Further Thoughts on State and Local Taxation of Telecommunications and Electronic Commerce

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1. Introduction

With the issuance of its Final Report1 on September 7, 1999, the work of the National Tax Association Communications and Electronic Commerce Tax Project is evidently over. Compared to the outcome that no written document be agreed to, consensus to issue the Final Report took the high road, in my view, by serving the educational purpose underlying the Project’s creation by the National Tax Association several years ago. The Report provides in one place a discussion of most of the policy, design, and detailed administrative problems which underlie creating the grand political trade in sales and use taxation that has slowly crystallized since Quill. The grand political trade entails:

- 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.

The Project’s Final Report constitutes the starting point for those interested in taking next steps to make such a grand trade a practical reality. It may be disappointing but not surprising that the various associations of private and public interests involved in the Project could not agree to the nature of the grand political trade because in good measure they were unable to agree to some of the important, financially sensitive details of how to make it work.

There are several reasons why agreement did not occur in my view. First, there was a clear absence of any federal interest in the work of the Project despite its being the only ongoing forum for the serious airing of views and discussion of policies involving internet taxation. As an alum of both the Office of the Secretary of the US Treasury and the Joint Committee on Taxation, US Congress, the lack of meaningful interest or participation by the former, and the absence of any role for the latter was disappointing.2 As I will discuss below, any meaningful implementation of an expanded duty to collect will require a trusted third party with meaningful authority to obtain compliance.

It is difficult to envision how anything but federal law and a federal agency can ensure this. While a US Treasury representative participated in some of the drafting meetings, Treasury elected not to vote and not to volunteer or discuss how it or IRS viewed the myriad of technical matters that arose.

Second, enactment by Congress of a moratorium on new or expanded state internet tax activity in mid-process of the NTA Project created a potentially fatal distraction from the forum which the NTA Project provided. It was natural for both groups of interests to shift attention to a Congressionally created commission, with an obligation to report its advice to the Congress by a date certain, and away from a voluntary organization equally lacking in resources to do a difficult job. Of course, deep disagreements about the proprietary or balance in the national commission’s membership also suggested that the NTA Project might be the more rational forum to deal with the multitude of linkages among major and minor policy issues. But the initial distraction of the creation of the commission cast a long shadow on the efficacy of the NTA Project which easily could have terminated it without any discernible outcome.

Third, there was reason, a priori, to be skeptical that remote sellers, currently without nexus, would agree to sacrifice what is now in hand, an exemption from such a responsibility and therefore a price advantage v. others with nexus, in return for simplification of state and local sales and use taxes.3 Given the reality that ‘money in hand is better

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1 The Final Report, approved September 7, 1999 by conference call, is available from the National Tax Association’s Web Site: http://www.ntanet.org/ecommerce/final.pdf; the membership of the project can be found at http://www.ntanet.org/ecommerce/members.pdf.

2 Particularly distressing was the absence of any support for the suggestion that the Chief of Staff of the Joint Committee on Taxation be invited to fill a vacant voting position on the Project.

3 Having watched during revenue exigencies (and admittedly provided staff support when required while in government service) some business sectors gang up politically to focus tax attention on other more favorably treated sectors, I have been surprised that the remote sellers without nexus do not appreciate the dangers of what may lay before them if some sort of reasonable agreement is not reached. It is imaginable that both government and the non-internet business sectors
than the prospect of money to be saved,’ it was easy to imagine that those immune from a duty to collect would find no NTA Project report to be far preferable to any report that required any agreement that might imply they were bound by honor or precedent as they approached the National Commission on Electronic Commerce or the Congress to protect their short-term financial interests.

Fourth, it was evident, at least to me, that a non-trivial portion of those representing business interests had several other reasons not to agree to any sort of report: (1) lack of expertise in tax matters generally, let alone state and local sales and use tax matters in particular; and (2) representation of organizations composed of very diverse and conflicting positions on the wisdom of either a grand political trade or its details. The lack of tax expertise necessarily engendered uneasiness about agreeing to what perceived adversaries suggested; this in turn forestalled agreement and could have slowed down the NTA Project to a complete halt. Intra-organizational conflict over policy also made agreeing to anything far more problematical and, again, could have prevented reaching agreement over anything, including the issuance of a report.

