ZEW policy brief

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EU should focus more on indirect taxes instead of proposals for a digital levy

As of the beginning of 2021, the European Commission has restarted the formal process to develop a stable regulatory and tax framework to address the challenges of the digital economy. In 2018, the European Commission initially intended to gain political agreement on a Digital Services Tax (DST) proposal as a "quick fix" for the international tax framework, but member states could not reach a collective understanding of the draft directive. Since then, several EU member states have used the DST proposal as a framework for legislative actions at the national level. Unilateral reforms conflict with the OECD's proposal to fundamentally reform worldwide corporate taxation and the efforts to gain a multilateral consensus.
The European Commission now intends to consider the developments at the international level, but recommends three additional policy options to tax corporations active in the digital sphere. First, it reconsiders a Digital Services Tax, which is a tax on revenues created by certain digital activities conducted in the EU. Second, it proposes a corporate income tax top-up to be applied to all companies conducting certain digital activities in the EU. Third, it proposes a tax on digital transactions conducted business-to-business in the EU.

KEY MESSAGES

- It is important to adapt the international tax framework to today's digitalized world and new business models. However, we appeal not to introduce any measure that targets a specific industry or has unanticipated interaction effects with national tax laws, as this will introduce distortive and discriminatory effects.
- A gross revenue tax deviates from the conceptual fundamentals of the existing tax framework of corporate profit taxation and is likely to increase complexity, to distort competition and to harm the position of EU member states in terms of international tax competitiveness.
- A tax rate top-up does not address the challenge to create a taxable nexus at the point of value creation. A tax on digital transactions conducted business-to-business in the EU increases complexity and provides incentives to relocate economic activity out of the EU.
- We recommend turning the focus on indirect taxes to generate tax revenues at the location of consumers and user participation, circumventing a potentially overshooting and discriminating tax reform.

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REVIVING THE DIGITAL SERVICES TAX PROPOSAL

A gross revenue tax severely affects corporations' profitability

The commonly discussed Digital Services Tax (DST) constitutes a gross revenue tax on the provision of specific digital services. A gross revenue tax deviates from the conceptual fundamentals of the existing tax framework of corporate profit taxation and is likely to increase complexity, to distort competition and to harm the position of EU member states in terms of international tax competitiveness. The effective tax burden from a gross revenue tax of three percent, as proposed by the European Commission in March 2018, depends on corporations' profit margin. It is negatively correlated with corporate profitability. For example, considering a company with a profit margin of ten percent, the DST would be equivalent to a corporate income tax rate of 30 percent. Even though companies may deduct the DST paid from corporate income taxes, a low-margin company may still suffer a disproportionately higher tax burden than a high-margin company.

Pre-specified thresholds are arbitrary and distort competition

Specifying quantitative thresholds for the applicability of rules is always, at least to some extent, arbitrary. Distortion of competition is conceivable, as one competitor, slightly above a threshold, would have to pay the tax, while another competitor, slightly below the relevant threshold, would be tax-exempt.

Expected additional tax revenues are a drop in the ocean

It is doubtful whether a digital levy such as the DST contributes to sustainable public finances. The estimated additional annual tax revenue generated from the DST of 3.9 to about 5 billion euros is a drop in the ocean, in relation to the overall tax revenue of more than 6,600 billion euros in all 28 EU member states in 2019.[2] It is also presumptuous to expect the additional revenue from any potential new digital levy to support the EU's borrowing and repayment capacities and recover the costs of the 750 billion euros NextGenerationEU temporary recovery instrument to help repair the immediate economic and social damage brought about by the coronavirus pandemic.[3]

Ring-fencing the digital economy threatens innovation and economic growth

The European Commission labels the DST as the interim solution that "focuses on activities where there is a large gap between the value created and Member States' ability to tax it – where user participation and user contribution play a central role in value creation".[4] However, it lacks an explanation why this gap is particularly large with respect to companies that offer services falling under the scope of the DST as opposed to services that are excluded from the scope of the DST. This selectiveness hampers the development of innovative business models and provides a disincentive to engage in new forms of value creation.

