Chapter 3

Aligning the International Tax System with the Globalized Economy

Corporations that operate in more than one country generate a substantial share of global economic activity. As shown in figure 3-1, multinationals account for roughly one third of global gross domestic product and more than half of all international trade. Given the economic significance of multinationals, taxation of their profits has the potential to be a major source of government revenue.

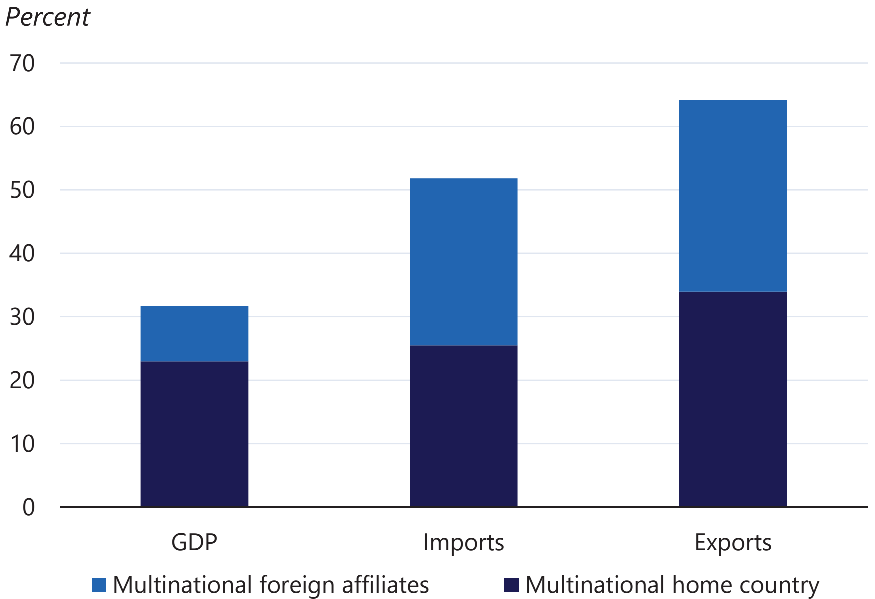
However, prior to 2021, a lack of coordination among countries in taxing multinationals led to a "race to the bottom" in corporate income tax rates from a 40.2 percent average worldwide statutory tax rate to 23.5 percent over the past four decades (Enache 2023). Many multinationals pay far less than that by shifting their profits to low-tax countries despite not engaging in meaningful economic activity in those countries. From 2017 to 2020, an estimated $2 trillion of multinational profits were taxed at effective tax rates below 15 percent (Hugger, González Cabral, and O'Reilly 2023). Clausing (2020) estimates that cross-border tax planning activity by multinationals costs the U.S. government more than $100 billion a year. This is particularly important in the current U.S. fiscal environment, where the federal government has run a budget deficit in 51 of the past 55 years, causing the debt-to-GDP ratio to reach 97 percent in Fiscal Year (FY) 2023 (OMB 2024; CBO 2024a).

At the same time, the growth of digital services business activity, such as entertainment streaming and digital advertising, has raised important questions about which countries have taxing rights over the activity (Cebreiro

Gómez et al. 2022). For example, when a Canadian business buys advertising space on a website run by a multinational headquartered in the United States and the ads are viewed by consumers in Mexico, which country or countries should have the right to tax the business activity at issue?

In response to the difficulties in addressing tax competition and digital services taxing rights on a unilateral basis, more than 130 countries, representing over 90 percent of the world economy, agreed in 2021 to modernize the principles governing the taxation of multinationals' profits (OECD 2021a). Known as the Global Tax Deal, the principles seek to preserve global corporate tax revenues and modernize the international tax system

Figure 3-1. Multinationals' Share of Global Economic Activity in 2016



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Sources: Organisation for Economic Co-operation and Development Analytical Activities of Multinational Enterprises database; CEA calculations.
Note: The navy bars, labeled as multinational home country, represent activity conducted by a multinational in its home country, while the blue bars, labeled as multinational foreign affiliates, represent activity conducted by a multinational through its foreign affiliates. 2016 is the most recent year of data available.
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by setting guidelines for where multinationals pay taxes and how much they pay (OECD 2023a). The global minimum tax component of the Global Tax Deal is already being adopted by countries around the world (Brosy 2024).

This chapter explains the challenges that gave rise to the historic agreement and how the Global Tax Deal addresses those challenges. The chapter first describes how the deal addresses tax competition and then explains how it handles digital services taxation. The chapter concludes with a discussion of why the United States would benefit from participation in the Global Tax Deal.

Globalization and a Patchwork of Corporate Tax Systems

In today's globalized economy with cross-border investment and multinationals, each country must consider its own corporate tax policies in the context of other countries' corporate tax policies when designing its corporate tax system. While many factors, including infrastructure, workforce makeup, and rule of law, determine multinationals' location choices, countries with relatively low corporate tax rates are generally more attractive than others, all else being equal (Siedschlag, Zhang, and Smith 2013; Castellani et al. 2022; Basu, Mitra, and Purohit 2023). As a result, countries compete with one another to keep tax rates low enough to retain or attract multinational economic activity. Such international tax competition can put pressure on countries to lower their corporate tax rates and thus undermine their ability to raise revenue (OECD 1998).

Globalization Without Cooperation: The Prisoner's Dilemma

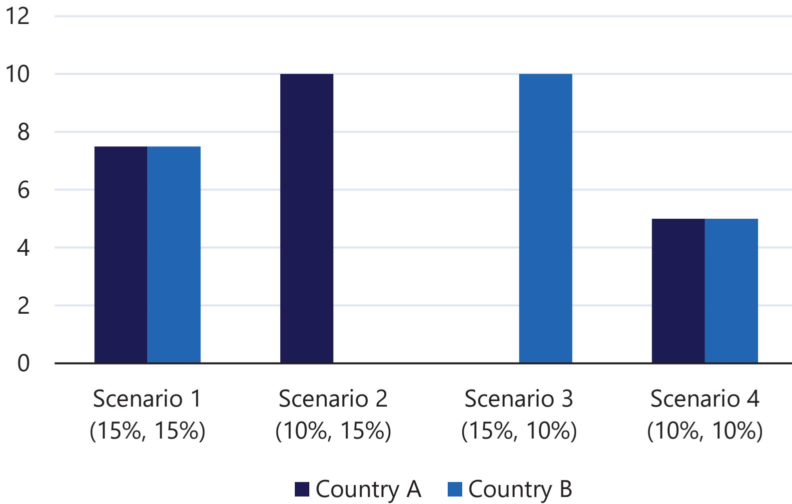
A simple example illustrates the fundamental dynamics of corporate tax competition across countries. Imagine Country A and Country B are simultaneously choosing between a 15 percent corporate tax rate and a 10 percent corporate tax rate. Multinationals in this scenario can freely choose where to locate economic activity that collectively generates $100 in taxable income.[1] When each country sets its tax rate independently rather than cooperating, the incentives resemble the classic "prisoner's dilemma" (Devereux 2023).[2]

[1] Cross-border tax planning can create a disconnect between where multinationals locate economic activity and where they report income, which is discussed later in the chapter.

[2] To fix ideas, this example assumes total economic activity is held constant and multinationals can only change the allocation of economic activity across countries. Changing tax rates could potentially change the total economic activity and thus total income.

Figure 3-2. Prisoner's Dilemma-Based Corporate Tax Revenue Prior to Global Tax Deal Pillar Two

Dollars



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Source: CEA calculations.

