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Richard S. SIMMONS

Lingnan University, Hong Kong, simmons@ln.edu.hk

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What Future for the Corporate Tax in the New Century?

Richard S. SIMMONS
PhD, FCA, FCPA, ATIIHK
Assistant Professor
Department of Accountancy
Lingnan University

Tuen Mun, Hong Kong
Tel: (852) 2616 8175
Fax: (852) 2466 4751
E-mail: simmons@LN.edu.hk

Hong Kong Institute of Business Studies
Lingnan University
Tuen Mun
New Territories
Hong Kong
Tel: (852) 2616 8373
Fax: (852) 2572 4171
E-mail: hkibs@ln.edu.hk

WHAT FUTURE FOR THE CORPORATE TAX IN THE NEW CENTURY?

ABSTRACT

It has long been recognised that the corporate tax suffers from several inherent deficiencies. However, in recent years, the transformation and integration of the world economy has exacerbated and highlighted these weaknesses, placing a question mark over the future of the tax. Through an examination of the problems besetting the tax today, a critical analysis of the conventional justifications for it, and a review of economic and political factors relevant to its continued existence, this article considers its future in the new century.

Five main criticisms of the tax are identified. First, allocating profit between tax jurisdictions is becoming increasingly problematic. Second, it is poorly equipped to adapt to new forms of commerce. Third, because of the existence of international tax differentials, it distorts the optimum allocation of global investment. Fourth, it distorts the capital structures of companies. Finally, it is increasingly inequitable.

Theoretical justifications for the tax are unconvincing. Its continued existence is more likely due simply to the importance of its revenues to government and political obstacles to its abolition.

The main present threat to the tax's existence is its possible repeal in an important economy such as the US, subsequent to which smaller countries may have no choice but to follow suit. A further threat is that increased tax competition may reduce the comparative importance of corporate tax revenues to governments. This, together with likely increased costs of compliance and enforcement, may eventually force governments to reconsider the merits of retaining the tax.

Classification codes: H25 Business Taxes, F02 International Economic Order

Keywords: corporate taxation; tax revenues; tax competition

WHAT FUTURE FOR THE CORPORATE TAX IN THE NEW CENTURY?

1. INTRODUCTION

The taxation of corporate income (“the corporate tax”) is a widespread source of government revenue; today, in one form or another, it forms part of the tax systems of nearly all developed nations. However, in recent years, it has come increasingly under attack. To long-standing criticisms of the tax purely in a domestic context have been added more recent complaints that it is ill adapted to a world economy that is becoming increasingly integrated and influenced by technological change.

Recent developments have combined to make the world a smaller place. In particular, advancing globalisation and the advent of electronic commerce have increased the interdependency of individual economies. This has brought with it an increased awareness of the need to formulate new sets of rules on an international basis to govern the new global environment. In some areas of international taxation, admirable progress has been made, for example on the use of tariffs and subsidies in the trade area. However, by contrast, comparatively little has been done to regulate corporate taxation. This lack of international co-ordination is at the heart of many of the problems besetting the tax today.

In view of recent global developments, the purpose of this paper is to critically review the current role and functions of the corporate tax, and, in this light, to consider its future. Indeed, a more basic question is considered of whether the tax can, or should, survive in the new century. While recently all taxes have, to one extent or another, been subject to pressures of change in fast-transforming domestic and global environments, these pressures have been applied most intensely to the corporate tax, since the corporate domain has been largely at the forefront of economic and technological changes. The future of the corporate tax is, then, important in the broader issue of how the structure of individual countries’ tax systems, and of the international tax system, might evolve in future.

The paper is divided into five further sections. The next section considers recent criticisms of the tax, and why these have become more pronounced in recent years. The paper then discusses why, in spite of these complaints, the tax remains widely in use. Section 3 analyses the more conventional justifications put forward for the tax’s existence while section 4 considers further explanations for its durability. The future of the tax is discussed in section 5. Section 6 concludes.

2. THE CORPORATE TAX UNDER ATTACK

Recent economic, political and technological developments have provoked renewed criticisms of the corporate tax. These criticisms are now outlined in turn.

a. Allocational Issues Across Jurisdictional Boundaries

When companies operate in more than one taxing jurisdiction, the question is raised of how to allocate the profits raised between those jurisdictions. In particular, policies and practices need to be established on how to charge transfers of physical goods, services and

intangible property between business units within a multinational group (transfer pricing). Over time, an international consensus has been built up, establishing the “arm’s-length principle” for transfer pricing, i.e. that intra-group transactions should be priced as though they were being transacted by independent persons. This international consensus culminated in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations in the mid-1990s, since when they have been regularly updated.

This consensus is now under great strain, for several reasons. First, the sheer volume of international intra-firm transactions is providing an enormous challenge to the regulatory efforts of national tax authorities.¹ Second, the operations of multinational enterprises (MNEs) are becoming more integrated. When the various functions involved in international operations (for example, trading, risk-management, funding, marketing, administration, etc.) need to be factored into transaction prices, traditional methods of ascertaining these prices are no longer adequate (see Doernberg and Hinnekens, 1999). Third, MNEs are becoming more service-oriented, and are relying more on intangibles such as brands and intellectual property to create wealth. These are difficult to price. Finally, as mentioned by Owens (1993), these highly integrated companies are increasingly able to take advantage of economies of scale, making price comparisons with unrelated parties increasingly inappropriate.

