FISCAL AFFAIRS

LEGAL

AFRITAC de l'Ouest

Domestic Revenue Mobilization

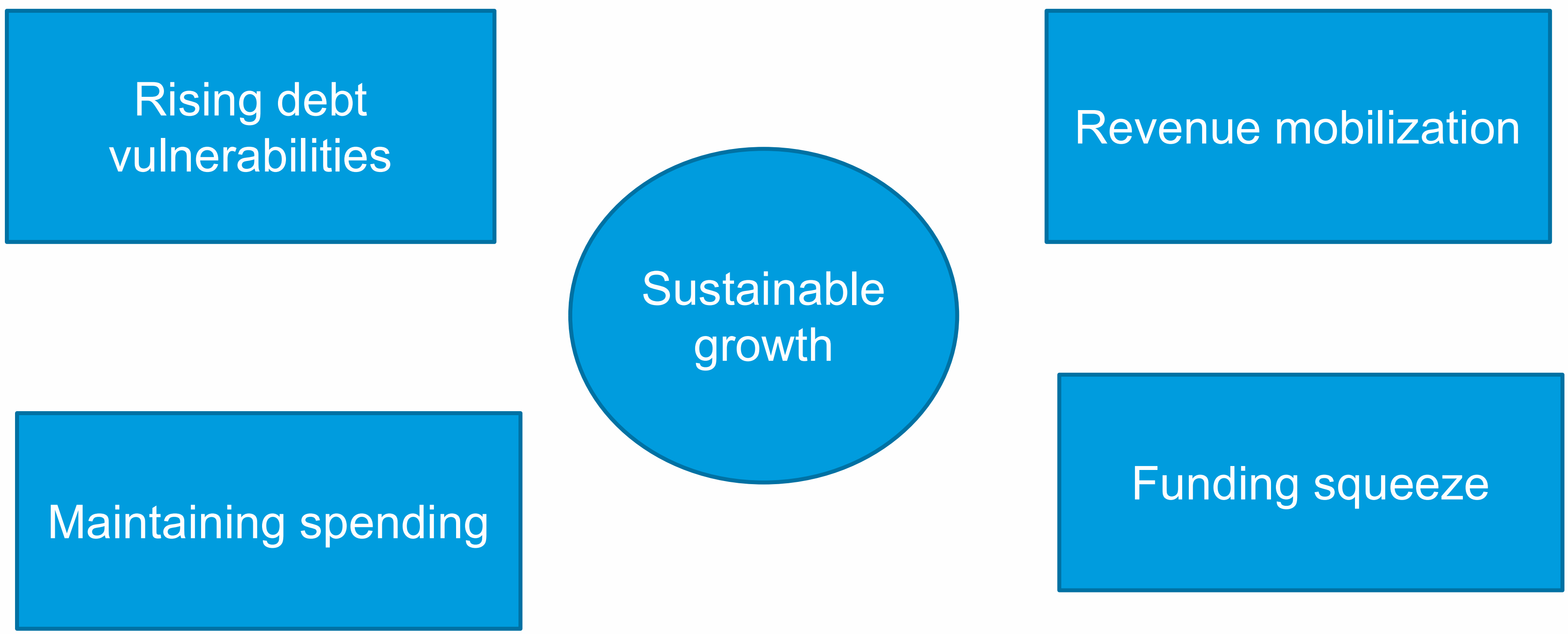
ORAL H WILLIAMS

A Fiscal Affairs,Legal Departments Team and AFRITAC de L'Ouest Teams

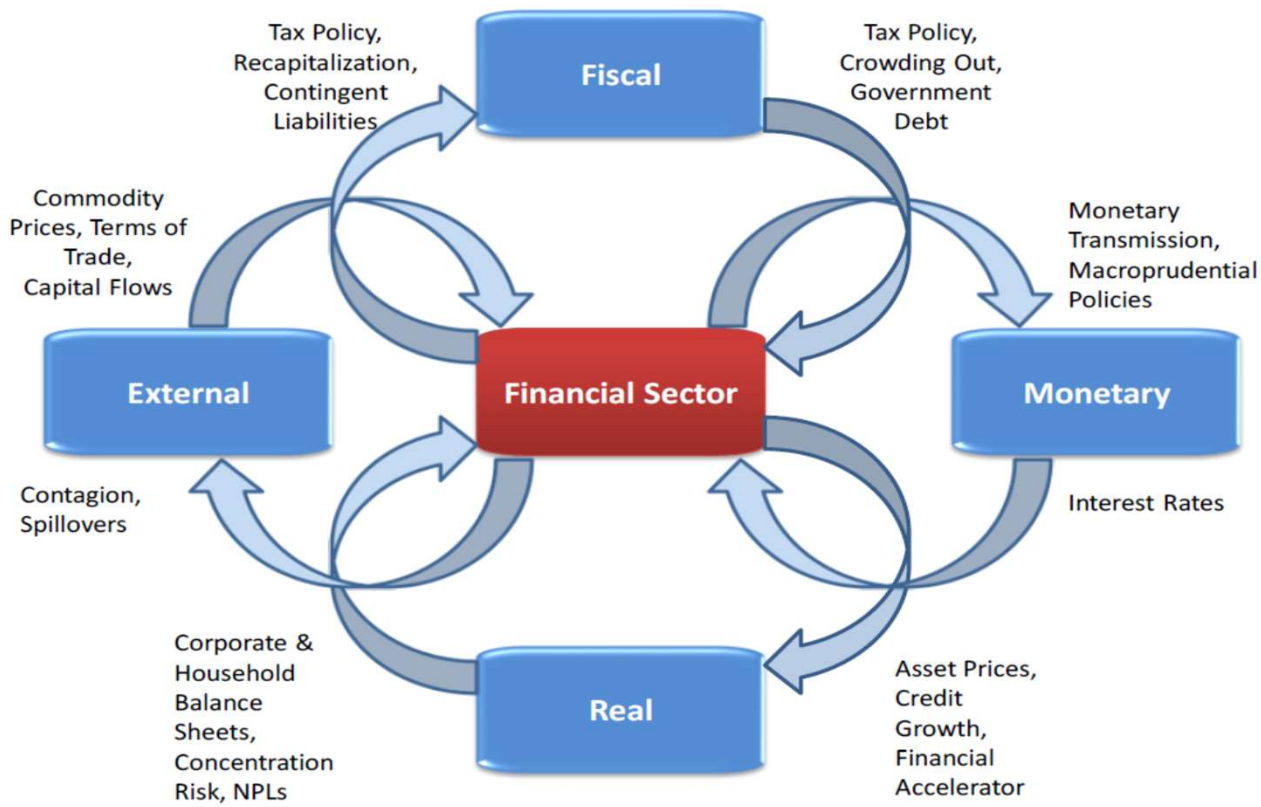
- **Domestic Revenue Mobilization**

- **Current context**
- Framework for implementing reforms
