Why tax corporate income? (And what can go wrong when we do?)

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16:00 - 17:00

IFS

UKRI Economic and Social Research Council

ESRC Festival of Social Science

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Why tax corporate income? (And what can go wrong when we do?)

November 2021

@TheIFS

Economic
and Social
Research Council

In today's lecture

Today's lecture will be in three parts:

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

What is a corporation tax and why do we have one?

What is a corporation tax?

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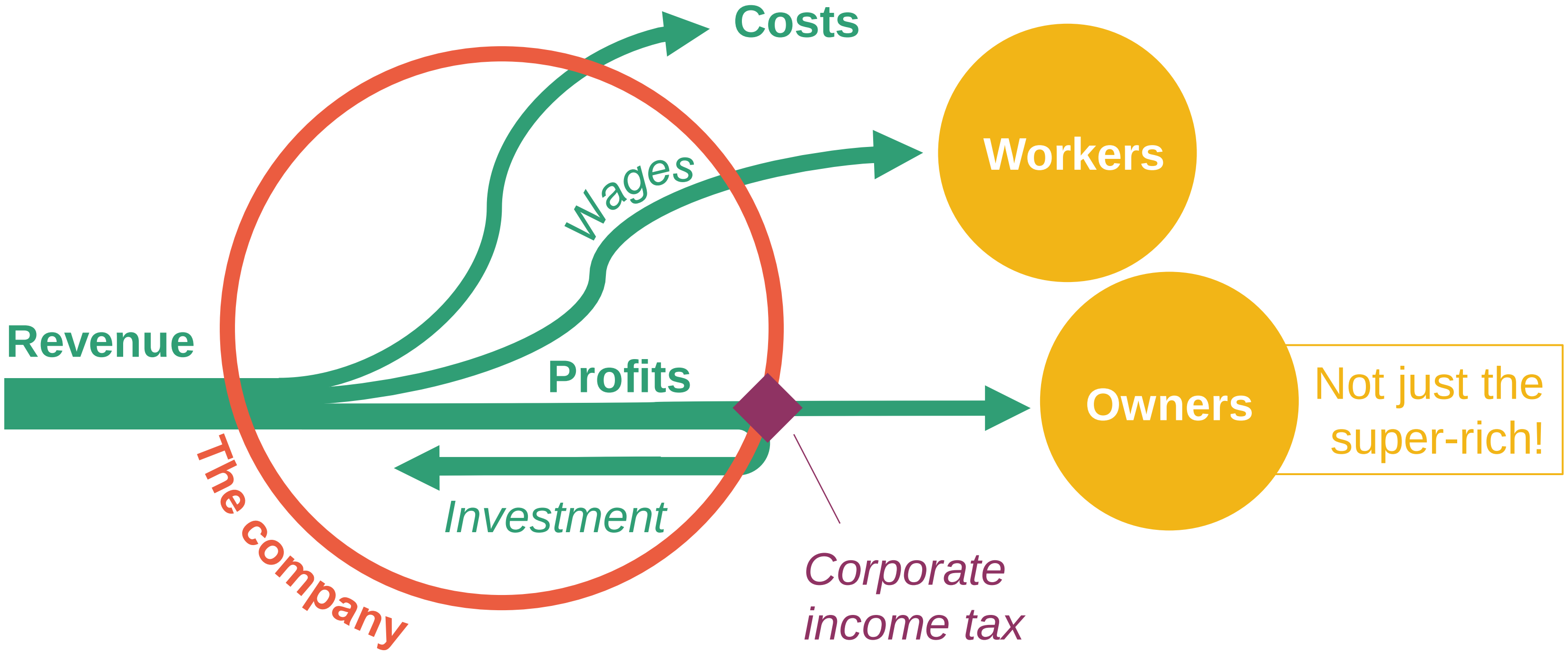
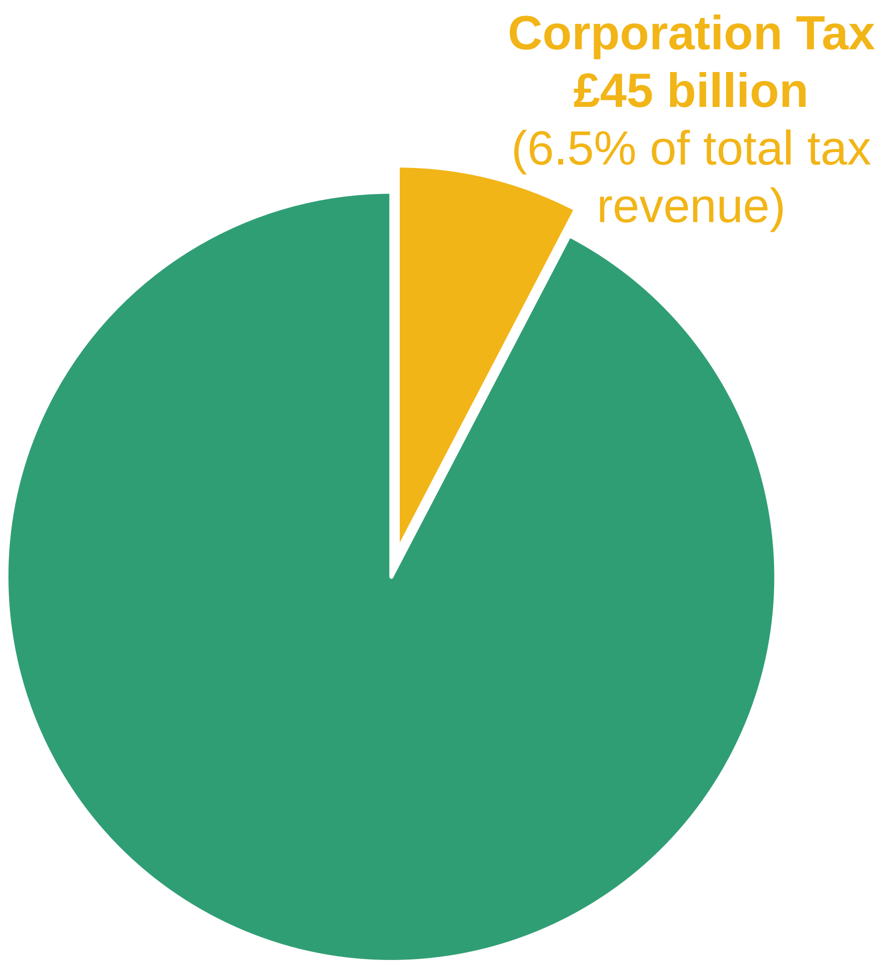
- Corporation tax is a tax on the profits of **incorporated businesses.**
- While the tax is charged on profits, we will see that who ultimately bears the burden of the tax, isn't so straightforward.

