

# Digital services taxes, trade and development

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## **Executive summary**

A rapidly expanding digital economy promises new opportunities and greater prosperity. Digitalization also makes for intensified economic interaction among nations in a more joined-up world. The invisibility of digital exchange across borders makes it harder for governments to identify and tax value generated in their jurisdictions through conventional approaches to revenue collection. Faced with a digital economy estimated to be worth one-quarter or more of GDP, tax authorities are searching for ways to capture the tax take they consider attributable to economic activities within their borders.

The dynamic growth of the digital economy, combined with the fiscal squeeze following the 2008/9 financial crisis and recession, as well as the economic destruction wrought by the COVID-19 pandemic, have all helped to propel international taxation issues up the policy agenda. At its St. Petersburg Summit in 2013, the G20 endorsed OECD's Base Erosion and Profit Shifting (BEPS) agenda. The concerns underlying the BEPS initiative go beyond digital economy issues, and BEPS addresses a range of other tax-related issues. These were summarized in 15 Actions aimed at tackling tax avoidance, improving the coherence of international tax rules and ensuring greater transparency in tax policies and procedures. The current efforts to reach agreement under Pillars 1 and 2 are an extension of work begun under Action One of the BEPS project on issues arising from digitalization.

The target date for completing current OECD efforts to reach agreement on international aspects of digital taxation has recently been extended to mid-2021. As the OECD's quest for a multilateral agreement on taxation of the digital economy has continued, some countries have opted for their own solutions. In 2018 the EU was the first jurisdiction to suggest a new digital services tax (DST) on particular activities, including advertising, the sale of data, and digital intermediary platforms that enable transactions among users. The tax was based on revenue and not profits but directed at particular enterprises identified by their size as well as their product offerings, regardless of where in the world they were incorporated. The initiative did not move forward because it met opposition from some member states. It remains unclear, however, what will become of the initiative if the OECD exercise does not yield results.

France instituted its own DST in July 2019, based on the EU model, and made it retroactive from the beginning of that year. Its implementation was delayed, however, pending the completion of the OECD outcome. Following an extension of the deadline for the OECD process until mid-2021, however, the French authorities decided to activate the tax. This will almost certainly lead to trade retaliation on the part of the United States. In the meanwhile, some two dozen jurisdictions have taken or are planning unilateral to develop their own DSTs or similar arrangements aimed at taxing digital transactions. The United States has already initiated actions against some ten jurisdictions, including the EU.

The paper argues that these events are a foretaste of the disruption, discord and avoidable costs that would be likely to ensue unless a multilateral solution is found to the digital tax issue. A successful multilateral solution would staunch costly trade wars these taxes would likely spark, with credibility consequences for both the OECD and the WTO.

Continuing unilateralism risks undermining a shared commitment to press on with the search for a multilateral outcome. Entrenched tax schemes of individual countries may not be adapted to a multilateral deal or be superseded by it, despite the stated intention of some countries to replace their unilateral actions with a multilateral outcome. A patchwork of varied approaches increases compliance costs for businesses, engenders uncertainty, creates regulatory friction for enterprises operating across borders, and sets the scene for trade conflict.

Another fundamental issue the paper takes up, which has received scant attention so far, is the WTO-consistency of DSTs. The General Agreement on Trade in Services (GATS) is the most important, but not the only, WTO agreement of interest here. The key provisions of relevance relate to non-discrimination (both the most-favored-nation and national treatment principles). While *de jure* infringements may be more straightforward to identify, much of the potential for discriminatory outcomes is of a *de facto* nature, where specific design features of a package have discriminatory consequences, intentionally or otherwise.

In sum, the paper argues that restraint in respect of unilateral initiatives to tax the digital economy and commitment to a multilateral solution are essential if significant economic costs and debilitating trade conflicts are to be avoided. At the same time, multilateral tax solutions need to be widely supported, and as user-friendly as possible by minimizing complexity. The WTO should also seek to clarify the relationship between tax regimes and its own rules.

## **I Introduction**

The contribution of digital technologies to growth and development in economies around the world is enormous (WTO, 2019). The transformational impact of technological advances feeds into policy and triggers pressure for change. Digitally-driven connectivity brings national economies closer together and fosters greater interdependence. This in turn places a higher premium on effective international policy cooperation. Fiscal policy is an exemplar of how technologically-driven connectivity has shifted the balance between policy autonomy and the need for cooperation to serve mutual interests.

Jurisdictional spillover effects brought about by digitalization increase the costs of failure to secure adequate cooperation among governments on key aspects of tax policy, creating lose-lose outcomes. Growing unilateral tendencies to introduce digital services taxes (DSTs) as a new revenue source challenge traditional international taxation precepts based on arm's-length pricing and physical establishment. Digital services taxes derive some of their revenue from cross-border transactions that are partially or entirely digital in nature, and that do not necessarily depend on a physical commercial presence in the jurisdiction where transactions occur. Efforts are concurrently underway at the OECD to adjust international tax norms so as to eradicate unilateral DSTs.

Unilateral tax policies with direct international effects burden business environments by engendering uncertainty, increasing transaction costs, and reducing operational efficiency. A lack of coordination in fiscal policy across borders also subjects businesses to double-taxation

risks and governments to double non-taxation outcomes. These cross-border spillovers can also lead to economic conflict, typically through retaliatory trade actions.

The international trade rules embodied in the WTO do not comprehensively encompass taxation issues. This means that any emerging international tax regime may not be aligned with WTO rules. This is something that governments should take up. The risk of trade conflict is heightened as several countries are designing and implementing their own digital tax arrangements. This paper argues that it is imperative that governments agree to consistent multilateral rules on trade and tax, not only as an imperative for conflict avoidance but also to support efficiency goals that foster growth and development.

The primary aim of this paper is to consider the implications for trade relations of developments in the area of digital taxation. The next section (Section II) briefly reviews aspects of the virtual economy in terms of their significance for production, trade, investment and consumption. Section III will identify various unilateral initiatives taken by governments on digital taxes. It will also discuss trade actions that have resulted, or are likely to result, in the absence of improved fiscal policy cooperation. Section IV will turn to a consideration of consistency issues raised by digital taxes in relation to WTO rules. Section V will briefly review G20/OECD initiatives aimed at fashioning a multilateral framework for managing international aspects of taxation, including in the digital economy.

## **II The economic benefits of digitalization**

The explosion of digitally-based economic activity, combined with new technologies including artificial intelligence, the Internet of Things and distributed ledger networks such as Blockchain are redefining the scope of communication, production and trade opportunities. Even before these more recent technological innovations, numerous studies have pointed to the growth and productivity dividends attributable to digitalization. Interchangeable references are made below to e-commerce, information and communications technology (ICT) and the digital economy.

Behind each of these overlapping terms is a wide array of activities. There is no generally accepted definition of digital media. A broad one encompasses exchange in goods and services (including freely available information) enabled by digital means, and which in some instances can be delivered not only digitally, but physically. Data of one sort or another underlie digital exchange, and besides being a vehicle for delivery, data can be a tradable asset in their own right.

It is important to note that any attempt to bifurcate the economy into its digital and non-digital components is senseless, given the ubiquity of virtual economic activity. As will be seen in due course, this is important from a policy perspective, including in the taxation domain. Discriminatory and distorting policy interventions arising from the ‘ringfencing’ of categories of producers or products are likely to be discriminatory in outcome, feeding inefficiency and stifling output and growth.