- International taxation developments
- Future Reform Directions and Conclusion

Confluence of shocks



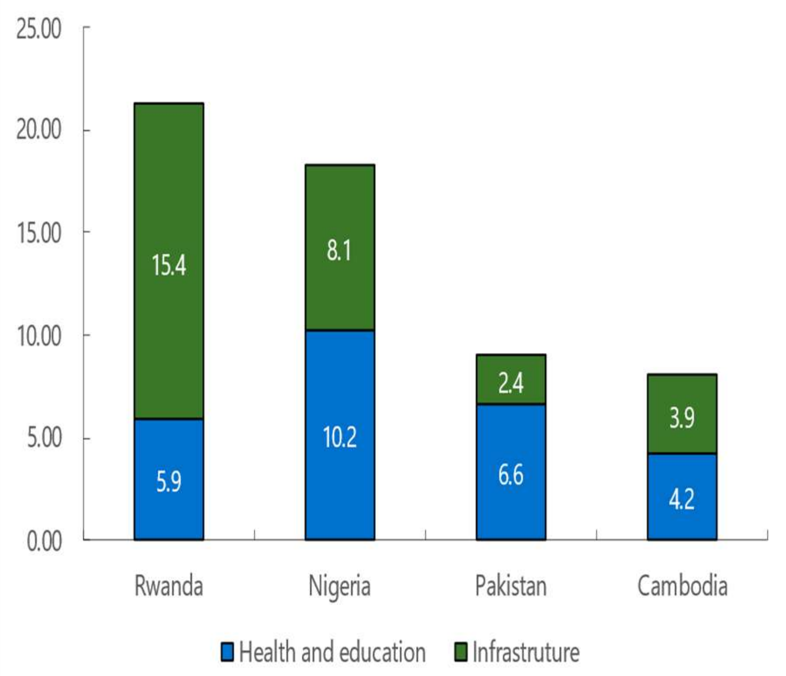
DRM: Macro-financial Linkages and Transmission Channels



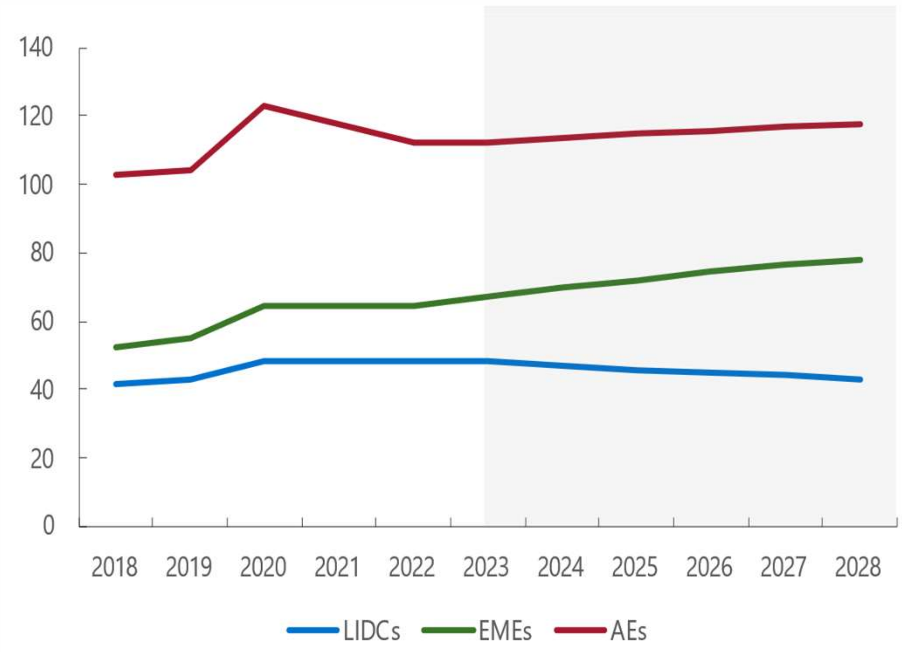
Source: IMF, 2017, Approaches to Macro-financial Surveillance in Article IV Reports (Board date March 6, 2017)