Fifth, and related to the previous observation, is the reality that while organizations may have been able to reach a policy position on aspects of sales and use taxation, they do not have the capacity to impose the organizational view on each of their members. In the case of governmental associations, this is important, because, while several (NGA and NCSL) early on approved resolutions endorsing one rate per state, and phasing out varying local sales and use tax rates intra-state, the diversity in local sales and use tax persists. According to Vertex, Inc, the number of counties adopting, *de novo*, local sales and use taxes numbered anywhere from 23 per year in 1998 to 43 per year in 1996. The number of cities adopting sales and use taxes, *de novo*, numbered anywhere from 141 in 1998 to 203 in 1995. (See Table 1).

Table 1: Number of Newly Enacted Local Sales and Use Taxes: 1993-8

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Source: Vertex Tax Cybrary http://www.vertexinc.com/

Both at the state and local level, there has been a long-term upward secular trend in the *rate* of sales and use tax imposed, no doubt reflecting revenue exigencies of various kinds. When viewed in conjunction with estimates of state and local sales and use tax pyramiding⁵, they suggest that the excess burden of such taxes has continued to increase.

Another aspect of governments’ continuing diversity in sales and use tax practice is the absence of action by any states, during the past two years, to take the necessary statutory steps to move towards one rate per state, as well as to develop the necessary intergovernmental fiscal mechanism to allay their local governments’ fears of being fiscally abandoned after giving up their own limited fiscal autonomy over their local sales and use tax rates.

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⁴ See http://www.vertexinc.com/
⁵ See Ring (1999).
Figure 1:
Average State Sales and Use Tax Rates 1981-1998

Average Rate in %
State Rate (Avg)

Year

Figure 2
Average Local Sales and Use Tax Rates: 1981-98
Jurisdictions with Tax

Average Rate in %
County Rate (Avg) City Rate (Avg)

Year
Yet, despite all these explanations for why the NTA Project might have been expected to collapse without a report, both an educational report was agreed to, and one which contained a statement of principles that Project members thought should accompany any subsequent grand trade that might be acceptable to stakeholders:

There should be one tax rate per state which would apply to all commerce involving goods or services that are taxable in that state. Provision must be made to ensure protection and equitable distribution of revenues to local jurisdictions. The details of how to encourage or require states, local governments, and businesses in this new system need further study.\(^6\)

For sourcing of transactions for sales and use tax purposes, the following principles should be followed:

Transactions should be sourced only to the state level; sourcing to a sub-state level should not be required

Transactions should be sourced to the state of use or destination to the extent adequate information is available in a practical, unobtrusive and efficient manner. Transactions for which information is not available should be subject to one or more default rules to be developed

Procedures should be developed dealing with audits and record keeping.\(^7\)

I would be remiss, however, if I did not observe that the process by which the Final Report developed had its low points. During the course of Project meetings, sometimes the debates, speeches, and maneuvers seemed to be worse (at least more disingenuous) than the those of the Carnegie-Mellon Faculty Senate, but more high minded than the shenanigans our three teenagers engage in to avoid family chores. Project combatants had as an excuse that large sums of money were in their minds at risk, whereas our three teenagers stall without apology simply to avoid doing unpleasant tasks and to see how angry they can get their parents.

Below, I would like to share with you my thoughts and ideas on a number of macroscopic and technical matters which may inform next steps in devising an acceptable grand political trade.

I presume in terms of background assumptions that such a trade will also entail, or aspire to entail, the long-term elimination of the most objectionable economic aspects of state sales and use taxes: the vast amount of pyramiding or cascading through the taxation of business inputs. Congressional action on the interstate taxation of electronic commerce is truly worthwhile when such federal action moves to eliminate the undue cascading which such taxes currently impose\(^8\). Further, such Congressional action is truly worthwhile when it ensures that functionally equivalent goods and services are taxed the same, regardless of whether they are obtained face to face, or via electronic commerce. For me, then, state sales and use tax nirvana is:

- taxation of only final, broadly defined consumption of all goods and services,
- state authority to vary only the (one) rate of tax per state,
- significant simplification and standardization of tax base across states,

in return for which the state and local sector would obtain collection of remote sales, and business would obtain not only simplification but also the elimination of cascading.\(^9\)\(^10\)\(^11\)

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\(^6\) Final Report, p. ii.

