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I. Introduction

With the rapid globalisation and digitalisation of the global economy, the question of how countries should approach the taxation of digital multinational enterprises (MNEs) has come to the forefront of international tax policy discussions. This digitalisation has made it more difficult for countries to tax economic activity which takes place within their own territory and has facilitated corporations' ability to shift profits. In 2015, the OECD implemented an Action Plan on Base Erosion and Profit Shifting (BEPS) that included 15 measures dedicated to “improv[ing] the coherence of international tax rules and ensur[ing] a more transparent tax environment” in order to prevent an estimated USD 100-240 billion annually lost in tax avoidance practices globally.¹ Australia was among the countries that implemented these OECD measures, including broadening their Goods and Services Tax (GST) to include imported digital goods and services.

In this brief paper, we provide an introduction to key questions around digital taxation. What exactly is a digital tax? How does it relate to other forms of taxation? What are the arguments for implementing a digital tax? What is the effect on economic activity of a digital tax and who bears its economic incidence? What have other countries done? How does a digital

¹ *What is BEPS?* (2019). OECD.

tax fit within existing taxation frameworks? We then examine possible policy options for Australia and conclude with our recommendations.

We recommend against a Digital Services Tax (DST) as a ‘knee-jerk’ reaction to the novelty, enormity, and apparent unaccountability of digital market leaders. We recommend treating taxation issues with digital MNEs similar to how Australia has been treating other BEPS transgressor issues. We also recommend serious consideration of substantive corporate tax reform in light of the evolving nature of global production.

II. What is a digital services tax?

A Digital Services Tax (DST) is a tax on selected revenue streams of multinational digital companies. Revenue streams that may be taxed by a country include advertising, intermediation, and digital marketplaces and data transmission. The rationale for the DST is to attempt to capture profits that are generated in a country but then shifted offshore by digital MNEs.

The DSTs implemented to date generally have a very high tax-free threshold which ensures that the tax only applies to large MNEs which are thought to make a significant amount of profit in the domestic country. By construction it is usually targeted at Google, Apple, Facebook and Amazon and is thus known as the “GAFA tax”. DSTs have gained political traction and media attention over the past few years, particularly in light of the high profile of these companies.

We will explore the implications of such a tax and the experiences of other countries around the world that have implemented or attempted to implement them.

III. Background

The Digital Economy

In today's economy, most businesses have adopted some digital elements into their business practice. Early efforts to implement digital taxes attempted to define a digital business model. Such models were not envisaged when the existing tax codes were designed. In its 2018 Interim Report, the OECD defined the digital economy as having the ability to have (1) "cross-jurisdictional scale without mass," (2) "reliance on intangible assets, including IP," and (3) a reliance on "data, user participation and their synergies with IP."² While profit shifting takes place in many industries and elements of these three factors are present in other industries (such as television and newspapers), the combination of these three features, and in particular IP (where television and newspaper have lagged), has changed the way in which value is created and has allowed for companies to minimise tax by allocating intangible assets in low-tax countries. Digital MNEs, born into an international tax environment with many BEPS opportunities, set up structures to take advantage of these opportunities from their inception.

Digital MNEs can produce substantial value in countries like Australia with minimal physical presence and consequently pay little tax. The European Commission found that within the EU, digital companies were subject to an average effective tax rate of 9.5% while traditional business models, with more of a physical presence, were subject to a 23% average effective tax rate.³ This has given momentum to efforts by countries to tax these foreign digital companies.

² *Tax Challenges Arising from Digitalisation –Interim Report 2018* (2018). OECD/G20.

³ Patrick, Stewart M. *OECD Digital Tax Negotiations Thread the Sovereignty Needle* (2020). Council on Foreign Relations. This statistic has been the subject of some debate, as discussed here: https://taxfoundation.org/eu-digital-tax-criticisms/#_ftn9

It is also important to recognise that digital companies have often been provided with assistance, including tax breaks, directly by governments. To foster innovation, the US provides subsidies and infrastructure, as well as tax benefits such as R&D credits and tax concessions.⁴ Across federal, state and local levels of government, these are worth billions of dollars to big technology companies. These benefits have proven to be disproportionately favourable to digital giants and reduce their tax burden to rates that are lower than headline rates.

OECD BEPS Action Plan

As mentioned above, the Base Erosion and Profit Shifting (BEPS) Action Plan reflects the particular concern held within the OECD with the digitalisation of the global economy. The OECD is under pressure to create a unified approach to global taxation in the 21st century that decreases BEPS practices while avoiding double-taxation. It has developed a two-pillar approach in response. The first pillar is a revision of international tax rules that determine who has the right to tax the profits of companies. It provides a new taxing right to jurisdictions in which goods and services are consumed, with or without the physical presence of companies.