In the absence of clear definitions, it is difficult to estimate the size of the digital economy. The United Nations Conference on Trade and Development (UNCTAD) and the U.S.

International Trade Commission (USITC) have come up with broadly comparable estimates of global digitally-enabled transactions across all economic sectors. According to UNCTAD (2020) e-commerce worldwide is worth over US\$25 trillion, equivalent to 30 percent of global Gross Domestic Product. Business-to-business (B2B) transactions represent a large proportion of total transactions, estimated at US\$21 trillion. Business to consumer (B2C) transactions are valued at US\$4.4 trillion. The USITC (2017) estimates for 2016 were some US\$27.7 trillion in total, of which around US\$4.2 trillion was accounted for by B2C transactions.

The virtual economy is also growing in prominence as a source of value in developing economies. A recent study undertaken jointly by the International Finance Corporation (IFC) and Google estimates that Africa's Internet economy will reach US\$180 billion by 2025, amounting to 5.2% per cent of GDP. It will increase four-fold by 2050. Among the driving forces behind this dynamism are increasing access to better quality connectivity, urban population growth and growing technical savvy (IFC and Google, 2020).

These ever-expanding dimensions of digital activity in the global economy are only part of the story. Other relevant aspects of the phenomenon are its contributions to accelerating global output, innovation, heightened efficiency and productivity growth. The small sample of studies referenced below support the proposition that ICT makes a higher contribution to growth and productivity than activities less linked to the digital world. This general conclusion holds despite differences in the elements of ICT that are examined using diverse methodologies, time periods and datasets.

Koellinger (2005) argues that business innovation reduces transactions costs, facilitates coordination, opens up more opportunities to participate in value chains, and increases economic diversification. As feasible interfaces for exchange become more numerous, successful enterprises are able to leverage off the efficiency gains and lower costs of doing business enabled by digitalization. Access to information is broader and deeper in the virtual world, making trust and reputation easier to acquire. Governments and businesses can use digital tools to facilitate compliance, and simplify verification and certification. Payments systems can be made easier to use and more secure.

Kiliçaslan et al. (2017) present an econometric study of Turkey, showing that ICT-related capital has an impact on productivity that is 20-50% greater than non-ICT-related capital. In an analysis of 149 countries, Majeed and Ayub (2018) find that the impact of ICT on growth has been greater in developing countries than in developed countries, which the authors argue is symptomatic of leapfrogging opportunities resulting from the digital economy. By contrast, Nasan and Majid (2009) observe that the growth effects of ICT are greater in developed than developing countries, suggesting that growth enhancement in developing countries calls for policies to facilitate ICT use. In an analysis of a sample of 59 countries, Niebel (2018) finds a positive link between ICT and economic development, but that the impact of ICT is no greater in developing than developed countries.

The OECD (2011) reviews an extensive literature on the relationship between ICT and innovation. The studies examined in the paper identify multiple instances of ICT-enabled

product and process innovation leading to increased growth, income and competitiveness. The paper also takes note of a range of factors relevant to the link between ICT and innovation about which not enough is known. Gretton et al. (2004), however, argue that there are two major ICT-enabled contributions to innovation. The first relates to the ICT 'platform' and its underlying multi-purpose technology that supports other productivity-enhancing innovations. The second source of productivity gains comes from the network effects of an ITC-enabled operating environment.

Other studies attempt to unbundle elements of ICT to determine which contribute the most to growth and productivity. Spiezia (2012) examines the impact on value-added growth of ICT investments in computer, software and communication technologies in 26 industries across 18 OECD countries. He finds that in most countries, investments in computing equipment accounted for more than half of the growth attributable to ICT investment. The study also concludes that ICT producing industries account for large shares of total factor productivity growth in several OECD countries (particularly in the United States, Germany, the United Kingdom, Slovenia, France and the Netherlands).

Stanley et al. (2018) conclude from a meta-analysis of 59 econometric studies that growth in both developed and developing countries has benefited significantly from landline and cellular telephony, with the latter contributing twice as much as the former. Developed countries benefit more from computing than developing countries. Little evidence emerged of the Internet making a positive impact on growth.

According to a recent WTO (2018) estimate, international trade costs fell by 15 per cent over the period 1996 to 2014. Diminishing trade costs could foster additional annual trade growth of between 1.2 to 2.0 percentage points, amounting to between 31 to 34 percentage points over 15 years. Although available data do not permit a precise attribution of these reduced costs to digitalization, it is reasonable to assume that this is a highly significant contributory factor.

An OECD (2003) study (OECD looks at the impact of policy on the link between ICT and economic growth. It identifies some of the key policies that help to shape the ICT-growth link. Relevant areas of government intervention include effective competition policy, creating a friendly business operating environment, minimizing financial risk, taking measures that underpin security and trust, reducing uncertainty, and fostering pro-innovation policies.

Xing (2018) examines the role of the Internet and e-commerce on bilateral trade flows among 21 developing and least-developed countries and 30 OECD countries. The study finds a clear association between access to ICT and bilateral trade. Highspeed Internet and secured servers are essential to realizing e-trade potential in developing and least-developed countries.

A study by Meijers (2010) argues that in a fully specified growth model, Internet use does not explain growth. The key element in understanding the relationship is trade. Openness to trade is the crucial bridge between growth gains and the Internet. This conclusion derives from the high correlation observed between open trade and Internet use. The logic is that Internet use spurs trade and trade spurs growth. This is an important finding, particularly in the current context where, as discussed later, tax disputes can lead to trade retaliation.



Understanding the impact of digitalization on cross-border trade requires answers to the questions of who trades, what they trade and how they trade. Against the background of a fast-moving, more diverse and multi-faceted landscape, innovative technologies are shrinking time and distance. They are creating fresh opportunities for enterprises to transact among themselves (B2B) and with consumers (B2C). New business models are empowered to make markets, expand customer bases, and nurture product variety.

### **III National actions on digital taxation**

With the support of the G20, the OECD began work in 2013 on Base Erosion and Profit Shifting (BEPS). The OECD's Action Plan on BEPS (2013) identified 15 areas for action, including one to address the tax challenges of the digital economy. Considerable analysis has been undertaken on this topic, based on a recognition that the pervasiveness of digitalization renders it impossible to ringfence the digital economy for tax purposes. The present work on digital taxation is incomplete, and is not a continuation of the BEPS exercise but rather a new tax design project (Morris, 2020). The most recent deadline for a negotiated outcome has been shifted to mid-2021. The OECD project is discussed further in Section V below.

While the OECD continues its work, currently involving 137 participating governments, a growing number of jurisdictions have adopted or are contemplating unilateral measures to tax digital transactions. Such initiatives are likely to multiply, not least in response to fiscal pressures resulting from the COVID-19 pandemic. This trend will result in a complex and costly patchwork of tax regimes, and provoke trade friction – hence the urgency of finding accommodation among countries on tax policies with international spillover effects.

#### ***Unilateral action on digital economy taxation at the national level***

The first initiative to shape a DST regime was taken by the EU with its Fair Taxation of the Digital Economy package (2018). The objective is to levy more tax on value created by intangible assets where users of services play a role in value creation and where on the supply side there is zero or minimal physical presence in the consuming market. The package proposes an interim and a long-term digital tax.

