Are the global tax proposals in the interests of low- and middle-income countries?

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Last month, 133 governments reached a high-level agreement[i] on the taxation of multinational corporations, combining a redistribution of taxing rights to market countries ("Pillar 1") with a global minimum tax ("Pillar 2"). How good is it for low and middle-income countries? And what should they do about it?

It's unclear whether "Pillar 1" is in the interest of low and middle-income countries – and it is incumbent on the United States to make it so.

The global minimum tax is good news for all countries except zero-rate tax havens – but low and middle-income countries should nevertheless consider opting out of it. The proposal is biased against them,[ii] and they have other options than just signing on the dotted line.

Negotiations are ongoing in a multilateral forum called the Inclusive Framework. They involve 139 countries (a handful have not joined last month's agreement). They are facilitated by the OECD, which sketched each pillar last year.[iii] The G20 Finance Ministers are expected to reach a final political agreement in October.

Show me the money!

Pillar 1 is at the same time revolutionary and paltry.

Revolutionary because for the first time it awards taxing rights to market countries (i.e., the countries of final sale of a multinational's goods or services). Hitherto only residence (aka home/headquarter) and source (aka host/operations) countries enjoyed taxing rights over multinational corporations' profits.

Paltry because the deal will apply to only a small fraction of the profits of a small fraction of corporations. Specifically, it will redistribute between 20% and 30% of the taxable profits above a 10% profit margin of mega-corporations with annual global turnover of over €20 billion (and excluding extractive and finance industries).

The redistribution to market countries should in principle benefit low and middle-income countries. Under current rules, they only tax the routine profits generated by multinational corporations' operations on their territory. The super-profits above the 10% profit margin targeted by Pillar 1 are typically attributed to intangible assets like patents and brands, which are generally located in the multinationals' home countries or shifted to tax havens.

But the benefits are likely to be very small given the lack of ambition of Pillar 1. An independent study estimates that only 78 corporations would be affected and $87 billion of annual taxable profits redistributed.[iv] Using GDP as proxy for market size, it means that low-income countries would get only $0.6 billion of these taxable profits, and middle-income countries $31 billion. Assuming a 25% tax rate on average, that means respectively $140 million and $8 billion in annual revenue (equivalent to 0.03% of their respective GDP). (And that is likely an overestimate as 45% of the 78 corporations are from the information technology industry, which probably represents a smaller share of consumption for low and middle-income countries' relative to high-income countries.)

One might say that a little is better than nothing. But there is a catch. An essential part of the deal is that all countries would renounce to levy taxes on digital services.

Under current rules, countries can tax only corporations that have physical presence on their territories. Digital services like web search (Google) or social networking (Facebook) provided across borders reflect monopoly power, represent a growing share of the global economy, and escape the corporate tax in market countries owing to a lack of physical presence.

An increasing number of countries have therefore adopted or are considering adopting digital services taxes. That includes both high-income countries and low and middle-income ones like Nigeria and Kenya (neither of which have endorsed the deal), or Sierra Leone.

Large digital services corporations are predominantly American. The US government thus regards these foreign digital services taxes as discriminatory against the United States. It has already taken trade sanctions against half a dozen countries that adopted such taxes, which are due to take effect in November, 2021.[v]

This looming trade war is what drove the Pillar 1 negotiation process in the first place. The United States wants to broaden the conversation to all mega-corporations, not just the tech giants, to avoid the appearance of discrimination. Still, 64% of the profits to be redistributed are from US corporations, according to the above-mentioned study. The quid pro quo for the United States to hand over these taxable profits is that other countries abandon all plans to tax big tech unilaterally.

The question is: Is it worth it from the perspective of other countries, particularly low and middle-income countries? In the absence of impact assessment of both Pillar 1 in its present form and country-specific digital services taxes, we don't know. But it may very well not be worth it in view of the low revenue estimate of Pillar 1 reported above. A recent back-of-the-envelope study suggests that big tech companies will pay substantially less tax to the United Kingdom under Pillar 1 than under the UK digital services tax that came into effect last year.[vi] (But Pillar 1 would also bring in new revenue from other industries.)

The US position is unreasonable: the fact that almost all big tech corporations happen to be American does not make digital services taxes discriminatory. Digital services taxes were not conceived to rob Americans, but to respond to a new economic trend and outdated international tax rules.

The threat of trade sanctions against sovereign states exercising their taxing rights is Trump-era bullying unfortunately sustained by the Biden Administration. The rest of the world should stand firm. If the United States really wants others to eliminate digital services taxes, it must offer the rest of the world a better deal by increasing the fractions of profits and of corporations that will be subject to Pillar 1.

Thanks! But no thanks…

The global minimum tax is meant to make nearly all large multinational corporations pay an effective tax rate of at least 15% in nearly all the countries where they operate.[1]

Its purpose is twofold: curb both tax avoidance and tax competition.

