

Internet Governance: A Rent-Seeking Analysis

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There is the notion that free market countries will do well in attracting capital only if they recognize the increased options that the Internet makes available. However, a tax policy that does not unduly damage incentives and efficiency is but one ingredient for wealth creation and economic growth. Progress requires that institutions define and enforce these property rights and promote unrestricted competition through free trade, sound money, and sound banking practices. The institutions of freedom should not be taken for granted and there are reasons to be concerned about restrictions on the Internet. This paper uses public choice analysis to examine the institutions that will affect efforts to tax and regulate the Internet. In this paper we argue that rent-seeking is a positive influence due to rapid changes which continue to take place in information technology.

The Internet has developed largely as a spontaneous order, without a central coordinating authority, in part because government regulators have simply failed to anticipate the pace of technology in this area and thus have been slow to introduce regulatory supervision. In his 1944 book *The Road to Serfdom*, Hayek writes that as the coercive power of the state will alone decide who is to have what, the only power worth having will be a share in the exercise of this directing power. That is, lobbying for special privilege, which public choice economists call rent-seeking, will be the only activity that matters.

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The actors

Government intervention in the Internet, as in so many other areas, is explained by the incentives facing various groups of people who constitute different sets of interests. First, there are the competitors of successful firms that want to hamstring their rivals by creating entry barriers, appropriating part of their rivals' businesses, or simply mitigating unfavorable (to them) market outcomes. Second, there are the bureaucrats and politicians whose interest lies in an ever-expanding government. Third, there are the trial lawyers engaged in redistribution through lawsuits. Prominent examples include actions against the tobacco industry, drug manufacturers, and gun manufacturers. In January 2000, perhaps using the Internet to recruit plaintiffs, a class action was filed against e-toy retailers for failure to make Christmas deliveries. And, we may soon see similar suits against high-fat food purveyors. Finally, a list of interested parties must include the various non-governmental organizations, including the advocacy groups favoring free Internet access in the name of addressing the so-called digital divide allegedly limiting minorities' access to the Internet. By shedding light on the incentives facing individuals and how these incentives will affect the development of the Internet, public choice analysis helps one identify institutional arrangements that would enable us to overcome these forces or to take advantage of them.

The evolution of e-commerce - an interest group model

One would expect virtual markets to reduce consumer search costs relative to conventional markets, although not necessarily to reduce the prices charged. We should expect prices to vary much more when search costs are relatively high. It simply doesn't pay for consumers to search for low-priced items, but if the Internet allows consumers more easily to ascertain retailers' prices, then we should expect electronic commerce to cause prices to converge. It might be argued that e-commerce more nearly approximates the model of perfect competition in which information is costless, the barriers to entry are low, and there is a large number of buyers and sellers who are price takers. In this model the total cost to consumers, which includes the price paid and the search costs they bear, will tend to

decline. However, we should also keep in mind that for certain types of goods (antiques, collectibles, commodities in fixed supply), the decrease in search costs may very well lead to a shift in demand to the right and consequently higher prices rather than lower prices. The retailers that choose not to sell online or whose products do not benefit from e-commerce will be among the groups seeking to shape regulations in their favor.

This section looks at the gainers and losers from e-commerce in order to predict behavior. An area of major savings is likely to be in business-to-business online purchasing. For example, in November 1999, both General Motors and Ford announced plans to publish online specifications for components. Ford's joint venture, AutoXchange, is with Oracle while GM's TradeXchange is a joint venture with Commerce One. The supply base for GM and Ford is \$500 billion from over 30,000 different suppliers. Expected savings from the ventures are on the order of 10-20% of total expenditures. Similar estimates were made for BP-Amoco's efforts to streamline the procurement process. BP-Amoco predict a savings of \$200 million as it uses the Internet to deal with its 100,000 suppliers. Its goal is that 95% of procurement take place online. For BP-Amoco, a 5% overall saving can translate into a 5-20% increase in operating profits.²

²Corzine, R., A Vision of e-business, @ *Financial Times*, Dec. 8, 1999, p. V. See, also, Tait, N., ANissan may join Ford buying pool, @ *Financial Times*, Jan. 12, 2000, p. 15.

