

Tariffs by Another Name: How Discriminatory Taxes on Cross-Border Services Threaten America's Export Edge

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Key Findings

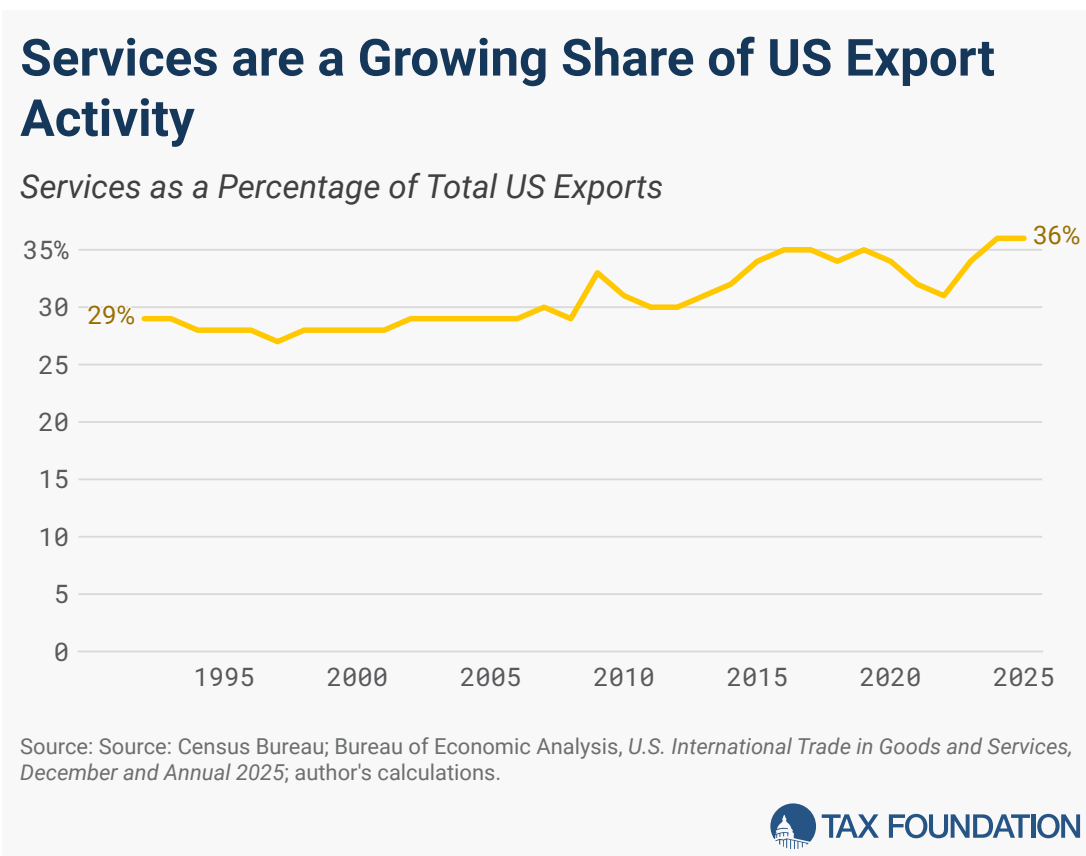
- Cross-border services face a growing patchwork of discriminatory taxes worldwide. Three prominent examples from the UN, Europe, and the US function as quasi-tariffs.
- All three attempt destination-based taxation in unprincipled or haphazard ways, resulting in tax pyramiding, double taxation, and distorted production decisions.
- Though foreign companies may seem like soft targets in domestic politics, any advantage of discriminatory taxation is lost when that discrimination is reciprocated. Countries that violate neutrality receive neutrality violations in turn.
- The UN convention on tax threatens to legitimize violations of tax policy principles, including forms of trade neutrality and net-basis taxation.
- European digital services taxes target gross revenues against a dubious and gerrymandered tax base.
- The US base erosion and anti-abuse tax creates many of the same distortions the US criticizes abroad.
- The US, as the world's largest services exporter, has a stronger interest in combating discriminatory services taxation than in pursuing tariffs.

Introduction

Around the world, cross-border services face a growing patchwork of discriminatory taxes. This paper will examine three examples: a proposal from a UN convention, the digital services taxes imposed in some Organisation for Economic Co-operation and Development (OECD) countries, and an element of the US tax code. These instruments differ in origin and design, but they share a defining feature: they impose higher effective tax burdens on cross-border service provision than on comparable domestic activity.

Services are significant because they are a growing share of global cross-border activity—in the US, for example, they have risen to 36 percent of all exports¹—and neutrality is significant because it is foundational to efficient tax policy. When taxation treats activities differently, it diverts labor and capital from their most productive uses. Firms may also expend precious resources navigating complexity or litigating their treatment. By contrast, a neutral tax system allows them to focus on more productive activities. These principles are well understood in public finance theory. However, in practice, they are eroding in the taxation of cross-border services.

Figure 1.



¹ Census Bureau; Bureau of Economic Analysis, *U.S. International Trade in Goods and Services, December and Annual 2025*, Feb. 19, 2026, <https://www.bea.gov/news/2026/us-international-trade-goods-and-services-december-and-annual-2025>.

The erosion of neutrality is obvious in goods trade, where tariffs are overt and salient. In services taxation, it is subtler. Some discriminatory taxation on services is embedded inside corporate tax codes, couched in language of fairness, or labeled as a response to legitimate concerns about profit shifting, giving it greater perceived legitimacy than slapping tariffs on boatloads of goods.

The policies are generally attempts to assert taxing rights based on customer location rather than production location. This concept is also known as destination-based taxation. Properly designed destination systems, such as value-added taxes (VATs), preserve neutrality and proportionality in ways that these policies do not, through proper deductibility of inputs and crediting of prior tax paid.

These poor attempts at destination-based taxation will ultimately make the world, and perhaps the US in particular, a poorer place. Services sectors like technology, consulting, and engineering depend on scale, specialization, and cross-border integration. The US runs persistent trade surpluses in these sectors because of its comparative advantage at the top of many of these value chains. Gains from specialization are among the best-known and best-validated facts in economics. It would be an error to discourage them with poor tax policy.

This paper examines three case studies that illustrate the trend. First, the UN Framework Convention on International Tax Cooperation, particularly its proposed withholding taxes on cross-border services. Second, digital services taxes (most typically levied by individual European countries). Finally, the US's own base erosion and anti-abuse tax (BEAT). In each case, I identify the principles at stake, explain why the design falls short, and consider why the US has a particular interest in restoring neutral treatment of cross-border services—not to preserve any one country's revenue claim, but to sustain the tax architecture that supports long-run growth and durable revenue.

What Neutrality Requires in Cross-Border Situations

Tax neutrality is a simple idea with far-reaching consequences. A tax is “neutral” when it does not change the relative prices of economic decisions that would otherwise be made on their merits.

Taxes that do change relative prices distort decisions, imposing real costs beyond the revenue they collect: they cause firms to choose less efficient production locations, consumers to substitute away from goods they value, and capital to flow toward tax-favored activities rather than its most productive uses. Economists call these costs “deadweight loss”; decades of public finance research have found this loss increases roughly with the square of the tax rate, meaning tax hikes on an activity that is already heavily taxed create more distortion per unit of revenue than tax hikes on an activity that is less heavily taxed.² Absent any unusual considerations, equal taxation across all economic activity is best.³ When the Tax Foundation describes the objective of taxation as raising revenue with the least economic harm, it is drawing on this body of work.