Because of these developments, the arm’s-length consensus is now in danger of breaking down. If it does so, the world may be left with what many consider to be a second-best alternative, such as the unitary or arbitrary formula approach to income allocation, or indeed no consensus at all.²

b. Problems Posed by Electronic Commerce

Electronic commerce compounds the problem of income allocation mentioned above. E-commerce enables MNEs to further integrate their operations, making it difficult for tax authorities to identify and measure contributions to profit and allocate them to different jurisdictions. This problem is augmented by the often unique features of electronic contributions to profit, which make it difficult to determine their economic value.

Further, as mentioned by Warren (2002), the growth of the Internet and of secure global company-based intranets has enabled companies to shift profits more easily from one tax jurisdiction to another to avoid tax. The lack of a secure and verifiable audit trail makes it difficult for tax authorities to identify transactions and trace where they take place, expanding the scope for both tax avoidance and evasion.

The advent of e-commerce creates an even more fundamental problem for the administrators of the corporate tax. Commonly, companies that are held to be resident in a country are taxed on their worldwide income. Non-resident corporations are normally subject to tax in that country only if their operations constitute a “permanent establishment” there, and then only on domestically-sourced income. Thus the concepts of residence,

¹According to Eden (1998), intra-firm transactions at the international level account for almost fifty percent of trade for industrialised countries.

²Under the unitary approach, the allocation of profits earned in more than one jurisdiction depends not on the source of the profits, nor on the residence of the head office, but on the application of a pre-determined formula to world profits. It is widely considered to have serious deficiencies in allocating profits (see for example, Weiner, 2001). Conversely, for arguments in support of this approach, see for example Tyson (1996).

permanent establishment, and the source of income are essential in the assessment of income to tax. However, with the borderless technology of the Internet significantly reducing the relevance of geographical considerations, the above concepts have become increasingly obsolete (indeed, the advent of e-commerce puts the entire traditional concept of jurisdiction to tax into question). In particular, there is a growing need for a new international consensus on the definition of a permanent establishment. Any such consensus would likely make the definition more complex, and thus possibly easier to avoid. It has been suggested that the location of web servers be used to determine residency or permanent establishment. However, servers are geographically very mobile, and can easily be placed in lowest-tax locations.

A final problem that electronic commerce creates for the corporate tax concerns the characterisation of income. A further international consensus has been built in that the nature of the income in question determines the extent and form of the tax applied to it. In particular, royalty income is commonly taxed through withholding taxes in the source country when the payment is made to the non-resident. Sales income, on the other hand, is normally taxed as profits in the country where the seller is resident or has a permanent establishment. Electronic commerce blurs the already hazy distinction between these two types of income. For example, if a digital product is purchased over the Internet, does the consideration involved constitute income from sales or is it a royalty from the right to use or for the use of the product's copyright? The difficulties involved in providing a definitive answer to this question allow considerable opportunity for tax avoidance.

c. Distortions to the Optimum Global Allocation of Resources

The tax systems of individual countries, almost without exception, have developed primarily to address *domestic* concerns, such as the redistribution of income and wealth, the macro-economic stabilisation of the economy, and the allocation of productive resources within the economy. Like any tax, the level at which the corporate tax is imposed in a country is therefore a reflection of the political, economic and social realities of that nation. Thus, as corporate taxes were introduced throughout the world, tax differentials between countries inevitably materialised. Although individual countries' tax systems have always affected and been affected by other economies, policy makers usually paid little attention to international tax differentials, as their effects were comparatively insignificant. Now, with the removal of non-tax barriers to investment and the integration of national economies, and the resultant increase in the mobility of international capital, corporate tax differentials are much more consequential, as they have an increasingly important role in determining the level and destination of foreign direct investment (FDI) (see, for example, Ruding, 1992; Baker and MacKenzie, 2001).

International corporate tax differentials, through their influence on investment location decisions, disrupt the optimum allocation of resources and reduce economic efficiency. This misallocation of resources is at the expense of the comparative advantage of countries in production and trade (see Ricardo, 1819), and leads to diminished world capital productivity and reduced levels of global output. International corporate tax differentials therefore pose an efficiency problem to the world economy as a whole.³

³For an alternative view, that tax differentials can be beneficial, see for example Cnossen (1990).

Since this was first recognised as a growing problem, two alternative solutions have been put forward. The first of these maintains that co-ordinated inter-governmental action can effectively remove tax differentials by aligning tax levels. However, while efforts to achieve such co-ordination have been made for many years, in particular in the European Union (EU), progress has been very slow and, so far, small. Obstacles to progress are numerous and varied in nature, and include, for example, the need to harmonise the level and composition of government expenditure as well as taxation if investment distortions are to be removed, the economic upheaval involved in coordination to companies and to economies as a whole, and the effect of international coordination on the distribution of tax revenues amongst countries. Especially important is the jealousy with which individual states cling to their sovereignty on matters of taxation (one of the very few areas in EU law where unanimity is required to pass legislation).⁴

According to the second school of thought, co-ordination between governments is not necessary, as the problem of tax differentials is self-correcting. As countries compete for investment from overseas, international tax differentials are reduced through a process of what has been termed “international tax competition”. Competitive pressures will force the “prices” of investing in countries, i.e. taxes, together. In other words, countries will spontaneously harmonise their tax systems or face the loss of international investment and the disadvantages this brings.⁵ Recent studies suggest that some spontaneous harmonisation is indeed taking place. Using data from nineteen developed economies over the period 1982 to 2003, Simmons (forthcoming) showed that the dispersion of statutory corporate tax rates fell by approximately one-third, while similar results were recorded for effective tax rates.