The second pillar is concerned with addressing outstanding BEPS issues. This could include implementing a global minimum tax that would level the tax treatment between digital and non-digital companies. The implementation of both pillars could be expected to raise global corporate income tax revenues by 4% (US\$100 billion annually) and average effective tax rates by 0.7% across all jurisdictions (primarily from the second pillar).⁵ The OECD's goal was to

⁴ The logic of R&D subsidies is to internalise the positive spillovers that are created by innovation. Special treatment of IP assets is generally justified because they are quite easy to mimic—similar to pharmaceuticals.

⁵ Asen, Elke. *Summary of the OECD's Impact Assessment on Pillar 1 and Pillar 2* (2020). Tax Foundation.

have a multilateral approach formulated by the end of 2020, but the COVID-19 crisis and tensions with the US are likely to delay that process until at least 2021.

Negotiations in the OECD are closing in on the two pillar approach. For pillar 1, a residual profit split method, based upon payroll, sales, and assets in the destination country has been suggested to allocate taxation rights in the destination countries. “Destination country” here refers to countries with users of digital goods and services in countries other than the country, or countries, in which the digital MNE resides. Pillar 2 focuses on enhanced rules around Controlled Foreign Corporations to allocate more revenue to residence jurisdictions.

The idea behind this approach is to share taxation between destination and source countries and to tax profits that are taxed in neither jurisdiction because of BEPS-type behaviour (double non-taxation). The economic incidence of such a tax would depend upon how it is structured.

In addition to consideration of a DST, cross-country harmonisation of rules and a minimum corporate tax, the OECD has recommended including digital goods in the Value Added Tax (VAT) framework of countries and removing existing tax benefits for digital companies.

Australia adopted the OECD’s recommendations and began applying GST to imported digital goods and services. After doing so, Australia has reported to have raised an additional AUD 728 million in revenue over the years 2017-2019 from digital goods and services.⁶ Unlike the DST, which applies different tax treatments to different types of companies, applying the GST to imported goods leads to a harmonisation of tax treatment of consumption irrespective of country of origin. This represents a neutral broadening of the consumption tax base to include digital firms but does not address the business-to-business nature of many transactions in the digital economy and does not address broader changes to the international corporate tax rules.

⁶ *GST administration annual performance report 2018-19*. Australian Taxation Office.

IV. Digital Services Taxation (DST)

Arguments for a DST

Digitalisation of the global economy has allowed corporations to reach new markets and create employment around the globe without a physical presence, leading to concerns about tax avoidance by MNEs.⁷ In addition, these digital companies rely on intangible and highly mobile assets. These two factors make it relatively easier for MNEs to engage in profit shifting and other forms of tax avoidance. DST proponents point to the geographical mismatch of where digital companies are based and pay tax and where the majority of their consumers reside. For example, the United States is home to 37% of the digital economy yet only 11% of global internet users.⁸ This mismatch in the distributions of digital producers and users raises political pressure to realign taxation with the location of users. Digital MNEs create value from users' data, frustrating governments in countries with users but without the physical presence of digital companies. Current taxation models make it difficult for these “destination” countries to tax this value creation.

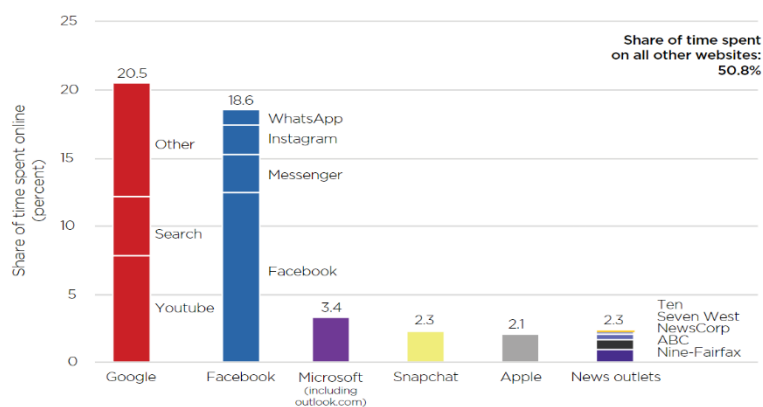
In addition, Australian officials have expressed concern with a perception of market power of American digital MNEs—particularly Facebook and Google (seen in the time Australians spend online in Figure 1). These companies have substantial market power in the supply of advertising, search engines, and social media platforms, as well as bargaining power in

⁷ This is in addition to the usual issues which allow MNEs to shift profits such as the location of joint product and overhead costs associated with marketing, management, etc.

⁸ Bunn et al. *Digital Taxation Around the World* (May 2019). Tax Foundation.

supplying news media in Australia.⁹ This market power undermines the competitiveness of smaller and local digital companies and other ‘traditional’ media companies. In fact, the COVID-19 pandemic may accelerate these digital giants’ advantages.¹⁰ Another concern raised is that these MNEs can manipulate the content that people see and, through this, potentially have power to influence the way people think.¹¹

Figure 1: Share of time spent online by Australians by company



Source: Australian Competitive and Consumer Commission (2019).

