United States and European Union Consumption Tax Policies in an Electronic Commerce World

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Introduction

Electronic commerce for several decades has manifested itself in some ways, such as electronic data interchange systems used by banks, but emergence of the World Wide Web combined with the development and proliferation of Web browsers in the 1990s contributed much to its exponential growth. In a report published by the Organisation for Economic Co-operation and Development (OECD) in 1997, the Sacher group defined electronic commerce as "all forms of commercial transactions involving both organizations and individuals, that are based upon the electronic processing and transmission of data, including text, sound and visual images." (OECD 1997a, 20) The US Department of Commerce estimated that business-to-business electronic commerce in the United States (US) would to grow to $1.3 trillion by 2003 (Commerce 1999, 5). Business-to-consumer electronic commerce in the US is projected to reach $184 billion by 2004 ("E-Commerce, Shopping around the Web" 2000, 5-6). Estimates of worldwide electronic commerce growth range between $300 billion to $1.5 trillion by 2001 (Tuohy 2000, 5).

Because of its semi-tangible and wealth-generating features, electronic commerce is challenging how supranational, national, and sub-national governments have traditionally taxed business activities. Generally, transactional taxes have been levied where the buyer and seller are in the same location, however, electronic commerce undermines this rule. Electronic commerce is routed over the Internet and may travel through several jurisdictions. The purchaser may be in one jurisdiction, his Internet Service Provider (ISP) in another jurisdiction, and the seller in a third.

While the US and the Members States of the European Union (EU) have strong democratic traditions and advanced economies, the US and the EU took different policy approaches toward the application of consumption taxation on electronic commerce from 1996 through 2000. Along a tax continuum, the US, at the federal level, has generally more reluctant to permit the application of consumption taxes on electronic transactions than the EU has. Meanwhile, states in the US have been divided into two groups about how aggressively they want to impose consumption taxes on electronic commerce; whereas Member States have generally held the position that consumption taxes should be applied on electronic transactions.

"Why did the US and the EU take different policies stances toward levying consumption taxes on electronic commerce between 1996 and 2000?" A public choice paradigm is used here to provide possible explanations, and archival sources and about 85 elite interviews provide the main sources of information.

This paper is divided four into sections. First, the policy differences between the US and EU regarding consumption tax on electronic commerce will be presented. Second, a public choice paradigm will be delineated. Third, a public choice paradigm will be used to analyze why the US and the EU took different policy approaches toward the consumption taxation of electronic commerce between 1996 and 2000. Finally, conclusions about the explanatory power of this public choice paradigm for explaining their different policy approaches will be discussed.

Policy Differences between the US and the EU

Historically, the US and EU took different policy positions toward applying consumption taxation on electronic commerce. The US has not had a uniform position toward applying consumption taxes on electronic commerce. At the federal level, the US, especially the Congress, has been much more reluctant than the EU to tax electronic commerce. Meanwhile,

the states in the US have been in conflict among themselves and with the federal government over whether and/or how to apply consumption taxes on electronic commerce.

Under the US tax system, the federal government, aside from a small amount of excise taxes on items, such as alcohol and tobacco, does not apply consumption taxes, but forty-five states, the District of Columbia, and about local 7,600 jurisdictions in thirty-four states levy sales and/or consumer use taxes.[28] These governments have a destination-based system. That, is they levy these taxes according to the location of the end user or place of consumption. The state sales and use tax rates have ranged from 3.0 percent in Colorado to 7.0 percent in Mississippi and Rhode Island. For most states, the combined state and local sales and uses rates have ranged from 4.5 to 8 percent (US General Accounting Office 2000, 5, 53-55).

However, the US Congress has the power to regulate how states and localities levy sales and consumer use taxes on interstate sales of mail order goods and services. In *Quill v. Heitkamp* (1992), the Supreme Court reaffirmed this congressional power and argued that the act of a state to force an out-of-state mail order firm to collect a use tax, without a substantial nexus with that state, would constitute too high a burden on interstate commerce (Cline and Neubig 1999, 2). With the rapid rise of electronic commerce, legal observers have interpreted that this court's decision applies to interstate sales of electronic commerce as well as mail order sales. Of course, many states levy a use tax on products bought sales tax-free from out-of-state vendors, but it is incredibly difficult to enforce on individual consumers.

Although the *Tech Law Journal* described the Internet Tax Freedom Act (ITFA), approved in 1998, as "perhaps the most important issue in the 105th Congress," and many reporters and policymakers believed then that it banned all Internet taxes, this act actually provided limited federal guidance for the application of consumption taxes on electronic commerce ("Tech Law Journal Congressional Scorecard" 1999).[29] For the period of October 1, 1998 – October 21, 2001, the ITFA imposed a moratorium of multiple or discriminatory taxes on electronic commerce and taxes on Internet access fees. Exceptions to this moratorium were Internet access taxes "generally imposed and actually enforced" before October 1, 1998 (H.R. 4328 1998, 1782-1783). More importantly, the ITFA did not overturn the *Quill* decision and left the decentralized, state and local sales and use tax system in place. Instead, it created a temporary 19-member Advisory Commission on Electronic Commerce (ACEC) to examine and to make recommendations about the application of consumption taxes to electronic commerce. Its members represented federal, state, local governments, consumers, and businesses (Noto 1998).

In the ACEC's April 3, 2000 report to Congress, a majority of its commissioners approved proposals regarding consumption taxes on electronic commerce.[30] One majority

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[28] Michigan has a sales tax and a single business tax. Michigan's single business tax is the only value-added tax in the US and is imposed on business activities (State of Michigan 1999, 1; Michigan Department of Treasury 2001). Business activities include the following: "The sale of real or personal property in exchange for a tangible or intangible consideration. Property rental, including both real property (housing, apartments, upstairs flats, etc.) and personal property. Performance of a service for a fee except services rendered as an employee or services rendered as the director of a corporation." (Michigan Department of Treasury 2001)

[29] A very strong argument can be made that the ITFA was not the 105th Congress' most important issue because it minimally affected state sales and use tax laws, but the ITFA was an important piece of tax and technology legislation because it was the first federal law addressing consumption taxation of electronic commerce.

[30] These proposals were not official recommendations or findings because two-thirds of the commissioners did not support each of them. Instead, eleven commissioners voted in favor, one opposed, and seven abstained.

proposal recommended that Congress enact a five-year prohibition of sales and consumer use taxes on "sales of digitized goods and products and their non-digitized counterparts." (ACEC 2000a)[31] During the duration of this proposed ban, a majority proposed that the simplification of the sales and consumer use tax system, and that Congress enact legislation clarifying the criterion for whether a nexus exists. It also recommended that Congress enact legislation to encourage states and localities to work in coordination with the National Conference of Commissioners on Uniform State Laws in preparing a "uniform sales and use tax act" by October 21, 2004. This act would have the goal of eliminating differences in tax collection costs between remote sellers and comparable sellers who operate exclusively within one tax jurisdiction. In addition, another majority proposal was approved that called for a permanent ban on Internet access taxes, including those taxes grandfathered under the ITFA (ACEC 2000a). At present, Congress has not approved these proposals.

EU Consumption Taxes

While US most federal politicians and some state politicians in the US have opposed certain consumption taxes on electronic commerce, the EU and Member State politicians have generally favored applying consumption taxes on electronic commerce as most state and local politicians in the US have. The EU's system is "transitional" with origin-based and destination-based features (Bolkestein 2001). An origin-based consumption tax system levies a value-added, sales, or use tax according to where the vendor is located, but a destination-based system levies these taxes according to the location of the end user or place of consumption. The standard VAT rates, in general, range from 0 to 25 percent in the Member States.[32] Member States administer and collect VAT revenues and remit a small portion of them to the EU.[33]

The key VAT decision-making bodies in the EU are the Commission and the Economic and Financial Council (ECOFIN), where each Member State's economic or finance minister represents his national government. The Commission has the sole right to initiate a VAT proposal, and the Member States in ECOFIN must approve it for it to become law.

Currently, the EU does not plan to enact new taxes on electronic commerce; instead, it wants to bring more kinds of electronic commerce under its VAT regime. The EU contends that goods purchased electronically are already subject to the VAT as goods purchased by other means have been. The VAT applies to most services as well including some that may be transmitted in digital form, such as telecommunications services. The new development is that the EU favors imposing the VAT on a large group of products delivered digitally, which it considers as services. This group includes broadcasting, films, and certain software delivered digitally.

On June 7, 2000, the Commission proposed to end tax discrimination benefiting non-EU established firms over EU established firms and to tax digitally transmitted services on business-to-business and business-to-consumer transactions through a system of VAT registration.[34] Its

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[31] Books and recorded music would fall into this category (Simpson 2000).

[32] The standard VAT rates range from 15 to 25 percent, but lower rates exist depending on the tax jurisdiction and the product.

[33] Regarding VAT revenues, Germany is an exception because the Landers, not the national government, collect them and share them with their national government. The EU receives a small proportion of these revenues.

[34] For this study, a EU established firm means that it has decided to establish itself in a Member State. For

provisions on business-to-business transactions have had the support of the Member States, but its provisions on business-to-consumer transactions have not. In addition to the Commission's proposal, ECOFIN has been examining proposals and remarks from the French Presidency, Sweden, Denmark, Belgium, Germany, and the United Kingdom to address the business-to-consumer concerns.

Public Choice Paradigm

A public choice paradigm is offered here to investigate why the federal politicians and appointees in the US have moved against imposing certain consumption taxes on electronic commerce and EU and Member State lawmakers have generally taken steps to tax electronic commerce.[35] Public choice theory, a subset of rational choice theory, has been defined as the application of an economic methodology to political science where the main assumption is that individuals are rational and utility maximizing (Mueller 1989, 1-2). Although there are many variations of the public choice paradigm, such as those that put more emphasis on an institutions as an explanatory variable and/or leave the individual's rational motivation undefined, this paradigm is within the "thick-rational *Homo economicus*" tradition (Buchanan and Tullock 1965, 17-29; Friedman 1996, 3). This tradition, in contrast to its thin-rational counterpart, specifies what actors seek to maximize.

This public choice paradigm has a basic unit of analysis, several basic organizing concepts, a dominant inference pattern, and theses. This paradigm's basic unit of analysis is an individual and/or a group of individuals. An individual/group makes choices that seek to maximize his/its self-interest, and self-interest is defined here as economic and/or political power. Policy outcomes are a function of these choices.

The basic organizing concepts of this paradigm are the actors, problem, selection process, and components of action. The actors are individuals and/or groups who act as public, quasi-private, and private actors. Public actors are government bureaucrats and politicians, and private actors and quasi-private actors are private firms and quasi-private firms, respectively. An example of a quasi-private firm is Deutsche Telekom, which the German government and private investors own. Public, private, and quasi-private actors have a set of goals and policy alternatives; they estimate the consequences that result from choosing a policy alternative.

The problem is for an actor to decide how to achieve his self-interests amid a changing tax environment. Many governments losing tax revenues make strategic policy choices to solve this problem by acting directly through administrative fiat or pressuring their lawmakers to raise these revenues. Meanwhile, private and quasi-private firms facing losses and a cumbersome tax system pressure their politicians to make policy decisions to address these concerns. Politicians seek votes to win an election, and to obtain this objective, they seek financial support, such as campaign contributions, and/or votes from those motivated to achieve more economic wealth. In exchange, politicians work to change tax and customs policies that benefit their supporters.

In solving their problems, these actors benefit from the public's rational ignorance. Rational ignorance, frequently assumed in public choice analysis and criticized by public choice critics as a concept, influences the ability of actors to attain their goals and objectives and refers

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example, Amazon.com is an American company, but it set up a British subsidiary, which is established in the United Kingdom for VAT purposes.

[35] In large measure, the format of this paradigm is copied from Allison's *Essence of Decision*. This author borrowed Allison's method, which consists of a paradigm, basic assumptions, concepts, and propositions.

to the idea that citizens have a very, finite incentive to vote in the electoral process because their vote is so small (Downs 1957, 298). Borrowing Down's concept and logic without judging its power for explaining voting, an reasonable assumption can be made that most US and EU citizens are rationally ignorant about tax policies, but their tax officials and politicians often are not.

Most US and EU citizens are rationally ignorant about tax matters, especially those dealing with consumption taxes. Taxes for most people in the US and the EU are an extremely complex, technical, and dry subject, so there is a large incentive for rational ignorance among the public. More specifically, few Americans realize that most states require them to self-report use taxes owed on their out-of-state purchases.

In the EU, the VAT is very often a hidden tax because the tax is included in the price. During the author's interview with Simon Woodside and Stéphane Buydens, tax experts with the OECD, they thought that the hidden quality of the VAT makes it easier for Member States to have high VAT rates (Woodside 2001; Buydens 2001). They stated that one of the few items where a bill specifically lists the VAT is the telephone bill, and they claim that you often hear about EU citizens complaining about the high tax on their bill.

Meanwhile, tax experts in government and businesses know how to close tax loopholes and raise consumption taxes without generating much public attention. In addition, politicians know how to give tax and tariff breaks to special interests inconspicuously.

Even if a few average citizens happened to be aware of these inconspicuous actions, it is very unlikely that they would actively oppose these actions. Cost of opposition for the average citizen would exceed any economic benefit (Tollison 1982, 591).

This paradigm's selection processes occur when public, quasi-private, and private actors in the US and the EU chose a solution for each of their policy problems. Under this circumstance, an actor makes a static selection from a set of policy alternatives. An actor does not make incremental decisions over a time span to solve a policy problem.

The components of an action include goals and objectives, policy options, consequences, and choices. As stated above, actors seek to maximize political power, economic rewards, or both. Politicians and government bureaucrats seek to maximize power. Politicians running for elected office seek votes to obtain political power. Bureaucrats seek to expand their agency's size and/or jurisdictional responsibilities to increase their power in policymaking. Similarly, politicians at the top of a bureau also seek to increase their bureau's size and responsibilities vis-à-vis other bureau's or branches of government to increase their power.

This tension involving agencies and/or branches of government often has been described in principal/agent terms (Hix 1999, 21-23). Weingast and Moran found that Congress had a high degree of oversight over the Federal Trade Commission (1983, 765-766) and Epstein and O'Halloran have provided a transaction cost approach to analyze the relationship between legislative and executive branches in the US (Epstein and O'Halloran 1999). Likewise, Pollack has investigated the relationship between the Member States on one side and the Commission, the European Court of Justice (ECJ), and the European Parliament on the other side and found that the Commission and the ECJ have some leeway to shape policymaking within the constraints of the Member States (1997, 99-101, 129). As will be discussed later, Commission politicians can seek to increase their power over tax policy development by using this leeway to loosen the grip of the Member States over this policy area.

Meanwhile, politicians and bureaucrats seek to maximize tax revenues (Brennan and Buchanan 1980; Niskanen 1994; Brennan and Buchanan 2000). Brennan and Buchanan derived

their proposition that government bureaucrats seek to maximize taxes by replacing the assumption that governmental officials act for benign reasons with the assumption that they act for despotic and selfish reasons (Brennan 2000, xiv). Since government tax officials are generally civil servants and extremely difficult to fire (Brennan and Buchanan 1980, 23-24), they are largely insulated from outside pressures and are difficult to influence. Moreover, government institutions have a monopoly on the supply of public services, and Brennan and Buchanan (1980, 27-29) contend that government bureaucrats will act collectively as a "Leviathan" by maximizing tax revenues.

Niskanen (1994, 281) echoes their argument, but he differs with Brennan and Buchanan because he argues that politicians and bureaucrats will maximize the revenues required for their discretionary budget. He (1994, 274) defines a discretionary budget as "…the difference between the total budget and the minimum cost of producing the output expected by the political authorities."

Niskanen (1994, 274) contends that government bureaucrats and politicians cannot claim part of this budget as personal income. Empirical research on European and US bureaucracies has indicated no or a weak relationship between personal income and increases in a bureau's budget (Peters 1991, 339-340; Friedman 1996, 4; Niskanen 1994, 274, Young 1991, 52-53). However, bureaucrats can spend a portion serving their economic interests. These interests consist of material rewards, such as remodeling their building, buying furniture, and hiring more staff, which reduces employee stress and stress-related health costs.

Politicians overseeing these bureaucrats spend the remaining portion on items that serve their economic interests (Niskanen 1994, 274). Their interests include spending funds that economically benefit private and quasi-private firms, and in exchange, politicians maximize political contributions from these firms (Ben-Zion and Eytan 1974, 2; Mueller 1989, 242-243). Snyder (1990, 1195) labels these contributors as "investor-contributors," and he (1196) assumes, "…that investor-contributors seek relatively small, private benefits, such as special tax exemptions, contracts to provide goods or services to government, or help dealing with regulatory agencies." More crudely, Ben-Zion and-Zion and Eytan (1974, 2) assert, "…that, via political contributions, there is at least a limited market in which political power can be "bought" by economic resources." For example, Lockheed Martin, a defense contractor, might lobby for higher taxes to fund higher defense spending by giving campaign contributions to influential policymakers.

Politicians have a large economic interest in securing campaign contributions and ensuring that they deliver on what the donor wants. Politicians are motivated to secure contributions to pay for the costs of campaigning for reelection. If a politician does not address an investor-contributor's policy concerns, he risks losing that investor-contributor's support when he seeks reelection. Moreover, if the investor-contributor is a constituent and contributes to a politician's campaign and the politician does not respond to the investor-contributor's concerns, the investor-contributor very likely will support a political challenger in the next election.

Politicians also can generate campaign contributions from private and quasi-private firms by cutting consumption tax rates. For example, a politician might lower vote to lower Internet access taxes because one of his investor-contributors, such as America Online Inc. (AOL), would benefit.

Meanwhile, politicians might deal with quasi-private firms in two different ways. First, politicians may take fiscal actions to maximize votes by using quasi-private firms as employment

and patronage centers (Vickers and Yarrow 1991, 113-115; Yergin and Stanislaw 1998, 115). Second, politicians will take fiscal actions to increase the value of the state-owned equity in a quasi-private firm if this firm has been slated for privatization. Since the 1970s, politicians have become increasingly attracted to privatization because selling the state's equity in a quasi-private firm reaps a windfall for the state and they can discontinue subsidizing this firm (Spulber 1997, 86; Vickers and Yarrow 1991, 125; Yergin and Stanislaw 1998, 317). They can use this windfall to fund programs desired by well-informed and organized voters, and these voters can benefit by becoming shareholders in the newly privatized firm, often on financially good terms (Vickers and Yarrow 1991, 120).

The need of politicians for political contributions complements the rent seeking and the profit maximizing strategies of private firms. Private firms often participate in interest groups and trade associations to maximize their profits. These firms often maximize profits through rent seeking (Bhagwati 1982, 989, Krueger 1974; Rowley *et al*. 1995, 91; Tollison 1982, 591; Tullock 1967). Since the technical definition of rent seeking has generally been defined more narrowly than what is needed in this dissertation (Bhagwati 1982, 989; Frey 1984, 208; Krueger 1974; Tullock 1967), the term, profit seeking will be used here. This term refers to private firms who in the pursuit of higher profits persuade the government to raise or lower consumption taxes and/or tariffs.

Private firms want to increase their profits by securing these politicians' support for favorable policy changes (Krueger 1974; Rowley *et al.* 1995, 91; Tullock 1967). They provide campaign contributions to politicians, and in exchange, politicians raise higher taxes to increase government spending on programs benefiting these them. On the other hand, private firms sometimes give political contributions to politicians with the expectation that they will cut their taxes or customs duties on some of their products to enable these actors to gain a competitive advantage over their competitors. In exchange for helping these firms to increase their profits, politicians support these actors' cause.

Meanwhile, the motivations of quasi-private firms are more complicated than those motivations of private firms. Quasi-private firms have less of an economic incentive to make a profit since they partially depend on the state for its finances. Because politicians frequently use these firms as employment centers, the managers of these firms generally have been less interested in making a profit than if they were managing a private firm. Quasi-private firms engage in rent seeking and seek to earn enough revenues to maximize the employment or workers. For these reasons, quasi-private firms often participate in interest groups and trade associations and provide political support to politicians, and in exchange, politicians raise higher taxes to increase government subsidies to them.