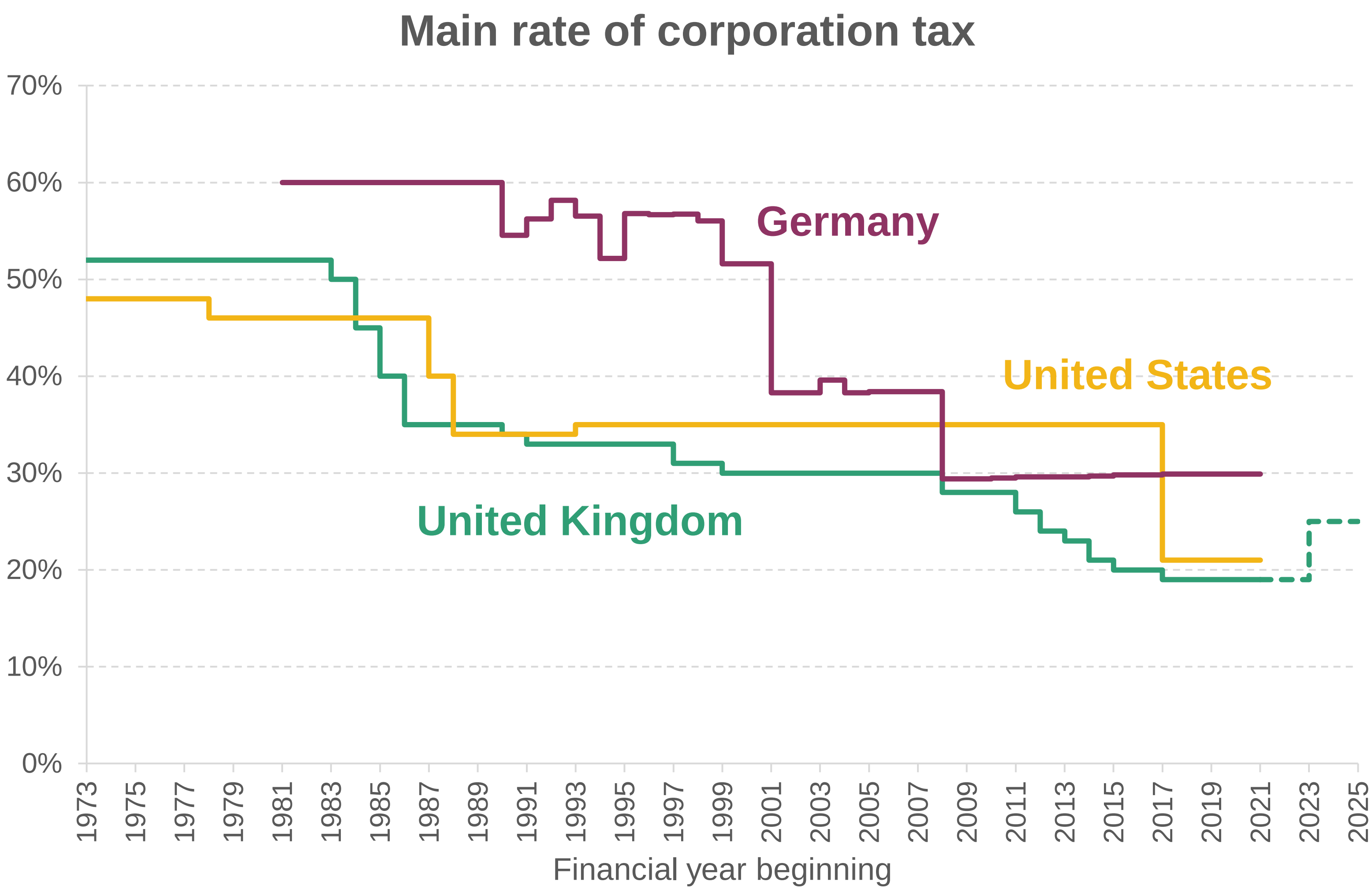


How much money does it raise?



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

How has corporation tax changed?



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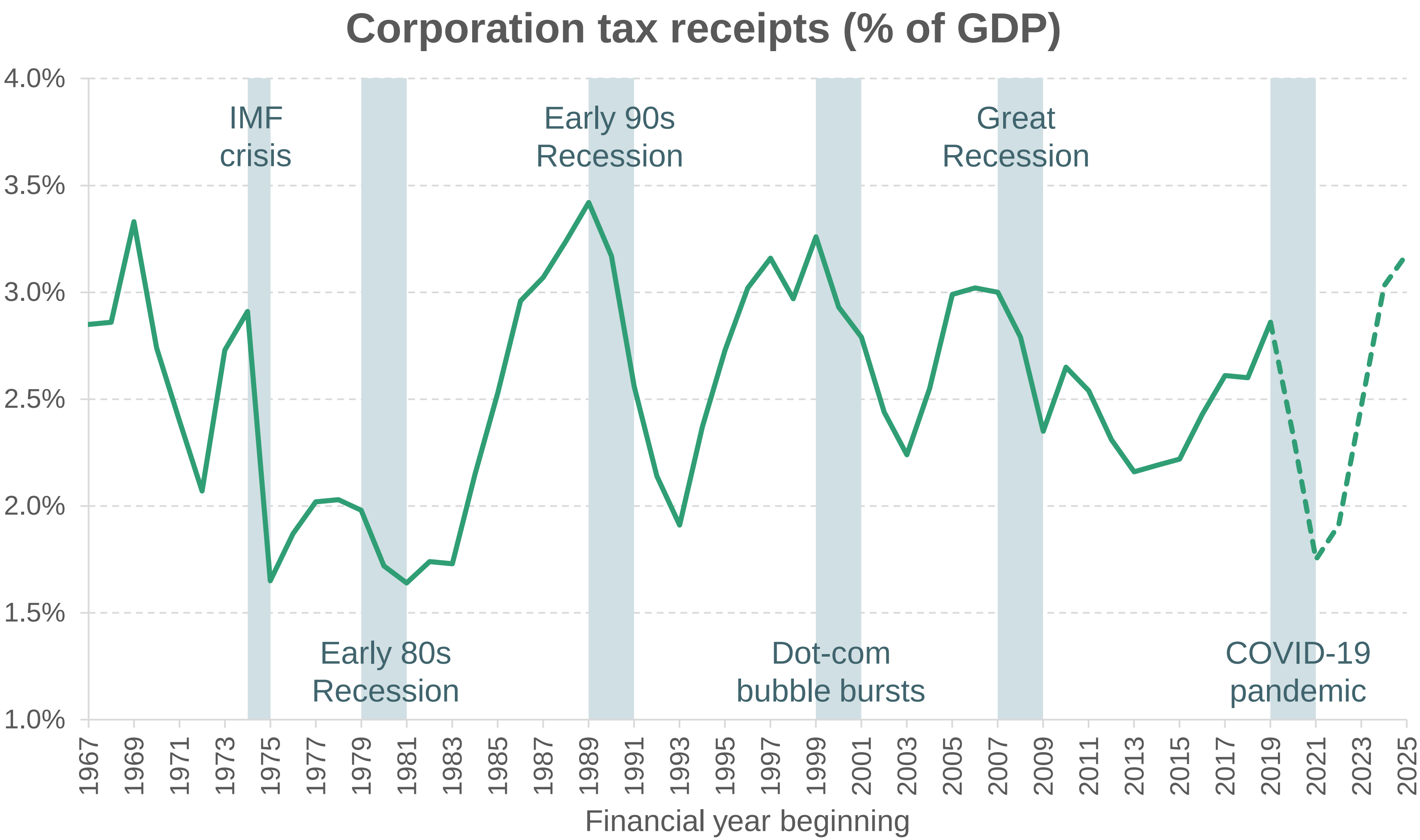
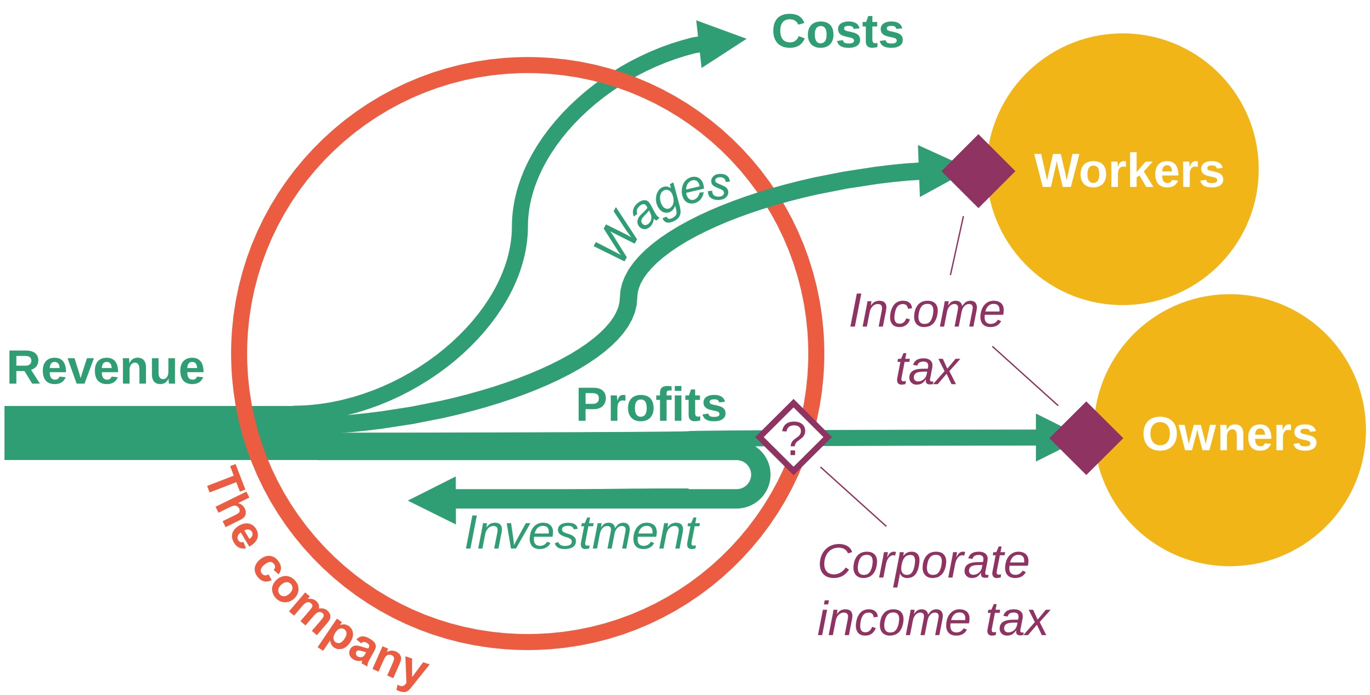