The former would focus on taxing particular digital services, including advertising, the sale of data, and digital intermediary platforms that enable transactions among users. The tax rate was set at 3 percent on gross revenues. Enterprises covered by the tax would have an annual turnover exceeding €750 million globally and €50 million in the European Union.

The long-term solution was designed to be more encompassing in determining the scope of taxable coverage by defining a “significant digital presence” with or without permanent establishment status. Businesses liable to the tax would meet any one of three criteria on an annual basis – revenue in excess of €7 million, a customer base of more than 100,000 in a Member State, and more than 3,000 B2B contracts for digital services. Enterprise profits would be taxable in all member states where a business had a taxable digital presence, at a rate

equivalent to “bricks-and-mortar” establishments. Covered entities could be either resident or non-resident where no double taxation treaty existed between the relevant Member State and the foreign jurisdiction concerned. The EU did not implement its Fair Taxation of the Digital Economy package because there was no consensus among members states to do so.

In July 2019 France introduced a digital services tax aimed at “modifying the trajectory of the decline in corporate tax” (Republic of France, 2019). The tax was largely modeled on the EU’s DST in terms of the latter’s scope of covered activities, the tax rate, and size thresholds for covered enterprises (digital turnover globally of €750 million and €25 million in France). The tax applies retroactively from February 2019. A decision was taken, however, to delay implementation until the end of 2020, which was the deadline for the OECD’s work. That deadline was then extended until mid-2021 at the October 2020 meeting of the G20 Finance Ministers and Central Bank Governors. At this point France announced that it would not extend its postponement of the tax beyond the end of 2020.

A growing number of other countries are adopting or considering unilateral DSTs and similar measures, notwithstanding the OECD’s multilateral efforts (Asen, 2020; Bunn et al., 2020; European Parliament, 2020:). Some 30 countries in total are involved. In addition to France, several other EU Member States have taken or are contemplating such measures. These include Austria, Belgium, Czech Republic, Hungary, Italy, Latvia, Poland, Slovakia, Slovenia, and Spain. Other countries outside the EU taking similar actions include Brazil, Canada, India, Indonesia, Israel, Italy, Kenya, New Zealand, Nigeria, Norway, Saudi Arabia, Tunisia, Turkey, and the United Kingdom.

A further five countries have proposed or imposed withholding tax on gross revenues attributable to digital services, including Pakistan, Peru, Thailand, Turkey, and Uruguay. These national actions embody multiple differences in terms of the scope of the tax base, the tax rates and the entities subject to the tax. All the jurisdictions involved in these initiatives are members of the G20/OECD Inclusive Framework on BEPS. The range of approaches adopted inevitably raises the level of uncertainty faced by potential and actual taxable entities, which is a source of additional operating costs. Dealing with multiple taxation regimes also raises compliance costs.

### ***Threats to trade in the absence of agreement on tax policy with international spillover effects***

Apart from their intrinsic economic costs arising from coordination failures in the face of international spillovers, unilateral tax policies aimed at the digital economy are likely to trigger retaliatory trade measures when they are perceived to prejudice the trade interests of other countries (Lee-Makiyama, 2018). Trade retaliation will most likely provoke counter-retaliation in a repeated downward spiral.

It is obvious that these outcomes are costly in terms of their direct economic effects as well as through the uncertainty and deteriorated trade relationships they engender. Given the

nature of targeted trade retaliation, the costs of such outcomes reach far and wide, as their price effects extend across different activities within the economy.

Despite these considerations, some authors and institutions advocate and encourage governments to adopt unilateral digital tax solutions. The South Centre (Grondona et al., 2020), the African Tax Administration Forum – ATAF (2020) and The Independent Commission for the Reform of International Corporate Taxation – ICRICT (2019) would appear to favor unilateral action on DST and other digital tax schemes. The South Centre provides an analysis of a range of national actions taken. It argues that since several OECD countries are acting unilaterally it is unreasonable to expect developing countries to refrain from doing so. It also argues that unilateral actions will help to speed up and shape the OECD process.

The ATAF paper argues that developing countries should not wait for the completion of the OECD process and intends to provide advice on a “Suggested Approach to Drafting Digital Service Tax Legislation” customized to the needs of developing countries. ICRICT also demurs when it comes to waiting for the OECD process to come to fruition, and sets out a blueprint on global tax reform for immediate action. It calls for treating MNEs as single entities and dividing up profits globally on the basis of an equitable, objective formula. The formula should not be based on the value of sales as a sole criterion and the allocation arrangements should not divide profits into routine and residual elements (see below on OECD proposals).

As already noted, these positions do not take account of the collective consequences of countries going it alone in this field. A parallel can be drawn between unilateralism in trade and in taxation. Both have to manage international spillovers that generate costs and fallout that are avoidable through appropriate international cooperation. Just as with trade, the appeal of a multilateral approach is in large measure favoured because of the alternative – ‘law-of-the-jungle’ outcomes that are suboptimal for all parties, but most especially for those with less bargaining power.

The United States initiated action against France in 2019 under Section 301 of the Trade Act of 1974. This provides a foretaste of what is likely to come absent a multilateral approach to taxation of the digital economy. The case against France’s digital services tax found that the relevant legislation was discriminatory in intent and effect. The discriminatory intent was determined on the basis of explicit statements from French officials, including reference to the intended legislation as the GAFA<sup>2</sup> tax.

As to the discriminatory effect, this was alleged to exist as a consequence of the digital activities singled out for taxation, as well as the size thresholds established for covered enterprises, which excluded competing French enterprises. A further source of discrimination arose from the treatment of DSTs in relation to deductibility rules under France’s corporate tax

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<sup>2</sup> GAFA refers to Google, Apple, Facebook and Amazon, all U.S. companies.

law. In addition, the Section 301 findings claimed that the retroactive application of the tax was an unwarranted burden.

Finally, by applying to revenue instead of profits the tax was deemed contrary to prevailing principles. The same argument was used to challenge the fact that the tax could be levied on enterprises without a physical presence. These last objections may become moot in the event of consensus around the Inclusive Framework blueprint (see below).

The finding allows the United States to levy duties up to 25 percent on imports from France valued at US\$1.3 billion in total. The covered products include beauty preparations, soaps and handbags. The United States did not trigger the retaliation following France's decision to hold off applying the tax until the end of 2020 when the OECD was scheduled to complete its work. Now that France has started to apply its DST following the postponement of the OECD deadline until mid-2021 (Bloomberg, 2020), it would be surprising if the United States did not also apply the trade measures authorized in its Section 301 proceeding.

As the number of unilateral initiatives has risen, so too has the incidence of retaliatory trade actions. Another Section 301 proceeding was initiated on June 5, 2020, against 9 countries plus the European Union (Federal Register, 2020). The other nine are Austria, Brazil, the Czech Republic, India, Indonesia, Italy, Spain, Turkey, the United Kingdom. The actions are against countries that have adopted DSTs, have draft legislation in hand or are contemplating it (Bunn, 2020). The complaints are similar to those of the French case, including discrimination against U.S. companies, retroactivity, and a 'possibly unreasonable tax policy.' Other allegations relate to divergences from international tax policy norms including extraterritoriality, taxing revenue and not income, and seeking to penalize particular technology companies.

