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From Impasse to Unanimity: Understanding Hungary's Position on Pillar 2

By Tim van Brederode

For decades, global minimum taxation was off the table, but a recent proposal out of the OECD has it back under consideration. It is now up to the Finance Ministers of the Member States to adopt the Pillar Two proposal in the Ecofin. The proposed reform of international taxation is transposed in an EU directive. In this blog, I discuss the recent impasse the EU countries have reached due to Hungary's veto and evaluate the objectives of the minimum tax policy against Hungary's national interests. I conclude with a debate about whether and how the directive will move forward unanimously, or, alternatively, by the procedure for Enhanced Cooperation. The procedure allows the Member States to establish common rules for a smaller group of participants.

Background

The European Union (EU) has the opportunity to greatly influence the international acceptance of Pillar Two. Should the EU be the first to adopt the minimum tax policy, other countries would likely follow. This is because the policy encourages at least one country to increase tax revenue(s), under the assumption that 'another jurisdiction will tax, if I don't'. Adopting the minimum tax across all 27 Member States first requires a unanimous vote during the meeting of The Economic and Financial Affairs Council (Ecofin). Outside of the EU, only six of the 140 countries committed to Pillar Two have begun the legislative preparations necessary for the adoption of the minimum tax.[i] Many countries seem to be waiting on the EU to make the first move. For example, the Swiss government has announced their intention to postpone an implementation of the minimum tax until they can first examine its progression in other countries.

Meanwhile, the EU's adoption of Pillar Two has hit several bumps. The first being a short-lived veto from Poland, which I elaborate on later in the blog. After resolving Poland's veto, Hungary announced its intention to vote against the directive. The position of Hungary is more worrisome. The Hungary administration's opposing position to the EU directive is supported by several political bodies, including US Congressional Republicans and the Hungarian national parliament.

The EU directive ensuring a minimum effective tax rate

The adoption of the minimum tax directive was a priority of the French Presidency of the Council of the European Union (Council) since their most recent term (beginning on the first day of 2022).

The objectives of adopting the minimum tax in the EU are two-fold, 1) to create a level playing field for businesses in the EU, and 2) to allow jurisdictions to better protect their tax bases worldwide by preventing profit shifting from high tax countries to low or zero tax countries. The level playing field can be explained as a group of countries that adhere to common rules and standards. On a global scale, common rules and standards would serve to promote international coherence of corporate taxation. The need for greater international coherence, which should limit possibilities for profit shifting by multinational enterprises (MNEs), is widely recognized and inspired the OECD.

In the first half of 2022, negotiations on the directive were held up by a few Member States. Some countries, such as Estonia, Malta, Poland and Sweden did not support the directive at first for technical reasons. These countries believed the implementation of the model rules should proceed simultaneously with Pillar One.[ii] To reach a resolution among Member States occupying this position, the Commission prioritised adopting Pillar Two and set a formal deadline for Pillar One's adoption. Should the OECD's implementation of Pillar One fail, then the Commission would have to develop a directive (similar to that of Pillar Two) to ensure the objectives of Pillar One move forward among the Member States.

After that Poland used the need for unanimity for "*political reasons*" to leverage advancing their national interests. While it was the only country blocking the adoption of the directive in the meetings that took place in April and May 2022, Poland ultimately agreed with the minimum tax after the country got its way on a separate issue. In order to persuade Poland, the Commission endorsed (and the Council approved) Poland's 35,4 billion euros plan for the recovery and resilience fund (RRF). This is the EU's plan to fund investments to help Member States recover from the Covid-19 pandemic and to stimulate green and digital transitions. The Council's approval was given in the Ecofin meeting on 17 June 2022, the date on which consensus was expected for the minimum tax. In a turn of events, which surfaced during the agenda-setting of the Ecofin meeting in June 2022, Hungary changed their position because of the same political opportunism. For over a year Hungary has been awaiting a decision for 7,2 billion euros in the RRF. The trade-off to lift Hungary's veto seems to be the approval of the funds. The release of funds to Hungary is a more controversial debate, given the EU's unaddressed concerns around the rule of law in the country that undermines EU values.