While we should expect lobbying to promote Internet business-to-business transactions by firms that expect to gain from the growth of e-commerce, there may be countervailing lobbying efforts by companies that stand to lose from e-commerce. If the Internet is about anything, it is about disintermediation B or cutting out the middleman and thereby shaking up the supply chain.³ While consumers at one end of the chain will benefit from lower prices and multi-nationals at the other end will benefit from lower costs, there will be a large number of firms caught in the middle. The transparent pricing mechanism and reduced costs for learning about buyer needs and market opportunities would identify high-cost producers who would be forced to compete more vigorously. Of the groups affected by business-to-business transactions we expect the consumers to lack representation. This will depend on the number of layers of distribution in a country. The US is relatively thin in this regard while countries such as Japan have multiple layers of distribution.

The losers from disintermediation

Further, disintermediation is potentially a force for change internal to the firm.⁴ Changes in the information hierarchy make it probable that conflict will result between managers of divisions that previously held a monopoly on information and those now privy to it. Some predict returns for the whole corporate sector will decline (at least initially) because many of the new firms have capital costs of zero since they can raise cash through equity on which there is little expectation that they will pay a dividend until well into the future.

Tax authorities - the municipalities and the states

³Nusbaum, A., AWeb cuts out an entire order of middlemen,@ *Financial Times*, Jan. 5, 2000, p. 14.

⁴See, e.g., Coggan, P., AShape of things to come,@ *Financial Times*, January 3, 2000, p. 15.

One less obvious effect of e-commerce will be to increase the mobility of capital and labor. Governments that impose taxes on Internet transactions or transmissions will be harmed while other, wiser governments compete to attract e-commerce related activity through tax and subsidy policies, growth-oriented regulations, and advertising of their differences.

Moving online - most brick and mortar have an Internet presence

The provision of certain kinds of labor services will be subject to competition from around the globe because physical distance no longer affects the relationship to users. For example, a computer programmer in India is a viable competitor with similar workers in the Silicon Valley or northern Virginia. Indeed, there are whole cities in India where the people do little else than write programs. The creation of a global marketplace for many labor services will be equivalent to worldwide mobility of this sort of worker as technology increasingly allows people to live in one country and earn income in another. Computer software development and various services like data processing and management advice would move to jurisdictions with lower taxes, lower labor costs, and fewer restrictions on business. The increased mobility of skilled workers because of their ability to deliver products and services online will also increase demands for more variety, self-reliance, and choice in the way employees are remunerated. As a consequence, the Atake it or leave it@ attitude of both companies and governments will have to change.

Moving offshore

But the electronic commute is not the only option for employees. Electronic banking will become more widespread and there will be substantial growth in online banking (the Glass-Steagall Act, which prevented banks from underwriting most securities, was largely repealed in 1999), online securities trading (24 hours, offline, and offshore), and multi-purpose smart cards that can also act as identification, debit, and credit cards. Smart cards will have not only an electronic photo of the owner but also his fingerprint and

voiceprint. Soon, even the small depositor can have the equivalent of a numbered Swiss bank account anywhere in the world and payable in any currency he may choose. One might speculate that such banks will not be banks in the literal sense but really mutual funds that can locate anywhere and specialize in customer-preferred assets with the additional feature that customers can receive and pay funds either officially or privately. For example, a customer could demand payment in gold through a Botswanan bank which, in turn, may have been paid in Russian rubles transmitted by signals bounced off a satellite. Moreover, of the three parties to any transaction, the buyer, seller, and bank, none needs to know the identity or location of more than two. Because anonymity and privacy is ensured, such changes in the relationship to customers and banks will empower individuals in a way previously unknown. All of these factors will make it more difficult for governments to intervene in private affairs, but we cannot expect government to forego trying.

A private policy of self-regulation?

The rapid development of the Internet raises a host of new policy questions for politicians on taxation, privacy, and intellectual property rights. Simultaneously, there is a push by industry for self-regulation. Such self-regulation is offered by corporate officers who serve the interests of their shareholders as a substitute for impending legislation and government regulation. Behind closed doors in Paris in September 1999, the Global Business Dialogue (GBDe), comprising government officials and a cross-industry group of the executives of the world's largest multinational companies that urge self-regulation, met to map out a strategy for avoiding government regulation. When challenged that the GBDe lacked public interest representatives to expose different sides of an issue, the response of the leaders was to offer to reach out for a broader membership in the future. It is too early to assess the likely success of the GBDe efforts to set standards for hardware and conduct as a means of staving off government regulation of the Internet.

Or government regulation?

