amcham issue analysis

digital services tax

executive summary

- The government proposes to impose a digital services tax on large digital services companies domiciled primarily in other EU countries.
- The cost of any tax is likely to be passed in the form of higher prices onto Czech companies purchasing those digital services.
- This will reduce the amount of tax revenue collected, because it will impact other taxes already being paid by Czech companies purchasing digital services.
- The US Trade Representative is likely to deem the Czech digital services tax in violation of Section 301 and impose reciprocal tariffs on Czech exports to the USA.
- We believe the reward of this policy will not a have a substantial economic benefit. We believe the risk of this policy could cause significant harm. The reward is less certain than the risk. We propose delaying action on the bill until the risk can be reduced or eliminated.

AmCham
American Chamber of Commerce
in the Czech Republic

The aim of this document is to examine whether the digital tax will achieve the government's stated economic aims, and what the overall impact of the tax will be on the economy.

Government Aims

The government stated its purpose was to raise more tax revenue and to prevent companies from not paying their fair share of tax in the Czech Republic. Some members of the government have argued that the digital tax would alleviate the discrimination faced by Czech digital services companies.

1. Tax Revenue.

How much revenue will the digital tax raise?

Exact numbers cannot be calculated without knowing how much digital services revenues were generated in the Czech Republic by the companies affected by the tax, how those companies will react to the tax, and how Czech companies purchasing their digital services will respond any change in the digital services companies' behavior, especially pricing. For example, some digital service companies could react to the tax by raising the price of their services. This could reduce the demand for the services, thereby reducing tax revenue. Companies purchasing higher cost advertising could raise the price of their own service and products, thereby passing the cost of the tax onto Czech consumers. Unless the digital service companies absorb the full cost of the tax, the reaction to the tax will have several layers of decisions, and each layer will add such complexity that the range of possible outcomes is too large for a useful calculation.

Instead of calculating an estimated range of public revenue, we will present the most probable way economic players will respond to the tax.

> *Will digital service companies absorb the tax or pass the cost to their customers?*
>
> First, digital service companies will try to pass the cost of the tax onto Czech companies that purchase their digital services. Their ability to do so will be determined by their market share and the price flexibility of their advertising.

Digital service companies market share (the number of users) should not be impacted by the digital tax, because the tax does not increase the cost to users. Therefore, the digital service companies should have the same attractiveness to purchasers of digital services as they did prior to the tax.

If the digital service companies maintain market share, Czech companies purchasing digital services will still need to purchase from the same digital service companies to reach those Czech users. This would make the price of their digital services flexible enough to allow the digital service companies to pass the cost of the tax onto their customers through higher prices for digital services.

Will the digital tax impact revenues from other already existing taxes?

Since we conclude that digital service companies will be able to shift the cost of the tax onto Czech companies, we can assume that the digital tax will impact the tax revenue collected from those companies through other forms of tax. In the simplest form, the higher price of digital services will reduce profits, which will lower the corporate tax collected. More complex forms include impact on employment taxes due to less revenue available for wages or reduced payment of VAT due to less spending on other items.

Conclusions:

- The digital tax will be paid by Czech companies purchasing digital services or their customers.
- Any increase in revenue from the digital tax will be partially or fully offset by reduced revenue from other means of taxing Czech companies which purchase digital services.
- The increase in overall tax revenue may not be significant.

2. Tax Fairness.

One of the arguments used by proponents of the tax is that digital service companies do not pay their “fair” share of taxes for their commercial activities in the Czech Republic. Opponents of the tax have argued that the digital service companies are paying tax in the jurisidictions where their activities occur and utilize the advantages of the EU common market to sell those services in the Czech market. These arguments would have to be examined for each digital service company to assess the accuracy of these arguments.

How much of the "fairness" issue stems from the EU Common Market?

The Common Market is one of the foundations of the European Union. The reason to combine national markets into a European market was 1) to provide a large enough market to allow companies to compete globally and 2) to reduce the advantage companies in large national economies have over those from smaller economies.

In principle, the common market should allow companies from smaller markets such as the Czech Republic to access customers in larger markets, and negate some of the advantages possessed by companies based in larger or wealthier national economies. The EU has developed some policies to balance economic outcomes in the market, such as structural funding.

Since 1989, the Czech Republic has taken advantage of the common market (84% of Czech export is within the EU). The country has also been a net recipient of EU funds (in 2018, the country received 4.1 billion euro and contributed 1.7 billion euro).

However, the Common Market has one flaw: it was built on existing national markets and is still governed in many cases by national rules. Taxation continues to be set by national governments, and varies widely throughout the Union. Ireland, for instance, has 12.5% corporate tax, and 6.25% for revenue tied to intellectual property. Hungary has 9%. France sits at the other end of the spectrum with 31%. Nine countries in the EU have lower rates than the Czech Republic. This variation of tax levels creates an incentive for companies to establish operations in a low tax jurisdiction and utilize the common market to access their customers.

Conclusions:

- The Common Market has offered Czech companies with the opportunity to access larger and wealthier markets, and to benefit from the overall increase in EU wealth through its status as a net-recipient of EU funds.
- These economic advantages must be offset against the disadvantage of having a higher corporate tax rate than some other EU countries.

