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Digital Service Taxes As Barriers To Trade

Case Study

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The spectre of a tariff-like tax on internationally traded services looms over many developed and emerging market economies. Governments across the globe have announced they are considering new taxes on companies with certain digital business models. France recently imposed a "Digital Services Tax" (DST), which by design explicitly discriminates against foreign importers of certain digital services.

Even though corporate taxes account for relatively low shares of a governments' tax revenue, policymakers seem to be concerned about the impact of digitalisation on governments' revenues from taxes on corporate income. Despite a decline in statutory corporate tax rates worldwide, politicians and government officials still aim to maintain corporate taxes as a source of government income.

Some EU policymakers are now calling for special taxes on a narrowly defined set of digital services, commonly referred to as DSTs. DST proponents' make the bold claim that "digital companies" do not pay "their fair share of taxes". The underlying assumption is that companies in the digital space are not paying the same amount of tax as their non-digital peers. It is assumed that there is a substantial source of untaxed profits that is waiting for the embrace of the taxman.

The wave of calls for taxes on digital services is accompanied by an official OECD initiative to preserve corporate taxes by defining new rules for corporate taxation in the digital age. Under the auspices of the "Inclusive Framework" representing 129 sovereign governments and territories, the "OECD's Task Force on the Digital Economy" (TFDE) has been suggesting a fundamental change to long-established corporate income tax rules.

Doubtful of the final achievements of the OECD initiative, the European Union's (EU) European Commission pressed ahead with its own proposals for an EU-wide DST, which soon became a template for jurisdictions outside the EU. With 2019 EU elections on the horizon, the DST was intended by EU officials to regain voter confidence in the EU and its institutions. In March 2018, European Commission's tax department, DG TAXUD, formally proposed to introduce an EU-wide three percent turnover tax targeting revenues from digital advertising and online intermediation services.

The EU's DST was intended to affect only companies with total annual worldwide revenues of at least EUR 750 million and EU revenues of EUR 50 million. The tax was designed to affect 1) revenues from selling online advertising space, 2) revenues from digital intermediary activities, which allow users to interact with other users and which can facilitate the sale of goods and services between them, and 3) revenues created from the sale of data generated from user-provided information.[1]

[1]In March 2018, the European Commission also presented second proposal in which a digital platform company would be deemed to have a taxable 'digital presence' or a virtual permanent establishment if its revenues exceed a threshold of EUR 7 million in annual revenues in a Member State, it has more than 100,000 users in a Member State in a taxable year, or more than 3,000 business contracts for digital services between the company and business users per annum.

THE EUROPEAN COMMISSION'S POLITICAL CAMPAIGN FOR SPECIAL TAXES ON DIGITAL SERVICES

The European Commission's political campaign for an EU-wide DST became a shining example of how policy-based evidence-making (rather than evidence-based policymaking) can result new barriers to international trade preventing citizens to benefit from greater choice, innovation and better-quality products and services.

The European Commission claimed that "international tax rules [were] no longer fit the modern context where businesses rely heavily on hard-to-value intangible assets, data and automation, which facilitate online trading across borders with no physical presence." It was further claimed that the current failure to "fairly tax" digital corporations leads to more opportunities for tax avoidance, which negatively impact on social fairness and "puts at risk EU competitiveness, fair taxation and sustainability of Member States' budgets."

The EU proposal was remarkable with respect to the actual design of the tax – corporate tax systems worldwide are based on the taxation of net income, i.e. profits, rather than gross revenues. On top of that, it should be noted that he Commission's claims are in many respects misleading. Tax avoidance is not a particular feature of companies with digitalised business models. In fact, all companies aim for reducing their tax bills. Moreover, taxes on businesses activities reduce companies' competitiveness. The EU kept silent about how its new taxes on digital services would increase EU firms' competitiveness. Furthermore, considering the actual development of overall EU tax receipts, it becomes immediately obvious that over the past 20 years a significantly higher amount of both household and corporate income has been collected by EU governments – with revenues from corporate taxes showing the highest growth rate.[2] An erosion of public budget, as claimed by the European Commission, is out of sight. The DST was proposed by the European Commission without any supporting evidence that it is in EU Member States' economic and fiscal interest to tax digital and non-digital business models differently.