To understand how actors achieve their economic goals and objectives, public choice theorists have often employed the median voter theorem and illustrated it by using spatial modeling in their analyses (Downs 1957, 115-118; Mueller 1989, 65-67, 112-122, & 180-183; Weingast 1998, 162). The median voter theorem promotes strategic behavior, another area of public choice investigation (Epstein and Knight 1998; Mueller 1989, 137-139). In this dissertation, the median voter theorem and a variant of it will be used to highlight the strategic choices that actors have made to maximize or come closest toward maximizing their maximizing their economic objectives (see Chapter 4 for information on the variant theorem).

In the US political system, these firms often participate in interest groups and trade associations, and they, in an strategic manner, lobby the appropriate lawmakers to obtain the economic benefits that these firms desire (Brock and Magee 1978; Schattschneider 1935). At the

federal level, lobbyists usually know who is helping whom financially, and using this information, they at a minimum need to secure the support of the median or 218th US Representative, the 60th US Senator, and the US President to change a federal tax statute. Frequently, decision makers logroll to achieve the minimum number of votes needed.

In the EU political system, firms lobby their Member State and other Member States usually through a peak association or increasingly through an American-style coalition. Once the Commission has submitted a proposal to ECOFIN, a firm needs the support of only one Member State to block a tax increase, but a firm needs the support of all fifteen Member States to raise a tax in the EU.[36] While public campaign finance in many Member States, such as Great Britain and Germany, generally makes political contributions less important in those Member States than in the US, political contributions, mostly given to political parties, are still very important (Alexander and Shiratori 1994, 3). European politicians know that by offending a major economic firm in their country, especially one in the beginning stages of its development, entails risks because that firm could swing its financial support to another political party. By attempting to achieve their objectives by using their lobbyists to change the tax code to their economic advantage, private and quasi-private firms influence policy outcomes.

Whether the actor is a firm seeking to maximize profits or a government official seeking to maximize revenues, a range of policy options is available to each actor. If enacted, each option has a set of consequences. These consequences impose costs and benefits for the actor as he pursues his goals and objectives. Among ranked policy alternatives, an individual or group chooses one that maximizes the greatest net economic benefit for him or it and decides in a strategic manner how to attain that policy outcome.

The general thesis is that a policy choice has consequences. These consequences have cost and benefits. A policy alternative with net costs will decrease the probability that that an actor will choose it. On the other hand, a policy alternative with net benefits will increase the probability that that an actor will choose it.

The dominant inference pattern is that government action results from the means that actors have to have to achieve their value-maximizing goals or objectives. An actor must have had the means to achieve his objective.

This paradigm has one general thesis to explain why the economic interests of the actors elucidate the different consumption tax systems in the US and the EU. It is as follows:

1. Differences between the US and the EU in terms of which strategically calculating and self-interested actors would gain votes, profits, and economic benefits and would lose votes, profits, and economic benefits from consumption tax policies explains the different US and EU policies toward levying consumption tax policies toward electronic commerce.

A number of different scenarios could support or reject this thesis. One scenario supporting and rejecting this thesis are provided here. If the winners and losers in the US and the EU explain the policy differences in the US and EU, one might find that in the US that politically informed and organized firms and trade associations contribute large political contributions to politicians and, that in exchange, politicians lower these taxes and customs duties to benefit these special interests. Meanwhile in the EU, Member State and Commission politicians and bureaucrats seek to raise consumption taxes revenues to increase their discretionary budget to

[36] A Member State that abstains in its vote cannot block a proposal.

pay for material rewards, such as remodeling their building or buying furniture. In a scenario rejecting this thesis, US politicians could raise consumption tax revenues to spend government funds to help organized and well-informed interest groups. In exchange, these politicians are bought by interest groups who provide them with votes and often, financial support used to help these politicians, campaign for votes. Meanwhile, Member State politicians raise consumption taxes and customs duties on imported digital services to protect EU-established private and quasi-private firms from competing third country firms. This scenario would provide evidence to reject this thesis.

Application of this Public Choice Paradigm

This public choice paradigm will be applied first to policy developments in the US and second to policy developments in the EU. The US case study on consumption taxes is divided into two main sections. The first and second sections examine the ITFA and the ACEC, respectively.

Median Voter Theorem, Strategic Behavior

Public choice scholars have employed the median voter theorem in various levels of sophistication to explain and illustrate voting among the public or legislators (Mueller 1989; Weingast 1998, 162). In a variation of the median voter theorem, Figure 1 below implicitly assumes that Marker G represents the position where support exists in the Congress (the 218th Representative and the 60th Senator) and with the President to approve the Internet Tax Freedom Act. Following the logic of the median voter theorem, it is assumed that the issues concerning the ITFA are identified below in one dimension along the tax cuts and tax increases vector and that lawmakers' preferences are "single-peaked" along that dimension (Mueller 1989, 65-66).

This figure is unintended to reflect all of the nuances of the political debate about and the consideration of the ITFA, but it is here to visually show in a simplified manner the changing positions of key actors and how they strategically formed coalitions and converged on Marker G which was acceptable to federal lawmakers and their influential constituents. Marker A represents the ideal position of strong ITFA supporters who wanted to eliminate taxes on the Internet, and Marker B represents the ideal position of strong ITFA opponents who sought to maintain existing sales and use taxes and expand the definition of nexus by closing the remote seller tax loophole. As discussed above, the US Supreme Court in *Quill v. Heitkamp* (1992) decided that the act of a state to force an out-of-state mail order firm to collect a use tax, without a substantial nexus with that state, would constitute too high a burden on interstate commerce (Cline and Neubig 1999, 2).

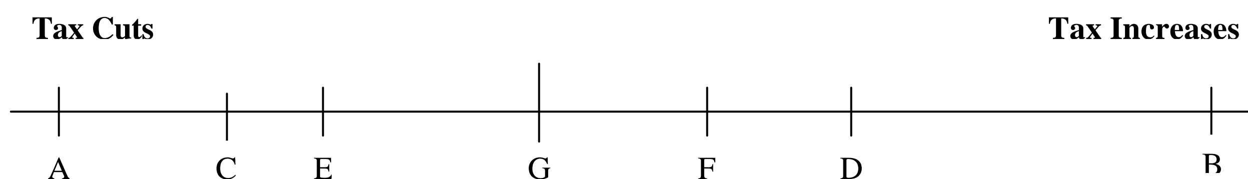

Figure 1: Positions on the ITFA

ITFA Proponents

ITFA supporters consisted mainly of mail order, electronic commerce, and Internet access firms and their associated trade associations. Of these firms and trade associations, AOL,

Charles Schwab, and the Direct Marketers Association (DMA)[37] were probably the most active lobbyists (Gardner 2000; Shafroth 2000; Sokul 2000). AOL and Charles Schwab also were major participants in the Internet Tax Fairness Coalition (ITFC), but since the ITFC actually had more of a public relation than a lobbying function, these firms and other ITFC members, for the most part, lobbied a part from it.[38] The following describes AOL's, the DMA's, and Charles Schwab's objectives at Marker C since at Marker A they did not have sufficient support among federal lawmakers due to the pressures coming from many states and localities.

Among ITFA supporters, AOL probably lobbied federal lawmakers to enact the ITFA in the most prominent and vigorous manner (Gardner; Shafroth 2000). For example, when asked who lobbied in favor of the ITFA, Frank Shafroth (2000) replied, "AOL, AOL and AOL." Although AOL had not yet merged with Time Warner, it was the world's largest ISP with 16 million subscribers.[39] It provided Internet access, electronic mail services, and content ("AOL plans to upgrade 1998).

AOL sought three objectives for the ITFA. First, AOL wanted no taxes on Internet access, including no grandfather clause. Defenders of this AOL goal often argued that AOL would not gain economically from a moratorium on these taxes. While this ban would not provide AOL with a competitive advantage over its competitors, such as AT&T, AOL and its competitors would benefit, however, because eliminating a tax on their online services would make their services cheaper.[40] Then, more subscribers could afford and sign up for their services. More subscribers for AOL meant more revenues from subscriptions and advertising.

Second, AOL sought language in the ITFA to limit how states and localities define nexus. In particular, AOL wanted legislative language to forbid states and localities from taxing out-of-state ISP's whose only connection to their jurisdictions was processing orders on a server located in one of those jurisdictions or showing an out-of-state vendor's or ISP's Web site on a server located in those jurisdictions (Duncan 2001 and 2000). AOL was concerned about having to file tax forms in thousands of jurisdictions because tax compliance with these jurisdictions would increase AOL's transaction costs.

Third, AOL was especially concerned about its tax liability in states, such as Connecticut.[41] The Connecticut Revenue Services in 1997 assessed AOL for over $3 million for

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[37] The DMA has had more than 4,700 member organizations and owns the Association for Interactive Media (AIM). AOL, AIM, AT&T, Bear Creek Corporation, Dell Computer, Federation of Direct Marketing Associations (FEDMA), IBM, L.L. Beam, McGraw-Hill, Microsoft, MCI WorldCom, Sun Microsystems, Swedish Direct Marketing Association (SWDMA), Symantec, Time Warner, and Visa have been some of its members (DMA 2001; AIM 1998).

[38] The ITFC is a coalition of consumer, retail, technology, and communications industry groups. Some of the ITFC's members have been AOL, Dell Computers, the California Internet Industry Alliance, Charles Schwab, Hewlett-Packard, IBM, ISA, ITAA, Software Publishers Association, Symantec, the US Chamber of Commerce, and the USIC (Nebergall 1998; ITFC 1998a; ITFC 1998b).

[39] Of the roughly 16 million subscribers, 3 million subscribed to CompuServe, which AOL had recently bought.

[40] AT&T also supported the moratorium on Internet access taxes because of its AT&T WorldNet Service, the fourth largest ISP in the country (Gardner 2000).

[41] Tennessee assessed on August 18, 1997 AOL for $9.6 million in sales, use, franchise, exc ise, and business taxes. AOL sued the State of Tennessee over its assessment in November 1997, and after much litigation, Davidson County Chancellor Elen Hobbs decided in AOL's favor (Ballard 2001; "AOL sues Connecticut… 2000)."

taxes, interest, and penalties for the period of January 1, 1995 to September 30, 1996. It based most of its assessment on its interpretation of Connecticut General Statute 12-407, which permits taxes on computer and data processing services. AOL disputed this assessment because it did not view its servers and modems as constituting nexus with Connecticut (Sheppard 1998a; Sheppard 1998d; Sheppard 1998e; Sheppard 1999a, 30-31).[42] In early 1997, AOL was a struggling company with its customers having problems accessing its online services, and this assessment would have hurt it financially (Keegan 1998). AOL sought language in the ITFA removing its liability to pay those past taxes and any tax liability that should arise in the future.

Meanwhile, many DMA members had substantial financial interests at stake as the Congress and the White House considered the ITFA. Catalog sales were over $78 billion in 1997, and many DMA members were catalog firms, such as L.L. Bean and the Bear Creek Corporation (Gleckman 1998, 131). The DMA strongly supported the ITFA by opposing Internet access taxes and advocating a moratorium of them, but the DMA was extremely wary of linking the Internet access tax issue with changes in the sales and use tax system that would make its members more liable to collect use taxes. Since the DMA did not want an expanded definition of a nexus where its members would serve as tax collectors in a jurisdiction in which they did not have any presence, it, like AOL, wanted a limited definition of nexus. The DMA and AOL lobbied for language in the ITFA limiting the liabilities of many DMA members to collect and remit use taxes. This limitation precluded higher transaction costs.

Because of the double-edged nature of direct marketing, the DMA wanted to avoid its members serving unnecessarily as tax collectors. Frequently, customers do not remit the correct amount of a use tax owed because of honest mistake or poor arithmetic. Aside from the cost of mailing a bill to customer, it is not good business practice to inform a customer that he owes an additional 50 cents in sales tax. On the other hand, if a customer overpays a direct marketing firm, such as Dell Computers, that firm must refund the customer the overpayment. By serving as tax collectors in jurisdictions where they lack nexus, the DMA's members were concerned that they would have higher transaction costs in terms of mailing overpayments and in absorbing losses accrued through underpayments than they currently have.

Meanwhile, the DMA supported the creation of the ACEC as long as its commissioners were representative of the interested parties. To ensure that state and local representatives who wanted an expanded nexus standard did not determine the ACEC's official recommendations and findings, the DMA strongly supported the ITFA's provision that required two-thirds of the ACEC to approve official recommendations and findings for Congress (Industry Observer #2).

Depending on the final form of the ITFA legislation, Charles Schwab, contrary to what one might expect, had substantial interests at stake. Charles Schwab was the largest business-to-consumer firm in the US with it transacting over $2 billion in securities per week and $26 billion during the first quarter of 1998 ("Schwab is a Leader… 1998). It ranked far ahead of well-known electronic commerce firms, such as AOL and Amazon.com (see Table 1). In 1997 and 1998, Internet taxes were Charles Schwab's number 1 policy priority (Kelly 2000).

Also, the State of North Dakota assessed AOL $5,000 for a 2 percent adjust gross receipts tax (Sheppard 1999a, 31).

[42] Ironically, the State of Connecticut was already phasing out its tax on Internet access with a reduction of 1 percent every year until 2002 (Sheppard 1998d).

Table 1: Business-to-Consumer Revenue Rankings of Selected Firms for the First Quarter of 1998

Firm	Millions
Charles Schwab	$26,000
Auto-by-Tel	$1,500
AOL	694
Dell Computers	450
Amazon.com	87

Source: (“Schwab is a Leader… 1998).

Because of Charles Schwab’s lucrative online business throughout the US, it was worried about multiple jurisdictions taxing its transactions. Frank Kelly, Vice President for Government Affairs, (Kelly 2000) stated, “We were the fatted calf.” A large proportion of Charles Schwab’s customers transact completely online. Generally, the sales of securities have been exempt from state and local sales and use taxes, but Charles Schwab was concerned that many of these jurisdictions might start imposing a stock transfer tax.

The possibility of this tax combined with new state and local taxes on Internet access would increase the transaction costs of Charles Schwab’s customers (Kelly 2000). These taxes would threaten Charles Schwab’s business because many investors use its online services because it offers great services, such as in-depth research, and it is cheaper than a traditional brokerage. Kelly asserted, “People use this because it’s one of the cheapest ways of saving.” He continued, “The last thing we want to see is another tax on them.” (Wells 1998)

One of the main arguments used by Charles Schwab and its allies to build support for a tax moratorium, which would benefit them commercially, was that taxing electronic commerce prematurely could limit its potential growth. Citing Forrester Research data that projected electronic commerce to grow to $327 billion in 2002 without major regulation, Gideon Sasson with Charles Schwab, declared, “Let’s not limit the potential of this important distribution channel with complex tax schemes until we more fully understand the impact of doing so.” (Schwab applauds Clinton… 1998)

ITFA Opponents

On the other hand, ITFA opponents had several concerns and major objectives. Most states and localities, unlike the federal government, heavily depended on sales and use tax revenues and sought to maximize these revenues through federal legislation. These jurisdictions, already frustrated in their past efforts to eliminate the use tax loophole for catalog sales from remote vendors, saw Internet transactions increasing the amount of lost revenues flowing through that loophole. Many state and local officials worried that in the future this stream of lost revenues would turn into a river since electronic commerce was then in its infancy. Without considering electronic commerce sales, the NGA estimated that they were already losing $3 billion a year in sales and use tax revenues from remote mail order sales (Gruenwald 1997, 2762). Consequently, these states and localities through their government officials and their representative associations, namely the Big 7 ones, wanted to enact federal legislation expanding the definition of nexus and closing the loophole that mail order and Internet vendors had been using to avoid collecting sales and use taxes from their out-of state customers.[43]

[43]The “Big 7” consists of the NGA, NCSL, the Council of State Governments (CSG), the NAoC, the USCM, the NLC, and the International City/County Management Association (ICCMA) (NGA 1998a).

Allied with these states and localities, the International Council of Shopping Center owners (ICSC) also sought to close the sales and use tax loophole through federal legislation.[44] The ICSC was concerned about how electronic commerce and mail order venders could financially hurt its members. As consumers increasing bought online to exploit the sales and use tax loophole and took away business from stores in shopping centers, these centers would lose customers and their property values. These economic losses would hurt ICSC's members include shopping center owners, developers, real estate agents, and real estate investors.

Most states and localities as represented by the Big 7, would have ideally preferred to oppose the ITFA because many states are heavily dependent on sales and use tax revenues.[45] However, the Big 7 could not continue to oppose the ITFA because members of the Big 7, especially the National Governors Association (NGA), recognized that their economic

Table 2: List of Lobbying Expenditures and Campaign Contributions for 1997 and 1998 by Selected ITFA Bystanders ($)

Selected ITFA Bystanders		
Organization	Lobbying Expenditure $	Campaign Contributions $
American Federation of State, County and Municipal Employees	2,460,000	3,722,220
American Resort Development Association	600,000	88,750
Circuit City Stores	680,000	302,439
Dayton Hudson Corporation (including Target Department Stores)	80,000	164,790
Home Depot	6,024	331,650
K Mart Corporation	400,000	685,567
International Mass Retail Association	300,000	15,460
Mortgage Bankers Association of America	870,000	459,029
National Association of Realtors	12,360,000	2,658,793
National Retail Federation	2,700,000	245,276
National Realty Committee (predecessor of the Real Estate Roundtable)	2,380,000	25,000
Tandy Corporation	520,000	3,000
Wal-Mart Stores	160,000	709,197

Source: The Center for Responsive Politics (2001; 1999).

influence was insufficient to offset the influence of AOL, the DMA, and their allies and to prevent federal lawmakers from adopting some sort of ITFA. Main Street retailers and businesses could have provided financial resources to offset the resources that ITFA proponents

[44] The ICSC has over 39,000 members in more than 75 countries, including the US, and they include developers, shopping center owners, investors, and retailers (ICSC 2001). The Association of Foreign Investors in US Real Estate, the American Resort Development Association, the Building Owners and Managers Association International, the Carlye Group, Goldman Sachs & Company, the ICSC, the Mortgage Bankers Association of America, the National Association of Industrial and Office Properties, the National Association of Real Estate Investment Managers, the National Association of Realtors, the National Multi Housing Council, the Transwestern Investment Company, and the Urban Land Institute have been many of the organizations involved in the RER (RER 2000).

[45] The "Big 7" consists of the NGA, NCSL, the Council of State Governments (CSG), the NAoC, the USCM, the NLC, and the International City/County Management Association (ICCMA) (NGA 1998a).

had (see Table 2), but these retailers and businesses were largely bystanders during the legislative consideration of the ITFA (Sheppard 2000a, 41).

Having greater economic resources than ITFA opponents, ITFA supporters spent more in lobbying and contributed much more political contributions than ITFA opponents. A comparison of lobbying expenditures for 1997 and 1998 by selected ITFA supporters and opponents is very striking (see Table 3).[46] For example, AT&T spent more in lobbying expenditures and campaign contributions than opponents, listed in Table 3, did in total. Moreover, the counties, municipalities, and transit authorities listed individually were among the top ten *government* spenders for lobbying services, but little evidence was found showing that they were heavily involved on a direct basis with the ITFA.

Spending ITFA proponents, especially relatively young technology firms, such as AOL and Microsoft, were very popular on Capitol Hill politically because they were making lobbying expenditures and campaign contributions in increasingly larger amounts during the 1990s. In her article entitled, "Silicon Valley goes to Washington," Holly Bailey, an investigative reporter with the Center for Responsive Politics (2000, 34) explains their popularity, "The increasingly wealthy industry has new money to spend and lots of issues to uphold." Democrats and Republican politicians were accepting this attention and money with enthusiasm

Big 7 Defects from the Opposition

Realizing their weak position, the NGA in February 1998 introduced its counterpart to the ITFA, the Internet Development Act of 1998 (IDA98). Its proposal was an attempt to generate political support by moving its position closer to Marker G, which represents what the 223rd representative in the House, the 60th Senator, and President Clinton could support. The NGA and other Big 7 groups moved from Marker B to Marker D (see Figure 1).
The IDA98 would have overturned the *Quill* decision by mandating that remote vendors to collect sales and use taxes from their out-of-state customers. The IDA98 would have encouraged each state to approve a single, statewide, sales and use tax on sales from Internet vendors, and it would have simplified tax collection for businesses through the development and use of a software package approved by the states. To move closer to the ITFA proponents' position located at Marker C, the NGA's bill would have prohibited new federal, state, and local taxes on Internet access and would have provided electronic commerce vendors with protection from multiple and discriminatory taxes.