Tax avoidance is the abuse of tax havens by multinational corporations. They use accounting gimmicks to shift their profits from high-tax to low-tax countries. With the global minimum tax, there would be no point in shifting profits to countries with effective tax rates below 15%. That should eventually put zero-tax havens like Bermuda out of business.

Tax competition is the global race to the bottom that governments have engaged in for decades. They have been cutting their corporate tax rates or giving away tax exemptions in order to attract foreign investment – most of the time ineffectively.[vii] With the global minimum tax, lowering a country's effective tax rate below the global minimum rate would become self-defeating, because other countries would then collect the global minimum tax, depriving the country giving away tax exemptions from revenues while nullifying any effect that these exemptions might have on investment. As a result, low-tax havens like Ireland or Singapore are likely to eventually raise their effective tax rates up to the global minimum.

That, at any rate, is the intent. Alas, last month's agreement has several weaknesses.

One problem is that 15% is too low – barely above the current rate of Ireland, for instance. Given that the average corporate tax rate is close to 25% and some countries have rates over 30%, a 15% minimum rate would leave ample room for significant tax avoidance and tax competition to subsist.[viii] The Inclusive Framework left the door open to a higher rate, and should definitely adopt one, like the 25% proposed by the independent expert group ICRICT[ix] and endorsed by Argentina.[x]

Another problem is the "substance carveout" that will exempt routine profits linked to brick-and-mortar operations from the global minimum tax. That could allow some degree of tax competition to continue below the global minimum rate to endure.

A third problem is that the proposed global minimum tax will be collected by the countries where multinationals are headquartered, which are predominantly high-income countries plus China and India. Only if the headquarter country opts out of the global minimum tax will the countries where multinationals operate (including low and middle-income countries) be allowed to collect it.

This pecking order is the latest manifestation of the tug-of-war between multinational corporations' home (aka residence) and host (aka source) countries, which dates back to the

1 The only profits that would fall through the cracks of the global minimum tax are those generated in countries that choose to opt out of the global minimum tax by multinationals whose headquarter countries also decide to opt out of it. Multinationals with annual revenue inferior to Euro750 million would be exempted, although countries could unilaterally apply the tax to their own multinationals of any size. International shipping is exempted.

1920s when colonial powers claimed rights for the former.[xi] Presumably under pressure from its members, the OECD secretariat proposed this pecking order at the outset of negotiations and has been inflexible about it ever since. It is neo-colonialism, pure and simple. It reminds us why global tax rules should be developed by the United Nations, not the OECD.

Practically this pecking order means that source countries must devolve the job of fighting tax avoidance to residence countries. The former are therefore expected to renounce their right to adopt unilateral anti-base erosion taxes (which are taxes on certain payments between the subsidiaries of a multinational corporations, like the US BEAT).[xii] That represents a surrender of sovereignty. The so-called “Subject to Tax Rule” that is part of the agreement is a very poor consolation prize for low and middle-income countries in that regard.[2]

Sovereign states currently have the right to adopt something like the global minimum tax unilaterally, as the United States did in 2017 with the GILTI and BEAT regime. (The Biden Administration has vowed to strengthen that regime unilaterally in case the international agreement fails.) Most low and middle-income countries have hitherto shied away from that for fear of scaring away foreign investment. Collective action should alleviate such fears. But paradoxically it would come at the cost of handing over the right to collect the global minimum tax to residence countries.

The OECD retorts that the priority for residence countries makes the global minimum tax much easier to administer, as each multinational will pay the tax to a single country (its home country) rather than to all the countries where it operates. It also argues that the priority question is moot in the long run because the global minimum tax will eventually disappear: its tax base are the profits currently stashed in tax havens, which will dwindle over time as multinationals unwind their complex tax planning structure because the tax will render them useless. All countries will be able to tax the profits no longer shifted to tax havens through their regular corporate tax.

But who gets to collect the global minimum tax is relevant in the short to medium term. Low and middle-income countries certainly face more dire needs in the context of the pandemic.[xiii]

Kenya, Nigeria and Sri Lanka have so far declined to endorse the agreement. Another 15 African countries reportedly endorsed it very reluctantly.[xiv] The African Tax Administration Forum has lamented how African countries’ interests have been sidelined.[xv] So has the global tax justice movement, with some advocates going as far as calling on their governments to reject the deal.[xvi]

The agreement actually makes the global minimum tax optional (unlike the Pillar 1): the minimum tax is “a common approach” that members “are not required to adopt”. Opting out is a genuine option for low and middle-income countries to ponder. Each country should make its own cost-benefit analysis considering the following four points:

2 This rule would require tax havens to allow low and middle-income countries to modify existing bilateral tax treaties to enable the latter to collect withholding taxes on royalties and interests. However, it comes with three major limitations. First, tax havens could avoid this obligation by leaving the Influencing Framework (although that would incur reputational costs and perhaps EU sanctions). Second, the agreement puts a cap on the withholding tax rate of between 7% and 9%. Third, withholding taxes do not protect countries from base erosion through inflated interests or royalties embedded in the cost of goods sold.

