The Digital Services Tax: A Principled Proposal for the Future of International Taxation

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Main Claims

- Digital services tax (DST) proposals identify genuinely new problems in international taxation, and provide attractive solutions to these problems from both efficiency and fairness perspectives.

- All policy proposals are politically motivated. Unlike many other current proposals, the DST actually embodies a good idea.

- DST proposals should not be equated with “unilateral actions”. They incorporate a rich notion of “location specific rent”, which should become a focal point for international cooperation in reallocating taxing rights.

New problems in international taxation

1. **Two-sided business models operating at a global scale create misalignments between sources of value creation and origins of payment.**

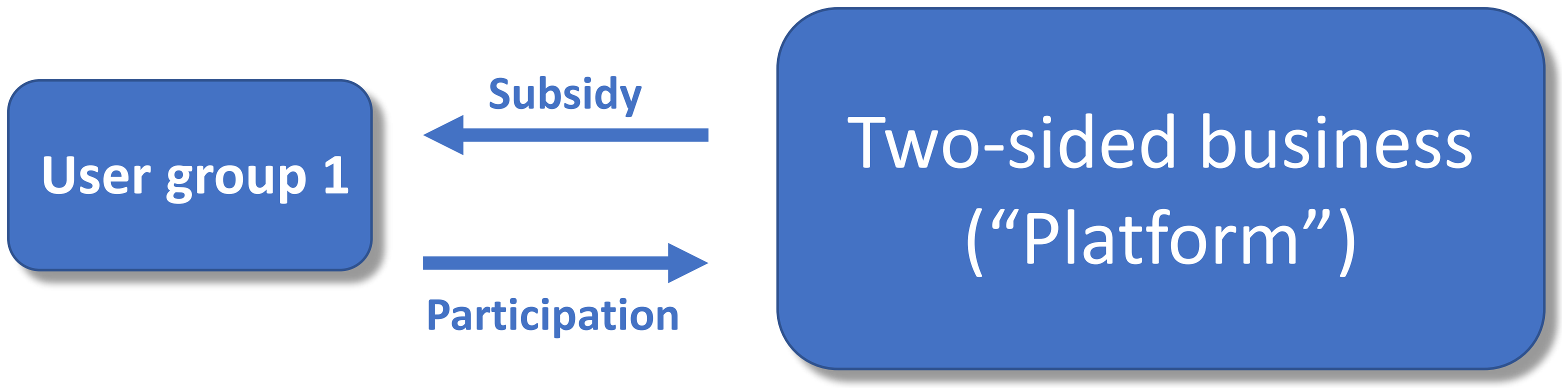
2. **Non-rival use and remote deployment of digital technology generate a significant new class of location specific rent (LSR)**

Basic structure of two-sided business model

Two-sided business
("Platform")

By manipulating the structure of prices charged to the two groups of users, a two-sided business can increase transaction volume to maximize profit

