Carrotestein: Tax Incentives for Digital Companies, WTO Agreements, and Harmful Tax Competition

By:

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You are my creator, but I am your master; Obey!

The Monster, in Frankenstein by Mary Shelley (1818)

At least, the rising of the digital economy posed two distinct challenges for tax administrations: how to tax big digital companies and how to promote research and innovation. Currently, the tax debate is heavily focused on the exercise of taxing rights on big companies. However, an increasing number of tax scholars such as Avi-Yonah (Avi-Yonah, Avi-Yonah, Fishbien, and Xu 2019 and Avi-Yonah

2020) are exploring the granting of tax incentives for corporations.

Of course, the topic is both edgy and controversial. Tax incentives failures to achieve the stipulated results, lax controlling mechanisms, and audit complexity shed legitimate doubts on the model. Criticism concerning corruption, loss of revenue, “race to the bottom”, and inefficiency among other failures are usual. Nonetheless, tax incentives are the core of the longest and most expensive trade dispute at the WTO so far: tax subsidies for the aircraft sector. And both the EU and the US are not willing to completely withdraw such tax incentives.

The Post-COVID19 path to economic recovery in Latin America and the Caribbean will demand both Domestic Revenue Mobilization measures and the promotion of domestic and foreign investment. Amid all the controversy surrounding the concession of tax incentives, the COVID-19 pandemic taught us a lesson: nothing is a sole economic issue. Public policies should address other concerns such as employment, health, environment, and education. A well-designed package of governmental measures may be a balanced proposal that includes diverse public interests to achieve optimal delivery of public goods. This post will focus on the granting of tax incentives for the digital economy in accordance with the GATT, the GATS, and the OECD’s recommendations on harmful tax competition.

Why tax incentives for digital companies?

The answer to the question may be bifurcated: profitable or big companies and start-ups. The taxation of profitable or BigTech companies is the epicenter of the international taxation on base erosion and profit shifting debate both at the OECD and the UN. Reaching an international consensus has been proved to be difficult and the solutions are complex. That delay is pushing the adoption of unilateral measures like the imposition of digital services tax that, on the other hand, are been threaten by the imposition of trade retaliation measures. While States engage in tit-for-tat behavior, profits remain undertaxed or not taxed undermining public investments.

In an interesting spin, MNEs are directly or indirectly involved in the supply of

public goods through charity entities controlled by themselves, founders, or management board members. Through foundations, a share of MNEs' profits are allocated to initiatives dedicated to the delivery of public goods such as vaccination, incentives for innovation, education, and the environment. However, little or no protagonism is left for governments regarding the setting of priorities or strategies related to the delivery of public goods.

We are living times of a worldwide movement towards the renegotiation of the existing Social Contract, thus, that is time to rethink the ways that governments and big companies interact. Certainly, the vertical model based on sovereignty is not working properly and public policy scholars and agents are not figuring out how to maintain the current model. Corporations are not only new international actors but powerful ones. Multinationals' budgets surpass the national budgets of most countries. So, establishing public-private relations based on sovereignty basis such as in the case of imposing taxes is challenging, at the best. Building horizontal relations like the granting of tax incentives conditioned to the delivery of public goods may be explored as a means of redistributing wealth among the diverse stakeholders and ascertaining some degree of sovereignty to be exercised in the determination of public policies to be implemented and pursued.

Another feature of the digital economy is innovation. BigTech, FINTECH, and start-ups are driving by and eager for innovation. Due to the relatively low investment costs to boost digital services, that is a reasonable option for developing countries to boost their economies, generate jobs, and rely on sustainable development policies. High ratios of digital natives in a population may be considered as a competitive advantage in the digital economy. However, high ratios of digital natives do not imply high Information and Communication Technological (ICT) skilled individuals in developing countries, especially in LDCs. This gap may impact the probability of success in developing digital innovative products or services and should not be neglected by governments.

Designing Tax Incentives Consistent with the WTO Agreements

Besides the practical issues above mentioned, the entry into force of the multilateral Subsidies and Countermeasures Agreement (SCM) in 1995 added legal concerns about the consistency of tax incentives with the WTO agreements and the assessment of litigation risks due to the new established WTO Dispute Settlement Body and the Dispute Settlement Understanding (DSU). Article 1.1(a)(1)(ii) of the SCM Agreement, determines *that "a subsidy shall be deemed to exist if (...) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits).* However, to be considered as a breach of the SCM Agreement, a subsidy shall also be specific and an export or "in substitution" subsidy (prohibited subsidies).

