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**Research Report**

## From digital tax symbolism to meaningful reform: Europe's substantial VAT gap as a source of untapped fiscal capacity

ECIPE Occasional Paper, No. 03/2026

**Provided in Cooperation with:**

European Centre for International Political Economy (ECIPE), Brussels

*Suggested Citation:* Bauer, Matthias; Pandya, Dyuti (2026) : From digital tax symbolism to meaningful reform: Europe's substantial VAT gap as a source of untapped fiscal capacity, ECIPE Occasional Paper, No. 03/2026, European Centre for International Political Economy (ECIPE), Brussels

This Version is available at:

<https://hdl.handle.net/10419/339282>

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OCCASIONAL PAPER – No. 03/2026

# From Digital Tax Symbolism to Meaningful Reform:

## Europe's Substantial VAT Gap as a Source of Untapped Fiscal Capacity

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This is an independent report commissioned by the Computer & Communications Industry Association (CCIA Europe). The opinions offered herein are purely those of the author and do not necessarily represent the views of CCIA Europe.

<sup>1</sup> The authors are grateful to Adam Michel, Director of Tax Policy Studies at the Cato Institute, for his valuable comments and insights.

## **EXECUTIVE SUMMARY**

Europe does not suffer from a lack of tax instruments – it suffers from too many. Over the past decade, new layers of corporate, digital, and global tax rules have been added to an already complex system, often delivering limited revenues while increasing legal uncertainty, compliance costs, and economic distortions. We argue that stronger industrial competitiveness and sustainable public finances will not be achieved through new digital taxes or unilateral corporate tax initiatives, but by strengthening existing tax bases and improving the efficiency, simplicity and predictability of current frameworks.

The multilateral approach has delivered some tangible progress, notably by enhancing transparency through country-by-country reporting, even if the full effects of its implementation are still unfolding. That said, further OECD initiatives should be rejected if they risk adding additional layers of complexity without enhancing global coherence or legal certainty.

Alongside international coordination, the most promising path lies in domestic tax reform. Governments should prioritise simplification, transparency and the strengthening of broad-based consumption taxes, particularly VAT, which remain the backbone of European public finances. Well-designed domestic reforms can strengthen fiscal resilience, enhance industrial competitiveness by reducing economic distortions and compliance burdens, and enable countries to secure first-mover advantages in an increasingly competitive global environment.

### **A System Built on Complexity Layers, Not Reform**

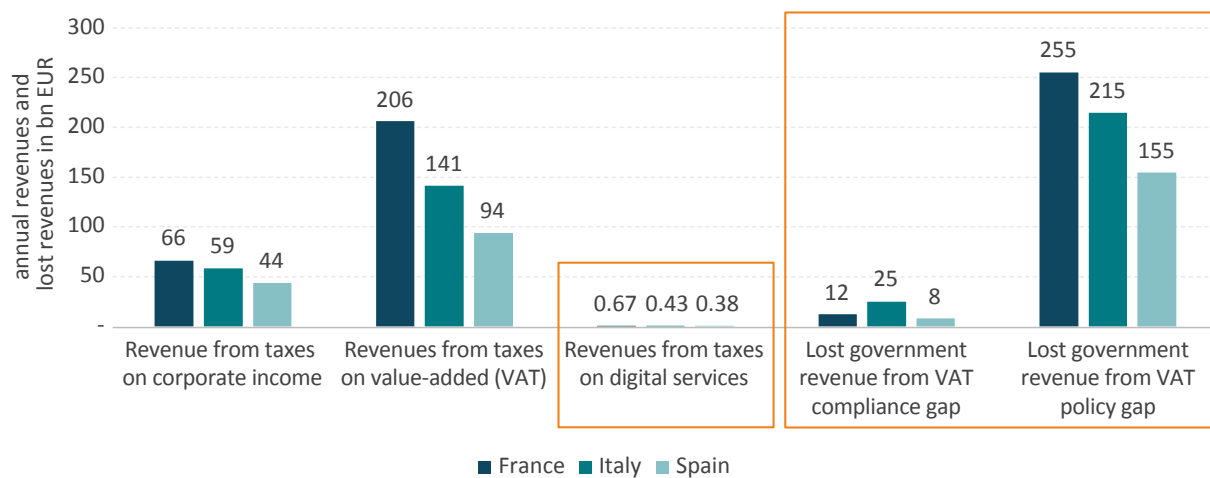
Over the past decade, reforms in corporate and digital taxation have largely followed a pattern of accumulation rather than replacement. Digital services taxes (DSTs), new nexus rules, and expanded reporting requirements have been introduced to address perceived fairness gaps. Yet each new initiative has added complexity without resolving the structural weaknesses of profit-based taxation. The system has become more fragmented, less transparent, and harder for firms and lawmakers alike to navigate. A central problem is that public debate often focuses on who formally pays a tax rather than who ultimately bears its cost. In practice, the burden of corporate and digital taxes is transmitted through prices, wages, and investment decisions. This weakens the case for highly visible, narrowly targeted measures that promise fairness but may create distortions and unintended side effects.

### **VAT as Europe's Real Fiscal Anchor**

The contrast in fiscal importance between different tax instruments is striking. For example, in France VAT generated around EUR 206 billion in revenue in 2023, more than three times the EUR 66 billion raised from corporate income taxes (CIT); while DSTs produced a mere 668 million. Italy and Spain display a similar pattern: VAT revenues of EUR 141 billion and EUR 94 billion respectively far exceed corporate tax receipts, while digital taxes remain negligible. Yet the most revealing figure is the unused revenue potential embedded in existing VAT systems. Estimated VAT policy gaps, largely reflecting reduced rates and exemptions, reach roughly EUR

255 billion in France, EUR 215 billion in Italy and EUR 155 billion in Spain. In other words, the fiscal capacity already sitting inside current VAT frameworks dwarfs both corporate tax revenues and the proceeds from politically contentious digital taxes. At a time when European governments are layering increasingly complex rules onto corporate taxation in pursuit of relatively modest revenue streams, the numbers suggest that Europe's real fiscal anchor, and its largest untapped source of revenue, lies in the far simpler and more stable architecture of consumption taxation.

**FIGURE 1: EUROPE'S UNTAPPED VAT POTENTIAL AND THE LIMITED REVENUES FROM COMPLICATED CORPORATE AND DIGITAL TAXES**



The evidence presented in this paper points to a clear structural reality: across Europe, VAT consistently generates more revenue, and does so more reliably, than corporate taxation. This pattern is particularly evident in countries such as France and Germany, which we examine later and which rely relatively little on CIT within their overall revenue mix. VAT is broad-based, comparatively stable across economic cycles, and already well adapted to the digital economy through destination-based taxation and integrated compliance mechanisms. Corporate taxation, by contrast, has become increasingly complex and volatile. It requires extensive administrative oversight, creates high compliance costs, and is sensitive to economic fluctuations and accounting structures. Its fiscal role, while still important, is often overstated relative to the effort required to maintain it. For reform-oriented governments seeking to strengthen investment, productivity, and industrial competitiveness, this imbalance should be a central consideration.

**Rethinking Reform Priorities**

The main implication is not that corporate taxation should be abolished overnight, but that the pursuit of ever more intricate methods of taxing corporate profits may prove counterproductive. Introducing new digital taxes, turnover-based levies or additional compliance frameworks that generate limited revenue risks exacerbating legal complexity and regulatory uncertainty for both taxpayers and tax administrations, without tackling the underlying structural challenges.

A far more effective reform agenda would focus on simplification and clarity. This includes strengthening VAT compliance, broadening the base, improving transparency around tax

incidence, and avoiding the proliferation of sector-specific tax instruments. Over time, some governments may even consider reducing reliance on corporate income taxation or shifting part of the fiscal burden toward more neutral and stable consumption-based systems.

### **A Tax Competitiveness Agenda for Europe**

Europe's tax systems have become increasingly complex and difficult to reform. Over time, dense legal frameworks, administrative routines, and entire advisory industries have formed around this complexity, creating strong inertia and making meaningful change politically challenging. At the same time, many of the technical details of modern corporate taxation are difficult to assess outside specialist circles, increasing the risk that policy is driven more by narratives than by economic reality.

High effective tax loads combined with heavy compliance requirements discourage investment, slow business expansion, and make it harder for firms to scale across borders. At a time when Western European economies face rising global competition and weak productivity growth, the cost of maintaining an overly complex tax environment is becoming increasingly visible. Simplification is therefore not a technical detail – it is an economic strategy. A more predictable and transparent tax system would lower compliance costs, strengthen investment incentives, and improve the overall business climate.

### **A Shift in Reform Priorities**

Taken together, the analysis points toward a reordering of priorities in EU and national tax policy. Rather than continuing to search for new ways to tax increasingly mobile and intangible profits, reform efforts could focus on

- Simplifying all existing tax structures
- Eliminating overlapping layers of corporate and digital taxation
- Strengthening compliance in broad-based consumption taxes
- Improving transparency regarding tax incidence and economic effects

The central message of this paper is not about reducing revenues. It is about recognising where Europe's fiscal strength already lies. Public finances depend far more on broad-based consumption taxes than on corporate profit taxation. Strengthening that foundation, rather than continuing to add new layers of corporate and digital taxes, offers a clearer path to a more competitive, investment-friendly, and resilient European economy.

## **ACRONYMS**

**BEPS** – Base Erosion and Profit Shifting

**CIT** – Corporate Income Tax

**CORE** - Corporate Resource for Europe

**DST** – Digital Services Tax

**DDTs** – Digital and Data Taxes

**ETR** – Effective Tax Rate

**IIR** – Income Inclusion Rule

**OECD** – Organisation for Economic Co-operation and Development

**PE** – Permanent Establishment

**QDMTP** - Qualified Domestic Minimum Top-up Tax

**SEP** – Significant Economic Preferences

**UTPR** - UTPR

**VAT** – Value Added Tax

**ViDA** – VAT in the Digital Age

**WHT** – Withholding Tax

# 1. INTRODUCTION: COMPLEXITIES SURROUNDING TAX REFORMS

The resurgence of Digital Services Taxes (DSTs) in Europe reflects political frustration with multinational taxation after the financial crisis. Following the financial market and sovereign crisis, public attention focused on high-profile cases of profit shifting by multinational firms, reinforcing the perception that established corporate tax rules were no longer aligned with modern patterns of value creation. Policymakers increasingly viewed digital business models as reflective of this mismatch, particularly because they generate significant cross-border revenues from users in a jurisdiction without a substantial physical presence under traditional tax rules.

However, such tax planning practices were not limited to digital firms. Multinational enterprises across a range of intellectual property (IP) intensive industries had long relied on similar strategies, legally shifting profits to low-tax jurisdictions through complex arrangements involving IP ownership and international subsidiaries.<sup>2</sup> Increased scrutiny of digital firms over time amplified public and political attention and created a strong impression that these companies were not paying their fair share of tax.<sup>3</sup>

Nevertheless, this characterisation is also misleading. All major technology companies operating digital platforms maintain substantial physical operations and economic presence within the jurisdictions in which they serve users and generate revenue. The core policy challenge therefore lay not in the complete absence of physical presence, but in the limitations of existing international tax rules, which attribute profits based primarily on legal and physical nexus rather than the location of users and market-based value creation.

These concerns translated into policy initiatives at the EU level, most notably the Commission's 2018 DST proposal. Although presented as an interim measure pending an international solution, its political symbolism quickly eclipsed its temporary character. As Member States could not agree unanimously in the Council, the proposal failed, and countries instead introduced their own national DSTs, leading to a fragmented landscape across Europe.<sup>4</sup>

Against the backdrop of the unresolved structural limitations of profit-based taxation, despite the OECD's Base Erosion and Profit Shifting (BEPS) reforms, and the implementation failures of Pillar One, many non-EU countries also began to introduce DST measures. With OECD Pillar

<sup>2</sup> However, while Pillar Two made some progress in limiting profit shifting by introducing a global minimum effective tax rate of 15%, it did not fully resolve the structural concerns that had motivated calls for Digital Services Taxes. Although the global minimum tax reduces incentives to shift profits to zero-tax jurisdictions, the relatively low minimum rate still allows multinational enterprises to benefit from locating profits in lower-tax jurisdictions compared to higher-tax market countries. Furthermore, Pillar Two ensures only that a minimum level of tax is paid somewhere, rather than reallocating taxing rights to the jurisdictions where users and markets are located. Various carve-outs, exemptions, and uneven implementation across countries further limit its effectiveness. As a result, while Pillar Two represents an important step in addressing base erosion and profit shifting, it does not fully resolve the perceived mismatch between the location of user-based value creation and the allocation of taxing rights, which policymakers have continued to cite as a justification for the introduction of DSTs. See: Cole, A. (2024). The Fatal Flaw of Pillar Two. Tax Foundation. Available at: <https://taxfoundation.org/blog/pillar-two-flaw/>

<sup>3</sup> Waka, H. (2014). The Double Irish and Dutch Sandwich tax strategies: Could a general anti-avoidance rule counteract the problems caused by the utilisation of these structures? Available at [https://openaccess.wgtn.ac.nz/articles/thesis/The\\_Double\\_Irish\\_and\\_Dutch\\_Sandwich\\_tax\\_strategies\\_Could\\_a\\_general\\_anti-avoidance\\_rule\\_counteract\\_the\\_problems\\_caused\\_by\\_the\\_utilisation\\_of\\_these\\_structures\\_/17006479](https://openaccess.wgtn.ac.nz/articles/thesis/The_Double_Irish_and_Dutch_Sandwich_tax_strategies_Could_a_general_anti-avoidance_rule_counteract_the_problems_caused_by_the_utilisation_of_these_structures_/17006479).

<sup>4</sup> European Parliament. (2019, April 15). Verbatim report of proceedings. Available at: [https://www.europarl.europa.eu/doceo/document/CRE-8-2019-04-15-ITM-021\\_EN.html](https://www.europarl.europa.eu/doceo/document/CRE-8-2019-04-15-ITM-021_EN.html).

One yet to evolve further, these developments have reinforced the return of DSTs to the centre of political debate.

At the same time, policymakers have signalled a willingness to resume multilateral negotiations under the OECD framework. Yet any future agreement is likely to depart significantly from the original design,<sup>5</sup> and there is still no clearly defined end point or credible timetable for implementation. This persistent uncertainty over how to tax the digitalised economy increases the likelihood that unilateral measures will endure. In that context, DSTs are likely to remain, at least temporarily, an alternative basis for taxation. Unlike profit-based taxes, they are generally levied on turnover and allocate taxing rights to jurisdictions where users or customers are located.

The underlying problem to the tax debate lies in the fundamental challenge of designing effective tax policies for the digital economy. International corporate taxation has long been built around the principle of physical presence within a country. However, the rise of digital business models has disrupted this logic, creating perceived gaps in the corporate income tax as a regulatory instrument.

One justification for DSTs is that existing consumption taxes were not designed to capture value created in the digital economy. Many digital business models rely on non-monetised exchanges, in which users receive "free" services in return for data and attention. Because these transactions do not involve explicit monetary payments, they fall outside conventional VAT and sales tax systems. Some proponents therefore argue that significant value creation remains untaxed and that DSTs can partially compensate for this perceived consumption tax gap.<sup>6</sup>

This justification is, however, misleading. Many of the concerns used to support DSTs, particularly those linked to digital advertising and data-driven business models, do not arise from shortcomings in consumption taxation. Most digital services are already covered by existing VAT systems, and non-monetised data collection does not represent a tax gap, as VAT is designed to apply to final monetary consumption rather than to intermediate or implicit exchanges. When properly designed, broad-based consumption taxes are neutral and non-discriminatory. They do not single out specific sectors and therefore do not require supplementation through targeted digital taxes.

