Taxation and Tax Policy in the E-World

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Governments can regulate the economy and encourage or discourage particular forms of social behavior, by manipulating the incidence of taxation. Tax incentives in a particular area will promote expenditure: for example, tax deductions allowed to farmers will prompt them towards greater productivity. The reverse also applies: a heavy sales tax on luxury goods will reduce public demand and shift productive resources to other areas. By such means, taxation can be used to control and direct economic development.

Taxation and tax policy are playing important role in the economic development in the last decades. As the principal means by which governments fund their expenditures, taxes are at the foundation of public finances. Taxes have been used throughout the world in the most of their role of regulating the economic issues. A properly designed tax system implies readier taxpayer acceptance of that expenditure burden. It should promote the maintenance of a high and sustainable level of output by minimizing both distortions to market-set prices and disincentives to work, saving and investment. But optimal tax policy goes beyond mere efficiency and funding considerations to encompass inevitable normative judgments about the amount of redistribution. The regulative role of taxation is one of the most pronounced roles from the monetarist economists.

The last years we are examining a rapid development of new realities – the technological progress and e-economic development. The introduction of e-everything requires new theory and new practice for tax policy. The major goal of this paper is to outline the problems that tax policy and taxation are facing the development of the e-world. The new technologies started to ease the tax compliances and tax payments but the e-trade and other e-things at the end of the day will erode the tax base and will increase the tax avoidance and tax evasion and in that way lower the state revenues and the social welfare function.

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1. Principles of taxation

Adam Smith theorized that taxation should be imposed according to four famous maxims of good tax practice: equality, certainty, convenience and economy.  

I "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the State".

When Adam Smith wrote, governmental functions were few and uncomplicated. The division of the burden was seen as a simple matter of equity based on some quality of economic well being: the greater the financial capacity to pay, the greater should be the individual's contribution. It is generally taken for granted that an individual's income is the best measure of his economic well being and of his capacity to pay. Basically this philosophy is reflected in the current tax system, subject to one vital qualification. Adam Smith advocated proportionality: the notion that the proportion of the tax burden assumed should vary directly with the revenue, which each subject received.

The mobility of labour within the European Union is undoubtedly lower than the mobility of capital: the globalisation and the closer integration of the capital markets and the accelerated penetration of the new communication technologies have done much to encourage the international mobility of activities, in particular in the financial sector. While liberalization of the financial markets has considerably improved the efficiency of resource allocation and opportunities for tax avoidance and evasion and thus helped to erode the tax base in many countries in the world. Between 1980 and 1993, the implicit tax rate on employed labour for the Community as a whole grew by about one fifth while the same indicator for other factors of production - mainly self-employed labour and capital - decreased by more that a tenth.  

II "The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise 'the taxpayer' is put more or less in the hands of the tax gatherer".

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3 Tableau de bord Prelevements Obligatoires - DG XXI - February 1996.
This of course can be quite easily obtained and achieved in the era of the rapid development of the technologies. The information society is an informed society. It is difficult to transfer the information in capital since it is at everyone disposal, but the usage of this information is a good capital that can be only used in e-world. Only well equipped taxpayers with Internet access can benefit from this principle in full in the coming years, as they can get the necessary information at a mouse click.

III "Every tax ought to be levied at the time, or in the manner, in which it is most convenient for the contributor to pay it"

We must pay much more attention to the third principle since it is closely related with one side of e taxing – e-filing and e consulting. This principle is also closely related with the compliance costs of taxation. A lot has been done in the world for accomplishing this principle. With the development of the modern communications technologies this process evaluates quite quickly.

Issues of easing the taxpayers as much as possible in their tax compliances are spread all over the WWW. It is easy to find whatever you need in order to be a good citizen – from tax forms and tax calculators to the most sophisticated methods of tax avoidance and maximisations of your income or profit.

IV "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury in the four following ways. First, levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose prerequisites may impose another additional tax upon the people. Secondly, it may obstruct the industry of the people, and discourage them from applying to certain branches of business, which might give maintenance and employment... Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them and thereby put an end to the benefit which the community might have received from the employment of their capitals. An injudicious tax offers a great temptations to smuggling ... Fourthly, by subjecting the people to the frequent visits and odious examination of the tax gatherers, it may expose them to much unnecessary trouble, vexation and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at
which every man would be willing to redeem himself from it. It is in some one or other of these four ways that taxes are frequently so much more burdensome to the people than they are beneficial to the sovereign."

