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

- *An impact assessment*

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Summary

On October 8, 2021, a group of 136 countries facilitated by the OECD and known as the Inclusive Framework reached a high-level political 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] The OECD is now drafting a multilateral convention to enact Pillar 1, which should take effect in 2023.

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, which do not necessarily have the data, resources, and administrative capacity to conduct their own impact assessment. This note 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 agreement.

We estimate what 49 developing countries could collect from Pillar 1 and compare this to the revenue that they could potentially raise instead through a Digital Services Tax (DST) with a rate of 3%, which is about the average rate that countries that have adopted a DST have applied. We compute that estimate with both the initial €20 billion size threshold and the reduced €10 billion threshold after seven years agreed by the Inclusive Framework.

The key result is that **the impact of Pillar 1 with the €20 billion size threshold on developing countries’ revenue is about the same as that of a 3% DST, and very small (0.026% of GDP).** Some countries would raise less than $1 million a year from Pillar 1, which may not be worth the administrative costs of implementation.

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.[2] This analysis puts into question whether the OECD’s Pillar 1 is much better in terms of bolstering developing countries tax revenues. This is an egregious lost opportunity at a time when developing countries are experiencing the largest increase in extreme poverty in decades.

[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-october-2021.htm

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

Methodology

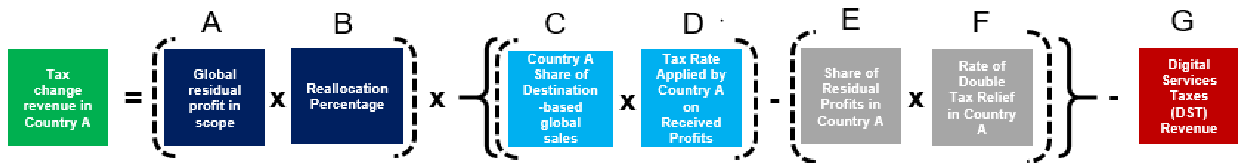
The quantification of the impact of BEPS 2.0 Pillar 1 in developing countries focuses only on the so-called “Amount A” – the amount of revenue from in-scope multinational enterprises (MNEs) that is above an agreed threshold that a country will now have a taxing right over, leaving aside, due to data 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 summarized in the table below:

Data Item	Data Input	Data Source
Multi-National Enterprises (MNEs)	Global turnover and profits of the 2,000 largest public companies	•Forbes Global 2000 List •US International Revenue Service
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 Consumer Price Index components	•World Bank •International Monetary Fund •Country Central Banks

The 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 profits above the profitability threshold for all MNEs above the revenue threshold and excluding financial, oil and mining companies. Using 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 the €20bn size threshold set by the Inclusive Framework. We have also computed the alternate global residual profit in scope with the size threshold reduced to €10 billion after seven years as agreed by the Inclusive Framework.
Data source: Oxford Economics based on Forbes Global 2000 dataset and IRS data.
Note: This amount may be underestimated as the Forbes Global 2000 List does not include MNEs that are not listed on stock exchanges.

Reallocation Percentage (B): This is the percentage of global residual profits that will be allocated to all market countries. The Inclusive Framework set this percentage at 25%.

Country A Share of Destination-Based Global Sales (C): A country will be allocated residual global 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, the proportion of global residual profits allocated to each country is estimated to be the country's share of the product of the number of internet users and the per capita spending on communication services (the latter being the product of per capita household consumption and the weight of communication in the Consumer Price index). For other activities, the proportion of global residual profits allocated to each country is estimated to be the country's share of global household consumption.
Data sources: World Bank for household consumption (https://bit.ly/3AB5HeF) and population (https://bit.ly/33Oxwo2); IMF for Consumer Price Index weights (https://bit.ly/3o0B4du); Internet World Statistics for number of Internet users (https://bit.ly/3AwDwO4).
Note 1: This component is a rough proxy. The correct amount (C) should be the actual sales of each MNE in Country A as a proportion of global sales. But that data is not publicly available. This proxy could bias the results of some countries. For instance, a lot of the in-scope companies are American, and they presumably make a large share of their profits in the United States; however this proxy assumes that their sales are evenly distributed across countries according to their household consumption.
Note 2: This is likely to overestimate the impact for developing countries as this approximation does not take into account the OECD's proposed rule that only countries deriving at least €1 million in revenue (€250,000 for countries with GDP under €40 billion) on their territories will get a share of the MNEs' global profits, 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.
Data source: PwC's World Tax Summaries (https://taxsummaries.pwc.com/).

Share of global residual profit in Country A (E): This accounts for the amount of residual profits that the country under investigation will have to contribute to the pool of global residual profits to be reallocated to other countries. It is assumed to be the sum of the reallocated in-scope global residual profits of all the companies headquartered in the country.
Note: The Inclusive Framework has not yet set the precise rules to determine this amount. It is possible that part of the double taxation relief will be provided by reducing taxes on subsidiaries in other countries than the multinational's home country.

