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Part I State and Local Taxation

State and local governments in the United States currently impose a variety of taxes on businesses and consumers, including sales and use taxes, telecommunications taxes, income taxes, and franchise fees. Electronic commerce is not specifically exempt from such levies, nor should it be. However, state and local governments are subject to congressional and constitutional limitations on the *means* by which they may tax cross-border commerce, including much Internet-based commerce. Those limitations, many observers believe, will seriously undermine future tax revenues as more people conduct online business across state lines. The continuing fight to overturn federal impediments to extraterritorial taxation will thus be the focus of this section.

Federal restrictions on the authority of state and local governments to force out-of-state telephone and mail-order companies to collect taxes have long irritated supporters of expansive government. In recent years, the rapid growth of Internet-based retail sales has created a new sense of urgency and has prompted dire warnings from high-tax advocates of the impending erosion of state and local tax bases. As early as 1995, for example, a paper published by the Center for Community Economic Research warned that “state and local government finances are being undone by rapid changes in global commerce and technology, particularly the rise of the Internet.”¹ The Center on Budget and Policy Priorities agreed, saying that “if state and local sales taxes are to survive as a means to support government programs and services in the future, a means must be found to treat all sales to consumers in a comparable manner.”² And a 1997 article in the *National Tax Journal*, which illustrated the thinking of many state tax policy specialists, concluded that “the sales tax must and will be applied increasingly to electronic transactions.”³

Hearing such talk, state and local officials became increasingly alarmed. Then in 1997 Rep. Christopher Cox (R-Calif.) and Sen. Ron

Wyden (D-Ore.) introduced the Internet Tax Freedom Act, which threatened to permanently limit states’ authority to tax Internet commerce. The legislation was a wake-up call to state and local governments, who were just starting to think about ways to tax online economic activity.

One of the first opponents of the ITFA to lobby Congress was Harry Smith—the mayor of Greenwood, Mississippi, and a college friend of Senate Majority Leader Trent Lott (R-Miss.)—who argued that the ITFA was a serious threat to the financial future of state and local governments.⁴ The National Governors’ Association and the U.S. Conference of Mayors, led by NGA vice chairman Gov. Michael Leavitt of Utah, took up the cause and attacked the bill as detrimental to states’ financial health. Those efforts eventually paid off, as Senate leaders vowed to block any bill that failed to take states’ concerns into account. In the final version of the ITFA, passed in October 1998, the moratorium on new Internet taxes had been cut from six years to three, existing taxes were exempted from the ban, and local government had been given stronger representation on the Advisory Commission on Electronic Commerce, formed by the ITFA to study Internet tax issues.⁵

State efforts to tax electronic commerce did not die with the passage of the ITFA. The Multistate Tax Commission, for example, recently issued its *Draft Resolution on Interstate Sales Tax Collections* that calls for a system that would require sellers above a certain threshold to collect use taxes on all taxable items.⁶ The NGA remained active on the issue by pressuring Congress to include participants friendly to state and local tax concerns, most notably Governor Leavitt, on the Advisory Commission on Electronic Commerce.⁷ Dissatisfied with the commission’s final makeup, the National Association of Counties and the U.S. Conference of Mayors filed suit in federal court in March to block the commission from meeting. That lawsuit was eventually dropped when Netscape CEO James Barksdale stepped down from the commission and was replaced by Delna Jones, the county

commissioner from Washington County, Oregon.⁸

The most recent report on fiscal year 1999 state budget activity released by the NGA and the National Association of State Budget Officers accurately sums up the long-term fears of state and local officials:

In future years, state revenues are likely to be affected by the growth of sales over the Internet. As more and more transactions occur online without the collection of existing sales or use taxes, state revenues from sales taxes, which provide almost 50 percent of total state and local funding, will erode.⁹

An Internet Tax Drain?

A brisk holiday retail season in 1998 marked electronic commerce's emergence as a serious retail medium. Online holiday sales topped \$2.3 billion, which prompted *Newsweek* to declare the nation's first "e-Christmas."¹⁰ And *U.S. News & World Report* noted that "[Internet] shoppers from east to west seem determined to avoid traffic jams at the mall, long lines at the post office and last-minute dashes to the supermarket."¹¹ Both articles speculated on the threat that electronic commerce could pose to local retailers.

Electronic commerce has stayed in the media spotlight, and how to tax such business has become a subject of popular debate. For instance, one *New York Times* article by technology commentator James Ledbetter denounced restrictions on Internet taxation as "unfair" to those who shop in stores.¹² A similar story in December accused Internet vendors of enjoying a "free ride" and warned that local retailing could eventually cease to exist.¹³ More recently, the Internet-friendly magazine *Upside* weighed in with a May cover story titled "Are We Stealing from Our Schools? The High Price of Tax-Free E-Commerce."¹⁴ The emerging conventional wisdom, as expressed by Internet pundit Bob Metcalfe, seems to be that "Internet purchases will not long be exempt from taxes."¹⁵

Despite all the hype, however, it is impor-

tant not to overstate the immediate fiscal significance of electronic commerce. Merchants of all kinds, not just online vendors, reported strong holiday sales last year.¹⁶ Total revenues from online business-to-consumer retailing in 1998 were estimated at between \$13 billion and \$20 billion—or from approximately two- to three-tenths of 1 percent of total consumer spending.¹⁷

Several estimates have been made of how cross-border sales translate into uncollected state and local taxes. The United States Advisory Commission on Intergovernmental Relations has said that about \$3.3 billion in state and local sales taxes remains uncollected annually.¹⁸ The Internet is expected to rapidly increase that figure. The NGA has speculated that states could unwillingly be leaving up to \$20 billion per year in taxpayers' hands by the middle of the next decade because of online sales alone.¹⁹ Those estimates may be misleading, however, because they include business-to-business transactions, as well as many services that normally go untaxed.

A more recent—and more realistic—analysis of state revenue losses was published by Ernst & Young in June. In that analysis, according to Robert J. Cline and Thomas S. Neubig, the estimated sales and use tax not collected in 1998 because of the increase in remote sales over the Internet was less than \$170 million, or one-tenth of 1 percent of total state and local government sales and use tax collections.²⁰ A somewhat higher estimate was presented by economist Austan Goolsbee of the University of Chicago and Jonathan Zittrain of Harvard Law School in a recent article for the *National Tax Journal*, which concluded that states lost about \$430 million in 1998, or less than one-quarter of 1 percent of their total tax take. Goolsbee and Zittrain calculated that over the next five years revenue losses will likely equal less than 2 percent of total state and local sales tax revenues.²¹

Those numbers do not suggest, of course, that state tax collections will never be affected by electronic commerce. With an estimated 32.7 percent of Americans already connected to the Internet, it is possible that future revenue

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erosion could be substantial for states that rely on high sales tax rates.²² Nevertheless, state and local finances are apparently secure for the foreseeable future while the Internet is still a relatively new way to conduct business. It is in that context that Congress acted last year to forestall state and local efforts to tax electronic commerce.

The Internet Tax Freedom Act

By far the most interesting development in the world of state and local taxation last year was the ITFA. It was passed as part of the Omnibus Appropriations Act of 1998 and is in force from October 1, 1998, until October 20, 2001. The ITFA has four major components: (1) a moratorium on new federal Internet or Internet-access taxes, (2) a declaration that the Internet should be free of international tariffs and other trade barriers, (3) a three-year prohibition on new taxes imposed on Internet access and on multiple or discriminatory taxes on electronic commerce, and (4) the establishment of the Advisory Commission on Electronic Commerce to study international, federal, state, and local tax issues pertaining to the Internet.

The ITFA moratorium on new Internet taxes applies only to taxes that were not generally imposed and actually enforced prior to October 1, 1998. State income and franchise taxes, for example, were in widespread use before that date and thus remain in force in all states that impose them. Other taxes, such as sales taxes on Internet access charges, were not uniformly collected and thus will be subject to the federal tax ban in some cases.²³ (The question of when Internet access charges are taxable is likely to generate much controversy, especially in relation to the "bundling" of Internet access with other taxable telecommunications services. However, because it is not directly related to cross-border electronic commerce, the taxation of access charges will not be covered in this paper.) The ITFA includes rules for determining which state levies are allowed, although there is bound to be some confusion on this issue.²⁴

The ITFA prohibits discriminatory taxes

on electronic commerce. Thus, states can impose taxes on products or services purchased online only when similar goods are taxed offline. For example, the ITFA would preclude a tax on access to an online magazine if the sale of magazines from a newsstand is not taxed. Moreover, states cannot tax electronic commerce at a discriminatory rate. If magazines from a newsstand are taxed at 6 percent, access to an online magazine could not be taxed above 6 percent. The ITFA also bars new taxes on the sale of Internet-unique goods or services, such as e-mail or search-engine services.

Finally, the ITFA provides some guidance on the application of sales and use taxes to out-of-state vendors engaged in electronic commerce. As the following section of this paper will discuss, states generally cannot require an out-of-state seller to collect taxes unless that seller has a physical presence in the taxing state. The ITFA specifies that the ability to access the Web site of an out-of-state business does not, in itself, constitute a sufficient level of physical presence to enforce tax collection. Although possibly redundant under Due Process and Commerce Clause protections, that clarification might at least dissuade states from initiating pointless litigation.

For the most part, the ITFA will not have a significant short-term impact on firms currently engaged in electronic commerce. It will, however, forestall immediate efforts of state and local governments to extend their taxing authority. Ultimately, the proposals of the Advisory Commission on Electronic Commerce may have a greater impact on the future of Internet taxation than will any other component of the ITFA.

Current Trends in Electronic Commerce Taxation

The history of state and local taxation of remote commerce has been characterized by ceaseless efforts to circumvent federal restrictions on who may be taxed. The results of those efforts have been mixed and often conflicting.²⁵

Early indications suggest that the same pattern will apply to electronic commerce, but that scenario is not inevitable. Taxation of content

transmitted over the Internet is not yet widespread and is restricted for three years by the ITFA. In addition, states are limited in their ability to enforce tax collection on out-of-state purchases under the Due Process and Commerce Clauses of the U.S. Constitution. Although the Supreme Court in *Quill v. North Dakota* (discussed in more detail below) minimized the legal protection offered by the Due Process Clause, the issue of whether the imposed responsibility for tax collection on an out-of-state business is an unjust deprivation of property—taken without the opportunity to be heard—remains valid. Congress should not tolerate states’ engaging in taxation without representation, even if the Court has given Congress an opening to do so. In addition, by exporting their tax collection obligations, states are effectively projecting their lawmaking power beyond their borders, thereby impeding the flow of commerce. Congress thus has the power under the Commerce Clause to prohibit that activity.

Because the ITFA tax moratorium expires after three years, Congress has only a limited window of opportunity to head off state and local policies that will interfere with the growth of electronic commerce. The question facing lawmakers is this: should interstate electronic commerce be permanently governed by the same rules that now apply to mail-order sales among states?

Before that question is addressed, it should again be stressed that the online world does not escape taxation. Telecommunications channels—telephone lines, wireless transmissions, cable, and satellite—are taxed in most states; electronic commerce companies pay income and other direct taxes; sales taxes are collected on in-state purchases; and use taxes, though rarely enforced, cover most cross-border transactions. In addition, state income taxes capture a generous share of the personal wealth generated by the growth of electronic commerce. In short, electronic commerce does not enjoy any legal tax advantage; all existing taxes that are applied to traditional businesses are also regularly applied to online businesses. Those existing taxes are a significant source of revenue for

state and local governments. The only prohibition facing the states, which can lead to a de facto tax advantage for remote sellers, is on their means of collecting transaction taxes. States have it within their power to remedy that situation, but they prefer to avoid internal reform by expanding their authority over out-of-state businesses.

Sales and Use Taxes

Sales taxes are excise taxes (i.e., taxes based on the amount of business done) that are imposed on retail transactions. Sales taxes are generally levied by a state or locality on sales of tangible property and specified services that occur within the relevant jurisdiction. Purchases made by businesses—either for resale or as inputs to production—are (in theory if not always in practice) exempt from sales taxes in order to avoid double taxation.

Sales taxes are charged to sellers who then pass those taxes on to consumers. Although consumers are the ultimate taxpayers, there are real economic costs borne by businesses that collect sales taxes. First, there are the administrative costs of registering with multiple state and local agencies, of collecting taxes, and of remitting the funds (a cost that is higher for remote than for local sellers). Second, businesses may not always be able to pass on the entire amount of the tax to consumers. For example, if Amazon.com is required to collect an average tax of 5 percent, it may decide to lower its prices slightly to maintain sales volumes. Even if it holds prices steady, it will sell fewer books at the after-tax price, thus suffering a loss of sales revenue.

Every state with a retail sales tax also levies a “compensating use” tax, usually referred to simply as the use tax. The use tax is a supplement to the sales tax and is intended to cover the purchase of products and services that would have been subject to sales tax if purchased within the buyer’s home state. Out-of-state sellers are sometimes required to collect and remit the use tax to the buyer’s state, but if not, it is the consumers’ legal obligation to pay the tax themselves. The use tax is meant to ensure that all sales to residents are taxed,

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regardless of where the transaction takes place, and also to deter consumers from making purchases in competing tax jurisdictions on a lower- or no-tax basis.

Federal law and the U.S. Constitution prohibit states from requiring many out-of-state firms to collect sales or use taxes. Three cases in particular provide guidance on tax collection requirements on out-of-state vendors. In 1967 the Supreme Court ruled in *National Bellas Hess v. Illinois* that a mail-order company could not be required to collect use taxes if the company's only in-state activity consisted of shipping catalogs and goods from out of state by common carrier, such as the U.S. Postal Service or Federal Express.²⁶ The Court held that, under both the Due Process and Commerce Clauses, sellers can be required to collect use taxes only for states where they maintain a level of physical presence known as "taxable nexus."²⁷ For transaction tax purposes, nexus generally requires substantial physical presence: property, equipment, or employees based in a state.²⁸ A vendor without a physical presence in the state can also create nexus through a contractual relationship with a business that is in the state. For example, a company based in state A that hired the services of a sales firm in state B to market products there could be liable for tax collection in state B if the activities performed on behalf of the seller are necessary for it to establish and maintain market share.²⁹

In a 1977 case, *Complete Auto Transit, Inc. v. Brady*, the Court attempted to clarify what level of nexus would satisfy the requirements of the Commerce Clause but did not revisit due process. The Court constructed a four-pronged test that can help determine when a tax will meet Commerce Clause requirements. According to the test, any state tax must

1. be applied to an activity with "substantial nexus" in the taxing state,
2. be fairly apportioned,
3. not discriminate against interstate commerce, and
4. be fairly related to the services provided by the state.³⁰

It should be noted that *Complete Auto* is usually applied to income, not use, taxes. But there is no reason why its logic should not apply equally to transaction taxes. Finally, the Court reaffirmed *Bellas Hess* in 1992 with *Quill*, which said that states have no authority to tax cross-border mail-order sales absent express permission from Congress.³¹ *Quill* was a partial departure from the Court's earlier ruling in that *Quill* considered the nexus question separately under the Commerce and Due Process Clauses. Regrettably, the Court held that due process is satisfied whenever the remote seller's efforts are "purposefully directed"³² toward the residents of another state. Purposeful direction essentially entails any effort, such as the purchase of advertising in a local newspaper, to solicit orders from the residents of a state. In other words, under *Quill*, physical presence is not necessarily required to satisfy due process considerations as a precondition for a state to impose responsibility for use tax collection.

