

Chapter 8

Potential options to address the broader tax challenges raised by the digital economy

This chapter provides an overview of potential options that have been discussed by the Task Force. It then provides a brief framework for evaluating options to address the broader tax challenges raised by the digital economy. Finally, it provides an initial evaluation of the options discussed, along with a description of some of the issues that will need to be addressed in developing and evaluating those options.

8.1 Introduction

The Task Force received proposals for several potential options to address the broader tax challenges raised by the digital economy. The proposals received were focused on several areas, including modifications of the permanent establishment (PE) threshold, the potential imposition of a withholding tax on certain types of digital transactions, and options in the area of consumption tax. As discussed in Chapter 7, there is in certain business models a substantial overlap between the challenges related to nexus, data, and characterisation. Many of the challenges related to data, for example, could alternatively be described as issues related to lack of nexus under existing rules or as issues with respect to characterisation of income. Similarly, because market country taxing rights depend heavily both on characterisation of income and on questions of nexus, issues with respect to nexus depend substantially on characterisation. As a result, options focused on addressing one of these challenges will inevitably impact the others as well.

There are likely to be certain advantages and disadvantages to approaching these challenges through indirect taxation and/or direct taxation. Ultimately, evaluation of the options therefore requires also an analysis of the economic incidence of value added tax (VAT) and corporate income taxation and its impact on the options to address the tax challenges raised by the digital economy.

Some of the proposals were also considered in the context of the work of the business profit Technical Advisory Group (BP TAG), which focused primarily on e-commerce. In that context, it noted that it “cannot address the issue of whether or not some countries may find that e-commerce has or will have an unacceptable effect on the international sharing of tax revenues,” but that “there was a need to monitor the evolution of the impact of e-commerce on tax revenue.” (OECD, 2005: 110-112). While the Task Force considers the work of the BP TAG useful, given the growth of e-commerce and developments in the digital economy more generally, the Task Force considers it important to examine these proposals again to evaluate whether the earlier analysis of those proposals is still valid in light of developments since that work was conducted.

The Task Force considered it important to develop a framework for evaluating options, to ensure a consistent and principled analysis and informed policy decisions. In this respect, as noted in Chapter 1, the Task Force considered the Ottawa framework principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility to be a good starting point for such a framework.

This chapter describes the options considered by the Task Force, the framework to evaluate those options, and an initial analysis of those options in the context of the BEPS Project and of the tax challenges to which they relate.

8.2 Options proposed to the Task Force

The Task Force discussed several potential options, which were received from a variety of sources, including proposals from country delegates, proposals from stakeholders, discussions at meetings of the Task Force, and discussions of other working groups. These potential options and their technical details were discussed and analysed by the Task Force and are outlined below in simplified form. Additional work on these options will need to be carried out by the relevant subsidiary bodies of the CFA and the Task Force itself (see also Section 8.4 below).

8.2.1 Direct tax options

8.2.1.1 Modifications to the exemptions from PE Status

One potential option discussed by the Task Force would modify the exceptions contained in paragraph 4 of Article 5 of the OECD Model Tax Convention. As noted in Chapter 6, above, as the economy has evolved, some of the activities described in subparagraphs (a) through (d) of paragraph 4 that were previously preparatory or auxiliary in the context of conventional business models (such as sales through a storefront) may have become core functions of certain businesses. Where the exceptions to the PE definition contained in paragraph 4 no longer serve their intended purpose as a result of that evolution, they should not be available. Several variations of this potential option could be considered. One possible option would be to eliminate paragraph 4 entirely. Other possible options would be to eliminate subparagraphs (a) through (d), or make their availability subject to the condition that the character of the activity conducted be preparatory or auxiliary in nature, rather than one of the core activities of the enterprise in question. Another would eliminate the word “delivery” in Article 5(4)(a) and (b) in order to exclude from these subparagraphs certain types of warehouses.