The key claim, widely- and repeatedly-spread by high-level European Commission officials, was that "[o]n average, domestic digitalised business models are subject to an effective tax rate in the EU of only 8.5%," which was said to be less than half compared to "traditional business models in the EU". However, the numbers for "effective tax rates" disseminated by high-ranking EU policymakers were based on far-fetched theoretical considerations. The figures referred to by policymakers reflect tax rates that might be paid by a merely hypothetical firm – not by real ones.
Numerous corporate tax experts, including those researchers that were quoted by the European Commission, repeatedly stated that hypothetical numbers cannot be used to compare the tax

[2] For the period 1995 to 2016, revenues from taxes on corporate income show by far the highest growth rate compared to other forms of taxation, i.e. (sales) taxes on value added (VAT) and taxes on individual and household income. Increasing by 147 percent from 1995 to 2016, the growth of overall EU government revenues from taxes on corporate profits exceeded the growth of general tax receipts by not less than 28 percentage points. Accordingly, between 1995 and 2016 the share of overall tax revenues in the EU relative to EU GDP increased by 2 percentage points to now 26.8 percent.

burdens of "digital" and "traditional" companies or determine whether these companies pay a certain fair share of tax or not.[3]

Industry data indeed show that the numbers promoted by the European Commission are highly misleading. Effective corporate tax rates (ECTRs), which are based on audited annual reports and therefore are widely accepted indicators for what real companies actually pay in taxes, tell a fairly different story.[4] Even though effective corporate tax rates must be interpreted with caution, the figures demonstrate that digital companies often pay far more in taxes than large and well-known traditional companies, of which many are actually headquartered in the EU.

For the period 2012-2017, an ECIPE analysis[5] for large companies listed in major stock market indices, finds that:[6]

1. Real-world ECTRs for digital companies are not systematically different from those of so-called traditional companies. Contrary to the European Commission's claims, the data reveal that many digital corporations show much higher effective tax rates than traditional companies.

2. Large digital companies, i.e. Alphabet (Google), Facebook, Microsoft and Amazon, show relatively high ECTRs, exceeding 26.8% for 6Y averages (2012 - 2107) and 24.1% for 3Y averages (2015 – 2017).

3. Considerably lower average ECTRs were found for traditional companies headquartered in Spain (IBEX35 companies) and Germany (DAX30 companies, where 6Y average (2012 – 2017) ECTRs amount to "only" 23.4% and 24.1% respectively.

The study also highlights that "tax avoidance strategies are not a unique feature of modern digital companies. Many large traditional companies that are headquartered in France, Germany, Italy and Spain show significantly lower effective tax rates than large US-based Internet companies. Renault, the French carmaker, for example, shows an average ECTR of only 17.6% for the period 2012 to 2017.

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[3]One clarification reads as follows: "The study does not calculate EATRs [Effective Average Corporate Tax Rates] using tax information for actual companies or sectors; more importantly, the study cannot be used to compare the tax burdens of 'digital' and 'traditional' companies. In interviews with Bloomberg, Law360, and Disco, Prof. Spengel of ZEW made clear that the study does not support conclusions that the digital sector is undertaxed. In summary, the ZEW-PwC study enables a comparison of the relative attractiveness of certain countries' tax regimes for intangible assets developed through R&D, but does not analyze the effective tax rates of actual enterprises or allow conclusions to be drawn regarding corporate taxes paid by the 'digital sector'." See PWC (2018). Understanding the ZEW-PwC Report, "Digital Tax Index, 2017". Available at https://www.pwc.com/us/en/press-releases/2018/ understanding-the-zew-pwc-report.html.

[4]The effective corporate tax rate (ECTR) is the average rate at which a corporation is taxed. More precisely, it is the average rate at which its pre-tax profits are taxed. ECTRs are determined by the ratio of taxes expenses *divided* by pre-tax profits. ECTRs therefore implicitly capture the tax benefits that reduce the taxable income base relative to financial profits.