Why tax profits?

- The entire burden of tax falls on people.
- We *already* tax the people to whom firm revenue ultimately flows.
- So why might we want to tax profits at the firm (as opposed to the individual) level?



Why tax profits?

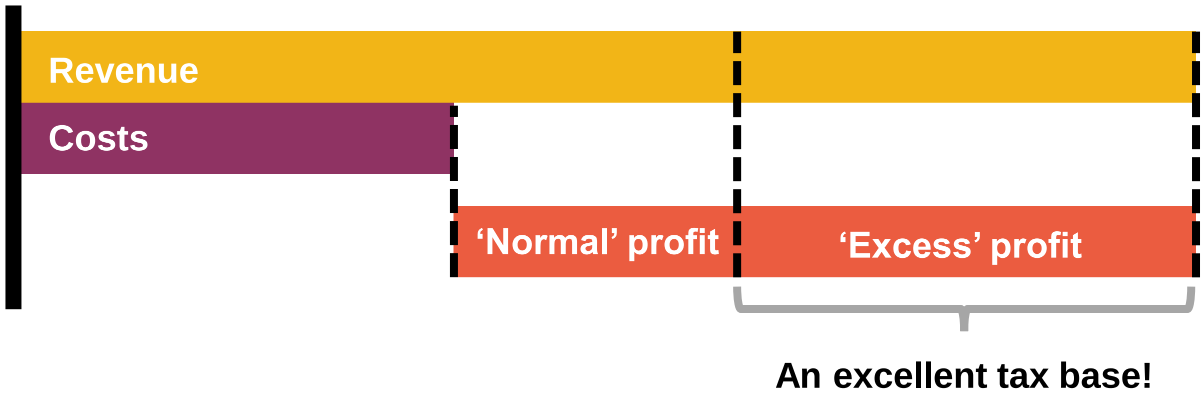
Because it allows us to **tax excess profits.**

- In a perfectly competitive market, firms earn just enough profit to compensate investors for putting their money at risk. We can think of these as **‘normal profits’**.

Why tax profits?

Because it allows us to **tax excess profits.**

- In reality, a whole range of factors can lead certain firms to make **'excess profits'** including possession of scarce resources (e.g. oil) and positions of monopolistic/oligopolistic market power etc.



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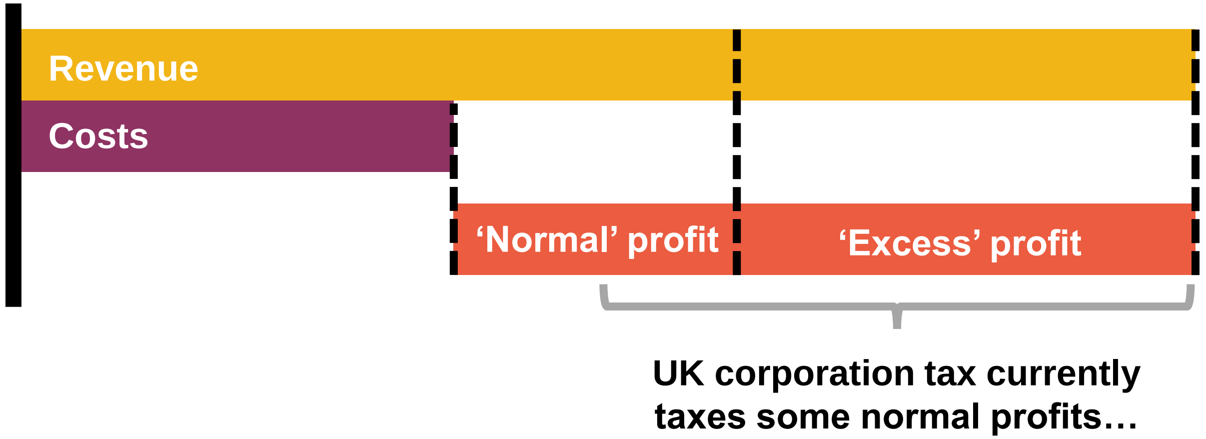

The international context

So, **excess profits are potentially a highly desirable** non-distortionary tax base.

HOWEVER in a global context (particularly when we are taxing normal returns not just excess profits) corporation taxes can run into serious challenges:

International mobility: capital can respond to corporation taxes at the international level:

1. **Moving activity overseas:** investment can flee overseas.
2. **Moving profits overseas:** multinational companies have opportunities to register profits in low tax countries.

Who bears the burden of corporation tax?