Nevertheless, recent evidence on effective tax rates (Baker and McKenzie, 2001; European Commission, 2001) suggests that international tax differentials currently remain high (at least in the EU) and represent a strong incentive for companies to choose the most tax-favoured locations for their investments. If tax competition is reducing distortions to investment, it clearly still has some way to go. Also, there are conceptual problems on relying on tax competition to reduce distortions to investment. As Musgrave and Musgrave (1990) argue, there is no clear theoretical backing for the supposition that tax competition will eventually result in a more efficient allocation of resources through reducing tax differentials. An equally likely scenario is that tax competition will foster a climate in which countries aim to attract capital through being tax-efficient rather than being least-cost locations, leading to *greater* rather than less distortion.

d. Distortions to Corporate Capital Structure

The corporate tax has long been criticised in that it favours one kind of finance (interest-paying debt) over another (shareholders’ equity), since debt interest is usually deductible in the calculation of taxable profits, whereas dividends are normally not.⁶ The

⁴For a further discussion of the many difficulties involved in corporate tax harmonisation in the EU, see for example James (2000).

⁵These potential disadvantages can nowadays be severe; investment inflows from overseas have been growing in significance to the economic health of individual countries. According to UNCTAD (2001), global inward FDI flows as a percentage of gross fixed capital formation nearly tripled between 1997 and 1999, rising from 5.9% to 16.3%.

⁶This distinction brings into question the very nature of the corporate tax base. Since interest on debt capital is deductible, the corporate tax does not represent a tax on the profits of a corporation before taking into account a return on capital employed. But also, since no country currently gives an allowance against tax for a “normal”

separate tax treatment of debt and equity capital creates a tax-induced distortion to the optimum capital structure of corporations, since the tax confers a benefit onto the raising of funds through debt. This distortion also raises corporate risk, as it increases the chances of excessive gearing and bankruptcy.

More recently, the distinction in the treatment of debt and equity has resulted in artificial investment forms that can be classified as debt but have the desired characteristics of equity (Cooper and Gordon, 1995). The difficulties that this situation has created have in recent years been exacerbated by the development of derivatives and other financial instruments that make the distinction between debt and equity much less clear than in the past. As Alworth (1998, p.512) explains:

“The tax systems of most countries are wont to subdividing transactions into particular categories which are then subject to specific provision...Since derivatives and other financial instruments allow easy modification of the external attributes of financial arrangements (transforming dividends into interest payments for example through the lending of securities) these separations have become increasingly arbitrary.”

As a result of these innovations, differences between countries' tax rules permit wide opportunities for international tax arbitrage, for example through benefiting from the treatment of a receipt as a dividend in one jurisdiction while deriving a deduction as an interest expense for the corresponding payment in another (see Citron, 2002).

e. The Corporate Tax and Equity

There are two issues involved with regard to the fairness of the corporate tax. The first of these concerns the effective incidence of the tax, the second the problem of “double taxation”.

The first issue rests upon the perception that a company *per se* cannot bear tax: only individuals can do so. Tax on corporate profits will thus ultimately be borne by the individual stakeholders in the company. Customers may bear the tax through an increase in the prices they are charged, the extent of the increase depending upon the degree of imperfection in competitive conditions. Employees may bear the tax through a reduction in their remuneration or an increase in unemployment, depending on the degree of imperfection in the labour market. Suppliers of capital may suffer the tax due to a reduction in the returns they are willing to accept. However, in a completely open economy, suppliers of capital will require the “world rate of return” or they will invest their money elsewhere. In this scenario, the corporate tax cannot reduce investors' returns below that world rate, but can only lead to a decrease in the amount of capital they invest (see Bond et al., 2000, p.23). Therefore, in a small open economy with few barriers to foreign investment, the incidence of the tax is likely to be borne completely, or at least more heavily, by providers of labour (and perhaps by consumers) than by the suppliers of capital. In light of recent increases in the international mobility of capital, its effect is therefore likely to be increasingly regressive.

return on equity, the corporate tax cannot be said to capture the "pure" profits of a corporation (that is, its income in excess of the remuneration of all factors of production, including capital). It is therefore not easy to define conceptually exactly what the tax seeks to capture.

In practice, then, the ultimate incidence of the corporate tax depends on how the tax burden levied on corporate profits is redistributed onto their various stakeholders. As this will vary by company, by industry, and by country, depending upon the elasticity of demand for the product and the elasticity of supply for capital and labour, the incidence of the tax throughout an economy is hard to predict (see Musgrave and Musgrave, 1989). Although this uncertainty is not necessarily inequitable in itself, it is likely to confound government attempts to distribute the tax burden in a manner which it considers fair.

A second equity issue concerns the double taxation of income, which is widely considered to be inequitable, as it represents “over-taxation”. Most countries tend to adopt tax systems that include taxes on the incomes of both companies and the shareholders of those companies. This leads to either the unfairness of double taxation on distributed profits or the necessity to avoid this by introducing technically complicated systems such as imputation.