Subsequently, the IDA98 during February and early March 1998 failed to garner the support of key lawmakers. On February 11, House Majority Leader Armey became another ITFA co-sponsor and fifteen days later, President Clinton endorsed the ITFA (Clinton 1998; Cox 2001; Macavinta 1998). On March 2, Senate Majority Leader Lott indicated the Senate might hold a vote on the ITFA later in 1998 and that he implied that he would vote for it ("Lott says moratorium…" 1998).

Without the equivalent financial resources to generate political support, the Big 7 and its allies sought to limit the scope and effects of the ITFA. Cox and Governor Leavitt agreed to a compromise proposal on March 19, 1998, and they incorporated many of these limits into it. As a result, the NGA and other Big 7 groups in varying degrees of fervor publicly dropped their opposition to the ITFA.

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[46] Opponents include those organizations that initially opposed the ITFA but later supported it.

Table 3: Comparison of 1997 and 1998 Lobbying Expenditures and Campaign Contributions by Selected ITFA Supporters and Opponents ($)

Supporters			Opponents		
Organization	Lobbying Expenditure ($)	Campaign Contribution ($)	Organization	Lobbying Expenditure ($)	Campaign Contribution ($)
AOL	1,804,000	139,750	Big 7	N/A	0
AT&T	15,540,000	2,122,971	Chicago	$905,000	79,445
Business Software Alliance	1,980,000	12,550	Denver (City and County)	$1,270,000	4,540
Charles Schwab	440,000	259,500	Federation of Tax Administrators	N/A	0
Computer Systems Policy Project	1,700,000	0	ICSC	600,000	312,239
Dell Computers	440,000	0	Los Angeles County	1,445,000	25,641
Direct Marketers Association	1,701,000	195,533	Miami-Dade County	1,410,000	15,943
Hewlett-Packard	1,138,656	77,750	Metro Transit Authority of Harris County, TX	900,000	0
IBM	10,792,000	90,278	NATOA	N/A	0
Information Technology Association of America	460,000	1,750	Orange County	929,000	7,708
Microsoft	5,860,000	1,353,271	Sacramento, CA	825,000	500
US Chamber of Commerce	31,240,000	31,151	San Diego County	$860,000	$10,914

Source: The Center for Responsive Politics (2001; 1999).

Their proposal specifically listed the taxes subject to the moratorium. Discriminatory and multiple taxes were included in a three-year moratorium. At the insistence of the Big 7, a 28-member commission was included in the bill, which would have consisted of federal, state, local, business, and consumer representatives. It would recommend legislation to the president and the Congress. In its recommendations, the commission would develop uniform definitions, streamline tax procedures, establish a single statewide tax rate with proportional revenues distributed to localities, create a third-party system to collect the taxes, provide incentives for states to implement such a system, and ban permanently Internet access taxes, bit taxes, and bandwidth taxes. States failing to implement this system within four years would have their remote sales and use tax rate drop to zero (Gruenwald 1998, 743; NGA 1998b).

The consequences of this compromise were that the Big 7 moved from Marker D to Marker F. On the other hand, Cox's agreement with the Big 7 forced ITFA supporters to move from Marker C to Marker E.

Reactions to H.R. 4105 and Concerns about S.442

On June 23, 1998, Cox on June 23, 1998 introduced H.R. 4105, which merged H.R. 3849 and H.R. 3529. The House had considered both bills after the Cox-Leavitt compromise. H.R. 4105 passed the House on the same day by voice vote.

ITFA proponents had mixed reactions. For example, Carol Cayo with the Information Technology Association of America (ITAA) thought that the bill was a move in the right direction but expressed her displeasure about the existence of grandfathering clause on Internet access taxes (Sheppard 1998b, 2055).[47]

Despite expressing its support for H.R. 4015 and calling on the Senate to follow the path taken by the House, the many states and localities had a couple concerns about it. First, the Big 7 was unhappy that main street retailers and consumers had no representation on H.R. 4015's commission (Sheppard 1998c). Second, many states and localities were unhappy with H.R. 4015's grandfather provisions (Sheppard 1998a). H.R. 4105 grandfathered eight states with statutes permitting Internet access taxes, but these states, during a 1 year period starting from the date of this bill's enactment, would have had to enact laws specifying that their tax is levied Internet access (H.R, 4105 1998, 3-4).[48] The opposition of major economic interests made it unlikely that the states would be able to enact such laws, so these states would lose revenues. It was estimated that Iowa, New Mexico, and South Dakota would have lost $4, 3, and 2.5 million, respectively if they failed to reenact their statutes (Sheppard 1998d). Connecticut would have lost $7 million annually in Internet taxes as Connecticut Tax Commissioner Galvin, one the most active opponents of this grandfather clause, (Sheppard 1998a) asserted, "Internet service providers provide about $7 million per year for their access."

After the House approved H.R. 4105, legislative action shifted over to the Senate where state and local officials were concerned about how some versions of the S.442 would affect their ability to collect past and future tax assessments. Frank Shafroth, Director of Policy and Federal Relations with the National League of Cities, was among those concerned that vague language in earlier versions of the ITFA would exempt ISPs from paying past tax bills and might, in fact, provide the ISPs with a refund (Sheppard 1998a). Connecticut Tax Commissioner John Galvin (Sheppard 1998a) complained, "To eliminate past debts is just absolutely absurd, in my opinion. All the online service providers could then file refund claims, which would cost a lot of money not budgeted for. The State of Connecticut would face millions and millions in dollars of refund claims." (Sheppard 1998e)

ITFA Successes and Failures

The actors reached Marker G when President Clinton signed the ITFA into law on October 21, 1998. AOL, the DMA, and their allies succeeded in reaching many of their objectives. Although they were unsuccessful in eliminating taxes on electronic commerce, they persuaded lawmakers to maintain the status quo with respect to nexus. They persuaded lawmakers to deal with most nexus issues in the future by creating a commission to study them.

[47] About 11,000 direct and affiliate members in the US have belonged to the ITAA. The ITAA's members sell information technology goods and services ("ITAA hails…" 1998). Amazon.com, AOL Time Warner, AT&T, Compaq Computer Company, Deutsche Telekom, DynCorp, Fujitsu, Global Crossing, IBM, Intel, Microsoft, Nortel Networks, Oracle, Symantec, VeriSign, Vertex, Visa USA, Inc., Walt Disney, Xerox, and Yahoo! Inc. have been some of ITAA's many members (ITAA 2001).

[48] This reenactment clause was inserted because the state tax authorities have used laws enacted before the widespread usage of Internet services.

On nexus issues regarding the display of content from and the processing of orders through a server, AOL and the DMA were successful in limiting their tax liabilities by succeeding to persuade lawmakers to include Section 1104(2)(b)(ii) in the ITFA. This provision added language to the definition of discriminatory taxes, taxes that were subject to this act's moratorium. Subsection 1104(2)(b)(ii) read,

> (ii) a provider of Internet access service or online services is deemed to be the agent of a remote seller for determining tax collection obligations solely as a result of – (I) the display of a remote seller's information or content on the out-of State computer server of a provider of Internet access service or online services; or (II) the processing of orders through the out-of-State computer server of a provider of Internet access service or online services. (H.R. 4328 1998, 1798)

AOL, the DMA, Charles Schwab and their allies obtained a moratorium of Internet access, multiple, and discriminatory taxes, but they failed to remove the grandfather clause. Meanwhile, Charles Schwab was successful in keeping provisions out of the ITFA that would tax securities transactions. Charles Schwab and its allies succeeded in creating a statutorily balanced commission to study tax issues associated with electronic commerce. They were able to include a language stating that the commission must have a two-thirds majority to issue official recommendations and findings.

The Big 7 and its allies, like AOL and its allies in the ITFC, had mixed success. The Big 7, the ICSC, and their allies failed to obtain congressional authorization permitting states to maximize their tax revenues by compelling remote vendors without nexus to collect use taxes on their sales to in-state customers. They were unsuccessful in stopping the moratorium.

On the other hand, the Big 7 and its allies were successful in other areas. First, they persuaded lawmakers to add a grandfather clause to the moratorium for those states that have already been taxing Internet access. Second, the Big 7 was successful inserting language into the ITFA to create a balanced commission, at least statutorily, with main street business. Third, lawmakers drafted this grandfather clause without the reenactment clause and with clear language permitting states and localities to collect taxes owed before the ITFA's enactment. Section 1101(c) read, "Liabilities and Pending Cases.—Nothing in this title affects liability for taxes accrued and enforced before the date of enactment of this Act, nor does this title affect ongoing litigation relating to such taxes."

Galvin and his aides had lobbied Senators Bob Graham, (D-FL), Joseph Lieberman (D-CT), and Daniel Patrick Moynihan (D-NY) to include this clause and exclude the reenactment clause. Senator Graham appeared to hear their pleas by making sure that this tax liability language was included in the final bill (Graham 1998, SS11852; Sheppard 1998e). Galvin contended, "If a state did not get that kind of provision, not only would it jeopardize current assessments, but Internet service providers would have had refund claims." (Sheppard 1999a, 31) Moreover, Galvin claimed, "For Connecticut, that would cost $25 million." (Sheppard 1999a, 31)

Appointment of ACEC Commissioners

As discussed in Chapter 3, the ITFA provided statutory procedures to appoint commissioners to serve on the 19-member ACEC. At least on paper, the ITFA had intended for Senate Minority Leader Daschle, House Minority Leader Gephardt, Speaker of the House

Gingrich, Senate Majority Leader Lott, to make their appointments in a manner that would balance the interests of state and local governments, brick and mortar retailers, electronic commerce retailers, telecommunications firms, small businesses and consumers. However, a legal controversy erupted over whom the congressional leaders had initially appointed (See Chapter 3).[49] Once the final appointments were made, these commissioners were to study a variety of electronic commerce issues and required to submit tax and technologically neutral recommendations and findings in a report to Congress within 18 months after the ITFA's enactment (ACEC 2000a, 70-71).[50] The ITFA required that two-thirds of the commissioners must approve ACEC recommendations and findings to Congress.

Critics raised questions about whether the ACEC over represented the high technology industry, the mail order industry, and electronic commerce vendors and underrepresented states, localities, consumer groups, and local brick-and-mortar retailers (see Table 4 for a list of the commissioners). Critics contended that high technology, mail order, and electronic commerce firms and trade associations used their economic power to obtain an appointment for themselves or person(s) who would look after their interests.

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[49] According to the ITFA, the commission's membership "…shall be as follows: (A) 3 representatives from the Federal Government, comprised of the Secretary of Commerce, the Secretary of the Treasury, and the United States Trade Representative (or their respective delegates). (B) 8 representatives from State and local governments (one such representative shall be from a State or local government that does not impose a sales tax and one representative shall be from a State that does not impose an income tax). (C) 8 representatives of the electronic commerce industry (including small business), telecommunications carriers, local retail businesses, and consumer groups, comprised of – (i) 5 individuals appointed by the Majority Leader of the Senate; (ii) 3 individuals appointed by the Minority Leader of the Senate; (iii) 5 individuals appointed by the Speaker of the House of Representatives; and (iv) 3 individuals appointed by the Minority Leader of the House of Representatives." (H.R. 4328 1998, 1790-1791).

[50] Generally, the ITFA (H.R. 4328 1998, 1793) provided, "The Commission shall conduct a thorough study of Federal, State and local, and international taxation and tariff treatment of transactions using the Internet and Internet access and other comparable intrastate, interstate or international sales activities." Furthermore, the ITFA suggested specific issues for the ACEC to study. The ITFA stated, "The Commission may include in the study under subsection (a) – (A) an examination of – (i) barriers imposed in foreign markets on United States providers of property, goods, services, or information engaged in electronic commerce and on United States providers of telecommunications services; and (ii) how the imposition of such barriers will affect United States consumers, the competitiveness of United States consumers, the competitiveness of United States citizens providing property, goods, services, or information in foreign markets, and the growth and maturing of the Internet; (B) an examination of the collection and administration of consumption taxes on electronic commerce in other countries and the United States, and the impact of such collection on the global economy, including an examination of the relationship between the collection and administration of such taxes when the transaction uses the Internet and when it does not; (C) an examination of the impact of the Internet and Internet access (particularly voice transmission) on the revenue base for taxes imposed under section 4251 of the Internal Revenue Code of 1986; (D) an examination of model State legislation that – (i) would provide uniform definitions of categories of property, goods, service, or information subject to or exempt from sales and use taxes; and (ii) would ensure that Internet access services, online services, and communications and transmissions using the Internet, Internet access service, or online services would be treated in a tax and technologically neutral manner relative to other forms of remote sales; (E) an examination of the effects of taxation, including the absence of taxation, on all interstate sales transactions, including transactions using the Internet, on retail businesses and on State and local governments, which examination may include a review of the efforts of State and local governments to collect sales and use taxes owed on in-State purchases from out-of-State sellers; and (F) the examination of ways to simplify Federal and State and local taxes imposed on the provision of telecommunications services." (H.R. 4328 1998, 1793-1795) The ITFA also read, "The Commission shall, to the extent possible, ensure that its work does not undermine the efforts of the National Tax Association Communications and Electronic Commerce Tax Project." (H.R. 4328 1998, 1795-1796)

Within the constraints of the ITFA, the congressional designators, for the most part, seemed to appoint officials connected to high technology, mail order, and electronic commerce firms to the ACEC. They did either, because the firms had given large amounts of campaign contributions to them, were a major economic presence in their state, and/or could use their financial resources to make political contributions in future elections. In addition, since the four designators are leaders in their political parties and their fellow legislators chose them as party leaders, they needed to consider how their appointments would affect the flow of political contributions to their fellow party members.

AOL, AT&T, Charles Schwab, DMA, Gateway 2000, MCI WorldCom, Microsoft, Time Warner, the made major political contributions to Members of Congress and the Democratic and Republican parties during the 1997-1998 election cycle (see Table 5). Each firm or association had at least one representative on the ACEC and had economic interests to protect (see Table 4).

Table 4: Commissioners by Name, Affiliation, Statutory Representation, and Appointer

Commissioner	Affiliation	Statutory Representation	Appointer
Andal	California Board of Equalization	State government	Gingrich
Armstrong	AT&T	Telecommunications carrier	Daschle
Gilmore	Commonwealth of Virginia	State government	Gingich
Guttentag	US Department of the Treasury	US Secretary of the Treasury	ITFA
Harris	Virginia House of Delegates	State government	Lott
Jones	Washington County, Oregon	Local government without a state sales tax	Lott
Kirk	Dallas, Texas	Local government	Gephardt
Leavitt	State of Utah	State government	Lott
Lebrun	National Conference of Commissioners on Uniform State Laws (NCCUSL)	State government	Daschle
Locke	State of Washington	State government without an income tax	Gephardt
Norquist	Americans for Tax Reform	Consumer group	Gingrich
Novick	Office of the USTR	US Trade Representative	ITFA
Parsons	Time Warner, Inc.	Electronic commerce firm	Gingrich
Pincus	US Department of Commerce	US Secretary of Commerce	ITFA
Pittman	AOL	Electronic commerce firm	Gephardt
Pottruck	Charles Schwab Corporation	Local business retailer	Gingrich
Sidgemore	MCI Worldcom and UUNET Technologies	Telecommunications carrier	Lott
Sokul	Association for Interactive Media	Electronic commerce trade association	Lott
Waitt	Gateway, Inc.	Local retail business	Daschle

Source: (ACEC 2000a).

Critics charged that Virginia-based AOL had more than one representative because Commissioners Gilmore and Harris were Virginia public officials. At a District of Columbia Bar's Taxation Section luncheon, Tax Attorney Kenneth Silverberg observed, "They have Jim

Gilmore [R], governor of Virginia, and they have a Virginia state legislator named [Paul Clinton] Harris [R]…but many people believe them to be under the hypnotic trance of America Online [Inc.] and therefore especially friendly to the Internet business community." (Sheppard 1999c, 930) In fact, AOL Chief Executive Officer Stephen M. Case gave $2,500 to Governor Gilmore's Commonwealth PAC on May 17, 1999.[51] On August 9, 1999, AOL gave $10,000 to Governor Gilmore's New Majority Project campaign fund.[52] On August 25, AOL gave $250 to Delegate Harris' reelection campaign. AOL made these donations just as the ACEC began its work (Virginia Public Access Project 2001). Gilmore, as he sought other statewide and national offices, and Harris, as he sought reelection and other political offices, might have expected larger contributions from AOL and other information technology firms in the future.

Meanwhile, Daschle might have appointed Armstrong because of AT&T's campaign contributions. AT&T gave over $2 million to federal candidates between 1997 and 1998 and gave Daschle $7,920 between 1997 and 1998 (see Table 6). It has been a larger provider of Internet services and owner of phone lines in the US.

The local business retail commissioner was Charles Schwab's Co-President David Pottruck, hardly the Co-President of a local department store. Charles Schwab, as the nation's largest online brokerage, had large economic interests.

Stan Sokul with the Association for Interactive Media, a recently acquired subsidiary of the DMA, represented the DMA. The DMA had a very large vested interest in the outcome of the ACEC because it represented many firms engaged in long distance sales.

ACEC critics charged that Washington State-based Microsoft had Washington Governor Gary Locke, and one its former lobbyists, Grover Norquist who has been President of Americans for Tax Reform and was ostensibly the ACEC consumer representative, on the ACEC (Ota 1999, 486). Norquist received $160,000 in lobbying income from Microsoft during 1997-1998 (Center for Responsive Politics 2001). Criticizing Norquist's consumer credentials, Senator Byron Dorgan (D-ND), a former North Dakota tax administrator stated, "Now I don't know Grover Norquist from a head of lettuce, but I know what he's about. And he is to consumerism what professional wrestling is to the performing arts." (Sheppard 1999b, 824)

Senate Majority Leader Lott and Senate Minority Leader Daschle each appointed high-ranking executives of major corporations in their states. Lott appointed John Sidgmore, Vice Chairman of MCI WorldCom, headquartered in Mississippi, and Daschle appointed Ted Waitt, Chairman of Gateway 2000, a major personal computer maker headquartered in South Dakota at that time. In short, ten of the nineteen commissioners could be construed to represent high technology, the mail order, and electronic commerce firms.

Meanwhile, the ACEC lacked representation from *traditional* main street retailers despite large campaign donations to federal candidates (see Table 2). A reasonable explanation is that main street retailers were relatively inactive politically regarding the ITFA, compared to the ITFA supporters, and these retailers did not use their expensive lobbyists and their considerable political contributions to persuade lawmakers to appoint them to the ACEC.

On the other hand, a minority of the appointees, just as a majority of Member State and EU politicians were concerned in the EU about VAT losses, feared how electronic commerce

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[51] Gilmore created this political action committee to raise funds during his service as governor (Virginia Public Access Project 2001).

[52] Gilmore established this political action committee to raise funds for Republican candidates in the 1999 General Assembly races (Virginia Public Access Project 2001).

would cause state and local sales and use tax losses because these revenues pay for much of the programs that their political supporters want. Commissioner Leavitt was concerned because as Chairman of the NGA, he represented the nation's governors, and 45 of their states depended in varying degrees on sales and use tax revenues, and because he, as Governor of the State of Utah, was concerned because sales and uses taxes represented 35.5% of Utah's revenues in 1998 (GAO June 2000; 56-57). Governor Locke, although Microsoft had its headquarters in his state, had concerns about state sales and use tax losses because Washington depended on sales and use taxes for 58.5% of its revenues in 1998 (GAO June 2000, 56-57).

At the same time, Mayor Kirk of Dallas, Texas had two reasons to worry about sales and use tax losses resulting from electronic commerce. First, this city's sales tax revenues during fiscal year 1999-2000 accounted for about 30% of Dallas' general fund budget and represented about 13% of Dallas' total budget (City of Dallas 2001). Second, if Commissioner Kirk were considering a future run for governor, he would need revenues to fund his programs, and sales and use taxes represented 50.6 percent of Texas' revenues in 1998 (GAO June 2000; 56-57).

