The effect of the OECD's Pillar 1 proposal on developing countries

- *An impact assessment*

October 2021

Summary

On July 1 a group of more than 130 countries under the OECD's Inclusive Framework endorsed a high-level agreement to redistribute taxing rights in the context of the digitalization of the economy (so-called Pillar 1) as well as to set a global minimum effective tax rate (so-called Pillar 2).[1] A final agreement is expected to be endorsed by the G20 leaders at the end of this month.

As we approach the final stages of negotiations little is publicly known of the impact of the proposed Pillar 1 due to the OECD's decision not to make an impact assessment of the current proposal. The lack of impact assessment has not least been a problem for developing countries, who do not necessarily have the data, resources and administrative capacity to conduct their own impact assessment. This analysis tries to bridge that gap by shedding light on what Pillar 1 will mean for developing countries. The analysis is based on a methodology developed by Oxford Economics for Oxfam. Due to data limitations the results are not exact, but should instead be seen as indicative of the order of magnitude of the impact of the proposal under discussion.

The OECD's July statement mentions a reallocation percentage for Pillar 1 of between 20 and 30% of profits exceeding a 10 percent margin. Developing countries under the G-24 have stressed that any percentage under 30% would be unacceptable,[2] and the African Tax Administration Forum (ATAF) has proposed a higher rate of 35%.[3] Meanwhile the OECD framework also makes clear that countries will have to remove unilateral measures such as Digital Services Taxes (DST). We estimate what 52 developing countries could collect from Pillar 1 using the different reallocation percentages being discussed in negotiations and compare this to the revenue that they could potentially raise instead through a DST with a rate of 3%, which is around the average rate that countries that have adopted a DST have applied.

The key results are:

- **With the low 20% reallocation percentage, the net impact for developing countries could be negative.** While the 52 developing countries for which we have data could gain around $1.43 bn. from Pillar 1, this would be less than the $1.66 bn. that we estimate a 3% DST could generate for these countries. The net effect could be an annual loss of $230 million to developing countries.
- **The net impact of Pillar 1 with the higher 30% reallocation percentage mentioned in the OECD's July statement would be positive, but insignificant for developing countries.** Comparing the revenue from Pillar 1 with a 30% reallocation percentage ($2.16 bn.) with a 3% DST ($1.66 bn.) for developing countries shows that they could experience a net gain of around $494 million. This would be less than $10 million on average for each

---

[1] 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

[2] https://www.g24.org/wp-content/uploads/2021/09/Comments-of-the-G24-on-the-IF-July-Statement.pdf

[3] 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

country, equivalent to just 0.007% of their GDP. Some countries would raise less than $1 million a year from Pillar 1, which may not be worth the administrative costs of implementation.
- **Should negotiators adopt ATAF's proposal for a 35% reallocation percentage the net gain for developing countries could be more meaningful.** The revenue generated from Pillar 1 with this reallocation rate ($2.54 bn.) would surpass the revenue from a 3% DST ($1.66 bn.) and produce a net gain for developing countries of $857 million. Although still low, this would be a significant improvement from the results using the OECD's suggested range of 20-30%.
- More detailed analysis for Kenya, Nigeria, Argentina and Mexico shows that **lowering the revenue threshold from the current €20 bn. to €10 bn. could double the revenue** for the four countries.
- Analysis for Kenya, Nigeria, Argentina and Mexico also shows that the **single largest improvement to Pillar 1 would be to abolish the distinction between routine and non-routine profits, and instead apply the reallocation percentage to all profits** and not just profits above 10% as suggested by the OECD July statement. For the four countries the removal of the 10% profitability threshold could increase the revenue by more than four times if the 35% reallocation percentage was used.

We already know that the OECD's Pillar 2 grants almost all revenue to a handful of rich countries, while leaving less than 3% for the poorest countries.[4] This analysis puts into question whether the OECD's Pillar 1 is much better in terms of bolstering developing countries tax revenues. Should negotiations end at a low reallocation percentage for Pillar 1 our results even suggests that the net impact on developing countries could be negative. At a time when developing countries are experiencing the largest increase in extreme poverty in decades this would be catastrophic and unacceptable. Oxfam is calling for urgent action to avoid this scenario by strengthening the OECD-deal to ensure that multinational corporations pay a fair share of tax in developing countries. As the G-24 have pointed out, anything less will render the OECD-deal unsustainable.[5]