Note: Figure shows the prisoner's dilemma-based corporate tax revenues collected by Countries A and B prior to the Global Tax Deal Pillar Two. The first term in parentheses is the corporate tax rate set by Country A, and the second term in parentheses is the corporate tax rate set by Country B. This example assumes that total economic activity is held constant, meaning multinationals can only change the allocation of economic activity across countries, multinationals report income where their economic activity is located, and total taxable income equals $100.

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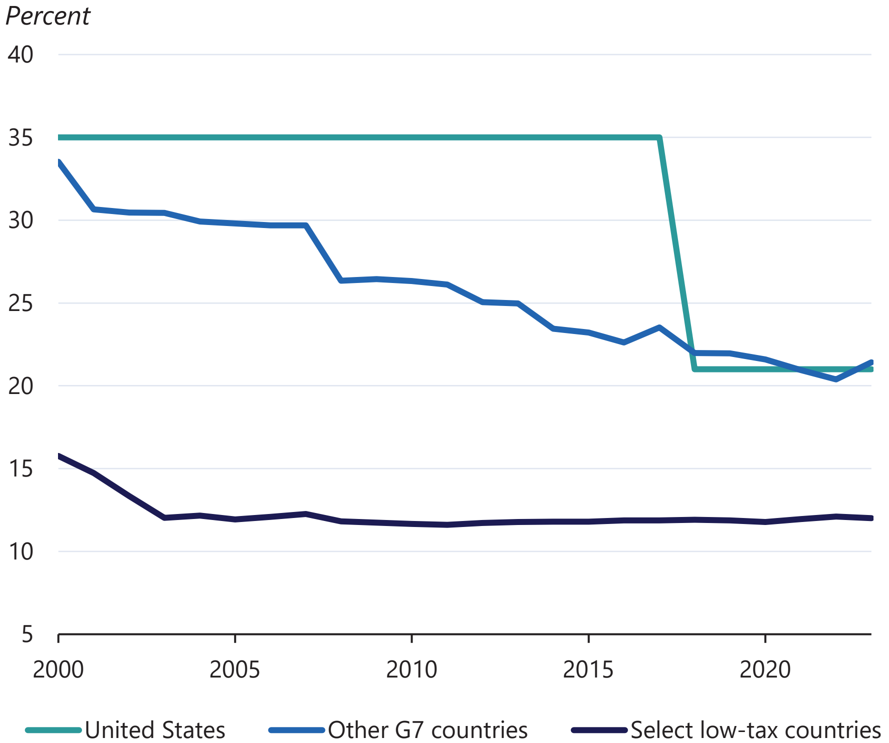
If both Country A and Country B enact a 15 percent tax rate (see scenario 1 in figure 3-2), multinationals will be indifferent about where to locate their economic activity and split the activity between the countries equally. As a result, both Countries A and B will collect $7.50 in tax revenue ($50 in taxable income per country multiplied by 15 percent). However, the 15 percent tax rate is likely not sustainable because each country knows that lowering its rate will attract increased economic activity and raise revenue collection. If Country A lowers its tax rate to 10 percent while Country B retains its 15 percent rate (see scenario 2 in figure 3-2), multinationals will locate all their economic activity in Country A. Country A will then collect

$10 in tax revenue while Country B collects $0.[3] Thus, Country B is incentivized to lower its tax rate to 10 percent, which moves the countries to scenario 4 in figure 3-2. Multinationals will be indifferent between Countries A and B if they both have a 10 percent tax rate, so both countries will collect $5 in revenue ($50 in taxable income per country multiplied by 10 percent). At

Figure 3-3. Statutory Corporate Tax Rates Across Countries



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Sources: International Monetary Fund; Organisation for Economic Co-operation and Development; Singapore Department of Statistics; U.N. Conference on Trade and Development; World Bank; CEA calculations.

Note: Select low-tax countries are Bermuda, British Virgin Islands, Cayman Islands, Ireland, Luxembourg, Montserrat, Switzerland, Singapore, and Turks and Caicos Islands. The G7 countries line does not include the United States. The corporate tax rates across G7 and low-tax countries are calculated by taking a GDP-weighted average of country-level corporate tax rates.

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[3] Scenario 3 in figure 3-2 represents the reverse outcome when Country A keeps its corporate tax rate at 15 percent and Country B lowers its corporate tax rate to 10 percent. In this scenario, multinationals will locate all of their economic activity in Country B. Country B will then collect $10 in tax revenue while Country A collects $0.

this point, Country A will not want to raise its tax rate unilaterally because doing so will drive all multinational activity to Country B, and vice versa. Thus, in equilibrium, both countries choose the lower relative tax rate and collect $5.

In this stylized example, when the countries compete to be an attractive location for multinational economic activity, they both lower their tax rates and collect less revenue. If tax competition continues, rates and revenues risk even further reduction. Both countries, however, would raise more tax revenue if they committed to cooperating (represented by scenario 1 in figure 3-2).

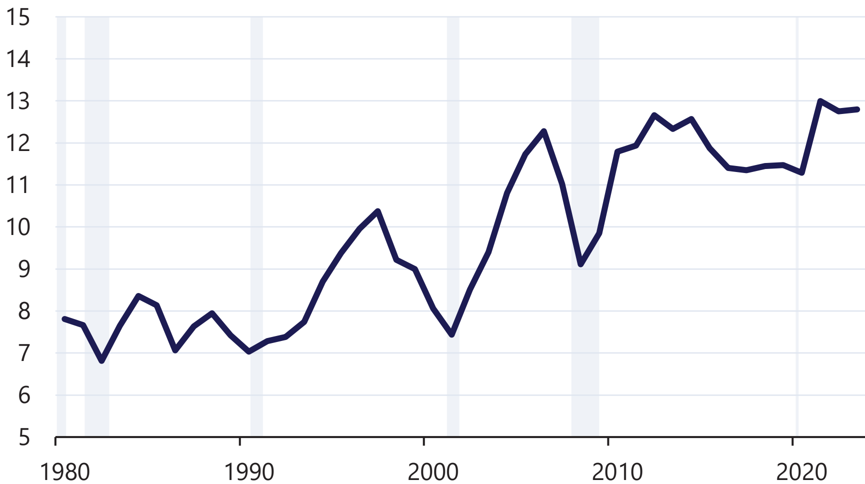
Prior to the Global Tax Deal, many countries engaged in tax competition (Duan et al. 2024). Specifically, several nations made their corporate tax systems favorable to business by reducing tax rates and providing targeted incentives to attract businesses and investment (Devereux, Lockwood, and Redoano 2008). Tax-haven countries, or low-tax countries, in particular offer low corporate tax rates to attract capital from high-tax countries (Hines 2007). Figure 3-3 shows how the U.S. statutory corporate tax rate (teal line) compares to that of other G7 countries (blue line) and select low-tax countries (navy line). The average corporate tax rate in these select low-tax countries has fallen from roughly 15 percent in 2000 to around 12 percent, where it has hovered for the last 15 years; by comparison, the other G7 countries' average corporate tax rate has steadily fallen from roughly 30 percent in the early 2000s to roughly 20 percent in 2023. In other words, tax competition has led to the race to the bottom predicted by the prisoner's dilemma, undermining government tax revenue collection.