Strategic Coalition Building

The beforementioned variant of the median voter theorem explains very well how the ACEC in its final report reached its unofficial findings and recommendations for sales and use

Table 5: 1997 and 1998 Spending by Commissioner's Firm or Trade Association ($)

	Overall Spending (1997-1998)		Contribution to ACEC Appointers			
Commissioner and His Organization*	**Total Lobbying Expenditure ($)**	**Total Campaign Contribution ($)**	**Daschle (1997-1998)**	**Gephardt (1997-1998)**	**Gingrich (1997-1998)**	**Lott (1997-1998)**
Armstrong, AT&T	15,540,000	2,122,971	7,920	3,500	7,500	5,000
Norquist, Microsoft	5,860,000	1,366,271	5,000	3,000	4,000	1,000
Parsons, Time Warner	6,000,000	1,535,496	22,500	14,500		
Pittman, AOL	<3,388,000	383,349	4,500	5,250		
Pottruck, Charles Schwab	<460,000	259,500	1,000			
Sidgemore, MCI WorldCom	6,351,702	1,801,318	8,500	3,000	3,500	7,000
Sokul, Association for Interactive Media						
Association for Interactive Media	<70,000	500				
DMA**	1,701,000	195,533	1,000	2,000		
Waitt, Gateway 2000	265,000	519,454	22,000			

Source: The Center for Responsive Politics (2001; 1999). < means less than. Subsidiaries are included. AOL includes 1997-1998 data from Netscape Communications, which AOL acquired in late 1998, and 1997 data from CompuServe. MCI WorldCom data includes data when MCI Telecommunications and WorldCom were separate companies. Time Warner includes data from Atlantic Records, Castle Rock, and Maverick Recording. **The DMA bought the Association for Interactive Media in the Fall of 1998.

taxes on electronic commerce.[53] To obtain the tenth vote, the commissioners strategically calculated by forming coalitions.

The commissioner's initially bonded into the anti-tax, pro-tax, business, and federal coalitions. The anti-tax coalition comprised Commissioners Gilmore, Andal, Harris, Norquist, and Sokul. The business coalition or caucus consisted of Commissioners Armstrong, Parsons, Pittman, Pottruck, Sidgmore, and Waitt. Commissioners Leavitt, Jones, Kirk, Lebrun, and Locke belonged to the pro-tax coalition. The members of the federal coalition were Commissioners Guttentag, Novick, and Pincus.

Every coalition, aside from the federal one, developed a major policy proposal. In Figure 4.2, Markers A, B, and C represent the initial and major policy proposals of the anti-tax, pro-tax, and business caucus coalitions, respectively.

Gilmore's November Proposal

ACEC Chairman Gilmore submitted to the ACEC on November 8, 1999 a proposal addressing sales and use taxes, which most, if not all, of the anti-tax coalition commissioners could support. Gilmore's proposal is at Marker A on the far right side of the continuum. His proposal called on Congress to amend the ITFA by banning permanently all sales and use

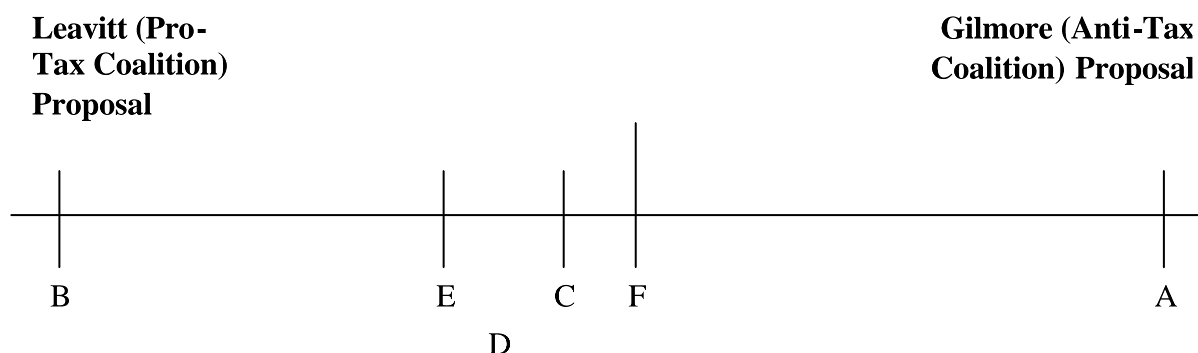

Figure 2: Positions on the ACEC

taxes on remote business-to-consumer transactions using the Internet. This ban would have apply to "…the sale of tangible or intangible goods and property, intellectual property, digital goods, services, securities, information and content, and entertainment." (Gilmore 1999, 5-6; Gilmore 2000b, 22) Concerned about how states and localities had started to view the Internet as providing nexus with out-of-state firms for business activity, sales, and use tax purposes, Gilmore borrowed Commissioner Andal's proposal to amend Public Law 86-272. With it, Gilmore's proposal would define nexus more clearly, apply to intangible products, and protect firms from unfair state and local taxation. Gilmore's proposal called on Congress to ban all taxes on Internet access, including those grandfathered under the ITFA (Gilmore 1999, 8-10; Gilmore 2000b, 22-23).

[53] Chairman Gilmore consulted with congressional leaders and the ACEC's legal counsel in March 2000. Subsequently, the two-thirds majority requirement for submitting a report to Congress dropped to a simple majority requirement, despite vigorous protests from the federal and pro-tax coalition commissioners (ACEC 2000a, 133-140). Recommendations and findings, approved with only a simple majority of the ACEC, were still unofficial ones.

Leavitt's November Proposal

On November 15, 1999, Commissioner Leavitt submitted on behalf of the pro-tax group and the Big 7 the Streamlined Sales Tax proposal (Leavitt 2000).[54] This proposal is at marker B. This proposal called for the creation of a zero burden and voluntary sales and use tax system over the following 2 to 5 years. It would rely on information technology to eliminate the economic burden for firms to collect state sales and use taxes through tax simplification. Simplification would happen by changing state laws, implementing uniform administrative procedures, and using technology administered by a trusted third party. After the states decided upon how to make these changes, they would implement the zero burden system within 18 months, but adjustments in state laws and technology might need changing after this system's implementation. Over 6 to 8 years, Leavitt's proposal called for the states to establish a uniform, comprehensive sales and use tax system by adopting the same tax definitions and auditing procedures. All states and localities would have to adopt this voluntary system and its nationwide standards (Leavitt 1999, 1-3).

Business Caucus Proposal

Attempting to broker a compromise proposal that could secure a two-thirds majority of the ACEC, the ACEC business caucus submitted a proposal on February 8, 2000 is and is at marker C.[55] This caucus recommended for five years that Congress extend the ITFA's moratorium of multiple and discriminatory taxes on electronic commerce, ban taxation of sales of digitized goods and products and their non-digitized counterparts, and repeal the three percent federal excise tax on communications services. This caucus proposed that Congress permanently ban Internet access taxes, including those that were grand fathered under the ITFA. Their proposal narrowly defined what factors would constitute nexus between a jurisdiction and a firm for sales, use, income, and business activity tax purposes. This caucus in its proposal called upon Congress to encourage states and localities to use the NCCUSL as a partner and forum to craft a uniform sales and use tax act by October 21, 2004. This act's goal would be the leveling of the collection cost playing field between remote vendors and equivalent vendors selling in a single tax jurisdiction through the simplification of state and local tax systems and through establishing uniform standards among tax jurisdictions in a number of areas. These areas would have included having one sales and use tax per state with limits on rate changes, uniform tax base definitions, uniform vendor discount, uniform audit procedures, and uniform tax filing forms. Congress would create a new advisory commission to oversee the NCCUSL's work drafting a Uniform Sales and Use Tax Act, and this commission would report to Congress within 6 months after the NCCUSL had finished its work (Business Caucus 2000, 3-6; Hurley 2000, 1).

The business caucus proposal forced Gilmore and his anti-tax allies to make a strategic decision.[56] Knowing the extreme unlikelihood of his anti-tax coalition forming a larger coalition

[54] The National League of Cities was not one of its sponsors.

[55] During most of the ACEC's proceedings, especially in the beginning, it was uncertain how many of the business caucus members, such as Commissioners Armstrong, Parsons, Pottruck, and Waitt, would act. At times, these commissioners seemed very interested in reaching a consensus on how to address the sales and use tax issue (Gardner 2000; Kelly 2000). For example, Commissioner Armstrong had wanted to be appointed onto the ACEC, but no one was sure how he would serve on it. AT&T has a lot of cross pressures from its customers. AT&T has telephone customers, Internet access subscribers, and traditional catalog customers who fear the Internet (Gardner 2000). Moreover, most of the moderates on the ACEC were from the business caucus (Christie 2000).

[56] Commissioner Gilmore may also have been motivated, in part, because Commissioner Andal did not

with the pro-tax coalition, Gilmore and others in the anti-tax coalition joined in a coalition (Coalition 1) with the business caucus at Marker F. In seeking this alliance, Gilmore and his coalition had to compromise with the business caucus to secure a majority of the ACEC commissioners. Responding to queries from the media and criticisms from anti-tax advocates of his supporting the business caucus proposal, Gilmore on February 23, 2000 (2000a. 1) asserted, "I believe America should ban sales and use taxes on the Internet permanently, for all time. If we secure tax freedom on the Internet through 2006, tax freedom on the Internet will become an entitlement for the American people and a political inevitability. No tax collector will be welcome on the Internet after 2006."

The Commissioners Gilmore and Harris had an additional incentive because Commission Pittman with AOL was a member of the business caucus. AOL is major economic presence in Northern Virginia, and it and its employees are a potential source of campaign contributions.

However, the anti-tax coalition made several concessions to the business caucus. First, the anti-tax coalition was forced to accept a five-year moratorium, instead of a permanent moratorium of all Internet access taxes and multiple and discriminatory taxation of electronic commerce. Instead of a permanent sales and use ban on remote sales of goods and services to private consumers and on digitized products bought by these consumers, the Business Caucus proposal limited the ban to five years and to digitized goods and products and their non-digitized counterparts. Second, the business caucus' proposal loosened the criteria to be used by the NCCUSL as it drafts a uniform sales and use tax act and works with states and localities to formulate policies to establish and maintain parity of collection costs (net of vendor discounts) between remote sellers and equivalent vendors who sell in one jurisdiction and do not sell remotely. Third, the business caucus proposal reduced the time limit for NCCUSL to draft its act from indefinite to 3 years from the expiration of the ITFA's moratorium.

On the other hand, the anti-tax coalition's proposal obtained an, albeit more minor, concession from the business caucus. The business caucus' five-year prohibition of digitized products was extended to their non-digitized counterparts (Business Caucus 2000, 3-6).

The business caucus proposal gave a few incentives for the pro-tax group to support it. First, it provided for a narrower five-year ban, instead of the broader and permanent one that the anti-tax proposal had wanted. Second, it called for further study of sales and use taxes issues that had less restrictive language than Gilmore's plan.

Kirk, Leavitt, Lebrun, and Locke's Proposal

Meanwhile, Commissioners Kirk, Leavitt, Lebrun, and Locke submitted their proposal, located at marker E.[57] It was based largely on the earlier Streamlined Sales Tax proposal and had four main parts.[58] First, their proposal favored the extension of the ITFA moratorium on

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support a tax free zone on the Internet. Commissioner Andal, however, did want laws, based on Public Law 86-272, enacted to limit nexus for sales, use, and business activity taxes (Staff Member for ACEC Member).

[57] Commissioner Jones did not sign onto this proposal, but she was a member of the pro-tax coalition because she abstained with the other pro-tax coalition commissioners when votes were taken on the sales and use tax parts of final report.

[58] National Governors Association, National Conference on State Legislatures, Council of State Governments, National Association of Counties, US Conference for Mayors, and the International City/County Management Association supported the Governor Leavitt's and Janklow's streamlined tax proposal.

After Commissioners Kirk, Leavitt, Lebrun, and Locke submitted their the minority proposal, Leavitt later withdrew it, and negotiations ensued among many of ACEC commissioners and their staff to make the minority proposal acceptable to a majority, and if possible, a two-thirds majority of the commissioners. Leavitt offered a vague substitute at the very end of the Dallas meeting, but his proposal went nowhere (ACEC 2000b, 278-310).

multiple and discriminatory taxes and on Internet access taxes, excluding the grand fathered Internet access taxes. The ITFA's moratorium should last as long as sales and use tax simplification efforts lasted. Second, states and localities would work with business, other public sector actors, and the NCCUSL to develop model state legislation to implement a streamlined, sales and use tax system. Similar to provisions in the business caucus proposal, their proposal had provisions that sought to provide tax simplification and uniformity among the jurisdictions in a number of areas, such as the establishment of uniform tax forms, definitions, registration measures, and audit procedures. Their proposal would seek to develop standard and reliable software that vendors could use to meet their tax compliance obligations. Third, their proposal, in contrast to the business caucus proposal, called for states and localities to form public/private partnerships with retailers to simplify taxes, decrease compliance costs and burdens, use simplification measures, and experiment integrating technology with voluntary tax collection systems. Finally, their proposal, unlike the business caucus proposal, urged that Congress at this time should not adopt laws to change nexus. That is, Congress for the moment should not reduce or expand a remote vendor's responsibility to collect sales and use taxes and should not change nexus laws affecting state business activity and income taxes (Kirk, Leavitt, et al. 2000, 9).

"Deal Breaker"

The nexus issue was the "deal breaker" that prevented Coalition 1 from reaching a compromise with the pro-tax coalition (Duncan 2001 and 2000; Rosenker 2000). Coalition 1 wanted to limit clearly the number of factors that a state could use to determine a vendor's nexus with it, but the pro-tax coalition supported a state using a large number of factors to determine nexus with it (Ota 2000, 895). If the pro-tax coalition had agreed to the compromise, the federal coalition would have followed the pro-tax coalition's lead by agreeing to a compromise. Since the federal government does not receive state and local sales and use taxes, Commissioners Guttentag, Novick, and Pincus at Marker D had a large incentive to serve as honest brokers and to let a consensus develop over these tax issues before they announced a position.[59]

At the last-minute negotiations in Dallas, Texas, Commissioners Kirk, Leavitt, and Lebrun on one side and Commissioners Armstrong, Pottruck, and Gilmore on the other side

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[59]In developing its position on the ACEC, Clinton Administration and particularly Vice President Al Gore, was put in an awkward position. With his run for president revving up, Gore did not want to be perceived as anti-Internet taxes on the one hand, but he did not want to be viewed as pro-Internet taxes, either. He needed to raise political campaign contributions from as many sources that he could.

In the late stages of the ACEC proceedings, David Beier, Vice President Gore's Domestic Policy Adviser in the White House influenced the federal coalition's position. Under Beier's direction, Deputy Secretary of the Treasury Stuart Eisenstat was the Clinton Administration's point person for the ACEC. According to Eisenstat, Beier met with Commissioners Guttentag, Novick, and Pincus, and National Economic Council officials on several occasions to coordinate their ACEC work (Eisenstat 2001). The Clinton Administration in March 2000 contended that the ITFA moratorium on Internet access taxes should become permanent, that the moratorium of multiple and discriminatory taxes should continue, and that states and localities should formulate a model act to simply the sales and use tax system in two years. During its formulation, Eisenstat contended that states and localities should investigate ways to reduce collection costs for businesses, to make the system fair for online and offline vendors, ensure consumer privacy, and levy and collect digitally transmitted products in a feasible manner. While the states and localities simplify, Eisenstat said that nexus rules should stay unchanged (Hamilton 2000).

In addition, many in the pro-tax camp viewed the Clinton Administration as siding through much of the proceedings with the pro-tax coalition in a covert and implicit manner (Goodman 2000). Covert and implicit in the sense that the pro-tax group explicitly favored Internet taxation, but the Clinton Administration officials would not explicitly do that (Goodman 2000; Norquist 2000). In fact, Norquist (2000) asserted that the Clinton Administration representatives played a "disingenuous game."

failed to hash out a deal because of nexus provisions (f), (g) and (h) of section 2 in the business caucus proposal (Christie 2000).[60] Provision 2(f), 2(g), and 2(h) dealt with the tax status of an affiliated firm, repair and warranty services, and the return of products purchased through a Web site or catalog (see footnote 59 below). The pro-tax group wanted them removed from the business caucus proposal, but Coalition 1 refused. Even if a compromise would have been reached over these two provisions, it was highly likely that the same sides would have had a tough job resolving their differences over the nexus provisions in section 3 of the business caucus proposal on business activity and income taxes.[61]

Furthermore, Commissioner and NGA Chairman Leavitt had strong backing from 42 of the 50 state governors. They were concerned that the nexus and other provisions in the business caucus proposal would reduce state and local tax revenues by $30 billion a year. Consequently, the NGA argued that this cut in tax revenues would force cuts in educational programs (NGA 2000). Many of these governors have received political campaign contributions from teachers' unions that would oppose educational cuts.

ACEC Majority Proposals

In any event, the business caucus' proposals on state and local Internet access taxes, state and local sales and use taxes, state business activity and income taxes, and the 3 percent federal tax on communications services, aside from some minor language changes and with the support of the anti-tax coalition, became ACEC majority proposals at Marker F. A majority of the ACEC approved the sales and use tax proposal, the Internet access tax proposal, and the repeal of the 3 percents by votes of 11 yeas, 1 nay, and 7 absentions (ACEC 2000a, 19-23). The 11 yeas were Coalition 1 consisting of Commissioners Andal, Armstrong, Gilmore, Harris, Norquist, Parsons, Pittman, Pottruck, Sidgemore, Sokul, and Waitt.

Ten Pigs at the Trough?

Why did these commissioners vote as they did? David Ignatius of the *Washington Post* (2000, A25) reported that an aggravated state representative labeled Commissioners Armstrong, Parsons, Pittman, Pottruck, Sidgemore, and Waitt as "six pigs at the trough," but given the possible economic interests of Gilmore, Harris, Norquist, and Sokul discussed above, perhaps "ten pigs at the trough" would have been a better characterization?

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[60] Section 2 reads, "Clarifies that the following factors would not, in and of themselves, establish a seller's physical presence in a state for purposes of determining whether a seller has sufficient nexus with that state to impose collection obligations: (a) a seller's use of an Internet service provider ("ISP") that has physical presence in a state; (b) the placement of a seller's digital data on a server located in that particular state; (c) a seller's use of telecommunications services provided by a telecommunications provider that has physical presence in a state; (d) a seller's ownership of intangible property that is used or is present in that state; (e) the presence of a seller's customers in a state; ***(f) a seller's affiliation with another taxpayer that has physical presence in that state; (g) the performance of repair or warranty services with respect to property sold by a seller that does not otherwise have physical presence in that state; (h) a contractual relationship between a seller and another party located within that state that permits goods or products purchased through the seller's Web site or catalogue to be returned to the other party's physical location within that state;*** and (i) the advertisement of a seller's business location, telephone number, and Web site address." (Business Caucus 2000, 3)

[61] Section 3 reads, "Clarifies that, in determining whether a seller has sufficient nexus with a state to be required to meet business activity and income tax reporting and payment obligations of that state, the following factors would not be taken into account: (a) all of the factors listed in (2)(a) through (i) above [see footnote 16 above], and (b) a seller's sales and use tax registration with that state and/or seller's collection and remittance of use taxes for that state." (Business Caucus 2000, 3)

They and the organizations that they had and have represented would have benefited if their majority proposals had become law. For the most part, these ten commissioners held together through logrolling, so that each obtained something that they wanted.

Strongly pushed by AOL (Greve 2000; Shafroth 2000), the proposed moratorium of Internet access taxes would have benefited AOL, AT&T, Charles Schwab, MCI WorldCom and Norquist's former employer, Microsoft from a permanent moratorium on Internet access taxes. These firms, except for Charles Schwab, provided Internet access. These providers wanted to keep the moratorium because it would have kept subscription fees lower than if there had been a tax. Having no Internet access taxes would have permitted these firms to retain their customers. Applying this moratorium to the states grandfathered under the ITFA would have possibly lowered monthly subscription charges for Internet access in those states, and more persons in those states might have been able then to afford subscribing to an ISP. Meanwhile, Charles Schwab wanted a tax ban to keep transactions costs low for its online customers (Kelly 2000).

Strongly desired by Time Warner,[62] the proposed five-year prohibition of sales and use taxes on digitized products and their non-digitized counterparts would have greatly benefited AOL and Time Warner greatly because they were two of the most powerful content companies in the world (Christie 2000; Duncan 2001 and 2000; Ignatius 2000, A25; Norquist 2000; Shafroth 2000).[63] Moreover, AOL and Time Warner had proposed a merger, which would combine AOL's subscriber list and content with Time Warner's books, magazines, and music. Removing a sales and use tax would make a post-merger AOL Time Warner's services and products cheaper and would enable some of their off-line and online customers to buy more of their products and services. As AOL Time Warner profited, Governor Gilmore and Delegate Harris might have benefited with large political contributions as they sought higher office.