Some policymakers have nevertheless argued that data-driven business models and digital advertising generate an "untaxed" form of consumption.<sup>7</sup> However, excluding non-monetised exchanges from the VAT base is necessary to prevent tax cascading across production and

<sup>5</sup> Vella, L. (2026, January 6). US Mulling Taxing Digital Economy After Global Minimum Tax Pact. BloombergTax. Available at: <https://news.bloomberglaw.com/tax-insights-and-commentary/assessment-needed-to-figure-out-taxing-digital-economy-us-says>; also see: Saeed, S. (2026). EU Sees Reopened OECD Digital Tax Talks Departing From Old Plan. Bloomberg Tax. Available at: <https://news.bloombergtax.com/daily-tax-report/eu-sees-reopened-oecd-digital-tax-talks-departing-from-old-plan>

<sup>6</sup> Kim, Y. R., & Shanske, D. (2022). State digital services taxes: A good and permissible idea (despite what you may have heard). *Notre Dame Law Review*, 98, 741–792 in Frieden, K. A., & Lindholm, L. D. (2023). State digital services taxes: A bad idea under any theory. *Tax Notes*. Available at: <https://www.taxnotes.com/special-reports/digital-economy/state-digital-services-taxes-bad-idea-under-any-theory/2023/04/07/7g9bc>.

<sup>7</sup> CMS. (2025, June 18). Italy's Tax Authorities Target 'Free' Online Services for VAT. Available at: <https://cms.law/en/ita/publication/italy-s-tax-authorities-target-free-online-services-for-vat>.

distribution stages. While the EU VAT Committee has expressed reservations about treating personal data as consideration for taxable supplies, the debate has resurfaced in discussions over whether large online platforms provide taxable services when users “pay” with data.

Attempts to expand the EU VAT base to solve perceived fairness problems in the digital economy risk weakening the system's neutrality and internal logic. DSTs are widely criticised because they target specific parts of complex production chains and distort who ultimately bears the tax. Similar problems arise if VAT were repurposed for comparable objectives. The key issue, therefore, is not just whether some forms of value appear to go untaxed, but whether existing tax tools are being stretched beyond the purposes they were designed to serve.

This paper argues that DSTs represent a misguided response to structural challenges in international taxation, and that a reformed, broad-based VAT offers a more coherent and sustainable alternative for EU Member States. Section 2 explains why Europe's current reliance on DSTs cannot deliver fiscal stability or support industrial competitiveness, examining their economic incidence, interaction with corporate taxation, and relationship with BEPS and Pillar Two. Section 3 develops an alternative, VAT-centred approach, highlighting the fiscal potential of VAT and the importance of addressing compliance gaps rather than redesigning its tax base. Section 4 concludes with policy recommendations focused on phasing out DSTs and reforming VAT in a broad-based, non-discriminatory, and consistent manner.

## **2. THE ECONOMICS OF SPECIAL TAXES ON DIGITAL SERVICES (DSTS)**

Unlike corporate income taxes (CIT), which are levied on net profits after the deduction of costs, DSTs, as pointed earlier, are imposed on gross revenues. This design places DSTs in an uneasy position between income and excise taxation. Since firms must pay DST irrespective of their underlying profitability, relatively low headline rates may generate disproportionately high effective tax burdens, especially in sectors characterised by high operating costs or narrow margins.

These design features contribute to the discriminatory character of DST regimes. Revenue thresholds restrict their application to large multinational firms,<sup>8</sup> excluding smaller firms engaged in similar activities. This selective coverage reinforces perceptions of unequal treatment and reflects a broader tendency to prioritise targeted revenue extraction over coherent and neutral tax policy. While progressive taxation and size-based differentiation are well-established principles, the thresholds embedded in DSTs are weakly connected to defensible policy objectives such as market power or economic rent.

DSTs have been justified through both consumption-gap and income-tax-gap rationales. While some commentators present DSTs as a form of consumption taxation targeting untaxed digital use (as pointed earlier), others frame them as a response to deficiencies in the international CIT

<sup>8</sup> Fano, A., and Stotzky, R. (2023). Taxation in the Digital Economy: Digital Services Taxes, Pillar One, and the Path Forward. Bipartisan Policy Centre. Available at: <https://bipartisanpolicy.org/article/taxation-in-the-digital-economy-digital-services-taxes-pillar-one-and-the-path-forward/>.

system. This dual justification reflects a broader conceptual ambiguity surrounding DSTs, which complicates their normative assessment.

The justification of the “income tax gap” approach, has also gained prominence within the EU. According to this view, national corporate tax systems, based on physical presence and source-based allocation rules, are poorly suited to digital business models.<sup>9</sup> Consequently, income generated in market jurisdictions may remain untaxed, strengthening the case for alternative forms of taxation. However, because DSTs are levied on gross revenues rather than profits, they do not directly address weaknesses in profit allocation. Instead, they impose uniform statutory rates that translate into uneven effective burdens across firms. For instance, a 3 per cent DST applied to a company with a 15 per cent profit margin implies an effective tax rate (ETR) of 20 per cent on profits, while the same levy corresponds to an effective rate of approximately 60 per cent for a firm with a 5 per cent margin.<sup>10</sup>

Under conventional CIT regimes, higher profit margins already lead to proportionately higher tax liabilities, as tax payments scale with profits at a constant rate. By contrast, under turnover-based taxes, identical statutory rates can generate sharply divergent effective burdens depending on firms’ cost structures and margins. As a result, markets characterised by a small number of very high-margin firms alongside a large number of low-margin competitors are likely to experience uneven and potentially distortive tax effects. Revenue-based taxation therefore risks penalising scale, entry, and growth among lower-margin firms rather than targeting economic rents, raising concerns about neutrality and competitive fairness.

These dynamics shift taxation away from profits and towards business models, which makes the system more complex and harder to apply consistently. In practice, it is increasingly difficult to draw a clear line between “digital” and “traditional” firms, as digital tools and services are now used across almost all sectors. Yet tax rules that try to single out digital activities create different treatment for companies engaged in very similar economic activities. This leads to a policy mix that is difficult to manage and explain. It weakens fairness, because tax burdens no longer clearly reflect a firm’s ability to pay. It reduces efficiency, because firms may be taxed differently depending on how their business is structured. And it adds administrative complexity, as overlapping national rules and definitions make compliance more costly and enforcement more uncertain.

These problems become even more visible in cross-border situations, where the same digital activity can be taxed in several countries at once. Different EU Member States have introduced their own DSTs, each with their own rules, definitions, and scope, which increases complexity for firms operating across borders.<sup>11</sup> For example, an online platform headquartered in one country may sell advertising space to a company in Germany, based on data generated by users in France and Italy. Each of these countries may claim taxing rights over the same revenue under their national DST rules, depending on how they define user location or taxable digital services.

<sup>9</sup> Frieden, K. A., & Do, S. T. (2021, May 10). State adoption of European DSTs: Misguided and unnecessary. *Tax Notes State*, 100(6), 581–590.

<sup>10</sup> Kennedy, J. (2019). Digital Services Taxes: A Bad Idea Whose Time Should Never Come. ITIF. Available at: <https://itif.org/publications/2019/05/13/digital-services-taxes-bad-idea-whose-time-should-never-come/>

<sup>11</sup> Enache, C. (2024). Digital Taxation around the World. Tax Foundation. Available at: <https://taxfoundation.org/research/all/global/digital-taxation/>.

The complexity increases further because DSTs are usually added on top of CIT rather than replacing it. In this situation, the company may still pay corporate tax where it is legally established, while also facing DST charges in several countries where its users are located. Without international coordination, countries apply different criteria to determine what counts as a taxable digital service and where the underlying value is created. This makes it more likely that the same revenue will be taxed multiple times, leading to overlapping tax claims and a real risk of double taxation on the same economic activity.

Empirical research indicates that DSTs often fail to achieve their stated objective of taxing large digital firms, as the economic burden is largely passed on to consumers and third-party sellers through higher prices and increased platform fees. This pass-through raises concerns about the equity of DSTs, as higher consumer costs erode the affordability and cost advantages typically associated with digital platforms.<sup>12</sup> DSTs typically single out "general-purpose" digital business models that operate across sectors and are used extensively in B2B markets, meaning that they affect far more than the large consumer-facing platforms they are politically associated with.

These structural weaknesses become even more pronounced once implementation and enforcement challenges are considered. A number of implementation challenges further amplify these effects:

- Identifying the location of "user value" across borders is technically uncertain and often inconsistent with privacy regulations such as the European Union Agency for Fundamental Rights' (FRA) General Data Protection Regulation (GDPR).
- Divergent national definitions increase compliance costs.
- DSTs are generally designed to fall outside the scope of double taxation treaties, meaning and Article 7 of the OECD Model Tax Convention would not apply. However, non-discrimination clauses may still operate independently.<sup>13</sup>
- The United States Trade Representative (USTR) initiated investigations under Section 301 of the Trade Act against several countries that introduced DSTs. Most of these investigations were later suspended or terminated following agreements in which those countries committed to withdraw or replace their unilateral DSTs as part of the OECD/G20 Inclusive Framework's global tax reform.

Since 2019, around 30 countries have implemented DSTs, with several others having proposals to do so. However these initiatives have been delayed, modified, or rescinded following trade tensions and tariff threats from the US (explained further below). The DST rates range from 1.5 per

<sup>12</sup> Langenmayr, D., & Muddasani, R. R. (2025, June 12). Navigating the Amazon: The incidence of digital service taxes. CESifo Working Paper.

<sup>13</sup> For instance, under the France-Ireland tax treaty, Irish-resident companies and their French subsidiaries may argue that the DST disproportionately affects foreign multinational enterprises while exempting most domestic firms. Such companies could challenge the tax on the basis that it constitutes discrimination based on nationality or foreign ownership, contrary to treaty non-discrimination provisions. This illustrates the broader tension between unilateral DSTs and the established international tax treaty framework. As most European DSTs apply similar revenue thresholds and target comparable digital services, they may raise equivalent concerns under bilateral tax treaties with the jurisdictions in which affected companies are resident, particularly given the largely uniform wording of non-discrimination clauses across treaties based on the OECD Model Convention. See: IELP. (2020). Digital Services Taxes Do They Comply with Tax and Trade Agreements and EU Law? Submitted to Tax Foundation. Available at: <https://files.taxfoundation.org/20200529172500/Trade-Lab-and-Georgetown-Law-A-Legal-Analysis-of-DSTs-Final-Draft-Additional-Footnotes-Added1.pdf>

cent to 8 per cent. These regimes vary widely in scope and legal framing, creating discriminatory effects across similar activities and firms.

In September 2025, the Constitutional Council of France upheld the legality of France's DST in a challenge brought by Digital Classifieds France.<sup>14</sup> The Council held that the absence of progressivity in the tax is not contrary to constitutional principles, and that it is irrelevant whether the online services concerned are also subject to CIT, since the DST is based on turnover rather than profits. Importantly, this ruling was grounded in constitutional interpretation rather than an assessment of the tax's economic efficiency or distributive effects. Given that the principles of equality in French constitution and the EU law are aligned, this decision may have an indirect influence on DSTs in other Member States.

For the countries where data are available, the relative fiscal significance of DSTs remains low when compared with CIT revenues and total national tax revenues (Annex I). Due to differences in reporting, the figures are constructed using the latest available year for each variable. The resulting ratios therefore represent the most recent available observations.

- Austria – DST revenues amount to 0.67 per cent of CIT revenues and 0.05 per cent of total national tax revenue.
- France – DST revenues equal 1.01 per cent of CIT revenues and 0.05 per cent of total national tax revenue.
- Italy – DST revenues correspond to 0.74 per cent of CIT revenues and 0.05 per cent of total national tax revenue.
- Spain – DST revenues represent 0.86 per cent of CIT revenues and 0.07 per cent of total national tax revenue.
- Switzerland – DST revenues amount to 2.74 per cent of CIT revenues and 0.35 per cent of total national tax revenue, the highest relative share in the sample. Although Switzerland does not apply a standalone DST, it has introduced a 4 per cent levy on digital streaming services as part of its streaming tax framework. Given that the measure targets digital service revenues, it is included here as a functionally comparable DST-type instrument. The levy is expected to generate approximately CHF 2.5 million.
- Turkey – DST revenues correspond to 1.98 per cent of CIT revenues and 0.25 per cent of total national tax revenue.
- United Kingdom – DST revenues equal 0.98 per cent of CIT revenues and 0.09 per cent of total national tax revenue.

Overall, DST revenues remain fiscally modest. In most jurisdictions, they account for less than 1 per cent of CIT receipts. While Switzerland (2.74 per cent) and Turkey (1.98 per cent) represent relative outliers within the sample, and France (1.01 per cent) is a slight outlier, even in these cases DST revenues amount to only 0.35 per cent, 0.25 per cent and 0.05 per cent of total national tax revenues, respectively. Across all countries examined, DST receipts remain well below 1 per cent

<sup>14</sup> Cosnard, D., and Piquard, A. (2025, September 12). French Constitutional Council upholds Gafa tax. Le Monde. Available at [https://www.lemonde.fr/en/politics/article/2025/09/12/french-constitutional-council-upholds-gafa-tax\\_6745338\\_5.html](https://www.lemonde.fr/en/politics/article/2025/09/12/french-constitutional-council-upholds-gafa-tax_6745338_5.html).

of aggregate tax revenues. These figures suggest that, notwithstanding cross-country variation, DSTs make only a limited contribution to overall public finances. The political prominence of these measures therefore appears disproportionate to their fiscal significance.

The US administration has consistently opposed DSTs, viewing them as discriminatory measures that disproportionately target US based digital firms. This opposition became particularly pronounced during the first Trump administration, when DSTs were subjected to heightened scrutiny through trade investigations and diplomatic pressure. Since then, US resistance has continued to shape outcomes at both the international and bilateral levels. This pressure is reflected in a number of recent trade agreements, in which partner countries have committed not to introduce such taxes.

A number of bilateral trade agreements, including those concluded with Argentina, Bangladesh, Cambodia, Ecuador, El Salvador, Guatemala, Indonesia, Malaysia, Switzerland and Liechtenstein, and Thailand, contain uniform provisions in which the parties commit to avoiding the introduction of DSTs that would discriminate against US firms. At the same time, several governments have postponed, suspended, or reversed previously proposed or enacted DST measures. Several countries have since reconsidered their unilateral digital taxation measures. Canada has halted its collection of DST revenues and will repeal the 3 per cent DST through a legislation under Budget 2025 (Bill C-15), France has refrained from increasing its rate to 6 per cent, India has repealed its 2 per cent equalisation levy on e-commerce services and then repealed the 6 per cent equalisation levy, on online advertising services, and New Zealand has suspended its plans to introduce a similar regime.<sup>15</sup>

## **2.1 Emerging Forms of Digital and Transaction-Based Taxation**

Some governments have also explored a range of unconventional fiscal instruments aimed at capturing revenue from the digital and financial economy. An overall lack of consistency in how jurisdictions define and target taxable digital activity has complicated both the design and objectives of DSTs and DST like measures (Table 1). These measures include internet data-traffic levies, tariffs on digital services, financial transaction taxes, and mandatory payments to content creators. Although they differ significantly in design and economic impact, they share a common political logic of targeting perceived "winners" of globalisation.

