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Rethinking corporate taxation in a globalised economy[1]

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ABSTRACT

The need to step up coordination around corporate taxation has returned to the forefront in recent years. The underlying article discusses the OECD approach to rethink the international corporate tax framework: the main elements of the two-pillar solution, the resulting tax revenue and other economic effects are discussed as well as some other -more general- reflections on its blueprint. All in all, the article argues that the two-pillar solution will effectively deliver what it was designed to do i.e., to reduce tax competition between countries, to reinstate the link between the place where taxes are paid and the place where value is created and to ensure that large multinationals pay their fair share of tax.

The current system of taxing corporate profits dates back to the 1920s. Since then, the economy has changed significantly; companies are operating more and more on a global scale and ongoing digitalisation has transformed daily life. International tax principles have failed to keep pace with these changes, resulting in a widespread perception that the current system is no longer fit for purpose. Multinationals are becoming increasingly adept at using loopholes in the tax system to lower their tax burden. In this context, the fundamental question of how taxation rights for multinational profits should be allocated across jurisdictions is left unanswered.

Consequently, the need to step up coordination in the area of corporate taxation has returned to the forefront in recent years. International institutions play an important role in making progress towards an overhaul of the current international tax framework. A good example is the OECD/ G20 Inclusive Framework on BEPS' Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy of 8 October 2021. This statement is an important milestone in reshaping the general consensus on how to deal with tax avoidance and tax evasion on an international scale. However, as noted by the IMF (2022) and others, implementation issues and potential refinements must still be worked out and broader challenges inherent in the taxation of multinationals dealt with.

[1] A more extensive version of this article can be found in the NBB Econmic Review (Rethinking corporate taxation in a globalised economy | nbb.be)

An OECD coordinated approach to rethinking corporate taxation

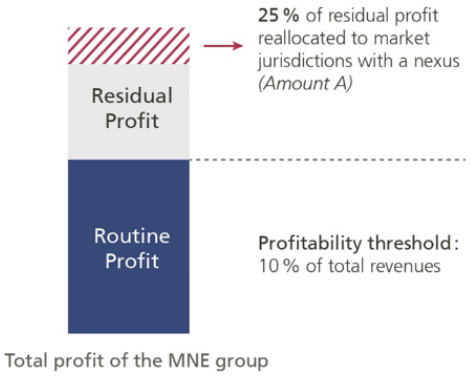
The design of Pillars 1 and 2

Pillar 1 adjusts the international corporate tax system by allocating to market jurisdictions taxation rights over a share of the profits of large multinational enterprises (MNEs). A portion of these profits are allocated based on where actual sales take place, without the need for the MNE to be physical present. Pillar 1 applies to multinationals with global turnover in excess of € 20 billion[2]. This approach to the redistribution of taxation rights from source to destination countries is shown in chart 1.
To allocate the profit share transferred to market jurisdictions, the MNE's profits are first broken down into normal or routine profits and excess or residual profits. Measuring excess profit, meaning that above a normal return on capital, is not always straightforward, that is why a simplified approach is used. More precisely, a profitability threshold is used to approximate the level of non-routine or residual profits. Profits in excess of 10 % of total revenue are considered residual; 25 % of non-routine profits are then transferred to market jurisdictions with a nexus, using sales as the key reallocation factor.[3] A country will be considered to have a nexus with a given MNE if sales in that country exceed €1 million (or €250,000 if the country's GDP is below €40 billion).

The implementation of pillar 1 will require that countries sign a multilateral treaty, implying they will have to repeal any possible unilateral digital service tax and similar measures and agree not to introduce new ones. According to the latest OECD communication (2022), negotiations to turn Pillar 1 into practice are ongoing. As a next step, the Inclusive Framework aims to have the Pillar 1 rules ratified globally, i.e. by a critical mass of countries, including the largest economies where most large multinational companies are headquartered, by mid-2023 so that Pillar 1 can enter into force in 2024.