Basic structure of two-sided business model



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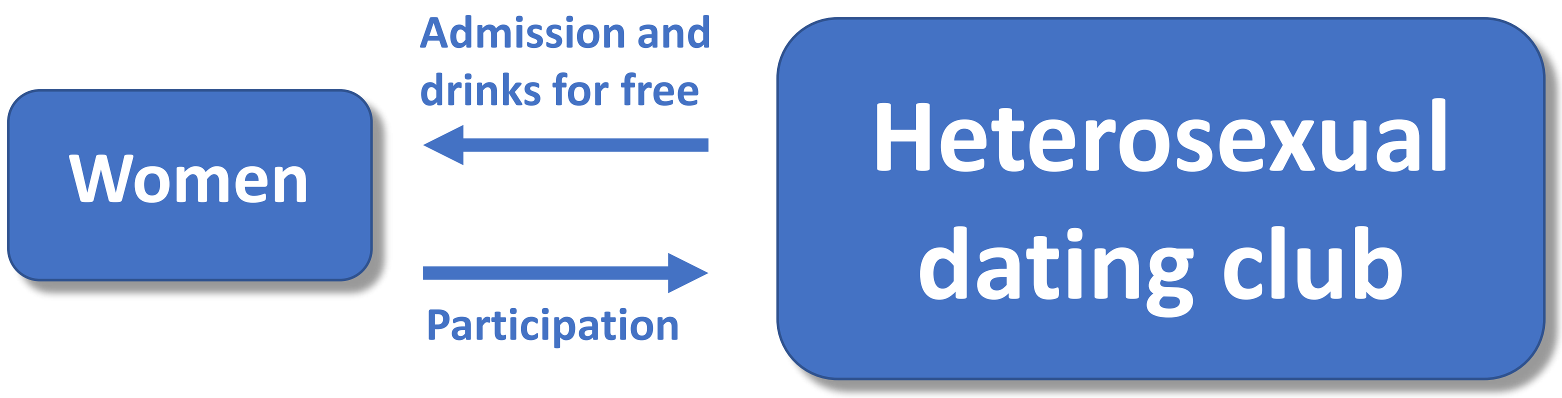
Basic structure of two-sided business model

By manipulating the structure of prices charged to the two groups of users, a two-sided business can increase transaction volume to maximize profit