² See, e.g., James Hines, *Three Sides of Harberger Triangles*, NBER Working Paper No. 6852, December 1998, <https://doi.org/10.3386/w6852>.

³ Peter A. Diamond and James A. Mirrlees, “Optimal Taxation and Public Production I: Production Efficiency,” *American Economic Review* 61:1 (March 1971): 8–27, <https://www.jstor.org/stable/1910538>.

In the international context, the stakes are higher. Cross-border transactions involve overlapping jurisdictions, each with its own tax system and its own incentives to assert taxing rights. When these systems interact badly—when they double tax, discriminate, or reach beyond their proper scope—the resulting distortions are not just inefficient but can unravel the cooperative framework that makes international trade possible in the first place.

Before exploring principles of neutrality, one might ask why governments so frequently violate them, especially in international contexts. One could sincerely want to help workers, taxpayers, and investors in one’s own jurisdiction more than one wants to help people in other jurisdictions, and this might be especially true if one is an elected representative of that jurisdiction. Or alternatively, one could simply be facing the realities of political pressure, and hope to push the burdens of taxation onto people who cannot retaliate as effectively.

Regardless of cause, violations of neutrality end up welfare-destroying if universalized. If each jurisdiction favors its own over others, it may make individually optimal decisions that are collectively suboptimal when universalized. As I will show in case studies, jurisdictions throughout the world are engaging in neutrality-violating taxation of services, with negotiation as a main path to restoring neutrality. Before turning to the case studies, it is worth defining each principle of neutrality precisely, plus one more principle concerning the efficiency of tax administration that seems particularly important for this discussion.

Production Location Neutrality

A tax system satisfies production location neutrality when it does not, all else equal, impose a heavier burden on a service provided by a foreign producer than on the same service provided domestically. This insight dates to David Ricardo’s insights about comparative advantage, refining prior observations by Adam Smith.⁴ While these early economists generally studied goods, a tax that penalizes imported services—whether through an explicit tax at the border or a cleverly scoped income tax—undermines these gains just as surely as a border duty on physical goods.

For a more modern take, Diamond and Mirrlees (1971) demonstrated that even a government with broad redistributive goals should avoid taxing intermediate inputs, because doing so distorts production decisions without improving the distribution of welfare.⁵ In their framework, the optimal tax system preserves efficient production even if the government then redistributes the output. Discriminatory taxation of cross-border services violates this principle directly: it makes the economy’s input mix less efficient by artificially raising the cost of foreign-sourced inputs relative to domestic ones.

This matters enormously in a modern economy where services are increasingly tradable and increasingly constitute intermediate business inputs. When a multinational enterprise (MNE) sources data analysis from India or engineering consulting from Germany, it does so because those providers offer the best combination of quality and price. A tax system that penalizes these choices, by taxing the foreign ser-

⁴ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (London: W. Strahan and T. Cadell, 1776), Book IV; David Ricardo, *On the Principles of Political Economy and Taxation* (London: John Murray, 1817), chap. 7.

⁵ Ibid. See also: Erica York, “New Analysis Shows How Input Tariffs Will Impact U.S. Manufacturing Sectors,” Tax Foundation, Jul. 16, 2018, <https://taxfoundation.org/blog/new-analysis-shows-input-tariffs-will-impact-u-s-manufacturing-sectors/>.

vice provider at a rate or on a base that would not apply to a domestic provider of the same service, is functionally equivalent to a tariff on business inputs. And as with tariffs on physical inputs, the cost does not fall solely on the foreign provider. It falls on the domestic firm that uses the service, on the domestic consumers of that firm's products, and, in cases where the domestic firm re-exports its output, on competitiveness in third markets as well.

Capital Import Neutrality

Production location neutrality addresses where *services* are sourced. A related but distinct set of concerns involves where *capital* is deployed. These forms of neutrality are difficult to reach, but more efficient where possible.

Capital import neutrality (CIN) holds that all firms competing in each market should face the same tax burden regardless of where ownership or parent companies might be located. Under CIN, a factory in Germany should be taxed the same whether it is owned by a German company, an American company, or a Japanese company, so that capital competes on a level playing field within each market. The classic mechanism for achieving CIN is pure territorial taxation: each country taxes only the income sourced within its borders, and exempts foreign-source income entirely. There is also a second condition, capital export neutrality, which pertains to treating a jurisdiction's own investment money equally, regardless of which jurisdiction it goes to. This is an important concept in tax, but less important to this particular paper.

These neutrality concepts, coined by Desai and Hines (2003), are much newer to economics than production location neutrality.⁶ Unfortunately, the conditions cannot be fully satisfied when countries have different tax rates—which they almost always do. Real-world tax systems, therefore, involve compromises. But both benchmarks share a core intuition: piling additional tax layers on cross-border transactions, beyond what either the source or residence country would normally impose on a purely domestic transaction, distorts the allocation of capital. In the long run, it reduces the productivity gains from specialization, and perhaps the risk-reducing benefits of portfolio diversification as well, by encouraging economic decision-makers to engage in more domestic favoritism than is warranted on the merits.

⁶ Mihir Desai and James Hines, Sep 2003, "Evaluating International Tax Reform," *National Tax Journal* 56:3 (2003), <https://www.journals.uchicago.edu/doi/abs/10.17310/ntj.2003.3.03>.

Net-Basis Taxation and Creditability

Two of the most important operational requirements of a neutral international tax system are net-basis taxation and creditability. They are conceptually distinct but practically intertwined: both serve to prevent the tax system from piling up costs that compound through supply chains with multiple participants.

Net-basis taxation (or deductibility of inputs) means that a business is taxed on its *profits*—revenue minus the costs of earning that revenue—rather than on its gross revenue. The alternative, to disallow deductibility in gross receipts taxes or other ill-thought-out measures, means the same unit of economic value-added can get the same layer of tax applied several times, causing an arbitrarily high number of extra layers of taxation, a phenomenon the Tax Foundation describes as “tax pyramiding.”⁷

Creditability can function as a substitute for net-basis taxation, if structured properly, as in value-added taxes. Fully crediting tax paid at prior steps in the process, as in invoice-credit taxation, can fix the harm of a gross-based tax system. This effectively pulls inputs out of the tax base after they’re included but uses credits instead of deductions to do so.

Creditability is also a mechanism by which the international tax system prevents double taxation. When a company earns income abroad and pays tax to a foreign government, both the US system for international taxation and the new Pillar Two system generally grant credit against the company’s international tax liability for foreign tax paid. This has some drawbacks, in that the crediting costs money and arguably encourages other countries to raise taxes on one’s own companies. But the foreign credit is the linchpin of capital export neutrality. It allows two countries to both assert taxing rights over the same income without the combined burden exceeding what either country would impose alone.

However, the creditability of foreign taxes is limited in many tax systems, in part because of the recognized drawbacks. Typically, under international corporate income tax systems, a creditable corporate income tax must be imposed on *net income* and must be compulsory. Levies that are imposed on gross revenue, that single out specific industries, or that are structured as something other than an income tax may fail the creditability test, leaving the taxpayer to bear the full burden of both the foreign levy and the domestic income tax on the same underlying activity, amplifying their distortionary effect.

