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@TheIFS

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



Economic
and Social
Research Council

In today's lecture

Today's lecture will be in three parts:

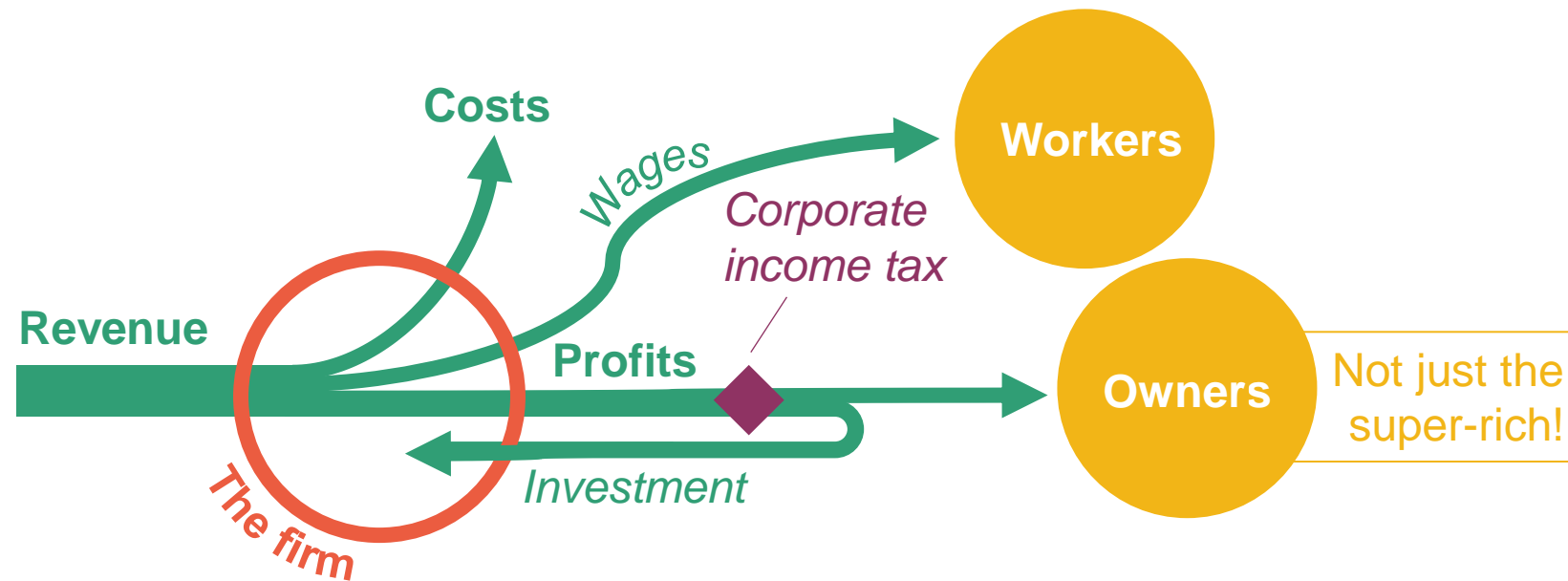
1. What is a corporation tax, and what function do policymakers intend it to fulfil?
2. Who ultimately bears the burden of corporation tax? Workers, or shareholders?
3. What particular problems arise when seeking to tax multinational corporations spanning multiple jurisdictions – why do we see stories about big companies paying so little?



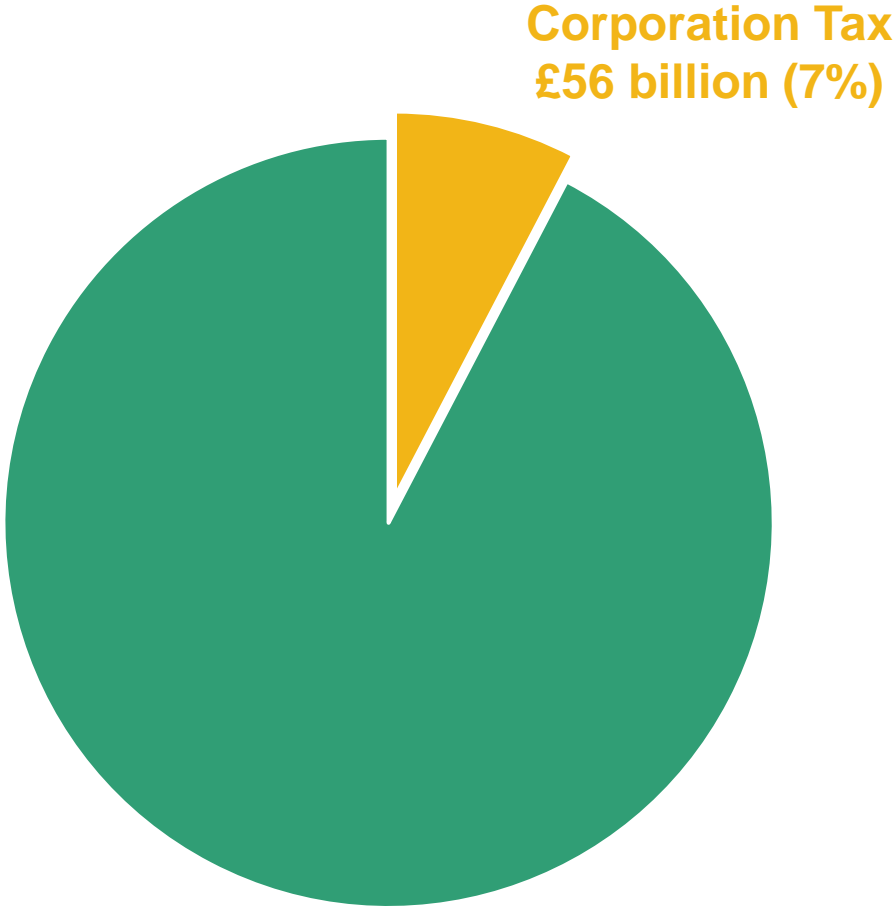
What is a corporation tax and why do we have one?

