SOUTH CENTRE

SouthViews
No. 234, 18 February 2022
www.southcentre.int
Twitter: @South_Centre

South Asia and the Need for Increased Tax Revenues from the Digitalized Economy

By Abdul Muheet Chowdhary

It is understandable why Pakistan and Sri Lanka, both members of the OECD Inclusive Framework, rejected the Two Pillar solution of the OECD on the taxation of the digitalized economy. Both Pillars would have deprived them of badly needed revenues, especially Pillar One. South Asian countries, amongst the poorest in the world and with high levels of external debt, must conduct a careful cost-benefit analysis if they are considering proceeding with Pillar One. Agreeing to this means foregoing unilateral measures on all companies, including those out-of-scope and losing vital policy space. Further, the agreement will have a long shelf-life and likely last for the next 30-40 years. Thus, all developing countries, including from South Asia, should be clear about what they are 'getting into'.

On 8 October 2021, the Organisation for Economic Co-operation and Development (OECD)/Group of Twenty (G20) Inclusive Framework (IF) on Base Erosion and Profit Shifting (BEPS), an influential standard-setting forum that produces rules on international taxation, came to an agreement on the taxation of the digitalized economy. This agreement was known as the "Two Pillar solution". Pillar One sought to update the rules through which highly digitalized businesses are taxed and Pillar Two established a global minimum corporate tax. Pillar One in particular was highly anticipated as modern businesses are increasingly moving away from brick-and-mortar operations to online modes. These have created tax challenges, as existing rules require the physical presence of companies in a country for them to be taxed. Thus, in the absence of a global solution, countries began resorting to unilateral measures to ensure that these companies, with famous examples being Facebook, Apple, Amazon, Netflix and Google (FAANG), paid their fair share of taxes.

However, Pillar One was criticized as being complex to administer and generating minimal to even negative revenues for developing countries. Four countries in the IF, two from Africa and two from South Asia, outrightly rejected the Two Pillar solution. These were Nigeria, Kenya, Pakistan and Sri Lanka. At the First African Fiscal Policy Forum in December 2021 organized by the South Centre and the Coalition for Dialogue on Africa, the Finance Ministers of Pakistan and Nigeria outlined their dissatisfaction and critiques of Pillar One, with the former saying it had "nothing for developing countries".

These countries have defied enormous pressure from the developed countries to conform and have taken a bold position to impose unilateral tax measures on the digitalized economy. This shows the importance of increased revenues for them. This article focuses on South Asia as a region, the tax revenue positions of its countries and the way forward vis-à-vis the digitalized economy.

Dangerously large tax gaps

Development – building schools, roads, hospitals, etc. – requires funds. There are many sources of such funds. Of these, the single most important source is tax collection, known more formally as "domestic resource mobilization". This has been recognized at the international level. Para. 20 of the Addis Ababa Action Agenda says,

> "For all countries, public policies and the mobilization and effective use of domestic resources, underscored by the principle of national ownership, are central to our common pursuit of sustainable development, including achieving the sustainable development goals."

A commonly used indicator is the tax – Gross Domestic Product (GDP) ratio. Recent research has begun indicating that a tax-GDP ratio above 15% is a "tipping point", which helps "countries generate sufficient domestic resources that can be invested in health, education, and infrastructure." Countries with such a ratio have seen larger increases in economic growth and development levels.

Where does South Asia stand? Data is provided in Figure 1 (see page 3).