Jurisdictional Restraint

A principled tax system taxes what happens within its borders—the income earned there, the transactions conducted there, the property situated there. Jurisdictional restraint is the principle that a country’s tax claims should be proportional to the genuine economic connection between the taxpayer and the jurisdiction.

⁷ Tax Foundation, “Gross Receipts Taxes,” <https://taxfoundation.org/taxedu/glossary/gross-receipts-tax/>; Tax Foundation, “Tax Pyramiding,” <https://taxfoundation.org/taxedu/glossary/tax-pyramiding/>.

Several of the measures examined in this paper violate this principle in a specific and troubling way: they condition a taxpayer's liability in one jurisdiction on its activities, revenues, or characteristics in *other* jurisdictions. A digital services tax that applies only to companies with global revenues above a certain threshold is not merely taxing what happens within the levying country's borders. It is using a company's worldwide size—revenue earned in dozens of other countries under dozens of other tax systems—as a criterion for liability.

This kind of quasi-extraterritorial taxation is problematic for several reasons. It introduces a new form of discrimination: two firms can provide the same service in the same market, but one faces a tax that the other does not, solely because of its operations in unrelated countries. It creates compliance burdens far out of proportion to the tax at issue, because the taxpayer must disclose and calculate global metrics to satisfy a single country's tax authority. And it undermines the basic bargain of international tax cooperation, which rests on the premise that each country's tax system is primarily concerned with economic activity within its own territory. When countries begin taxing based on what happens elsewhere, the system of reciprocal restraint breaks down, and the risk of cascading, overlapping claims or retaliatory measures rises sharply.

Instrument Neutrality

Economically equivalent transactions should face equivalent tax treatment regardless of their legal form or delivery mechanism. This principle is under severe strain in the digital economy, precisely because many new tax measures are defined by their delivery channel. Digital services taxes typically apply to revenues from online advertising, digital marketplaces, and user-data monetization, but not to their offline analogs.

The result is a tax system that penalizes digital delivery, creating an incentive to structure transactions in less efficient forms solely to avoid the tax—or, more likely, simply imposing a higher cost on the digital transactions that firms and consumers increasingly prefer.

This is especially perverse given that digitization often makes services more tradable, which in turn creates more scope for the gains from specialization that Ricardo and Smith identified. Taxing the digital delivery channel more heavily than its analog predecessor fails the neutrality test and actively penalizes the mechanism through which the gains from trade in services are realized.

Compliance and Enforcement Efficiency

A final principle, less the provenance of economic theory and more from the practice of tax administration in the real world, is a sort of proportionality between the compliance and administrative costs of a tax and the revenue it raises. A tax that generates little in revenue but causes taxpayers heavy compliance burdens, or tax collectors heavy enforcement burdens, is a bad tax even if its economic incentives are acceptable in theory. Instead, when compliance costs are high relative to revenue, the tax directly uses the productive labor of intelligent accountants and lawyers, whose talents would be better used elsewhere. This is one reason the Tax Foundation identifies simplicity as a key component of sound tax design.

Case Study 1: The UN Framework Convention on International Tax Cooperation

In recent years, a process at the United Nations has been moving toward a potentially sweeping overhaul of international tax rules. The UN Framework Convention on International Tax Cooperation (UNFCITC) seeks to influence how countries cooperate on taxation—including, critically, how they allocate the right to tax income from cross-border services. The convention is being drafted by an Intergovernmental Negotiating Committee, with final text expected for submission to the UN General Assembly in 2027.

The UNFCITC matters for this paper’s purposes because it threatens to provide multilateral legal legitimacy for exactly the kind of haphazard destination-based taxation that violates the principles outlined above. While the convention covers a range of topics—from high-net-worth individual taxation to exchange of information—its most consequential provisions, from the standpoint of cross-border services, are Article 4 of the draft framework convention and Protocol 1, the early protocol on cross-border services taxation.

What Article 4 Does

The October 2025 draft of the framework convention includes an Article 4, titled “Fair Allocation of Taxing Rights,” which states: “The States Parties agree that every jurisdiction where a taxpayer conducts business activities, including jurisdictions where value is created, markets are located and revenues are generated, have a right to tax the income generated from such business activities.”⁸

This single sentence, critically, blends two quite different taxing-right claims. “Where value is created” describes traditional source-based taxation—taxing where production is located. This principle is dominant in international corporate income tax law; despite some drawbacks, it is generally how corporate income is apportioned internationally, through transfer pricing and other rules.

The second taxing right is “where markets are located and revenues are generated.” This is destination-based taxation: the assertion that the country where a customer resides has a right to tax the income earned from selling to that customer, even when the service provider has no employees, no assets, and no establishment in that country. For example, a US-based software firm serving clients in dozens of countries from servers in northern Virginia would, under this principle, owe income tax in each of those countries—not because it uses any of those countries’ public infrastructure, but simply because its customers happen to be there.

8 United Nations, Ad Hoc Committee to Draft Terms of Reference for a United Nations Framework Convention on International Tax Cooperation, *Co-Lead’s Draft Framework Convention Template (A/AC.298/CRP.21)*, Oct. 24, 2025, https://financing.desa.un.org/sites/default/files/2025-11/A_AC.298_CRP.21_WSI%20Co-Lead%E2%80%99s%20Draft%20Framework%20Convention%20Template%2024Oct%202025.pdf.

Destination-based taxes are traditionally found more in consumption taxation than corporate income taxation. The destination base may have virtues—it may be more robust to profit shifting concerns than the source base—but an awkward mix of source- and destination-based claims will almost invariably incentivize unprincipled policy: one could call this “source-based taxation for my exporters, but destination-based taxation for my importers.”

Article 4 does not, on its own, impose a tax. But it provides the legal and rhetorical foundation for Protocol 1, which would translate this principle into operational taxing mechanisms.

What Protocol 1 Envisions

Protocol 1, the early protocol on “taxation of income derived from the provision of cross-border services in an increasingly digitalized and globalized economy,” is where abstract principle may become concrete tax policy. The January 2026 Co-Lead’s Draft Options Paper lays out the central policy choice under negotiation.⁹

Many developing countries currently impose gross-basis withholding taxes on payments made to nonresidents for services. Under most existing bilateral tax treaties, including many signed by the US, or many of those following the OECD Model Tax Convention, these withholding taxes are constrained or eliminated: service income is generally classified as business profit taxable only in the source country.

By contrast, the protocol is considering new rules that would permit market countries to tax cross-border service payments even in the absence of any physical presence by the service provider. This draws heavily on recent additions to Article 12 of the UN Model Double Taxation Convention.¹⁰

The UN Model Double Taxation Convention is a separate convention from the UNFCITC, more a guide for bilateral treaty-making than an attempt at an ambitious multilateral agreement. (As these conventions are separate, articles numbered 4 and 12 discussed above are not from the same document, and their numbering is not commensurate.) Both conventions position themselves as developing-country-friendly alternatives to their OECD counterparts, and both are too accommodating of gross-basis taxation. The UNFCITC draws directly on the UN Model Convention’s approach to cross-border services.

