

Tax challenges from digitalisation: A global two-pillar solution could increase tax revenues and support economic activity

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The international corporate tax system faces growing challenges. While the OECD/G20 Base Erosion and Profit Shifting (BEPS) project represented an unprecedented multilateral effort to tackle profit shifting, many questions over the allocation of taxing rights remain unresolved. Digitalisation and globalisation have highlighted certain vulnerabilities in the existing framework, which allocates taxing rights principally on the basis of physical presence. In addition to this, some BEPS issues remain. In this context, an increasing number of jurisdictions are taking uncoordinated and unilateral actions (e.g. digital services taxes), contributing to an increase in tax and trade disputes and growing tax uncertainty.

The COVID-19 crisis is exacerbating these tensions by accelerating the digitalisation of the economy and increasing pressures on public finances. The fact that many firms have benefitted from direct or indirect government support during the crisis is also likely to intensify public dissatisfaction with tax avoidance by multinational enterprises (MNEs).

Towards a global two-pillar solution

Against this backdrop, the OECD/G20 Inclusive Framework on BEPS (Inclusive Framework), which brings together 137 member jurisdictions, is discussing proposals for a consensus-based reform of the international tax rules to address the tax challenges arising from the digitalisation of the economy. The proposals fall under two pillars, which are described in the Pillar One and Pillar Two Blueprint reports released last week (OECD, 2020a; OECD, 2020b). In their latest communiqué, G20 Finance Ministers confirmed that they remain committed to further progress on both pillars and urged the Inclusive Framework to address the remaining issues with a view to reaching a global and consensus-based solution by mid-2021 (G20, 2020).

Pillar One seeks to adapt the international corporate tax system to the digital age through significant changes to the rules applicable to business profits to ensure that the allocation of taxing rights on business profits is no longer exclusively determined by reference to physical presence.

Pillar Two aims to address remaining BEPS challenges and is designed to ensure that large internationally operating businesses pay a minimum level of tax regardless of where they are headquartered or the jurisdictions they operate in.

This blog post summarises the main findings of the Economic Impact Assessment of the proposals carried out by the OECD Secretariat (OECD, 2020c). This is an 'ex ante' assessment, which relies on a number of illustrative assumptions on proposal design and parameters, without prejudice to the final decisions of the Inclusive Framework.

The proposals would increase global tax

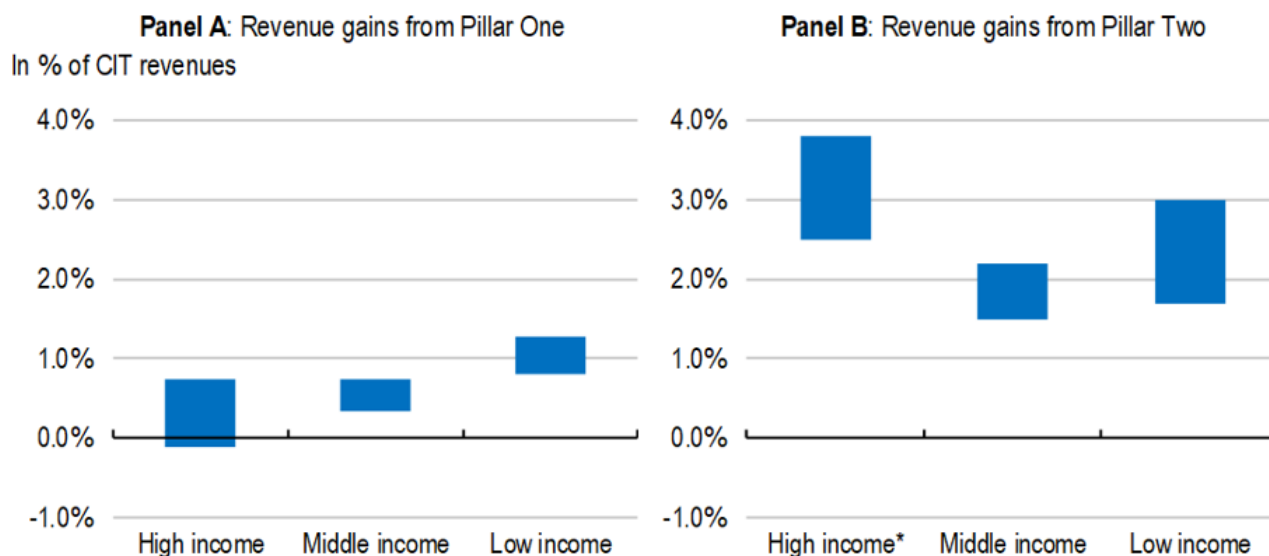
revenues

Pillar One and Pillar Two could increase global corporate income tax (CIT) revenues by about USD 50-80 billion per year. Taking into account the combined effect of these reforms and the US GILTI regime, the total effect could represent USD 60-100 billion per year or up to around 4% of global CIT revenues.

