

IS EU COORDINATION NEEDED FOR CORPORATE TAXATION?

Frank Barry
Trinity College Dublin

Frank.Barry@tcd.ie

October 2007

The paper takes into account three interesting elements:

- real FDI
- the shifting of paper profits e.g. through transfer pricing, and
- the need for budget balance, so that a corporation-tax reduction will typically be associated with an income tax increase.

It discusses tax harmonisation AND consolidation of the tax base, both separately and together.

Effects of a unilateral reduction in the corporation tax rate:

This reduces welfare elsewhere (by a small amount) because of FDI diversion, and can possibly also reduce welfare in the initiating country (as the model suggests would occur in the Irish case).

Effects of an Irish unilateral reduction (Table 1):

This does not entail a huge shift of paper profits to Ireland because Irish rates are already so low, so this channel – beneficial for Ireland – is closed off.

Why does Irish welfare fall? FDI rises but the loss in corporation tax revenues (primarily from captive domestic firms) means that labour taxes have to be raised, and this reduces employment. The conclusion is:

“For low corporation tax economies, it is better to cut labour taxes rather than CIT.”

The explanation given is that “at lower corporation-tax rates, the distortions in the alternative taxes on consumption and labour exceed the distortionary effects of the corporate income tax on investment and profit shifting. So, no member state will unilaterally abandon its tax on corporate income”.

Question:

How does this relate to the well-known Diamond and Mirrlees (1971) result that for a small open economy which takes the international rate of return to capital as given, a labour income tax dominates a corporate income tax, even from the perspective of labour?¹ Under these conditions the burden of both corporation taxes and income taxes is borne entirely by

¹ See also Dixit (1985) for an elaboration of this argument.

labour and other fixed domestic factors, and a labour tax is less distortionary. The answer as to why this result does not arise here is to be found in the small print in Appendix 2: capital is not perfectly mobile internationally. There are two types of capital: internationally mobile capital and fixed location-specific (internationally immobile) capital. Since the return on the latter, “being a rent, is part of the corporate tax base, this type of capital motivates a lower bound on the corporate income tax rate”. This is what distinguishes this paper from the Jim Hines paper (“Sensible Tax Policies in Open Economies”) published in the Journal of the Statistical and Social Inquiry Society several years back.

This is important because it is why, though “there will be a race (i.e. if one country cuts its rate this incentivises other countries to do so), it will not be to the bottom”.

A further point:

Ireland may attract US FDI away from Germany, which might be detrimental to the latter. It may also attract more German FDI by a tax cut. Is this also likely to be detrimental to Germany? No. Higher capital expenditures on the part of foreign affiliates of US MNEs have been found to be associated with higher US investments by the parent companies (Desai, Foley and Hines, 2005); the overall implication is that home and foreign production are combined to generate final output at lower cost than would be possible without outward direct investment (ODI).

A smaller point:

Footnote 17 points out that a large employment increase can raise GDP but cause a reduction in welfare due to the decline in leisure. What then is going on in Table 1, where we have an increase in both Irish GDP and leisure (i.e. a fall in employment), yet welfare falls?² This result may have to do with the distinction – well known in Ireland – between GDP and GNP, in which case the consequences for GNP could usefully be shown.

Other results on tax-rate harmonisation:

Imposition of an EU minimum tax rate of 30 percent or a harmonised rate of 33 percent (the current EU average) are posited to have no effect on EU GDP. I will question the grounds for this result below.

Common Consolidated Tax Base

A consolidated tax base would reduce compliance costs for multinational enterprises (MNEs), but would, as the study shows, cause firms to shift real production activities across borders in order to continue to reap the benefits of differences in tax rates. (Paper profits could no longer be shifted). It would therefore aggravate tax competition.

The precise effects of consolidation would depend on its design:

² Note the extreme equilibrium assumptions on which CGE models are typically based. A fall in employment would not normally be regarded as beneficial just because it allows more leisure to be consumed.

- If firms have to make their tax declaration according to the rules of their home country, this would give preferential treatment to subsidiaries originating from member states with a narrow tax base.
- If consolidation is compulsory, then a broad tax base implies a higher tax burden for MNEs, resulting in less FDI and a decline in EU welfare.
- A voluntary system PLUS a broad CC tax base would mean that very few MNEs would choose the CCB, making the reform superfluous.

