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The hunt for footloose capital: taxing profits in a global world

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UKRI Economic and Social Research Council

In today's lecture

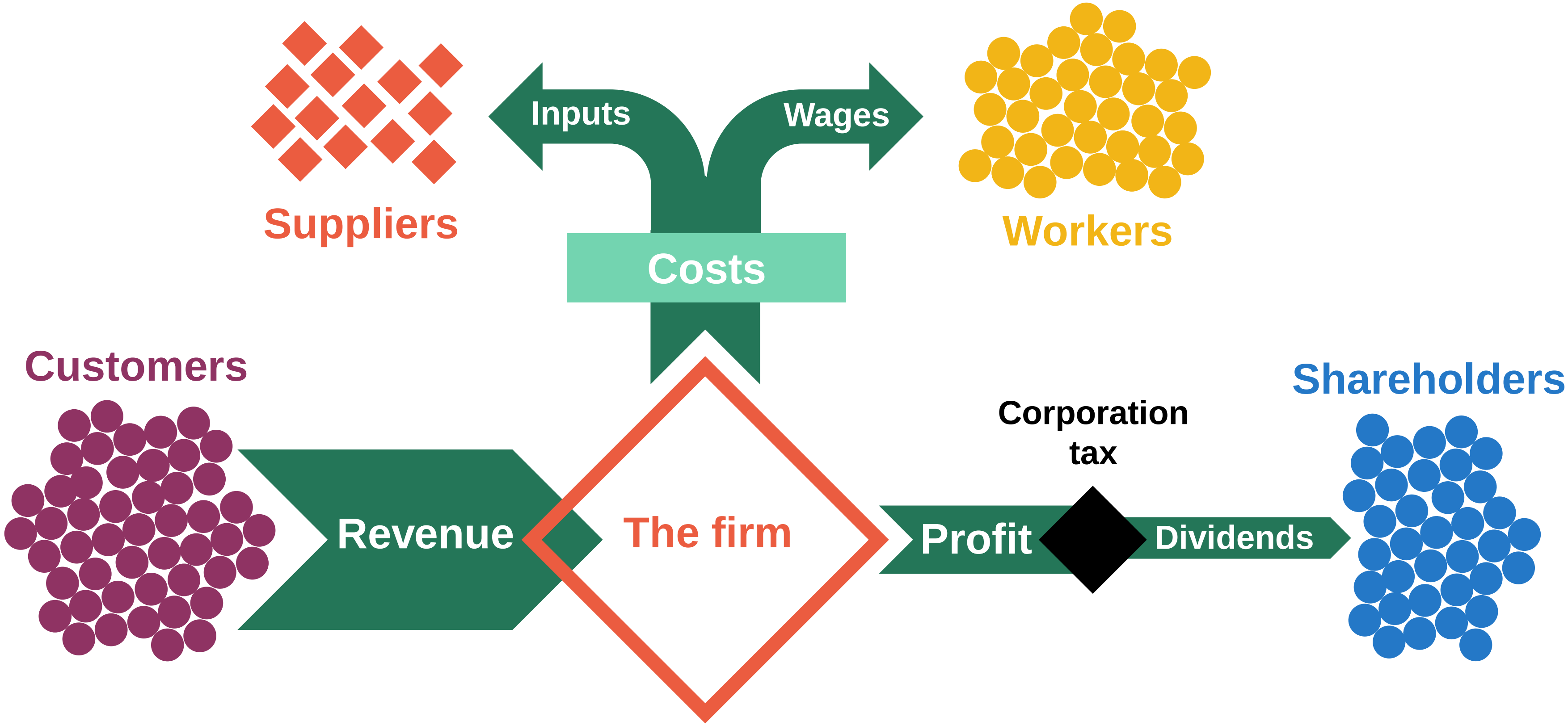
Today's lecture will be in three parts:

1. What is a corporation tax?
2. Who ultimately bears the burden of corporation tax: workers, or shareholders?
3. What problems arise when seeking to tax multinational corporations spanning multiple jurisdictions – why do we see stories about big companies paying so little?

What is a corporation tax?

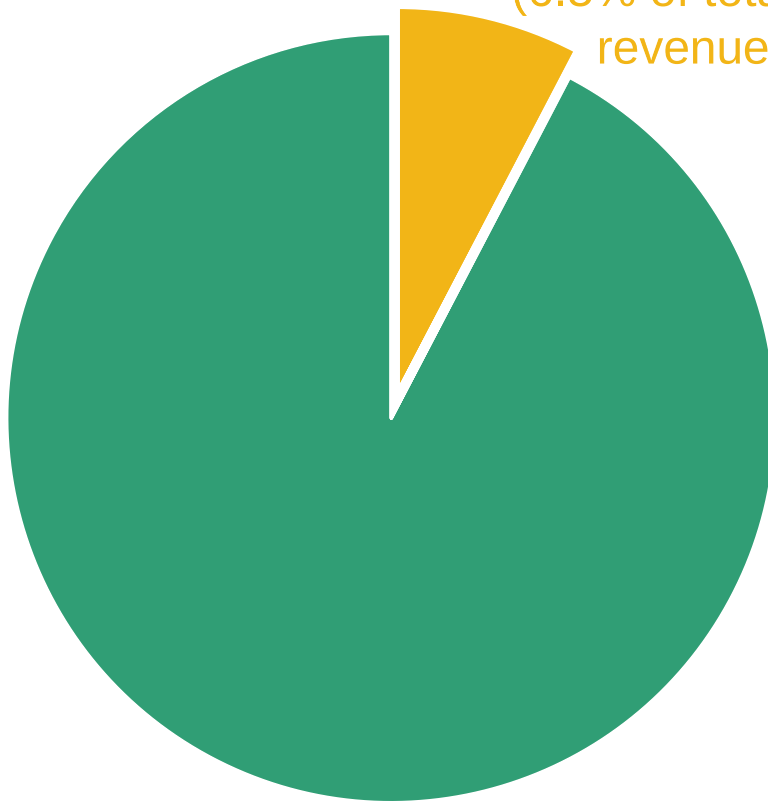
What is a corporation tax?

- Corporation tax is a tax on the profits of **incorporated businesses.**
- While the tax is charged on profits, we will see that who ultimately bears the burden of the tax, isn't so straightforward.