[5]See Bauer (2018). Digital Companies and Their Fair Share of Taxes: Myths and Misconceptions. ECIPE Occasional Paper 03/2018.

[6]Indices analysed: DAX30 (Germany), CAC40 (France), IBEX35 (Spain), MIB40 (Italy), DJIA (US), MSCI World Technology (global) and MSCI World Software and Services Index (global).

Valeo, a French automotive supplier shows a 6Y ECTR of only 19.5%. In Germany, despite a 29.5% statutory tax rate on corporate income applied over the entire period 2012 to 2017, Germany's three largest partly state-owned companies show relatively low ECTRs: Volkswagen, the German car-maker, shows a comparatively low 6Y average ECTR of 20.5%, while Deutsche Post, Germany's major logistics services supplier, shows a 6Y average ECTR of only 15.0%, and Deutsche Telekom, Germany's major telecommunications operator, shows a 6Y average ECTR of only 19.1%."

ONLY FRANCE MOVED AHEAD WITH THE DST

The proposed DST on turnover would undoubtedly have direct and indirect consequences for many firms and for economic activity. The European Commission so far failed to provide an appropriate impact assessment, evaluating, for example, the impacts on European SMEs, consumers and the innovative capacities in the EU. The Commission's was thus sharply criticised by the EU's Regulatory Scrutiny Board. It is neither reasonable nor credible to assume that this tax would not have enough impact on EU economies to warrant a full tax-economic impact analysis.

Member State governments are still split about the DST. In November 2018, the European Commission, largely supported by the European Parliament, was aiming for a consensus in the Council on its original DST proposals, but some Member States strongly opposed the proposals. In December 2018, the Austrian EU presidency suggested targeting only revenues from the supply of digital services where users contribute to the process of value creation. It did not find consensus either. Another recommendation by the governments of France and Germany to target only advertising services was also rejected. The Council did not reach an agreement at the March 2019 meeting of EU finance ministers. Various EU governments (formal opposition to the EU-wide DST mainly came from Ireland, Luxembourg, Denmark and Sweden) are still dismissive of the idea of taxes on certain digital services.

Despite these developments, the French government imposed a narrowly defined DST (the Senate of the French Parliament passed the legislation on 11 July 2019). Its final version – by design – excludes French and European companies.[7] The government of Austria introduced a five per cent digital tax to come into force by 2020. The Czech Ministry of Finance has drafted a law introducing a seven per cent digital tax.

THE IMPACT(S) OF DSTS

[7] The final law was designed specifically to exclude one of France's best-known digital companies, Criteo. Criteo is excluded from the French DST due to this narrow definition. To date, France has not identified a single French or European company that will be directly affected by the DST. France's Secretary of State for Digital Affairs, Mr Mounir Mahjoubi, has explicitly stated that no European companies will be subject to this tax. See, e.g., *L'Express* article 'Taxation des GAFA: la France peut-elle faire cavalier seul?' from 3 January 2019. Available at https://lexpansion.lexpress.fr/actualite-economique/taxation-des-gafa-la-france-peut-elle-faire- cavalier-seul_2055669.amp.html.

BURDEN ON SMES

Empirical evidence on consumption taxes demonstrates that revenue taxes, e.g. sales taxes and VAT, are passed on to consumers. Numerous studies even report significant over-shifting effects, i.e. changes in taxes drive price increases that are larger than the original tax change. The tax-induced price increase is often found to be higher the smaller a market and the lower competition in this market. However, in the case of tax revenues from digital services, this notion has so far been ignored by those advocating for them for the EU as a whole and in some EU Member States.

As some companies targeted by European policymakers are leading players in the markets for online advertising and online intermediation services – and leaders in the innovation cycle – it is very likely that the DST will to a substantial extent be passed through to consumers, i.e. the users of digital services, with second and third-round incidence effects on the workers, consumers and owners of businesses users. Indeed, on 1 August 2019 US-based Amazon notified sellers, of which most are SMEs, of the change in its pricing policies for the French market, which takes effect 1 October: "Following the creation of a 3 per cent digital services tax in France, we would like to inform you that we will have to adjust our referral fee rates on Amazon.fr to reflect this additional cost," the company told sellers (Johnston 2019). Other companies affected by the tax are likely to follow suit.

