TAXING DIGITAL ECONOMIES

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ABSTRACT

The digitalisation of the global economy raises significant challenges in terms of taxing corporate income and imposing and collecting value-added tax on cross-border online sales. Newly agreed international tax rules could significantly benefit developing countries, expanding their right to tax the foreign income of multinational enterprises and improving their ability to protect their tax base from tax avoidance. There is also largely untapped revenue potential from the rapid growth of e-commerce. A significant portion of this market is international transactions. As most African countries have not yet updated their value-added tax rules to account for digital trade, this chapter highlights that they are missing out on significant tax revenues. While some developing countries have digitalised their tax systems, improving efficiency and generating increased revenue, many more need support to implement the digital transformation of their tax administrations.

Key messages

- More than 60 developing countries played a key role in negotiating new international tax rules to address the challenges of the increasingly digitalised global economy and stand to benefit substantially from new taxing rights over profits of multinational enterprises.
- Evidence from countries that have implemented internationally agreed value-added tax standards on cross-border sales of digital services shows significantly increased tax revenues.
- Developing countries will need technical assistance and expertise to make the necessary changes in their laws and tax systems to take advantage of international reforms, build tax policy and administration capacity, and address the evolving taxation challenges of digital economies.

Digital transformation has significant implications for developing countries' domestic tax revenues. Increasing their tax base is vital to ensuring that they have the resources necessary for their development needs. In Africa, for example, taxes represent a far smaller share of countries' gross domestic product (GDP) on average than they do in OECD countries (16.5% versus 33.9%, respectively).[1] In low- and middle-income countries overall, corporate income tax and value-added tax (VAT) often are the main components of the tax base. However, in a digitalised economy, protecting this tax base has become more and more challenging as digitalisation has accelerated in the 21st century. For example, the rules for taxing international business income, which were developed more than 100 years ago, are no longer fit for purpose and have resulted in multinational enterprises (MNEs) not paying their fair share of tax despite the huge profits many of these businesses have garnered as the world has become increasingly interconnected. Ensuring that the appropriate amount of VAT is collected in respect of online sales of goods and services has also become increasingly important as e-commerce has grown dramatically in recent years.

The Two-Pillar Solution: Reforming international tax rules for a digitised world

Following years of detailed and intensive work and negotiations to bring the international tax rules into the 21st century, members of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) (the Inclusive Framework) agreed on 8 October 2021 to the Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy.[2] The Two-Pillar Solution will ensure that MNEs will be subject to a minimum tax rate of 15% and will reallocate profits of the largest and most profitable MNEs to countries worldwide.

In addition to these changes to the taxation of MNEs, the Inclusive Framework has established a clear standard to co-ordinate the imposition and collection of VAT to the online sales of goods and services, which is already generating significant tax revenue for many jurisdictions around the world. These advances in the international tax architecture provide opportunities for developing countries to increase their tax revenues. To fully capture the benefits, tax administrations are moving towards digitalised services to improve compliance, efficiency and the overall quality of service for taxpayers. Developing countries can benefit greatly from these technological advances to protect their tax bases and are often able to lead the way by leapfrogging more advanced economies.

New taxing rights will boost developing country revenues

The digitalisation of the global economy creates new challenges for all countries in the taxation of MNEs and the provision of digital goods and services that call for global solutions. The newly agreed two-pillar reform is designed to address two key problems with the existing international tax rules:

1. MNEs often conduct large-scale business in jurisdictions where they have little or no physical presence. But under existing rules, broadly, the profits of a foreign company can only be taxed in another country where the foreign company has a physical presence. While this made perfect sense a century ago when business revolved around factories, warehouses, and bricks-and-mortar stores, it does not reflect today's digitalised world.
2. Most countries tax only domestic business income and not foreign income of their MNEs, on the assumption that foreign business profits will be taxed where they are earned. With digitalisation and the growth of intangibles such as brands, software algorithms, copyright and patents, MNEs can more easily shift profits to jurisdictions that impose little or no tax. Moreover, many jurisdictions are engaged in tax competition by offering reduced taxation – and often zero taxation – to attract foreign direct investment, which is a further challenge.

Pillar One of the Two-Pillar Solution provides the jurisdictions where the biggest and most profitable MNEs have their markets a right to tax a share of those profits, regardless of whether the MNE has a physical presence in the jurisdiction. Under this reform, more than USD 125 billion of profits are expected to be reallocated to the market jurisdictions.