Many proponents of a DST view information as generating location-specific rent (LSR) for companies. They draw similarities between the information a country's residents provide on the internet and natural resources as they are both excludable, can be seen as national assets, and are unique to a specific location.¹² They argue for a DST to address this problem. As we will see below, however, DSTs are a poor instrument to tax LSR.

⁹ Australian Competitive and Consumer Commission. *Digital Platform Inquiry: Final Report* (2019).

¹⁰ In this paper, we do not consider the recent attempts by the Australian Competitive and Consumer Commission to force digital companies to pay for local media content. These could be seen as a form of tax on digital companies with the transfer being made to a third party.

¹¹ Chenoweth, Neil. *Google, Facebook's \$6b Tax Break* (2020). Australian Financial Review.

¹² *IMF Policy Paper: Corporate Taxation in the Global Economy* (2019). International Monetary Fund.

Disadvantages and other considerations of a DST

While a DST is a solution to the lack of source-based taxation on the growing digital economy, it is important to consider how it fits in our current frameworks of taxation, the ways in which it distorts economic activity, its economic incidence, and its distributional impacts.

DSTs, by placing a specific tax on a set of imported consumption goods, are best thought of as a tariff or a targeted consumption tax.¹³ We know that tariffs are poorly targeted taxes that are ultimately paid for by consumers, not businesses. In the case of digital services, they increase input costs for businesses and undermine the international competitiveness of Australian businesses.

Yet, much of the discussion around DSTs has been in the context of corporate income taxes. The reason for this is the concerns around double non-taxation and the ease with which digital MNEs can shift profits, particularly in relation to IP. In a single country context, the best way to tax such IP would be through a tax on economic rent-- that is a tax on profit earned above normal economic returns. In the current international tax framework, this IP is taxed in the country of origin. Hence the OECD's focus on profit-shifting and developing new rules for allocating taxation rights.

DSTs as implemented are not corporate taxes under our current system, and there is compelling evidence that the incidence of DSTs will fall heavily on consumers. Anecdotal evidence from Google and Amazon demonstrates that these corporations intend to pass the tax

¹³ This Peterson Institute article discusses the way in which these taxes act as tariffs in more detail: [Policy Brief 18-15: The European Union's Proposed Digital Services Tax: A De Facto Tariff \(piie.com\)](https://www.piie.com/policy-briefs/policy-brief-18-15-the-european-union-s-proposed-digital-services-tax-a-de-facto-tariff).

directly to consumers through higher prices.¹⁴ A general equilibrium model of France's DST¹⁵ estimated that, "Approximately 55% of the total tax burden will be borne by consumers, 40% by businesses that use digital platforms, and only 5% by the large internet companies targeted."¹⁶ In the context of Australia, Google claims to support "AU\$15.1 billion dollars' worth of economic activity annually for the approximately 840,000 Australian businesses who connect with consumers through Google."¹⁷ In addition, in 2015 Google "supported \$AU14.8 billion of free benefits for Australian consumers, saving the average Australian 31 hours finding information on the web and 29 hours in transport time."¹⁸ The Australian Bureau of Statistics finds that digital activities accounted for a disproportionate amount of Australia's total GDP growth.¹⁹ As a percentage of GDP, Australia has one of the highest levels of contribution from the digital economy.²⁰

Digital companies have significantly increased downstream competition in music, retail, and small business.²¹ Thus, levying a tax on the revenues generated by these corporations in Australia directly impacts the Australian businesses and consumers who would bear the burden of them and would slow the economic growth that these digital companies support.

The economic incidence of a DST can most effectively be seen in the supply and demand framework in Figure 2. If we assume that a MNE has a monopoly on providing advertisements

¹⁴ Bunn et al. *Digital Taxation Around the World* (May 2019). Tax Foundation.

¹⁵ This model made several assumptions regarding the amount of pass-down, as well as the elasticity of demand across the digital marketplace for goods, services, and advertising.

¹⁶ Pellefigue, Julien. *The French Digital Service Tax: An Economic Impact Assessment* (2019). Taj and Deloitte.

¹⁷ Google's [submission](#) to *The digital economy and Australia's corporate tax system* (2018). Australian Government: The Treasury.

¹⁸ Ibid.

¹⁹ *Measuring Digital Activities in the Australian Economy*. Australian Bureau of Statistics.