Under the “classical” system, currently pertaining in, for example, the USA, company profits are taxed at the corporate level and then at the individual level when distributed. As no credit is given to the shareholders for tax suffered at the corporate level, this system results in double taxation. If one sees a company as being merely a conduit for income as it makes its way to its owners, then, in principle, there is little justification for taxing distributed profits at the corporate level. From this viewpoint, the corporate tax acts merely as a huge withholding tax on distributions, collectable at a convenient stage for the government.

Imputation systems represent one common way of relieving double taxation. Under these systems, part or all of the corporate tax charged on dividends is imputed to shareholders against their personal income tax liability on such dividends. However, the growing international dispersion of share ownership has accentuated a deficiency of these systems. A fully neutral treatment of investment income requires that countries not discriminate between domestic and foreign shareholders by denying to the latter the tax credit that the imputation system provides. Nonetheless, in practice there is a natural strong reluctance to grant foreign shareholders the tax credit, as it would have to be given by a different tax authority from the one levying the corporate tax. Thus imputation systems disfavour the foreign ownership of share capital. In times when the ownership of corporations was mostly domestic, this aspect of imputation did not constitute a major problem. Now, with the diffusion of share ownership throughout the world, the inequity of this situation is more apparent. In the EU, the European Court of Justice has recently ruled this aspect of imputation incompatible with single market freedoms.⁷ This has resulted in some countries, for example Ireland, moving away from imputation back to the classical system, with its attendant double taxation implications for shareholders in those countries.

As the above analysis suggests, recent economic and technological developments have transpired to accentuate and draw attention to the inherent weaknesses of the corporate tax. In light of this, it is useful to review the justifications that have been traditionally put forward for the tax. These are identified and critically analysed in the following section.

⁷The Metallgesellschaft Case (C-397/98) and the Hoechst Case (C-410/98), 2000 (joined cases).

3. EMERGENCE OF AND CONVENTIONAL JUSTIFICATIONS FOR THE CORPORATE TAX

The first taxes on corporate income were introduced by individual states of the USA in the mid-19th century. In the early years of the following century, many countries began a process of moving away from their traditional indirect tax base towards direct taxation. A federal tax on corporate profits was introduced in the USA in 1909 and, as a war-time measure, in the UK in 1915, where it represented an additional tax on company profits to that already imposed upon individuals' income from capital. The tax then spread rapidly to other nations, until today it is almost universally applied in the developed world.

The original rationale for the introduction of the new tax was that companies were, as they are now, separate legal entities from their owners (whose liability is limited to the sums they invest in the enterprise), with the right of perpetual independent existence, and the right to sue and be sued (Oates, 2002). Thus if individual persons were subject to taxation on their income, it was considered reasonable that corporate persons should also be so. From the outset, then, a separate corporate tax was felt to be justified in that it was perceived as the price to pay for the privilege of incorporation with limited liability.

However, it is not clear why being granted the legal privilege of limited liability is an appropriate justification for the taxation of company profits, or, more specifically, why the benefits of incorporation should be thus considered proportional to those profits (see, for example, Kay and King, 1991). It has been suggested that a licence fee would be more appropriate (Krever, 1985; James and Nobes, 2003). Indeed, the first business income taxes mentioned earlier evolved from licenses and were flat fees. In any case, it can be argued that incorporation already comes with a price: in the statutory audit and information dissemination requirements.

A further rationale for the corporate tax is that, as it gives the government more flexibility with regard to fiscal policy, it is potentially useful as an additional tool in macro-economic stabilisation. Indeed, this role may even have strengthened recently in some countries, as a result of restrictions on the use of alternative stabilisation strategies.⁸ However, it has long been recognised that corporate tax policy is something of a blunt, and slow-acting, instrument with which to regulate the economy. Not only is it subject to the usual time lags involved in fiscal policy, but it is also normally collected well in arrears (James and Nobes, 2003). Also, the corporate tax is nowadays less suited to a role as a domestic macro-economic stabiliser than, say, the individual income tax, since its level is highly influenced by tax levels overseas due to competition for mobile capital.

It is also argued that the tax prevents the possibility of individuals shifting their earned personal income into corporate income, thus avoiding tax. Securing government revenue in this way would, on the face of it, appear to be an important function of the corporate tax. Gordon and MacKie-Mason (1995) go as far as to say that

⁸In the EU, monetary union and the use of a common currency have meant that to a large extent many member states have surrendered their ability to control their economies through exchange rate and monetary policy. This is on top of earlier surrender of control over tariff and trade policy.

“...the primary role of the corporate tax appears to be as a backstop to the personal tax on labour income rather than as a tax on the return to capital invested in the corporate sector.”

However, the type of tax avoidance activity mentioned above can and has been successfully countered in several countries through the introduction of specific anti-avoidance provisions, although such legislation necessarily complicates the tax system.⁹ At any rate, to rest the case for an entire tax on the inability of another to counter abuse is less than convincing.

The underlying argument here for the corporate tax is that, in its absence, while the individual income tax system would capture corporate income distributed as dividends, retentions would remain untaxed. It is true that in practice no country attempts to fully impute corporate profits to shareholders.¹⁰ However, retained profits can be, and commonly are, taxed in other ways. For example, capital gains taxes (or, eventually, death duties) eventually capture retained profits through the increase in the capital value of the shares upon disposal (or death). Thus this argument for the tax is merely that it prevents the *deferral* (as opposed to the avoidance) of the tax liability on retained profits.