8.2.1.2 A new nexus based on significant digital presence

Another potential option discussed by the Task Force focuses on establishing an alternative nexus to address situations in which certain business activities are conducted wholly digitally. Under such a proposal, an enterprise engaged in certain “fully dematerialised digital activities” could

be deemed to have a taxable presence in another country if it maintained a “significant digital presence” in the economy of that country. Focusing on “fully dematerialised digital activities” is intended to target only those businesses that require minimal physical elements in the market jurisdiction for the performance of their core activities, regardless of the fact that physical elements (such as offices, buildings, or personnel) may be present in the market jurisdiction to conduct secondary functions.

Under this potential option, to address administrative concerns businesses performing such fully dematerialised digital activities would be deemed to have a PE only if they exceeded certain thresholds which would indicate a

Box 8.1. Fully dematerialised digital activities

Potential elements of a test for when a fully dematerialised digital activity was conducted could include the following:

- The core business of the enterprise relies completely or in a considerable part on digital goods or digital services.
- No physical elements or activities are involved in the actual creation of the goods or of the services and their delivery other than the existence, use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialisation of location-relevant data.
- Contracts are generally concluded remotely via the Internet or by telephone.
- Payments are made solely through credit cards or other means of electronic payments using on-line forms or platforms linked or integrated to the relative websites.
- Websites are the only means used to enter into a relationship with the enterprise; no physical stores or agencies exist for the performance of the core activities other than offices located in the parent company or operating company countries.
- All or the vast majority of profits are attributable to the provision of digital goods or services.
- The legal or tax residence and the physical location of the vendor are disregarded by the customer and do not influence its choices.
- The actual use of the digital good or the performance of the digital service do not require physical presence or the involvement of a physical product other than the use of a computer, mobile devices or other IT tools.

substantial ongoing interaction with the economy of the market country. These thresholds could include, for example, measures of total contracts for digital goods and services that are concluded remotely, the active engagement of substantial numbers of users (for example, the number of active accounts for social platforms, the number of visitors to websites, or the number of users of online tools) as well as the overall level of consumption of the digital goods or services of the enterprise in the market country. As regards practicalities, this variation would rely on relevant provisions regarding protection of personal data.

Box 8.2. Significant digital presence

For an enterprise engaged in a fully dematerialised business, a significant digital presence could be deemed to exist in a country when, for example:

- A significant number of contracts for the provision of fully dematerialised digital goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes in the country.
- Digital goods or services of the enterprise are widely used or consumed in the country.
- Substantial payments are made from clients in the country to the enterprise in connection with contractual obligations arising from the provision of digital goods or services as part of the enterprise's core business.
- An existing branch of the enterprise in the country offers secondary functions such as marketing and consulting functions targeted at clients resident in the country that are strongly related to the core business of the enterprise.

The Task Force also discussed a variation of this potential option to create a new tax nexus for enterprises engaged in fully dematerialised digital activity where the entity does a significant business in the country using personal data obtained by regular and systematic monitoring of Internet users in that country, generally through the use of multi-sided business models. This variation was proposed in order to address concerns that the existing tax rules do not adequately address the challenges posed by increased reliance on data and users participation in the digital economy, particularly where users provide personal data that can then be used to attract revenue from other users through multi-sided business models.

8.2.1.3 Replacing PE with significant presence

One potential option proposed in public comments would be to replace the existing PE concept with a “significant presence” test intended to respond to the changing nature of customer relationships in the digital economy while continuing to rely in part on physical presence. The criteria for this test intend to reflect the contribution to value of these closer, more interactive customer relationships and would include:

- Relationships with customers or users extending over six months, combined with some physical presence in the country, directly or via a dependent agent.
- Sale of goods or services by means involving a close relationship with customers in the country, including (i) through a website in the local language, (ii) offering delivery from suppliers in the jurisdiction, (iii) using banking and other facilities from suppliers in the country, or (iv) offering goods or services sourced from suppliers in the country.
- Supplying goods or services to customers in the country resulting from or involving systematic data-gathering or contributions of content from persons in the country.

8.2.1.4 Creation of a withholding tax on digital transactions

Another potential option that has been suggested to address challenges related to nexus is to impose a final withholding tax on certain payments made by residents of a country for digital goods or services provided by a foreign provider. To avoid requiring withholding by individual consumers, one potential option to be considered would be to require withholding by the financial institutions involved with those payments. Such a withholding tax could be introduced as a standalone provision to address concerns that it may be possible to maintain substantial economic activity in a market without being taxable in that market under current PE rules due to lack of physical presence in that market. Alternatively, such a withholding tax could be used as a primary enforcement tool for one of the new nexus standards described above. If such an approach were taken, taxpayers providing digital goods and services covered by the withholding tax could file returns in order to ensure that they were ultimately taxed on a net basis.