Overall, the practical effect of the protocol is to multilateralize and legitimize withholding taxes on payments flowing out of jurisdictions to foreign service providers.

⁹ United Nations, Intergovernmental Negotiating Committee on the UN Framework Convention on International Tax Cooperation, Workstream II, *Co-Lead’s Draft Options Paper (A/AC.298/CRP.27)*, Jan. 21, 2026, [https://financing.desa.un.org/sites/default/files/2026-01/WSII%20\(21%20Jan%202026\)%20Co-Lead’s%20Draft%20Options%20Paper.pdf](https://financing.desa.un.org/sites/default/files/2026-01/WSII%20(21%20Jan%202026)%20Co-Lead’s%20Draft%20Options%20Paper.pdf).

¹⁰ KPMG, “Overview of topics and workstreams discussed at recent meeting of UN Tax Committee,” Apr. 1, 2025, <https://kpmg.com/kpmg-us/content/dam/kpmg/taxnewsflash/pdf/2025/04/tnf-kpmg-report-un-apr1-2025.pdf>.

How the UNFCITC Violates the Neutrality Framework

Measured against the principles of neutrality outlined earlier in this paper, the UNFCITC's approach to cross-border services taxation fails on nearly every count.

Net-basis taxation. The most likely mechanism to emerge from Protocol 1 is gross-basis withholding: functionally, a tax levied as a flat percentage of the total payment for a service, without any deduction for the costs of providing that service. The options paper discusses net-basis taxation, but leans in the direction of gross basis. It touts the simplicity of gross-basis for developing countries, but administrative simplicity is not a sufficient justification for a fundamentally flawed tax base. It also argues, functionally, that low rates can serve as “rough justice” for denial of inputs. However, low rates are more likely to disguise potential pyramiding and other problems with proportionality. Often, when a tax is advocated only at low rates, it is a bad sign: it suggests that even the proponents know it is unsound. A fairer point concerns the challenges of filing net income tax returns in dozens of market jurisdictions, each potentially with its own rules.

However, this cost-benefit analysis, by confining itself to the corporate income tax, may miss the best way to achieve the stated goals; consumption tax systems may be better, which will be discussed later on.

Avoidance of double taxation, including creditability. The draft convention is conspicuously weak on double-taxation relief. It mentions the topic in passing but makes no binding commitment that residence countries must grant foreign tax credits for new source-country withholding taxes, or that the withholding taxes authorized by Protocol 1 will be creditable under existing treaty networks. (Of course, given the flaws in gross-based withholding taxes, residence countries might understandably be uninterested in incentivizing them.)

Regardless, the result for taxpayers will be unrelieved double taxation: the service provider pays withholding tax in the market country *and* income tax on the same earnings in its home country, with no mechanism for relief.¹¹ This would become a pure cost increase on cross-border services rather than a reallocation of taxing rights, even if such a reallocation were deemed desirable.

The absence of double-taxation safeguards is particularly notable when compared to the OECD's approach to similar problems. Whatever the flaws of the OECD process, it at least attempted to address creditability and double taxation. For example, Pillar Two income inclusion rules and the recent side-by-side agreement with the US show a commitment to applying the 15 percent minimum broadly, but only once. The UNFCITC, by contrast, asserts new taxing rights for market countries with no corresponding commitment to double-taxation relief.

The contrast with well-designed tax instruments is instructive more broadly. Traditional source-based taxation through permanent establishments is accompanied by treaty-based creditability mechanisms that prevent the same income from being taxed in full by both the source and residence country. Value-added taxes use input tax credits to ensure that the tax does not cascade through supply chains. The withholding taxes contemplated by Protocol 1 have neither safeguard.

¹¹ International Chamber of Commerce, *Submission to INC/Tax Workstream II*, July 2025, [https://financing.desa.un.org/sites/default/files/2025-07/International%20Chamber%20of%20Commerce%20\(W%20WS%20II\).pdf](https://financing.desa.un.org/sites/default/files/2025-07/International%20Chamber%20of%20Commerce%20(W%20WS%20II).pdf).

Production location neutrality. A gross-basis withholding tax on payments to nonresident service providers does not apply to domestic service providers performing the same work for the same customer. If an Indian company hires a US-based engineering consultancy, India could withhold tax on the payment; if the same Indian company hires a domestic Indian engineering consultancy providing an identical service, no withholding applies. The foreign provider bears a cost that the domestic provider does not.

This is the definition of production location discrimination. It raises the relative cost of purchasing services from foreign providers, discouraging the international specialization that makes economies more productive. It is, in economic terms, a tariff on service imports—and it carries the same deadweight losses that tariffs on goods do. The Tax Foundation has argued that the UNFCITC measures risk suppressing foreign direct investment (FDI) at a time when global FDI flows are already declining.¹²

The tariff analogy extends further. In trade policy, it is well understood that tariffs on intermediate goods—business inputs—are particularly damaging because their costs compound through supply chains. The same logic applies here. If a developing country imposes gross withholding taxes on services, it may disadvantage its own companies' development by putting a large tax on a business input, reducing their competitiveness against foreign adversaries that don't have such a quasi-tariff on their inputs. Countries that impose these taxes may believe they are capturing an advantage in trade, while disadvantaging themselves in actuality.

New empirical evidence suggests that gross-basis withholding taxes can distort cross-border services trade in another way too: tax planning, in addition to distortions in real activity. Using a newly compiled dataset of bilateral services imports and withholding tax rates from 2005 to 2021, an IMF working paper by Liu, Klemm, and Lal estimates that a one percentage point increase in the applicable withholding tax rate is associated with roughly a one percent decline in bilateral services imports—and about a four percent decline in bilateral royalty payments.¹³

But the paper's most striking finding is that these bilateral effects do not translate into lower total services imports for the taxing country. Instead, the results are consistent with treaty shopping and rerouting: higher withholding taxes appear to shift imports toward more lightly taxed jurisdictions rather than reduce overall imports.

In other words, withholding taxes may change where payments are booked more than they change the underlying volume of services consumed—adding friction and compliance burdens, and potentially yielding less incremental revenue than a purely static estimate would imply once behavioral responses are taken into account.

Jurisdictional restraint. Article 4's assertion that a market's location gives rise to a taxing right is an expansive claim about the reach of national tax jurisdiction. Under traditional international tax principles, a country's right to tax foreign businesses is grounded in some tangible connection to its territory, whether that's a physical office, employees on the ground, or assets deployed within its borders. Concepts like "permanent establishment" help establish principles for when a foreign company has sufficient presence for taxation.

¹² Daniel Bunn and Cristina Enache, *Testimony to the United Nations on Tax Cooperation*, March 2024, <https://taxfoundation.org/testimony/un-tax-cooperation/>.

¹³ Li Liu, Alexander D. Klemm, and Parijat Lal, "Shaping Services Trade: The Heterogeneous Effects of Withholding Taxes," IMF Working Paper WP/25/214, October 2025, <https://www.imf.org/en/publications/wp/issues/2025/10/24/shaping-services-trade-the-heterogenous-effects-of-withholding-taxes-571345>.