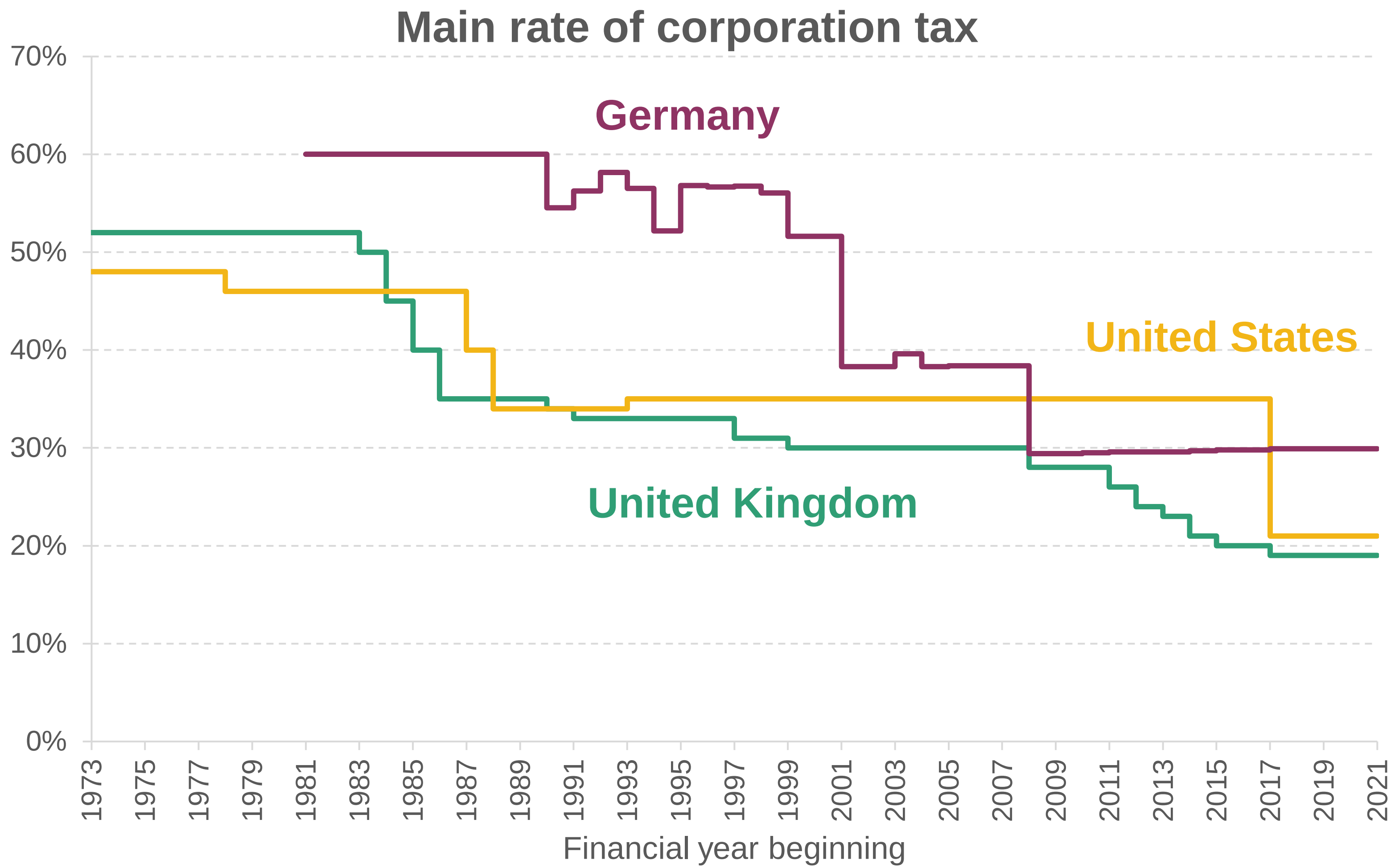
How much money does it raise?

Corporation Tax
£45 billion
(6.5% of total tax revenue)



UK tax revenue 2020-21
(temporarily depressed because of COVID-19)

How has corporation tax changed?



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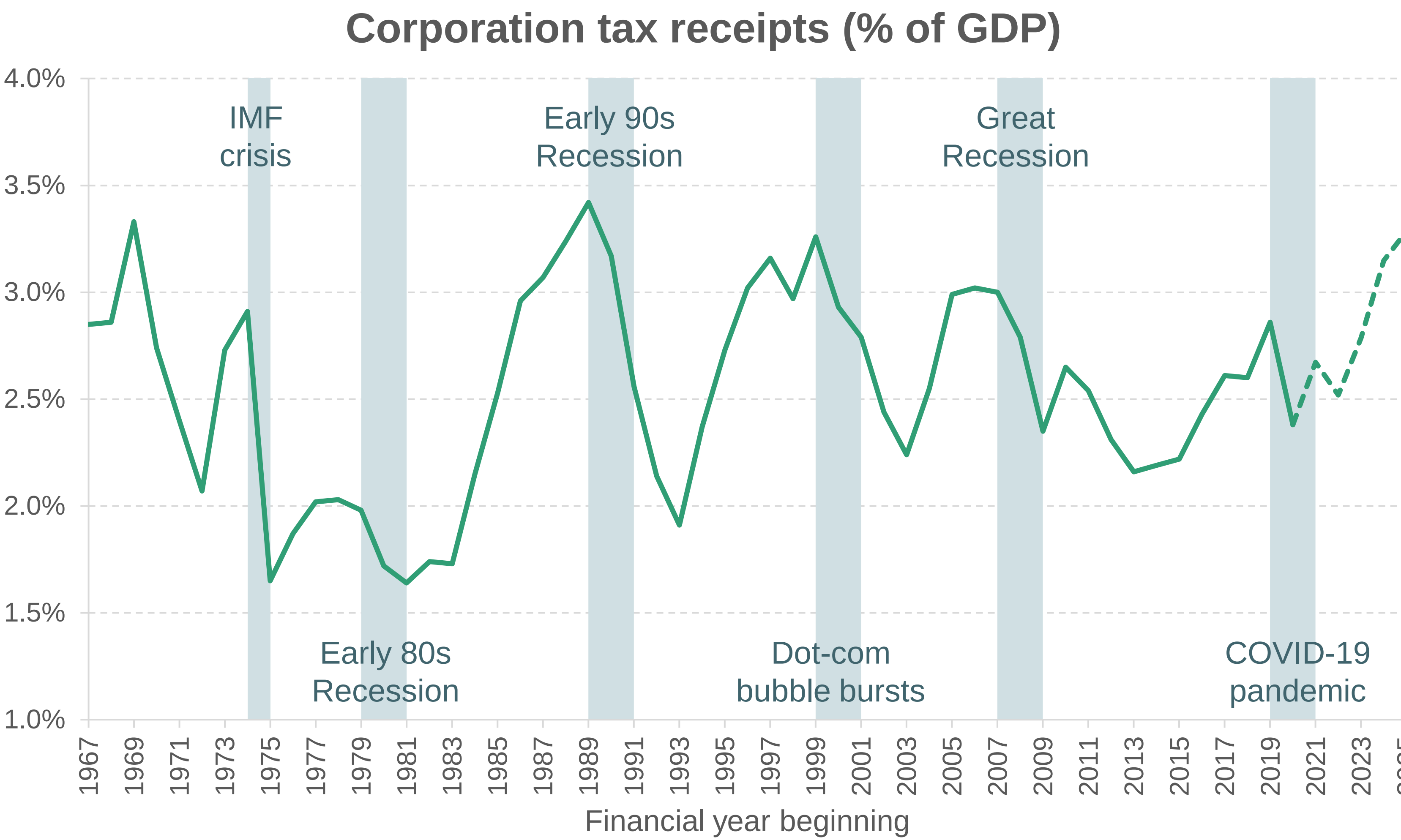


The international context

Implementing corporation taxes in a global context comes with serious challenges:

1. **The burden on workers:** The mobile nature of international capital shifts (at least some) of the tax burden onto workers
2. **Multinational avoidance:** Difficulties with allocating revenue create opportunities for multinationals to avoid taxation.