Among these initiatives were internet-usage and data-traffic taxes – often labelled "bit taxes" – which attempted to monetise online activity itself rather than the profits generated from it. Proposed in countries such as Hungary, they were framed as pragmatic tools to finance telecommunications infrastructure or plug fiscal gaps. In practice, however, they were widely

<sup>15</sup> Canada Department of Finance. (2025, June 29). Canada rescinds digital services tax to advance broader trade negotiations with the United States. Available at: <https://www.canada.ca/en/departement-finance/news/2025/06/canada-rescinds-digital-services-tax-to-advance-broader-trade-negotiations-with-the-united-states.html>; VATCalc. (2025, November 5). France government to strike down proposed DST rise to 6%. <https://www.vatcalc.com/france/france-dst-rise-to-6-proposal/>; VATCalc. (2025, May 21). NFTC. (2025, April 1). NFTC Welcomes India's Removal of Discriminatory Digital Ads Tax. NFTC. Available at: <https://www.nftc.org/nftc-welcomes-indias-removal-of-discriminatory-digital-ads-tax/>; New Zealand withdraws 3% digital services tax bill. Available at: <https://www.vatcalc.com/new-zealand/new-zealand-3-digital-services-tax-2025/>.

criticised as blunt and distortive measures that risked penalising basic connectivity and innovation. Following strong public backlash and concerns over their broader economic impact, the proposal was ultimately abandoned.

### **Fragmentation through New Platform-Based Levies**

Despite these shortcomings, governments have not abandoned efforts to develop new forms of digital taxation. Instead, policy approaches have increasingly diverged. Australia's evolving News Media Bargaining Code and proposed News Bargaining Incentive<sup>16</sup> impose a financial charge on large digital platforms that fail to enter commercial deals with news publishers, with penalty rates in a similar range to typical DSTs.

While the government frames this as a mechanism to support a sustainable news sector rather than as a tax, critics argue the approach resembles a turnover levy and may incentivise platforms to restrict news content rather than pay.<sup>17</sup> The Code likely results in uneven benefits across publishers, lending credence to concerns that larger media organisations may capture most of the financial gains, while small and independent outlets may benefit less. Poland has similarly indicated their intention to explore new DST regimes, through a new 3 per cent DST proposal which will tax targeted advertisements, multilateral digital interfaces and monetisation of user data.<sup>18</sup> A comparable pattern of fragmentation is evident in Latin America, where countries continue to experiment with distinct and uncoordinated digital tax measures.

### **Expanding Tax Nexus – SEP and Virtual Permanent Establishment**

Simultaneously, policymakers are continuing to explore digital or virtual Permanent Establishment (PE) rules and other nexus adjustments to bring remote, not because digital business models fall outside the existing tax framework, but because some policymakers are dissatisfied with how current rules allocate taxing rights among jurisdictions. This represents a shift from the traditional notion of physical presence to a concept of significant economic presence (SEP) or user-based nexus, under which profits may be allocated to jurisdictions based on digital user engagement, data collection, or market participation.

SEP frameworks broaden the definition of taxable nexus beyond physical presence, tying profit allocation more closely to the location of users or consumers. In doing so, they shift taxation rights away from payment locations and physical assets toward jurisdictions where user activity is deemed to contribute to value creation. Efforts to build regional consensus on the reallocation of taxing rights have coexisted with unilateral measures.

<sup>16</sup> Under the proposed model, digital platforms generating more than A\$250 million in annual revenue from search or social media services in Australia would be subject to a levy of 2.25 per cent on that revenue. See: The Treasury (Commonwealth of Australia). (2025). Implementation of the News Bargaining Incentive: Consultation paper (Consultation paper). Commonwealth of Australia. Available at: [https://storage.googleapis.com/files-au-treasury/treasury/p/prj38f28c23f2accd6993e91/page/c2025\\_718159.pdf](https://storage.googleapis.com/files-au-treasury/treasury/p/prj38f28c23f2accd6993e91/page/c2025_718159.pdf).

<sup>17</sup> Caballero, L. (2025, November 13). Labor's news bargaining incentive looks a lot like a digital services tax. Will Trump notice? TheConversation. Available at: <https://theconversation.com/labors-news-bargaining-incentive-looks-a-lot-like-a-digital-services-tax-will-trump-notice-269703>

<sup>18</sup> Enache, C. (2026). Poland Considering a Second Harmful Digital Tax. Tax Foundation. Available at: <https://taxfoundation.org/blog/poland-digital-tax/>; also see: Wanat, Z., Krasuski, & Kowalcze, K. (2026, February 2). US companies blast Polish ministry's digital services tax plan. Bloomberg. Available at: <https://www.bloomberg.com/news/articles/2026-02-02/us-companies-blast-polish-ministry-s-digital-services-tax-plan>.

India, for instance, introduced SEP thresholds for non-residents, based on revenue or user count effective from April 2022. Similarly, Colombia's 2024 tax reform established an SEP rule under which non-resident digital businesses are subject to a 10 per cent withholding tax on gross income, or alternatively, may opt for a 3 per cent tax on gross revenues. Nigeria also implemented SEP provisions and a 6 per cent levy on the turnover of non-resident providers offering streaming, data transmission, and other digital services to Nigerian users.<sup>19</sup>

The African Tax Administration Forum (AFTF) has encouraged its members to consider temporary solutions pending a global agreement. Kenya replaced its 1.5 per cent DST with a SEP regime in December 2024, while other African countries have introduced taxes on digital services provided by non-resident firms through a variety of instruments and rates, including turnover taxes, corporate income taxation, and withholding taxes. Recent activity (again both unilateral and multilateral) has increased the scope for royalties' taxation to include digital services. This has been done by explicitly expanding the definition of royalties to, in some cases, include payments for software.<sup>20</sup>

### **Withholding Taxes as Interim CIT Proxies**

Meanwhile, several jurisdictions, particularly developing countries, have introduced gross-based withholding taxes (WHT) on digital services as an interim measure, a proxy for CIT that bypasses the complex task of defining and administering virtual PEs. Given that they apply regardless of the business size, these measures can cause double taxation and trade tensions when they overlap with other unilateral or multilateral tax rules.

For example, Slovakia levies a 5 per cent WHT on payments made to foreign digital platforms facilitating transport and accommodation services within its territory when such platforms are not registered as a PE. Taiwan imposes withholding on payments to foreign providers of online advertisements and electronic services such as games, video and audio streaming, and online platforms, while Türkiye applies a 15 per cent WHT on online advertising payments made to both resident and non-resident service providers in addition to a DST which was originally levied at 7.5 per cent and was reduced to 5 per cent from 1 January 2026 and will further be reduced to 2.5 per cent from 1 January 2027, while continuing to operate alongside the WHT.<sup>21</sup> Uganda

<sup>19</sup> Ernst & Young. (2021, May 11). India issues thresholds for triggering "significant economic presence" in India. EY Tax News. Available at: <https://taxnews.ey.com/news/2021-0943-india-issues-thresholds-for-triggering-significant-economic-presence-in-india>; VATUpdate. (2025, August 27). Colombia's SEP framework: A modern alternative to digital services tax. Available at: <https://www.vatupdate.com/2025/08/27/colombias-sep-framework-a-modern-alternative-to-digital-services-tax/>; Onu, E. (2022, January 6). Nigeria introduces tax on foreign digital-services companies. Bloomberg Tax. Available at: <https://news.bloombergtax.com/daily-tax-report/nigeria-introduces-tax-on-foreign-digital-services-companies>.

<sup>20</sup> KPMG LLP. (2025). Taxation of the digitalized economy: Developments summary. Available at: <https://kpmg.com/kpmg-us/content/dam/kpmg/pdf/2023/digitalized-economy-taxation-developments-summary.pdf>; <https://taxfoundation.org/research/all/global/digital-taxation/>; Enache, C. (2024). Digital Taxation around the World. Tax Foundation. Available at: <https://taxfoundation.org/research/all/global/digital-taxation/>; It should be noted that, in some cases, e-transaction taxes and sector-specific levies have also been characterised as forms of digital services taxes, as in Indonesia's case. Similarly, taxes or levies on digital streaming and online content are often framed as cultural surcharges, commonly referred to as "Netflix taxes", and are frequently grouped within the broader category of digital taxation. However, the classification of such measures as DSTs remains contested and open to debate. See: Tazeem, M. and Christians, A. What are Digital Services Taxes, and What Aren't Digital Services Taxes? CTFCF. Available at: [https://www.ctf.ca/EN/EN/Newsletters/Blogs\\_and\\_Reports/Digital\\_Services\\_Updates/Entries/Entry03.aspx](https://www.ctf.ca/EN/EN/Newsletters/Blogs_and_Reports/Digital_Services_Updates/Entries/Entry03.aspx).

<sup>21</sup> EY. (2026, January 6). Türkiye revises Digital Service Tax rate for 2026 and 2027. Available at: <https://taxnews.ey.com/news/2026-0117-turkiye-revises-digital-service-tax-rate-for-2026-and-2027>

modified its existing DST in 2025 by introducing a 15 per cent WHT on certain related-party digital transactions, while retaining the DST for other cases.<sup>22</sup>

Comparable developments are also visible in the US at the state level, the South Dakota v. Wayfair decision expanded states' ability to tax businesses based on economic nexus rather than physical presence. In Chicago, the personal property lease tax was increased to 11 per cent and expanded to include intangible property such as software-as-a-service (SaaS) and cloud-based software, which had previously been exempt from Illinois sales tax. More recently, as part of its FY2026 budget, Chicago adopted a new tax on social media companies, effective January 1, 2026, imposing a charge of \$0.50 per month for each Chicago user in excess of 100,000.<sup>23</sup> Maryland has also enacted a 3 per cent sales tax on specific technology services, including data processing, software publishing, and web hosting, while eliminating the exemption for SaaS used for commercial purposes.<sup>24</sup>

The momentum has not reduced the appetite for introducing additional measures in the EU either. In 2021, the European Commission proposed an EU-wide digital levy, which could have taken the form of a CIT top-up, a tax on revenues generated by specific digital activities within the Union, or a levy on business-to-business digital transactions. Although this initiative was not pursued at the time, renewed attention to EU-level revenue sources following the Covid-19 pandemic and the resulting debt obligations revived interest in turnover-based taxation.

This process culminated in proposals such as the Corporate Resource for Europe (CORE), a revenue-based charge on companies with annual turnover exceeding EUR 100 million.<sup>25</sup> Although presented as a "contribution," CORE would in practice operate as the EU's first genuine tax, established under Article 311(4) TFEU, collected by Member States, and transferred directly to the EU budget. Like DSTs, CORE reflects the Union's continued reliance on symbolic turnover taxation. Its economic drawbacks mirror those associated with DST regimes, including the disproportionate burden imposed on low-margin firms, the risk of international trade disputes, increased compliance costs, and tensions with broader objectives of promoting investment and industrial competitiveness.

<sup>22</sup> Tazeem, M. and Christians, supra 21; in practice, the debate on digital taxation has led many countries to extend existing tax rules to digital business models. This has occurred across both consumption taxes and CIT, alongside efforts to adapt permanent establishment (PE) concepts. This means that if one country adopts a digital PE definition unilaterally, without coordination or corresponding relief mechanisms, double taxation may arise. In such a case, the same profits are taxed more than once, not because tax rates exceed 100 per cent, but because taxing rights overlap, resulting in an effective double (or multiple) taxation of the same income.

<sup>23</sup> Eversheds Sutherland. (2025, December 22). Singing the blues: Chicago's proposed social media tax, other tax increases. Available at: <https://www.eversheds-sutherland.com/en/estonia/insights/singing-the-blues-chicagos-proposed-social-media-tax-other-tax-increases>

<sup>24</sup> Tazeem, M. and Christians, supra 21

<sup>25</sup> Sorgi, G. (2025, July 11). Victory for Trump as EU backs down on digital taxes in next budget. Politico. Available at <https://www.politico.eu/article/victory-eu-donald-trump-meta-tax-digital/>.

TABLE 1: DIFFERENT DIGITAL TAXATION MEASURES

Category	Enacted Measure Type	What it Is	Jurisdictions (Enacted) (among others)
Direct Revenue Taxes	Digital Services Tax (DST)	A tax on <b>gross revenues</b> from specific digital activities like advertising, marketplaces, and user data.	Argentina, Austria, Canada, Ethiopia, France, Italy, Nepal, Rwanda, Sierra Leone, Spain, Tanzania, Tunisia, Türkiye, Uganda, United Kingdom
Nexus-Based Income Taxes	Significant Economic Presence (SEP) / Digital PE <sup>26</sup>	Allows taxation of a non-resident's <b>income</b> based on digital interaction (users/revenue thresholds) regardless of physical presence.	Colombia, India, Israel, Kenya, Nepal, Nigeria, Vietnam
Transaction Withholding	Withholding Tax (WHT)	A tax <b>withheld at the source</b> on payments for digital services like advertising, content creation, or e-commerce.	Bangladesh, India, Kenya, Malaysia, Mexico, Pakistan, Slovakia, Taiwan, Tanzania, Tunisia, Türkiye, Vietnam
Specialised Digital Duties	Digital Transaction Duty / Fee	A duty triggered by <b>digital records or documents</b> for transactions like loans, leases, subscriptions, and IP licenses.	Greece
Financial Levies	Electronic Money Transfer Levy (EMTL)	A fixed levy applied to <b>electronic receipts or transfers</b> above a certain amount.	Nigeria
Special Solidarity Taxes	PAIS Tax	A temporary tax on the acquisition of foreign currency for purchasing goods/services from non-residents, with a <b>discounted rate (8%)</b> for digital services.	Argentina
Sector-Specific Levies	Streaming & Cultural Levies	Charges on streaming revenues to support <b>domestic broadcasting</b> or filmmaking industries.	Canada (Streaming Tax), Denmark (Cultural Contribution Levy), Ecuador (Single Income Tax on sports betting), France (Recorded music tax), Portugal (Audiovisual levies)
Gambling & Betting Taxes	Digital Gambling/ Betting Tax	Specialized taxes on <b>online bets</b> , sports betting, or offshore gambling profits.	Argentina, Ecuador, New Zealand, Peru, Zambia
Excise Taxes	Excise Duty on Digital Activity	Applied to specific digital products, such as <b>video games</b> with certain content or <b>excisable services</b> provided via internet.	Kenya, Mexico
Consumption Taxes	VAT / GST (Non-resident)	Over 100 jurisdictions require non-residents to register and collect tax on <b>cross-border B2C</b> digital sales.	Global (e.g., EU, Australia, Japan, South Africa, Mexico, Canada)
Local Digital Taxes	Municipal/State Digital Taxes	Taxes applied by sub-national governments, such as on <b>delivery apps</b> or digital lodging.	Argentina (Buenos Aires), Mexico (Mexico City, Veracruz)

Source: KPMG

<sup>26</sup> Although SEP and Digital PE rules are intended to enable net-basis taxation of business profits, in practice some regimes rely on simplified attribution methods or revenue-based proxies, resulting in outcomes that resemble gross-basis DSTs.

