Fair and efficient? On the EC's proposals for corporate tax reform in the digital single market

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In the wake of the Ecofin meeting that took place in Tallinn on September 15-16, the European Commission published a communication on "A Fair and Efficient Tax System in the European Union for the Digital Single Market" -- code for "How to extract more tax revenue from multinational digital companies".

Political momentum is clearly building up for similar proposals, as a declaration initiated by the finance ministers of France, Italy, Germany, and Spain (who have called for tax changes in the past) was joined by six other countries. Everyone is in favour of a "fair and efficient tax system," but what such a system would look like is far from obvious, and the Commission's paper comes short of delineating that.

The problem – or, is there a problem?

The Commission maintains that the current international tax framework no longer fits economic reality at a time when the globalisation and digitalisation of trade enables companies to conduct business in any country without the need to set up shop in a particular jurisdiction. This story has been told so many times that it is taken for granted by commentators; however, that does not imply that it is true. It is unfortunate that even those parties who oppose EU tax reform are willing to concede the fundamental point that international tax principles are obsolete, and call for a comprehensive review. Their only objection seems to be that the process should be led by the OECD rather than the EU.

Let us give a closer look at the allegedly outdated principles of international taxation. Traditionally, production has been taxed in the jurisdiction where the producer was based, while consumption has been taxed in the jurisdiction where the consumer was based. According to this framework, for instance, a French winery or a Spanish ham maker would be subject to corporate tax in France or Spain respectively, even though they exported most or all of their production to, say, Italy; Italy, on the other hand, could only claim sales taxes on the actual transactions.

How is our example any different from the case of a digital company selling goods or services online? The Commission addresses four major models for online businesses:

- the "online retailer model, whereby online platforms sell goods or connect buyers and sellers in return for a transaction or placement fee or a commission;"
- the "social media model, whereby network owners rely on advertising revenues by delivering targeted marketing messages to consumers;"
- the "subscription model, whereby platforms charge subscription fee for continued access to digital services (e.g. music or videos);" and
- the "collaborative platform model, whereby digital platforms connect spare capacity and demand, use reputational currency mechanisms to underpin consumption, and enable individuals to share 'access' to assets rather than own them outright."

For these models to work, no "permanent establishment" is required in any particular country. Online retailers might employ distributed warehouses to be able to serve customers quickly and efficiently, but that is covered by article 5 of the OECD's model tax convention, which inspires virtually all tax treaties currently in place. Social media and collaborative platforms might resort to independent agents or even maintain fixed places of business for the purpose of collecting information or other auxiliary activities, but these activities are exempted by article 5 as well. Subscription services, on the other hand, are unlikely to require any forms of presence in the countries where their subscribers are based. While it is clear that technology brought distance-trading to a new scale, it is hardly the case that it also changed the economic nature of the transactions involved.

The Commission acknowledges that "profits should be taxed where the value is created", but it fails to show that any value is created within the jurisdictions where consumers are based, while all business operations take place where companies are based. When the Commission asks itself "how to establish and protect taxing rights in a country where businesses can provide services digitally with little or no physical presence despite having a commercial presence," it is begging the question.

Technology and tax competition aren't causing member states to lose revenue

The conventional narrative has it that digitisation and increased tax competition have led to a 'race to the bottom' in tax rates which in turn has led to a decline in revenues raised from corporate profits. Whilst the leap between declining rates and falling revenue is easily made, there is no reason to believe it is automatic or indeed true for the European experience in recent years.

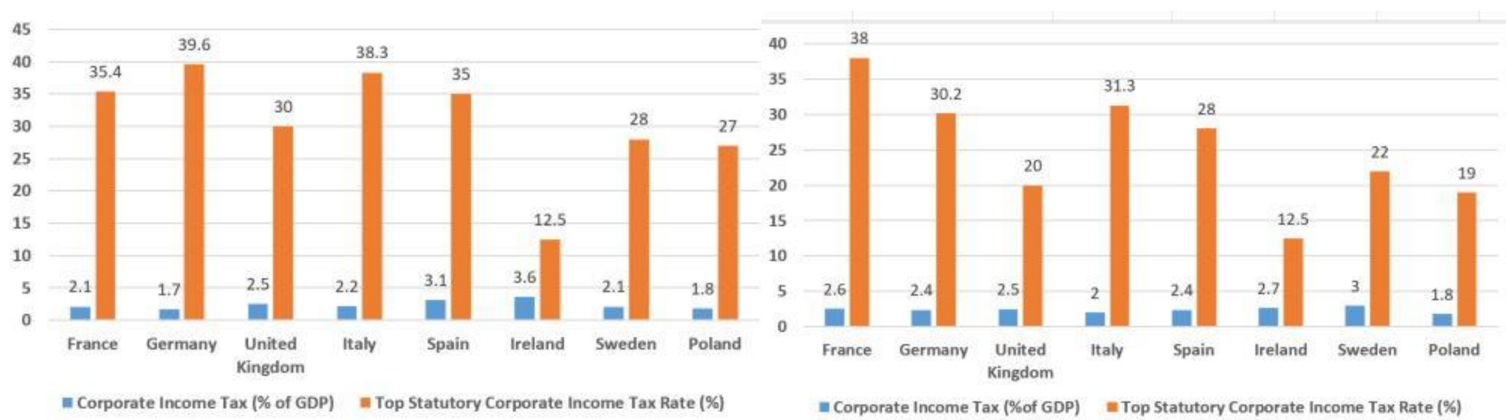
Fig. 1 shows corporate income tax rates and revenue raised by this tax for selected EU member states which feature prominently in discussions of EU tax policy: France, Germany, Italy and Spain as the main losers from recent trends, and also the most vocal advocates for reform; the UK and Ireland as low-tax member states who are contributing to the erosion of the tax base elsewhere; and Sweden and Poland as two other large and salient member states.

