
Taxation of the Internet and Pennsylvania's Economic Climate

Robert P. Strauss*

Testimony before:

Honorable Frank Tulli, Jr.
Chairman

Subcommittee
on Economic Development
Committee on Commerce
and Economic Development

Pennsylvania House of Representatives

August 23, 2001

Allegheny County Courthouse
Conference Room 1
10:00 AM

*Professor of Economics and Public Policy, H. John Heinz III School of Management and Public Policy, Carnegie-Mellon University, Pittsburgh, Pennsylvania, 15213-3890. Email: RS9F@Andrew.CMU.Edu; Home Page: <http://www.heinz.cmu.edu/~rs9f>. The views and opinions in this testimony are solely those of the author, and do not represent those of Carnegie-Mellon University or its Board of Trustees.

1. Introduction

Chairman Tulli, and members of the Subcommittee on Economic Development, I want to thank you for the opportunity to testify before you this morning on the issue of state taxation of Internet transactions, and its relation to economic development in Pennsylvania. As you know, Internet taxation is very controversial, and can be very complex. Congress is currently debating whether or not to extend its 1998 moratorium that expires later this year. Leading Congressional proposals¹ would extend the expiring moratorium through the close of 2005. If enacted, there would continue to be a moratorium on new (1) taxes on Internet access, unless such tax was generally imposed and actually enforced prior to October 1, 1998; and on (2) multiple or discriminatory taxes on electronic commerce.

Since 1997, I have been researching, writing and giving seminars on the issue of taxation of the Internet.² During 1998-99, I participated in a national committee of government representatives, industry representatives, and academics whose work immediately preceded and final report³ materially informed the Advisory Commission on Electronic Commerce (ACEC) that Congress established in the 1998 moratorium. Recall that the ACEC was unable to reach agreement on what to recommend to Congress last year. Also, in March, 1998 I was invited by your colleagues in the House to comment on Senate Bill 2,⁴ and urged, with success, that the local option sales and use tax be dropped from the legislation, because it conflicted with emerging national trends about what the states would have to do in order for there to be some sort of reasonable compromise on state taxation of transactions over the Internet.

Given the evident national slow-down in economic activity and the fact that state and local tax receipts have also begun to materially slow down, the matter of whether or not to subject transactions over the Internet to taxation has much greater urgency than several years ago. Below, I want to comment on the following issues:⁵

1. What are the core issues that generate so much heat and light over taxation of transactions on the Internet? (Section 2 below)
2. What does the national debate over simplification of state sales and use taxes in return for an expanded duty to collect use taxes involve? What are the major issues? What is the range of policy options for federal implementation? (Section 3 below)

¹ See, for example, HR 1410 in the U.S. House of Representatives, and S 512 in the U.S. Senate. Neither has been reported to or passed its respective floor as of August 17, 2001.

² See: Jon M. Peha and Robert P. Strauss (1997), "A Primer on Changing Information Technology and the Fisc," *National Tax Journal*, 50, 3 (September, 1997) 607-621. http://www.heinz.cmu.edu/~rs9f/peha_strauss97.pdf; Robert P. Strauss (1999), "Further Thoughts on State and Local Taxation of Telecommunications and Electronic Commerce," *State Tax Notes*, 17, 17 (October 25, 1999), 1113-1124. <http://www.heinz.cmu.edu/~rs9f/fta99.pdf>; Robert P. Strauss(2000), "Federal Tax Mechanisms to Enable State Taxation of Final Consumption." Testimony before the Subcommittee on Oversight. House Committee on Ways and Means. U.S. Congress. May 16, 2000.(reprinted in *State Tax Notes*, May 29, 2000 and *Tax Notes*, 87, 12 (June 19,2000),1657-64. <http://www.heinz.cmu.edu/~rs9f/wm00b.pdf>; Karen Clay and Robert P. Strauss(2000), "Trust, Risk, and Electronic Commerce: Nineteen Century Lessons for the Twenty-First Century," , 93rd Annual Conference on Taxation, National Tax Association, Santa Fe, New Mexico. http://www.heinz.cmu.edu/~rs9f/nta_11_12_00_bob.pdf. and "Further Thoughts on Federal Tax Mechanisms to Enable State Taxation of Final Consumption," Testimony submitted for inclusion in the hearing record of the Senate Finance Committee, US Congress, August 1, 2001 Hearings on Taxation of the Internet. http://www.heinz.cmu.edu/~rs9f/finance_8_9_01.doc, <http://www.heinz.cmu.edu/~rs9f/fta99.pdf>

³ See *Final Report* of the National Tax Association Communications and Electronic Tax Project; available at: <http://www.heinz.cmu.edu/~rs9f/final.pdf>.

⁴ See Robert P. Strauss(1998), "Is Senate Bill 2 True Local Tax Reform? or Will Buffy (the Property Tax Slayer) Slay You, Me, and the Pennsylvania Economy?" <http://www.heinz.cmu.edu/~rs9f/legis98.pdf>.

⁵ Sections 2-3 are largely based on my earlier testimony before Congress.

3. What should Pennsylvania do regarding this national debate and national negotiations? (Section 4 below)
4. What linkages are there between growth in the Internet and economic development opportunities for Pennsylvania? (Section 5 below).

2. Core Issues Surrounding State and Local Taxation of Internet Transactions

In order to pay for public services that the Pennsylvania Constitution obligates the General Assembly to provide, you have fashioned a system of state and local taxes that tax income, consumption, gross receipts, and various types of wealth. Taxation of transactions over the Internet, as well as taxation of the purchase of Internet access, *per se*, essentially involves state and local consumption taxes---the Internet tax debate thus directly involves state sales and especially use taxes. Recall that sales taxes are imposed on taxable items purchased and consumed in Pennsylvania, while use taxes are imposed on the importation into Pennsylvania of taxable items.

2.1 The Federal Constitutional Setting

It is settled federal constitutional law that the *rate of tax* on imported items can be no higher than on items purchased within the state. Similarly, it is settled federal constitutional law that if an imported item is taxable, then its domestically purchased counterpart must also be taxable. While it is technically constitutional for a state to tax more lightly or even exempt destination sales or imports of a particular item into a state compared to the taxation of an identical domestic purchase, the realities of how domestic merchants (who vote and make campaign contributions) might view such favoritism has precluded that from occurring.