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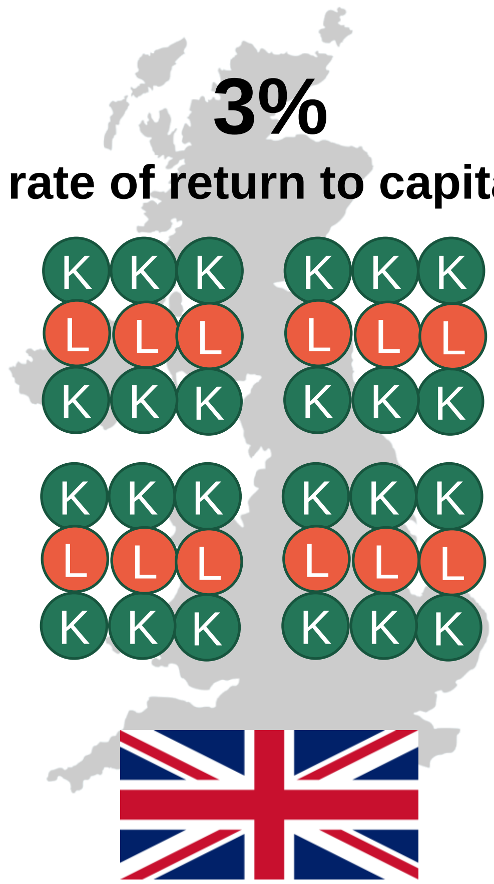
- **All tax is ultimately paid by people.**
- But which people? When a corporation tax is imposed, who ends up worse off?
- In general equilibrium wide range of individuals potentially impacted (e.g. contractors, customers etc.), we will focus on two groups: **workers and shareholders**.
- Relevant for answering a whole range of questions, including questions of inequality (because shareholders tend to be wealthier than wage earners).

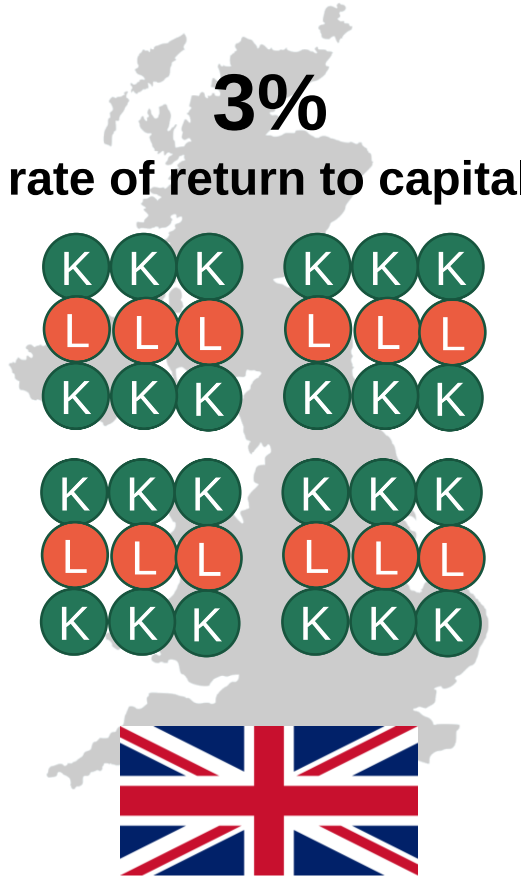
Who ‘pays’ corporation tax?

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



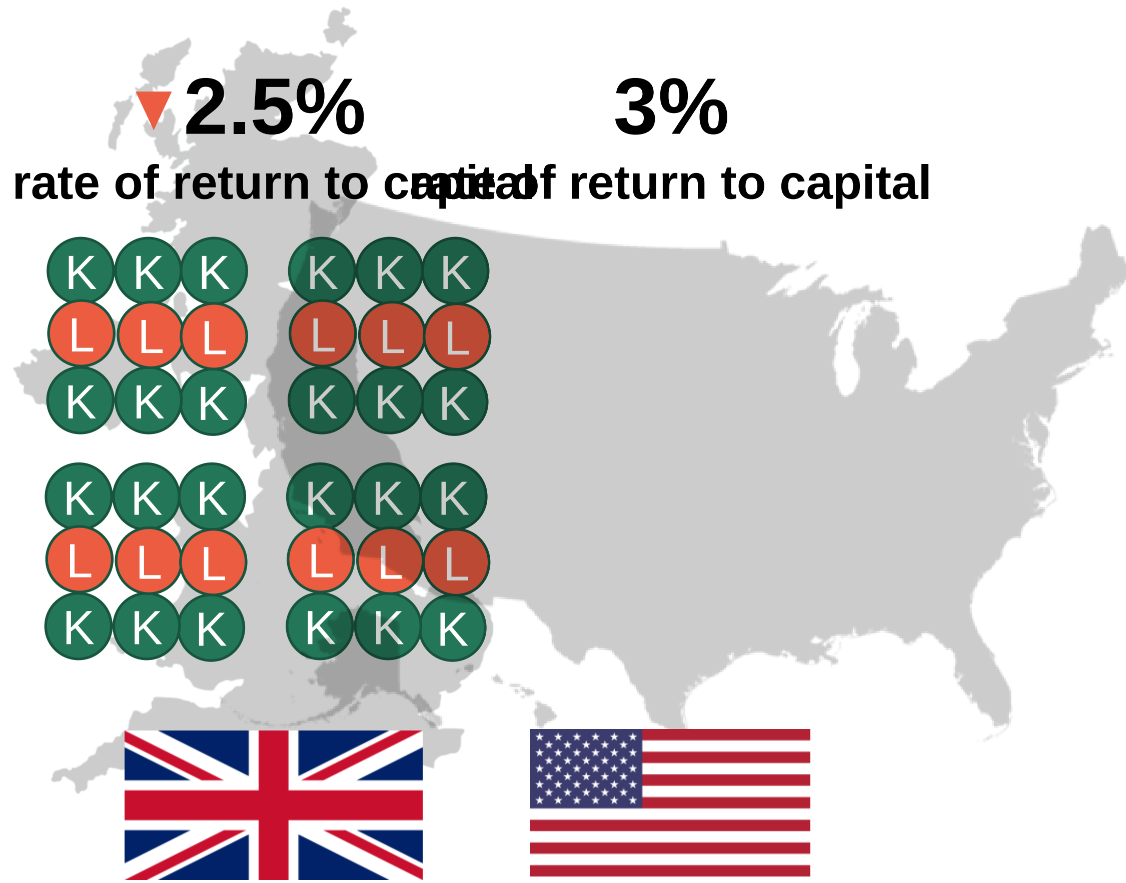
Who 'pays' corporation tax?

- Now suppose we impose a corporation tax.



