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Recasting BEPS' Pillar 2 for green FDI in developing countries

by
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Developing countries' investment policy space has been significantly reduced following global coordinated efforts to address MNEs' Base Erosion and Profit Shifting (BEPS), particularly through Pillar 2 rules. While the broad objectives of tax-coordination measures are largely beneficial, Pillar 2 rules--which establish a global minimum tax of 15% for MNEs with an annual turnover of over €750 million—are largely misaligned with the Global South's investment objectives and strategies regarding the green-transition.

There is an urgent need to address the green investment finance gap for developing countries, as highlighted by COP28, which called for the deployment of trillions of dollars to address climate change and to encourage climate-resilient development. Achieving the green transition requires in tandem efforts from multilateral development banks, private investors and governments. The focus is to ensure a conducive regulatory environment, including investment risk protection and fiscal measures.

While tax incentives are usually secondary factors influencing MNEs' location decisions, they play a prominent role for the green transition, particularly in derisking sustainable development goals-related projects. Renewable energy is now more cost-effective than fossil fuels due to lower technology and operating costs. Despite this, developing countries encounter significant challenges, the most prominent being high upfront investment costs, weak regulatory environments, government red-tape, and corruption that often hinder renewable energy projects and a just energy transition in the Global South. Fiscal incentives, while not an optimal policy tool to attract FDI, counterbalance and mitigate investment risks by facilitating higher returns. They are also a variable tool at governments' disposal that is relatively easy to implement.

Government policy shapes market behavior, innovation and investment. Thus, policy must ensure that investments in low-carbon innovation, green adjustment and transition efforts are rewarded. Such policies exist in both developed and developing countries, the former utilizing

R&D and capital allowances and credits. Preferential corporate tax rates and tax holidays are highly utilized incentives by developing countries; but, while beneficial for MNEs, they are costly for governments. Developing countries are consequently the most affected by Pillar 2 rules. Expenditure-based incentives are also targeted by Pillar 2 rules, though to a lesser degree due to substance-based exclusions that remain low (5% each for payroll and infrastructure). New green investment-incentive regimes, including reduced tax rates introduced as early as in 2021-2022, have consequently been weakened by Pillar 2.

The positive effects of Pillar 2 lie in its potential to increase domestic revenue from MNEs if a minimum tax is introduced. This could finance green investment. However, developing countries, often faced with budget deficits and challenges, prioritize critical services like public health and infrastructure, making green expenditures secondary. Pillar 2 reduces the profits of MNEs, including green-oriented ones in the developing world, through top-up taxes, a mechanism aimed at ensuring that the total amount of taxes paid on MNEs' profits in a jurisdiction is at least 15%. MNEs with the requisite capital to finance green investment would have to pay an effective tax rate of at least 15%, even if a developing country is unable to finance its green transition or climate adaptation and seeks to offer low-tax incentives to firms willing to invest.

Global tax rules need to be recast to address the investment architecture, particularly for developing countries that stand as the most socio-economically vulnerable to global warming. Several amendments to the existing Pillar 2 rules could incentivize green investment in developing countries by:

- *Introducing a green carve-out rule based on expenditure*. Capital allowance and accelerated depreciation for key green sectors (including infrastructure and technology) could be provided up to a rate of 50%.

- *Establishing transition rules*. Developing countries could opt out of Pillar 2 for green investment for a specified period of time (e.g., 3-5 years), to avoid top-up taxes.

- *Reducing the effective tax rate for green investment.* This could go from 15% to a proposed lower rate ranging between 5% and 10%, for a specified period of time.

In order to operationalize any of these proposals, it is critical to establish eligibility rules for qualifying developing countries. Furthermore, "green investment" would need to be clearly defined, by identifying specific activities that meet the required criteria with a minimum threshold of investment being met. Adequate domestic regulation and transparent verification processes would be critical to curb government-complicit corruption that has similarly been a recent challenge in the carbon credit market and broader climate governance.

The legal basis for special and differential treatment of developing countries is the common-but-differential treatment provided for under articles 2(2) and 4(3) of the Paris Agreement; it is founded on broad principles of equity. International tax law should ultimately reflect states' interests and priorities, recognize the asymmetry of states' capacity to transition and be predicated on equity. If things remain as they currently stand, BEPS rules are mis-aligned with developing countries' green transition investment, tax and finance objectives.

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