

## **White Paper on digital economy taxation**

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### **Unauthorized English translation of the executive summary**

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**The digital revolution has happened. It has given birth to a digital economy which undermines the way we think value is created.** It is true that the digital economy is still dependent on the traditional production of goods and services. Yet as they serve hundreds of millions of users, startups and global corporations never stop changing the rules of the game and radically transform all industries, by their intensive use of digital technologies, by their innovative business models, by their access to plentiful sources of financing, in particular to venture capital, by their constantly refining the design of their interfaces and the user experience delivered by their applications, by the special relationship they establish with the users through these applications, last by their leveraging data about user behavior. Through these companies, the digital economy represents a growing fraction of the total added value generated by the major national economies.

**While the digital economy reaches into the confidential behavior of billions of users, its added-value escapes us.** The way it self organizes, the power of its network effects and the size of the externalities it generates through its business models bypass the rules for measuring added value. Meanwhile the number of connected terminals and objects grows in an exponential manner, the time spent using them is ever increasing, manufacturing, commerce and entertainment now belong to a digital economy which daily reaches into the confidential behavior of billions of users - be they consumers, creators, salaried or self-employed workers. The digital economy is thus everywhere, yet not always correctly accounted for. In reality a significant fraction of its added-value tends to leave the territory of the major countries and escape toward tax havens, not without grave consequences, economic, especially fiscal, in nature. Despite their intensive domestic activity within the largest countries by population, the large corporations of the digital economy pay almost no taxes there.

**Therefore the productivity gains generated by the digital economy do not result in an increase in fiscal revenues for the major countries.** This situation is without a precedent in history.

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**By its characteristics and the logic it follows, the digital economy differs radically from the Glorious Thirty (1):**

- the digital economy speeds up the rate of innovation and adoption of new goods and services. Internet reached the majority of the French population more than three times faster than fixed telephony. An application like Facebook has gained a billion users in less than eight years;
- with venture capital, a critical source of funds for short cycles of innovation, the digital economy puts to work massive amounts of capital. This comes with a strong pressure for high returns on investment from the few companies which meet with success and large scale growth;
- through an amazing application of leverage, the digital economy frequently leads to dominant positions. It does not force competition among companies on well identified markets, but among whole ecosystems encompassing various markets linked together;
- the digital economy rests on a model according to which most of the profit is reinvested rather than distributed to shareholders, the latter getting paid through hoped for capital gains. In such an economy to refuse paying dividends is considered as a sign of intensive innovation;
- the digital economy is for ever evolving at a fast pace, in all industries, so that it is difficult to identify its fixed characteristics, including in order to tax it. Neither the technologies, nor the business models, nor the services provided can be considered stable enough;
- last, the digital economy systematically decouples the fixed place of business from the place where the service is consumed. As a result, it is more and more difficult to identify where value is added in this economy and apply the rules from a tax code it renders obsolete.

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**The point shared by all the leading companies of the digital economy is their intensive use of data** collected through a regular and systematic recording of user behavior:

- data, foremost personal data, is the lifeblood of the digital economy. Data enables the companies which collect it to measure and improve the results of an application, to personalize the services it provides, to sustain the flow of innovation which gives rise to new applications, to take strategic decisions. Data can also be monetized among third parties to whom it is licensed, especially via some type of software platform. In general, data is the lever which enables the leading companies of the digital economy to scale up and reach high profitability levels;
- data collection brings into the open the reality of "unpaid work". Data collection through a regular and systematic recording of user online behavior bears no monetary compensation. The users, who enjoy the service being provided, become in this way like voluntary contributors for the companies. Collected, stored and processed so as to be integrated in real time with the production process, the data supplied by their "unpaid work" tends to erase the border between production and consumption. Attracted by the quality of the interfaces and network effects, users participate in the production process through their data and create a value which various other sides of the business models turn into profits.

