

Global Minimum Tax Reform and the Future of Tax Competition

This article focuses on the effects of global minimum tax reform on tax competition. It also discusses whether the new tax competition landscape will become more equitable and efficient, and, if not, how the OECD's Inclusive Framework can better address these problems in the future.

1. Introduction

For more than two decades now, the OECD has played a leading role in multilateral cooperation to counter, inter alia, harmful tax competition. Its latest action is the global minimum tax reform. As of 7 June 2023, 139 jurisdictions under the OECD/G20 Base Erosion and Profit Shifting (BEPS) Inclusive Framework have committed to the two-pillar reform programme.¹ Pillar Two introduces a global minimum tax rate of 15%. According to the OECD, Pillar Two “does not seek to eliminate tax competition, but puts multilaterally agreed limitations on it”.² However, this is just an intuitive and brief statement. The effect of Pillar Two on tax competition is more complex and it requires a deeper analysis at the theoretical level. In this context, this article aims to address the following three series of questions to contribute to the research on tax competition:

- (i) What are the differences between Pillar Two and the OECD's previous efforts to counter corporate income tax competition? What motivated the 139 jurisdictions to reach a consensus on Pillar Two? What lessons can be drawn from the history of the OECD's efforts to counter tax competition? (See section 2.)
- (ii) In what way, and to what extent, will Pillar Two restrict corporate income tax competition? Will there

still be room for other forms of competition in the future, and if so, in what form? Specifically, what role can game theory play in explaining these issues?³ (See sections 3. and 4.)

- (iii) Will the new competition landscape lead to greater equality and efficiency? If not, how can the Inclusive Framework better address these problems in the future? (See section 5.)

The authors' conclusions are set out in section 6.

2. Comparison of Pillar Two with the OECD's Previous Efforts to Counter Tax Competition

2.1. Introductory remarks

The OECD's campaigns against tax competition can be divided into three stages. The first stage (the pre-BEPS stage, for which, see section 2.2.2.) began with the publication of the Report on Harmful Tax Competition: An Emerging Global Issue (the OECD 1998 Report).⁴ In the second stage (the BEPS 1.0 stage, for which, see section 2.2.3.), the OECD released 15 Final Reports of the BEPS Project in 2015. BEPS Action 5 specifically targeted harmful tax practices,⁵ while other actions such as the controlled foreign company (CFC) rules and country-by-country (CbC) reporting may also indirectly restrict tax competition by reducing profit shifting.⁶ The third stage (the BEPS 2.0 stage, for which, see section 2.2.4.) is the current global minimum tax reform.

Sections 2.2. to 2.4. compare these three stages in terms of their focus, methods and legitimacy. These sections reveal that tax competition is a complex and dynamic concept that takes on different forms at different stages. Correspondingly, the multilateral efforts to regulate tax competition are a gradual process, with changing emphases and methods at different stages.

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1. OECD, *Members of the OECD/G20 Inclusive Framework on BEPS Joining the October 2021 Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy as of 9 June 2023* (OECD 2023), available at www.oecd.org/tax/beps/oecd-g20-inclusive-framework-members-joining-statement-on-two-pillar-solution-to-address-tax-challenges-arising-from-digitalisation-october-2021.pdf (accessed 9 July 2023) [hereinafter *Members of the OECD/G20 Inclusive Framework on BEPS*].
2. OECD, *International community strikes a ground-breaking tax deal for the digital age* (OECD), available at www.oecd.org/tax/beps/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm (accessed 22 Mar. 2023).

3. It should be noted that multinational enterprises (MNEs) may also make strategic responses to Pillar Two, making them players in the broader tax game. However, the focus of this article is limited to the strategic responses of jurisdictions.

4. OECD, *Harmful Tax Competition: An Emerging Global Issue* (OECD 1998) [hereinafter the *OECD 1998 Report*].

5. OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance: Action 5 – 2015 Final Report* (OECD 2015), Primary Sources IBFD [hereinafter the *Action 5 Final Report* (2015)].

6. OECD, *Designing Effective Controlled Foreign Company Rules – Action 3: 2015 Final Report* (OECD 2015), Primary Sources IBFD and *Transfer Pricing Documentation and Country-by-Country Reporting: Action 13: 2015 Final Report* (OECD 2015), Primary Sources IBFD.

2.2. Differences in regulatory focus

2.2.1. Opening comments

Although the concept of “tax competition” is commonly used to refer to the behaviour of countries using various tax measures to attract paper profits, businesses, investors or high-net-worth individuals (HNWIs),⁷ it is a very broad concept that can include different forms of tax competition.

2.2.2. *The pre-BEPS stage: Countering illegal tax evasion facilitated by tax secrecy*

In the pre-BEPS stage, the OECD 1998 Report established the factors to identify tax havens and harmful preferential tax regimes. For tax havens, the four key identifying factors were: (i) no or only nominal taxes; (ii) a lack of effective exchange of information; (iii) a lack of transparency; and (iv) no substantial activities.⁸ With regard to harmful preferential tax regimes, the four key factors were: (i) no or low effective tax rates (ETRs); (ii) ring-fencing of regimes; (iii) a lack of transparency; and (iv) a lack of effective exchange of information.⁹

However, considering the difficulty in applying the tax rate and economic substance standards, the OECD made several important modifications to the identifying factors regarding tax havens in the 2001 Progressive Report. In determining which jurisdictions would be considered as uncooperative tax havens, commitments would be sought only in respect of the principles of effective exchange of information and transparency.¹⁰ Accordingly, in the following decade, the OECD’s work to address harmful tax competition was largely limited to transparency and information exchange aspects. The concept of “harmful tax competition” was used to describe jurisdictions that offered tax secrecy to facilitate illegal tax evasion.

2.2.3. *The BEPS 1.0 stage: Countering harmful tax competition*

In the BEPS 1.0 stage, the OECD focused on the use of preferential tax regimes with harmful elements that result in artificial profit shifting.¹¹ It did not intend to address all forms of non-taxation, but only those associated with abusive or harmful practices, where no indication had been made that low or non-taxation was considered to be a harmful practice in itself.¹² The action of the OECD at this stage was not aimed at unifying the tax structure and tax rate levels of each jurisdictions, but mainly at resolving the problem of harmful tax competition.

2.2.4. *The BEPS 2.0 stage: Countering tax competition in both harmful and genuine cases*

Unlike the previous stages which predominately focused on harmful tax competition, Pillar Two is considered by scholars to have a broader scope, and is aimed at reducing corporate income tax competition in both harmful (i.e. artificial profit shifting) and genuine (i.e. real investment shifting) cases.¹³ As stated by Liotti et al. (2022), even non-harmful tax regimes compatible with BEPS Action 5 may be subject to Pillar Two, if they result in an overall ETR of less than 15%.¹⁴

Overall, the OECD’s actions so far have been focused on traditional corporate income tax competition. However, as described in section 3., Pillar Two may give rise to new forms of competition. This means that the forms of tax competition and the actions taken to counter them may change and evolve over time.

2.3. Differences in regulatory methods

2.3.1. Opening comments

In theory and practice, there are different mechanisms to counter tax competition. This is the subject matter of sections 2.3.2. to 2.3.4.

2.3.2. *The pre-BEPS stage: Primarily using the list of uncooperative tax havens*

In the pre-BEPS stage, although the OECD 1998 Report proposed countermeasures at unilateral, bilateral and multilateral levels, the OECD primarily utilized the list of uncooperative tax havens to increase tax transparency.¹⁵ Between 2000 and 2009, the OECD achieved success in promoting compliance with tax transparency and information exchange principles by developing the list of uncooperative tax havens. In May 2009, due to commitments made by the last three countries on the list of uncooperative tax havens (Andorra, Liechtenstein and Monaco) so as to implement the principles of tax transparency and information exchange, the OECD removed them from the list. Since then, no tax jurisdiction has been included on the OECD list of uncooperative tax havens.¹⁶

2.3.3. *The BEPS 1.0 stage: Using the peer review mechanism*

In the BEPS 1.0 stage, the peer review mechanism was used to supervise the preferential tax regimes of all the Inclusive Framework members and remove the harmful elements. The peer review mechanism has reviewed a total of 319 regimes. To date, more than 120 preferential

7. Z. Hassan Fazal, *Tax Competition: A Blessing in Disguise for Small Countries*, 22 J. Austrl. Taxn. 1., p. 65 (2020), available at www.jausttax.com.au/Articles_Free/JAT%20Volume%2022%20Issue%201.pdf (accessed 18 July 2023).
8. OECD 1998 Report, *supra* n. 4, at p. 23.
9. *Id.*, at p. 27.
10. OECD, *The OECD’s Project on Harmful Tax Practices: The 2001 Progress Report* (OECD 2002) [hereinafter *The 2001 Progressive Report*].
11. OECD, *Action 5 Final Report* (2015), *supra* n. 5, at p. 11.
12. OECD, *Action Plan on Base Erosion and Profit Shifting* p. 10 (OECD 2013), Primary Sources IBFD.