3. Discrimination against Czech digital service firms
We have not been able to review the government's economic argument for the claim that Czech digital service companies are discriminated against by the current tax regime. We presume the argument is based on Czech digital service companies having to pay a higher tax rate because they operate in a country within the EU Common Market with a higher tax rate than the country in which their competitors operate.

This situation may be more a consequence of business strategy than discrimination. The digital service companies affected by the tax have a global strategy that requires them to operate in several or all of the EU national markets, and to scale their operations by operating out of central locations. Czech digital service companies- with exceptions such as Avast- seem to have focused on the Czech market, and their Czech language requirements might necessitate keeping their operations in the Czech Republic.

Conclusion:

- Any disadvantage incurred by Czech digital service companies for establishing a majority of their operations in the Czech Republic appears to be the result of business decisions based on market focus and not discrimination.

What will be the overall impact of the digital tax?

Our estimate of the impact is that the government may raise some further tax revenue, but that revenue ultimately will be paid for by Czech companies purchasing digital services or the customers of those companies. Whether these tax revenues will benefit the economy will depend on whether the government can generate greater return on spending those tax revenues than the companies.

In our view, the digital tax will not resolve the issue of fairness, which is the result of varying tax rates within the EU Common Market. This would need to be addressed through international negotiations. These negotiations could be accelerated, delayed or not impacted by the Czech digital tax. This will depend on the response of other countries, the EU, and the OECD.

The digital tax will not address the major disadvantage of Czech digital service companies. This disadvantage is the result of focusing on the Czech market. This prevents the level of scaling common in the digital services industry. One Czech company that has not focused on the Czech market, Avast, may actually incur the digital tax. This is a disadvantage it would not face in other countries in the Common Market.

The digital tax could have three unintended consequences that could increase the risk of enacting it. First, the US Trade Representative could review the tax and impose reciprocal tariffs against Czech exports. Second, companies considering whether to place major parts of their operations in the country could reconsider due to concerns that the country's reputation as a stable business environment was no longer valid. Third, the affected digital service companies could avoid investing in the country, and this could damage the country's ambition to become a center for artificial intelligence.

1. Potential US Trade Representative Section 301 proceedings

The US Trade Representative (USTR) has announced it will review all approved digital taxes for Section 301 violations. The USTR has reviewed the French digital tax and announced it would apply reciprocal tariffs. Two (tax on revenue instead of income and extra-territoriality) of the four reasons for applying reciprocal tariffs apply to the Czech tax, and an argument can be made for a third (discrimination against US companies). When announcing the outcome of the French review, the USTR announced its intention to review the Austrian, Italian and Turkish tax.

We can thus conclude that the USTR will review a Czech digital tax and that there is a high probability that reciprocal tariffs would be imposed.

Even a one year imposition of tariffs could do substantial harm to Czech exports to the US. In some cases, it could lead to the sale of Czech operations in the US or the elimination of sales. This would have negative effects on both the economy and government revenue. From the perspective of creating national wealth, imposing a digital tax to protect Czech digital service companies which generate their income from already existing Czech wealth and damaging the national wealth-creating activities of Czech export companies seems economically counterproductive.

One coalition party suggested that the Czech government should cancel the recently agreed contract to purchase military helicopter from a US company if the US Trade Representative imposes tariffs on Czech exports in response to the Czech digital tax. We presume the helicopter purchase was based on a national military need and the procurement process identified the product that would fulfill its purpose under the best possible conditions at the best possible price. The cancellation would therefore require the government either not to fulfill a need or to fulfill that need at a higher price. This, too, would cause the Czech Republic economic harm.

Conclusion:

- As long as the current US administration is in office, reciprocation for a digital tax seems almost certain.
- Responding to the reciprocal tariffs with punitive measures aimed at US companies seems likely to provoke an escalating cycle of harmful economic measures.

2.. Loss of Reputation as a Stable Business Environment

The country has earned a reputation as a good place to invest due to the continuing simplification of its regulatory regime, including taxation. The recent consideration of a banking tax combined with the passage of a digital tax could change this image, and hurt the country's chances to attract long-term investment in areas such as research centers and company headquarters. The loss of that reputation, of course, depends on how many "gimmick" taxes the country introduces relative to its neighbors and the size of those taxes.

3. Potential Impact on AI investment

The argument has been made that taxing the digital services companies could do serious damage to the country's chances to become a power in artificial intelligence. The logic in this argument is that the digital service companies potentially impacted by the tax are also some of the leading investors in artificial intelligence research. We think it is unlikely those companies would refuse to invest in high potential research because of the tax. Doing so would harm their competitiveness against global rivals. However, it could influence their willingness to support the development of the country's artificial intelligence capabilities.

Overall Conclusion:

- Imposing a digital tax may slightly increase government revenues. The economic impact of higher government revenues would depend on how effectively the government spent that money.
- Such a tax ultimately would be paid by Czech companies which purchase digital services, and the higher cost could hurt their competitiveness in the EU.
- The current US administration has declared it will review all digital taxes, and its decision on the French digital tax makes it highly probable that the US will place reciprocal tariffs on Czech exports to the USA. This will have a significant impact on the Czech economy.
- A digital tax will have a neutral to negative effect on investment into the country.
- A digital tax could harm the development of the artificial intelligence sector in the Czech Republic.