What is a corporation tax?

- Corporation tax is a tax on the profits of **incorporated businesses**

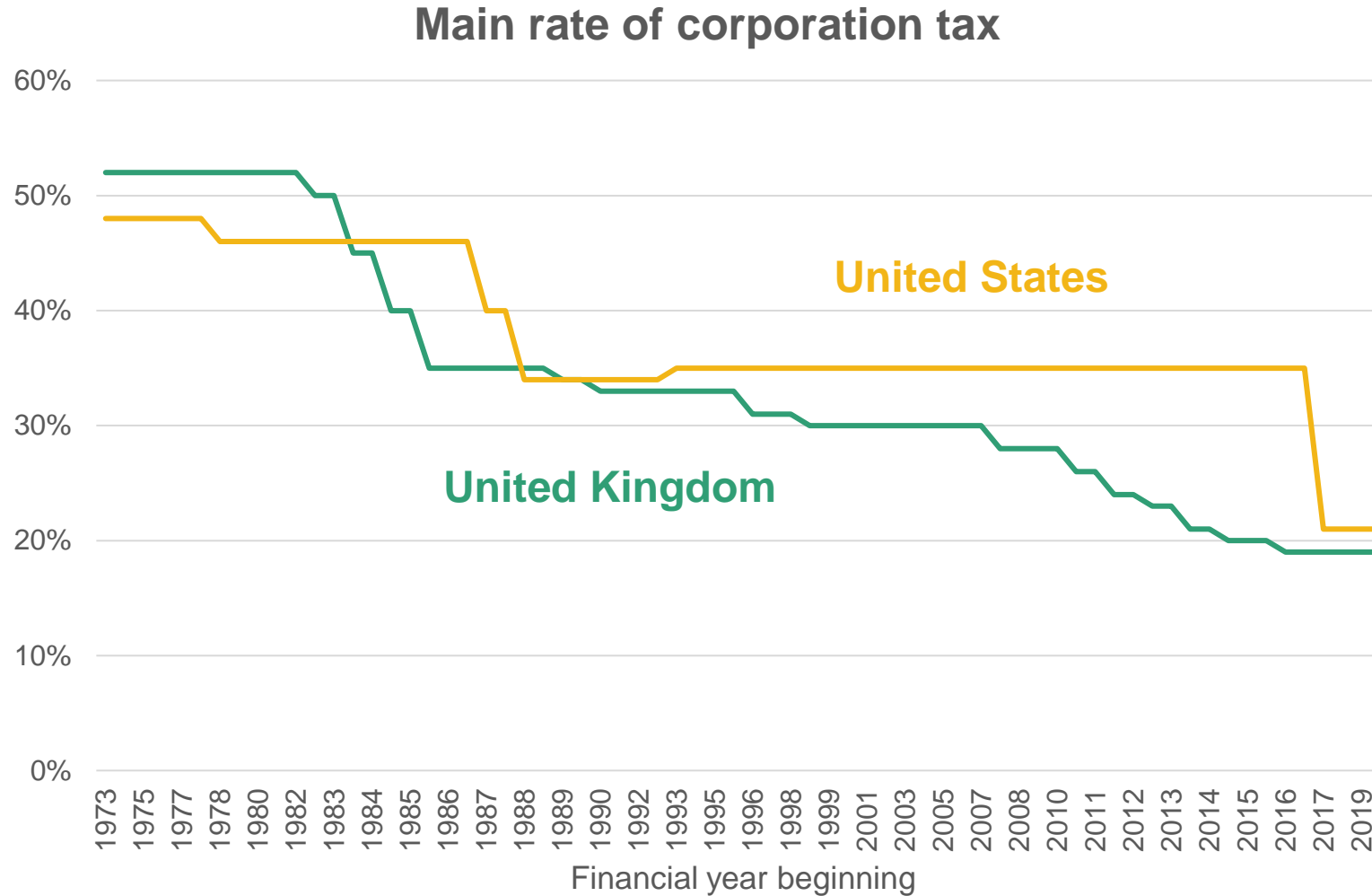


How much money does it raise?