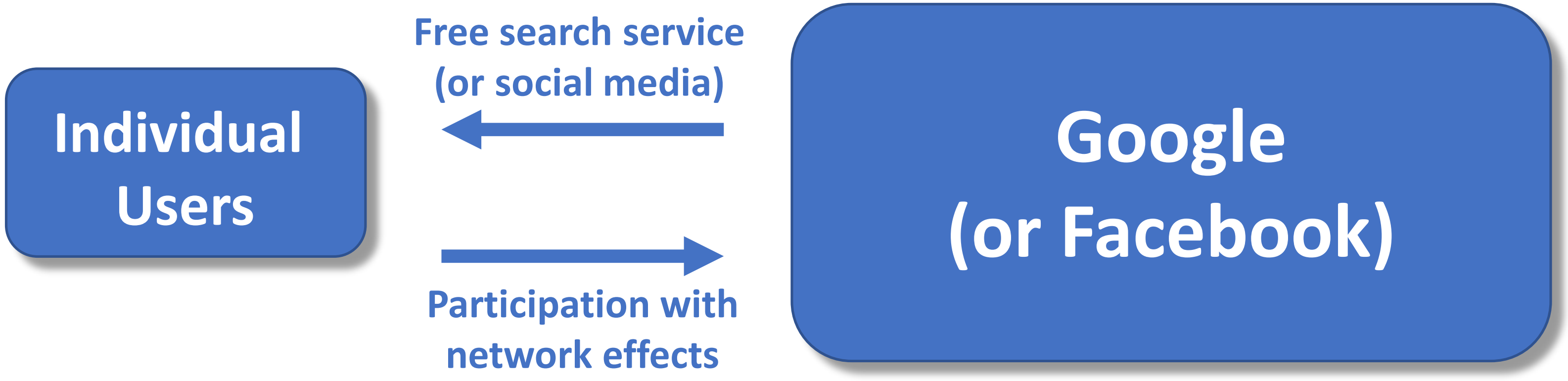
Heterosexual dating club


Women
Admission and drinks for free
Participation
Heterosexual dating club

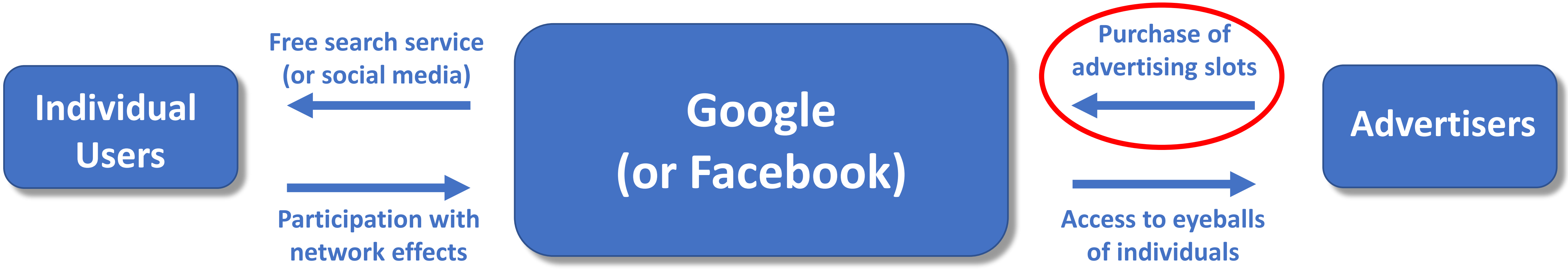

Women
Admission and
drinks for free
Participation
Heterosexual
dating club
Admission fees
Access to women
Men

- Charging men $10 and letting women in free can attract 50 men and 50 women.
- Charging $5 to everyone puts women off, and without women attracts only 70 men.
- Same aggregate price, one price structure generates more profit than the other.

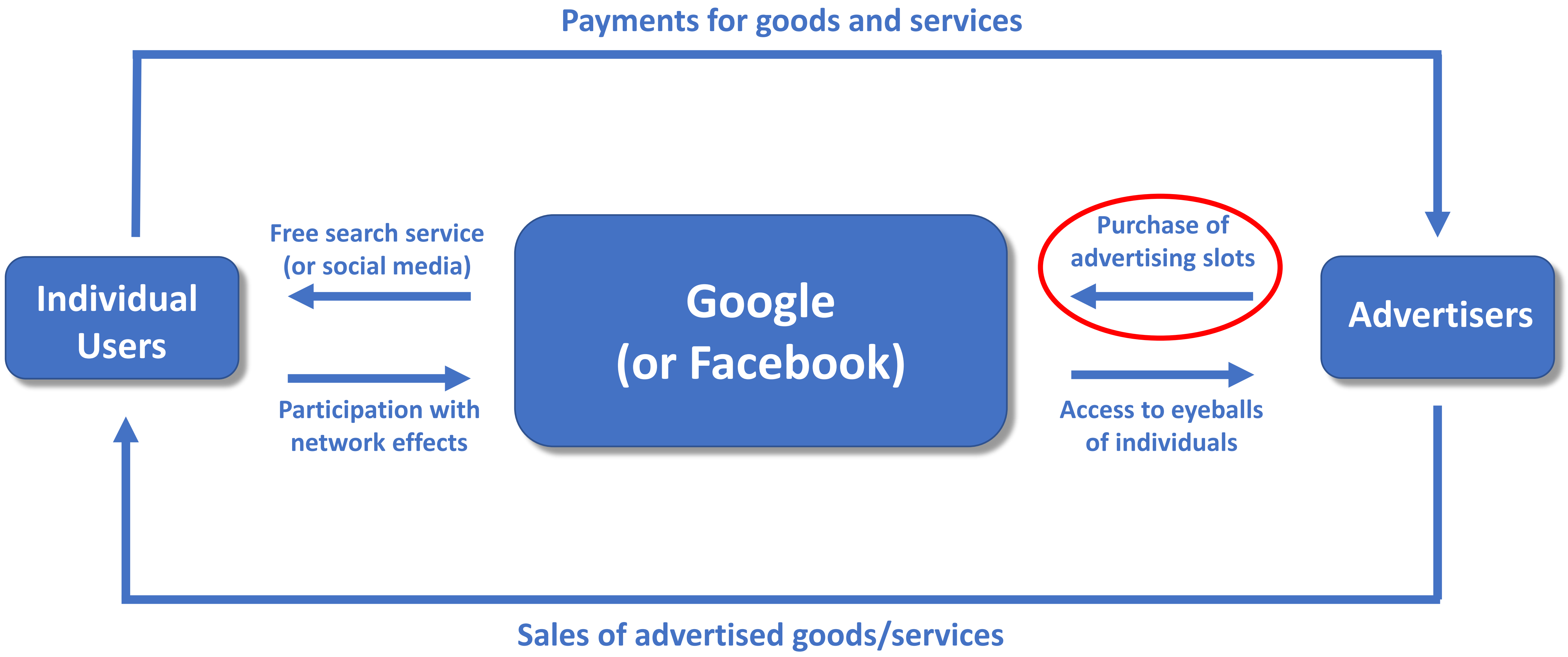
Google
(or Facebook)



