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Should Governments Tax Digital Financial Services? A Research Agenda to Understand Sector-Specific Taxes on DFS

Summary of Working Paper 136 by Mary Abounabhan, Laura Munoz, Giulia Mascagni, Wilson Prichard, and Fabrizio Santoro

Low-income countries are facing strong pressure to bring in more revenue at home. With digital financial services (DFS) rapidly expanding across Africa and other low-income countries a growing number are therefore considering new taxes on DFS. In light of the heated debate over DFS taxes, this paper explores the rationale for these taxes and their likely impacts in order to help governments and other stakeholders arrive at policies that best meet their competing needs.

Debating taxes on DFS

The debates around DFS taxation have focused on three questions.

- Do taxes on DFS unfairly target DFS service providers or do these taxes correct under taxation?
- Will taxes on DFS distort the market and obstruct financial inclusion? Or will the new revenue outweigh costs?
- Will taxes on DFS complement or deter broader development goals?

We found both sides of the debates lack sufficient and compelling evidence, specifically regarding differences across countries in the design of taxes on DFS. With more evidence the debate may shift from whether taxes on DFS are justified, to what kinds of taxes may be more or less appropriate and where.

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Assessing the impact of taxes on DFS

In order to guide good policy, we need to understand the financial services landscape.

Table 1

Characteristics	Key variation
Universality	Does the tax apply only to DFS providers, most often telecommunications firms, or to all firms providing DFS and/or equivalent financial services?
Service types	Which types of DFS are subject to the tax? Are comparable non-digital financial services subject to equivalent taxation?
Point of incidence	To what specific aspects of DFS transactions does the tax apply? For example, does it apply to deposits, withdrawals, transfers, etc.?
Rates	How high is the rate of taxation?
Progressivity	To what extent does the tax design seek to increase progressivity, for example through thresholds below which transactions are not taxed?

How is DFS supplied? Who uses it? And how it is used? By looking at the design of the tax, from Table 1, we can help illuminate potential impacts of the tax across four key areas:

- **Government revenues and tax equity:** Revenue will depend on how the tax policy is designed and how users will respond.
- **Price and tax burden distribution:** Because DFS markets are made up of a few big players, there is concern that taxes will largely be passed on to consumers instead of firms. Where taxes result in hefty price increases, consumers will have less to spend on necessities, negatively affecting their well-being. We need to understand how these price increases affect individuals differently especially the most vulnerable.
- **Usage:** To understand the impact of tax on usage we cannot just look at total subscriptions or total transactions over a short period of time. This does not tell us anything meaningful about specific impacts on different users and how they use DFS. Assessing how usage changes with taxation can shed light on broader policy implications. For example, to address market failures in traditional banking, many stakeholders argue for tax incentives to encourage expanded DFS usage. We still do not know, however, if a change in tax policy is enough to bring about increased use of DFS without also improving regulation or infrastructure.
- **Market structure:** Taxes may alter the playing field in which financial service providers operate. They could foster better competition between providers or slow down the development of an emerging industry i.e. DFS. Well-designed taxes on DFS could even enhance user experience by encouraging greater collaboration between networks.

Policy processes for taxes on DFS

Finally, understanding the realities of tax practices is important to evaluate how and why DFS taxation takes a certain shape. Things to consider:

First, decisions about tax policy and administration are often highly political, influenced by competing interests and political priorities. Taxes on DFS create winners and losers, which can depend on specific features of tax design.

Second, policy processes depend on who is making policy, and who is included in the decision making. There is often missing links between tax policy departments, central banks, and financial sector departments required to create well aligned tax policy. To design good taxes on DFS, we need to bring all stakeholders, inside and outside government, to the table. Without this approach, the interconnectedness of the financial sector leaves too much scope for unintended consequences.

Third, tax policy decisions are often also shaped by the interests and needs of tax administrations. Their preferences are shaped by operational constraints – costs, access to information, their legal powers and professional skills – that impact on their ability to tax particular activities.

Ideally, policy processes seek to make the trade-offs between different options clear and to use evidence to inform the best choices. In practice, and for a host of reasons, policy processes may lack such space for deliberation.

Overall, with more evidence we can understand the effects of new taxes on different groups and financial services. Evidence will help us assess the broader rationale for specific taxes on DFS and facilitate dialogue among different stakeholders. These efforts will support evidence-based policy making more broadly.

Further reading

Lees, A. and Akol, D. (2021) *There and Back Again: The Making of Uganda's Mobile Money Tax*, ICTD Working Paper 123, Brighton: Institute of Development Studies

Clifford, K. (2020) *The Causes and Consequences of Mobile Money Taxation: An Examination of Mobile Money Transaction Taxes in Sub-Saharan Africa*, GSMA

Ndulu, B., Joseph, C. and Tryphone, K. (2021) *Fiscal Regimes and Digital Transformation in Sub-Saharan Africa*, Digital Pathways at Oxford Paper Series 11, Oxford: Blavatnik School of Government

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