## 2.2 The Incidence of DSTs and Taxes on Corporate Income

Public debates about taxation often focus on who formally remits the tax rather than on who ultimately bears its economic cost. This distinction between legal incidence (who pays the tax to government) and economic incidence (whose real income is reduced once prices, wages, and investment adjust) is fundamental, yet frequently overlooked. Political narratives tend to frame new taxes in terms of redistribution and the targeting of perceived economic “villains”, placing emphasis on visible taxpayers rather than on the broader adjustment mechanisms through which costs are passed on. As a result, the burden may fall partly on consumers through higher prices, on workers through lower wages, or on investors through reduced returns.

By neglecting these dynamics, policy debates risk becoming overly symbolic and distributive in tone, rather than grounded in economic reality. Designing taxes around the identity of the payer instead of the incidence results in poorly targeted measures, unintended side effects, and distorted incentives. A more consistent focus on how tax burdens are actually transmitted through the economy would help move the discussion away from politically convenient narratives and towards more effective and economically coherent policy design.

The central difficulty with DSTs and DST-like measures lies in their economic incidence, which is almost always ignored or played down in public debate despite being the most policy-relevant question. Discussions tend to focus on who is seen to remit the tax, reinforcing narratives about targeting large multinational firms and redistributing income from perceived economic “winners”. In doing so, they divert attention from the more consequential issue of who ultimately bears the cost once prices, wages, and investment adjust.

One strand of the literature holds that such taxes function as levies on economic rents, implying that the burden falls primarily on the owners of large multinational enterprises. An alternative perspective characterises DSTs as de facto tariffs on cross-border digital services, selectively targeting foreign suppliers and resulting in higher prices for domestic consumers and business users. Which outcome dominates is an empirical question shaped by market structure, legal institutions (such as labour and contract law), competitive conditions, and demand elasticities.

In practice, however, evidence suggests that a significant share of the tax burden is passed through to consumers, business users, and third-party sellers, rather than being absorbed entirely by firm owners.<sup>27</sup> While DSTs are widely criticised for their economic distortions, the broader concern is that similar ambiguity and ad hoc design increasingly characterise other digital tax instruments as well. This blurs the distinction between different forms of digital taxation and compounds uncertainty across the tax system.

<sup>27</sup> Michel, A. N. (2025, November 20). Foreign digital services taxes are bad, but the alternatives are worse. Liberty Taxed: A Blog on US Tax Policy. Available at: <https://adamnmichel.substack.com/p/foreign-digital-services-taxes-are>; Sales Tax Institute. (2025, November 25). The expanding digital tax net – How states are taxing digital goods and services in 2025. Available at: <https://www.salestaxinstitute.com/resources/expanding-digital-tax-net-digital-goods-services-2025/>

## Legal vs. Economic Incidence

Public debate often conflates the legal payer of a tax with its economic bearer. Economists draw a crucial distinction: legal incidence identifies who remits the tax to government, while economic incidence identifies whose real income declines once prices, wages, and investment adjust. In reality, the burden rarely falls where lawmakers intend. For corporate and digital taxes alike, the key variables determining incidence are:

- **Elasticity of supply and demand** - more inelastic factors bear heavier burdens;
- **Market structure** - concentrated sectors allow easier price pass-through;
- **Capital mobility** - highly mobile capital can avoid taxation by relocating;
- **Labour bargaining power** - weaker labour markets shift burdens onto wages.

Understanding these mechanisms helps explain why selective, turnover-based DSTs applied to highly mobile and borderless sectors can be especially distortionary. Much of the problem stems from a persistent confusion about what "tax fairness" actually means in practice. In EU tax debates, fairness is often understood as stricter enforcement against multinationals or stronger coordination among Member States to reduce tax avoidance. These are important goals in a legal sense, but they are not the same as economic fairness, which asks a simpler question: who really ends up paying once the effects spread through prices, wages, and investment.

This distinction is rarely made clearly. As a result, a tax can look fair on paper because it targets large firms, but in reality it may place part of the burden on consumers, smaller businesses, or workers. Turnover-based taxes in particular make this more likely, as companies often respond by adjusting prices or passing costs along the value chain. If incidence is not taken into account, policymakers focus on who is supposed to pay in law rather than who actually pays in practice.

## Corporate Tax Incidence: What the Evidence Shows

Empirical research shows that corporate-tax burdens are shared between shareholders, workers, and consumers, a logic that applies equally to DSTs.<sup>28</sup> These distributional effects raise concerns when specific demographic or income groups are disproportionately affected, and cast doubt on the reliability of CIT and DSTs as major revenue instruments. Although DSTs were introduced to fill gaps in CIT, by ensuring that firms contribute fairly to government revenues by taxing income where services are sold, the economic incidence of both instruments is far from straightforward.

DSTs were originally justified on the premise that digital companies should be taxed "where value is created". Yet under international tax rules, foreign firms become subject to CIT only when they establish a permanent establishment (PE). Where DSTs and CIT now coexist, this creates overlapping and in some cases double taxation risks that further complicate the incidence picture.

<sup>28</sup> Durante, A. (2021). Who Bears the Burden of Corporation Taxation? A Review of Recent Evidence. Tax Foundation. Available at: <https://taxfoundation.org/blog/who-bears-burden-corporate-tax/>. Also see: Toder, E. (2025). The Incidence of the Corporate Tax. Tax Policy Centre. Available at <https://taxpolicycenter.org/journal-articles/incidence-corporate-tax>.

## From Firms to Families – How Corporate Taxes Burden Workers and Consumers

Studies using German firm-level data find that workers face diminished wage growth following increases in corporate taxes.<sup>29</sup> Further, vulnerable labour groups may disproportionately bear the burden of corporate taxes. Women and younger employees are more likely to experience lower wage growth and higher opportunity costs to labour.<sup>30</sup> Industry differences also matter. Goods-producing firms tend to raise investment after-tax returns which boosts productivity and leads to higher wages, as workers are paid in line with their productivity.

Service-sector firms, by contrast, may return a larger share of earnings to investors through dividends, reallocating capital toward more productive uses also benefiting workers with new jobs and higher wages.<sup>31</sup> Examined holistically, this suggests that while both capital owners and workers bear the burden of corporate taxation, a substantial share does fall on wage earners through lower wages, with relative impact often greater for lower income groups, particularly women and younger workers.

### Passing the Cost Downstream

By now we know turnover taxes selectively target turnover rather than profit, magnifying their impact on margins and pricing decisions. Evidence from early adopters shows that companies typically pass DST costs down the value chain:

- Online retailer Amazon responded to the UK's 2 per cent DST by raising fees for third-party sellers, disproportionately affecting SMEs.<sup>32</sup>
- Apple app store increased app and in-app purchase prices in both the UK and France to offset DST costs, passing them directly to consumers.<sup>33</sup>
- Google advertisement raised advertising prices, indirectly increasing costs for SMEs and consumers.<sup>34</sup>

DSTs are therefore not borne primarily by large digital companies, at least not in the way public narratives suggest. Instead, the burden is spread across smaller businesses, consumers, and workers in downstream sectors. This regressive pattern is particularly problematic for SMEs that rely on large platforms to reach customers and operate in price-sensitive markets. Turnover-based taxes also have geographically uneven impacts. Economies with large consumer markets tend to capture more revenue, while smaller, export-oriented economies face disproportionate costs.

<sup>29</sup> Rada, C. D. (2021). Digital taxation and the tax challenges of the digitalized economy (Discussion Paper No. 262). Archiv der Universität Duisburg-Essen. <https://ideas.repec.org/p/zbw/arqudp/262.html>

<sup>30</sup> Kennedy, P. J., Dobridge, C. L., Landefeld, P., & Mortenson, J. (2024). Heterogeneity in corporate tax incidence by worker characteristics. *AEA Papers and Proceedings*, 114, 346–351. Available at: <https://doi.org/10.1257/pandp.20241015>.

<sup>31</sup> Cloyne, J., Kurt, E., & Surico, P. (2025). Who gains from corporate tax cuts? *Journal of Monetary Economics*, 149, 103722. Available at: <https://doi.org/10.1016/j.jmoneco.2024.103722>

<sup>32</sup> Amazon. Upcoming fee changes in the UK following introduction of Digital Services Tax. Available at <https://sellercentral-europe.amazon.com/seller-forums/discussions/t/e42592bce44261937d8366fedg786f4e>.

<sup>33</sup> Apple. Upcoming tax and price changes for apps and in-app purchases. Available at <https://developer.apple.com/news/?id=oyy56t2r>.

<sup>34</sup> Barker, A. (2020, September 1). Google to pass cost of digital services taxes on to advertisers. *Financial Times*. Available at <https://www.ft.com/content/fda648aa-bb52-4ab2-aa18-46b5023cb893>.

The European Economic and Social Committee (EESC) warned in its 2018 opinion that selective turnover taxes like DST could shift resources toward larger Member States while penalising smaller ones, undermining cohesion within the Single Market.<sup>35</sup> In sum, corporate and digital taxes are rarely paid entirely by the companies they legally target. In reality, who ultimately bears the cost depends on factors such as market structure, elasticity, and the mobility of capital and labour.

### **3. TAX CODE COMPLEXITY AND THE FLAWS OF GLOBAL CORPORATE TAX INITIATIVES**

The international corporate tax system has evolved into a dense layering of national rules, bilateral treaties, OECD standards, and new global minimum tax mechanisms. Each reform has aimed to close specific gaps, yet collectively they have made the system harder to navigate, administer, and coordinate. The current debates over digital taxation, tariffs on electronic transmissions, and the Pillar One and Two frameworks are best understood as responses to – and drivers of – this growing structural complexity.

#### **The WTO Moratorium and the Risk of New Digital Tariffs**

Ongoing debates over digital taxation have also revived attention to the WTO moratorium on customs duties on electronic transmissions, in place since 1998. By prohibiting tariffs on cross-border digital flows, the moratorium has prevented the emergence of an additional layer of digital taxation. Most recently extended in 2024 until 2026, its lapse at the next ministerial meeting would allow governments to impose duties on digital products and services, including software, streaming content, and online communications.

Unlike DSTs, which operate as domestic turnover taxes, customs duties function as trade tariffs on imports. In the context of the evolving international tax landscape under the Inclusive Framework, the moratorium has played an important stabilising role by limiting further fragmentation of digital taxation. Its expiration would permit the imposition of tariffs on cross-border digital trade.<sup>36</sup> More broadly, the removal of the moratorium risks adding another layer of taxation to digital services, encouraging market fragmentation and suppressing digital trade. The continued debate reflects unresolved questions concerning the legal classification of electronic transmissions and their treatment under international trade law.

In this context, the moratorium has functioned as a constraint on further legal layering. Its removal would not only introduce new tariffs, but also add another instrument to an already crowded and overlapping system of digital taxation, reinforcing the underlying trend towards institutional and legal complexity.

<sup>35</sup> Council of the European Union. (2018). Opinion of the EESC. Available at <https://data.consilium.europa.eu/doc/document/ST-11484-2018-INIT/en/pdf>.

<sup>36</sup> Beaumont-Smith, G. (2023, September 15). Borders matter, even for purist free traders. Cato at Liberty. <https://www.cato.org/blog/borders-matter-even-purist-free-traders>.

## BEPS, Pillar Two, and the Growth of Systemic Complexity

Historically, the OECD played a central role in coordinating international tax systems in order to reduce double taxation and facilitate cross-border trade and investment.<sup>37</sup> The OECD's BEPS initiative has been widely regarded as a significant milestone in international tax cooperation, prompting substantial reforms across many jurisdictions. Its influence can be seen in measures such as the United States' Tax Cuts and Jobs Act of 2017, particularly the introduction of GILTI and BEAT, and the EU's Anti-Tax Avoidance Directives (ATAD I and II). Today, the Inclusive Framework remains the principal multilateral forum for international tax coordination. While its consensus-based structure inevitably slows decision-making and implementation, it reflects a deliberate trade-off in favour of long-term stability and coherence. At the same time, the growing complexity of the rules suggests considerable scope for simplification.

In recent decades, however, this framework has increasingly reflected competing national fiscal interests, moving beyond traditional principles of neutrality and efficiency. Debates over digital taxation illustrate this shift as market jurisdictions seek expanded taxing rights that erode the tax bases of residence countries where foreign digital suppliers are based. Ultimately, these conflicts are not borne by firms alone, but are largely passed on to consumers. As a result, international tax coordination has gradually shifted from simplifying cross-border taxation to managing an increasingly complex architecture of overlapping claims, reporting requirements, and corrective mechanisms. Each new layer has been justified as a targeted fix, yet together they have made the system less transparent and more difficult to interpret.

The layering of BEPS reforms and Pillar Two onto existing national CIT systems has further intensified the complexity of international taxation. These measures introduce additional compliance obligations and interact with existing domestic and treaty-based rules, making the system more difficult to navigate and administer. This shift costs indirectly through the economy, obscuring the ultimate incidence of taxation. Legal liability, economic incidence, and political accountability increasingly diverge, as additional instruments (other DSTs and DST like measures) are layered onto existing corporate tax systems rather than replacing them. While these reforms are designed to curb profit shifting and base erosion, their growing complexity and still-unfolding economic effects also produce distributive consequences that are far less visible to the public than more explicit instruments such as DSTs.

### Limits of BEPS

As noted earlier, the BEPS 1.0 initiative represented an important and ambitious effort to strengthen international tax coordination, even though some actions have been only partially implemented or remain incomplete. However, it did not fundamentally simplify or redesign the underlying architecture of international corporate taxation. Instead, it largely operated by layering additional technical rules onto an already complex system. As a result, although BEPS addressed specific avoidance strategies, it also increased the technical complexity of the

<sup>37</sup> Morriss, A. P., & Moberg, L. (2012). Cartelizing Taxes: Understanding the OECD's Campaign Against "Harmful Tax Competition". *Colum. J. Tax L.*, 4, 1.

system and did not fully resolve the structural challenges posed by digitalisation. Two long-standing features of international tax rules made this particularly difficult:

Two long-standing features of international tax rules made this particularly difficult:

- The permanent establishment (PE) standard, which generally requires physical presence to establish taxing rights, thereby limiting the ability of market jurisdictions to tax highly digitalised firms operating remotely.
- The arm's length principle, which allocates profits among affiliated entities based on functions, assets, and risks, and often struggles to capture value created through user participation, network effects, and digital platforms that operate across jurisdictions without traditional physical operations.

Although, the BEPS project sought to address these gaps through stricter transfer pricing rules, controlled foreign corporation (CFC) provisions, and country-by-country reporting. While these measures increased transparency, they did not fully address concerns among some policymakers regarding the level and allocation of corporate taxation under existing international tax principles. This gap set the stage for the Pillar One and Two negotiations.

### **3.1 Pillar One – Reallocating Taxing Rights in the Digital Age**

Pillar One, an extension of the OECD's BEPS initiative, has yet to regain meaningful momentum, as negotiations have faced persistent technical disagreements, political hesitation, and implementation challenges. Pillar One sought to introduce a partial reallocation of taxing rights to market jurisdictions, allowing countries where users and customers are located to tax a portion of multinational enterprises' residual profits, even in the absence of physical presence.<sup>38</sup> In contrast, the global minimum tax under Pillar Two has been prioritised because the primary focus of international tax coordination in recent years. However, new efforts are emerging to address digital taxation under Pillar One again.

Technically, Pillar One applies only to large and highly profitable multinational firms, and the OECD estimated that around USD 200 billion in profits would be reallocated, generating roughly USD 17–32 billion in additional global tax revenue based on 2021 data. Yet the system's design, numerous open questions around scope, tracing of revenues, and methods of double-taxation relief have made agreement and ratification difficult (with estimation being contested).