Cross-Border Tax Planning by Multinationals

Variation in corporate tax rates across countries allows multinationals to locate economic activity in countries with relatively lower tax rates. Multinationals also reduce their worldwide tax liability through "income shifting," where they report income in low-tax countries and deductible expenses in high-tax countries in ways that are out of alignment with the economic activity that gives rise to their profits. This phenomenon is well-documented in the academic literature (Lall 1983; Grubert and Mutti 1991; Swenson 2001; Wier and Zucman 2022). Multinationals can engage in income shifting by: (i) manipulating transfer prices (e.g., prices on the sales and purchases of goods, services, and the use of intangibles between multinational affiliates) to shift income to tax-favorable countries,[4] and (ii)

[4] Transfer pricing rules require the use of an "arms-length" price, a price that would be reasonable to both parties in a transaction between unrelated parties, in transactions between affiliates within the same multinational group. However, taxpayers often fail to comply with these rules (Wier and Zucman 2022), and transfer pricing issues are the second most common uncertain tax position reported to the Internal Revenue Service (Towery 2017).

Figure 3-4. U.S. Corporate Income as a Share of U.S. GDP



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Sources: Bureau of Economic Analysis; CEA calculations.
Note: Gray bars indicate recessions. Income measure is before tax with inventory valuation and capital consumption adjustments.
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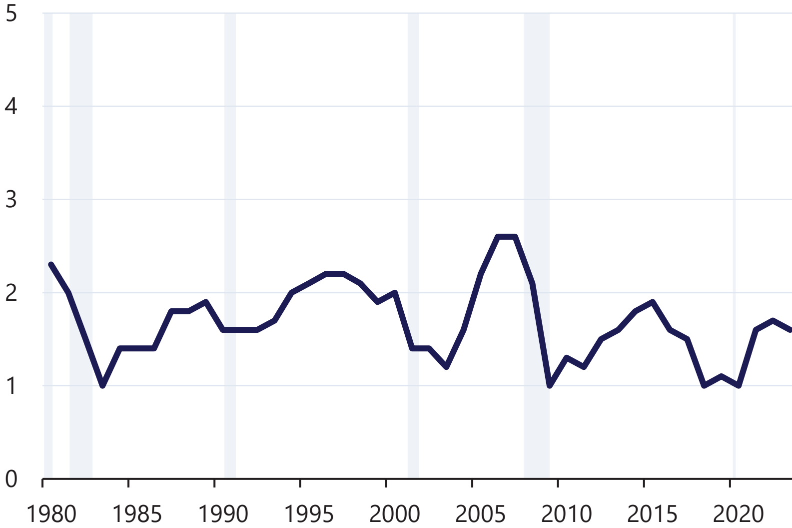
"earnings stripping" to lower taxes by strategically locating interest on debt in high-tax countries where tax deductions are more valuable (Treasury 2007). Heckemeyer and Overesch (2013) suggest that roughly three quarters of income shifting is achieved through transfer pricing manipulation and one quarter of income shifting is achieved through earnings stripping.

A more extreme way for multinationals to reduce their worldwide income tax liability is through corporate inversion. Inversions occur when multinationals change their country of domicile—or home country, usually where the parent entity is located—to take advantage of a favorable corporate tax regime (CBO 2017). Corporate inversions are not usually accompanied by major operational changes, highlighting the tax motivation for the transactions. A well-known inversion was the merger of U.S.-based Burger King and Canada-based Tim Horton's in 2014 (Capurso 2016). At the time, the U.S. corporate tax rate was 35 percent, while the corporate tax rate in Ontario, Canada was 26.5 percent (Deloitte n.d.).[5] The combined company moved its domicile to Canada, likely to secure the lower rate. The Congressional Budget Office estimates that companies inverting between

[5] Canada's federal corporate income tax rate was 15 percent, and the Ontario provincial corporate income tax rate was 11.5 percent in 2014.

Figure 3-5. U.S. Corporate Income Tax as a Share of U.S. GDP



Council of Economic Advisers
Sources: Congressional Budget Office; CEA calculations.
Note: Gray bars indicate recessions.
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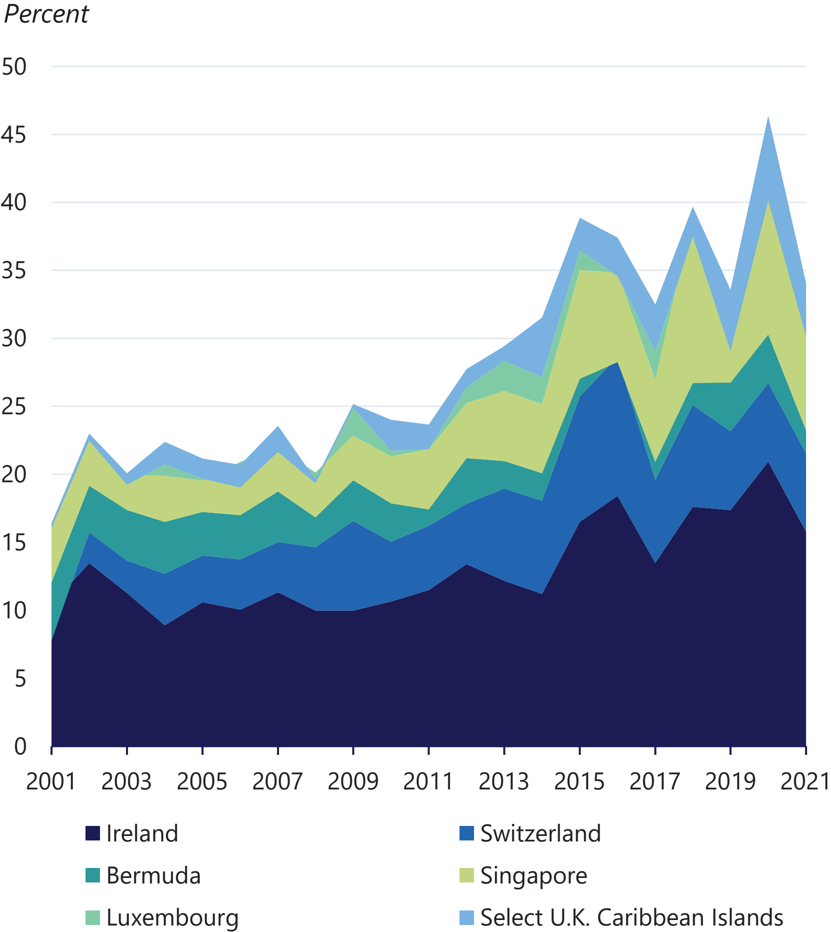
1994 and 2014 saw a $45 million reduction in their corporate tax expense after inversion on average (CBO 2017).

Strategies to exploit tax regime differences are collectively referred to as cross-border tax planning activities (Edwards, Hutchens, and Persson 2024). The effects of these activities on global corporate tax revenues are significant. As shown in figures 3-4 and 3-5, U.S. corporate income as a share of GDP has increased dramatically over the last forty years, yet corporate income taxes as a share of GDP have remained flat. Considering where foreign income is reported sheds light on the diverging trends. Among U.S. multinationals, the share of foreign income reported in the low-tax countries of Bermuda, British Virgin Islands, Cayman Islands, Ireland, Luxembourg, Montserrat, Singapore, Switzerland, and Turks and Caicos Islands more than doubled from 16 percent in 2001 to 34 percent in 2021 (figure 3-6).[6]

[6] This increase in the share of foreign income in low-tax countries occurred despite the 2017 Tax Cuts and Jobs Act reduction in the U.S. statutory corporate tax rate from 35 percent to 21 percent and reforms to the international tax system discussed later in the chapter.