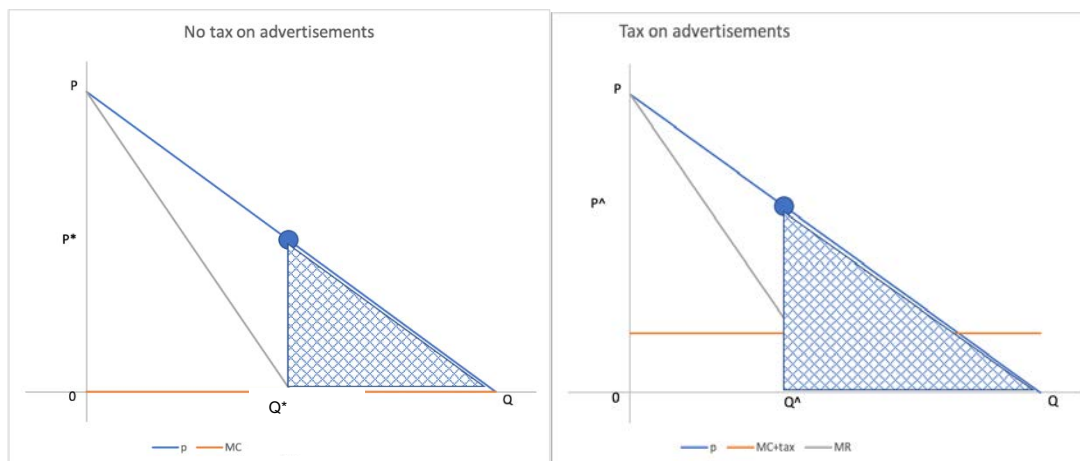
²⁰ Watson, T., 2018. Digital Economy Measurement and Digital Policy. *The Public Sphere: Journal of Public Policy*, 6(1), pp.235–253.

²¹ See Bailin Rivaes, Gal, Millot and Sorbe (2019). Like it or not? The impact of online platforms on the productivity of incumbent service providers. OECD Economics Department Working Paper No. 1548.

on its platform, then the equilibrium price will be determined by the standard monopoly analysis of price equalling the point where marginal revenue is equal to marginal cost—see the left-hand panel of Figure 2. We assume that the marginal cost of the MNE selling an advertisement is zero. This seems reasonable since, given the existing algorithms and advertising network, the cost of adding one additional ad is essentially zero.

The right-hand panel of Figure 2 shows the imposition of a simple per-advertisement tax on the MNE. As we can see, this will reduce the quantity of advertisements and increase their price. This additional cost will be borne by advertisers, who, depending upon the structure of the markets in which they sell their goods and services, will pass some fraction of these costs on to consumers.

Figure 2: Supply and demand for advertising services and the effect of a tax



As we can see in comparing the left-hand side of Figure 2 to the right-hand side of Figure 2, the imposition of the tax increases the deadweight loss. Initially there is a deadweight loss (the shaded area) from the monopoly provision. The tax increases the deadweight loss which now incorporates deadweight loss from the tax and deadweight loss from the monopoly.

Depending upon the slope of the demand curve, profits for MNEs may decrease. This might explain the opposition of Google and Facebook to such taxes. This graph is consistent with the estimates reported above for France that 95% of the tax burden would fall on users rather than on the GAFAs companies.

While such a tax might raise costs for large MNEs, it is not at all clear that this would lead to a decrease in their market power. Such a tax could also dis-incentivise competition as potential competitors to large MNEs may be deterred from becoming too successful lest they too become a target for special tax treatment.

The argument that a DST is a response to geographical mismatch is not an argument that is consistently applied. The observed geographical mismatch could simply be a product of comparative advantage. Some countries have an advantage over others in producing some goods and services due to geographical endowments. For example, Brazil produces over 40% of the world's coffee while exporting almost all of that coffee to countries in the EU and the US.²² Australia has historically been the world's largest iron ore producer, producing around 35% of the world's supply for the last several years,²³ yet comprises a negligible proportion of the world's steel consumption.²⁴ No one argues for taxing the profits of Brazilian coffee companies in the EU or taxing Australian iron ore in China and for good reason.

Bolstering a weak domestic industry by imposing a tariff is universally viewed as bad policy as opposed to supporting free trade. The US does appear to have developed a comparative advantage in the production of digital goods and services. This is due to its highly-

²² International Coffee Organization. *Trade Statistics Tables*.

²³ US Geological Survey. *National Minerals Information Center: Iron Ore Statistics and Information (2020)*.

²⁴ Sedov, Andrey. *Overview of the Steel and Iron Ore Market (2018)*. Deloitte.

educated labour force, abundance of available capital, and investment in blue-sky research.²⁵ By this proposition, Australia should allow for free trade and allocate its resources to leverage its own comparative advantages in other industries.