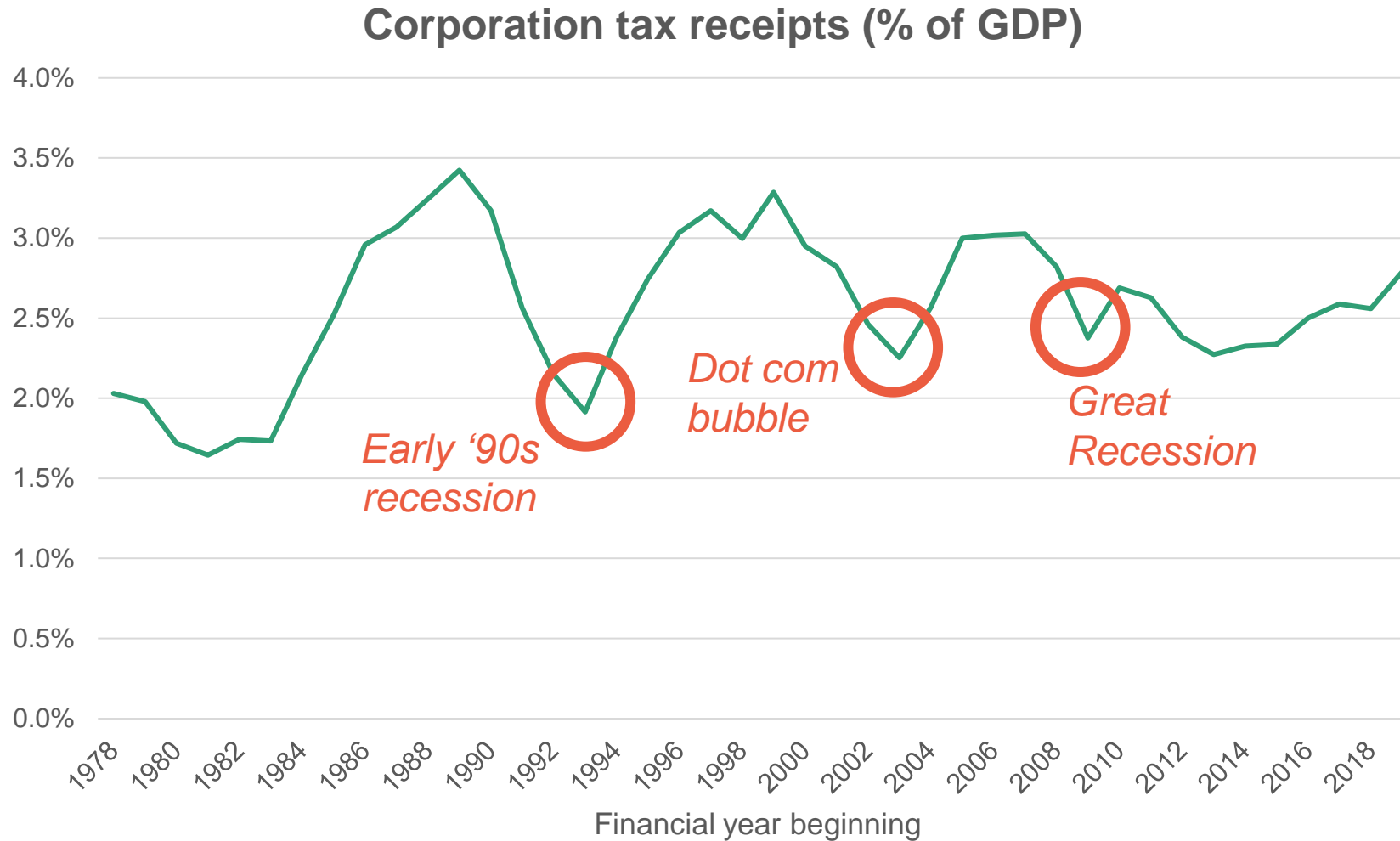


UK tax revenue 2018-19

How has corporation tax changed?

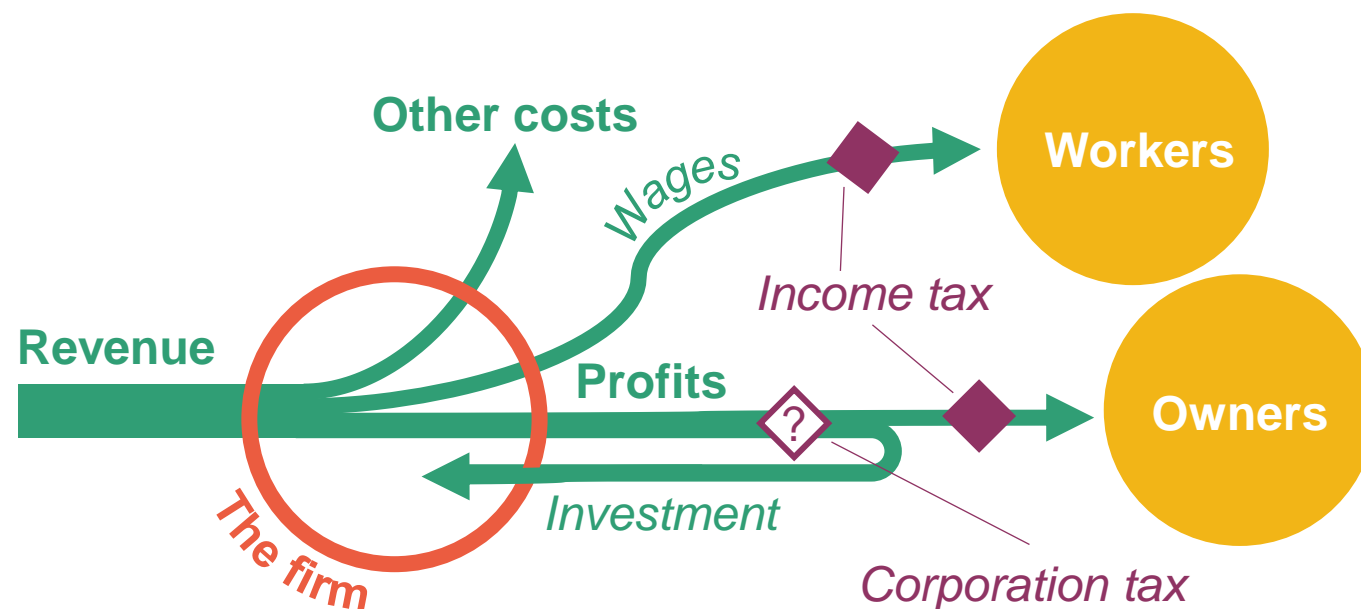


How has corporation tax changed?



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**.

