The economic impact of a tax reform: Fixing the budget deficit or driving economic growth?

Clemens Fuest

Centre for European Economic Research (ZEW) and University of Mannheim

ifa Luxemburg Tax Reform Debates, Oct 19, 2015


TAXFREE
MULTINATIONALS
TAX-PAYERS

Tax evasion costs European Union 'one trillion Euros a year'

TAX evasion by businesses in the European Union (EU) costs governments across Europe a trillion Euros (£856 billion) each year.

By: Dion Dassanayake
Published: Wed, May 22, 2013

I. Capital mobility and forms of international tax competition

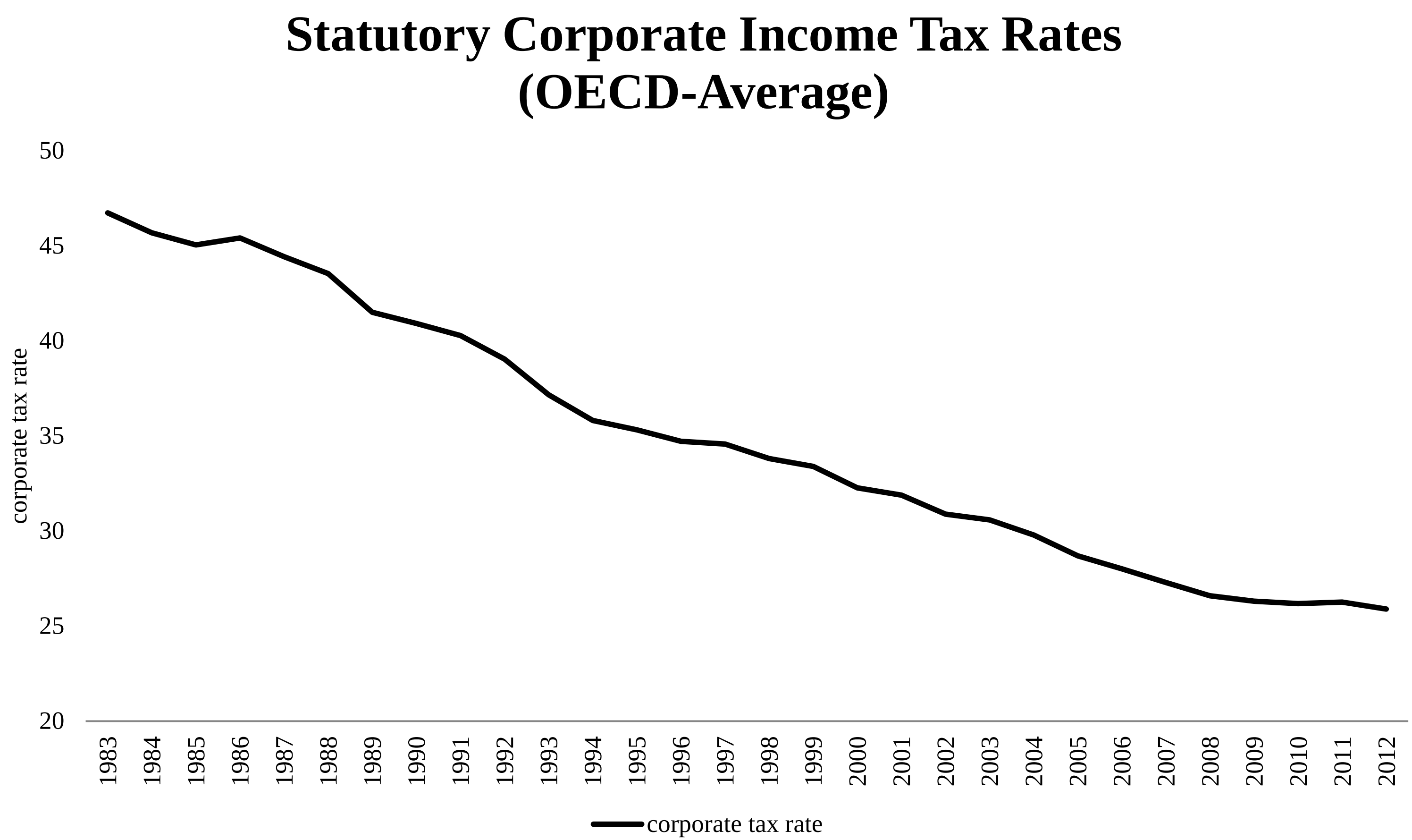
II. How significant is the problem of base erosion and profit shifting?