1. Low and middle-income countries will get close to no direct revenue from the proposed global minimum tax because of its neo-colonial pecking order. The OECD's impact assessment should not be trusted.[3]
2. Low and middle-income countries will nevertheless benefit indirectly from the global minimum tax because it will reduce both tax avoidance and tax competition. However, they will reap these indirect benefits even if they opt out of the global minimum tax, as long as a critical mass of residence countries (like the G7) opt in.
3. There is a cost for low and middle-income countries to opt in the global minimum tax, which is the renouncement of anti-base erosion taxes.
4. There is no cost for low and middle-income countries to opt out of the global minimum tax as long as their effective tax rate is above 15%, which is the case for most of them.

This last point could no longer be true if the European Union blacklists all the countries that opt out of the global minimum tax as tax havens. That would be a good idea for countries that have effective tax rates below the global minimum rate. But it would be outrageous to blacklist high-tax low and middle-income countries as tax havens on the ground that they refuse a neo-colonial deal. Low and middle-income countries should ensure that the final deal prevents the blacklisting of high-tax countries.

One outcome of the global tax negotiations may thus be to agree to disagree: let high-income countries adopt a global minimum tax tailored to their interests, while letting low- and middle-income countries opt out of it while reaping its indirect benefits anyway.

Low and middle-income countries should also consider acting collectively. A coalition of the willing could opt out of the global minimum tax, copy all the technical work done by the OECD, and adopt an alternative global minimum tax that would be exactly the same as the one agreed to by the Inclusive Framework except that it would be collected in priority by countries where multinationals operate rather than headquarter countries. They currently have the right to do that. Why give it up?

3 The impact assessment of the global minimum tax (https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-economic-impact-assessment-0e3cc2d4-en.htm) shows low- and middle-income countries reaping direct revenue from the global minimum tax equal to 1% to 2% of their current corporate tax revenue, compared to 2.5% to 4% for high-income countries. However, the former estimate is misleading because it relies on the unrealistic assumption that the taxable profits from multinational corporations headquartered in countries that opt out of the global minimum tax will be distributed among other countries according to their share of the corporations' global turnover. According to the proposed global minimum tax rules, these taxable profits will actually accrue in priority to countries that host intermediate holding subsidiaries and opt into the global minimum tax. For example, assuming that Switzerland opts out and Zambia and Luxembourg opt in, if a Swiss corporation owns its Zambian subsidiary through an intermediate holding subsidiary in Luxembourg, the corporation will pay the global minimum tax owed on its Zambian profits to Luxembourg, not Zambia. Since all EU members are expected to opt into the tax, and since most multinational corporations are structured with intermediate holding subsidiaries in Luxembourg, the Netherlands, or Ireland, there will be very little direct tax revenue left for low and middle-income countries.

NOTES

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[i] https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf

[ii] https://www.oxfam.org/en/press-releases/oecd-inclusive-framework-agrees-two-pronged-tax-reform-and-15-percent-global-minimum

[iii] https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint-beba0634-en.htm

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[iv] https://www.econpol.eu/sites/default/files/2021-07/EconPol_Policy_Brief_36_Who_Will_Pay_Amount_A_0.pdf

[v] https://ustr.gov/issue-areas/enforcement/section-301-investigations/section-301-digital-services-taxes

[vi] https://www.taxwatchuk.org/dst_tax_cut/

[vii] https://www.oecd.org/tax/options-for-low-income-countries-effective-and-efficient-use-of-tax-incentives-for-investment.htm

[viii] https://www.cnbc.com/2021/07/16/oecd-tax-reform-g-20s-crackdown-may-create-a-new-kind-of-tax-haven.html

[ix] https://www.icrict.com/

[x] https://www.reuters.com/business/argentina-says-15-global-minimum-corporate-tax-rate-too-low-2021-06-28/

[xi] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1888397

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[xii] https://www.taxpolicycenter.org/briefing-book/what-tcja-base-erosion-and-anti-abuse-tax-and-how-does-it-work

[xiii] https://www.oxfam.org/en/research/dignity-not-destitution

[xiv] https://twitter.com/ATAFtax/status/1410871916391538693?s=20

[xv] https://www.ataftax.org/130-inclusive-framework-countries-and-jurisdictions-join-a-new-two-pillar-plan-to-reform-international-taxation-rules-what-does-this-mean-for-africa

[xvi] https://taxjusticeafrica.net/african-civil-society-organizations-call-for-rejection-of-g7-global-tax-deal/

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