The Internet is under siege from established institutions that seek to influence its development, including telecommunications regulators, tax authorities, and other government bureaucracies. U.S. domestic institutions include the Federal Communications Commission (FCC), the U.S. Department of Commerce, and the Internet Corporation for Assigned Names and Numbers (ICANN) (a self-regulatory organization with U.S. and foreign representation that enjoys U.S. Government support). International institutions with some degree of regulatory authority include the European Union (EU), the Organization for Economic Cooperation and Development (OECD), the World Trade Organization (WTO), and the World Intellectual Property Organization (WIPO). The EU will no doubt involve itself in decisions relating to the Internet and e-commerce since these transcend the national boundaries of member states. Founded in 1961 and located in Paris, the OECD is devising an international taxation policy for electronic commerce and in addition is working on privacy and consumer-protection issues. Comprised of some 140 countries, the WTO oversees the creation (by negotiation) of and enforces global trade accords, covering, notably, telecommunications, financial services, intellectual property, and customs duties. The WIPO seeks to provide international protection for nationally-designated patents, copyrights, and trademarks.

Although not regulatory bodies, two additional international organizations should be mentioned because of their advisory role: the aforementioned Global Business Dialogue (GBDe) on e-commerce and the International Chamber of Commerce (ICC). The ICC produces model contract clauses for digital signature guidelines, trans-border flows of personal information, and international trade.

The threat from government

In addition, technological developments will continue to reduce the ability of politicians to extract wealth from wealth creators. The Internet will make knowledge of government predation more readily available than it would otherwise have been and hence will allow people to take preventive and remedial action, other than the obvious example of voting with their feet. As a consequence, it

will be easier for the average person to avoid or evade taxes. Second, it will be extremely difficult to collect taxes or tariffs on services that can be delivered online. Not only would this include what can be delivered electronically or in audio-visual form, but such huge sectors of the modern economy as software, entertainment, and business services of all kinds. In fact, there are many new Internet websites (information utilities) which provide the software and storage for work which was undertaken at any location.⁵ Since all these goods will be delivered online instantly, taxing the buyers of intangibles of this kind will require a different tax structure. The IRS will simply not be able to pry into every Internet transaction by reading the buyers' email or by listening to their cell phone calls or by monitoring their digital transmissions. It is not to say it could not be done in principle, but it would not be practical because of the sheer volume of transmissions over the Internet. In the U.S., tax laws are enforced upon suspicion of tax evasions and it is at this point that records would be examined. Nor would the most stringent enforcement of the tax laws be in the interest of government because sellers would avoid taxes by simply picking up and moving to another country or an electronic location on the high seas, although none of this would be costless. There are a number of new banks in the Bahamas seeking to capture e-commerce account clearances.

⁵Intel outlines its plans to market Internet devices via ISPS, Telcos, @ *Investors Business Daily*, January 6, 2000, p. 12.

Unless a country bans computers and cellular phones that require only a click to move money around, the ease of online shopping, investing, and banking will severely constrain any national effort to obstruct or to attract e-commerce-related activity, to tax it, or otherwise to regulate trade in it within or between countries. Free trade will emerge by default as the declining cost of communication and the decreasing importance of location will intensify competition (taxes and subsidies) among countries. Governments will then find themselves in a position similar to firms in that they have to compete in producing the most value for the lowest possible cost for the firms that locate within their boundaries. Countries where the marginal cost of government is too high relative to the services it provides, will find it increasingly difficult to attract and retain capital, whether it be tangible, financial, or human. In the same way as low tax countries attract flows of investments and immigrants, countries with punitive tax systems will face both capital flight and brain drain.

Public choice insights - rent-seeking behavior

Public choice theory holds that governments are driven by the material and ideological interests of politicians and bureaucrats and by special interests who can reward them. This section examines institutions which affect the development of the Internet and its governance by focusing on the incentives of individuals involved in interest groups, including not only those in the private sector, but also politicians and bureaucrats seeking rents. Rent-seeking is defined as efforts to create special privilege to interfere with mutually beneficial trades. It can take place either in the public sector or in the private sector through regulation. Government involvement in the Internet began just over 30 years ago with the Defense Advanced Research Projects Agency (DARPA), which funded an electronic computer network among scientists (also a major interest group which seeks rents through government decisions), aimed at facilitating the exchange of research. The next stage of government involvement was through the National Science Foundation. It in turn contracted with Network Solutions, Inc. (NSI), a private entity, to manage development of the Internet through the sale of domain names and number addresses. NSI was recently