There is no apparent trend of declining revenues as tax rates have dropped. The corporate tax take in fact rose as a share of GDP between 2003 and 2015 in France and Germany, the two countries pushing most forcefully for changes to the EU tax regime. As Zuluaga (2016) shows, corporation tax revenues in the average OECD country[1] have increased as a share of all tax revenue and as a portion of GDP since 1981, when globalisation began and value creation by firms started to be driven more and more by intangible property.

> In contrast to the conventional narrative, corporation tax revenues have risen in both France and Germany between 2003 and 2015. Corporation tax revenues in the average OECD country increased as a share of all tax revenue and as a portion of GDP since 1981.

Figure 1. Corporate tax rates (%) and revenue (% of GDP), selected EU member states

(a) 2003 (b) 2015



That tax rates have declined sharply since 1981 is a function of the increased mobility of capital and the realisation by officials that direct taxes on firm profits are comparably inefficient. But the associated decline in revenues posited by proponents of reform is nowhere to be seen.

Free-riding by companies?

A slightly different argument put forward by the Commission contends that, by engaging customers in other countries, companies are free-riding on the legal institutions of those jurisdictions, as their business could not thrive in the absence of secure property rights and the rule of law. However, multinational corporations are hardly free-riding in any meaningful sense of the expression: indeed they generate conspicuous revenue from sales taxes.

On a more fundamental level, and irrespective of who is footing the tax bill, such revenues would not be there in the first place if the corresponding sales had not occurred. Moreover, foreign companies may bring in further tax revenue by acquiring goods and services from local vendors, even when those transactions don't amount to the creation of a permanent establishment: just think of the income taxes of independent agents or the workers hired to build and maintain warehouses.

The weaknesses of the Commission's story also affect its stated goals: fairness, competitiveness, sustainability, and the integrity of the single market. First of all, subjecting companies to different tax rules, based on whether they sell leather goods or online video subscriptions would be utterly unjustified from the perspective of equality before the law. Secondly, we may wonder what notion of competition the Commission subscribes to if it thinks that companies should have to compete for market shares, but governments should not have to compete for tax bases. As far as sustainability is concerned, it seems short-sighted to assume that the only interests to be taken into account are the Treasury's rather than the taxpayers'. And finally, while it may be true that uncoordinated

[1] All the countries featured in Fig. 1 are members of the OECD.

initiatives at the national level pose a threat to the integrity of the single market, embracing full tax harmonisation would present an even greater risk, by preempting the adoption of a healthy trial-and-error approach to tax policies.

Solutions – what solutions?

The proposed reforms provide even more reason for concern. The Commission's favourite option would be a revamp of the Common Consolidated Corporate Tax Base proposal, which has been in the works since 2011 but was revived by the Juncker cabinet in 2016. Under this approach, the profits of multinational companies would be allocated to different jurisdictions for tax purposes, based on indicators such as assets, labor, and sales. While the sheer quantity of goods and workers employed is arguably a measure, albeit a crude one, of value creation in a jurisdiction, the amount of sales in a given member state bears no relationship with the value created.The use of sales as a factor is only meant to benefit larger countries vis-à-vis smaller, often lower-tax and more dynamic ones. The ultimate effect of the CCCTB proposal, should it come into force, would be to neutralise the fiscal dimension of companies' freedom of establishment and thus to reduce (corporate) tax competition in Europe.

Shorter-term solutions would be even more problematic. The Communication mentions three options. The first is an "equalisation tax" to be levied on "all untaxed or insufficiently taxed income generated from all internet-based business activities" (similar to the UK's Diverted Profits Tax). The second would be a standalone gross-basis final withholding tax on payments made to non-resident online providers, aiming to curb profit shifting among subsidiaries but which is little justified as a general policy. The third alternative offered by the EC is a tax on revenues generated from the provision of digital or advertising services to in-country customers where a non-resident entity has a significant economic presence.[2]

Not only would such proposals discriminate between digital and brick-and-mortar businesses, but they would contradict another pillar of the theory of taxation: the idea that profits only, and not revenue, should be taxed, if we are to preserve the ability-to-pay principle.

> The Commission's long-term and short-term solutions entail potentially dangerous consequences for European economies. The CCTB would reduce tax competition whilst the three short-term options would tax revenues instead of profits and therefore contradict the ability-to-pay principle.

The call for corporate tax reform in the EU has little to do with fairness and competitiveness and more to do with the insatiable appetite of Treasury departments, particularly in high-tax jurisdictions. This is something even the Commission implicitly concedes, when it states that "the longer it takes to find a solution, the bigger the losses in tax revenues will be." Corporate tax should not be thought of as the price to pay for conducting business in a given country, but rather as a beneficial – though not the most significant – by-product of entrepreneurial value creation. While the international tax system might well need refinements or adjustments in view of new economic realities, its fundamental principles should not be jeopardised. It is an alarming sign that even those parties which stand to lose more from the proposed measures (low-tax jurisdictions and multinational corporations, digital or otherwise) have so far failed to respond to them robustly. But then again, as Victor Hugo once wrote, "nothing is more powerful than an idea whose time has come." Sadly, that would seem to apply especially to simplistic and dangerous ideas.

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[2] The second and third options were debated in the Italian parliament.