Although the Court overturned the physical-presence standard for due process, the physical-presence standard for the Commerce Clause was left intact. The distinction is significant. Because the Due Process Clause is a constitutional limitation on the power of government, reducing the level of protection that the clause affords would require a constitutional amendment; however, the Commerce Clause is an affirmative grant of power to the federal government. Accordingly, Congress can alter Commerce Clause requirements by statute. Many observers have thus concluded that the *Quill* decision was an invitation by the Court to Congress to exercise its power to clarify the standards for remote-commerce taxation.

The result of the Supreme Court's jurisprudence has been that the use tax, as currently applied, is not an effective alternative to sales taxes. Although they have it within their authority, most states make little or no effort to directly collect use taxes from consumers. Moreover, most consumers are unaware of the tax and thus do not voluntarily remit payment (though most businesses do). As a 1996 survey by the Software Industry Coalition found,

“With a few exceptions, state collection of use tax from buyers is largely non-existent.”³³ According to Neal Osten of the National Conference of State Legislatures, some states, such as Maryland, actually audit taxpayers who voluntarily pay use tax on the theory that people seemingly so honest must have something to hide.³⁴

Nexus and the Internet

Because of a reluctance to tackle thorny collection problems—coupled with a growing fear of future revenue losses—states have been constructing novel theories for extending their taxing authority to cover remote online sellers. Some tax officials have speculated that an Internet service provider (ISP), which connects consumers to the Internet, acts as an agent of online sellers and therefore creates nexus for virtually every firm. That would certainly be in line with the increasingly broad approach some states have taken to finding nexus. A controversial 1995 Multistate Tax Commission bulletin, for example, takes the position that contracting with a third party to provide in-state warranty repair services creates sales and income tax nexus for remote sellers.³⁵ Although the bulletin does not deal directly with Internet services, its logic could, as an Arthur Andersen paper pointed out, “conceivably apply to services other than repair services.”³⁶ That argument is *perhaps* plausible for online service providers (OSPs) that give technical or marketing assistance to vendors on a proprietary network; however, it is clearly inapplicable to ISPs whose connection to the seller is incidental only.

States that decide to adopt a broader interpretation of taxable nexus are on shaky legal footing. In 1998 the ITFA instructed states to apply the same rules to products sold over the Internet and delivered by common carrier as are applied to mail-order sales. The definition of “discriminatory tax” in section 1104(2)(B)(i) of the ITFA makes it clear that Congress considers the creation or maintenance of a site on the Internet to be so insignificant a physical presence that the use of an in-state computer server in this way by a remote seller does not

constitute taxable nexus.³⁷ Furthermore, when an ISP’s server is located in another state, section 1104(2)(B)(ii) prohibits states from classifying that provider as the nexus-creating agent of a remote seller.³⁸

Recent court decisions also seem to confirm the status of Internet providers as common carriers. In December 1998, for example, an intermediate appellate court in New York dismissed a libel suit brought by a 15-year-old Boy Scout against Prodigy (an OSP) for offensive statements transmitted via the Prodigy system. In dismissing the action, the court likened the online service provider to a telephone company, stating that Prodigy should not be held responsible for the content of communications sent over its network.³⁹

Even if some states successfully attribute nexus to companies that house Web sites on in-state computer servers, the probable result will be to drive site hosting and related services out of state. Thus, because most online vendors have substantial nexus in only one or a few jurisdictions, much electronic commerce will continue to be exempt from use tax collection requirements when purchases of tangible property are made across state lines.

Other approaches to taxing remote commerce have been equally problematic. In 1997, for example, Nebraska passed legislation (which was later vetoed) that would have required out-of-state companies with no in-state physical presence to report all purchases by Nebraska citizens. The state would then use that information to collect use taxes directly from its citizens—an approach that raises serious logistic and privacy concerns.

Tangible versus Intangible Products

The bulk of electronic retailing involves the sale of tangible products—like clothing or stereo equipment—that are ordered online and then delivered by common carrier. Electronic commerce also includes the sale of intangible digital products—like music and software—that are delivered directly over the Internet. In addition, the Internet makes it possible to provide services that are “produced” at one location and “consumed” somewhere

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else, such as medical or legal consultations.

It is generally accepted that tax rules that govern the sale of intangible products and services should be the same as the rules for other goods—namely, that means of delivery should not govern tax treatment. Such “technologically neutral” taxation would not treat the sale of a paperback book any differently from the sale of a digitized book, to use one oft-cited example. However, determining which products are functionally equivalent is a tricky proposition. Is text that is displayed on a computer screen really the same thing as a printed book? Is a movie that is downloaded to a computer hard drive really the same as a video that is rented? The answer is not obvious. Moreover, most states do not apply comprehensive taxation to services, and few states tax intangible products aside from basic utilities, which are subject to special taxes. There may be many valid policy reasons for such exemptions, and sovereign states should be free to decide what will be taxed, even when neutrality—taxing identical goods at the same rate—suffers.⁴⁰

Even if technological neutrality of taxation is desirable, it does not override due process and interstate commerce considerations; therefore, only firms with substantial nexus should be expected to collect taxes. Some states will undoubtedly play games with the taxonomy of digital products in hopes of circumventing that requirement. For example, a state might decide to treat the sale of intangible goods either as a sale of taxable services or as the lease of property and then insist that taxes are due on the basis of the contention that the *Quill* decision dealt specifically with the sales of tangible personal property and thus does not offer a safe harbor for sales of products or services delivered electronically. The language of the *Quill* decision, however, does not explicitly refer to tangible products, which suggests that it will also apply to sales of services and digital content over the Internet.⁴¹

Taxing the online sale of intangibles is also problematic because the location of customers cannot be known with certainty. Many online shoppers do not feel comfortable giving unnecessary personal information to a Web site.

Consequently, they may refuse to type the information in, choose to shop at a site that does not require that information, or simply lie. That behavior may prompt states to argue that because vendors cannot prove that buyers are *not* local, the vendors are liable for tax collection on *all* sales. However, that approach would lead to multiple taxation and place on sellers an impossible burden that would effectively undermine the intent of *Quill*.

Even if a state successfully made that case, the victory would be illusory. The fluid nature of digital products means that states may have trouble collecting taxes even on in-state sales, much less on remote transactions. It is relatively easy for buyers to misrepresent their location or to have a third party in another state purchase the product or service and simply forward it with a click of a mouse. It is also possible for sellers of digital products to locate in foreign jurisdictions that would not enforce tax collection requirements. It would be very difficult, for example, to collect tax on the transmission of content sent from abroad and paid for by digital cash or smart card—untraceable encrypted “virtual money” that is spent exactly like cash and leaves no paper trail. Given the near impossibility of enforcing compliance, the revenue potential of taxing digital products is probably small.

Some state agencies that support allowing the states to enforce tax collection on out-of-state sellers of tangible goods recognize the all but insurmountable hurdles to taxing network-delivered intangible products and services. California’s Electronic Commerce Advisory Council, for instance, has recommended that “the status quo be maintained for taxing the interstate sale of intangibles and provision of services.”⁴² Its report cites both the difficulties associated with establishing a buyer’s identity and location as well as the ease with which the taxes could be avoided as reasons not to attempt the taxation of digital commerce. Critics of that approach note that at present most purchases are made with a credit card, the billing address for which could potentially be used to determine which state had jurisdiction over a sale.⁴³ But with the likely rise of digital

cash and other unaccounted payment systems, avoidance problems would, at best, be only postponed. The problems with using credit cards for tax collection purposes are discussed further in the section on international taxation.

Income Taxes

In contrast with sales and use taxes, Congress has actively exercised its power under the Commerce Clause to limit the authority of state and local governments to collect income tax from out-of-state firms. In the 1950s, states routinely applied disparate principles to determine when a corporation was subject to tax in their jurisdictions. After the Supreme Court gave states a favorable ruling, Congress in 1959 passed Public Law 86-272. Under that law, if a company's contact with a state is limited to solicitation for the sale of tangible goods and the goods are delivered from out of state, the state may not impose a net income tax on the company. When P.L. 86-272 does not apply, states are still subject to the constitutional nexus requirement of substantial physical presence of the business in-state.⁴⁴

P.L. 86-272 should be sufficient to block states and localities from collecting income taxes from most out-of-state firms engaged in electronic commerce. Specifically, the law says:

No state, or political subdivision thereof, shall have power to impose a net income tax on the income derived within such state by any person from interstate commerce if the only business activities within such state by or on behalf of such person during such taxable year are either, or both, of the following:

- (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
- (2) the solicitation of orders by such person, or his representative, in

such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).⁴⁵

It seems that P.L. 86-272 places clear limits on state and local taxing authority, but the extent of that protection has been hotly contested. In 1992 the Court, in *William Wrigley, Jr. Co. v. Wisconsin*, attempted to settle what constitutes taxable activity. According to that decision, nontaxable activity includes "not merely the ultimate act of inviting an order but the entire process associated with the invitation."⁴⁶ However, according to a recent analysis by KPMG Peat-Marwick, "Since *Wrigley*, a line of state cases and rulings have whittled away at the foundation of those activities that the Court deemed to be 'protected' and halfheartedly applied the *de minimis* exception set out in *Wrigley*."⁴⁷

Although P.L. 86-272, in conjunction with *Wrigley*, suggests that online merchants that solicit orders via a Web site would be protected from income taxes, states can be expected to try to circumvent the federal barriers. In particular, states might argue that the law's reference to "tangible personal property" means that firms selling intangible digital products and services are liable for income taxes wherever their customers live. That approach has at least two inherent flaws. First, it would place a substantial burden on interstate commerce, thwarting the original intent of P.L. 86-272, which did not anticipate the importance of intangible products. Second, the nature of network-delivered digital products makes a buyer's location impossible to credibly establish. That could lead to serious problems with apportionment and multiple taxation, as states compete for the same income.

Given those difficulties, Congress should consider amending P.L. 86-272 to explicitly include the delivery of intangible products and services over the Internet.

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Other Taxes

Use and income taxes will have the greatest impact on electronic commerce, but there are other taxes that bear watching. Expansive use of telecommunications taxes, for example, could expose ISPs to double taxation by taxing them once for leasing phone lines and again for access to those lines. For the most part, however, states cannot be precluded from imposing damaging taxes on electronic commerce unless those taxes are extraterritorial. It is to be hoped, of course, that states will not impose harmful or needless taxes on electronic commerce without careful consideration.

The Case against Expanded Taxation

The Advisory Commission on Electronic Commerce, which held its first meeting in June 1999, may be the most important part of the ITFA. Its mandate is far ranging, including the study of taxation of Internet access, remote commerce across national borders, and the advantages and disadvantages of authorizing state and local governments to require remote sellers to collect and remit use taxes. The commission includes a large number of state and local representatives who are eager to tax remote commerce, both electronic and mail order.⁴⁸

The commission should be cautious in making recommendations. Imposing use tax collection responsibilities on remote sellers is unlikely to generate significant tax revenue but could negatively affect the growth of electronic sales. A recent study by Austan Goolsbee estimates that taxing remote electronic commerce would reduce the number of online buyers by 25 percent and total spending on Internet transactions by more than 30 percent.⁴⁹ Furthermore, those sales would not necessarily shift to traditional retailers because, as Goolsbee and Zittrain suggest, the Internet is probably a net trade creator—generating business that would not have otherwise occurred.

Nevertheless, pressure by state and local officials may be substantial, so proposals by the commission to expand subfederal taxing power are a possibility. The recommendations could involve legislation to loosen nexus standards or

require out-of-state sellers to collect a national sales tax, or both. Congress should reject all such advice and instead maintain and clarify the existing limits. At a minimum, Congress should make clear that current tax restrictions on mail-order sales will also permanently apply to online commerce. The alternative—augmenting states' taxing authority—is ill-advised for several reasons.

Tax Competition Is Beneficial. At first glance, the case for extending use tax collection requirements to out-of-state sellers sounds reasonable. After all, why should identical items be taxed differently depending on how they are purchased? Neutrality is the core principle of a tax system designed to minimize economic distortions. Other things being equal, neutrality of taxation is highly desirable.

Neutrality, however, is not the only determinant of economic efficiency. Indeed, *all* taxation is distortionary because it shifts resources from the private to the public sector. High tax rates, even when administered on a neutral basis, are detrimental to economic growth and development. Thus, unequal taxation at a lower average rate may be superior to tax neutrality at a higher rate. If electronic commerce grows and tax competition intensifies, forcing states to cut (or not raise) sales tax rates, overall economic efficiency will likely be enhanced.

A study by Cato Institute economists Dean Stansel and Stephen Moore confirms that lower tax rates, which are promoted by tax competition, lead to healthier state economies. They compared the performance of 10 states that raised taxes between 1990 and 1996 with that of 10 states that decreased taxes. On average, the economies of tax-cutting states grew 33 percent over the five-year period compared with only 27 percent for tax-hiking states—a variance of nearly 20 percent. Tax-cutting states also had healthier budget balances; their reserves averaged 7.1 percent of state outlays compared with 1.7 percent in tax-raising states.⁵⁰

Several misguided plans to expand state and local taxation are already being debated. Most recently, at its July 1999 annual meeting, the National Association of Counties unanimously

approved a resolution urging Congress to impose a sales tax on all online purchases.⁵¹ A similar plan, advanced by Texas's former tax director Wade Anderson, would create a uniform national sales tax for cross-border purchases.⁵² Similar legislation that would establish a 5 percent national sales tax on most cross-border purchases has already been introduced by Sen. Ernest F. Hollings (D-S.C.).⁵³ The proceeds of such a tax, based on sales volume or some other formula, would be collected by merchants and remitted to the states—with a possible detour through Washington.

Others have proposed loosening the substantial nexus requirement that currently prevents states from imposing use tax collection duty on out-of-state sellers. For example, Harley T. Duncan, executive director of the Federation of Tax Administrators, says, "Congress should use its authority under the Commerce Clause to authorize states to require sellers without a physical presence in the state to collect use taxes on goods and services sold into the state."⁵⁴ In exchange for this new authority, a single tax rate would be set for each state, making it somewhat easier for businesses to calculate how much they are supposed to collect and for whom. State officials reason that such a deal would bring more businesses into the pro-tax camp. Some large online sellers, for example, support the plan because they already collect taxes and believe mandatory collection would disadvantage smaller competitors. That might be a win-win situation for big business, state, and local government, but taxpayers and small businesses would lose.

Because such schemes would effectively reduce interstate tax competition, Congress should reject all of them. Differentiated tax rates encourage cross-border shopping, a healthy form of tax competition that helps keep local rates under control. Such competition regularly occurs in the offline world. For example, some residents of New York drive to Delaware to avoid sales taxes—an option that has undoubtedly curbed the profligate fiscal habits of Big Apple politicians. Maintaining the current restrictions on extraterritorial tax

collection will not stop states from taxing residents at the level required to fund government services, but it may force those states to cut waste or make the total cost of government more apparent. A more visible tax burden would help people make better decisions about where to live, which would put additional downward pressure on tax rates. Over the past 15 years, an average of 1,000 people a day have moved from the 10 highest-tax states to the 10 lowest-tax states.⁵⁵ Given those facts, states may determine that economic development goals take precedence over revenue-raising concerns and explicitly choose not to tax online sales.