In a response to the Section 301 case, India raised the question of the WTO-consistency of unilateral trade actions by the United States (Government of India, 2020). India also argued that its 3 percent Equalization Levy was designed precisely to attain tax neutrality among non-resident and resident e-commerce operators, and that this was in line with ongoing BEPS-related work at the OECD. India further pointed out that there was no retroactivity in its measure, nor extra-territoriality, a position it deemed consistent with the U.S. Supreme Court's ruling in *South Dakota vs Wayfair, Inc.*<sup>3</sup> It may be noted that in this case the tax in question was a sales (consumption) tax and not a tax on profits.

If these cases result in trade restrictive action under Section 301, particularly in the absence of due process in the WTO, they are likely to spark WTO litigation, or more probably direct retaliation from the affected countries, which could in turn lead to further tit-for-tat trade actions. Furthermore, while it is only the United States so far that is taking action against

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<sup>3</sup> In this ruling, the Court stated that 'a business does not need a physical presence in a State to meet the requirements of due process which call for some definite link, some minimum connection, between a state and the person, property or transactions it seeks to tax' (cited in Grondona et al., 2020).

unilateral DST and similar initiatives, there is no reason to believe that other countries would refrain from such actions in the absence of multilaterally-based accommodation.

#### **IV Digital Sales Tax and the WTO**

The WTO has little to say explicitly about tax matters beyond regulating tariffs – an indirect tax levied at the border on imports of merchandise under GATT. The core relevance of the WTO in relation to taxation resides in the interpretation of the two key principles of non-discrimination – most-favored-nation (MFN) and national treatment. The WTO agreements do not circumscribe the right of members to impose internal taxes as long as these are non-discriminatory. The applicability of MFN and national treatment sometimes relies on the interpretation of questions such as the likeness of suppliers or products, *de jure* and *de facto* (formally identical or formally different) treatment, and less favorable treatment. Circumstantial detail is often key to a judgement regarding consistency. Definitive determinations are not always a straightforward matter.

#### ***The growing fiscal challenges of technological innovation and globalization***

As digital interactions have become a major means of transaction, production and consumption are no longer so easily separable by geography. Digitalization has made it possible for enterprises to produce outside a jurisdiction and sell at scale in another jurisdiction without establishing a physical presence there, thus making the collection of direct taxes in the traditional way infeasible. Business models whose stock-in-trade is data and intangible assets are harder to corral or observe than transactors more rooted in physical exchange. In the absence of adjustments to traditional taxation practices, perceptions about what is fair or sufficient do not always meld easily with existing international tax solutions. This is where WTO rules might play a useful clarificatory role.

Governments, however, have yet to engage in discussions on the WTO consistency of digital services taxes. This is not altogether surprising considering that with the exception of tariffs on goods, the WTO's interface with tax policies is implicit in relation to its non-discrimination rules. Moreover, the OECD's work on digital taxation is still under construction. Adjudicated WTO disputes touching on digital economy issues have been tangential to the core issues surrounding the DST debate. A further reason for relative quiet on this front is that at least some of the countries that have adopted DST measures consider their introduction or continuation contingent upon the outcome of the OECD process. It might be noted that the U.S. Section 301 action against France made no explicit reference to WTO provisions.

The scholarly literature is somewhat diffuse, except for a paper by Mavroidis (2020) that systematically addresses WTO consistency questions.<sup>4</sup> The DST issue is most relevant to the General Agreement on Trade in Services (GATS), although the GATT and the Agreement on

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<sup>4</sup> Much of what follows is based largely on that analysis.

Trade-Related Intellectual Property Rights (TRIPS) may enter into play in some circumstances. As with other agreements under the WTO umbrella, the paucity of direct reference to taxation in GATS provisions does not imply the absence of authority to judge the consistency or otherwise of tax practices relevant to services.

### *The architecture of GATS*

Despite the fact that GATT and GATS deal respectively with goods and services, the architecture of the two agreement is quite similar. The differences in GATS – established only in 1995 – reflect contrasting characteristics of services in terms of their intangibility, greater within-product heterogeneity, and aspects of the way in which services are transacted. The digital economy is mostly, but not entirely about services. Of particular relevance in this context is the GATT Agreement on Subsidies and Countervailing Measures. There are circumstances in which the GATT Agreement could apply to services, and this is taken up briefly at the end of this section.

As already noted, the trade issues at stake in relation to the DST debate turn on non-discrimination – both MFN and national treatment. Legal rights and obligations are also expressed in GATS in terms specific commitments at the sector and product level undertaken by WTO members. Most-favored-nation treatment under Article II of GATS requires that all WTO members receive the same treatment in the market of a member of the Agreement. It is a basic principle of general application, much like GATT provisions dealing with goods. It exists independently of market access commitments inscribed in schedules of specific commitments, and applies regardless of whether a member has undertaken specific commitments. The only difference between GATT and GATS in regard to MFN is that under GATS, exemptions can be made by members with respect to particular measures. But this is only possible at the time of signature of the Agreement, or accession to the WTO. Such exemptions are not particularly far-reaching, but would obviously be relevant were they to cover DST-related policy matters.

In contrast to MFN, national treatment under GATS is different from the case of GATT in that it is not a standard of policy behavior of general application, but rather a matter of negotiation. National treatment is negotiated on a sector-by-sector basis and inscribed, unconditionally or otherwise, in members' schedules of specific commitments. As a result, some members will have no national treatment obligations for certain services. Article XVII of GATS defines national treatment as treatment of services and service suppliers of other members no less favorably than the treatment accorded domestic services and service suppliers in respect of all measures affecting the supply of services. Article XVII:3 states that formally identical or formally different treatment will be regarded as less favourable if it tilts the conditions of competition in favor of the member concerned compared to the services or services suppliers of any other member.

If a WTO member has not undertaken a specific commitment granting national treatment to a specified product, there is no case to be answered in terms of discrimination on these grounds as between foreign and domestic services or service suppliers in the market concerned.

It should be also noted that under the General Exceptions provisions in Article XIV of the GATS, there are two provisions providing exemptions to national treatment and MFN. Article XIV(d) allows a departure from a national treatment commitment under Article XVII where the difference in treatment is to ensure “the equitable or effective” imposition or collection of direct taxes. Article XIV(e) allows a departure from MFN under Article II provided the difference in treatment is the result of a double taxation agreement. The headnote to Article XIV states that these exceptions should not be applied in a way that would result in arbitrary or unjustifiable discrimination where like conditions prevail, nor serve as a disguised restriction on trade.<sup>5</sup>

Along with Article XVII dealing with national treatment, market access conditions are additionally defined under Article XVI. Conditions that can qualify unhindered market access under Article XVI are defined in terms of six categories of possible limitations. These relate to limitations on the number of service suppliers, the value of service transactions, the quantity of transactions, the number of natural persons that may be employed, the type of legal entity supplying services, and the degree of foreign equity participation in the service supplying entity.