III. How should the international corporate tax system work?

IV. What should governments do?

V. Conclusions

I. Capital mobility and forms of international tax competition



Statutory Corporate Income Tax Rates
(OECD-Average)
50
45
40
35
30
25
20
corporate tax rate
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
corporate tax rate

Corporate Tax Revenue 1965-2012
(Unweighted OECD-Average, % of GDP)
4
3,5
3
2,5
2
1,5
1965 1967 1969 1971 1973 1975 1977 1979 1981 1983 1985 1987 1989 1991 1993 1995 1997 1999 2001 2003 2005 2007 2009 2011

Forms of Tax Competition:

- Competition for ‘real economic activity’
- Competition for ‘book profits/tax base’
- [Competition for portfolio investments of private investors]
- [Cross border shopping….]

Do corporate tax cuts cause real economic effects?:

- Do tax changes affect growth and by how much?
- Do tax changes affect real investment?
- Do tax changes affect labor income?

Do corporate tax changes affect investment?

- Large and partly contradictory literature

- Hasset and Hubbard (2002): The methods described… generally yield estimates that imply… elasticities of investment with respect to the user cost of capital between -0.5 and -1.0.

- Implication: Reducing user costs by 10% will increase investment by between 5 and 10%

Do corporate tax changes affect investment?

- Recent Study: Bond and Xing (2013)
- Sectoral Panel Data Australia, USA, Japan, several EU countries 1982-2007
- Question: How does the **tax component** of the **user cost of capital** affect investment in equipment and structures, (measured by the capital output ratio)?

