Introduction to Bitcoin: Unique features and data availability

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1.1 Introduction to Bitcoin

Bitcoin is both a computer protocol and a digital asset or unit of account. The design of the protocol was released in 2008 under a pseudonym; Satoshi Nakamoto. Its mysterious beginnings were intended by the author as a strategy to ensure that the security and use of the technology did not depend on the credibility of the creator. The protocol was made open source for everyone to read and build upon. It was first implemented on January 3rd 2009 and was announced on the Cryptography mailing list on January 11th 2009.

Initially, Bitcoin was adopted by tech enthusiasts and libertarians. The first known Bitcoin purchase for real goods took place on 21st May 2010. A pizza was purchased by a volunteer in England to be delivered to Laszlo Hanyecz, a programmer living in Florida. Laszlo sent the volunteer 10,000 BTC in exchange for $25 worth of pizza. In May 2010, there were approximately 230 transactions taking place on the network on any given day. Over the past three years, there has been substantial growth in the number of transactions. The average number of daily transactions in October 2013 was 53,124.

The volatility of the price of Bitcoin has attracted much media attention. The price is currently approximately $380. At the beginning of 2013 the price was approximately $13. The Financial Times, the Wall St Journal amongst other news sources release stories documenting changes in the price and point to their potential sources. Most recently, there has been a large surge in demand in China with the Chinese Yuan overtaking the dollar as the currency most traded for Bitcoin.

Bitcoin is part of a much wider class of internet-based currencies and economies that are growing in significance in many parts of the world. The focus on Bitcoin in this seminar reflects its influence in establishing a new generation of currencies but should not limit the discussion. The issues raised are easily applicable to different spheres of research, which will provide a good basis for interdisciplinary collaboration.

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1 This note was prepared for the seminar at the Oxford Internet Institute 21st November 2013. Comments on this note are very welcome. If you have any corrections or suggestions please email me at jonathan.levin@economics.ox.ac.uk

2 This does not represent transactions for goods and services but rather any movement of Bitcoin around the network. Such decomposition remains an interesting challenge for research.
1.2 Bitcoin’s unique features

Although Bitcoin seems like a drop in the ocean in comparative terms, there are some distinctive features that make it an interesting object of study. These can be split into three broad categories.

1. Bitcoin’s design and attributes
2. The behaviour observed on the network
3. Bitcoin’s interactions with existing institutions

1.2.1 Bitcoin’s design

Bitcoin is the world’s first decentralised payments system. All existing payments systems have central trusted authorities at the core that process transactions on its network, verifying against the classical security threats that exist: fraud and double spending. In order to establish a decentralised payment system, any such system would have to solve these security threats without the ability to have trust of anyone else on the network. Bitcoin therefore marks a departure from traditional payment systems as it removes any trust lines that needed to exist. The protocol assumes that the majority of nodes in its network are honest, and resorts to a majority vote mechanism for double spending avoidance, and dispute resolution. It does so through the use of public-key cryptography and a peer-to-peer protocol that distributes a timestamp service providing a fully serialized log of every transaction ever made, otherwise known as the blockchain. Initially all users used to keep a copy of the ledger of all transactions, although now there are many users who do not engage in the payment processing otherwise known as mining.
If Alice creates a transaction to pay Bob 5.0 BTC, she has to prove that she owns the bitcoins in the first place. To do this Alice uses her private key to gain access to her bitcoins and then signs the transaction using her private key. The resulting signature is a combination of the contents of the transaction with her private key. It is designed so that each signature is unique and the private key cannot be deciphered. The signature is proof that Alice has the password to her wallet but does not reveal it for everyone to see. The signature allows everyone to know that Alice has ownership of the coins and the time stamped record of all the Bitcoin transactions confirm that she has not spent them elsewhere before this transaction. If the transaction gets validated, the public record will now show that the 5.0 BTC that were in Alice’s wallet are now in Bob’s and he is free to spend them. The ledger does not contain account balances per se rather each coin’s owner is verified through links with all of its previous transactions.

