and standards for electronic record

32 It has been argued that the administrative burdens to remote sellers of making this sort of check of registration number and record that the sale was exempt for use tax (as well as sales tax) purposes are very substantial. Certainly some sort of vendor discount can be imagined to compensate for any software development or acquisition costs. In a world with the identical sales and use tax base per state, with only the rate of tax varying, record-keeping seems minimal and the lookup to calculate the amount of tax to remit rather minimal. Just as the credit card companies automate this service, one can readily envision a service (preferably supervised by a federal agency) which confirms registration numbers. With regard to record-keeping issues, per se, any vendor must keep track of sales for income tax purposes, and undoubtedly will be keeping track of who is receiving the transacted item[s] for follow-up marketing and other purposes.
retention to be critical as well. Remote authentication of parties to transactions, and the maintenance of partial or complete records of such transactions will require not only standards, but also the development of “trusted third parties” whose endorsement of veracity is useful for private and public purposes. Various federal agencies such as the IRS, Post Office and Federal Reserve System could play these direct roles, or supervise private organizations who do this.

With regard to the development of modernized and harmonized state sales and use taxes, the paper suggests a variety of ways the federal government could assist the states once there is political agreement to make the great political trade: federal legislation would be enacted to impose an expanded duty to collect by remote sellers, currently without physical presence, in return for agreement that state sales and use taxes would contain only one tax rate per state, and significant simplification of administrative procedures. It is suggested, and mechanisms described, that would impose such reformed sales and use taxes on only final consumption. Finally, it is suggested that the relationship between the federal-state unemployment taxes be expanded so that any employer under the system be newly obligated to collect and remit use taxes to the destination state of the customer.
6. Bibliography