8.2.1.5 Introducing a bandwidth or “Bit” tax

Another potential option proposed in public comments would be to tax websites’ bandwidth use. Such a tax would be based on the number of bytes used by the website, although in order to introduce an element of progressivity, different tax levels would apply depending on the enterprise

size or the turnover. For administrative purposes, such a tax would apply only to businesses that exceed minimum threshold of annual bandwidth used. In order to maintain equity between digital businesses and traditional businesses, the proposed bandwidth tax would be creditable against corporate income tax.

8.2.2 Consumption tax options

The digital economy has allowed businesses to significantly increase their ability to market and sell goods, services and intangibles from remote locations to consumers in foreign jurisdictions. It has also introduced payment mechanisms that facilitate online shopping by consumers. These developments have resulted in significant growth in cross-border business-to-consumer (B2C) supplies which present challenges to VAT systems as these supplies often result in no or an inappropriately low amount of VAT collected and create potential competitive pressures on domestic suppliers. As the digital economy continues to evolve, new challenges may also emerge.

8.2.2.1 Exemptions for imports of low valued goods

The thresholds for these exemptions vary widely across jurisdictions. When establishing these thresholds, jurisdictions attempt to find the balance that is appropriate for their jurisdiction between the administrative and compliance costs of taxing low value imports and the revenue loss and potential competitive distortions that the exemptions may create. The thresholds in many jurisdictions were established before the advent and growth of the digital economy and may require a review to ensure that they are still appropriate.

If tax authorities were to make significant improvements to the efficiency of processing such low value imports and of collecting the VAT on such imports, governments would be in a position to lower these thresholds and address the issues associated with their operation. This could notably be achieved by requiring non-resident vendors of low value parcels to charge, collect and remit the tax on the imports of these goods in the importing jurisdiction. Compliance by non-resident suppliers with their tax obligations in the country of importation would need to be facilitated through simplified registration and compliance mechanisms, using the possibilities offered by new technologies (e.g. on-line registration and filing, electronic payment). While countries may wish to consider the use of registration thresholds to minimise potential compliance burden on small and medium enterprises, such thresholds create their own complexity as they generally differ between countries. Countries should therefore ensure that simplified registration mechanisms are sufficiently clear and accessible so that non-resident vendors, including small and medium enterprises, may easily comply thereby eliminating the need for registration thresholds.

8.2.2.2 Remote digital supplies to consumers

Past work carried out by international organisations, including the Organisation for Economic Co-operation and Development (OECD) and the European Union (see e.g. Annex A), and country experience indicate that the most effective and efficient approach to ensure an appropriate VAT collection on such cross-border B2C supplies of services and intangibles is to require the non-resident supplier to register and account for the VAT on these supplies in the jurisdiction of the consumer. While such a vendor collection mechanism was first recommended under the OECD's 2003 E-commerce Guidelines, experience since then, notably within the European Union, which has been the first to implement it, has shown that it still remains the most viable option today.

It is recognised that requiring non-resident suppliers to register and account for VAT in as many foreign jurisdictions as they have consumers of remotely delivered services and intangibles may impose compliance burdens on these suppliers, which may weigh particularly heavily on small and medium enterprises. Countries should therefore ensure that simplified registration mechanisms are sufficiently clear and accessible so that non-resident vendors, including small and medium enterprises, may easily comply thereby eliminating the need for registration thresholds. Nevertheless, it is recognised that certain businesses, particularly small and medium enterprises, may prefer to rely on the expertise of third-party intermediaries to assist them in complying with their requirements to register and remit VAT abroad. Thus third-party intermediaries could play an important role in facilitating and encouraging compliance by non-resident suppliers.