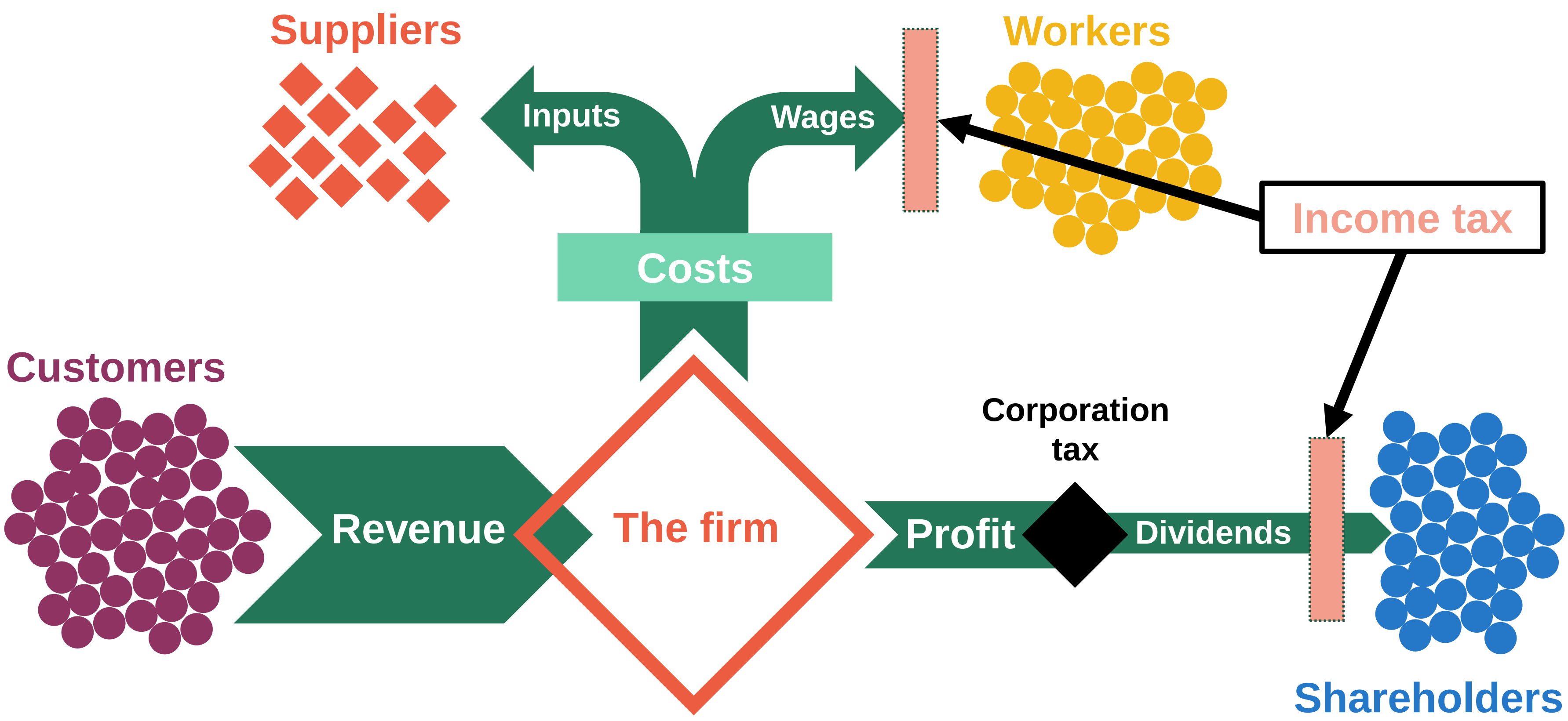
Who bears the burden of corporation tax?

Who bears the burden of corporation tax?

- All tax is ultimately **paid by <u>people</u>.**
- But which people?
- Relevant for answering a whole range of questions, including questions of inequality (e.g. shareholders tend to be wealthier than wage earners).

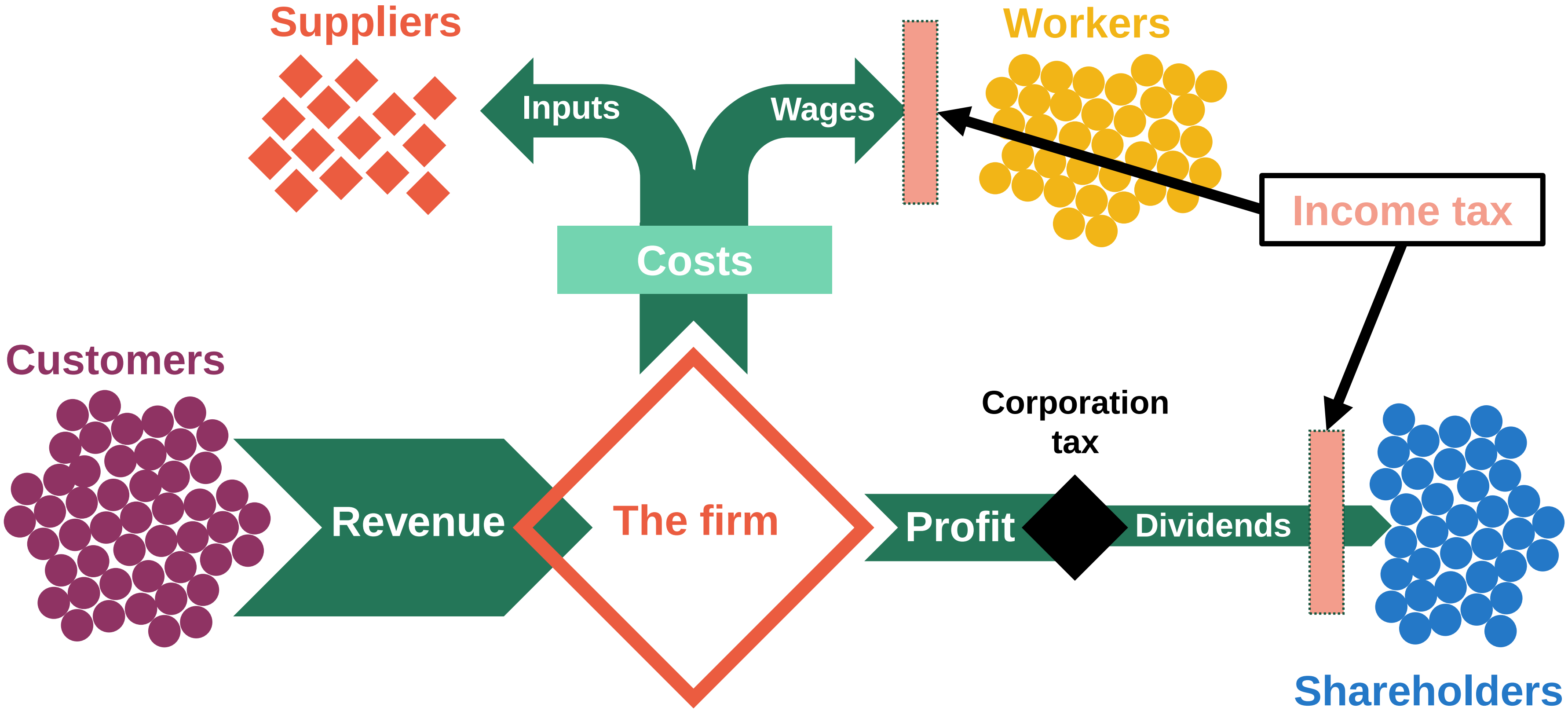
Who are we trying to tax?

- Income that flows out of firms is ***already* subject to income tax** – this begs the question, **why tax profits at the firm level?**



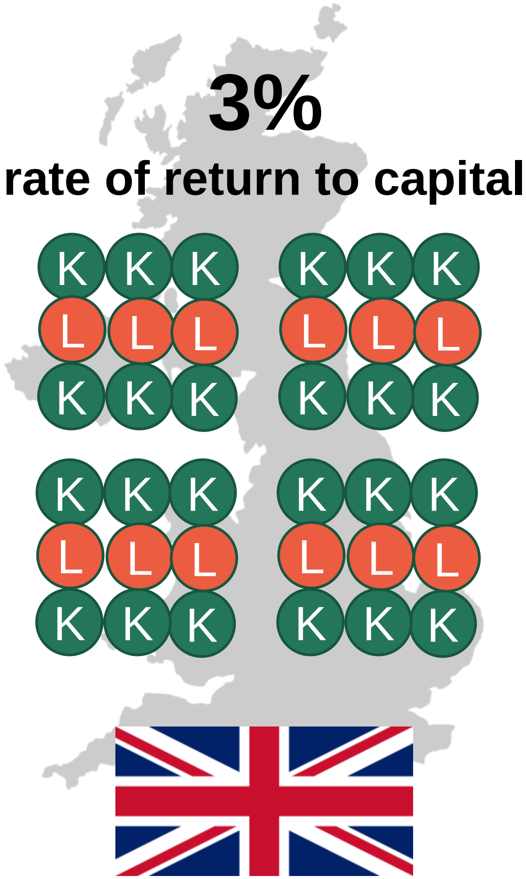
A tax on foreign owners?