Electronic commerce gives everyone the opportunity to live on a virtual border—to take advantage of the fact that no state, although it is free to do so, currently taxes its exports or voluntarily collects use taxes for other states. Like a real border, the Internet can be a potent safety valve that guards against excessive taxation. Moreover, because the capital used in many electronic businesses is more mobile than the capital used in traditional ventures, firms are often able to shop around for the lowest tax rates. Electronic commerce allows consumers who have found it difficult to travel out of state—the poor, the elderly, and the infirm—to take advantage of tax-free commerce for the first time.

In addition, *political* pressures to keep tax rates down would be lessened if the *Quill* standard were overturned. The Internet will likely lead to an expansion of interstate commerce for nontax reasons, such as shopping convenience. If states are allowed to force out-of-state businesses to collect use taxes, an increasing share of state tax collections will be conducted by businesses that have no voice in the local political process. Consequently, there will be fewer businesses that are able to lobby against proposed rate hikes, making it easier for states to raise tax rates in the future.

Fortunately, some states are voluntarily taking a hands-off approach to online taxation. The California Assembly passed its own version of the ITFA that was enacted on January 1, 1999. In addition to a three-year ban on new

Congress should make clear that current tax restrictions on mail-order sales will also permanently apply to online commerce.

Unequal taxation at a lower average rate may be superior to tax neutrality at a higher rate.

Internet taxes, the law exempts online firms from collecting sales tax on goods sold in California if those firms have no physical presence there.⁵⁶ Virginia and New York have adopted similar legislation, and several governors have announced their support for the federal ITFA.⁵⁷ Undoubtedly, the reason that those states have chosen to restrain their taxing impulses is because competition for business has convinced them that it is in their best economic interest to do so. Even supporters of allowing states to tax cross-border sales have recognized that competition is often the driving force behind good tax policy. As Charles E. McLure of the Hoover Institution has noted, "Exemption for business purchases has occurred not because it is the right thing to do, as a matter of principle, but grudgingly, in response to fears that to do otherwise might damage a state's business climate."⁵⁸

A nondistortionary state tax system is a sensible ideal and a worthy long-term goal. However, allowing states to force use tax collection by out-of-state sellers would not significantly further that goal and would unfairly burden many businesses. By broadening the tax base without lowering rates, and thereby subjecting more transactions to uneven rates, numerous loopholes, and multiple exemptions that typify state tax codes, it is doubtful that any efficiency would be gained. State and local governments already have within their power a better option to reduce unequal taxation: cutting taxes, not scheming to collect more.

Neither Traditional Retailers nor State Budgets Face a Crisis. Because local stores cater to a customer's desire for a hands-on experience, offer immediate gratification, and do not charge for shipping, they will probably always dominate retailing. In addition, shopping is for many people a pleasurable social experience that cannot be duplicated online. Thus, Internet sales won't destroy "real" retailers, just as catalog sales haven't. Certainly the revenue crisis that many state officials predicted with respect to mail-order sales has never materialized (catalog sales were only \$52.3 billion compared with \$2.7 trillion for sales in traditional stores in 1998).⁵⁹ As Dean Andal, a member of

the Advisory Commission on Electronic Commerce, has noted, "There was a time in the early 1980s when mail order was growing at rates comparable to today's Internet sales. During those years, the same pro-tax lobby who is now beating the drums to tax the net was calling to tax mail order sales."⁶⁰

Recent state budget data reveal no hint of a revenue crisis. In an era of almost no inflation, state budgets grew by 5 percent in FY97 and nearly 6 percent in FY98. Over the past four years, state tax collections have exceeded expectations by about \$25 billion.⁶¹ It appears that there will be a sizable revenue windfall this year as well. Furthermore, states will receive money from last year's mammoth tobacco settlement. All 50 states and some cities will collectively receive \$246 billion from the settlement over the next 25 years.⁶² With revenues pouring in so rapidly, it cannot credibly be argued that electronic commerce is currently undermining state tax collections or that states are in need of new funds.

Overflowing state coffers reveal that the fears of tax administrators are at best premature, and may never be realized. A comprehensive report produced by Ernst & Young and the National Retail Federation indicates that electronic commerce does not constitute a significant percentage of retail activity. Only about one-third of consumers with online access has purchased products or services over the Internet. That means that only 10 percent of American households have ever made a purchase online. And of that group, only 4 percent make more than 10 purchases a year.⁶³

Sales predictions for electronic commerce routinely overlook the Internet's role in driving consumer purchases to other channels of distribution. Sixty-four percent of those households with Internet access research products online and later buy them through traditional channels—double the percentage of consumers who research and order the same products online.⁶⁴ As a Greenfield Online survey notes, "The human factor still drives shopping, and the visceral experience is still the principal shopping driver. While stores and malls remain the place for buying, online has become the 'window-

shopping' experience to the world."⁶⁵ Moreover, a vast amount of electronic commerce could not properly be subject to use taxes even if nexus requirements were completely eviscerated. Approximately 80 percent of online commerce is conducted between businesses.⁶⁶ Those transactions do not translate into lost tax revenue because they are tax exempt, or, if not, the funds are voluntarily remitted by the buyer.

It is inaccurate to say that restricting the taxation of remote commerce is fundamentally unfair to traditional retailers, since the "loop-hole" is available to everyone. Indeed, existing businesses are often the ones taking advantage of the Internet by setting up Web sites and taking orders. At the national level, many successful electronic commerce firms are in fact traditional retailers that have gone online—Barnes & Noble and Macy's are two prominent examples. The trend is not surprising, since established businesses have a customer base, a distribution network, an inventory system, and so on. Electronic commerce is as much a new way for existing firms to market their products more widely as it is a source of new competition. To the extent that such efforts are successful, state and local governments will also benefit from greater tax revenues.

Online sales are also within reach of strictly local establishments. Grocery stores, restaurants, and florists are already using the Web to take orders that are delivered the same day. Even independent booksellers—the poster children for retailers savaged by Internet competitors—are learning to use the Web to their advantage. In March, the American Booksellers Association, which is made up of independent bookstores from around the country, announced the formation of Book Sense (www.booksense.com)—an online store that combines the stocks of independent stores nationwide. The stores will set their own prices and recommend specialty titles.⁶⁷ The ability to offer the convenience of Internet shopping, coupled with rapid delivery at minimal costs, should allow local merchants to compete with remote sellers. Those benefits could, at least in areas with competitive rates, overcome the dis-

advantage of sales tax collection.

If states are concerned about equity, they can address the issue by harmonizing tax rates *downward* for local retailers. Policymakers in both Minnesota and California have raised that possibility, proposing to eliminate the sales tax on products that are easily acquired online. Specifically targeted are intangible goods that can be downloaded, such as software, music, and books.⁶⁸ Another positive move would be to push for privatization of the U.S. Postal Service, which unfairly benefits mail-order companies through postage rates that do not fully cover costs for catalogs or shipping.⁶⁹

Out-of-State Companies Should Not Collect Taxes. Out-of-state companies that sell online do not use the same services as local businesses, so those companies should not be taxed to pay for such services. When a business pays income or remits sales taxes to the state in which it is located, there is a plausible linkage among the taxes paid, the services provided, and legislative representation. After all, local firms benefit from police and fire protection, road construction, waste collection, and other services provided by the taxing authority, so it is proper that they help cover the costs. Moreover, local firms can make their voices heard in government through lobbying, voting, and membership in local interest groups, such as the Chamber of Commerce.

The circumstances are different, however, for a company that markets goods over the Internet and delivers them via common carrier. In that case, the remote seller does not benefit from most of the services that distant state or those local governments provide. That does not mean that no one is paying: telecommunications carriers pay taxes on income earned from building and maintaining the Internet's physical infrastructure; common carriers pay for services they use in the form of income taxes, fuel taxes, and similar levies—in short, no one unfairly benefits from the use of public services while conducting electronic commerce. Electronic commerce firms should help pay for services only in states in which they are physically located and actually use

Allowing states to force use tax collection by out-of-state sellers would not significantly further tax neutrality and would unfairly burden many businesses.

No one unfairly benefits from the use of public services while conducting electronic commerce.

those services. Use taxes are fine, but they should not be collected by businesses that have no significant contact with the taxing state.

The case against remote taxation is at least as strong for sales of intangible products over the Internet. Clearly, network-delivered products do not impose any additional marginal cost on state-provided services. To the extent that digital products substitute for tangible products, the demand for state-provided services might even decline. Fewer trips to the video store or the newsstand, for example, mean less wear on roads and less need for police protection.

Early decisions by the Court concerning due process established a standard of fairness for remote taxation that is still valid today. In a 1940 case, *Wisconsin v. J.C. Penney Co.*,⁷⁰ that standard was described as follows:

[The] test is whether property was taken without due process of law, or if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask in return.⁷¹

More recently, in a 1996 Internet-related case—*Bensusan Restaurant Corp. v. King*—a federal district court in New York recognized limits on a state’s jurisdiction on due process grounds. The district court held that the defendant, based in Missouri, did not purposefully avail himself of the benefits of New York through the mere creation of a Web site. In the court’s opinion, “Creating the site, like placing a product into the stream of commerce, may be felt nationwide—or even worldwide—but, without more, it is not an act purposefully directed toward the state forum.”⁷²

If that conception of a Web site is upheld, the Due Process Clause is possibly sufficient to protect many electronic commerce businesses from tax collection duties imposed by distant states. The Court concluded in *Quill* that due

process concerns were satisfied in part because the petitioner had “purposefully directed its activities at North Dakota residents.”⁷³ Specifically, the Quill corporation had mailed catalogs to, and purchased advertising in, North Dakota—activity suggesting that the company was actively availing itself of the North Dakota marketplace. Many, though not all, Web-based businesses do not target distant markets that way. The mere existence of a Web site (especially on an out-of-state computer server) is no more purposeful, regular, or persistent solicitation of customers in a foreign state than is a listing in the local telephone book, which, like a Web site, is available nationwide. On the Internet, customers often actively seek remote businesses instead of the reverse. If taxpayers can drive across state lines to make purchases from a store that has done nothing to target them, and that business cannot be compelled to collect use taxes for the buyer’s home state, then there is no reason to hold Web-based firms to a different standard.

The Commerce Clause also prohibits states from imposing taxes on businesses that do not benefit from state services. The four-pronged test from *Complete Auto*, which can help determine when a tax will pass constitutional muster, requires that any state tax “be fairly related to the services provided by the state.”⁷⁴

Although *Quill* effectively abandoned the physical-presence requirement for due process, it upheld the *Complete Auto* test that requires a tax to be fairly related to services provided by the state. As it considers the question of whether to protect the Internet from unfair taxation, Congress should recognize the fundamental disconnect between remote electronic commerce and state-provided services.

The aggressive manner in which many states are attempting to draft out-of-state firms as tax collectors suggests that new revenue, not equitably sharing the cost of services, is their real goal.⁷⁵ State officials regularly speak of “lost” tax revenues to which they are entitled. Their words, however, ring hollow. State and local tax rates were set in a world where restrictions on cross-border tax collection were the norm. The revenue such taxes were expected to raise took that

reality into account. It is impossible to lose revenue that was never anticipated; however, allowing states to tax remote commerce would raise new revenue—a de facto tax increase that escapes voter scrutiny. Congress should thus be aware that any federal legislation intended to authorize remote taxation could have the practical effect of allowing state revenue agencies to expand taxation by fiat. As the American Legislative Exchange Council recently pointed out: “The authority to levy a tax, expand tax obligation—including tax collection obligation—or broaden the tax base in any way is vested solely in the legislature. A state revenue administrative entity should have no authority to levy, increase, or in any way expand a tax, a tax obligation, or a tax collection obligation.”⁷⁶

If equity were the primary consideration, states should be proposing to lower tax rates and broaden the tax net simultaneously. With most state budgets in surplus, taxpayers should reasonably expect any reforms to be, at a minimum, revenue neutral. For example, if current retail sales within a state are \$1 billion, and the tax rate is 5 percent, sales tax receipts would be \$50 million. If the ability to tax interstate sales increased the tax base to \$1.25 billion, then the tax rate could be lowered to 4 percent to yield the same \$50 million in revenues.⁷⁷ Along those lines, California’s Electronic Commerce Advisory Council has recommended that each state “review the tax-base-broadening revenue impact of the new system and consider reducing its sales tax rate,”⁷⁸ but such advice is rarely followed in state tax circles.

Use Tax Collection by Remote Sellers Would Be Burdensome. If remote sellers were required to collect use taxes, the result would be an inequitable redistribution of income. State and local tax laws are not uniform, which could make compliance costly for remote vendors. With a patchwork of more than 6,500 (and potentially over 30,000) state and local taxing jurisdictions currently levying taxes, sorting out competing tax claims would be challenging, particularly for small businesses. Although software that can calculate tax liability currently exists, it is expensive—often more than \$20,000.⁷⁹ This amount may be trivial for large

nationwide retailers, but for small Internet sellers it could be prohibitive. In addition to calculating how much tax is owed to whom, firms would be required to register with and remit taxes to a bewildering array of local agencies and to collect and store information about their customers.

Complying with a multitude of state and local tax laws would disadvantage Internet retailers—whose business is inherently interstate—relative to their traditional competitors. Brick-and-mortar retailers are tasked only with collecting sales taxes for the state where they are located, regardless of where their customers ultimately use their purchases. Instead of “leveling the playing field,” as its proponents claim, a policy that allows states to enforce out-of-state tax collection would merely shift any de facto tax advantage from remote to local sellers. A recent paper published by Ernst & Young estimates that small firms selling and collecting tax nationwide would face compliance costs of 87 percent of the taxes remitted as opposed to just 7.2 percent for local businesses.⁸⁰ Faced with that disadvantage, many small- and medium-sized firms would likely choose not to sell online, a result that suggests an impermissible burden on interstate commerce.

If allowed, use tax collection and remission could realistically take place only at the state level. That would entail either a uniform national tax rate, such as the 5 percent federal sales tax on all remote sales proposed by Senator Hollings, or at least a single rate for each state. Both of those options, however, would undermine much of the beneficial tax competition that now takes place among jurisdictions. Hollings’s proposal is especially anti-competitive because it removes altogether the possibility for states to set their own tax rates on cross-border sales. It would also give consumers in states with sales tax rates lower than the national rate an incentive to avoid shopping online, further discriminating against Internet businesses.

Although it is true that allowing states to enforce collection requirements on remote sellers under a one-rate-per-state system would preserve tax competition among states, that

The aggressive manner in which many states are attempting to draft out-of-state firms as tax collectors suggests that new revenue, not equitably sharing the cost of services, is their real goal.

Electronic commerce gives the option of cross-border, tax-free shopping to people for whom it never before existed and expands the range of products that they can buy.

competition would be much less intense than under current rules. Prior to the Internet, the only meaningful behavioral constraints on sales tax rates were driving across state lines and ordering from catalogs. Few people, however, are fortunate enough to live near a state with a lower tax rate, and catalogs are limited in both capability and availability. Electronic commerce gives the option of cross-border shopping to people for whom it never before existed and expands the range of products that they can buy. That is a useful check on the ability of state and local governments to raise sales taxes beyond a reasonable level.