Administrations are likely to face a number of challenges in enforcing compliance with VAT requirements by non-resident suppliers. These challenges include identifying that supplies have been made, enforcing collection and remittance of tax by the non-resident supplier and follow up enforcement actions such as accessing books and records, auditing and collection procedures for outstanding taxes. Improved international co-operation between jurisdictions will be required to address these challenges. This should include enhanced exchange of information, assistance in recovery and simultaneous audits. The Convention on Mutual Administrative Assistance in Tax Matters, which was developed jointly by the Council of Europe and the OECD, also covers VAT matters and provides a useful platform for developing such improved international co-operation.

8.3 Framework for evaluating potential options

For purposes of evaluating potential options, the Task Force agreed on a framework starting from the basic tax principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability, in light of the proportionality of the changes in relation to the tax challenges they are intended to address in the context of the existing international tax framework. Evaluating potential options using this framework is intended to ensure that the analysis can be done consistently and objectively. In evaluating potential options, no single principle can be given greater priority than any other. Instead, the assessment under this framework shall be based on an overall consideration of the individual factors that are part of the framework.

8.3.1 *Neutrality*

Potential options will be evaluated with respect to their neutrality between different forms of business activities, as compared with the existing tax framework. In particular, an option should be evaluated to ensure that its enactment would not result in discrimination in favour of or against particular ways of doing business. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation, in order to avoid introducing distortions to the market. In other words, the same principles of taxation should apply to all forms of business, while taking into account specific features that may otherwise undermine an equal and neutral application of those principles.

8.3.2 *Efficiency*

Options will be evaluated with respect to their efficiency relative to the existing tax framework. The benefits of any reform should outweigh the costs of its adoption, including transitional and implementation costs. Taxation should ideally accomplish its intended purpose while minimising compliance costs for both business and administrations to the extent possible. Many existing tax rules were based on the practical considerations that applied at the time those rules were enacted. For example, the PE threshold was based in part on assumptions, rooted in the economic realities of the time, that a certain physical footprint was required before taxpayers and tax administrations could effectively determine the profits to be taxed. Evaluation of the efficiency of potential options relative to the existing framework should therefore take into account whether the administrative considerations underlying the existing rules are still applicable, or whether advances in technology may have made those practical constraints less important.

8.3.3 Certainty and simplicity

Potential options will be evaluated with respect to their certainty and simplicity relative to the existing tax framework. Tax rules that are easily understood make it easier for taxpayers to anticipate the tax consequences of transactions in advance, and for administrators to evaluate compliance. As a result, businesses are more likely to make optimal decisions and respond to intended policy signals, minimising the potential for disputes. A simple tax system is also likely to involve lower compliance costs, resulting in a more efficient taxation system.

8.3.4 Effectiveness and fairness

Potential options will be evaluated with respect to their effectiveness and fairness relative to the existing tax framework. As recognised in the Ottawa framework conditions, taxes imposed should produce the right amount of tax at the right time. In assessing the fairness of any proposed options, it is important to consider who may bear the ultimate tax burden (i.e. shareholders, workers, or consumers) and in what proportion. In order to preserve fairness, it is also important to ensure that any tax imposed must be structured in a way that effectively ensures that taxes are imposed on persons from whom collection will be enforceable as a practical matter. Enforceability is important because a tax system that is difficult to enforce is unlikely to be either equitable or neutral, and may undermine the public perceptions of the fairness of the whole system in the long term. In the absence of enforceability, there is also a risk that tax avoidance may develop as taxpayers will face different tax liabilities depending on their scruples. In this respect, evaluation of potential options must also keep in mind the need to avoid creating new risks of double taxation or new opportunities to artificially avoid taxation.

8.3.5 Flexibility and sustainability

Potential options will be evaluated with respect to their flexibility and sustainability relative to the existing tax framework. It is important that a tax system is sustainable and flexible enough to meet the changing revenue needs of governments on an ongoing basis. Potential options should therefore be evaluated based not only on whether they address the tax challenges in the current environment, but, to the extent possible given the difficulty of predicting future developments, on whether they can be expected to be flexible and dynamic enough to adapt to future commercial and technological developments, so that they can continue to be effective.