**The digital economy is thus a way which goes beyond the theory of the firm:** it becomes possible to put application users to work, as in the past suppliers or salaried employees were made to work. The absence of a monetary compensation for this user activity explains in part the spectacular productivity gains of this economy. Yet no fiscal revenues arise from such user participation to contribute to the collective effort within the country where the users reside and "work" for free. The activity of application users is enabled and even magnified at public expense, notably in education, social protection or the extension to the whole country of communication networks. The development of the digital economy itself calls for an assertive industrial policy, which demands new public resources. The leading companies of the digital economy which leverage the activity of internet users must also respond to this call.

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(1) Note of the translator: the period of rapid growth extending from 1945 to 1975 and corresponding to the recovery of the French economy after WWII

**A common trait of the global companies of the digital economy is the low level at which they pay income tax.** Even though they are not alone in indulging in the fiscal optimization of their profits (a practice common to all multinational groups), the companies of the digital economy find it easier to benefit from the competition between countries:

- they can easily transfer their profits to tax havens by locating there the compensation of their intangible assets, whose value is magnified by economies of scale. Since these profits are not used to pay dividends, they can be retained and reinvested without incurring any income tax as such;
- using their multisided business models, the companies of the digital economy spread their activities the world over to put their users to "work", but focus the activity from which they realize their income in the countries which offer the easiest way to transfer profits to tax havens;
- while older companies must restructure in order to achieve fiscal optimization, the ones engaged in the digital economy are natively organized so as to put to best advantage the differences between the fiscal regimes of each country, in particular by picking where to register their headquarters.

**Tax law, whether national or international, is hard put to evolve in phase with the digital revolution.** The consequences are palpable with respect to both direct taxation (income tax, local taxes) and indirect taxation (value-added tax):

- international tax law gives the power to tax income to the country in which the company has registered its headquarter rather than the one in which it carries its business. This principle is the basis for the bilateral fiscal convention model drawn by the OECD, whose object is to prevent cases of double income taxation;
- the only exception to this rule is when exists a fixed place of business in a country other than the country where the headquarter is located. Yet the definition of a fixed place of business, which supposes the availability of real estate and workers, is stamped with economic concepts dating from the period following the last world war, no longer in line with the digital economy;
- the studies toward a common consolidated base on which to assess the income tax in order to eliminate fiscal competition within the European Union go nowhere and do not take into account the particularities of the digital economy. The same goes for the studies sponsored so far by the OECD, which rarely mention this economy as such;
- the bottom line is a little more positive with respect to the added-value tax whose localization rules have been able to be modified in favor of the countries where the consumption occurs, despite the difficulty to reach a unanimous agreement. However the implementation of this agreement is progressive till 2019 and not all difficulties have been solved;
- last, the first attempts to create tax laws geared toward the digital economy, made on a purely national scale, have missed their target.

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**It is urgent to take action and stop the economies of industrialized countries from sliding into a death spiral.** Beyond the simple decrease of their fiscal resources, the growth of the digital economy results into a disappearance of the fiscal base in these countries under the conjunction of two phenomena:

- on the one hand, the ascendancy of the business models for intermediaries, which enable corporations whose income is not taxed locally to capture an increasing fraction of the margin to the expense of the other actors in the added-value chain;
- on the other hand, the pressure squeezing prices in view of the market power of these intermediaries, which feed their activities with the data collected from those who use their applications.

**It is all the more urgent to take action as, far from being restricted to a few industries, the digital domain in fact "devours" all the sectors of the economy.** Whether it is tourism, banking, telecommunications and, tomorrow, car manufacturing, municipal services or healthcare, digital economy companies will insert themselves in the added-value chains, focus their effort on a key step and, through their putting users "to work", capture an increasing fraction of the margin of the local companies subjected to their market power. As the whole economy becomes digitized, the margins of the various industries will migrate abroad, disappear from the GNP of the major countries (thus undercutting their recorded growth) and take away the increase in tax revenues of their public administrations which would potentially derive from the productivity of this economy. Started ten or fifteen years ago, this trend has been accelerating ever since.