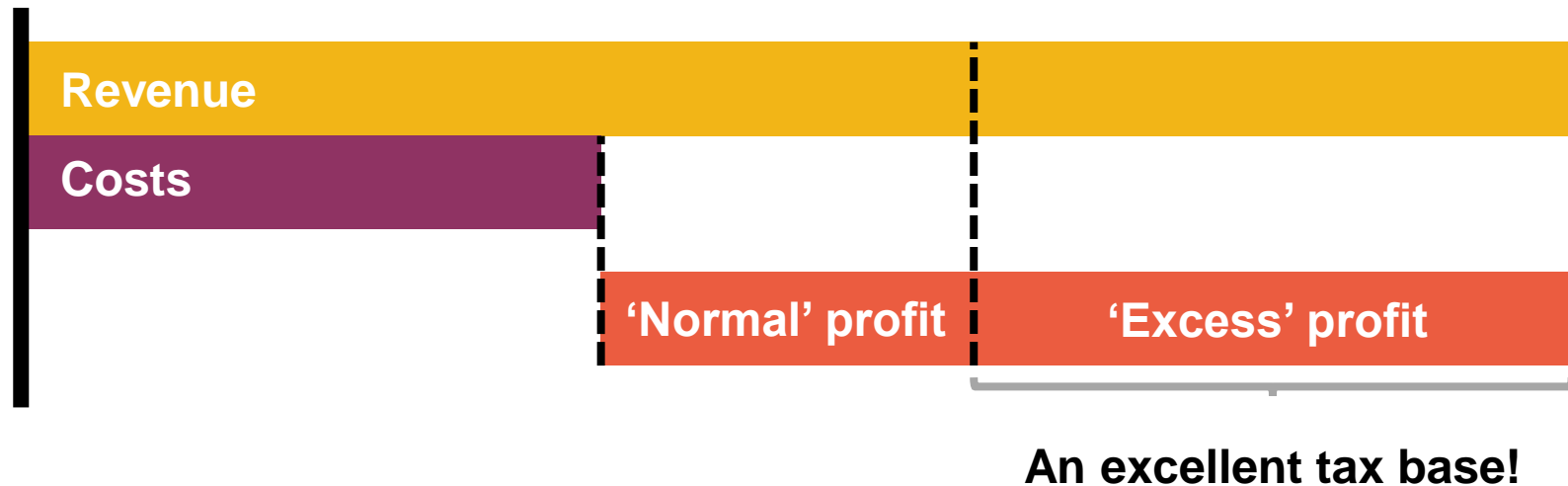
- In a perfectly competitive market, firms earn just enough profit to compensate investors for putting their money at risk. We can think of these as **'normal profits'**.



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.



The international context

So, in a domestic context **corporation taxes can play an important role in taxing excess profits** – a non-distortionary tax base.

HOWEVER once we start thinking about corporation tax in a global context that is no longer true – the tax runs into problems:

1. **The burden on workers:** The mobile nature of international capital shifts some of the tax burden onto workers – making the tax distortionary
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 people.**
- But which people? When a corporation tax is imposed who end up worse off, **workers or shareholders?**
- Relevant for answering the question of how progressive a corporation tax is – i.e. do the rich pay more – because shareholders tend to be wealthier than workers (although, remember anyone with a private pension is a shareholder).

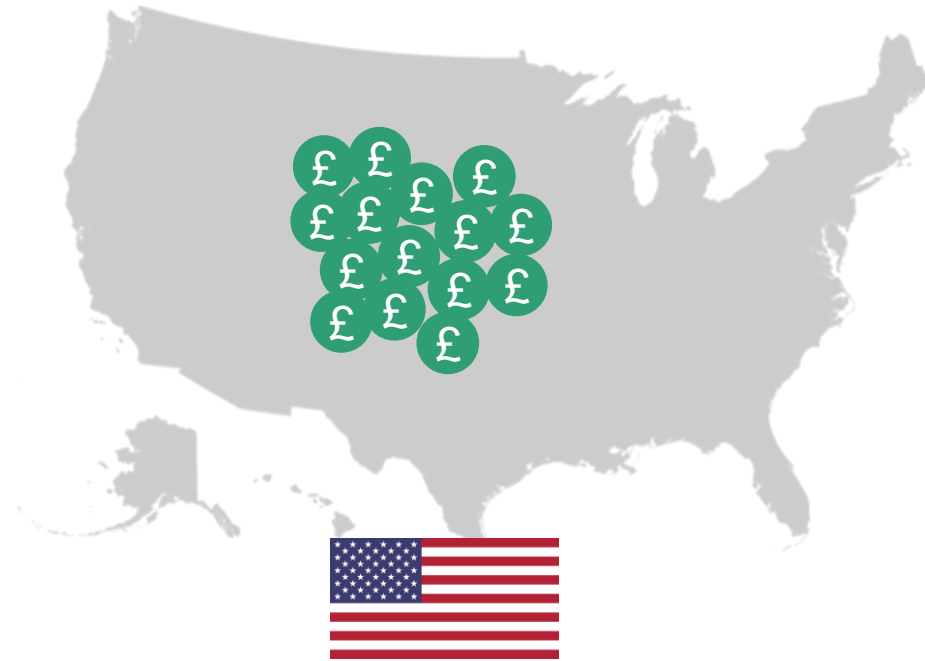
Who bears the burden of corporation tax?

- Suppose UK and US risk adjusted returns to investment are initially equal

3% rate of return



3% rate of return



Who bears the burden of corporation tax?