Case for Mobilizing Domestic Revenues

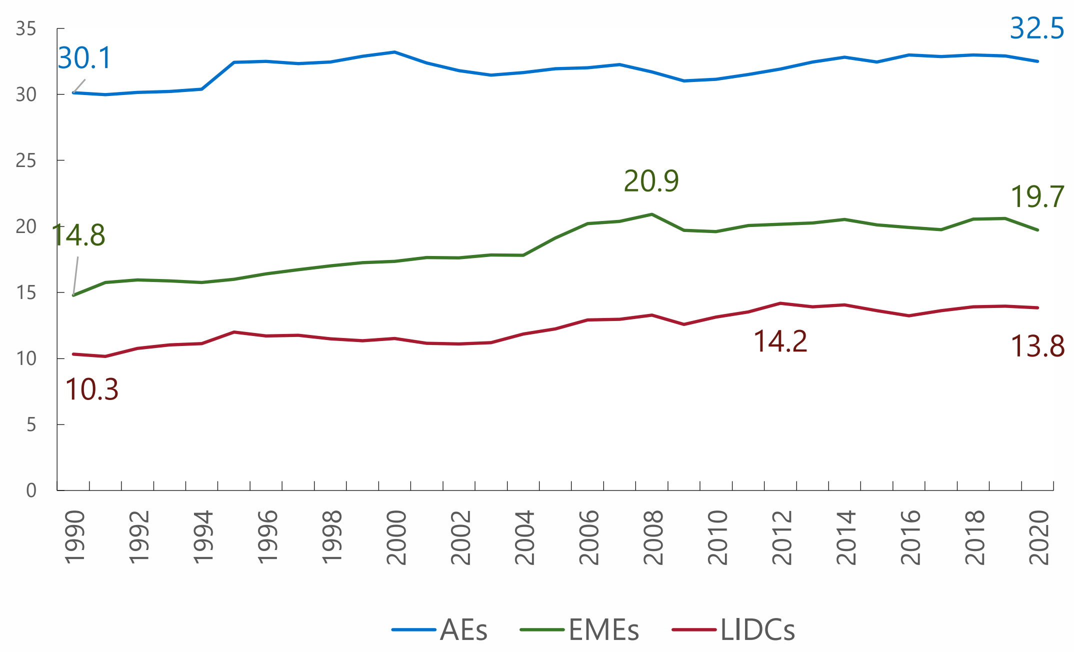
Additional Annual Financing Needs to Meet the SDGs (Percent of GDP)



Gross Debt (Percent of GDP)



Tax revenue to GDP



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- Taxes and sustainable growth

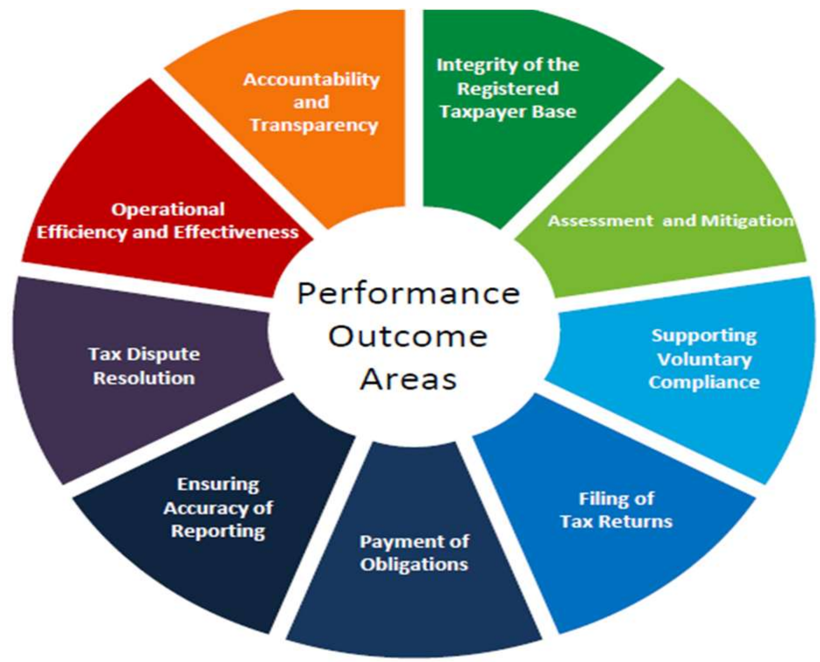
Miscellaneous Analytical Tools

Revenue Gap Analysis (RA-GAP)