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

[5] https://www.g24.org/wp-content/uploads/2021/09/Comments-of-the-G24-on-the-IF-July-Statement.pdf

Methodology

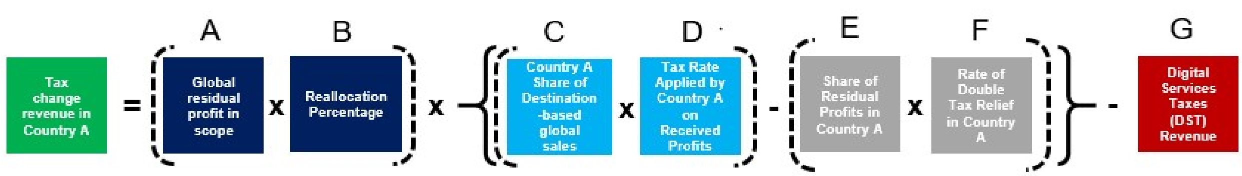
The quantification of the impact of BEPS 2.0 Pillar 1 in developing countries focuses only on the so-called “Amount A” – the amount of revenue from in scope multinational enterprises (MNEs) that is above an agreed threshold that a country will now have a taxing right over, leaving aside, due to data limitations, the potential effects of the two other elements of Pillar 1: Amount B and the improved tax certainty processes.

The data used in the analysis is summarised in the table below:

Data Item	Data Input	Data Source
Multi-National Enterprises (MNEs) Data	Global Turnover and Profits of the 2,000 Largest Public Companies	- Forbes Global 2000 List - US International Revenue Service (IRS)
Measures of Allocated Profits and Customers	Average Consumption Per Capita Number of Internet Users	- World Bank - Internet World Statistics
Tax Information	Corporate Income Tax Rates Digital Services Tax (DST) Rates Total Tax Revenue	- PwC Tax Summaries - Country Statistics, Treasury and Revenue Services Offices
Macroeconomic Data	Nominal GDP GDP per capita Exchange Rates CPI and components	-World Bank - International Monetary Fund - Country Central Banks

The utilized data are from 2019 and the results are therefore also reported in 2019 US dollars.

To calculate the tax revenue impact of Pillar 1 in developing countries, the following simplified formula below was used:



Global residual profit in scope (A): The formula used to determine the global residual profits in scope is defined as the aggregated profit above the profitability threshold for all MNEs above the revenue threshold and excluding financial, oil and mining companies. Utilising a dataset of MNE financial data, consolidated from the Forbes Global 2000 List and US IRS databases, the MNEs that are in scope were determined based on the 10% profitability threshold and two size thresholds (revenue of at least €20bn or €10bn).
Note: This amount may be underestimated as the Forbes Global 2000 List does not include MNEs that are not listed on stock exchanges. But it can also be overestimated as some of the MNEs in scope serve mainly their domestic markets and hence little of their profits would be reallocated.

Reallocation Percentage (B): This is the percentage of global residual profits that will be allocated to each country. This percentage will be agreed upon by the Inclusive Framework. Given that this percentage is yet to be finalized, several rates were used in a scenario-based approach:

20% and 30% (considered by the Inclusive Framework) as well as 35% (advocated by the African Tax Administration Forum). Taken together, components A and B represent the total amount of global residual profit that would be reallocated to countries under Amount A.

Country A Share of Destination-Based Global Sales (C): A country will be allocated residual profit in proportion to the share of the in-scope global MNE sales that take place in that country. This share was estimated based on proxies for MNE destination-based sales for two activity groupings: Automated Digital Services (ADS) and other activities. For corporations providing ADS, an approach based on the number of internet users per country, share of communication in the consumption basket, and data on the average consumption per person was utilised. For other activities, a proxy based on household consumption was used to estimate this share.
Note: This is likely to overestimate the impact for developing countries as this approximation does not take into account the OECD's proposed rule that countries will only get a share of the MNEs' global profits deriving at least €1 million in revenue (€250,000 for countries with GDP under €40 billion) on their territories, which is likely to hurt small and low-income countries in particular.

Tax rate applied by Country A on received profit (D): The tax rate applied to residual profit received as a result of any reallocation was assumed to be the statutory corporate income tax (CIT) rate.

Share of global residual profit in Country (E): This accounts for the amount of residual profits that the developing country under investigation will have to contribute to the pool of global residual profits to be reallocated to other countries. To estimate this, the financial data (from the Forbes Global 2000 List) of the MNEs headquartered in the country under consideration that are in scope was analysed.