- Now suppose a rise in UK corporation tax reduces returns

▼ **2.5%** rate of return



3% rate of return



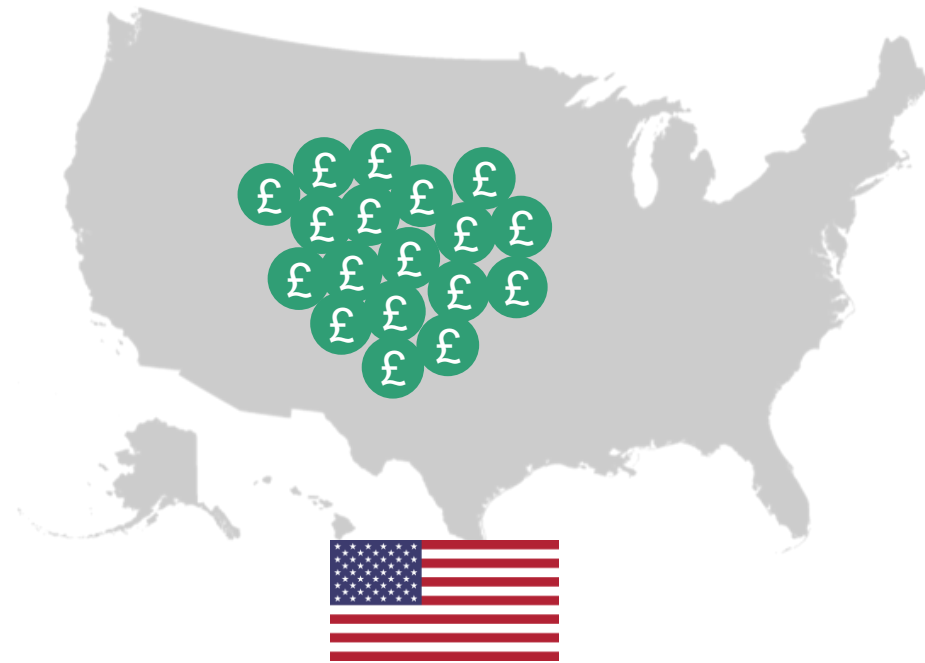
Who bears the burden of corporation tax?

- Scarcity of investment drives up returns for investors

▲ **3%** rate of return



3% rate of return



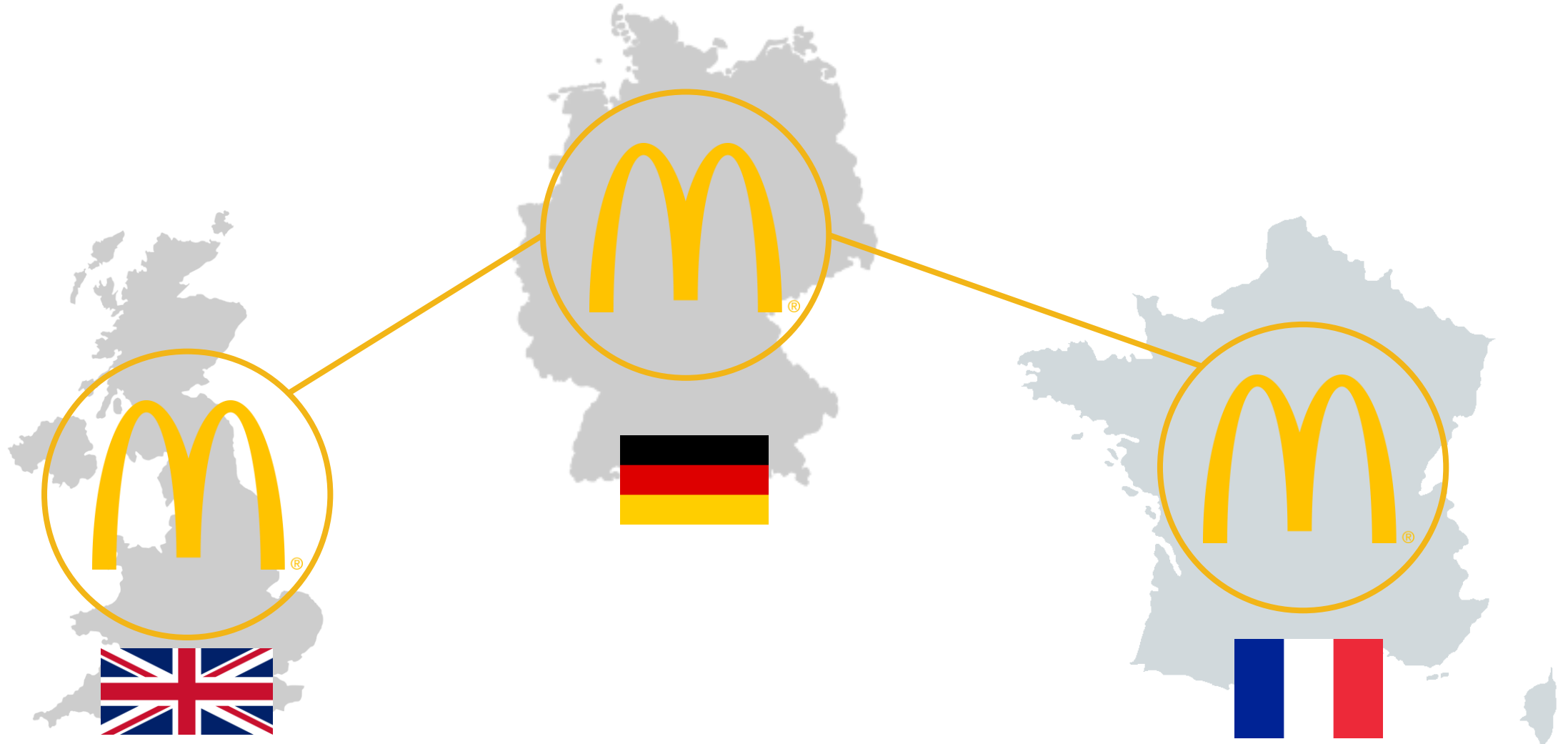
Incidence: conclusions

- 100% of the tax burden falling on workers in an **extreme example**.
- Of course, **not all investment can move easily from one country to another**. For example some investments may be location specific (e.g. you can't mine diamonds in Devon), etc.
- As a result, statistical estimates by economists suggest that in developed economies somewhere **between 1/3 and 2/3** of the burden of corporation tax is ultimately borne by workers.