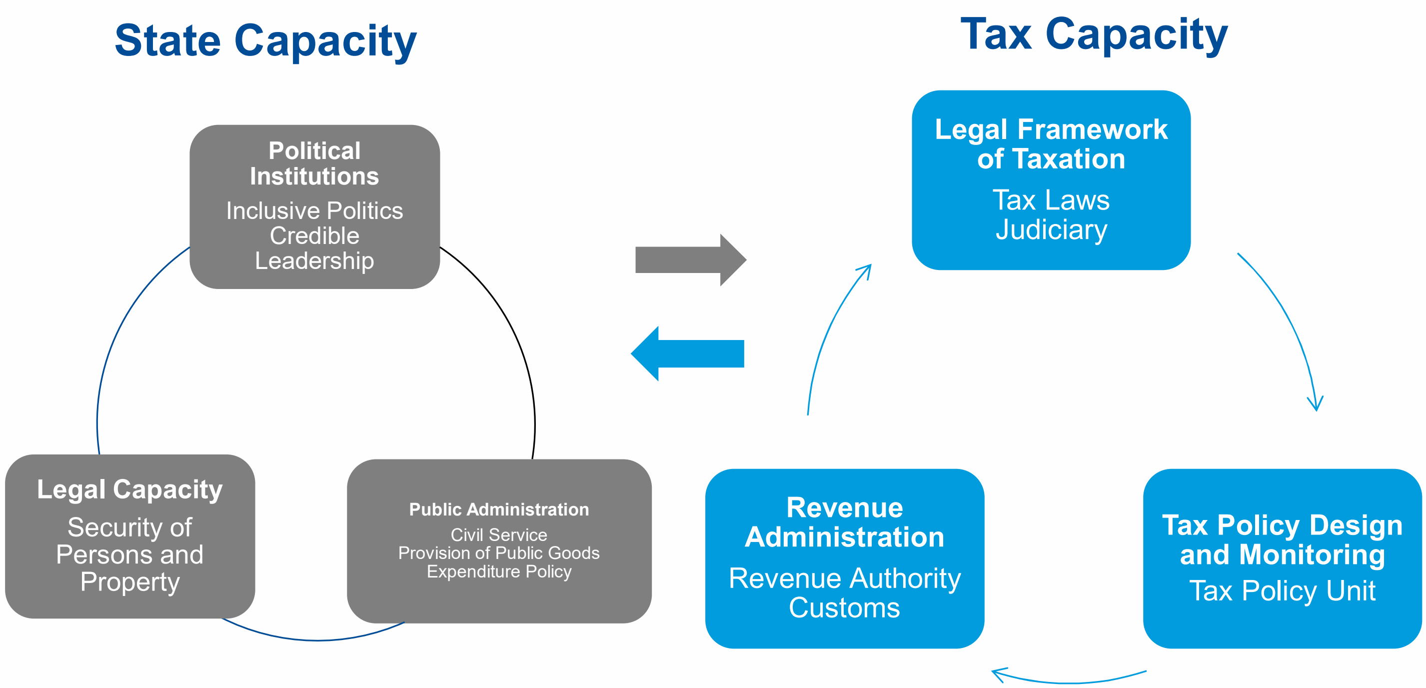
- RA-GAP= Potential-Actual Revenues

- (Tax liability –Tax Paid)* Taxpayers
- Compliance vs Policy gaps

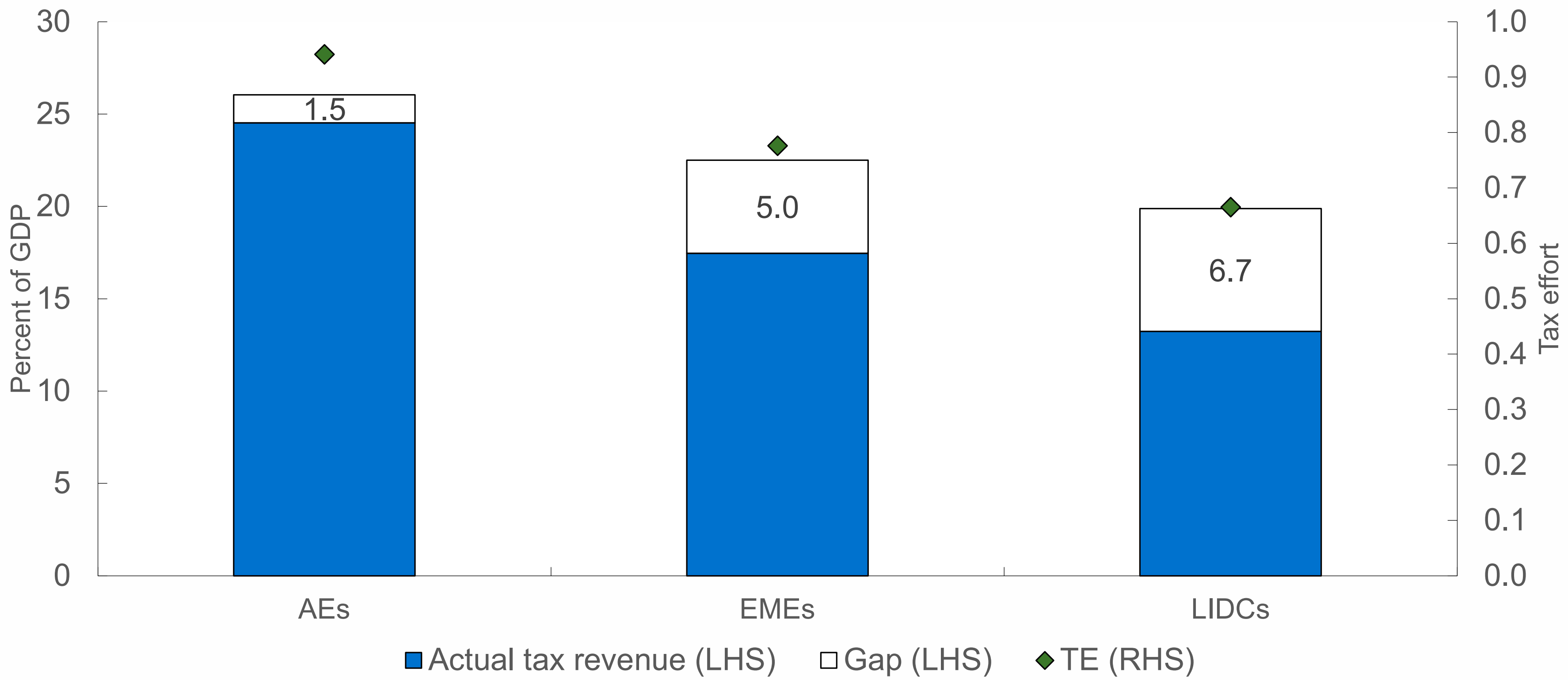
TADAT EVALUATION



State Capacity and Tax Capacity



Tax Effort and Tax Potential (2020)



