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Pillar Two and Tax Competition: Implications for Investment Policy, Incentives, and FDI Dynamics

Abstract

This study examines how the OECD/G20 Pillar Two global minimum tax is reconfiguring international tax competition, the design of investment incentives, and foreign direct investment (FDI) dynamics. The core policy challenge is that jurisdictions that historically relied on low effective tax rates (ETRs), preferential regimes, and profit-based incentives may experience diminished competitiveness once top-up taxes apply where jurisdictional ETRs fall below the 15% minimum. Methodologically, the paper combines doctrinal and policy analysis of the Global Anti-Base Erosion (GloBE) architecture—focusing on jurisdictional ETR computation, the mechanics of top-up taxation, and the operation of transitional and permanent safe harbours—with an empirical illustration based on a structured time series (2020–2025). The dataset includes an ETR proxy, an investment-incentives intensity index, and FDI inflows measured as a share of GDP. The results show a clear movement toward minimum-tax alignment alongside a measurable reduction in the intensity of incentives, while FDI remains broadly stable in aggregate but displays sensitivity to the retrenchment of incentives. Forward-looking scenario projections for 2026–2030 indicate that jurisdictions can mitigate adverse investment effects by shifting from rate-reducing incentives toward Pillar Two–compatible instruments, notably qualified refundable tax credits, and by strengthening non-tax determinants of location attractiveness such as regulatory predictability, infrastructure quality, and human capital. The findings support a policy agenda centered on transparent, rules-based incentive frameworks, enhanced certainty mechanisms, and systematic monitoring of competitive shifts from tax-rate competition to broader investment-climate fundamentals.

Keywords: Pillar Two; global minimum tax; tax competition; investment incentives; effective tax rate; foreign direct investment

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1. Introduction

The OECD/G20 Inclusive Framework's Pillar Two global minimum tax represents a structural reorientation of international corporate tax competition. For decades, many jurisdictions sought to attract and retain mobile capital by reducing effective corporate tax burdens through low statutory rates, preferential regimes, and targeted incentives. Pillar Two constrains this strategy by introducing a coordinated top-up tax system designed to neutralize low-tax outcomes for in-scope multinational enterprise (MNE) groups. At the core of the Global Anti-Base Erosion (GloBE) Model Rules (released in 2021) is a jurisdictional effective tax rate (ETR) computation, paired with a top-up tax that arises when the jurisdictional ETR falls below the 15% minimum. This architecture alters the marginal value of tax incentives that reduce covered taxes, because any reduction in the jurisdictional ETR may be offset—partly or fully—by a compensating top-up tax elsewhere within the group's structure. In the European Union, Council Directive (EU) 2022/2523 establishes a harmonized implementation framework for large MNE groups and large-scale domestic groups, amplifying the policy salience of minimum-tax alignment and reducing the scope for unilateral, rate-centered competition.These reforms do not eliminate tax competition; rather, they change its instruments and loci. Jurisdictions retain incentives to influence real investment decisions, but the policy toolkit shifts toward instruments that are compatible with the minimum-tax regime, transparent in fiscal cost, and defensible under international coordination. The design of investment incentives becomes more tightly linked to the mechanics of GloBE—especially the determination of covered taxes, the treatment of tax credits, the timing of tax attributes, and the operation of transitional and ongoing safe harbours. Consequently, policymakers face a recalibration problem: how to preserve investment attractiveness while minimizing the risk that incentives are neutralized through top-up taxation, while also maintaining revenue adequacy and administrative feasibility. This challenge is particularly acute for economies that have historically relied on preferential regimes or narrow, sector-specific tax expenditures to compete for FDI, as the minimum tax reduces the relative advantage of lowering effective burdens for covered groups.Against this background, the present study develops a policy-analytic and empirical illustration of how Pillar Two reshapes the relationship between tax competition, incentives, and FDI outcomes. Conceptually, the paper links three elements: (i) the institutional logic of the GloBE rules—jurisdictional ETR computation, top-up tax mechanics, and safe harbours; (ii) the investment-policy implications of these rules for incentive design, including the migration from rate-reducing measures toward Pillar Two–compatible instruments such as qualified refundable tax credits and rules-based, transparent support; and (iii) the macro-investment dimension, captured through observed and projected FDI responses under alternative incentive pathways. Empirically, the paper employs a structured dataset for 2020–2025, combining an ETR proxy, an investment-incentives intensity index, and FDI inflows as a share of GDP, and complements these data with scenario projections for 2026–2030. The scenario component operationalizes a present–future comparison between a constrained-incentives pathway—where traditional rate-based tools are progressively neutralized—and an adaptation pathway—where incentives are redesigned to preserve effectiveness under GloBE while strengthening non-tax fundamentals (e.g., regulatory predictability, infrastructure, and skills). In doing so, the paper aims to provide an implementable perspective for policymakers and investment agencies seeking to navigate the transition from tax-rate competition toward broader, fundamentals-based competitiveness in a minimum-tax environment.