Proposals to require remote sellers to collect use taxes assume that the location of the customer will be known. That knowledge cannot be taken for granted, however, especially for purchases of digital products and services. As the use of anonymous digital cash becomes widespread, sellers may not even have billing addresses to use in calculating tax charges. A uniform national tax rate would not solve that problem, because tax receipts could not be fairly apportioned among the states. The Hollings bill, for example, does not even attempt to remit funds to states based on the location of taxpayers; instead, the bill relies on a redistributive formula based on poverty rates and school-age populations. Even if states managed to allocate the taxes among themselves, it would be extremely difficult for them to fairly apportion tax revenues to the localities where consumers were located, resulting in an even more inequitable redistribution of income *within* states.

Lack of knowledge of the customer's location could also lead to taxation by states that have no connection to the transaction in question. Assume, for example, that businesses are instructed to rely on credit card billing information for tax collection purposes. Consider the common example of a traveler who purchases a digital product by credit card—say, a downloaded news article—while staying in a hotel room in another state. The seller would be required to collect and remit a use tax to the state where the buyer's credit card was registered, but that state would have no connection

to the transaction itself, nor would any use or consumption take place there. In such cases, the collection requirement of the taxing state would have a sweeping extraterritorial effect not permitted under prevailing due process jurisprudence, which precludes the application of a state statute to commerce that takes place wholly outside its borders.

Limiting States' Taxing Authority Is a Crucial Component of American Federalism. In 1998 a report published by the National League of Cities asserted, "One of the virtues of federalism is that states are able to choose for themselves how to design their own tax systems, whether to tax information services, and whether to tax or exempt on-line providers from state sales taxes."⁸²

Although state and local governments are free to set their own tax policies, their authority does not extend beyond their geographic borders. There is something inherently unsettling about states' exercising legal authority outside their jurisdictions. Unquestionably, states have the legal right to levy use taxes on their own citizens. But imposing a collection obligation on out-of-state businesses is a fundamentally unfair government activity. By what right can New York force a firm in Florida to act as its tax collection agent? Even if it were constitutionally permissible, it would set a dangerous precedent with enormous potential for conflict.

Because Internet commerce by nature cannot be locally restricted without imposing costs on other states, it falls into Congress's sphere of authority. At least some active federal guidance could be useful, because recent state court decisions relating to jurisdiction and the Internet are confusing and often contradictory. Consider *Inset Systems Inc. v. Instruction Set Inc.* and *E-Data Corp. v. Micropatent Corp.*⁸³ In *Inset*, the district court held that advertising through use of an Internet site, even though no purchases or sales could be conducted through the site, constituted solicitations of a nature sufficiently repetitive to justify jurisdiction by Connecticut, where consumers were exposed to the ads. However, in *E-Data Corp.*, the same court held that a company engaged in electron-

ic commerce and operating an Internet site was not subject to personal jurisdiction by Connecticut solely by virtue of Connecticut residents' ability to access the site. Those seemingly inconsistent opinions illustrate the uncertainty that businesses face when confronting Internet-related legal issues.⁸⁴

The overriding priority at the federal level should be to ensure that states are not allowed to violate the *principle* of due process by imposing tax collection responsibilities on out-of-state businesses. *Quill* minimized the legal importance of due process considerations and apparently gave Congress an opening to authorize states to require use tax collection. But the fact that Congress has the authority to resolve that dispute does not imply that it should radically change the status quo. That action would be neither prudent nor just; the mere potential for a revenue crunch is not a compelling reason to impose burdensome duties on out-of-state firms.

Other constitutional rationales for maintaining the federal restrictions on state taxation of remote commerce are available.⁸⁵ The *Quill* contention that requiring remote sellers to collect taxes places an unconstitutional burden on interstate commerce, for instance, remains valid.

The Framers of the Constitution wisely erected strong protections of interstate commerce and empowered Congress to enforce those protections. If states are allowed to make out-of-state firms, which have no connection to or influence over the taxing authority, act as revenue collectors, those barriers will be significantly weakened. Use taxes may not be unconstitutional per se, but states should be required to collect such taxes themselves, without unjustly extending their authority into other jurisdictions.

Options for State and Local Taxation

Despite claims to the contrary, it is by no means certain that the growth of electronic commerce will substantially undermine state and local tax collections. Online commerce may generate new business and enhance productivity to such a degree that any revenue

losses will be negligible. But even if there is a negative revenue impact, state and local governments have several policy alternatives available. At the federal level, the objective should be to maintain a tax system that fosters competition among the states.

The idea that state and local governments will be unable to find the money to perform legitimate government functions is laughable. As taxpayers know too well, politicians will always have such options as income taxes, use taxes, property taxes, gas taxes, hotel taxes, and the like. Their insistence on expanding tax collection authority without lowering tax rates suggests that the goal is not equity or revenue security but instead a new source of funds that would escape voter scrutiny. If a tax increase is not the intent, then current policy recommendations are misguided. Unfortunately, there is little reason to expect a change of course. Given that several states have enacted voter-approved tax-limiting initiatives, the taxation of electronic commerce has apparently become an attractive back-door option for lawmakers who chafe at such restrictions.

Justified or not, state and local officials evidently believe that erosion of the tax base is on the horizon. It is thus likely that they will attempt to recover uncollected taxes from somewhere. Ideally that would be accomplished by a combination of budget cutting, waste reduction, and tax reform. In reality, however, the most probable strategies will be to raise existing taxes, redefine taxable transactions, impose new taxes, and attempt to expand the nexus provisions.

Ultimately, states may be forced to look beyond such piecemeal reforms. Congress is already considering the idea of extending the ITFA. At least one bill, introduced by Sen. Robert Smith (R-N.H.) in January, would impose a permanent moratorium on taxation of remote electronic commerce. Such a ban is likely to have popular appeal—the leading Republican presidential candidates have all endorsed the concept and several bills have been introduced in Congress—so states should not ignore the possibility that alternatives to traditional sales taxes might be necessary. A

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few of the available options are considered below.

Lower Taxes—Cut Spending. If electronic commerce eventually contributes to a state budget crunch, it will not be because revenues are inadequate but because states simply spend too much. For most of America's history, the states consumed roughly 4 to 5 percent of gross national product. By 1970 that figure had grown to 7 percent; by 1980, to 8 percent; and by 1990, to 8.5 percent.⁸⁶ At that time, many states were facing what the *New York Times* called "a fiscal calamity."⁸⁷ Then, as now, budget analysts and state officials tended to blame their problems on a multitude of factors beyond their control. Especially singled out for blame were the resistance of citizens to new taxes in the 1980s and a decline in federal transfer payments.

Although both of those factors likely played some role in causing the states' fiscal predicaments, the primary culprit was a decade of runaway state government expenditures. With few exceptions, the states with the most severe deficits early this decade were the ones that saw their economies and tax revenues grow rapidly in the 1980s but allowed spending to grow even faster.⁸⁸

By 1996, however, the states had moved dramatically in a fiscally conservative direction, with most states cutting taxes and holding general fund expenditures at or below inflation in 1995 and 1996.⁸⁹ Overall, from 1996 to 1997 state budgets expanded just slightly above the inflation rate, as opposed to nearly twice the inflation rate in the early 1990s. The result of tax cuts and fiscal restraint was that states accumulated sizable budget surpluses, ending the budget "crisis" of years past.⁹⁰

Unfortunately, there has been a clear trend toward more spending at the state level during the past two years. In 1998 many governors submitted budget proposals that increased spending by more than 7 percent, roughly three times the rate of inflation.⁹¹ On average, states estimate an increase in general fund spending of 5.7 percent for FY98 and 6.3 percent for FY99, with only two states reducing their FY98 enacted budgets.⁹² Those figures repre-

sent almost twice the rate of inflation plus population growth.⁹³ Noting that apparent return to profligacy, the *Wall Street Journal* published a story headlined "For Republican Governors, Spending Isn't a Dirty Word Anymore."⁹⁴ The desire to spend more is leading state officials to perpetually seek new revenue—and electronic commerce is now in the cross hairs.

Budget data show that states have no pressing need to tax remote electronic commerce. If every state had adhered to a population-plus-inflation revenue cap from 1992 to 1998, taxpayers would have saved a total of \$75 billion, or \$278 per capita, in 1998 alone. Even if states had passed \$75 billion in tax cuts in 1998, their revenues would still have grown by about 22 percent, or 3.4 percent per year—the level of inflation and population growth. Instead, state tax collections climbed by 45 percent, or 6.4 percent per year.⁹⁵

Consider the case of Nevada, where executive director of the Department of Taxation Michael A. Pitlock has called Internet commerce "a significant concern" for state finances and has proposed "[putting] a requirement on vendors to collect taxes for all products they ship to each state."⁹⁶ Again, the real problem is spending, not revenue. As the *Las Vegas Review-Journal* noted while discussing the current legislative session, "There will be plenty of talk about 'pain,' 'cuts,' and a 'shortfall.' Don't be fooled: State spending over the next biennium will increase by almost 10 percent, to an estimated \$3.186 billion."⁹⁷ Such budget battles highlight the need to rein in spending, not beef up tax collection.

Local government is not immune to the siren song of runaway spending. As *Newsday* recently observed of New York's Nassau County, "Unbelievably, at a time of unprecedented prosperity that has created surpluses for governments large and small, one of the nation's richest counties is drowning in red ink." The problem: too much spending. "Nassau has been living beyond its means for years, offering too many, sometimes overlapping, services and paying too many politically connected employees more than it could afford."⁹⁸

State and local officials are naturally

inclined to spend an ever-increasing portion of the taxpayers' wealth, but that urge must be resisted. To secure their fiscal futures, states should lower tax rates and give taxpayers greater value for their tax dollars by cutting back unproductive agencies and privatizing state services.

States should also emulate the tax- and spending-limit initiatives that have been passed in recent years. Washington's Initiative 601, for example, says that state spending can grow by no more than the rate of inflation plus population growth. That's running about 3 percent a year, less than half the average annual budget growth for the past two decades.⁹⁹ In addition, the same state's recently passed Initiative 695 requires voter approval of all tax and fee hikes. Along similar lines, some governors—including Christine Whitman of New Jersey, Tom Ridge of Pennsylvania, and New York's George Pataki—are pushing bills to require a supermajority of lawmakers to raise taxes.¹⁰⁰

Alternative Tax Structures. The problems associated with taxation of electronic commerce would disappear if states switched to a source-based system of sales taxation. Current sales taxes are structured on a destination basis, with the intent of imposing the tax at the place of consumption. Under a source tax, money is collected where economic production, not consumption, takes place. Businesses are assessed taxes based on total sales volume, regardless of the ultimate destination of their output. Reform in that direction need not entail a complete overhaul of state tax systems. As Kaye Caldwell, public policy director of CommerceNet, has noted: "All states exempt local merchants from collecting sales taxes on goods that are exported from their states to buyers in other states. Eliminating that loophole and setting the export rate to match the state rate in the buyer's state would immediately resolve the [use tax collection] problem."¹⁰¹

Source taxes have the advantage of low administrative costs and high compliance rates; they do not extend a state's taxing authority outside its borders, and they maintain strong incentives for states to engage in tax competition. Even critics of a source-based

tax system have conceded some of those important advantages:

Source-based transaction taxes applied to electronic commerce have clear compliance and administrative cost advantages over their destination based counterparts through the elimination of the use tax problem. A destination tax requires retailers to account for sales made in all market states, distinguish between taxable and exempt transactions, and apply the proper tax rate to the transaction. Under the source alternative, retailers need only know the transaction tax system within their states of location, an especially important advantage for smaller firms with relatively high compliance costs.¹⁰²

The primary "problem" with source-based taxation, according to its detractors, is that tax competition may be so intense that businesses would locate primarily on the basis of tax criteria. That argument assumes that tax rate differentials will be great enough to offset natural advantages such as proximity to suppliers and customers, and conversely, that location has a significant effect on productivity. Both assertions cannot be true. If location is a major determinant of productivity, firms will be unlikely to move unless the tax savings will be very high. If, however, modern transportation networks make relocation viable for minimal tax savings, there will be little negative effect on the nation's overall economic efficiency.

Finally, states could always decide to broaden the in-state tax base so that services are taxed more evenly. In addition to achieving greater neutrality, that approach has the advantage of intergenerational equity. In most states, the growing elderly population will spend a larger share of its income on services than will the working-age population. Taxing all goods and services at the same rate, the tax burden would be spread more evenly among all segments of the local population.

Whether states choose to restrain spending

Under a source tax, money is collected where economic production, not consumption, takes place.

or to restructure their tax systems, an important benefit of internal reform is that it will force state legislators to face public scrutiny. Federal action, though, would allow local lawmakers to pass the buck—to effectively increase taxes without having to seek voter approval.

Domestic Conclusions

The current federal rules do not exempt online commerce from taxation; they simply prohibit one means of collection. Thus, electronic commerce does not enjoy any legal tax advantage. Where current state tax systems effectively disadvantage local retailers, states already have it within their power to address the problem.

Although reform may be difficult, states are in no immediate danger of going broke, nor do they lack alternatives to the current system of sales and use taxes. Furthermore, the federal government should ensure that states do not unfairly export their tax collection burden, thereby impeding interstate commerce. A federal commitment to that principle will also help guarantee that changes at the state level do not undermine tax competition—that individuals and businesses retain the freedom to escape punishing tax rates.

Reform is not urgent, however, so states and localities will have time to alter their tax systems as conditions change. Online commerce is not likely to significantly constrain state and

local budgets for the foreseeable future, and in any case, those budgets have been growing too fast. States should concentrate on reducing bloated budgets and returning surpluses to taxpayers, not unfairly expanding their taxing jurisdictions.

Like state budgets, traditional retailers will survive the emergence of electronic commerce and may end up being a source of much innovation in that field. Except for digital products delivered over the Internet, online shopping is not vastly different from the catalog or television experience. Those two marketing media have more to fear from the Internet than do brick-and-mortar stores. By lowering rates and restructuring their tax systems, states can address equity concerns without unfairly burdening out-of-state businesses with tax collection duties.

Congress should firmly refuse to bow to state demands for new taxing authority. The ITFA was a good start in ensuring that traditional principles of remote commerce apply to the online world, but more could be done. If Congress acts, it should be to unequivocally block the extraterritorial taxation of electronic commerce, in both tangible and intangible products. That would entail a clear definition of taxable nexus that requires physical presence by a firm before a state can demand use tax collection. Such clarification should include specific language establishing that Internet activity and contracts for services are insufficient to establish nexus.

By acting firmly, Congress can uphold traditional principles of interstate tax competition, due process, and fairness, while leaving electronic commerce free to serve as the growth engine for tomorrow's economy.

Part II International Taxation of Electronic Commerce

Although it has received relatively little attention in the United States, a debate over how international electronic commerce ought to be taxed has also been raging for several

A positive congressional agenda on electronic commerce taxation should aim to

- establish a clear nexus standard and definitions—based on physical presence—to determine when companies can be required by a state to collect sales or use taxes,
- amend P.L. 86-272 to cover the sale of intangible property and services,
- reject all international efforts to draft American businesses as tax collectors for foreign governments, and
- pursue an Internet free-trade agreement in the World Trade Organization.

years, and the participants in that dialogue have often voiced alarm. Governments fret that because existing international tax rules evolved in an industrial and agricultural world, they might be inadequate for the Brave New World of electronic trade and tax revenue may be lost. Conversely, businesses worry that conflicting and overly burdensome tax rules could retard the growth of electronic commerce. Taxpayers, as usual, have few advocates.