Domestic Revenue Mobilization

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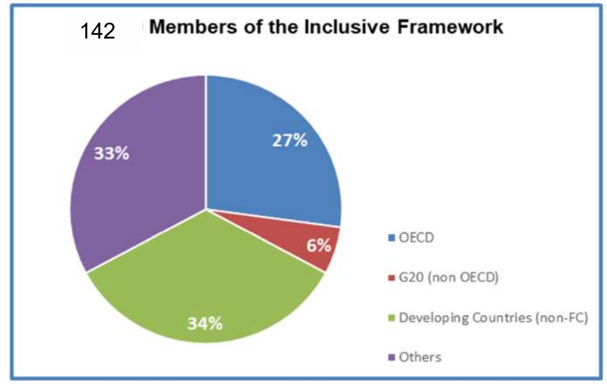
A major international tax reform was agreed in October 2021

- Inclusive Framework (IF) 2-pillar reform
- Arguably most important international tax reform for 100 years



BREAKING | Oct 8, 2021, 03:09pm EDT

136 Countries Agree To Establish 15% Minimum Corporate Tax Rate

Téa Kvetenadze Forbes Staff
Business
I'm a New York-based reporter covering breaking news.

TOPLINE The Organization for Economic Cooperation and Development announced Friday that 136 countries representing over 90% of international GDP have agreed to tax reforms that include establishing a 15% minimum corporate rate beginning in 2023, clinching a long sought-after deal to end

136 nations agree to biggest corporate tax deal in a century

OECD-led pact sets 15% floor aimed at raising $150bn annually as US wins two-year ban on tech levies

OPINION | REVIEW & OUTLOOK

Yellen's Global Tax Railroad

She wants to use an OECD pact to coerce Congress to go along.

By The Editorial Board
Oct. 21, 2021 6:34 pm ET

Global Deal to End Tax Havens Moves Ahead as Nations Back 15% Rate

More than 130 countries agreed to set a minimum tax rate of 15 percent as governments look to end a race to the bottom on corporate taxation.

Pillar 1: Revised Allocation of Taxing Rights

- Mandatory for all committed countries by 2024
- Coverage: 100 large MNEs with turnover at least € 20 billion (excludes natural resource and financial sectors)
- An addition to existing international tax-based system on separate entity level taxation.
- Allocates 25% of MNEs profits > 10% return to market jurisdictions.

Pillar 1: Revised Allocation of Taxing Rights cont’d

- A change from previous norms. Not dependent on physical presence; Taxable profits on Group Basis vs Transfer prices to individual entities.
- Includes rules to relieve double taxation
- Removal and not introduce new digital services tax
- Under the existing system, countries have no right to tax such profits in the absence of a physical establishment such as a warehouse or factory on their territory.

Pillar 2 – Global Minimum Tax

- MNEs with global turnover exceeding €750 million
- 15 percent minimum effective tax on excess profits (country basis).
- Minimum tax based on 3 inter-related tax rules
  - Income inclusion rule (IRR)
  - Undertaxed profit rule (UTPR)
  - Subject to tax rule (STTR)
- The simplified allocation of profits by a formula reduces scope for aggressive tax planning.

Anatomy of inter-related tax rules

- **Income Inclusion Rule**: Subjects MNEs to a top up tax if effectively taxed below the 15% minimum rate in any jurisdiction.
- **Caveat**: Source jurisdictions can preempt IIR by applying a **qualified domesitc minimum top up tax** (QDMTT) based on same scope and rates as IRR
- **Undertaxed Profit Rule**: Allows source countries to apply a top up tax if no IRR or QDMTT applies. Jointly known as anti global tax evasion rules (GLoBE taxes).
- **Subject ToTax Rule**: treaty-based rule allowing source jurisdictions to impose limited source taxation (e.g., withholding taxes, on certain related-party payments subject to tax below a minimum rate of 9 percent.

Impact of the reform--Uncertain

Pillar 1-CIT

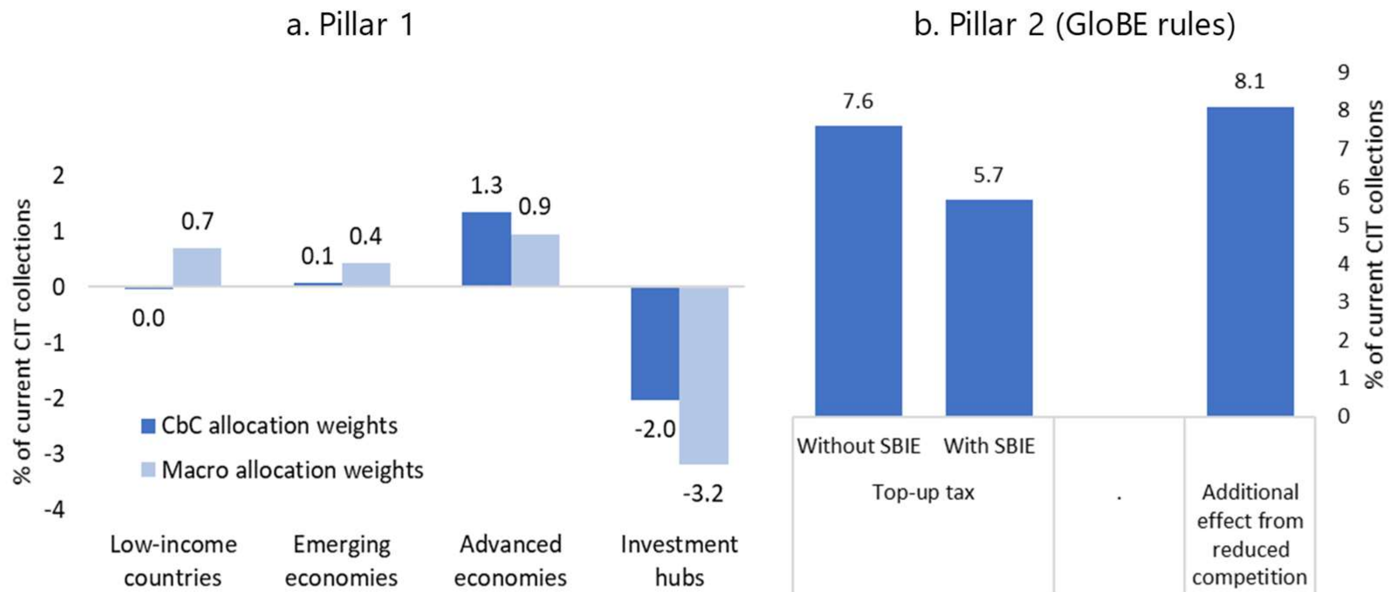
- Reallocate about 2 percent of total profits of MNEs, mainly from low-tax investment hubs to other countries, raising global Corporate Income Tax (CIT) revenue by $12 billion