Taxing multinationals

The allocation problem



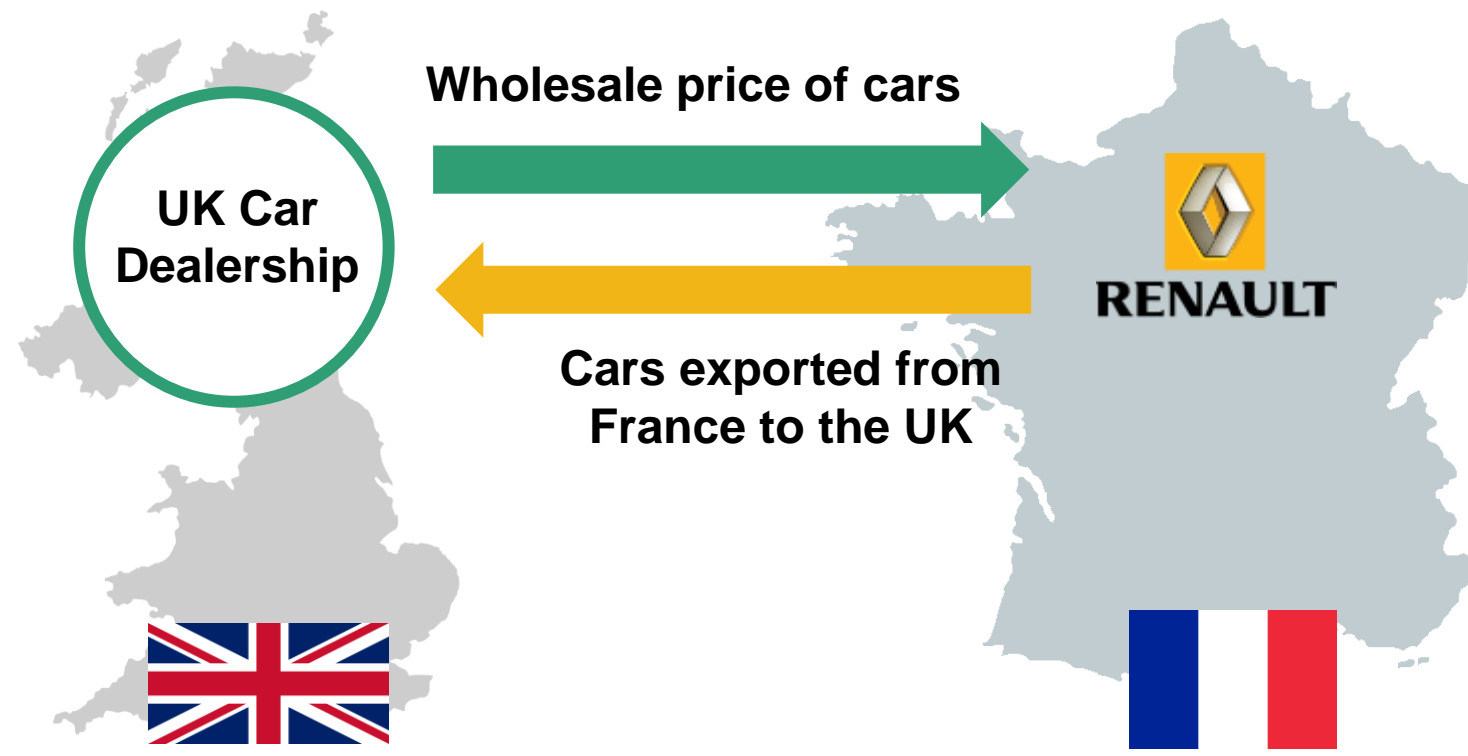
The allocation problem

- 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 the share of profits made in their country.



