T20 Policy Brief

G20 BRASIL 2024

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Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Getting an Equal Piece of The Pie: Taxing the Digital Economy in South Asia and Latin America

Hakshala David, Economist – Innovative Financing Associate, United Nations Development Programme (Sri Lanka)

Dinesh Thapa, Strategic Partnerships Coordinator, Global Development Network (France)

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Abstract

Digital Services Taxes (DSTs) are a newly introduced fiscal tool aimed at taxing digital companies and have emerged as a direct consequence of the failure of existing international tax standards to tax these companies. Nearly 100 countries including India, Nepal, Pakistan, and Sri Lanka either implemented or proposed DSTs. Unlike the traditional tax problems that involve two competing tax jurisdictions, digital platforms can involve three competing tax jurisdictions where platforms, user-advertisers, and user-consumers are located. Neither the international nor multistate tax rules were designed with this structure in mind. While several countries in the Global South have begun implementing DSTs, aside from Colombia, no other Latin American country is actively pursuing the taxation of the digital economy. Nepal introduced a DST in July 2022 at a rate of 2% of the transaction value of digital services. Similarly, India introduced a 6% equalization levy in 2016. Pakistan introduced a fee for offshore digital services with a 5% levy on the gross amount. Research indicates that Sri Lanka's proposed digital services tax is likely to generate four times as much revenue as they could hope for under Pillar One and that Sri Lanka would lose revenues through OECD implementation in several scenarios.

This policy brief articulates the G20's enabling role in the immediate roll out of unilateral DSTs in the Global South at least until Pillar 1 comes into effect.

Diagnosis of the issue

At present, the digital economy makes up over 15% of the global GDP and is expected to contribute about 24% to the global economy by 2024 (Asian Development Bank, 2022). The rise of digitalization has seen businesses and consumers increasingly move online, but not all countries are equally positioned to benefit. The USA and China are the front runners holding 90% of the market capitalization of the world's largest digital platforms (UNCTAD, 2021). As a result of outdated tax rules, countries do not have the right to tax the digital economy, resulting in foregone revenue, thus creating a need for further negotiations to enforce this right in the first place. The implications of this are largely felt by growing digital economies, notably the developing countries in the Global South.

Addressing the taxation of the digital economy in developing Asia can be a contributor to domestic revenue mobilization, which is essential in the region (ADB 2022). Asia has the largest internet usage in the world, having more than 2.5 billion users. The ongoing growth in internet usage means that the digital economy in Asia will continue to significantly expand in the future. Despite being the home to some of the largest global companies operating in the digital economy, developing Asia faces substantial challenges to lift overall tax revenues, with many having low tax-to-GDP ratios. In 2021, the average tax-to-GDP ratio in 29 Asian and Pacific economies was 19.8% below the averages for the OECD and Latin America and the Caribbean of 34.1% and 21.7%, respectively (OECD, 2023). As per the World Bank (2018), it is essential for developing countries to close the total tax-revenue gap and reach a recommended minimum of 15% of GDP in tax revenues as a way of maximizing finance for development and generating sufficient domestic resources to meet their development goals. Contrary to this, Sri Lanka's ratio, for example, fell to 8% in 2021, making it the lowest in the world (IMF, 2022). These fiscal challenges have been further exacerbated because of the fiscal impact of COVID-19 and the subsequent global crises (OECD, 2021).

Therefore, the emergence of the DSTs directly stems from the inadequacy of current international tax norms in effectively taxing tech entities. Recently, several governments, including India, Nepal, Sri Lanka, Pakistan, Indonesia, Philippines, and Vietnam, have either implemented or proposed DSTs. Furthermore, tech giants including Google, Facebook (Meta), Alphabet, and Amazon have not only profited in their home countries but also in market countries. Such highly digitalized business models can now generate profits in foreign jurisdictions without ever having a physical presence there—thus avoiding taxation of those profits in those countries. Furthermore, firms that derive significant revenue from intangible property, such as the large digital platforms, are better able to shift profits to low-tax jurisdictions and there is significant evidence that they do so (Ran, Kim and Shanske, 2023).