For business users, e.g. SMEs that rely on online advertisement services to reach clients, the economic magnitude of the pass-through effect would be much higher for low or negative margin operations. A company with a 2 per cent profit margin will simply have no choice but to pass on the tax burden to downstream consumers in order to commercially survive. Not passing the tax on would wipe out business profitability and result in lower levels of market competition and upward pressure on the prices charged by other companies to downstream consumers.

RETALIATION

DSTs undermine WTO rules. The French DST as well as the European Commission's proposals are by design discriminatory. Generally, any DST law that follows the example of France or the EU may be considered a violation of the WTO moratorium on customs duties for e-commerce. DSTs may therefore be considered a legitimate cause for multiple retaliatory measures which would further distort international trade in goods and services.

The US government's expressed harsh criticism of the French DST. The EU's DST bears a realistic risk of retaliatory trade policy measures, which would cause additional economic distortions. In July 2019 the United States Trade Representative (USTR) launched a formal Section 301 Investigation of France's DST to address whether the tax is unreasonable or discriminatory and the extent to which the French DST burdens or restricts US commerce (USTR 2019). The discriminatory design of the EU's proposed DST may also warrant a finding by the USTR that it is actionable under Section 301.

CONTINUED NEGLECT OF THE NEGATIVE DISTRIBUTIONAL IMPLICATIONS OF CORPORATE TAXES

The EU's DST distracts public attention away from the flaws of corporate tax regimes. Corporate income taxes are at the root of double taxation for multiple sources of individual incomes. As a result of the economic incidence, corporate taxes depress the real income of workers, consumers and entrepreneurs. Paradoxically, due to the positive impact on progressivity in the overall tax system, more tax avoidance by corporations would actually have a positive impact on households' disposable incomes. Nevertheless, policymakers still mainly care about defending governments' tax revenues rather than the often-stated objective to achieve more fairness in taxation on the basis of more transparent and more objective tax regimes.

As recently outlined in a study for the European Economic and Social Committee (EESC), "[t]he risk is that whilst public debate remains uninformed about the importance of tax incidence, tax policy making will remain suboptimal in terms of its impact on employment and growth, if policymakers, either through ignorance or convenience ignore the importance of incidence."[8]

Regarding its DST, the European Commission blanked out the distributional implications on different actors of the economy that would result from new taxes on certain digital services. Most notably, the Commission did not address the critical issue of tax incidence, i.e. the questions about who is effectively bearing the financial burden of special taxes on digital services. The systematic misrepresentation of the tax incidence by EU policymakers reveals that collective tax planning is would not help overcoming economic distortions. The lessons from the EU's deceptive digital services tax campaign demonstrate that collective action in taxation can substantially aggravate tax obfuscation, leading to misinformed media representative and a misinformed general public respectively.

Paolo Gentiloni, the former Italian Prime Minister and from November 1, European Commissioner for Economy, recently stated that the EU's DST would be a priority for him, stating that "the European Union will introduce a tax on digital services even if the rest of the world can't agree on such an accord."[9]

Any politician concerned about fairness and accountability should be particularly wary of the path dependency in corporate taxation, i.e. the historical pattern that tax complexity breeds further tax complexity, effectively taking corporate tax rules out of the control of elected lawmakers. It remains an open question whether other EU governments will follow Commissioner Gentiloni in his endeavours. After all, in the European Union taxation still is a competence of the EU's sovereign Member States.

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[8] See Baert, P., Lange, F. and Watson, J. (2019). The Role of Taxes on Investment to Increase Jobs in the EU – An Assessment of Recent Policy Developments in the Field of Corporate Taxes. Study commissioned by the European Economic and Social Committee (EESC). May 2019.

[9] Neowin (2019). EU will introduce a digital services tax even if the world can't agree, accessed at https://www.neowin.net/news/eu-will-introduce-a-digital-services-tax-even-if-the-world-cant-agree.