### ***The role of specific commitments and modes of supply under GATS***

Before delving further into the meaning of non-discrimination under GATS, it is worth considering how specific commitments enter the picture. Specific commitments are set out in terms of market access (Article XVI) and national treatment (Article XVII) in relation to four modes of supply. Mode 1 deals with cross-border transactions and is akin to traditional merchandise trade transactions, without tariffs on imports at the border. Mode 2 is consumption abroad. A consumer could travel to consume in the supplying jurisdiction, as for example in the case of tourism. Alternatively, a consumer could send data abroad for processing, in which case the transaction would be exclusively digital. In both cases, the key is the locus of consumption. Mode 3 is commercial presence, or foreign investment in the form of a juridical person or other form of presence (branch or representative office without a juridical personality). Mode 4 is the cross-border movement of service suppliers or employees of service suppliers (natural persons).

Schedules of specific commitments under the GATS comprise four columns defining the scope of commitments. The first column lists product descriptions and nomenclature. It is important to note that commitments are expressed as products and not as transactions, industries or activities. The greatest possible degree of clarity is required in the description of each sector or subsector in order to facilitate an authoritative interpretation of the legal status of a commitment. In contrast to GATT and its Harmonized System of Tariff Nomenclature, however, no requirement exists under GATS to employ standard nomenclature. WTO members have nevertheless relied mostly on the GATS Classification List (MTN/GNS/W/120), and its cross-references to definitions set out in the 1991 Provisional Central Product Classification (CPC) of the United Nations.

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<sup>5</sup> These escape clauses on direct taxes may assist in designing equitable and effective taxing solutions in the context of the OECD exercise.

The lack of precision and uniformity in product nomenclature can be a source of confusion as to the precise scope of a specific commitment. The classification list and 1991 version of CPC have become increasingly outdated. This problem arises particularly in the case of sectors at the forefront of digitization such as telecommunications and computer services, as well as some of the ICT-enabled services that have become more readily tradable than in the past (e.g. business process outsourcing). The problem is partly addressed by the notion of technological neutrality. Data processing, for example, which currently features in the GATS classification scheme, would encompass more recent technologies such as cloud computing, so-called Big Data, or artificial intelligence.

The second column of specific commitments specifies market access commitments under each mode of supply. The third column relates to national treatment commitments. Where these are entered into, they provide for non-discriminatory treatment between local and foreign supplies and suppliers, subject to any specified restrictions. The treatment may be formally identical or formally different to that accorded to domestic services and service suppliers. In either case, the treatment must not favor domestic ‘like’ supplies and/or suppliers of services. The fourth and final column provides for any additional commitments, likely to be of a regulatory nature.

### ***The elusive quest for a non-discrimination standard***

The most likely manner in which DSTs and similar measures may be ruled in breach of GATS commitments is that they are discriminatory in terms of MFN and/or national treatment. In the case of DSTs, a key question is whether limitations on the scope of application of measures is discriminatory. From an MFN perspective, measures could be found wanting in a *de jure* sense if they explicitly targeted or exempted services or service suppliers of a particular origin, unless an MFN exemption had been established upon signature of the GATS. Market access limitations under Article XVI would only be relevant in this context if they were applied selectively on an origin basis to services or service suppliers. In the case of national treatment, specific commitments granting national treatment applied selectively to particular jurisdictions would also constitute a *de jure* infringement.

Of more relevance is situations in which measures appear to be designed in a non-discriminatory manner but in a *de facto* sense discriminate among services and/or service suppliers. A *de jure* equivalence may hide *de facto* discrimination. Hufbauer and Lu (2018), for example, consider a *de facto* reality to be the essence of a discriminatory outcome in the planned EU DST regime.

For a case to be made that discrimination is occurring through DST arrangements, a ‘likeness’ standard must be met first. Likeness in the GATS context refers to both services and service suppliers. Digital taxes may be designed as direct taxes, aimed at suppliers, as is the case with some of the unilateral initiatives referred to in Section III and the OECD’s draft blueprint.

This is in contrast to the option adopted by some countries of relying on sales (GST) or value-added taxes (VAT), which are indirect taxes falling on products not producers. When taxes fall on products rather than producers, the dimensions in which *de facto* differences matter are



sharply reduced. In essence, the question would come down to a comparison of products in terms of likeness. This raises questions of substitutability and relevant market – in other words whether the products being compared are in a competitive relationship. This may not always be a straightforward interpretative matter, but as seen below, it raises fewer questions than those arising when producers and not products are the tax target.

Where suppliers and not what they supply are taxed, it is not difficult to understand why DSTs focus on revenue and not profits as the base for calculating a tax on income. One reason for this is that companies typically pay taxes on profits in the jurisdiction where they are headquartered and not where they sell. It is not entirely clear, however, why once a revenue base has been selected for a tax, the supplier and not the products become the target for taxation. A possible explanation for designing DSTs as a ‘hybrid’ tax – as something between a profits-based and consumption-based tax – may be in order to avoid issues that could otherwise arise under existing tax treaties.

Another consideration might be that a discriminatory intent is harder to conceal with a product-based tax, since in contrast to a producer-based tax less scope exists for identifying areas where likeness may not apply. Moreover, if a government has undertaken to tax the product with a VAT or sales tax, a national treatment commitment under Article XVII would constitute a solid basis for challenging a discriminatory product tax. In practice, the extent to which WTO members have undertaken national treatment commitments in GATS is modest at best. In the case of many industrialized members including in the EU, however, national treatment commitments exist for data processing and advertising services.

Returning to the direct tax scenario, where the supplier is taxed, a series of scope-related questions arise. One aspect of this is the value threshold, or firm size proxy, of the kind envisaged in the EU DST package and applied in the case of France’s DST.<sup>6</sup> A distinction relying on firm size by the value of turnover or another size criterion could be sufficient to establish the absence of likeness among suppliers, but GATS jurisprudence to date has not offered a clear answer. A DST designed with thresholds that deliberately targeted foreign suppliers would certainly be a strong candidate for a legal finding of *de facto* discrimination.

A second consideration is whether it is possible to deem that likeness exists across modes of supply. This would be relevant to the distinction between Mode 1 and Mode 2. Under Mode 1 consumption would occur in the market where the consumer resides, while under Mode 2 the consumer would have “moved” to the jurisdiction of the supplier. The distinction between Mode 1 and Mode 3 also matters, since under the latter Mode the supplier is deemed to be commercially present in the market of the consumer. It should also be borne in mind that if two services were deemed like, WTO members can still differentiate commitments among modes of supply.

A third factor is technological neutrality in the determination of likeness. One aspect of this question relates to concerns about the design of DSTs that ringfence particular suppliers of digitalized products. This issue arose in the Section 301 case against France’s DST regime where

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<sup>6</sup> It remains to be seen whether or how such thresholds may be part of the OECD’s tax solution.

digital advertising services business was within scope but coordinating and publishing advertisements in newspapers was out of scope. As noted by Mavroidis (2020) a counter-argument that might establish the absence of likeness would turn on the advantages accruing to the digital advertising activity on account of scale and network effects.

A fourth consideration is whether the difference between ownership of a platform (an interface) and ownership of content constitutes a relevant distinction in deciding upon likeness. In the French Section 301 case an example was the comparison between Uber that did not own the transport service and a French taxi company using an app to sell its service. The relevant distinction that would explain the fact that Uber was in scope and the French taxi company was not turned on ownership of the service.