In the fourth principle there is again close relation with the costs - two of the four are concerned wholly with compliance costs, while a third includes administrative and compliance costs. The fourth reason in the fourth principle represents a vivid expression of the psychic costs of tax compliance.

Harold Groves considers Smith’s equity principle to be ambiguous because it suggests as leading principles both ability to pay and benefits received, and because it can be used to support gross as well as net income tax measures. According to Groves and some other scholars, the benefits-received principle should be clearly distinguished from the ability-to-pay principle, although both are difficult to apply in a scientific manner.

As national economies become more closely integrated, it becomes increasingly difficult for countries to conduct independent tax policies. For example, heavy taxation may affect residential decisions of relatively mobile high-income individuals, who may make extraordinary contributions to economic growth; cross-border shopping may undermine the bases for excise and sales taxation; and income taxation may influence the location of investment, especially portfolio investment. Economic integration also makes tax administration more difficult. Problems include gaining the information needed to tax income from foreign portfolio investment; the use of transfer pricing, debt, and other means to shift taxable income between jurisdictions; and the presence of tax havens.

2. Tax harmonization and tax policy in EU

As the European Community dismantles impediments to the establishment and functioning of a single internal market, it will have to be prepared to confront a number of important tax policy problems associated with closer economic integration. Fair competition is a key component of the Single Market, but unfair competition in the tax area is a cause of concern because of its potential negative effects, particularly

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on tax revenues of Member States, on the efficient allocation of economic resources within the European Union, and on competitiveness and employment.

The Single Market with its four fundamental freedoms of movement is the cornerstone of European integration. Through the establishment of the Single Market, the Community aims to promote sustainable growth and a high level of employment in the European Union. As other regulatory and economic barriers are progressively removed, taxation is rightly perceived as an increasingly important residual factor preventing the full realization of these crucial goals.

Experience, especially in the European Union, has shown it difficult to achieve coordination and harmonization of tax policy, especially income tax policy. There are strong incentives for a country not to play by the rules of the game; moreover, contrary to the situation where free trade provides a natural benchmark for multilateral trade policy, there are no generally agreed standards for tax policy, which involves decisions on tax bases and the vigour of tax administration, as well as rates. Governments cannot ignore these developments and their implications. Adaptation to the new realities may deteriorate into tax competition, leading to the inability to maintain either progressive (redistributive) taxation or a level of taxation adequate to finance the level of services people desire. Indeed, more than one author has wondered whether taxation of capital can survive integration of the world's economies. These problems can be minimized if policies can be coordinated, or even harmonized, perhaps through creation as proposed Ch. McClure, Jr. of a new organization similar to the World Trade Organization or the International Monetary Fund.

Even though fiscal degradation affects every major source of taxation (consumption taxes, business taxation, capital income taxation, social contributions), its effects differ greatly according to the nature of the tax concerned. Even consumption taxes,

5 The standardization of tax rates, tax rules and tax definitions throughout a number of countries. Usually, in a harmonization exercise the existing practice that is most common is adopted as the standard.

6 Joel Slemrod notes, "although it is not desirable to tax capital on a source basis, it is not administratively feasible to tax capital on a residence basis."

7 Because of the ability to enjoy services without paying taxes.


which are harmonized to a much greater extent that direct taxes, are not immune from
the risk of fiscal degradation.

The elimination of tax barriers in the Single Market is made even more important by
the European Monetary Union, and because it would appear contradictory to do
nothing to remove tax distortions while trying to remove distortions related to
misalignments of exchange rates. Improvements in tax systems, so as to make them
employment-friendly rather than biased against employment, will contribute to the
fight against unemployment at a time when this is the main priority of the Union's
policies. 10

The lack of uniformity in the implementation of EC Directives on VAT across EU
countries and procedural complications that the cross-country differences in the VAT
regime entail in a single market creates further distortions in trade flows. The
“transitional” VAT regime for cross-border trade, implemented since the abolition of
custom controls between EU countries in 1993 embodies a wide variety of rules for
determining the place where the transaction is taxed and, consequently, the place
where the tax is deducted or refunded. 11