Another issue that has arisen is the principle of neutrality that is violated with the implementation of a DST. First, a DST would dismantle neutral treatment between digital and non-digital firms in the tax code. Second, taxing the revenues of companies by taxing transactions, as a DST does, disproportionately harms those with lower profit margins. Last, firms that reside below the revenue threshold would be advantaged by the tax. Simplicity is one of the hallmarks of good tax design²⁶, and the complexity introduced by thresholds and definitional differences between digital and non-digital companies are exactly the type of complexities that companies exploit to pay less tax. A DST introduces new distortions into the system.

One of the main issues with a DST has been in the forefront of the media—its ability to create trade tensions.²⁷ One example is the US backlash following France’s announcement of its DST in 2019. Robert Lighthizer, U.S. Trade Representative, announced an investigation to determine whether the DST “is discriminatory or unreasonable and burdens or restricts United States commerce” as well as violates WTO rules.²⁸ Article XVII of the WTO’s General Agreement on Trade in Services states that a member cannot treat another country’s services less favourably than its own domestic services and suppliers.²⁹ Since the tax applies in its current

²⁵ Wolak, Frank A. *Our Comparative Advantage* (2011). The New York Times.

²⁶ *Tax Fact #1: Principles of Tax System Design* (2018). Tax and Transfer Policy Institute

²⁷ [Trump Gets It Right on Digital Taxes! | PIIE](#) , [Policy Brief 18-15: The European Union’s Proposed Digital Services Tax: A De Facto Tariff \(piie.com\)](#)

²⁸ Schulze, Elizabeth. *France approves digital tax on American tech giants, defying US trade threat* (2019). CNBC.

²⁹ WTO Analytical Index: Article XVII.

form primarily to American companies, the DST likely violates WTO law. DSTs also likely violate Article 107 of the Treaty on the Functioning of the European Union that prohibits EU countries from providing any kind of aid that distorts competition.³⁰ Because the revenue thresholds of the DST only apply to international digital firms, French digital companies have a competitive advantage from the lower tax burden they face compared with foreign-owned tech firms. Rather than challenging these violations, U.S. President Trump threatened France with large tariffs. In response, France agreed to postpone implementing its DST until at least the end of 2020, on condition that the US agree to the OECD BEPS recommendations. Ultimately, if the tax is implemented and unleashes a trade war, the outcome will be higher prices for consumers in both countries and is unlikely to be worth the relatively small gain in government revenue.

DST proponents point to the value that is made of Australian data by these companies and suggest that a tax might be a way of reclaiming that value for the Australian consumer. This seems unlikely given the nature of the market as illustrated in Figure 2. It also fails to recognise that the data of Australian consumers have little value in the absence of imported digital technology. Australian consumers freely give their data to digital companies which in exchange provide them with services at no cost. Since no cash is transacted, it is a value exchange that is difficult to tax. In this way, it is similar to many other barter-type transactions in the economy generally excluded from tax.

Extending this analogy, we could view this economic activity as a form of bartering where consumers provide data in exchange for untaxed income in the form of free services from digital companies. In that case, a DST where the incidence falls on consumers might be viewed

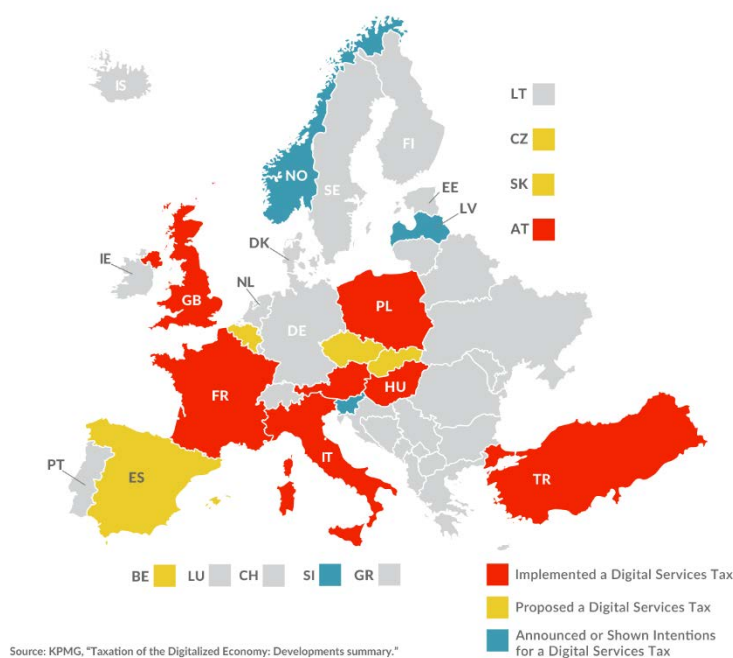
³⁰ Consolidated Version of the Treaty on the Function of the European Union (2012). Official Journal of the European Union.

as a way of taxing this otherwise untaxed economic activity. In that case, the argument that the DST falls on consumers may not be an objection to the tax, but rather, the goal.