Neither legal clarity intrinsic to the provisions (which can hardly be written to cover every eventuality) nor existing jurisprudence provide adequate guidance on where GATs would stand with respect to the robustness of a range of scope-determining *de facto* distinctions when it comes to determining the parameters of likeness. Moreover, even if likeness is established, there is also the matter of whether or not ‘less favourable treatment’ that ‘modifies the conditions of competition’ is meted out to a foreign service or service supplier.

A DST might, for example, result in a disproportionate burden on foreign sources of supply notwithstanding a determination of likeness between foreign and domestic services or service suppliers. In addition a service or service supplier may confront a DST or other taxation in the home market which results in a competitive disadvantage in a foreign market, amounting to double taxation. This is something that Pillar 1 in the OECD exercise seeks to address through its unified approach (see below), but which the GATS may not be able to handle easily for jurisdictional reasons.

A further question is whether a turnover or other size-related cut-off criterion to determine the scope of a DST might possibly be defended via the general exceptions provided in GATS Article XIV. This Article covers public policy exceptions and its headnote requires that any such exceptions must not be applied “in a manner that would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail.” As Mavroidis (2020) suggests, however, Article XIV(a) referring to public morals and public order might be invoked to justify less favorable treatment for larger, more successful firms. The argument would have to be based on some distributional or social justice public policy criterion. This is virgin territory and a complete unknown in terms of outcome, including whether such an argument could easily be linked to firm size.

As already noted, Article XIV(d) and (e), deal with exceptions to national treatment and MFN for the purposes of the equitable or effective imposition or collection of direct taxes on services or service suppliers. These are relevant to likeness where the tax target is the suppliers of services and not the services themselves.

Finally, there is the question of jurisdictional competence under GATS. International trade and trade-related agreements like GATS do not consider as extraterritorial actions taken by governments in their own jurisdictions to accommodate or counteract actions taken by trading

partners in their jurisdictions. The GATS was written before the virtual economy had become as powerful and ubiquitous as it is today. The new tax nexus –between consumers and producers without a physical presence in the country of consumption – that is currently applied or contemplated falls outside any consideration of the jurisdictional competence of the GATS.

### ***Clarifying and strengthening the GATS***

The inescapable conclusion from the above discussion of GATS rules, and how to interpret them in relation to likeness and less favorable treatment standards, is that more work is required to prepare the GATS for the challenges that await on digital tax issues. The paucity of authoritative answers in relation to the compliance of particular tax measures is not helped by scarce GATS case law. Where there is a litigated footprint, it does not necessarily indicate a clear direction. The core GATS provisions on non-discrimination are nevertheless valuable in setting benchmark standards to support a trading environment that seeks to benefit WTO members.

At the 11<sup>th</sup> WTO Ministerial Meeting in Buenos Aires in 2017, a group of 76 members (EU member states and 48 others) launched a negotiation on e-commerce, referred to as one of several Joint Statement Initiatives (JSI) that came out of the meeting. The e-commerce JSI covers a range of issues arising in a virtual business environment. Taxation issues are not central to the deliberations, but they have been touched upon. Proposals put forward include measures to protect the integrity of double taxation agreements and to prohibit customs duties on electronic transmissions. Considering the complexity of the issues involved in the e-commerce negotiations, and the progress made so far, it may be inadvisable to extend JSI deliberations to address digital taxation issues more explicitly at this stage.

Nevertheless, the WTO needs to focus more on the impending clash between taxation and trade. Two areas for near-term action suggest themselves. First, members could improve specific market access offers in their schedules of specific commitments, particularly in relation to national treatment. Second, work could be done to establish a more standardized nomenclature for classifying services trade.

Finally, it is also essential that the WTO collaborates more closely with the OECD in its quest for international accommodation on taxation matters that is compatible with non-discrimination principles.

### ***A brief note on the relevance of the GATT subsidies agreement***

The WTO Agreement on Subsidies and Countervailing Measures is a GATT agreement that primarily addresses subsidies on goods. Subsidies are defined as a financial contribution (including revenue foregone) by a government or public body, a direct financial transfer (loans, grants, equity infusions or loan guarantees), the provision by government of goods or services, or any income or price support to an enterprise. In all these cases, a benefit must have been conferred. Another element of the definition is specificity. A subsidy must be specific, in the sense of being non-automatic and available only to specific firms or industries.

The Agreement prohibits export subsidies on manufactures<sup>7</sup> and subsidies that are contingent upon the use of domestic rather than imported goods. Other subsidies to production are actionable if they cause injury to a domestic industry or serious prejudice to the interests of another member. These subsidies are not illegal *per se*, but two remedies are available in the face of harmful subsidization – countervailing duties and multilateral dispute settlement.

Countervailing duties may be levied upon a determination of injury to a domestic industry. Dispute settlement can be invoked where a complainant considers that serious prejudice has arisen on account of adverse effects such as product displacement in the domestic or foreign markets. Other grounds for a challenge on serious prejudice grounds could include subsidies to cover operating losses or direct debt forgiveness.

While the Agreement is focused on goods, subsidies to digital (and other) services inputs could be actionable. This could arise if a subsidized service input was incorporated in a good subject to an anti-subsidy action, either a countervailing duty or a dispute. Consider, for example, the case of a manufacturer reliant on subsidized digital service inputs. Those goods could be subject to action on account of the subsidies on the services. Many examples suggest themselves, such as financial, transportation, or ICT services granted to particular firms or industries under subsidized conditions. In the digital domain, firms could be challenged, for example, on R&D subsidies or patent boxes.

A final point to make is that the GATS has no explicit rules on subsidies. Article XV of GATS sets out a mandate to develop rules on subsidies, but nothing has come of this. Although explicit rules on subsidization are absent, it may be argued that implicitly the GATS does control subsidy practices through its national treatment provisions in Article XVII. If a member inscribes national treatment obligations in its schedule of specific commitments, a non-discrimination requirement will kick in.

While this does not control subsidy practices in a general sense, it can inhibit the use of subsidies where governments are reluctant to extend them to foreign supplies or suppliers. Any efforts to remove or lessen subsidies in the absence of multilateral rules on the matter will likely find expression in some form of tax or regulatory action. Such actions could be susceptible to legal challenge under the GATS.

## **V The OECD's Work on Base Erosion and Profit Shifting (BEPS)**

As already discussed, DSTs and similar initiatives at the national level have burgeoned, increasing pressure for an international consensus approach. The perceived urgency for joint action shared by many governments has weighed upon the OECD's efforts in this area, creating demand for a rapid solution. But it takes time to find a landing zone, at the point where competing interests become less important than a common cause, especially in light of the sheer complexity of the subject matter.

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<sup>7</sup> The Agreement only covers manufactures because agricultural subsidies are dealt with in the Agreement on Agriculture.

A major focus of the G20/OECD BEPS project concerns the ability of multinational enterprises (MNEs) operating in multiple jurisdictions to establish a physical presence in low-tax jurisdictions, and/or to adopt intra-company pricing strategies (‘transfer ‘pricing’) that result in the declaration of profits for tax purposes in low-tax countries.

Transfer pricing practices have been the subject of debate for many years. As economies have increasingly globalized, long-standing concerns in this field have become more pronounced. This issue is by no means limited to digital companies or digitalized businesses. It is about companies with international operations more generally, but has also been addressed in the OECD’s digital taxation work (see below). As far as international digital companies are concerned, it is far from obvious that they pay less corporation tax globally than companies relying on more traditional business models. This is discussed briefly in the subsection below.