The issuance of the currency is not done by centralised authority removing the possibility for any manipulation in the supply of currency. Instead, it is used as an incentive mechanism to provide rewards to users who carry out the process of mining. The rate of issue of the currency is completely fixed not in time but in the increments that the currency is released. Every block of transactions that will ever be part of the blockchain has a specified number of new bitcoins that will enter circulation. A block simply contains information on all previous transactions. The distribution of the currency is dependent on a proof of work algorithm; miners have to provide the solution for a complex cryptographic puzzle in order to prove that they are contributing power to the network. This is a computational puzzle where the success rate for the puzzle is statistically independent for every attempt. Therefore the more computing power that a miner throws at the puzzle the more likely they are to win the reward of the new block.

As Figure 2 shows, the first line in a new block is the generation of new coins to the miner that has successfully solved the cryptographic puzzle. The initial reward for “finding” a new block was 50 BTC, this halves after 210,000 blocks (approximately four years). Every 2016 blocks (two weeks) the difficulty of the cryptographic puzzle that the miners are solving adjusts according to the history of the blockchain to try and ensure that new blocks are found every ten minutes in expectation.

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3 This is a proof of work algorithm. This process involves the repeated computation of a cryptographic hash function so that the digest of the transaction, along with other pending transactions, and an arbitrary nonce, has a specific form.
result the release of new coins is predetermined and the total number of bitcoins will converge at 21 million.

Figure 3. Some transactions from a block visualised in a tabular format

<table>
<thead>
<tr>
<th>TransactionHash</th>
<th>Fee</th>
<th>Size (kB)</th>
<th>From (amount)</th>
<th>To (amount)</th>
</tr>
</thead>
<tbody>
<tr>
<td>a5da69b694...</td>
<td>0</td>
<td>0.125</td>
<td>Generation: 25 + 0.21646943 total fees</td>
<td>1AgTMY7kmH7ZxBuLUR5wJPFUvqGsa23sesr: 25.21646943</td>
</tr>
<tr>
<td>0930697715...</td>
<td>0</td>
<td>0.36</td>
<td>19untUpNcFmG3HDEZZ7LsmPbV3dszs1xGq: 345.43</td>
<td>1GBGgGnnJ6mKroRArL6v6RdyPTehVYy7m7e9: 38</td>
</tr>
<tr>
<td>30d4d8ecf1...</td>
<td>0.0001</td>
<td>0.226</td>
<td>1LRtpwKEtMhJvWgCQuQepEBw334z4KeF: 71</td>
<td>18aHaPcZ3li8yYt3XYQ84GAaNskaKVRpS: 20.9999</td>
</tr>
<tr>
<td>4a3b6d3c83...</td>
<td>0.0005</td>
<td>0.619</td>
<td>19Jgxx5n3c3R5YFc2uTmzmkqzwSkRy1TFj: 39.9999</td>
<td>1C84EeiSKvU1wrt6zW8Cy9BChHuqXPqgK: 119.22843527</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>19Jgxx5n3c3R5YFc2uTmzmkqzwSkRy1TFj: 67.9999</td>
<td>19Jgxx5n3c3R5YFc2uTmzmkqzwSkRy1TFj: 78.76956473</td>
</tr>
</tbody>
</table>

Source: http://blockexplorer.com/

The attributes of Bitcoin that have contributed to its adoption are also interesting areas which can be analysed either in tandem or distinct from Bitcoin’s technical features.

— Transactions on the network are pseudonymous. This means that whilst every transaction is publicly announced, there is no easy way to link addresses to real world identities. Some techniques have been developed to get around this.

— There are no direct costs of using the network. Miners who prop up the network have so far been incentivised largely by the creation of new coins. Eventually, transaction fees will incentivise the miners to carry out the costly process of verifying transactions.