It is also settled federal constitutional law that remote vendors without a physical presence in the destination state are under no legal obligation to collect and remit use taxes. It is for this reason that catalog sales⁶, and sales from other remote vendors such as QVC or the Home Shopping Channel into Pennsylvania over 800 phone numbers do not obligate the vendor to collect and remit use taxes to the Pennsylvania Department of Revenue.

It is crucial, however, to understand that Pennsylvania residents *are legally responsible* under current Pennsylvania use tax law to pay the use tax directly to the Pennsylvania Department of Revenue on such purchases from remote vendors if the item is, in fact, taxable. However, it is well known that individual taxpayer compliance with this obligation is weak to non-existent.

2.2 The Sales and Use Tax in Pennsylvania

Pennsylvania's sales and use tax has evolved over the decades in terms of rate and base. Among the states, the current sales and use tax base is one of the narrower in that it excludes a wide variety of goods and services from taxation. In terms of tangible purchases, food (in the grocery store), medicine (exemption for over the counter *and* prescription medicines), clothing (partial exemption) are broadly exempt as are a wide range of specific commodities (motor fuel, natural gas and electricity) that are subject to specific excise taxes. Additionally, a wide variety of services (rents, most leases, and, among others, personal legal and accounting services) are exempt from the household sales and use tax. A broad manufacturer's exemption also exists to prevent cascading of sales and use taxes.

Pennsylvania's sales and use tax rate has been 6% since 1968, and, at about \$7 billion/year, currently amounts to about 35% of state tax revenues.

In Pennsylvania, sales and use taxation was the sole prerogative of the state until 1991. In June 1991, Philadelphia's dire financial situation led to your enabling Philadelphia to impose a 1% sales and use tax. In 1993 you enabled Allegheny County to adopt a parallel 1% sales and use tax in conjunction with the elimination of the

⁶ Sales into Pennsylvania by such companies as Lands End or LL Bean, who mail out catalogues and fulfill orders placed by Pennsylvania residents on toll free numbers and ship to Pennsylvania addresses, do not obligate the vendor to collect and remit Pennsylvania use taxes.

County, Pittsburgh City and School District personal property taxes; Allegheny County's sales and use tax became effective in July, 1994 with the proceeds being shared to a Regional Asset District and in turn to the municipalities and various arts and cultural organizations in the County. In both cases the Pennsylvania Department of Revenue actually collects and remits the additional 1% sales and use taxes to Philadelphia and Allegheny County. In 2000, Allegheny County sales and use taxes were about \$36 million, about 5.7% of total county government revenues, and about 13% of total county government taxes.⁷

2.3 Generally Perceived Core Issues in the Internet Tax Debate

Revenue Issues

There is widespread disagreement about how fiscally important sales over the Internet of tangible personal property are, and what the potential revenue loss will be over the next few years as a result of diversion.⁸ In February 2000, the Pennsylvania Department of Revenue revised its estimates of sales and use tax losses due to predicted diversion. It believes that in FY98/9 lost revenues were \$17.5 million, and losses are predicted to grow to \$125 million/year by fiscal year 2002/3.⁹ While most popular attention has focused on diversion through household consumers purchasing via the Internet rather than through face-to-face transactions, some of the larger, national estimates of revenue loss find that most is due to loss of those sales and use taxes currently collected from business to business (B2B) transactions. Nationally, about 40% of sales and use taxes are collected from B2B transactions rather than business to consumer (B2C), and the movement of B2B activity to the Internet is occurring much more quickly than for B2C. In Pennsylvania about 36% of sales and use taxes are collected from business to business transactions.¹⁰

Table 1 displays the most recent independent national estimates of revenue loss from B2C and B2B diversion. Note that some Internet purchases by households and businesses will replace mail order and toll free telephone methods of purchase. Bruce and Fox (2000) estimated that in 2000, \$2.7 billion of net state sales and use tax revenues were incrementally lost, compared to \$174 billion in actual sales and gross receipts tax collections¹¹, or 1.6%. By 2003, they expect this to grow to \$10.8 billion in lost state sales and use tax revenues. Bruce and Fox estimate that Pennsylvania's share of the \$10.8 billion national, incremental revenue loss in 2003 would be \$358 million, or almost three times that of the Pennsylvania Department of Revenue's February, 2000 revised estimate.

⁷ See p.23, 2000 Comprehensive Annual Financial Report of Allegheny County Controller.
<http://www.county.allegheny.pa.us/controll/tran2000.pdf>.

⁸ For an industry perspective, see: Robert Cline and Thomas Neubig (1999), "The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998," *State Tax Notes*, July 5, 1999, p 43.-49.

⁹ Pennsylvania Department of Revenue, Bureau of Research (February, 2000). *The Impact of Electronic Commerce on Pennsylvania Sales and Use Tax*, p. 1.

¹⁰ Raymond Ring, Jr. "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal*, LII, 1 (March, 1999), Table 1.

¹¹ See <http://www.census.gov/statetax00.html>.

Table 1: Bruce-Fox Estimates of State Sales and Use Tax Losses Due to Diversion of B2C and B2B Sales (\$ Billions)

	1999	2000	2001	2002	2003
Total Business-to-Business via Internet (B2B)	\$106.59	\$244.87	\$486.63	\$821.80	\$1297.80
Less Exempt Sales	-47.54	-105.05	-208.76	-369.81	-616.45
Less B2B on which sales/use tax collected	-34.07	-80.96	-164.77	-281.59	-444.24
Equals B2B Base Loss	24.98	58.87	113.09	170.40	237.11
Less substitution for other remote sales	-12.49	-29.43	-56.55	-85.20	-118.55
Equals Incremental B2B Base Loss	12.49	29.43	56.55	85.20	118.55
Approximate Revenue Loss from B2B (\$ billion)	\$0.80	\$1.88	\$3.61	\$5.44	\$7.57
Total Business-to-Consumer via Internet (B2C)	19.75	37.79	62.59	98.62	140.19
Less Exempt B2C	-8.32	-15.34	-23.53	-32.74	-41.78
Less B2C on which sales/use tax collected	-1.14	-2.60	-5.51	10.54	-20.57
Equals B2C Base Loss	10.29	19.85	33.55	55.34	77.85
Less substitution for other remote sales	-3.60	-6.95	-11.74	-19.37	-27.25
Equals Incremental B2C Base Loss	6.69	12.90	21.81	35.97	50.60
Approximate Revenue Loss from B2C (\$ billion)	0.43	0.82	1.39	2.30	3.23
Approximate Incremental Revenue Loss (\$ billion)	\$1.23	\$2.70	\$5.00	\$7.74	10.80

Source: David Bruce and William Fox (2000), "E-Commerce in the Context of Declining State Sales Tax Bases," *National Tax Journal* LIII, 4, Part 3 (December, 2000), 1373-1388.