purchased for some \$21 billion. The next stage involved the U.S. Commerce Department, which opened Network Solutions, Inc. to competition and was instrumental in establishing the Internet Corporation for Assigned Names and Numbers (ICANN).⁶ In late 1998 the White House agreed to hand over the government's stewardship of the Internet to this international, private sector, non-profit organization. Serving as the Internet's highest level of decision making, ICANN is the central coordinating body for the Internet's technical operations and is potentially a bottleneck that will affect policy. As a consequence, it has the power to shape the Internet's underlying infrastructure by ruling on any new domain names, numbering changes, or questions about technical standards used by firms. Because it is an entity implicitly operating subject to government entity (Commerce Department) oversight, it is likely to be overly cautious and bureaucratic. But there is more to the story.

⁶ICANN was founded in 1998 and is located in Marina del Rey, CA. It coordinates the domain name system, IP address assignments, and the work on the Internet's technical standards. Information can be found at www.icann.org.

In response to foreign concerns, ICANN's Board is required to include representatives from Europe and Asia and to hold meetings open to the public and stress transparent decision making.⁷ Supporting Organizations' interest groups whose members are involved in Internet-related activities will lobby and make presentations to ICANN's Board. They will seek representation on the Board or at least that the ICANN Board members will include those sympathetic to their views. In addition, the World Intellectual Property Organization (WIPO), which is dedicated to promoting strong trademark and copyright protection, will provide advice to ICANN. In particular, ICANN, with WIPO input, has sponsored an alternative dispute resolution system that allows trademark holders to seek to strip domain name holders of web addresses that allegedly infringe trademarks. Currently, ICANN is holding a series of meetings to gain visibility and receive input in defining its role in Internet administration. In addition to industry, a number of non-profit groups will also participate.

The scope for rent-seeking

The administration of the Internet's mail system is based on the Internet Protocol address. Here at the end point is a logical place for regulators (domestic and foreign) to add a tax or allow a regulated entity to capture a rent. For the e-mail system to function, every computer sending and receiving information must have a unique number, so that the network routers know where to send each packet of information and so that computers on the Internet can know which packets are intended for them. IANA (the Internet Assigned Numbering Authority), ICANN's predecessor organization, was assigned the exclusive task of assigning unique numerical identifiers (addresses) to facilitate communication among network participants. The network addresses provide each computer on a network a unique identifier in the form of numbers. Before a computer can use

⁷ICANN Adopted Bylaws (As Revised), A California Nonprofit Public Benefit Corporation, November 23, 1998. The website lists members, advisory committees, meeting notes, and formal associations with other groups (Berkman Center for Representation in Cyberspace and the WIPO).

a domain name to contact another computer on the Internet, it must translate the domain name into the IP address to which it corresponds.

The assignment of numbers permits authorities to discriminate and thus creates the potential for rent-seeking rather like zoning of commercial and residential activities. Consider, for example, the distinction between a .com and an .org which engages in substantial commercial activities. A non-profit group, such as the Sierra Club or the American Association for Retired Persons (AARP), has the .org designation even though a substantial part of its income is generated by the sale of goods and services. People may be more favorably disposed to buy products and services from an .org than to purchase similar goods from what they perceive as a purely for-profit organization. One would expect those operating commercial activities to appreciate the ability to create a distinction between an .org and a .com and to be willing to invest resources to acquire the valued .org designation. One would also expect ICANN and others concerned with designating names and numbers to understand this and to seek to capture at least some of the available rents through, for example, price discrimination.

What future for the Internet?

The rapid development of the Internet raises a host of new policy questions for politicians on taxation, privacy, and intellectual property rights. Since these are political questions, an element of rent seeking is involved. Simultaneously, there is a push by industry for self-regulation. Such self-regulation is offered by corporate officers who serve the interests of their shareholders as a substitute for impending legislation and government regulation. More likely, however, is the continuation of national and international regulation (for example, the U.S. Commerce Department continues to have influence over ICANN).

There is also the risk that foreign governments will be tempted to exploit the opportunities for rent-seeking and thus become more heavily involved in the regulation of the Internet. Moreover, the U.S. Federal Communications Commission (FCC) arguably opened the door to the imposition of access fees under the

guise of universal service as the vehicle for wealth transfers from telecommunications users in high density areas and firms with inelastic demand to users in low density areas and households with relatively elastic demand.