It is further argued that the tax gives those countries receiving inward investment (“host” or “source” countries) the ability to tax corporate income originating on their territory, even (and especially) if the corporation is foreign-owned. In its absence, the income of foreign shareholders would not be captured by the domestic tax system. The international tax system has over the years evolved whereby the right to tax active business income is given primarily, or at least first, to the host country (by contrast, the right to tax passive, non-business income is normally granted to the residence country). This role of the corporate tax would be especially important in capital-importing countries such as Australia and Canada (Oates, 2002). The recent overall rise in the importance of FDI to the health of individual economies has arguably made this rationale for the tax of greater significance.¹¹

Certainly, the host country has a reasonable claim to tax company profits originating on its territory, since it is providing cost-reducing services to the corporate sector. Examples of these are the provision of infrastructure, the basic education of the workforce, or the provision of security through police force and armed services. But does this justify the existence of the corporate tax? It is difficult to discern a clear relationship between the benefits to a company of public services and the corporate taxes that the company pays. Also, the host country is likely to gain from foreign investment in ways other than tax revenue, such as the creation of employment for the local population. Perhaps most importantly, there are alternatives to the corporate tax; the host country government can, and usually does, take its “cut” from the profits of the foreign-owned company through other means, such as withholding taxes on dividends and other transfers overseas, excise duties or payroll taxes.

Taken as a whole, then, the conventional theoretical arguments in favour of the corporate tax would not appear to be entirely convincing, suggesting the existence of further reasons for its durability. These are considered in the next section.

⁹Examples include “service company” legislation in Hong Kong.

¹⁰An exception to this is the system for “S” Corporations in the US, where a partnership election for certain clearly defined companies is allowed if all shareholders agree.

¹¹For an indication of the importance of these flows, see note 5 above.

4. REASONS BEHIND THE DURABILITY OF THE CORPORATE TAX

Two further considerations support the continued existence of the corporate tax: the importance of the government revenues it produces and the political difficulties involved in its abolition.

For an understanding of the importance of corporate tax revenues to governments, these revenues are displayed as a percentage of total tax revenues and of GDP in Table 1 below. The table shows these percentages at five-year intervals from 1980 to 2000 and for 2002 for the fifteen (pre-enlargement) EU member states as a whole (EU15), and for the OECD as a whole.

Table 1 about here

For the EU15, tax revenues from corporate profits as a percentage of total tax revenues rose from 5.8% in 1980 to 8.6% in 2002, an increase of nearly one half. For the OECD, the percentage also rose, from 7.6% to 9.3%, an increase of approximately one-quarter. Tax revenues from corporate profits as a percentage of GDP show a similar story, with the increases for the EU15 and OECD being roughly two-thirds and two-fifths respectively. In all cases, the increases were continuous between 1980 and 2000, with a small decrease being recorded between 2000 and 2002.

Corporate tax revenues thus in general constitute a significant, and (at least until recently) increasing, proportion of total tax revenues and GDP. Abolishing the corporate tax would, then, deprive governments of a useful source of revenue, and thus is likely to be strongly resisted. In some individual countries, this proportion is far larger than the EU or OECD averages, such as for Luxembourg (20.5% of total revenues and 8.6% of GDP in 2002) and for Australia (16.8% and 5.3%). The abolition of the tax would likely meet with even firmer resistance in these countries.

Revenues from the corporate tax are important today for another reason. Many developed economies, in particular Japan and certain Western European states, currently face intensifying budgetary crises due to a rapid ageing of these countries' populations. This phenomenon is leading to difficulties for governments in fulfilling their public retirement promises and to increases in health and social care spending. At the same time, countries' tax bases are being reduced, as the population of working age declines. Other issues that will put pressure on governments for increased public expenditure include environmental concerns and, more recently, measures to counter terrorism. It would be extremely difficult in times of present and future budgetary exigency to convince governments that a major source of public revenue should be discontinued. This is in spite of the fact that if the tax were abolished, governments would likely recoup at least some of this foregone revenue through subsequent increases in receipts from capital gains taxes (through increases in share prices) and personal income taxes (through increased dividend income). Corporate investment is also likely to be enhanced, with subsequent indirect benefits for the government exchequer, through, for example, greater employment.

A second reason for the tax's longevity is its degree of support from the general population. Such support rests on the belief that it redistributes income within society, since the tax is seen as being borne by shareholders who are, in general, more affluent than those who do not own shares. However, there are problems with this belief. Share ownership has become more diffused across society, at least in developed countries, and is now hardly the sole province of the rich. Further, the redistributive consequences of the corporate tax may well be misperceived. Indeed, as mentioned earlier, the effective incidence of the tax may now fall more on labour (through lower wages and/or unemployment) and consumers (through higher prices) than on the owners of capital. Nonetheless, it is likely that this transfer of the tax burden is not fully appreciated by the general public. The corporate tax is therefore to some extent "hidden", and as such is comparatively attractive to governments who, sensitive to the views of their electorate in matters of taxation, have always been keen to "pluck the goose with the least amount of hissing".

