Digital Service Taxes and the Broader Shift From Determining the Source of Income to Taxing Location-Specific Rents

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4-part motivation

1) Source: Incoherent? Fixable? Production vs. market countries?

2) IP and global rents/tax avoidance, location-specific rents? (LSRs)

3) Unilateral & strategic national welfare, coordination / cooperation.

4) DSTs for digital? More broadly? Relevance of digital platforms, 2-sided markets? Of user participation? Facebook/Google vs. Starbucks.

Hard paper to present in 25 minutes, so let's do a few highlights from each of those 4 topics.

Source in theory

Sourcing income not a "category error," orthogonal to but not in tension with defining economic income. (NYC rooftop garden example, Tagalog novel example.)

But neither logic nor consensus allows choosing between production-based and market-based theories.

Each of those 2 resolutions has its own problems, but in principle these are smaller than we sometimes think.

E.g., we know where leading US MNCs actually created valuable IP under a production-based view. (Hint: their overseas cost-sharing affiliates did zero.)

Bilateral monopoly profit-split puzzles are fun but often irrelevant.

Production vs. market-based views in practice

Starbucks claimed to be losing ££ in the UK – despite having 988 stores there (246 in London alone).

Used transfer pricing, royalty/interest flows to create fake UK losses.

But were significant ££ earned there, under a production-based view?

Clearly not – just routine / normal returns. US-created IP, US-monitored "Starbucks experience," not based on finding unique baristas.

Still, once large profits are being earned through UK stores, (a) the UK tax authorities have a shot, (b) UK voters & policymakers may want a decent share, & (c) who can blame them? (PE rules: reflect similar ambiguity?)

OECD and "value creation"

Source by another name – to be revived by addressing transfer pricing, permanent establishment (PE) rules.

But hamstrung by: (a) production / residence countries' reluctance to get too vigorous about it.

(b) market countries' eagerness for a piece of the action.

(c) production / residence countries' reluctance to recede officially or entirely.

If nothing else, value creation offers a "negative source rule" ($$ not earned in tax havens).

Sales-based FA & RPA-I

Proposed tax base shift to market countries, based on end-consumers' lesser mobility, not source theory.

Residual profit allocation by income (RPA-I) is an improved version.

Adoption might have to be unilateral, not globally coordinated.

Remaining tax planning opportunities may inadvertently favor some industries over others. (Also, tax rate issue re. rents.)

VATs / DBCFTs better resist some of the tax planning, but currency adjustment might negate external incidence. (And another version of the tax rate issue.)

Taxing global rents

Leading MNEs w/ valuable IP have tax avoidance opportunities, earn rents ex post. But are these true rents ex ante?

Individual countries might not care – time consistency, spillover.

But maybe that's OK! The labor income & risk-taking may not be highly elastic, plus note incentives to seek market power.

Also, not clear that collective over-reach is likelier than under-reach.

Concern about over-reach would be eased by natural tax base division via LSRs (a la natural resource taxation).

Defining LSRs

Same problem as defining source: production vs. market countries.

E.g., Facebook rents are created in the US, earned country-by-country.

Firm-specific rents created in the US = sum of the market-side LSRs to be earned in each country. (Although note, e.g., AirBnB & residence vs. geography-based.)

May be some benefit to responding through new & tailored instruments.

Insofar as LSRs self-allocate & little "Monty Python taxation," that just leaves residence / production vs. source (a familiar problem).

Unilateral & strategic national welfare

Global welfare concerns are relevant, but I like to stay grounded in the real world of national actors.

Mainly interested in own residents; unilateral & strategic frameworks.

Norms with arguable long-term strategic payoffs may help to explain aversion to “Monty Python taxation,” even where it might be feasible.

When peer countries advance their own self-interest at the expense of one’s own, it’s useful to consider reasonableness.

Even before he-who-shall-not-be-named, I viewed this as dictating a mild US response to the EU state aid cases.

Digital companies

Facebook & Google earn rents (subject to the usual *), pay low global taxes, avoid PEs, have market country-side LSRs.

They also have digital platforms, two-sided markets, user input.

Digital platforms: may imply low marginal cost of tapping a particular country's users.

Two-sided markets: when linking third parties, only the sum total must be arm's length. Cf. linked transactions between 2 parties (banks & depositors).

User input: helps market countries to feel good about imposing taxes, but otherwise irrelevant. (Facebook vs. Netflix vs. Hulu if it were global.)

Digital service taxes

Main issues posed include selective application by industry, use of gross revenues, revenue thresholds.

Selective application: may want to vary by industry; tax planning opportunities may anomalously so vary under "neutral" taxes.

Gross revenues: suppose low marginal costs, note use of deductions to shift profits to tax havens.

Revenue thresholds: rationalizable, but have prompted accusations of undue hand-tailoring.

Anti-American? – who'd a thunk it? But not a great time (on either side) to pick fights.