[2] Extractives and regulated financial services are currently excluded (IMF, 2022).
[3] The share of profits reallocated under Pillar 1 is called "Amount A" (OECD, 2021c).

Chart 1 - Pillar 1: Allocation of taxation rights in a globalised economy



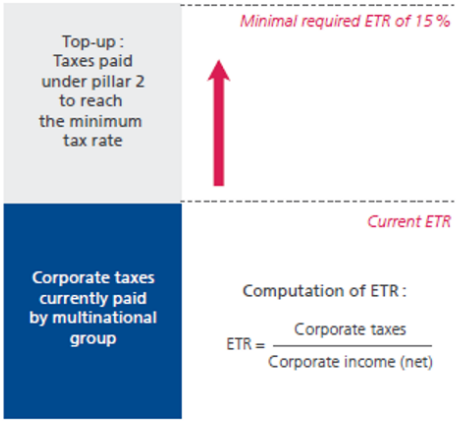
Source(s): OECD (2021a)

Pillar 2 provides for a minimum corporate tax rate, set at 15 %, to ensure that large multinational firms pay their fair share of taxes regardless of where they are located. Pillar 2 applies to multinationals with global turnover of at least €750 million, meaning it covers many more MNEs than Pillar 1. Chart 2 summarises the mechanism. If corporate income is taxed below the minimum effective tax rate, the MNE will be required to pay a top-up tax in order to reach the effective rate of 15%. Pillar 2 includes two important interrelated tax rules: (i) the income inclusion Rule (IIR) and (ii) the undertaxed- payments rule (UTPR).

Regarding the top-up tax, a correct calculation of the average effective tax rate (ETR) is crucial. The first step is to determine the tax base (the denominator), namely the profit before tax, using financial accounting standards. For policy reasons, a number of adjustments are then made to add or remove certain items so as to eliminate a number of common book-to-tax differences. In addition, it is necessary to agree on the taxes covered (the numerator); the entity's current taxes for the fiscal year form the basis and are adjusted to reflect certain timing differences. Tax relief that provides only a timing advantage will not depress an entity's ETR (Deloitte, 2021).

The introduction of a global minimum tax is a "common approach", meaning it is not mandatory for countries to implement it. However, by joining the IF Statement on the Two Pillar Solution, countries implicitly accept the adoption of this solution by others. In its latest communication (2022), the OECD states that the technical work on Pillar 2 is almost complete and points out that implementation now lies in the hands of IF members, with sufficient progress already having been made. It seems that many countries are planning on entry into force in 2024. The EC has also proposed a directive to ensure a global minimum effective tax rate of 15% for large groups operating in the EU. In December 2022, unanimity was reached amongst the Member States to the introduction of a global minimum effective tax rate, after Hungary dropped its veto on the matter.

Chart 2 - Pillar 2: The Level of taxation in a globalised economy



Source(s): OECD (2021a)

Tax revenue effects of the introduction of Pillars 1 and 2

When assessing the tax revenue effects, it is important to take into account two important caveats. First, existing impact assessments are often based on outdated data. For example, the data used by the OECD (2020) and Barake et al. (2021) predate significant tax policy reforms, such as the 2017 US and Belgian corporate tax reforms (see also Bunn, 2022). Moreover, a credible estimate of the behavioural reaction of both firms and governments is crucial for a solid impact assessment. However, anticipating dynamic behaviour is not straightforward, leading to an impact analysis being surrounded by much uncertainty.

Bearing these caveats in mind, there will be clearly a major difference between the entry into force of the two pillars. The implementation of Pillar 1 will entail a significant change to the manner of allocating at least a portion of taxing rights between countries. However, this will lead to only a modest – if not negligible - increase in global tax revenue. On the other hand, the introduction of a minimum ETR pursuant to the implementation of Pillar 2 could potentially lead to a significant increase in worldwide corporate income tax revenues.