Figure 1: Average capital-output ratio (in logs): manufacturing industries

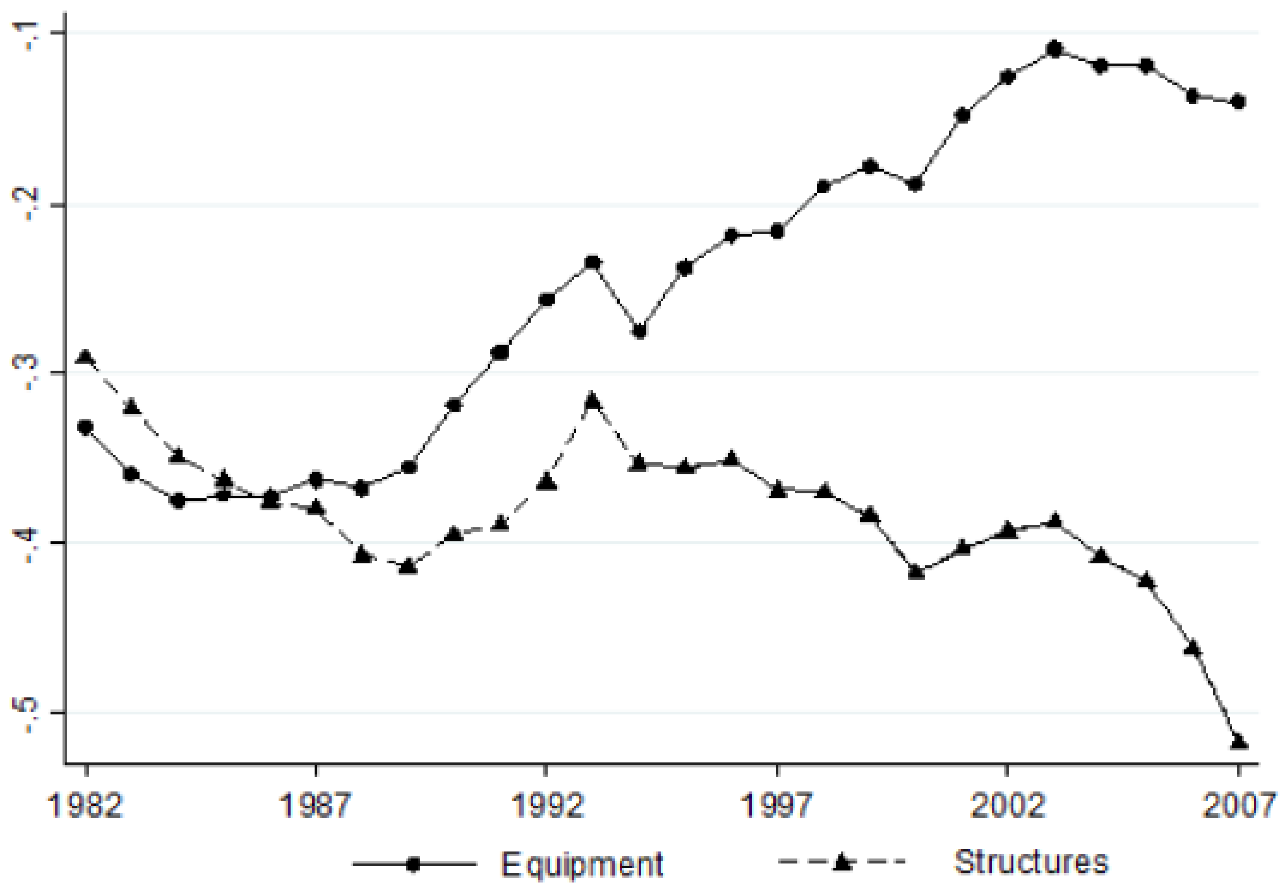


Figure 2: Average relative price of assets (in logs): manufacturing industries

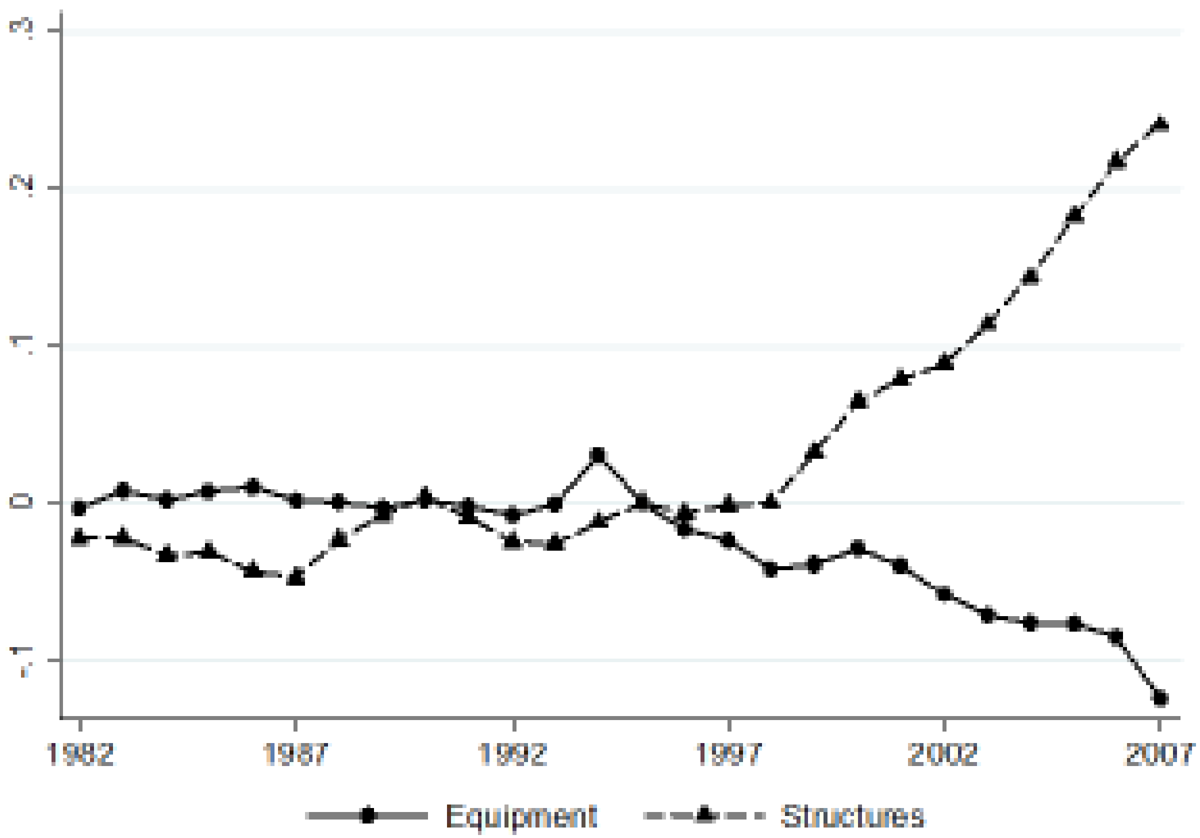


Figure 3: Average tax component of the user cost of capital (in logs): manufacturing industries