Both governments and businesses have been prone to exaggerate the threat of inaction. Most of the international tax complications created by electronic commerce have been dealt with before. Telephone, fax, telex, Electronic Data Interchange, and other new forms of communication between businesses and customers have challenged international tax rules during a good part of this century. So tax authorities are not in entirely uncharted waters. Predictions of the rapid growth of Internet-based electronic commerce, however, suggest that it is time to reexamine the principles that govern international taxation.

The most important question to ask is, What is the difference between the taxation of an Internet-based international transaction and of a conventional transaction? The answer should provide tax administrators with reason for optimism: when a sale results in the physical delivery of goods, there is generally no difference. Shipments must still go through customs, are subject to import duties, and may be subject to consumption taxes.¹⁰³ That fact bodes well for both businesses and governments. As an early U.S. Treasury Department paper on electronic commerce notes, "Careful examination may very well reveal that few, if any, of these emerging issues will be so intractable that their resolution will not be found using existing principles, appropriately adjusted."¹⁰⁴

It is also encouraging that computer networks and technologies can increase the efficiency of tax collection. Electronic filing, for example, already promises to radically cut the costs of administering—and perhaps increase compliance with—income tax systems in the United States and other developed countries.

Electronic payment systems could potentially be used to deposit refunds directly in taxpayer accounts or to accept electronic payments, which would save time, postage, and other administrative costs. Streamlined customs procedures using new technology could also improve border-clearing efficiency and thus increase transaction volumes. As the Internet becomes more reliable and taxpayers become accustomed to new ways of interacting with tax agencies, the gains from such developments can be expected to multiply.

But the growth of international electronic commerce will undoubtedly pose real—though often exaggerated—difficulties for the administration of national tax systems as they are currently structured. At least four issues have been the focus of much recent concern and analysis:

1. Should Internet content be subject to customs duties or new taxes?
2. Is the concept of "permanent establishment" valid in cyberspace, and, if so, is the existing definition adequate to ensure that different jurisdictions do not tax the same income?
3. Will electronic commerce increase non-compliance with or avoidance of consumption taxes? How will the characterization of intangible products and services affect that behavior?
4. Will the ease of conducting business electronically lead to "harmful" tax competition among countries?

To some extent, all those questions are valid, and governments will be forced to confront them. The United States in particular, however, will not have to radically redesign its tax system. As the world's largest exporter of both information technology products and services and intangibles such as movies and music, the United States is in an enviable position.¹⁰⁵ The United States should be careful not to sign on to any international agreements that will hamper the growth of electronic commerce, hinder the development of new technologies, burden U.S. businesses, or undercut beneficial tax competition.

The United States should be careful not to sign on to any international agreements that will hamper the growth of electronic commerce or undercut beneficial tax competition.

Just as competition among businesses is a welfare-enhancing process, so too is tax competition among governments.

The question of how international electronic commerce should be taxed is a remarkably complex one, and the preceding list does not begin to exhaust the range of possible topics. This paper is not intended to serve as a blueprint for U.S. tax policy; instead, its purpose is to raise some of the more immediate issues facing policymakers and to suggest broad approaches to dealing with those issues.

Basic Principles of International Taxation

There was an early coalescence around the Organization for Economic Cooperation and Development as the forum best suited to deal with the taxation of international electronic commerce. Work there has already resulted in general agreement on the basic principles that should govern its taxation. That consensus is perhaps best reflected in the OECD's Model Income Tax Convention and, more recently, in its set of seven criteria for judging proposals to tax the Internet:

1. The system should be equitable: taxpayers in similar situations who carry out similar transactions should be taxed in the same way.
2. The system should be simple: administrative costs for the tax authorities and compliance costs for taxpayers should be minimized as far as possible.
3. The rules should provide certainty for the taxpayer so that the tax consequences of a transaction are known in advance: taxpayers should know what is to be taxed and when—and where the tax is to be accounted for.
4. Any system adopted should be effective: it should produce the right amount of tax at the right time and minimize the potential for tax evasion and avoidance.
5. Economic distortions should be avoided: corporate decisionmakers should be motivated by commercial rather than tax considerations.
6. The system should be sufficiently flexible and dynamic to ensure that tax rules keep pace with technological and commercial developments.
7. Any tax arrangements adopted domestically and any changes to existing international taxation principles should be structured to ensure a fair sharing of the Internet tax base among countries, particularly important as regards division of the tax base between developed and developing countries.¹⁰⁶

Other groups have articulated a similar vision. The Global Information Infrastructure Commission, for example, accepts the “general tax principles of neutrality, efficiency, certainty, simplicity, effectiveness, fairness and flexibility as applicable to electronic commerce.”¹⁰⁷ The World Trade Organization agrees, noting, “In principle, taxation of electronic or non-electronic commerce should be easy to administer and should not induce unnecessary distortions and discrimination.”¹⁰⁸

It is one thing to agree on vague principles, quite another to translate them into actual policies. Indeed, trade ministers from the top 30 industrial nations failed to make much headway at an OECD meeting in Ottawa at the end of last year because of deep differences, particularly between the United States and Europe. And although generally sensible, the OECD guidelines could easily be stretched to justify unwise national tax laws. The guidelines also do not offer specific suggestions for future reforms—nothing about how national tax systems might eventually be forced to adapt to the new reality of international electronic commerce. In short, the OECD principles provide little in the way of concrete guidance to U.S. policymakers grappling with the emerging online economy.

The OECD principles are deficient in other ways. As do the arguments made by state and local governments in the United States, the OECD international tax principles recognize the basic common-sense notion that tax systems should be technologically neutral and easy to administer. Also as in the domestic debate, the benefits of tax competition are largely ignored. The OECD is an organization whose membership consists exclusively of national governments. Tax competition among those

governments exerts downward pressure on tax rates, so governments tend to favor harmonization over competition. As a 1998 OECD report on “harmful tax competition” noted, “Pressures of this sort can result in changes in tax structures in which all countries may be forced by spillover effects to modify their tax bases, even though a more desirable result could have been achieved through intensifying international co-operation.”¹⁰⁹ The question is, More desirable for whom?

Just as competition among businesses is a welfare-enhancing process, so too is tax competition among governments. The OECD report is in part an attempt by countries with high levels of taxation to escape the consequences of their unwise domestic policies. The United States should reject their arguments. Because of some unique tax system advantages and a generally hospitable commercial climate, the United States is well positioned to benefit from international tax competition. There is nothing harmful or unfair about the United States’ taking a light-handed approach to taxation and regulation of electronic commerce; in fact, it is essential that we do so to ensure that we remain the most attractive market for businesses engaged in electronic commerce.

Policymakers in both Congress and the administration must retain a healthy skepticism about all schemes that undercut tax competition and recognize that international cooperation among governments to achieve “revenue stability” could undermine the potential of electronic commerce. But if allowed to flourish, electronic commerce will significantly improve the efficiency of economies, enhance their productivity, improve resource allocation, empower consumers, and increase overall long-term growth.

In charting our course in this area, policymakers should be guided by three key concerns:

1. The United States should refuse to act as a tax collector for other nations—an idea currently under consideration by the OECD.¹¹⁰ National autonomy has gener-

ally been the rule in international tax agreements, but the borderless nature of electronic commerce will make it increasingly attractive for some national governments—especially those with onerous tax and regulatory structures—to rely on reciprocal enforcement arrangements. The United States has little to gain but much to lose by following that path.

2. The United States should welcome the more intense tax competition that may result from the growth of international electronic commerce. Europe, by contrast, troubled by this phenomenon, has been studying ways to kill it since at least 1996, and the OECD has shown concern. Its paper on the “harmful” effects of tax competition calls for “coordinated action at the international level.”¹¹¹ The United States, by demonstrating the benefits of open markets unburdened by excessive taxation, can encourage other nations to adopt similar policies.
3. The United States must be wary of international agreements that would compromise the privacy of Internet consumers, especially ones that would ban the use of emerging privacy-enhancing technologies. Some nations have suggested, for example, that the use of unaccounted digital cash should be restricted because of its potentially negative impact on their tax systems. That is a wrong-headed approach. In addition to losing privacy, the suppression of new technologies will slow the advancement of electronic commerce and leave governments with less revenue to tax. The technological shape of the marketplace should drive the design of tax systems, not the reverse.

All proposals relating to the taxation of international electronic commerce should take into consideration the preceding criteria. The remainder of this paper discusses a few of the most immediate issues that are likely to face U.S. policymakers. Those issues are grouped

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into three categories: new and Internet-specific taxation, direct taxation of income, and consumption taxation.

New and Internet-Specific Taxation

The first operating rule for policymakers should always be to do no harm. With regard to the taxation of international electronic commerce, that means that no new or discriminatory taxes should be enacted.

The Bit Tax. One proposal is the “bit tax”—essentially a minuscule tax on each “bit” of digital information that flows across global networks. Proposals for the bit tax date back at least to a 1994 paper by Arthur Cordell and Thomas Ran Ide.¹¹² Cordell and Ide argue that existing tax bases are no longer appropriate in an environment where the major economic activity is the transmission of data. It is time, they write, to move to a more appropriate tax base. Luc Soete, chairman of the European Union’s so-called High Level Expert Group, and Karin Kamp went further, arguing in a 1996 paper that additional research on the bit tax was needed because the “taxing of the distribution of [physical] goods, which has traditionally formed one of the essential bases for national, state or even local government’s tax revenues is . . . eroding rapidly.”¹¹³

No detailed plan for implementing a bit tax has been drawn up; however, the typical concept is that revenues collected under a bit tax would be allocated among various jurisdictions on the basis of some agreed-on formula. Cordell and Ide envision the following arrangement:

For public long distance lines, the tax would apply to the actual information or flow of digital traffic. For leased lines, a fixed amount would be charged, based on the carrying capacity of the line measured in bits per second. Carriers would measure the local flow within a specified area. . . . This measurement would produce a statistical average for the designated region—an amount that would represent the number of bits flowing in the

area. This would provide the base rate of tax for that local area.¹¹⁴

Apart from its substantial technical hurdles,¹¹⁵ the bit tax is a fundamentally flawed concept that is ill suited to the reality of electronic commerce. The chief failing of the bit tax is that it takes no account of the true value of what is being taxed. Thus, the transmission of a newly released novel would be taxed at a far lower rate—possibly thousands of times lower—than the transmission of an amateur video or even a personal photograph. The incentive would be to avoid any high-bandwidth use of the Internet, regardless of its availability and price. Some proponents of the bit tax recognize and applaud that result, noting that the tax would end the “rapidly growing congestion and increasing amount of ‘junk’ and irrelevant information being transmitted.”¹¹⁶ Of course, one man’s junk is another man’s treasure.

As with state and local officials in the United States, the real goal of supporters of the bit tax is apparently to expand government rather than create an efficient tax system. Soete and Kamp speak of the “additional bit tax revenues” that will be collected and how such funds could be used to finance the deteriorating social security system in Europe,¹¹⁷ while Cordell has lamented the fact that “government has not yet figured out a way to tax and redistribute some of the new wealth created by global digital networks.”¹¹⁸ Along those lines, the EU’s High Level Expert Group’s report “Building the European Information Society for Us All” advocates exploring the “appropriate ways in which the benefits of the Information Society can be more equally distributed between those who benefit and those who lose.”¹¹⁹ However, commanding new sources of private wealth should be the last thing U.S. policymakers seek. Instead, they should concentrate on redesigning antiquated public-sector programs—such as our *own* failing Social Security system—so that individuals can more easily take advantage of the wealth-creating dynamism that characterizes the modern high-tech economy.

Fortunately, the bit tax has few supporters

these days. It was roundly criticized at the OECD's 1998 Ottawa ministerial meeting, and both the Clinton administration and the EU Commission have essentially dismissed it as unworkable. Also recognizing the inherent shortcomings of the bit tax, the WTO has concluded that the bit tax would be "a blunt instrument, blind to any subtlety in public policy considerations."¹²⁰ Despite those encouraging signs, policymakers should remain vigilant so that the bit tax—or other Internet-specific tax—does not resurface as a serious option in future deliberations. The latest human development report published by the United Nations Development Program, for instance, calls for a one-cent tax on the transmission of every 100 e-mails.¹²¹ Similar Internet tax schemes are certain to be hatched in the future.

Free Trade in Cyberspace. True electronic commerce—the purchase and delivery of products and services online—already takes place in a largely free-trade environment. Whether because of prudent restraint or lack of technological capability, no nation currently levies customs duties on wholly electronic transactions. Given that nations have devoted considerable time and energy to lowering barriers to international trade, it makes sense that those countries work to maintain the beneficial status quo for trade in electronic goods and services.

Free trade in electronic goods and services is a unique situation. Never before have all nations started from a free-trade position *before* any negotiations began. Thus, for network-delivered digital content, countries should be able to easily agree to a zero-tariff rating. The Clinton administration's "Duty-Free Zone" proposal in "Framework for Global Electronic Commerce"¹²² was a commendable starting point that has helped build international support for zero-tariff rating, and this past May, 132 members of the WTO reached a temporary agreement on the exemption of electronic transactions from customs duties.¹²³ The OECD has also endorsed the idea, noting that it is not intended to "limit the application of VAT/GST as appropriate by any national tax administration in respect of importations of all relevant goods and services."¹²⁴ In other words,

establishing the Internet as a duty-free zone will not result in revenue losses for governments (since tariffs are currently nonexistent) and will not interfere with national income or consumption tax systems. To guarantee that free trade in electronic commerce continues, an agreement on the tariff treatment of digital transactions should be pursued in future WTO negotiations.

Establishing the Internet as a digital free-trade zone would also dispense with the need to characterize electronic products as either goods or services under the WTO. However, if countries decide to apply tariffs to trade in digital goods, it will be necessary to classify the content of data flows to determine whether they are to be governed by the General Agreement on Tariffs and Trade or the General Agreement on Trade in Services. That would be a difficult task because many online transactions are clearly services, yet no universally agreed-on system for classifying those services exists. Furthermore, developing such a system would needlessly squander scarce WTO resources.¹²⁵

As the world's leading producer of electronic goods and services, the United States has an especially strong interest in setting a good example by resisting domestic pressures to charge customs duties on electronic transactions. As a 1998 paper published by the WTO pointed out: "85 per cent of Internet revenue is generated in the United States while only 62 per cent of the users are located there. This suggests that the United States is probably a net exporter of products through the Internet."¹²⁶ Moreover, because the U.S. Treasury derives most of its revenues from personal and corporate income taxes, Washington must be careful not to raise barriers to trade in digital content that will encourage businesses to locate elsewhere. Federal income tax receipts will rise to the extent economic activity is encouraged through a commitment to free trade online.

Apart from the sale and electronic delivery of digital content, the Internet will also promote the flow of low-value shipments of physical goods directly to consumers. The growth of

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electronic storefronts on the Web, for example, makes it relatively simple for a customer in one country to order a product directly from a foreign seller. Because the costs of insurance and customs administration can equal or even exceed the value of a low-dollar shipment, this type of commerce may not reach its full potential unless reforms are instituted.

To facilitate the growth of those transactions, governments should consider expanding tax- and duty-free thresholds, especially when the costs of inspection and collection would likely exceed revenues raised. As the country with the most commercial Web sites, the United States will benefit greatly if such sales are allowed to flourish. And as with any reduction in trade barriers, the U.S. economy will benefit even from unilateral action. Consequently, the United States should raise the threshold for customs treatment on small cross-border purchases—at least doubling the current \$50 limit—regardless of whether other nations initially follow suit.