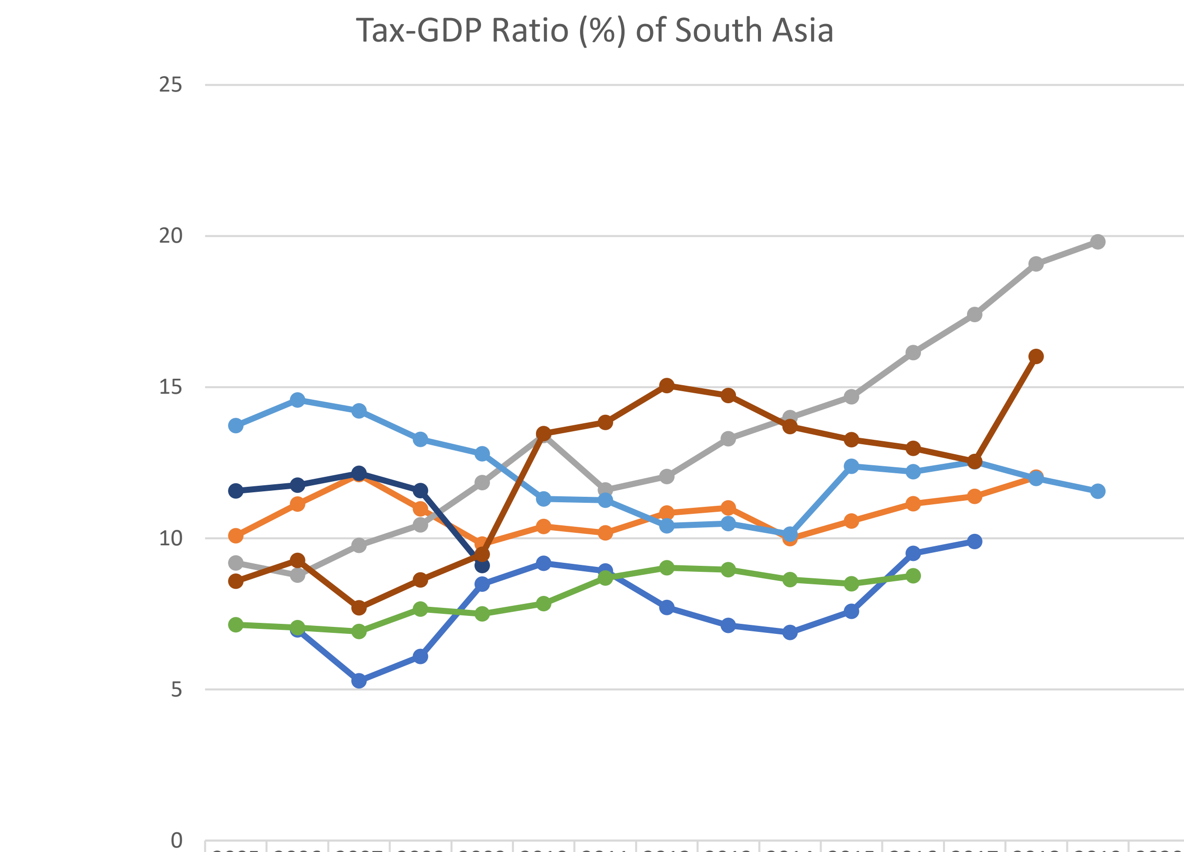
It can be seen that Nepal (19.8%) and Bhutan (16%) are the only two South Asian countries that have managed to break out of the tipping point. The remaining countries are all within the 15% threshold, with Afghanistan (9.9%), Bangladesh (8.8%) and Maldives (9.1%) at critically low levels.

Thus, it can be concluded that the majority of South Asian countries need to undertake strong measures to accelerate tax collection such that it reaches and crosses the 15% mark. For comparison, the average for OECD countries, the richest in the world, is 33.4%.

Dangerously high levels of external debt

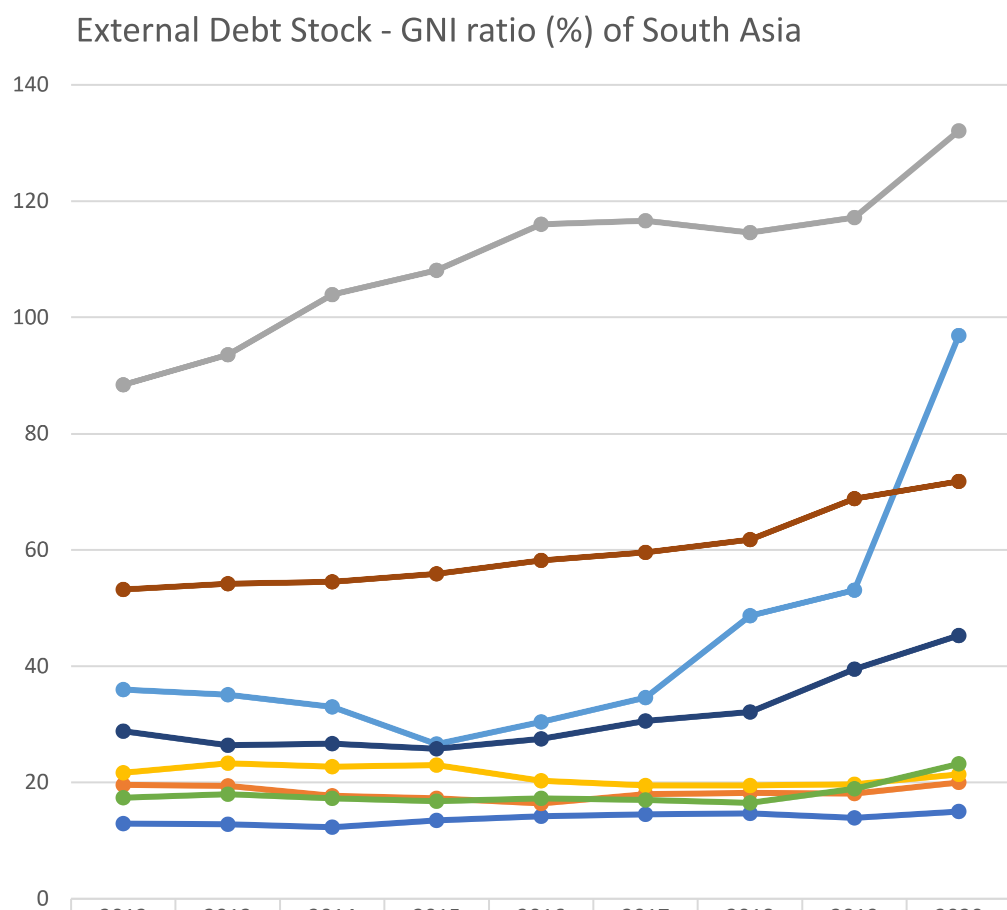
A natural question that may arise is how governments obtain funds if not through taxes. The answer more often than not is debt. The less a country's tax-GDP ratio, the more it would be forced to rely on debt, which has multiple negative ramifications. A useful indicator in this regard is the ratio of the external debt stock (total amount of money owed to foreign creditors) to Gross National Income (GNI). The situation of South Asian countries is provided in Figure 2 (see page 4).