Pillar Two provides a minimum tax on corporate profit of 15%, thus establishing a floor on tax competition. Where effective tax rates on MNEs in a particular jurisdiction are below the agreed minimum, additional taxes will be allowed to bring the rate up to the agreed minimum. As a result, tax competition is now backstopped by a minimum level of taxation wherever an MNE operates. Pillar Two will generate around USD 150 billion in additional tax revenues per year.

An inclusive reform process recognised developing countries' needs

Developing countries make up a large part of the Inclusive Framework's membership and their voices have been active and effective throughout the negotiations. Of the 140 member countries and jurisdictions in the Inclusive Framework, 68 are developing economies, as are 10 of the 24 members of the Steering Group.[3]

They work on an equal footing with other countries, and their participation has helped ensure that the reforms consider developing economies' needs and priorities. In Pillar One, for instance, the threshold for the new taxing right to apply to MNEs is reduced for smaller jurisdictions with a GDP below EUR 40 billion, and special rules will apply to developing economies with respect to opting out of mandatory binding arbitration provisions in certain circumstances. In Pillar Two, developing economies will have the right to request the first call on the right to levy the top-up tax on certain high-risk payments. The OECD estimates that, on average, countries of all income levels – low, middle and high – would experience revenue gains because of Pillar One. However, these gains are expected to be larger (as a share of current corporate income tax revenues) for low-income jurisdictions. Overall, the Pillar Two rules will relieve pressure on developing countries to provide excessively generous tax incentives to attract foreign investment. At the same time, there will be carve outs for activities with real substance. Box 14.1 describes the benefits that Egypt, an active participant in the development of the new rules, expects to gain from the reforms.

Countries need technical support to adapt their tax systems to international reforms

The agreed timeline for completing the technical work on the two pillars and

BOX 14.1. EGYPT IS WORKING WITH THE OECD TO IMPROVE TAX COLLECTION

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Egypt became a member of the Inclusive Framework on Base Erosion and Profit Shifting in 2016. With the support of other members and through the Egypt-OECD country-tailored domestic resource mobilisation programme, it has remained actively engaged in the international tax reforms, including the BEPS minimum standards requirements and measures to tackle tax avoidance, improve the coherence of the international tax system and ensure a more transparent environment to encourage foreign direct investment. Egypt is already seeing benefits of the various reforms underway to address the tax challenges of digitalisation.

The Inclusive Framework aims to close gaps in the international taxation system that can lead to tax evasion and to erosion of the tax base through aggressive tax-planning schemes, outcomes that tend to disproportionately affect developing countries. As it relies heavily on tax as a key revenue source, these efforts are immensely important to Egypt: Tax accounts for approximately 75% of total revenues for the 2020/21 fiscal year.

In September 2020, Egypt deposited its instrument of ratification of the Multilateral Convention to implement tax treaty-related measures, evidence of its support for updating international tax rules and lessening the opportunity for tax avoidance by multinational enterprises. In 2021, it has played an important role in the negotiations to reach the Two-Pillar Solution, which could increase Egypt's tax revenues by approximately USD 70 million from Pillar One reforms and by USD 130 million from Pillar Two provisions. These amounts could be even higher, given that recent statistics indicate that Egypt now has 60 million active Internet users in various fields such as travel, online services and online purchases and that USD 1.4 billion is now spent on online advertising.

Egypt also is working with the OECD on applying both the value-added tax on e-commerce and on reforms of international tax legislation. These efforts began to bear fruit for Egypt in 2020, generating additional and much-needed tax revenues during the pandemic. For instance, the Egyptian Tax Authority managed to finalise transfer pricing-related adjustments amounting to EGP 685 million (Egyptian pounds), the equivalent of USD 98 million, which have led to EGP 154 million (USD 22 million) in additional tax collected as well as USD 10 million in related penalties. To strengthen tax administration and build capacity to successfully carry out legislative reforms, the OECD Centre for Tax Policy and Administration is also supporting Egypt in building a reliable and technically competent team at the Egyptian Tax Authority's International Tax Unit.

subsequent implementation is ambitious, with the necessary model legislation and guidance due to be completed in 2022 and implementation to take place in 2023. The scale and speed of these changes will be challenging for developing countries, and many will need significant support, both technically and politically, to cover the range of legislative and administrative changes both pillars will require. In addition, some countries may require assistance to reform existing tax incentive regimes to secure the global minimum tax. Support to capacity building for domestic resource mobilisation has increased significantly in recent years, from USD 178 million in 2015 to USD 266 million in 2019.[4] Yet, these amounts still represent only around 0.2% of official development assistance and will need to continue to increase.

