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INSIGHT: Taxes or Growth? The Equalization Levy Conundrum

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Meyyappan Nagappan, of Nishith Desai Associates, India, discusses whether expanding the scope of the equalization levy will have detrimental consequences on the growth of the digital sector in India in the long run.

For several years the Indian government has advocated that entities which carry on economic activity in a jurisdiction ought to be taxed even if they do not have a physical presence in that jurisdiction.

While the Indian government has been coordinating with the Organization for Economic Co-operation and Development (OECD) on global efforts to arrive at a consensus, it has deviated significantly from any form of global consensus and has unilaterally imposed the widest digital tax in an unprecedented manner, presumably with a view to taxing digital income.

At a time when digital services and operations are essential for the functioning of the world economy, it is unfortunate that such a tax has been imposed. The total damage that could have potentially been caused by the Covid-19 pandemic has been mitigated to a great extent thanks to digital operations by the big tech companies.

Change in Attitude towards Taxing Big Tech Companies

Further, in the taxation field there appears to be a change in the thinking towards taxation of big tech companies.

Where the premise for the last few years has been that big tech companies are not paying adequate taxes, reputed tax academics and scholars have started questioning that premise, taking into consideration the total benefit to society.

It would not have been possible to handle this crisis if it were not for the investments made over several years into infrastructure and technology by these companies. This is supported by the fact that digital operations by companies have helped both businesses and people stay connected, receive groceries, medicines and essentials, manage mental health, stay entertained, helped businesses continue operations online thereby saving them and the economy, worked with the government to prevent the spread of misinformation, and the list goes on.

Further, a turnover tax such as the equalization levy has faced severe criticism from a tax policy perspective both internationally and in India. It has also invited swift retaliatory taxes from the U.S. when the French government tried to impose it. Studies also show that such taxes increase the cost of critical services and goods for customers and inputs for businesses having an adverse and anti-competitive impact.

Adverse Impact on Consumer Buying Behavior

Consumer sentiment and demand has plummeted for online purchases. All orders other than essential orders have been canceled. Many e-commerce companies which are into trading non-essential items are incurring major losses. Investments into tech start-ups are slowing down and smaller ones are unlikely to survive. Many start-ups take years to become profitable and require foreign investment during the period where they are trying to acquire a user base. In such a situation, increased digital costs do not help such start-ups or e-commerce companies: It would exacerbate problems and result in significantly lower foreign investment and capital flows.

This is because, while the equalization levy has been styled as a tax on the foreign e-commerce operator, many empirical studies have shown that consumers bear the burden of indirect taxes of such turnover taxes in the form of higher prices.

The equalization levy may act as a tax on business inputs, for example, advertising or cloud computing which is a critical business input. It is accepted that as part of an optimal tax system, taxes on business inputs should generally be avoided as they may distort production decisions by domestic firms and prevent production efficiency.

Consumers, particularly those that are price sensitive, face an affordability barrier in the adoption of technology if taxes increase the total cost of services or sales. Consequently, this will drive down consumption thereby affecting demand and the ability to restart the economy quickly after the crisis.

The equalization levy is intended to be a form of income tax, and will have a varying effect as the effective tax rate will change widely as profit margins are never equal across all firms and different firms incur losses or profits. Particularly, as younger firms are more likely to incur losses, a turnover tax creates barriers to market entry that protect the market shares of incumbents, with a resultant anti-competitive effect. This ultimately means an increase of cost for consumers and Indian businesses.

Future of Equalization Levy: Balancing Growth and Revenue

The Indian government needs to consider the trade-offs between revenue generation and the potential negative impact on the development of the digital sector while expanding the equalization levy. Taxation of goods or services sold via the internet should be considered favorably, in light of the benefits to consumers and Indian businesses. For example, consumer welfare increases when the purchase prices are lower.

Bearing all this in mind, the tax collection of 939 crore rupees ($124 million) through the equalization levy in FY2019 suggests that Indian entities spent at least 15,650 crore rupees to place advertisements with foreign digital companies, up from the 9,800 crore rupees they spent in FY2018.

While the government is in need of revenue to deal with the Covid-19 crisis, the incremental tax that the government may rake in may have far more negative consequences on growth of the digital sector in the long run. The expanded equalization levy would result in several crores of rupees effectively flowing out of the pockets of start-ups and domestic businesses into the tax coffers of the Indian government, thereby extracting a huge toll on the local economy.

It is better to roll back the levy or defer implementation and reconsider before irreversible damage is done.

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