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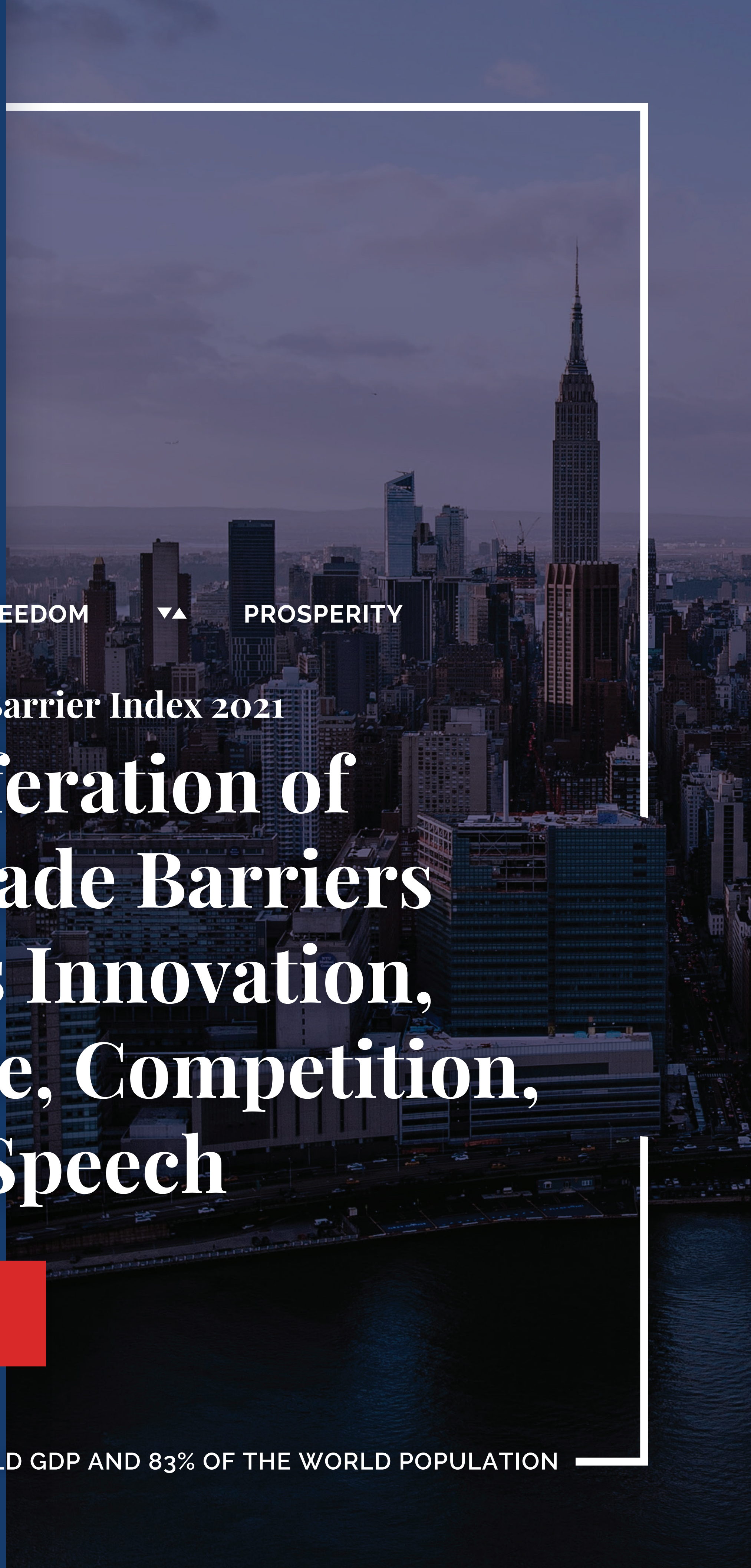

INNOVATION ▼▲ FREEDOM ▼▲ PROSPERITY

International Trade Barrier Index 2021

The Proliferation of Digital Trade Barriers Threatens Innovation, Free Trade, Competition, and Free Speech

Case Study

COVERING 94% OF THE WORLD GDP AND 83% OF THE WORLD POPULATION

The Proliferation of Digital Trade Barriers Threatens Innovation, Free Trade, Competition, and Free Speech

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I. Introduction

Since the early days of the World Trade Organization addressing potential trade barriers for cross-border data transmissions and e-commerce were considered within the scope, and a necessary mission of the organization. In 1998 the WTO began the Program on Electronic Commerce which sought recommendations from relevant bodies for the General Council to ensure that free-trade rules would extend to electronic commerce. As work on cross-cutting e-commerce issues progressed over time between WTO bodies the Council has continued to extend a moratorium on customs duties for electronic transmission.