With regard to the expected global revenue effects of Pillar 1, the recent IMF analysis (2022) illustrates that the reallocation of a portion of excess profits to market countries would be equal to around $150 billion, and thus only 2% of total multinational profits. The IMF further estimates that around 140 multinationals will be impacted by Pillar 1. This estimate is in line with OECD projections (2021b) that Pillar I will apply to about 100 of the largest and most profitable multinationals.

When analysing the revenue effects from the introduction of Pillar 2, both the static and dynamic impact – including behavioural effects – are considered. It is important to note that estimates vary widely between studies. Three main factors can explain this significant variance: (i) differences in the

data used, with regard to both scope and time period, (ii) differences in the additional assumptions needed for a static estimate and (iii) differences in how the behavioural reactions of firms and governments are assessed.

Estimation results from the OECD (2020) for introducing a minimum ETR of 15 % show that – excluding any behavioural reaction – global corporate income tax revenues increase by between 1.7 and 2.9 %. Including the dynamic behaviour of firms and governments, global corporate income tax revenue could potentially rise by up to 4 %. According to IMF estimates (2022), Pillar 2 will result in an increase in global annual corporate tax revenue of about 4.8 %[4]. Taking into account dynamic behaviour, reduced tax competition will lead to an additional 8.1 % in global corporate tax revenue.
Finally, the analysis of Barake *et al.* (2021) of the EU Tax Observatory should be mentioned. This study also estimates the revenue effects from the introduction of a minimum ETR of 15 % but, unlike other studies, presents country-specific projections. These projections should be interpreted with caution, however, as they are subject to substantial uncertainty as country-specific results are much more driven by data imperfections than more aggregate results. The IMF (2022) compared its results with those of Barake *et al*. (2022) and found that, for countries included in both studies, corporate tax revenue increased on average by 7.4 % according to Barake *et al*. but only by 4.8 % according to the IMF. This difference may be due to a few outliers in the analysis of Barake *et al*. (2021).

Other economic effects from the introduction of Pillars 1 and 2

As explained above, the introduction of Pillars 1 and 2 will reduce profit-shifting opportunities for internationally operating firms. Together with the direct effect from the introduction of a minimum effective tax rate, this will result in a higher effective tax rate on business investment for in-scope multinationals. However, to the extent countries react by raising their overall tax rates, other firms will be affected as well.

An increase in the ETR raises the user cost of capital, i.e. the minimum pre-tax rate of return on an investment a firm needs to achieve in order to break even after taxes. The OECD (2020) has illustrated that global adoption of the two-pillar solution will cause the effective marginal corporate tax rate to increase by 1.4 percentage point[5] on average. However, when evaluating the exact impact on business investment choices, it is important to take into account the distinction between (i) the relocation of investment between entities in a multinational group and (ii) changes in overall investment at group level. As noted by the OECD (2020) the latter could be less affected, as investment is merely shifted from one location to another. This point is also mentioned by Devereux et al. (2020) who acknowledge that an increase in tax rates could improve global economic efficiencies, the idea being that a reduction in ETRs across countries decreases tax-induced distortions in location decisions and investment behaviour.

[4] Pursuant to OECD (2020) estimates, we report the IMF (2022) projection for a sample that excludes the US, the reason being that the US levies its own minimum tax (the global intangible low-taxed income provision). So we expect both taxes to coexist.

[5] This is a weighted average. Moreover, it should be noted that the OECD's (2020) calculations are based on a minimum ETR under Pillar 2 of 12.5 rather than 15 %.

Although the precise revenue impact of the two-pillar solution is highly uncertain, it is clear that corporate tax revenue will increase. Moreover, its negative impact on economic activity will be limited[6]. Given the current fiscal situation in many European economies, characterized by significant government assistance to deal with the energy and inflation crisis, an increase in tax revenue, with little distortive economic effects, would be very welcome to help restore or maintain the sustainability of public finances. Moreover, as the additional revenue would be permanent, it could be used to revise the optimal mix of taxation across the various factors of production, e.g., to lower taxes on labour. Other possible uses include support for public investment and a reduction in public debt. All in all, the additional revenue will undoubtedly have an overall positive impact on the economy.