Equally important is providing expertise to developing economies in this area. As international taxation is a highly specialised field, and skilled practitioners are in short supply, it is vital for OECD countries to provide more experts for capacity-building programmes, among them the Global Relations Programme training courses[5] that offer intensive, expert-led training on a range of tax policy and administration issues and the Tax Inspectors Without Borders initiative,[6] a joint initiative of the OECD and the United Nations Development Programme, which provides experts to work hand-in-hand with tax administrators on live cases. Tax Inspectors Without Borders and related programmes in partnership with the African Tax Administration Forum and the World Bank Group have raised over USD 1 billion in additional revenues to date (OECD, 2021[1]). Support to capacity building for domestic resource mobilisation has increased significantly in recent years, from USD 178 million in 2015 to USD 266 million in 2019.[7] Yet, these amounts still represent only around 0.2% of official development assistance and will need to continue to increase.

Low- and middle-income countries should focus on value-added tax on e-commerce

Digitalisation has greatly increased the volume of sales of goods and services over the Internet. When the buyer and seller are located in different jurisdictions, the appropriate imposition and collection of VAT can be challenging. On average, VAT is the single most important source of tax revenue in developing countries. In 2018, for example, VAT provided 29.7% of total domestic revenues in Africa and 27.8% of the total in Latin America and the Caribbean compared to 20.2% in OECD countries (OECD, African Union Commission and African Tax Administration Forum, 2020[2]). Securing effective VAT collection on e-commerce will be important to ensure the competitiveness of the VAT system and sustainability of VAT revenues. For example, the African e-commerce market is already worth USD 27 billion and expected to grow by around 13% a year, to reach USD 46 billion by 2025 (Statista, 2021[3]). A significant portion of this market is international transactions, and the value of imports of digitally deliverable services in Africa's ten largest economies increased by an (unweighted)

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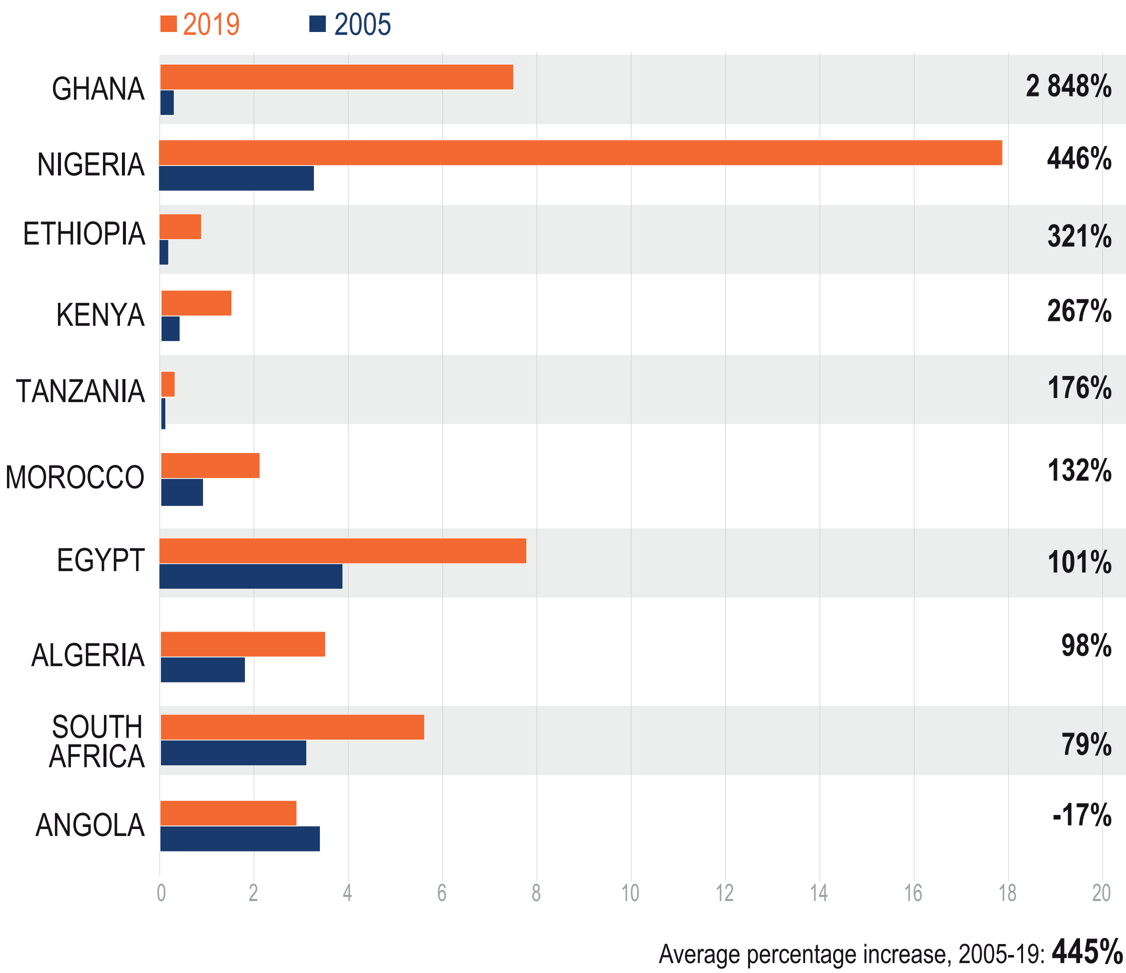
average of 445% over 2005-19 (Figure 14.1) (UNCTAD, 2021[4]). As most African countries have not yet implemented updated VAT rules to facilitate the application of VAT on e-commerce, significant VAT revenues are being forgone.