Commissioner Waitt of Gateway 2000 sought sales and use tax nexus provisions 2(f), 2(g), and 2(h), and these provisions would have permitted businesses to set up affiliate stores in a tax jurisdiction and perform certain services, such as the repair and return of products, by removing the legal obligation of these businesses to collect sales and use taxes on the products that it sold in that tax jurisdiction.[64] In what Dr. Charles McLure, Jr. at Stanford University sarcastically named the "Gateway Giveway," provision 2(f), would have permitted Gateway 2000 to exempt its Gateway Country stores from collecting sales and use taxes (ACEC 2000a,

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[62] In interviews, some respondents (Christie 2000; Sokul 2000) said that Time Warner did not consider this provision as very important for Time Warner. In fact, Christie stated that Time Warner would have given it up if it would have enabled the ACEC to develop a compromise that two-thirds of the commissioners could support. His firm did never thought that this ban would become law (Christie 2000). However, why put it in the report if it was unimportant?

[63] The five-year prohibition of non-digitized counterparts was included to make the tax prohibition tax neutral.

[64] Section 2 reads, "Clarify that the following factors would not, in and of themselves, establish a seller's physical presence in a state for purposes of determining whether a seller has sufficient nexus with that state to impose collection obligations: (a) a seller's use of an Internet service provider ("ISP") that has…; ***(f) a seller's affiliation with another taxpayer that has physical presence in that state; (g) the performance of repair or warranty services with respect to property sold by a seller that does not otherwise have physical presence in that state; (h) a contractual relationship between a seller and another party located within that state that permits goods or products purchased through the seller's Web site or catalogue to be returned to the other party's physical location within that state;*** and (i) the advertisement of a seller's business location, telephone number, and Web site address." (ACEC 2000a, 19)

19; Ignatius 2000, A25). In fierce competition with Dell Computers, Gateway 2000 during the course of the ACEC changed its business plan (Norquist 2000; Observer 2000; Staff Member for ACEC Member 2000). Gateway 2000 had recently turned its Country Stores into affiliates and depending on the jurisdiction, would have possibly, under the majority proposal, had removed their stores' responsibility to collect sales taxes on computers and other wares that their customers would have bought in those stores. Since Dell Computers has sold its computers and accessories online and owned buildings in a few states, Dell Computers has not had nexus with most states and has not had to collect sales taxes from its customers in states where it has lacked nexus. This difference in distribution and tax strategies between Dell Computers and Gateway 2000 has put Gateway 2000 at a competitive disadvantage in most states. This majority report provision attempted to eliminate this disadvantage for Gateway 2000 (Greve 2000).

Related to provision 2(f), provisions 2(g) and 2(h), also sought by Commissioner Waitt, provided, that Gateway 2000 and other firms acting in certain ways would not in and of themselves constitute nexus. Provision 2(g) provided that a firm would not have nexus for sales tax purposes by performing repair or warranty services on goods in a jurisdiction, and provision 2(h) provided that a firm accepting the return of goods purchased through a Web site or catalog would not constitute nexus for sales tax purposes (ACEC 2000a, 19; Shafroth 2000). These goods would have, of course included computers. Speaking in practical terms about what provision 2(h) would mean for goods, Neal Osten, the NCSL's Director of Commerce and Communications (Whiskeyman and Bennett 2000, G-6-G-7) complained, "…To bring a book back, right now you would have to send it to the dot.com fulfillment center. You couldn't bring it back to the store to exchange it because that's nexus. But this would allow you to bring it back to the store to exchange it [without the store having to collect sales taxes on this purchase]."

Meanwhile, Charles Schwab would have benefited from provision 3(f), which said that a state would not consider a vendor's affiliation with another taxpayer, who had physical presence in that state, as nexus with that state. Having nexus with that state would have required this vendor to report and pay state income and business activity taxes. Charles Schwab and other financial services firms would have benefited from provision 3(f) because these firms typically have profited by working as a combination of online and brick-and-mortar operations (Ignatius 2000, A25).

AT&T and MCI WorldCom, two of the US's largest long distance carriers, and AOL, which was considering entering the phone business, strongly favored including a repeal of the 3 percent federal excise tax in the ACEC report (Goodman 2000; Greve 2000; Norquist 2000; Observer 2000; Shafroth 2000; Staff Member for ACEC Member). This tax repeal would have benefited them. Because it would have made their customers' phone calls a little less expensive, and their customers might have used this saving to pay for longer phone conversations.

In addition, many members of Sokul's Association for Interactive Media and its parent, the DMA, would have also benefited from these proposed nexus rules for sales, use, income, and business activity taxes. With these proposed rules, their online and mail order members would have limited their tax liabilities, and could have avoided the continuation of costly litigation and lobbying over state nexus statutes.

In the US, private firms and trade associations used their increasingly financial clout to influence lawmakers to reduce certain taxes on electronic commerce. Politicians recognized that these interests were increasingly sources of campaign contributions for their political campaigns and of employment for their constituents. In contrast, developments in the EU, as will be discussed below, were different because private and quasi-private firms and their trade

associations recognized that the Member States and the Commission were determined to apply the VAT to electronic commerce and private and quasi-private firms sought to tweak the VAT system to their economic advantage.

EU

Since the political deliberations among the Member States, private firms, and quasi-private firms about the Commission's proposal involves several issues with multiple dimensions, a variant of the median voter theorem, as in the first half of this chapter, to analyze how actors strategically made their policy decisions. Nevertheless, this case study presents the Commission's June 7, 2000 proposal and subsequent Member States' amendments and remarks and analyzes how public, quasi-private, and private actors pursuing their economic interests shaped them.

<u>*Commission's Proposal*</u>

Developed in consultation with the business community and tax authorities in various Member States,[65] the Commission's June 2000 proposal reflected the economic interests of the European business community and Member States. The economic interests of the Member States were to maximize VAT revenue, while promoting the development of electronic commerce, while the European business community sought to develop a consumption tax policy that promoted its global competitiveness in electronic commerce. Echoing their concerns, the Commission's Working Party N° 1 in its June 8, 1999 working paper boldly set forth two reasons explaining the Commission's approach toward levying VATs on electronic commerce. Its paper (Directorate-General XXI 1999, 2) read,

> The Commission's approach to the question of taxation of e-commerce has been motivated by two factors – protection of tax revenue and ensuring that the development of e-commerce in the E.U. was not hindered by a distortive or disadvantageous tax regime. VAT accounts for nearly a fifth of Member States' tax receipts and, as an own resource, for 44% of the Community budget. It is understandable that the Commission would wish to protect the integrity of that revenue, particularly given its responsibility for the VAT system. It would be wrong however to address e-commerce solely in the context of a downside risk. The level of taxable activity is probably modest at the moment but the Internet has the capacity to become a major economic thoroughfare and wealth generating engine. It is essential that European business is at the front of this process and is not hampered by uncertainty about the future tax regime or by tax rules which fail to give a level playing field.

Despite subsequent statements by Commission officials, competition *and* VAT revenue concerns weighed heavily on the Commission's decision to release its proposal because the Commission

[65] Commission contended in its proposal that it consulted over 100 business representatives. These representatives included the Confederation Fiscale Europenne, ETNO, Eurocommerce, European Convergent Networks Association, ECTSG, European Mortgage Federation, FEDMA, Federation des Experts Comptables Europeens, GBDe, ICRT, and UNICE (Commission 2000b, 29).

knew that its proposal needed the approval of every Member State for it to become EU policy.[66] In fact, ECOFIN on July 6, 1998 endorsed various provisions of the Commission's June 1998 communication to ECOFIN, the European Parliament, and the Economic and Social Committee. These provisions included classifying digitally transmitted products as services and levying VATs on them. If the VAT concerns of the Member States, as claimed by Commission officials, were not very important in the Commission's formulation of its proposal, why did not the Commission propose to ban the VAT on digital services?

To understand how the economic interests of the European business community and the Member States guided the Commission in developing its June 2000 proposal, the four major components of the Commission's proposal will be presented and analyzed in terms of who benefited and lost economically. First, the Commission proposed that no new taxes would be levied on electronic commerce. Second, it contended that goods purchased electronically were already subject to the VAT as goods purchased by other means have been. Third, the Commission proposed including digital services, not covered by the 1999 telecommunications directive, within the VAT system by classifying digitally transmitted products as services, considering the place of consumption as the place of taxation, and taxing digitally transmitted services on business-to-business and business-to-consumer transactions through a system of VAT registration. Finally, it advocated measures to minimize the administrative and compliance burden, such as proposing one place of VAT registration for non-EU established businesses.

No New Taxes – Bit Tax

In its proposal, the Commission, backed by a July 6, 1998 ECOFIN decision, stated that it opposed new taxes on electronic commerce (Commission 2000b, 4). The most prominent of these new taxes was the bit tax.

When Professor Soete proposed the bit tax to the European policy community in the mid-1990s, he viewed it as a means to maintain tax revenues in the face of eroding tax bases caused, in large part, by globalization and technological changes. The bit tax gained the support of some Commission officials and many European politicians, including the Belgian and Italian governments, which were concerned that Member States would be unable to levy the VAT on certain kinds of electronic commerce (Alcock 1997, 23; "Connected: Joy over Veto"1997, 2; "Global Regulations: the Disappearing Taxpayer" 1997; Schenker 1997, 1).

Despite this support, European Commissioner Mario Monti publicly stated the Commission's opposition to the bit tax on April 7, 1997 when he (1997) asserted,

> Taxation also affects the development of electronic commerce. Tax rules must be clear; and the burden on this new form of business must not be heavier than that on traditional commerce. VAT already applies to electronic trade in goods and services, so there is no need to introduce new forms of tax, such as a "bit tax", within the EU. At the same time, governments need to address the tax avoidance and erosion concerns that are raised by the potential speed, untraceability, and anonymity of electronic commerce.

[66] Commission officials, including Commission Bolkestein, de-emphasized the concern for lost tax revenue and strongly emphasized the need to promote electronic commerce in the EU by ending the VAT discrimination against EU established vendors of digital services (Bolkestein 2001; Bill 2001; Kerrigan 2000, 4).

Monti's pronouncement against the bit tax was reiterated in the Commission's April 15, 1997 communication to the European Parliament, ECOFIN, Economic and Social Committee, and Committee of the Regions (Commission 1997, 19).

Meanwhile, the most plausible explanations for why the Commission and many Member States rejected the bit tax were because they could substitute the existing VAT for this tax, and they, under pressure from the European business community, had strong reservations about how it would affect the development of electronic commerce. The business community opposed the bit tax because it saw this tax as undermining electronic commerce's development and did not think Internet usage merited a special tax. George Hall, Director of Corporate Affairs with ICL, (Hall 2001, 2001) called it a "loony idea."[67] Roger Wilson, Director of Public Affairs for Hewlett-Packard Europe (Schenker 1997, 1) stated, "Our fear is that a bit tax would be an incremental tax and further erode the competitiveness of Europe." Meanwhile, Harold Summa with Electronic Commerce Forum, a German association of ISPs, contended that he did not oppose levying VATs on physical goods bought via the Internet, but he argued that a bit tax would be detrimental to businesses (Schenker 1997, 1). Ian Taylor, the United Kingdom's Science and Technology Minister, criticized a bit tax because it would impede electronic commerce's development, although he supported the idea that electronic commerce should be taxed, (Alcock 1997, 23).

Since the Commission's decision in 1997, various business groups have continued to oppose the bit tax, in case the Commission would change its mind. These groups have included the Alliance for Global Business (AGB),[68] the European e-Business Tax Group (EeTG),[69] EuroCommerce,[70] the Global Business Dialogue on Electronic Commerce (GBDe),[71] the

[67] Fujitsu owns ICL, but ICL has its headquarters in the UK.

[68] The founding members of the AGB are the Business and Industry Advisory Committee to the OECD (BIAC), Global Information Infrastructure Commission (GIIC), International Chamber of Commerce (ICC), International Telecommunications Users Group (INTUG), and World Information Technology and Services Alliance (WISTA) (ABD 1999, 47). INTUG is a global organization, and several of its full members have been the Association Francaie des Utilisers du Telephone et des Telecommunications, Australian Telecommunications Users Group, the Belgian Telecommunications Users Group, the Camara de Empresas de Software y Servicios Informaticos, the Hong Kong Telecommunications Users Group, and the International Communications Association (INTUG 2001). WITSA is an association of 39 information technology associations from countries around the world. The Bundesverband Informationstechnologien, the Information Technology Association of Canada, the Information Technology Association of Canada, Israel Association of Software House, the Japan Information Service Industry Association, the Singapore Information Technology Federation, the Swedish IT – Companies' Organisation AB, and Syntec Informatique are a sample of WITSA's members (WITSA 1999).

[69] The EeTG had consisted of ABB, Agilent, Cisco Systems, Compaq, Deutsche Post, DHL, EDS, Ericsson, France Telecom, GE Capital, Gefco, Hewlett-Packard, IBM, ICL, KPN, Microsoft, Omnitel, Proctor & Gamble, Sony, and the TNT Post Groep. Amdahl, EMC, and Oracle with the ECITA also supported this EeTG comments. PricewaterhouseCoopers has served as the EeTG's secretariat (EeTG 2000; EeTG 1999b, 5). In addition, PricewatershouseCoopers has been very involved in the Electronic Commerce Tax Study Group (ECTSG) in the US (Lejeune 1999, 3).

[70] EuroCommerce is the European peak association for retail, wholesale, and international trade businesses.

[71] The GBDe began on January 14, 1999 (GBDe 1999a). As of August 30, 2000, the GDBe had seventy-one member companies from around the world (Industry Observer 2000). Alcatel, AOL, Bertelsmann AG, Deutsche Bank, Deutsche Telecom, EDS, France Telecom, Fujitsu, Hitachi, Ltd., KPN, Nokia Corporation, Nortel Networks, MCI WorldCom, Siemens, Telefonica S.A., Telefonos de Mexico, S.A. de C.V., Time Warner, and

International Communications Round Table (ICRT),[72] the Transatlantic Business Dialogue (TABD),[73] and Union of Industrial and Employers' Confederations of Europe (UNICE)[74] (AGB 1999, 35; EeTG 1999a, 2; EuroCommerce 1998, 1; GBDe 1999b; ICRT 1998, 5; TABD 1998; UNICE 1999a, 5).

Treatment of Goods Ordered Electronically

In its June 2000 proposal, the Commission contended that Member States would continue to levy VATs on goods purchased electronically (Commission 2000b, 3). Most likely, the Member States influenced this Commission's position more than the business community did. The Member States wanted to continue the value-added taxation of goods purchased through electronic means because they wanted to maximize their VAT revenues. Expressing this sentiment, the Commission's Working Group N° 1 in its June 8, 1999 working paper (Commission 1998, 4) stated,

> For businesses involved in e-commerce, and for their advisors, the message from tax administrations is that existing taxes can and will be applied. The only question is how. It is inconceivable that today's tax environment – which favors non-E.U. e-commerce and threatens E.U. tax revenues – will remain forever. The potential for tax loss is too great and the distortive effect will deflect the benefits which might otherwise accrue to European economies.

Venezuela Analitica Editores, S.A., were among its members then (GBDe 2000; Industry Observer 2000). Chief executive officers, board members, and/or other high-ranking officials from these companies participate heavily in the GBDe's functions. At that time, AOL Chairman and Chief Executive Officer Steve Case and Time Warner Chairman and Chief Executive Officer served as GBDe Overall/Americas Co-Chairs (GBDe 2000).

[72] The ICRT is an informal group of over thirty publishing, media, computer, and communications firms (ICRT 2000a). These firms have included ABN-Amro, Academic Press Ltd., American Express Services Europe, Ltd., AOL Bertelsmann Online Europa GmbH, Bertelsmann AG, British Telecom, EDS, IBM, ICL plc, KPN, Microsoft Europe, Nortel, Philips Electronics, Reuters Ltd, Siemens, The Walt Disney Company, Time Warner Europe, and Vivendi (ICRT 2000b).

[73] Established in Seville, Spain at a November 1995 conference that was attended by chief executive officers from more than 100 US and EU companies, the European Commissioners for Trade and Industry, and the US Secretary of Commerce, the TABD provides a forum where US and European companies develop joint policy recommendations on trade in consultation with the US and the European Commission (TABD 2000). PricewaterhouseCoopers, Electrolux, Lafarge, United Technologies, Xerox, Philips Electronics, BASF, and Tenneco, AOL, Erissson, Deutsche Telekom, Arthur Andersen, Time Warner, and ICL have been some of its participating companies (TABD 2001a; TABD 2001b).

[74] Established in 1958, UNICE represents more than 16 million small, medium, and large companies engaging in European commerce, and over 106 million people work for these firms. Furthermore, it has 39 industrial and employer federations from 31 European countries as its members (UNICE 1999b, 3). These federations include the Federation des Enterprises suisses (ECONOMIESUISSE), Bundesverband der Deutchen Industrie e.V. (BDI), Bundesvereinigung der Deutschen Arbeitgeberverbande e.V. (BDA), Danish Employers' Confederation (DA), Confederation des Employeurs Espagnols (CEOE), Mouvement des Enterprises de France (MEDEF), Employers' Confederation of Service Industries in Finland (PT), Confederation of Finnish Industry and Employers (TT), Confederation of British Industry (CBI), Confederazione Generale dell' Industria Italiana (CONFINDUSTRIA), Irish Business and Employers Confederation (IBEC), Federation des Industriels Luxembourgeois (FEDIL), Vereniging (VNO-NCW), and Confederation of Swedish Enterprise (UNICE 2001).

Meanwhile, the European business community accepted this policy position.

Inclusion of Digital Products

The Commission in its proposal classified digitally transmitted products as services and sought to include digital services, outside the scope of the 1999 telecommunications directive, under the EU VAT system by making the place of consumption as the place of taxation, and taxing digitally transmitted services on business-to-business and business-to-consumer transactions through a system of VAT registration.[75] The Commission acted for three reasons. First, the Member States were worried about losing VAT revenues from electronic commerce. Second, the current VAT system has benefited third country suppliers of certain digital services and penalized comparable EU-established suppliers. Politicians in several Member States probably feared that this circumstance would hurt these EU-established firms financially, and these politicians feared that the owners and employees of these firms would not support them politically if their companies began losing money and laying off workers. Third, telecommunications firms pressured their Member States and the Commission, and some Member State politicians may have been concerned about their governments' investments in their national telecommunications firms that were moving into electronic commerce. Finally, the UK wanted to please politically influential Sky TV.

Losing VAT Revenues

Commission documents used to prepare for its June 7, 2000 proposal expressed the Commission's concerns and its awareness of Member States' concerns about losing VAT revenues from electronic commerce. As quoted above, the Commission's Working Party N° 1 in its June 8, 1999 working paper had expressed their VAT revenues concerns. Moreover, this working party in its April 3, 1998 working paper had also expressed these concerns when it (Directorate-General XXI Customs and Indirect Taxation 1998, 7) asserted,

> VAT accounts for 18.6% of the tax revenues of Member States (1994 figure, including social contributions) and, as an own resource, 44% (1996 figure) of the Community's own budget. The risk to these revenues from network commerce lies in business and private individuals exploiting any uncertainty in the VAT regime to achieve savings in tax payment. Under the VAT system, problems will arise which have the potential to diminish the power of tax administrators to enforce taxation.

Member State officials participated in the production of this April working paper because three smaller working groups consisting of Commission and Member State officials had contributed to this paper (Directorate-General XXI Customs and Indirect Taxation 1998, 9).

While the VAT losses were small in 2000 because trade in digitally transmitted, services was small then, Commission and Member State officials were aware of economic forecasts that predicted an enormous future growth in digitally transmitted services. Meanwhile, current VAT

[75] The scope of the digital services covered under the Commission's June 7 proposal are, services supplied electronically and the supply of rights to use these services. These services include the following: "…cultural, artistic, sporting, scientific, educational, entertainment or similar activities, including the activities of the organizers of such activities, and where appropriate, the supply of ancillary services (Article 9 (2) (c) first indent) this includes all forms of broadcasting as well as other sound images released and delivered by electronic means…" (Commission 2000b, 12-13) Furthermore, computer games, data processing, information, software, Web-design, and Web-hosting supplied by electronic means also are within this proposal's scope (Commission 2000b, 13).