13. R.S. Avi-Yonah & Y.R. Kim, *Tax Harmony: The Promise and Pitfalls of the Global Minimum Tax*, 43 Mich. J. Intl. L., p. 515 (2022), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4102332 (accessed 18 July 2023).
14. B.F. Liotti et al., *The Treatment of Tax Incentives under Pillar Two*, 2 Transnatl. Corp. J. 2, p. 43 (2022), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4132515 (accessed 18 July 2023).
15. OECD 1998 Report, *supra* n. 4.
16. OECD, *List of Unco-operative Tax Havens* (OECD), available at www.oecd.org/countries/monaco/list-of-unco-operative-tax-havens.htm (accessed 22 Mar. 2023).

tax regimes with harmful features have been or are in the process of being abolished or amended.¹⁷

2.3.4. *The BEPS 2.0 stage: Using the fiscal fail-safe under the guidance of game theory*

In the BEPS 2.0 stage, Pillar Two promotes the harmonization of corporate income tax rates worldwide by setting a minimum tax rate. In order to stimulate adoption and compliance, the designers of Pillar Two intentionally utilized the fiscal fail-safe under the guidance of game theory.

Dagan (2018) has analysed international taxation as a decentralized market, where governments have increasingly become strategic actors.¹⁸ In the decentralized competitive structure, states are assumed to tax strategically. As the tax policies of different jurisdictions interact with each other, jurisdictions design (or, if operating rationally, need to design) their international tax rules to best serve their national interests because their choices interact and compete with the choices made by other jurisdictions. Based on this feature, fiscal fail-safes establish a mechanism to link the tax treatment across jurisdictions, under which, if one country does not tax, another country fills the tax void. By automatically filling tax gaps, fiscal fail-safes are effective for achieving full taxation or curbing state defection. Although fiscal fail-safes are not new to international tax,¹⁹ Pillar Two is considered to have introduced a coordinated and more complex fiscal fail-safe,²⁰ which aims to maximize the strategic interactions among jurisdictions.²¹ By way of this mechanism, Pillar Two is expected to regulate traditional corporate income tax competition more directly and effectively.

2.4. Differences in democratic legitimacy

2.4.1. *The improvement of democratic legitimacy from the pre-BEPS stage to the BEPS 2.0 stage*

In terms of democratic legitimacy, the OECD's work in the pre-BEPS stage did not receive widespread support from most jurisdictions in the world, which was considered by Littlewood (2004) to be due to significant legitimacy deficiencies.²² With support from 141 Inclusive Framework members as of November 2021,²³ BEPS 1.0 made up for

17. OECD, *New results show progress continues in combatting harmful tax practices* (OECD 2022), available at www.oecd.org/tax/beps/new-results-show-progress-continues-in-combatting-harmful-tax-practices.htm (accessed 22 Mar. 2023).
18. T. Dagan, *International Tax Policy: Between Competition and Cooperation* p. 4 (Cambridge U. Press 2018).
19. Examples of existing fiscal fail-safes include the CFC rules and the BEPS anti-hybrid rules. See R. Mason, *The Transformation of International Tax*, 114 *American J. Intl. L.* 3, pp. 376-380 (July 2020), available at www.cambridge.org/core/journals/american-journal-of-international-law/article/transformation-of-international-tax/A335E9177D1C7A692362066205689D1B (accessed 18 July 2023).
20. R. Mason, *A Wrench in GLOBE's Diabolical Machinery*, 107 *Tax Notes Intl.* 12, p. 1391 (2022).
21. W. Cui, *Strategic Incentives for Pillar Two Adoption*, U. Brit. Columbia (UBC), Faculty of Law, p. 1 (15 Aug. 2022), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4161375 (accessed 18 July 2023).
22. M. Littlewood, *Tax Competition: Harmful to Whom?*, 26 *Mich. J. Intl. L.* 1, pp. 441-442 (2004), available at <https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1227&context=mjil> (accessed 18 July 2023).
23. OECD, *What is BEPS?* (OECD), available at www.oecd.org/tax/beps/about/ (accessed 22 Mar. 2023).

deficiencies of the previous stage to some extent. Similarly, Pillar Two has received widespread support from 139 jurisdictions.

2.4.2. *The potential motivation behind the Pillar Two consensus*

Given the stricter restriction on corporate income tax competition under Pillar Two, one may wonder why so many jurisdictions reached a consensus on it. One explanation is that jurisdictions were genuinely acting cooperatively to achieve the single tax principle and advance their common interests.²⁴ Another explanation is that one of the common justifications is gaining additional tax revenue.²⁵

Given the diverse national interests and positions on tax competition, the motivations behind the agreement of jurisdictions on Pillar Two may be more complex. For those high-tax jurisdictions that welcomed Pillar Two, their common goals may be to overcome the problem of the lack of collective action and protect their tax bases. On the other hand, other jurisdictions may find themselves being deprived of one of the policy tools to attract investment and putting themselves at a disadvantage in future competition. Nevertheless, Dagan has correctly pointed out that it is possible for jurisdictions to cooperate against their better interests.²⁶ For these jurisdictions, the following factors may explain why they gave their reluctant support.

The first factor is the strong political pressure from developed countries. As Wei Cui (2022) has pointed out, by pressuring jurisdictions to adopt Pillar Two, the designers of Pillar Two, whether the OECD, the European Union or the United States, have been advocating that jurisdictions that fail to adopt Pillar Two would lose out to jurisdictions that do adopt it.²⁷

The second factor is the fiscal fail-safe. Under this mechanism, failure to cooperate does not protect companies from tax. Rather, it merely results in a loss of tax revenue for the uncooperative state.²⁸ While an archetypal low-tax jurisdiction may prefer not to impose tax at all, if tax is going to be imposed in any event, it would rather collect the revenue itself than have it snapped up by another country.²⁹ This motivation to avoid economic loss can explain why many typical tax havens joined the Pillar Two agree-

24. Cui, *supra* n. 21, at p. 40.
25. J. Li, *Introducing a Global Minimum Tax (Pillar Two) in Canada: Some Knowns and Unknowns*, *Can. Tax J.* (forthcoming 2023).
26. Dagan, *supra* n. 18, at p. 166.
27. Cui, *supra* n. 21, at p. 23.
28. Mason, *supra* n. 20, at p. 1393.
29. See H. Wardell-Burrus, *State Strategic Responses to the GloBE Rules*, *Oxford U. Ctr. Bus. Taxn.*, U. Oxford, Faculty of L., pp. 7-8 (2022), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4291190 (accessed 18 July 2023).

ment.³⁰ The reason why Estonia changed its position and joined Pillar Two may also demonstrate this point.³¹

The third factor may be the complexity of rules and tight timelines, whereby the representatives from many jurisdictions lacked the necessary technical expertise to fully understand the complex rules and sufficient time to brief their political leaders before they signed on the deal. Accordingly, as Li (2022) has noted, it is quite possible that many jurisdictions “agreed to” the deal out of “politeness”.³²

Some jurisdictions were also dissatisfied with the OECD-led reform and may wish to negotiate through other platforms, such as the United Nations. However, the network effects and opposition from developed countries could pose obstacles to this effort.³³

To summarize, revenue concerns may be the common reason for these interest-divergent jurisdictions to reach consensus, either proactively increasing fiscal revenue (for pro-coordination jurisdictions) or strategically avoiding fiscal losses (for low-tax jurisdictions). Nevertheless, even in the post-Pillar Two era, the divergent interests of jurisdictions are likely to persist, leading to different strategic responses. Jurisdictions that want to maintain competitiveness may seek new forms of competition, while those opposed to tax competition may take further measures in response. This “back and forth” effect reveals the potentially complex interaction between states as they seek to maximize their positions in an interactive cross-border strategic game.³⁴