The Hungarian veto

To elaborate on Hungary's veto, we must first discuss the country's public arguments in support of their position. During prior Ecofin meetings, Hungary voted in favour of the minimum tax directive. After it became clear that Poland would agree, the Hungarian Finance Minister suggested that Hungary should oppose the directive due to "the huge pressure economies and companies are under from the war in Ukraine and rising inflation." Beyond this pressure, another Hungarian official warned of the disadvantageous effects on EU competitiveness and the potential job losses as a result of the minimum tax.

At first consideration, these arguments seem to hold water. The Ukraine war is undoubtedly taking a toll on European economies and companies, especially those in neighbouring countries. Disruptions of supply chains are directly affecting price stability, which has consequences for consumption and the cost of production. Economists have suggested these disruptions are the result of both the ongoing war and covid restrictions.

But let's take a critical lens to these arguments.

In response to the "pressure on economies… and rising inflation", the leadership in Hungary has begun preparing for a recession, despite GDP forecasts of Hungary showing positive growth for 2022 and 2023. Since corporate taxes are only levied on companies' profits, in the event that Hungary does experience a recession, companies that suffer losses would not be impacted by the adoption of Pillar Two. These companies would not have to worry about the existing corporate tax rate, let alone the top-up required to adhere to the minimum tax policy. However, MNEs may be more insulated from a recession than we might assume. A study found that affiliates of MNEs actually show consistent profits in (foreign) markets in which they operate and thus seem less sensitive to cyclical economic patterns, including recession. In this case, the minimum tax may be a bit of a hard sell for MNEs who are expecting steady profits but would serve as a significant benefit for the Hungarian government amid a recession. With the government being more likely to feel the consequences of the recession, increasing the tax on MNEs could serve as a critical lifesaver.

This is in line with budget estimates on the minimum tax policy. According to the OECD, global tax revenue is expected to increase by 150 billion US dollars annually. In addition, the EU Tax Observatory calculated tax revenues for each Member State, and their model suggests that Hungary would collect 600 million euros in additional taxes per year. The OECD revenue statistics show that the 2019 corporate tax revenue in Hungary, as is, stands around 1,6-1,8 billion euros. Thus, the increase in corporate tax revenue with the top-up tax would amount to 33-35%; a significant benefit to help keep a government, struggling through a recession, afloat.

So while the Hungarian government suggests that their veto stems from concern for companies amid the ongoing war and pandemic, this claim isn't quite justified. Companies that suffer losses won't be affected by the adoption of Pillar Two and those that maintain profits could serve as a critical benefit to the government. Now, for the second part of Hungary's argument: jobs.

It is known that a sudden increase of corporate tax rates or dogmatic anti-avoidance measures cause economic distortion on the labour market. This has historically had impacts on labour, reducing wages in the long-run. However, the current low unemployment rate in Hungary has a positive effect and generally benefits labour wages. Additionally, Hungary's current focus on attracting foreign direct investments (FDI) with incentive programs for rural regions has been creating new job opportunities. Maintaining a good climate for FDI should be possible with a minimum tax due to the gaps in global minimum taxation, in which the 15% minimum tax rate is not always 15%. This statement can be illustrated by the following:

(1) substance-based carve-outs allow for a lower effective rate than 15%.

The model rules introduced a transition period for substance-based carve-outs as a common rule, referring to tangible assets and payroll costs for employees in the jurisdiction where the MNE operates. The idea behind the safe harbour is to shield existing investment from the impact of the minimum tax. The substance-based carve-outs exclude certain income from the tax base; in this way, the prescribed 15% is calculated over a lower tax base. Hypothetically, the effective tax rate could be lower than the minimum rate after the top-up tax, meaning it still may deviate from the standard.

(2) tax incentives that favour foreign investments.