Fast forward 23 years, in the absence of a comprehensive e-commerce text to ensure free-trade rules applied to the sector, governments largely chose a non-interventionist strategy which allowed the industry to develop under market constraints. It thrived. In that time period, e-mail was adopted as a common tool for communication, social media giants such as Facebook had their start, and a certain e-commerce retailer transitioned from selling only books to literally everything under the sun.

Today 4.8 billion people are connected online, they spend, on average, seven hours a day surfing its 1.8 billion webpages where they exchange 2.5 quintillion data bytes. In less than five years the Internet is expected to connect 6 billion consumers and grow to 60 percent of global GDP becoming digitized. Internet connected business grow faster, participate in international trade more than their counterparts, and continue to employ a growing share of the workforce.

In the last five years, however, the industry has become a focal point for many regulators across the world that use a variety of justifications for the burdens. Often they describe the digital economy as a "wild west"[3] that needed to be tamed, and sector to target for additional revenues for coffers,[4] or a security threat due to its democratizing effects on information gathering and distribution.

In response, the 2021 Trade Barrier included a methodological update to its Digital Trade Barrier indicator. This included creating a taxonomy of digital trade barriers: content localization, content moderation, data flow barriers, security barriers, digital taxes, gig economy barriers, or other onerous regulations. Then classifying aspects of proposed and imposed digital trade rules from the countries included in the index according to the taxonomy. Between 2019 and 2021 the world saw a dramatic increase in digital regulations that can be determined to be digital trade barriers by the TBI.

The TBI identifies the European Union as a chief originator of most of the additional digital trade barriers in 2021. This is due primarily to the introduction of Digital Service Taxes, and the adoption of the Digital Markets Act and Digital Service Act. Aspects of these three regulations are classified fall under content moderation, restrictions on data flows, and digital taxes. As a region, Western Europe, which is the EU, Switzerland, and the UK on the Index, leads the world in digital trade barrier restrictions.

3. Chee, "Google CEO Apologises for Document, EU's Breton Warns Internet Is Not Wild West."
4. Christie, "Taxing Big Tech – IMF F&D."