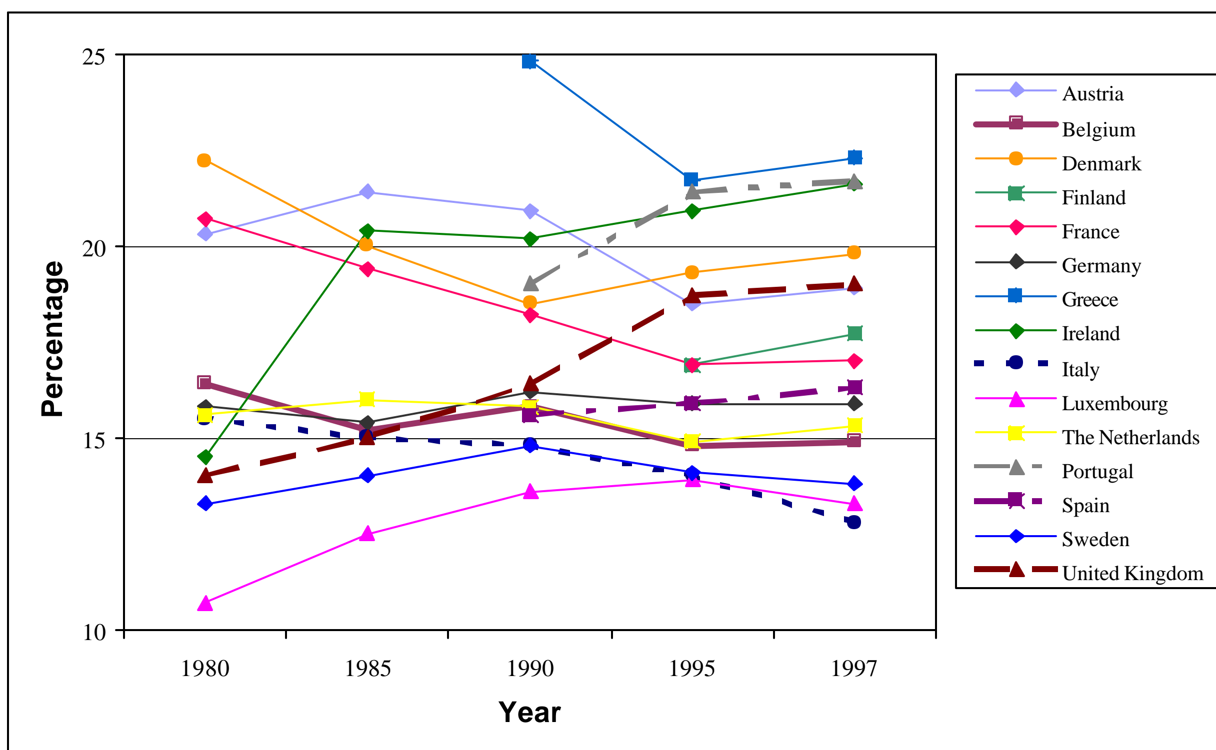

Figure 4: VAT Revenues for Each Member State as a Proportion of Total Revenues between 1980 and 1997
Source: European Communities (2000a, 80). The data is partly estimated for Denmark, Greece, Italy, Portugal, Spain, and the United Kingdom.

law, as discussed earlier, has problematic framework and enforcement mechanisms for sales of certain digitally transmitted services. These problems would cause Member States potentially to lose large amounts of future VAT revenues unless mechanisms were found to facilitate the levying of VATs on third country exports to the EU.

The current losses and potentially much greater losses of VAT revenues are important because the Member States and the Commission have been very dependent on VAT revenues to fund their budgets (see Figures 4.3 and 4.4 below). In 1997, twelve of the fifteen Members States depended on VAT revenues for 14.9 percent or more of their total revenues (Commission 2000a, 80). In 1999, the European Community depended on VAT revenues for about 36 percent of its total revenues, but, unlike the Member States, little evidence was found indicating that Commission politicians and bureaucrats were motivated to make the Commission's proposal on digital services because they feared the Commission would lose VAT revenues for its budget. In addition, no evidence was found suggesting that the Commission and Member State politicians and bureaucrats acted for material reasons, such as pay raises.

Member States' revenue concerns partly explain a couple major administrative and compliance provisions in the Commission's proposal, which were included to enable Member States to collect their VAT revenues. These provisions were the reverse charge mechanism on business-to-business sales of digital services by third country vendors to EU-established vendors

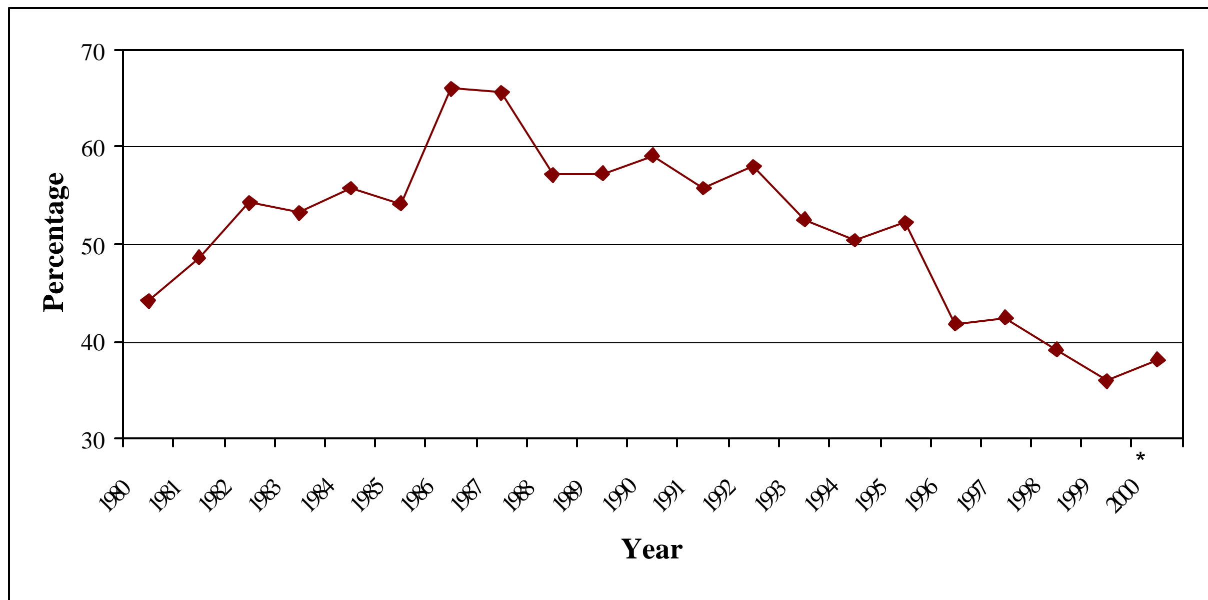

Figure 4: VAT Revenues as a Proportion of the Total Revenues for the European Communities

Source: European Communities (2000b, 6, 42-43). This EU data comes from the European Community budget because this budget is the EU's largest budget and provides the Commission's funding. * Budget 2000.

and language calling on the Member States to levy the VAT on business-to-consumer sales of digital services by third country vendors to EU-established vendors.

VAT Discrimination against EU-established Firms

Under present VAT law, Member States taxed certain digital services supplied by EU-established firms to third country customers, but the Member States and foreign countries generally did not tax comparable sales to the EU customers. As remedies, the Commission proposed to end VAT discrimination against EU-established vendors of digitally transmitted services by making the place of consumption as the place of taxation, implementing "reverse-charge" mechanisms for business-to-business transactions, and establishing VAT registration for non-EU established firms selling these services their to private customers in the for applying the VAT to digitally transmitted services. In other words, digital services, supplied by non-EU established firms located in third countries, for consumption within the EU would be subject to the EU's VAT, and these services, supplied by EU established firms, for consumption outside the EU are not subject to this tax (Commission 2000b, 4).

Consequently, an economic distortion, albeit a small one, has existed where VATs have frequently not been levied on digital services exported by non-EU established suppliers located in third countries to EU customers, while VATs and possibly foreign taxes have been levied on digital services exported by EU established suppliers to their customers in third countries. Gerard de Graaf, Trade Counselor at the Delegation of the European Communities in Washington, DC stated that in 1999 total electronic commerce sales in the US were less than 1 percent of GDP and comparable sales in the EU were about .2 percent of GDP, he contended that this distortion was "big enough to see, but small enough to solve." (Gnaedinger 2000)

The Commission contended that this distortion has favored non-EU electronic commerce firms over comparable EU firms. The Commission sought to correct this distortion by changing the place of taxation from the place of supply to the place of consumption and by requiring non-EU established firms selling from a third country to customers in the EU to register in a Member State for VAT purposes.

From the perspective of the Commission, the Member States, and EU-established electronic commerce firms, this situation needed correcting for two reasons. First, economic and market analysts have forecasted that digitally transmitted services will play an increasingly larger role in the EU economy, but the US has dominated the EU market because the US has many of the leading news, entertainment, and information technology companies. Second, the high VAT rates, and the VAT laws concerning the current place of taxation have hindered the ability of EU-established suppliers of these services to compete with comparable US based suppliers.

Potentially Lucrative Market Dominated by US Firms --

The market for digitally transmitted services is important for EU firms and their governments because the future economic potential of this market is very large and they want to begin benefiting from this potential in the beginning stages. Once the broadband infrastructure, such as cable, fiber optics, and wireless technologies, have been developed and distributed on a widespread basis, bandwidth will increase dramatically, and it will be possible to watch films and play music with high quality pictures and sounds streaming into your home over the Internet. As higher bandwidth lowers the time to download large amounts of software from several hours to a few minutes, worker productivity and consumer convenience would increase. Many companies, such as Sun Microcomputers, have already begun acting as an application service provider by supplying software over the Internet, and Microsoft is already hedging its bets by exploring how to renting their software to their customers over the Internet as opposed to the traditional method of selling their software in computer stores. Meanwhile, suppliers of hardware and other information technology equipment will benefit as they support and continue to build a broadband infrastructure (Commission 2000c, 4)

US firms have generally been one or two years ahead of similar EU firms in taking advantage of this potentially lucrative market, despite the strong efforts of EU firms to catch up (Cornet and Milcent 2000, 31-34). US firms have been global leaders in supplying Internet access, content, and other digital services and have moved aggressively to market these products in the European Union.

Market share, trade, audience, and entertainment data provide some indicators of how US firms generally have been beating EU firms in the digital arena. In the late 1990s, the US, Europe, and Japan had 52, 33, and 15 percent of the world market in online information, respectively (Commission 2000c, 4). In a December 14, 1999 Communication to the Council of Ministers, the European Parliament, the Economic and Social Committee, and the Committee of the Regions, the Commission reported that US audiovisual products have between 60 and 90 percent of the Member States' audiovisual markets, but comparable EU products have only 1 or 2 percent of the US market. These products include film box office sales receipts, video sales and rentals, and TV programming (Commission 1999, 7).

In *The Prospects of International Trade in Services*, a report published by the Friedrich Ebert Foundation and supported financially by the Commission, Dietrich Barth revealed that the US with 40 percent of the world's trade in movies, videos, and TV programs, has increased its domination of the EU market (Barth 1999, 2 & 66). Broadcasters in the Member States, on average, have imported about two-thirds of the entertainment that they air. The EU's trade

deficit with the US for cinema and TV movies rose from ECU 1.8 billion in 1988 to ECU 3.2 billion in 1994 (Barth 1999, 66). For these films, the US had about a $2.5 billion global trade surplus, but France, Italy, and Germany had global trade deficits of $411 million, $375 million, and $1.6 billion, respectively (see Table 7 below).

High VAT Rates and Place of Taxation --

The European Commission, Member States, and EU established businesses were facing this competitive environment in the late 1990s and early 2000s, and the VAT system hindered

Table 7: 1994 Trade Balances in Cinema and TV Films for Selected Countries (US$ Millions)

Country	Net Trade Surplus/Deficit
US	2,484
France	-411
Italy	-375
Germany	-1,609

Source: Barth 1999, 67. These figures are based on Different definitions. For instance, the US figure only includes rented films, which suggests that the US surplus is larger.

and would increasingly impair the ability of EU established firms to compete with US-based and other third country firms. Confronting this American digital onslaught, the Commission, under pressure from EU established suppliers of digital services and, more importantly, the Member States, which also were under pressure by these suppliers, formulated its June 7, 2000 proposal on VAT and digital services. As Commission Bolkestein (2000) put it,

> The fundamental reason for making the current proposal is to remove the competitive handicap currently affecting our EU providers on both the domestic and world markets. We propose to do this by removing the obligation on EU suppliers to levy VAT on digital products sold to customers outside the Union. At the same time, we will ensure that non-EU operators face the same tax obligations as domestic operators when they sell to consumers within the EU. In doing this, we are simply ensuring that our tax system is in conformity with the principles set out in Ottawa. Since Ottawa, the Commission has undertaken an extensive programme of consultation with industry and with national tax administrations on how the principles should be applied. What we have proposed is the outcome of these consultations.

EU established suppliers of digital services have been hindered in their efforts to compete with US based suppliers of these services because the current VAT rules on the place of taxation force EU exporters of these services to pay high VAT rates on their sales to customers in third countries and possibly pay third country taxes on their sales. VAT rates for these services range from 15 percent in Luxembourg to 25 percent in Denmark and Sweden (see Table 8 below). Coincidentally, much of the European information technology industry, particularly the wireless

Table 8: 1999 VAT Rates in the Member States on Digitally Transmitted Services (%)

Member State	Standard Rate
Austria	20
Belgium	21
Denmark	25
Finland	22
France*	20.6
Germany	16
Greece	18
Ireland	21
Italy	20
Luxembourg	15
The Netherlands	17.5
Portugal**	17
Spain	16
Sweden	25
United Kingdom***	17.5

Source: Murrath and Lejeune (1999, 4, 198, & 329). *Corsica is excluded from France. ** The Azores and Madeira Islands in Portugal levy a 12% VAT on these services. The United Kingdom's Channel Islands do not levy the VAT and are considered as a third country.

sector, is located in Scandinavian countries, very high VAT rate countries.

As the Commission developed its proposal, EU established firms, including EU-established subsidiaries of third country corporations, supplying digital services expressed through their trade associations their desire to change the place of taxation from the place of supply to the place of consumption because the Member States must levy these high VAT rates on their exports of these services to third countries. EuroCommerce, European Public Telecommunications Network Operators (ETNO),[76] the EU Committee of the American Chamber of Commerce in Belgium (EU Committee),[77] and the ICRT contended that the Member States should levy the VAT in a neutral manner (EuroCommerce, 1998, 1; ETNO 1999b; ICRT 1998, 3). While the EeTG, ETNO, EU Committee, ICRT, and UNICE argued that this VAT discrimination against EU suppliers should end. However, the ICRT, as a policy option, the ICRT suggested a delay in levying the VAT on sales by third country suppliers of these services to private EU customers (EeTG 1999a, 2; EeTG 1999b, 2; ETNO 1999b; ICRT 1998, 6; ICRT

[76] As of December 2000, ETNO had 44 full members, including Belgacom, British Telecom, Deutsche Telekom, Eircom, Entreprsise des Postes et Telecommunications Luxembourg, France Telecom, KPN, Portugal Telecom, Telefonica, Tele Danmark, Telekom Slovenije, Sonera, Telekom Austria, Telenor, Telia, and Viatel UF, Ltd. (ETNO 1999a). An ETNO reflection document (2001) represents "a statement which has not been opposed, fully or partially, by more than 33 percent of the Members."

[77] The EU Committee represents the policy views of over 147 American firms that operate in Europe and are controlled or owned by US nationals. Arthur Andersen, AT&T, Bell Atlantic, Compaq, EDS, Hewlett-Packard, IBM, Intel, Microsoft, Motorola, Sun Microsystems, Viacom, and the Walt Disney Company are among its members (The EU Committee 2000a).

1999, 3; UNICE 1999a, 5-6). The ICRT presented this option because it believed the compliance costs would outweigh the small amount of revenue collected (ICRT 1998, 6; ICRT 1999, 3).

Keeping the place of supply as the place of taxation along with the high rates accompanying the place of supply have made it difficult for EU firms and EU-established subsidiaries of third country corporations to sell at a competitive price and have benefited mainly US based firms as they have competed in US and EU electronic commerce markets.[78] European business groups and the Commission emphasized this competitiveness concern, an ETNO reflection document (1999b) read, "Although many different figures concerning the growth of E-Commerce are circulating, it is obvious that within a few years companies will make significant sales through the Internet to private persons, and therefore VAT will become a pricing issue and also a major competitive advantage."[79] Echoing ETNO's concerns, the Commission (2000b, 6) in its proposal asserted, "These [existing rules] have the potential to constitute a major distortion of competition and to place EU service providers at a competitive disadvantage in relation to non-EU suppliers. This is clearly an untenable situation and its rectification is an immediate objective of the current proposal."

Telecommunications Firms

European telecommunications firms sought to end VAT discrimination against them and and to clarify VAT law governing services by standardizing them. ETNO sought to modify VAT law so that their digitally transmitted exports to third country consumers would not be taxed and that comparable sales by third country firms to EU private consumers would be taxed. Many ETNO members, European telecom companies, wanted this change because they had already sold digital services, aside from traditional telecommunications, such as phone calls, or they were moving into the digital content and other digital services (Gregory 2001). British Telecom, Deutsche Telekom, France Telecom, KPN, Portugal Telecom, Sonera, and Telekom Austria are several telecommunications firms that have sold data services, digital content, online software, media services, and/or Web hosting (Ewing *et al.* 2000, 22; Market Guide 2001a; 2001b; 2001c; 2001d, 2001e, 2001f, 2001g, and 2001h; Hoover's Online 2001d). VAT rules discriminating against these firms, hindered their ability to compete with third country firms in the EU. British Telecom, France Telecom, and KPN feared that this discrimination would cause them to lose market share to their third country competitors that they could not regain (Gregory 2001). *Ceteris paribus*, if they could change the VAT code to tax the imports of these digital services supplied by these third country firms to EU private consumers and remove the VAT on exports of these services to third country private consumers, they would make themselves more competitive and profitable.

European telecommunications firms, especially KPN, and other providers of bundled, digitally transmitted services wanted the Commission to propose a standard set of rules for digitally transmitted services (de Putter 2001). Because bundled, digital services by definition incorporate different services, Member States tax separate components of that bundled service differently.

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[78] Of course, these VAT rates did not make US dominant in electronic commerce because a variety of other factors, such as the US's large internal market and technological innovations, were more important, but these VAT rates have helped US digital suppliers in the EU.

[79] An ETNO reflection document (2001) represents "a statement which has not been opposed, fully or partially, by more than 33 percent of the Members."

Ambiguous and, at times, contradictory VAT laws governing the taxation of services complicates this already complex VAT structure. Without certain changes, VAT laws, particularly Articles 9.1, 9.2(c), and 9.2(e), would apply the VAT on supplies of certain digital services in a complicated and contradictory manner. For instance, Article 9.1 provides that Member States tax certain digital services at the place of supply; Article 9.2(c) contends that Member States tax certain digital services where these services are "physically carried out;" and Article 9.2(e) provides that Member States tax certain digital services according to where customers consume them (Murrath and Lejeune 1999, 266-269). Depending on how Member States interpret these provisions, they could tax the same service under different VAT provisions. KPN has been one of those firms that has wanted the Commission to propose a standard set of rules for applying the VAT on its bundled, digitally transmitted services to reduce its administrative and compliance costs (de Putter 2001).

However, the executives and private shareholders of these EU established telecommunications companies are often not the only persons who want their firms to earn higher profits. Many of these telecommunications firms have been partially government owned (see Table 9 below), and many Member State politicians have two economic interests in making these firms more profitable. First, several Member States still partially owned their national telecommunications firms and if one of these firms became unprofitable and layoffs

Table 9: Selected Telecommunications Firms by the Proportion of Member State Ownership in 2001

Telecommunications Firm	Member State	Ownership (%)
Belgacom	Belgium	50
Deutsche Telekom AG*	Germany	45
France Telecom	France	54
KPN	The Netherlands	35
Sonera Corporation	Finland	53
Telekom Austria	Austria	48
Telia AB	Sweden	71

Source: Hoover's Online (2001a, 2001b, 2001c, 2001e, 2001f, 2001g, and 2000h). With Deutsche Telekom's purchase of VoiceStream PowerTel, the German government's equity in Deutsche Telekom dropped from 60 percent to 45 percent (Hoover's Online 2001a).

ensued, it might reflect poorly on the Member State's political leadership since these firms often employed many citizens who vote. Second, politicians would prefer that these firms make profits, and a portion of these profits flow into the national treasuries. Then, politicians could distribute these public funds to reward their key supporters.