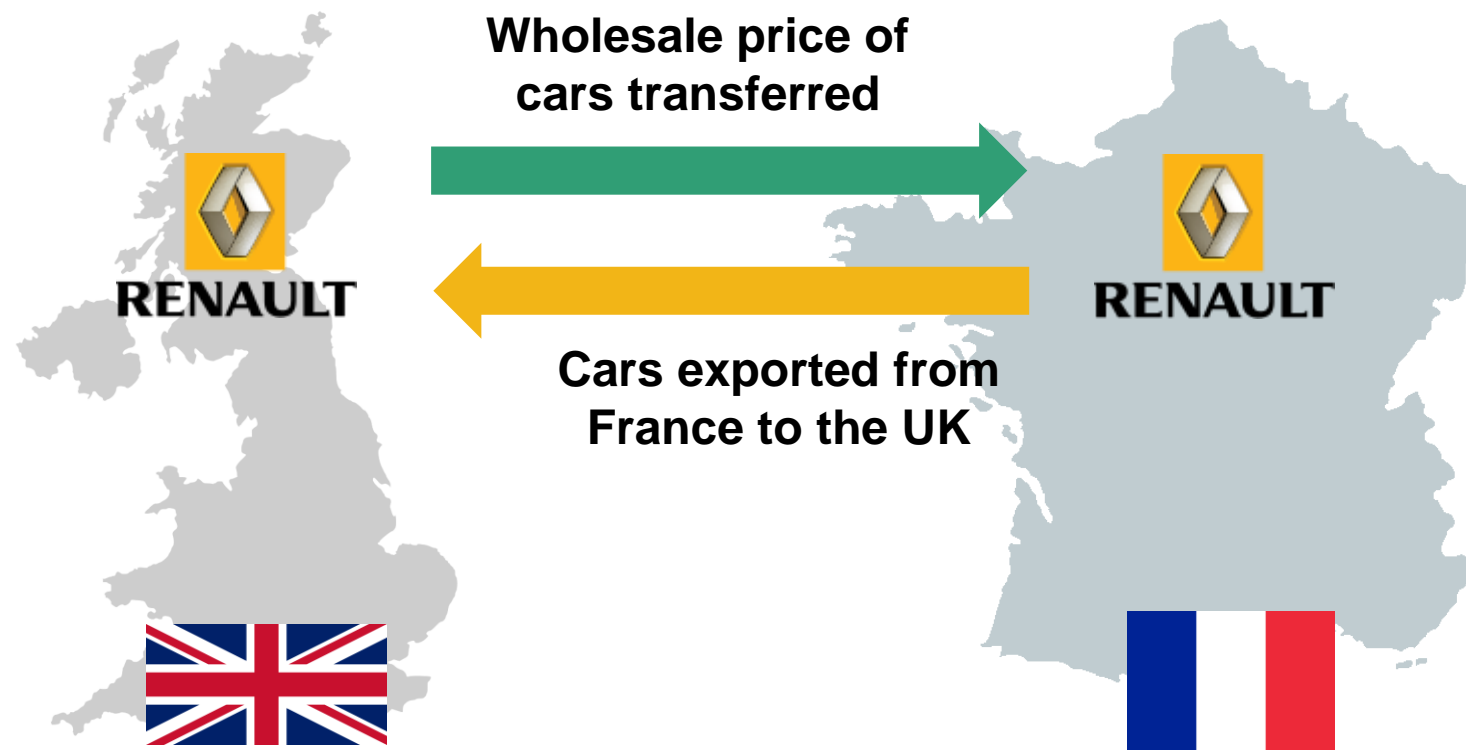
Taxation at source

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



Transfer pricing

- Multinationals must emulate the free market by transferring the price of imported inputs internationally
- **Transfer prices** are decided on the **'arm's-length principle'**



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

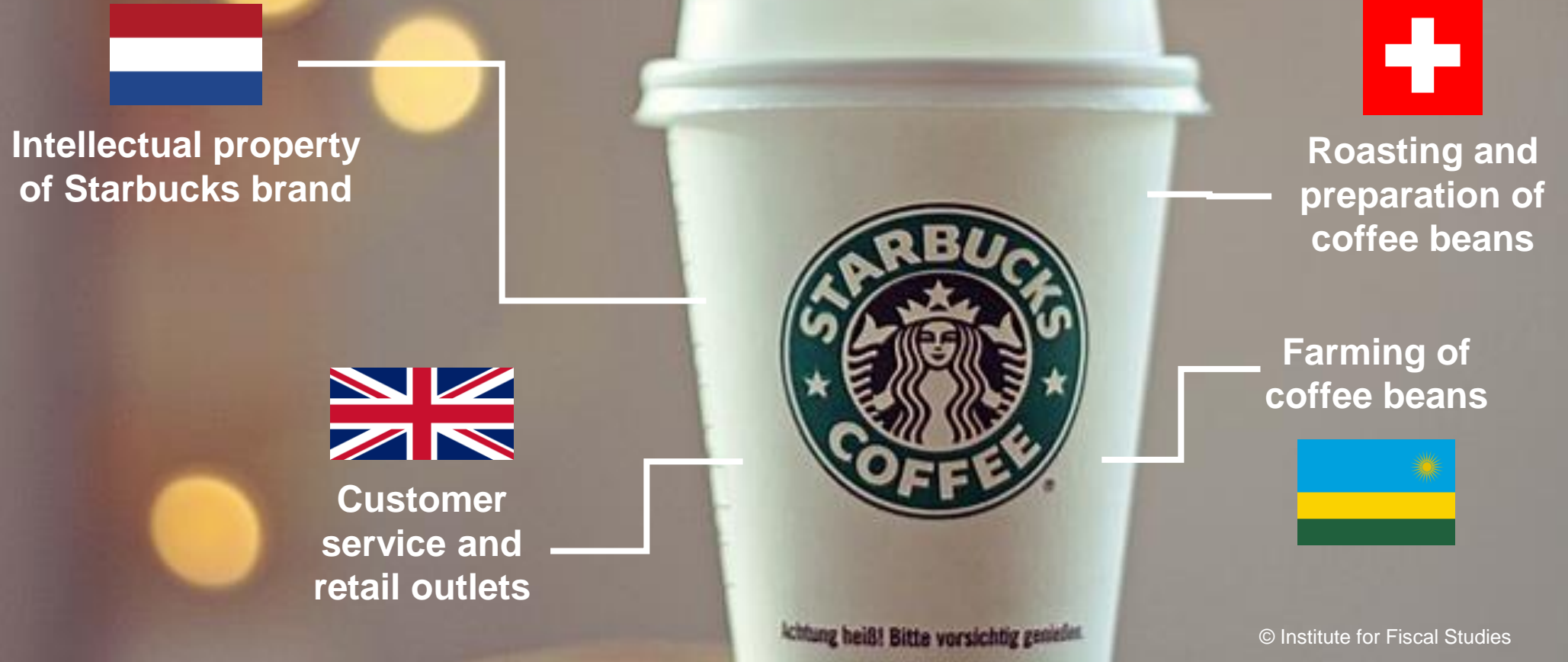
Amazon pays just £220m tax on British revenue of £10.9bn

ays



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?