The destination-based claims in the UNFCITC dispense with this requirement. A service provider with no employees, no office, no server, and no assets of any kind in a country may nonetheless be subject to that country's tax simply because a customer there purchased its services. This is a fundamental expansion of the scope of national taxing jurisdiction for income taxes. As noted, it is more commonly associated with consumption taxes like VAT, which are designed to be destination-based from the ground up.

VAT systems harmonize taxation of domestic activity with international activity, and have crediting mechanisms to prevent double taxation. Net income taxes may be able to adopt destination bases if they ensure deductibility of inputs and include careful attention to border adjustment mechanisms. But gross-basis withholding on income has none of these features. Asserting the right of destination-based income taxation without the tools to implement it well is a recipe for haphazard, distortionary outcomes.

The Broader Political Context

It is worth noting the institutional dynamics driving this process. The UNFCITC was championed largely by developing countries, which have long argued that the OECD-led system for setting international tax norms excludes them from meaningful decision-making. By contrast, higher-income countries are less enthused about the process. The US withdrew entirely from the negotiations in February 2025.¹⁴

The developing world's desire for a greater voice in international tax governance is legitimate. So is the concern that current treaty networks leave many low-income countries unable to collect meaningful tax revenue from cross-border services delivered digitally into their markets. But acknowledging these concerns does not require endorsing the specific mechanisms the convention proposes. A gross-basis withholding tax on cross-border services is not the only, or the best, way for a developing country to tax economic activity connected to its market. Properly designed consumption taxes—particularly a VAT extended to digital services, as many countries have already done successfully—capture the same tax base with far less distortion, far greater neutrality between domestic and foreign providers, and far lower compliance costs.

Indeed, the empirical evidence suggests that gross withholding taxes may not even achieve their stated revenue objective. The IMF's finding that withholding taxes reroute bilateral trade flows rather than reducing total service imports implies that revenue gains from these taxes are substantially offset by trade diversion—payments shift to routes through lower-tax jurisdictions, reducing collections for the taxing country while still imposing compliance costs on all parties.¹⁵

The risk is that the UNFCITC, even if it ultimately fails to achieve broad adoption, provides a kind of institutional legitimacy to taxes that do not deserve that legitimacy. What is framed as international tax cooperation more resembles an uncooperative stance toward international trade in services.

14 United States Mission to the United Nations, "Statement at the Session for the Intergovernmental Negotiating Committee on the UN Framework Convention on International Tax Cooperation," Feb. 3 2025, <https://usun.usmission.gov/statement-at-the-session-for-the-intergovernmental-negotiating-committee-on-the-un-framework-convention-on-international-tax-cooperation/>.

15 Li Liu, Alexander D. Klemm, and Parijat Lal, "Shaping Services Trade: The Heterogeneous Effects of Withholding Taxes."

Case Study 2: Digital Services Taxes

While the UN convention threatens to legitimize discriminatory taxation from the developing world, a more immediate and concrete set of violations has already taken root in some of the world's wealthiest economies. Digital services taxes (DSTs)—unilateral levies on the gross revenues of large digital companies—have been adopted by several countries in the last decade, especially in Europe.¹⁶

These taxes share a common design: they apply a percentage-of-revenue charge to specific digital activities, such as online advertising, digital marketplaces, and user-data monetization. Rates range from 1.5 percent in Poland to 7.5 percent in Hungary and Turkey, with most levies clustered around 2–3 percent.¹⁷

DSTs were widely described at their adoption as interim measures, placeholders pending the OECD's Pillar One agreement, which would have reallocated some taxing rights to market jurisdictions through a multilateral framework. That agreement has stalled, risking the interim becoming indefinite. And the taxes, far from converging toward a principled framework, fail the neutrality principles described earlier in this paper. Often, the violations of neutrality resemble those in the UN Convention's ideas. In a few cases, they are worse.

The Revenue Threshold Problem

Perhaps the most unusual structural feature of DSTs is their use of global revenue thresholds to determine tax liability within a single country. The most common design—used by France, Italy, and Spain—applies the tax only to companies with worldwide revenues exceeding €750 million. These thresholds are paired with domestic revenue floors, though Italy eliminated its domestic threshold entirely in 2025, extending the tax to any globally large company with even minimal Italian digital revenue.

The effect is striking. Two companies can sell identical digital advertising in France, to the same customers, through equivalent technology. Nonetheless, if one has global revenues of €800 million and the other has global revenues of €700 million, only the first pays the DST. The tax liability in France is determined not by anything that happens in France, but by the company's commercial success in dozens of unrelated markets. This feature, in particular, creates a horde of neutrality violations in one fell swoop. Most obviously, it fails on the jurisdictional restraint discussed above. But it also violates capital import neutrality, favoring ownership by companies with a smaller global footprint. And for companies with a larger global footprint, it is likely to create a production location distortion, as they'll prefer to avoid DST-heavy countries.

The thresholds also create compliance burdens potentially disproportionate to the revenue at stake. A company might, for example, calculate and certify its worldwide revenues across every business line and every country, all to show that it does not cross the threshold and therefore does not owe DST.

¹⁶ Cristina Enache, Tax Foundation, "Digital Services Taxes in Europe, 2025," May 6, 2025, <https://taxfoundation.org/data/all/eu/digital-services-taxes-europe/>.

¹⁷ Ibid.

Over the longer run, these revenue thresholds are often not adjusted for inflation, so more and more companies will fall into the net. This would, on net, make the revenue thresholds less discriminatory, but also increase the number of small firms facing high compliance burdens for little revenue.

Gross Revenue and the Margin Problem

DSTs are levied on gross revenue, not on profit. This gives DSTs similar flaws to those in the gross-based UN proposal. Headline rates of two or three percent dramatically understate burdens, especially on low-margin business. Consider a digital marketplace that connects buyers and sellers, earning a commission on each transaction. If the marketplace operates on a net profit margin of 5 percent—not unusual for a competitive platform business—then a 3 percent tax on gross revenue consumes 60 percent of its profits from the taxed activity. And as with the UN process, “pyramiding” is possible, lining up a sequence of DSTs taxing the same value-add as a product goes through a value chain using multiple specialized online marketplace companies. The Tax Foundation has highlighted this concern in a variety of contexts, including for US states.¹⁸

The gross-revenue base also means DSTs are not creditable against US corporate income tax.¹⁹ Similar to potential UN gross-based withholding taxes, the US may have good reasons for choosing not to credit DSTs, but the practical result for taxpayers is a high rate of taxation, with the DST as a pure tax hike, not a reallocation of taxing rights between governments.

Many of the services covered by DSTs are not final consumer products. They are intermediate business inputs. As discussed earlier, Diamond and Mirrlees demonstrated that this is inefficient even under substantial redistributive goals.²⁰

Put in concrete terms, a European small business that purchases advertising through a large US platform bears much of the incidence of the DST through higher advertising costs.²¹ The European small business is made less competitive—not against the US platform, which is one of its suppliers, not a competitor—but rather, against its own rivals in third markets who could source that same advertising DST-free. This insight implies that recent debates in France over increasing the DST rate, for example, might harm French producers as well as US producers.

The “Digital” Line and Instrument Neutrality

DSTs are often defined by their delivery channel. A brick-and-mortar retailer operating a physical store and connecting buyers and sellers in person might go untaxed, while an online marketplace performing the same economic function is taxed. In practice, the line between “digital” and “analog” is economically arbitrary, and increasingly blurry in a world where most businesses operate online.