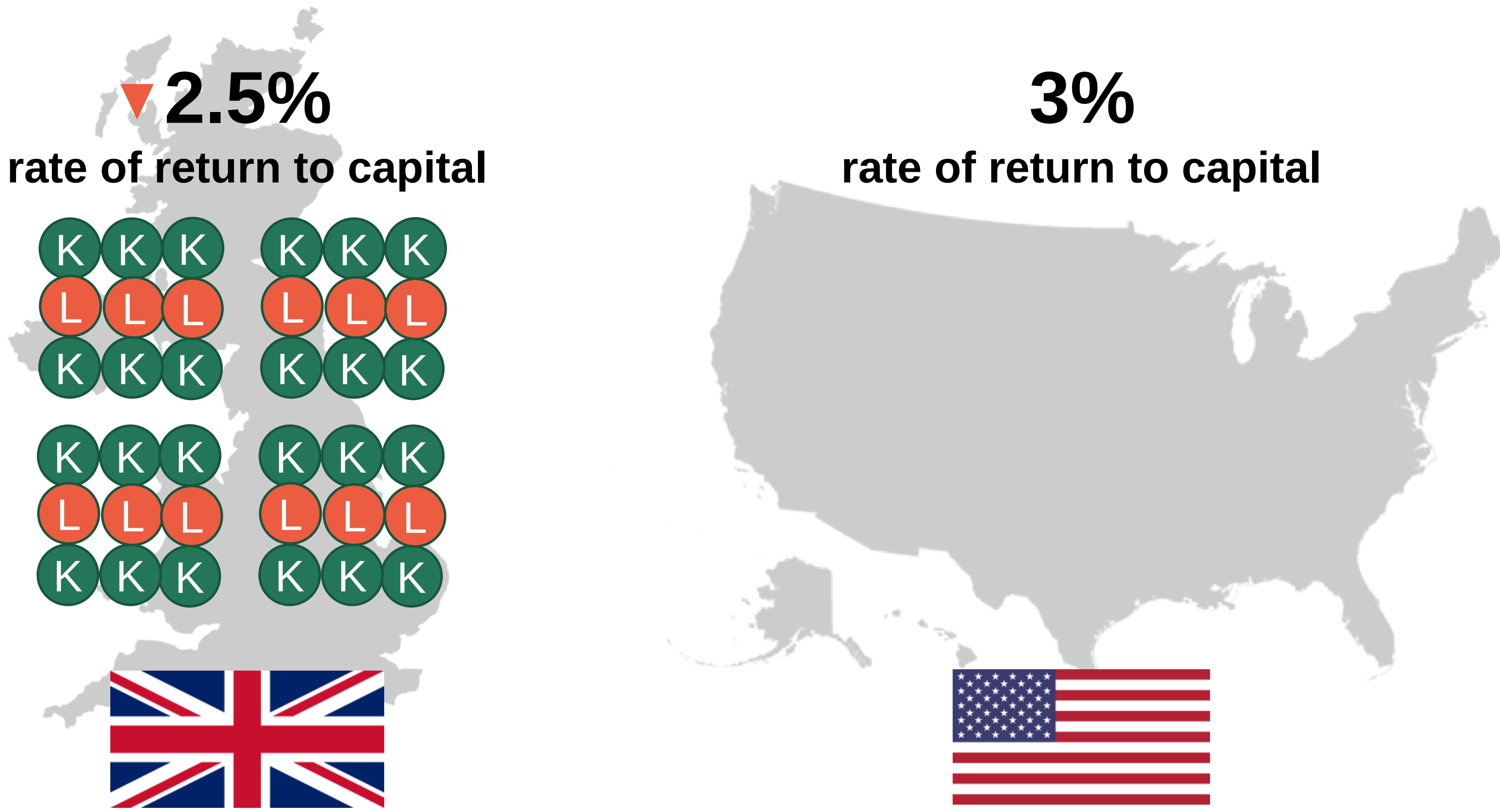
Who ‘pays’ corporation tax?

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



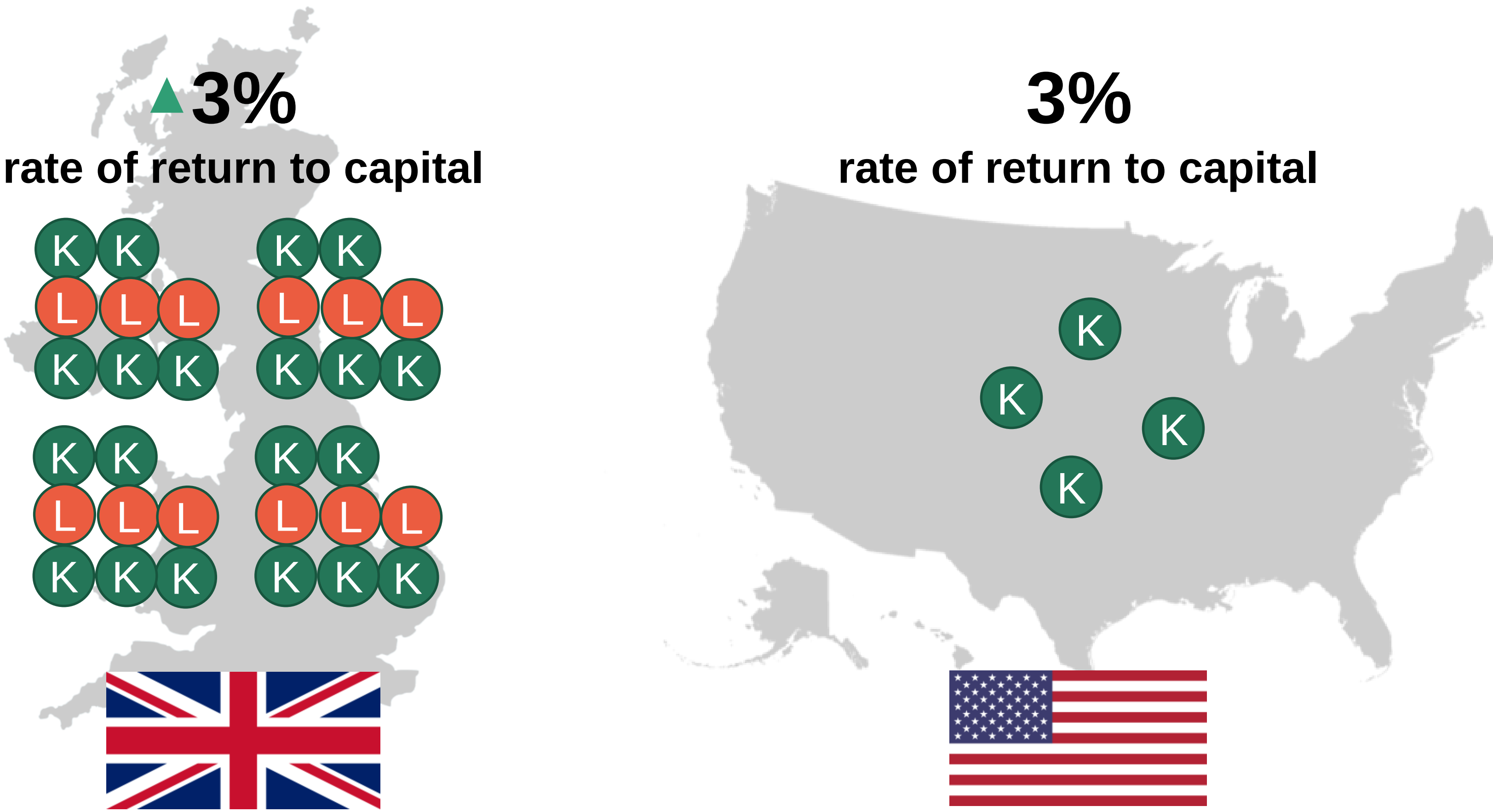
Who ‘pays’ corporation tax?