Sky TV

Meanwhile, the UK supported the change in the place of taxation and the inclusion of broadcasting within the scope of the Commission's proposal partly because of pressure from Sky TV. Currently, Sky TV must collect VAT on its broadcasts to the UK's Channel Islands, which are exempt from the VAT system. By changing the place of taxation to the place of consumption, VAT would no longer be levied on Sky TV's broadcasts to these islands.

Administration and Compliance Burdens

The Commission's June 7, 2000 proposal sought to reduce administration and compliance burdens for the Member States and businesses by proposing for business-to-business sales the use of the reverse charge mechanism and the existing VAT registration system and for business-to-consumer sales one place of VAT registration, sales thresholds, credit card billing systems, and electronic invoicing. With input from the business community and the Member States, the Commission in drafting its proposal, reflected and balanced their economic interests.

Reverse Charge and Existing VAT Registration

The Commission proposed using the reverse charge mechanism with the existing VAT registration system for business-to-business sales of digitally transmitted services sold by a non-EU established supplier to an EU-established business because it minimized administrative and compliance burdens and costs for Member States and businesses. Bolkestein (2000) explained, "The compliance model which we are proposing is designed to be as simple as possible. For business-to-business transactions, which account for by far the greater part of on-line transactions there is no charge. Tax will continue to be accounted for in the EU under the reverse charge system – in other words, traders will asses their own VAT liability."

For these reasons, the reverse-charge mechanism had the support of the Member States and various trade groups, including the EeTG, EU Committee, ETNO, and UNICE (EeTG 1999a, 4; ETNO 1999b; EU Committee 2000b, 6; UNICE 1999a, 9; UNICE 1999c, 2). For example, ETNO (1999) contended, "…the reverse charge mechanism has proven to be a company-friendly way of dealing with VAT, not only for supplies from outside the EU but also for supplies within the EU, and even within a Member State."

Single Place of VAT Registration

The Commission, Member States, and the business community influenced the Commission's decision to propose one place of VAT registration for non-EU established firms selling certain digital services to private consumers in the EU. The Commission and perhaps some Member States viewed one place of VAT registration within the EU as an effective way to collect revenues from non-EU established firms, but as subsequent events would reveal, many Member States would have preferred these firms to register in each Member State where these firms sold services above a low sales threshold.

Several influential trade associations representing EU established firms were open to considering or supported third country firms registering in at least one Member State for VAT purposes. ETNO suggested either single or multiple VAT registration for third country firms supplying digital services to EU private consumers as long as EU-established firms were treated equally (1999b).

The ICRT, consisting of EU firms and EU-established subsidiaries of American companies, presented two options to ensure that third country firms selling digital services to EU private consumers would collect and remit the VAT owed. First, the ICRT suggested that third country and EU-established suppliers of these services should be allowed to register in a single Member State of their choice, provided they have sales there. Second, the ICRT recommended that that the EU allow these companies to outsource use a trusted third party as part of a possible VAT compliance solution. These firms could choose either option (ICRT 1999, 5-6).

UNICE, the huge European peak association representing employers, advocated one place of VAT registration for all third country suppliers of digitally transmitted services for two reasons. First, UNICE argued that a single place of VAT registration was needed to provide an incentive for third country suppliers to comply with the VAT system by reducing the compliance

burdens for these firms. Otherwise, these suppliers would evade collecting VAT on their sales to EU private consumer if the procedures were too burdensome. UNICE contended that a single place of registration would eliminate much of that burden. Second, UNICE argued that VAT administration and enforcement would be much simpler and less costly for tax authorities in the EU if third country suppliers registered in one as opposed to potentially fifteen Member States (UNICE 1999a, 10-12). European businesses had an economic interest in ensuring that their third country competitors paid a VAT because European business would possibly be paying VAT in third countries.

In its June 8, 1999 response to the Commission's June 8, 1998 working paper, the EeTG with the support of Amdahl, EMC, and Oracle proposed that EU established and third country firms making business-to-consumer sales of digital services have the choice between two options for VAT purposes (EeTG 1999b, 1 & 5). The first option provided that EU established and third country suppliers should have an opportunity to register in a single Member State for VAT registration purposes and be able to report in one VAT return to this Member State the VAT that they levied on transactions made in the EU. While ensuring that this option does not distort competition within the EU, the EeTG proposed that these firms would levy at the VAT rate of the Member State in which they registered for VAT purposes. If this option were not feasible in the short-run, the EeTG advocated that the implementation of a single place of VAT registration for these suppliers. These suppliers could report the VAT that they collected to their Member State of VAT registration, and they could submit a VAT return containing fifteen boxes to report the VAT owed for every Member State at their respective VAT rates. The second option called for these suppliers to outsource the administration of their VAT responsibilities to a third party. This party could be a bank, credit card company, a telecom operator, or another firm (EeTG 1999b, 2-3).

The EU Committee recommended in a February 1, 2000 position paper an approach sharing many features of the EeTG's approach. The EU Committee proposed that third country *and* EU-established suppliers should have a choice between registering at single place of VAT registration or using a third-party VAT collection system where they *could* outsource their VAT obligations to banks, credit card companies, telecom firms, or another business. If an EU-established firm based in Sweden decided to register in one Member States for VAT purposes regarding its sales to private EU consumers, it could register in Luxembourg, even if this Swedish firm had no presence there. This option would ensure that VAT neutrality would exist between it and other EU firms and third country firms who could register in one place (EU Committee 2000b, 5).

<u>Sales Thresholds</u>

Meanwhile, the business community concerns about compliance costs influenced the Commission to include the sales threshold provisions in its proposal for determining whether non-EU established firms must register in a Member State. To reduce the compliance burden of third country suppliers of digital services to private consumers in the EU, the ICRT in October 1998 recommended that the Commission consider the establishment of sales thresholds and one place of VAT registration for these suppliers (ICRT 1998, 7).[80] Below a sales level, a third country supplier would escape taxation, but above it, the supplier's sales to private EU consumers would be taxed. For those sales above this threshold, VAT registration in one Member State would reduce the compliance burden on third country firms. Many American subsidiaries established in the EU, such as IBM, may have wanted or wanted these provisions

[80] The ICRT seemed to back away from supporting a threshold in December 1999 (ICRT 1999).

because many of their or their corporate parent's customers were small and medium sized companies who are located in third countries. The timing of the ICRT's proposal in October 1998 strongly suggests that the Commission may have borrowed this threshold idea from the ICRT since the Commission first mentioned in a major policy document the possibility of using it in Working Party N° 1's June 8, 1999 working paper (Directorate-General XXI 1999, 12).

Regardless of who conceived idea first, the Commission accounted for business concerns by introducing these thresholds to make VAT compliance for businesses simple. Bolkestein (2000) asserted,

> For businesses outside of the EU, it will only be the case of sales to consumers that they will be required to register for VAT purposes and charge VAT. Even then, the proposal applies only to the bigger players whose annual sales to private consumers in the EU exceed 100,000. They will have the option of registering in a single Member State. These requirements have been designed to encourage compliance to the greatest extent possible the threshold is high and the registration requirements are as simple as possible.

While the Commission's proposal would correct one aspect of the adverse VAT discrimination facing EU established vendors vis-à-vis third country vendors, the Commission's proposed threshold provisions would not remedy the VAT discrimination against EU established firms within the EU.[81] First, the threshold requiring an EU established firm to register for VAT purposes in a Member State would be much lower than that of a comparable third country firm supplying its digital services to its private EU customers. This means that young and small EU businesses would likely have higher transactions costs because they would often have to register for VAT purposes before its third country counterpart. Second, EU established firms with sales above the low VAT registration threshold would have to levy at the VAT rate of its Member State, but third country firms with sales above the 100,000 Euros threshold could choose to register in any Member State where they have sales. These firms would then, collect taxes on its sales throughout the EU at the chosen Member State's VAT rate.

Two hypothetical examples illuminate the economic implications of these rules. In the first example, Allen.com decides to export by transmitting software to its customers in the EU, but because its EU sales of 70,000 Euros do not exceed 100,000 Euros per year threshold, its tax accountant does not need to register Allen.com with a Member State. It would effectively avoid paying the VAT because it would not have to register. Meanwhile, Stockholm.com sells the same product to its Belgian customers and generates the same amount of annual sales, but it would have to register if one assumes the annual Belgian threshold for registration is less than 70,000 Euros. *Ceteris paribus*, Allen.com would have a competitive advantage over

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[81] Refreshing the reader's memory, the Commission put into its proposal a plan for third country suppliers of digital services to EU private consumers to register in one Member State for VAT purposes, provided the supplier had sales in the Member State chosen and that these sales exceeded 100,000 Euros annually in the EU. This vendor would charge the VAT rate of its Member State of registration for sales through the EU. Below this threshold, the third country vendor did not have to register in any Member State. Meanwhile, a EU firm must register for VAT purposes in the Member State where it is established if its sales exceed a certain threshold. Member State thresholds for VAT registration are much lower than the proposed 100,000 Euros threshold for third country vendors (Lejeune 2000, 8). Assuming that its sales exceed its Member State's threshold for VAT registration, these rules mean that this EU-established firm must levy a VAT at its Member's State rate on its sales of digitally supplied services.

Stockholm.com since the former would have lower transaction costs than the latter and it could avoid paying the VAT. In a second example, one assumes that each firm has enough sales requiring each firm to register for VAT purposes. Allen.com could decide to sells a few services in Madeira or in Luxembourg where it would only have to charge VAT at 12 percent or 15 percent, respectively, for all of its services throughout the EU. Meanwhile, Stockholm.com would charge a whopping VAT rate of 25 percent on its sales throughout the EU. *Ceteris paribus*, Allen.com would have a considerable competitive advantage over Stockholm.com in the EU market.

The Balancing Act

Despite the positions of European businesses, why did the Commission decide not to offer the same VAT registration and sales threshold provisions to EU established vendors that it offered to third country ones?[82] From a public choice perspective, it would seem that the Commission sought a compromise balancing the economic interests the Member States and businesses and based its balancing act on two calculations. First, the Member States politicians did not want to give up their right to levy high VAT rates. Member State politicians probably wanted to continue to provide the increasingly expensive government social services that their citizens have expected. Second, the Commission probably figured that though complaints would come from EU-established suppliers of digital services, these suppliers would be satisfied enough with the Commission's proposal. It would end the taxation of these EU suppliers' exports to third countries, tax their competing third country's exports of digital services to the EU, and encourage these third country firms, who sell more than 100,000 Euros of these digital services to the EU private consumers, to register for VAT purposes in a Member State where they have sales. While these third country firms probably would choose to register in Luxembourg with its 15 percent VAT rate on these services and provided they have sales there, their sales would at least be charged some VAT on their intra-EU sales.

ECOFIN Action

The Commission's proposal provoked debate in ECOFIN, and several Member States, perceiving that the Commission's proposal as written did not sufficiently represent their economic interests, offered amendments to the Commission's proposal. The Members States generally did not oppose the provisions in the Commission's proposal concerning business-to-business electronic commerce transactions of goods and services, but every Member State, except for Luxembourg opposed the business-to-consumer provisions of the Commission's proposal because they did not view these provisions as being in their economic interests.

Luxembourg Support for the Commission

Luxembourg was the only Member State to support the business-to-consumer provisions of Commission's proposal because it would have benefited economically from them (Luxembourg Government Official 2000). Under these provisions, third country companies would have three incentives to register for VAT purposes in Luxembourg. First, Luxembourg's VAT standard rate of 15 percent is the lowest for an entire Member State, so a third country firm would have more of an economic incentive to register there than in other Member States, such as Denmark, Finland, or Sweden because its products, *ceteris paribus*, would have a competitive advantage over most of its EU-established competitors. Dimitri Kalogeras, an attorney with EuroCommerce complained, "This would give a competitive advantage to US companies."

[82] The EU Committee is considered here as part of the European business community since it represents EU-established subsidiaries of US-based corporate parents.

(Stone 2000) Kalogeras claimed, "They would all go to Luxembourg, the Netherlands, the UK or Ireland, where the tax rates are lower." (Stone 2000) Second, Luxembourg's business location, infrastructure, and service economy are among the best in the EU, which makes it an ideal location, if that firm would decide to set up physical operations in Europe. Third, Luxembourg would probably attract US firms because many English speakers reside there.

If third country businesses registered in Luxembourg, this circumstance would benefit Luxembourg politicians in two ways. First, the Luxembourg government's tax revenues would increase ("Foreign firms face…" 2000). These new funds would provide more funds for its incumbent politicians to distribute through social spending or a tax cut to their organized and informed supporters.[83] Second, the information technology and related sectors in Luxembourg would benefit as some of the newly registered third country firms might decide to locate some of the facilities there. The incumbent politicians, then, could count on the support of voters in these sectors.

Member State Opposition

The opposition of every Member State, except for Luxembourg, to the Commission's proposal, not surprisingly, centered on how its provisions regarding the sales of certain digital services by third country vendors to private EU consumers would divert VAT revenues from them. For example, Denmark, Finland, and Sweden opposed these provisions because their high VAT rates would discourage third country vendors to register with either of them. A Swedish diplomat asserted, "The position of the Scandinavian countries is that the single country of registration approach in the proposal is not acceptable." Moreover, this diplomat ominously contended, "There has to be some way to share revenue." (Kirwin 2000, G-2)

Member State Amendments and Remarks

Because most Member States objected to these provisions in the Commission's proposal the British, Belgians, Danes, French Presidency, Germans, and Swedes offered their amendments or remarks to modify the Commission's proposal. Since the French Presidency's, Belgian, and German proposals have generated the most support in ECOFIN and the British scuttled the Commission's proposal during the Spring 2001, their proposals and remarks, as of January 1, 2001, will be discussed here. In addition, a brief discussion of relevant decisions made by ECOFIN will be presented. The common and predominant theme threaded through these amendments and remarks was how the Member States could maximize their VAT revenues.

<u>French Presidency's Amendment</u>

France presented its French Presidency amendment at the ECOFIN meeting on October 17, 2000. In its amendment, the French Presidency generally agreed with the provisions of the Commission's proposal relating to business-to-business transactions, but the French Presidency made some changes in how the Commission proposed to tax business-to-consumer transactions. Under its amendment, when a third country business supplies digital services in excess of 5,000 Euros annually to a private EU customer, that third country business must register for VAT purposes with a Member State into which its services were supplied. The VAT rate of the Member State, where the third country business is registered and where private consumers buy these services, would apply. However, a third country firm conceivably could supply 5,000 Euros of services to customers in each Member State totaling 75,000 for all the Member States without that firm having to register with a Member State.

[83] Ironically, Luxembourg would not need the extra tax revenues since it has had a positive budget for a long time (Luxembourg Government Official 2000).

Nine Member States supported the French Presidency proposal, but the Commission, Belgium, Denmark, Finland, Luxembourg, Sweden, and the UK opposed it.[84] Luxembourg opposed it because the Commission's proposal would benefit it much more. Either Belgium or Denmark argued that requiring a third country supplier to register in each Member State would backfire because it could enter through a backdoor. This firm could enter the EU market by deciding to create a European subsidiary and establishing itself in one Member State. Under EU VAT law, an EU established firm can register in one Member State for VAT purposes. Large firms would probably pick Luxembourg, and Member States with high VAT rates, such as Denmark, Finland, and Sweden would lose.

This backdoor procedure happened in the past year when the EU approved telecommunications directive in 1999. This legislation required third country telecommunications firms to register in every Member State, and many US-based firms decided to set up European subsidiaries and establish themselves physically in one Member State.

The UK opposed the French Presidency proposal because it feared that it would lose VAT revenues to Luxembourg. The UK believed that third country firms, most of which are American, would establish themselves in Luxembourg where the standard VAT rate is 2.5 percent lower than the UK's rate and a large population fluent in English resides.

The fatal wound to the French Presidency amendment came from a frustrated Commissioner Bolkestein who asserted, "Member States seem to be focusing too much on the virtual revenues which none of them currently charge nor receive on sales to final consumers by suppliers from outside the EU." ("EU fails to agree…" 2000) He threatened to withdraw the Commission's proposal because he contended that the French Presidency amendment with its possible 15 places of VAT registration would violate national treatment provisions in Article XVII of the WTO's General Agreement on Trade in Services (1995) ("Internet VAT scheme…" 2000; Murri 2001).[85] His threat was equivalent to dropping a nuclear bomb in EU policy circles because Member States cannot resubmit a proposal for ECOFIN's consideration after the Commission has withdrawn it.

It is very likely that the Commission proposed a single place of VAT registration, instead of multiple places of VAT registration because of WTO concerns. Before the Commission makes a proposal, relevant Directorate-Generals routinely vet proposals that a Directorate-General has formulated. The Directorate-General for Trade habitually works with the Directorate-General for Indirect Taxation and Customs Union to ensure that the proposals coming from the Directorate-General for Indirect Taxation and Customs Union are WTO-consistent. The Directorate-General for Trade considered the Commission's proposal as WTO consistent since its proposal a single place of VAT registration (DG Trade Official 2001).

Commissioner Bolkestein's WTO fears stemmed from the hostility of US firms toward the Commission proposal and French Presidency amendment. US firms and the US government, in response to these firms' complaints, had numerous complaints about this proposal and

[84] While the sources were conflicted over whether Finland and Sweden opposed it, an evaluation of them pointed toward Finnish and Swedish opposition.

[85] There is some debate, however, over whether requiring non-EU established firms to register in each Member State where they have sales would violate WTO national treatment rules. For example, no country has challenged in the WTO the EU's 1999 Directive 1999/59/EEC which permitted Member States to require foreign based suppliers of telecommunications services to register in their country for VAT purposes.[85] Moreover, the GATS, in comparison to the GATT, is a relatively virgin legal area for WTO dispute settlement proceedings.

amendment,[86] but the multiple places of VAT registration requirement in the French Presidency amendment provided US firms with the most potent political and economic argument. The EU Committee charged, "…that a multiple registration model would be inconsistent with the World Trade Organization commitments, specifically with respect to the General Agreement on Trade in Services." (Chapple 2000) Referring to the French Presidency proposal, Kimberly Pinter, Director of Corporate Finance and Tax at the National Association of Manufacturers complained, "That's just insane, incredible burden to put on a company that doesn't even reside in its borders." (Gruenwald 2000).

Under international trade law, US firms had no legal basis to file with the WTO an unfair trade complaint against the Commission's single place of VAT registration requirement. However, US firms could argue that the French Presidency's amendment requiring up to fifteen places of VAT registration would violate the WTO's rules regarding national treatment. In layman terms, a WTO panel could seriously consider the EU as violating national treatment rules because US firms would have to register in up to 15 Member States in the EU, but EU firms would only have to register once in the US, if the US required a similar registration requirement.

With their increasing political muscle and campaign contributions, American electronic firms would have had little difficulty persuading the Clinton Administration to file an unfair

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[86] Aside from the national treatment issues, US businesses based in the US and in Europe had a number of complaints. In expressing its opposition to the Commission's June 7, 2000 proposal, the ECTSG had four major complaints. First, the requirement for a third country vendor to register with a Member State when its sales exceed 100,000 Euros in the EU would impose costly extraterritoriality obligations on these firms. These obligations would set a "dangerous precedent" because they would impose extreme compliance burdens on businesses, especially if other jurisdictions followed the EU's lead, and VAT registration might provide tax jurisdictions with future justification to impose income tax, privacy, and other legal obligations on businesses. Second, this proposal would not treat digitized goods and their non-digitized counterparts in a neutral manner as Member States would often tax the former at higher rates than the latter. Third, the costs of third country businesses, especially for small and medium sized ones, to comply with this proposal would create non-tariff barriers and a competitive disadvantage for them. Fourth, the ECTSG argued that the Commission's proposal is not globally scalable. That is, the ECTSG contended that multilateral cooperation and agreements are necessary for the Commission's proposal to ensure effective VAT compliance and verification. Otherwise, tax evasion and double taxation would likely result (Sanderson and Merrill 2000, 1-5).

