

Why the EU's digital turnover tax is a bad idea

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The European Commission has proposed a tax on revenues raised from certain digital activities. However, this is essentially a political gesture with only weak economic foundations.

The Commission starts from the presumption that digital companies are paying less than their fair share of tax, but there is little evidence to support this. The fact that a company does not have a physical presence in a country may be a perfectly good reason for it to pay less tax, because it is not making the same demands on taxpayer-funded public services or infrastructure.

The Commission's proposals might tap into public hostility towards the tech giants, but the reality is that taxes are ultimately paid by people, not companies. Indeed, corporate tax is a particular bad tax. A truly radical reform would be to scrap it completely and replace it with a tax on the income distributed to shareholders.

The proposals

On 21st March 2018 the European Commission proposed new rules 'to ensure that digital business activities are taxed in a fair and growth-friendly way in the EU' (European Commission, 2018). The Commission has identified two problems. First, that the current corporate tax rules 'do not capture business models that can make profit from digital services in a country without being physically present'. And second, that the rules fail to recognise 'the role that users play in generating value for digital companies'. As a result, there is a potential disconnect between where value is created and where taxes are paid.

The European Commission has proposed a fundamental reform of the corporate tax system in the EU, with the aim of strengthening the link between where profits are made and where they are taxed.

In response the Commission has made two specific proposals:

1. A fundamental reform of the corporate tax rules, so that profits are taxed where businesses have significant interaction with users through digital channels. This could be integrated into the Commission's proposal for a Common Consolidated Corporate Tax Base (CCCTB), the aim of which is to create a single corporate tax system across the EU, reducing compliance costs and making it harder to shift profits arbitrarily to low-tax jurisdictions (European Commission, 2016). This is the Commission's preferred long-term solution.
2. In the meantime, though, the Commission has also proposed an interim tax on certain digital activities, which will be applied to revenues rather than profits. This digital turnover tax would be charged on revenues from activities including online advertising, digital intermediary activities (such as online marketplaces and auction sites), and selling data generated from user-provided information. The tax would only apply to companies with total annual worldwide revenues of €750 million and EU revenues of €50 million. An initial rate of 3% has been suggested, which might raise €5 billion annually.

As an interim measure, the Commission has also proposed a tax on revenues raised from certain digital activities. This digital turnover tax would initially be set at 3%, paid by larger companies.

Is the Commission right to target the tech sector?

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To support this, the Commission cites data suggesting that these firms only pay EU taxes at an average rate of 9.5%, compared to 23.2% for more traditional businesses. But this isn't good evidence of a problem. If digital companies are based outside the EU, it might actually be fairer for them to pay less tax than local firms, because they are not making the same demands on taxpayer-funded public services or infrastructure.

The fact that a company does not have a physical presence in a country may be a perfectly good reason for it to pay less tax.

Indeed, the general principle is that profits should be taxed in the country where goods and services are produced, and hence where the value is created, rather than where they are sold. The Commission has therefore had to argue that an exception should be made for digital companies, for two main reasons.

First, the Commission has noted that these firms often depend on hard-to-value intangible assets, such as the intellectual property tied up in technology, algorithms or brands. It might therefore be easier for digital companies to minimise tax bills by allocating assets to business units in lower tax countries and claiming that the bulk of 'production' takes place there. However, this argument also assumes that digital companies are indeed exploiting these loopholes. A blanket tax rise for all digital companies, whether they are behaving badly or not, would be a pretty crude way to address this problem, which is certainly not limited to the tech sector.

Second, the Commission has argued that some the 'production' of digital companies takes the form of value created by users themselves, for example by participating in online auction sites or providing personal data that a digital company can then sell on to advertisers or marketing firms. Arguably, then, this part of 'production' actually takes place in the country where the goods or services are consumed, and it might be right to tax it there. Nonetheless, users themselves also benefit enormously from these models. Digital companies often provide services, such as membership of social media platforms, at no financial cost to consumers, as well as all the other advantages of increased competition and convenience that online marketplaces provide. It is not obvious why this cooperation should be penalised via the tax system.

The case against a digital turnover tax

The justification for a digital turnover tax is particularly weak. The reality is that taxes are ultimately paid by people, not companies. Part of the burden of an increase in corporate tax will be borne by shareholders, who may be better off than the population as a whole. But it will also fall on customers (in the form of higher prices), workers (fewer jobs and lower wages) and the general public (lower investment and economic growth).

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Indeed, turnover or sales taxes in particular are more likely to be passed on to consumers.

(The Commission simply asserts that there is 'no reason why this should happen', therefore wishing this problem away.) What's more, taxes on revenues can lead to very high tax rates on profits. A company paying an additional 3% tax on revenues but making margins of, say, 6%, would effectively face a marginal corporate tax rate of more than 50%. The Commission has tried to minimise these problems by proposing a low initial rate. However, this means that the digital tax is more of a political gesture than a serious revenue-raising measure. Indeed, revenues of €5 billion won't go far when spread across all EU members.

The case against the CCCTB

The Commission's preferred long-term solution is flawed too. The CCCTB would be used to calculate the total consolidated taxable EU profits of a multinational company. These would then be allocated between Member States according to their shares of sales and the amounts of labour and capital employed. Each State would then tax its share of the profits at its own national tax rate.

This would be complicated and require a high degree of coordination across the EU. Unless national tax rates were harmonised (which would undermine sovereignty and lose the benefits of tax competition), there would still be scope for unscrupulous companies to play the system. And any model that depends on allocating capital to individual countries would be particularly hard to apply to the intangible assets of digital companies.

If the Commission does want to go down this route, any attempt to tax the activities of multinational companies on a consolidated basis would work far better as part of a global reform. It would make more sense for the EU to focus on OECD-wide initiatives rather than attempt to go it alone (see some of the responses cited by the European Parliament Think Tank, 2018). Alternatively, there is a strong consensus among economists that corporation tax is a particularly bad tax. A truly radical reform would be to scrap it completely, replacing it with a tax on the income distributed to shareholders (Zuluaga, 2016).

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Conclusion

There is, of course, plenty of public hostility towards the tech giants, fuelled by alleged misuse of personal data, worries about 'fake news' and extremist material, failures to protect children and other vulnerable groups, and allegations of vote tampering. It is tempting to add 'tax dodging' to this list. However, populist demands for 'something to be done' rarely lead to sensible policy choices.

References

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