In this sense, the current stalemate is hardly surprising. A framework that seeks to rebalance taxing rights across numerous jurisdictions, sectors and legal traditions will inevitably encounter both conceptual and administrative limits, while creating clear winners and losers.

In practice, a considerable share of the proposed reallocation would likely come at the expense of the US tax base, since many of the largest and most profitable firms targeted by digital services

<sup>38</sup> OECD Pillar One. (n.d.). Pillar One summary. Available at: [https://oecdpillars.com/pillar\\_one/pillar-one-summary-2/](https://oecdpillars.com/pillar_one/pillar-one-summary-2/)

taxes abroad are also among the largest corporate taxpayers in the US. This distributive effect has fuelled significant political resistance, particularly in Congress, where concerns centre on the implications for US tax revenues and fiscal sovereignty.

The threshold-based design of Pillar One reflects a political compromise rather than a principled economic benchmark, raising the question of where any reallocation of taxing rights should logically end. By applying the new allocation rules to only a narrow segment of multinational profits, while leaving the bulk of the tax base governed by traditional permanent establishment and arm's length principles, Pillar One establishes a hybrid regime. This layered architecture entrenches complexity and institutional fragility, as it sets a precedent for reallocating taxing rights without embedding that shift within a coherent and comprehensive framework for profit allocation.<sup>39</sup>

More broadly, Pillar One illustrates how attempts to correct perceived gaps in the system introduce additional complexity. The framework requires new tracing rules, allocation formulas, and coordination mechanisms across jurisdictions, adding yet another interpretative layer to an already intricate tax environment.

### **Amount A and the Limits of Double Taxation Relief**

Under it, Amount A was developed as a limited redistribution of tax revenues from countries where major multinational enterprises are headquartered or operate to those where their customers are based.<sup>40</sup> According to estimates by the Joint Committee on Taxation (JCT), US MNEs would represent around 70 per cent of the profits reallocated under Amount A, implying an annual revenue loss for the US of roughly USD 100 million to USD 4.4 billion, based on 2021 data.<sup>41</sup> However, Amount A raised several technical challenges in how double-taxation relief is delivered.

The on-going attempts resulted in jurisdictions to rely on tax-credit systems, even though credits often do not fully offset tax liabilities, instead of mandating the more reliable exemption method.<sup>42</sup> While tax credits can function effectively when tax rates are broadly aligned across jurisdictions, they often fail to provide full relief where market jurisdictions impose higher tax rates than the relieving state. By contrast, the exemption method, under which foreign-source income is excluded from the domestic tax base, offers more certain and comprehensive relief. Nevertheless, this approach was not adopted as a mandatory feature of the framework.

### **Amount B and the Limits of Simplification**

Alternatively, Amount B under Pillar One was introduced as a simplified framework for allocating income among countries for baseline marketing and distribution activities. This standardised

<sup>39</sup> Michael, A. (2023, October 31). OECD's Pillar One: A Step Towards Chaos Rather Than Stability. LibertyTaxed. Available at: <https://adamnmichel.substack.com/p/oecd-pillar-one-a-step-towards-chaos>

<sup>40</sup> OECD Pillar One. (n.d.). Pillar One summary. Available at: [https://oecdpillars.com/pillar\\_one/pillar-one-summary-2/](https://oecdpillars.com/pillar_one/pillar-one-summary-2/)

<sup>41</sup> Joint Committee on Taxation: Congress of United States. (2024). Background and Analysis of the Taxation of Multinational Enterprises and the Potential Reallocation of Taxing Rights under the OECD's Pillar One. JCX-7-24. Available at <https://www.jct.gov/publications/2024/jcx-7-24/> as referenced in Michel, A. (2024). The OECD's Pillar One Global Tax Cannot Be Salvaged. Liberty Taxed. Available at <https://adamnmichel.substack.com/p/the-oecd-pillar-one-global-tax-cannot>

<sup>42</sup> Michael, A. Ibid

approach aimed to reduce disputes and minimise costly transfer pricing audits by limiting opportunities for countries to expand their tax base through aggressive enforcement. However, despite this stated objective, Amount B did not result in providing the stability and predictability.

The benefits of simplification are undermined by the fact that the rules are entirely optional for countries, apply only to routine marketing and distribution of tangible products, and still allow tax administrations to rely on non-quantitative, subjective criteria when determining applicability. A further limitation is that Amount B provides only limited relief because its scope largely excludes digital services. As a result, it preserves a distinction between “traditional” distribution activities that qualify for simplification and the digital economy activities that originally motivated the Pillar One negotiations.<sup>43</sup>

### Conceptual Targeting and Design Weaknesses

Pillar One was initially justified on the basis that large digital firms were paying unusually low levels of CIT. While there is evidence that many digital firms exhibit relatively low ETRs, similar patterns are also observed in other IP, intensive sectors, such as pharmaceuticals. Much of the variation in tax outcomes can be attributed to differences in national tax systems, including R&D credits, deductions, and statutory rates, rather than to digitalisation alone. Accordingly, although digital business models may facilitate profit shifting through the use of intangible assets, this feature is not unique to the digital sector. These conceptual limitations are reflected in the design of Pillar One itself.

Its thresholds for profit margins and revenue are politically driven rather than grounded in coherent tax principles, effectively targeting certain large US technology firms. The treatment of “tail-end revenues”, profits not traceable to specific consumer locations, further illustrates this ambiguity, as the OECD proposed allocating them to lower-income countries based on a loosely defined concept of “global need.”<sup>44</sup> These conceptual and structural weaknesses also shaped the incentives countries would have faced when considering whether to participate in Pillar One. The framework did not prevent governments from adopting new “out-of-scope” digital taxes that fall outside the convention’s withdrawal commitments, allowing them to raise revenue through unilateral measures while still benefiting from Amount A allocations.<sup>45</sup>

The narrow scope of Pillar One reinforced this risk. Applying a value-creation approach to fewer than 100 multinational groups is inherently unstable, particularly when purchaser or user locations cannot be reliably traced for large segments of the digital economy. A system with such limited coverage cannot resolve these underlying tracing challenges.<sup>46</sup> These design tensions reflect a broader structural problem: the more policymakers attempt to fine-tune taxing rights through targeted rules, thresholds, and exceptions, the more complex and politically fragile the system becomes.

<sup>43</sup> Ibid

<sup>44</sup> Michael, A. (2023, October 31). OECD’s Pillar One: A Step Towards Chaos Rather Than Stability. LibertyTaxed. Available at: <https://adamnmichel.substack.com/p/oecds-pillar-one-a-step-towards-chaos>

<sup>45</sup> Ibid

<sup>46</sup> CRS Report. (2024). The OECD/G20 Pillar 1 and Digital Services Taxes: A Comparison. R47988. Available at [https://www.congress.gov/crs\\_external\\_products/R/PDF/R47988/R47988.2.pdf](https://www.congress.gov/crs_external_products/R/PDF/R47988/R47988.2.pdf)

## Concentrated Incidence and Political Frictions

While DSTs are likely to persist in the absence of a new multilateral agreement, critics have argued that the OECD's Pillar One proposal risked generating even greater political and economic frictions.<sup>47</sup> Available evidence indicates that both Pillar One and DST regimes would have imposed highly concentrated burdens on US headquartered firms. US companies were initially expected to account for between one half and two thirds of Amount A, despite representing only 37 per cent of the total profits of the world's 500 largest firms. Similarly, the USTR estimated that approximately 75 per cent of the French DST on digital advertising would be borne by Alphabet and Meta. In the UK, around 90 per cent of DST revenues were paid by five firms that are largely or entirely US-based.<sup>48</sup>

This asymmetric incidence has important political and institutional implications. By disproportionately affecting firms from a single jurisdiction, these measures have been widely perceived as discriminatory, contributing to sustained opposition from the US and undermining the political legitimacy of the multilateral framework. A further study found that Pillar One would have applied to only 78 companies, of which 37 were European, with approximately 45 per cent of reallocated profits originating in the technology sector.<sup>49</sup>

This concentration reflects both the exclusion of financial and extractive industries and the effects of size and profitability thresholds. Moreover, some countries may adjust the design of their digital taxes to fall outside the scope of Pillar One's restrictions. By doing so, they could continue to raise revenue through new unilateral measures while still benefiting from the profit reallocation mechanism under Pillar One.

## 3.2 Pillar Two – the Global Minimum Tax

### Design Ambitions and Practical Constraints

Pillar Two was designed to establish a binding global minimum corporate tax and to curb profit shifting by large multinational enterprises. By requiring groups to pay a minimum ETR of 15 per cent on a jurisdictional basis, the regime seeks to limit tax competition and reinforce the integrity of national corporate tax systems. In practice, however, several design features create significant compliance challenges and may influence how consistently Pillar Two operates as a global tax floor as implementation continues to stabilise across jurisdictions. Extensive safe harbours, reliance on accounting-based ETRs, and interaction with unilateral measures increase administrative burdens for both taxpayers and tax authorities. In principle, while Pillar Two represents a major step toward coordinated minimum taxation, further implementation experience will be needed to assess the extent to which it functions as a durable and uniform tax floor.

<sup>47</sup> Michel, A. N. (2025, November 20). Foreign digital services taxes are bad, but the alternatives are worse. Liberty Taxed: A Blog on US Tax Policy. <https://adamnmichel.substack.com/p/foreign-digital-services-taxes-are>

<sup>48</sup> Gravelle, G. J., (2024). The OECD/G20 Pillar 1 and Digital Services Taxes: A Comparison. CRS R47988. Available at: <https://www.congress.gov/crs-product/R47988>

<sup>49</sup> Devereux, M., & Simmler, M. (2021, July). Who will pay Amount A? EconPol Policy Brief, No. 36, 5. Available at: [https://www.econpol.eu/sites/default/files/202107/EconPol\\_Policy\\_Brief\\_36\\_Who\\_Will\\_Pay\\_Amount\\_A\\_0.pdf](https://www.econpol.eu/sites/default/files/202107/EconPol_Policy_Brief_36_Who_Will_Pay_Amount_A_0.pdf); The SBTI-SH favours countries where multinational companies record their assets, rather than where they actually produce goods. As a result, asset-rich but highly financialised jurisdictions, may benefit disproportionately from the safe-harbour rules

## Safe Harbours and Accounting-Based ETRs

Following the June 2025 political agreement between the G7 and the US, the OECD introduced the Side-by-Side Package, alongside extensions to the Transitional Country-by-Country Reporting Safe Harbour and the creation of a permanent Simplified ETR Safe Harbour and a Substance-Based Tax Incentive Safe Harbour.<sup>50</sup> Under these arrangements, qualifying jurisdictions may be treated as effectively equivalent for Pillar Two purposes, allowing top-up tax liabilities under the Income Inclusion Rule and Undertaxed Profits Rule (UTPR) to be reduced to zero in specific cases.

However, the US side-by-side deal does not mean that US companies are excluded from the global minimum tax. US companies will still file the global return and may be required to pay top-up taxes where their ETR falls below the minimum threshold (Global Intangible Low Tax Income). US multinational enterprises are also subject to national-level minimum taxes developed as part of Pillar Two, including Qualified Domestic Minimum Top-up Taxes (QDMTTs), which allow jurisdictions to collect top-up taxes on income earned within their borders. These rules can become overly burdensome in terms of compliance, and there is a growing need to simplify the minimum tax framework as part of broader efforts to support growth and competitiveness. While simplification efforts are progressing under Pillar Two, the framework continues to evolve, and greater clarity is expected as implementation advances.

Pillar Two relies heavily on accounting-based ETRs as indicators of tax compliance. Simplified calculations under the Side-by-Side and Simplified ETR safe harbours are based largely on financial accounting income and covered taxes, subject to limited adjustments. This reliance reflects a broader tendency in policy debates to treat effective tax rates as proxies for corporate tax burdens.

However, firm-level ETRs calculated under accounting-based frameworks remain inherently sensitive to financial reporting dynamics and can therefore diverge materially from statutory tax rates. Although the Pillar Two rules incorporate deferred tax adjustments to account for timing differences – such as immediate expensing and loss carry forwards – reported ETRs will still be influenced by temporary losses, restructuring charges, impairments and other accounting events that affect reported income and tax expense in a given period.

The case of Philips illustrates this problem. Although its ETR typically ranged between 10 and 20 per cent, it rose to approximately 390 per cent in 2024 due to an exceptionally low profit base and one-off restructuring costs. Such figures are economically meaningless and demonstrate the limited analytical value of headline ETRs. As Pillar Two increasingly operates through accounting-based metrics and jurisdiction-level instruments, the divergence between reported ETRs and underlying economic tax burdens is likely to widen further. This undermines the credibility of the minimum tax as a stable benchmark.

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<sup>50</sup> US Department of Treasury. G7 Statement on Global Minimum Tax. [Available at:](#)

## Carve-Outs, Incentives, and Sectoral Distortions

Substance-based carve-outs and financing structures distort the distribution of Pillar Two's tax burden. Under this, taxable income may be reduced based on payroll and tangible assets, granting preferential treatment to jurisdictions hosting labour- or asset-intensive activities. As a result, tax leeway is unevenly distributed across countries, and may in EU's case result in favouring certain Member States and encouraging differentiated national strategies.

Moreover, the financial structure of digital firms further complicates the effects of international tax reform. R&D-intensive industries, particularly software-based businesses, rely disproportionately on equity financing, reflecting higher earnings volatility and the limited collateral value of intangible assets. This reliance on equity makes such firms particularly sensitive to revenue-based and minimum-tax regimes. At the same time, this effect is reinforced by the well-documented debt bias in corporate taxation. Because debt-financed investment is typically taxed more lightly than equity-financed investment, asset-heavy multinational structures often exhibit persistently low accounting-based effective tax rates for reasons unrelated to underlying economic activity. When combined with substance-based safe harbours, this bias risks entrenching pre-existing distortions rather than correcting them.

As a result, relatively low ETRs in digital sectors are not primarily driven by debt financing, but by the widespread use of targeted tax incentives- a disparity largely attributable to the availability of IP box regimes and generous R&D tax credits. Approximately half of EU Member States operate patent boxes, with preferential rates ranging from very low levels in some jurisdictions to around 14 per cent in others, including France. Italy repealed its patent box in 2021 and replaced it with a super-deduction of 230 per cent for qualifying R&D expenditure, reflecting a shift from income-based to expenditure-based incentives. In addition, many Member States provide R&D tax credits, direct subsidies, and accelerated depreciation for intangible assets.<sup>51</sup>

Depending on their design, these measures can significantly affect the effective taxation of IP income, including through preferential regimes and targeted investment incentives. While Pillar Two treats certain forms of support, such as qualified refundable tax credits and direct subsidies, as income rather than reductions in covered taxes, these policies continue to shape effective tax burdens across sectors. As a result, sectoral differences in ETRs often reflect deliberate policy choices aimed at encouraging innovation and investment, rather than aggressive tax planning alone.

The sectoral differences in ETRs are often the product of deliberate policy choices rather than aggressive tax planning. Nevertheless, because Pillar Two relies on accounting-based ETRs and accommodates substance-linked incentives through safe-harbour mechanisms, such differences continue to shape minimum tax outcomes and perceptions of fairness. This helps explain the persistence of political dissatisfaction with the taxation of digital firms and the continued reliance on turnover-based instruments, such as DSTs, alongside the Pillar Two framework.