Rate of double tax relief in Country A (F): While double taxation rules are yet to be finalized under the Inclusive Framework, it is assumed that countries would provide relief for double taxation in proportion to the share of global residual profits collected from that country. The rate of double tax relief, which determines the gross tax revenue loss of a country, is assumed to be the country's double tax treaty rate, and in the case where a country does not have one, the statutory CIT rate was used.
Note: This assumes that countries currently tax all their residual profits, which is not the case. This is therefore an overestimate and it is better understood as a loss of tax potential or loss of taxing rights rather than a loss of actual tax revenue.

Digital Services Tax (DST) Revenue (G): This captures the loss in DST revenue as a result of the implementation of Pillar 1 – under Pillar 1, DST would be abolished. For the four focus countries, where actual or budgeted DST revenue are published (e.g., Kenya), the calculation uses this figure. Otherwise it is calculated by multiplying the statutory DST rate by the country's share of sales of the ADS-producing MNEs (e.g., Mexico and Argentina). All the ADS-producing MNEs in the Forbes Global 2000 List, including those not in scope, are considered. For Nigeria where the tax is a top up of the corporate income tax for digital companies instead of a DST, the base is profit rather than sales. For all other countries, we assume a DST of 3% on ADS revenue, whether they currently have a DST or not. For these countries, (G) is therefore an estimate of loss of tax revenue potential (revenue that they could choose to raise in the future if they don't join

Pillar 1) rather than a loss of actual tax revenue. 3% is the average rate applied by countries that already have adopted or have proposed to introduce a DST[6].

Components C and D relate to the tax revenue a country will receive as a result of the reallocation of the residual profits, while components E, F and G relates to the tax revenue the country loses in the reallocation and the implementation of Pillar 1. The tax revenue impact is the net product of the tax base effect (A*B*C and A*B*E) and the tax rates applied to it (D and F) as well as the DST revenue loss.

Tax Revenue Impact = {(A * B * C) * D} - {(A * B * E) * F} – G

Summary of findings

Oxford Economics has analysed the impact on Kenya, Nigeria, Argentina and Mexico, and Oxfam has replicated this methodology to other countries for which data is available.

Table 1 shows the estimated revenue from Pillar 1 for the 52 low- and lower-middle income countries for which data is available under the different reallocation percentages considered (components A to F of the above formula) and compares it to the revenue that they could potentially raise with a 3% DST if they did not adopt Pillar 1 (component G).

Table 1: Net impact of Pillar 1 for 52 developing countries

	Pillar 1 revenue ($million 2019) [A to F]	Potential DST revenue ($million 2019) [G]	Net impact ($million 2019)	Net impact %GDP)
20% reallocation	1.433	1.664	-230	-0.003%
30% reallocation	2,158	1,664	494	0.007%
35% reallocation	2,537	1,664	857	0.012%

As is evident from Table 1, the lowest of the reallocation percentages under consideration in the negotiations (20%) could result in a negative net impact on developing countries. The 30% reallocation percentage does yield a positive impact, but just barely considering that the net revenue of $512 million is divided between 52 countries. The Pillar 1 revenue for some low-income countries could be less than $1 million a year, which may not be worth the administrative costs of implementation. The 35% reallocation percentage proposed by ATAF produces the best result for developing countries, although the net impact is still very low as a percentage of GDP.

Figure 1 illustrates the impact on the tax revenue of four middle-income countries (Kenya, Nigeria, Argentina, and Mexico) under the two scenarios under consideration by the Inclusive Framework, compared to what they currently raise unilaterally with DSTs, which they would need to give up. The 20% reallocation scenario yields about the same revenue as our estimate of what they currently raise through their unilateral DST. Only the 30% scenario would yield an increase in

[6] The average rate is around 3.4% as calculated from: https://globaltaxnews.ey.com/news/2021-5471-now-available-digital-services-tax-2021-jurisdiction-activity-summary, https://taxfoundation.org/digital-tax-europe-2020/ and https://www.orbitax.com/news/archive.php/Sierra-Leone-Finance-Act-2021--45111.

revenue, which would be very modest as a percentage of GDP. Results for more ambitious scenarios are available for these countries in Table 2.