Given the reality that state and local governments must balance their operating budgets to provide public services, the evident economic slowdown, and the growing importance of the Internet as a mechanism for modern commerce, governments argue that they need improved fiscal mechanisms that will enable them to collect use taxes from remote vendors.

Complexity of State and Local Sales and Use Taxes

Business groups from the high tech and traditional retail communities have expressed sympathy for state and local revenue needs; however, they point to several types of complexity which inhibit their ability to collect and remit use taxes even if they elected to do so under current law. First, there are better than 7,500 local governments which impose sales and use taxes, and in several states, most notably Arizona, each municipality which elects to impose the sales and use tax can decide on what is exempt, what is taxable, and what the rate of tax is. Business groups argue that it is impossible without significant expenditure on their part to ascertain what the taxable base is, and it is equally difficult to determine the rate of tax for so many jurisdictions.

Second, among the states, not only are there differences in what is taxable and what is not, there is no agreed upon standard set of definitions of commodities and services that all the states currently embrace. Third, the vendor registration requirements, forms, and calendars of filing vary across the states. Especially for small Internet vendors, this can make compliance expensive. Table 2 displays the variability in the structure of state sales and use tax laws.

Table 2: Characteristics of State Sales and Use Tax Laws

Characteristic	States	Total	States
No local option sales and use taxes (single sales/use tax rate)	10	10	Connecticut, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Jersey, Rhode Island, West Virginia
Allow local option sales and use taxes (single rate)	2	12	DC, Hawaii
Allow local option sales tax (multiple rates); no local option use tax (single rate)	6	18	Idaho, Illinois, Iowa, Kansas, New Mexico, Vermont
Allow local option sales and use taxes (multiple rates)	29	47	Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Louisiana, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, Wisconsin, Wyoming

Source: Streamlined Sales Tax Project, *Draft Issues Papers and Proposals, No. 2*, pp. 17-18, August 11, 2001
<http://208.237.129.206/sline/aug01IP.pdf>

3. Simplifying State Sales and Use Taxes in Exchange for Expanded Business Duty to Collect and Remit Use Taxes

Since 1998, there have been various forums in which business interests have expressed a willingness to negotiate the terms of an expanded duty to collect use taxes for the states in exchange for a vastly simplified system of state sales and use taxes that the states would agree to adopt.

The major components of such simplification are:

- Elimination of local collection of sales and use taxes, and simplification or adoption of one sales and use tax rate per state
- Adoption of the shipping address or credit card mailing address to determine destination state, and uniform sourcing rules
- Adoption of standardized classification of goods and services
- Adoption of standardized administrative rules, including a vendor's discount for upfront software and related implementation expenses, and uniform audit and payment procedures

Currently, 32 states¹² are participating in a cooperative effort to develop a uniform sales and use tax statute which would accomplish these 4 simplification objectives. In addition, 6 states¹³, including Pennsylvania, are observing the activities of the streamlining project.

¹² Alabama, Arkansas, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Nevada, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming. See: <http://www.geocities.com/streamlined2000/participatingstates.html>

¹³ California, Colorado, Connecticut, Georgia, Idaho and Pennsylvania.

3.1 What might a Simplified System on Just Household Consumption Look Like?

As noted earlier, current sales and use taxes are substantially imposed on business input purchases. This is troubling from both economic and political perspectives. Such hidden taxes encourage purely tax-motivated changes in business form (vertical integration), location of activity (through drop shipments and warehousing), and hide from voters true tax burdens.¹⁴

How much are business inputs taxed by current state sales and use taxes? Table 3 displays recent estimates by state of the extent to which households (Column 3) and non-households or essentially business (Column 4) pay sales and use taxes. On average about 40% of sales and use taxes are paid by business; the range is from 11% (West Virginia to 72% (Hawaii).¹⁵ Table 3 also indicates what a reformed state sales and use tax system might entail were only final household consumption taxed rather than the mixture of business and household purchases. Current state and local sales and use taxes are thus far from transparent, and, in my view, nothing citizens in each state should be particularly proud of as a way to finance their public services.¹⁶

Table 3: State Sales and Use Tax Rates, Household's Share, and Estimated Final Consumption Sales and Use Tax Rates

State	January, 2000 State Sales & Use Tax Rates	Household Fraction Of Sales & Use Taxes	Non-Household Fraction of Sales & Use Taxes	1998 Sales Taxes as % of State Personal Income	1998 Sales Taxes as % of State Personal Outlays	Final Consumption State Sales and Use Tax Rate	Final Consumption State Rate as % of Current State Rate
	[1]	[2]	[3]	[4]	[5]	[6]	[7]
Alabama	4.0%	73.0%	27.0%	1.8%	2.2%	3.1%	76.3%
Arizona	5.0%	50.0%	50.0%	2.4%	3.0%	6.0%	119.4%
Arkansas	4.6%	60.0%	40.0%	2.9%	3.7%	6.1%	132.7%
California	6.0%	53.0%	47.0%	2.4%	3.0%	5.6%	93.5%
Colorado	3.0%	60.0%	40.0%	1.3%	1.7%	2.8%	93.8%
Connecticut	6.0%	58.0%	42.0%	2.5%	3.1%	5.3%	89.0%
Florida	6.0%	50.0%	50.0%	3.3%	4.2%	8.4%	140.2%
Georgia	4.0%	64.0%	36.0%	2.1%	2.6%	4.1%	101.8%
Hawaii	4.0%	28.0%	72.0%	4.1%	5.1%	18.2%	455.4%
Idaho	5.0%	62.0%	38.0%	2.5%	3.2%	5.1%	102.4%
Illinois	6.3%	68.0%	32.0%	1.7%	2.1%	3.1%	48.9%
Indiana	5.0%	54.0%	46.0%	2.2%	2.8%	5.2%	103.1%
Iowa	5.0%	59.0%	41.0%	2.2%	2.8%	4.7%	94.8%
Kansas	4.9%	67.0%	33.0%	2.5%	3.1%	4.6%	94.4%

¹⁴ The lack of political transparency of sales and use taxes is likely viewed positively by state and local elected officials.