18 Garrett Watson, “Resisting the Allure of Gross Receipts Taxes: An Assessment of Their Costs and Consequences,” Tax Foundation, Feb. 6, 2019, <https://taxfoundation.org/research/all/federal/gross-receipts-tax/>.

19 Internal Revenue Service, “Notice 2023-55,” Jul. 21, 2023, <https://www.irs.gov/pub/irs-drop/n-23-55.pdf>.

20 Peter A. Diamond and James A. Mirrlees, “Optimal Taxation and Public Production I: Production Efficiency.”

21 For evidence of DST burden being passed on, see: Muddasani, Rohit Reddy, and Dominika Langenmayr, “Navigating the Amazon: The Incidence of Digital Service Taxes,” Working Paper/Preprint, WU Vienna University of Economics and Business, Jun. 12, 2025, <https://research.wu.ac.at/en/publications/navigating-the-amazon-the-incidence-of-digital-service-taxes/>.

There is also a subtler problem. Countries that impose DSTs tend to be net importers of digital services but strong in other IP-intensive services. Consider European companies with a group of valuable fashion labels, or a portfolio of liquor brands, or an array of pharmaceutical patents. These companies have, in many respects, similar economic characteristics to tech companies, making money from a wide variety of developed-market consumers using an intangible like intellectual property. But drawing a boundary around “digital” services—arguing that digital companies in particular require destination-based taxation—can exclude these IP-heavy companies from the grouping. The result can resemble the “source base for my exporters, destination base for my importers” problem identified earlier—perhaps by deliberate choice. Overall, the nonneutral design choices around industry and instrument, and the global revenue thresholds, paint an unflattering picture: nonneutral taxes are always a problem, but DSTs, in particular, seem gerrymandered to an extraordinary degree.

The Political Economy of DSTs

DSTs emerged from a specific political moment: rising public concern about large technology companies, frustration with the pace of OECD negotiations, and a perception that digital firms were not paying their “fair share” of taxes in market countries. Digital firms did pay taxes, including in market countries, but primarily through taxes with an explicitly destination-based design, like VATs. And in many cases, especially prior to the US 2017 Tax Cuts and Jobs Act (TCJA), the source-based system for corporate income taxation proved vulnerable to transfer mispricing.

Ultimately, large digital platforms do earn substantial revenues from users in countries where they have little taxable presence under traditional permanent establishment rules. Questioning the source-based system of corporate income taxation and moving toward destination-based principles is a legitimate policy goal.

But DSTs are the wrong instrument for achieving it. If countries want to tax digital services consumed within their borders, the VAT is the better tool. DSTs fail almost every test laid out in this paper, and VATs generally pass them. A VAT does not discriminate between domestic and foreign providers, does not condition liability on global revenue, and does not tax gross receipts without deductibility or creditability. And most of all, the VAT illustrates by example the inferiority of DSTs in our last criterion: the ratio of a tax’s revenue to its compliance and enforcement costs. VATs generate extraordinarily large amounts of revenue for European countries with far less fuss.

Consider, for example, four of the largest DST-imposing countries, with revenues from both taxes measured in the billions of local currency in 2024 (Table 1). The VAT revenue is in all cases hundreds of times larger than the DST revenues. This reflects that the VAT is a comprehensive and integrated system designed to tax most, or even all, consumption in an economy. VATs include not just digital services, but everyone else as well, and furthermore, they have mechanisms in place to ensure that VAT is remitted even if an individual contributor to the value chain is foreign or otherwise unreachable. By taxing within their own jurisdiction, and crediting prior tax paid, VATs do not need to concern themselves with exactly how digital services are provided as intermediate inputs; they simply become part of the tax base in the end.

Table 1. VAT Revenues Greatly Exceed DST Revenues

Country	VAT Revenue (Billions)	DST Revenue (Billions)
UK (FY 2024-2025)	£171	£0.8
France (2024)	€211	€0.8
Italy (2024)	€184	€0.5
Spain (2024)	€91	€0.4

Source: HM Revenue & Customs, "Annual UK VAT statistics 2024 to 2025 commentary"; HM Treasury, "Digital Services Tax Review Report"; Département des études et des statistiques fiscales, "La collecte des recettes fiscales par la DGFIP au 3e trimestre 2025"; Senato della Repubblica, "Rendiconto generale dell'Amministrazione dello Stato per l'esercizio finanziario 2024"; Agenzia Tributaria, "Informe mensual de recaudación tributaria. Diciembre 2024."

The cooperative framework around DSTs has broken down; the current US administration has initiated reviews of foreign DSTs under Section 301, with tariff retaliation as a possible response. Section 899, a retaliatory tax provision that was included in the One Big Beautiful Bill Act (OBBBA) before being removed following G7 negotiations on Pillar Two, also could have involved retaliation against DSTs if not for the last-minute deal. This paper will return to 899 in a later section on US policy.

This escalatory dynamic illustrates the broader pattern identified in this paper. When countries reach for unilateral instruments that violate neutrality, they receive neutrality violations in turn. Any individual choice may appear defensible or better than less domestically palatable alternatives, but collectively, the global trading system becomes worse.

Even the OECD's Pillar One, for all its shortcomings, at least attempted to address the problems that DSTs ignore: it proposed creditability mechanisms, proportionality limits, and multilateral coordination. Its prospective scope was also quite different, covering only the very largest firms' residual profits rather than gross revenues of all digital activity. The lesson of DSTs, much like the lesson of the UN convention's gross-based taxes, is not that market-country taxation is inherently illegitimate—it is that unilateral, gross-basis, narrowly targeted instruments are the worst possible way to pursue it.

Case Study 3: The US Base Erosion and Anti-Abuse Tax

The first two case studies examine measures imposed by foreign governments that threaten US services exporters. But the US itself maintains a provision in its tax code that creates many of the same neutrality violations and applies them to foreign companies' service and intellectual property exports into the US. If the US wants credibility in opposing discriminatory taxation of cross-border services, it should attend to its own code.

The provision is the base erosion and anti-abuse tax, or BEAT, enacted as part of the TCJA.

BEAT does get some things right. It ostensibly addresses a genuine and well-documented problem: multinational enterprises can use payments to related foreign affiliates—particularly for services, royalties, interest, and rents—to shift taxable income out of the US. This is a real revenue concern, and perhaps a more compelling justification than DSTs or the UNFCITC proposals because it articulates a clear theory of how reported accounting might not match economic substance. Furthermore, the broad approach of

BEAT, which attempts to identify and deter the most suspicious patterns of deductions without litigating every individual transaction, has some appeal.

But the execution of BEAT is quite poor. It exceeds its stated purpose and, in doing so, creates the same kinds of distortions this paper has identified in foreign measures. While the Tax Foundation has discussed needed substantive reforms to BEAT in recent years,²² BEAT has ultimately retained its 2017 structure.

How BEAT Works

BEAT functions as an alternative minimum tax on certain large multinational corporations. A company is potentially subject to BEAT if it has average annual gross receipts of at least \$500 million and its “base erosion payments”—deductible payments to related foreign parties in categories associated with profit shifting—exceed 3 percent of its total deductions. The targeted payment categories are telling: services, royalties, interest, rents, and similar charges for intangible property. However, cost of goods sold is deductible as in a normal income tax.

