The Corporate Tax Canard?

Publish Date:

November 2014

This article from the November 2014 edition of the IPA Review is by Policy Director at the IPA, Chris Berg, and Senior Fellow at the IPA and Professor of Institutional Economics at RMIT University, Sinclair Davidson.

Earlier this year Joe Hockey announced that the upcoming G20 meeting, being hosted in Brisbane in November, has a target of an extra two per cent economic growth for all its members.

But the only concrete policy the G20 has come up with is the 'Base Erosion and Profit Shifting action plan'—a crackdown on multinationals taking advantage of the low corporate taxes offered in some countries.

It's a sad reflection on the state of international politics that the only thing the world's biggest economies can agree on is the need to tax corporations more.

The corporate income tax is only one among many other taxes. As it is, corporations not only pay the corporate income tax, they also pay payroll taxes, local rates, and a host of other charges and levies. To judge the merit of a multinational corporation only by the corporate income tax it pays is to ignore the real economic value of these organisations. Multinational corporations provide investment, create jobs, facilitate innovation transfers, provide goods and services, in addition to paying tax.

However, there is a widespread perception that large corporations pay very little corporate income tax. There is undeniable populist outrage over the ‘low’ amounts of corporate income tax paid by multibillion dollar corporations such as Apple, Google, and Starbucks. We hear so much about ‘Double Irish Dutch sandwiches’ (the practice of basing subsidiaries in Ireland and the Netherlands because of their low tax rates) and ‘base erosion’ (the apparent draining away of government revenue from tax shifting). Something must be wrong.

Most advanced economies have large fiscal deficits and little prospect of returning their budgets to surplus.

It is quite clear that excessive government expenditure is the basis for their fiscal deficits. Governments with deficits have two choices. They can cut spending or increase taxes. Increasing corporate tax is a politically desirable policy given the fiscal illusion that surrounds this form of taxation.

On average OECD economies raise more tax revenue now than they did 25 years ago. In fact, while corporate tax rates have declined over the past 25 years, corporate tax revenues have not.

So how is it that multinationals like Apple, Google and Starbucks pay ‘low’ amounts in corporate tax? The answer is simple. Much of the activity that Apple, Google and Starbucks undertake is not sourced within the UK or US and hence is not taxable in those jurisdictions. This is like complaining that firms which shift their manufacturing to China are no longer liable for payroll tax in the United States.

Corporate tax rates are as much a part of the economic competitiveness of a country as productivity, infrastructure and labour costs. Countries have to choose whether they would like unattractively high taxes and high social services or attractively low taxes and privately provided social services—and no amount of international cooperation is going to eliminate that trade-off.

So while it is true that these corporations do not pay as much tax as various governments would like them to pay, they do pay as much tax as is required by the laws that those governments have passed. There is little evidence of any actual wrongdoing by any of the corporations regularly singled out for abuse.

The past 25 years or so have seen substantial tax competition between nations. This has resulted in a decline in corporate income tax rates, but there is little evidence to support the notion that tax competition has reduced actual corporate income tax revenues. Furthermore, there is no evidence to support the view that a decline in corporate tax revenue has contributed to current budget deficits. If anything it is clear that government expenditure decisions, and not decreased revenue, has contributed to these deficits. Nonetheless, it is the popular misconception that under-taxed corporations are to blame.

Consequently, the OECD and various European politicians have advocated ‘tax rate harmonisation’ among nations.

Tax harmonisation refers to the process by which taxes are made the same, or similar, in any given region. Generally, it means *increasing* tax in low-tax jurisdictions rather than reducing tax in high-tax jurisdictions. The best example is the European Union where all countries must have a value added tax of at least fifteen per cent. The latest theoretical argument to support the notion of tax harmonisation is the so-called ‘stateless income doctrine’ developed by Edward Kleinbard, Professor of Law at the University of Southern California.

Under this theory, multinational corporations are able to generate income that is apparently untaxed. While Kleinbard’s definition of stateless income is quite convoluted, the basic idea is quite simple. Stateless income can be understood as the movement of taxable income within a multinational group from high-tax to low-tax source countries without shifting the location of externally-supplied capital or activities involving third parties. This particular phenomenon is not unknown or even unusual—yet Kleinbard claims that stateless income is not equivalent to capital mobility or aggressive transfer pricing.

The key to understanding Kleinbard’s argument is the term ‘low-tax jurisdictions’—the whole notion of stateless income turns on the definition of the corporate income tax base, and the protection of property rights.

The problem with his argument is that governments have chosen and created the architecture that governs the tax system. Some of the features of the tax system that he identifies as generating stateless income include: deductibility of interest payments, freedom of contract, limited liability, and the veil of incorporation. These legal innovations have driven much of the prosperity that we have experienced since the mid-nineteenth century. They also result, apparently, in the government raising less revenue than otherwise. At best his argument is that the tax base should be defined differently, but that is not an argument that the tax base is being eroded.

Contra Kleinbard, there is no such thing as ‘stateless income’. Rather, there is income that governments do not tax because under their own legal systems that income is not sourced in their own economy. Unsurprisingly, governments have been reluctant to meddle with these long-standing, tried-and-tested business principles.

There is little empirical evidence to support the notion of stateless income. In a 2013 article published in the *Journal of Public Economics,* Dhammika Dharmapala and Nadine Riedel investigate the amount of profit shifting that actually occurs using 5400 European multinational affiliates over the period 1995–2005. In the first instance they report that profit shifting does occur. The magnitude of the profit being shifted, however, is only two per cent of parent corporation profits. While they indicate that this amount is ‘substantial’ it is much lower than many other (indirect) estimates of the amount being shifted.

It is true that some multinational corporations do not pay as much tax in their host economies as their consumers and voters in those economies might expect. Yet this does not necessarily imply any wrong-doing on the part of those multinational corporations.

The corporate income tax system is not broken. These claims arise only when government expenditure creates large debts for which they must then drum up revenue—cue the cry for increasing taxes on those who should ‘pay their fair share’. In other words, the ‘base erosion’ problem, such as it is, is in the public sector, not the private sector.