The SCM Agreement not only affected the grant of new tax incentives but also the negotiation and effectiveness of tax sparing clauses in tax treaties. Both the SCM definition of subsidy in Article 1.1(a)(1)(ii) and the tax sparing clauses are based on the "tax due but not paid" standard. If a tax credit or tax exemption should attract the application of a tax sparing provision, that would also be defined as a subsidy for SCM Agreement's purposes. Thus, the first step in the analysis of the consistency of a tax incentive (subsidy) with the SCM Agreement would be easily completed. The standard similarity between tax sparing clauses and the definition of subsidy in the SCM Agreement added complexity to the design of tax incentives. Recently, developing countries' tax incentives and Special Economic Zones (SZE) (Shadikhodjaev 2019)had been successfully challenged before the DSB in cases such as Brazil-Taxation and India-Export Related Measures.

On the other hand, subsidies for trade in services are regulated by Article XV of the GATS that provides for a mandated to negotiate an SCM agreement for the sector. Until this date, that has not been implemented. Thus, granting tax incentives for digital services and digital services suppliers is not bound by the same strict subsidy rules applicable to the supply of digital goods.

Also, tax incentives for digital goods or services or services suppliers may comply with the GATT and the GATS non-discrimination rules such as the most favoured nation, national treatment, and market access. However, unlike the international taxation system, the GATT and the GATS provide for general exceptions to justify measures that are inconsistent with nondiscrimination

provisions. The international trade system recognizes the relevance of other regulatory concerns that may justify the adoption of measures that depart from the non-discrimination provisions. Article XX of the GATT and Article XIV of the GATS enumerates general exceptions such as the imposition of measures necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of the GATT or the GATS. Besides, such measures should not *constitute a means of arbitrary or unjustifiable discrimination between countries*. The general exceptions present a reasonable degree of flexibility that may be explored and when designing tax incentives conditionalities for the digital economy.

Tax Incentives and Harmful Tax Competition

The granting of tax incentives is also tangled by the harmful tax competition narrative. (Chaisse & Ji 2020)(Navarro 2020) Preferential tax regimes, mainly when ring-fenced, may be considered as distortive measures. The OECD issued several reports on the issue of recommending the adoption of defensive measures to minimize tax basis erosion. Recently, under the Unified Approach negotiations, Pillar II is focused on GloBE (Global Anti-Base Erosion) rules. (HTC98, BEPS5 Action, and Pillar II)

The taxation-restricted approach toward capital export/import neutrality has contributed to the current narrative. Nonetheless, capital neutrality is not just a matter of taxation. In 2018, the World Economic Forum has introduced the Global Competitiveness Index 4.0 (GCI 4.0) providing the metrics for ranking countries' competitiveness. The GCI 4.0 assessment is divided into 12 pillars: institutions, infrastructure, information and communication technology (ICT) adoption, macroeconomic stability, health, skills, product market, labour market, financial system, market size, business dynamism, innovation capability. Tax and subsidies distortions are one of the factors under the product market pillar.

By only focusing on taxation, the narrative of “leveling the playing field” and harmful tax competition creates distortions and obstacles for fair competition for investments among countries. The self-contained assessment of each competitiveness pillar may lead to the misleading conclusions. For example,

jurisdictions with better assessment under the education and skills pillar and where education is provided exclusively by governmental institutions should be considered as a “harmful education competition” jurisdiction, thus, subject to defensive measures. Of course, that would be considered an absurdity. However, that is exactly how taxation systems are currently evaluated.

Capital neutrality should be assessed holistically and not only based on taxation. In fact, countries should promote public policies to strengthen all the pillars to achieve capital neutrality. The self-contained approach for taxation inhibits the use of tax policies even to develop other pillars that contribute to increasing competitiveness. In this context, tax incentives conditioned to the strengthening of other competitiveness pillars may be considered as a fair tool for leveling the playing field and not the opposite.

Learning Lessons from the Past

Indeed, both digital taxes and incentives are not easily designed or implemented. Like the Monster, digital companies are powerful and hard to control. Reliable controlling mechanisms are essential to tax incentives' effectiveness. Tax incentives are “taxes due” and should be submitted to the same good public governance standards of transparency and efficiency.

Luckily, tax administrators may rely on previous failed or successful experiences. Moreover, the granting of tax incentives in the digital economy should reflect a new kind of State-Private Sector relationship based on dialogue and cooperation, and oriented to the achievement of public goods. At the of the day, the Monster rage was triggered by Dr. Frankenstein's thoughtless behavior ignoring and even rejecting his creation. In the words of the Monster to Dr. Victor Frankenstein: *Do your duties towards me, and I will do mine towards you and the rest of the mankind.*

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