Figure 3-6. Low-Tax Country Share of U.S. Multinationals' Foreign Affiliate Income



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Sources: Bureau of Economic Analysis; CEA calculations.

Note: Select U.K. Caribbean Islands are British Virgin Islands, Cayman Islands, Montserrat, and Turks and Caicos Islands. Foreign affiliate income includes majority-owned foreign affiliates only and equals pre-tax income net of income from equity investments (Blouin and Robinson 2023). When available, only equity from investments in foreign affiliates is used. Missing observations are assigned previous year's value.

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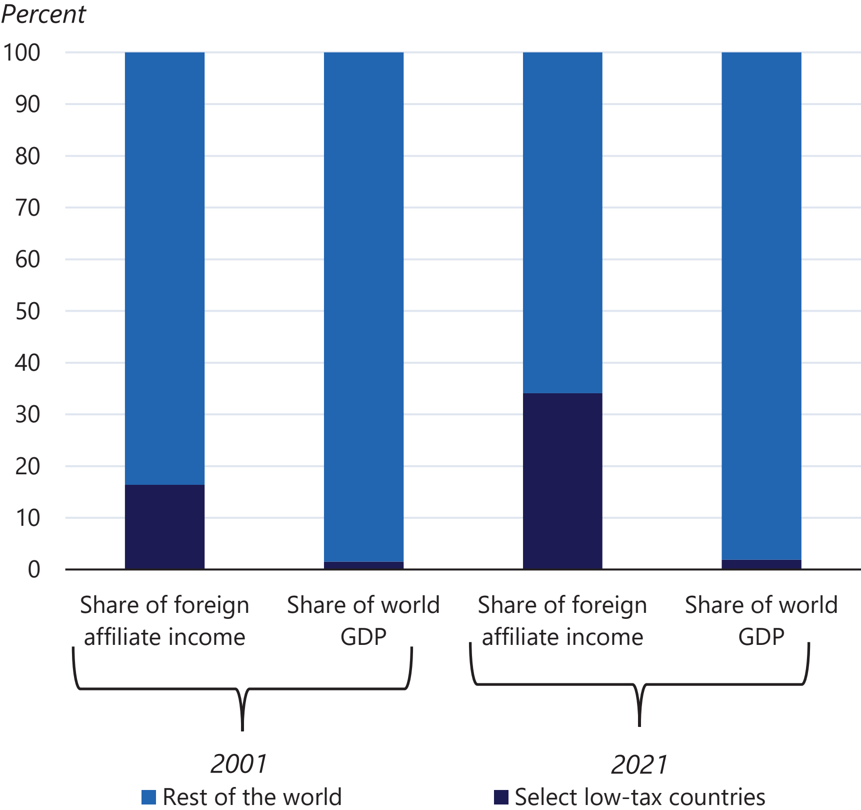
Economic Implications of Cross-Border Tax Planning

Cross-border tax planning, which includes the relocation of economic activity and income shifting, can yield production inefficiencies and social costs. In general, societal benefits can arise when multinationals allocate

their resources to locations where they are most productive. For example, many non-U.S. multinationals locate activity in the United States to access a highly skilled workforce, legal protections, and innovation (Asadurian, Derrick, and McMahon 2024). When a multinational relocates economic activity to a country with comparatively low corporate tax rates but a highly productive environment, net societal benefits may remain if the productivity gains are sufficient to overcome lost corporate tax revenue.

Figure 3-7. Share of U.S. Multinationals' Foreign Affiliate Income vs. Share of World GDP



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Sources: Bureau of Economic Analysis; International Monetary Fund; Singapore Department of Statistics; U.N. Conference on Trade and Development; World Bank; CEA calculations.
Note: Low-tax jurisdictions include Bermuda, British Virgin Islands, Cayman Islands, Ireland, Luxembourg, Montserrat, Singapore, Switzerland, and Turks and Caicos Islands. Foreign affiliate income includes majority-owned foreign affiliates only and equals pre-tax income net of income from equity investments (Blouin and Robinson 2023). When available, only equity from investments in foreign affiliates is used. Missing observations for equity income are assigned previous year's value.
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On the other hand, if a multinational relocates economic activity to a less productive location because tax planning attracts it to low corporate tax rates, then the lost corporate tax revenue is compounded by the social cost of lower productivity.[7] Yet in other cases, multinationals shift income to less productive, low-tax locations without relocating economic activity, as discussed above, which deprives the more productive locations where such activities are actually performed of the related corporate tax revenue (Wier and Zucman 2022).

The macroeconomic implications of the scenarios above vary. Cross-border tax planning can undermine the efficient allocation of resources to the extent it causes multinationals to locate economic activity in less productive locations. For example, the analysis below examines mismatches between the allocation of reported corporate income versus actual economic activity as measured by GDP, which is often a consequence of cross-border tax planning.

The imbalance between the share of income earned in low-tax countries and the share of world economic activity occurring in low-tax countries suggests that multinationals record their income in low-tax countries for the tax benefit, not because the locations are conducive to growing their businesses. Figure 3-7 compares the share of U.S. multinational foreign affiliate income earned in select low-tax countries and the rest of the world to the relative GDP shares for the locations in 2001 and 2021.[8] In 2001, 16 percent of foreign affiliate income was reported in the select low-tax countries, which earned only 2 percent of total world GDP. In other words, the share of U.S. multinational income located in the low-tax countries was disproportionately larger than local GDP. By 2021, the gap had widened. The share of foreign affiliate income earned in the low-tax countries more than doubled to 34 percent, while the countries' GDP share remained at 2 percent. The trend suggests that cross-border tax planning likely reduces the U.S. corporate tax base without generating gains in economic output.

Unilateral Country Actions to Curb Cross-Border Tax Planning

To thwart cross-border tax planning activities and preserve corporate tax revenue, some countries have implemented policies unilaterally. For example, corporate anti-inversion rules have been used to discourage multinationals from relocating their headquarters to lower-tax countries (Yang and Aquilino 2016). Interest barrier rules limit interest deductibility amounts

[7] The scenarios described here are simplified for illustrative purposes. There would potentially be other tradeoffs and social cost/benefit issues associated with, for example, balancing corporate taxation and revenue needs with optimizing corporate investment, productivity, employment, and other factors, both from the perspective of a given country and globally.

[8] A foreign affiliate of a multinational is an entity that is partially or wholly owned by the multinational and is located in a country other than the multinational's home country (BEA 2018).

to prevent multinationals from holding excess debt in high-tax countries (Knauer and Sommer 2012). Controlled foreign corporation regimes levy income taxes on the foreign income of domestic companies to discourage shifting income to low-tax countries (Arnold 2012).

In the United States, the 2017 Tax Cuts and Jobs Act (TCJA) created three provisions that attempted to discourage cross-border tax planning, in addition to reducing the corporate tax rate from 35 percent to 21 percent (Congress 2017). First, the Global Intangible Low-Taxed Income (GILTI) provision levies a minimum tax on low-taxed foreign income associated with intangible assets (with an offsetting partial Foreign Tax Credit). Second, the Foreign-Derived Intangible Income deduction rewards companies that keep intangible assets within the United States with a reduced effective tax rate. Third, the Base Erosion and Anti-Abuse Tax applies a minimum tax to multinationals making large payments to foreign affiliates, a common strategy for shifting income outside of the country.

Importantly, because unilateral actions do not invoke global cooperation, they fail to overcome the prisoner's dilemma, which allows international tax competition to persist and enables multinationals to continue exploiting differences in tax regimes to lower their income tax liability. Indeed, the TCJA failed to stop cross-border tax planning: Clausing (2024) finds that the provisions have had indeterminate effects on cross-border tax planning, and figure 3-6 shows U.S. multinationals continue to report substantial income in low-tax countries.