The paper discussed several types of formula apportionment but mentions that apportionment based on sales by destination could not be investigated in the current version of the model. It is clear however that for a small export-platform location such as Ireland, the latter would have very adverse effects.

The paper goes on to note that the inefficient reallocation of real activities across borders could only be tackled by harmonising tax rates *alongside* consolidation of the tax base. This outcome is unlikely as each EU country retains a veto over any such proposals in the new EU treaty. Even if it were possible, “harmonisation with consolidation” would yield only a relatively small welfare gain to the EU as a whole. The distribution of the gains is uneven:

- Countries which switch from a small base to the common (EU-average) base will suffer.
- Countries with a broad base tend to gain (Germany).
- In Ireland, the gains from having a more efficient European corporate tax system would not compensate for the effects of rate harmonisation.

This finding of a beneficial EU-wide effect however, no matter how small, arguably ignores two key characteristics of global tax systems. The first is that larger, richer and less peripheral countries in Europe are particularly attractive to investors, and these countries exploit this factor by levying higher corporation tax rates than countries like Ireland or the new member states of Central and Eastern Europe (Baldwin and Krugman, 2004). There are good reasons why some countries choose high tax rates and others choose low ones. Once this is recognised, it is clear that harmonisation could be detrimental to both groups of countries.

The second point relates to the specifics of the US tax system, which is particularly important for Ireland as it is the single most important source of inward FDI. The United States taxes income on a residence basis, meaning that American corporations owe taxes to the US government on all of their worldwide income. In order to avoid subjecting American MNEs to double taxation, the US provides a tax credit for *aggregated* income taxes paid abroad. There are no rebates for taxes paid abroad at rates in

excess of the US rate however (see e.g. Hines and Rice, 1994).³ This means that the existence of a low-tax jurisdiction like Ireland reduces the disincentives that US firms face in investing in high-tax economies such as Germany. This strengthens the earlier point: if EU countries have reasons to choose different corporation tax rates, then a low tax jurisdiction facilitates the higher tax jurisdiction in maintaining its inflow of FDI. Recent empirical evidence from Desai et al. (2006), which shows that the firms most likely to initiate operations in low-tax countries are those with growing activity in nearby high-tax regimes, supports this proposition.

References

- Baldwin, R., and P. Krugman (2004) Agglomeration, integration and tax harmonisation, *European Economic Review* 48 (2004) 1 – 23.
- Desai, Mihir, C. Fritz Foley and James. R. Hines Jnr. (2005) “Foreign Direct Investment and the Domestic Capital Stock”, *American Economic Review*, 95, 2, 33-38.
- Desai, M., C.F. Foley and J.R. Hines Jr. (2006), ‘Do tax havens divert economic activity?’, *Economics Letters*, 90 (2), 219–24.
- Diamond Peter A., and James A. Mirrlees (1971) “Optimal Taxation and Public Production, I: Production Efficiency (II: Tax rules).” *American Economic Review* 61 Nos. 1,2 (March and June, 1971): 8-27 (261-278)
- Dixit, Avinash K. (1985) “Tax Policy in Open Economies.” In *Handbook of Public Economics*, vol. 1, edited by Alan J. Auerbach and Martin Feldstein, 313-374. Amsterdam: North-Holland
- Hines, J., Jr., (2003/04) “Sensible Tax Policies in Open Economies”, *Journal of the Statistical and Social Inquiry Society of Ireland*.
- Hines, J., and E. Rice (1994). “Fiscal paradise: foreign tax havens and American business”. *Quarterly Journal of Economics*, (109:1), pp. 149-82.
- Navaretti, Giorgio Barba, and Anthony Venables (2004) *Multinational Firms in the World Economy*, Princeton and Oxford: Princeton University Press.

³ Technically, the tax competition results only go through under source-based (as opposed to residence-based) taxation. Bilateral tax treaties normally give the host country the right to tax income originating within its territory, implying that the source principle is in operation. However, exemptions or tax credits for tax paid elsewhere imply that the residence principle also enters (Navaretti and Venables, 2004, p.244).