2. Materials and Methods

This study employs a mixed, policy–empirical design intended to connect the legal mechanics of Pillar Two to observable investment-policy patterns and to plausible future trajectories under alternative incentive strategies. The approach has two complementary components: (i) doctrinal–policy analysis of the Global Anti-Base Erosion (GloBE) rules and (ii) an empirical illustration based on a structured time-series dataset covering the period 2020–2025, supplemented by scenario projections for 2026–2030.

2.1. Policy-analytic component: GloBE design features and incentive compatibility

The policy analysis focuses on three features of the Pillar Two architecture that are most consequential for investment incentives and tax competition. First, it examines jurisdictional effective tax rate (ETR) computation, emphasizing how covered taxes and the tax base are determined and how these elements can interact with incentive instruments that reduce tax liabilities or shift the timing of recognition. Second, it analyzes the design logic of top-up taxation, including the conditions under which top-up liability arises when the jurisdictional ETR falls below 15%, and how this mechanism can neutralize the intended benefits of rate-reducing incentives for in-scope multinational enterprise (MNE) groups. Third, it assesses the role of transitional and ongoing safe harbours as administrative and compliance-reduction devices, with attention to how safe harbour availability may affect both the feasibility of incentive redesign and the short-run stability of tax outcomes during implementation.This component is conducted as a structured qualitative assessment. Relevant provisions and interpretive guidance are mapped to policy choices faced by jurisdictions—particularly whether to rely on traditional tax expenditures that lower covered taxes, or to shift toward instruments more likely to remain effective under GloBE, such as qualified refundable tax credits and rules-based, transparent support mechanisms. The output of this policy analysis is an incentive-compatibility narrative that informs the construction of the empirical scenarios and the interpretation of observed co-movements between tax-rate proxies, incentive intensity, and FDI.

2.2. Empirical illustration: dataset structure and variables (2020–2025)

The empirical component uses a structured annual time series for 2020–2025 to illustrate directional patterns consistent with the paper's conceptual model. The dataset contains three variables:

1. **Statutory ETR proxy (percent):** A rate-based indicator intended to approximate the direction of minimum-tax alignment over time. While Pillar Two relies on jurisdictional ETRs derived from financial accounting measures and covered taxes, statutory or policy-rate proxies provide a tractable indicator of the policy environment in which jurisdictions operate and adjust.
2. **Investment incentives intensity index (0–100):** A standardized index capturing the relative "strength" or prevalence of investment incentives, where higher values represent more intensive use of incentives and lower values indicate retrenchment or redesign away from rate-reducing measures.
3. **FDI inflows (percent of GDP):** A macro-level indicator used to express investment outcomes in a comparable scale across time, consistent with common empirical practice in the FDI literature.