\(^7\) Final Report, p. iv-v.

\(^8\) Ring(1999)estimates that consumers directly paid 59% of sales and use tax collections; thus business paid 41%.

\(^9\) While some might view these as improbable goals, I think it is unwise to lose sight of desirada prior to actually engaging in legislative compromises.

\(^10\) McLure(1999) describes this sort of ideal consumption tax in a federal system as the “neutral system” in which e-commerce is taxed, and sales to business exempt, and sales of final consumption of services and intangibles are taxed.

\(^11\) See Hellerstein(1999b) for a constitutional analysis which concludes there are no restraints on Congressional authority to “…expand, restrain, or otherwise prescribe the rules governing state taxation of electronic commerce.” (p. 114).
Below, I address three questions:

• How should one think about answering the question of whether or not internet commerce constitutes a significant fiscal threat to the state and local fisc in the foreseeable future? (Section 2)

• What alternatives are available to achieve tax harmonization among the states and with varying roles for the federal government? (Section 3)

• What are the approaches to the difficult problem of classifying goods and services for sales and use tax purposes which might ease administration both for main street and e-commerce? (Section 4)

2. Thinking about the State and Local Revenue Consequences of Diversion of Traditional Retail Commerce to the Internet

There has been considerable confusion, in my view, about how to think about the tax revenue consequences of electronic commerce. Cline and Neubig (1999) quickly responded to America OnLine’s desperate call at a NTA Project meeting earlier this year for a reliable study to end the continuing speculation about whether or not e-commerce has caused the state and local fiscal sky to fall. They calculated with aggregate data that the revenues foregone due to diversion of sales over the internet in place of face-to-face (e.g. taxable) sales were modest (.1% of total sales and use tax collections), and therefore nothing to worry about. Duncan (1999) subsequently made the important point that the issue at hand involves not what happened in 1998, but what will happen a few years from now.

Parenthetically I should note that for those who have worried about Goolsbee’s estimates, recognize that the underlying sample he used for statistical analysis was for 25,000 individuals who purchased on the web in late 1997; this was still an early period in terms of internet purchasing. His estimated diversion effects, due to sales taxes are extremely large; he reports elasticities of 2.3 to 3.6. What these large elasticities mean for the fisc depends critically on what fraction of the population winds up using the net for commerce contrasted with main street. In 1997 not many were engaged in net purchases.

This past May when he gave his paper at the UNC Tax Policy Conference at Chapel Hill, I urged him to report the results of what happens to his estimates when he weights his data to match age X sex X race X income tabulations which can be easily obtained from, say, the Current Population Survey, and then does his policy experiments with the parameters he reported. If he indeed has reliable parameter estimates, this would tell us what would happen if everyone were on the net (those currently engaging in net purchases do not look like the general population), and tell us how robust his results are.

There are, however, other ways to think about the fiscal risks to the state and local sector that e-commerce poses which can suggest a far different qualitative conclusion about the future, and one that is much more troubling in terms of the ability of state and local governments to finance themselves in the future. First, think about why individuals might prefer to purchase traditional goods and services via the web rather than face to face, and think about who they are. There already is reliable evidence that computer ownership and usage is concentrated in the upper income brackets in the sense that the fraction of an income interval that owns and uses computers rises as one moves up the income scale. Thus absolute dollars of discretionary spending are concentrated among those with the fullest access to the net.