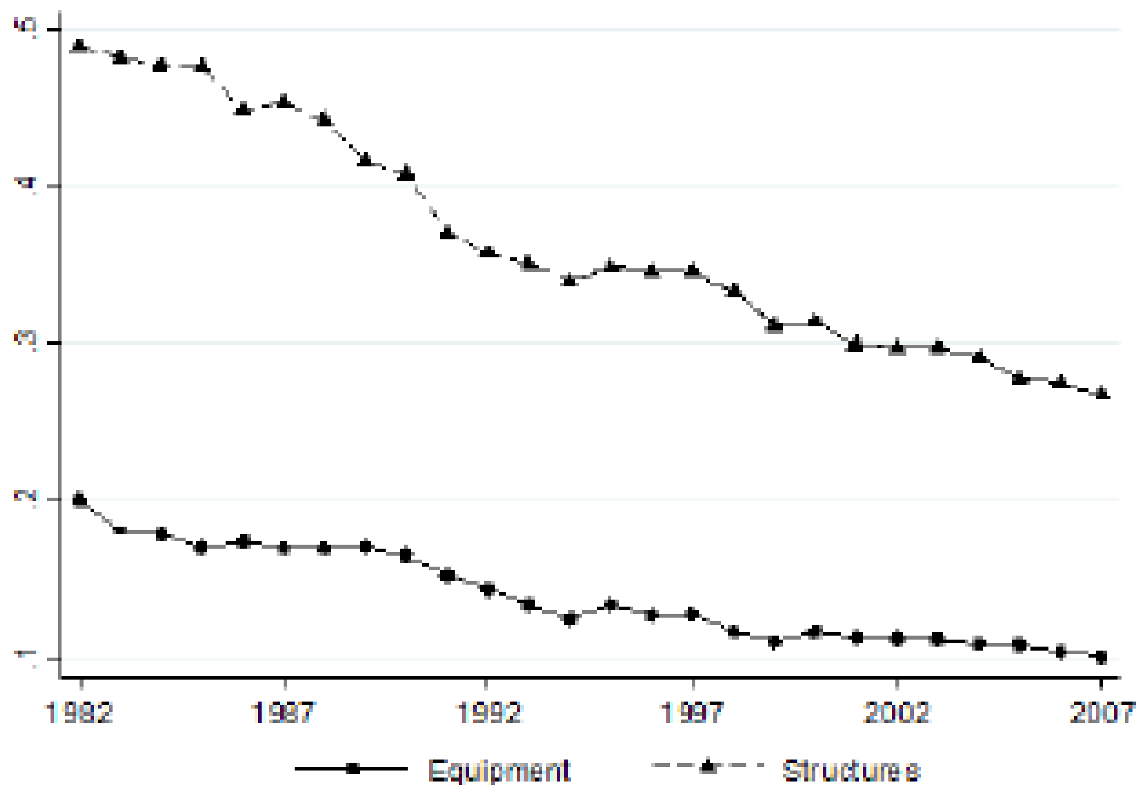


Figure 4: Average capital-output ratio and the measured components of the user cost of