Given the illustrative purpose and the small sample size, the analysis emphasizes transparency rather than causal identification. The empirical work begins with descriptive statistics (levels and changes over time) and proceeds to simple bivariate associations to formalize the direction and approximate magnitude of co-movements. Specifically, the study computes (i) year-to-year changes for each variable, (ii) correlation measures among the three series, and (iii) a qualitative comparison of turning points—e.g., whether declining incentive intensity is contemporaneous with higher ETR alignment and whether FDI inflows appear resilient or responsive. These techniques do not claim causal inference; instead, they provide an internally consistent illustration of how minimum-tax alignment and incentive retrenchment can co-occur and how FDI may respond under different incentive environments.

2.3. Scenario design: 2026–2030 pathways

To translate the policy analysis into forward-looking implications, the study constructs two illustrative scenarios for 2026–2030. Scenario design is anchored in the logic of Pillar Two: the diminishing effectiveness of incentives that lower covered taxes for in-scope groups, and the potential persistence of investment support where instruments are compatible with GloBE and where non-tax fundamentals improve.

- **Scenario A (Constrained-incentives pathway):** This scenario assumes continued tightening of traditional tax incentives, limited capacity to redesign instruments, and a predominantly compliance-driven approach to minimum-tax alignment. Incentive intensity is assumed to decline further, and any improvement in investment attractiveness is driven primarily by non-policy factors rather than deliberate reforms. Under this pathway, FDI inflows are expected to remain stable at best, with downside risk if incentive retrenchment is not compensated by improvements in the broader investment climate.
- **Scenario B (Adaptation and redesign pathway):** This scenario assumes active policy adjustment, including the redesign of incentives toward Pillar Two–compatible instruments—most notably qualified refundable tax credits—and incremental but measurable improvements in non-tax fundamentals such as regulatory predictability, administrative efficiency, infrastructure quality, and workforce skills. Incentive intensity is assumed to stabilize or decline more slowly, reflecting a transition from rate-reducing incentives to structured, transparent support. Relative to Scenario A, Scenario B implies a more favorable FDI trajectory, not because the minimum tax is avoided, but because policy instruments and investment-climate reforms better align with the post-Pillar Two competitive environment.

2.4. Interpretation and limitations

The combined methodology is designed to generate policy-relevant insights rather than definitive causal estimates. The time series is short, the variables are stylized, and the scenario projections are illustrative. Accordingly, conclusions are framed as structured implications derived from the interaction between Pillar Two's legal mechanics and the direction of observed macro-level patterns, rather than as statistically identified treatment effects. This design choice prioritizes clarity and implementability, enabling policymakers and researchers to translate Pillar Two concepts into a coherent analytical framework and to refine the dataset and estimation strategy in subsequent work.

3. Results

Table 1 presents the structured dataset underpinning the empirical illustration. Table 2 reports descriptive statistics for the statutory ETR proxy, the investment-incentives intensity index, and FDI inflows (percent of GDP), while Table 3 summarizes pairwise correlations to formalize the direction and approximate strength of co-movements across the series. Figure 1 visualizes normalized historical trajectories over 2020–2025 to facilitate comparison across variables measured on different scales. Consistent with the paper's conceptual expectations under Pillar Two, the historical profile indicates a pronounced upward movement in the ETR proxy toward the 15% minimum benchmark accompanied by a systematic decline in incentive intensity. Over the same period, FDI inflows remain within a relatively narrow range, suggesting partial resilience of investment outcomes despite incentive retrenchment. This pattern is consistent with the interpretation that non-tax determinants—such as macroeconomic stability, regulatory predictability, infrastructure quality, and sectoral opportunities—mediate the transmission from tax-policy adjustments to realized FDI.Scenario projections for 2026–2030 are summarized in Figures 2 and 3. Figure 2 compares alternative incentive

pathways under constrained redesign capacity versus Pillar Two–compatible redesign (including qualified refundable tax credits), while Figure 3 reports the implied FDI trajectories under the same assumptions. Taken together, the scenario outputs highlight that a shift toward compatible, transparent instruments—combined with incremental improvements in non-tax fundamentals—can stabilize the incentives profile and support higher expected FDI inflows relative to a pathway characterized by continued incentive erosion and limited policy adaptation.