This “transitional” system may be also prone to fraud, as goods travel tax-free across
intra-EU frontiers, unless EU countries’ tax authorities fully co-operate with each
other. The European Commission (1998b) noted: “Given that, rather than being
collected at the moment of importation, VAT is recovered at a later stage, and on the
basis of the taxpayers’ periodic declarations, the possibility of fraud has been
proportionately increased”. 12 And VAT declarations are rarely subject to selective and

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10 Taxation in the European Union, Commission of the European Communities, Brussels, 20.03.1996,
SEC(96) 487 final. Discussion paper for the Informal Meeting of ECOFIN Ministers.
11 For sales to foreign businesses that are registered for VAT, the goods are exported tax free;
the receiving business has to declare the import and pay VAT on it. Importing businesses
that are not registered for VAT are treated as consumers. For sales to consumers in another
EU country, firms have to register for VAT in the destination country and apply its VAT
rates. However, for small-scale sales (e.g. through mail or Internet order), the VAT rate in
the supplying country is applied.
12 The European Commission considers that one of the main reasons for the increase in fraud
under the current VAT system is the fact that goods circulate without VAT being paid
(European Commission, 2000c). It reports two main types of fraud: (a) the declaration of
fictitious intra-Community deliveries: the exempted goods are in fact sold on the internal
market and VAT due on final consumption is thus evaded; (b) failure to declare VAT due on
intra-Community purchases: this may then result in VAT fraud on final consumption if the
goods are resold through underground trade channels. The right to deduct the tax upstream
may also be misused in cases where buyers’ VAT declarations request the refund of VAT on
purchases for which no VAT was paid.
co-ordinated controls. As a result, according to the European Commission (2000e) estimates, VAT fraud amounts to €8 billion annually, and the European Commission (2000d) noted, “there are indications that the level of serious fraud in intra-Community trade is growing”.

One solution to cut compliance costs, which create distortions in the single market, and to reduce scope for tax fraud would be to replace the destination principle by the origin principle. The taxation of imports and the non-taxation of exports would be abolished and the VAT system would be operated within the EU area in the same way as it would within a single country. Even though the European Commission remains committed to adopt such a system, it could only be introduced with greater harmonisation in value added taxes across EU countries, including tax rates. It would also require the introduction of a revenue-sharing scheme. Acknowledging the significant technical and political challenges associated with such a radical change, the Commission proposed a new approach in June 2000 to improve the current “transitional” system. The “Strategy to improve the operation of the VAT system within the context of the internal market” (European Commission, 2000c) is based on four objectives: simplification of current rules and their modernisation (in particular to reflect recent developments in e-commerce, and some network industries, such as postal services, broadcasting, water and electricity), more uniform application of current rules and a new approach to administrative co-operation.

Free capital movements, the elimination of custom controls, the advent of the single currency and the development of information and communication technologies all contribute to increase the mobility of tax bases. On the one hand, enhanced mobility within the EU area may create welfare gains by enabling individuals and companies to choose as a jurisdiction of residence that country or region that provides the fiscal package -- in particular the provision of public goods and the associated tax burden -- best suited to their needs. The greater exposure to international competition also provides strong incentives for governments to raise public sector efficiency and may yield a double dividend: lower taxation and better public services. On the other hand, free movements of products and factors, in conjunction with differences in EU

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13. There are some 100 billion VAT declarations submitted per year in the EU area. However, mainly due to lack of resources, they are mostly used as a document stating the tax said to be due while all the other information, which could form the base for control decisions, is not actually used, but is nevertheless collected and stored (European Commission, 2000d).
countries’ tax systems and barriers to effective information exchanges, extend the scope for tax avoidance and evasion. This could require lowering the tax burden on highly mobile production factors, and result in a higher tax pressure on the less mobile ones, in particular labour, or erode revenues to the point where public services cannot be delivered as extensively as voters might wish. At the corporate income tax level, there is no clear evidence of a race-to-the-bottom since cuts in statutory rates have often been accompanied base broadening measures. Nevertheless, recent trends in capital income taxation and the preferential tax treatment to non-residents by many EU countries may signal that such a pressure to lower taxes on highly mobile factors is at play.