— Transactions are not location specific and can be sent across borders seamlessly.

— Bitcoin’s themselves are divisible down to eight decimal places but are not fungible in the sense that the history of each coin matters to determine its ownership.

— Basic transactions are irreversible. Once the transfer has been made there is no way for a third party to force a chargeback. Scripting allows for more complex transactions to be constructed on top of the Bitcoin protocol.

Each feature raises particular concerns and questions regarding use cases and possible legal implications.
The more technical adopters define Bitcoin as much wider than just a digital currency. It provides an application-programming interface (API) for money. The existing banking system has APIs but they are, in general, closed. The VISA network has an API but it requires a trusted merchant status in order to program it to suit the needs of the client. Bitcoin offers an open source API for wallets and transactions. The security of the existing financial system relies on security through exclusion. Companies only allow access to their APIs to the few that are trusted. Bitcoin, on the other hand, uses trust by computation. Trust is distributed through the network of miners. The majority voting constrains the ability of bad actors to hijack the network. As a result there is no need to put exclusion controls in place. The Bitcoin network offers three distinct APIs.

- **A transaction scripting language**: The most commonly used form of the script defines the transaction as “Transfer X coins from Alice’s wallet to Bob’s wallet”. In this standard setting the transaction is irreversible. However, the scripting language allows for the development of escrow services and the possibilities of joint accounts with multiple signatories. The M–of–N signatures script is designed to allow the transaction to be approved if any M of a total N keys are used to sign it. In a corporate setting, this allows for capital accounts to require two or more signatories to spend, for example the CFO, the treasurer and the auditor. An escrow service can be constructed without the need for the trusted third-party to ever actually hold the funds. There are also further options to increase the validation conditions further than private keys. For example time stamps can be used or transactions that are co-paid for or crowdsourced could be designed. The language can also be extended over time.

- **The P2P network protocol**: The P2P network protocol allows nodes to communicate, exchanging transactions, validating new blocks of transactions and newly generated coins. The public ledger of all the transactions allows the creation of services that require such information. An application of this could be the auditing of charity expenditures and donations. If the charity discloses their public address for donations, they can instantly have a complete record of all donations and can hire tax accountants or consultants to help them maximise their revenue. On top of this it could make for fully transparent disclosure of expenditures.

- **The “Northbound” client API**: This API offers the kinds of services that customers have come to expect from online banking. Its services include balance checking of a wallet, creating new transactions, creating new wallets. There are many more features like these that are able to execute transactions and other services on the network. This includes programming autonomous machines to function on the network.

Each of these protocols can also be built upon. The Internet Protocol (IP) not only has APIs and protocols that extend it, for example TCP, it also has layers of protocols above it, providing the application layer protocols of the internet such as SMTP and HTTP. Bitcoin can also support such developments. For example, using the existing ledger, developers have been able to create a document attestation and notarisation service that, once created, is independent of their service. Bitcoin allows for the creation of services with a direct API into the ledger of transactions which can facilitate the storage of information such as property rights and communication between machines.
1.2.2 The behaviour observed on the Bitcoin network

There are many different types of users on the Bitcoin network. At the most technical level there are users who are mining new coins and run specialised hardware to complete the task. They have organised into mining pools to smooth their income from running the mining software on their computers. Even on a weekly basis, it is not guaranteed that the rewards from contributing computer power will necessarily match the amount of power that any pool contributes to the network (Figure 4). Due to this uncertainty, there is also an incentive to increase the amount of computing power that any individual user is contributing to increase their chances of finding a new block. In such an environment with no property rights assigned for future coins, there is likely to be overprovision of computer power.