3. The Fiscal Fail-Safe of Pillar Two and Its Potential Restriction on Traditional Corporate Income Tax Competition

3.1. The fiscal fail-safe of Pillar Two

The fiscal fail-safe of Pillar Two is key to understanding its effect on corporate income tax competition. The Global Anti-Base Erosion (GloBE) rules have two interlocking components: (i) the Income Inclusion Rule (IIR); and (ii) the Undertaxed Payment Rule (UTPR). As the primary rule, the IIR imposes top-up tax on a parent entity in respect of the low-taxed income of a constituent entity. In order to allocate top-up tax among different jurisdictions, the IIR generally adopts a top-down approach. The Ultimate Parent Entity (UPE) jurisdiction will usually have the first priority to collect the top-up tax. If the UPE jurisdiction does not apply an IIR, the top-up tax is imposed on the next intermediate parent entity in the ownership chain

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30. To name but a few: the Bahamas; Bermuda; the British Virgin Islands; the Cayman Islands; the Cook Islands; Jersey; and the Isle of Man. See OECD, *Members of the OECD/G20 Inclusive Framework on BEPS*, *supra* n. 1.
31. Estonia; OECD; G20 - Estonia Notes Reasons to Join OECD Global Tax Agreement (2 Nov. 2021), News IBFD.
32. J. Li, *The Global Tax Agreement: Some Truths and Legal Realities*, Osgoode Hall L. Sch. York U., Osgoode Digital Commons p. 6 (2022), available at https://digitalcommons.osgoode.yorku.ca/cgi/viewcontent.cgi?article=1350&context=all_papers (accessed 22 Mar. 2023).
33. Netherlands; UN - Netherlands Opposes Establishment of UN International Tax Cooperation Framework (7 Dec. 2022), News IBFD.
34. Wardell-Burrus, *supra* n. 29, at p. 42.

that is subject to the IIR. Moreover, the UTPR will serve as a back-up to the IIR. If there is low-taxed income beneficially owned by a UPE that is not brought into charge under an IIR, the low-taxed income will be subject to the back-up UTPR mechanism, which denies deductions or requires an equivalent adjustment.³⁵

The interplay between the IIR and the UTPR gives rise to a multiplayer game, where each jurisdiction’s taxing right and its tax incentives are very likely to be influenced by the tax policies of other jurisdictions and vice versa. The game involves at least two stages: (i) a subset of states (usually high-tax residence jurisdictions) agree on a fail-safe in stage one; and, then, (ii) all of the jurisdictions respond in stage two by aligning their systems with a triggering threshold.³⁶ In stage two, jurisdictions may either implement the GloBE rules (an “attack strategy”), or raise their tax rates to the global minimum to avoid the top-up tax levied by other jurisdictions (a “defence strategy”).³⁷ These strategies will interact with each other, leading the game to evolve into the next stage.

3.2. The potential restriction on traditional corporate income tax competition

With regard to its influence, it is expected that Pillar Two will provide a strong economic incentive to jurisdictions in respect of their adoption strategies and broader tax policies.³⁸ Although Pillar Two is not legally binding and the “do nothing” option is feasible on paper, failing to act or moving too slowly will not only no longer deliver the intended benefits to the investors, but also result in foregoing tax revenues, as other jurisdictions are moving to impose top-up taxes. Even jurisdictions that are not part of the Inclusive Framework may be influenced by Pillar Two.³⁹ As a result, it is expected that Pillar Two will reduce the incentives for jurisdictions to engage in traditional corporate income tax competition. However, as discussed in section 4., it will have broader effects on the tax strategies of jurisdictions in the medium and long term.

The potential effect on tax competition is evidenced by the latest practices of jurisdictions, namely to act swiftly to reform their tax systems. Not only are the major supporters of Pillar Two (such as France and Germany) actively promoting its implementation, many low-tax jurisdictions (such as Hong Kong, Ireland, Singapore and Switzerland)

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35. OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, art. 2.1 and 2.5 (OECD 2021), Primary Sources IBFD [hereinafter the *Global Anti-Base Erosion Model Rules (Pillar Two)*].
36. Mason, *supra* n. 20, at p. 380.
37. N. Bammens & D. Bettens, *The Potential Impact of Pillar Two on Tax Incentives*, 51 *Intertax* 2, p. 165 (2023).
38. F. Heitmüller & I. Mosquera, *Special Economic Zones Facing the Challenges of International Taxation: BEPS Action 5, EU Code of Conduct, and the Future*, 24 *J. Intl. Econ. L.* 2, p. 489 (2021), available at <https://academic.oup.com/jiel/article/24/2/473/6246114> (accessed 18 July 2023). With regard to the economic analysis of the effects, see N. Johannesen, *The Global Minimum Tax*, 212 *J. Pub. Econ.*, pp. 1-8 (Aug. 2022), available at www.sciencedirect.com/science/article/pii/S0047272722001116 (accessed 18 July 2022).
39. OECD, *Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules* p. 6 (OECD 2022) [hereinafter *Tax Incentives and the Global Minimum Corporate Tax*].

are also considering introducing a domestic minimum tax to safeguard their taxing rights, while exploring solutions to maintain their competitiveness.⁴⁰

4. Remaining Scope for Tax Competition in the Post-Pillar Two Environment

4.1. Introductory remarks

Although the fiscal fail-safe of Pillar Two will result in a reduction in traditional corporate income tax competition, Pillar Two does not eliminate the conditions for tax competition. The revenue threshold, covered tax, ETR computation, exclusions and carve-out of Pillar Two will generate heterogeneous effects on tax competition. While some tax incentives would definitely be affected by Pillar Two, other tax incentives could be partially, largely or completely preserved by it. Consequently, jurisdictions are expected to respond by adopting strategies that have either been left open or have been newly created by Pillar Two.⁴¹ Sections 4.2. to 4.8. illustrate seven major (but not exhaustive) circumstances in which jurisdictions may respond strategically and continue to participate in tax competition.

4.2. Tax incentives for multinational small and medium-sized enterprises

In order to avoid adverse effects on small and medium-sized enterprises (SMEs), the application of the GloBE rules is limited by a revenue threshold of EUR 750 million.⁴² This means that Pillar Two is only targeted at large multinational enterprise (MNE) groups, which earn more than 90% of global corporate revenues.⁴³ MNE groups with earnings below the EUR 750 million threshold will not be subject to Pillar Two and, therefore, any tax incentives for them will not be affected either.⁴⁴

Currently, while it remains true that large MNEs still dominate cross-border trade and investment, SMEs are increasingly reaching out beyond their traditional domestic habitat and engaging in transboundary trade and investment. The internationalization of these SMEs will generate positive spillovers, such as creating higher levels of employment and improving wages and working conditions, particularly in developing countries.⁴⁵ In practice, the number of these multinational SMEs may be considerable. Under the EUR 750 million revenue threshold of Pillar Two, 85% to 90% of MNE groups will fall outside the

scope of the rules.⁴⁶ As the policy outcomes of SMEs' tax incentives will be fully preserved, it is possible that jurisdictions may turn to compete for multinational SMEs in the new tax competition landscape.

As SMEs are often regarded as the backbone of an economy,⁴⁷ tax incentives are conducive to the establishment of a favourable environment for their creation and growth.⁴⁸ However, poorly designed tax incentives of SMEs can have distortive effects. First, SMEs are very heterogeneous in terms of industries, profitability, growth potentials and innovation behaviours. This means that careful targeting of tax incentives is required to ensure that the preferential regimes can achieve their intended goals. Second, the costs associated with tracking eligibility and keeping specific records can increase the complexity of a tax system. Moreover, tax incentives for SMEs may give enterprises an incentive to remain small or to split up into different entities to continue benefiting from the incentives.⁴⁹ Accordingly, jurisdictions need to be cautious when designing tax incentives for SMEs.

4.3. International shipping tax incentives

Maritime transport is the cornerstone of international trade and the global economy. Over 80% of the volume of international trade in goods is carried by sea, and the percentage is even higher for most developing countries.⁵⁰ The capital-intensive nature, the level of profitability and long economic life cycle of international shipping has resulted in a number of jurisdictions introducing alternative or supplementary taxation regimes for this industry.⁵¹ The widespread availability of these alternative tax regimes means that international shipping often operates outside the scope of corporate income tax. Accordingly, including international shipping within the scope of the GloBE rules would have raised policy questions in light of the policy choices of these jurisdictions.⁵² In this regard,

40. The implementation status of Pillar Two is set out in the following database: *Pillar Two: a Country by Country Perspective*, Bloomberg Tax, available at www.bloomberglaw.com/product/tax/document/X6BK3OUO000000 (accessed 21 Nov. 2022) (only accessible upon subscription).