capital (in logs): manufacturing industries

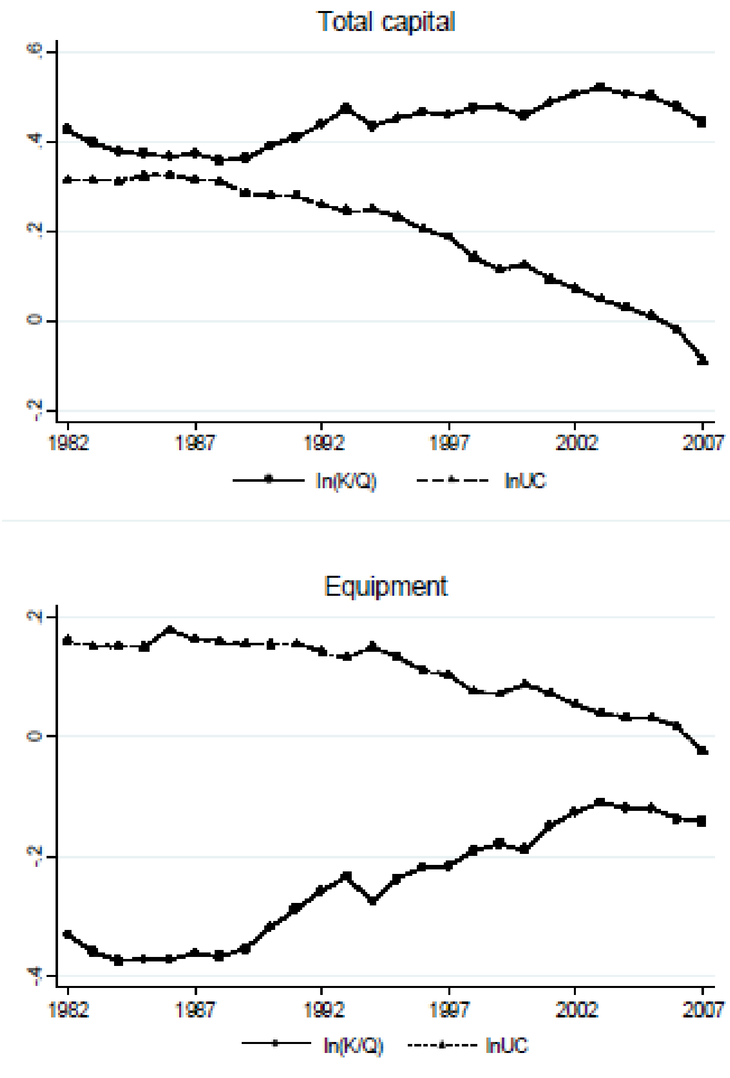
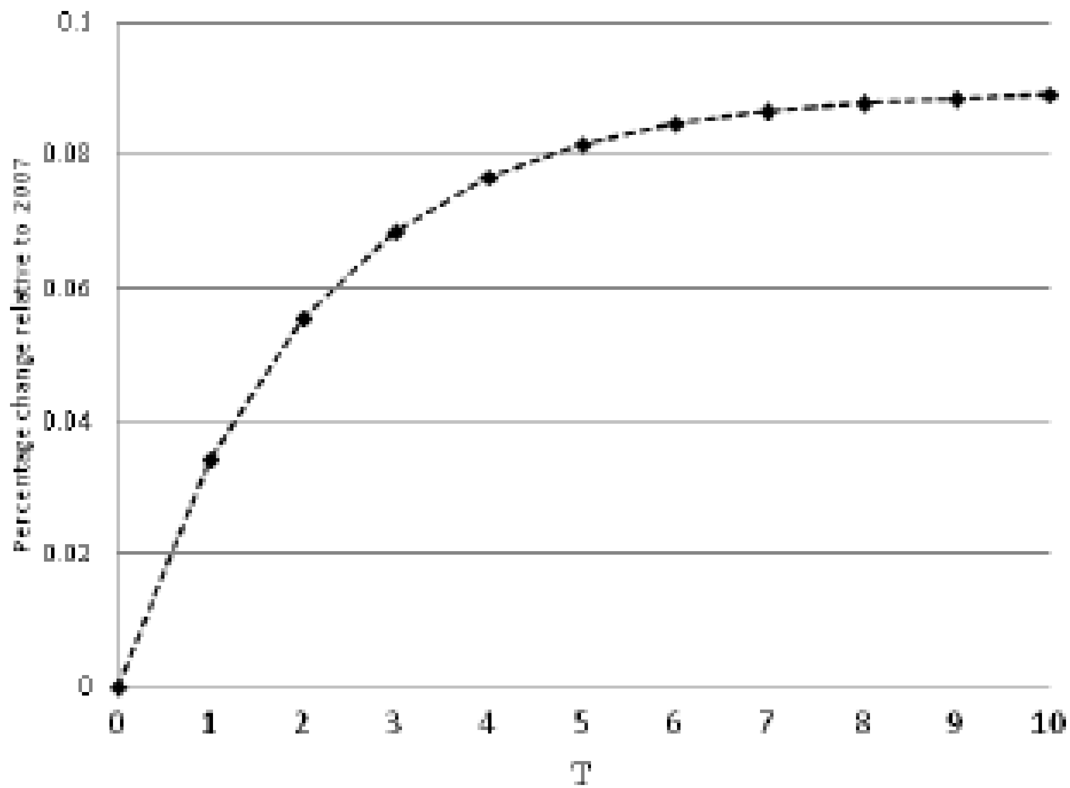