A final consideration is that the implementation of a DST would pose new compliance and administrative costs which are predicted by some to be quite large. This is due to the risk of multiple taxation, different interpretations of the tax law, and uncertainty in the tax base from a lack of sufficient data to measure the activity.³¹ Finland decided that the costs associated with implementing a DST would exceed the revenues generated from the tax.³²

DSTs in Practice

Figure 3: Digital Service Taxes in Europe as of June 22, 2020



Source: Tax Foundation (2020).

³¹ Such concerns were expressed in the submissions to the discussion paper, *The digital economy and Australia's corporate tax system* (2018). Australian Government: The Treasury.

³² Kirwin, Joe. *EU Races to Solve Issues Hampering Digital Tax Proposal* (2018). Bloomberg Tax.

Although the OECD has not come to a consensus on a multilateral approach to taxing the digital economy, primarily because of US opposition, several countries have moved forward with their own approach, as illustrated in Figure 3. Thus far, DSTs have been announced or implemented in Austria, France, Hungary, Italy, Poland, Turkey, and the UK. Several other countries have also published proposals and show the intention of implementing a DST in the future. These countries include Belgium, the Czech Republic, Slovakia, Spain, Latvia, Norway, and Slovenia. New Zealand has also considered a DST.³³

These DSTs have generally been viewed as “temporary solutions” to the tax challenges of the digital economy until agreement can be reached in multilateral forums. The DST tax bases generally cover the revenues from some or all online advertising, marketplaces, social media platforms, and search engine activity. Some of these tax bases might be more amenable to measuring and monitoring at lower cost than others. All these taxes have a global and domestic revenue threshold that ensures that the tax is targeted at the large, American MNEs.³⁴ Such thresholds may give rise to distortive tax planning behaviour. The contribution of DSTs to countries’ tax revenues to date has been quite small.

Set out below are a few examples of implemented DSTs around the globe.

EU Proposal: In 2018, the EU proposed a 3% DST on the revenues generated in the EU from online advertising, marketplaces, and sales of user data. Businesses with over €750 million global revenues and €50 million revenues in the EU would have been subject to the tax. The tax

³³ Walker, Benjamin, (2020), Analysing New Zealand’s Digital Services Tax Proposal, Austaxpolicy: Tax and Transfer Policy Blog, 23 April 2020, Available from: <https://www.austaxpolicy.com/analysing-new-zealands-digital-services-tax-proposal/>

³⁴ Bunn et al. *Digital Taxation Around the World* (May 2019). Tax Foundation.

was expected to raise revenues of €5 billion, or 0.08 percent of total tax revenues collected in the EU in 2018.³⁵ The bill did not receive enough support to be enacted, leaving countries on their own to take individual action if they desired.³⁶

France: France has also announced the implementation of a 3% DST on the revenues generated from the provision of a digital interface and online advertising. Like that proposed by the EU, France's DST would be applied to digital companies that have global revenues exceeding €750 million, and €25 million generated within France. This tax was estimated to have been able to raise €500 million in revenue in 2020. Ongoing 'negotiations' with the US saw implementation of the tax postponed until at least 2021 and an agreement to attempt to resolve the issue through the OECD.

Austria: As of January 1st, 2020, Austria has implemented a 5% DST on the revenues generated from online advertising, digital interfaces, and any software or websites in Austria. The revenue thresholds of its tax are likewise €750 million globally and €25 million domestically. It is set to raise €25 million in revenue this year.

UK: Beginning in April 2020, the UK implemented a 2% DST on the revenues generated by search engines, social media platforms, and online marketplaces from the UK. This tax has a threshold of £500 million in global revenues and £25 million of revenues derived from users in the UK. In the next calendar year, it is estimated to raise £275 million in tax revenue as well as

³⁵ Bunn, Daniel. *Revenue Estimates for Digital Service Taxes* (2019). Tax Foundation.

³⁶ [Digital Services Taxes \(DSTs\): Policy and Economic Analysis](#) (2019). Congressional Research Service.

incur an administration cost of £8 million to implement new systems to manage the volume of data that is involved in the process.³⁷

Italy: As of 2020, Italy has also implemented a version of a DST. Italy's is rather a 3% levy on the revenues generated from digital advertising, social networks, online marketplaces, and the transmission of user data. The revenue threshold to qualify businesses for the tax is €750 million globally and €5.5 million domestically. In 2020 and 2021, the tax has been projected to raise €600 million in revenue, which is 0.08% of total tax revenues.³⁸

Turkey: In March of 2020, Turkey implemented a 7.5% DST on online advertisements, content sales, and sales of services on social media platforms. The President was given the authority to reduce the rate to 1%. The global revenue threshold for businesses is €750 million, and the domestic threshold is TRY 20 million.