It becomes evident that there is wide variation and evenly split. Four countries have medium levels ranging between 15-25% and these are Afghanistan, Bangladesh, India and Nepal. The other four have relatively high levels of external debt, at 45% (Pakistan), 72% (Sri Lanka), 97% (Maldives) and 132% (Bhutan).



	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Afghanistan		6,968	5,283	6,088	8,482	9,17	8,917	7,708	7,123	6,882	7,585	9,503	9,898			
India	10,08	11,13	12,11	10,98	9,81	10,39	10,18	10,84	11	9,985	10,57	11,15	11,39	12,03		
Nepal	9,179	8,78	9,772	10,44	11,84	13,4	11,6	12,04	13,3	13,99	14,69	16,14	17,41	19,08	19,81	
Pakistan																
Sri Lanka	13,73	14,58	14,22	13,28	12,8	11,3	11,26	10,41	10,49	10,14	12,38	12,2	12,53	11,98	11,56	
Bangladesh	7,136	7,043	6,917	7,656	7,498	7,835	8,686	9,025	8,962	8,635	8,498	8,765				
Maldives	11,57	11,76	12,15	11,58	9,101											
Bhutan	8,576	9,266	7,698	8,625	9,466	13,46	13,84	15,05	14,72	13,7	13,26	12,98	12,54	16,02		

Source: data.worldbank.org



	2012	2013	2014	2015	2016	2017	2018	2019	2020
Afghanistan	12,9	12,8	12,3	13,5	14,2	14,5	14,7	13,9	15
Bangladesh	19,6	19,4	17,7	17,3	16,4	18	18,2	18,1	20
Bhutan	88,4	93,6	103,9	108,1	116	116,6	114,6	117,2	132,1
India	21,7	23,3	22,7	23	20,3	19,5	19,5	19,7	21,4
Maldives	36	35,1	33	26,6	30,4	34,6	48,7	53,1	96,9
Nepal	17,4	18	17,3	16,8	17,3	17	16,5	18,9	23,2
Pakistan	28,8	26,4	26,7	25,8	27,5	30,6	32,1	39,5	45,3
Sri Lanka	53,2	54,2	54,5	55,9	58,2	59,6	61,8	68,8	71,8

Source: World Bank International Debt Statistics

Digital economy – a lucrative source of revenue

In this context it is understandable why Pakistan and Sri Lanka, both members of the Inclusive Framework, rejected the Two Pillar solution. Both Pillars would have deprived them of badly needed revenues, especially Pillar One. India, the largest South Asian country, has agreed to the Two Pillar approach, but it simultaneously also championed an alternative solution in the United Nations known as Article 12B, which is much more suitable for developing countries. Further, India (and Maldives) have not yet legally agreed to implement Pillar One and the commitments made are only political and non-binding. It thus remains to be seen whether South Asian countries will actually adhere to the OECD's solution.

All South Asian countries still have full freedom of action to decide how they want to proceed. The digitalization of the economy continues to grow, accelerated by COVID-19. Thus, effective taxation of these businesses will become an increasingly important source of revenue in the future.

South Asian countries, amongst the poorest in the world, must conduct a careful cost-benefit analysis if they are considering proceeding with Pillar One. Agreeing to this means foregoing unilateral measures on all companies, including those out-of-scope and losing vital policy space. Further, the agreement will have a long shelf-life and likely last for the next 30-40 years. Thus, countries should be clear about what they are 'getting into'.

There are many easier to implement alternatives which can bring these countries much larger revenues. Any cost-benefit analysis must also provide assessments of revenues available through alternative policy options and this must be publicly available. Policy makers must ensure that this critical decision is one that will bring South Asia, one of the cradles of human civilization, the needed resources to come out of extreme poverty and achieve the Sustainable Development Goals.

Author: Abdul Muheet Chowdhary is a Senior Programme Officer with the South Centre Tax Initiative, part of the Sustainable Development and Climate Change (SDCC) Programme at the South Centre.

This article was originally published in *OneWorld SouthAsia* on 2 February 2022: https://owsa.in/southasia-calls-for-increased-tax-revenues-from-the-digitalized-economy/.

*** The views contained in this article are attributable to the author and do not represent the institutional views of the South Centre or its Member States.**