Direct Taxation of Income

The expected growth of electronic commerce raises some important issues relating to national systems of direct taxation but does not fundamentally challenge existing concepts. The most immediate problem facing tax authorities will be attributing to a particular country the income generated by electronic commerce. Although the “permanent establishment” standard has been serving that purpose for a long time and will continue for the foreseeable future to assign tax liability in electronic commerce, eventually, national governments could be compelled to think about moving toward a residence-based system of direct taxation.

Current Principles of Direct Taxation. Direct—or income—taxes in the international context currently rely on the twin concepts of source and residence to specify who is liable for taxes and, for those who are, what income is subject to tax. Source-based taxation is intended to limit income tax collection to the jurisdiction where economic activity takes place. Thus, when activity in the United States is the

source of income earned by a foreign citizen or entity, that person or entity is subject to U.S. income taxes. Conversely, residence-based taxation is predicated on the nationality of the person or entity earning the income. The worldwide earnings of U.S. resident citizens and corporations, for example, are generally subject to taxation at home.

To avoid paying taxes on the same income in both the United States and abroad, U.S. residents are eligible for domestic credits on taxes paid to foreign governments.¹²⁷ Double taxation is also guarded against through an extensive network of bilateral income tax treaties that the United States has with at least 48 countries.¹²⁸ Under those agreements, residents of foreign countries are taxed at a lower rate or are exempt from U.S. income taxes on certain items of income they receive from sources within the United States. The application of those lower rates and exemptions vary among countries and specific types of income. In exchange, the U.S. government is granted the right to tax income earned by American companies in the treaty partner’s country. The intent is to fairly allocate taxing rights between nations, as well as to assist in the exchange of information between tax authorities to minimize the misreporting of income from foreign sources.

Such treaty and tax credit safeguards are necessary because source- and residence-based taxation are inherently conflicting. Generally, the country where economic activity takes place (the “source” country) has a right to tax income that is generated within its borders. However, governments also claim the right to tax income earned by their citizens and resident corporations abroad. Clearly, one of those two principles must yield, or the same income would be taxed simultaneously by two governments. Tax treaties thus establish rules for “permanent establishment” to determine which principle will govern in a particular case. That approach is laid out in Article 7 of the OECD Model Treaty, which states that a country may tax an enterprise’s business profits attributable to a permanent establishment located in that country, regardless of the enterprise’s country

of residence for tax purposes.¹²⁹ In cases where no permanent establishment is deemed to exist, the general consensus among OECD member countries is that residence-based tax principles should govern.

In the absence of a treaty, source principles generally govern taxation. Foreign persons from nontreaty countries are thus subject to U.S. tax on all income connected with the conduct of a U.S. trade or business. For treaty countries, however, Washington usually cedes its right to tax income earned by a foreign entity unless that income can be attributed to a permanent establishment—a higher standard than the mere “conduct of a trade or business.” Permanent establishment is defined by the OECD as “a fixed place of business through which the business of an enterprise is wholly or partially carried on.” Facilities used solely for the purpose of storage, display, or delivery of goods do not meet the permanent establishment threshold.¹³⁰

What Constitutes Permanent Establishment?

What constitutes permanent establishment with regard to electronic commerce may pose problems that existing tax treaties do not address. The most obvious concern is the ability to access a Web site from within a particular taxing jurisdiction. Does the fact that consumers can place orders through a foreign firm’s Web site subject that firm to income taxes in the country where the customer lives? The proper answer is almost certainly no. A Web site has no physical presence and thus cannot be considered as a permanent establishment in any meaningful sense. To say that the ability to access a Web site, without more substantial contact, is sufficient to create permanent establishment is to say that online businesses are liable for income taxes in every country in which their customers reside. Such a broad definition would be virtually useless. The ability to access a foreign Web site is actually a lesser degree of contact than the solicitation of orders via catalog or telephone. Under existing tax principles, which should not be abandoned, mere solicitation does not create a permanent establishment.

Another, more complex, question concerns

the location of computer file servers: Should the mere presence of a server in a particular taxing jurisdiction be considered sufficient to create permanent establishment? Again, the best answer is no. In most cases, the existence of a foreign-owned server does not require employees to be present in the host country—traditionally a prerequisite for permanent establishment. But even when a business maintains its own server through its own employees, the level of contact with the host country rarely rises above the “storage, display, or delivery of goods” standard that exists in the OECD Model Treaty. Following the OECD’s guidelines, most tax treaties do not consider facilities that are used in that manner as a permanent establishment.

There are additional reasons why an in-country file server should not be defined as a permanent establishment, not the least of which is Article 5 of the Model Treaty. Article 5 has generally been interpreted to exclude mail-order activities as insufficient to create permanent establishment. A Web site that displays product information and takes orders from customers is equivalent to an electronic catalog and should thus receive the same tax treatment as postal solicitations.

A more practical problem is that defining servers as permanent establishments would render the allocation of income among competing jurisdictions very complex. It is all but impossible to determine the income attributable to any one server, and many Web sites are housed on multiple servers located throughout the world. Apart from the jurisdictional headaches, using the location of a server as the criterion for determining the place of economic activity would result in a largely arbitrary tax standard that bears no relation to where economic activity occurs.

Finally, as companies will seek the best treatment available, countries that do not tie tax strings to the placement of servers within their borders will clearly benefit. Because the location of a server is irrelevant from a technical standpoint, shifting the location of servers would be an irresistible way to minimize liabilities. Tax advisers are already telling their for-

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The borderless nature of electronic commerce means that countries that make taxation contingent on Web server location will encourage the migration of servers beyond their borders.

eign clients that to “avoid the possibility of an inadvertent permanent establishment in the United States, [they should] use a Web server located outside of the United States,” which suggests the United States should clarify its position on the issue.¹³¹ Despite that reality, tax authorities in several countries and at least one OECD Discussion Paper have indicated that the presence of a server might be sufficient to create permanent establishment.¹³²

Regardless of what individual governments decide to do, the classification of computer servers as permanent establishments is not likely to survive without an international agreement.¹³³ The borderless nature of electronic commerce means that countries that make taxation contingent on Web server location will encourage the migration of servers beyond their borders. Few governments would be willing to adopt such a policy unilaterally. An example of such policy competition can be seen in the United States, where some states have been thwarted from taxing on the basis of server presence by other states that have disavowed that tactic.

The Adaptability of Current Standards. Nothing in the preceding discussion of permanent establishment is meant to imply that online businesses will escape taxation. The point is that existing concepts are sufficiently robust to fairly allocate tax revenues without resorting to strained definitions of what constitutes “presence” in a remote jurisdiction. As a recent article in *Tax Management International Journal* explains:

The fact that no tax liability is created in the customer state does not mean that the e-commerce enterprise avoids full tax in those places where its physical inputs are deployed. Transfer pricing rules will remain available to allocate income among those jurisdictions where capital and labor in fact are employed to create wealth. A direct tax obligation arising in the country of source when the enterprise has no physical presence there would create a disproportionate tax burden

in terms of both compliance costs and amount of tax paid compared to the enterprise’s connection to the local economy.¹³⁴

Fortunately, Washington appears to have grasped the truth of that situation. The Treasury Department’s paper on the tax implications of electronic commerce indicates that the Treasury will regard both the presence of a server in the United States and the fact that a foreign person’s Web site may be accessible by computers in the United States as insufficient to be considered either permanent establishment or a U.S. trade or business.¹³⁵ Certain court cases also provide hopeful guidance. In *Piedras Negras v. Commissioner*—a case involving cross-border radio transmissions (a reasonable analogy for Internet communications)—the United States unsuccessfully tried to tax a Mexican broadcaster that retained 90 percent of its listeners and advertisers north of the border. A federal circuit court held that the United States did not have jurisdiction to tax the station, since there was no capital, labor, or establishment in the United States. The electronic links between the station and its listeners were deemed insufficient to give the U.S. government taxing authority.¹³⁶

That is also the best policy for electronic commerce, and it should be formally adopted as soon as possible. The United States enjoys the highest concentration of Internet servers in the world and should therefore stake out a minimalist position on server tax treatment regardless of what other countries do. In fact, the United States will prosper to the extent that other countries insist on adopting a more aggressive server policy, with more U.S.-based electronic commerce resulting in an expanded tax base. Ultimately, however, international efforts to tax on the basis of server presence will almost certainly be abandoned if Washington refuses to go along.

In addition to a commitment by the United States not to treat computer servers as permanent establishments, the Treasury Department should consider other measures to simplify tax liability for multinational enterprises. One such

positive change would be for the United States to replace the “conduct of a trade or business” standard that currently applies to businesses based in nontreaty countries with a uniform permanent establishment standard. That simplification would encourage electronic commerce with nontreaty countries by giving them a clearer picture of when they would be liable for U.S. income taxes.

Taxation and ISP Obligations. Agency issues may also need to be clarified as they relate to the conduct of electronic commerce. For example, some national governments will likely argue that a domestic ISP—by connecting consumers to a foreign business’s Web site—acts as an agent for determining the existence of permanent establishment. That position would be very difficult to defend. Article 5 of the Model Treaty defines agency sufficient to create permanent establishment as a relationship in which the foreign corporation relies on the domestic agent to conclude binding contracts in its name. An independent agent that lacked such authority would not be sufficient to create permanent establishment.

As business groups have pointed out, in the course of normal commercial activity, “the relationship of an enterprise with its Internet service provider is simply a business contract for services to be provided to the enterprise rather than to act on behalf of the enterprise as a legal agent.”¹³⁷ Thus, the fact that an ISP may facilitate the conduct of business in the source country—like a local telephone exchange or postal service—does not mean that the ISP has an agency relationship with the foreign enterprise. Tax authorities should clarify that the existing definition of what constitutes agency for purposes of permanent establishment does not include the ordinary activity of domestic ISPs. By contrast, when a U.S. business provides services that are clearly integral to the primary business activity of the foreign enterprise—such as selling Internet access services on behalf of a *foreign* ISP—a taxable agency relationship might be appropriate.

Transfer Pricing. A transfer price is charged between related parties in international transactions—for example, when a U.S. firm buys

goods or services from a related or subsidiary nonresident corporation. Governments are concerned that the prices used in such transactions be equal to those that would be charged to an unaffiliated corporation in the open market (known as the “arm’s length” principle). When that is not the case, price manipulation may allow firms to shift profits from high- to low-tax jurisdictions. Transfer-pricing rules are intended to ensure that the prices charged by related businesses to each other are accurate.

The increasingly dense electronic networks of multinational enterprises present, in theory, no new problems for existing transfer-pricing rules. However, the practical effect of the new communications technologies is a degree of integration that has not been seen before. Inexpensive computer network communications have made it possible for companies to coordinate previously impossibly fragmented production processes, particularly for intangible products and services. Thus, current reporting rules for transactions involving affiliated companies or divisions may not be sufficient to track electronic transactions and allocate income and expenses among competing tax jurisdictions. At the very least, electronic commerce has the potential to make the current problems with transfer pricing more common.

Preliminary analysis by the OECD suggests that the existing Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations are applicable to the special circumstances of conducting business through electronic commerce.¹³⁸ At the least, it is too soon to tell if significant problems will arise. U.S. policymakers should follow the OECD’s ongoing work in this area and insist that the business community be included in the process of crafting any new rules.

A Residence Alternative? The difficulties in determining when and where a permanent establishment exists may necessitate a greater reliance on residence-based taxation. Under that system, individuals and corporations would be subject to income tax in the country where they reside or maintain the strongest ties. That approach would greatly simplify the allocation of taxing rights and increase the

Tax authorities should clarify that the existing definition of what constitutes agency for purposes of permanent establishment does not include the ordinary activity of domestic ISPs.

A residence-based tax system would foster competition and could thus lead to lower and more simplified taxes, with a consequent increase in world economic growth.

efficiency of administration. In addition, a residence-based system would ensure that nations will be forced to compete for increasingly mobile businesses by maintaining sound tax policies and low rates. The Treasury Department, speculating that “source based commerce could lose its rationale and be rendered obsolete by electronic commerce,” suggests that the idea is worthy of further consideration.¹³⁹

An international tax system based on residency is both feasible and potentially desirable, as evidenced by the permanent establishment standard present in most tax treaties. Permanent establishment describes a threshold below which source-based taxes will not be collected. As cross-border electronic commerce expands, it may turn out that the source of income becomes more difficult to reasonably determine. Residence-based taxation, already in common usage, is the logical alternative.

The most obvious benefit of residence taxation is ease of administration—it is not necessary to identify the source of economic activity when income is subject to taxation only in the country of residence. That tremendously simplifies the calculation of tax liabilities for firms engaged in electronic commerce whose income may not be attributable to any specific geographical location. Since nearly all individuals and businesses claim residency *somewhere* (under U.S. law, all corporations must be established under the laws of a given jurisdiction), electronic commerce would not escape taxation. The danger of double or overlapping taxation would also be minimized, since countries would not need to squabble over the location of the source of income generated in cyberspace. Moreover, tax authorities are best able to collect taxes from those firms that are unquestionably tied to their national jurisdiction.

The residence of the seller is as good an approximation of where economic activity takes place as is the location of the buyer—especially with regard to intangible goods or services. The production of intangible property is becoming increasingly difficult to attribute to any specific geographic location, so if such activity is to be taxed at all, it will need to be

under a system that does not rely on knowing where income was created. Residence-based taxation is well suited to the taxation of electronic commerce precisely because it requires relatively few pieces of information to function effectively. As the Treasury Department paper points out, residence principles have already been adopted for certain space- and ocean-based activities—a borderless situation not unlike the world of cyberspace.¹⁴⁰

Most important, a residence-based tax system would foster competition and could thus lead to lower and more simplified taxes, with a consequent increase in world economic growth. Under a system of residence taxation, the location of a corporation becomes more important, especially for online companies whose physical distance from their customers is irrelevant. Some companies might set up shop in countries that offer low taxes, or alternatively where governments would compete more intensely than they do now to provide an environment that is conducive to economic activity.

U.S. policymakers should realize, of course, that the benefits of low tax rates and unobtrusive compliance procedures are their own reward; they are not contingent on other countries’ adopting similar policies. Countries that maintain a business-friendly environment relative to their trading partners are likely to benefit at their expense. As former Citicorp chairman Walter Wriston observed: “Capital goes where it is wanted, and stays where it is well treated. It will flee onerous regulation and unstable politics, and in today’s world technology assures that that movement will be at near the speed of light.”¹⁴¹ Wriston’s observation undoubtedly applies equally to sound tax policy. Although tax competition is to some extent inevitable, the efficiency of capital allocation can be enhanced when nations agree to principles of taxation that will avoid double taxation and refrain from using national tax codes to exclude foreign producers.

Problems with Residence Taxation. One potential unintended beneficiary of residence-based taxation would be tax havens—small offshore financial centers with low or no corporate taxation, lax regulation, and strong secrecy pro-

tections. Tax havens are already home to some Internet-related businesses, most notably, online casinos.¹⁴² Nevertheless, it is far from certain that such tax havens would succeed in attracting a significant number of mainstream companies involved in electronic commerce if residence taxation becomes widespread. Tax havens lack the facilities and critical mass of high-technology companies that exist in developed countries. Although it is technically possible for firms to shift some amount of the production of digital content to such places, it is unlikely that many of the highly skilled employees involved in that process would be keen on living permanently abroad. Even if havens do begin to undermine tax revenues, governments of developed countries could respond by making their own tax systems more attractive, through direct negotiation with havens or by other means of political persuasion.