We have already seen that, in response to foreign pressure, ICANN's board of directors includes foreign representatives, and that ICANN will have a transparent decision-making process that allows for public input. This will entail public comment periods and possible government funding for public interest groups to participate in filings and hearings, and, of course, regulatory lawyers to monitor their inputs. Procedural compliance will be assured, but substance is likely to be driven out or minimized in the process. While we can expect the usual array of consumer advocacy groups that argue for lower prices, others will argue for special privilege and subsidies. Educational interest groups and telephone companies have been successful in obtaining such subsidies.

Interest groups can accomplish their redistributive goals. These range from simply limiting the number of websites to denying the registration of similar website addresses. Conceivably, ICANN's board might find it more effective to enlist government to limit the number of domain names and provide criteria for authorizing new categories of domain names. Such collusion in the name of a harmonious working relationship would enable them to collect the rents generated by their monopoly status while avoiding the charge that their actions were somehow self-serving. (New top level domain names that might compete with .com have yet to be introduced in the U.S.) The unfortunate consequence would be to constrain the growth of new competitive opportunities that would otherwise be spawned by new top-level domain categories that might even include new parallel Internet systems. By centralizing the authority for top-level domain names, one is obviously creating the circumstances under which rent-seeking may flourish. It appears that ICANN is really the institutional actor to monitor. As an aside, monitoring will be low cost because information on ICANN is readily available over the Internet.

Bureaucrats under the bed

Consider, for example, the advice the US Occupational Safety and Health Administration gave a Texas firm.⁸ The firm had requested advice on the firm's obligation to meet OSHA workplace regulations for those who sought to work at home. OSHA's published letter on the Internet indicated the firm would be held to the same standards relating to toilets for the handicapped and glare-reducing computer screens as apply to corporate offices. Alexis Herman, the Secretary of Labor, later withdrew the letter. Whether this is explained by hasty decision-making or simply election-year politics is left to the reader.

FCC regulation

⁸Bureaucrats under the bed? @ *Financial Times*, Jan. 5, 2000, A22 and Labor Secretary retracts home-work letter as criticism mounts, @ *Investors Business Daily*, Jan. 6, 2000, p. 13.

Several major telecom-related issues will bear on the future of the Internet and provide government with the opportunity to regulate and tax Internet assets and activities. Internet Service Providers (ISPs) have not up to now paid to gain access to local phone lines controlled by incumbent local exchange carriers (ILECs), e.g., Verizon. This may eventually change, in light of a February 1999 FCC ruling (although FCC officials still publicly state that the FCC does not currently plan to impose such charges). Even if one accepts the argument that ISPs should bear the congestion costs they impose on phone networks,⁹ there remains the risk that, once involved with the Internet, the FCC will have an incentive to expand its involvement, given the rapid economic growth and the wealth created by the Internet, and hence the obvious potential for political trades. This argument stems from public choiceCbureaucrats have the incentive to aggrandize their status and their budgets by expanding their regulatory scope to encompass new areas, particularly when those areas are responsible for wealth creation. Public choice suggests that bureaucrats may seek to redistribute wealth from newly regulated sectors to satisfy special interest constituenciesCsuch as Apublic interest@ groups that want to expand the scope of Auniversal service@ or the politically well-represented rural users that want to garner greater subsidies. The FCC has engaged in rent redistribution in the past, and as the Internet grows, it would appear to be a likely target for this sort of intervention.¹⁰

⁹A number of economists, such as Gregory Sidak of the American Enterprise Institute, have stressed the importance of making ISPs bear the congestion costs they impose on telecom networks in order to avoid Acyberjams.@ While this is a valid point, there is the equally valid concern that access charges could be imposed in amounts that are many times the cost of access -- as is the case with the access charges currently imposed on long distance telephone service providers (those high charges are used to cross-subsidize favored rural and low income consumers). Such excessive charges would retard the efficient growth of Internet traffic and services. Moreover, given the rapid development of new technologies that increase the carrying capacity of existing infrastructure B and that bring forth new higher capacity transmission media B the problem of congestion costs imposed by Internet traffic may soon become (if it is not already) more theoretical than real.

¹⁰Another possible means for FCC involvement in the Internet warrants mention.