- Pillar One would involve a significant change to the way taxing rights are allocated among jurisdictions, as taxing rights on about USD 100 billion of profit could be reallocated to market jurisdictions. This would lead to a modest increase in global tax revenues. On average, low, middle and high income economies would all benefit from revenue gains, while 'investment hubs' would tend to lose tax revenues.
- Pillar Two would yield a significant increase in CIT revenues and significantly reduce the incentives for MNEs to shift profits to low-tax jurisdictions, which would generate revenue gains in addition to the direct gains resulting from the implementation of the new rules.
- The combined revenue gains from the two pillars are estimated to be broadly similar – as a share of current CIT revenues – across low, middle and high income jurisdictions (Figure 1).

Figure 1. Estimated effect of the proposals on tax revenues, by jurisdiction groups

Estimates based on illustrative assumptions on the design and parameters of Pillar One and Pillar Two



* Excluding the United States (given illustrative assumption that the US GILTI would co-exist with Pillar Two)

Source: OECD (2020c).

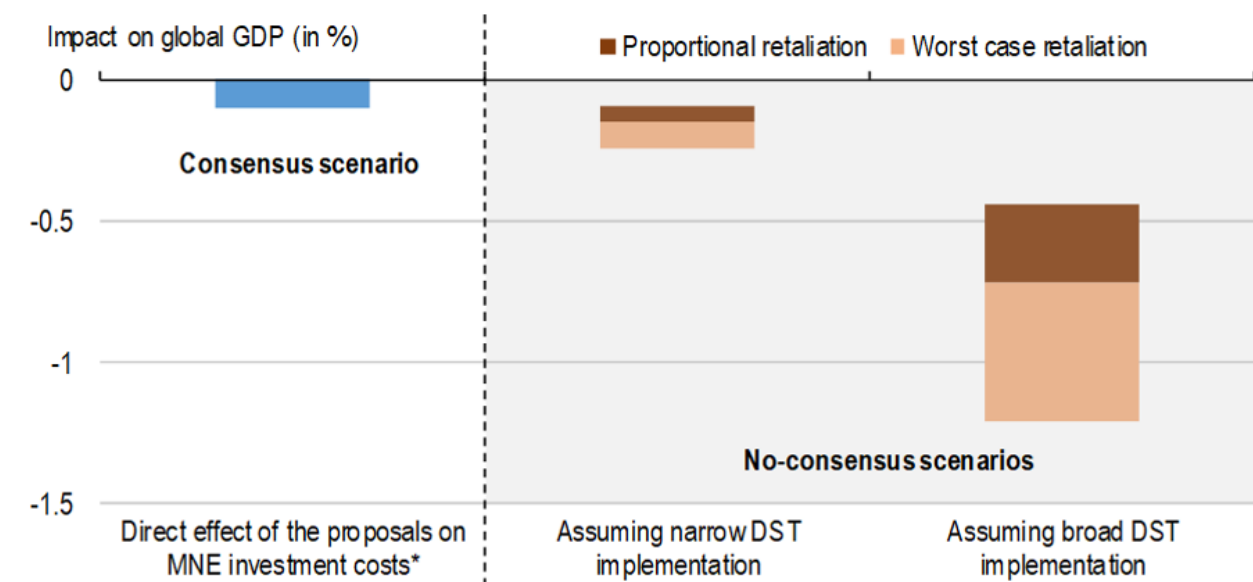
A consensus-based solution would support investment and economic growth

A consensus-based multilateral solution involving Pillar One and Pillar Two would lead to a more favourable environment for investment and growth than would likely be the case in absence of an agreement by the Inclusive Framework:

- The two pillars would lead to a relatively small increase in the average (post-tax) investment costs of MNEs (Hanappi and González Cabral, 2020). The ensuing negative effect on global investment is estimated to be very small, as the proposals would mostly affect highly profitable MNEs whose investment is less sensitive to taxes (Millot et al., 2020). Overall, the negative effect on global GDP stemming from the expected increase in tax revenues associated with the proposals is estimated to be less than 0.1% in the long term.
- In contrast, the absence of a consensus-based solution would likely lead to a proliferation of uncoordinated

and unilateral tax measures (e.g. digital services taxes) and an increase in damaging tax and trade disputes. This would undermine tax certainty and investment and also result in additional compliance and administration costs. The magnitude of the negative consequences would depend on the extent, design and scope of these unilateral measures, and the scale of any ensuing trade retaliation. In the “worst-case” scenario, these disputes could reduce global GDP by more than 1% (Figure 2).

Figure 2. Estimated effect on global GDP in stylised scenarios



* The proposals would also have positive impacts on GDP through indirect channels (e.g. increased tax certainty, reduced need to increase other distortive taxes) which are not quantified in this figure.

Note: The estimates in this figure are based on illustrative assumptions on the design and parameters of Pillars One and Two and on the potential no-consensus scenarios.

Source: OECD (2020c).

The COVID-19 crisis has increased the need for reform

The full impact of the COVID-19 crisis remains highly uncertain at this stage, but a few likely implications for the impact assessment of Pillar One and Pillar Two already stand out:

- The COVID-19 crisis is likely to reduce the expected

revenue gains from the proposals at least in the short run as the crisis weighs on the profitability of many MNEs, even though some digital-intensive MNEs have managed to sustain or enhance their profitability since the beginning of the crisis.

- The crisis has accelerated the digitalisation of the economy, increasing the need to address the tax challenges arising from digitalisation.

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