¹⁵ The non-household share, Column [3] in Table 2, can be thought of as the ratio of (E + G) to (A + C + E + G) in Table 1.

¹⁶ One often hears from the high tech community that it is more sensible to base consumption taxes on the *origin* principle rather than the current state and local (and international) standard of *destination* principle. Dividing geographic principles (origin for the Internet, destination for the rest of commerce) is easily a recipe for tax planning that would result in the claim that all sales originated in sales tax free states such as Oregon. Further, it would create ambiguity and confusion over which kinds of transactions would be subject to origin vs. destination sourcing rules.

Perhaps the most obvious argument in favor of destination as a sourcing rule involves the simple admission that the purpose of taxation is to pay for public services which residents enjoy. Given the obvious incidence of final consumption based taxes (on final consumers of the goods and services), placing taxation where the public services are enjoyed makes the most sense and avoids the most confusion and tax planning opportunities.

State	January, 2000 State Sales & Use Tax Rates	Household Fraction Of Sales & Use Taxes	Non-Household Fraction of Sales & Use Taxes	1998 Sales Taxes as % of State Personal Income	1998 Sales Taxes as % of State Personal Outlays	Final Consumption State Sales and Use Tax Rate	Final Consumption State Rate as % of Current State Rate
	[1]	[2]	[3]	[4]	[5]	[6]	[7]
Kentucky	6.0%	54.0%	46.0%	2.8%	3.5%	6.5%	107.7%
Louisiana	4.0%	51.0%	49.0%	2.4%	3.0%	6.0%	149.4%
Maine (4)	5.5%	57.0%	43.0%	2.9%	3.7%	6.4%	116.5%
Maryland	5.0%	60.0%	40.0%	1.7%	2.2%	3.6%	72.6%
Massachusetts	5.0%	62.0%	38.0%	1.5%	1.8%	3.0%	59.3%
Michigan	6.0%	58.0%	42.0%	3.0%	3.8%	6.5%	108.9%
Minnesota	6.5%	56.0%	44.0%	2.8%	3.6%	6.4%	97.9%
Mississippi	7.0%	66.0%	34.0%	3.9%	4.9%	7.4%	106.0%
Missouri	4.2%	64.0%	36.0%	2.0%	2.5%	3.9%	92.2%
Nebraska	5.0%	60.0%	40.0%	2.2%	2.8%	4.7%	93.2%
Nevada	6.5%	44.0%	56.0%	3.7%	4.7%	10.6%	163.4%
New Jersey	6.0%	62.0%	38.0%	1.7%	2.2%	3.5%	58.6%
New Mexico	5.0%	50.0%	50.0%	4.5%	5.6%	11.3%	225.2%
New York	4.0%	66.0%	34.0%	1.4%	1.7%	2.6%	65.8%
North Carolina	4.0%	62.0%	38.0%	1.8%	2.3%	3.7%	91.4%
North Dakota	5.0%	60.0%	40.0%	2.6%	3.3%	5.5%	110.8%
Ohio	5.0%	66.0%	34.0%	2.0%	2.5%	3.7%	74.8%
Oklahoma	4.5%	66.0%	34.0%	2.7%	3.4%	5.2%	114.9%
Pennsylvania	6.0%	64.0%	36.0%	2.0%	2.5%	3.9%	64.3%
Rhode Island	7.0%	59.0%	41.0%	2.0%	2.5%	4.2%	60.4%
South Carolina	5.0%	61.0%	39.0%	2.7%	3.4%	5.5%	109.8%
South Dakota	4.0%	61.0%	39.0%	2.7%	3.4%	5.5%	137.8%
Tennessee	6.0%	63.0%	37.0%	3.1%	4.0%	6.3%	104.6%
Texas	6.3%	53.0%	47.0%	3.0%	3.8%	7.2%	115.2%
Utah	4.8%	63.0%	37.0%	2.9%	3.6%	5.8%	121.2%
Vermont	5.0%	56.0%	44.0%	2.2%	2.7%	4.8%	96.7%
Virginia	3.5%	70.0%	30.0%	1.4%	1.8%	2.6%	74.0%
Washington	6.5%	49.0%	51.0%	3.1%	3.9%	8.0%	123.4%
West Virginia	6.0%	89.0%	11.0%	2.8%	3.6%	4.0%	66.7%
Wisconsin	5.0%	62.0%	38.0%	2.3%	2.9%	4.7%	94.3%
Wyoming (3)	4.0%	54.0%	46.0%	3.0%	3.8%	7.0%	174.9%
Mean	5.2%	59.4%	40.6%	2.5%	3.1%	5.6%	111.1%
Std Dev	1.0%	8.8%	8.8%	0.7%	0.9%	2.7%	61.4%
Min	3.0%	28.0%	11.0%	1.3%	1.7%	2.6%	48.9%
Max	7.0%	89.0%	72.0%	4.5%	5.6%	18.2%	455.4%

Notes: Column [1] from Federation of Tax Administrators WebPages www.taxadmin.org; 2000; Column [2] and [3] from Raymond Ring, Jr. "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal*, LII, 1 (March, 1999), Table 1, p. 81; Column [4] John L. Mikesell, "Retail Sales Taxes, 1995-98: An Era Ends," *State Tax Notes*, Table 4, pp. 592-3. Column [5]= Column [4] / .794, the ratio of 1998 BEA Consumer Outlays/BEA Personal Income; Column [6]=Column [5] / Column [2]; Column [7]=Column [6] / Column [1]

The Pennsylvania row of Table 3 indicates that were Pennsylvania to only tax households on *all* of their consumption, the current sales and use tax rate could be lowered from 6% to 3.9%. This would involve moving about 36% of the current sales and use taxes paid by business to households. In states such as Washington, in which business sales and use tax cascading is very heavy, the rate of sales and use tax would have to be *increased* from 6.5% to 8% in order to bring in the same amount of revenues.