<sup>51</sup> Michael, A. (2023). OECD rules risk fueling competition for state subsidies. GIS reports. Available at: <https://www.gisreportsonline.com/r/oecd-rules-risk-fueling-competition-for-state-subsidies/>

## Parallel Regimes and Continued Fragmentation

Pillar Two operates largely in parallel with unilateral digital taxation measures, including DSTs. These taxes are generally not creditable against GloBE liabilities or (QDMTP). This lack of coordination increases overall tax burdens and obscures tax incidence, as costs are frequently passed on to consumers and users. Moreover, because Pillar Two does not fundamentally reallocate taxing rights toward market jurisdictions, and because amendments and safe-harbour provisions allow countries to preserve or redesign tax incentives without triggering top-up taxes, market jurisdictions may conclude that large digital groups can still achieve low ETRs through “accepted” structures. This perception weakens incentives to dismantle unilateral measures and contributes to the continued fragmentation of the international tax system. As a result, Pillar Two functions less as a comprehensive solution to profit shifting than as a negotiated compromise shaped by political constraints. Its limitations help explain why unilateral measures such as DSTs continue to proliferate and why dissatisfaction with the international tax framework persists.

## 4. THE SIMPLE, EFFECTIVE AND EFFICIENT SOLUTION: VAT AS EUROPE’S DIGITAL AND INDUSTRIAL TAX BASE

### Neutrality and the Limits of Targeted Digital Taxes

Previous sections suggest that identifying a realistic and coherent set of policy options for taxing highly digitalised business models has become increasingly difficult within an already layered and complex international tax environment. Many recent proposals do not replace existing rules but are instead added on top of them, further expanding an already dense system of corporate tax instruments. Legal constraints, political trade-offs, and administrative challenges leave policymakers with few viable and durable alternatives. A complete replacement of CIT, while politically ambitious, may not be feasible in the near term. Corporations are therefore likely to continue paying CIT as a core component of national tax systems. This constraint, at least in the near term, warrants careful consideration of how CIT systems can be structured to minimise economic distortions and improve economic efficiency (Box 1).

### BOX 1: ESTONIA’S CORPORATE INCOME TAX MODEL

Estonia provides an instructive case study in the design of CIT. While CIT remain problematic, both because their economic burden is borne by capital owners and workers (mostly the workers, as outlined in this paper), and because they may hinder economic development, it is still worthwhile to consider how such taxes can be structured more efficiently if they are to remain in place. In particular, the design of the tax base remains the most important, after which the lawmakers can focus on the statutory rate.

Estonia’s corporate tax system is distinctive in that it taxes only distributed profits, currently at a rate of 20–22 percent, while retained and reinvested earnings are exempt. This allows firms to reinvest profits without immediate tax liability, thereby supporting business expansion and capital accumulation. As a result, Estonian companies face a neutral tax

treatment between reinvestment and taxation, which reduces distortions in investment decisions.

In addition, the system simplifies tax compliance, as firms are taxed only upon profit distribution rather than on accrued accounting profits. Estonia's tax framework also allows loss offsets across time, which helps smooth tax burdens over business cycles. This feature can support firms during downturns and improve overall investment stability. This approach is particularly beneficial for startups and growing firms, as it facilitates rapid scaling by allowing earnings to be reinvested tax-free until distribution. By targeting distributed profits rather than all corporate earnings, Estonia's system enhances competitiveness while remaining consistent with international tax standards, including OECD principles.

Source: Authors' elaboration based on Tax Foundation, Republic of Estonia e-residency and Enty

A further consideration to be taken is also Estonia's approach to VAT. Estonia applies VAT to a broad base with relatively few exemptions, resulting in lower compliance burdens and improved neutrality. Given that most countries already rely heavily on consumption-based taxation, one possible direction is to continue raising revenue through consumption, as has historically been the case, rather than further expanding overlapping layers of profit- and turnover-based taxation. Some commentators argue that if market jurisdictions wish to subject foreign sellers to taxation, they should move away from income taxation and instead adopt licence-type taxes. This thinking has influenced proposals for digital data taxes (DDTs), which often resemble toll-like charges or service fees linked to access to digital infrastructure or user markets. However, licence-type taxes tend to weaken the connection between tax liability and economic performance, as they are typically levied on turnover rather than profit.<sup>52</sup>

According to the principle of tax neutrality, taxes should, as far as possible, avoid distorting economic behaviour or interfering with investment and spending decisions. Although perfect neutrality is unattainable, it remains an important benchmark in tax policy design. When tax policies favour certain types of economic activity over others, they risk encouraging tax-motivated planning and misallocating resources. If business decisions are driven primarily by tax considerations, the system fails to meet neutrality standards.

DSTs raise particular concerns in this respect. They often discriminate between firms operating in similar economic circumstances through activity-based rules and revenue thresholds. Such differentiation risks breaching neutrality in the same way that identical treatment of fundamentally different businesses violates horizontal equity. A fair tax system requires that similar taxpayers be treated similarly, while relevant differences are appropriately recognised. Assessing whether horizontal equity is satisfied therefore requires careful comparison of business models and their underlying economic conditions.

<sup>52</sup> Jade, A., & Keen, M. (2021). Tax theory applied to the digital economy: A proposal for a digital data tax and a global internet tax agency. World Bank. Available at: <https://documents1.worldbank.org/curated/en/615591614758099110/pdf/Tax-Theory-Applied-to-the-Digital-Economy-A-Proposal-for-a-Digital-Data-Tax-and-a-Global-Internet-Tax-Agency.pdf>

Some scholars argue that highly digitalised or "tax-disruptive" business models should be taxed differently from traditional firms because they operate under distinct economic conditions, including strong network effects and reliance on user-generated value. At the same time, these same perspectives often stress that neutrality requires avoiding thresholds, carve-outs, and targeted incentives. They therefore conclude that domestic digital activities should generally be taxed in the same manner as their traditional equivalents. This tension illustrates how difficult it is to justify differential treatment on principled grounds.<sup>53</sup>

Once concerns about avoidance, fragmentation, and behavioural distortion are taken seriously, the case for neutrality re-emerges. Technological novelty alone does not provide a stable or coherent basis for departing from general tax rules. Sustainable reform is therefore more likely to be achieved through integrated, system-wide solutions than through the continued proliferation of targeted digital taxes.

### **VAT as Europe's De Facto Digital Tax System**

Over the past decade, coordinated EU reforms, including the destination principle, OSS/IOSS, platform rules, and the forthcoming ViDA package have already transformed VAT into Europe's de facto digital tax, integrating online services seamlessly into the general tax system. More importantly, VAT is where Europe's real fiscal capacity lies. Since 2015 the taxation of digital services in the EU had been initially governed by the destination principle, under which VAT is charged based on the location of the consumer rather than the supplier.<sup>54</sup>

As a result, any business, whether established inside or outside the EU, is required to apply the VAT rate of the Member State in which the customer resides when supplying digital services. Because VAT is a consumption tax levied at the point of use, it is designed to ensure equal tax treatment of domestic and foreign suppliers, enhancing trade neutrality and global compatibility. However, in practice, the extent to which neutrality is achieved depends on policy design choices, including those adopted by EU policymakers. Ideally this should reduce competitive distortions and significantly lower the risk of retaliatory trade measures, while providing EU Member States with a stable and predictable source of revenue.<sup>55</sup>

### **The Strength of VAT: Neutral, Integrated, and Scalable**

Neutrality remains VAT's defining strength. Its broad base and input-deduction mechanism minimise distortions to production, trade, and investment, treating domestic and imported goods equally and avoiding sector-specific biases. Legally, VAT fits within international tax norms and WTO non-discrimination rules, while the harmonised EU VAT Directive ensures a relatively consistent framework across Member States. Economically, taxing only final consumption keeps

<sup>53</sup> Ibid

<sup>54</sup> Directive 2006/112/EC provides that as from 1 January 2015, all telecommunications, broadcasting and electronic services are to be taxed in the Member State in which the customer is established or has his permanent address or usual residence (hereinafter the 'Member State of consumption') regardless of where the taxable person supplying those services is established." Council Regulation (EU) No. 967/2012 of Oct. 9, 2012, amending Implementing Regulation (EU) No. 282/2011 as regards the special schemes for nonestablished taxable persons supplying telecommunications services, broadcasting services, or electronic services to nontaxable persons, Recital 1

<sup>55</sup> Parada, L. (2025). Balancing DSTs and geopolitics: The European dilemma. *Tax Notes International*, 117(19). Available at SSRN: <https://ssrn.com/abstract=5662270>

intermediate production untaxed, enabling European firms to operate competitively within global value chains, in sharp contrast to digital turnover taxes, which disrupt supply chains and amplify compliance burdens.

VAT integrates digital activities into the general tax system, while DSTs carve out arbitrary segments of the digital economy, creating parallel fiscal layers. DSTs reflect political frustration, not sound tax design. VAT applies broadly across sectors, uses the destination principle to tax where consumption occurs, and relies on well-established registration and remittance mechanisms.

### **The Risk of Overstretching VAT: The Italian Data Case**

However, recent political pressures suggest growing interest in stretching the existing structure of VAT to address perceived gaps in the taxation of digital platforms. In 2025, Italy's Revenue Agency issued a landmark VAT assessment against Meta, X (formerly Twitter), and LinkedIn, amounting to more than EUR 1 billion, including penalties and interest. The Italian authorities argued that the free access users receive to these platforms in exchange for their personal data constitutes a barter transaction and should therefore fall within the scope of VAT.<sup>56</sup>

This position raises significant conceptual and practical difficulties. Taxable barter arrangements traditionally involve reciprocal exchanges in which both parties can identify, value, and account for the consideration received for sales and income tax purposes. By contrast, non-monetised interactions between digital platforms and individual users lack a clear and direct link between the services supplied and the consideration allegedly received. The valuation of such exchanges is inherently uncertain, varying with the intensity and scope of platform use and the economic exploitation of data, and does not lend itself to standard VAT valuation methods. In practice, attempting to align these fundamentally different transactions within a single VAT framework is highly problematic.

Italy's position also encountered resistance at the EU level. The EU VAT Committee rejected the view that the mere presence of data exchange automatically constitutes a taxable barter arrangement. In particular, it emphasised that Article 80 of the VAT Directive, governing the valuation of non-monetary consideration, presupposes a clear legal or personal relationship between identifiable parties and a sufficiently determinable consideration. However, the Committee did not entirely reject it, and said that while such conditions cannot be presumed in the context of mass digital platforms and must instead be assessed on a case-by-case basis.

This partial agreement nevertheless opens the possibility of new tax, and potentially criminal proceedings against large technology companies in Italy and, by extension, abroad. However, the legal basis for such proceedings remains highly debatable and contentious. Even if ultimately unsustainable, the approach risks creating a "domino effect," encouraging tax authorities in other jurisdictions to reinterpret VAT rules in ways that stretch existing legal concepts beyond their intended scope. Proponents of this may justify that introducing a new

<sup>56</sup> Charmes, G. (2025, October 16). Regulating the digital economy: VAT controversy over user data at META. Meridian Global Services. <https://meridianglobalservices.com/regulating-the-digital-economy-vat-controversy-over-user-data-at-meta/>

tax somewhere along the transaction chain is justified, given the substantial value accruing to large digital advertisers that appears to escape taxation under current regimes.<sup>57</sup>

From a VAT law perspective, however, this reasoning is difficult to sustain. According to the 2018 opinion of the EU VAT Committee, personal data cannot be regarded as consideration exchanged for digital services, since platforms provide their services in the same manner regardless of the quantity or quality of personal data supplied by users, which may, in any event, be incomplete or inaccurate. The Italian approach, could nevertheless have far-reaching implications beyond the digital sector. This raises broader concerns about legal certainty and the risk of undermining the coherence of VAT principles by using them to address perceived gaps in the taxation of the digital economy.

The first step in addressing these challenges is to correct the underlying fallacy of digital services taxes and to resist the temptation to extend their logic to VAT. Hypothetically, if non-monetised data collection were brought within the VAT base, it would likely be treated as a taxable business input. Under the neutrality principle of VAT, any tax charged at this stage would be creditable against VAT due on subsequent taxable supplies, such as advertising or subscription services. As a result, little or no additional VAT burden would ultimately be borne by the platform, undermining the effectiveness of VAT as a tool to capture the perceived untaxed value of data extraction.<sup>58</sup> In short, one cannot repurpose VAT to tax digital rents without breaking the logic.

### **The Real Weakness: Compliance Gaps, Not Conceptual Design**

VAT's main weaknesses lie not in its underlying conceptual design but in two practical challenges: compliance gaps, arising from evasion and administrative inefficiencies, and policy gaps created by reduced rates, exemptions, and exclusions from the tax base. According to the Commission's VAT Gap Report 2025, EU Member States lost EUR 128 billion in 2023, equivalent to 9.5 per cent of potential VAT revenue, due to evasion, fraud, bankruptcies, and other administrative inefficiencies.<sup>59</sup> The EU's VAT policy gap amounted to around 50.5 per cent of the notional ideal VAT revenue in 2023, reflecting the cumulative impact of policy choices that substantially narrow the effective tax base. In absolute terms, this implies that close to one trillion euros of potential VAT revenue is forgone each year under the current system when compared to a benchmark in which all final consumption is taxed at the standard rate.

This finding illustrates a basic principle of tax design: a broader and more harmonised VAT base allows lower statutory rates without reducing fiscal capacity. A simplified and more uniform VAT framework would therefore strengthen both competitiveness and fiscal stability, in contrast to the

<sup>57</sup> Italy's recent approach illustrates the political pressure faced by governments. When VAT is perceived as incapable of adequately capturing value generated in digital markets, and when corporate income taxation is constrained by limits on international coordination, authorities may seek to stretch existing VAT concepts beyond their traditional scope. Where such efforts prove ineffective or encounter legal resistance, digital services taxes are likely to proliferate as second-best instruments, despite their legal uncertainty and distortionary economic effects.

<sup>58</sup> Frieden, K. A., and Lindholm, L. D. (2023). State digital services taxes: A bad idea under any theory. Tax Notes. <https://www.taxnotes.com/special-reports/digital-economy/state-digital-services-taxes-bad-idea-under-any-theory/2023/04/07/7g9bc>

<sup>59</sup> European Commission (2025). VAT gap in the EU – 2024 report. Available at <https://op.europa.eu/en/publication-detail/-/publication/b5c7403b-d67f-11f0-8da2-01aa75ed71a1/language-en>.

growing reliance on narrow and distortionary taxes such as DSTs, the proposed CORE levy and other sector-specific tax measures.

Therefore, as discussed earlier, these difficulties illustrate the limits of attempting to repurpose VAT to capture the perceived economic rents generated by digital platforms. When a social media platform provides services without charging a monetary price, instead conditioning access on users' acceptance of extensive data collection and commercial exploitation, the question arises as to whether a taxable transaction has occurred for EU VAT purposes.

The apparent simplicity of this question is misleading. Beneath the surface lie complex doctrinal issues concerning VAT's most fundamental concepts, including the nature of consideration, the scope of economic activity, the requirement of a direct link between a supply and any consideration received, and the determination of a taxable amount in the absence of monetary exchange.

### **Distributional Concerns and the Limits of VAT Engineering**

Concerns about the distributional impact of VAT, however, should be addressed separately from debates on digital taxation. The OECD recommends that equity objectives be pursued primarily through measures that directly increase the real incomes of lower-income households. And it makes sense to do so rather than make ad hoc adjustments to indirect taxes. Redistribution through the spending side of the budget is generally more transparent and effective than attempting to achieve equity through the structure of VAT.