In addition to existing incentives, the option for new tax incentives is on the table as well, inspired by countries such as the United States, United Kingdom, and Switzerland that consider refundable tax credits or cash subsidies as an important tool to promote investments. Refundable tax credits would mean that the MNE follows the model rules and is paying the 15% tax rate on their profits. After that, the MNE would receive a refundable tax credit on the difference between the 15% and the pre-Pillar-Two rate (which is 9% in Hungary). This tax credit often funds a specific investment goal, such as promoting local employment or renewable energy.

After a critical analysis, it appears that Hungary has something to gain and possibly something to lose from the adoption of the minimum tax directive, which partially depends on consequent policy choices on FDI and how persistent rising inflation will be. The effects on employment for Hungary could be marginal, if the country decides to create new tax incentives and to continue in tax competition. But of course, these decisions often come down to the politics of the thing — meaning the public reasons Hungary has voiced to justify their veto are likely not the true reason at all. It is more likely that the country is using its upper hand for leverage, as discussed earlier under 'political position.'

Where does the European Union go from here?

On 1 July 2022, the Czech Republic took over the rotating EU Presidency of the Council. The Presidency's priorities on Pillar Two suggest ongoing discussions with Hungary. Despite the Czech Republic's aim for consensus on the minimum tax directive at the Ecofin in October there is no guarantee that it will be successful.

If the plan for a unanimous vote does not pan out, then there is space in the EU constitutional framework to move the implementation of the minimum tax policy forward through an alternative procedure, which would not require unanimity. Under the Enhanced Cooperation procedure, Member States can adopt the model rules amongst a smaller group of participating countries to establish cooperation amongst themselves. The provisions and conditions are set out in article 20 TEU and articles 326 to 334 TFEU.[iii] In this case, Enhanced Cooperation could leave Hungary out of the EU-wide adoption of the minimum tax policy. The participating countries in the Enhanced Cooperation approving the minimum tax directive would, therefore, not be legally binding for Hungary. Yet, the advantage for EU Member States is that they could impose top-up taxes on Hungarian low-taxed profits.

The first time this procedure was used to propose a tax directive was in 2012, to advance the financial transaction tax (FTT). The topic still divides the Member States, only 11 countries participated in the procedure for an FTT directive. At the time, it was unsuccessful when one of the participating countries blocked unanimity in the Enhanced Cooperation procedure, which was a requirement agreed upon by the participants. However, this can be prevented by deciding on a qualified majority (instead of unanimity) at the start of the procedure. Enhanced Cooperation could turn out to be the best route to adopt the minimum tax, despite the timely exercise. The use of this procedure also fuels ongoing debate about the end of the need for unanimity on (most) tax issues in the EU.

Finally, EU Member States could decide on one more route, which is advancing with the national transposition of the model rules. This idea suggests that a tax directive is not necessary and each country could choose to adopt the minimum tax domestically. Germany announced to start implementing the global minimum tax in their latest inflation relief package, without awaiting an EU directive.

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[i] The United Kingdom, South Korea and Switzerland published draft legislation. Malaysia launched a public consultation paper. Canada and Mauritius announced detailed intentions to adopt the global minimum tax in their budget plans. In the case of Switzerland adopting Pillar Two required a constitutional amendment.

[ii] Pillar One focuses on the allocation of taxing rights to source countries to establish a digital presence. This initiative is not as advanced as Pillar Two and ongoing work is currently being publicly consulted. As a result of that process, it suffers a delay which would make it challenging to implement at the same time. The timeline for Pillar One shows that a detailed legal text (in preparation for a multilateral convention) is to be expected in 2023. The Member States that could not support an initial directive in the Ecofin at the meeting of 15 March 2022 were Estonia, Malta, Poland and Sweden.

[iii] The Enhanced Cooperation procedure is discussed at length in the Kluwer International Tax Blog by Weber and Steenbergen, Enhanced cooperation: EU Implementation of Pillar 2 without unanimity, http://kluwertaxblog.com/2022/06/07/enhanced-cooperation-eu-implementation-of-pillar-2-without-unanimity/ [accessed on 26 July 2022)

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