Figure 5: Simulated effects of a 10 percent reduction in the user cost on the capital-output ratio: equipment



Do corporate tax changes affect wages?

- Estimates for wage effects ranging between zero and several times the corporate tax revenue raised

- Distinguish between ‘direct’ and ‘indirect’ effect (Arulampalam, Devereux, Maffini, 2012)

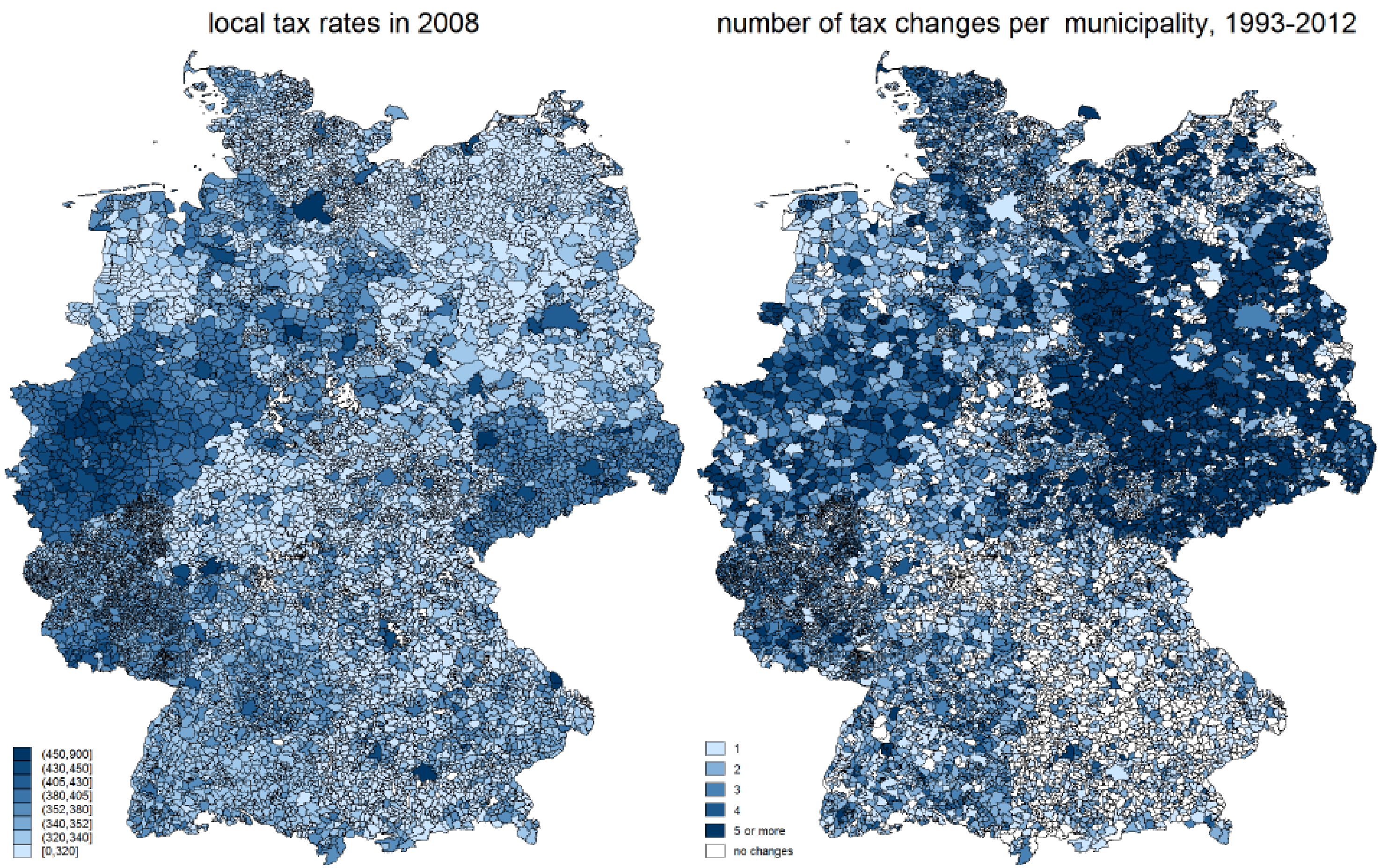
- Direct Effect: Wage change for given level of investment and employment (e.g. ‘rent sharing’)