**The digital economy will continue to develop. Yet it will not create jobs in the major countries without an industrial policy** aiming at two complimentary goals: *helping* the organic development of the digital economy within their borders and *facilitating* the diffusion to the rest of the economy of the productivity gains it enables. Fiscal policy is one of the tools of this industrial policy, in order at the same time to create the conditions for a healthy competition between the companies of the digital economy, to guide their R&D efforts appropriately and to generate the tax revenues which are necessary for public administrations to encourage this transition.

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**Given this diagnostic, the mission comes out with three sets of proposals.**

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**1- Recover the power to tax the domestic income generated by the digital economy corporations:**

- the corporate income tax is the most suitable tool to ultimately arrive at a contribution proportional to the added value created within the borders of a country. Income is precisely an aggregate measure to evaluate the net riches created by a company through its business activities. Tax law must therefore be reformed so that the corporate income tax captures the benefits of the digital economy;
- It is impossible to reach this goal in isolation. Given the constraints intrinsic to international taxation, it is indispensable to start negotiations at the level of Europe and within the OCDE so as to get that the rules on how to share the power to tax be modified. This requires a redefinition of a fixed place of business specific to the digital economy;
- this definition must take into account the central role played by personal data and the "unpaid work" of the users, which is today ignored in fiscal theory - even though these contributions are at the very heart of the creation of value, easily located within each country and common to all the dominant business models of today's digital economy;
- the objective of these negotiations is to enable the determination of a fixed place of business whenever a company has a domestic activity which uses the data issued from a regular and systematic recording of internet users' online behavior within the same country. The fraction of the income linked to the exploitation of this data would be deducted from the transfers linked to the compensation of the intangible assets located outside the country.

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## **2- Meanwhile create a taxation linked to the exploitation of the data issued from a regular and systematic recording of internet users' online behavior within national boundaries.**

The collection of data issued from a regular and systematic recording of user behavior is the only factual basis which guarantees the neutrality of the levy with respect to the business models, technologies and country arbitrage methods used by corporations. Linking the taxation to data collection and exploitation is an approach which is both neutral and sustainable, a way to reveal the domestic implantation of the digital economy and a strategy by which, putting forward economic and industrial arguments as to the value of data, one can accumulate political capital in the context of future international negotiations on sharing the power to tax the major corporations of the digital economy.

The proposal from this mission does not consist in taxing data collection as such. Rather it aims to create a taxation which will prompt the companies which engage in collecting and exploiting data issued from a regular and systematic recording of internet user behavior to adopt practices conforming to four public interest objectives to:

- strengthen the protection of individual freedom
- facilitate innovation in the digital trust industry
- encourage the emergence of new services from which users may benefit
- generate productivity and growth gains.

**The stake is to set up a principle for the companies engaged in the regular and systematic recording of their user behavior similar to the "polluters pay" principle** which undergirds environmental taxation. Without in any way exonerating the companies from their obligation to abide by the fundamental rights relative to personal data protection, this **"predators pay" principle** would lead to taxing those content to formally abide by the current laws while in reality they practice a kind of exclusive appropriation of the data they collect, especially by creating de facto obstacles to the portability and personal reuse of this data by the very users.

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## **3- Create a tax environment favorable to the emergence of new companies** by reforming the taxation of R&D and private financing, especially by:

- adapting the definition of R&D to the characteristics of the digital economy;
- reforming and simplifying its main mechanisms (research tax credit and innovative startup status)
- prompting the development of private funding for the digital economy.

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**The development of the digital economy promises progress but is also an all out assault on the economies of the major industrialized nations.** An industrial policy is necessary to manage this transition and work to the effect that its productivity gains give rise to the organic development of new activities which in turn will create new jobs domestically. Through taxation, the companies of the digital economy must take their fair share of this collective effort. The proposals of this report thus aim at recapturing the power to tax the income stemming from the "unpaid work" of internet users by: opening negotiations on international tax law; by setting up a domestic tax both consistent with the economic arguments to put forward in these negotiations and helpful to the domestic development of the digital economy.