Two advantages of purchasing consumer goods over the internet are typically advanced: lower price and “convenience.” Convenience, I suggest may turn out to be more important for high income households than price per se, because convenience really means saving time which is inherently more limiting than income for most consumer goods in question. One only has to add up the amount of time spent waiting in traffic, then in line at virtually every store on a weekend to complete a shopping list that one will subsequently consume to recognize how time consuming pre-consumption shopping can be. The combination of a consumer’s travel time, search time, purchase time, and return-

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12 Only 9.7% of families with income under $10,000 had personal computers in 1997, while 64.5% of families with income over $50,000 had personal computers. (Table 1223, Statistical Abstract of the United States: 1998).
travel time, when priced at the opportunity cost of his wage rate, can easily equal the cash outlay for the goods purchased.

If the median income in the US is about $45,000, and it represents 2,000 hours of work per year, then the gross, hourly wage rate is $22.50/hour. Shopping on a Saturday can easily consume 4 hours of time or be worth $90.00.\textsuperscript{13} A trip to a local bookstore to buy a book can easily consume a total of an hour, and outweigh the retail price of the book. If the local shopping mall is 5 miles from ones residence, one winds up additionally using about $3.20 ($0.32/mile) in resources to drive to and from the mall. UPS charges for small items compare favorably and further explain why a virtual bookseller might readily have a business model which will prove successful, irrespective of use tax arbitrage considerations.

One reason even high income families shop at retailers selling consumer goods in large quantities is that by purchasing large quantities of a staple (large quantities are often unavailable at regular retail outlets), they have reduced the time cost of the subsequent per unit consumption. Since they value time foregone in terms of their shadow wage (which is also the price of their true leisure), it makes sense to go to Wal-Mart to stock up on, say paper towels, as long as the time cost of the transaction (waiting in line), is no worse than at a traditional retail outlet where they would be forced to return more often.

There are two outstanding impediments to replace systematically face to face purchases with web based purchases: (1) limited communications bandwidth to the home personal computer, and (2) the problem of trust in providing private financial information over the web (primarily unease about the security of credit card numbers and their authorization or pin codes).\textsuperscript{14} Lack of bandwidth hampers the speed with which a potential customer can obtain detailed, product images and information from one or several vendors. Once consumers can obtain instantaneous high resolution graphics or pictures of items of interest, consumers will experience enormous time savings in comparing brands, features, and, of course, prices of various vendors offering the commodities in question. As confidence improves generally about the security of transmitting pin codes over the web, then I expect diversion to accelerate markedly.

The behavior of college freshman in their high bandwidth dorms constitute a natural experiment of sorts. Anecdotes abound at CMU of freshman students, empowered with credit cards, not allowed to have cars their first year, and facing very heavy academic work loads, nonetheless aggressively shopping at such virtual retailers as J. Crew and Victoria’s Secret. Since they do not have the time or ready transportation to go mall shopping, they turn to the internet as a way to satisfy their consumption needs.\textsuperscript{15}

Another way to think about why a very large fraction of household consumption may get transacted over the net rather than through face-to-face commerce involves analyzing the cost components of a traditional consumer good bought through a traditional retail channel. A traditional retailer must engage in advertising as must the traditional manufacturer to both inform the potential consumer about the product and to generate and maintain brand loyalty. Second, there are wholesaling and distribution costs which ultimately are built into the final retail price. Third, inventory carrying costs as well as the overhead from the retail establishment itself need to be combined with the marginal retailing costs and a reasonable profit margin. These components of distribution or intermediation all combine to build up prices from manufacturer to final consumer. Ignoring the consumer’s capital costs for a personal computer, and the cost of

\textsuperscript{13} Given the difficulties of finding out with any accuracy whether or not a store has in stock what one wants, this cycle can be repeated were the mall expedition unsuccessful. Web commerce eliminates much of the uncertainty about inventory once web vendors learn themselves the value of credible assertions about availability.

\textsuperscript{14} Mikesell(1998) also observed that (a) slow realization of adequate bandwidth to provide directly various digital product versions of across the counter purchases (music, rental movies etc.) and (b) security worries imply slow growth in the net commerce, and therefore a small effect on state and local sales and use tax receipts. He also estimates that 63 percent of consumption is “hard to digitize.”