To the extent that large multinational firms are traditionally subject to a lower minimum effective tax rate due to a wide array of tax planning options, smaller businesses are placed at a competitive disadvantage and competition among firms decreases. Ultimately, this can lead to the creation of very large multinational firms with high (possibly monopolistic) market power, lower consumer welfare, less innovation, increased profit-shifting options, etc. Global adoption of the two-pillar solution could help to restore a level playing field as large multinationals will need to pay a minimum effective tax rate of 15%. Additional indirect positive economic effects could thus be expected due to the lessening of the competitiveness disadvantage for small and medium-sized enterprises in terms of the tax burden.

Other reflections on the OECD's two-pillar solution

Through their national corporate tax system, countries offer a wide range of tax incentives and relief. Generally, these incentives tend to reduce the effective corporate tax rate. A general criticism on the design of Pillar 2 is how it deals with these tax provisions. In general, Pillar 2 does not distinguish between tax incentives that encourage welfare enhancing activity, such as investment in R&D, and those intended as instruments of tax competition (Salehy, 2022). For in-scope multinationals, tax incentives could lose their effectiveness if the benefit they confer is cancelled out by the (increase in) top-up tax needed to arrive at an ETR of 15 %. However, it should be noted that tax provisions will still lower the effective tax rate for firms not subject to Pillar 2 (small and medium-sized enterprises and multinationals with consolidated profits of less than €750 million) and for multinationals subject to an ETR above the minimum rate.

When considering tax incentives in Belgium, the reduced effectiveness of tax provisions for in-scope multinationals could generate some adverse effects. An oft-heard criticism is that the introduction of Pillar 2 will substantially reduce the effectiveness of Belgian R&D tax incentives, which have significantly increased over the last decade. The main R&D tax relief provisions in Belgium are, in terms of input-related R&D support, the partial exemption schemes from payment of the withholding tax on the wages of R&D employees and the R&D tax credit or investment deduction in the corporate

[6] The OECD (2020) estimates the direct impact on current economic activity of lower corporate investment due to the global introduction of the two-pillar solution to less than 0.1 % of GDP.

tax system. When it comes to targeting the output of innovation, Belgium has a system where IP-derived income is taxed well below the statutory rate.

A decline in the effectiveness of R&D tax incentives could lead to a drop in foreign direct investment in Belgium and even to relocation by multinationals to other countries. However, the argument often raised by critics of the two-pillar solution that R&D tax incentives will lose their attractiveness should be nuanced.

First, the main goal of R&D tax incentives is to foster private investment in R&D. They should not primarily be used as pure instruments of tax competition. When it comes to input-related R&D, research by Dumont (2019) provides robust evidence for Belgium that the different schemes of partial exemption from payment of the withholding tax on the wages of R&D personnel are effective in stimulating additional R&D activities. When firms use these partial exemption schemes, however, their average effective tax rate is not impacted as the implied subsidy on the wages of R&D personnel is also taxed at the corporate rate. Consequently, even under Pillar 2, this tax incentive would remain very effective.

R&D tax credits, on the other hand, decrease a firm's ETR. For multinationals subject to Pillar 2, such credits may become less attractive if they result in an ETR below the minimum rate. However, as noted by Salehy (2022), within Pillar 2, special rules apply to *qualified* refundable tax credits.[7] According to our understanding, the Belgian R&D tax credit could be considered as a qualified refundable tax credit: it is calculated as a fixed percentage of qualifying R&D expenditure, applied to the taxpayer's tax liability and becomes refundable if not fully used after four years. As stated by Salehy (2022), to calculate the ETR, Pillar 2 considers a qualified refundable tax credit as part of qualified income, not a reduction in or reimbursement of taxes. This favourable treatment will lead to a much smaller reduction in the ETR than if the credit were treated as simply a tax reduction. Therefore, even for in-scope multinationals, R&D tax credits could be an effective tool to stimulate private R&D investment.