Also, to the person in the street, it appears reasonable to tax corporations. They benefit from public expenditure, such as the provision of infrastructure. They are entities that have an important effect on society and on the lives of individual citizens. Indeed, companies, especially multinational enterprises, are seen by some as being overly powerful and answerable to no one. Further, as the tax has been a part of nearly all developed economies for many years, its existence today is widely taken for granted. In addition to these existing preconceptions, the abolition of the tax would certainly result in windfall gains for those who bought shares at prices that at the time reflected the expectation of the continued existence of the tax. It is likely that these gains would not be widely appreciated by the general public. Thus, the tax's removal is likely today to appear unacceptable, if not perverse, to a large section of the electorate.

In sum, revenue considerations and political risk-avoidance are likely to be decisive factors in any individual government's decision as to whether to retain the corporate tax. Indeed, to date, no government that has introduced the tax has ever repealed it.

5. THE FUTURE OF THE CORPORATE TAX

The above analysis suggests that recent criticisms of the corporate tax have been heightened by the increased interdependency of nations' economies. Any effective solution would thus require an orchestrated international response. A radical solution that has been put forward is the worldwide abolition of the tax.¹² Certainly, such a bold international initiative would remove at a stroke most of the concerns referred to above. However, given the economic and political difficulties confronting any individual government's attempt to repeal the tax, and in light of the unsuccessful attempts at international co-ordination of corporate taxes to date (after all, worldwide abolition represents an extreme form of co-ordination), any solution along these lines must, in anything but the long term, be considered remote.

Nonetheless, it might well be the case that if a major participant in the world economy decided to take it upon itself to be the first to abolish the tax, others may be willing to follow

¹²The *Economist* Newspaper has consistently advocated abolition of the tax. See, for example, in the *Economist*, "Taxes for Corporate Europe", 21st March 1992, and "Time to Hiss: A Bad Tax whose Time has Gone", 31st January 2004. Abolition of the tax has been considered in the past in several individual countries, for example in the UK by the Meade Committee (Meade, 1978).

suit. This would more likely be the case if the move resulted in attracting significant amounts of investment away from them and reducing the viability of their own corporate tax regimes. It is of course highly likely that in such a scenario the “first mover” would be very attractive as a haven to park paper profits.

There are currently two potential candidates for the role of first mover: the EU and the US. Take first the EU. A central feature of the EU’s approach to economic integration has, since its founding, been the principle that the allocation of productive resources should not be distorted by the actions or policies of individual governments. The abolition of corporate taxation would certainly represent a complete, albeit radical, solution to such distortion.¹³ While the EU thus has a clear incentive to abolish the tax within its borders, there are serious practical obstacles to this becoming a reality. The EU is of course composed of individual states, each, as mentioned earlier, with its own veto on matters relating to taxation, and so the seemingly intractable problems mentioned earlier in obtaining agreement would apply. The failure of all the European Commission’s proposals to date on the approximation of corporate taxes in the EU attest to the very low likelihood of their abolition within that bloc.

The US is a potential first mover simply because the debate in that country is at a more advanced stage than elsewhere. As alternatives to the present corporate income tax, two variants of an expenditure tax were heavily promoted within the US Congress during the 1980s and 1990s, although neither reached the statute books. The debate shows no signs of flagging. In March to June 2004, the House Majority Leader made a series of speeches in Congress on radical tax reform, including the idea of a national sales tax to replace the corporate tax. The high level at which the debate is continuing in the US suggests that if any worldwide movement to eliminate the corporate tax is forthcoming, it is most likely to originate in that country.

Notwithstanding the above, the demise of the corporate tax seems unlikely in the foreseeable future. How then is it likely to evolve in the 21st century? One likely development is that costs of tax enforcement and compliance will continue to rise. In recent years, the complexity of enforcement and compliance has increased dramatically, in particular concerning cross-border investment, with transfer pricing and controlled foreign company (CFC) anti-avoidance provisions being introduced in several countries and strengthened in others. Such developments are likely to further increase costs in terms of personnel and time for both companies and tax administrators.

A consequence of these pressures is that in future tax authorities may be more amenable to international measures aimed at improving international exchanges of information. In this regard, new communications technology, often viewed with trepidation by tax administrators, may become an important ally. Progress in international information exchange has already been made. The OECD has issued a Model Agreement on Information Exchange (OECD, 2002) which strengthens exchange of information powers over those traditionally contained in bilateral tax treaties. Also, tax havens, under pressure from developed country institutions such as the OECD and the EU (see discussion on tax competition below), have, apart from a few recalcitrants, agreed to reduce their traditional reliance on secrecy and to exchange information with developed nations under certain conditions.¹⁴

¹³For discussions on the abolition of the corporate tax in the context of the European Union, see for example Devereux and Pearson (1989) and Gammie (2001).

¹⁴All but five tax havens have now committed to cooperate with the OECD with regard to improving transparency and information sharing. For a history of this OECD initiative, see, for example, Spencer (2004).

Developments have also taken place in response to the need for an increasingly co-ordinated response to the problem of allocating income between jurisdictions. In 1990, the EU instituted its Arbitration Convention, which provides an independent mechanism for resolving transfer pricing disputes that result in double taxation. This could well be used as a model for international arbitration in a more global sphere. Also, the use of Advance Pricing Agreements (APAs), in which MNEs and relevant tax authorities agree in advance on transfer pricing methodology, has been rapidly expanding in recent years. This process is likely to continue. Looking further into the future, there is currently discussion of the establishment of a World Tax Organisation on the lines of the World Trade Organisation, which would, amongst other roles, provide a forum for the arbitration of international tax disputes (see for example, Sawyer, 2004).