If a company crosses both thresholds, BEAT requires the company to compute a modified version of its taxable income in which base erosion payments are added back—that is, the deductions for those payments are denied. The company then owes the greater of its regular corporate income tax liability or the BEAT rate applied to this modified base. The BEAT rate was set at 10 percent under the TCJA and has since been adjusted to 10.5 percent under the OBBBA.

One way to understand BEAT is as a form of statistical discrimination. Transfer pricing disputes are expensive to litigate. Determining whether any individual royalty payment to a foreign affiliate reflects the genuine arm’s-length value of the intellectual property, or instead reflects an inflated price designed to shift profits to a low-tax jurisdiction, requires deep investigation of subjective facts. BEAT sidesteps this by looking at the aggregate picture: if a company’s profile of cross-border, related-party payments is statistically consistent with profit shifting, it pays additional tax. A BEAT liability is not evidence that a particular company has engaged in transfer mispricing. Rather, it is a rough proxy, a blunt instrument applied at the portfolio level.

There is nothing wrong with this approach in principle. Tax enforcement involves trade-offs between precision and administrability, and sometimes a rough-justice approach is more efficient than attempting perfect accuracy at enormous cost. But the rough justice is only defensible if the proxy is reasonably well calibrated—if it is catching mostly the behavior it claims to target. And this is where BEAT’s execution diverges from its name.

Though it is named for base erosion, BEAT does not actually test for base erosion. It does not ask whether the payment went to a low-tax jurisdiction. It does not ask whether the payments are unreflective of substance. It asks only whether the company made deductible payments to related foreign parties in certain accounting categories.

22 Alan Cole, “How to Improve the Base Erosion and Anti-Abuse Tax,” Tax Foundation, Apr. 23, 2024, <https://taxfoundation.org/blog/base-erosion-anti-abuse-tax-beat-reforms/>.

This means BEAT sweeps in an enormous amount of FDI that has nothing to do with base erosion, particularly from high-substance countries with reasonably high tax rates, such as Japan or France or Germany. Companies from those countries have legitimate outbound payments in BEAT's categories that reflect legitimate substance.

But those payments do not reflect income shifted to a low-tax jurisdiction; no base has been eroded. In some cases, the company is shifting income toward a higher-tax jurisdiction by making them.

BEAT's flaws are not limited to the double taxation of payments to high-tax, high-substance countries. It can also, in some cases, tax income that already falls into the US tax net under Subpart F. This, too, is an example of BEAT applying to inappropriate income.

BEAT's over-inclusiveness is the design flaw that connects BEAT to the broader pattern identified in this paper. DSTs use the language of addressing the "digital economy" to justify a gross-revenue tax that overshoots its target. The UNFCITC uses the language of "fair allocation of taxing rights" to justify withholding taxes that go well beyond any principled reallocation. BEAT uses the language of "base erosion" to justify a tax that reaches far beyond actual base erosion. In each case, a legitimate concern is invoked to legitimize an instrument that is far broader than the concern warrants.

Overall, it resembles our other case studies in one more way. Above, I noted that a low rate is often a warning sign of a poorly structured tax, one that even its proponents would not trust to function well at a higher rate. BEAT's low rate relative to the corporate income tax is a telltale sign.

Where BEAT Violates the Neutrality Framework

Because BEAT's reach exceeds its stated purpose, it creates distortions that closely parallel those identified in the foreign measures examined earlier.

One of these is a violation of production location neutrality from the perspective of a foreign-headquartered company that might make a lot of payments in BEAT categories; the US subjects them to a discriminatory tax they do not face elsewhere. Alternatively, the company might reduce the discriminatory tax burden by shifting the location of service provision, even where it is not efficient to do so.

Another is a violation of capital import neutrality. Consider a domestic and a foreign company that both rely on a considerable amount of intellectual property and services from their headquarters location. Both companies may be engaged in identical economic activity within the US. Both may be employing American workers, serving American customers, and generating American profits. But the foreign-parented company is far more likely to face the additional burden of BEAT.

This asymmetry makes BEAT function as a quasi-tariff on imported services and intellectual property—specifically, on services and IP purchased from related foreign parties. It raises the cost of deploying foreign-developed intangibles in the US market, discouraging FDI. This is the same mechanism identified in the first two case studies: a tax that penalizes cross-border provision of services relative to domestic

provision of those same services, creating a drag on the international specialization that makes economies more productive. The difference is that here, the US is the country imposing the tariff.

BEAT's treatment of deductibility also moves it toward the problems this paper has identified with gross-basis taxation. BEAT is technically an alternative minimum tax on modified taxable income, not a gross-revenue tax. But its mechanism—adding back deductions for base erosion payments—partially converts the income tax into something closer to a gross-basis levy for affected companies, denying deductibility for what may be legitimate business expenses. For a company operating on thin margins, the denial of deductions for genuine service costs can represent a very high effective tax rate on the actual economic profit from US operations.

Overall, the low quality of BEAT makes it quite possibly not worth the trouble. BEAT's direct revenue estimate is generally not high, perhaps a couple of billion dollars a year.²³ It may raise more revenue indirectly, perhaps significantly, by incentivizing different behavior under the ordinary corporate income tax. However, computing an alternative minimum tax base takes time and effort for that amount of revenue. Such recalculations may be worthwhile if the goal is to undo genuinely mislabeled accounting. But BEAT is so likely to catch legitimate accounting in its net that it is hard to make an unabashed case for it.

BEAT as a Mirror Image of DSTs

The parallel between BEAT and European digital services taxes is more than superficial. European DSTs tax the gross revenues of large (predominantly American) digital companies from services exported into European markets. BEAT taxes—through denied deductibility—foreign companies' service and intellectual property exports into the US market. This denial of deductions makes BEAT more like a gross-basis tax than many income taxes.

Both function as tariffs on cross-border services. Both use rough proxies rather than precise measures of the problem they claim to address. Both create false positives that penalize genuine economic activity. And both generate relatively modest revenue for the distortions they create.

The irony is pointed. When the US objects to European DSTs—as it has, including through Section 301 investigations and the threat of retaliatory tariffs—it argues that these levies discriminate against US companies, tax gross revenue rather than profit, and violate established principles of international tax cooperation. These are valid objections. But BEAT is vulnerable to precisely the same critique from the other direction: it discriminates against foreign-parented companies, denies deductibility in ways that move toward gross-basis taxation, and reaches beyond genuine base erosion to penalize legitimate cross-border commercial activity.

This connection was made explicit during the legislative debate over Section 899, the retaliatory tax provision initially included in the OBBBA and briefly mentioned in a prior section. Section 899 would have weaponized BEAT against companies from countries with taxes Congress deemed discriminatory or

²³ Joint Committee on Taxation, "Background and Analysis of the Taxation of Income Earned by Multinational Enterprises," <https://www.jct.gov/publications/2023/jcx-35r-23/>.

extraterritorial—raising the BEAT rate, removing the \$500 million threshold, and denying additional credits. The provision would have confirmed that the US views discriminatory taxation of cross-border services as a legitimate policy lever to be wielded or withdrawn in a “carrot or stick” approach, and that it views BEAT specifically as its tool for discrimination.²⁴

Fortunately, the provision was removed following G7 negotiations in which the US agreed to drop Section 899 in exchange for an exemption from the OECD’s undertaxed profits rule. The episode illustrates both the danger of escalatory cycles and the possibility of negotiated resolution.