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[2] *https://ec.europa.eu/eurostat/databrowser/view/gov_10a_taxag/default/table?lang=en*; Fuest, C., Meier, V., Neumeier, F., & Stöhlker, D. (2018). Die Besteuerung der Digitalwirtschaft and European Commission. (2018). Commission Staff Working Document—Impact Assessment accompanying the document Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence.

[3] https://ec.europa.eu/info/strategy/recovery-plan-europe_en

[4] European Commission. (2018). Communication from the Commission to the European Parliament and the Council—Time to establish a modern, fair and efficient taxation standard for the digital economy—COM(2018) 146 final.

TOP-UP OF CORPORATE INCOME TAX AND A TAX ON DIGITAL BUSINESS-TO-BUSINESS TRANSACTIONS

A corporate income tax top-up to be applied to all companies conducting certain digital services in the EU is not effective

An additional corporate income tax top-up is not well-suited to achieve the European Commission's objectives to secure tax revenues and contradicts incentives to promote innovative activities. First, any top-up to the corporate tax rate could only be effective if the corporate tax was levied at the place of value creation. However, it is – as the European Commission acknowledges – one of the major challenges of the digital economy that taxes are paid in locations different from where the value is created. Under current nexus and transfer pricing rules, only a small fraction of profit is attributed to local subsidiaries or branches in market jurisdictions. Thus, a tax rate top-up on these profits is unlikely to result in substantial additional tax revenues. Second, corporate tax revenues and corporations' effective tax burden depend on an interplay of tax base regulations and the tax rate. Without a harmonized tax base, a tax rate top-up might increase the sensitivity of affected firms with respect to location choices across EU member states. Third, the major challenge of taxing the digital economy is not a tax rate issue but an issue of allocating the tax base. Adjustments in the tax rate, therefore, fail to address the key challenge. Fourth, many European countries provide incentives for research and development activities by granting lower tax rates to proceeds that are attributable to innovative activities, e.g., income from patents or royalties. A corporate tax rate top-up would reverse the effect of intellectual property box regimes.

A tax on digital transactions conducted business-to-business in the EU is distortive

A tax on digital transactions conducted business-to-business in the EU increases complexity and provides incentives to relocate economic activity out of the EU. First, differentiating transactions depending on the business partner, consumers or businesses increases the complexity of corporate taxation tremendously. Second, the proposed transaction taxes that cannot be passed through to consumers increase input costs for digital services. Third, the transaction tax resembles the DST on a transaction level if the tax is to be levied on the gross transaction price. Consequently, corporations will be inclined to avoid business-to-business taxes by exiting the European common market and serving local European consumers from abroad.

ALTERNATIVE SUGGESTIONS TO ENSURE TAX REVENUES IN A DIGITALIZED ECONOMY

Focusing on value added taxes instead of a digital levy

As an already existing means to tax consumption in market jurisdictions, the role of value-added taxes (VAT) is surprisingly barely considered in the current political discussion. Yet, as presented in a study for the European Commission, billions of tax revenue are at stake if consumption taxes are not collected appropriately.[5] Thoroughly adapting the VAT framework and enforcing VAT on digital services might be crucial to generate and protect tax revenue in EU member states.

A global consensus solution to reform corporate taxation is preferable to unilateral actions

With the United States' recent tax reform proposal the multilateral discussion to introduce a global minimum tax and to push forward a far reaching reform of the global corporate tax system along the lines of the OECD's two pillar approach has gained momentum. In a globalized economy it is preferable to reach a multilateral consensus solutions with as many collaborators as possible. A globally harmonized corporate tax system can mitigate national barriers and can improve cross-border trade. If the system is well designed, it further ensures countries a fair share of tax revenues.

[5] CASE, & IHS. (2017). Study and Reports on the VAT Gap in the EU-28 Member States: 2017 Final Report (TAXUD/2015/CC/131)

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