On the other hand, tax policies targeting the output of innovation through a patent/ intellectual property (IP) box will indeed significantly lower a firm's ETR. As a result, for in-scope multinationals, the entry into force of Pillar 2 will heavily reduce the attractiveness of this type of preferential tax regime. However, it should be noted that the evidence suggests that IP regimes do not necessarily stimulate R&D investment, one argument being that they do not reduce the *ex ante* risk to innovation as they reward only successful projects (Schoonackers, 2020).

It could thus be argued that IP regimes are mainly an instrument of tax competition, and it just so happens that Pillar 2 is designed to address tax competition, limit the race to the bottom in corporate taxation and ensure that multinationals pay their fair share of tax. As preferential tax treatment will be less effective in attracting multinationals and corresponding investment, countries could consider investing more in other factors such as the quality of public infrastructure and highly skilled labour.

[7] A qualified refundable tax credit is a one that, under relevant national law, must be paid to the recipient in cash or cash equivalents within four years from the time the recipient meets the conditions to receive it (Salehy, 2022)

However, it is important to keep in mind that the focus of tax competition between potential locations could shift to other tax fields such as the taxation of highly skilled labour.

Finally, it is worth emphasising a number of important elements and consequences regarding the blueprint of Pillars 1 and 2. As discussed by Valenduc (2021), Pillar 1 has some appealing features as it is a first step towards unitary taxation, i.e., the transferred taxation rights are determined at group level and thus on a consolidated base. In addition, the destination principle is used to allocate rights between countries. As sales to final consumers are a much more immobile tax base than production, this leaves less room for tax competition between countries. Of course, this also implies – as Bauer (2020) and others have argued - that taxation powers could be shifted from small open economies to the world's largest countries. However, it should be clear that this is not necessarily the case for all small economies, but merely for low-tax investment hubs.

In addition, as the use of preferential tax regimes will become less effective in steering the investment and production choices of large multinationals, large countries could again benefit more compared to small(er) open economies. The reason being that big countries have the competitive advantage of a large internal market. This claim is hard to assess ahead of time, as behavioural responses are very difficult to predict. However, it is safe to say that for small open economies like Belgium, tax competition is and should not be the only instrument to attract economic activity from globally operating firms. Other location-specific determinants - such as the country's geographic position in Europe, R&D support which, as argued above, will remain effective, and a highly skilled labour force - also play an important role.

Moreover, the substance-based income exclusion rule[8] incorporated into the design of Pillar 2 still leaves some room for tax competition between countries. Ideally, this rule should eventually be phased out as it somewhat contradicts the fundamental purpose of Pillar 2, namely to put a stop to tax competition.

Finally, when considering the scope of Pillars 1 and 2, it is hard to understand the justification for the agreed thresholds. Pillar 1 has an excessively limited scope, which is very regrettable. At least aligning the Pillar 1 threshold to the same parameters as Pillar 2 would be advisable. Moreover, the group of firms subject to Pillar 2 could be expanded. After all, all profit-making companies should pay their fair share of tax and establishing a minimum ETR of 15 % could significantly reduce tax competition between countries and contribute to a more efficient sharing of the tax burden between the factors of production.

Conclusion

The international corporate tax framework is nearly 100 years old and was designed for traditional brick-and-mortar economy. Over time, economic life has changed significantly due to the rise of

[8] When calculating the top-up tax for in-scope multinationals, it will be possible to deduct 5 % of the value of tangible assets and 5 % of payroll costs from the tax base (in an initial phase, these percentages will be higher). The justification for such an exclusion is that Base Erosion and Profit Shifting behaviour is less present when real economic activity takes place.

global value chains and digital business practices. Unfortunately, however, the international tax architecture has not kept pace with these developments. Consequently, multinationals and digitalised firms are using loopholes in the system to lower their overall tax liability, resulting in a widespread perception that the current international tax framework is no longer fit for purpose.