- Indirect Effect: Effect of change in investment and employment

Do corporate tax changes affect wages?

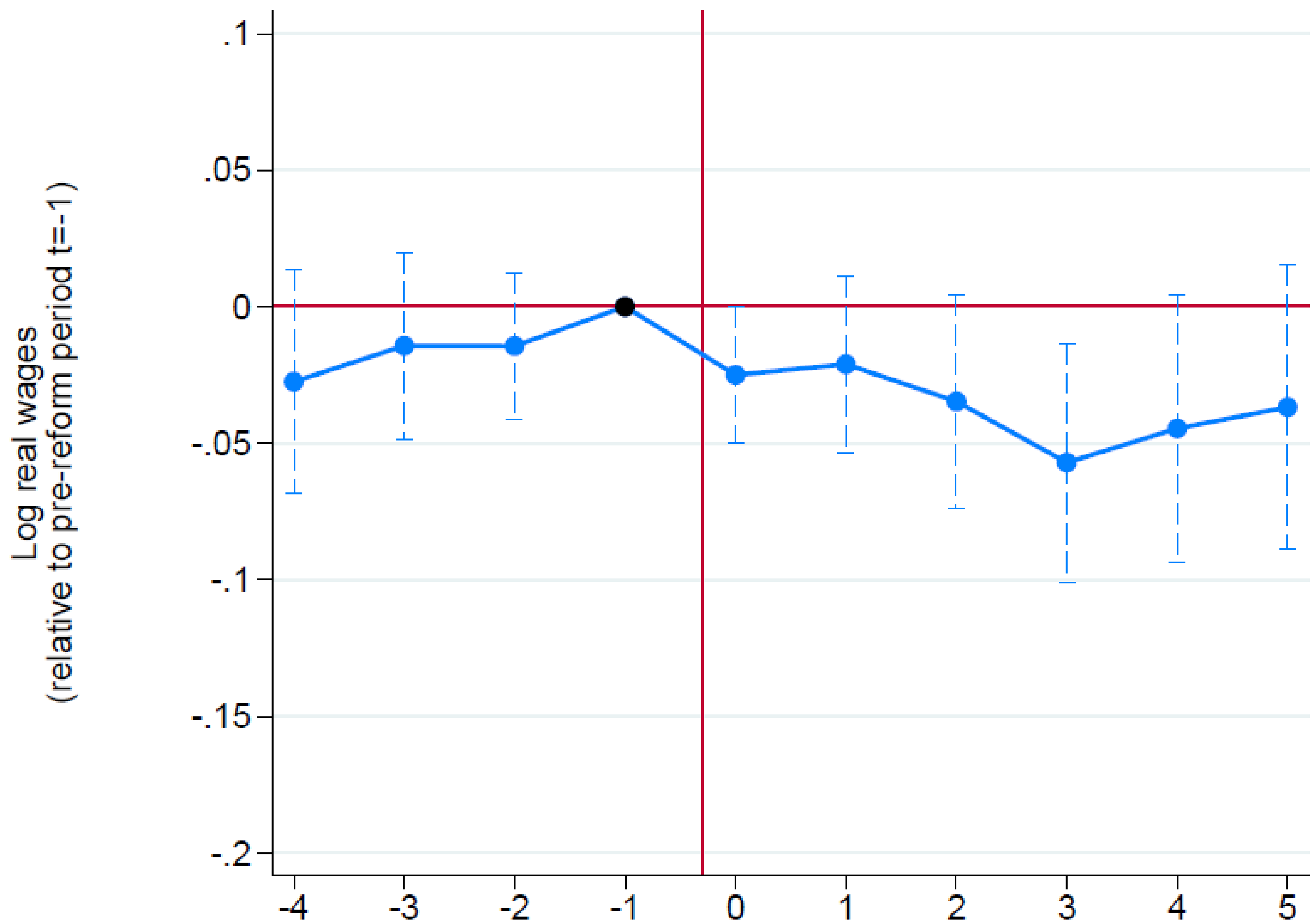
- Fuest, Peich, Siegloch (2015)
- Local Corporate Tax Changes in Germany 1998-2008 (appr. 13.000 ‘tax reforms’)
- Matched Municipality Firm Employee Data
- Question: How do wages develop after a local corporate tax change, compared to wages elsewhere where no such change occurs?