Table 1. Structured dataset used in this study (2020–2025).

Year	Statutory_ETR_percent	InvestmentIncentivesIndex_0_100	FDI_inflows_percentGDP
2020	8.93	80.4	4.92
2021	9.00	77.8	4.92
2022	9.30	81.2	5.14
2023	10.04	76.5	5.29
2024	12.03	70.6	4.74
2025	14.83	61.2	4.56

Figure 1. Historical co-movement of ETR proxy, incentives intensity, and FDI inflows (normalized).

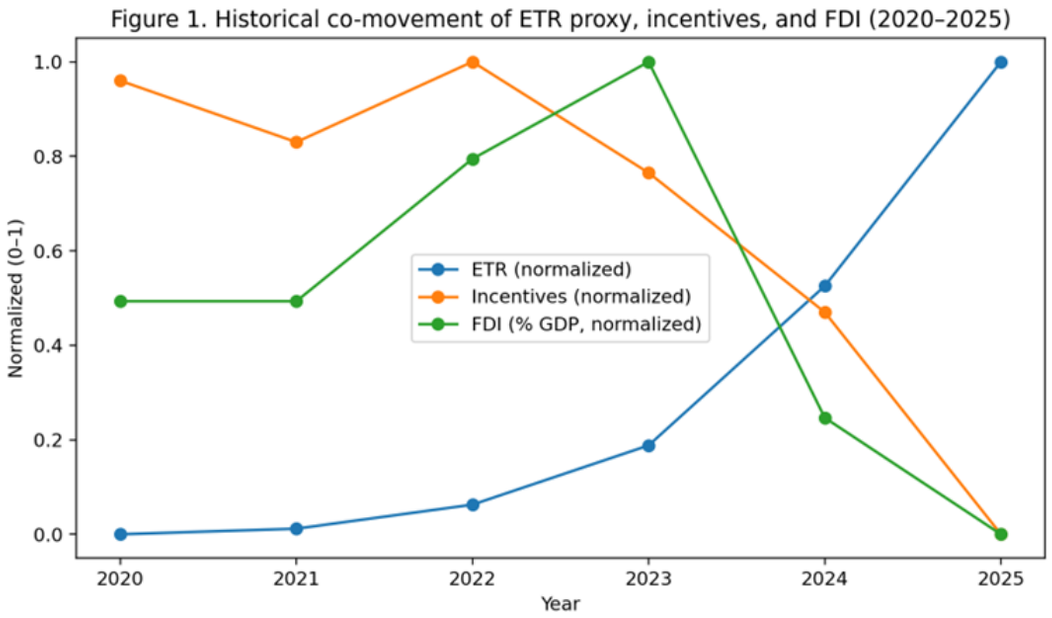


Figure 2. Illustrative incentives trajectories under Pillar Two (Scenario A vs Scenario B).