Much of the projected growth in the African e-commerce market will be new consumption driven by overall economic growth. However, the increase will also reflect a shift from physical transactions to e-commerce, as seen elsewhere in the world. It is important to ensure effective VAT on these online sales to not only generate revenues from new activity, but also preserve revenues from activity that will move online.

Using Inclusive Framework standards to enhance VAT collection

Traditional VAT rules make it difficult and complicated for countries to effectively assert taxing rights over VAT and also to collect VAT on the online sale of digital products and services (e.g. applications on mobile phones or on-demand television

Figure 14.1. The value of imports of digitally deliverable services in Africa's ten largest economies increased dramatically, 2005-2019



Notes: The value of imports is measured in USD billions. The average percentage increase is an unweighted average.
Source: UNCTAD (2021[4]). International Trade in Digitally-deliverable Services, Value, Shares and Growth, Annual (database), https://unctadstat.unctad.org/wds/TableViewer/tableView.aspx?ReportId=158358

streaming services), particularly when suppliers in foreign jurisdictions are selling to private consumers. The volume of imports of low-value goods sold on line continues to rise globally, presenting VAT collection challenges under the traditional customs procedures. These challenges could result not only in considerable VAT revenue losses, they also create unfair competitive pressure on domestic businesses that are required to charge VAT on their sales while low-value imports of equivalent goods (e.g. t-shirts) often receive exemptions from VAT. Moreover, higher value items are vulnerable to fraudulent undervaluation and miscategorisation by foreign suppliers wishing to benefit from exemptions of this kind.

Internationally agreed standards developed by the OECD Global Forum on VAT provide ready-made solutions for all countries for the effective collection of VAT on e-commerce. More than 70 countries (more than half of them developing countries) have either implemented or announced the intention to implement standards on cross-border supplies of digital services. The impact on their revenues is significant: Since implementation in 2014, South Africa has raised more than ZAR 15.3 billion (South African rand), the equivalent of about USD 929 million, for instance. Recognising that online marketplaces and/or digital platforms facilitate a large proportion of online sales, the OECD standards recommend leveraging the power of the platforms by creating a central role for them in the VAT collection process in certain circumstances. Developing countries can benefit from the experience already gained in implementing these standards, not least evidence that most of the major online platforms (which are responsible for the majority of online sales) have developed the systems and processes to comply with these standards and so have at their disposal the means to become compliant as additional countries implement the standards.

The OECD is developing a series of regional VAT Digital Toolkits in partnership with the World Bank Group and relevant regional partners. The first toolkit – for the Latin American and Caribbean region, published in June 2021 – provides detailed guidance for the policy design, implementation and operation of a comprehensive VAT strategy targeting digital trade, including strategies to strengthen the enforcement of VAT collection obligations on non-resident businesses such as digital platforms (OECD et al., 2021[5]). It also draws on expertise and best practices, including from jurisdictions in the Latin American and Caribbean region that have successfully implemented the standards, including Bahamas, Barbados, Chile, Colombia, Costa Rica and Mexico. These early adopters have already achieved very positive results in terms of VAT revenue collection, compliance levels, and reduction of competitive distortion between traditional bricks-and-mortar stores and foreign online vendors. The OECD is finalising toolkits for Asia Pacific and Africa at the time of writing. These will be complemented by e-learning programmes and workshops.