The provision of computing power is important to deter a 51 per cent attack. Such a scenario would mean that one user would be able to ignore any transactions that are made on the network and publish alternative histories, which are likely to be accepted by the rest of the network. Although there have not been any 51 per cent attacks on the Bitcoin network of late, back in March 2013 there was a significant fork in the blockchain. There were two competing histories for a period of six hours. It was caused by an incompatibility between two versions of the protocol but meant that the miners had to coordinate on one history of the network. The core development team, headed by Gavin Andersen resolved the issue by instructing the miners to follow the earlier version of the protocol. This decision required coordination between different miners and let to approximately $35,000 of costs.

Figure 4. Weekly share of blocks found and hashrate contributed to the network

There has been a large amount of investment in the virtual currency ecosystem over the past two years with some firms receiving as much as $9 million in seed capital. Most of this has focussed on
the exchanges, which serve as the interface between government issued currencies and virtual currencies. There have also been significant investments in wallet providers and payment processing services. These services allow users to easily transact and pay for goods and services. Some of the services have their own protocols that are built on top of the Bitcoin protocol. The companies that run these services are subject to operational failures, thefts and counterparty risk in some instances.

One of the largest uses of Bitcoin has been online gambling. The protocol allowed the early development of automated games that have provable odds. Satoshi dice was the original game accounting for a large proportion of transactions in early 2013 (Figure 5). The pseudo-anonymity, irreversible transfers and instant confirmation makes Bitcoin a good gambling chip. These features have also led to its use for paying for illegal substances online on platforms such as the Silk Road and Atlantis (both closed September 2013).

Bitcoin and other virtual currencies provide a window into people’s behaviour in environments without well-defined property rights. It prompts questions about the incentives and games that are played in the creation of alternative currency systems. Bitcoin and other decentralised currencies represent store of value payment systems. In such systems, some object of value is transmitted. It hinges on the recipient being able to verify the object of transfer. In Bitcoin this is easily done and the risk of counterfeits is much smaller than any cash system. The concerns of users and their behaviours are therefore likely to be very different from existing financial systems. In particular, there may be motives to hoard currency in the expectation that its value must appreciate if more people are using the currency.
1.2.3 Bitcoin’s interaction with existing institutions

One of the most prominent examples of Bitcoin’s interaction with existing institutions has been the case law and regulatory guidance that has been issued on Bitcoin. Bitcoin was not the first virtual currency to receive the attention of regulators but due to its decentralised nature has caused much discussion over the correct steps to take to prevent illegal activity and protect consumers who choose to use the currency or other virtual currencies. This area seems ripe for research and close attention due to precedents set.
<table>
<thead>
<tr>
<th>Issuing Body</th>
<th>Takeaway</th>
</tr>
</thead>
<tbody>
<tr>
<td>ECB</td>
<td>Virtual currencies do not present an immediate concern for financial stability</td>
</tr>
<tr>
<td>UK regulators</td>
<td>No official comment so far from UK regulators, exchanges have been told that they do not need to apply for licenses but no UK banks are currently willing to back a UK exchange.</td>
</tr>
<tr>
<td>German Finance Ministry</td>
<td>Bitcoin is “a unit of account”, income from it is taxable but if stored for more than a year then do not pay the 25% capital gains tax. Miners do not pay income tax.</td>
</tr>
<tr>
<td>Case Law</td>
<td>Bitcoin is a form of money and currency. SEC case against ponzi scheme Bitcoin Savings and Trust (BTCST). Judge declares that the defence of “no money changed hands” is insufficient as Bitcoin is easily convertible into USD. Coinlab has also been ordered to pay Bitvestment 8,000 bitcoins for reneging on a contractual obligation.</td>
</tr>
<tr>
<td>FinCEN</td>
<td>Money transmission licenses needed for exchanges and miners who sell their mined coins.</td>
</tr>
<tr>
<td>SEC / FBI / FEC</td>
<td>Bitcoin investment trusts under consideration. Assets have been seized and held by the FBI. Federal Electoral Commission declared it legal to accept donations in Bitcoin.</td>
</tr>
<tr>
<td>Thailand Central Bank</td>
<td>No license was granted to a Bitcoin exchange from the regulator, leading to perceptions that Bitcoin is illegal.</td>
</tr>
<tr>
<td>Finland Tax Authority</td>
<td>Sales made with virtual currencies are to be treated in line with other monetary instruments and similarly subject to income tax. Newly issued Bitcoin received by miners is also to be taxed as ordinary income. Capital gains should be applied.</td>
</tr>
<tr>
<td>Kenyan Central Bank</td>
<td>Unless something is legal tender, it does not fall within our mandate.</td>
</tr>
<tr>
<td>Sweden</td>
<td>Money transmission licenses needed for exchanges</td>
</tr>
<tr>
<td>Tax Authorities</td>
<td>Many tax authorities have had to deal with other alternative currencies such as local currencies, barter exchanges etc. Most require the reporting of such activities at “fair market prices” in annual tax returns</td>
</tr>
</tbody>
</table>

