Are Trade Rules Undermining Taxation of the Digital Economy in Africa?

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Summary of Working Paper 181

Introduction

In the face of emerging and new digital business models, countries are facing a political and technical choice of adapting the existing taxation instruments of corporate income tax (CIT) and value added tax (VAT) or creating new ones, such as digital services taxes (DSTs) and customs duties on electronic transmissions (CDETs). Countries have the potential to tax the digital economy through a combination of at least these four measures, which can be incorporated into their industrial policy and revenue collection strategies.

In making these decisions, the African continent is at a particularly critical juncture. In the international tax context, in November 2023 the United Nations General Assembly approved the a resolution tabled by Nigeria on behalf of the African Group (A/C.2/78/L.18/REV.1) that initiated talks to create a UN framework convention on international tax cooperation, and called specifically for a protocol on 'the taxation of income derived from the provision of cross-border services in an increasingly digitalized and globalized economy'. Some African countries have also been involved in the 'Two-Pillar Solution' to the challenges of digitalisation of the economy developed by the G20/OECD Inclusive Framework on Base Erosion and Profit Shifting. In the international trade context, the Assembly of Heads of State and Government of the African Union have mandated negotiations on the Protocol on Digital Trade to the African Continental Free Trade Area (AfCFTA). Seven African countries are also part of the Joint Statement Initiative on Electronic Commerce (the 'E-Commerce JSI or simply the 'JSI'), which reflects the shared intention of a group of 89 WTO Members to commence negotiations on 'trade-related aspects of electronic commerce'. At the same time, African countries continue to pursue their individual preferential trade/free trade agreement (PTA/FTA) agendas.

As fiscal pressures mount, it is imperative that African countries beware the implications of trade provisions for their ability to tax their digital economy. This paper argues that the extent to which countries can tax the digital economy is critically shaped by three types of trade rules: i) trade rules on services, ii) trade rules on electronic transmissions and iii) digital trade rules. It develops a comprehensive framework for analysing the impact of trade rules on tax regimes in the digital economy and then applies it the cases of Kenya, Rwanda, and South Africa to illustrate what is at stake in practical terms.

Trade rules and taxation of the digital economy

The framework finds that trade rules have the capacity to impact the ability to tax the digital economy in at least three important ways;

i)   Trade rules in services (under GATS and PTAs/FTAs) can constrain the ability of a country to impose a CIT or VAT if it violates the principles of National Treatment and Most-Favoured Nation Treatment. Through these principles, trade rules in services can also have a direct effect in determining the legal position of a country to impose DSTs. This will depend on the commitments taken by the country in specific sectors and modes of supply under GATS, specific drafting of non-discrimination provisions in trade agreements, classification of digital services and design of the DST as well as tax exemptions or carve-outs.

ii)   A moratorium on CDET affects the ability of countries to raise revenue. At the WTO, a set of mostly developed Members are pushing to make the moratorium permanent, which will have critical revenue implications for some African countries. In parallel to the extension of the WTO moratorium, PTAs/FTAs containing bans on the imposition of CDETs are being concluded in an effort towards norm-setting.

iii)   Digital trade rules, such as free cross-border data flows, affect taxation rights through an administrative effect. They are currently undermining the ability of governments to track where data is being generated/mined, processed, and monetised, which in turn affects their ability to tax data sourced from their countries and data transactions conducted within economies. Bans on data localisation and offshoring of data make it more difficult for tax authorities to assess the value of locally generated data and undermine the ability of countries to leverage locally generated data for advancing development prospects.

Key findings from case-studies

Kenya has taken commitments on communication and audio-visual services under GATS but not on other sectors relevant to the digital economy, such as computer and related services (CRS). In its design of the 1.5 per cent DST, Kenya has excluded communication services, such as text messages, phone calls and digital advertising services, which are instead subject to VAT. The digital advertising services are further subject to a withholding tax at the time of the transfer of payment by the customer, with a tax return necessary at the end of every tax quarter.

South Africa has country has CRS commitments under GATS but has not signed any digital trade agreements or agreements with digital trade provisions. It can therefore leverage digital trade policy instruments, such as data localisation, which would lead to foreign firms setting up their servers within the physical boundary of the country, establishing local presence. Alternatively, if it chooses to adopt a DST, it could follow the EU's example in designing and defending its DST, in accordance with its international trade, investment and taxation obligations. It could also make use of certain exceptions for taxation purposes related to direct taxes on income or capital under GATS, making the categorisation of digital taxes very important.

The Rwanda case study showed that the country recognises the need to tax commercialisation of user data, which is the main income generating asset of platform owners. For Rwanda, custom duties on ET, based on applied tariffs, could have generated an additional revenue of $14 million in 2020, higher than revenue estimates under other digital taxation approaches.

"Trade rules have the capacity to impact the ability to tax the digital economy in at least three broad ways, i.e., through: (1) a direct effect on the legal ability of governments to tax the digital economy; (2) an indirect effect via changes to business structure and taxation rights; and (3) administrative effects on data collection and capacity to monitor and implement measures aimed at taxing the digital economy."

Credits

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