3.2 How Might a Simplified State Sales and Use Tax System be Adopted?

Right now the states are negotiating with various business interests to define a model sales and use tax statute. The next question that will arise when that process is complete is how the model statute can be made operational. Frankly, I am not optimistic that the unilateral legislative adoption of a model sales and use tax statute would generate meaningful levels of compliance from remote vendors. After all, under *National Bella Hess* and *Quill*, the two prevailing U.S. Supreme Court decisions, remote vendors without physical presence are under no legal obligation to collect and remit, and the vast majority does not. To the extent they believe they are gaining sales they would otherwise lose to traditional bricks and mortar vendors, remote vendors might readily defy destination states and continue their current stance.¹⁷ It is because of this likelihood that I believe that some sort of federal legislation will be necessary to require remote vendors to collect and remit use taxes under a simplified state sales and use tax regime.

3.3 Some Possible (but Unlikely) Federal Roles

State Piggybacking onto New Federal Retail Sales Tax

Periodically, there has been discussion about the desirability of moving to a federal consumption tax--either a value added tax or retail sales tax. In conjunction with such a redesign of federal revenues, it has been suggested that the states could piggyback onto federal administration. Time and space limitations do not permit an extensive discussion of whether or not it is a good idea to now consider a federal retail sales tax as a mechanism for either fundamental federal tax reform or as a way to help the states. However, let me state my conclusion, having looked at the issue closely several years ago,¹⁸ that the economic argument favoring federal consumption tax as a cure to lackluster economic performance is not as persuasive today as it was a decade ago. Even if the federal government were to enact its own national retail sales tax, it is unclear whether or not the states would be drawn to such a template, especially if they did not retain control of their own rate of tax. Especially in times of economic duress and revenue exigencies, relying on the federal government in terms of tax base and willingness to collect and write checks to the states sounds like a dicey proposition.

Federal Revenue Sharing to States of New Federal Retail Sales Tax

Were the federal government to enact a national retail sales tax and then share back some or all of the revenues to the states, the states would still likely want to maintain their own sales and use taxes, although they might reduce reliance on their own. Issues of sovereignty would undoubtedly arise while the method or formula for federal revenue sharing would likely be a difficult issue for Congress to resolve. Moreover, this approach might not readily deal with the above-mentioned use tax problems should the states retain their own sales and use taxes, nor would it deal with cascading or complexity issues either.

3.4 Some Other (more likely) Federal Roles: Federal Assistance/Insistence but not Federal Collection of State Use Taxes

If there is to be meaningful federal role, but one that stops short of actual federal collection, there still remain the issues of how much standardization should take place to trigger federal assistance or insistence. The first issue that arises is how to define taxable consumption, and then how the federal government might encourage use of a standardized approach.

Defining Final Taxable Consumption

¹⁷ Some years ago the Pennsylvania Supreme Court held that the Internet subsidiary of Bloomingdales Department Store which sells into Pennsylvania was not obligated to collect and remit use tax, even though Bloomingdales has a physical presence in the state. Ultimately the issue will be adjudicated by the US Supreme Court. Should the Pennsylvania General Assembly seek to level the playing field between traditional retailers and remote retailers, it could overturn, in my judgment, through a carefully drawn state statute the Pennsylvania decision.

¹⁸ Robert P. Strauss, "Administrative and Revenue Implications of Federal Consumption Taxes for the State and Local Sector," *State Tax Notes*, 15, 5 (February 1, 1999), 327-338.

There are several reasons to favor the states moving to the same definition of household consumption. First, it makes administration much more simple, especially for remote vendors, since one need not keep track of the extraordinary fine distinctions among goods and services which the states have made over the years for public policy and other reasons. Second, a broader base means that the rate of tax can be lower, and thus have a smaller impact on consumption choices made by households. Third, by just taxing final consumption, the states will inform their citizens about what the tax costs of government are.

Historically there have been a variety of approaches to define what is taxable under state sales and use taxes, and how to exempt certain items, either in terms of the nature of the customer, or in terms of the nature of the good or service. A rather simple way to move a household final consumption sales and use tax base 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 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” 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.¹⁹ 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 at 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.²⁰

Five Federal Approaches to Assisting/Insisting on An Expanded Duty to Collect and Remit Use Taxes

After the issuance of the NTA *Final Report* in September, 1999, the National Governors Association and National Conference of State Legislators began developing a proposal which they believed would enable the states through bilateral, cooperative agreements to obligate businesses which originated inter-state sales to remit to the destination state as a consequence of the cooperative agreement being in place. The states evidently view this approach to eliminating the need to come before the Congress to ask for federal legislation. Elsewhere²¹ I have characterized this as “each state permitting the other to fiscally hunt in the dark.” I am not alone in such pessimism, and I have heard that some governors wonder if their bilateral approach can be timely, practical and effective.

¹⁹ 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.

²⁰ Evidently the new Russian Federation’s Regional Sales Tax appears to be structured in a similar manner. See John L. Mikesell, “Structure of the Russian Federation’s New Regional Sales Tax,” *Tax Notes International*, 18 (March 15, 1999).

²¹ Robert P. Strauss, “Further Thoughts on State and Local Taxation of Telecommunications and Electronic Commerce,” *State Tax Notes*, 17, 17 (October 25, 1999), 1113-1124.

Certainly, there is no impediment to the Congress legislating to assist the states under its taxing or commerce powers. The general solution to what is usually called the tax harmonization problem I develop below involves federal participation to ensure compliance of remote vendors to collect and remit, but one that stops a bit short of actual federal piggybacking.

One set of federal solutions 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.

Another set of federal solutions entails a freestanding federal penalty tax should non-compliance to collect and remit occur.

Approach 1: Hollings S1433

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 5%. The bill created 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.

Approach 2: Expand FUTA Eligibility Requirements to Include Expanded Duty to Collect

A second variant of this type of harmonization, and one that is more workable in my view, is to utilize an existing well-harmonized federal-state tax instrument. The historical harmonization of federal and state unemployment taxes can be 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 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 as 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.

Whether or not the unemployment system can or should handle this new responsibility remains an open question. Also, given that current state use tax rates are in the 3-7% range, it is possible that remote vendors might simply forego taking advantage of the federal credit since 3 to 7% of their gross sales would dwarf any federal offset of state employment taxes.