My point here is that once these two obstacles are overcome, many more “hard to digitize” goods will be transacted by remote sellers because of convenience and price considerations with significant effects on both state and local revenues. Already employees in high bandwidth office buildings are substituting web purchases for main street purchases according to the Wall Street Journal of September 24, 1999.

\textsuperscript{15} Admittedly not having to finance their purchases, and not being under direct parental supervision may also have something to do with the explosion in their shopping via the internet.
having internet access, the consumer now faces an opportunity to share with the manufacturer or broker a very high percentage of the retail price in the form of a price reduction. If one examines the value added attributable to retailing, wholesaling, transportation, and those elements of financial intermediation which are amenable to being replaced through web rather than face to face access, one winds up with a considerable portion of GDP.

Finally, the evident vast investments currently being made to develop direct marketing of hard goods and services over the web, let alone new, digital and multimedia services, suggests to me that more than simple tax arbitrage, which we have seen in good measure through catalog sales, is at work here. Imagine the implications to the sales and use tax base if Sears decided to do what Egghead Software did several years ago: entirely eliminate their physical presence in the form of physical retail stores and operate through catalogs and the web. Further, imagine that Sears located all of its warehouses in Oregon. It would become nexus-free and not be obligated to collect and remit use tax anywhere, despite being primarily in the business of selling “hard goods.” In other words, the commitment of very substantial funds to utilize the web as the direct distribution channel and bypass several layers in historical commerce suggests that risk capital thinks that significant portions of the economy can be rerouted over the web. This will necessarily impact state sales and use taxes and indirectly impact the local property tax. As main street retailing atrophies, so will the local commercial real estate taxes collected from them, as will real estate taxes levied on the structures (and sometimes inventories) of wholesale distributors who are within regional access to customers.

To make this more concrete, consider the fact that in 1997, 6.6 million in the US were employed in wholesale trade, and 22 million in retail trade out of total employment of 122 million. The combined GDP in 1997 of these two sectors was $1,141.8 billion. It is the activities of these two sectors which web commerce is, in a fundamental sense, seeking to replace by linking consumers directly to the producers of goods and services via the net and spot auctions.

Thus, such diversion in the sale of what one might call “hard goods” from face to face transactions to web-based transactions, with attending opportunities for tax management or worse, could readily have far worse fiscal implications for the states and localities than one might glean from Goolsbee(1998) or Kline and Neubig(1999).


The absence of face to face confirmation of activities in an e-commerce world generates a series of “trust” issues which ultimately impact the fisc. I explore three below.

A. 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

16 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.
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.\textsuperscript{17}

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 as 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.

\textsuperscript{17}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.
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\(^{18}\). 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 standard composition of any packet of binary information over the net follows TCP/IP format, and is the underlying reason why communication of any information in that form can be ubiquitous.\(^{19}\)

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)\(^{20}\), 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.\(^{21}\)

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\(^{22}\). 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

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\(^{18}\) We take it for granted that to securely transmit something, typically for legal purposes, that we can send a letter or notice via 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.

\(^{19}\) 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 ultimate destination. The “sniffing” of packets to capture passwords is a favorite dorm past-time among undergraduate engineering and computer science students, and also enables any organization through its MIS management to engage legally in rather general surveillance of its employees.

\(^{20}\) 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.

\(^{21}\) 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.

\(^{22}\) This becomes important when exemption certificates to, say manufacturers, or wholesalers are provided to avoid sales or use tax pyramiding.
federal or state tax purposes is one which will have to be addressed as paperless record keeping becomes increasingly widespread.

B. 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.

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 in my view a constitutionally permissible hunting license, but be in the dark as to where to look for their fiscal prey. I think all sub-federal parties who continue to negotiate over the grand political trade would do well to engage in some mature reflection about what fiscal hunting in the dark really means. For sellers with a physical presence intra-state, permitting this sort of midnight fiscal hunt in the dark could simply mean arrows continue to come only their way.

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. McLure (1998a) correctly observes that a simple piggybacking system could run fatally afoul of state sovereignty concerns.