41. Wardell-Burrus, *supra* n. 29, at p. 2.

42. OECD, *Global Anti-Base Erosion Model Rules (Pillar Two)*, *supra* n. 35, at art. 1.1.1.

43. OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS* p. 41 (OECD 2020) [hereinafter the *Report on Pillar Two Blueprint: Inclusive Framework on BEPS*].

44. OECD, *Tax Incentives and the Global Minimum Corporate Tax*, *supra* n. 39, at p. 31.

45. T. Rensmann, *Small and medium-Sized Enterprises in International Economic Law* pp. 1-2 (Oxford U. Press 2017).

46. OECD, *Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, *supra* n. 43, at p. 41.

47. F. Tudor, *Short Considerations on Tax Competition for SMEs*, 27 *Euro-Economica* 1, p. 92 (2011), available at <https://journals.univ-danubius.ro/index.php/euroeconomica/article/view/787/713> (accessed 18 July 2023).

48. OECD, *Survey on The Taxation of Small and Medium-sized Enterprises* p. 4 (OECD), available at www.oecd.org/tax/tax-policy/39597756.pdf (accessed 22 Mar. 2023).

49. OECD, *Taxation of SMEs in OECD and G20 Countries* pp. 13-14 (OECD 2015).

50. United Nations Conference on Trade and Development (UNCTAD), *Review of Maritime Transport 2021*, available at <https://unctad.org/web-flyer/review-maritime-transport-2021> (accessed 22 Mar. 2023).

51. Examples include the EU tonnage tax regimes and similar shipping tax incentive regimes in Singapore and Hong Kong. See PwC, *Choosing your course: Corporate taxation of the shipping industry around the globe*, available at www.pwc.com/cy/en/publications/assets/choosing-your-course-shipping-taxation.pdf (accessed 22 Mar. 2023).

52. OECD, *Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, *supra* n. 43, at p. 40. As a domestic shipping fleet and related maritime infrastructure are important to economies and national security, international shipping tax incentives are regarded as necessary to maintain employment and maritime know-how, and to address both strategic and national defence concerns. See OECD/G20 Inclusive Framework on BEPS – Public Consultation Document 1 (12 October 2020 – 14 December 2020), “*Report on the Pillar One Blueprint*” and “*Report on the Pillar Two Blueprint*”, Submission by: the World Shipping Council (“WSC”), the International Chamber of Shipping (“ICS”), the European Community Shipowners’ Associations (“ECSA”), and the Cruise Lines Interna-

Pillar Two excludes international shipping income and qualified ancillary international shipping income from the computation of GloBE income or loss.⁵³

As a result, jurisdictions may continue to use their special shipping tax regimes to support their ambitions to be “maritime nations”, develop their own maritime clusters and bolster their ship registries in the global maritime centre competition.⁵⁴ Nonetheless, such jurisdictions need to be mindful of certain requirements in Pillar Two.

First, jurisdictions need to consider whether the qualifying activities requirement in their special shipping tax regimes is in line with the definition in the GloBE Model Rules. For instance, the UK tonnage tax system applies to both international shipping and domestic shipping activities. While the income from international shipping may be excluded from Pillar Two, an MNE’s constituent entity benefiting from the UK tonnage tax treatment in respect of its UK domestic shipping activity may be affected.⁵⁵

Second, Pillar Two stipulates that the aggregated qualified ancillary international shipping income of all constituent entities located in a jurisdiction shall not exceed 50% of international shipping income of those constituent entities.⁵⁶ Jurisdictions may consider introducing a separate computation requirement and a limitation on the amount of qualified ancillary income in their special shipping tax regimes.

Third, according to the substance requirement in Pillar Two, jurisdictions should set a strategic or commercial management requirement in their special shipping tax regimes to qualify for the exclusion.⁵⁷

4.4. Incentives for non-covered taxes

Corporate income tax has long been the main battlefield of international tax competition. Governments lose much-needed tax revenues from some of the largest companies in the world: conservatively estimated at around 4% to 10% of global corporate income tax revenues, or USD 100 to USD 240 billion annually.⁵⁸ In this context, Pillar Two is mainly targeted at corporate income tax. According to the GloBE Model Rules, the definition of

covered taxes includes taxes on corporate income.⁵⁹ In other words, Pillar Two will have no effect on taxes and charges not based on corporate income, such as VAT, personal income tax, customs duties, revenue-based taxes such as mineral royalties, production sharing arrangements and any incentives granted by governments on these revenue streams.⁶⁰

Given that corporate income tax is not the only tool in the fiscal toolbox when it comes to either revenue or competitiveness,⁶¹ jurisdictions may shift to competition in the field of non-covered taxes in the future. Personal income tax and wealth tax are potential candidates. Research has found that there is indeed scope for tax competition in these areas: reductions in personal income tax and wealth tax as well as special tax arrangements for foreigners trigger an inflow of high-income earners and wealthy individuals, while tax increases provoke a corresponding outflow.⁶² For instance, although Switzerland has become well-known for its low corporate income tax rate, the rates of its personal income tax and property tax are not that low. As a result, it is suggested that Switzerland should improve its personal income tax and property tax systems for investors and high earners if it aims to remain tax competitive in the future.⁶³

However, moving to non-covered taxes, competition is not a simple process of copying and pasting relevant corporate income tax incentives. The function of different tax types and the tax structures of different jurisdictions are highly heterogeneous. In respect of tax types, different tax types have divergent effects on economy and investment. Put simply, personal income tax influences the cost of labour,⁶⁴ and consumption tax affects future consumption and investment,⁶⁵ while property tax changes the flow of investment capital.⁶⁶

tional Association (“CLIA”), p. 4 (14 Dec. 2020), available at www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/12/joint-shipping-oced-consultation-submission.pdf (accessed 22 Mar. 2023).

53. OECD, *Global Anti-Base Erosion Model Rules (Pillar Two)*, supra n. 35, at art. 3.3.1.
54. R. Stephens, *A Global Minimum Tax Rate – How Special is Shipping (and Does Anyone Care)?*, Watson Farley & Williams (1 June 2021), available at www.wfw.com/articles/a-global-minimum-tax-rate-how-special-is-shipping-and-does-anyone-care/ (accessed 22 Mar. 2023).
55. KPMG, *Pillar Two and the prognosis for UK tonnage tax*, (24 Jan. 2022), available at <https://home.kpmg/uk/en/home/insights/2022/01/tmd-pillar-2-and-the-prognosis-for-uk-tonnage-tax.html> (accessed 22 Mar. 2023).
56. OECD, *Global Anti-Base Erosion Model Rules (Pillar Two)*, supra n. 35, at art. 3.3.4.
57. Id., at art. 3.3.6.
58. OECD, *Ending offshore profit shifting* (OECD), available at www.oecd.org/about/impact/ending-offshore-profit-shifting.htm (accessed 22 Mar. 2023).