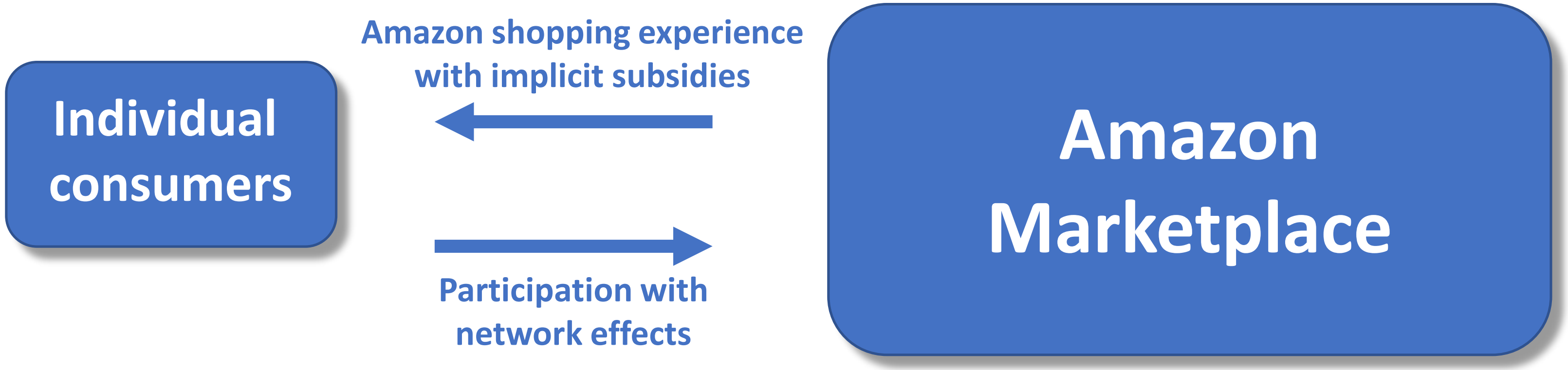
Individual Users
Free search service (or social media)
Participation with network effects
Google (or Facebook)


Individual Users
Free search service (or social media)
Participation with network effects
Google (or Facebook)
Purchase of advertising slots
Access to eyeballs of individuals
Advertisers


Individual Users
Free search service (or social media)
Participation with network effects
Google (or Facebook)
Purchase of advertising slots
Access to eyeballs of individuals
Advertisers
Sales of advertised goods/services


Payments for goods and services
Individual Users
Free search service (or social media)
Participation with network effects
Google (or Facebook)
Purchase of advertising slots
Access to eyeballs of individuals
Advertisers
Sales of advertised goods/services