Taxing the Internet

In late February 1999, the FCC overturned state decisions regarding reciprocal compensation and thereby opened the door for Internet access charges. The Commission action puts in jeopardy a longstanding rule that bars local phone companies from assessing usage-sensitive access charges on Internet service providers. Without this FCC AESP exemption¹ rule, consumers could be forced to pay per-minute fees for dial-up connection to the Internet and services such as America Online. (As telecom facilities' carrying capacity grows rapidly, due to the advent of new technologies, usage-sensitive fees may not be needed to prevent inefficient and costly network congestion). The Eighth Circuit had upheld the FCC's access charge exemption for ISPs based on a key distinction made by the FCC in holding that the FCC did not discriminate in favor of ISPs because they do not utilize LEC services and facilities in the same way or for the same purposes as other customers who are assessed per-minute interstate access charges.² The FCC had argued that the ISPs do not use the network in a manner analogous to the IXCs (interstate long distance carriers which pay by the minute). The court noted that the ISPs subscribe to LEC facilities in order to receive local calls from customers who want to access the ISP's data, which may or may not be stored in computers outside the state in which the call was placed. An IXC, in contrast, uses the LEC facilities as an element in an *end-to-end* long-distance call that the IXC sells as its product to its own customers.

Taxation is not an issue that will go away. In order to understand the gainers and losers of taxation and, hence, the incentive for rent-seeking, it is important to distinguish between two different concepts: taxation of Internet assets and a tax on e-commerce. The first concept is the taxation of Internet assets like ISPs or domain names. These assets could be taxed in several different ways. One possibility is a tax levied on the value of the assets. Another would be a tax levied on the number of hits to a domain name or website. Yet another possibility is a tax in respect of the volume of traffic through each ISP. Or there could be a tax based on all calls to an area code designated exclusively for Internet access. One might envisage discriminatory treatment in favor of all calls placed to .org web sites, in which case the value of such designations would increase and lead to the expenditure of resources to secure this privilege. As previously observed, because they provide such designations, ICANN and NSI would benefit from these arrangements.

The second concept is a sales or use tax assessed on the commerce generated through the Internet. Sophisticated software programs are a double-edged sword. On the one hand, they enable people to engage more easily in complex transactions designed to avoid taxation. On the other hand, software programs enable government to administer more easily a complex system of taxation as they provide government the means to monitor economic activity by retrieving and analyzing records.

Taxing Internet assets and e-commerce will affect the incentives of firms and their customers. Development will be slowed or may simply not occur for some uses that would otherwise prove wealth-enhancing. The arguments about taxing the Internet take two forms: infant industries and equity. The infant industry argument is used by those wishing to protect domestic firms from foreign competition. The second argument is about equity or fairness and asserts that *not* to tax the Internet (assets, the sale of goods and services) has several unfair effects. First, a bonanza is produced for web entrepreneurs who have developed the Internet. Second, existing sales taxes are regressive because those without Internet access are generally low income households that would therefore pay a

disproportionately large share of state and local sales taxes. It may also be argued that those with access to the Internet do not pay their fair share of such taxes.

Never, sometimes, and always

The Federal Advisory Commission on E-Commerce was chaired by Virginia Governor James Gilmore, a strong opponent of Internet taxation. There are three plans under consideration: *never*, *sometimes*, and *always*. The *never* group led by Gilmore opposed all taxes on the Internet. The *sometimes* group favored taxing only those e-retailers that have a physical presence in their state. The *always* group advocates the use of a trusted third party (e.g., a credit card company) to collect taxes and immediately remit it to states by a formula or their actual tax rates, although this is thought to be difficult due to differences in rates and categories of items taxed by different states. The Advisory Commission, which disbanded in the spring of 2000, failed to reach the required supermajority needed to forward a consensus recommendation to Congress on Internet taxation (a slim but insufficient majority favored extending the existing federal moratorium on new Internet taxation). The failure of the Commission to reach a consensus is a cautionary tale about the difficulty of enacting coherent policy on Internet taxation, given the clash of powerful interest groups (state governments favoring taxation and retailer groups opposed to taxation) in this area.

Internet Tax Freedom Act (1998-October 31, 2000)

The Internet Tax Freedom Act of 1998 established a moratorium on Internet taxation that prohibits federal taxation of the Internet, but says nothing about sales and use taxes on transactions that occur over the Internet. In a 1992 decision entitled *Quill Corp. v. North Dakota*, the U.S. Supreme Court held that the mail-order stationery and paper products company was not obligated to collect sales taxes from transactions to consumers buying its products in other states, unless it could be proved that the company had some sort of physical presence, known as a nexus, in the purchasers' state. A "nexus" might be a web site host such as an Internet Service Provider [ISP], or a retail outlet, or a warehouse. As a practical

matter, the *Quill* decision has proven a major impediment to states' taxation of e-commerce sales.

