Tax Policy Alert
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OECD findings on the economic analysis of Pillar One and Two

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In brief

The OECD Secretariat hosted a webcast on February 13 in which it presented preliminary findings on economic analysis of Pillars One and Two of the digitalizing economy project. The OECD analysis suggests that the combined effects of the two pillars, based on assumptions without prejudging key policy design features of the framework, results in an initial estimate of a 4% increase of corporate income tax revenue collected – about $100 billion annually across all jurisdictions – with little effect on investment costs. The OECD will continue to refine these findings as new data is shared. Policymakers will be discussing the analysis as the Inclusive Framework (IF) continues discussions to reach a consensus solution on the key design features by July 2020.

In detail

Background

Governments, businesses, and civil society have long sought analysis of the potential economic and revenue effects of the Pillar One and Pillar Two proposals. The OECD has committed for some months to release initial estimates based on its economic analysis. In prior public statements the OECD indicated that its ongoing research showed general positive outcomes for many jurisdictions (other than 'investment hubs') but has delayed releasing its initial findings until now.

Analysis

The OECD analysis was conducted by a broad team of economists from different departments. The Secretariat's focus is providing some level of evidence and analysis for the IF to review in the decision-making process, while not seeking to prejudge any IF decisions. The Secretariat made clear the need for assumptions as key design features and parameters have not yet been set. Therefore, any analysis had to take into account simplifying methodological assumptions since there were no perfect data sources available.

Data sources

The OECD has used a combination of data sources: 1) unconsolidated financial statement data for 27,000 MNEs; 2) country-by-country reports (CbCR) shared by 24 jurisdictions on an anonymized basis; 3) aggregate foreign direct investment data; and 4) information from the OECD Activities of Multinational Enterprises (AMNE) database. Some extrapolation was required due to gaps in available information. The analysis covers more than 200 jurisdictions, and so is broader than the IF membership.

The OECD did not present results at the individual country level, but rather on the basis of jurisdictional groups (i.e., high-, middle-, and low-income countries based on World Bank classifications) and investment hubs (identified as countries with foreign direct investment greater than 150% of GDP).

Preliminary findings

The OECD estimated that the combined revenue gain of Pillars One and Two equals about 4% of present-law corporate income tax (CIT) revenue on a global basis, or approximately $100 billion each year. In general, the Pillar Two revenue effects are estimated to be larger than the Pillar One effects, with low-income countries gaining relatively more revenue from Pillar One and high-income countries gaining relatively more revenue from Pillar Two.

With respect to Pillar One, only the effect of Amount A was modelled, assuming 20% of profits above a threshold of 10% or 20% of pre-tax profits would be reallocated to market jurisdictions. The commodities and financial sectors were excluded and the US proposal for a safe harbor was not incorporated (it is unclear whether non-consumer facing sectors were included). The top 100 MNEs were responsible for more than half of the profits reallocated under the regime. It appears that Amount A was assumed to be surrendered in proportion to residual profits, and it was noted that investment hubs surrendered some of this profit.

The preliminary analysis treats the status quo as the baseline without taking account of adoption of unilateral measures that might occur absent agreement on Pillar One. It appears that high-income, middle-income, and low-income countries all gain from Pillar One. It is unclear whether investment hubs are included in the three income groups, as they are estimated to lose as much as 5% of corporate income tax receipts.

The range of effects for Amount A are found to be generally greatest as a percentage of CIT in low income countries (1-1.9%), then middle income (0.3-1.2%) and finally high income (-0.1-1.1%) countries.

For Pillar Two, the analysis assumes a minimum tax rate of 12.5% calculated on a per-country basis and the imposition of the income inclusion rule before the base-eroding payments rule. The interaction with Pillar One is modeled as well as some behavioral responses by companies (reduced profit shifting) and governments (increase in corporate tax rate by low-tax countries).

Overall, the Pillar Two corporate income tax revenue gain is anticipated to be more than four times larger than that of Pillar One. The analysis also models the impact of Pillars One and Two on effective average tax rates (EATRs). The combination increases EATRs by about 0.5 percentage points, almost entirely due to the effects of Pillar Two; the increase in investment hubs is nearly four times as great.

With regard to investment and growth, the OECD determined only small effects on investment costs, with many firms unaffected as the proposals mainly target firms with high levels of profitability and low ETRs. The OECD also believes the proposals would lead to reallocation of investment to jurisdictions where productivity is higher, thereby enhancing global growth. Further impacts on investment and growth will be analyzed by the end of March.

In commentary during the webcast, OECD officials said they hope to release country specific results in the future, but made no firm promise. They also noted that: 1) the OECD has done some analysis of impacts by industry segment for use by the IF in scoping, but there was no mention of public release of this information; 2) the potential policy responses of high-tax countries were not included in the analysis; and 3) the results of the OECD analysis are broadly in line with work done by the International Monetary Fund, the European Union, and the Africa Tax Administration Forum.

The takeaway

Country-by-country data relied on for the preliminary analysis only covers tax years through 2016; consequently, the findings may not account for behavioral changes by companies and governments as a result of BEPS implementation or US tax reform (the Tax Cuts and Jobs Act). As a result, the revenue effects may in reality be smaller than projected. Notwithstanding limitations in the data availability and uncertainty about the ultimate design of the proposals, the preliminary results will be of interest to all stakeholders.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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