59. OECD, *Global Anti-Base Erosion Model Rules (Pillar Two)*, supra n. 35, at art. 4.2.
60. A. Readhead, T. Lassourd & H. Mann, *The end of tax incentives: How will a global minimum tax affect tax incentives regimes in developing countries?*, Intl. Instit. Sust. Dev. (IISD) (7 Oct. 2021), available at www.iisd.org/itn/en/2021/10/07/the-end-of-tax-incentives-how-will-a-global-minimum-tax-affect-tax-incentives-regimes-in-developing-countries-alexandra-readhead-thomas-lassourd-howard-mann/ (accessed 22 Mar. 2023).
61. D. Bunn, *Switzerland should view the global minimum tax as an opportunity*, SWI swissinfo.ch (22 Jan. 2022), available at www.swissinfo.ch/eng/switzerland-should-view-the-global-minimum-tax-as-an-opportunity/47279704#:~:text=Multinational%20companies-,Switzerland%20should%20view%20the%20global%20minimum%20tax%20as%20an%20opportunity,global%20minimum%20corporate%20tax%20rate (accessed 22 Mar. 2023).
62. D. Gstrein, E. Herold & F. Neumeier, *Harmful Practices and Competition in the Area of Personal Income and Wealth Taxation*, European Parliament, Policy Department for Economic, Scientific and Quality of Life Policies, Directorate-General for Internal Policies, available at [www.europarl.europa.eu/RegData/etudes/IDAN/2022/703343/IPOL_IDA\(2022\)703343_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/IDAN/2022/703343/IPOL_IDA(2022)703343_EN.pdf) (accessed 22 Mar. 2023).
63. Bunn, supra n. 61.
64. See D. Bunn, *International Tax Competitiveness Index 2022*, p. 16, Tax Foud., Ctr. Global Tax Policy (TaxFund. 2022), available at https://files.taxfoundation.org/20221013150933/International-Tax-Competitiveness-Index-2022.pdf?_gl=1*k3gr18*_ga*MTYyMTA3NTMwNy4xNjYzNzY5NDU4*_ga_FP7KWDV08V*MTY2NzI3NTAzNC41LjAuMTY2NzI3NTAzNC42MC4wLjA (accessed 22 Mar. 2023).
65. Id., at p. 19.
66. Id., at p. 22.

However, little research has been done to comprehensively analyse the role and relationship of these tax types in tax competition. Depending on the real incidence of the respective tax, reductions might not benefit MNEs to the same extent as lower effective corporate income tax rates.⁶⁷ Accordingly, jurisdictions should be cautious as to precisely which of the non-covered taxes may be the most appropriate alternative, and whether they can achieve the same or similar goals of attracting investment.⁶⁸

Moreover, there are significant differences between the tax structures of jurisdictions.⁶⁹ While some jurisdictions raised their tax revenues mainly from direct taxes, others relied more heavily on indirect taxes. Consequently, jurisdictions also need to take into account their own tax structures while evaluating the feasibility of introducing non-covered tax incentives.

4.5. Qualified refundable tax credits and non-tax subsidies as ETR denominators

The GloBE ETR is determined by dividing the amount of covered taxes (the numerator) by the amount of income as determined under the GloBE rules (the denominator).⁷⁰ The extent of the effect of the GloBE rules on tax incentives depends on whether a given tax incentive reduces the numerator or increases the denominator. Tax incentives are more likely to be affected where they are treated as reductions in the numerator.⁷¹

The GloBE rules follow financial accounting by treating Qualified Refundable Tax Credits (QRTCs) and cash grants as income, which means that these types of incentives are less likely to be affected.⁷² This preferential treatment for QRTCs and non-tax subsidies can shape the landscape of international tax and subsidy competition in the future. Jurisdictions are believed to have a stronger incentive to adopt QRTCs and non-tax subsidies to attract investment.⁷³ For instance, the UK government has determined that its Research and Development Expenditure Credit (RDEC) will be treated as an addition to income rather than a reduction in tax in the ETR calculation, which will ensure that the RDEC will continue to be an effective instrument for promoting R&D activities in the United Kingdom.⁷⁴

67. J. Englisch, *GloBE Rules and Tax Competition*, 50 *Intertax* 12, p. 871 (2022).

68. For instance, VAT is generally considered less exposed to the risk of harmful tax competition than direct taxes. See O. Pastukhov, *The E-VAT Directive: Mitigating Tax Competition or Spurring It*, 2 *J. Intl. Com. L. & Tech.* 2, p. 54 (2007), available at <https://media.neliti.com/media/publications/28633-EN-the-e-vat-directive-mitigating-tax-competition-or-spurring-it.pdf> (accessed 18 July 2023).

69. OECD, *Tax Policy Reforms 2022: OECD and Selected Partner Economies* p. 37 (OECD 2015).

70. OECD, *Global Anti-Base Erosion Model Rules (Pillar Two)*, *supra* n. 35, at art. 5.1.

71. OECD, *Tax Incentives and the Global Minimum Corporate Tax*, *supra* n. 39, at p. 36.

72. *Id.*, at p. 8.

73. N. Noked, *From Tax Competition to Subsidy Competition*, 42 *U. Pa. J. Intl. L.*, p. 445 (2020), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3565835 (accessed 19 July 2023).

74. His Majesty's Treasury and His Majesty's Revenue & Customs (HMRC), *OECD Pillar 2 Consultation on Implementation*, p. 24 (Jan. 2022), available at <https://assets.publishing.service.gov.uk/government/uploads/>

However, QRTCs and cash grants will raise many fiscal and legal challenges, especially for developing countries. First, the refundability provision may result in substantial revenue losses. This can be particularly damaging, especially for developing countries with limited fiscal room to manoeuvre, as the credits will have to be paid out to entities with lower tax liability.⁷⁵ This is also why refundable tax credits and cash grants are more commonly found in developed countries than in developing countries.⁷⁶

Second, non-tax incentives may increase the cost and complexity of tax administration, given their varied nature and the number of governmental departments involved in the process.⁷⁷ The preference for non-tax subsidies over equivalent tax subsidies could also result in distortions and welfare losses.⁷⁸

Jurisdictions should also note that there are certain legal constraints on direct subsidies. These include the EU State Aid rules and the World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures.

4.6. Mixing of high-taxed and low-taxed income under the jurisdictional blending approach

The GloBE rules adopt a jurisdictional blending approach rather than a worldwide blending, or a separate-entity approach in the ETR calculation. This means that MNE operations in any given jurisdiction will be added together to calculate the jurisdiction's GloBE income and ETR.⁷⁹ Accordingly, a GloBE tax liability will arise when the ETR of a jurisdiction in which the MNE group operates is below the minimum rate.⁸⁰

This critical design may have an influence on the tax competition strategies of jurisdictions as well as the investment decisions of MNEs. For jurisdictions, jurisdictional blending means that high-tax jurisdictions may be affected less by the GloBE rules, even if they have some low-taxed incomes. A similar point holds true for entities. For instance, where multiple entities operate in a jurisdiction, they will be able to blend low-taxed income with high-taxed income to calculate the GloBE ETR, thereby moderating the effect on highly profitable activities.⁸¹ As

system/uploads/attachment_data/file/1045663/11Jan_2022_Pillar_2_Consultation_.pdf (accessed 22 Mar. 2023).

75. See OECD, *Tax Incentives and the Global Minimum Corporate Tax*, *supra* n. 39, at p. 49; See also V.J. Perry, *Pillar 2, Tax Competition, and Low Income Sub-Saharan African Countries*, 51 *Intertax* 2, p. 6 (2023).

76. Seventeen out of the forty-nine countries in the OECD R&D tax incentive database have refundability provisions. See OECD, *Tax Incentives and the Global Minimum Corporate Tax*, *supra* n. 39, at p. 17. Most recorded subsidy programmes are implemented by the largest trading economies. Collectively, the top trading regions of China, the European Union and the United States account for over half of the number of global subsidy measures. See IMF, OECD, World Bank and WTO et al., *Subsidies, Trade, and International Cooperation*, available at <https://doi.org/10.1787/a4f01ddb-en> (accessed 22 Mar. 2023).

77. A. Titus, *Pillar Two and African Countries: What Should Their Response Be? The Case for a Regional One*, 50 *Intertax* 10, p. 719 (2022).

78. Noked, *supra* n. 73, at p. 478.

79. OECD, *Tax Incentives and the Global Minimum Corporate Tax*, *supra* n. 39, at p. 30.

80. OECD, *Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, *supra* n. 43, at p. 72.

81. OECD, *Tax Incentives and the Global Minimum Corporate Tax*, *supra* n. 39, at p. 31.

a result, jurisdictions and MNEs may have an incentive to exploit this feature to benefit from its mixing effect.

However, not all jurisdictions can equally benefit from the jurisdictional blending approach. In practice, the size of the territory and the economy, the industry structure and the comparative advantage of jurisdictions vary. It would appear to be easier for a jurisdiction with a broader territory and a more complete industrial system to utilize the jurisdictional blending approach.

For instance, the standard corporate income tax rate in China is 25%, which is a medium rate around the world. Nonetheless, China has developed a relatively complete industrial system, with 41 major categories, 207 medium categories and 666 minor categories as stipulated by the UN Industrial Classification.⁸² It has also established a number of special economic zones, which have contributed 22% of its GDP, 45% of its total national foreign direct investment and 60% of its exports.⁸³ With these advantages, China can optimize its district-specific and sector-specific tax incentives, encouraging MNEs to set up both high-taxed and low-taxed entities with complementary functions in different regions and sectors so as to benefit from the jurisdictional blending approach.