8.3.6 Proportionality

Potential options will be evaluated with respect to their proportionality to the tax challenges they are intended to address. The existing tax framework has endured in part because it has historically been possible to adapt within that framework to new business developments. Where the digital economy has raised tax challenges with respect to the application of that existing tax framework, it will be important to evaluate not only whether the proposed options address those tax challenges, but also what broader impact those options may have. Potential options should ideally be tailored to the scope of the particular challenges they are intended to address.

8.4 Initial evaluation of potential options

As described in Chapter 6, it is expected that the work to develop the direct tax measures envisaged in the base erosion and profit shifting (BEPS) Action Plan (OECD, 2013) will take into account the key features and business models that have emerged in the digital economy, and will therefore effectively address the BEPS concerns that arise in the digital economy. The work to address BEPS concerns is expected to result in substantial changes to existing international tax rules in order to tackle stateless income and address practices that artificially segregate taxable income from the activities that generate it. As a result, addressing BEPS concerns in the digital economy also has the potential to substantially affect the scope of several of the broader tax challenges raised by the digital economy.

The staggered time frame of the BEPS Project, the interaction among the various BEPS outputs, and their actual impact on BEPS therefore make it difficult to evaluate the ultimate scope of the broader tax challenges of the digital economy in the area of direct taxation. If the BEPS issues outlined in Chapter 5 are fully addressed through the measures envisaged in the BEPS Action Plan, addressing the challenges described in Chapter 7 may become less pressing. Indeed, one potential option in such a case would be to conclude that the broader tax challenges of the digital economy were reduced in scale to the point that no further action was necessary in the area of direct taxation. On the other hand, if BEPS issues in the context of the digital economy are not addressed fully, then addressing the broader tax challenges of the digital economy could become a more pressing issue. Work to evaluate the broader tax challenges described in Chapter 7, and to further develop and evaluate the potential options to address them, can be carried on alongside the work being done on the rest of the BEPS Action Plan, and it will ultimately need to take into account the results of that work.

As a result of these considerations, application of the framework described above to these potential options would be premature. Instead,

with respect to certain of these potential options, discussion by the relevant working parties of the Committee on Fiscal Affairs (CFA) in the context of the BEPS Project will be necessary in order to advance the work further. With respect to other potential options, further development of the issues and the completion of other BEPS work will be necessary in order to make it possible to evaluate them in full. Because all potential options under consideration require additional discussion or the completion of additional work in order to permit full evaluation, neither final evaluation nor adoption of any options was made by the Task Force at this point in time.

8.4.1 Options to be developed further by relevant working parties

8.4.1.1 Modifications to the exemptions from PE status

With respect to the option to modify the exemptions from PE status, work has already begun under Action 7 of the BEPS Action Plan to determine whether modification or elimination of paragraph 4 of Article 5 is necessary to ensure that the exceptions to PE do not allow the artificial avoidance of PE status, for example by fragmenting operation among different locations or group entities. This work, which will be completed by 2015, should be expanded to address situations in which these exceptions inappropriately apply to activities that have become core functions, whether this relates to BEPS (due to lack of both source and residence taxation) or not.

8.4.1.2 Consumption tax options

The collection of VAT with respect to B2C transactions is a pressing issue that needs to be addressed urgently to protect tax revenue and to level the playing field between foreign suppliers and domestic suppliers. Working Party No. 9 of the OECD CFA is already developing work with respect to the option relating to remote digital supplies to consumers in the context of its work on the OECD International VAT/GST Guidelines. This work should be completed by the end of 2015, should include Associates in the BEPS Project participating on an equal footing with the OECD member countries, and should also examine compliance issues. In parallel with its work on remote digital supplies, and as separate work stream from the development of the OECD International VAT/GST Guidelines, Working Party No. 9 should develop work on approaches and best practices for a possible implementation of the options relating to the exemption for imports of low value goods.

8.4.2 Options requiring further development by the Task Force

As discussed above, issues related to nexus, data, and characterisation are closely related, and overlap significantly in scope in relation to certain business models brought about by the digital economy. The options to create a PE based on significant (digital) presence, the option to create a nexus for digital tax presence based on collection of data, as well as the option to impose withholding tax on digital transactions, all relate to those issues. In order to fully understand the scope of these issues and their interaction, and to be able to determine whether these options are proportionate to the tax challenges they are intended to address, the Task Force will need to more thoroughly evaluate: (i) the extent to which businesses in the digital economy are in fact able to achieve significant sales in a market country without maintaining physical presence; and (ii) the participation of users and consumers in value creation in the digital economy, including in particular the use of data provided by users in multi-sided business models.