- A common response is that corporation tax allows us to tax **foreign owners of corporations**.
- But **does corporation tax actually achieve that?**



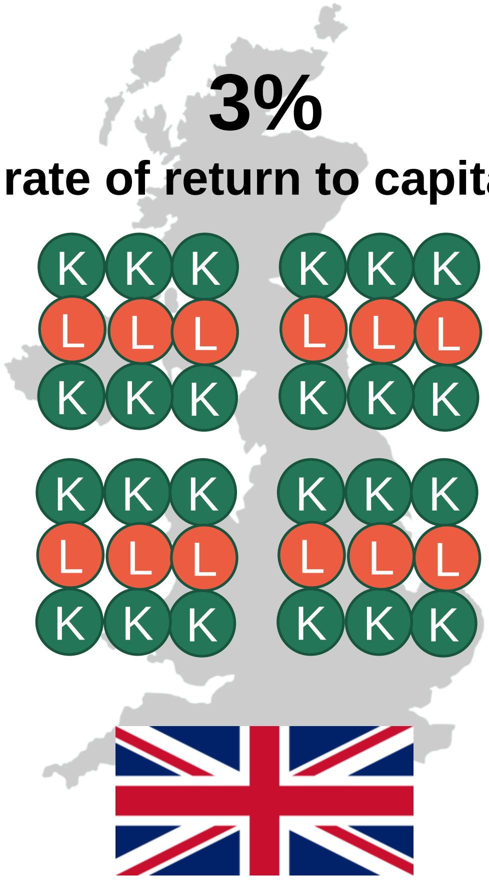
Who 'pays' corporation tax?

- Start with a very basic set up: fixed factor supplies, fully employed factors, perfect competition, constant returns to scale.



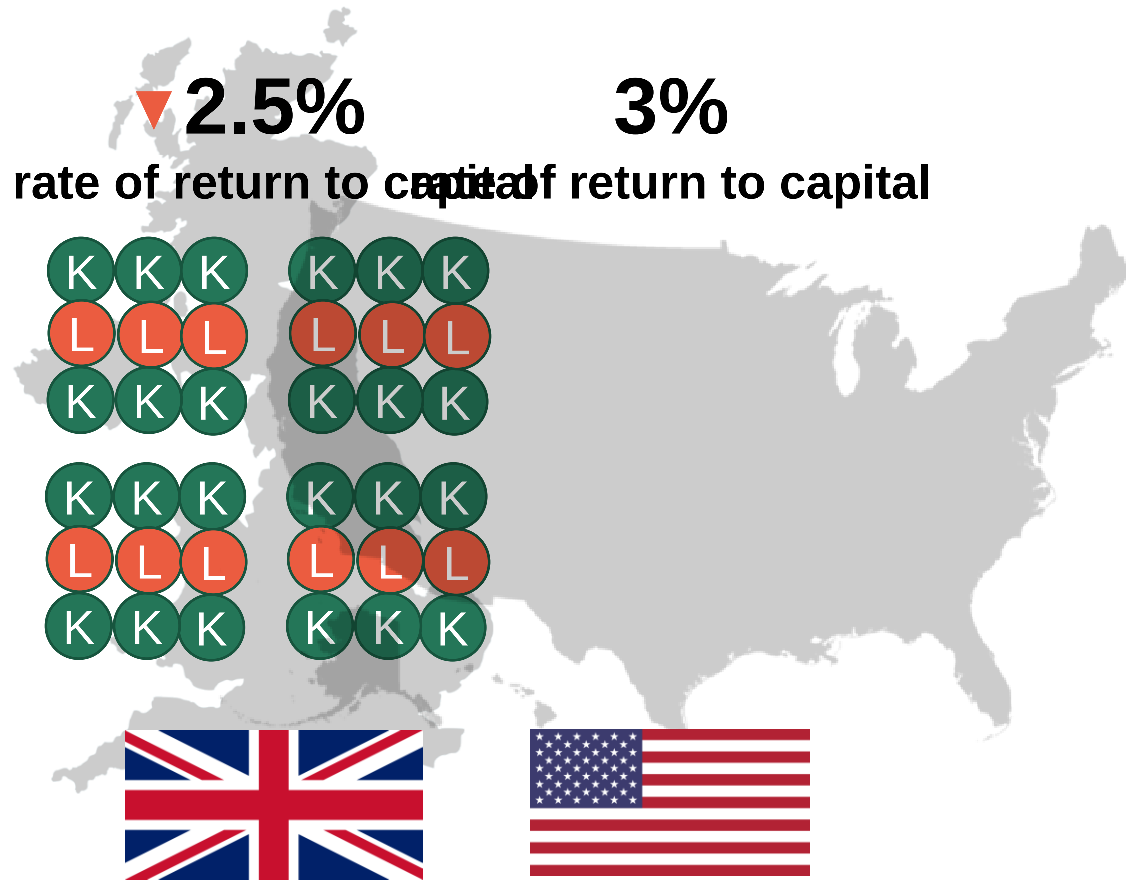
Who ‘pays’ corporation tax?

- Now suppose we impose a corporation tax.



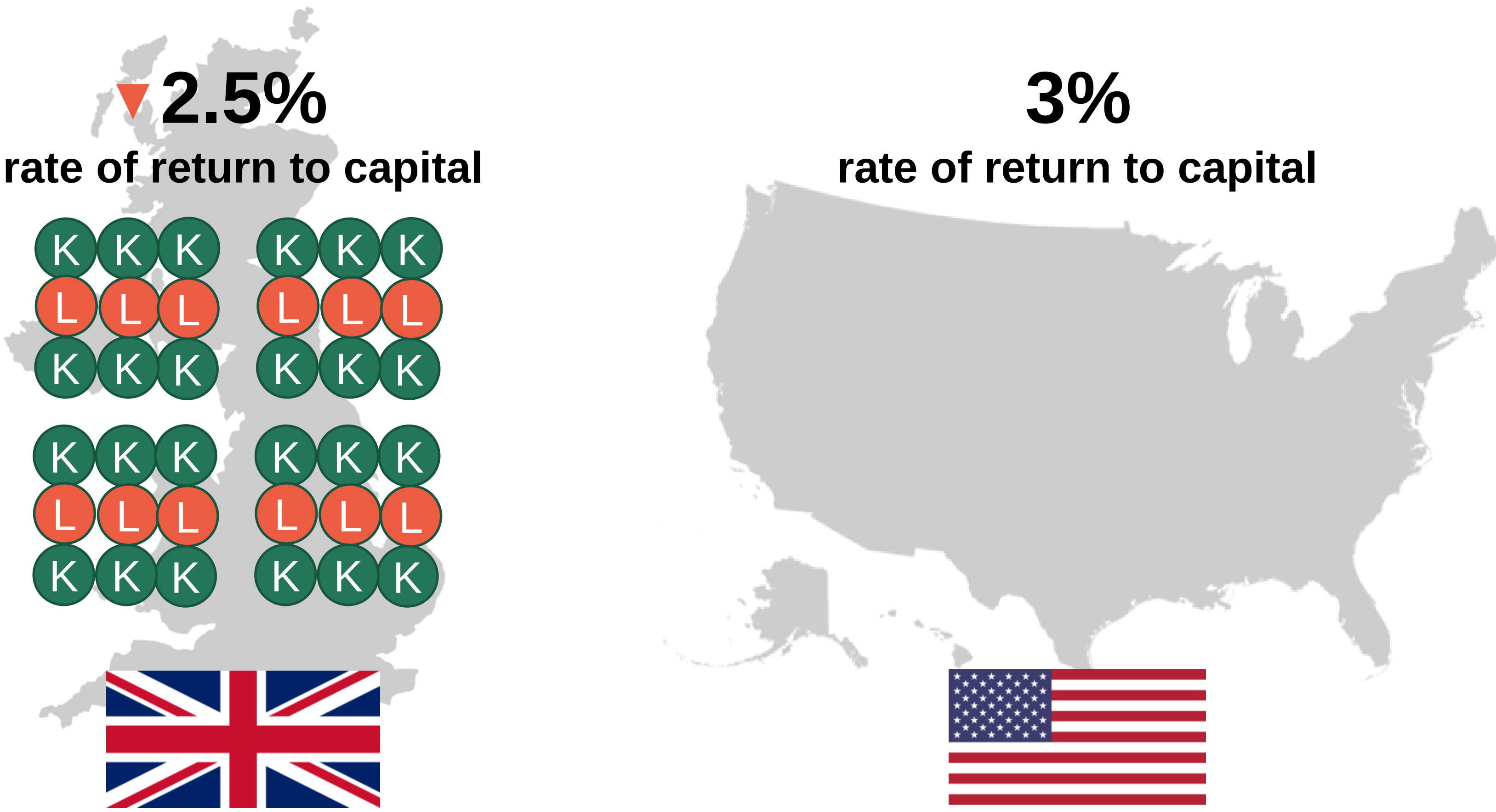
Who ‘pays’ corporation tax?