Approach 3: Conditional 10 % Federal Sales Tax

Another, related way to encourage remote vendors to collect and remit use taxes would be to obligate any federal taxpayer, engaged in remote sales, to pay to the IRS an excise equal to 10% of its sales, *unless* it agreed to collect and remit use taxes to each destination state which had in place a reformed sales tax base contained in federal law (e.g. per Section 4.1 above) at the state's use tax rate. If a state did not have in place the reformed or "qualified sales and use tax", the state would not benefit from federal insistence on the remittance of the use tax. This would enable all non-sales tax states to remain sales tax free. As long as taxpayers collected and remitted, IRS would never see or touch any of the use tax monies. With suitable administrative mechanisms in place, states would continue to enjoy fiscal autonomy by virtue of having control (with suitable notification) of their sales and use tax rates.

Compliance with this obligation to collect and remit would entitle the taxpayer to an exemption from the 10% federal sales tax. Presumably all taxpayers would understand they would do much better by collecting and remitting the use tax than standing in non-compliance and be subject to the 10% federal tax.

Approach 4: 10 % Federal Penalty Approach

A variant on the conditional 10% federal sales tax would be to structure the relationship between the taxpayer and a federal agency as a penalty for non-compliance, given that the destination state had in place a "qualified state sales and use tax." Now, the penalty would be measured by a high percentage (e.g. 10%) applied to the taxpayer's sales. Arguably the penalty approach could be acted upon by a committee other than a tax committee of the Congress, although there would be a question of which federal agency to turn over any possible proceeds, as well as a question of which federal agency, if not Treasury/IRS, would be responsible for determining that any state indeed had in place a "qualified" sales and use tax.

An advantage of these approaches is that they could be devised to leave both *Quill* and *Bella Hess* undisturbed, and thus not raise *any* nexus issues in *other* areas of state taxation (e.g. business gross receipts, income or franchise taxes). Remote vendors would be collecting and remitting simply to forestall an adverse, federally imposed financial consequence. By the same token, any state which felt strongly that its current sales and use tax base, imposed partly on households and partly on business, rather than on final consumption, was more meritorious than a "qualified state sales and use tax" could continue to enjoy its sovereignty over base and tax rate. In this circumstance, remote vendors would not be obligated under threat of federal penalty to collect and remit use taxes. Of course, such states would continue to find use tax remittances lagging, and, as electronic retail commerce grows, this could have increasingly serious financial consequences to them.

Congress might find legislating under this second approach somewhat easier, because you would not be requiring *per se* that each state with a sales and use tax to necessarily adopt the "qualified state sales and use tax." Greater state sovereignty would be, of course, at the expense of simplification, ease of administration and compliance, and elimination of tax cascading.

Approach 5: Strengthening *Current* Federal Law to Solve the Problems of State and Local Sales Use Taxes: An Experiment to Modernize Reporting Requirements under the Jenkins Act

Under Title 15 Chapter 10A of the US Code, enacted by the tax committees of the Congress in 1949 and typically referred to as the Jenkins Act, remote sellers of cigarettes have been obligated to provide destination state tobacco tax administrators with monthly memoranda of retail cigarette sales into each state. The memoranda must contain "...the name and address of the person to whom the [retail] shipment was made, the brand, and the quantity thereof." Were state *sales* tax administrators provided comparable information from remote sellers, their use taxes would undoubtedly be better collected from residents.

The Jenkins Act reflects a long-standing federal policy of intergovernmental tax administration. As Congress considers how to extend the Moratorium, it could modernize the Jenkins Act as an experiment to ascertain if federally mandated information reporting is a sensible template for improving state use tax administration. Not only is the consumption item (cigarettes) already well defined, there are relatively few sellers in the market. Manufacturers, who may who may also be vendors, are already subject to federal supervision through application of the federal tobacco tax.

Modernization of the Jenkins Act would entail enhanced and more standardized reporting, and utilization of new technology. For example, Congress could enhance the required memoranda to include the dollar value and prices of various cigarettes in the shipment. Also, Congress could require that the federal government promulgate a standardized *format* for the memoranda reporting requirement²², and positively affirm that electronic transmission of such memoranda from remote vendor to state tobacco administrator fulfills the reporting requirement. Much could be learned about the practicalities of federally required information reporting requirements as a more general solution to the problem of improved use tax collections.

Finally, Congress could strengthen the Jenkins Act by statutorily providing a supervisory role for the Treasury and/or IRS. Such supervision might include federal penalties for vendor non-compliance in conjunction with these modernized federal reporting requirements.

4.0 Things for the General Assembly to do while Congress Deliberates

It is difficult to predict the final outcome of the Congressional battle over extension of the moratorium. Traditional bricks and mortar retailers and traditional business manufacturing interests are now actively pressing Congress to do something besides a simple extension of the 1998 Moratorium, because they realize that to the extent the New Economy does not pay for the costs of public services, they increasingly will have to. Traditional retailers are especially concerned about the prospect of losing business to remote vendors while they pay higher local taxes to support the costs of local government. At the same time, local governments are pitted against their governors and state legislatures to make good on a promise that the National Governor's Association and National Conference of State Legislatures publicly adopted. Three years ago both agreed at their national conventions to create intergovernmental fiscal mechanisms that would hold local government fiscally harmless if local sales and use taxes were eliminated through federal pressure. No state with local option sales and use taxes has taken up the challenge, and distrust between local governments and their state leaders is growing.

Here in Pennsylvania, I would guess that elected officials in Allegheny County and Philadelphia are not aware of national pressures to eliminate local option sales and use taxes, and both would react with derision to such ideas. On the other hand, such simplification is likely to be part of any final federal Congressional action that deals with use tax collection problems. Should that come to pass, I would conjecture that each of you will have to face up to the unpleasant prospect of finding state level revenues to hold harmless both Allegheny County and Philadelphia. Whether or not Congressional action might motivate you to act more quickly than the Pennsylvania Supreme Court's decision on county court costs 15 years ago is an interesting question. What is likely is that a recession and serious state revenue problems might force some action on the state sales tax base. Certainly few dispute that the additional 1% local sales taxes have caused shopping diversion to lower tax jurisdictions; however, how much that has occurred is difficult to measure.²³

I hope these remarks add caution to any further consideration of local option sales and use taxes in Pennsylvania. On the other hand, given the growing pressures for local services, and the collapsing confidence in the local real estate tax, questions arise as to what you will allow local governments to use to raise their necessary revenues if you do not raise it for them and share it back. Time and space limitations prevent any extensive discussion of what fixing local finances entails; however, I think you see that logic will drive one to facing directly that set of issues if the local options sales and use tax is no longer on the table.