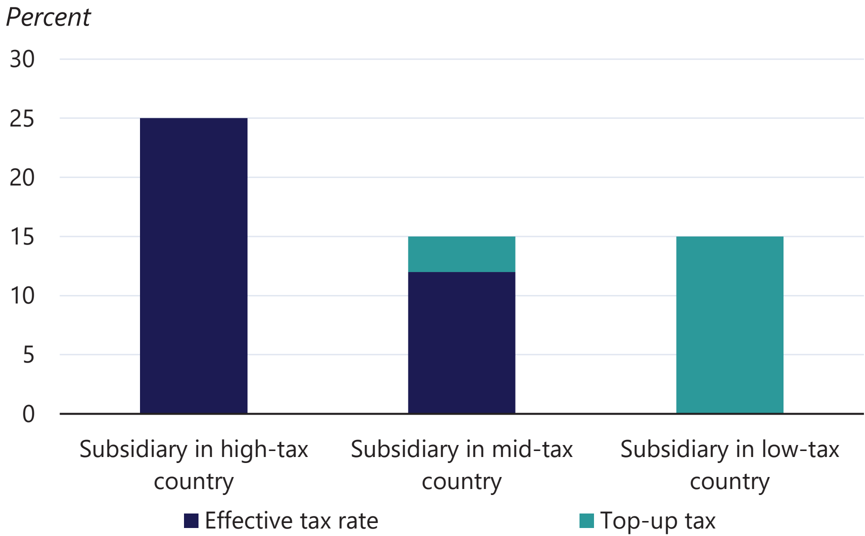
Addressing the Dilemma: Global Coordination

The Global Tax Deal outlines two pillars of reform (OECD 2021b). Pillar One, discussed in the next section of this chapter and not yet finalized, addresses where multinationals pay income taxes. Pillar Two, the Model Rules of which were published in December 2021 and are being implemented by countries around the world, addresses how much multinationals pay in income taxes (OECD 2021c).

Pillar Two aims to reduce tax competition by ensuring large multinationals pay a minimum level of tax regardless of where they operate. Multinationals with at least €750 million ($817 million in October 2024) in global revenues are subject to a global 15 percent minimum tax, effectively increasing taxes on multinationals with income in low-tax countries (OECD 2022). The minimum tax addresses the prisoner's dilemma arising from international tax competition by structuring payoffs such that any country's best option is to cooperate when setting corporate tax policies.

Pillar Two relies on three self-reinforcing mechanisms to ensure multinationals pay the 15 percent global minimum tax (OECD 2022). The mechanisms also incentivize countries to participate in Pillar Two. The first

Figure 3-8. Illustrative Example of Pillar Two Provisions for U.S. Multinationals



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Sources: Organisation for Economic Co-operation and Development; CEA calculations.
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mechanism is the Income Inclusion Rule, which is applied by the home country to a multinational's parent entity. Under the rule, the parent entity must calculate the effective tax rate the multinational faces in each country where it has a subsidiary.[9] For any country in which the multinational pays an effective tax rate of less than 15 percent, the home country imposes an additional tax, commonly known as a "top-up" tax, to account for the difference. The Income Inclusion Rule reduces incentives for multinationals headquartered in countries with such a rule to offshore income to low-tax countries.

For example, suppose the United States implements an Income Inclusion Rule and a U.S. multinational has three subsidiaries: the high-tax subsidiary has an effective tax rate of 25 percent, the mid-tax subsidiary has an effective tax rate of 12 percent, and the low-tax subsidiary has an effective tax rate of 0 percent. In figure 3-8, the teal area represents the difference between the effective tax rate the U.S. multinational pays in each country

[9] The effective tax rate equals the ratio of taxes paid in the country to domestic Global Anti-Base Erosion (GloBE) income in the country. GloBE income is financial reporting income adjusted to more closely align with the concept of corporate taxable income. See Hanlon and Nessa (2023) for a detailed discussion of the adjustments.

and the 15 percent global minimum tax. Under the Income Inclusion Rule, the United States collects the extra tax revenue represented by the teal area.[10]

The second mechanism is the Undertaxed Payments Rule (OECD 2020). The rule is applied to subsidiaries of multinationals headquartered in high-tax countries that do not implement an Income Inclusion Rule.[11] The Undertaxed Payments Rule incentivizes countries to participate in Pillar Two because if they fail to do so, they sacrifice revenue to other countries. Countries with the Undertaxed Payments Rule can disallow deductions for subsidiaries located within their borders if any other entities of the same multinational group pay an effective tax rate of less than 15 percent. The rule effectively allows countries who have signed on to Pillar Two to ensure that any multinationals with subsidiaries operating within their borders pay a global minimum tax of 15 percent, regardless of where the parent company is located. Notably, the Income Inclusion Rule has priority over the Undertaxed Payments Rule; that is, the latter cannot be applied to multinationals headquartered in countries that have implemented an Income Inclusion Rule (OECD 2020).

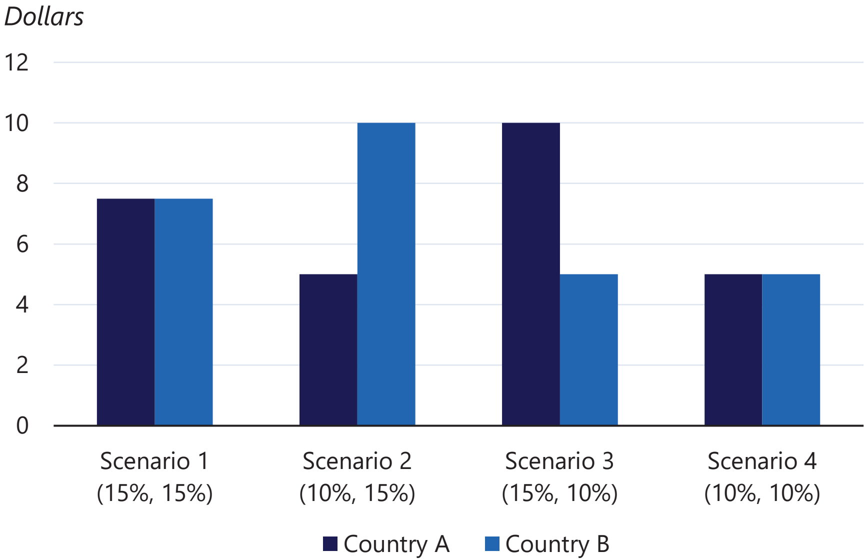
Continuing the previous example, suppose the United States does not implement an Income Inclusion Rule but the high-tax subsidiary country implements an Undertaxed Payments Rule. The Undertaxed Payments Rule allows the high-tax subsidiary country to collect the extra tax revenue represented by the teal area in figure 3-8.

The third mechanism is the Qualified Domestic Minimum Top-up Tax, which addresses situations where a country's tax rate falls below the global minimum tax rate (OECD 2023c). In this case, the country can apply its own top-up tax to ensure that large multinationals operating within its borders pay at least the global minimum tax rate. Adoption of a Qualified Domestic Minimum Top-up Tax is voluntary but self-reinforcing: If a country with a tax rate below 15 percent does not impose a Qualified Domestic Minimum Top-up Tax and a multinational subsidiary in the country pays an effective tax rate below 15 percent, other countries will be able to collect the top-up tax via the Income Inclusion Rule or Undertaxed Payments Rule. In other words, the low-tax country sacrifices tax revenue to another country and

[10] The U.S. GILTI regime in its current form does not qualify as an Income Inclusion Rule because the effective GILTI tax rate is less than 15 percent and the tax is calculated on a global basis rather than a country-by-country basis. Levying a minimum tax on a global basis enables multinationals to pay less than 15 percent tax in low-tax countries because tax rates are averaged across high- and low-tax non-U.S. countries in which they operate. Further, some design features of the GILTI regime create incentives for U.S. multinationals to shift income outside of the United States (Treasury 2024).