Rate of double tax relief in Country A (F): While double taxation rules are not yet 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 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 overestimation and it is better understood as a loss of tax potential or loss of taxing rights than a loss of actual tax revenue. A more precise analysis would use the country's double tax treaty rate instead of the CIT rate.

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, DSTs would be abolished. It is calculated by multiplying the DST rate by the country's share of sales of the ADS-producing MNEs. All the ADS-producing MNEs in the Forbes Global 2000 List, including those not in scope, are considered to compute the global revenue from ADS activities. Each country's share of this global amount is estimated with a formula based on the country's household consumption, weight of communication services in the country's Consumer Price Index, and number of Internet users similar to that described in (C) above. We assume a DST rate of 3% on ADS revenue for all countries. 3% is the average rate applied by countries that already have adopted or have proposed to introduce a DST.[3] Given that most countries do not currently have a DST, (G) is therefore an estimate of loss of tax revenue potential or loss of taxing rights (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. Note: A more precise analysis would use the actual DST revenue for countries that do have a DST, but this data is not published for most countries.

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

Table 1 shows the estimated revenue from Pillar 1 for the 49 low- and lower-middle income countries for which data is available[4] and compares it to the revenue that they could potentially raise with a DST (3% of gross revenue from automated digital services) if they did not adopt Pillar 1.

Table 1: Net impact of Pillar 1 for 49 low and lower-middle income countries

	Pillar 1 revenue ($million 2019) [A*B*C*D]	Pillar 1 relief for double taxation ($million 2019) [A*B*E*F]	Potential 3% DST revenue ($million 2019) [G]	Net impact ($million 2019)	Net impact %GDP)
€20bn size threshold	749	0	702	48	0.002
€10bn size threshold	1,011	0	702	309	0.011

[3] 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.

[4] Angola, Benin, Bhutan, Bolivia, Burkina Faso, Burundi, Cape Verde, Cambodia, Cameroon, Chad, Rep. of Congo, Cote d'Ivoire, Djibouti, El Salvador, Eswatini, Ethiopia, The Gambia, Ghana, Guinea-Bissau, Haiti, Honduras, Iraq, Kenya, Lesotho, Liberia, Madagascar, Mali, Mongolia, Mozambique, Nepal, Nicaragua, Niger, Nigeria, Pakistan, Philippines, Occupied Palestinian Territories, Rwanda, Senegal, Sierra Leone, Sri Lanka, Sudan, Tanzania, Timor-Leste, Togo, Tunisia, Uganda, Ukraine, Vietnam, Zambia.

With the €20 billion size threshold, Pillar 1 would yield $0.75 billion divided among the 49 countries. None of these countries are home to an in-scope multinational, such that this sum is also a net benefit. However, it is barely more than what these same countries could potentially raise through a DST at a 3% rate. The increase in tax revenue from Pillar 1 is thus about the same as the taxing rights forfeited. The net impact becomes hardly more significant if the size threshold is lowered to €10 billion. And it turns negative with a DST rate of 4% (at the €20 billion threshold). Although positive, the Pillar 1 revenue are very small: about 0.026% of the 49 countries' GDP with the €20 billion threshold. For some countries it is less than $1 million a year, which may not be worth the administrative costs of implementation. The impact net of DST is smaller still: 0.002% of GDP.

Table 2: Countries where profits are reallocated from

	Number of corporations - €20bn threshold	% of reallocated profits - €20bn threshold	Number of corporations - €10bn threshold	% of reallocated profits - €10bn threshold
United States	36	64.8%	74	61.3%
South Korea	2	9.3%	3	7.2%
China	3	4.5%	8	5.0%
Switzerland	3	4.4%	6	4.1%
Japan	3	3.4%	10	4.4%
Hong Kong	2	2.7%	4	2.2%
Taiwan	1	2.7%	2	2.1%
United Kingdom	4	2.2%	9	4.1%
Netherlands	1	1.7%	2	1.7%
Brazil	1	1.1%	1	0.8%
Germany	3	0.8%	4	0.7%
France	3	0.8%	5	1.0%
Ireland	2	0.7%	3	0.7%
Saudi Arabia	1	0.4%	2	0.7%
Spain	1	0.3%	1	0.2%
India	1	0.1%	5	1.0%
Denmark	0	0.0%	1	1.1%
Russia	0	0.0%	2	0.7%
Singapore	0	0.0%	1	0.2%
United Arab Emirates	0	0.0%	1	0.2%
Canada	0	0.0%	2	0.2%
Finland	0	0.0%	1	0.1%
Australia	0	0.0%	1	0.1%
Sweden	0	0.0%	1	0.1%
Luxembourg	0	0.0%	1	0.1%
Norway	0	0.0%	1	0.0%
TOTAL	67	100.0%	151	100.0%

Other key findings 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. This is fewer than the "about 100" in-scope companies floated by the US government.

- 36 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 2).

- 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 $76 billion a year, climbing to $102 billion if the size threshold were lowered to €10 billion. This is less than the $125 billion estimated by the OECD.[5]

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 (25% 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.

[5] https://www.oecd.org/tax/beps/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm

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.