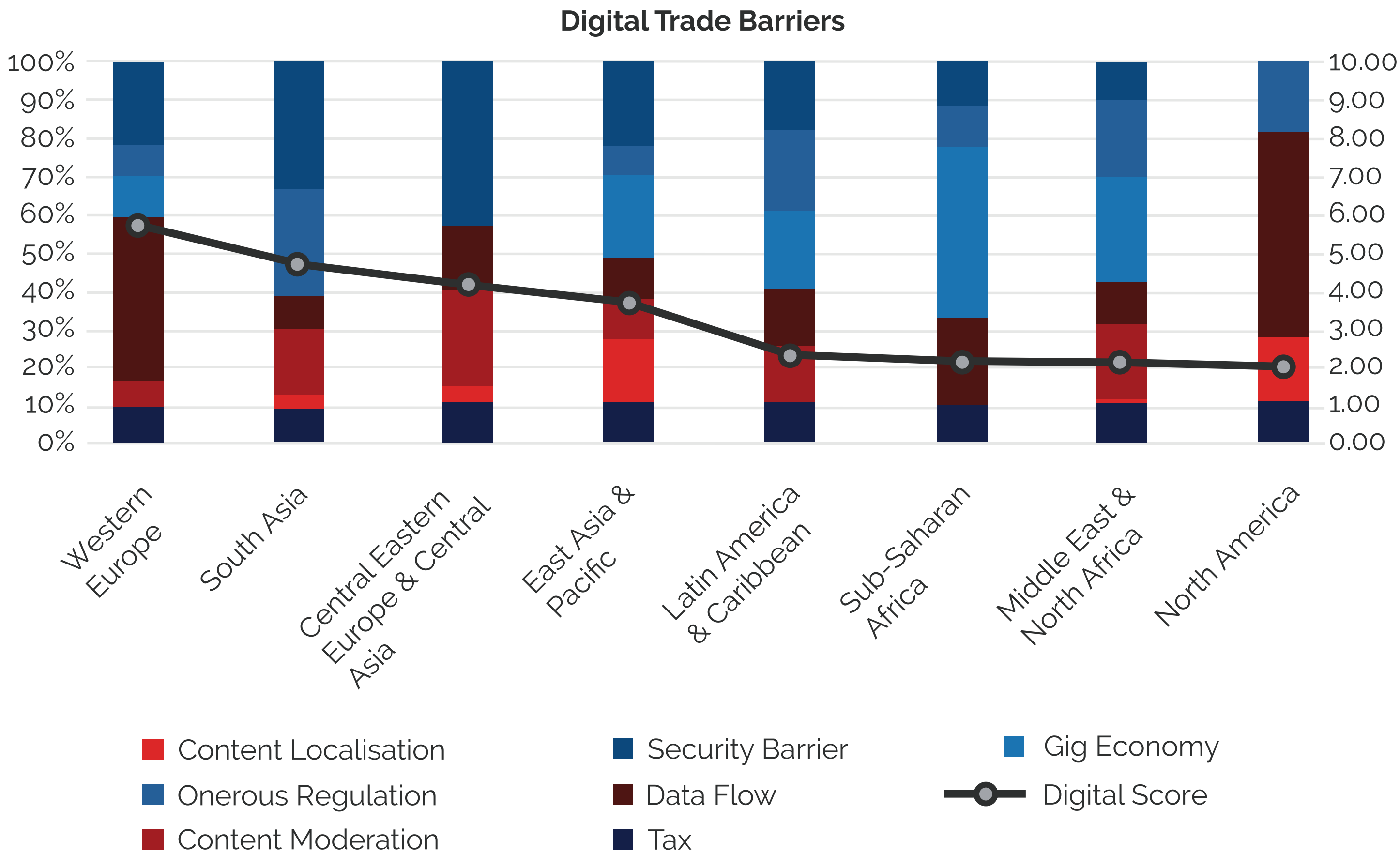

Figure 1

The uptick sets a dangerous precedent for the WTO and the next two decades of the digital economy. Several of these digital trade barriers, such as the Digital Markets Act, are seen as violations of WTO commitments. In the absence of an assertive WTO, members using its dispute process, or a comprehensive e-commerce text other bodies such as the OECD have stepped in to shepherd a process that would entrench such trade barriers as international best practices. In other cases, non-intervention may allow barriers, such as those concerning content moderation, to proliferate and become accepted global norms.

For instance, Digital Services Taxes which are tariff-like taxes on revenue that were introduced by more and more countries. Governments across the globe have imposed these new taxes on companies with specific digital business models that do not require a physical presence in the market.

The first digital tax was proposed by the European Union. The tax was designed to target mainly American tech companies like Uber, AirBnB, Amazon, Facebook, and Google, even if they are not physically present in the EU, potentially taxing them close to five billion euro ($5.7 billion). Companies with annual worldwide revenues above 750 million euro ($924 million) or yearly "taxable" revenues above 50 million euro ($57 million) in the EU were supposed to face a 3 percent tax on their turnover—in most cases the gross revenue. The plan would erect a new tax regime, as the tax would be levied by the countries where the digital users are located, not based on where the companies are physically present. This new form of taxation poses unprecedented dangers to tax competition and worldwide economic growth. The new tax represents a dramatic and irreversible shift for the international tax system and it is extremely harmful as a barrier to free trade.