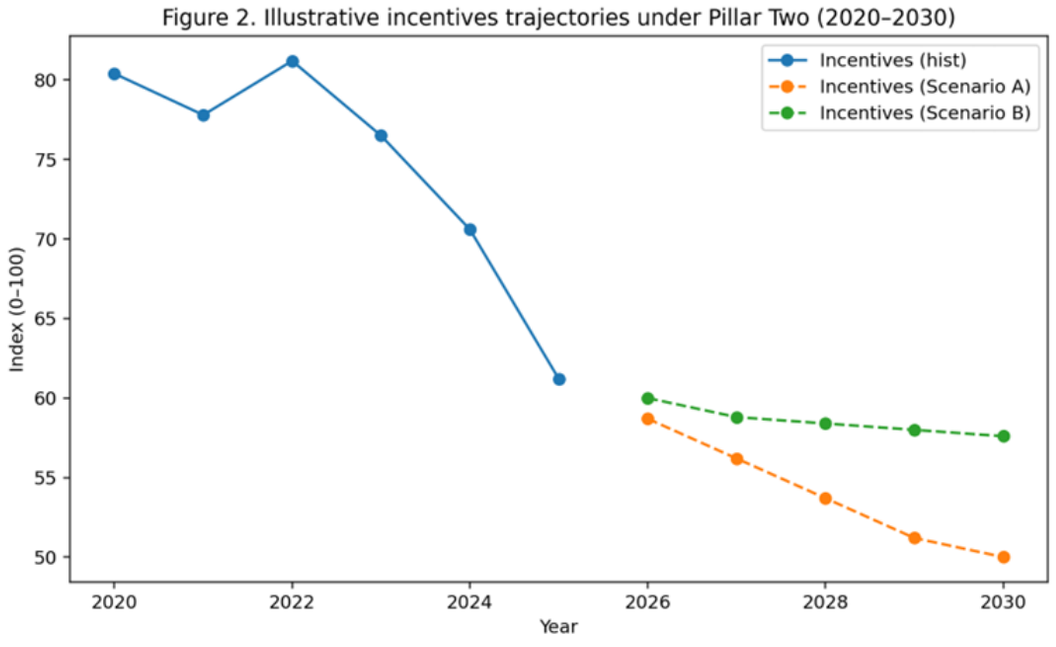
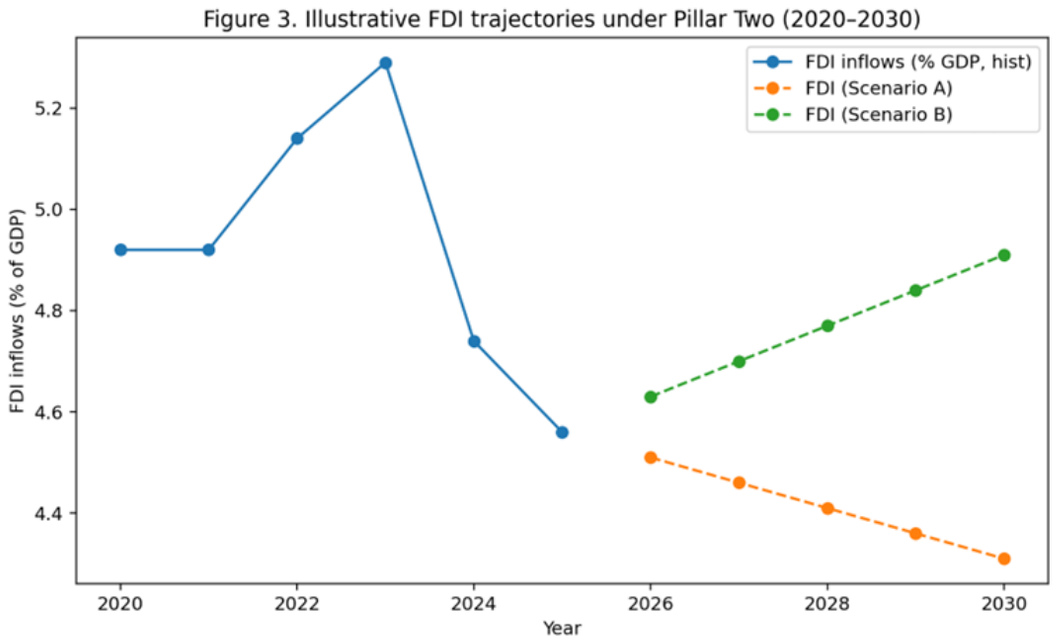


Figure 3. Illustrative FDI trajectories under Pillar Two (Scenario A vs Scenario B).