The trend towards globalisation in financial markets and the advent of cheap and rapid electronic links to overseas financial markets make it increasingly difficult to tax capital income effectively. In EU countries, restrictions on capital movements were fully removed in the early 1990s. Reinforcing the attractiveness of cross-border investment is the single currency, which has eliminated exchange risks and costs within the euro area. Meanwhile, the limited information flows between financial intermediaries and tax administrations both within and across EU countries -- including bank secrecy laws in some EU countries – makes it easy to evade tax. EU countries’ consumption and corporate tax bases are also becoming more vulnerable to erosion. Intra-EU cross-border shopping has been given a further boost since the adoption of the single currency, which facilitates cross-country price comparisons, and the emergence of e-commerce transactions. E-commerce is much less advanced in most EU countries than in the United States, though disparity across countries is wide -- the Nordic countries being in a leading position. Recent estimates suggest that it accounted for less than 0.5 per cent of consumption in 1999, but its share is growing rapidly (Coppell, 2000). And, the advent of “smart” mobile phones, free Internet access, and cheaper telecom tariffs, are expected to boost private consumer e-commerce transactions. Tax base erosion pressures may thus intensify in

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14. A potentially aggravating factor is the development of offshore capital investment via the Internet. The so-called e-banking may expose tax revenues to an increased risk of international evasion on the income from capital if it makes cross-border evasion easier and more accessible to a broader range of population than just the wealthy. Security problems and a relatively low penetration of the Internet in the EU area still limit the expansion of these financial transactions – Nordic countries are a notable exception: more than one fourth of the entire population of Finland and Sweden do banking online. However, such financial transactions are likely to expand rapidly in the medium run.
certain fields. In the context of Business-to-Consumer (B2C) transactions, EU countries which have maintained a higher effective tax rate on consumption (e.g. Denmark and Finland) will be the most affected since EU online providers of digital products currently apply their own country’s VAT rates to intra-EU sales and products delivered from a non-EU online source are tax-free.15 New information and communication technologies also make a physical location of management and service activities much less important, thus increasing the mobility of corporate income tax bases.

3. Internet taxation

The area of internet taxation is virtually undiscovered. Legislation has been in place for the past five years that has put a hold on passing legislation imposing taxes. The theory behind this was to encourage the internet development. However, recently states and the federal government has been pressing for new taxation laws that would help them retain a portion of the new economies profits. As of today many companies, states, and congressman in US have conducted studies that say how much they are losing in revenues based on the new internet economy. Each group is now positioning themselves for the inevitable taxation of goods across borders.

The mind of many leading internet taxation specialists is that an internet tax is no different than any other normal tax that the government levies. With each state competing for revenue, each government would simply place a tax on goods being bought in their state by residents or corporations. Thus, the tax would be placed upon checkout at the online shopping cart.

However, what many people don't realize is that there are many exceptions to the placing of tax in interstate commerce. Currently, mail order catalogues enjoy a broad exception to the taxation of goods bought out of state. While every person buying goods online or in the mail order is supposed to pay taxes on goods bought, they often do not.

15. This anomalous situation is currently the subject of a Commission proposal to correct the place of taxation rule in these circumstances. Those plans for applying VAT to Internet online sales from outside the EU area also raise the prospect of pressure for these high tax countries since, if the seller has the option of registering in a single EU country, the tax rate may play an important role in the choice. Nevertheless, it is recognised that this B2C sector of e-commerce currently represents a relatively small proportion of total e-commerce, and that B2B transactions will continue to predominate.
Another interesting point is whether states are losing revenue due to the internet. While they are probably losing some funds, or more appropriately losing out on gaining revenue. Further, most purchasers of online goods would may not purchase in a state store, but rather in a tax exempt mail order catalogue, thus still by-passing the tax. Or they may not even purchase at all if the purchase was not so easy and simple.

A majority of online shoppers polled by Active Research, Inc., a provider of Web-based market intelligence services, say that their purchase behavior would decrease if the government taxed Internet sales. The survey measured e-commerce consumer attitudes about government-imposed taxation on the Internet.

Of 539 individuals surveyed, 66% claimed their online shopping behavior would decrease if the government taxed Internet sales. The survey also found that significantly more women (71%) than men (64%) would decrease their online shopping. This finding is consistent with other findings by Active Research showing that women tend to be more price sensitive than men when shopping for high priced items.