Amazon
Marketplace

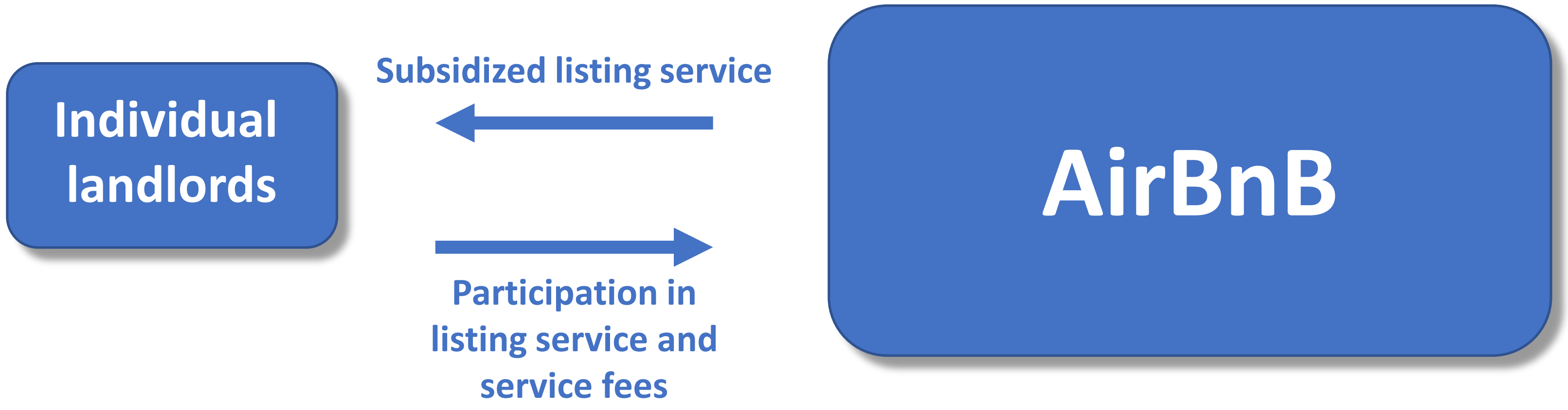

Individual consumers
Amazon shopping experience with implicit subsidies
Participation with network effects
Amazon Marketplace

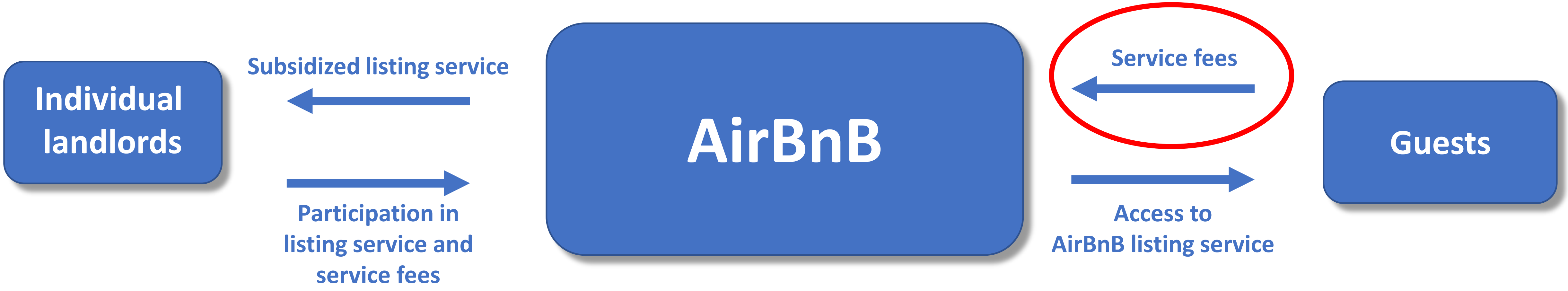

Individual consumers
Amazon shopping experience with implicit subsidies
Participation with network effects
Amazon Marketplace
Commission on sales
Access to Amazon buyers
Third party online sellers