Figure 1: Tax Revenue Impact of Pillar 1 (% of GDP)

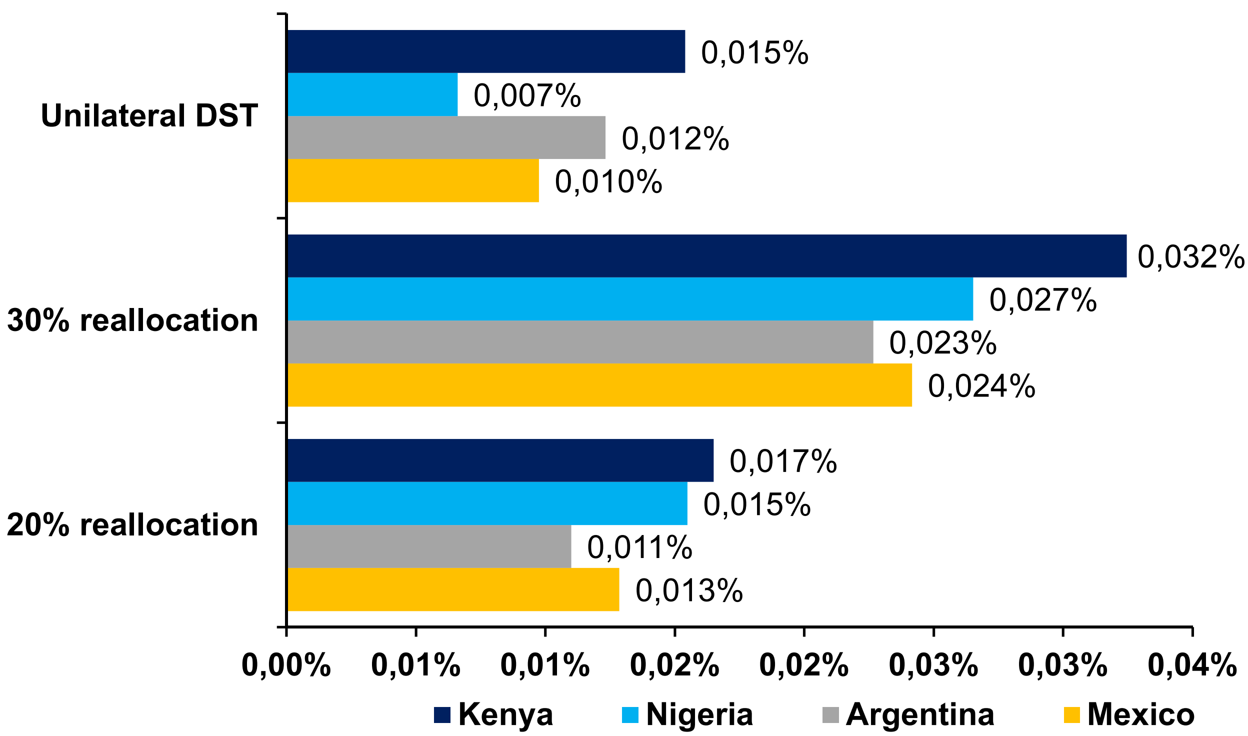


Table 2a: Impact on tax revenue for Kenya

$ million, 2019	Pillar 1 revenue size threshold >€20bn [A to F]	Current DST (2021 budget) [G]	Net impact	Net impact with size threshold >€10bn
20% of profits above 10% margin	30.5	14.7	15.8	26.0
30% of profits above 10% margin	45.7	14.7	31.0	46.3
35% of profits above 10% margin	53.3	14.7	38.6	56.5
35% of total profits	203.4	14.7	188.7	257.0

Table 2b: Impact on tax revenue for Nigeria

$ million, 2019	Pillar 1 revenue size threshold >€20bn [A to F]	Current SEP (estimated) [G]	Net impact	Net impact with size threshold >€10bn
20% of profits above 10% margin	99.0	29.6	69.4	109.9
30% of profits above 10% margin	148.5	29.6	118.9	179.6
35% of profits above 10% margin	173.2	29.6	143.6	214.5
35% of total profits	774.4	29.6	744.8	1,020.1

Table 2c: Impact on tax revenue for Argentina

$ million, 2019	Pillar 1 revenue size threshold >€20bn [A to F]	Current DST (estimated) [G]	Net impact	Net impact with size threshold >€10bn
20% of profits above 10% margin	103.9	54.9	49.0	109.1
30% of profits above 10% margin	155.9	54.9	101.0	163.7
35% of profits above 10% margin	181.9	54.9	126.9	191.0
35% of total profits	721.4	54.9	666.5	912.5