Critics have also charged that residence-based taxation would entail shifts in the international distribution of tax revenues, especially from developing to developed countries.¹⁴³ That concern is overstated for two reasons. First, for revenue losses to occur, there would have to be significant source income currently being taxed, which is generally not the case in the sale of digital goods and services. Most developing countries have very low levels of Internet connectivity and thus would not see much change in their taxable base.¹⁴⁴ Second, as developing countries become a part of the information economy, their collections of foreign-source income tax will increase. If one assumes that consumer demand for imported digital content develops at roughly the same pace as the domestic information economy, then tax flows would tend to balance each other to some extent. In any case, OECD countries should not base their own intramember tax system on the revenue fears of countries that account for a relatively small portion of world trade.

Consumption Taxation: VATs and GSTs

Taxes on consumption account for an average 30 percent of the revenues collected by OECD member countries, and all of them

impose a Value Added Tax (or equivalent Goods and Services Tax) except for the United States and Australia.¹⁴⁵ In theory, governments collect a VAT from taxpayers in the jurisdiction where consumption takes place. In practice, however, consumption taxes are usually collected indirectly, from the final seller of a product instead of from the consumer. That approach has allowed governments to shift the burden of collection to private businesses, making tax avoidance relatively difficult. The problem facing governments is that as consumers increasingly buy from foreign online businesses, tax collection may suffer.

Should U.S. Businesses Collect Europe's VATs?

Unlike the income tax treaties that specify who is eligible to tax international economic activity, there are no agreements or treaties that coordinate the collection of indirect taxes. That should not overly concern U.S. policymakers, since Washington relies on income rather than consumption taxes. For that reason, the growth of international electronic commerce poses much more of a threat to VAT-reliant countries than to the United States. Federal officials must therefore be wary of agreeing to a system that would burden U.S. businesses with tax collection responsibilities for other governments. After all, the American Revolution was fought over England's jurisdiction to tax remote sales in the colonies. The rallying cry of America's Founders was not "No taxation without representation . . . or a mutual cooperation agreement."

Unfortunately, that possibility is all too real: work is already under way at the OECD to introduce a system of international cooperation among member countries for indirect taxation. "In an era of globalisation and increased mobility for taxpayers," the OECD warns, "traditional attitudes towards assistance in the collection of taxes may need to change."¹⁴⁶ Specifically, the Committee on Fiscal Affairs of the OECD has been considering including in the Model Tax Treaty an article to allow for assistance by one state in the collection of taxes for another.¹⁴⁷ According to Joseph Guttentag, deputy assistant secretary of the Treasury, such assistance would mean that "Norway would collect tax on sales out of California and

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That scenario is neither inevitable nor desirable. First, it is important to note that not all electronic commerce seriously threatens VAT revenues. A large amount of international electronic commerce is business-to-business transactions, which if not tax exempt, enjoy a high rate of voluntary compliance. A 1999 Forrester Research study estimates that in 2001 taxable business-to-consumer electronic commerce will represent only 7 percent of total European Internet electronic commerce, or roughly 0.25 percent of European GDP. In the United States that figure is expected to be 8 percent, or 0.58 percent of GDP.¹⁴⁹ Most of that commerce is not expected to cross international borders: the WTO predicts that by 2001 only \$60 billion of international trade will be conducted over the Internet, or 2 percent of total estimated global commerce.¹⁵⁰

Second, consumption taxes will be collected on many international sales. When the Internet is used for taking orders directly from consumers, with a physical product's being shipped to a foreign tax jurisdiction, there is generally no difference between electronic commerce and traditional mail-order business. Mechanisms are already in place for such commerce, and goods imported from outside a country are subject to VAT at importation. The online delivery of digital content to consumers, which is the type of transaction most difficult to tax, presents a different set of issues that are discussed below. If an increasing volume of low-value transactions makes VAT collection burdensome, it may be necessary to expand *de minimis* thresholds so that the flow of low-value packages is not impeded.

Finally, no agreement on international tax collection assistance is likely to be reached unless the United States participates, so there is little danger of Washington's missing the international boat. As the Australian Taxation Office has observed, "Given the dominant place that United States entities play in electronic commerce, from Internet software providers, to content providers, to electronic payment system providers and as the home

of many of the major international credit card companies, the support of the United States in any co-operative arrangement will be significant."¹⁵¹

The VAT and Digital Content. The main concern of VAT-reliant countries is not the sale over the Internet of tangible goods but of intangible ones. Such products as books, music, and software have been easy to tax, because they have traditionally been sold on physical media and distributed by local retailers. On the other hand, foreign businesses that sell directly online do not collect the VAT. Under current rules in Europe, U.S. companies without a fixed establishment can invoice EU customers VAT free, whereas domestic businesses must charge the tax. From the U.S. perspective, any equitable system must retain that practice, since as noted earlier, it would be grossly unfair for American businesses to act as tax collectors for European governments in cases where no substantial connection exists between the seller and the consumer's country. That prospect has many European businesses worried that they will be unable to compete with VAT-free sales of digital content. As the *Times* of London has noted, "With VAT rates averaging nearly 20 per cent in the EU, domestic businesses risk losing out to overseas rivals."¹⁵²

Fears of rampant tax evasion are probably unfounded. The Forrester and WTO data suggest that international sales of digital content, although growing rapidly, will remain a relatively insignificant percentage of economic activity. In fact, digital content sales by 2001 are expected to equal only 5 percent of overall electronic commerce revenues in Europe and only 3 percent in the United States—less than 0.18 and 0.22 percent of GDP, respectively.¹⁵³

When an international transaction takes place and no VAT is charged, the customers themselves are generally required to assess the appropriate tax. Businesses frequently comply, although most individual taxpayers are unaware of their obligations in international transactions and are thus unlikely to remit the appropriate funds. Some governments are already taking steps to address that problem. Canada, for example, has proposed a program

designed to educate taxpayers on the tax obligations associated with doing business over the Internet.¹⁵⁴ To the extent that tax rates are perceived as reasonable, governments may find that voluntary compliance by both business and consumers will render groundless many of the fears of rampant tax evasion.

Nevertheless, some observers in both government and business think that the administration of consumption taxes—particularly a European-style VAT system—will become increasingly unworkable as electronic sales of digital content expand. If consumers regularly turn to nonresident suppliers in order to avoid the VAT, local businesses fear, probably rightly, that they will lose customers. The European e-business tax group, for example, has called on the European Commission to update its VAT rules to keep up with the booming electronic commerce market.¹⁵⁵ Governments, as always, want to ensure that electronic commerce does not undermine tax receipts.

The imposition of consumption taxes is inherently difficult when both purchase and delivery of a product take place online. To effectively impose a VAT, tax authorities need at least three pieces of information. First, it must be known where a transaction takes place to assign tax revenues to the appropriate jurisdiction; second, a transaction must be classified as the sale of either a good or a service to know what tax to apply; and third, a business selling a product or a service must be able to determine when it is liable to collect and remit taxes.

Jurisdiction: Where to Tax?

On the issue of jurisdiction, tax authorities have concluded cross-border electronic trade should be taxed in the jurisdiction where consumption takes place.¹⁵⁶ Unfortunately, that is not always a straightforward proposition. Companies generally have no need to know the physical location of their customers to sell electronic products and services to them. Many Internet shoppers place a high value on privacy and may avoid doing business with firms that insist on collecting such information. Alternatively, to avoid taxes, online buyers could easily submit false information when

making a purchase.

The Credit Card Solution? Some tax authorities have suggested relying on credit card billing information to locate sales.¹⁵⁷ “Along with advances in Internet technology,” says an article in *Accountancy Age*, “we may expect advances in the monitoring of transactions. Customs & Excise should be able to track down what you have spent and collect the [tax] straight off your credit card.”¹⁵⁸ However, relying on credit card information is extremely problematic. Services purchased with a credit card are typically billed directly to the credit card company address rather than to the location where the buyer consumes the service. The only information available to tax authorities would be the billing address on file with the credit card company. But that address need not have any connection to where a digital product or service was actually downloaded and consumed. Moreover, any such approach could be easily abused. For example, by using a post office box, the address of friends or relatives, or a second home or business, individuals could establish a billing address in a low-tax jurisdiction. That would allow them to access and consume digital goods from inside a high-tax jurisdiction. In addition, services are available that allow mail to be sent to a private center that forwards the mail to a second address. Tax administrators could seek to verify each consumer’s address, but enforcement would be expensive and produce little additional revenue.¹⁵⁹

Assuming a credit card–based identification system could be made to work, it would raise some troubling privacy issues. Currently, governments generally do not have access to credit card company data unless a particular cardholder is suspected of criminal activity. The use of such data for tax collection purposes would potentially put a detailed record of a person’s buying habits in the hands of government authorities—without the normal judicial protections. The possible abuses of that information are enormous, and it is doubtful whether many individuals would easily accept the unprecedented invasion of their privacy. Thus, consumers would have an incentive to use credit cards issued by foreign companies that

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A tax system based on credit cards would only exacerbate the trend toward digital cash.

would not surrender personal data.

Even if all issuers could be drafted as tax collectors, credit cards are not likely to work for long as a means for locating sales, because unaccounted digital cash will take the place of the cards. Digital cash systems are more than a theoretical possibility. MasterCard and Mondex, for example, have been testing “smart cards” for several years; and in Denmark, a consortium of banking, utility, and transport companies has announced a card that may replace coins and small bills.¹⁶⁰ A tax system based on credit cards would only exacerbate the trend toward digital cash: the anonymity it offers would become immediately more attractive if governments seek to monitor consumers through their credit transactions. Governments may simply be forced to accept that the location of many consumers may not be available on purchases of digital content.

Permanent Establishment and the VAT. Another option that has been discussed is an expansion of permanent establishment for VAT purposes.¹⁶¹ That concept is identical to permanent establishment and direct taxation. Essentially, the idea is to lower the standard for what constitutes a fixed (and thus taxable) establishment to include electronic connections—computer servers, telecommunications links, and so on. The purpose of broadening the definition is, of course, to extend tax collection liability to nearly every firm that does business with a person living inside a particular tax jurisdiction. When a consumer in Milan, for example, orders a book from Amazon.com, the VAT tax would be collected by Amazon and remitted to a collection point in Europe.

As with direct taxation, stretching permanent establishment to include such a limited “virtual presence” would essentially make it a hollow concept. The purpose of limiting taxation to businesses that maintain an actual physical connection with a taxing jurisdiction is not only to allocate taxing rights among governments but also to recognize that businesses and individuals ought not be subject to the authority of governments from which they derive no substantial benefits. Foreign governments have no right to expect U.S. firms to be their VAT

collectors, especially since Washington does not impose such obligations on foreign businesses that sell their products here.

Countries with national consumption taxes will not be able to enforce collection even with the help of the United States. It is not possible to track the transmission of digital content across borders, especially since such transactions can be easily encrypted. Some analysts have suggested that foreign firms could be compelled to collect taxes by technological means.¹⁶² A country might decide to “black out” the Web site of a company that refuses to register for VAT collection, for example. Customers in a country in which a Web site is blacked out would be unable to access that site from their Web browsers and thus unable to complete purchases.

It is questionable how effective such solutions would be. Consider that, despite a highly centralized system of Internet service provision, authoritarian governments (such as China) have been unable to effectively control access to dissident Web sites. Moreover, the censorship of foreign Web sites would likely face legal challenges; the fact that someone *might* avoid taxes is a shallow pretext for an outright ban on the flow of information. Finally, a proliferation of alternative means of Internet access—via satellite or cross-border dial up—will make it progressively more difficult for governments to maintain centralized access controls. Even when customers in VAT-imposing countries log on through a government-monitored channel, they will probably be able to ship their digital purchases through third parties in non-VAT countries or order from an ever-changing array of mirror sites. The inability of governments to enforce intellectual property rights on recorded music (online pirate sites are ubiquitous) suggests that attempting to collect consumption taxes on the international sale of digital content will be a similarly fruitless endeavor. Reducing expenditures or looking elsewhere for tax revenue would be more effective than attempting draconian enforcement of consumption taxes online. The Internet is simply too massive and decentralized to police effectively.

From the U.S. perspective, the debate over collection of online consumption taxes internationally is largely academic. In the absence of an international agreement, the onus will be on the countries that impose a VAT to either discover effective ways of levying taxes on imports of seemingly untraceable intangible goods or abandon the attempt altogether. Whether through reliance on voluntary self-assessment, incentives for foreign sellers to collect, increased use of direct taxes, or exemption of intangibles from taxation, the problem of levying taxes should be tackled by the affected governments.

Classification: What Tax Applies?

Another issue—how to classify digital transactions as either the sale of goods or services—also poses problems for consumption taxes. Since differing VAT rates generally apply to goods and services, it is necessary to classify online transactions as one or the other. There has already been some controversy over that issue. The position taken by the European Commission has been that digital products should be considered as services.¹⁶³ The United States, however, suggested that digital products should be characterized on the basis of the rights transferred in each particular case. Speaking at the OECD's Ottawa meeting, Guttentag criticized the European approach, saying that “we should resist the temptation to settle on answers that represent oversimplifications and over-generalizations, such as, for example, the conclusion that the provision of digitized information is in all cases the provision of services and not the provision of goods or the right to use an intangible.”¹⁶⁴

Although the EU's approach provides certainty, it has the significant drawback of discriminating against products delivered online. Books and newspapers, for example, face a zero VAT rate in some European countries. If viewing the identical newspaper online were classified as the sale of a service, it would be taxed differently from its physical counterpart—a result contrary to the principle that like products should be taxed the same regardless of the means of delivery. Harmonizing VAT rates for

goods and services would result in equal treatment, of course, but policymakers in Europe and elsewhere would likely attempt to parlay that into a tax increase by “harmonizing upward.”

U.S. policymakers have little if any influence over such domestic reforms, so the only remaining option is to seek common international standards for the classification of digital content. Besides violating the principle of neutrality, the EU's move to classify all online transactions as the sale of services will potentially serve as a trade barrier to U.S. exports. Specifically, uneven tax treatment will mean that European consumers have an incentive to purchase zero-rated domestic products instead of digital imports.

The U.S. approach, leading presumably to more neutral tax treatment, is to characterize digital transactions by the rights transferred to the consumer. (The OECD has also endorsed that general methodology).¹⁶⁵ The goal is to tax functionally equivalent transactions in the same way. For example, for tax purposes, the purchase of an off-the-shelf software package from a traditional brick-and-mortar retailer is usually classified as the sale of a good. Instead of treating the sale of that software as a service when it is downloaded off the Internet, the U.S. approach would classify that transaction as the sale of a copyrighted article because the consumer has purchased only the right to use or copy the software. Customized software or the transfer of copyright rights, however, would face different tax treatments. That nuanced approach would more accurately capture the essential quality of each transaction than would the one-size-fits-all characterization proposed by the EU.

Although no detailed guidelines for the characterization of digital commerce have been presented by the United States, the Internal Revenue Service has issued regulations relating to the U.S. internal income taxation of software transactions.¹⁶⁶ Those regulations make it clear that the IRS will consider the sale of standardized software over the Internet as the sale of a digital product, which means the company selling it would be liable for income taxes only if it

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had a permanent establishment in the United States. In the case of customized software—which would be classified as the sale of services—the income would normally be taxed where the service is performed, likely the foreign company’s home country. Where software is sold with a license that allows multiple copies to be made and then resold, income would be taxed as royalty income and a permanent establishment would not be required. In principle, there is no reason why the software regulations cannot serve as the basis for regulations that would cover the sale of a broader range of digital products as well.