To integrate these companies into the tax system, Nepal introduced a DST in July 2022 at a rate of 2% of the transaction value of digital services. By the end of the year, twelve multinational companies had registered in the system, with over USD 1 million collected. Similarly, India introduced a 6% equalization levy in 2016, initially known as the 'Digital Advertising Tax', later expanding its scope to include foreign and non-resident e-commerce operators in India. Transactions are now taxed at 2% on the revenue generated from India. Consequently, the initial Indian Equalization Levy, implemented in 2016 and levied on payments for advertising services, generated revenues amounting to approximately 0.02 percent of GDP between 2016 and 2020 (IMF, 2021). Similarly, while DSTs commonly target advertising and intermediary services, in the case of India, they also cover the provision of digital content and the sale of goods. Likewise, Pakistan introduced a fee for offshore digital services with a 5% levy on the gross amount (Asia Internet Coalition, 2019). Research indicates that Sri Lanka's proposed digital services tax is likely to generate four times as much revenue as they could hope for under Pillar One and that Sri Lanka would lose revenues through OECD implementation in several scenarios (Starkov and Jin, 2022).

Against this backdrop, DSTs prove to be an evidence-based tool to imprint the Global South's development perspective in equitable taxation of the digital economy, thereby providing a strong impetus for the G20 to drive this agenda. With the G20 having committed at the level of Heads of Government to implement the Two Pillar solution of OECD, the road ahead for DST is challenging, however, with Brazil's presidency of the G20 and noting the growing potential of the Latin American Countries in the digital economy, Brazil's leadership in strongly advocating the DST is pivotal.

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Recommendations

Owing to the low probability of the immediate ratification of the multilateral convention, bring the DST as a priority issue under the purview of the Finance Track of the G20. This strengthens the leadership and interlocutor role of the G20 in supporting the Global South tax policymakers on the unilateral adoption of DSTs, as an alternative solution: With the recent extension of OECD negotiations deadline to June 2024 for Pillar One convention, multiple caveats are at play. Differences continue to remain around Amount A of Pillar One. Likely, opposition from the USA to the proposals remains at large, as most companies in scope are American-retriggering potential retaliatory measures from the US. Several countries have put their alternative unilateral DSTs on hold in the hope that these negotiations will reach an agreement soon, whereas others have forged ahead. Further, the timeline for reaching consensus on the implementation of Amount A of Pillar One continues to remain unclear. Countries such as Brazil, Colombia, and India remain concerned about aspects of the OECD's Amount A of Pillar One proposal.

Geopolitical interests often dominate negotiation outcomes, hence, the need for political consensus and strengthening the link between political leaders and tax officials of the Global South is a need of the hour. Against this context, there lies an opportunity for unilateral DST regimes already threatened or implemented to make a stronger come-back, actively encouraged by the G20 presidency of Brazil. In this regard, the Finance Track of the G20, which aims to increase the efficiency of tax systems and reduce inequalities, has the leverage to provide the developing countries with a much-needed political forum on tax negotiations pertaining to DSTs, thereby increasing the voice and demand of the Global South in ensuring equitable access to the merits of the global digital transformation.

Immediately roll out unilateral DSTs in the Global South, notably in Brazil amongst other Latin American and South Asian countries, at least until Pillar 1 comes into effect: This year, Brazil holds the baton of the G20, presenting a timely opportunity for Latin America to address this issue and explore pathways for the implementation of DSTs. Aligning itself to global tech trends, Brazil is aggressively advancing its digital economy agenda. The Brazilian ICT market ranked 9th in the world in 2020 and was valued at USD 49.5 billion. Brazil is the fifth largest digital population in the world, with approximately 181.8 million internet users in January 2023. This number is expected to reach almost 190 million by 2027 (International Trade Administration, 2023). Brazil is home to 18,000 start-up companies, accounting for 77% of startups in Latin America and over 70% of start-up investment in the region. Therefore, Brazil's digital economy demonstrates the potential for growth over the medium and long-term, presenting opportunities for taxing digital companies. Similarly, in the South Asian context, Sri Lanka's digital economy was 4.37% of the GDP in 2022, which as of February 2024 has surpassed 5%. The Government anticipates a boost of USD 15 billion to Sri Lanka's GDP through the expansion of the digital economy by 2030 (President Media Division, 2023).

Brazil having already advanced several proposals to tax digital services, the implementation of the same will be a strong signal towards the unilateral adoption of DSTs within the Global South.

Investing in strengthening the capacity of the Tax Administrators as a means of addressing the DST implementation challenges: The rise of digital economy has created new challenges for tax authorities who struggle to capture the value generated by these companies in their jurisdictions. Considering the diverse perspectives on DST, it becomes clear that finding the best solution requires a global consensus, specifically when the company does not have a physical office in the market country. To address this, the Finance Track of the G20 can play a crucial role in setting the path for the future of shaping the Digital Services tax policy, by promoting dialogues to identify the main difficulties that the digital economy poses in the application of DSTs.