The above developments notwithstanding, the future of the tax will more fundamentally depend on whether it can continue to justify its existence in terms of generating government revenues. As shown above, these revenues have been maintained, and have even increased, in recent years. But will this continue to be the case in future?

In the last quarter of a century, corporate tax reform has been characterised by a decrease in statutory tax rates in many countries (see for example Singleton, 1999; Wunder, 1999; Devereux et al., 2002). This has been due to important trends in politics and economics, such as the election of more “business-friendly” governments and the associated movement towards supply-side economics that has encouraged reductions in marginal tax rates to boost productivity. It has also likely been due to increased international tax competition for investment and paper profits.

Table 2 shows movements in statutory tax rates and a commonly used measure of effective tax rates, the Effective Marginal Tax Rate (EMTR)¹⁵ at 10-year intervals from 1983 to 2003. The table shows data for selected countries and the average for nineteen OECD countries (comprising the G7, all pre-enlargement EU member states excluding Denmark and Luxembourg, plus Australia, Norway and Switzerland). The data are provided by the Institute for Fiscal Studies (IFS).¹⁶

Table 2 about here

Statutory tax rates decreased markedly in most countries between 1983 and 1993. This steep decline reflects the flurry of tax reform that took place in the late 1980s, following the first moves to reduce rates in the UK and the US. The more moderate falls (and, in some cases slight increases) between 1993 and 2003 reflect a period of comparative consolidation in most countries, although France and Germany are still in the throes of their corporate tax reforms. Between 1983 and 2003, the average rate for the nineteen OECD countries fell from 48% to 33%, a drop of nearly one-third. In that period, seventeen out of the nineteen countries reduced their rates, while only two increased theirs.

The OECD regularly issues Progress Reports on its initiative. For the latest of these, see OECD (2004).

¹⁵The EMTR represents the tax rate that applies to a marginal investment project, i.e. it summarises the impact that taxes have on a project that just earns the minimum required rate of return after tax.

¹⁶Data available online from the IFS at www.ifs.org.uk.

Effective tax rates followed a similar pattern to movements in statutory rates, falling markedly between 1983 and 1993, and then more moderately (or in some cases rising slightly) between 1993 and 2003. Over the entire period, the average rate fell from 28% to 20%, a drop of nearly one-third. Of the nineteen countries, fourteen showed a decrease in their EMTRs, while five showed an increase.

It is likely that tax rates will in general continue to fall. Non-tax barriers to overseas investment will likely further decline, especially in Eastern Europe and Asia, increasing the mobility of capital and forcing further competitive reductions in tax rates. As a recent example of this process, most former Soviet-bloc countries that have entered the EU have been active in reducing their tax rates to attract investment. Poland, Hungary and Latvia have all cut their rates to below twenty percent, well below the levels pertaining in most pre-enlargement member states. In line with trends in corporate tax policy in Eastern Europe, Russia recently announced its implementation of a “flat tax” at a rate of a mere thirteen percent.

At one stage, it seemed that corporate tax competition might be curbed through the development of international initiatives aimed at outlawing harmful tax practices. When the OECD unveiled its recent project against harmful tax competition (OECD, 1998), the criteria employed for identifying harmful tax practices included a country’s effective tax rate. However, this initiative no longer targets overall tax levels. After pressure from within its own committees, and notably from the Bush administration in the US which made its support for some degree of tax competition clear, the OECD refocused its project away from tax competition towards the exchange of information to counter tax evasion.

In similar vein, and at around the same time, the EU unveiled its own package to tackle harmful tax competition (European Commission, 1997). The package included a Code of Conduct for Business Taxation whereby member states undertook to avoid tax measures that constitute harmful tax competition such as incentives that apply only to non-residents, or the “ring-fencing” of tax regimes. Under the Code, however, cuts in the general level of corporate taxation pertaining in a country are viewed as not constituting harmful tax competition. Such a view arguably makes this kind of tax cutting more likely, leading to the prospect of a “race to the bottom” with regards to overall tax rates, which could severely damage revenues (see Keen, 2001).

Up to now, the impact on tax revenues of falls in tax rates has tended to be mitigated somewhat by a concurrent expansion in nations’ tax bases (see for example Lee and McKenzie, 1989; Collins and Shakelford, 1996). This has been achieved through, for example, the phasing out of investment credits, a reduction in accelerated depreciation, and attempts at tax exportation by tightening up of transfer pricing and controlled foreign company legislation. However, this tax base expansion cannot occur indefinitely. At some point, if tax competition continues to push tax rates downwards, this process will inevitably impact upon government revenues.

Corporate tax revenues have up to now also been supported by improvements in corporate productivity that have led to an increase in the relative size of the corporate sector

in many nations, such as the UK.¹⁷ This suggests that the increase in corporate tax revenues may be explained by reference to the Laffer curve, the bell-shaped curve that explains that there is an optimum rate of tax at which maximum government revenue is yielded. At rates lower than this optimum, revenues will increase due to a combination of the incentive effect of the lower tax rate on corporate activity and a decrease in the incentive to avoid or evade taxation. If, as is now widely believed, tax rates were on the “wrong” or inverse portion of the curve before the tax reforms of the early 1980s, then this would explain the subsequent reductions in tax rates being accompanied by increases in corporate tax revenues.