- Now suppose we impose a corporation tax.
- In the short run K is fixed: the return to capital falls.



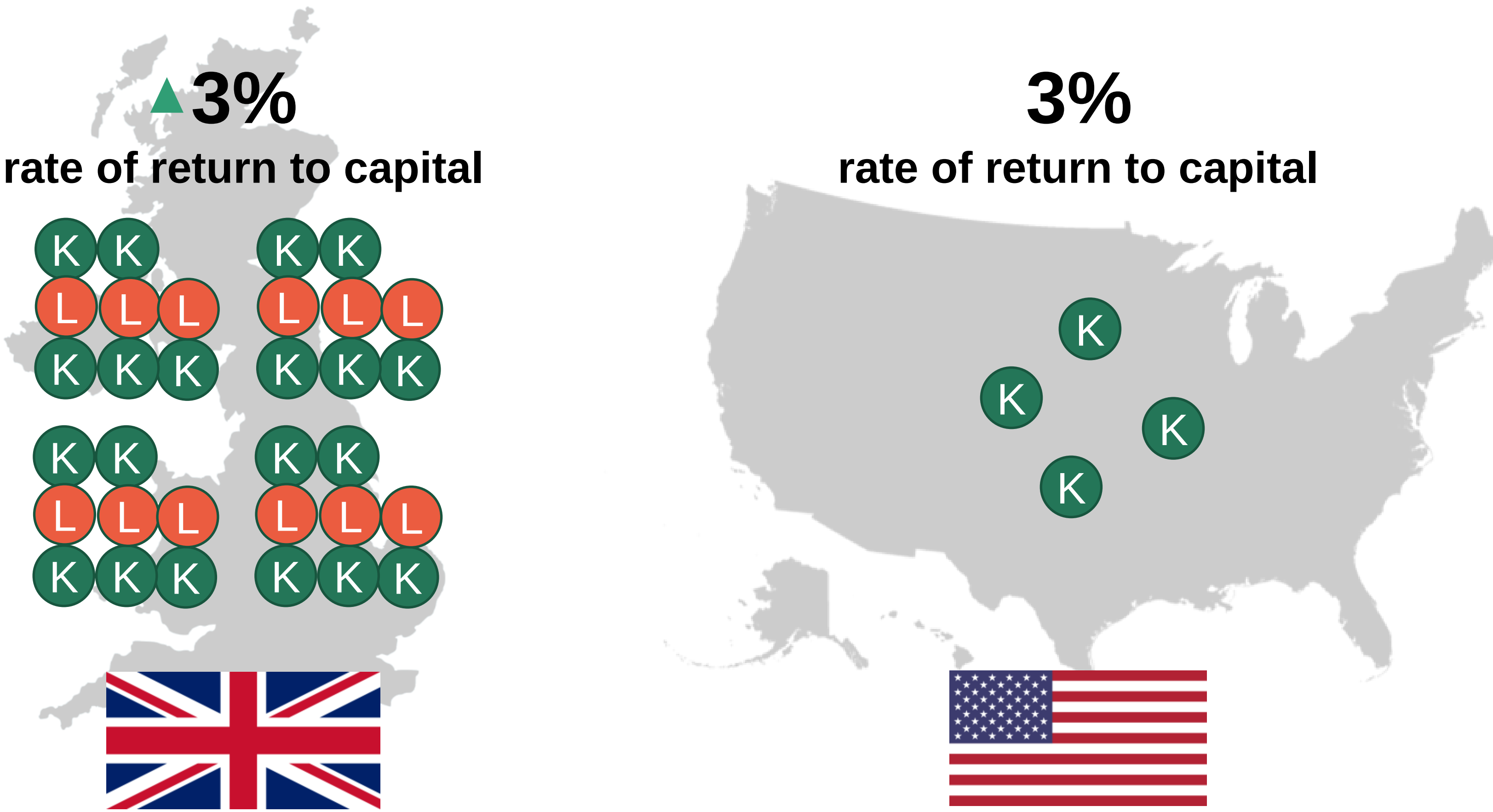
Who ‘pays’ corporation tax?

- But in an open economy, where capital is mobile this leads capital to flow overseas.



Who ‘pays’ corporation tax?

- The reduced supply of domestic capital drives returns back up.
- Reduced capital intensity drives down MPL and, therefore, wages.



Incidence: conclusions

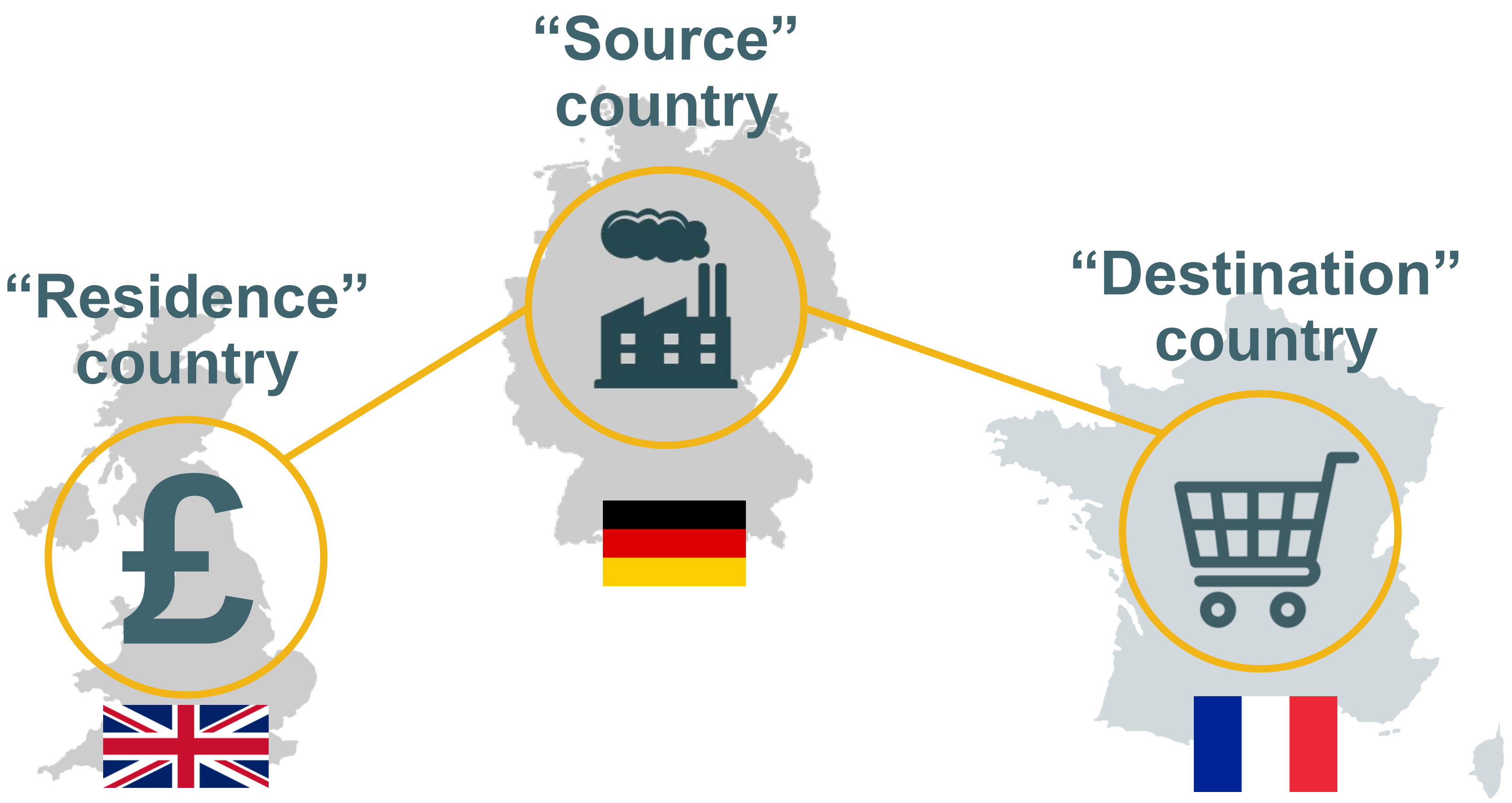
- In a small open economy, where capital is perfectly mobile, **labour bears the burden of the tax** through lower wages.
- And it does so by **reducing the efficiency** of domestic production.
- In reality, we wouldn't expect to find quite such an extreme scenario.
  - For example, **location specific rents** (e.g. North Sea Oil).
  - Labour isn't the only fixed factor. Fall in capital-per-worker will also be fall in capital-per-square-mile. **Incidence also on landowners.**
- The more mobile capital is the lower the optimal rate is likely to be – could explain falling CT rates internationally.