However, Hong Kong, for example, is a different case. With a rather limited industrial structure, which greatly relies on financial services, tourism, trading and logistics, and professional and producer services,⁸⁴ it may be difficult for Hong Kong to take advantage of the jurisdictional blending approach. As a result, not all jurisdictions can equally benefit from the jurisdictional blending approach.

4.7. Substance-based income exclusion and the protective effect on tax incentives

Pillar Two provides for a formulaic substance-based income exclusion (SBIE) excluding an amount of income, i.e. 5%, of the carrying value of tangible assets and payroll.⁸⁵ Its policy rationale is to exclude a fixed return for substantive activities within a jurisdiction from the application of the GloBE rules. The use of payroll and tangible assets as indicators of substantive activities is justified because these factors are generally expected to be less mobile, and less likely to lead to tax-induced distortions. Conceptually, excluding a fixed return from substantive activities focuses GloBE on “excess income”, such as intan-

gible-related income, which is most susceptible to BEPS risks.⁸⁶

This highlights a design question. Under the SBIE, if investments have high levels of substance or low levels of profit,⁸⁷ they may be more or less protected from the application of the GloBE rules. Policymakers, therefore, need to carefully consider whether, and to what extent, their tax incentives encourage a high amount of substance in the jurisdiction.⁸⁸ In the future, jurisdictions may continue to engage in “tax competition for real investment”. For instance, all of the profit tax incentives formulated by Hong Kong in 2022 included an economic substance requirement. The government pointed out that these were to meet the requirement of the latest international tax standard and to realize the policy goals of increasing economic activities and creating employment opportunities for Hong Kong.⁸⁹ The latest developments in Hong Kong demonstrate the increasing importance of economic substance in the new tax landscape.

That said, the SBIE may not fully protect the effectiveness of tax incentives, as it is limited in its scope. Only a limited amount of return would be accepted by Pillar Two. Anything above a modest return or any intangible return would immediately be subject to recapture by the GloBE rules (presumably because it is deemed to be abusive).⁹⁰

However, value does not only derive from human resources and tangible assets. In practice, the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangible assets are important value creation activities and may well have economic substance, especially in the current knowledge economy. With a narrow understanding of value creation, the SBIE does not provide any protection to intangible assets. This will give rise to a ring-fencing effect. Considering only payroll and tangible asset components and not factoring in intangibles for carve-out purposes will largely favour traditional manufacturing and extractive industries, dependent on tangible assets and a manufacturing workforce. It will also create an odd distinction between asset-intensive businesses and others with fewer tangible assets (such as the financial or insurance sectors) or busi-

82. J. Wei, *China's Industrial Policy: Evolution and Experience*, South-South Integration and the SDGs: Enhancing Structural Transformation in Key Partner Countries of the Belt and Road Initiatives, UNCTAD/BRI PROJECT/RP1, p. 28 (July 2020), available at https://unctad.org/system/files/official-document/BRI-Project_RP11_en.pdf (accessed 22 Mar. 2023).

83. World Bank, *China's Special Economic Zones: Experience Gained*, available at www.worldbank.org/content/dam/Worldbank/Event/Africa/Investing%20in%20Africa%20Forum/2015/investing-in-africa-forum-chinas-special-economic-zone.pdf (accessed 22 Mar. 2023).

84. HK: Census and Statistics Department, *Hong Kong Monthly Digest of Statistics*, p. 2 (Dec. 2021), available at www.censtatd.gov.hk/en/data/stat_report/product/FA100099/att/B72112FA2021XXXXB0100.pdf, (accessed 22 Mar. 2023).

85. OECD, *Tax Incentives and the Global Minimum Corporate Tax*, *supra* n. 39, at p. 4.

86. OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)* p. 119 (OECD 2022), Primary Sources IBFD hereinafter *Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*.

87. Englisch, *supra* n. 67, at p. 864.

88. OECD, *Tax Incentives and the Global Minimum Corporate Tax*, *supra* n. 39, at p. 39.

89. HK: Transport and Logistics Bureau, LC: Speech by STL on resumption of Second Reading of Inland Revenue (Amendment) (Tax Concessions for Certain Shipping-related Activities) Bill 2022 (Chinese only), available at www.tlb.gov.hk/eng/legislative/transport/bills/2022/20220713d.html (accessed 22 Mar. 2023); and HK: Inland Revenue Department, Foreign-sourced Income Exemption, available at www.ird.gov.hk/eng/tax/bus_fsie.htm#a08 (accessed 22 Mar. 2023) and Trade Consultation on Enhancing Aircraft Leasing Preferential Tax Regime Launched, available at www.ird.gov.hk/eng/ppr/archives/22112201.htm (accessed 22 Mar. 2023).

90. L.E. Schoueri, *Some Considerations on the Limitation of Substance-Based Carve-Out in the Income Inclusion Rule of Pillar Two*, 75 Bull. Intl. Taxn. 11/12, sec. 4. (2021), Journal Articles & Opinion Pieces IBFD.

nesses driven by intangible assets. Such a distinction is thought to be detrimental to new-age digital economies.⁹¹

4.8. Domestic minimum tax as an efficient tool to safeguard taxing right

The implementation of Pillar Two makes it necessary for jurisdictions to take action to revise or repeal their ineffective tax incentives. However, this is not an easy task, especially when a jurisdiction has a large number of incentives in its tax system. As Pillar Two will not affect all taxpayers or all tax incentives in the same ways and to the same extent,⁹² jurisdictions can never have absolute certainty that their ETRs will not fall below the minimum tax rate unless the ETR calculation is performed every time.⁹³

Fortunately, the GloBE Model Rules provide jurisdictions with an efficient and targeted mechanism to safeguard their taxing rights, i.e. the Qualified Domestic Minimum Top-up Tax (QDMTT). The GloBE Model Rules define the QDMTT as a minimum tax that is included in the domestic law of a jurisdiction and meets the following three requirements:

- It determines the excess profits of the constituent entities located in the jurisdiction in a way that is equivalent to the GloBE Model Rules.
- It operates to increase domestic tax liability regarding domestic excess profits to the minimum rate for the jurisdiction and constituent entities for a fiscal year.
- It is implemented and administered in a way that is consistent with the outcomes provided for under the GloBE Model Rules and the Commentary, provided that such jurisdiction does not provide any benefits that are related to such rules.⁹⁴

It has been widely recognized that jurisdictions should introduce the QDMTT in the immediate term. Through a QDMTT, the jurisdiction granting the tax incentives will be entitled to collect top-up tax on such low-taxed profits before other jurisdictions apply the GloBE Model Rules. Meanwhile, introducing such provisions does not result in any additional loss of competitiveness, as any additional top-up tax collected by the jurisdiction will otherwise be collected by other jurisdictions in the absence of a QDMTT.⁹⁵ It is anticipated that many jurisdictions will benefit from adopting the QDMTT, especially develop-

ing countries, financial centres with substantial economic activities and developed countries with low corporate tax rates or pockets of low-taxed profits.⁹⁶

However, while the QDMTT provides an immediate solution to safeguard their taxing rights, jurisdictions need to think further if they wish to maintain their tax competitiveness. With regard to the additional revenue raised by the QDMTT, jurisdictions need to provide alternative supportive measures to compensate the investors if they want to stay competitive.⁹⁷ Moreover, any non-tax benefits must not be directly tied to a domestic minimum tax, or the tax will not qualify as a QDMTT.⁹⁸

The QDMTT is not a panacea. It does not spare jurisdictions from reforming their ineffective tax incentives in the longer term because the process of providing ineffective tax incentives and then topping-up the tax themselves is just an unnecessary waste of resources that will increase the administrative and compliance costs of both governments and taxpayers.