[11] The OECD established a transitional safe harbor where no tax will be payable under the Undertaxed Payments Rule for any undertaxed income of a multinational in its ultimate parent entity country if that country applies a corporate income tax rate of at least 20 percent (OECD 2023b). The safe harbor will defer the application of the Undertaxed Payments Rule to such income until 2026.

Figure 3-9. Prisoner's Dilemma-Based Corporate Tax Revenue Under Global Tax Deal Pillar Two



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Sources: Organisation for Economic Co-operation and Development; CEA calculations.
Note: Figure shows the prisoner's dilemma-based corporate tax revenues collected by Countries A and B under the Global Tax Deal Pillar Two. The first term in parentheses is the corporate tax rate set by Country A, and the second term in parentheses is the corporate tax rate set by Country B. This example assumes that total economic activity is held constant, meaning multinationals can only change the allocation of economic activity across countries, multinationals report income where their economic activity is located, and total taxable income equals $100.
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would be better off enacting a Qualified Domestic Minimum Top-up Tax to collect the tax revenue. Consistent with this incentive, multiple low-tax countries have announced their intention to impose a Qualified Domestic Minimum Top-up Tax, and Bermuda has increased its statutory corporate tax rate from 0 percent to 15 percent (Sullivan 2023; PwC 2024a).

Building on the ongoing example, if the mid-tax subsidiary country and the low-tax subsidiary country do not want to forgo revenue, they can collect the tax revenue represented by their respective teal areas by enacting a Qualified Domestic Minimum Top-up Tax.

Thus, the proposition that Pillar Two lays out to countries is quite simple: As long as at least one country involved implements one of the Pillar Two provisions, the tax revenue up to a 15 percent effective tax rate (represented by the teal area in figure 3-8) is available for collection. Countries can

either adopt one or more of the Pillar Two provisions and collect their share or allow other countries to collect the additional tax revenue.

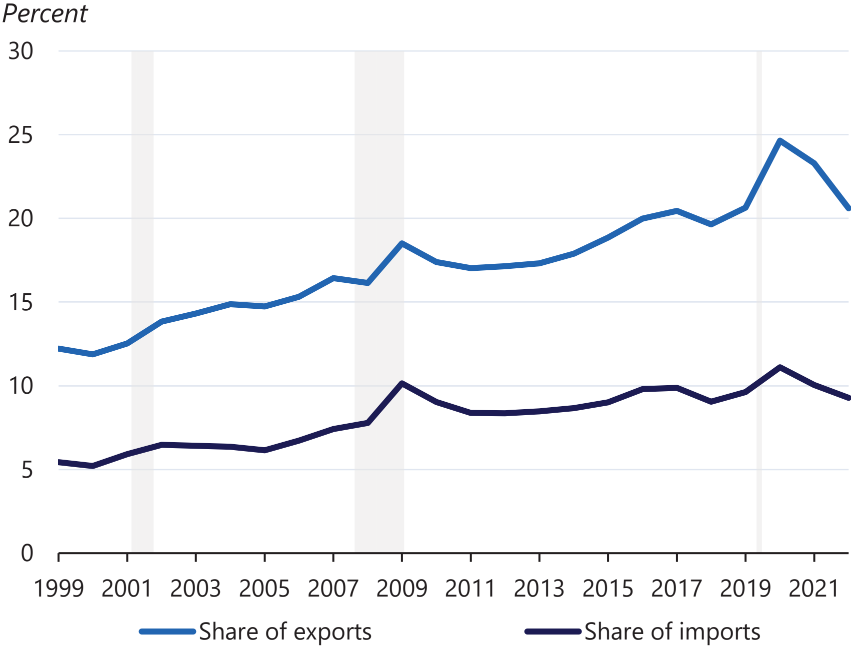
Revisiting the two-country prisoner's dilemma example, Pillar Two restructures the payoffs such that each country's best option is to cooperate. Figure 3-9 shows the adjusted payoffs. As before, if both countries have a corporate tax rate of 15 percent, as described in scenario 1, multinationals choosing whether to locate economic activity in Country A or Country B will be indifferent between them, so both countries will collect $7.50 in tax revenue ($50 in taxable income per country multiplied by 15 percent).

The innovation of Pillar Two is that the three mechanisms collectively make multinationals indifferent between Countries A and B, even if one of them chooses to lower their tax rate, because multinationals will pay 15 percent tax regardless. Pillar Two therefore removes countries' incentives to lower their corporate tax rates. Consider scenario 2 of figure 3-9. If Country A reduces its tax rate to 10 percent and therefore does not participate in Pillar Two, it will collect only $5 in tax revenues on the $50 of income within its borders. This is because the Pillar Two provisions enable Country B to collect extra taxes so that multinationals still pay an effective rate of 15 percent on Country A income. Country A collects 10 percent on the $50 earned within its borders, while Country B collects 15 percent on the $50 earned within its borders plus 5 percent on the $50 earned in Country A. Country A only collects $5, while Country B collects $10. Neither country has an incentive to defect from the agreement represented by scenario 1 of figure 3-9 and should therefore cooperate. This is in contrast with the pre-Pillar Two payoff structure, where both countries could earn higher payoffs by lowering their corporate tax rate relative to the other country.

Overall, Pillar Two overcomes the prisoner's dilemma by eliminating a country's incentive to reduce its corporate tax rate below 15 percent.[12] In doing so, it protects future global corporate tax revenues by curbing tax competition. This is particularly important given the fiscal challenges facing countries around the world (Dabla-Norris, Di Gregorio, and Cao 2024). However, its ultimate success depends on countries enacting legislation to incorporate Pillar Two into their national laws. The Organisation for Economic Co-operation and Development published the Model Rules in December 2021 (OECD 2021c). As of September 2024, 31 countries, including most EU members, Canada, Japan, Liechtenstein, Malaysia, New Zealand, Norway, South Korea, Switzerland, Turkey, the United Kingdom, and Vietnam, have enacted legislation to incorporate Pillar Two (PwC 2024b). Another 34 countries have proposed legislation or announced plans for implementation. The United States has not yet passed legislation to enact

[12] The Pillar Two 15 percent tax rate represents a floor, so countries may choose to have a higher global tax rate. For example, in the United States, the President's FY 2025 Budget proposes a 21 percent GILTI tax rate (Treasury 2024).

Figure 3-10. Digital Services as a Share of U.S. Trade



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Sources: Bureau of Economic Analysis; Census Bureau; CEA calculations.

Note: Gray bars indicate recessions. Digital services are defined as services potentially enabled by information and communication technology.

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Pillar Two, though the FY 2025 President's Budget proposes one path to implementation (White House 2024).

Digitalization and Rethinking Taxing Rights

In addition to cross-border tax planning activities, the rise of the digital services business model creates unique taxation issues. Many traditional tax systems focus on production location to determine taxing rights, meaning multinationals have historically paid income tax where they produce goods or services, rather than where their customers are located (Nersesyan 2021). However, digital services can be produced across multiple countries or on the internet.