The characterization of income derived from new business models, and how to ensure the effective collection of DSTs with respect to the cross-border supply of digital goods and services, may require a thorough analysis of the various business models in this sector, hence capacitating the tax officials of the Global South better positions these countries in the consideration of a DST. Therefore, it is imperative to underscore the significance of bolstering tax administration capacity as effective tax administration empowers governments to mobilize domestic resources, enhance public service delivery, and promote social development initiatives. The reforms being proposed to tax the digital economy are extensive and complex. Therefore, many countries in the Global South will require capacity building to assist them to understand, assess, and implement the reforms. Hence, the role of the G20 forum is crucial in facilitating the required technical assistance, training and fostering cross border connectivity between regional experts.

Scenario of outcomes

Scenario 1: Developing economies in the Global South do get an equal piece of the pie, at least until Pillar 1 comes into effect.

Using VAT as a proxy to indicate the revenue potential of DSTs, it can be examined that when Australia introduced its GST on digital services in 2017, it was expected to generate AUD 350 million (0.02% of GDP) over two years. Further, estimates based on survey data suggest that charging VAT on remotely delivered digital services and some goods to customers could directly increase overall VAT revenue by between 0.04 and 0.11% of GDP in Bangladesh, India, Indonesia, the Philippines, and Vietnam.

Therefore, it has been demonstrated that taxing the digital economy could serve as a valuable revenue stream for the governments of the Global South. DSTs aim to create a fairer system and provide a level playing field to ensure that the tax system does not result in the monopolistic or oligopolistic advantage of MNEs. As noted earlier, the revenue collection in some of the countries provides suggestive evidence that DSTs can generate more revenue in the future to finance the countries' development endeavors, at least until international consensus on the OECD proposal is attained. However, with less than half of the developing Asia countries having already agreed to the new international tax rules proposed by OECD, the debate continues. Albeit, given that such commitments remain at the political level, and are yet to be legally binding, Brazil's enabling role in the immediate adoption of unilateral DSTs in the Global South, including Latin American countries, at least until Pillar 1 comes into effect, is critical.

Scenario 2: But, at what cost is a DST rolled out and what is the opposition?

Evidence suggests that if Amount A is implemented, it would decrease the taxing rights of developing countries instead of boosting them. This outcome undermines the negotiation for Amount A, as its goal was to enhance the taxing rights of developing nations. In this regard, DSTs have now become the new trade war flashpoint, leaving the Global South countries, such as the Latin American and South Asian countries, further at risk of retaliation by the US. The South Centre's revenue calculation results of 2020 for 84 developing member states showcase that these 84 countries will obtain approximately \$5 billion from Amount A with a Euro 20 billion threshold and more than twice, approximately \$12 billion, from the United Nations' alternative of Article 12B.

Further, companies that sell online can easily avoid paying taxes in countries where they nevertheless make significant sales. According to the European Commission, global tech companies paid a 9.5% average tax rate compared with 23.2% for traditional firms in 2018. Stay-at-home policies too have played to the strengths of companies such as Amazon.com and Netflix, along with other platforms that compose the nearly \$26 trillion global e-commerce marketplace.

The U.S. strongly opposes DSTs, viewing them as unfairly targeting its multinationals and as a de facto tariff on U.S. tech giants. In 2019, the U.S. threatened tariffs on \$2.4 billion worth of French exports after France implemented a 3% DST.

Along with Canada, which did not agree to the ban on introducing new DSTs, Russia, Belarus, Pakistan, and Sri Lanka—have been strong voices throughout the negotiations on the two pillars at the OECD. The policy for Canada's 3% DST has been adopted but is yet to be implemented. In practice, Canada's DST would apply mainly to U.S. tech giants, such as Meta, Walmart and Amazon, alluding to potential retaliation from the US.

Further, taxation of the digital economy has been the subject of international debate for over two decades, but international consensus remains elusive. With the UN building its own role in multilateral tax negotiations, its role in harmonizing the international tax rule-making system could be a new development that may reshape this conversation in the global fora. The recent adoption of the UN General Assembly resolution to develop a multilateral framework convention on international tax cooperation aims to establish the legal basis for 'fully inclusive and more effective' international tax law also targets 'taxation of income derived from cross-border services in an increasingly digitalized and globalized economy'. A Convention such as this could instill much-needed stability, coherence, and fairness into the global tax framework.

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