Incidence: conclusions

- The empirical evidence is mixed (partially because estimation is technically difficult). But most estimates suggest the tax is shared between capital and labour.
  - Suárez, Serrato & Zidar (2016) estimate **30-35% burden on labour** in a study using variation in state corporation taxes in the United States.
  - Fuest, Peichi & Siegloch (2018) use local business taxes in Germany to estimate that **~50% of the burden of corporation tax falls on labour.**

Taxing multinationals

The allocation problem

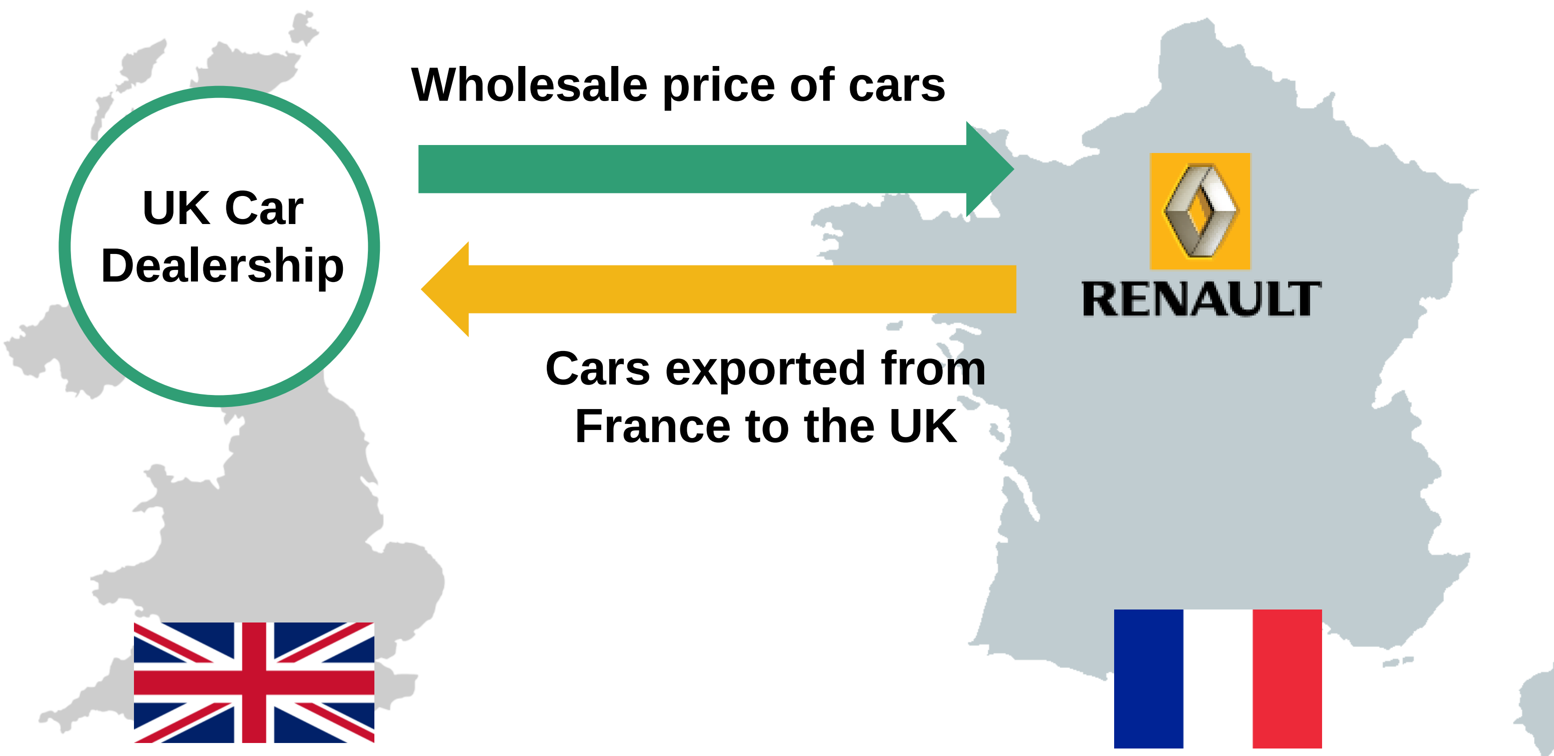


The allocation problem

- Taxation of multinational corporations operates on the basis of the so-called **‘1920s compromise’** brokered by the League of Nations (the predecessor of the UN).
- The principle of **taxation at source** dictates that countries have the right to tax value added generated in their country.