V. The digital economy and the broader corporate tax system

The rapid change of the global economy raises the question of the need for broader change in our approach to corporate tax. The key question is where a MNE's profitable economic activity takes place and the allocation of taxation rights. If the data of Australian consumers is analysed in another country using an algorithm owned by a non-Australian company, is there any taxation right that should accrue to Australia?

While many countries have implemented a narrow approach to taxing large digital companies directly, a more systematic approach will be needed as the global economy becomes more

³⁷ [Policy Paper: Digital Service Tax](#) (2020). Gov.UK.

³⁸ Bunn, Daniel. *The Italian DST Remix* (2019). Tax Foundation.

globalised and digitalised. This is an obvious and predictable trend; responding to it with ad hoc taxes on individual companies is not the ideal way to create a tax system resilient to evolving circumstances. Digitisation is an extreme example of the diversification and integration of global supply chains.

With the digitalisation of the economy, assets are also highly mobile. Thus, it might make more sense to give taxing rights to the destination country of digital goods and services, as consumers are relatively immobile. One solution that has been of growing interest to economists is a destination-based cash flow tax (DBCFT). A DBCFT is applied to all imported goods and services and domestic production that is domestically consumed, while excluding domestically produced goods that are consumed elsewhere. Since the DBCF taxes the cash-flow associated with consumption while allowing for immediate expensing, it takes away any incentive to shift profits, relocate activities, and removes pressure to lower corporate tax rates among countries.³⁹ The IMF found that a universally adopted DBCF tax could be structured to generate a similar amount of revenue to a corporate income tax, but would create winners and losers across different countries. Given its heavy reliance on the corporate tax received from mining companies, Australia would, by most accounts, be a loser in a universal DBCFT.^{40,41}

The DBCFT is, in many ways, not that different from the OECD's formulary apportionment aspects of pillar 1. Generally speaking, excess (residual) profits probably include some firm specific rents (i.e. related to IP), and some location specific rents (i.e. related to market characteristics, etc). Both the cash flow and the formulary apportionment method should not

³⁹ Auerbach et al. *Destination-Based Cash Flow Taxation* (2017). Oxford University Centre for Business Taxation.

⁴⁰ Hebous et al. *Revenue Implications of Destination-Based Cash-Flow Taxation* (2019). IMF.

⁴¹ This paragraph is not intended as a thorough discussion of Destination-Based Cash Flow Taxation and some proposals that have been made contain provisions to address some of these issues. We simply note that these are issues that would need addressing in any switch.

distort location/activity decisions if the firm is earning excess profits due to location specific rents, but it might distort location/activity decisions if the rents in question are firm specific, and therefore mobile. IMF research indicates that Australia would face a shrinking tax base under formulary apportionment to the degree that it was based upon sales.⁴²

It is beyond the scope of this report to thoroughly canvass the possibilities for corporate tax reform if Australia were to move away from its current source-based profit taxation.⁴³ One obvious conclusion from this paper is that we need to rethink corporate taxation in the face of accelerating changes in globalisation and digitalisation.

VI. Should Australia Implement a DST?

In answering this question, it is useful to outline Australia's options in light of the information presented above. Potential routes Australia can take and the trade-offs inherent to them include:

Do Nothing: Australia can choose to do nothing on digital taxation. We may simply decide that it is inappropriate to tax digital MNEs based in other countries given the current source-based taxation systems. The large MNEs that are targeted by a DST provide value to the Australian people and facilitate economic growth. Staying with the current tax structure would avoid potential trade tensions inflamed by a DST. In addition, Australia already has a very robust tax structure surrounding BEPS and a GST that treats digital companies neutrally by comparison with other companies. This essentially means adopting an attitude which views these companies

⁴² [Spillovers in International Corporate Taxation; IMF Policy Paper; May 9, 2014.](#)

⁴³ See Tax and Transfer Policy Institute (2020), "Corporate income taxation in Australia: Theory, current practice, and future policy directions", Tax and Transfer Policy Institute Policy Report, forthcoming.

as providing direct well-being to Australians rather than providing well-being through tax revenue. It also recognises that any tax is likely to fall on consumers and businesses.

Rethink Source-Based Profit Taxation: As discussed above, we could take this opportunity to do a major re-think of corporate taxation and move towards a destination-based cash flow tax (DBCFT). Another option would be the OECD's residual profit split method through some kind of formulary apportionment. Both of these are essentially a shift away from taxing investment towards taxing consumption.

Tax Value Created: While global taxation is aligned with the source of profits, there is pressure to realign taxation to where value is created. This has become more difficult with the digital economy. Attributing value created to consumers using a free service and contributing to a network effect is empirically difficult. In addition, it is not parallel to the ways in which we tax the value created by network effects in other areas of the economy (such as the use of telephones).