In 2016 an Inclusive Framework was established in recognition of the need for a broad-based initiative involving parties beyond G20 and OECD membership, including developing countries. With effect from the end of 2019, 137 countries and jurisdictions had signed up and, at least nominally, are all participating in the search for an effective, equitable and durable set of international tax arrangements suited to the virtual economy. This work is now considered a holdover from the BEPS initiative, intended to shape new elements in the design of international tax arrangements.

In 2019 the OECD Secretariat proposed a two-pillar approach to addressing digital economy taxation issues. Pillar 1 creates a new tax nexus between consumers in a given jurisdiction and producers who supply them, unconstrained by a need for a physical presence of the companies concerned. This amounts to the establishment of a new tax right and therefore involves fiscal revenue sharing arrangements among jurisdictions.

In 2020 a ‘Unified Approach’ was adopted under Pillar 1. The entities subject to tax under the new nexus suggests focus on two categories – automated digital service providers and consumer-facing businesses. The latter suggests that the reach of Pillar 1 will extend beyond a narrow focus digital tech companies. Business to consumer (B2C) transactions will be central, but some B2B transactions may also be covered, where there is an intermediary role. A decision is yet to be taken on whether a size threshold will also be applied as a determinant of taxable scope additional to the question of sectoral or product coverage.

In the new approach to taxation, revenue has been chosen as the base rather than profits, although it is the supplying enterprise and not the product that is subject to tax. This reflects the reality that enterprises with large revenue streams may only declare modest profits in particular jurisdictions. There are, however, instances where governments that have adopted unilateral approaches to digital taxation have chosen to use sales taxes or a VAT rather than a profits tax.

Since profits are not taxed directly, but rather as a function of revenue, allocation rules are required for distributing the tax take among jurisdictions on that basis – in other words, as a

proxy for profits. The allocation will be based on a formula. Total calculated profit will be divided into ‘routine’ profit and ‘residual’ profit. The residual will be divided up among jurisdictions on the basis of agreed criteria. Pillar 1 will also contain provisions to ensure that no double taxation or double counting occurs, as can be the case with the kinds of DSTs designed under some unilateral digital taxation initiatives. Finally, Pillar 1 also contemplates a dispute prevention and dispute settlement mechanism, but this is among the issues yet to be agreed.

Pillar 2 establishes a minimum tax rate whose purpose is to discourage corporate tax planning by reducing the incentive for MNEs to locate in jurisdictions with low taxes or transfer price in order to reduce their tax burdens. The enterprises potentially covered by this Pillar will not just be digital companies, but all MNEs. Pillar 2 is also sometimes referred to as the Global Anti-Base Erosion proposal (GloBE).<sup>8</sup> In addition to the minimum tax, Pillar 2 also contains tax adjustment mechanisms in cases where sole reliance on the minimum tax rate creates skewed outcomes.

This short descriptive summary belies the complexity of the undertaking in general and the design of a global taxation system in particular. Numerous other decision points form part of the structure and will need to be agreed in an overall package.

### ***Some concerns, observations and commentaries from stakeholders***

Many commentators, including from business<sup>9</sup> support the OECD’s efforts to develop a multilateral approach, fearing the economic costs of unilateralism in matters of international taxation. As outlined in Section III, a plethora of alternative approaches have been adopted, sometimes of questionable WTO legality. As noted in Section IV, measures designated as discriminatory in the context of national treatment and/or MFN under GATS, either in a *de jure* or *de facto* sense, would constitute a WTO infringement. The costs of managing a mix of varying regimes, the uncertainty they engender, and the trade retaliation they threaten, all add to pressure on governments to find multilateral solutions. It is important to note that not all the misgivings come from international digital companies. Non-digital MNEs that nevertheless rely on the digitalized economy in their business models are also concerned about how developments in this area are going to affect them.

A key question is whether the issue at hand is about paying more taxes or about the redistribution of tax receipts. When the EU initially drew attention to the digital taxation issue with its 2018 Fair Taxation of the Digital Economy package, its analysis was backed up by an estimate that large digital companies on average paid an effective corporate tax rate of 9.5 percent – much less than the average of other companies. This number appears to have been

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<sup>8</sup> It is worth noting that the US Tax Cuts and Jobs Act of 2017 also has a minimum tax threshold for certain intangible assets referred to as global intangible low-taxed income (GILTI). This measure is conceptually similar to GloBE and was installed after the 2017 Act moved partially away from taxing worldwide corporate profits.

<sup>9</sup> See, for example, the written commentary from the Coalition of Service Industries (2020) to the Office of the USTR in relation to the Section 301 action against several countries (Federal Register, 2020).

calculated on the basis of a hypothetical investment project, and it contrasted sharply with the much higher tax rates calculated by others. Work by Lee-Makiyama and Verschelde (2014), Ferracane and Lee-Makiyama (2018) and Bauer (2018) demonstrates that contrary to the notion that large tech companies underpay corporation taxes, they are in effect amongst the most highly taxed on their global profits.

Bauer (2018), for example, calculates average effective corporate tax rates (ECTRs) affecting different kinds of businesses distinguished by their degree of reliance on the digital economy. The calculations were made for 140 firms divided into three categories – traditional less digital firms (49), large and well-known digital firms (12), and other less well-known digital and other firms (79). On the basis of a five-year average, the mean ECTRs of these corporations were 27.1%, 26.8% and 29.4% respectively.

If the issue is less about the tax burden and more about jurisdictional geography, then the issue becomes one of distribution. The DST debate has been led by the assumption that the tax revenue transfers necessary for a ‘fair’ income would be from the United States and perhaps China to Europe and elsewhere. The extent to which this is true depends in part on the scope question – on how broadly-based and antithetical to ringfencing is the design of any digital tax.

Moreover, a recent paper by Lee-Makiyama (2018) has calculated the tax burden that could fall on EU services exports if the United States and China were to subject them to a digital tax in a retaliatory move. In such a scenario, the EU would stand to lose more than what it would harvest from its proposed but so far unenforced digital tax. These observations emphasize the attraction of an internationally agreed outcome on this issue.

In addition to the level/distribution question on digital taxation, another concern is that DSTs are discriminatory by intent, designed not only to raise revenue but for protectionist purposes as well. The latter concern is reinforced by a number criteria included in some schemes, where firm size and product definitions limit the scope of coverage (Lee-Makiyama, 2014; Hufbauer and Lu, 2108; Internet Association, 2018; Copenhagen Economics, 2018 and 2018a; Kennedy, 2020 and 2020a).<sup>10</sup> A further concern is the likelihood that affected firms would face double-taxation outcomes. These features potentially make the measures WTO-inconsistent.

The intention to eliminate DSTs under the OECD’s Pillar 1 and Pillar 2 constructs should help in reducing if not removing some of these features. Concerns remain, however, about *de facto* discrimination that could arise from size thresholds or other metrics to define the enterprises that will be within scope of the tax arrangements. These misgivings are linked to a desire to avoid the discriminatory distorting results of digital ringfencing.