Pillar 2-CIT

- P2 would raise global CIT revenues by 5.7 percent, which is before any behavioral responses by firms

Global direct revenue effects modest, especially for P1, but:
(1) Effects for some countries more significant
(2) Dynamic effects can be important

Figure 1. Revenue Impact of Pillars 1 and 2



Source: IMF staff estimates (Appendix I and Fiscal Monitor, 2022).
Notes: Estimates for Pillar 1 are based on 136 MNEs, which likely somewhat overestimates affected MNEs. For example, while the analysis excludes financial firms it does not deduct possible revenues from financial affiliates of a non-financial group. SBIE stands for substance-based income exclusion.

Revenue gains 0.2% Global GDP…and other gains for developing countries also small.

- Details of simplification measures still under discussion (Amount B: fixed margins on distribution and marketing)
- Might lose from abolishing digital service taxes

- Additional source-based tax (STTR) unlikely to yield much
  - Rate of 9%, crediting Witholding Tax (WHT) and residence country tax
    - For LICs treaties in force, share of WHT < 9% is 19% for interest; 20% royalties.
    - No more than about 100 treaties affected.
    - # Treaties eligible for STTR declines sharply wrt nominal CIT in recipient country.
    - Impact 0-0.14% of current CIT revenue per country

The complexity of the agreement implies high administrative costs

- Double taxation rules under Pillar 1 are complex
- Combination of minimum inbound and outbound top up taxes and coordination between them adds complexity, with potential variations between countries
- Assessing and auditing will require unprecedented cross-border cooperation
  - Lack of de facto access to existing information exchanges not a good sign. (Australian law on disclosures—OECD lobbied against)

Optimal reactions to IF agreement differ, but a specific minimum tax is almost always advisable…

Pillar 1: effectively mandatory (if critical mass can be reached)

Pillar 2: strategic choice on reaction

- Major economies: need sufficient adopters to enforce system
- Capital importers (most developing countries)
  - Adopt "Qualified Domestic Minimum Top-Up Tax" (QDMTT)
    - Raises revenue with no downside
    - Dominates tax rate increases/tax incentive cuts
- Conduit countries
  - Major structural adjustment need
- Unaffected countries: those with minimal MNE activities

Investment not expected to decline much…

- Decline in investment due to higher taxation
  - UNCTAD (2022) estimates potential FDI decline of 2%
  - OECD (2020) suggests MNE investment rate decline by 0.12 pp

- Impact might be smaller
  - Substance-based income exclusion prevents increase in marginal effective tax rates
    - Can even be negative in some low-tax jurisdictions
  - Past studies based on single country change
    - If all countries raise taxation, FDI cannot go elsewhere

Unfinished Agenda

- Further Simplification: such as simplified approaches to taxing routine marketing and distribution operations.

- Collecting more from other major taxes—VAT—significant untapped potential in many countries.
- The global tax agreement is an important step in the right direction, but it is not yet operational

Fundamental reform ideas should keep driving developments

- Destination-based taxation more robust than residence- and especially source-based taxation
  - DBCFT , also: sales factor for apportionment, strengthening VAT

Strengthen IF agreement over time

- Reduce thresholds to cover more MNEs
- Reduce / eliminate substance-based income exclusion
  - Raises revenue (2% of CIT collection) and removes incentive to locate real activities in low-tax countries
  - Reduction to 5% already foreseen
- Eliminate sectoral exemptions (shipping)

Strengthen Developing Country Agenda

- Access to country-by-country data
- Complete Amount B and ensure broad coverage
- Expand STTR to a wider set of payments or disregard tax in receiving country
- Clearer guidance on broader applicability of WHTs
- Deduction limits for potentially base-eroding payments

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Capacity Development and Donor Coordination

International Bodies

Ministries and
Beneficiary
Institutions

IMF and
Other Donors

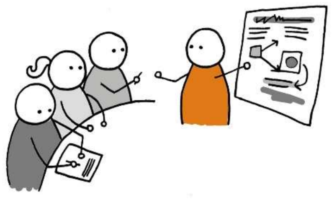
Civil Society

The following can hinder the delivery of Capacity Development and/or reduce the impact:

Frequent changes in management due to election cycle and political economy

Funding inadequacies that hinder follow-up support and slow down implementation of CD recommendations

Unforeseen shocks e.g. Covid; War in Ukraine



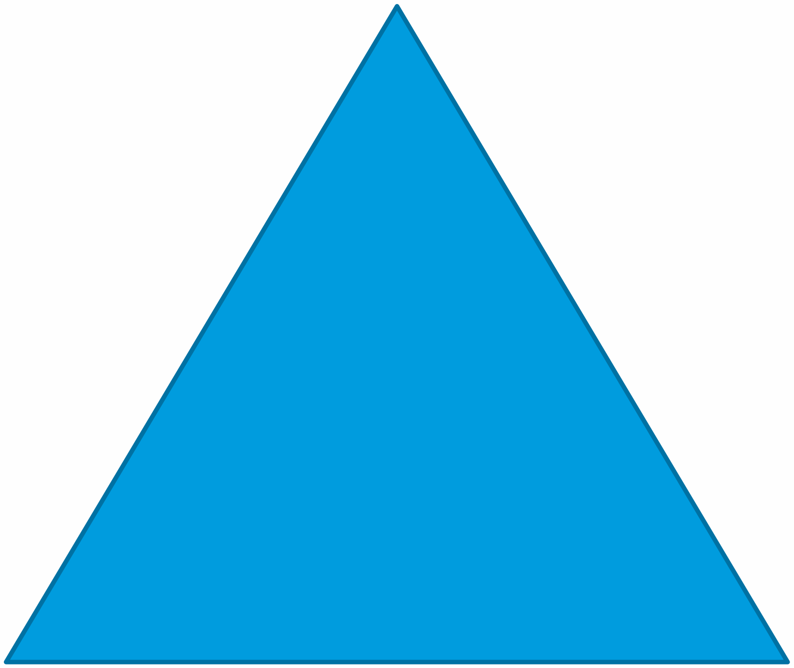
Nomination of untrainable and/or near-to-retire officers for trainings

Industrial Policy Revisited

- No longer taboo.
- US CHIPS ACT. $280 billion
- Japan: $500 million to 57 companies to invest locally
- EU: COVID policy €160 billion for digital innovations (chips, batteries, climate adaptions)

GROWTH STRATEGY TRILEMMA

NATIONAL CHAMPIONS



FISCAL & FINANCIAL STABILITY

GROWTH

Some Guiding Principles

- Cost benefit: including distributional and social. Social rate of return > best alternative investments
- Benefits often uncertain and accrue in the future
- Accountability, Transparency
- Reduce information frictions: One stop shop

Tax Incentives: First Principles

Striking the right balance between an attractive tax regime for domestic and foreign investment

- ❑ Fair
- ❑ Simple
- ❑ Efficient
- ❑ Often Complicate tax system
- ❑ Create horizontal inequities
- ❑ May forego revenues

Tax Incentives Cont'd

- Lowering investment costs vs profit based
- **Cost based**: specific allowances linked to investment expenses (accelerated depreciation; special deductions and credits).
- **Profit based**: reduce the tax rate wrt taxable income (tax holidays; preferential tax rates; income exemptions).
- **Eligibility:** (1) Special size (2) Special sectors; (3) Special zones.
- FTZ: "*Performance data are elusive because the effects of zones are hard to disentangle from other economic forces*" *(The Economist)*

Taxes: Corporate Income Tax

- CIT: imposed on economic rents.
- CIT: Administrative appeal due to withholding function.
- Drawbacks: Raise the cost of capital on equity (distort investment decisions)
- Bias: Debt vs equity finance. Implications for welfare loss and financial stability.
- Alternative CIT as rent tax: (1) Cash flow tax expensing for investment vs deductions for depreciation.
- Alternative CIT: (2) Current CIT plus notional deduction for ROE to equalize treatment for interest

Tax Incentives Cont’d

- **Life cycle**: Continued monitoring of firms
- **Tax incentives**: Temporary vs permanent (sunset provisions in the law)
- **Governance**: Policies and admin. Transparent; scrutiny.
  - Legal
  - Economic
  - Administrative
- **Granting authority**: weighing priorities; costs vs benefits
- **Avoid beggar-thy-neighbor policies**. Cross-border spillovers

Consumption Taxes

- Efficiency vs Equity Considerations
- Minimize distortion between taxed and untaxed goods and services (leisure/informal labor).
- Avoid a swath of exemptions; (ii) high threshold; (iii) single rate; (iii) broad base.
- High threshold: reduces compliance costs (strengthens progressivity
- Exemptions: inefficient to achieve equitable outcomes.
- Pigovian taxes: Address externalities

Consumption Taxes Cont’d

- **Pigovian taxes**: to internalize the external cost of a transaction in the price (i.e. “setting the price right”)
- Complement broad-based consumption tax per unit of consumption.
- At a level directly related to the external costs—such as the social cost of carbon emissions in the case of climate externalities

A QUOTE ON INDUSTRIAL POLICY

Former US Treasury Secretary Lawrence Summers recently said he liked his industrial policy advisers the same way he liked generals.

“The best generals are the ones who hate war the most but are willing to fight when needed. What I worry is that people who do industrial policy love doing industrial policy.”

Thank you

… and is a major improvement over the current system.