4. Discussion

The findings support the central proposition that Pillar Two meaningfully constrains traditional, rate-based tax competition by weakening the marginal effectiveness of incentives that reduce covered taxes for in-scope multinational enterprise (MNE) groups. In a minimum-tax environment, jurisdictions can no longer assume that lowering the local effective tax burden will translate into a durable advantage for covered groups, because top-up taxation is designed to recapture low-tax outcomes. This shifts the policy calculus from "how low can we set the effective rate?" toward "which instruments remain effective under the rules, and which non-tax factors can credibly improve location attractiveness?" The historical co-movement observed in the dataset—rising alignment of the ETR proxy toward the 15% benchmark alongside declining incentive intensity—accordingly aligns with an incentive-retreat dynamic: governments respond to minimum-tax alignment by scaling back or reshaping incentives that would otherwise be neutralized through top-up mechanisms.A key interpretive point is that the relative stability of FDI inflows over 2020–2025 does not imply that tax policy is irrelevant. Rather, it suggests that the transmission from incentives to investment outcomes is mediated by a broader set of determinants that frequently dominate the tax margin, particularly in periods characterized by macroeconomic volatility, institutional reforms, or sectoral shifts. Investment decisions—especially for long-horizon, capital-intensive projects—respond not only to post-tax profitability but also to regulatory certainty, administrative efficiency, infrastructure reliability, labor-market depth, access to suppliers, and perceived political risk. In this context, the observed narrow band of FDI inflows is consistent with an interpretation in which non-tax fundamentals buffer the short-run impact of incentive retrenchment, while incentives may still matter at the margin for footloose activities and for projects where location choice is sensitive to after-tax returns.The scenario projections clarify the strategic implication of this shift. Under the constrained-incentives pathway (Scenario A), continued erosion of traditional incentives generates limited scope for maintaining a fiscal advantage for covered groups, placing greater pressure on fundamentals and potentially increasing the risk that jurisdictions experience a gradual loss of competitiveness if reforms are not undertaken in parallel. By contrast, the adaptation pathway (Scenario B) produces a more favorable investment trajectory, not by circumventing Pillar Two, but by aligning incentive design with the new regime and reinforcing complementary drivers of investment. This result is consistent with the expectation that competitive strategies will increasingly prioritize Pillar Two–compatible instruments—particularly qualified refundable tax credits and transparent, rules-based

support that is less likely to be offset by top-up tax—together with institutional improvements that reduce transaction costs and uncertainty for investors. From a policy standpoint, the implication is that the "new" tax competition is likely to be more visible and governance-intensive: governments will compete through the credibility of their regulatory frameworks, the predictability of their fiscal regimes, and the quality of public services and infrastructure, rather than primarily through hidden or discretionary tax expenditures. The analysis also underscores a governance trade-off. Pillar Two may reduce the attractiveness of opaque preferential regimes, but it does not eliminate incentives; instead, it creates incentives to shift toward instruments that are administratively robust and defensible under international coordination. This elevates the importance of transparency, rule-based design, and ex ante evaluation of fiscal costs and investment additionality. Jurisdictions that respond to Pillar Two by merely compressing incentives—without developing an alternative policy mix—may face a dual downside: diminished tax-based appeal without compensating improvements in the investment environment. Conversely, jurisdictions that redesign incentives while strengthening institutional capacity can potentially convert minimum-tax alignment into an opportunity to improve the quality of their investment policy, reduce distortions, and enhance credibility with both investors and the public.Several limitations should qualify the interpretation of these results. First, the empirical component is intentionally illustrative: the dataset is short, stylized, and designed to operationalize the conceptual argument rather than to deliver causal estimates. Second, the use of an ETR proxy necessarily abstracts from key features of the GloBE computation, including differences between financial-accounting income and taxable income, the timing of covered taxes, and the treatment of specific credits and attributes. Third, the scenario projections represent structured expectations rather than forecasts; they are sensitive to assumptions about policy capacity, compliance behavior, global economic conditions, and the pace of Pillar Two implementation and enforcement. These constraints imply that the evidence should be read as consistent with the theoretical mechanism—neutralization of rate-reducing incentives for covered groups—rather than as definitive proof of investment effects.Future research can substantially strengthen the evidence base by moving from a single structured illustration to multi-country, cross-jurisdiction panels that exploit variation in Pillar Two implementation timing, safe-harbour eligibility, and domestic incentive reforms. A promising strategy would combine firm-level or project-level investment data with policy indicators that distinguish between incentives likely to be neutralized (e.g., profit-based tax holidays or preferential regimes that reduce covered taxes) and incentives more compatible with Pillar Two (e.g., qualified refundable credits or non-tax support). Difference-in-differences designs leveraging staggered implementation, combined with robustness checks addressing concurrent macroeconomic shocks, would enable more credible identification of causal effects. In parallel, qualitative institutional research on administrative capacity, certainty mechanisms, and investor perceptions could illuminate why some jurisdictions manage the transition more effectively than others.