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 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 fiscally hunting in the dark. Getting the Congress to pony up in a time of surplus does not seem entirely far-fetched, especially if the notion of block grants is sold as a new federal-state partnership of elected officials with suitable positive publicity and continued expressions of state-local gratitude.

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.

23 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.
Space and time limitations preclude an extensive discussion of what a national retail sales tax might entail. 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 analysis, 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. 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. 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.

There are both direct, and indirect approaches to accomplishing both kinds of compliance. The direct approaches involve federal grant 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).

A 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

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25 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.
27 There would likely be some sort of constitutional scuffle over the Congress trying through federal statute to assert how the states should apply sales taxes to intra-state commerce. That is, I surmise that 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 to maintain access to the federally enabled use tax would have to survive a Fulton 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.
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.

This past July, 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 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.28

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 simply 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 could 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 would be made initially 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 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.

C. 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 budgetary fiasco, 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.

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.

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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

A. 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 known29, 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.30

If sales and use tax nirvana 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.

29 See Due and Mikesell(1994).
30 See Due and Mikesell(1994), Chapter 4.
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\(^{31}\) that he tried to convince California, as it was first 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.

B. Solving the Classification Problem and Defining Final Consumption: An Immodest Proposal

In the spirit of innovation, and in light of the hoped for opportunity for 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, I would like to suggest a new solution to this age old problem. My objective here is to give both economists and lawyers something to take credit for on the way to sales and use tax nirvana.

The innovation involves reversing 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 proposed approach, sales and use taxation is an \textit{exception} to a general \textit{prohibition} on the taxation of anything. The exception is for \textit{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). Purchase or use means would cover any consumer purchase or rental. This concept is quite broad; for example, consumer services are automatically covered under this definition since they are paid for by a natural person who is not a business. \(^{32}\) 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, \textit{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.

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 proposal 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 radically simplify the administration of retail sales and use taxes, AND, move their application much closer to what economists


\(^{32}\) 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.
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.  

5. Summary and Conclusions

My purpose in this paper has been several-fold: to explain the many reasons why the NTA Project could have ended without accomplishing anything, and to examine three questions which will need to be answered by those who wish to take next steps to effect the grand political trade. First, I think there are a variety of reasons to believe that web commerce involving traditional “hard goods,” let alone new goods and multimedia services, is about to explode which will alter the terrain of the US economy and affect the state and local fisc. The likely geometric growth in purely electronic record keeping raises a host of issues for financial accounting and record keeping, and thereby affects the private sector’s ability to describe to any third party (private or public) what is going on with revenues and expenses. The adoption of standards for such record keeping ultimately involve federalism issues, and benefit from federal leadership to establish such standards.

The matter of establishing trusted third parties who are supervised or certified by a public entity or entities becomes central to the workable design of the grand political trade that would federally obligate remote sellers, currently without nexus, to collect and remit to destination states in return for a simplified system of one sales and use tax rate per state, and a uniform, broad based definition of consumption as the tax base. If pure piggybacking or a national retail sales tax are not acceptable, then one can rely on an existing state-federal tax mechanism, the FUTA tax and state credit, to provide federal oversight which will alter the terrain of the US economy and affect the state and local fisc. The likely geometric growth in purely electronic record keeping raises a host of issues for financial accounting and record keeping, and thereby affects the private sector’s ability to describe to any third party (private or public) what is going on with revenues and expenses. The adoption of standards for such record keeping ultimately involve federalism issues, and benefit from federal leadership to establish such standards.

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To be sure the use of the FUTA mechanism amounts to mixing apples and oranges to achieve a particular set of policy objectives; however, in the absence of substantial federal leadership to help make taxation of remote sellers a reality, it is the one existing state-federal tax mechanism which can basically do the job.

Similarly, some may find a completely inclusive sales and use tax base for final consumption to create insurmountable political difficulties because of vertical equity concerns. Obviously, if national agreement can be reached on what food, medicine, and other necessities are, and done in a simple, functional manner, then it is imaginable that regressivity might be forestalled, albeit at the loss of considerable simplification intra and inter-state.

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33 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.
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