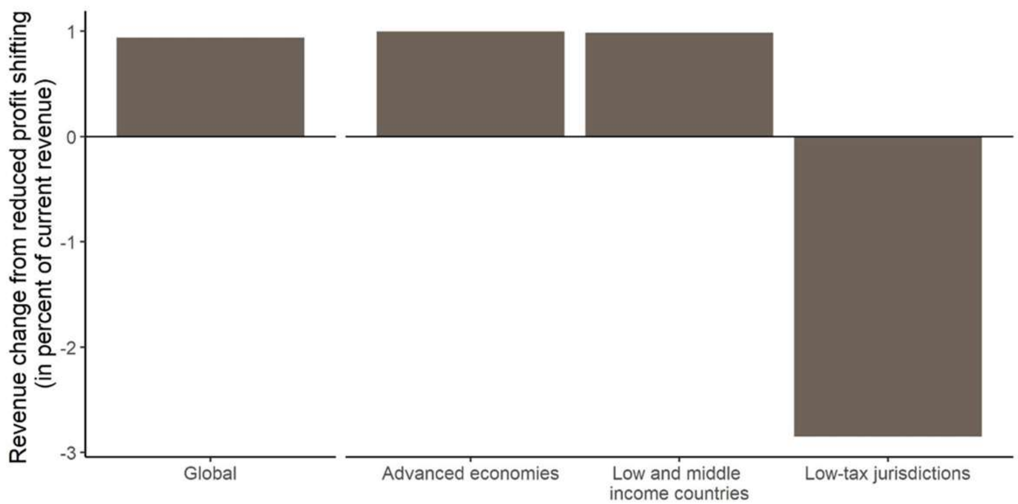
	Protection against:		Ease of implementation:		Suitability to circumstances of LICs
	Profit Shifting	Tax Competition	Practically	Legally	
Current arrangements					
Full RPA					
Pillar 1					
Full minimum taxation					
Pillar 2					

Key:

Low	Low Medium	Medium	Medium High	High

…while profit shifting will lessen.

Figure 1. The Impact of Pillar 2 on Profit Shifting Gains and Losses

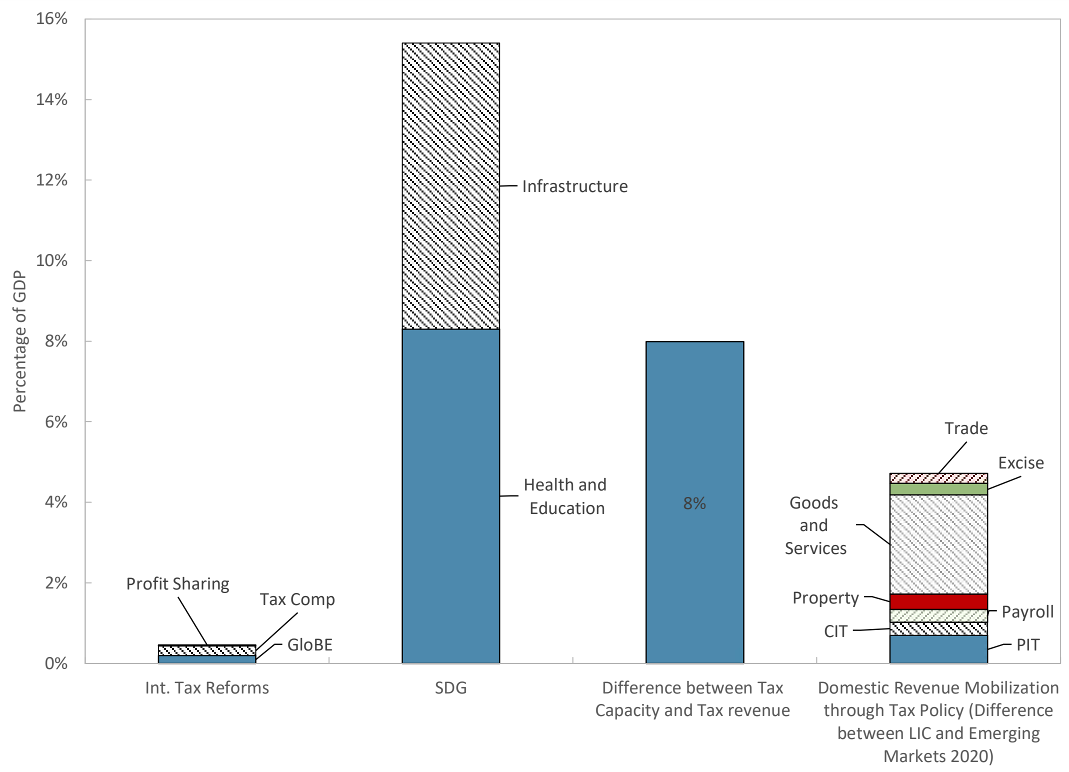


Source: IMF Staff estimates.

Notes: Graph shows weighted average gains and losses from changed profit-shifting behavior. Low-tax jurisdictions include 19 jurisdictions with statutory tax rates below 15 percent. The remaining countries are grouped into 34 advanced economies and 116 low and middle-income countries.

- Minimum tax reduces net return to MNEs' tax minimization efforts
- Empirical estimates imply that global revenue leakage could lessen by about ¼ (+1% of CIT revenue)
  - Reduction in profit shifting likely more muted due to substance-based income exclusions (not factored into empirical estimates)
  - Important variation across countries exists

Developing countries will need measures beyond tax from multinationals.



- Revenue gains from international tax reforms are dwarfed by developing countries' spending needs

Effects through various channels

- Uncertainty; some aspects not finalized; complex to model.
- Direct ('static') revenue impact
- Dynamics:
  - Countries reactions: setting taxes and domestic reforms
  - MNEs' reactions:
    - impact on profit shifting
    - Impact on investment
- Complexity of the resulting international CIT framework