International Trade in Cyberspace: 
How to Tax Digital Goods

Jürgen Stehn
Kiel Institute for World Economics

Abstract

The paper discusses various possible approaches to turnover taxation in cyberspace. It shows that the main challenge of the new economy is to effectively cope with B2C international trade in digital online goods and services. However, most approaches to turnover taxation discussed in the literature give rise to several surveillance, efficiency, incentive, and identification problems. As a consequence, there seem to be only two appropriate approaches to deal with the special characteristics of international trade in cyberspace, the country-of-origin principle combined with a taxation of digital goods and services at the physical location of producers, and the community principle in combination with a withholding tax (WITHVAT).

• JEL Classifications: F 15, H 21

• Key words: International trade, Turnover taxation, Electronic commerce, Sectoral efficiency

I. The Problem

In 1998, the U.S. government declared a turnover tax moratorium in electronic commerce. At the same time, the governments of the EU member states heavily discussed whether the supply of electronic products over data networks should be regarded as supply of goods or supply of services. They finally agreed on the latter. As a consequence, on-line sales from non-EU suppliers to final consumers
inside the EU, and sales from EU suppliers to consumers outside the EU are not subject to value-added taxes (VAT). In the case of on-line sales from EU suppliers to EU consumers, the VAT rate of the country of origin is applied. However, if the consumer is a taxable enterprise, the on-line transaction is taxed using the rate of the country of destination.

These two very distinct reactions to the upsurge of electronic commerce are the mirror image of the difficulties in creating an effective system of turnover taxation in cyberspace that have their roots in the wide spectrum of different turnover tax rates in OECD countries. Even in internal markets like the United States and the EU, turnover tax rates differ to a considerable extent. Varying tax rates among trading partners require border controls and border tax adjustments in order to ensure effective turnover taxation. However, border controls in borderless cyberspace are a contradiction as such. The objective of this paper is to present possible solutions to this seeming contradiction. Two obvious solutions to this contradiction will not be discussed in this paper: (1) worldwide harmonization of turnover tax rates and (2) implementation of technological advances that make worldwide surveillance of Internet transactions by national governments possible. Both of these seem to be politically unfeasible and socially undesirable.

The paper is organized as follows. The next section analyzes the advantages and disadvantages of traditional approaches to the turnover taxation of international trade in digital goods and services Section II presents and discusses some innovative proposals for turnover taxation in cyberspace. Section III draws some conclusions.

II. Traditional Turnover Tax Systems and Internet Transactions

A. The Transitional System of the EU

As a visible outcome of the completion of the internal market, almost all physical border controls within the EU belong to the past. In 1991, the EU-Commission decided to preserve the country-of-destination principle in value-added taxation (VAT) for a transition period from January 1, 1993, to December 31, 1996, by shifting fiscal controls from national borders to exporting and importing firms and national tax authorities. In 1997, the transitional system was put in place for an indefinite period of time because the member states could not agree on the envisaged VAT system “based on the principle of taxation of goods