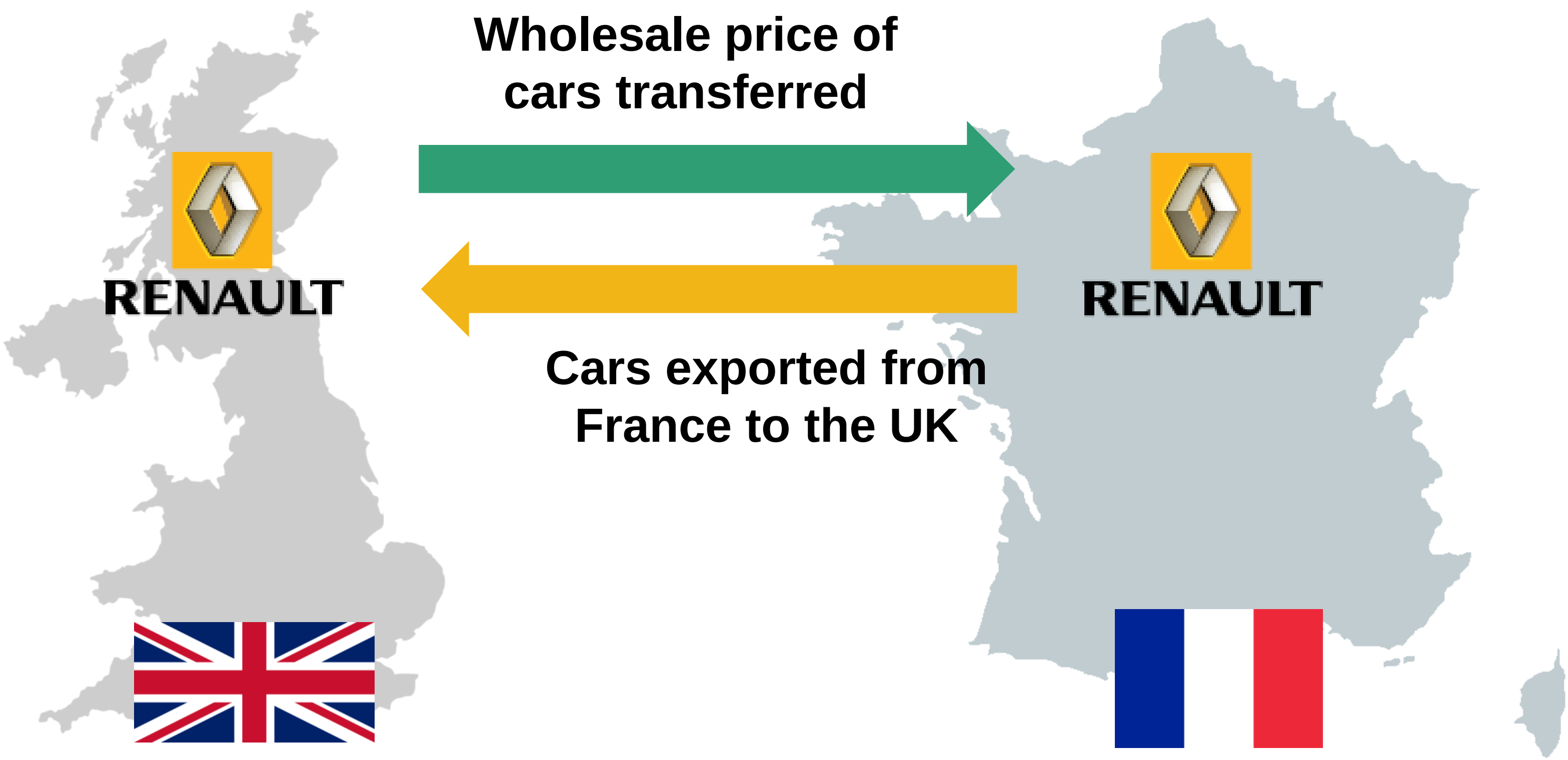
Taxation at source

- Where trade occurs internationally between two separate companies, value added is automatically transferred.



Transfer pricing

- Multinationals must emulate the free market by transferring the prince of imported inputs internationally.
- Transfer prices decided on the so-called **arms-length principle**.



Failures of taxation at source

But if taxation at source is such a good solution to the problem, why do we see headlines like these?

Starbucks pays £18.3m tax but £348m in dividends

Amazon had sales income of €44bn in Europe in 2020 but paid no corporation tax

Despite lockdown surge the firm's Luxembourg unit made a €1.2bn loss and therefore paid zero corporation tax

Where is value created?

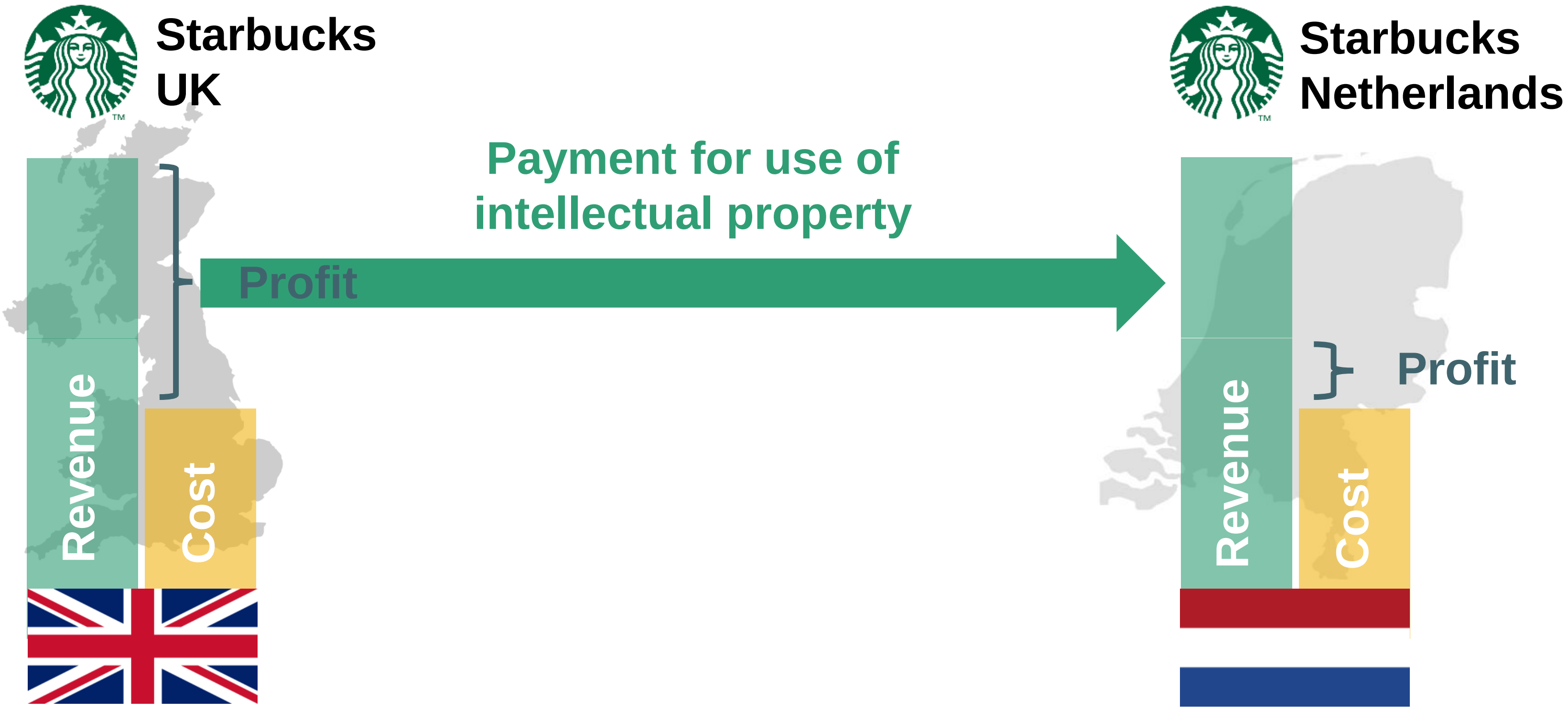
Determining what value is added in which jurisdiction turns out to be very hard. What gives a cup of Starbucks its value?

Where is value created?

- The truth is that there is often no right answer to the question ‘where is value created?’
- The increasing importance of intangible assets like intellectual property (such as brands and patents) makes the question **inherently ambiguous.**
- Where there is no single right answer, it is hardly surprising that companies choose the answer that minimizes their tax burden.

Where is value created?

- Companies are supposed to adhere to an **‘arm’s length’ valuation** of each process, but in practice this is extremely hard to police. How much is use of the Starbucks brand worth?
- This can lead to so-called ‘**profit shifting**’.



International responses

World's leading economies agree global minimum corporate tax rate

istoric agreement signed by 130 countries

nies, including the biggest tech groups, pay at least $100bn a year more in taxes © Jenny

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nomies have signed up to a plan to force multinational
al minimum corporate tax rate of at least 15 per cent
iations in Paris at the OECD.

