# Digital Tax Sovereignty of the EU

## European Solutions for a Fair Taxation of Multinational Digital Service Providers

### Executive Summary of the Study by the Centre for European Policy (cep)

- **The internet giants from the US and China are already conquering the next growth areas (AI, LLM, etc.) and increasing their market power. Europe's gap to the global digital powers is widening and digital sovereignty is declining - at a time when technological development is accelerating.**

- **Multinational digital service providers pay virtually no profit tax in the EU. By 'voluntarily' foregoing taxes, the EU is 'financing' its own digital dependency. It urgently needs to regain its digital tax sovereignty.**

- **Every year, the EU misses out on around three to four billion euros in digital tax alone. And the trend is rising sharply. Since 2018, when the EU launched its initiative for a digital tax initiative, the tax shortfall has accumulated to an estimated 30 billion euros. The digital mass markets have been in US hands since the mid-2000s. The cumulative and continued 'tax foregone' is causing lasting economic damage. Despite the AI Act and GDPR, the EU is threatened with 'digital colonisation'.**

### Digital Sovereignty: A Vital Question for the European Economy and Small and Mid-sized Enterprises (SMEs) in Germany

The European economy is threatened in its organization and sovereignty by far-reaching technological and geopolitical changes. This is particularly true for German SMEs. Prosperity and competitiveness are at stake. It is about a fundamental reorganization of the global economy and its balance of power and rules, during which the EU must not become the loser. We are talking about two major structural, almost regulatory changes:

- The industrial order has played into the hands of German SMEs for decades. Digital capitalism, however, operates according to different principles and mechanisms. The order of the industrial period based on the principles of competition and comparative advantages is being replaced by an (unregulated) monopolistic platform and data economy.
- For decades, the multilateral order has created a global, rules-based 'level playing field' in which German SMEs have been able to play to their strengths. Geopolitical changes are now causing a transition from the multilateral, rules-based globalization of the past three decades to a multipolar, power-based one.

It is not just a question of maintaining prosperity and competitiveness, but - as a precondition - of defending geostrategic sovereignty and authority over technology, infrastructure and tax justice. The rapid pace of digitalization and the exponential development of technologies and business models have promoted the rise of multinational platforms to the most valuable

players in the global economy. European dependence on these players is already high and, if nothing is done, will continue to grow - to the point of a 'digital colonization' of Europe. Digital sovereignty includes the independent use and development of technologies, the control of infrastructures and the enforcement of laws and taxes.

## Digital Dominance: Growing Imbalance between the US and the EU

The digital imbalance between the EU and the US is growing. The big Internet giants of today are also driving investment in artificial intelligence (AI), securing the business models and growth areas of the future. They are exercising their market power along increasingly digital value chains, expanding them and increasingly penetrating into traditional business areas. This can also be seen in digital trade. While the EU has a trade surplus in physical goods, digital services are strongly dominated by US companies. In 2020, the estimated turnover of US digital service providers in the EU amounted to more than 160 billion euros, compared to only around 20 billion euros for EU digital service providers in the US market. The dominance of US - and increasingly Chinese - suppliers is growing at an alarming rate. And with this growing dominance, the problem of tax avoidance and the lack of a level playing field for German and European SMEs is becoming ever more acute and politically unacceptable. Particularly in the digital logic of network effects, economies of scale and exponential technological progress, it is important to avoid emerging dependencies and lock-in effects or, where they exist, to consistently reduce them. With exponentially growing technologies and innovations, the first mover advantage is becoming increasingly important. While the first digital platforms took years to reach a market of millions of users, AI-based language models now achieve this goal in a matter of hours.