²² Reporting could be required to be on a Treasury Department promulgated form.

²³ I do not want to leave the impression that I believe that the Congress has the constitutional authority to prohibit local option sales and use taxes. We can do what we wish inside our borders; the federal constitution typically does not affect within state tax structure unless equal protection or due process assurances are severely violated. What seems likely for Congress to do is simply prohibit federal assistance/insistence in the use tax area unless any state desiring such assistance also has in place a model sales and use tax law. If that model law winds up not allowing local option sales and use taxes, and Allegheny County and Philadelphia prevail viz. a viz. the General Assembly, then the sort of revenue losses discussed above will occur.

Also, I would hope that you take seriously some of the more problematical scenarios about what is going to happen to sales and use tax collections in the Commonwealth. You are more aware than I that Spring, 2001 General Fund revenues were disappointing, and that the tardiness in reaching agreement on the budget was due largely to squishy revenues for next fiscal year.

5.0 Pennsylvania's Economic Climate and the Internet

It is imaginable that I could have come before you this morning and argued that taxation of transactions on the Internet are harmful to an infant industry, and that the General Assembly should do all in its powers to oppose this destruction of new, high paying jobs. Instead I have argued that the tax issues surrounding the Internet look like the tax issues surrounding the taxation of catalogue sales, and that whether or not this old issue gets addressed has more to do with Congress than the General Assembly.

However, I do not want to leave the impression that the Commonwealth is helpless in using the Internet to foster economic growth. Indeed, there is much the public sector can do to encourage technology. Unfortunately, given our traditions of local control and our extraordinary patchwork of local government, getting it done requires a lot of political will. There are two areas where state government through inaction or action can make a difference viz. a viz. the New Economy. The first area involves providing an adequate physical infrastructure for the Internet and an informed regulatory climate, and the second involves providing a legal environment that protects business and consumer interests in an even-handed way so that businesses and households view Pennsylvania as being an enlightened place to do business and live.

5.1 State Government's Role in the Physical and Regulatory Infrastructure of the Internet

Whether or not the Internet becomes an engine for economic growth in an area depends on the traditional economic forces of supply and demand. State and local government can affect both the supply and demand for Internet services.

- The *supply* of Internet services involves the speed or bandwidth that is available, its reliability and price;
- The *demand* for Internet services (that will foster economic growth) depends obviously on the price and availability of Internet services, as well as on the ingenuity, capitalization, and perseverance of those who want to use it to develop ideas and products, and market them.

Government and the Supply of Internet Services in Pennsylvania

While it is true that the market for telecommunication services has been broadly deregulated by the federal government, it is also true that State government impacts the supply of Internet services directly and indirectly through state public utility law and regulations and the decisions of public utility commissions, and state definition and control over the activities of local government.

If you want to see an army of very well dressed and very focused business representatives from the telecommunications industry instantly in your offices, simply announce your intention to hold hearings on private and public access to telecommunications right of ways, and on the valuation and taxation of such right of ways for real estate and other local tax purposes. Who can put what on whose phone poles, and for what purposes, is more than a passing matter to the companies which got the original right of way and put up the poles. Equally sensitive is what the owner can charge for others to put their lines on their poles.

You can garner further interest and attention by stating your intention to reconsider the standards of service governing telecommunications providers who are permitted by the Public Utility Commission to do business in Pennsylvania. The regulated authority to generate and distribute electricity is also very important in affecting the speed, price and reliability of the supply of Internet services; electric power companies in Northern Europe are the primary suppliers of Internet services in conjunction with the transmission of electricity to businesses and residences.

This past Friday's *Wall Street Journal* (August 17, 2001) had a fascinating front page story about how local municipal Internet networks are using public provision of Internet services to foster economic development, and are causing such cable giants as AT&T (formerly TCI) to face up to meaningful local competition. Most of the new municipal suppliers of Internet services are emerging out of the municipal power business, and are following the European pattern of supplying electricity and high-speed data at once. A rural county in Washington is touting its bandwidth as an economic development opportunity.

While some here in Western Pennsylvania would like to see Maglev be the 21st century technological innovation that propels the region back to prosperity, I think there is equal merit in asking out loud what it is that state and local government can do to make sure that high speed Internet access is plentiful, reliable, and cheap. Once one recognizes that the region that can move information around most quickly, and has the best ideas to move is the region that will "win" in the New Economy, then the agenda for public action changes rather dramatically.

The impediments to making Pennsylvania a leader are not trivial. Certainly, consolidating local governments, which currently control access to cable, so there is sensible local policy is not easy to do. Indeed, there are parts of the 1967 Pennsylvania Constitution dealing with municipal consolidation which have yet to be implemented by the General Assembly. Similarly, changing state law to permit and encourage municipalities to compete with for profit Internet providers would likely be very difficult.

Forcing current telecommunications providers to make their Internet service promises made to be promises actually kept is apt to create political heartburn, although it would find much consumer approval. Today, at our residence in Murrysville in Westmoreland County, I have high-speed Internet access via our cable TV provider (Adelphia) over a cable modem. My neighbor made another choice, and has DSL access via our local telephone company (Alltel). Remarkably, were we living near the Carnegie-Mellon in Pittsburgh, our choices would be more limited, as AT&T, the local cable provider currently only provides high speed data access to only 1% of its Pittsburgh customers. Also, some have called into question the availability and reliability of DSL in Pittsburgh through Verizon.

Twenty years ago, I chaired a technology committee of the Allegheny Conference, and urged some of Pittsburgh's corporate leaders to take advantage of the fact that there was more high-speed fiber optic cable laid downtown and around Pittsburgh than any other metropolitan area in the U.S. Why was this the case 20 years ago? The very high concentration of corporate headquarters downtown coupled with the suburban location of their remote data centers (due to security and cost considerations) required that high speed data links be created, and the requisite fiber optic cable was laid and used.