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4 Coinfloor has just opened a UK based exchange but their banking relationship is not public information yet.
1.3 Datasets available

<table>
<thead>
<tr>
<th>Source</th>
<th>Description</th>
<th>Restrictions</th>
<th>Website</th>
</tr>
</thead>
</table>
| Blockchain   | A record of all transactions done on the Bitcoin network. Also has aggregate data of transactions using the public keys | Data is pseudonymous, unit of observation is the public keys | http://blockchain.info/  
|              |                                                                            |                                                   | http://www.bitclook.com/  
|              |                                                                            |                                                   | http://blockexplorer.com/ |
| Sourceforge  | Number of Bitcoin client downloads by country                               | Not likely to be a good proxy for usage due to web based services | http://sourceforge.net/projects/bitcoin/ |
| Organofcorti | Weekly statistics on mining                                                 | Weekly reports not aggregated tables of data over time | http://organofcorti.blogspot.co.uk/ |

| Exchanges    | Historical price data across all the major exchanges | Some dates are missing due to downtime on servers or inaccuracies. | http://api.bitcoincharts.com/v1/csv/  
|              |                                                          |                                                   | https://bitcoinaverage.com/ |
| Bitstamp     | Major Bitcoin exchange publishes price data and its order book             | Would need to get permission to get this data.     | https://www.bitstamp.net/ |

| Casinos      | Record of all bets placed on the game. Record of the investments made in the house casino | Static data observed at one point during time. Although with scrapping this could be made into a panel. | https://just-dice.com/ |
| Coinroll     | Record of all bets placed on the game. 40 million bets placed. 119,172 XBT in volume. Need to differentiate between human play and bots. |                                                              | https://coinroll.it/stats |

1.4 The Blockchain

All transactions are publicly announced but they take a specific form that needs to be manipulated to render some useful information. There is also the possibility to use it and overlay the data from the blockchain with some specific IP/TCP data or other sources.
Some techniques could be used to uncover identities or specific behaviours.

— Many transactions have two outputs: one is the payment from a payer to a payee and the other is the return of change to the payer. With some assumptions or information about the specific implementation of the protocol. The public-key that the change was assigned to can be mapped back to the user who created the transaction.

— Most of the Bitcoin exchanges have open order books to support trading tools. Purchases of Bitcoin are made from other currencies and therefore have a precise decimal value with eight significant digits. It may be possible to find transactions with corresponding amounts and thus map public-keys and transactions to the exchanges.

— Over an extended time period, several public-keys, if used at similar times, may belong to the same user. It may be possible to construct and cluster a co-occurrence network to help deduce mappings between public-keys and users.

— There are far more sophisticated forms of attack where the attacker actively participates in the network, for example, using marked Bitcoins (taint analysis) or by operating a laundry service.

— Transactions in quick succession without waiting for confirmation can usually be interpreted as being done by the same individual.

— Identification of particular hot wallets may allow for specific services to be mapped. This might allow for an estimation of economic activity on the network.