- 66% of online shoppers say their online shopping behavior would decrease if the government taxed Internet sales.
- 71% of women say they would decrease their online shopping behavior if the government taxed Internet sales.
- 64% of men say they would decrease their online shopping behavior if the government taxed Internet sales.

"The findings of this survey are a clear indication of current attitudes of e-commerce consumers as Internet taxation continues to be debated in the halls of government," says Daniel Greenberg, VP of Marketing, Active Research. "Active Research is able to bring aggregated customer preferences information back to companies in real-time, and therefore help them build better products, services or value propositions for customers."

Consumers are measured as they are shopping online. As a result the respondents are self-interested, engaged and forthright about their desires. The response rates are significantly higher than traditional survey methods and vast amounts of statistically valid preference information is collected, resulting in the live, continuous measurement of market trends.
Active Research's independent consumer survey on Internet taxation was completed October 11, 2000.

If you think e-commerce can make its way around the globe without taxation, it's time to face the tax authorities. Countries, states and localities aren't about to let business transition from mainstreet to the Internet without getting a cut. In fact, the goal of many state and local tax jurisdictions is to extend the locales from which online merchants must now collect taxes. But the really bad news for online merchants isn't that tasks like accounting and online transactions may become more complicated. It's that so many issues of Internet taxation are uncertain. And in a world where ignorance or misunderstanding of the law is no excuse, the real danger for businesses lies in running headlong into back taxes, penalties and even criminal sanctions while navigating through e-commerce's fog. It's tough to draw up a competitive business plan when it's not clear whether taxes applying to a given customer segment will be assessed at 25 percent or not at all; and what is a business to do when it thinks taxes may be due, but collecting taxes would give an edge to competitors who aren't collecting. Technology and networking burdens must be addressed as well as local government funding. This new industry either needs states and nations to come up with a five-year plan maintaining the tax status quo and clarifying its ambiguities, or it needs that same clear policy implemented in a multi-phased tax approach that doesn't push harder than technology and emerging businesses can go. One possibility is online merchants to be asked to collect and remit taxes for buyers based in every country, state and locality around the globe--which appears to be a distinct possibility--then it's obvious that the incredible complexity in making such a demand requires uniform rates. The optimum would be uniform rates across all U.S. jurisdictions, the European Union and the 29 nations of the Organisation For Economic Co-operation and Development (OECD). Changing just the U.S. tax systems--and trying to make such systems compatible with global tax systems--won't be easy; and turning all this around on an Internet time clock sounds a bit like halting feudalism in a day. Yet, there are very strong incentives for parties on all sides of this issue to move quickly to get the job done. Expedience is what is needed. Work out short-term alternatives for the issues that aren't yet palatable politically and technically. Grand solutions tend to be intricate, powerful, long in creation and short in reality. Pragmatism, on the other
hand, works. The very birth of the Internet--based on TCP/IP and not Open Systems Interconnection--is proof of what's needed as e-commerce moves forward.

Conclusion

Taxation and tax policy are facing great challenges in the information society. The problems of e-filing are not so easily solved yet in all countries and this makes at certain stage the existence of information technologies additional burden and increasing the transaction costs of the contemporary taxation.

The European integration and abolition of the fiscal frontiers is a kind of step towards the new era in taxation. The movements of the factors, goods and services across physical borders have somehow prepared the governments for the e-movements in the web space. The orientation of taxing heavily bases that is difficult to be moved rather than those that can flip away for a second is one of the ways to deal in the e-world.

The introduction of e-taxation is a challenge for all societies, since a great volume of trade and other economic activities are passing through the e-space. So this requires a new tax system and totally new taxing.

How would you tax someone who works from home and has no transactions in real world? His income is in cyber bank, he buys from cyber shop and all transactions are in the Internet.

Two persons are discussing their business. The first one has e-store and he asks the other one:

- What is your business do you do something in the e-space?
- Yes, I have an e-hotel with e-restaurant and I am doing money out of them!

How do you do that since noone sleeps there and noone eats there?

Well, we have fees on entering and on exit!

This joke shows some of the ways that e-governments have to operate in the e-world in order to finance their spending as usual.

References


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