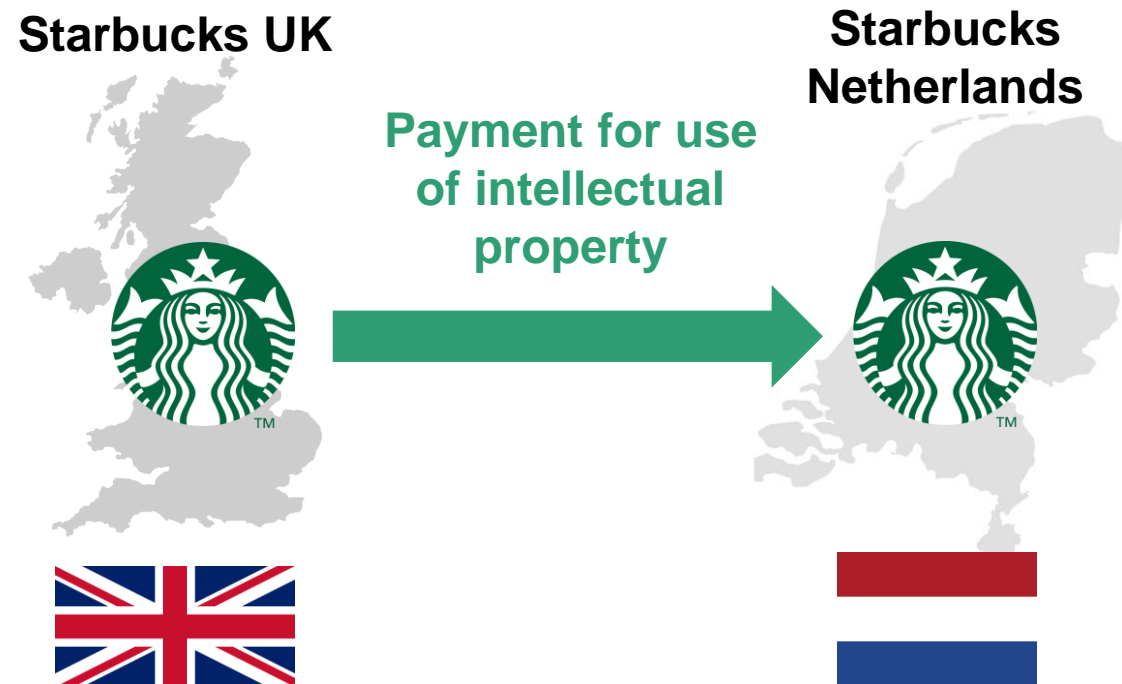


Where is value created?

- 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

Profit Shifting

- 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's brand worth?
- This can lead to so-called 'profit shifting'.

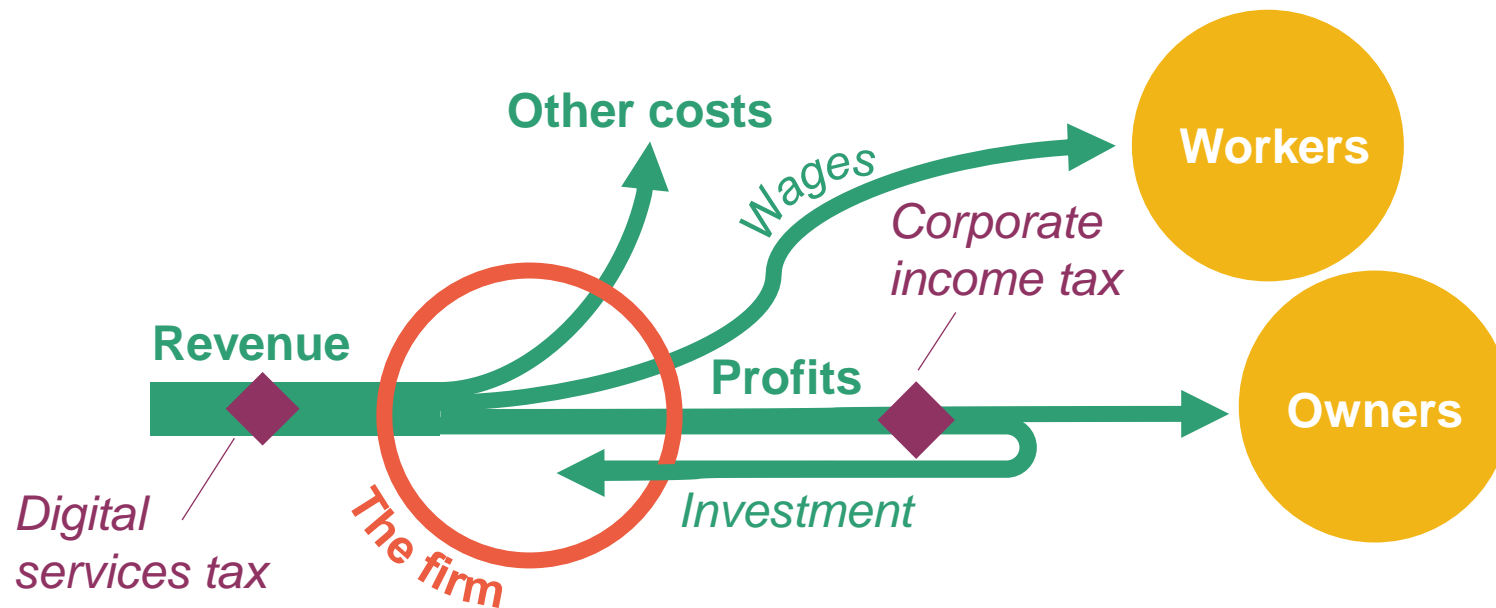


Government responses

- **The Diverted profits tax:** the UK government charges a higher rate of corporation tax on profits that are deemed to have been ‘diverted’ (i.e. where the arm’s length principle is deemed to have been violated). This **increases the financial risk of violations for multinational corporations.**
 - **BUT** as we’ve seen the problem isn’t primarily that companies are breaking the rules. It’s that the rules **are inherently ambiguous!**

Government responses

- **The digital services tax:** because digital services (like search engines and social media) are particularly vulnerable to profit shifting a number of European countries – including the UK – have chosen to adopt digital services taxes.
 - Taxes revenues rather than profits.



Government responses

- In 2018-19 the Diverted Profits Tax brought in **£12 million** to the UK Treasury, while the Digital Services Tax is eventually forecast to bring in around **£500 million** of revenue
- That's a drop in the ocean compared to the >£50 billion in revenue yielded by corporation tax
- Ultimately these are **sticking plaster solutions**. The real challenge is that 'taxation at source' is no longer a robust method for allocating profits internationally



Conclusions

Conclusions

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

BUT

- The globalized economy in which we live poses challenges to the efficacy of the corporation tax in two key ways:
 1. It pushes a larger portion of the tax burden onto wages by making domestic industry **less efficient** and the 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.

Conclusions



Thank you!

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