## Tax Avoidance: Billions Lost and Economic Damage to the EU

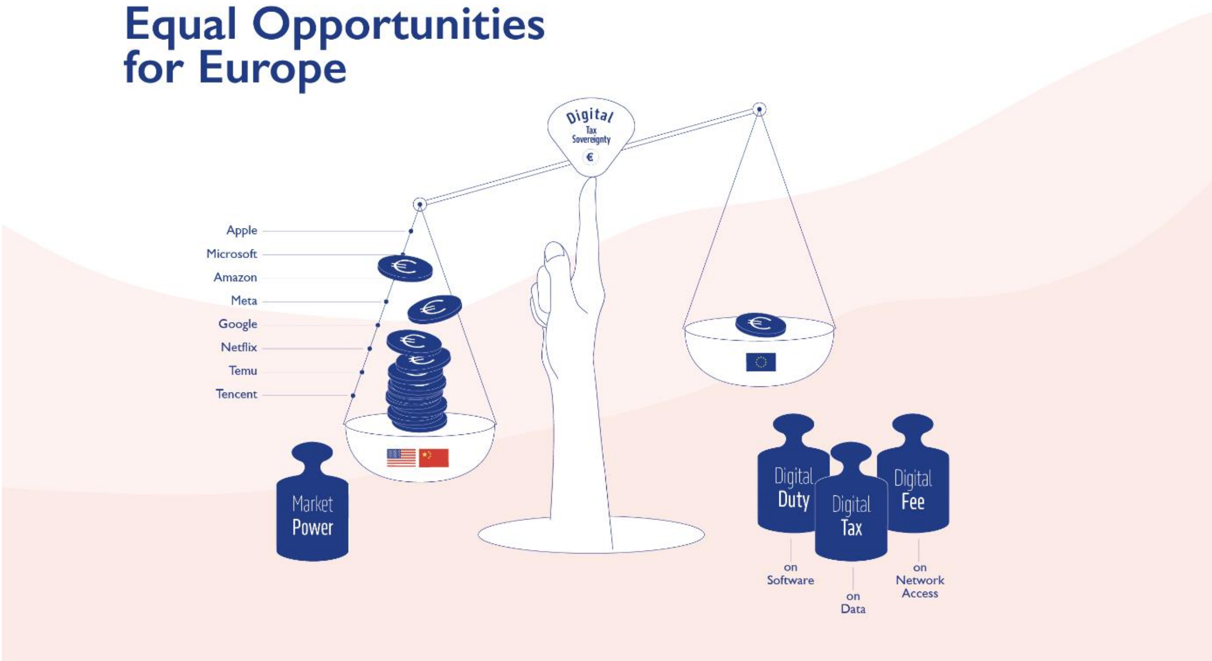
As a direct consequence of this dominance, the market power of the few providers is increasing, making more and more sectors of the traditional economy, including the non-digital economy, dependent on them. Another consequence of this dominance is increasing tax avoidance through so-called BEPS (base erosion and profit shifting) practices. Multinational digital service providers pay hardly any tax in the EU and therefore contribute little or nothing to the financing of public goods, even though they generate high returns and extract economic rents.

European countries are losing billions in revenue due to the lack of fiscal intervention in multinational digital services. The ifo Institute estimates that the annual revenue potential of a tax on income from the sale of user data, online advertising and brokerage on online marketplaces alone would amount to around three to four billion euros.[1] This adds to the free use of public goods and other infrastructure to which the multinational digital providers contribute little or nothing. On the contrary, the EU's 'tax waiver' is causing lasting economic damage by underfunding digital infrastructure and leaving digital business models developed in the EU in a worse tax position.

[1] This includes revenues from the sale of user data, online advertising and the provision of online marketplaces. These revenues amount to around 132 billion euros. A digital sales tax of 3% is levied on these revenues in the calculation. Companies with a global annual (group) turnover of at least 750 million euros are subject to the tax (see ifo, Die Besteuerung der Digitalwirtschaft, 2018).

The market power of US and increasingly Chinese digital providers combined with the increase in digital value creation (AI, Metaverse, Web3.0) will lead to even greater tax losses in the coming years. More and more wealth will flow out of Europe if the market power of the large foreign digital providers is not curbed. Moreover, an unresolved problem is the large language models that systematically violate copyrights on a massive scale without compensating authors for the use of their intellectual property.

**Figure 1: (Un)equal Digital Opportunities for Europe**




Source: own illustration

The cumulative tax loss from the digital tax alone is estimated at 30 billion euros to date (i.e. since the EU initiative to introduce a digital tax) (see Figure 1). The current market power of the big internet giants dates back to the beginning of the commercialization of digital innovations on mass markets in the mid-2000s (smartphones, apps, social media, etc.). Today, it poses a structural, competitive and ultimately regulatory problem for the European digital economy - with consequences that reach deep into society, the economic interests and the normative order of the EU, considering the dangers of manipulation and disinformation for democracy and the rule of law.

## Digital Monopolies: The Quasi-Sovereign Power of the Platforms

Against this backdrop, regulators have a role to play in enforcing fiscal sovereignty, defending digital sovereignty and creating a level playing field for SMEs. Digital value creation has specific characteristics compared to industrial value creation. In particular, network effects and economies of scale favor the creation of market power. Its intangible nature makes it difficult to capture physically or spatially. The drivers and main beneficiaries of digitization today are predominantly multinational digital service providers in US hands, whose dominance and

market power are constantly growing. This development poses three major problems for EU policy makers:

**Problem 1:** High concentration and low competition in digital markets

Competition in digital service markets is not functioning well at present. This is due to significant economies of scale, and network effects. Digital markets are therefore often dominated by a small number of providers.

**Problem 2:** High digital dependency and threat to digital sovereignty

The dominance of multinational US digital service providers in European markets threatens the digital sovereignty of the EU. The EU is dependent on US digital service providers in more and more areas. Such dependence makes it difficult to enforce European values and rules.