Some scholars have also noted that the QDMTT could create a new form of tax competition, where some jurisdictions may wish to replace their traditional corporate income tax with a QDMTT, thereby ensuring a tax burden of 15% on excess profits. In these circumstances, the introduction of Pillar Two may even increase tax competition. However, for the great majority of non-haven countries, such an extreme scenario is unlikely to materialize, as the abolition of general corporation tax will generate significant revenue implications.⁹⁹

5. Towards a More Equitable and Efficient Tax Competition Landscape?

5.1. Introductory remarks

Sections 3. and 4. anticipated the future landscape of tax competition. However, these are only objective predictions of the possible strategies that may be taken by interest-divergent jurisdictions under the game mechanism. A question worthy of further discussion is whether the new tax competition landscape will be more equitable and efficient. Supporters of multilateral cooperation to curtail tax competition claimed that it would promote both distributive justice and efficiency, while critics argued that it could be problematic on both aspects.¹⁰⁰ Sections 5.2. to 5.4. describe how Pillar Two may not ensure a more equitable and efficient tax competition landscape.

91. N. Trivedi, *Pillar Two Substance-Based Carve-Out – “To Be, or Not to Be”*, Independent, pp. 7-8 (2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3864705 (accessed 19 July 2023); L. Parada, *Global Minimum Taxation: A Strategic Approach for Developing Countries*, U. Leeds, Sch. of L., p. 6 (2022), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4280669 (accessed 19 July 2023); and J.M. Mintz, *The Global Corporate Minimum Tax: A Cure or Not?*, 70 *Can. Tax J.*, p. 248 (2022), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4402208 (accessed 19 July 2023).

92. OECD, *Tax Incentives and the Global Minimum Corporate Tax*, *supra* n. 39, at p. 7.

93. Liotti et al., *supra* n. 14, at p. 33.

94. OECD, *Global Anti-Base Erosion Model Rules (Pillar Two)*, *supra* n. 35, at p. 64. See also OECD, *Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, *supra* n. 86.

95. OECD, *Tax Incentives and the Global Minimum Corporate Tax*, *supra* n. 39, at p. 53.

96. N. Noked, *The Case for Domestic Minimum Taxes on Multinationals*, 105 *Tax Notes Intl.* 6, p. 668 (2022).

97. Bunn, *supra* n. 61.

98. See Noked, *supra* n. 96, at p. 672. See also N. Noked, *Designing Domestic Minimum Taxes in Response to the Global Minimum Tax*, 50 *Intertax* 10, p. 679 (2022).

99. See Englisch, *supra* n. 67, at p. 867; Bammens & Bettens, *supra* n. 37, at p. 169; and M.P. Devereux, J. Vella & H. Wardell-Burrus, *Pillar 2: Rule Order, Incentives, and Tax Competition*, Oxford U. Ctr. Bus. Taxn. Policy Brief 2022, p. 10, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4009002 (accessed 19 July 2023).

100. Dagan, *supra* n. 18, at p. 132.

5.2. Equality

Whether Pillar Two can level the playing field, and especially narrow the gap between developed and developing countries, has been a controversial issue. The OECD and proponents of Pillar Two argue that given the need for tax revenues, developing countries would generally prefer to refrain from granting tax incentives,¹⁰¹ and Pillar Two could shield developing countries from pressure to offer inefficient tax incentives.¹⁰² These narratives, however, were considered paternalistic, as they implicitly suggested that developing countries were to blame for their “ineffective” tax incentives,¹⁰³ whereas tax competition is not always objectionable and corporate income tax incentives can be beneficial if properly used.¹⁰⁴ Critics have also pointed out that Pillar Two was largely to serve the interests of European countries and the United States. It would likely limit the tax policy choices of developing countries and force them to adopt exceedingly complex legislation.¹⁰⁵

In the authors’ opinion, although Pillar Two was portrayed as benefiting all jurisdictions involved (except for tax havens), it appears to mainly serve the interest of high-tax developed countries, while its net benefit for developing countries is unclear.¹⁰⁶

Developing countries usually lose out in tax competition, especially in harmful competition, as they are caught in a dilemma where they try to attract investment from developed countries, while facing tax competition pressure from tax havens and other developing countries. In this sense, Pillar Two can alleviate some of the pressure on developing countries to participate in the traditional corporate income tax competition by forcing tax havens to comply. However, this is only one aspect of the issue, as the cost-benefit analysis is actually more complex.

In terms of revenue effects, it has been estimated that the gains tend to be greater for high-income jurisdictions than for lower-income ones.¹⁰⁷ Pillar Two cannot be expected

101. R.S. Avi-Yonah, *International Taxation, Globalization, and the Economic Digital Divide*, 26 J. Intl. Econ. L. p. 9 (2023), available at <https://doi.org/10.1093/jiel/jgac068> (accessed 22 Mar. 2023).

102. OECD, *Public Consultation Document: Global Anti-Base Erosion Proposal*, 8 November 2019 – 2 December 2019 (OECD 2019), available at www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf (accessed 22 Mar. 2023).

103. B.J. Arnold, *The Evolution of Controlled Foreign Corporation Rules and Beyond*, 73 Bull. Intl. Taxn. 12, sec. 6.3.2. (2019), Journal Articles & Opinion Pieces IBFD (2019).

104. A. Titus, *Global Minimum Corporate Tax: A Death Knell for African Country Tax Policies?*, 50 Intertax 5, p. 419 (2022) and Parada, *supra* n. 91, at pp. 10-18. Chukwudumogu summarized the following beneficial effects of tax competition: efficiency; inter-nation equity; national economic growth; reduction in potential over-taxation of foreign taxpayers; and democratic choice of taxpayer-voters. See C.G. Chukwudumogu, *The Regulation of Tax Competition: Rethinking ‘Harmful’ Tax Competition in a Global Context* pp. 104-121 (Edward Elgar 2021).

105. Li, *supra* n. 32, at p. 6.

106. The OECD’s “benefit-to-all” narrative has been criticized as being suspect and self-serving. See Littlewood, *supra* n. 22, at p. 417 and Dagan, *supra* n. 18, at p. 7.

107. OECD, *Tax Challenges Arising from Digitalisation – Economic Impact Assessment* p. 120-122 (OECD 2020). Baraké et al. estimated that the largest beneficiaries of the IIR would be large European countries such as Germany and the United Kingdom and the United States, while the least developed countries gain no or very limited revenues. See

to provide the bulk of the additional revenue needed by developing countries.¹⁰⁸

On the other hand, by limiting the ability of developing countries to use corporate income tax incentives to attract investment,¹⁰⁹ Pillar Two indicates that it will be more acceptable and beneficial for developing countries to attract investment through those non-tax factors (such as infrastructure quality, political and/or economic stability, human resources and legal environment). Empirical research by international organizations has noted that taxation usually does not top the list of investment factors. However, at the same time, tax incentives might be one of the few (albeit second-best) instruments for low-income jurisdictions to offset disadvantaged circumstances.¹¹⁰

Accordingly, the problem is that Pillar Two limits the space for developing countries’ tax policies and it has made little effort to benefit them by providing funding or technical assistance to improve their overall investment climates.¹¹¹ As a result, the “benefit-to-all” narrative of Pillar Two is questionable. Without any substantive development assistance as part of the Pillar Two package, it is unclear whether and how Pillar Two can truly reduce the North-South wealth gap and promote distributive justice.

5.3. Efficiency

Whether the new tax competition landscape in the post-Pillar Two era will be more efficient is also open to question. The overall effect of Pillar Two on tax competition seems to be mixed. Although it may improve efficiency to some extent by restricting traditional corporate income tax competition, it may also introduce some new inefficiencies.¹¹²

Section 4. described how, since Pillar Two does not eliminate the conditions of tax competition, some jurisdictions may respond strategically and continue to participate in tax competition. As these new forms of tax competition still have many unknowns, there is no evidence to prove that they will be more beneficial than traditional corporate income tax competition.

In contrast, the analysis in section 4. described how such incentives may well be problematic and distortive inherently if not appropriately designed. This is because:

M. Baraké et al., *Revenue Effects of the Global Minimum Tax Under Pillar Two*, 50 Intertax 10, p. 706 (2022). Suranjali Tandon and Chetan Rao of the South Centre, *infra* also anticipates that there will be limited or no gain to developing countries from Pillar Two. See S. Tandon & C. Rao, *Evaluating the Impact of Pillars One and Two*, S. Ctr., Research Paper 165 (4 Oct. 2022) available at www.southcentre.int/wp-content/uploads/2022/10/RP165_Evaluating-the-Impact-of-Pillars-One-and-Two_EN.pdf (accessed 22 Mar. 2023).

108. See IMF, *Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment* (Oct. 2015), available at www.imf.org/external/np/g20/pdf/101515.pdf (accessed 22 Mar. 2023).

