As Internet based transactions grow, Governments around the world are trying to find a way to tackle the problem of Internet taxation. Several American States and some European Countries have already come up with proposals for new Internet taxes, which usually have caused lots of noise and have proved to be essentially unenforceable. This article's aim is to discuss some of the proposals and try to examine the problem in its different parts.

In order to do so, it is necessary to briefly discuss the role of taxation in a modern economy. Most of the proposed Internet taxes have been designed with the only aim of raising funds for the government, without considering a very important issue: taxes should induce economic behaviour that is beneficial to society, or at least not discourage it.

Furthermore, there are two main types of taxes. Income taxes are based on the principle that each citizen should contribute to the funding of the State according to his income. For this reason in most countries there are increasing tax brackets, so that the rich are taxed proportionately more than the poor. Income tax is levied in the country in which the income is generated, irrespectively of where it is spent.

Indirect taxes, such as VAT, are based on the principle that the more you consume the more you ought to pay. Furthermore, if you want to consume luxury goods you must pay a higher amount than if you want to consume basic goods. This is justified on the basis that who consumes more is better off than who consumes less. VAT is levied in the country in which the income is spent, irrespectively of where it is generated.

How does that apply to the proposed Internet taxes?

Luc Soete, the director of the Maastricht Economic Research Institute on Innovation and Technology (MERIT), proposes a bit tax. Existing taxes, he claims, are hardly enforceable in cyberspace. For example, if you buy a piece of software from a shelf, you pay VAT. On the other hand, if you download it from the Internet, you don't. Therefore, he says, a tax should be introduced on information flows. Every bit transmitted over the net would be taxed, say, 0.000001 cents. Assuming that such a proposal would be technically feasible, what would be the consequences? Funds would be raised for the government. However, such a tax would disincentive the use of the net in favour of other transmission media. But most of all, it would be a very unfair tax. If I am an investor connecting to the New York Stock exchange to download price information and input orders, I would be taxed much less than a kid downloading a video game off the net, as price information is composed of far less bits. Furthermore, which government would be entitled to collect the tax for a transmission across a border? If the government of each country whose servers are involved in the transmission can levy a tax, this would favour other networks over the Internet whose structure is not designed to minimise the number of countries "crossed" by a bit travelling to its destination.

In Tacoma, Washington, a different approach was attempted. A tax of 6% was levied on gross revenues generated by electronic transactions originating within the State. This tax was unique in that it affected any subject who received income from transactions originating in Tacoma, independently of its location. Thus CompuServe, AOL etc. were all subject to the tax for the revenue generated by their customers in Tacoma. The tax was later scrapped following protests. This tax was more fair, as it taxed revenues, not bits. Thus more expensive services would be taxed more than less expensive ones. In practice, this tax resembled VAT in that it taxed consumption of Internet services. The reason it
failed is that it was a local tax which infringed upon non residents.

So how could an Internet tax regime work? There are three questions which need to be answered. First of all, what should be taxed. Secondly, who should tax it. Thirdly, how. I will only try to answer the first two questions, leaving the third one open for discussion.

As to what should be taxed, I think that the basic principle of taxation, i.e. that either income or consumption should be taxed, is still applicable. On the Internet, income can be taxed by taxing the companies that do business on it. Consumption is harder to tax, and will be even harder if payer anonymity takes off. The only way of taxing consumption would then be to force companies selling goods on the Internet to disclose to the tax man their transaction log (which does not imply the disclosure of the identity of the customers, as this is not known to the company). Technically, some system to prevent companies from hiding transactions should be developed. Some module which encrypts the transaction log with a government key could do the job. Who should have the right to tax? Suppose I connect to AOL from the UK and buy a report in Spain, who should tax me, the UK, the US or Spain? The answer is: all three countries, but I will be taxed differently. As I live and work in the UK, I will pay income tax in the UK. In the US, AOL will pay taxes to the American Government on the revenue generated by my activity (AOL might in turn pass on to me a part or all of the tax), and the Spanish Government will tax the seller for the income it gets from me through income tax and VAT. This system would still work if I could buy anonymously, as long as AOL and the Spanish firm cannot hide my payment (as an example, in the Digicash scheme they have to send the coin to the bank which credits their account, so that they cannot hide transactions). However, if the system basically works for Internet commerce, it stops working when we consider the Internet as a financial network. If I can send money to other countries anonymously, then I can buy assets abroad anonymously, and obtain income which is not recorded anywhere. Although this income would be partially taxed when it is used for purchases, it would escape any form of income tax.

It is to be noted, however, that this problem already exists. Although in a double entry bookkeeping system such as today's banking system it is theoretically possible to track any transfer to its source, in practice this is every hard and lengthy process. Many companies, and indeed many individuals already hold offshore accounts to avoid taxes. The big difference would be that the Internet would allow everyone, and not just a small elite, to avoid the tax man. This problem, as far as I can see, will remain unresolved, at least until some international agreement or political pressure will force tax heavens to change direction and introduce a minimum level of rules. Maybe the fast development of the Internet will be a spur to Governments to tackle this issue once and for all.