The future direction of corporate tax revenues is likely therefore to depend largely upon whether the deleterious effects on government revenues of reductions in tax rates will continue to be offset by the revenue enhancing consequences of improved corporate productivity, investment and the expansion of the corporate sector; that is, upon whether tax rates still currently dwell on the inverse portion of the curve. Lower tax rates might also reduce the incentive for international tax avoidance and evasion, although increased opportunities for such activities are likely to mitigate against this.

Ultimately, however, the extent to which tax revenues will wither depends largely on whether voters see a greater value in maintaining taxes at a comparatively high level, with, presumably, an accompanying high level of public investment, or in allowing tax competition to lower tax levels to encourage private investment. In other words, it may rest on the future political persuasions of electorates as to the extent to which they accept market forces or government involvement as the main driving force for change. It is also likely to depend upon the extent to which governments are able to find alternative sources of tax revenue. While limitations of space restrict a broad discussion of the future of other taxes, a few brief comments may be useful here.

Taxes on the income of individuals have until recently been comparatively immune to competitive pressures, since, for reasons of family ties, language, rules of professional association, etc., the individual income tax base is normally much less internationally mobile than the corporate one. However, its mobility is undoubtedly growing, especially within blocs such as the EU. This means that in future, governments may find that tax revenues from this source may well be curtailed through tax competition. The same may well be true of consumption or expenditure taxes, at least in the case of small countries with close borders, and in view of the fact that purchasing over borders has been facilitated by Internet technology. In any case, the ability of governments to tax expenditure in many countries seems to have reached a ceiling, especially in Europe where VAT rates find themselves close to the limits of their political acceptance. In light of these limitations, tax authorities may in future find themselves looking more to the most immobile of tax bases, property, as a source of revenue. Further sources of revenue may be found in newer forms of taxation, such as “green” taxes, which are likely to find increasing acceptance with the sensibilities of electorates as concerns about the environment rise. These taxes have already made a significant impact on the structure of tax revenues in many developed countries.

6. CONCLUDING REMARKS

¹⁷ Some countries, having competed aggressively for foreign investment through reductions in corporate tax rates, have also gained significant corporate tax revenues from their expanded stock of overseas capital. Ireland is a case in point here.

As the world economy continues to transform and integrate, the problems posed by the existence of the corporate tax have intensified and become more exposed. These trends are likely to continue in future.

In spite of these challenges, the corporate tax is likely to survive in some form, at least for the foreseeable future. Today it represents a long-established, significant and welcome source of revenue for governments. It can be collected from an easily identifiable source, and is widely seen as justified by the general public. As Gammie (1991, p.9) succinctly put it:

“Perhaps the most persuasive reason for retaining a separate tax on profits is not only that we do, but that we can.”

Worldwide abolition is unlikely in the foreseeable future as it would require international tax co-ordination on a scale that has not been in evidence to date. A more possible scenario is that a major economy such as the US would take the lead in abolishing the tax, in which case smaller countries would have a strong incentive (or have no choice but) to follow its lead.

Even in the absence of such a move, if competitive pressures reduce the corporate tax's importance to government revenues and compliance and enforcement costs continue to rise, governments may eventually be forced to reconsider the merits of retaining the tax. Whether this scenario will eventually materialise depends largely on uncertain future trends in economic and political direction and the ability of governments to identify and exploit alternative sources of revenue.

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Table 1

EU15 and OECD Revenues from Corporate Taxation as a Percentage of Total Tax Revenues (TTR) and as a Percentage of GDP (1980-2002)

	<u>EU15</u>		<u>OECD</u>	
	%TTR	%GDP	%TTR	%GDP
1980	5.8	2.1	7.6	2.4
1985	6.4	2.6	8.0	2.7
1990	6.8	2.6	7.9	2.7
1995	6.9	2.7	8.0	2.9
2000	9.2	3.8	9.7	3.6
2002	8.6	3.5	9.3	3.4

Source: OECD Revenue Statistics (2005)

Table 2

Corporate Taxes: Statutory¹ and Effective Marginal Tax Rates (EMTRs)² OECD Selected Countries (ten year intervals, 1983-2003)

	<u>Statutory Rates</u>			<u>EMTRs</u>		
	1983	1993	2003	1983	1993	2003
	%	%	%	%	%	%
Australia	50	33	30	32	21	24
Belgium	45	39	34	31	26	22
Canada	44	35	36	16	25	25
France	50	33	35	26	18	22
Germany	63	58	40	43	38	30
Japan	55	51	41	42	38	29
Portugal	55	40	33	48	24	19
USA	50	39	39	22	24	24
OECD 19 (mean)	48	36	33	28	23	20

Notes:

- 1) Statutory rates are on undistributed profits. For individual countries where the tax rate depends on the type of industry, the manufacturing rate is used. The rate includes local taxes (or average across regions) where they exist. Supplementary taxes are included only if they apply generally.
- 2) EMTRs calculated on the following assumptions: investment is in plant and machinery, financed by equity or retained earnings; depreciation at 12.5%; common inflation rate of 3.5%; real interest rate at 10%; no personal taxes.

Source: IFS

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