It is important to point out, that this tax functions similar to a discriminatory tariff, as the EU intentionally designed this tax in a way to almost exclusively target American companies as there is no comparable digital industry anywhere in the European Union. Due to the European Union's inability to reach a consensus on imposing the tax, some member states went ahead and introduced their own digital services taxes unilaterally. France, in January of 2019, was one of the first countries that successfully imposed such a trade barrier, again, that is exclusively designed to discriminate against foreign exporters or users of digital services. The French DST is taxing not only the revenue but also earnings from digital advertisement. French Finance Minister Bruno Le Maire, who said at an informal meeting, "We want to tax American tech giants, but certainly we don't want the Chinese to tax Louis Vuitton," expects over 500 million euro ($570 million) in additional tax revenue — money that the French government desperately needs to expand the welfare state.

Along with France, many other European nations like Spain, Austria, the UK, Czech Republic followed along as well as India and Malaysia. In order to end those unilateral measures and to avoid a global trade conflict the OECD started a process to find solutions to allocating taxation rights in a digitalized world called "Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalization of the Economy." Unfortunately, the two-pillar approach was designed to unite all DST-nations against holdouts, chiefly the United States, and impose even more stringent barriers to trade, competition, and the free market.

If enacted, these proposals, which run counter to the OECD's own advocacy of more efficient tax systems with lower corporate tax rates, would undermine economic sovereignty of nation states, disproportionally hurt smaller economies, and hinder opportunities for companies to innovate and invest in research and development. It would also prevent developing countries from pursuing policies to boost their economies and lift people out of poverty. In addition, as the world struggles with an international recession due the impact of Covid-19, increasing the tax burden would significantly prevent nation states' abilities to enact pro-growth policies to stimulate and help rebuild their economics. Now more than ever countries need to reduce the tax burden to allow for rapid economic growth and increases in employment, whereas these proposals would do the exact opposite.

The OECD proposals mainly consist of two pillars, which, combined, are estimated to increase global tax revenue by $100 billion USD annually. Pillar I covers the reallocation of taxing rights across jurisdictions, and while initially designed to cover digital companies, appears to have significantly expanded to apply to other industries. Pillar II is the specific creation of a global minimum tax on corporate profits. Combined, these two proposals would represent a significant rearrangement of the international corporate tax system, while representing a shift in funds from open economies to countries with large degrees of corruption, state intervention, and violations of human rights such as China, Russia, and Argentina, which, while not members of the OECD, are part of the broader Framework "Base Erosion and Profit Shifting" (BEPS).

The entire premise of this two pillar approach is based on a fundamentally flawed and deeply misguided understanding on international tax competition which posits that tax competition forces rates below optimal levels. The reality, however, is quite the opposite. Per the nonpartisan Tax Foundation: "Tax competition can help to keep taxes closer to their optimal level,[5] constraining wasteful government excess. Taxes will not be driven to zero through competition, as moving capital and labor abroad does come at a cost." As such, international tax competition is vital for the continuance of a vibrant and dynamic international economy, and in ensuring efficient levels of taxation across member states. Different countries have different approaches to vitalize their economies. Tax competition for countries such as Ireland and Luxembourg is key to their economic strategy and success. At the same time, tax competitiveness applies much needed pressure to certain high tax countries like Germany and France to be efficient and responsive to market demands. This healthy process of tax competition will be minimized if not eliminated following the OECD's approach.

Despite rhetoric on how tax harmonization as envisaged under these two pillars would create a "level playing field," this proposal would significantly hurt smaller countries, who do not have the intrinsic advantages and economies of scale[6] that comes with larger population bases. Lower corporate tax rates are the only way in which such nations are able to overcome their competitive disadvantage caused by their smaller size and attract vital investment and compete against countries with larger capital markets. For this reason, high tax jurisdictions are primarily large countries, whereas low taxing jurisdictions are almost exclusively small and open economies. Through the imposition of such a regime, investment would be directed away from smaller countries who will therefore be placed at a considerable relative disadvantage as, in the words of The European Centre for International Political Economy, "the shift in effective taxing powers would undermine small countries' attractiveness to international businesses and, in addition, induce domestic businesses to relocate to larger countries with the economic gravity of larger market."[7]