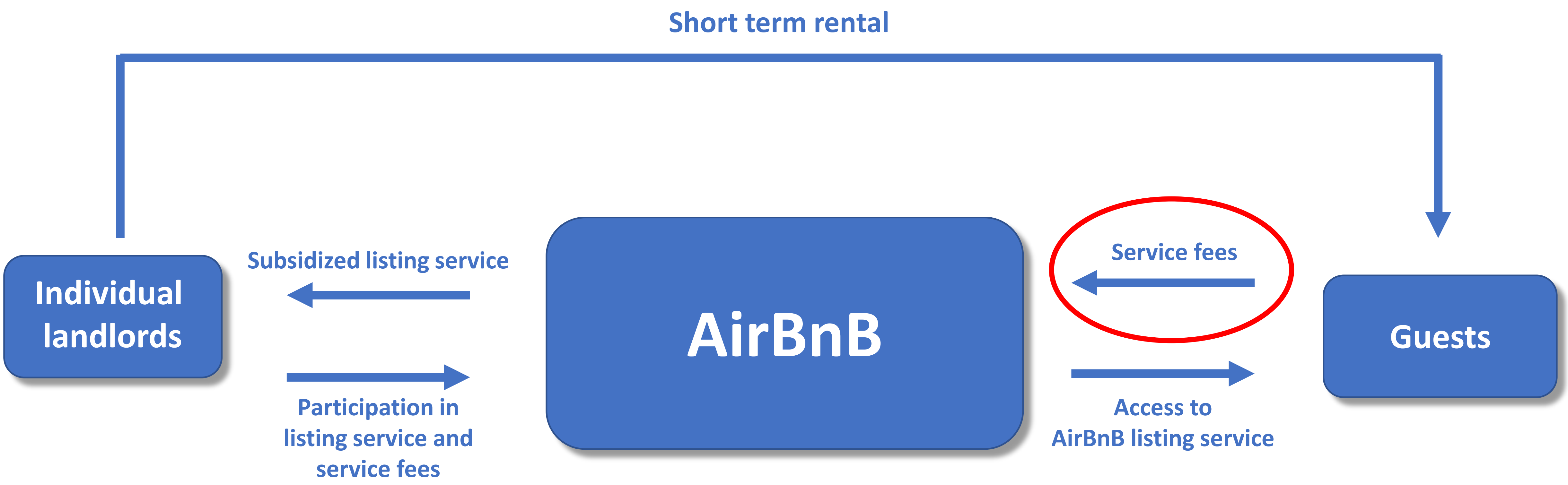

Individual consumers
Amazon shopping experience with implicit subsidies
Participation with network effects
Amazon Marketplace
Commission on sales
Access to Amazon buyers
Third party online sellers
Sales of goods and services