There are some existing tools to turn the blockchain into a more readable format
http://www.vo.elte.hu/bitcoin/zipdescription.htm
http://www.quantabytes.com/articles/the-quantabytes-schema
https://github.com/gavinandresen/bitcointools

1.5 Other cryptographic currencies

The source code for Bitcoin was made open source at its inception to show its integrity and to allow others to experiment in the domain of decentralised payment systems. Since the creation of Bitcoin, copying the source code, making some technical adjustments and additions along the way, has created over 100 different digital currencies. However, the market cap of Bitcoin is approximately 30 times that of Litecoin, the second largest digital currency (Table 2).

Any currency that will displace Bitcoin as the leading cryptographic currency will have to boast sufficient technical advantages over Bitcoin that render its network effects insufficient to continue using it. At the moment the currency design of the competing currencies is very similar. They all use a process of mining to secure the network and provide a method for the issuance of new currency. Most currencies also usually have an upper limit, with the exception of Novacoin, which has a soft limit of 2 billion that can be lifted at some point in the future if required. There are large differences in the more technical side of the currency. One large distinction is in the hashing algorithm that is used. Bitcoin uses SHA-256 but some currencies have opted for a scrypt algorithm as it lowers the barriers to entry for miners and helps create a more decentralised network.
Table 2. Competing cryptographic currencies are very small in comparison to Bitcoin

<table>
<thead>
<tr>
<th>Coin</th>
<th>Algorithm</th>
<th>Merged mining</th>
<th>Current Block reward</th>
<th>Price (BTC)</th>
<th>Market Cap ($M)</th>
<th>Transactions(^5) (last 24hrs)</th>
<th>Value of transactions ($000’s) last 24hrs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bitcoin</td>
<td>SHA-256</td>
<td>N</td>
<td>25</td>
<td>1.000</td>
<td>5,000.0</td>
<td>70,000</td>
<td>730,000</td>
</tr>
<tr>
<td>Litecoin</td>
<td>scrypt</td>
<td>N</td>
<td>50</td>
<td>0.010</td>
<td>99.0</td>
<td>6,000</td>
<td>490,000</td>
</tr>
<tr>
<td>PPCoin</td>
<td>SHA-256</td>
<td>N</td>
<td>233</td>
<td>0.002</td>
<td>14.0</td>
<td>750</td>
<td>380</td>
</tr>
<tr>
<td>Namecoin</td>
<td>SHA-256</td>
<td>Y</td>
<td>50</td>
<td>0.001</td>
<td>4.5</td>
<td>760</td>
<td>220</td>
</tr>
<tr>
<td>Feathercoin</td>
<td>scrypt</td>
<td>N</td>
<td>200</td>
<td>0.000</td>
<td>2.3</td>
<td>3000</td>
<td>83</td>
</tr>
<tr>
<td>NovaCoin</td>
<td>scrypt</td>
<td>N</td>
<td>9</td>
<td>0.012</td>
<td>2.5</td>
<td>580</td>
<td>66</td>
</tr>
<tr>
<td>Freicoin(^6)</td>
<td>SHA-256</td>
<td>N</td>
<td>215</td>
<td>0.000</td>
<td>2.0</td>
<td>320</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: (Coinwarz, 2013; CryptoCoin Explorer, 2013)

1.6 References and further reading

Below are some references that are helpful for understanding Bitcoin and other virtual currencies.

1.6.1 Introductory texts


1.6.2 Technical papers


Transactions are defined as movements of currency from one address to another and therefore not an accurate representation of the number of transactions between people.

Freicoin is based on “Freigeld” invented originally by the economist Silvio Gesell. There is a cost of 4.89 per cent per annum of holding the currency.


1.6.3 Legal guidance and cases


1.6.4 Economics articles


Luther, W. J. & Olson, J. (2013). Bitcoin is Memory Available at: http://ssrn.com/abstract=2275730