- 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

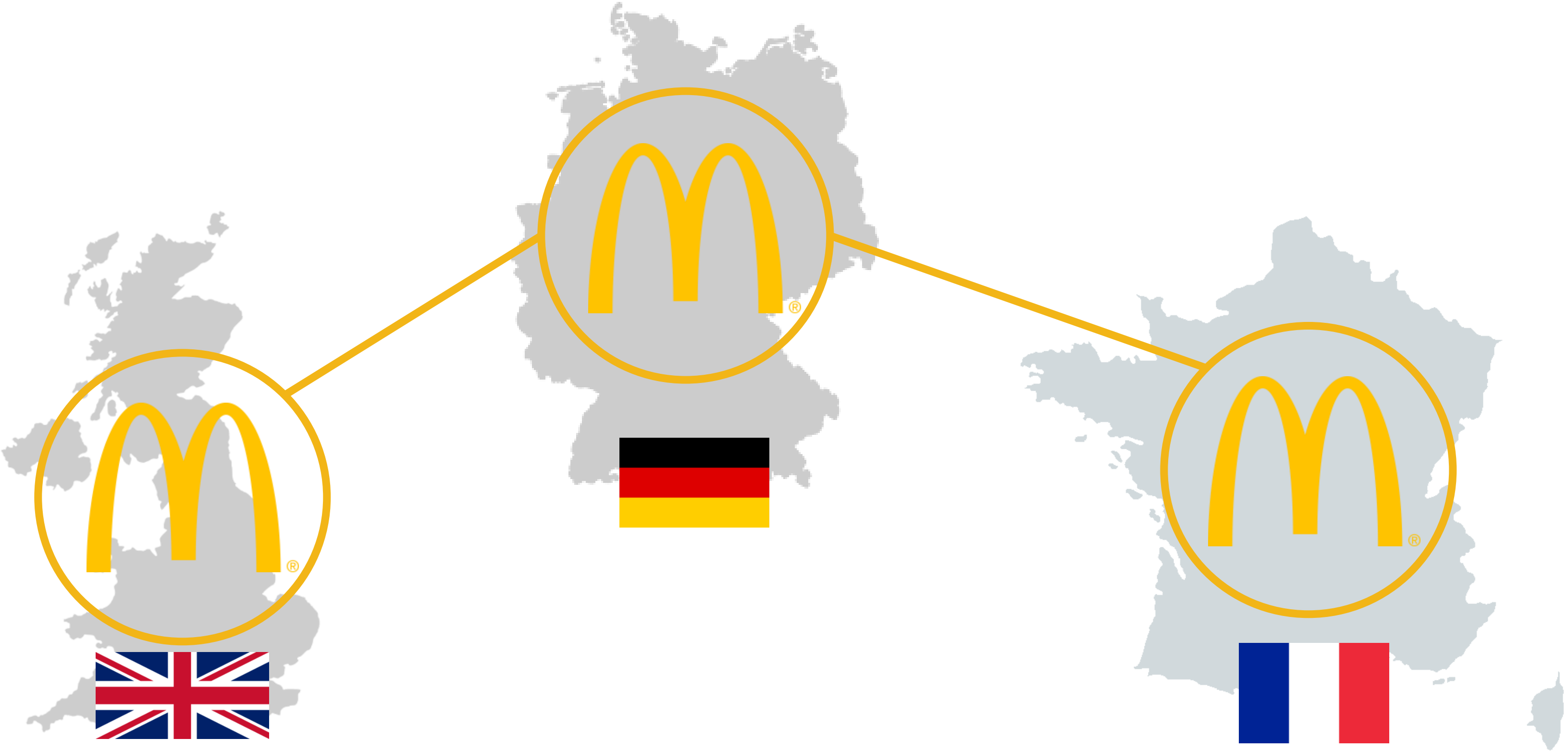
- In a small open economy, where capital is perfectly mobile, **labour bears the burden of the tax** through lower wages.
- In reality, we wouldn't expect to find quite such an extreme scenario. For example some investments may be location specific (e.g. you can't mine diamonds in Devon), etc.

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.**
- The incidence of corporate income taxes is **highly uncertain.**

Taxing multinationals

The allocation problem

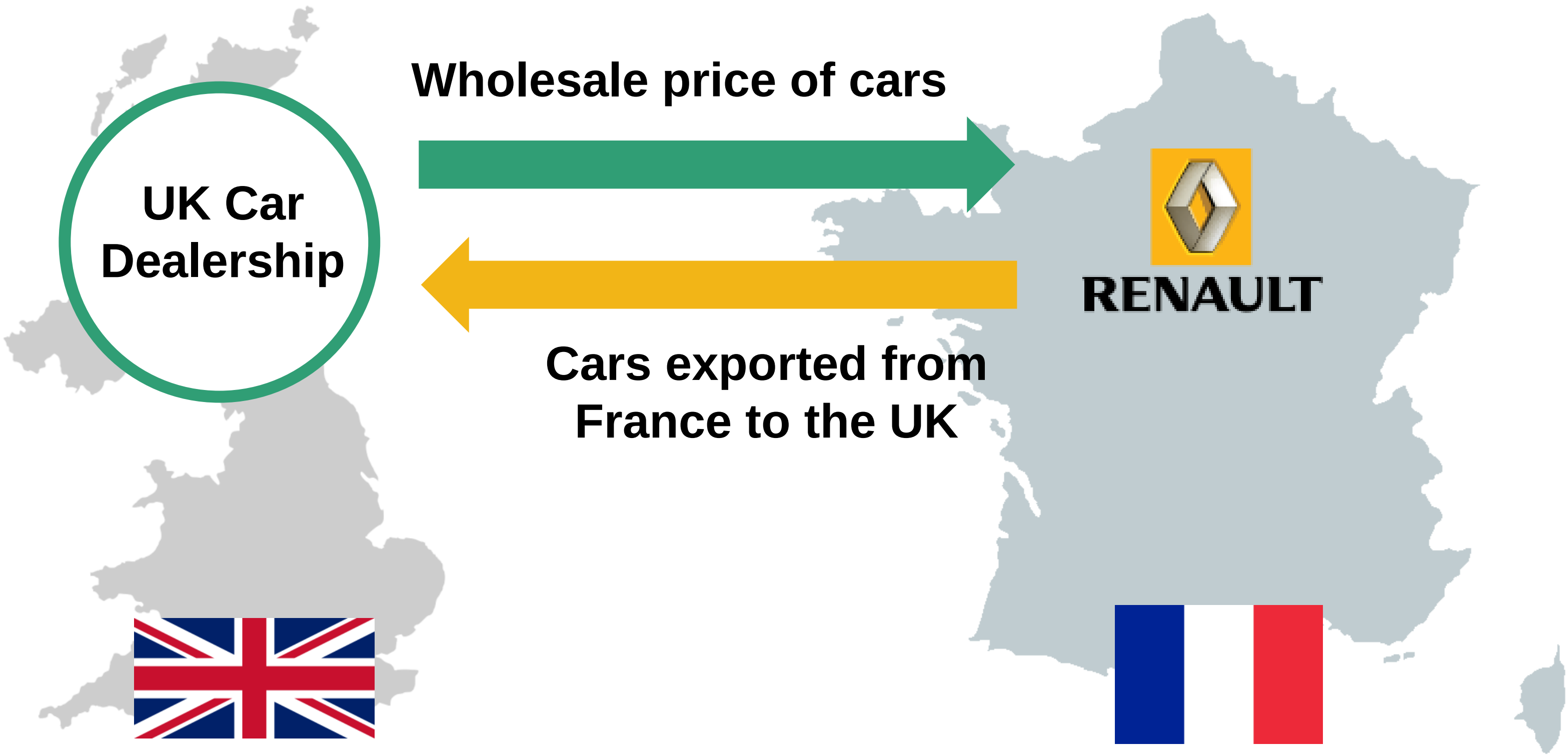


The allocation problem

- 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** is that profits are taxed where value added activity takes place, not where sales and customers are located.