Consider the following hypothetical scenario of a U.S. multinational operating a search engine available to users worldwide. When a business in Canada buys advertising space on the U.S. multinational's search engine and the advertisements are viewed by Canadian consumers, which country has

Table 3-1. Digital Services Tax Implementation Timeline

2019	*2020*	*2021*	*2022*	*2023*	*2024*
France	Argentina	Kenya	Nepal	Uganda	Canada
	Austria	Spain	Tanzania		Colombia
	Italy				Sierra Leone
	Poland				
	Tunisia				
	Turkey				
	United Kingdom				

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Sources: KPMG; CEA calculations.
Note: Table lists countries that have enacted a digital services tax. Countries are listed under the year that their digital services tax went into effect. Canada's digital services tax, which went into effect on June 28, 2024, retroactively applied to revenues earned as of January 1, 2022.
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the right to tax the advertising profits? Under a traditional tax system, the United States has taxing rights because the multinational physically operates in the United States and does not have a physical presence in Canada.

To provide perspective on the magnitude of cross-border digital services activity, figure 3-10 shows that the share of U.S. trade involving digital services has increased from 14 percent to 21 percent of exports and from 6 percent to roughly 9 percent of imports over the past two decades. The growth in digital services has exacerbated the tension between traditional tax systems and the global nature of multinationals.

In response to the rise of digital services activity, some countries have unilaterally attempted to levy taxes on revenue multinationals generate from customers within their borders (KPMG 2024). Often referred to as digital services taxes, they are grounded in part on the claim that users create value for digital services companies, and these companies therefore do not pay enough tax in the countries where those users are located (Stotzky and Fano 2023). Generally, countries impose the taxes on large multinationals based on total revenue associated with specific digital services (e.g., advertising, online marketplaces, cloud services, social networks, and online dating).

To illustrate the prevalence of digital services taxes, table 3-1 provides a timeline of implementation around the world. In addition to the 16 countries listed in the figure, other countries have announced intentions to implement a digital services tax.

A country-by-country approach to taxing digital services is problematic for at least three reasons. First, unilateral digital services taxes may pose potential barriers to international trade to the extent they disproportionately burden or restrict the economic activities of the implementing country's

trading partners. One approach that could be considered discriminatory is when a country sets a revenue threshold on its digital services tax such that foreign multinationals are disproportionately impacted by the tax and domestic multinationals are disproportionately excluded from it. Foreign multinationals subject to discriminatory digital services taxes may then be forced to compete on unfair terms. The discrimination concern is especially pronounced for U.S. multinationals because they represent a plurality of the largest global digital companies (Forbes 2024).

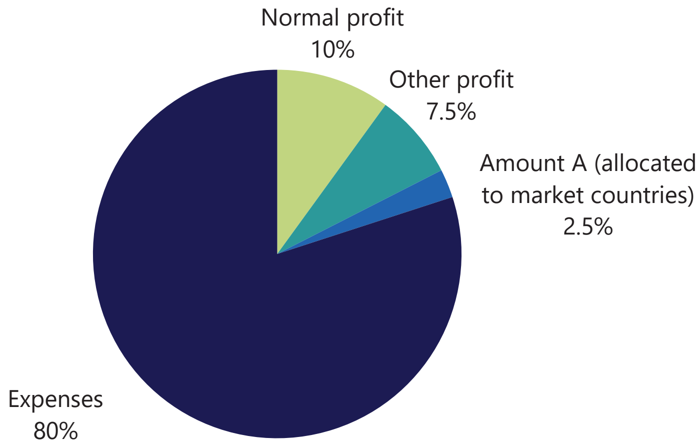
Second, as discussed in Hines (2023), countries acting unilaterally have incentives to impose excessively high tax rates on digital multinationals because the costs of higher taxes (i.e., reduced economic activity) are borne by all countries in which the digital multinationals have users. For example, imagine a European country levies a tax on the digital services revenue of a U.S. multinational providing a search engine. Because the tax reduces the multinational's after-tax profits, the multinational could respond by reducing economic output, such as reducing the quality of its search engine. The reduced search quality would be borne by all of the multinational's worldwide consumers, not just those in the European country. Thus, because the European country collects all the tax revenue generated by its consumer activity but bears only a portion of reduced worldwide economic activity, the European country is incentivized to impose inefficiently high tax rates on digital services activity. Indeed, all countries where the U.S. multinational has users have the same incentive to impose significant taxes. This ultimately can result in a reduction of economic activity, which erodes the global tax base.[13] These incentives underscore the need for a cooperative approach to taxing digital services activity.

Third, when digital services are taxed unilaterally, countries do not coordinate to ensure that the same revenues are not subject to multiple layers of taxation. In other words, without a coordinated method of apportioning the revenues, the multinational can end up paying multiple layers of tax on the same advertising revenues. Further, because digital services taxes are levied on revenues rather than profit (revenues minus expenses), the multinational could face digital services taxes, and potentially multiple layers of digital services taxes, even if it is not profitable. For example, a multinational that earns revenues of $1 million and incurs expenses of $1.5 million reports net losses of $500,000. If a digital services tax is levied on the multinational's revenues rather than its profit, the multinational might not have the wherewithal to pay the tax because its expenses exceed its revenues.

Given the concerns with a unilateral approach to cross-border digital services taxation, Pillar One of the Global Tax Deal would replace the

[13] It is also important to consider the economic incidence of digital services taxes. To the extent that customer demand is inelastic, passing digital services taxes on to customers through increased prices could reduce the impact of digital services taxes on multinationals' economic activity.

Figure 3-11. Illustrative Example of Pillar One Amount A for Multinational Earning a 20% Profit



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Sources: Organisation for Economic Co-operation and Development; CEA calculations.
Note: Figure illustrates the computation of Amount A for a multinational with global revenues above 20 billion euros that earns profit equal to 20 percent of revenues.
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existing patchwork of digital services taxes with a unified framework for levying taxes based in part on the location of a multinational's customers (OECD 2023d). Specifically, Pillar One reallocates a portion of a multinational's taxable profit, referred to as Amount A, to its "market countries," defined as countries where its customers are located regardless of where its physical operations are located or where value is actually created (OECD 2023d). For example, Canada would be a market country for a U.S. multinational operating a search engine and earning revenue from Canadian businesses advertising to Canadian consumers via the search engine, even if the multinational has no physical presence in Canada.

Amount A is a portion of a multinational's residual profit, calculated as 25 percent of profit exceeding 10 percent of revenues (OECD 2023e). For example, say a large U.S. multinational operating a search engine earns profit equal to 20 percent of its revenues (see figure 3-11). Pillar One deems the first 10 percent as routine and the associated taxing rights would therefore not be reallocated from the multinational's home country to market countries. Twenty five percent of the remaining 10 percent (i.e., 2.5 percent) represents the multinational's Amount A income. The right to tax the Amount A income would be reallocated to market countries in proportion to the multinational's sales distribution across the market countries.

Levying taxes on profit rather than revenues ensures that multinationals with low or negative profits do not face taxes that they do not have the wherewithal to pay. In cases where multiple countries have claims to a multinational's residual profit, the profit is allocated across countries according to a formula based on final sales in each country. Tax credit and deduction rules help ensure that digital services profits are not taxed multiple times (OECD 2023f).