Reduced VAT rates and exemptions are commonly justified on equity grounds, on the basis that lower-income households spend a larger proportion of their income on consumption, particularly on basic goods and services. They are also sometimes used to encourage the consumption of so-called merit goods, such as cultural or environmentally beneficial products. In practice, however, reduced rates and exemptions are often poorly targeted and may even have regressive effects, since higher-income households typically benefit more in absolute terms from lower prices.<sup>60</sup>

Several studies suggest that eliminating most reduced VAT rates in EU Member States could broaden the tax base and allow standard rates to fall significantly, in some cases to below 15 per cent, while maintaining overall revenue neutrality<sup>61</sup>. Such reforms would improve simplicity and efficiency and create fiscal space for more targeted social transfers. This reinforces the broader argument that VAT reform should focus on strengthening compliance and broadening the base, rather than attempting to adapt VAT to perform functions better served by income taxation and social policy.

<sup>60</sup> Gale, W. G., & Hansen, J. (2023, June 19). Is the value-added tax (VAT) progressive? Tax Foundation. <https://taxfoundation.org/blog/value-added-tax-vat-progressive/>

<sup>61</sup> Enache, C. (2023, January 10). VAT expansion and labor tax cuts. Tax Foundation. Retrieved from <https://taxfoundation.org/data/all/global/vat-tax-expansion-and-labor-tax-cuts/>

## VAT vs. CIT: Europe's Real Fiscal Backbone

In 2023, VAT contributed to 18.5 per cent of all tax revenues in Germany, 16.6 per cent in France, 15.7 per cent in Italy, 20.6 per cent in the UK, 18.6 per cent in Austria, 21.5 per cent in Finland, 18.4 per cent in Netherlands and 21.6 per cent in Sweden respectively.

A comparison of CIT receipts with VAT revenues further undermines the claim that existing tax instruments are no longer adequate in the digital economy. Across Europe's major economies, the same structural pattern emerges: VAT remains substantially larger and more stable than CIT, even where both have grown since 2010. In 2023, CIT amounted to 32.4 per cent of VAT in Germany, 32.3 per cent in France, and 41.8 per cent in Italy, while Austria, Finland, and Sweden confirm the same underlying trend, in fact the role of CIT relative to VAT is even smaller. Even in countries where CIT has expanded rapidly, such as Ireland, the Netherlands and Czech Republic, VAT remains the principal revenue anchor.

These figures demonstrate that consumption taxation continues to provide governments with a reliable fiscal base, while corporate taxation remains a significant, if smaller, contributor. This undermines the narrative that digitalisation has rendered traditional tax instruments obsolete and that new turnover-based taxes are therefore required. Rather than reflecting structural failure, the persistence of strong VAT revenues suggests that DSTs respond primarily to political pressures and distributional concerns, rather than to genuine revenue deficiencies.

The ratios over time underline this fiscal reality. Since 2010, German CIT receipts have doubled, yet VAT remains almost three times larger. France exhibits the same pattern, with VAT exceeding CIT by more than threefold despite the latter's growth. Italy's VAT base consistently exceeds CIT by a factor of approximately 2.4. This pattern also holds in countries such as Austria, Belgium, the Netherlands, and Czech Republic. Even in countries such as Ireland, where CIT may exceed VAT in some years (including 2023), VAT remains a substantial source of public revenue. These cases should be treated as exceptions driven by distinctive sectoral or multinational tax-base dynamics, rather than as a generalisable fiscal structure.

These CIT–VAT relationships reinforce the broader conclusion of this section. Even under favourable conditions, CIT remains too narrow, too volatile, and too unevenly distributed to shoulder Europe's fiscal burdens on its own. VAT, by contrast, is broad-based, relatively stable, and delivers between two and four times more revenue in most major economies. Any serious effort to simplify Europe's tax system or reduce dependence on politically contentious corporate taxation must therefore focus primarily on strengthening the VAT base broadening, improved compliance, and simplified registration procedures, particularly for small businesses, while preserving the core principles of VAT and avoiding interpretations that risk distorting its intended function.

When properly designed, particularly through full expensing of capital expenditure, corporate taxation need not deter marginal investment under standard models of tax and investment behaviour. Although most European systems fall short of full expensing and are therefore economically sub-optimal, they nonetheless continue to generate significant revenues.

## Why New Digital Taxes Are Hard to Justify

DSTs were originally justified on the basis that profits should be taxed where value is created. Under traditional international tax rules, however, foreign firms become subject to corporate taxation only once they establish a permanent establishment (and sometimes virtual PE has been the case). DSTs were introduced as a response to the perceived mismatch between digital value creation and physical presence. Yet, with DSTs and CIT now coexisting in many jurisdictions, this justification has weakened. The result is increasing overlap between turnover taxes and profit taxes.

Moreover, recent revenue trends further undermine the case for additional instruments. Since 2020, CIT revenues in EU Member States have increased and stabilised at approximately 8.2 per cent of total tax revenue and 3.2 per cent of GDP. This recovery suggests that the existing corporate tax framework continues to capture a meaningful share of business profits. Introducing parallel mechanisms such as DSTs or the CORE framework therefore appears increasingly difficult to justify on economic grounds, particularly given their distortionary effects on pricing, market structure, and investment decisions.

In digital markets characterised by fragmented users, complex supply chains, and opaque purchasing patterns, allocating profits to market jurisdictions is inherently difficult. A regime covering fewer than one hundred firms cannot provide a stable or scalable solution. Limited coverage undermines both administrative feasibility and perceived fairness, while preserving incentives for avoidance and regulatory arbitrage.

### VAT vs. DST: Two Opposing Approaches

Therefore, while VAT integrates digital activities into the general tax system, DSTs carve out arbitrary segments of the digital economy, creating parallel fiscal layers. DSTs reflect political frustration, not sound tax design. DSTs and VAT-on-digital-services regimes represent two fundamentally different approaches to taxing the digital economy:

- VAT integrates digital activities into existing consumption tax architecture. It applies broadly across sectors, uses the destination principle to tax where consumption occurs, and relies on well-established registration and remittance mechanisms.
- DSTs, in contrast, create a parallel tax layer on specific business models, disconnected from consumption or profitability.

The distinction between two is not merely technical: it reflects fundamentally different fiscal philosophies, integration versus exceptionalism. By contrast, VAT is a long-proven, broad-based, and more neutral (or much less discriminatory) instrument that captures value in the digital economy without creating new distortions or discriminatory effects.<sup>62</sup>

<sup>62</sup> Although VAT is levied at each stage of production and distribution, its credit-invoice mechanism ensures that the effective rate applies only once, on the final sales price. By taxing only the value added at each step, the system prevents double taxation of inputs and avoids the "tax-on-tax" pyramiding typical of cumulative sales taxes. See: Bray, S., and Walczaak, J and York, E., (2025, February 12). The European VAT is Not a Discriminatory Tax against US Exports. Tax Foundation. Available at: <https://taxfoundation.org/blog/trump-reciprocal-tariffs-eu-vat-discriminatory/>

## Narrowing the Compliance Gap in VAT

To move beyond conceptual arguments, it is useful to illustrate the relative fiscal role of consumption and corporate taxation through a simple simulation. The exercise below does not advocate the immediate replacement of CIT in practice. Rather, it provides an analytical benchmark to assess the scale, stability, and revenue potential of VAT compared with corporate taxes. At the same time, it underscores a broader structural point: corporate taxation has become increasingly complex, costly to administer, and politically contentious, while generating comparatively modest and volatile revenues.

This alone should prompt governments to reconsider the current reliance on corporate taxation, not only from a fiscal perspective but also in view of its implications for Europe's business environment, investment climate, and long-term competitiveness. By examining how far improvements in VAT compliance and base broadening could substitute for corporate tax receipts, the analysis highlights where Europe's real fiscal capacity lies and how strongly it depends on consumption rather than profits.

Germany and France are used as illustrative cases because both rely relatively little on CIT within their overall revenue mix, face competitiveness pressures linked to high effective tax burdens, and possess the political weight to influence European tax reform. Their fiscal structures reflect a broader EU pattern in which corporate taxation generates comparatively low and volatile revenues while imposing substantial compliance and administrative costs on firms.

The analysis draws on 2024 VAT and 2023 CIT revenue data from OECD Revenue Statistics 2025 (2024 data) and the EU VAT Gap report. The estimation proceeds in two stages. First, potential revenue gains from improved VAT enforcement are calculated using the Value of Total Theoretical Liability (VTTL) under full compliance. Second, the remaining corporate tax revenue is treated as the amount that would need to be replaced through VAT expansion. Throughout this exercise, the VAT policy gap arising from reduced rates and exemptions is initially held constant.<sup>63</sup>

Table 2 presents the results of this simulation. Closing the compliance gap would generate approximately EUR 29.5 billion in additional revenue in Germany and EUR 12.6 billion in France. While these gains are economically meaningful, they remain modest relative to corporate tax receipts. Even under full compliance, Germany would still need to replace approximately EUR 65.1 billion in CIT revenue, and France around EUR 53.8 billion. This indicates that enforcement improvements alone cannot support a substantial reduction in reliance on corporate taxation.

<sup>63</sup> The calculation assumes that VAT revenues increase proportionally with the statutory VAT rate while the underlying tax base remains unchanged. First, VAT revenues are adjusted to reflect the estimated VAT Total Tax Liability (VTTL) after closing the compliance gap. Second, the remaining corporate income tax (CIT) revenue to be replaced is added to this adjusted VAT revenue. Finally, the required VAT rate is derived by multiplying the current standard VAT rate by the ratio of required VAT revenue (adjusted VAT revenue plus remaining CIT revenue) to current VAT revenue after compliance improvement. This provides a stylised estimate of the VAT rate needed to fully offset the elimination of CIT revenue. Importantly, the calculation does not take into account the substantial VAT policy gap – such as reduced rates, exemptions, and other preferential treatments – which in many cases exceeds total corporate income tax revenues. Partial rationalisation of these policy gaps would therefore significantly reduce the VAT rate adjustments required under a revenue-neutral reform.

Under a hypothetical revenue-neutral scenario in which existing corporate tax revenues are replaced through higher VAT receipts, the required scaling of VAT revenues would imply standard rates of approximately 22.9 per cent in Germany and 24.9 per cent in France. These figures illustrate the magnitude of adjustment required in the absence of base broadening and highlight the political and economic constraints on rate-based reform.

At the same time, such rates would not be without precedent in Europe. Several countries already operate with similarly high or higher standard VAT rates, including Hungary at 27 per cent – the highest in both the OECD and the EU – followed by Finland at 25.5 per cent after its recent increase, and Croatia, Denmark, Norway, and Sweden, all at 25 per cent. Greece and Iceland also apply comparatively high standard rates of 24 per cent. This comparison underscores that, while politically sensitive, VAT rates in the range suggested by the simulation fall within the spectrum of existing European practice.

**TABLE 2: GENERAL VAT RATE IMPLICATION FROM REPLACEMENT OF CIT BY VAT (GERMANY AND FRANCE), NUMBERS PROVIDED IN EUR BILLION**

Country	Standard VAT rate (2023)	VAT revenue 2023	CIT revenue 2023	VTTL after closing compliance gap (€ bn)	Extra VAT from compliance improvement	Remaining CIT to replace	Required standard VAT rate to fully replace CIT	Final VAT revenue after reform
Germany	19%	291.8	94.5	321.3	29.5	65.1	≈ 22.9%	386.3
France	20%	205.6	66.3	218.2	12.6	53.8	≈ 24.9%	271.9

Source: ECIPE estimation based on OECD revenue statistics 2025 (2024 data) and VAT gap in the EU – 2024 report. Note: VTTL = Value of Total Theoretical Liability under perfect compliance; compliance gap rates sourced from the European Commission's VAT Gap in the EU study (Germany 2023: 9.7%; France 2023: 5.6%). No consideration of (substantial) VAT policy GAP (rate gap, exemption gap).

A potential objection to this analysis is that consumption taxation, like DSTs, is largely (but not exclusively) borne by consumers through price pass-through. However, the economic and normative implications of pass-through differ fundamentally between the two instruments. VAT is expressly designed as a broad-based, transparent, and harmonised tax on final consumption. Its pass-through to prices is therefore an intended and predictable feature embedded within a coherent fiscal framework. By contrast, DST pass-through is selective, opaque, and uncoordinated, affecting only users of specific services and varying across jurisdictions.

The problem is not that consumers bear the burden, but that DSTs impose it in an arbitrary and distortive manner. Moreover, VAT systems in many countries still contain substantial unused revenue potential. The scope for mitigating rate increases becomes clearer once VAT policy gaps are considered. According to Commission estimates, Germany's VAT policy gap amounted to EUR 288 billion in 2024, including approximately EUR 147 billion in actionable reduced rates and exemptions. France's policy gap reached EUR 255 billion in 2024, with around EUR 128 billion considered actionable.

It is particularly noteworthy that these amounts substantially exceed corporate tax revenues in both countries. Even a partial rationalisation of preferential treatments would therefore significantly reduce the VAT rate increases required to achieve revenue neutrality.

This fact alone should give policymakers pause. Governments continue to focus political attention on taxing corporate income, one of the most distortive forms of taxation, which directly affects investment, productivity, and competitiveness across the entire economy, while leaving vast inefficiencies in consumption taxation largely untouched. The issue is not whether consumers ultimately bear tax burdens, they almost always do, but whether taxes are designed in ways that minimise economic distortions and support economic development.

Despite this revenue potential, VAT reform faces significant political constraints. Reduced rates and exemptions are concentrated in politically sensitive sectors, including food, energy, transport, hospitality, pharmaceuticals, and tourism. Although often justified on social grounds, empirical evidence suggests that these preferences disproportionately benefit middle- and higher-income households. Sectoral interests and institutional inertia further complicate reform. Advisory, accounting, and compliance industries have developed around existing complexity and possess strong incentives to preserve current structures. These political-economy constraints must be recognised, although they should not obscure the broader objectives of improving competitiveness and fiscal sustainability.

## **5. IMPLICATIONS FOR EU AND NATIONAL TAX REFORM INITIATIVES**

The preceding analysis points to a broader structural conclusion. Europe's tax debate is increasingly shaped by institutional path dependency, growing legal complexity, and a policy culture that tends to add new instruments rather than reconsider the overall architecture. Each reform cycle has attempted to correct perceived gaps in the corporate tax system, yet the cumulative effect has been to make the system more fragmented, less transparent, and more difficult to administer.

This dynamic has important implications for both EU-level initiatives and national tax policy. Instead of converging toward a simpler and more stable framework, international and European taxation has evolved into a layered structure in which new instruments coexist with older ones, often addressing the same underlying concerns through different mechanisms. Digital services taxes, withholding regimes, significant economic presence rules, and minimum tax overlays illustrate this pattern. None replaces existing systems; all sit on top of them.

### **Path Dependencies and Institutional Lock-In**

Tax policy does not operate in a vacuum. Once a system becomes complex, it generates its own constituencies. Administrative structures, legal interpretations, advisory industries, and compliance practices grow around existing rules and develop strong incentives to preserve them. Over time, this produces institutional lock-in. Even when reform is widely recognised as necessary,

simplification becomes politically difficult because complexity itself has become embedded in administrative routines and professional interests. At the EU level, this dynamic is reinforced by the interaction between national tax sovereignty, coordination requirements, and the technical nature of international tax law. Successive efforts to close gaps in corporate taxation have produced new reporting standards, allocation formulas, and compliance obligations. These measures are often justified individually, but collectively they reduce transparency and make the system harder to understand not only for firms, but also for elected lawmakers.