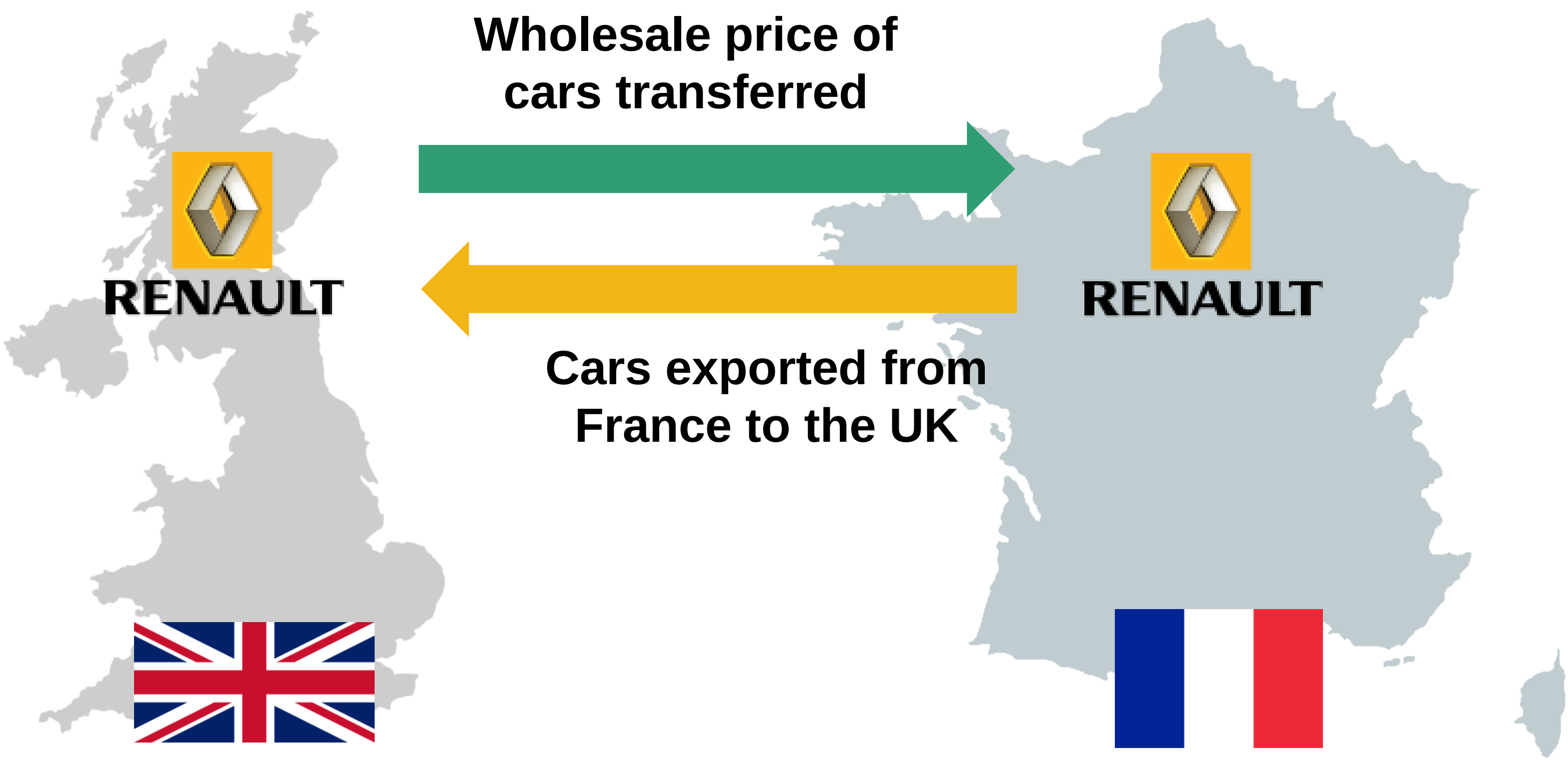
Taxation at source

- 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

Threats to taxation at source

1. Taxation at source creates incentives for companies to move profits to low-tax countries. The growing importance of intangible assets is making this easier.
2. By taxing profits at source (i.e. where production takes place) companies can have lots of customers in a country but pay no tax there.

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Hard to value assets

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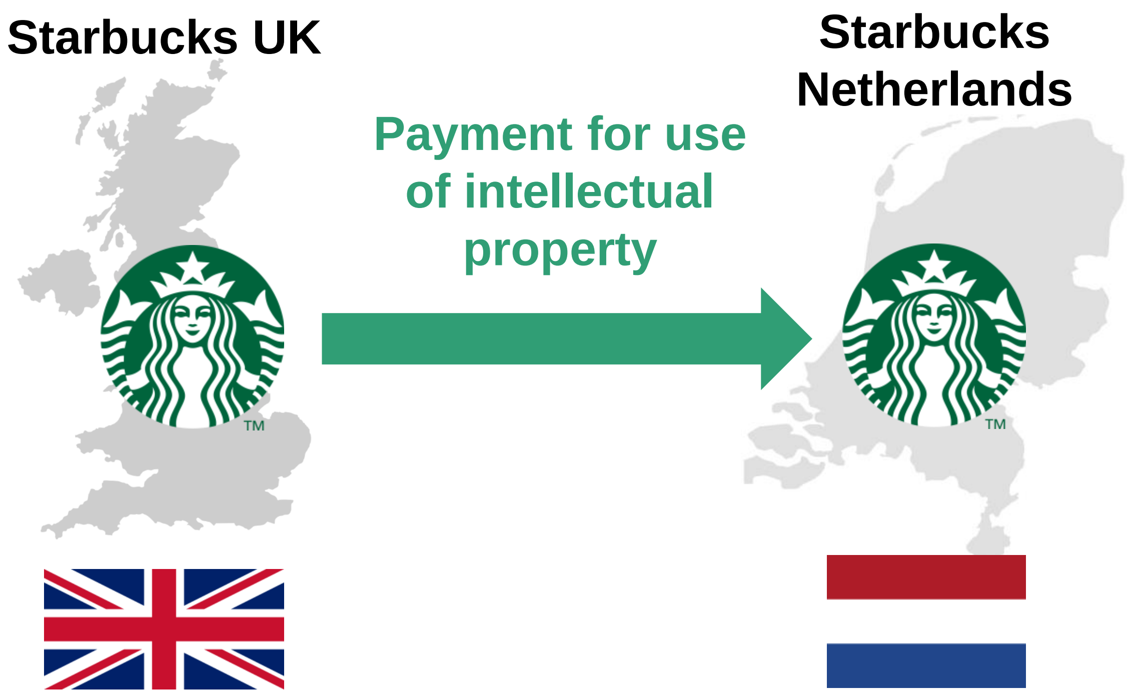
Determining what value is added in which jurisdiction turns out to be very hard. What gives a cup of Starbucks its value?

Where is value created?