Ringfencing concerns are also about the sequencing of implementation such that the digital companies would come into scope first and the consumer-facing enterprises that also rely

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<sup>10</sup> A series of articles referenced in the bibliography to Inside U.S. Trade trace aspects of the evolution of the DST discussions.

on the digital economy in their business models would follow later. An additional worry for some observers is that the reliance on formulae for such matters as profit allocation will be unstable, and greater emphasis should be placed on clear principles (Morris, 2020). Finally, the OECD initiative has many moving parts that render it complex and subject in some instances to multiple interpretations (Greil and Eisgruber, 2020). An ongoing theme as the OECD initiative develops is likely to concern questions of complexity and possibilities for simplified approaches.

### ***Why not a consumption or sales tax?***

The Tax Foundation has argued for a consumption or sales tax rather than a digital service tax (Bunn et al., 2020;). The proposal is for a broad-based tax that treats digital and physical businesses equally and would apply to both cross-border and local commerce on a non-discriminatory basis. The recommendation is that this tax should replace revenue-based digital taxes on profits that are considered more distorting in terms of economic outcomes. The product coverage of such a tax would raise similar questions regarding scope as the OECD's Unified Approach. Depending on the criteria applied, departures from a single rate of taxation across product lines could also be an issue.

Another concern is that users of the Internet enjoy value-creating free access without necessarily entering into transactions. These transactions constitute the taxable base for consumption taxes, so if services are free it is not obvious how consumers can be taxed. The tax could only be charged when B2C or B2B commercial transactions actually take place. Furthermore, while such taxes may be non-discriminatory between domestic and foreign supplies and suppliers, they are regressive in their distributional impact on the usual assumption that such taxes are passed on to the consumer.

The GATS would not be able to deliver non-discriminatory outcomes from indirect taxation of this nature where countries had not committed to national treatment in their specific schedules of GATS commitments. But the overall tax structure could be aligned with traditional tax practice, pass the non-discrimination test if properly applied, avoid any need to adjust for double taxation, and involve fewer decision points and estimation imperatives. A VAT or sales tax approach would replicate what is already commonplace today, where taxes on products are treated as non-discriminatory destination taxes. It is noteworthy that some interstate taxation systems in the United States rely on sales taxes that encompass digital transactions. It may be worth considering a more prominent role for traditional indirect taxation in the OECD exercise.

## **VI Conclusions**

Attempts to identify core taxation principles are not new. In *The Wealth of Nations* (1776) Adam Smith enunciated four principles – fairness, certainty, convenience and efficiency. In more recent times, the 1998 Ottawa Taxation Framework Conditions, specifically aimed at e-commerce and formulated by the OECD (1998), included neutrality, efficiency, certainty and



simplicity, effectiveness and fairness, and flexibility. The Taxation Foundation (Bunn et al., 2020) zeroed in on simplicity, transparency, neutrality and stability as guiding principles. Focusing specifically on the international dimension of taxation, the WTO focuses on non-discrimination. These formulations have much in common even if they use different words.

All taxation arrangements can be measured against the above principles. Some can be designed in ways that will come close to complying with them. Others infringe the principles by design. Unilateral DSTs and withholding taxes arguably fall into this category. Given the inevitable spillover effects across jurisdictions of taxes on the digital economy, such unilateral approaches to digital taxation are a sure recipe for conflict. As noted above, trade is the obvious target in such circumstances, and international cooperation is the only exit strategy from a negative-sum outcome.

Increasing digitalization of economic activity has engendered demands for fundamental changes in international tax policy. These demands have not gone unchallenged even as the international community attempts to forge tax arrangements that redistribute tax revenue towards jurisdictions where consumption occurs in the absence of a physical presence of producers of the products concerned. The OECD's initiatives on digital taxation are an attempt to shape a multilateral approach to the issue. Discussions and negotiations have been going on for some years, and have been extended to mid-2021. Significant progress has been made in drawing up the contours of a consensus-based set of arrangements. But important differences remain to be resolved in what is a complex and intricate approach to achieving results that all parties can live with.

Despite the current OECD program of work involving over 130 countries, a growing number of national authorities are acting in parallel by adopting, designing or contemplating unilateral approaches to taxing the digital economy. These initiatives include digital services taxes, gross-based withholding taxes, and a variety of sales and value-added taxes. The costs of some of this fiscal divergence are high. Taxes can be discriminatory in intent and/or effect, entail increased compliance risks, result in double taxation outcomes and impose additional transaction costs on firms and tax administrations. The maze of assorted approaches also carry additional costs of potentially significant proportions arising from uncertainty.

A body of empirical work strongly suggests that ICT contributes disproportionately to output and productivity growth. Different methodological approaches and data challenges yield mixed evidence, but most analysts would argue that the core message remains robust. Digitalization is an inseparable feature of modern economies, extending in one form or another across virtually every aspect of economic activity. Growing dependency on the medium makes a strong case for the competitive and efficient supply of digital services. Unilateral international taxation policies with discriminatory effects do not only compromise the economic gains. They are also likely to provoke trade retaliation, counter-retaliation and the makings of a trade war.

Evidence already exists of entanglement between unilateral tax measures and trade restrictive responses. This is merely a foretaste of what is likely to ensue in the absence of a multilateral agreement on tax policies for the digital economy. To succeed, such an agreement

would at the very least need to focus more broadly on businesses relying on the digital economy, and be non-discriminatory in its effects.

The WTO, and in particular the GATS, is not fully attuned to taxation issues and has little precedent to rely upon. This complicates efforts to mediate and manage trade disputes arising from taxation regimes. The core of WTO relevance is based on its principles of non-discrimination – MFN and national treatment. Many, but not all, facets of digital tax regimes with discriminatory features rely on *de facto* assessments of policy design rather than readily identifiable *de jure* infringements of non-discrimination. This adds to complexity and complicates authoritative determinations of WTO compliance and non-compliance.

This situation arises partly because of a relative lack of binding commitments in the relevant areas of GATS, but also because of a lack of jurisprudential guidance. The international trade rules have developed largely in parallel to international tax regimes, leaving limited scope for ready solutions to trade conflict provoked by discord over fiscal policy. There may, however, be ways of short-circuiting these difficulties, including through simplifying the interface between tax policies and WTO rules.

Were the WTO to engage in negotiations to improve the coverage of their services schedules – something that for various reasons has not occurred in the last 25 years, this would go some way in enabling the GATS to deal more effectively with taxation arrangements on the wrong side of the non-discrimination principle. This applies particularly to national treatment commitments.

In sum:

- A multilateral solution to taxation of the digital economy is essential if costly and friction-filled outcomes detrimental to both sound tax policy and the robustness of the WTO system of trade rules are to be avoided.
- Work is needed at the WTO to clarify and develop rules to address international digital taxation issues. Relevant work is already taking place in the WTO through the Joint Statement initiative on e-commerce. Work on the digital taxation conundrum should probably be kept separate from the e-commerce negotiations, but there ought to be improved coordination between the WTO and the OECD on the links between the tax issues and the global trade rules.
- Consideration should also be given to simpler ways of taxing the digital economy in a WTO consistent manner. This may include making greater use of a GST/VAT approach to taxation, as a complement and not a substitute to the ongoing OECD initiative.
- New negotiations on market access and national treatment commitments under the GATS would contribute to a more orderly multilateral approach to digital taxation. Such negotiations could be part of the JSI initiative on e-commerce. An additional area where further work on GATS could prove useful is in relation to product nomenclature.

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