Where Pennsylvania stands in relation to its competitor states viz. a viz. the Internet is likely to be viewed many years from now, I am afraid, as another version of the Pennsylvania Canal debacle. Lest you forget, New York State built the Erie Canal while politicians in Pennsylvania dithered. As a result the Empire State was born, and the long term decline in Philadelphia's role as a national port set in. By the time the Pennsylvania Canal was debated, approved, and finally finished, its only use was to be sold, bankrupt, for \$1 as a right of way for the Pennsylvania Railroad. I find it ironic that as early as 1994 New York State was using high-speed statewide transmission over the Internet of surgical and other medical services. I wonder if we have anything like this in place yet that ties together all the teaching hospitals in the state.

Government and the Demand for Internet Services in Pennsylvania

Government can affect the demand for Internet services in a number of ways. First, government affects the provision of public and higher education, and thus affects Internet use through its own instructional activities and in the training of technologists who will invent and use the Internet as part of their business activities.

Second, government can use the Internet to improve directly the provision of public services ---online provision of tax forms and electronic personal income tax filing are simple examples. Another positive example of the use of

information technology and the Internet in the provision of government services is the online display of real estate assessment information.²⁴

Third, government through tax exempt financing and tax exemption more generally, can make Internet activities more attractive to use. Finally, government can through statistical measurement inform the larger community on use and interest, and more generally inform the community about activities and opportunities of the New Economy.

5.2 Government's Role in Balancing Consumer and Business Rights and Responsibilities in the New Economy

Up until the collapse of the NASDAQ, the New Economy was viewed unambiguously as a heaven-sent economic miracle: falling unemployment rates, rising real wages and standard of living for most or all, and no inflation. More recently, the bankruptcy of many .com companies have led observers to talk about the Digital Tulip Market, and the lasting value of good old business virtues like profits, and price-earnings ratio that look more like 1/market rate of interest (20:1), rather than my cholesterol level (too far over 165:1). Nonetheless, the question arises, what else can State government do to encourage growth in the New Economy?

To answer this, one must recognize that the area of commercial law which each state controls can make a difference. Just as there have been very strong debates in Congress about whether or not, or how transactions over the Internet should be taxed, there have been fights and debates in Congress and in each state capitol about whether or not, or how consumers and businesses transactions over the Internet are and should be protected.

It is now generally accepted that the *rate* of growth in *retail* Internet transactions has been falling. For example, in the last quarter of 2000, business to consumer electronic commerce finally exceeded 1 percent of retail sales. While the \$8.7 billion sold in that quarter was a 67 percent increase over the fourth quarter of 1999. This compares to a 1998 to 1999 fourth quarter to fourth quarter growth rate of better than 100 percent.

The primary reasons B2C is decelerating entail issues of trust and risk.²⁵ Consumers concerns about remote merchant conduct include: the risk of merchant opportunism where goods or services are not ever delivered, or, when delivered, are of lower quality than represented; the risk of misuse of personal information (privacy violations) by merchants either opportunistically or accidentally or by third parties seeking this information to engage in credit card fraud. The primary concern for merchants about remote consumers' conduct involves credit card fraud, particularly for information goods. Firms engaged in business to consumer electronic commerce, alone or with the help of governments, have strong incentives to mitigate these problems.

Business engaged in B2C have worked hard in Congress to get digital signature legislation enacted, and in state capitols to get uniform commercial laws related to electronic commerce passed. Neither Congress nor the Conference of Commissioners on Uniform State Laws has been willing to pass UCITA or some variant of it, and only a handful of states, excluding Pennsylvania, have done so. I am not suggesting you endorse UCITA, rather I am simply commenting that legislating in this area can make a difference. Again, if you announce your intention to hold hearings on a Pennsylvania version of UCITA, you will find instantly a long line of well dressed men and women anxious to talk to you about why you should pursue a protective policy towards E-commerce retailers, and a more relaxed policy towards protecting consumer interests. This may be an area where business self-interest has turned out to be self-defeating. What is clear to me is that coming up with modern laws of commerce that protects both business and consumer interest (and protects privacy in particular) can make Pennsylvania a better place for doing electronic commerce.

²⁴ Of course, this has not been without its own controversy as noted on the front page of the *Wall Street Journal* April 23, 2001.

April 23, 2001.

²⁵ See Karen Clay and Robert P. Strauss, "Institutional Barriers to Electronic Commerce: An Historical Perspective," Conference on New Institutionalism in Strategic Management, Columbia Business School, April 22, 2001.

6.0 Summary and Conclusions

There are many things the Pennsylvania General Assembly might act upon to modernize our laws and regulations in light of E-commerce and the Internet. Many of these involve modernizing commercial law in an evenhanded manner that both protects traditional consumer interests and rights, and also protects E-commerce vendors.

Whether or not Pennsylvania should tax transactions across the Internet is, in my view, a bit of a red herring, because Pennsylvania consumers already have an obligation to pay taxes on items they purchase from remote vendors. As in the case of catalog sales, we tend to forget this obligation. A meaningful solution to this problem will require, in my judgment, federal legislation, and I have outlined a variety of approaches that can work. Whether or not there is the federal political will to do anything is beyond my area of expertise to accurately predict. However, sooner or later, the revenue losses to the states and the diversion of economic activity from traditional commerce will force federal action.

On a prospective basis, the General Assembly would be well advised not to consider additional local sales and use taxes as a source of local finance; the pressures across the country are going in the opposite direction. What local governments should use to finance needed public services is not a question to resolve quickly²⁶, and especially in the case of our public schools, one that increasingly is being asked around the Commonwealth. Both the Pennsylvania House and Senate have study groups looking at these issues; I hope they consider the impact of technology on the structure of local revenues as they fashion their recommendations.

If we look at the New Economy as something that the General Assembly should find ways to encourage in order to maintain and bring more high paying jobs to the Commonwealth, I have outlined a series of things that deserve further consideration. State government (and therefore state legislatures) continues to have a lot to say about the way the telecommunications revolution plays out in each state. Again, much depends on the willingness to tackle difficult state local governmental issues.

D:\testimony\pahouse\pahouse_8_23_01.doc 8/20/2001 6:23:38 PM

²⁶ Few would argue today, I believe, that Act 50 provides an adequate framework or source of revenues.