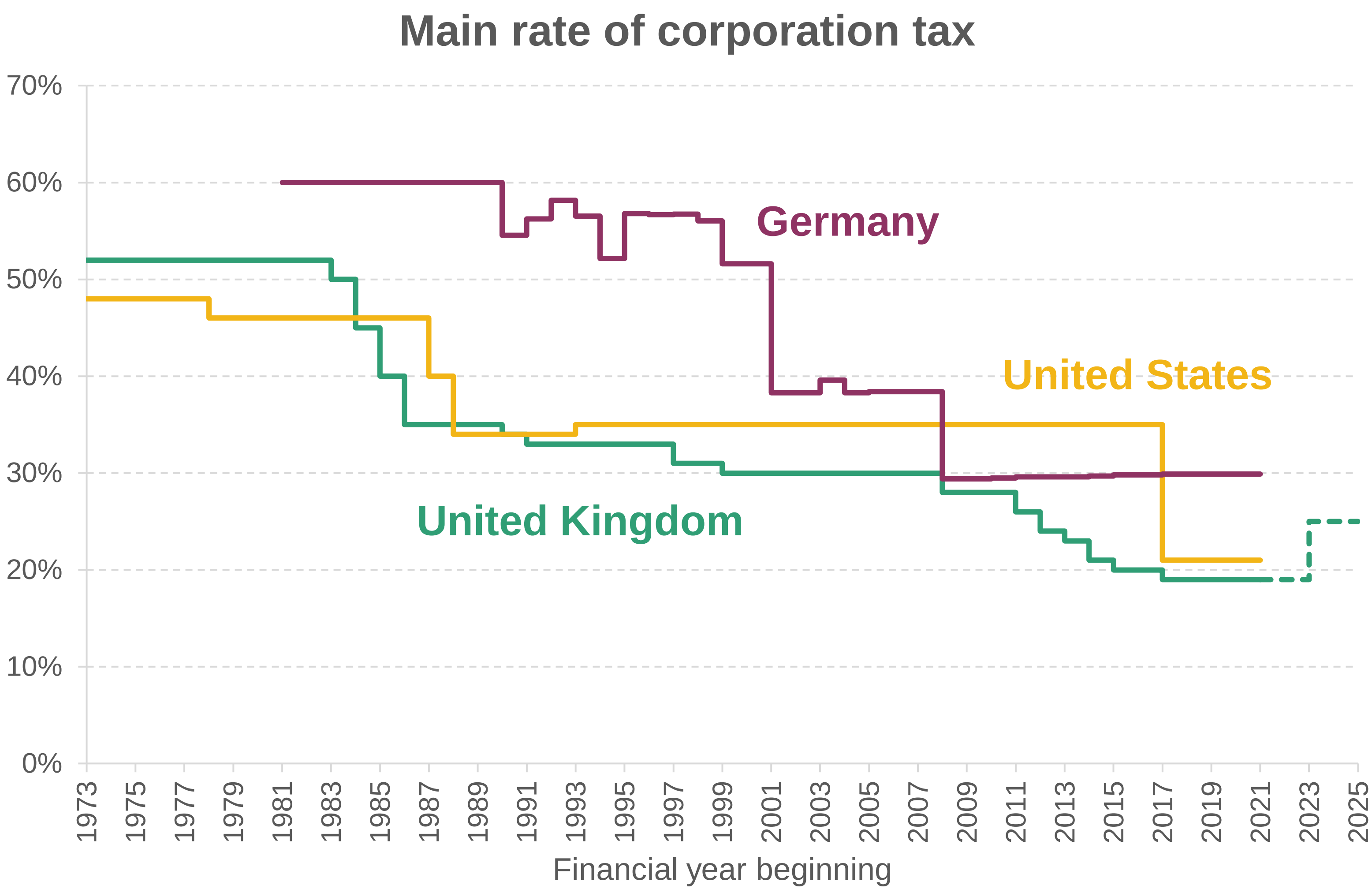
- The truth is that there is often no right answer to the question ‘where is value created?’
- The increasing importance of intangible assets like intellectual property (such as brands and patents) makes the question **inherently ambiguous.**
- Where there is no single right answer, it is hardly surprising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

Hard to value assets

- 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'.



A race to the bottom?



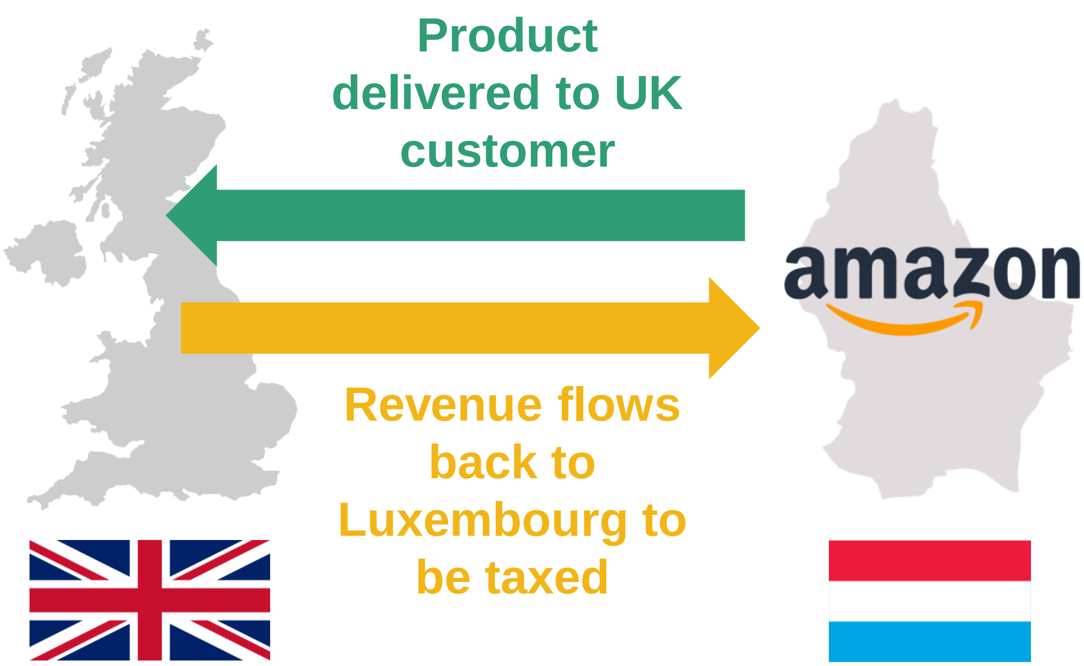
Threats to taxation at source

1. Taxation at source creates incentives for companies to move profits to low-tax countries. The growing importance of intangible assets is making this easier.

2. **By taxing profits at source (i.e. where production takes place) companies can have lots of customers in a country but pay no tax there.**

Customers ≠ Tax

- The location of a company's customers isn't considered for the purposes of corporation tax.
- Companies (**particularly digital companies**) can have lots of customers in a country but pay no tax there.



The international response

World's leading economies agree global minimum corporate tax rate

historic agreement signed by 130 countries

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

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398

onomies have signed up to a plan to force multinational
bal minimum corporate tax rate of at least 15 per cent
tiations in Paris at the OECD.

Nations agree to 15% minimum corporate tax rate

By Daniel Thomas
Business reporter, BBC News

2 days ago

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

International responses

Pillar 1

Trying to better align tax liability with the location of the customer/user

Pillar 2

Global minimum tax rate to tackle ‘race to the bottom’

Pillar 1 (tax based on customers)

- Trying to address the problem of (particularly digital) companies who have customers but no physical presence in a country.
- Basic idea is that profits of some large multinationals will be reallocated for corporation tax to countries where users and customers are based (even if no physical presence exists).

BUT the scope of the agreement seems quite limited:

- Will apply to consumer-facing multinationals with revenues of **>€20 billion**. That's only about 100 companies. Excludes:

Pillar 2 (minimum tax rate)

- Trying to reduce incentives to profit shift by imposing a **global minimum corporation tax rate of 15%**.
- Potentially sensible idea.

BUT maybe not quite what it seems:

- Companies with lots of employees or assets in a country will face a **much lower minimum rate**.
- May create new incentives to shift profits to countries with employees and physical assets.

Conclusions

Conclusions

- Excess profits are a desirable tax base, the aim of a corporation should be to tax them.

BUT

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

  1. Capital can flee overseas, making it hard to tax and leading corporation taxes to **reduce domestic wages and efficiency**.

  2. Companies can move profits to lower tax countries in response to corporation tax. Taxing production (as opposed to something less mobile, like customers) can create **incentives for countries to ‘race to the bottom’** on tax.

Conclusions

Thank you!