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The EU's misguided tax on tech giants is doomed to fail

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Politicians on the continent have worried for years about the tax planning of these (usually American) super-firms.

Last week, they issued a proposal to deal with the perceived problem: allow individual countries to tax the local revenues of these giants at a three per cent rate.

The aim? To compensate for the fact that, according to the EU, digital firms pay an effective corporate tax rate of 9.5 per cent, compared to the 23.3 per cent faced by "bricks and mortar" firms.

Developing a whole new tax base (revenues rather than profit) for a relatively small number of companies seems a dramatic – and arbitrary – course of action. And it throws up all sorts of problems, some of which require further carve-outs and convolutions of the tax system.

For starters, new, upcoming digital companies going global for the first time would now have to navigate and structure their businesses according to two completely different types of tax base, beyond the ordinary compliance costs of operating across countries.

This would be particularly harmful to small companies. Little surprise then that the EU has introduced a threshold: companies would have to have revenues of $750m worldwide and $50m in the EU to fall under the regime.

But that's just the half of the potential distortions. A revenue tax creates a liability irrespective of whether the business is making a profit or loss, heightening the possibility of business failures.

In fact, it would be particularly destructive to digital businesses with very high turnover but low margins, which is often the case when firms are expanding and trying to build big networks.

As the Institute of Economic Affairs' Julian Jessop has outlined, "a company facing an additional three per cent tax on revenues but making margins of, say, six per cent would effectively be paying corporation tax at a rate of more than 50 per cent" – presuming they do not change their behaviour to compensate.

The effects on innovation could be more broadly damaging.

Entrepreneurial new products or services bring with them substantial uncertainty over whether they will be profitable or loss-making ventures. Adding in a new tax cost associated with revenue generated by a new idea could deter investment in new services across the board.

One might consider all these effects a price worth paying were this new tax regime genuinely "levelling the playing field" for different types of business. That, after all, is the stated aim.

But this tax will almost certainly not achieve that objective in economic terms.

Before assessing why, it's worth noting just how difficult it is to define what a "level playing field" should mean for business taxation, and hence how much digital firms should pay.

Where, exactly, do economic activities for digital giants take place: where the users or buyers of products exist, or where the intellectual property, programmers, and developers of the networks reside?

These are the questions international tax lawyers are grappling with, and there's no simple or crude answer.

Traditionally, advocates of "tax justice" have asserted that the moral case for clamping down on tax planning arises because companies all use the local country's public infrastructure. Where digital firms are concerned, this argument is much weaker. So what exactly are we trying to equalise?

The EU has concluded the aim should be to bring the effective tax rates paid by tech companies to the level of other firms. But while this tax may achieve that in an official financial sense, the economic costs of a revenue tax on tech firms in the EU are likely to be borne by other businesses and customers, especially in the short term.

A 2016 report from the EU's Audiovisual Observatory suggested that Google and Facebookaccounted for 42.2 per cent of the total amount spent on online ads across Europe. In fact, 17 global non-European companies made up 67 per cent of the total spend.

Though most digital markets are contestable, advertisers want to go where the potential customers are. So the most likely near-term outcome of this tax will be for Google, Facebook and others to increase their advertising rates for local European businesses wanting to use them. Far from levelling the playing field, local businesses will actually find themselves having to pay more to advertise their products.

In a world of changing business structures, sophisticated supply-chains, intellectual property, and network effects, business taxation is complex. But reaching for a highly-targeted populist tax on one sector represents a triumph of politics over good economics.

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