In its October 26, 2000 letter to the Commission, the EU Committee had two major serious concerns. First, it argued that technology did not exist at that time to create and operate an efficient VAT compliance system. Second, while the EU Committee recognized the Commission's right to tax sales occurring within the EU and supported the Commission's proposal to permit third country firms to register in one Member State, it opposed an amendment to that proposal which would require these firms to register in more than one Member State for VAT purposes. The EU Committee argued that this requirement would impose burdensome and discriminatory compliance costs on third country firms (Chapple 2000).

Deputy Treasury Secretary Eisenstat expressed many of the complaints from US businesses by offering four substantive criticisms of the Commission's proposal. First, he argued that it would not ensure tax neutrality. Member States would tax digitally delivered products differently than their non-digital counterparts. Second, the Commission's proposal risked creating adverse and unintended consequences for businesses, while the Member States would collect very little revenues in the short run (Eisenstat 2000a; Eisenstat 2000b; Nicholson 2000). The compliance provisions of the Commission proposal would require vendors to share marketing information with Member State tax authorities because these authorities would need customer information, such as addresses, for VAT enforcement. This information might encourage governments to violate the privacy of customers. Third, VAT registration in the EU would set a precedent that might require firms to register with other countries that might follow the EU's example. This development would possibly mean that a US vendor would need to register with over 100 countries. Businesses would incur transaction costs from these compliance obligations, and these would impair electronic commerce's development. Finally, the Commission's proposal is vague about how its proposed VAT collection system would operate (Eisenstat 2000b).

trade complaint against the EU in the WTO. If a WTO panel was to find the EU guilty and that American businesses suffered some amount of economic damage, the US legally could raise tariffs on EU exports to the US equaling value of the economic damage as compensation. The US could target the exports of politically influential economic sectors in the EU for higher tariffs.

In addition, the Commission may have wanted to avoid adding another trade dispute to the existing list of disputes with the US. For example, the US and EU during 2000 were already using the WTO dispute resolution process in their contentious wrangling over bananas, hormone-treated beef, aircraft, and export subsidies for foreign sales corporations (Cox 2000, 1B).

<u>Amendments of the Third Way</u>

Between the second half of October 2000 and mid-November 2000, Belgium and Germany respectively offered amendments that sought a "Third Way." As of January 1, 2001, the Belgian and German plans were the frontrunners because of all of the amendments and remarks discussed, they best represented the interests of the Members States and the Commission. A common feature of both amendments were provisions that attempted to distribute to each Member State its fair share of VAT revenues.[87]

ECOFIN's Actions at the End of 2000

At the end of 2000, ECOFIN between November 26 and 27 made some important decisions reflecting the interests of Member States' politicians to approve legislation that would enable them to levy VATs on certain digital services. ECOFIN confirmed the principle of applying the normal VAT rate to certain digital services supplied to EU businesses and private consumers and exempting from it these services supplied to third country customers from the VAT. It requested that its Working Party on Tax Questions consider all of the Member States' proposals to find a solution about how to register and enforce VAT registration for non-EU established operators selling these services to EU private consumers. This working party was to submit by June 30, 2001 an amended draft of the Commission's proposal for ECOFIN's approval (ECOFIN 2000).[88]

Conclusions

This paradigm's thesis contended that differences between the US and the EU in terms of which strategically calculating and self-interested actors would gain votes, profits, and economic

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[87] Under the Belgian amendment, sales by a non-EU established vendor to a EU private consumer would require VAT registration of that non-EU established vendor in one Member State with an online VAT verification system or with a newly created office within the EU. The VAT rate applied on these services would be based on the Member State of consumption, and the revenues would be distributed among the Member States through a computer system. The Belgians did not proffer a sales threshold because they considered it as a secondary issue that the Member States would address later (Neckebroeck 2001).

The German amendment suggested a single access point via a portal to permit VAT registration for a non-EU-established vendor, which is selling its services by electronic means to a EU private consumer. Through this portal, the VAT registration for this business would be in the Member State of consumption. A Member State would tax supplies consumed in it according to its VAT rate, and if these services were consumed in additional Member States, the respective VAT rates of these Member States would apply. This portal would allocate the VAT revenues to the appropriate Member State. This amendment did not have a threshold in late 2000. Otherwise, the technological details of these amendments were vague then.

[88] That deadline passed without the Member States reaching a unanimous agreement on how to treat these sales because the UK changed its position by deciding to oppose taxing these services in the short-run.

benefits and would lose votes, profits, and economic benefits from consumption tax policies explains the different US and EU policies toward levying consumption taxes on electronic commerce. An evaluation of this thesis, using the empirical evidence that has been presented, reveals that this public choice paradigm had more explanatory power than the policy networks paradigm for explaining why the US and the EU took different approaches to levying consumption taxes on electronic commerce. Yet, this paradigm, despite its explanatory strengths, had explanatory weaknesses in answering some major questions about why the US and the EU took different policy approaches.

Consumption Taxes – Paradigm's Strengths

The strengths of this paradigm for explaining the different approaches of the US and the EU toward levying consumption taxes on electronic commerce were its deductive method and the use of that method to parse out the winners and losers of the US and EU policy outcomes. The determination what actors would benefit or suffer economically under alternative tax policy proposals sheds light on why the US moved to lower certain taxes on electronic commerce and the EU sought to levy taxes on electronic commerce. For the ITFA, this paradigm explained very well that ITFA proponents put ITFA opponents at political disadvantage because private firms and trade associations outspent groups, who initially opposed or opposed the ITFA throughout the ITFA's legislative process, in terms of political contributions and lobbying expenditures by wide margins. This imbalance forced the Big 7 to make a strategic decision to join the ITFA proponents in order to take out items of earlier ITFA bills that it did not like. ITFA proponents, such as Congressman Cox, calculated that they needed to compromise with the Big 7, to facilitate, especially in the Senate, the passage of the ITFA.

In the end, the ITFC, AOL, the DMA, Charles Schwab, and their allies were major winners. The Big 7 benefited from this statute because it created the ACEC and limited the attempts of those who wanted significant federal preemption of state and local sales and use tax laws, but most states, represented by the Big 7, the ICSC, and their allies lost economically because they did not want the ITFA in the first place. They would have preferred federal legislation that would have closed or severely narrowed the sales and use tax loophole on interstate sales.

The ACEC was in large part a case study of private firms capturing a federal commission, and these firms, by strategically making policy choices were able to approve recommendations that would have benefited them financially. Groups and individuals, such as the Big 7, AT&T, AOL, and others, that organized themselves politically on this issue because they perceived concentrated economic benefits in securing an appointment to the ACEC, usually were able to secure slot an appointment. The perception among the Congressional leadership that the information technology industry was an increasingly economically powerful industry and an industry, which was making itself politically powerful through increasingly larger campaign contributions and lobbying expenditures, most likely weighed on the minds of the four congressional appointers and influenced whom they appointed to the ACEC.

On the ACEC, many commissioners were motivated in large measure by economic self-interests. To some extent, a few of the ACEC Commissioners, such as Gilmore and Harris, probably were influenced by this increasingly rich and politically influential industry and by pondering how this industry could make campaign contributions to their future political campaigns, and they may have taken this industry's concerns into account as they made decisions on the ACEC. In the EU, politicians did advocate lowering taxes as Commissioners Gilmore and Harris did, and following the

Meanwhile, many of the Business Caucus commissioners throughout the ACEC proceedings sought a civic-minded compromise solution, but they, as were the other Business Caucus commissioners were businessmen who wanted to make policies that would profit their firms, too. For example, Parsons of Time Warner has been mentioned in interviews as one of those civic-minded commissioners, but he was able to insert a provision in the majority report that called for a five year moratorium on sales of digitally transmitted products and their non-digital counterparts. Several respondents indicated that Time Warner would have removed it if it had become a deal breaker; but if it was unimportant, why did Parsons put it in the majority report?[89]

Symbolically, the ITFC, AOL, AT&T, Charles Schwab, the DMA, Gateway 2000, MCI WorldCom, and their allies were the winners on the ACEC. If federal lawmakers had enacted the majority proposal into law, these actors would have benefited economically from its provisions. These commercial actors, *ceteris paribus*, would have increased their profits. Governors Gilmore and Delegate Harris would probably have benefited from significant political contributions as their reward for their votes in favor of the majority proposal.[90] The Big 7, the ICSC, and Main Street retailers would have lost economically.

Across the Atlantic Ocean, the public choice paradigm provided great insight into why the Commission fashioned a proposal that struck a balance between the economic interests of the Member States and the European business community, including subsidiaries of multinational corporations of American parentage. Commission politicians, were in large part, agents of Member State politicians. Member States politicians sought to rectify a VAT distortion that penalized their native suppliers of certain digital services because the European business community lobbied them to change it. These politicians were concerned about how the VAT system impaired the development and global competitiveness of European information technology and telecommunications firms.

Member State politicians were probably particularly concerned about how the VAT system has been negatively affecting their national telecommunications firms. These formerly state-owned and, in some cases, still partly state-owned telecommunications firms, such as KPN and Deutsche Telekom, wanted to change EU law because they feared that VAT rates generally ranging from 15 to 25 percent would make them uncompetitive to their third country, especially US, competitors, who charge no sales or use taxes on their exported digital services. They feared that they would not be able to recover their market share, once they lost it to their third country competitors.

Many Member State politicians were responsive for two reasons. First, it would be politically unpopular among employees of a national telecommunications firm to find that their incumbent politician or political party was responsible for the poor financial performance of their national telecommunications firm, a very large employer. If this firm laid-off workers, these incumbent politicians would risk losing votes from these workers. Second, Member State politicians involved in overseeing the Member State's investment in a national telecommunications firm would probably want this partially state-owned firm to be profitable.

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[89] This author is not arguing that the Business Caucus commissioners made unethical decisions. Corporate officials, as the Business Caucus commissioners were, are hired by their shareholders to make money.

[90] True, Gilmore was a lame duck governor, but he could run for national office or for another statewide office.

Meanwhile, the Member State politicians were concerned about how the existing VAT system prevented and would prevent them from collecting increasing amounts of revenues from VATs on certain digital services supplied by third country supplier to EU customers. These politicians sought to maximize their VAT revenues, which fund popular and expensive social programs. VAT revenues account for a significant proportion of total tax revenues in the Member States. This situation is particularly true in Scandinavian countries. Groups who benefit from these programs might vote for the opposing party's candidates if the Member State eliminated or scaled back these social programs.

The Commission, which often provides political cover for the Member States, probably put the single place of VAT registration provision in its proposal because it feared that the US government, under pressure from the US information technology industry, would file an unfair trade complaint at the WTO. If the US had filed such a case, the US would likely have argued that fifteen places of VAT registration would violate national treatment provisions in WTO law. If the US government won its case, it could potentially levy tariffs on EU products imported into the US to compensate for the damages that the WTO trade dispute panel found. In this case, the US could draw up a list of items, such as Roquefort cheese, on which it would raise tariffs. These tariffs would adversely affect in a concentrated manner firms in the Member States, and incumbent Member State politicians would risk losing votes in the next election and perhaps financial support from the owners and employees of these firms.

Provisions of the Commission's proposal on involving private firms in the VAT compliance process reflected the economic interests of the Member States and business community. Member State politicians had an interest in seeing, that they could levy VATs on digital services to maximize their country's VAT revenues, but at the same time, Member States did not want to alienate the business community. The business community was divided between financial intermediaries that might not benefit from using private firms in a VAT compliance system and information technology firms that would benefit by selling their goods and services to create a sophisticated VAT system.

Business community and probably to a lesser extent the Member States pushed the Commission to discuss the use of electronic invoicing in its proposal. Having EU-wide standards for electronic invoicing would benefit businesses selling goods and services because transaction costs for businesses would be lower. Meanwhile, the Member State politicians would benefit because their tax administrators could more efficiently collect VAT revenues, and these politicians could use these savings to reward key political supporters.

Under the Commission's proposal, Luxembourg and other Member States with low VAT rates would probably have benefited because third country vendors would have registered themselves within their borders, but Member States with high VAT rates would have possibly suffered VAT revenue losses. These Member States might have engaged in tax competition by lowering their VAT rates on sales of digital services and other related goods and services as an economic incentive for electronic commerce firms to register and/or establish themselves within their borders. Nonetheless, third country firms may not have been influenced by VAT rates in their decisions over where to register for VAT purposes because it is possible that other factors, such as language, infrastructure, and education levels, would have been more important economic factors in their strategic decision-making.

As with the Commission's proposal, EU-established firms would have benefited economically from the French Presidency, Belgian, or German amendments, which eliminated the VAT discrimination against them. However, US-based vendors by registering themselves in

a Member State with a low VAT rate under the Commission's proposal or establishing themselves in a Member State with a low VAT rate under the French Presidency proposal could still have benefited economically.

The multiple place of VAT registration requirement in the French Presidency amendments would not have benefited the Member States because a third country vendor could avoid the multiple places of registration requirements by establishing themselves as an EU firm in one Member State. Moreover, the Member States risked US economic retaliation sanctioned by the WTO.

Meanwhile, the Belgian and German proposals would have had mixed economic effects on the Member States. These proposals looked financially appealing to the Member States because they could avoid VAT competition and collect VAT revenues through one point of VAT registration. Nonetheless, the costs involved in building a VAT compliance system to distribute the VAT revenues to the correct Member State would be expensive.

Consumption Taxes – Paradigm's Weaknesses

While the use of this public choice paradigm to identify, based on the assumption of self-interest, the constellation of winners and losers provides much insight into why the US and the EU took different approaches, this paradigm's assumptions are too limited because they neglect the role of institutions and culture. This paradigm's weaknesses stem from this neglect.

Following the logic of Niskanen's budget maximization argument, one might have thought that US and EU government bureaucrats would have sought to maximize their economic interests, such as remodeling their office or pay raises, by maximizing their bureau's discretionary budgets through maximizing their government's consumption tax revenues. The evidence suggests that government bureaucrats at the state and local levels in the US and at the Member State and Commission levels in the EU did not seek to maximize consumption tax revenues, for their individual economic self-interests, such as pay raises or remodeled offices.

Why does not Niskanen's argument apply here? The evidence suggests that government bureaucrats at the state and local levels in the US and at the Member State and Commission levels in the EU acted for other reasons. Federal, state, and local bureaucrats in the US and the Member State bureaucrats generally acted because they were agents for the politicians who had enacted tax consumption legislation and/or because they were products of an institutional culture. Commission bureaucrats appear to have acted as products of organizational culture and as agents of Commission politicians who, in turn, acted as agents of Member State politicians.

This explanation raises a number of questions about and deficiencies in this paradigm's explanatory power. What is this source of this culture? Why should Commission politicians care about what the Member States want? It seems that the institutional funding relationship between the Member States and the Commission provides part of the answer to the latter question, but, while economic self-interest is consistent with this public choice paradigm, why does this relationship exist? Are Commission politicians completely agents for Member State politicians? If so, how could Commission Bolkestein threaten to withdraw this Commission's proposal if the Member States were going to approve a multiple place of VAT registration plan? Furthermore, in his description of the EU policy process, Gregory with IBM-Europe and Middle East asserted, "The commission proposes a racehorse and (EU governments) produce a camel." (Hoenig and Mitchener 2000, 1) If the Commission were an agent of the Member States, why did not it propose a camel? Also, why did the Commission and the Member States want third country firms to register in some manner for VAT purposes anyway? In other words, why could not the EU get third country governments to collect these taxes from firms based within their borders?

The answer points to the lack of international institutions to ensure VAT compliance. This public choice paradigm cannot answers these questions, but a historical institutional paradigm with its emphasis on institutions and culture can.

Meanwhile, most states, the Member States, and the Commission have depended heavily on consumption taxes as a revenue source, therefore one would expect that politicians running these entities would have wanted to maximize this revenue source by applying consumption taxes on electronic commerce. However, a vocal minority of state lawmakers, aside from those politicians in states without sales and use taxes, during the consideration of the ITFA and the ACEC, opposed closing the tax loopholes for out-of-state vendors or narrowing the nexus rules too much. Why? Many were certainly influenced by the political campaign contributions and votes from the affected, highly informed, and well-organized special interests, such as AOL and the DMA, but that does not mean that these politicians were bought and sold.

On the other hand, many politicians, such as Congressman Cox, Governor Gilmore, and others also held strong ideological beliefs in smaller government and lower taxes that complemented their self-interests. Their strong ideological beliefs suggest that the assumptions of the public choice paradigm are too constricted, and that perhaps a paradigm, such as historical institutionalism would be more appropriate since its assumptions would include ideological and institutional ones, in addition to self-interested ones.

Although the opaque nature of the EU policy arena made it difficult to determine how much the profitability of partially state-owned telecommunications firms weighed on the tax decisions of Member State politicians. Intuitively, Member State politicians would have an interest in shaping tax policies that would help to ensure that a quasi-private firm could maintain employment levels, or they would have an interest in pursuing policies that would increase this firm's value if the government had already decided to privatize this firm. For this policy arena, quasi-private firms did not weigh on the minds of US politicians since the US had no quasi-private firms that would be significantly affected by sales and use taxes on electronic commerce. Why did not US have any of these quasi-private firms? Differences in the historical and cultural developments of the US and the EU appear to account for the absence of quasi-private firms in the US.

On the other hand, firms and their trade associations can also seek to lower taxes in a manner that will benefit them by obtaining the support of politicians. These commercial interests can provide to politicians and/or make a case that their employees will vote their pocketbooks and vote for them in the next election. In exchange, politicians will vote for the requested tax cuts. In the US and the EU, major commercial interests suggested lowering and placing a moratorium on consumption taxes under certain circumstances. US lawmakers imposed a moratorium on selected consumption taxes, and the ACEC proposed a five-year ban on state and local sales and use taxes on the sale of digital products and their non-digitized counterparts and the elimination of certain taxes. Yet, the Commission and every Member State opposed a VAT moratorium on sales of digitized services. Why did EU policymakers take no action in the EU to achieve tax neutrality by reducing taxes as many federal and some state policymakers did?

A major part of the explanation for why this circumstance existed was that this public choice paradigm does not account for the cultural, ideological, and institutional factors. Cultural and ideological factors may have influenced state politicians, such as Gilmore, just as much as fiscal considerations and political campaign contributions did. These politicians believed in smaller government and in cutting taxes. Meanwhile, federal lawmakers have more fiscal

freedom regarding sales and use taxes than many state politicians have had because the federal government levies a minimal amount of consumption taxes.

Looking much more deeply at institutional factors, what was the main fundamental issue that caused the greatest controversy in the debate over the ITFA and on the ACEC? Nexus was the issue. The US Supreme Court had generally decided what nexus was in their *Quill* decision, but this court had no direct economic interest in its decision. In fact, it relied on an institutional feature of the US Constitution, the interstate commerce clause. Under this clause, this court ruled that Congress had authority to close the sales and use tax loophole.

One might argue that the US Supreme Court acted in *Quill* for economic reasons, although the justices themselves did not have obvious economic reasons, because the interstate commerce clause reflected the economic interests of the Framers of the US Constitution and private firms in the late 1780s (see Beard 1941), but that argument is too simplistic on two counts.[91] First, the Framers drafted the US Constitution as a federal document that protected a level of state sovereignty because they were distrustful of a too powerful central government (Lipset 1996, 20-21). Second, cultural phenomenon often initially begins when individuals act for some economically self-interested reason, but as time passes, the following generations often are unaware of that rationale and that phenomenon becomes one with cultural and institutional properties (Fukuyama 1995, 20-21).

On the other hand, a comparable nexus problem does not exist in the EU. The EU has developed an increasingly comprehensive and coordinated VAT system since the 1970s. Moreover, the Member States, unlike the states in the US, have direct institutional representation in the consumption tax decision-making process.

What does this paper mean for future research? This paper focused on how actors in the US and the EU pursued the maximization of political power and economic benefits, and their pursuit of these goals explained a great deal of the differences in the US and EU policies toward the consumption taxation of electronic commerce. Upon a closer, though very superficial, evaluation of this public choice paradigm's applicability to the empirical data, it seems that cultural and institutional factors also played a major role. These cultural and institutional differences between the US and the EU strongly suggest that future research on the differences between US and EU consumption tax policies should be analyzed through a paradigm that takes into account how cultural and institutional factors, *in addition* to self-interested ones, shape the motivations of actors.

[91] For a powerful methodological critique of Beard's thesis, see Brown 1956.

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