In addition to unfairly targeting smaller economies, these proposals would also seriously jeopardize the opportunities for developing countries to pursue a pro-growth agenda and boost their economies, thereby depriving them of the opportunity to increase economic growth and therefore improve living conditions. As the UK's Department for International Development recognizes, "research that compares the experiences of a wide range of developing countries finds consistently strong evidence that rapid and sustained growth is the single most important way to reduce poverty. A typical estimate from these cross-country studies is that a 10 per cent increase in a country's average income will reduce the poverty rate by between 20 and 30 per cent."[8] Given that, as noted once again by the Tax Foundation, "Cutting corporate tax rates leads to increased investment, productivity gains, and, in turn, increased economic growth, output, and higher standards of living,"[9] any policy that would hinder developing countries ability to enact such policies would effectively entrench the dominance of highly developed economies, and would have significantly greater effects than any additional revenue benefits the OECD posits developing nations may achieve through attempts to limit "profit shifting" under Pillar II. It is noted that the BEPS framework includes 135 countries, and is not limited to OECD members, and as such many will be impacted by this through pressure brought upon them by the OECD. In addition, poorer OECD member states, such as Poland which has a GDP per

5. Wiebe, "The Benefits of Tax Competition."
6. Bauer, "Unintended and Undesired Consequences: The Impact of OECD Pillar I and II Proposals on Small Open Economies."
7. Ibid.
8. DFID, "Growth: Building Jobs and Prosperity in Developing Countries."
9. Hodge, "How Lowering Corporate Tax Rates Encourages Economic Growth."

capita three times lower than richer nation states such as Germany, would similarly be negatively affected. Doing so is a highly immoral approach, and one that would lead to significant levels of poverty that would otherwise be ameliorated. By preventing developing countries from pursuing polices to lift them out of poverty, and put them closer to parity with wealthier nations, these proposals would continue to perpetuate global inequality and further entrench the "north-south" divide.

Furthermore, it is noted that ultimately corporations don't pay tax, individuals do. Taxes will ultimately be passed down to the consumer level, harming individuals in addition to depressing economic growth further through higher costs leading to lower demand. Similarly, increases in tax rates will also hurt individuals who rely on dividends for retirement savings, with particularly devastating consequences given current global economic uncertainty.

Of the 140 countries engaged in the negotiations, 136 signed on to the new outline. Holdouts are Kenya, Nigeria, Pakistan, and Sri Lanka. Though the United States is counted as part of the agreement, there is an active dispute between Senate leadership and the Treasury Department over which branch has constitutional authority to negotiate and accede to the agreement.[10]

Despite the U.S.'s mixed support, a few details remain. The new agreement specifically states that digital services taxes and similar policies will need to be removed as part of implementing Pillar 1, but that will likely only apply to "new" DSTs and not already existing ones.[11] At the same time, the European Commission remains committed to tabling a proposal for a new "digital levy" in October 2021, independently from OECD agreements on new international tax rules.[12] The decision was made after members of the European Parliament and EU Commissioners said the levy is needed to support the EU Budget, especially the European Coronavirus Relief Fund.

The overall goal is to provide the EU with their own financial resources in order to be less dependent on EU member states. The expansion of the Emissions Trading Scheme, a carbon border adjustment mechanism, and a new digital levy are all part of this approach.

In conclusion, the foundational principles of digital services taxes and both the OECD's Pillar I and Pillar II are based on a fundamental opposition to the operations of free and open trade, international tax competition, and the benefits it brings to ensuring individual prosperity. Not only do these proposals undermine fundamental principles of democratic sovereignty and accountability in countries, through the effective transfer of taxation power from elected legislatures to unelected bureaucracies in the European Union or at the OECD in Paris, they will have a devastating impact on trade relations. More disturbingly, these proposals would also have severe negative unintended consequences harming smaller economies and preventing developing countries from boosting their economies through trade and reducing poverty.

10. Sen. Crapo, Sen. Risch, and Sen. Toomey, "Ranking Members Warn Against Bypassing Treaty Process | U.S. Senator Mike Crapo of Idaho."
11. OECD, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy – 8 October 2021 - OECD."
12. Vela, "EU to Postpone Digital Tax Proposal."

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