5. Conclusions

The OECD/G20 Pillar Two global minimum tax materially alters the operating conditions of investment policy and the logic of international tax competition. By design, the GloBE regime reduces the effectiveness of traditional rate-based strategies—such as preferential regimes, tax holidays, and other instruments that lower covered taxes—when these measures push the jurisdictional effective tax rate below the 15% minimum for in-scope multinational enterprise groups. In this setting, the marginal benefit of reducing the local tax burden is increasingly offset by top-up taxation, diminishing the capacity of jurisdictions to compete primarily through low-tax outcomes and raising the risk that legacy incentive regimes generate fiscal costs without delivering commensurate incremental investment.The central policy implication is not that incentives disappear, but that they must be redesigned and governed differently. Investment policy should prioritize transparent, rules-based instruments that can retain effectiveness under Pillar Two and that allow credible budgeting, monitoring, and evaluation. In practice, this points toward a shift away from

discretionary or opaque tax expenditures and toward instruments that align with minimum-tax constraints, including qualified refundable tax credits and clearly defined, time-bound support mechanisms linked to measurable performance criteria. Equally important, the results reinforce that competitiveness will increasingly depend on non-tax fundamentals—regulatory predictability, administrative efficiency, infrastructure reliability, workforce skills, and the overall quality of the investment climate—because these determinants remain fully "binding" under a minimum-tax environment.Taken together, the evidence and scenario analysis suggest a strategic rebalancing. Jurisdictions that respond to Pillar Two by merely compressing incentives, without improving fundamentals or upgrading policy design, may face a gradual erosion of attractiveness for mobile investment. Conversely, jurisdictions that proactively adapt—by aligning incentives with the post-Pillar Two rule set, strengthening certainty mechanisms, and investing in non-tax drivers of productivity—are better positioned to stabilize investment promotion outcomes and sustain FDI performance. Future work should deepen these conclusions with cross-jurisdiction empirical tests that exploit implementation timing, safe-harbour eligibility, and heterogeneous incentive reforms to identify the conditions under which policy adaptation can most effectively support investment in a global minimum-tax era.

6. Patents

Not applicable.

Supplementary Materials

Underlying CSV tables and code for figures can be provided upon request.

Author Contributions

Conceptualization, H.X.; methodology, H.X.; formal analysis, H.X.; writing—original draft preparation, H.X.; writing—review and editing, H.X.; visualization, H.X.; supervision, H.X.

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Conflicts of Interest

The author declares no conflicts of interest.

Appendix A.

This study provides an illustrative, policy-aligned empirical structure. To strengthen inference and enhance external validity, future applications of the framework should incorporate a robustness protocol that evaluates whether the core patterns persist under alternative measurement choices, timing assumptions, and model specifications. Recommended checks include the following:

1. **Alternative ETR measures and tax-burden proxies**

    - Replace the statutory ETR proxy with **cash ETR** (cash taxes paid divided by pre-tax income) and **GAAP/financial-statement ETR** (total tax expense divided by pre-tax income), where firm-level data are available.
    - Construct a **jurisdictional ETR proxy** that better approximates GloBE logic by aligning the tax numerator with covered taxes and adjusting the denominator toward a financial-accounting income concept.
    - Test robustness to alternative indicators of tax policy stance (e.g., statutory corporate income tax rate, marginal effective tax rate estimates, or composite tax competitiveness indices).