International Agreement on DST: Australia can wait for the OECD to reach a multilateral approach to taxing the digital economy. This would help ensure a cohesive agreement that prevents double taxation and minimises trade tensions. The US proposed a pause in negotiations to this end in June, 2020, to permit countries to focus on economic recovery in the wake of the pandemic. While a unified approach to taxing large digital companies would be more desirable than each country pursuing its own policy, critics believe that the OECD should focus on a broader approach to corporate taxation that doesn't narrowly target US digital businesses. The

United States, not unreasonably, views the GAFA tax as a direct attack on its domestically-based companies.

Take Unilateral Action: Australia can also follow the lead of several other countries and implement a unilateral DST. As outlined above, this would create costs for Australian consumers and businesses and cause trade tensions with the US. This would be harmful in promoting economic growth, of particular concern now as we face a difficult post-pandemic recovery.

Setting a precedent of taxing value generated elsewhere but consumed in Australia could create other problems. Other countries could put tariffs on our exports on the same basis. Lower tariffs and freer movement of goods and services have benefited the Australian economy over the past 30 years, and protecting global trading systems should be a priority for Australia.

Different people will view the trade-offs outlined above differently. Simply because the US opposes something does not mean we should not consider it. Likewise, simply because something might be politically difficult does not mean we should not pursue it.

VII. Conclusion

Despite political pressure to implement a DST in Australia, the economic and political consequences outlined above lead us to believe that a DST would be a bad idea for Australia at this time. Ultimately, the digital economy is a large contributor to Australia's economic growth.

Estimates suggest that it raises Australia's GDP per capita by about AU\$5,000 per annum.⁴⁴ It does not seem wise to implement a tax that risks hurting well-being, lowering growth, and deterring investment, particularly in the midst of the COVID-19 crisis, for what is likely to be a small revenue gain.

Our preferred approach is for Australia to be an active participant in multilateral negotiations about international corporate tax reform that can reduce base erosion and profit shifting while seriously contemplating a re-design of our approach to taxing corporate income. Rather than an ad hoc response to the rise of a handful of companies, this is a more promising long-term approach-- to build a more resilient tax system which can adapt flexibly to global trends.

Australia's recent efforts to include digital goods and services in its GST framework is, at least in theory, a more neutral and less administratively complex way in which revenue can be raised from the digital economy, although it does not deal with business-to-business transactions nor with profit shifting by digital MNEs. A consumption-based tax such as this allows Australia's government to tax transactions that take place in Australia even when a company has no physical presence. In addition, a broadened GST removes the bias between digital and non-digital services and levels the playing field for Australian tech companies. The implementation of these GST changes was relatively low-cost in terms of administration and proceeded fairly smoothly. The implementation of the GST on imported digital goods and services required the production of an AUD \$800,000 Simplified GST Registration System⁴⁵.

⁴⁴ *Australia's digital pulse: policy priorities to fuel Australia's digital workforce boom*. Deloitte Access Economics 2017.

⁴⁵ *Budget 2015-16*. Commonwealth of Australia. The Australian Treasury pointed out to us that "While there is an AUD 800,000 expense listed in the 2015-16 budget as part of the measure "GST — applying to digital products and services imported by consumers", the Budget paper doesn't specify that it was

The application of GST to large MNEs, however, has not come without costs for consumers. They can be difficult to quantify, but it is clear that prices for consumers have increased and the choice of products which they can consume has been reduced. For example, Amazon purchased property in Australia such that they could direct Australians to a domestic site that had four million products rather than the 60 million products available on the US site.⁴⁶ In response to the implementation of the GST, Netflix raised its prices between 11.1% and 20% (depending on the product).⁴⁷ This demonstrates that the burden of the GST, like the DST, is borne mostly (if not entirely) by Australian consumers. We do not know how many companies might have sold goods or services into Australia in the absence of the GST registration requirements. Digital goods ultimately raised 0.05% of the GST revenues—a tiny amount relative to total tax revenues.⁴⁸

While there might be emotional appeal to “sticking it to” Facebook and Google, somewhat akin to a big night out on the town, the bill and the hangover are probably not worth it.

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intended to be used to create a Simplified GST Registration System. However, the relevant Explanatory Memorandum and Regulation Impact Statement for extending GST to digital products specifies that \$800,000 of capital expenditure would be provided to the ATO to implement the measure (a vendor registration model).”

⁴⁶ Landis-Hanley, Justine. *Amazon Rankles Australian Customers by Pushing Them to a Local Site* (2018). The New York Times.

⁴⁷ Mason, Max. *Stranger Things: Netflix and the challenge of tax in the digital world* (2019). Australian Financial Review.

⁴⁸ Bunn et al. *Digital Taxation Around the World* (May 2019). Tax Foundation.

the Australian Treasury and the Australian Taxation Office. All errors and omissions remain our own.