National Governors Association

In an effort to supersede the *Quill* ruling, the National Governors Association has a proposal to establish an interstate compact to have a trusted third party (cyber-partnering as tax farmer for the state) collect sales taxes in respect of goods and services supplied to residents of states in which the supplier has no physical presence. It would seem that states that don't have sales taxes have no incentive to join this compact, but there aren't many of these. Indeed, there might be a tendency for firms to locate in the no-sales tax states because these states would not be collecting sales taxes for other states. This is in principle no different from the problems which arose from catalog sales. However, the Internet makes sales more easily recorded whereas such easily generated records may not exist for catalog sales.

The Clinton administration

The Clinton Administration indicated that it would await the completion of the Commission's report before taking a position. When the Commission failed to reach a consensus, the Administration remained silent. At present it has neither expressed opposition to extending the moratorium nor expressed support for taxation of the Internet. The position of the new Administration that will take office in January 2001 cannot now be predicted.

What economists say

Some economists have suggested that not taxing online sales would put pressure on traditional retailers to press for reductions in the sales taxes they already pay. However, prohibiting taxation of online sales might encourage state governments to increase existing sales taxes to recoup the revenue they have lost as consumers increasingly shop online. And we might expect that bricks and mortar stores would prefer state governments to tax Internet commerce in the belief that this would reduce the pressure to raise taxes on their

own sales. Because business-to-business transactions are exempt from state sales and use taxes, the tax controversy encourages discussion of a national sales tax similar in form to the European value-added tax.

Although the Internet Tax Freedom Act established a two-year moratorium on Internet taxation by federal authorities of every sort and does not define nexus for taxation by the states, it does not apply to foreign jurisdictions. But there is a kind of prisoners-dilemma because a state (or a foreign country) that moves first to establish a new tax or to increase an existing tax will be at a disadvantage relative to others. (An interstate compact of the sort described above would only work well if all states joined it.) It is interesting to note that India dropped all taxes on computer hardware. Taxation of any sort would slow the growth of the Internet, and would affect decisions about investment, location, and business model for firms, and thus the structure of Internet governance. We should therefore expect that those countries that tax Internet-related activities least will experience the fastest growth of Internet commerce and the facilities that sustain it.

There are forces that may operate against efforts by governments to tax, regulate, or otherwise use the Internet to fund or pursue redistributive goals. Meddling, whether inspired by ICANN or by the interests of political constituencies, would be wealth destructive and counterproductive. However, standards-setting bodies as well as technology entrepreneurs and providers might be expected to engage in rent-seeking with beneficial outcomes for society.¹¹ Moreover, the possibility to create valuable intellectual

¹¹This concept has been applied in a number of papers, see, e.g., Abbott, A. F. and Brady, G. L., "Telecommunications Policy: A Rent-Seeking Analysis," *European Journal of Law and Economics*, Vol. 8, No.2, 1998; "Dezoning the Spectrum: Opportunities for Rent Seeking in Telecommunications," *Journal of Private Enterprise*, 1996; "Innovation-Induced Rent-Seeking: The Case of Air Quality Management," *Journal of Institutional and Theoretical Economics* (1990); and "Tollison Rents and Technological Innovation: The Case of Environmental Regulation," *Public Choice* 157 - 165, (1990).

property rights through new top level domains, which in effect become new parallel Internets, might provide the incentive for possible creators of such rights to fight against regulations that would deny these wealth-creating opportunities. Indeed, some new parallel Internets are already in existence.

Concluding remarks

This paper has focused on contemporary developments and both the reality of, and the potential for further, government intervention. Our focus was on a detailed account of the institutions that administer the Internet and the opportunities for rent-seeking. Nevertheless, it is clear that the Internet also promises remarkable possibilities for human freedom and the creation of wealth. It is equally evident, however, that government will not refrain from seeking to acquire that wealth. Public choice analysis provides a useful framework and valuable insights about behavior that enables us to understand a great many aspects of Internet governance, past, present, and future. As technological progress unfolds, public choice will help us evaluate proposed policy options and assist us in putting government back in its cage.