Table 2d: Impact on tax revenue for Mexico

$ million, 2019	Pillar 1 revenue size threshold >€20bn [A to F]	Current DST (estimated) [G]	Net impact	Net impact with size threshold >€10bn
20% of profits above 10% margin	286.9	123.7	163.1	266.9
30% of profits above 10% margin	430.3	123.7	306.6	462.2
35% of profits above 10% margin	502.0	123.7	378.3	559.8
35% of total profits	1,634.1	123.7	1,510.4	2,731.8

Key findings at global level include:

- Only 67 corporations would be in-scope of Pillar 1, climbing to 151 if the size threshold is lowered to €10 billion, as the OECD framework proposes should happen after seven years.

- 35 of the 67 corporations are American and they generate 65% of the reallocated profits; twelve other high-income countries account for another 30% of reallocated profits (see Table 3).

- The only middle-income countries that are home to in-scope corporations are China (3), Brazil (1) and India (1), and they together account for 6% of the reallocated profits.

- The reallocated profits taxable by market countries would globally amount to between $61 billion a year (with a reallocation percentage of 20%) to $91 billion (with 30%), climbing to $82 billion and $122 billion if the size threshold were lowered to €10 billion (see Table 4).

- Increasing the reallocation percentage to 35% as recommended by the African Tax Administration Forum would increase the reallocated profits to €106 billion; a truly ambitious deal would also eliminate the profitability threshold and lower the size threshold immediately, and would yield $559 billion of reallocated profits (see Table 4).

Table 3: Countries where profits are reallocated from

	Number of corporations	% of reallocated profits
United States	36	65%
South Korea	2	9%
China	3	5%
Switzerland	3	4%
Japan	3	3%
Hong Kong	2	3%
Taiwan	1	3%
United Kingdom	4	2%
Netherlands	1	2%
Brazil	1	1%
Germany	3	1%
France	3	1%
Ireland	2	1%
Saudi Arabia	1	0%
Spain	1	0%
India	1	0%
TOTAL	67	100% of 20% to 30% of $303bn

Table 4: Raising the ambition of Pillar 1 – Scenarios of taxable profits reallocation

$ million per year	Size threshold >€20 bn	Size threshold >€10bn
20% of profits above 10% margin	60,534	81,646
30% of profits above 10% margin	90,801	122,469
35% of profits above 10% margin	105,935	142,881
35% of total profits	416,895	558,616

Green: Scenarios on the table. Orange: Scenarios conditionally on the table after seven years. Blue: An ambitious deal.

Background

What is "Pillar 1"?

Pillar 1 is an international agreement that would reallocate taxing rights over the profits of multinational corporations among participating countries. It is being negotiated by 140 nations that are member of the OECD's Inclusive Framework.

A foundational principle of international tax is that "source" (or host) countries come first in the pecking order and can tax the profits generated by operations that take place on their territories and priced at market value. "Residence" (or home) countries can then choose to tax "residual profits".

Pillar 1 introduces destination-based taxation. "Market" countries (where sales to customer take place) will get a cut at the profits of multinational corporations. That will not affect taxing rights of source countries, but will come at the expense of residence countries through foreign tax credits.

The proposed reallocation of taxing rights to market countries has a narrow scope: it would cover only a fraction of the profits (20% to 30% of the profits in excess of a 10% profit margin) of an extremely small fraction of corporations (those with annual revenue over €20 billion, excluding financial and extractive industries and possibly going down to €10 billion after a seven-year review). Market countries where such a corporation has sales over €1 million (or €250,000 for small economies) would receive a portion of that corporation's reallocated profits proportional to their share of the corporation's sales.

Why Pillar 1?

The driver of Pillar 1 is the digitalization of the economy. In some digital business models, users in market countries create value for businesses that do not necessarily have any physical presence in these countries, which are therefore unable to tax that value at source under current rules.

An increasing number of countries have adopted or are contemplating adopting Digital Services Taxes (DSTs) on the gross revenue of digital services used by their residents. Because most of the large providers of digital services are American, the United States considers DSTs discriminatory. It has threatened a number of countries with trade sanctions if they don't abandon them.

Pillar 1 is a compromise whereby market countries would gain taxation rights over the profits in all industries (such that the United States does not perceive it as discriminatory) in exchange for relinquishing their DSTs.