### **The Political Economy of Tax Complexity**

The growing density of tax rules has created a widening gap between technical tax design and political decision-making. Many of the most consequential elements of modern corporate taxation – transfer pricing rules, minimum tax calculations, safe harbours, and allocation formulas – are highly technical and often poorly understood outside specialist circles. As a result, policy debates increasingly rely on simplified narratives about fairness and targeting rather than on a clear understanding of economic incidence and behavioural effects. This creates space for symbolic policy responses. Turnover-based digital taxes, for example, are politically visible and easy to communicate, even if their fiscal contribution is limited and their economic incidence uncertain. By contrast, the structural weaknesses of profit-based taxation – volatility, narrow tax bases, and high compliance costs receive less attention, even though they have far greater implications for long-term fiscal stability and competitiveness.

### **Re-centring the Debate on Incidence, Simplicity, and Efficiency**

A constructive future-oriented reform agenda would begin by shifting the focus away from the identity of the legal taxpayer and toward economic incidence. Much of the public debate continues to assume that corporate and digital taxes are primarily borne by large firms. In practice, as discussed earlier, a significant share of the burden is transmitted to consumers, workers, and smaller businesses through price adjustments, wage effects, and changes in investment patterns. If incidence rather than symbolism becomes the guiding principle, the case for further layers of corporate and digital taxation weakens considerably. Turnover-based taxes, global minimum tax overlays, and nexus expansions do little to address underlying structural problems. Instead, they add legal complexity, increase compliance costs, and introduce new distortions into investment and pricing decisions.

This suggests that future reform should prioritise neutrality, simplicity, and administrative clarity over targeted revenue extraction. In practical terms, this implies:

- Avoiding the proliferation of new digital taxes and similar sector-specific instruments
- Exercising caution toward additional global corporate tax initiatives that further layer complexity onto existing systems
- Refocusing reform discussions on strengthening broad, neutral, and administratively efficient tax bases

## The Case for a Consumption-Centred Tax Structure

The fiscal comparisons presented in earlier sections highlight a clear structural reality. Across Europe, VAT consistently provides a broader, more stable, and more predictable source of revenue than corporate taxation. Corporate taxes, by contrast, are narrower, more volatile, and far more complex to administer. They are also highly sensitive to economic cycles, accounting practices, and international tax planning structures. This does not mean that corporate taxation will disappear. In the near term, it will likely remain part of national tax systems. However, the evidence suggests that its fiscal role is overstated relative to the administrative effort required to maintain it. For some governments, this raises a legitimate long-term question: whether corporate income taxation should remain a central pillar of revenue collection or gradually play a more limited role within a broader consumption-based framework.

A number of countries should, over time, consider more fundamental reforms, including significant reductions in corporate tax reliance or, in more radical cases, partial or full replacement through broad consumption-based systems. The underlying logic is straightforward: consumption taxes are harder to avoid, easier to administer, and more closely aligned with where economic activity ultimately takes place. Any shift in this direction may face strong political economy constraints, as corporate taxation is closely tied to public narratives about fairness and supported by a large ecosystem of tax authorities, consultancies, and compliance professionals who operate within and benefit from the existing complexity. Reform is therefore more likely to come through gradual simplification – strengthening VAT compliance, broadening the base, and reducing reliance on volatile corporate tax instruments – rather than through ambitious new global tax frameworks.

### A Shift in Reform Priorities

Taken together, the analysis points toward a reordering of priorities in EU and national tax policy. Rather than continuing to search for new ways to tax increasingly mobile and intangible profits, reform efforts could focus on:

- Simplifying existing tax structures
- Eliminating overlapping layers of corporate and digital taxation
- Strengthening compliance in broad-based consumption taxes
- Improving transparency around tax incidence and economic effects

Such an approach would not only reduce administrative burdens and legal uncertainty, but could also improve Europe's business and investment environment. A simpler, more predictable tax system lowers compliance costs, reduces distortions, and strengthens the competitiveness of firms operating within the Single Market. In this sense, the core message of this paper is not that governments should abandon revenue needs or fiscal responsibility. It is that the search for ever more complex solutions to perceived gaps in corporate taxation may be moving policy in the wrong direction. The simplest instruments – broad-based, neutral consumption taxes – remain the most robust foundation of Europe's fiscal capacity.

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## ANNEX I FISCAL PERFORMANCE OF DIRECT DIGITAL SERVICES TAXES

### SELECTED EU MEMBER STATE LIST

Country	Scope / Target	Tax Rate	Year	DST Revenue in Millions (in Euro millions)	CIT Revenue (M LCU)	Total Tax Revenue (M LCU)	DST Revenue (Share of CIT)	DST Revenue (Share of Nat'l Revenue)
Austria	Online advertising services	5%	2023	103.95	15,614	203,607	0.67%	0.05%
France	Digital interface; advertising services based on user data; paid and free access to online content	3%	2024	668	66,333	1,239,579	1.01%	0.05%
Italy	Online advertising; multisided digital interfaces; data transmission services	3%	2024	434	58,619	889,688	0.74%	0.05%
Spain	Online Advertising services; online intermediary services; data transmission services	3%	2024	375	43,501	545,398	0.86%	0.07%

Source: Author's calculations based on Tax Foundation, OECD Revenue Statistics (2025)

### SELECTED NON-EU COUNTRY LIST

Country	Scope / Target	Tax Rate	Year	LCU	DST Revenue in Millions LCU	CIT Revenue (M LCU)	Total Tax Revenue (M LCU)	DST Revenue (Share of CIT)	DST Revenue (Share of Nat'l Revenue)
Switzerland	Gross income generated from streaming or television services	4%	2024	Swiss Francs	752	27,424	216,164	2.74%	0.35%
Turkey	Online services (advertising, content sales, paid services, social media websites)	7.50%	2023	Turkish Lira	15,561	786,318	6,163,076	1.98%	0.25%
United Kingdom	Social media platforms, internet search engines, online marketplaces	2%	2025	Pound Sterling	900	91,532	947,974	0.98%	0.09%

Source: Author's calculations based on Tax Foundation, OECD Revenue Statistics (2025)

## ANNEX II – KEY DRIVERS OF THE EU'S SUBSTANTIAL VAT POLICY AND COLLECTION GAP

- VAT compliance gap (2023): €128 billion (≈ 9.5 per cent of potential revenue), up from around €101 billion (≈ 7.9 per cent) in 2022 and above the pre-pandemic level in nominal terms, reflecting renewed pressures on tax collection despite earlier improvements in compliance
- VAT policy gap: ≈ 50.5 per cent of notional ideal VAT revenue, reflecting the revenue foregone through reduced rates, exemptions, and components of consumption excluded from the VAT base
- Rate gap: ≈ 12.3 per cent of notional ideal revenue; exemption gap: ≈ 38.3 per cent.
- Actionable vs structural components: around 23–24 per cent of notional ideal revenue is actionable through policy choices (primarily reduced rates and discretionary exemptions), while roughly 23 per cent reflects non-actionable structural elements such as public services, imputed rents, and other activities outside the practical scope of VAT.
- C-efficiency: averages roughly 55 per cent across EU Member States, with substantial variation across countries depending on tax base breadth and compliance performance.
- Actionable standard VAT rate: ≈ 16.6 per cent for the EU, indicating that a broader VAT base without reduced rates and exemptions could sustain current revenues with a standard rate several percentage points below today's EU average.

### Persistent challenges remain:

- **Fragmented rules and exemptions** that distort markets and raise administrative costs.
- **Narrowed VAT base** through reduced rates and exemptions, weakens neutrality and increases administrative complexity, and limits the efficiency of existing VAT systems
- **Insufficient cross-country data and transparency** since the discontinuation of the "Own Resources" VAT database.
- **Uneven digital infrastructure** and limited analytical capacity in tax administrations.
- Non-compliance through **evsion, carousel fraud, insolvencies, and data errors**.

### Reform Priorities and Policy Recommendations by the Directorate-General for Taxation and Customs Union of the European Commission

#### 1. Digitalisation of tax administration

- Expand mandatory **e-invoicing, digital reporting, and online cash register systems**.
- Build digital public infrastructure that simplifies compliance rather than shifting burdens to taxpayers.
- Invest in data literacy and analytics to enable real-time fraud detection.

#### 2. Further VAT harmonisation and simplification

- Limit and standardise reduced and zero rates in line with **Directive 2022/542**, which phases out reduced rates on fossil fuels and pesticides by 2030–2032.
- Gradually remove discretionary exemptions and align VAT bases across Member States.

#### 3. Enhanced data sharing and analytical capacity

- Rebuild EU-level datasets to replace the discontinued **Own Resources** database.
- Encourage sector-level VAT gap analysis and exchange of audit data among tax administrations.

#### 4. Targeted compliance measures

- Maintain **reverse-charge** and **split-payment** mechanisms in high-risk sectors such as electronics and construction.
- Strengthen cross-border cooperation to combat fraud and insolvency abuse.

#### 5. Capacity building and digital skills

- Train and retain tax officials with strong digital and analytical expertise.
- Use digitalisation not only to move processes online but to **simplify and streamline** them

## ANNEX II – KEY ELEMENTS OF THE VAT IN THE DIGITAL AGE (ViDA) PACKAGE

The **ViDA** package represents the most significant reform of the EU VAT framework in more than two decades. Adopted in 2025, it will be implemented progressively until January 2035. ViDA is not a new tax, but a **modernisation of the EU's most important consumption tax**, aligning it with digital business models, platform economies, and real-time reporting. It aims to **strengthen revenue collection, reduce fraud, and simplify compliance** without introducing discriminatory levies. The package consists of three main pillars:

1. E-invoicing and digital reporting,
2. Platform economy rules, and
3. Single VAT registration.

These elements, together, provide a structural response to the political concerns that originally motivated digital services taxes – **but through a coherent, legally grounded system** rather than fragmented turnover taxes.

### Pillar I: E-Invoicing and Digital Reporting

Uneven rollout of digital tools is a main reason for persistent VAT losses. ViDA directly targets this gap. Aligning implementation timetables and technical standards will therefore determine whether VAT can function as Europe's true digital-era fiscal infrastructure. The first pillar gives Member States the power to introduce **mandatory e-invoicing for domestic supplies** without prior Council authorisation. This change is expected to accelerate e-invoicing across the Union before July 2030, with a transitional phase to ease the adjustment for SMEs.

From July 2030, **structured e-invoices** will be required for cross-border business-to-business (B2B) and business-to-government (B2G) transactions within the EU. Over time, e-invoicing will replace the European Sales List (ESL) and enable **real-time digital reporting**, improving both transparency and compliance. While ViDA aims for full harmonisation by 2035, Member States with existing reporting systems are allowed transitional arrangements. This staggered implementation creates some complexity for cross-border operators, but it also reflects a pragmatic approach to aligning national systems with a common EU standard. Once fully operational, this system will significantly reduce **VAT fraud and compliance costs**, while enhancing fiscal stability.

### Pillar II: Platform Economy Rules

The second pillar of ViDA updates the VAT treatment of transactions facilitated by **digital platforms and online marketplaces**, particularly in sectors such as passenger transport and short-term accommodation. Under the revised framework, platforms can be treated as **deemed suppliers** – that is, responsible for collecting and remitting VAT – when they intermediate transactions for third-party sellers. This ensures that VAT is effectively collected at the point of consumption, even when the underlying supplier has no physical presence in the EU. However, Member States may

**exclude platforms** from the deemed supplier regime if the underlying supplier qualifies for the SME VAT regime.

While this flexibility may introduce some national variation, the overall effect is to close VAT gaps and ensure more consistent taxation of platform activities. Importantly, ViDA aligns taxation with the **economic reality of intermediation**, ensuring large platforms contribute fairly through existing VAT rules, rather than through sector-specific levies like DSTs. Consistent with this policy goal, these rules could also require platforms and online marketplaces to collect and remit VAT on behalf of domestic EU sellers, thereby simplifying compliance and improving revenue collection for governments.

### **Pillar III: Single VAT Registration**

The third pillar simplifies compliance by moving towards **Single VAT Registration** across the EU. Businesses will be able to declare and remit VAT in one Member State for all intra-EU supplies, significantly reducing administrative burdens. This builds on the success of the One Stop Shop (OSS) and Import One Stop Shop (IOSS), introduced under the e-commerce package. These mechanisms already allow businesses, including non-EU suppliers, to register in a single Member State and account for VAT on all sales across the EU.

However, a caveat exists: participation in these schemes is not mandatory for all businesses, and their optional nature may leave compliance gaps and create opportunities for fraud or avoidance. Making such frameworks mandatory could further strengthen compliance, reduce fragmentation, and enhance revenue collection by ensuring consistent VAT reporting across the internal market. Given that the impact of these reforms is already measurable, VAT revenues from digital services rose from €3 billion in 2015 to over €20 billion in 2022, demonstrating the effectiveness of a harmonised VAT framework in capturing value in the digital economy, this evidence supports consideration of a policy shift towards mandatory participation in Single VAT Registration mechanisms.<sup>64</sup>

### **Strategic Implications of ViDA**

The VAT gap report has revealed that more than half of the potential VAT base remains untapped due to policy choices such as reduced rates and exemptions. Rationalising these could allow Member States to maintain fiscal revenue while lowering statutory rates by up to five percentage points – achieving both competitiveness and equity without new taxes. ViDA thus also illustrates why selective **turnover-based digital taxes are unnecessary and inefficient**. Rather than carving out artificial tax categories for “digital” activities, the EU is integrating digital transactions into its **existing VAT architecture** – a legally robust, neutral, and well-functioning system.

The OECD has repeatedly underlined that digitalisation has become inseparable from the broader economy. Attempting to “ring-fence” digital activities through targeted taxes like DSTs ignores this

<sup>64</sup> DG Taxation and Customs Union. (2023). EU VAT rules for e-commerce two years on: Updated revenue figures point again to a successful implementation. Available at: [https://taxation-customs.ec.europa.eu/news/eu-vat-rules-e-commerce-two-years-updated-revenue-figures-point-again-successful-implementation-2023-06-30\\_en](https://taxation-customs.ec.europa.eu/news/eu-vat-rules-e-commerce-two-years-updated-revenue-figures-point-again-successful-implementation-2023-06-30_en)

reality and risks fragmentation, double taxation, and trade disputes. The European Commission itself acknowledged in 2017 that turnover taxes may conflict with double-taxation treaties, EU State aid rules, and international trade obligations.<sup>65</sup>

By contrast, the VAT Directive explicitly **prevents Member States from introducing general turnover taxes** alongside VAT, precisely to avoid cascading effects and distortions. VAT is designed to tax value added at each stage of production, exempting business-to-business transactions and targeting final consumption. This makes it both economically efficient and legally sound.

In short, ViDA demonstrates that the EU already possesses **the fiscal and legal tools to tax the digital economy effectively**. Strengthening VAT through digitalisation, harmonisation, and platform rules delivers the same objectives that DSTs claim to address – but without their economic and diplomatic downsides.

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<sup>65</sup> European Commission (2018a, p. 57) states that “[C]rediting the new tax (an indirect tax) against corporate income tax (a direct tax) or vice versa would compromise the legal nature of the tax and impact double tax conventions.” European Commission. (2018a). Impact assessment: Fair taxation of the digital economy (Commission Staff Working Document SWD(2018) 81 final). Publications Office of the European Union