**Problem 3:** Aggressive tax avoidance by multinational digital service providers

Multinational digital service providers often minimise their tax burden by artificially understating their tax assessment basis and/or shifting their profits to low-tax countries (*base erosion & profit shifting*, *BEPS*). Companies that minimise their tax burden in this way contribute very little to the financing of public infrastructure and other public assets, even though they benefit from them.

## OECD-Agreement: Implementation is Up in the Air and Faces Trade Conflicts

The first steps towards solving problem 1 have been taken. § Section 19a of the ARC and the Digital Markets Act (DMA) will curb the spread of market power of multinational digital companies. Measures have also been taken to address problems 2 and 3. For various reasons, however, they have not yet been able to improve the situation sufficiently. In 2015, the OECD and the G20 agreed on a 15-point program to tackle aggressive tax planning by multinational companies. However, this did not fully address the problem of tax avoidance that is specific to digital services. To address this issue, 137 countries agreed on a further two-pillar package of measures at OECD level in October 2021. However, high thresholds and political compromises limit the expected impact. Moreover, implementation is questionable, especially in the US. Europe is therefore well advised to develop its own instruments - also to strengthen its negotiating position in the face of geopolitical and trade conflicts. The CEP brings a closed tax system concept into the discussion. This is important because the traditional tax system is based on very 'industrialized' concepts of value creation, while digital value creation has in some cases created entirely new phenomena that cannot be adequately captured conceptually by traditional instruments.

## Concept: Proposal for a Synthetic Taxation[2]

The cep proposal is conceptually based on a decomposition of digital value creation added with the aim of tracing its creation back to its ultimate sources and then taxing them. A digital service and its business models are conceptually divided into three components: (i) the provision of software, (ii) access to the telecommunications network and (iii) user interaction (see Figure 2). In many cases, this is a two-way process: users are not only recipients of

[2] "Synthetic" refers to the interaction of the three proposed types of measure in formulating a holistic concept of the taxation of digital services.

information, but as 'prosumers' they also provide information, e.g. social media content, customer reviews, etc., which improves the quality of digital services, trains algorithms and AI, and thus increases the network effects of digital business models. We can therefore distinguish three types of sources of value based on which the major digital providers can create revenues:

- The **provision of software** as a **“**system service” (by digital service providers to other digital service providers; often intra-group).
- The **access to the digital infrastructure** as a “connectivity service” (by network operators to digital service providers and their users).
- The **interaction with users** as an “interaction service” (between digital service providers and their users).

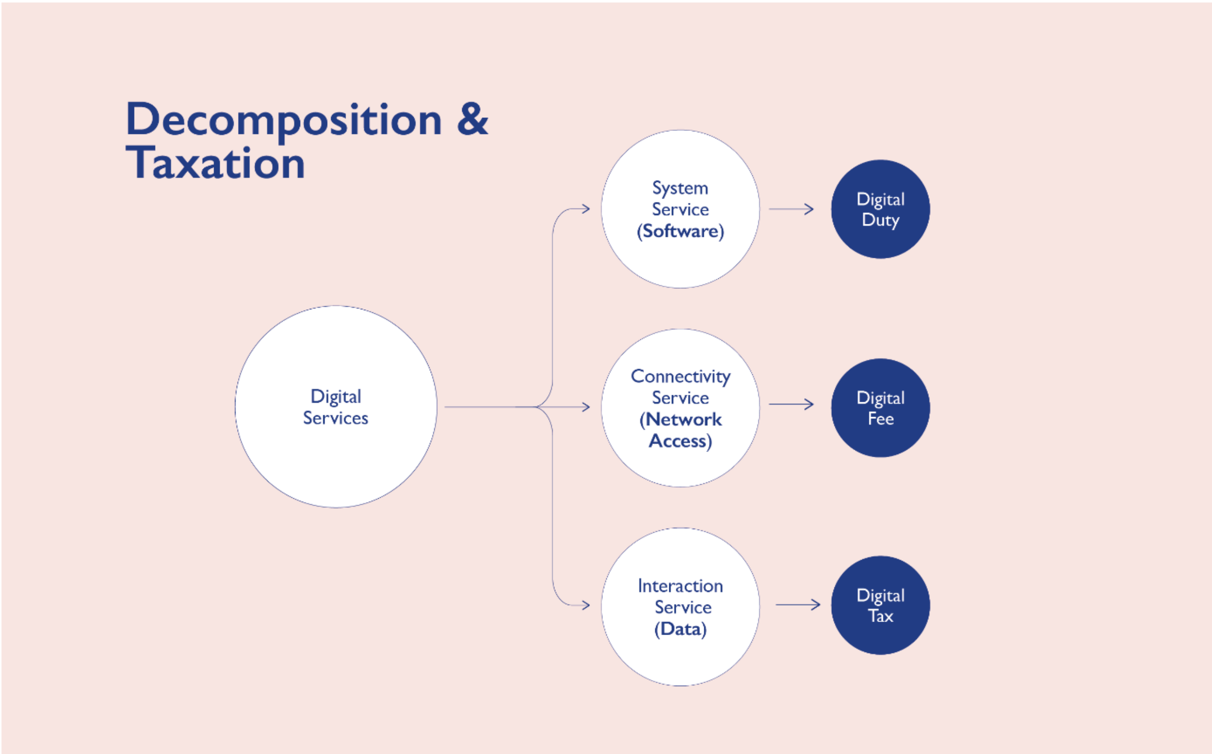
This breakdown produces three possible measures for taxing digital services:

- ▷ A **digital import duty on system software** (→ system service), i.e. on the cross-border transfer of ownership and usage rights to software, licences, etc. that implement the system service (“digital duty”).
- ▷ A **digital fee for network access** (→ connectivity service) according to the *sender pays*[3] principle (as envisaged by the EU Commission). The network access fee can be designed via auction procedures in such a way that digital rules are enforced in favour of greater digital sovereignty.
- ▷ A **digital sales tax** (→ interaction service) on revenues from users' value-added contribution to digital services (“digital tax” in accordance with the EU proposal; for two-sided markets, the national advertising revenue).

The central idea of this concept is to use existing instruments to create a kind of 'net' for the taxation of those parts of digital value added which are physically and territorially not or hardly attributable. It ensures that large multinational digital providers can no longer easily 'slip through' by means of BEPS practices. The single measures are explicitly not necessarily cumulative but complementary, i.e. they do not lead to unintended multiple taxation.

[3] I.e. the principle that infrastructure costs arising from data traffic are paid at least in part by content providers (as the main data-sending organisations).

**Figure 2: Decomposition and Taxation of Digital Services**




Source: own illustration

The use of revenues differs between the three measures. The digital import duty would flow into the EU budget as customs revenue and could be used to finance the structural investments needed for the transformation. The revenue from the digital network fee could be earmarked. For instance, it could be used to finance the expansion of digital networks. The revenue from the digital sales tax could be used freely. The specific design of the measures is important. Especially when taxing monopolies, passing on the tax could ultimately disadvantage consumers. Nevertheless, such 'countervailing duties' would redistribute some of the monopoly rents and tax losses currently accruing to the EU. When considering the segments 'Licences to reproduce and/or distribute computer software' and 'Computer software; software originals' from the OECD EBOPS statistics, relevant EU imports in 2019 (most recent data) amounted to 4.2 billion euros. At a tariff rate of 20%, this would imply a revenue potential from a digital import duty of around 800 million euros per year (not taking into account evasion effects). As not even all EU Member States report trade data in these segments, this would be a rather conservative estimate, even without considering evasion effects. In comparison, EU customs revenues in 2022 amounted to around 25 billion euros. The third measure overcomes the free-riding of multinational digital service providers in the financing of public goods and network infrastructures. In this respect, a digital network fee can fill a gap, especially for streaming services, which account for a significant share of data transfer.

## Pressure to Act: Why Action Must Be Taken Now

Time is of the essence. The global race for supremacy in future digital technologies, especially AI, has only just begun, but the EU already seems almost left behind. Trade conflicts will continue to worsen, making political agreement on common rules very unlikely. The EU's political and regulatory response must therefore ensure that it is on an equal footing with multinational digital service providers. Concrete solutions are needed to limit market power and create tax fairness in order to protect and strengthen Europe's innovation and digital sovereignty. There is an urgent need to tax multinational digital service providers for the following five reasons:

1. **A question of fairness:** The size of the European market makes it a key growth market for US digital companies. So far, this has not been matched by adequate tax revenues.
2. **A question of investment:** In the current situation, additional revenues would have a high future return for EU Member States: it is important to maintain competitiveness in emerging markets by resolutely promoting innovation and good location conditions, without burdening future generations.
3. **A question of competition:** The welfare effect of digital value added must be judged based on its coherence with societal values and preferences. More competition means more transparency and innovation. This is particularly true for the development of AI, which will rapidly become ever more important for digital value added.
4. **A question of trade policy:** By redirecting high returns from US digital companies to investments supporting own European digital exports, our measures contribute to a fairer, more resilient and more stable global trade in the long run.
5. **A question of sovereignty:** Technological sovereignty presupposes the ability to tailor the technology mix in the economy to one's own specific resource advantages (natural resources, human capital, knowledge). Dominant business models of foreign companies that reflect foreign technology paths should therefore be restricted in their development through taxation.