Implications of the Digitalization of the VAT Process for the Tax Competition in the European Union !

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- “The economy is becoming digital. Digitalization is the process of spreading of a general purpose technology. The last similar phenomenon was electrification. Digitalization of products and services shortens distances between people and things. It increases mobility. It makes network effects decisive. It allows the use of specific data to such an extent that it permits the satisfaction of individual customer needs – be it consumers or businesses. It opens up ample opportunities for innovation, investment, and the creation of new businesses and jobs. Going forward it will be one of the main drivers of sustainable growth.”

Digitalization , VAT and Competition

- The development of e-commerce has changed the conditions for fiscal competition between countries setting their rate of VAT. E-commerce leads to a decrease in cross-border transaction costs and a possibility of evading taxation, which strengthens competition between countries under the origin principle, resulting in a decrease in VAT rates. On the other hand, under the destination principle, e-commerce substitutes for cross-border shopping, and reduces competition between countries, leading to higher VAT rates. Typical e-commerce platforms prevent sellers from price discriminating among buyers according to their country of residence. When price discrimination is banned, and buyers have a bias in favor of domestic goods, tax competition between the two countries is mitigated and tax rates are higher than when sellers can adjust their prices to buyers according to their geographical location.

Digitalization , VAT and Competition

- Public economics and tax system literature address tax competition between countries as both mobility factors and firms multinationalization lead the way to fiscal optimization profitable to the lowest tax bidder. The issue at stake is to go further the different tax systems prevalent in a context of globalization and see to what extent digitalized economy presents specific criteria calling for particular adaptation of these tax competition models.

Digitalization , Tax and Competition

- Tax systems are designed and implemented by governments on a national scale. Their history is to be understood in a quite closed economy where mobilities –labor, capital, goods and services– between countries were limited or traceable. Various elements disrupt these historic tax systems: international trade, the multinational activity of companies, the development of intangible assets, digitalization of goods and services, etc. These transformations require thinking over and modifying tax systems along with the need for international cooperation. Governments are engaged in a game with one another since tax systems have become inter-independent.

Digitalization , Tax and Competition

- Tax system shortened to its simplest form enables to differentiate indirect taxes on consumption (VAT being the best known) from direct taxes on the income of economic agents (labor or capital) and corporate taxes. Economic literature agrees on the idea that because of capital mobility, capital income tax turns out to create competition between countries making it most profitable to the lowest tax bidder. With the increase of capital mobility and the growth of multinationals, the tax impact of capital income tax is even more reduced and, *de facto*, the capital income tax rates converge downwards (Auerbach and Feldstein, 2002). Besides this classic theme of tax competition when tax base is mobile, internationalization of activities is also at the origin of several difficulties. For instance tax authorities have to define the tax base corresponding to value creation in their jurisdiction.

Digitalization , VAT and Competition

- Tax on consumption (*sales tax* in the US, VAT in Europe) was introduced when most of international trade relied on tangible goods consumed locally. Growing e-commerce and then, to a greater extent, of e-services, has seen the development, across frontiers, not only of tangible goods but also of digital services, making it difficult to trace trades and locate the consumer. Analyzing these consumption taxes requires to differentiate destination-based taxation from origin-based taxation. According to the principle of destination, the tax rate of the consumer's country applies, while according to the principle of origin, the tax rate of the producer's country applies. It is necessary to set apart whether the consumer is the final consumer (BtoC) or a company (BtoB)

Digitalization , VAT and Competition

- From January 2015, the destination principle is gradually applied in the EU, VAT in Europe has been going back and forth between the origin principle and the destination principle. Since both principles carry advantages and disadvantages, European policies have implemented different solutions. The main advantage of the destination principle is that no matter the place of origin of the good (locally produced or imported), the same VAT rate applies and thus the consumer prices of imported and locally produced goods are equalized. The destination principle is effective since, regardless of the production place, companies receive the same pre-tax price and balance their marginal costs at this price.

Digitalization , VAT and Competition

- The main drawback, especially if custom borders are removed, is the difficulty in locating exchanges and defining the consumption place. The cross-border transit is difficult to embody –thus to define– while the location of the company is not determined. This last point advocates for the origin-based principle. However, the origin-based principle triggers tax competition between countries: if a country has a low VAT rate, it gives its companies a competitive advantage for export. The origin-based principle therefore encourages the company to locate in the country with the lowest consumption tax rate which leads to tax competition between countries to the benefit of the lowest bidder.

Digitalization , VAT and Competition

- E-commerce may seem close to the pre-digital economy and often seems affiliated to distance-selling. Goods traded *via* online platforms are not specific goods: the first two categories of top selling items on eBay are antiques and clothes. E-platforms business model is neither based on the use of personal data nor on an advertising model. The market is not two-sided but is closer to a model of supplier / distributor / consumer. If traded goods are not specific, traditional taxation and VAT can theoretically apply. True reality covers other difficulties (e.g. identifying trade, particularly the sale of services).

The Debate in the Academic Literature ?

- Why taxing?
- How to tax?
- Competition and Tax?
- What do we tax?

Taxation and Market Structure

- Taxation affects the market structure and competition among internet platforms. If platforms invest in quality to attract users, taxation may increase the joint profit of the platforms by preventing unproductive investments, but will result in lower quality for users. On two-sided markets, when two platforms compete to attract users on one side of the market, taxation has no effect on the market structure when the platforms are symmetric, but may distort the sizes of the platforms when the platforms are initially asymmetric.

E-commerce and fiscal competition

- The development of e-commerce affects the choices of rates of VAT through three channels. First, e-commerce reduces transaction costs, in particular cross-border transaction costs, and makes it easier for consumers to buy goods produced in different countries. Second, e-commerce opens up the possibility that buyers evade taxation altogether (by buying from a seller who is also an individual rather than a firm). Finally, with e-commerce, the link between economic agents and geographical locations becomes blurred: platforms of e-commerce, like e-bay, connect buyers and sellers from different locations without any discrimination.

E-commerce and fiscal competition

- Clearly, under the origin principle, e- commerce results in stronger competition between the two countries to attract consumers, and hence tax competition is strengthened, resulting in lower levels of VAT in both countries. Under the destination principle, consumers have no incentive to shop in the other country, increasing the level of taxes at the Nash equilibrium of the game of tax competition.

E-commerce and fiscal competition

- The development of e-commerce has changed the conditions for fiscal competition between countries setting their rate of VAT. E-commerce leads to a decrease in cross-border transaction costs and a possibility of evading taxation, which strengthens competition between countries under the origin principle, resulting in a decrease in VAT rates. Under the destination principle, the emergence of e- commerce reduces cross-border shopping and relaxes tax competition, allowing for higher levels of sales taxes.

Thank you!

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