As this work progresses, the Task Force will further develop the potential options to address these challenges, to ensure that these potential options are well tailored to the scope of the challenges they are intended to address. In this respect, several aspects of these options would need to be developed further.

In particular, with respect to the options to create or modify standards for nexus, consideration should be given to:

- How the scope of each option could be tailored in order to address the tax challenges presented by the key features of the digital economy without creating substantial tax incentives for particular ways of doing businesses.
- How to balance the need for a combination of factors broad enough to effectively address the tax challenges of the digital economy with the need to provide clear and objective standards in order to minimise potential dispute and to avoid double taxation.
- With respect to options to create a new standard for PE, how profits (including deductions and losses) would be attributed to such a PE, notably with respect to the share of profits attributable to the collection of data, and whether doing so would require the current rules for attribution of profits to PEs to be substantially modified.
- How to manage administration and enforcement, particularly where a taxpayer has no or minimal physical presence in a jurisdiction.
- How to minimise the compliance burden on businesses that could potentially have a large number of PEs.

With respect to the option to impose withholding tax on digital goods and services, consideration should be given to:

- How to define the scope of payments covered by such a tax in a way that avoids creating substantially different tax results for similar businesses and avoids dispute on the characterisation of payments covered.
- How to ensure consistency with trade obligations and other legal constraints.
- How to address the challenges of withholding in the case of transactions with individual customers.
- If financial institutions were required to withhold the tax in lieu of withholding by individual customers, how to ensure that those financial institutions could reliably determine which transactions were within scope.
- To the extent that such a tax would be imposed as a final withholding tax, whether thresholds or other methods could be used to mitigate the impact of gross-basis withholding tax in the context of an enterprise that may incur significant expenses or losses.

The additional work on these topics will be completed by 2015. This work, coupled with an analysis of the outcomes of the BEPS Project will allow the Task Force to take an informed decision on the relevance, urgency, and scope of these challenges and on the potential options to address them. If needed, any necessary work following the completion of the various elements of the BEPS Project will therefore be performed efficiently and within an agreed framework.

In addition, as noted in Chapter 7, the challenges related to nexus, data and characterisation may at the same time create opportunities for achieving BEPS,¹ for example when the lack of taxation in the market country is coupled with the lack of taxation in the jurisdiction of the income recipient and in that of the ultimate parent company. This would be for example the case where a parent company in a jurisdiction with no controlled foreign company (CFC) rules establishes a subsidiary in a low-tax jurisdiction to operate a subscription-based online gaming service that relies substantially on user-contributed content and data contributed by users from a market country, but does not maintain any physical presence in that market country.

If further actions are necessary to address BEPS concerns with respect to the digital economy, one possible approach would be to limit the application of potential options to address the broader direct tax challenges referred to in Chapter 7 and 8 to situations in which such BEPS concerns arise. Similarly, such options could be pursued as domestic law measures to address

situations where there is no relevant double tax treaty in place, e.g. in case of a no-tax jurisdiction or when the claimed benefits of the relevant tax treaty are not due. Limiting application of these measures to BEPS concerns could effectively address these concerns without changing the paradigm for the allocation of taxing rights between source and residence jurisdictions.

Notes

1. As indicated in the BEPS Action Plan, BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low-taxation by shifting profits away from the jurisdiction where the activities creating those profits take place. No or low-taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it. In other words, what creates tax policy concerns are cases in which, due to gaps in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere, or be only unduly lowly taxed.

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From:
Addressing the Tax Challenges of the Digital Economy

Access the complete publication at:
<https://doi.org/10.1787/9789264218789-en>

Please cite this chapter as:

OECD (2014), "Potential options to address the broader tax challenges raised by the digital economy", in *Addressing the Tax Challenges of the Digital Economy*, OECD Publishing, Paris.

DOI: <https://doi.org/10.1787/9789264218789-11-en>

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