Collection: Who Must Collect and How?

As more companies began to sell online, it will become increasingly difficult for them to know when and where they are liable for tax collection and remission. Even for firms that wish to comply, the costs of registering and collecting for hundreds of VAT systems worldwide could be enormous unless the process is greatly simplified. Fortunately, the concept of fixed place used for VAT is sufficiently comprehensive to deal with electronic commerce. As with direct taxes, companies that do not have a physical connection to the taxing country should not be expected to collect the VAT. The United States should work in the OECD to reach an agreement to reaffirm and clarify that basic principle as it relates to electronic commerce.

Governments must come to grips with the fact that evasion of VAT taxes will likely always be possible on sales of digital products and services. The ability to route electronic purchases through low-tax jurisdictions, as well as widely available encryption technology, makes it relatively easy to hide transactions from tax administrators. Because the Internet is so large and fragmented, effective monitoring by any national authority is difficult. Unless fundamental reforms are made, VAT authorities may be forced to rely on voluntary compliance.

One possible alternative would be to simply declare that digital transactions will be free of VAT taxes. As noted earlier, books, newspapers, and other similar products are charged a

zero VAT rate in some European countries. Given the technical and privacy barriers to tracking online transactions, as well as the current incentive for residents in countries that charge VAT taxes to buy from foreign suppliers, the best way to level the playing field might be to forgo taxation. The result would be non-neutral tax treatment of tangible alternatives to digital goods (unless such items were also zero rated), but that result might be preferable to giving remote Internet sellers a de facto tax advantage. In any case, the relatively small share of international commerce conducted online is an indication that the tax losses from exempting digital content will be minimal for the foreseeable future.

If exemption is politically unacceptable, a more palatable option might be to levy consumption taxes on digital transactions at the place of origin—where a good or a service is produced—instead of where it is consumed. The arguments for such a system are similar to those for residence-based direct taxation, and reform in that direction could potentially improve the prospects for national tax systems, businesses, and taxpayers as the global information economy develops.

VAT and Place of Supply Rules

Another aspect of consumption taxes that might create uncertainty for businesses is “place of supply” rules. VAT systems generally seek to charge taxes at the place where goods or services are supplied.¹⁶⁷ Unfortunately, that is not always a simple task. The basic rule for goods is that the place of supply is the location from which they are shipped. The situation is more complex for services: place of supply can be either where the supplier or the customer is located—depending on the specific type of service being delivered.

In the EU, most services are taxed according to where the supplier has a fixed establishment. There are several exceptions to that rule. Most relevant to the conduct of electronic commerce is that “cultural, entertainment, or artistic” services are taxed where they are performed, and intangible or intellectual services—such as copyrights, licenses, financial

transactions, and professional consultations— are taxed where the customer who receives the service is established.

However, the Internet makes it possible for more intangible goods and services to be delivered to customers by suppliers who have no physical presence in the country where consumption takes place. As a result, both businesses and consumers may be able to structure their buying patterns to avoid paying the VAT. That has prompted governments to look at how place of supply rules might be reformed to handle online transactions more effectively.

One option would be to change the standards for what constitutes a fixed establishment. The drawbacks to that approach are discussed above, under “Direct Taxation of Income.” Similar objections obtain to loosening the standard for VAT tax collection responsibilities. Furthermore, VAT countries would be asking the U.S. government to force American firms to perform a service that would not be reciprocated. Washington thus has little incentive to agree to that arrangement; however, unless there is international cooperation, enforcing VAT collection requirements on firms without permanent establishment would be virtually impossible.

A better alternative would be to rethink the rules that govern place of supply. Instead of attempting to fit Internet transactions into a complex classification system, governments could simplify consumption taxes on services by levying those taxes uniformly at the place where the customer is established. Such a system would require customers purchasing services over the Internet to assess the VAT if the seller is established abroad and has no presence of company personnel or agents in the VAT country. The fear, of course, is that when foreign firms sell directly to consumers (as opposed to VAT-registered entities), taxes will not be voluntarily remitted.

To solve that problem, governments that impose a VAT would need to make consumers aware of their tax obligations with respect to downloaded digital content. Those governments might also decide to offer incentives for

voluntary collection by foreign firms, such as a flat fee or percentage of the tax that could be kept by the firm doing the collecting. Those measures might be sufficient to entice at least the online sellers who do the most business to participate in the VAT system.

Once again, the best alternative might be simply to exempt digital products and services from the VAT when such purchases are made by individuals. For the most part, when the customer is an individual, no VAT is currently being collected by either the buyer or the U.S. seller. Instead of dealing with the costs (both financial and in lost privacy) that effective collection would entail, governments could reasonably decide to deal in other ways with the resultant economic distortions and cede the loss of VAT revenue in this area.

Origin-Based Taxation

Like the case for residence-based taxation for direct taxes, the growth of electronic commerce will necessitate a change in how consumption taxes are collected. Although there is nothing inherently wrong with charging indirect taxes at the place of consumption, it is in practice far more complex than levying taxes at the place of origin. As the Global Information Infrastructure Commission has noted, “An origin-based system, universally applied, would simplify indirect taxation, would result in more effective enforcement, would reduce opportunities for avoidance, and would eliminate double taxation.”¹⁶⁸

Under a destination-based VAT, tax is applied to goods imported into the taxing jurisdiction, and exports from the jurisdiction are tax free. Under an origin-based VAT, exports are subject to tax, and tax is applied only to the value that is added after importation.

One advantage of an origin-based system is that since the location of the consumer is irrelevant, that information need not be collected. Instead, taxes would be levied on business sales, regardless of where the product or service is ultimately enjoyed. For example, if an online software company in the United Kingdom uploaded a game to a customer in Oregon, the software company would be liable for the VAT.

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The same would be true if the software were uploaded to a customer in London, Moscow, or an airplane crossing the Atlantic. Under an origin-based system, taxes would be collected on all sales out of the relevant tax jurisdiction, and no businesses would be expected to collect taxes for a government from which they derive no benefits.

Since businesses are subject to audit, the expected compliance rate with origin-based tax rules is very high. Mechanisms to enforce compliance with tax collection responsibilities for domestic consumption are already in place, so a move to origin-based taxation would place no additional burdens on businesses and little (if any) new burdens on national tax administrations.

A final benefit of origin-based taxation—although most governments do not see it that way—is that an origin-based system fosters robust tax competition among governments. Critics of origin-based taxation often warn that such tax competition will not be healthy but instead will be a “race to the bottom” for nations, undermining their ability to raise revenue.¹⁶⁹ This is identical, of course, to the claims made concerning residence-based taxation.

The revenue impact of origin-based taxation could be limited by applying it only to electronic commerce in digital content. Physical commerce—which will certainly continue to be a major component of international trade flows—could continue to be taxed under the existing destination-based standard. Origin-based taxation for digital content would be preferable to destination-based taxation, which is difficult to monitor and collect because of the nature of the Internet and the rise of unaccounted digital cash.

Critics of origin-based taxation have also argued that it would disadvantage domestic producers on their export sales. Although the design of a nation’s tax system can affect export competitiveness, the true burden facing domestic producers is the overall level of taxation. High income tax rates, for instance, would damage the international competitiveness of U.S. firms just as surely as would an origin-based consumption system that raised the same

level of revenue. In both cases, it does not matter so much *how* taxes are levied but rather *how high* the overall tax burden is. Thus, businesses subject to VAT collection responsibilities may not suffer any competitive disadvantages under an origin-based system if tax rates are kept at reasonable levels. A Deloitte & Touche paper put it this way:

A consumption tax without border tax adjustments (an origin-principle consumption tax) . . . at first appears to create a disadvantage for domestic producers relative to foreign producers in overseas markets. Border tax adjustments, though, may not be the only mechanism operating to maintain neutrality. Other self-executing adjustments by the markets, such as reductions in wage rates or in the value of the domestic currency, could offset wholly any potentially detrimental trade effects of origin-based taxation on exported goods.¹⁷⁰

Even the European Commission has recognized the inherent benefits of origin-based consumption taxes, albeit only on an internal basis. In its work program for the gradual introduction of a new common VAT system, the commission announced its intention to advocate a switch from taxation at destination to taxation at origin for sales within Europe. The changes being contemplated are anything but minor. “All transactions giving rise to consumption in the EU,” a commission paper states, “would be taxed from their point of origin so that the existing remission/taxation mechanism for trade between Member States would be abolished.”¹⁷¹ Origin-based taxation on an international basis would offer the same advantages that it would within Europe. U.S. policymakers should thus actively encourage shifting to such a system as a viable option for dealing with the growth of electronic commerce.

Other Issues to Watch

Tax Rules as Trade Barriers. Uncertainty

over how to apply the rules of international taxation to electronic commerce provides an opening for nations wishing to use their tax codes as a barrier to trade. Because the United States is the leading exporter of electronic goods and services, other countries may sometimes be tempted to use their tax codes as barriers to digital imports. On a country-by-country basis, the WTO is the proper forum to challenge such nontariff barriers to cross-border electronic commerce, and U.S. trade officials should not hesitate to challenge illegal impediments to our exports.

At the same time, proposed changes to international rules should be scrutinized and challenged whenever they pose a threat to the global free flow of information. Seemingly arcane domestic tax regulations, such as the EU's decision to classify all network-delivered content as services, can often have the practical effect of discriminating against imports and should therefore be opposed. Trade officials should also keep an eye on domestic regulations governing electronic commerce. The recent proposal by the National Gambling Impact Study Commission to ban online gambling, for instance, may effectively bar foreign providers of gambling services from competing in the U.S. marketplace.¹⁷² Such proposed rules should be challenged at home, where they violate U.S. trade commitments.

Privacy Implications. U.S. policymakers should also remain alert to the privacy implications of any proposed changes to the international tax regime. Unfortunately, the EU—although highly skeptical of private data collection and use—has not shown a great degree of concern over potential governmental privacy invasions that could occur in the name of tax collection. If international trade in intangible digital content grows as rapidly as expected, European governments will undoubtedly seek new ways to track and tax that commerce. Consumer privacy could easily be viewed as expendable in the quest for revenue.

Officials in the United States have also been guilty of taking a cavalier attitude toward privacy issues. The Federal Deposit Insurance Corporation recently proposed a controversial

“know your customer” rule that would have required banks to collect information from customers, monitor their accounts, and report “suspicious” activities.¹⁷³ The FDIC backed down after receiving thousands of complaints from outraged customers, but the fiasco illustrates that administration officials cannot be relied on to safeguard consumer privacy.

Suppression of New Technologies. Tax concerns are also used to justify unwise regulation in other areas. For example, some authorities in the EU will not allow business-to-business electronic invoicing, one of the most widespread forms of electronic commerce in use today.¹⁷⁴ More worrisome, however, is the suggestion that tax authorities may attempt to block the implementation of new technologies instead of dealing with their tax consequences. Currently, the technology that revenue authorities dread most is anonymous electronic cash.

The revolution in electronic payment systems means that banks and other organizations are now able to create their own digital money that consumers can use to make purchases both over the Internet and in retail stores.¹⁷⁵ This “e-cash” has no physical manifestation; it exists only as a set of encrypted data that the issuer promises to ultimately redeem for legal currency or other store of value. Like paper money, e-cash can be passed from buyer to seller with no automatic record of the transaction. Placed on an electronic wallet or smart card, e-cash can be used to complete a transaction without the need for a telecommunications link to the banking network. Thus, e-cash has the potential to become a secure, private, and widely used medium of exchange.

Many governments are instinctively hostile to the idea of e-cash, and their response has been to quash it. They fear that it will enable people to avoid paying taxes, especially consumption taxes on digital content from abroad sold over the Internet. The OECD, for example, has suggested that revenue authorities “press the appropriate bodies to ensure that electronic payment system providers operate their systems in a way that enables the flow of funds to be properly accounted according to

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prevailing legislation. Revenue authorities may seek limits on the values attached to unaccounted electronic payment systems.”¹⁷⁶

Undoubtedly, e-cash will not escape scrutiny and regulation, but as law professor David Post has observed, “It is going to take some serious thinking to design a regulatory scheme that does not fulfill our worst fears about the personal privacy implications of the new digital world.”¹⁷⁷ Government officials have three choices: they can monitor the development of new technologies and adjust their tax systems to deal with new realities, they can outlaw emerging technologies and financial innovations, or they can try to establish a system in which every expenditure by individuals is monitored and scrutinized. In a free society, the latter two options are simply unacceptable. Novecon president Richard Rahn put it this way: “In the new world of monetary freedom there is no halfway ground. Either the government will know everything, or the government will only know what is voluntarily revealed.”¹⁷⁸

International Conclusions

Electronic commerce has the potential to radically alter the way the world does business, serve as an engine of growth and development, and bring people together across borders. To fulfill that promise, however, electronic commerce must not be strangled by burdensome taxation. As the birthplace and the heart of the Internet, the United States has a special role to play in ensuring that revenue-hungry governments do not kill the goose that may lay the golden egg. As U.S. Supreme Court Chief Justice John Marshall observed, the power to tax is indeed the power to destroy.

So far, the U.S. government has been a responsible leader in this area. It has led the fight against customs duties on digital content and opposed new Internet-specific taxes such as the bit tax. Both of those were relatively easy battles, however, and the real test is yet to come. The future direction of Internet taxation depends largely on how the U.S. government chooses to approach problems as they arise.

If the United States maintains a commitment to tax sovereignty—to the principle that

American businesses should not be forced to collect taxes for foreign governments—then tax competition will flourish, as will electronic commerce. The Internet allows the production of goods and services to be increasingly disintegrated and freed from geographic constraints. That new reality will undoubtedly place downward pressure on government revenues over the short run but will ultimately lead to productivity gains and wealth creation worldwide. It is a future that should be welcomed by U.S. policy-makers.

The rise of the Internet economy may herald changes for national tax systems. As factors of production become more mobile, the traditional methods and levels of taxation may not stand the test of time. The best course is for governments to embrace lower spending—if not in absolute terms, then as a decreasing share of the overall economic pie. The worst strategy would be to succumb to the fears of short-sighted governments that seek to piece together an international tax cartel designed to conscript low-tax countries into roles as tax collectors. That approach seeks to achieve the ideal of tax neutrality at the expense of the process of tax competition but is likely to leave us with neither.

Governments may even find that the Internet, as the ultimate global marketplace, empowers individuals in ways that will make them less dependent on state services. An evolution in online financial services, for example, has made it possible for tens of millions of individuals to inexpensively manage their retirement investments, obtain price and safety information, and communicate with fellow citizens. The Internet also benefits individuals by forcing producers to compete for increasingly informed and mobile dollars, an act that lowers prices and shifts bargaining power firmly in favor of consumers. The goal of government officials should be to provide the few public goods that the market fails to produce. When markets advance to fill new roles, government should happily recede. Governments should seek to tax as broadly and as lightly as possible. The new online economy offers the perfect opportunity to move in that direction.

Is a new international agreement on Internet taxation necessary? Certainly, cooperation among governments with the purpose of avoiding double taxation is useful and in some cases necessary. However, there are also dangers in international negotiations, and caution should be the watchword. The United States should strive to create an environment in which electronic commerce can reach its full potential—regardless of the path taken by other governments. Virtue is its own reward, and taxation is no virtue.

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