Globalisation has increased the international mobility of capital, thereby widening the range of possible production locations and dramatically increasing profit-shifting options. As a result, tax competition between countries has intensified to attract economic activity. On the other hand, the digitalisation of the economy has increased the relative importance of intangible assets, which are often hard-to-value, again expanding firms' profit-shifting options. Moreover, due to digital business models, the link between the physical presence of a firm and the place where real added value is created is disappearing.
Consequently, the debate on reform of the international tax framework and how to deal with tax avoidance and tax evasion has returned to the forefront. The OECD Inclusive Framework Agreement on BEPS and its October 2021 Statement on a Two-Pillar Solution to Address the Tax Challenges from the Digitalisation of the Economy are an important milestone and symbolise a real political shift. Pillar 1 deals with the question of where to tax, the idea being to redistribute taxation rights from source to destination countries. Taxation rights over a portion of the profits of large multinationals will be assigned to market jurisdictions. The multilateral adoption of Pillar 1 is a first step towards unitary taxation, which will significantly reduce profit-shifting options. Moreover, sales to final consumers will be used to allocate taxation rights between countries. This is a much more immobile tax base than actual production and leaves less room for tax competition between countries. Pillar 2 focuses on how much to tax and introduces a minimum corporate tax rate of 15 % on the profits of multinationals. This will limit tax competition between countries by ensuring that in-scope multinationals pay their fair share of tax, regardless of where they are located.

It is difficult to measure with precision the tax revenue effects of the two-pillar solution. One reason for this is the need for a credible estimate of the behavioural reactions of firms and governments. Anticipating such dynamic behaviour is not straightforward and by definition uncertain. As a result, studies on the revenue effects have reached widely different conclusions. However, it is safe to say that multilateral adoption of Pillar 2 will significantly increase global corporate tax revenue while Pillar 1 will mainly lead to a redistribution of tax revenue between countries. Assessing country-specific revenue effects is much harder. In general, low-tax investment hubs will lose revenue under Pillar 1, while Pillar 2 will benefit the most advanced economies significantly. Quantifying country-specific results remains very challenging. However, this is not a reason not to welcome introduction of the two-pillar solution.

When it comes to flaws in the design of the two-pillar solution, Pillar 2 seems not to distinguish between tax incentives that encourage welfare enhancing activity and those intended to be used to facilitate tax competition. In that sense, an oft-heard criticism is that Pillar 2 will significantly reduce the effectiveness of the Belgian R&D tax incentives for in-scope firms. This argument should be taken with a grain of salt. The main goal of R&D tax incentives is to stimulate investment in R&D. Pillar 2 will not affect the effectiveness of the partial exemption from payment of the withholding tax on the wages of R&D personnel. Moreover, Belgian R&D tax credits will also remain effective, as under the

Pillar 2 rules they will be considered qualified refundable tax credits. This implies a much more favourable basis for calculating the ETR. Finally, the Belgian IP regime will significantly lose its attractiveness due to the adoption of Pillar 2. However, this regime can be considered a policy instrument designed for tax competition. Reducing its effectiveness should therefore be applauded for efficiency reasons as location decisions should be based on fundamentals and not be tax-induced.

That being said, the design of both pillars could be improved. The threshold used to determine the scope of Pillar 1 is too narrow and should at least be aligned to that of Pillar 2. In addition, the substance-based income exclusion rule in Pillar 2 could be abolished as this still leaves some space for tax competition between countries.

All in all, the two-pillar solution is a first step in the right direction when it comes to rethinking international taxation and will effectively deliver what it was designed to do i.e. to reduce tax competition between countries, to reinstate the link between the place where taxes are paid and the place where value is created and to ensure that large multinationals pay their fair share of tax. The multilateral convention on the two-pillar solution could therefore significantly help to achieve a more efficient sharing of the tax burden between production factors. Policymakers should thus be encouraged to ratify the convention and put the two-pillar solution into practice. In addition, future international efforts should focus on further substantial international harmonisation of corporate taxation by advocating for a common consolidated tax base. This would significantly increase tax fairness and overall efficiency and considerably reduce compliance costs.

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