2. **Lag structures and dynamic responses**

    - Estimate specifications with **distributed lags** to account for delayed investment responses to policy changes (e.g., one- to three-year lags for incentive intensity and ETR proxies).
    - Compare contemporaneous versus lagged relationships to distinguish short-run announcement effects from medium-run real-investment adjustments.

3. **Macroeconomic and institutional controls**

    - Introduce controls for macroeconomic conditions that are plausibly correlated with both policy and FDI outcomes, such as GDP growth, inflation, exchange-rate volatility, sovereign risk spreads, interest rates, and global demand indicators.
    - Include institutional and governance controls where feasible (e.g., regulatory quality, rule-of-law proxies, political stability, public procurement integrity indicators), recognizing their central role in investment-location decisions.

4. **Implementation timing and policy heterogeneity**

    - Conduct sensitivity tests to **implementation timing** by coding Pillar Two adoption and effective dates, transitional safe harbour periods, and key administrative milestones.
    - Apply event-study or difference-in-differences designs where cross-jurisdiction variation exists, testing whether effects differ by (i) early versus late adopters, (ii) safe-harbour eligibility, and (iii) baseline reliance on preferential regimes.

5. **Alternative incentive definitions and instrument classification**

    - Disaggregate the incentives index into categories expected to be differently affected by Pillar Two, distinguishing **rate-reducing instruments** (e.g., tax holidays, preferential regimes) from **Pillar Two–compatible instruments** (e.g., qualified refundable tax credits or transparent, rules-based subsidies).
    - Test whether the relationship with FDI is driven by the composition of incentives rather than their aggregate intensity.

6. **Outlier, leverage, and structural-break diagnostics**

    - Re-estimate results excluding influential observations, using robust estimators or winsorization where appropriate.
    - Test for structural breaks around major policy announcements, implementation dates, or macro shocks that may confound interpretation.

7. **Placebo and falsification tests**

    - Implement placebo timing assignments (e.g., pseudo-implementation years) to verify that observed relationships are not artifacts of general trends.
    - Test outcomes that should be less sensitive to incentive policy (where theoretically justified) as a falsification strategy.

Together, these checks would allow researchers to move from descriptive co-movement toward more credible inference about the magnitude, timing, and conditionality of Pillar Two–related adjustments in incentives and investment outcomes.

Appendix B.

This appendix defines the variables used in the structured dataset and clarifies measurement conventions.

- **Statutory_ETR_percent**

Definition: Statutory corporate income tax rate or a policy-based proxy for the effective tax rate, expressed as a percentage.
Unit: Percent (%).
Interpretation: Higher values indicate stronger alignment with a minimum-tax environment. In this illustrative dataset, the measure serves as a tractable proxy for the direction of minimum-tax alignment, recognizing that GloBE jurisdictional ETRs are computed using covered taxes and financial-accounting income concepts.

- **InvestmentIncentivesIndex_0_100**

Definition: Composite index measuring the intensity of investment incentives on a normalized scale from 0 to 100.

Unit: Index (0–100).

Interpretation: Higher values reflect a more intensive or generous incentive environment (e.g., more prevalent tax expenditures or stronger incentive packages), whereas lower values indicate incentive retrenchment, redesign, or reduced reliance on rate-based instruments. Where the index is constructed from multiple components, documentation should specify weighting, coverage, and whether it distinguishes Pillar Two–compatible and non-compatible instruments.

- **FDI_inflows_percentGDP**

Definition: Inward foreign direct investment inflows divided by gross domestic product.

Unit: Percent of GDP (%).

Interpretation: Measures the annual scale of inward FDI relative to the size of the economy. Higher values indicate stronger inward investment activity; the measure is commonly used to normalize FDI across time and across jurisdictions.

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