Digital infrastructure and peer learning can revolutionise tax administration

Many tax administrations are increasing their efficiency and effectiveness by shifting to e-administration and new technology, aiming to both enhance compliance and reduce the administrative burden on taxpayers (OECD, 2019[6]). Off-the-shelf software can jump-start the digitalisation of developing countries' tax systems, for example by allowing taxpayers to upload electronic tax returns. More complex digital tools can enable the direct transfer of information from taxpayers to tax administrations, though introducing them is more resource intensive.

While some developing countries are making significant progress in digitalising their tax administrations, many others lag behind, as shown by responses to the 2020 International Survey on Revenue Administration.[9] The survey found that while basic online registration and filing for taxpayers is fast becoming the norm globally, including in many developing countries, 36% of developing countries had not yet offered online taxpayer registration by 2019. Where digitalisation is progressing, some tax administrations in developing countries are achieving great results. According to the survey, 26 developing countries reached a level of 100% online filing for corporate income tax and 18 reached 100% online filing for personal income tax. More broadly, many developing countries are not yet able to make full use of more innovative digital tools. For example, only 24% of those surveyed were using or introducing artificial intelligence and/or machine learning into their tax administration by 2019, compared to 64% of high-income countries. Such tools can process much higher volumes of data, which help develop taxpayer profiles and identify risks, non-compliance and irregularities. These can improve the efficiency and revenue collection of tax administrations.

International support of digital peer learning is crucial for tax administrations

Peer learning can help address challenges such as Internet reliability; the availability of investment for longer term projects; and ensuring access to e-services for all taxpayers, which is especially difficult in rural areas and hampered by skills shortages (Wilton Park, 2017[7]). While many of these challenges require broader responses, there is significant scope for peer learning across tax administrations. Initiatives of regional tax organisations can provide valuable support.

For example, the African Tax Administration Forum provides 38 African tax administrations training, guidance and research on all aspects of tax administration, including digitalisation. Ensuring that developing economies can learn from others' successes (and failures) can help tax administrations digitalise faster and more effectively. The Tax Administration 3.0 initiative of the 53-member Forum on Tax Administration also sets out a vision for the digital transformation of tax administrations that results in an increasingly seamless and frictionless taxation process over time (OECD, 2020[8]). The specific challenges faced by developing countries in digitalisation is the focus of one of the workstreams of this initiative, which aims to identify potential solutions including, for example, adapting the Tax Inspectors Without Borders model and providing experts to work in tax administrations on their digital transformation.

To digitalise tax administrations and apply the new international standards on VAT and corporate income tax, developing countries will require technical and other support. Facilitating peer learning, and more broadly ensuring access to and training in the necessary technical expertise, will be crucial. As technical expertise is currently in such short supply, development partners have important roles to play in providing and building technical tax expertise and opportunities for peer learning.

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NOTES

1. See the OECD Global Revenue Statistics Database (2018 data) at: https://stats.oecd.org/Index.aspx?DataSetCode=RS_GBL#.
2. See: https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm.
3. As the name suggests, the role of the steering group is to steer the Inclusive Framework and provide advice to help inform the framework's decisions.
4. The figures refer to total disbursements by countries in the Development Assistance Committee, countries' total, disbursements, constant prices.
5. For more information on the Centre for Tax Policy and Administration Global Relations Programme in taxation, see: https://www.oecd.org/ctp/tax-global/global-relations-calendar-of-events.htm.
6. For more information on the initiative, see: www.tiwb.org.
7. The figures refer to total disbursements by countries in the Development Assistance Committee.
8. The figures refer to total disbursements by countries in the Development Assistance Committee.
9. More than 150 tax administrations are covered in the International Survey on Revenue Administration, which is conducted jointly by the Asian Development Bank, the Inter-American Center of Tax Administrations, the International Monetary Fund, the Intra-European Organisation of Tax Administrations and the OECD. Apart from the Middle East and North Africa region, the survey has wide geographic and income-level coverage. See more: TAS Database - Forum on Tax Administration (oecd.org)

From:

Development Co-operation Report 2021

Shaping a Just Digital Transformation

Access the complete publication at:

https://doi.org/10.1787/ce08832f-en

Please cite this chapter as:

Stead, Joseph (2021), “Taxing digital economies”, in OECD, *Development Co-operation Report 2021: Shaping a Just Digital Transformation*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/3cf15fef-en