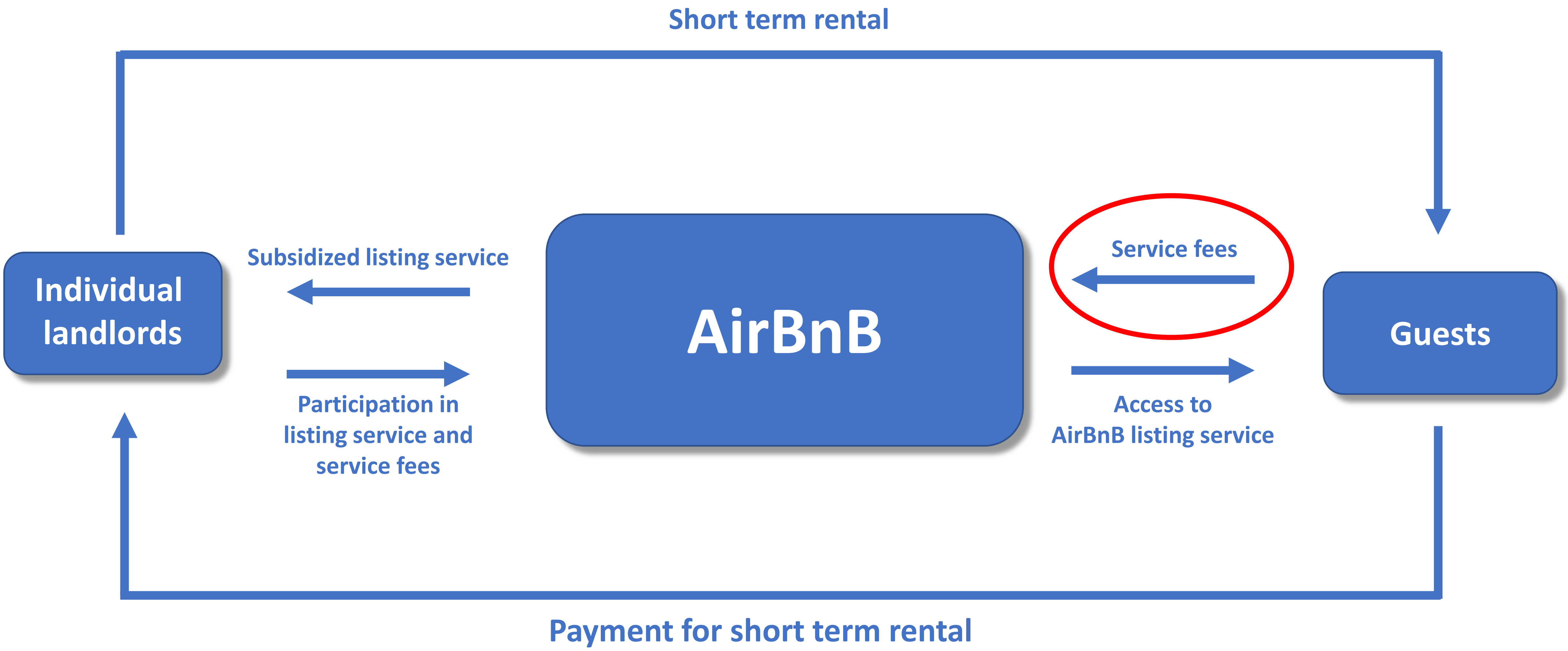

Payments for goods and services
Individual consumers
Amazon shopping experience with implicit subsidies
Participation with network effects
Amazon Marketplace
Commission on sales
Access to Amazon buyers
Third party online sellers
Sales of goods and services

AirBnB


Individual landlords
Subsidized listing service
Participation in listing service and service fees
AirBnB


Individual landlords
Subsidized listing service
Participation in listing service and service fees
AirBnB
Service fees
Access to AirBnB listing service
Guests


Short term rental
Individual landlords
Subsidized listing service
Participation in listing service and service fees
AirBnB
Service fees
Access to AirBnB listing service
Guests


Short term rental
Individual landlords
Subsidized listing service
Participation in listing service and service fees
AirBnB
Service fees
Access to AirBnB listing service
Guests
Payment for short term rental

Summary

- Platforms “bring to market” certain users valued by users on the other side. The rent thereby earned by the platform can be seen as specific to the side of the first user group, even though the rent is embodied in payments received from elsewhere.
    - The first group of users may be in countries of consumption (“destination”), production (“origin”), or even investment (“residence”). Location specific rent is not exclusively source- or destination-based.

- Operating in one country does not affect operation in another. Rent earned in one country can be earned only there.
    - Assigning the rent to that country is a less arbitrary assignment than to where IP is held.
    - It is equally compelling an assignment as to the country of technology inventor.

Fundamental inadequacies of the traditional international tax regime

- Recall the two new problems of international taxation:
    1. Two-sided business models operating at a global scale create misalignments between sources of value creation and origins of payment.
    2. Non-rival use and remote deployment of digital technology generate a significant new class of location specific rent (LSR)
- Profit attribution based, in a completely ad hoc manner, on physical presence and source of payment. Stumbles in dealing with problem 1.
- Arm's length principle completely silent on proper allocation of rent (arising from market power) among unrelated parties. Stumbles in dealing with problems 1 and 2.
- Residual profit allocation lacks guiding principles of fairness and ignores market structure. Stumbles in dealing with problems 1 and 2.

Is the DST as currently designed acceptable?

- All business models covered are likely to have near-zero marginal cost.
- Much of the losses faced by the platform companies are due to expenditures to capture market share, which has little social value in platform contexts characterized by natural monopoly.
- Low-rate tax on revenue is likely to under-tax rent, just like low-rate resource royalties.
- In its application to advertising and data, very unlikely to create double taxation.
- Intra-community coordination part of the EC proposal.

Wei Cui, The Digital Services Tax: A Conceptual Defense (2018)

Wei Cui and Nigar Hashimzade, The Digital Services Tax as a Tax on Location-Specific Rent (2019)

Thank you and comments are welcome!
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