Pillar One alters the authority of market countries to tax the profits of certain multinationals based on the multinational's sales to customers within their borders, regardless of the physical location of the multinational's assets (OECD 2023e). The Amount A rules apply only to multinationals with global revenues above €20 billion ($21.8 billion in October 2024) and profitability above 10 percent of revenues (OECD n.d.). Devereux and Simmler (2021) report that 78 of the world's largest 500 companies would likely be affected by Pillar One, with roughly 64 percent of Amount A income associated with multinationals headquartered in the United States.

Although Pillar One Amount A applies to large multinationals across different industries, its coordinated approach to taxing digital services addresses the global rise in digitalization.[14] Negotiations are ongoing to finalize the Pillar One guidelines. As noted, a growing number of countries have implemented or plan to implement digital services taxes. Pillar One would replace the existing patchwork of digital services taxes, effectively prohibit new digital services taxes, and resolve substantial uncertainty regarding their fate around the globe.

Why the United States Would Benefit from Adopting the Global Tax Deal

In October 2021, U.S. negotiators agreed with over 130 other countries to develop a version of Pillars One and Two of the Global Tax Deal that includes certain pre-agreed key elements, maintaining that U.S. participation would level the playing field for U.S. businesses and protect U.S. workers

[14] Another element of Pillar One (commonly known as "Amount B" or the "simplified and streamlined approach") aims to simplify transfer pricing rules for certain routine wholesale distribution activities of multinationals (OECD 2024). As noted previously, multinationals sometimes manipulate transfer prices on transactions between affiliates to shift income between countries. This leads to a corresponding shift of the tax base between countries. Wholesale distribution transactions are extremely common within multinational groups and are relatively easy to price. However, despite their frequent nature and the ease of pricing them, these transactions are notorious for generating costly disputes, not only between taxpayers and tax administrations, but also between tax administrations (Sutton 2024). The Amount B provision of Pillar One is intended to improve tax certainty, reduce tax compliance and tax administration costs, and improve efficiencies in the tax system by providing simplified and streamlined transfer pricing rules for routine wholesale distribution activities.

(Yellen 2022). Although the Pillar One guidance is not yet finalized, the President's FY 2025 Budget proposes multiple measures designed to bring the United States into compliance with Pillar Two (Treasury 2024). The measures include modifying the GILTI rules to be applied on a country-by-country basis, raising the minimum tax rate on GILTI to 21 percent, and adopting an Undertaxed Payments Rule.

Ultimately, legislative action would be required to bring the United States into compliance with the Global Tax Deal. The United States has strong reasons to enact such legislation, including potential revenue generation and more efficient allocation of economic resources.

Potential Revenue Generation

The global race to the bottom and the rise of cross-border tax planning have contributed to growing budget deficits. The Congressional Budget Office projects that the U.S. national deficit will rise to a peak of 7.1 percent of GDP in 2033 as the aging population increases Social Security and Medicare spending and revenues do not keep pace (CBO 2024b). High deficits could present challenges, including limiting the government's ability to finance coordinated federal responses to negative macroeconomic shocks, crowding out private investment, and raising government borrowing costs (Boskin 2020). Although analysts do not agree on a tipping point at which debt levels become economically harmful (Caner, Grennes, and Koehler-Geib 2010; Yang and Su 2018; Gokhale and Smetters 2023), recent and projected trends underscore the need for revenue-raising tax reform, including from multinationals, that can ensure the United States is on a sustainable fiscal path.

Given that many U.S. multinationals are already operating in countries that have enacted Pillar Two legislation, the United States will lose out on revenue if it does not adopt the deal. As long as any single country where a multinational operates has enacted an Undertaxed Payments Rule, the multinational must pay the 15 percent minimum tax in all countries in which it operates. Other countries may therefore capture tax revenue that would otherwise flow to the United States. If the United States adopts the Global Tax Deal, it will collect the top-up tax on U.S. multinationals' foreign income. If the United States does not adopt the deal, other countries will collect the top-up tax on U.S. multinationals' foreign income via their Undertaxed Payments Rule. Indeed, the Income Inclusion Rule, Undertaxed Payments Rule, and Qualified Domestic Minimum Top-up Tax are designed to incentivize countries to adopt the Global Tax Deal because they will miss out on potential tax revenue, and even surrender the revenue to other countries, by failing to adopt.

Scoring the prospective revenue from U.S. adoption of Pillar Two is challenging, given the many variants of how countries can adopt and how

multinationals can change their income shifting behavior. However, the CEA's view is that U.S. adoption of Pillar Two is highly likely to generate new revenues by stabilizing the international tax system and ending the race to the bottom, thus allowing the United States to more sustainably and fairly tax multinationals' income.

More Equitable and Efficient Economic Resource Allocation

As discussed earlier, international tax competition resulted in a significant reduction in average corporate tax rates over the past two decades. To the extent U.S. multinationals relocate economic activity to less productive locations because they are attracted to low corporate tax rates, lost corporate tax revenue is compounded by the social cost of lower productivity. Further, U.S. multinationals shifting income to less productive, low-tax locations without moving economic activity out of the United States deprives the United States of the related corporate tax revenue. The Global Tax Deal alleviates this distortionary behavior.

Domestic businesses cannot engage in cross-border tax planning activity, making it harder for them to compete with multinationals as they must earn greater pre-tax profits to make the same after-tax profits as multinationals. The Global Tax Deal levels the playing field for domestic U.S. businesses by disincentivizing cross-border tax planning. In doing so, the deal also encourages businesses to allocate capital based on workforce talent and market factors instead of tax minimization strategies.

The revenue thresholds for digital services taxes generally result in the taxes being applied to large multinationals, which are disproportionately based in the United States. A 2019 report by the Office of the U.S. Trade Representative indicates that eight of the nine firms potentially subject to France's proposed Digital Services Tax on advertising revenue at the time were based in the United States and more than 75 percent of digital advertising in France was accounted for by U.S.-based Alphabet (formerly Google) and Meta (formerly Facebook) (USTR 2019). Pillar One's worldwide efficacy therefore depends on U.S. approval. Without Pillar One, digital services taxes will continue to proliferate, leading to excessively high digital services tax rates and double taxation that will disproportionately harm U.S. multinationals.

Adopting the Global Tax Deal will also enable multinationals to reallocate resources used for tax planning and tax compliance to more productive uses. Multinationals often hire employees or outside advisers specifically dedicated to optimizing their income shifting strategies. U.S. adoption of the Global Tax Deal would bring congruence and stability to the international tax system, which will reduce tax uncertainty for U.S. multinationals

and make the monetary investments in tax-motivated income shifting less profitable.

Conclusion

Despite significant macroeconomic shocks and geopolitical tensions over the past decade, the global economy remains deeply interconnected. Given the integrated world economy, the rise of digital services, and the distortionary incentives that result from tax competition, a multilateral tax system aligned with the nature of today's multinationals would benefit the United States and the world. International tax coordination will evolve as countries learn whether the provisions are functioning as intended. But given that multinationals based in the United States represent a substantial portion of global GDP, the country's participation in any international tax agreement is crucial for the system's effectiveness and efficiency.

Many provisions of the 2017 Tax Cuts and Jobs Act are set to expire at the end of 2025, giving U.S. lawmakers an opportune moment to consider the Global Tax Deal (CRS 2024). The impending sunsets, combined with the need for more revenue to address growing budget deficits, have generated much discussion about the future of the U.S. tax system, including multinational taxation. From the perspective of efficiency, fairness, productivity, and fiscal sustainability, the United States would benefit from adopting the Global Tax Deal provisions and working cooperatively with other countries to bring the international tax system into alignment with the globalized economy.