Nations agree to 15% minimum corporate tax rate

By Daniel Thomas
Business reporter, BBC News

2 days ago

GETTY IMAGES

Chancellor Rishi Sunak and US Treasury Secretary Janet Yellen both welcomed the deal

The ‘minimum tax’

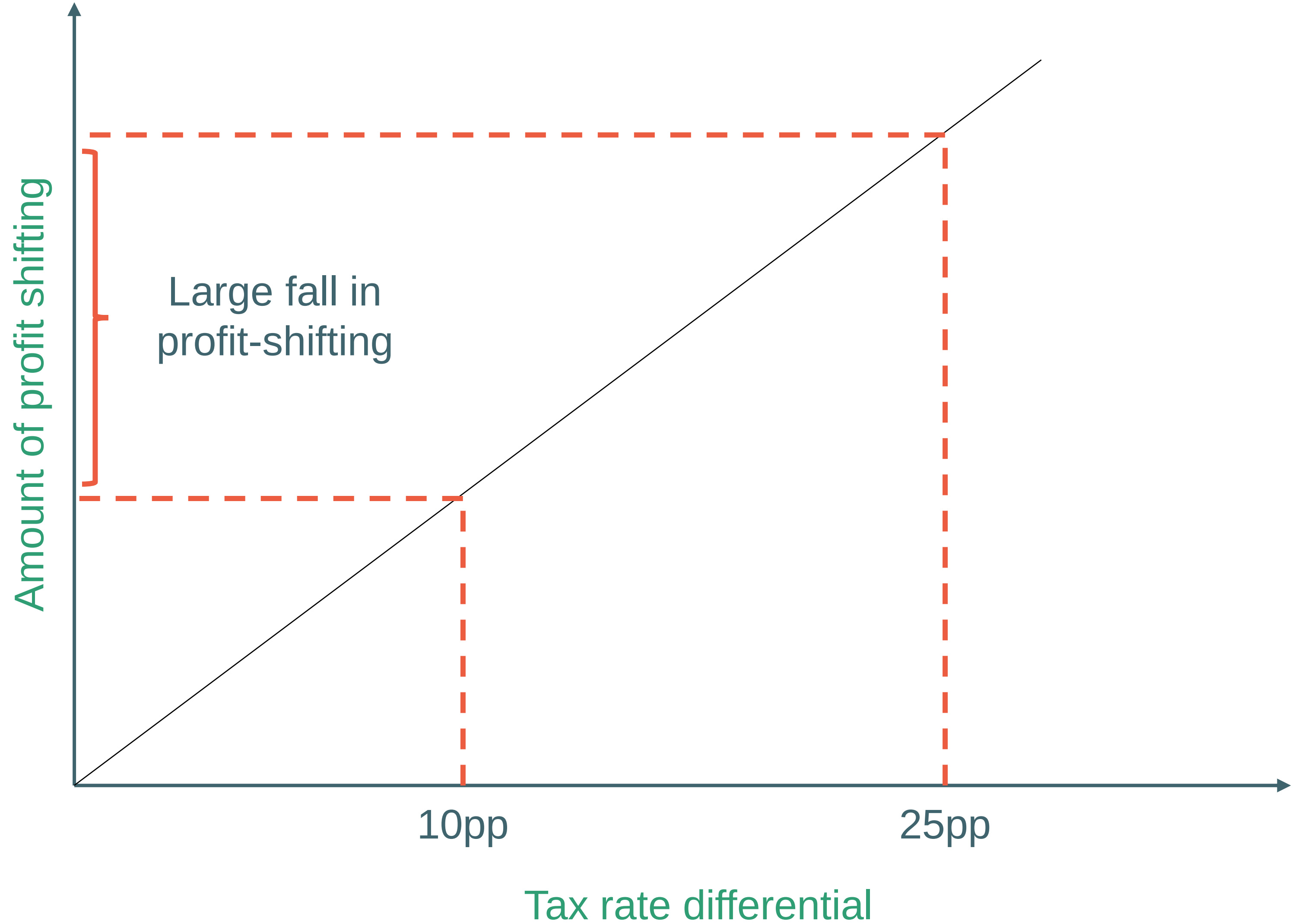
What is it?

- Trying to reduce incentives to profit shift by imposing a **global minimum corporation tax rate of 15%**.
- Applies to all sectors and to all firms with global revenues of **>€750 million** (~8,000 companies).

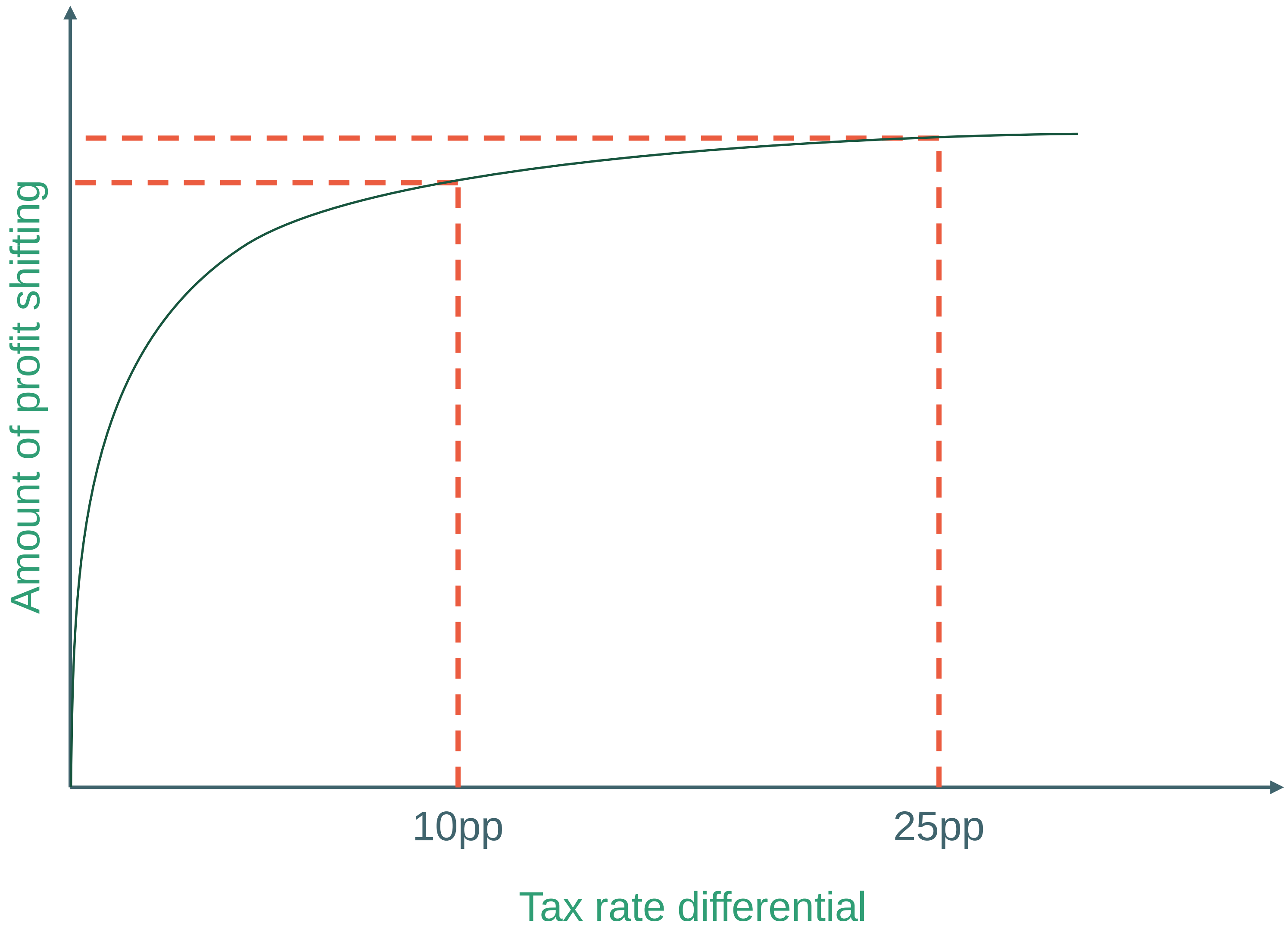
Will it work?

- Carve outs for real economic activity (“substance based carve outs”) could blunt efficacy:
  - 5% of payroll costs and 5% of physical assets can be deducted from profits subject to 15% rate in each jurisdiction.
- If profit shifting is non-linear, the impact could be minimal.

Non-linear profit shifting



Non-linear profit shifting



Conclusions

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- There are reasons why a corporation tax may be desirable (e.g. taxing location-specific rents).

BUT

- The globalised economy in which we live poses challenges to the efficacy of the corporation tax in two key ways:

1. It pushes a portion of the tax incidence onto wages by making domestic industry **less efficient** – a feature that also has the potential to make the corporation tax **less progressive.**

2. The importance and mobility of intangible assets like intellectual property has made **the principle of 'taxation at source' increasingly nonsensical**, leading to failures in the taxation of multinationals (reasons to believe attempts to patch this system up may not be effective).

Conclusions

Thank you!

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