109. Li, *supra* n. 32, at p. 6.

110. IMF, *supra* n. 108.

111. The Subject to Tax Rule (STTR) was noted as an integral part of achieving consensus on Pillar Two for developing countries. However, it is unlikely to raise significant revenue for low-income countries and has no direct contribution to improving the investment environment. See H. Wardell-Burrus, *Pillar Two and Developing Countries: The STTR and GloBE Implementation*, 51 Intertax 2, p. 118 (2023).

112. Mintz, *supra* n. 91, at p. 231.

(i) improperly designed SME tax incentives may give rise to a small-business trap; (ii) there are still many unknowns regarding the competition in the field of non-covered taxes, and the resulting competition in some areas (such as personal income tax) may also be fierce; (iii) QRTCs and cash grants will bring many fiscal and legal challenges, especially to developing countries; (iv) the jurisdictional blending approach is more friendly to large jurisdictions than to small ones; (v) the SBIE may discourage intangible investments relative to tangible investments; and (vi) by replacing traditional corporate income tax, the QDMTT can create a new form of tax competition.

These are only a few examples, but they reflect that Pillar Two may cause new inefficiencies. Whether intentionally or unintentionally, these distortions may be problematic, as they either run counter to the objectives of Pillar Two, or damage economic efficiency, or exacerbate inequality between countries. In such cases, the remedy may ultimately prove to be worse than the sickness.¹¹³

5.4. Some preliminary observations

In light of the deficiencies of Pillar Two in terms of equality and efficiency, this section provides some preliminary observations on whether, and how, the Inclusive Framework can better address these problems in the future. History has shown that the efforts to counter tax competition is a stage-by-stage process. Political compromises that produce questionable policy features are unavoidable in practice.¹¹⁴ As Wardell-Burrus (2022) points out, the deficiencies of Pillar Two may be due to the fact that it is an “incompletely theorized agreement”. Nevertheless, there would be further opportunities for jurisdictions to discuss these issues under the Inclusive Framework over time. It should not be inferred, from the fact that a compromise has not yet been reached, that one could not be reached.¹¹⁵ The authors acknowledge that many international organizations have pointed out the problems caused by harmful tax competition,¹¹⁶ and, therefore, the authors do not oppose the multilateral efforts to regulate it. What the authors propose is that the Inclusive Framework address tax competition in a more holistic, equitable and systematic manner in the future.

With regard to equality, the global justice principle should be followed to ensure that developing countries can obtain a fair deal on tax competition. This means that small developing countries with obvious comparative disadvantages should receive meaningful financial or technical support as compensation for the limitation on their ability to use the tax tools at their disposal,¹¹⁷ as well as a redistributive mechanism to reduce their comparative disadvantages in non-tax factors.¹¹⁸ In order to achieve this, the sustainable

113. Parada, *supra* n. 91, at p. 13.
 114. M.P. Devereux, J. Vella & H. Wardell-Burrus, *Pillar 2’s Impact on Tax Competition*, p. 51 (2022), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4203395 (accessed 19 July 2023).
 115. Wardell-Burrus, *supra* n. 29, at pp. 43-44.
 116. IMF, *supra* n. 108.
 117. Hassan Fazal, *supra* n. 7, at p. 96.
 118. It is interesting to note that Hungary removed its veto on the Pillar Two Directive, after the European Union approved Hungary’s recovery

development goals can be taken into consideration in the reform of the international tax system.¹¹⁹ When setting the agenda, the regulation of tax competition can be linked to relevant subjects, such as the improvement of the investment climates of developing countries. As a useful tool of negotiation, issue linkage can address global issues in a more holistic way, promote the coordinated development of rules and policies in different legal fields and create broader benefits for all parties involved.¹²⁰

With regard to efficiency, the Inclusive Framework and relevant international organizations (such as the OECD, the International Monetary Fund (IMF), the World Bank, the United Nations Conference on Trade and Development (UNCTAD)) may issue reports or guidelines to make developing countries aware of the problems they may encounter when participating in new forms of tax competition. Further multilateral agreement may also be achieved to refine the rules within the Inclusive Framework, where such agreements can be reached.¹²¹ As tax competition and the campaign against it are a permanent topic, it is possible for jurisdictions to launch a new round of cooperative talks under the Inclusive Framework (or any other more popular platform) at some point in the future, bringing the international tax regime into the “BEPS 3.0” stage.

6. Conclusions

Based on the analysis in this article, this concluding section will summarize answers to the three-level questions. First, tax competition is a complex and dynamic concept that takes on different forms at different stages. Correspondingly, the multilateral efforts to regulate tax competition involve an evolving process, with changing emphases and methods at different stages. The OECD’s efforts to counter tax competition can be divided into the following three stages: (i) the pre-BEPS stage; (ii) the BEPS 1.0 stage; and (iii) the BEPS 2.0 stage. In the BEPS 2.0 stage,

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 ery and resilience plan and agreed to release COVID-19 recovery funds. This may provide a reference for developing countries to bargain with developed countries under the Inclusive Framework. See Council of the European Union, *Outcome of Written Procedure on Aid to Ukraine, Minimum Tax, Hungary’s Recovery Plan and the Conditionality Mechanism*, Press Release (16 Dec. 2022) available at www.consilium.europa.eu/en/press/press-releases/2022/12/16/outcome-of-written-procedure-on-aid-to-ukraine-minimum-tax-hungary-s-recovery-plan-and-the-conditionality-mechanism/ (accessed 22 Mar. 2023).
 119. The goals most relevant to international tax reform include Goal 8 (Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all), Goal 9 (Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation) and Goal 10 (Reduce inequality within and among countries). See United Nations, *Transforming our world: the 2030 Agenda for Sustainable Development*, available at <https://sdgs.un.org/2030agenda> (accessed 22 Mar. 2023).
 120. The use of linkage as a form of side payment when there are asymmetric benefits across countries is especially important in the context of the relations between northern and southern countries. If cooperation on an individual issue benefits country A, but hurts B (or is simply not of the interest of B), linkage permits country A to compensate B by offering cooperation on a different issue that benefit B. See O. Perez, *Multiple Regimes, Issue Linkage and International Cooperation: Exploring the Role of the WTO*, 26 U. Pa. J. Intl. Econ. L., p. 742 (Spring 2005), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=872429 (accessed 19 July 2023).
 121. Wardell-Burrus, *supra* n. 29, at p. 43.

Pillar Two intends to curb corporate income tax competition in a more comprehensive way through the fiscal fail-safe. The motivations for interest-divergent jurisdictions to reach consensus on Pillar Two are complex, but revenue concern may be a possible explanation.

Second, the designers of Pillar Two intentionally utilized the fiscal fail-safe to promote adoption and compliance. As a strategic response to Pillar Two, jurisdictions may either implement the GloBE rules or raise their tax rates to the global minimum to avoid the top-up tax levied by other jurisdictions. Accordingly, it is expected that Pillar Two will substantially influence the tax policies of jurisdictions and reduce their motivation to engage in traditional corporate income tax competition. However, Pillar Two does not eliminate the conditions of tax competition. Jurisdictions may turn to other forms of tax competition that are not or less affected by Pillar Two in the medium and long term. For instance, jurisdictions will continue to compete for multinational SMEs and international shipping business. They may use non-covered tax incentives, QRTCs and non-tax subsidies to attract investment. They can also utilize the jurisdictional blending approach, the

QDMTT and the SBIE. The authors' analysis in this article reveals the degree and extent of effectiveness of Pillar Two in addressing tax competition, thereby paving the way for future research and tax reform.

Third, the authors argue that Pillar Two may not ensure a more equitable and efficient tax competition landscape. In terms of equality, the "benefit-to-all" narrative of Pillar Two is questionable. Without any substantive development assistance as part of the Pillar Two package, it is unclear whether, and how, Pillar Two can truly reduce the North-South wealth gap and promote distributive justice. In terms of efficiency, the overall effect of Pillar Two on tax competition seems to be mixed. Although it may improve efficiency to some extent by restricting traditional corporate income tax competition, it may also introduce some new inefficiencies. These distortions can be problematic because they either run counter to the objectives of Pillar Two, damage economic efficiency, or exacerbate inequality between countries. In light of such a finding, the authors suggest that the Inclusive Framework should address tax competition in a more holistic, equitable and systematic manner.



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