The Road Not Taken, and What Better Policy Looks Like

The legislative history of BEAT in the OBBBA produced several alternative visions worth noting. The final legislation set the BEAT rate at 10.5 percent—higher than the original TCJA rate of 10 percent, but well below the scheduled increase to 12.5 percent that would have taken effect in 2026. It also preserved the applicability of US tax credits to the BEAT calculation, preventing what would have been a significant tightening of the provision.

More interesting, however, is a reform that appeared in a Senate draft but did not survive to the final bill: a high-tax exemption. Under this proposal, base erosion payments to countries where the taxpayer faced an effective rate above 90 percent of the US rate—approximately 18.9 percent—would have been exempt from BEAT. This single change would have gone a long way toward aligning BEAT with its stated purpose. If the concern is profit shifting to low-tax jurisdictions, then payments to high-tax jurisdictions are not the problem, and exempting them would have converted BEAT from a blunt quasi-tariff on all cross-border services into something more narrowly targeted at the conduct it claims to address. Unfortunately, this provision was cut from the bill before final passage, possibly because the drafted changes to BEAT showed a significant loss of revenue in Joint Committee on Taxation (JCT) modeling.²⁵ This would seem to confirm that much of BEAT’s revenue comes from its targeting of companies in high-tax jurisdictions.

The broader point returns to the theme of this paper. The US has a strong interest in establishing and defending a global norm against discriminatory taxation of cross-border services. To advocate credibly for that norm—whether in negotiations over DSTs, the UNFCITC, or whatever comes next—it should ensure its own provisions meet the standard it asks of others. A reformed BEAT, narrowly targeted at genuine profit shifting and exempting legitimate high-tax commercial activity, would improve the US tax code on its own merits and strengthen US credibility.

²⁴ Alan Cole and Patrick Dunn, “The Future of BEAT,” Tax Foundation, Jul. 24, 2025, <https://taxfoundation.org/blog/beat-tax-changes-obbbba-section-899/>.

²⁵ Joint Committee on Taxation, “Estimated Revenue Effects Relative To A Current Policy Baseline Of Tax Provisions Contained In A Senate Substitute To Provide Reconciliation Of The Fiscal Year 2025 Budget,” Jun. 21, 2025, <https://www.jct.gov/publications/2025/jcx-29-25/>.

Toward Principled Cross-Border Services Taxation

The three case studies examined in this paper differ in origin, mechanism, and political context. The UNFCITC emerged from developing-country frustration with OECD-centric tax governance. European DSTs emerged from frustration with large technology platforms and the slow pace of multilateral reform. BEAT emerged from a legitimate concern about profit shifting out of the US. But beneath these different motivations lies a common pathology: each instrument opportunistically asserts destination-based taxing rights over cross-border services without the safeguards that make destination-based taxation work.

This paper has identified this pattern as a kind of unprincipled eclecticism in which countries apply source-based rules to their own exports and destination-based rules to their imports. The net result of this, when universalized, is that the tradeable sectors of the economy are effectively taxed twice, while non-tradeable sectors are taxed once. Some of the mechanics are complex to explain, but the ultimate result is clear: a core violation of decades of public finance research on tax neutrality.

Every example has reached for the base that maximizes its own revenue claim in each particular case, and the cumulative result is a patchwork of overlapping, discriminatory levies that distort trade, discourage investment, and waste the time of talented people on compliance.

Why the United States Should Take This Seriously

The US has a larger stake in the neutral treatment of cross-border services than perhaps any other country. It is the world's largest services exporter, running persistent trade surpluses in technology, financial services, consulting, engineering, and other high-value sectors. These are precisely the sectors targeted, directly or indirectly, by each of the three instruments examined in this paper. A global norm that permits discriminatory taxation of cross-border services is a global norm that permits discriminatory taxation of America's most successful export industries.

The US also has an interest in the treatment of its own services imports. This paper has noted several times that tariffs on intermediate inputs—business services purchased from abroad—hurt companies that re-export their output. An American manufacturer that sources specialized engineering services from Germany, or data processing from India, and then sells finished products into third markets is made less competitive by any tax that raises the cost of those imported services. A principled US position on cross-border services taxation should recognize that cheap, high-quality imported services are a competitive asset, not a threat.

The US possesses enormous economic leverage in international negotiations. How it deploys that leverage is a choice with consequences that extend well beyond any single tax provision.

In recent years, US trade policy has often been organized substantially around bilateral goods trade deficits—the idea that a country from which the US imports more goods than it exports is somehow taking advantage of the relationship. This framing has led to tariffs on physical goods, threats of further tariffs, and a general posture of confrontation with trading partners over the composition of goods flows.

The discriminatory taxation of cross-border services documented in this paper represents a far more defensible target for US international economic engagement. Unlike bilateral goods deficits, which reflect comparative advantage and consumer choice rather than unfair practice, discriminatory services taxes represent genuine policy distortions imposed by foreign governments that measurably raise costs for US firms and reduce the efficiency of global supply chains. They violate established principles of tax neutrality. They are documented, specific, and amenable to negotiation.

In turn, credibility requires self-reform. The US needs to be willing to put BEAT reform on the table, at least with a high-tax exemption, as part of an effort to remove DSTs abroad.

Principles for Better Policy

And what of other countries looking for more revenue from cross-border services? Better instruments already exist. The value-added tax is the most obvious. VATs are explicitly designed as destination-based consumption taxes. Most countries that have adopted DSTs already operate VAT systems that either already cover digital services or could be extended to do so. The revenue generated by VATs dwarfs that of DSTs, at a fraction of the compliance cost per dollar collected. Expanding pre-existing consumption tax bases to cover services more comprehensively is nearly always preferable to “creative” new ideas.

Where income taxation is concerned, clean net-basis systems should be the standard. Deductibility of legitimate business expenses is not a loophole; it is the mechanism by which an income tax measures actual income. As deductions are denied and systems approach gross-based taxation, clear-cut neutrality violations are guaranteed, creating the inefficiencies warned about in the economic literature I’ve referenced. Instead, net-basis taxation should be the default unless a specific category of deduction is demonstrably and overwhelmingly associated with profit shifting. The low rates of all these gross-based or quasi-gross-based taxes are, as I note, a red flag; they’re signs of problems in the tax design, and a well-warranted lack of confidence that the tax base is legitimate.

The stalling of the OECD’s Pillar One agreement has led to much of the situation described in this paper. For all its shortcomings, Pillar One at least attempted what the unilateral instruments in this paper do not: creditability, proportionality, and multilateralism. It was not ideal, but superior to less principled unilateral alternatives. All countries should remain at the negotiating table for principled engagement on the tax architecture that governs cross-border services.

Most of all, the US has built its economy on the global services trade. It would especially benefit from dispensing with antiquated ideas about goods balances, and instead direct its enormous leverage toward restoring the principled treatment of cross-border services, with the eventual goal of a planet-spanning neutral trade architecture.