Figure 1: Cross-sectional and time variation in local tax rates

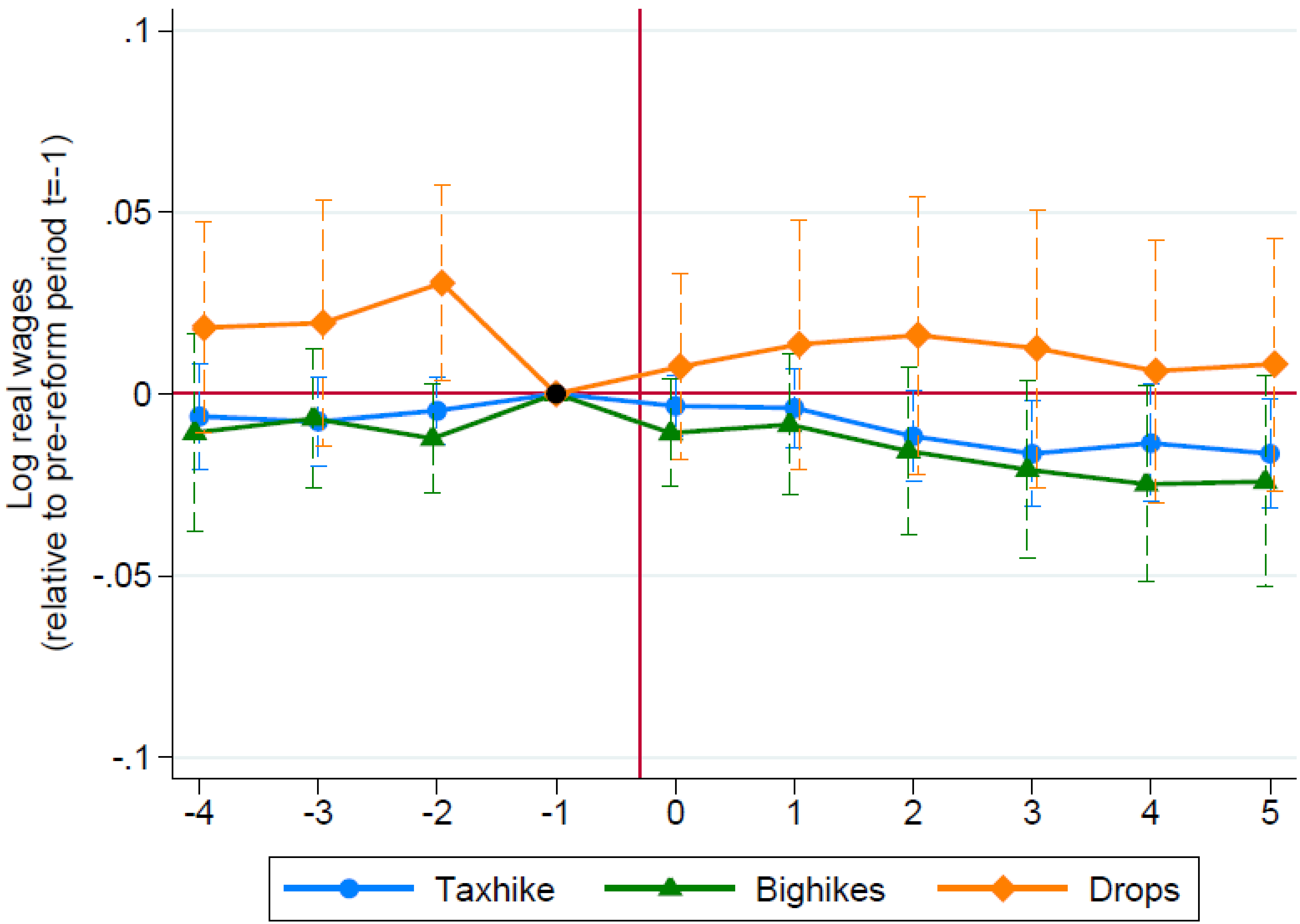


Source: Statistical Offices of the Länder. *Notes:* Jurisdictional boundaries as of December 31, 2010.

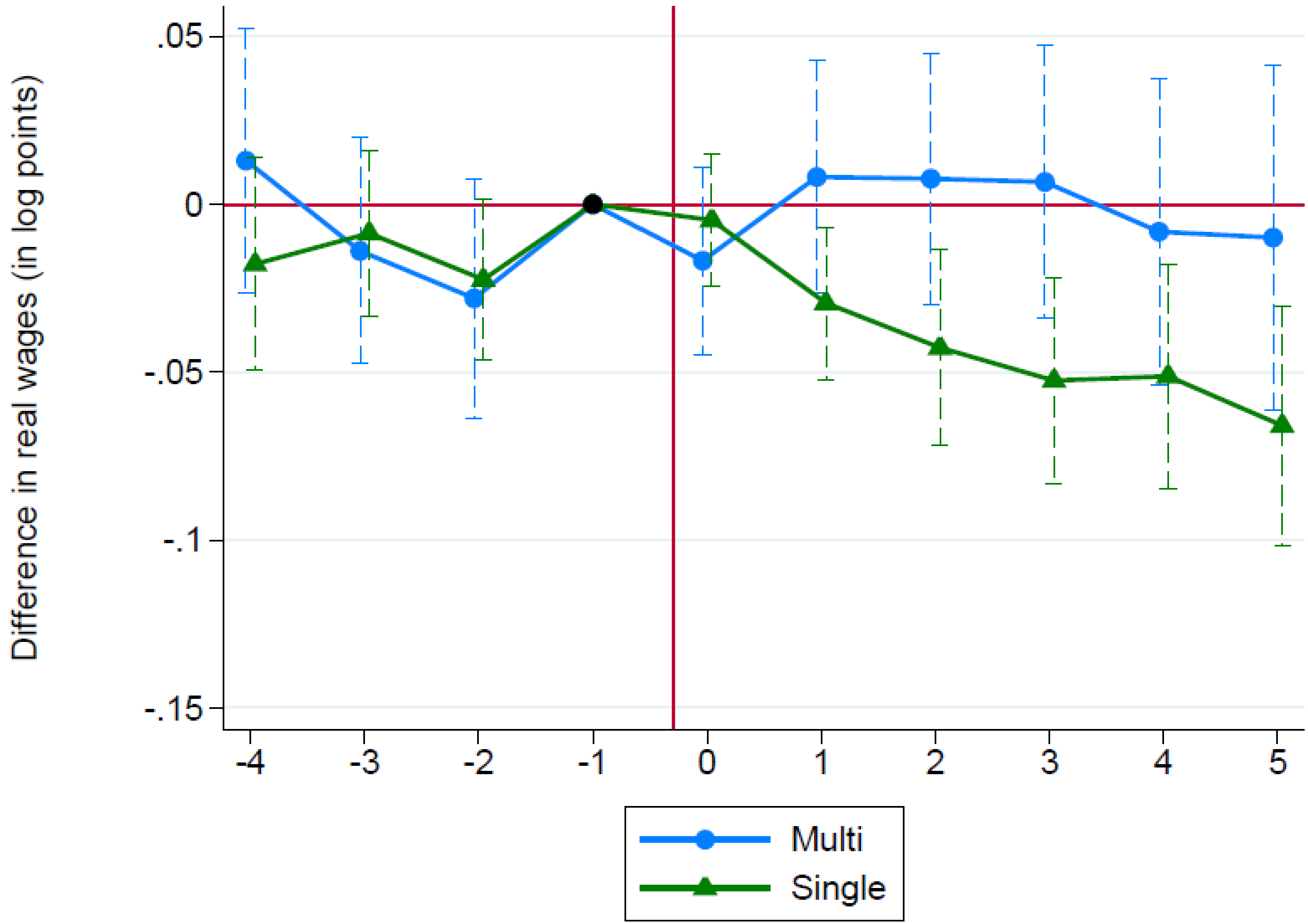
Figure 2: Event study: Effect on municipal wages - baseline results



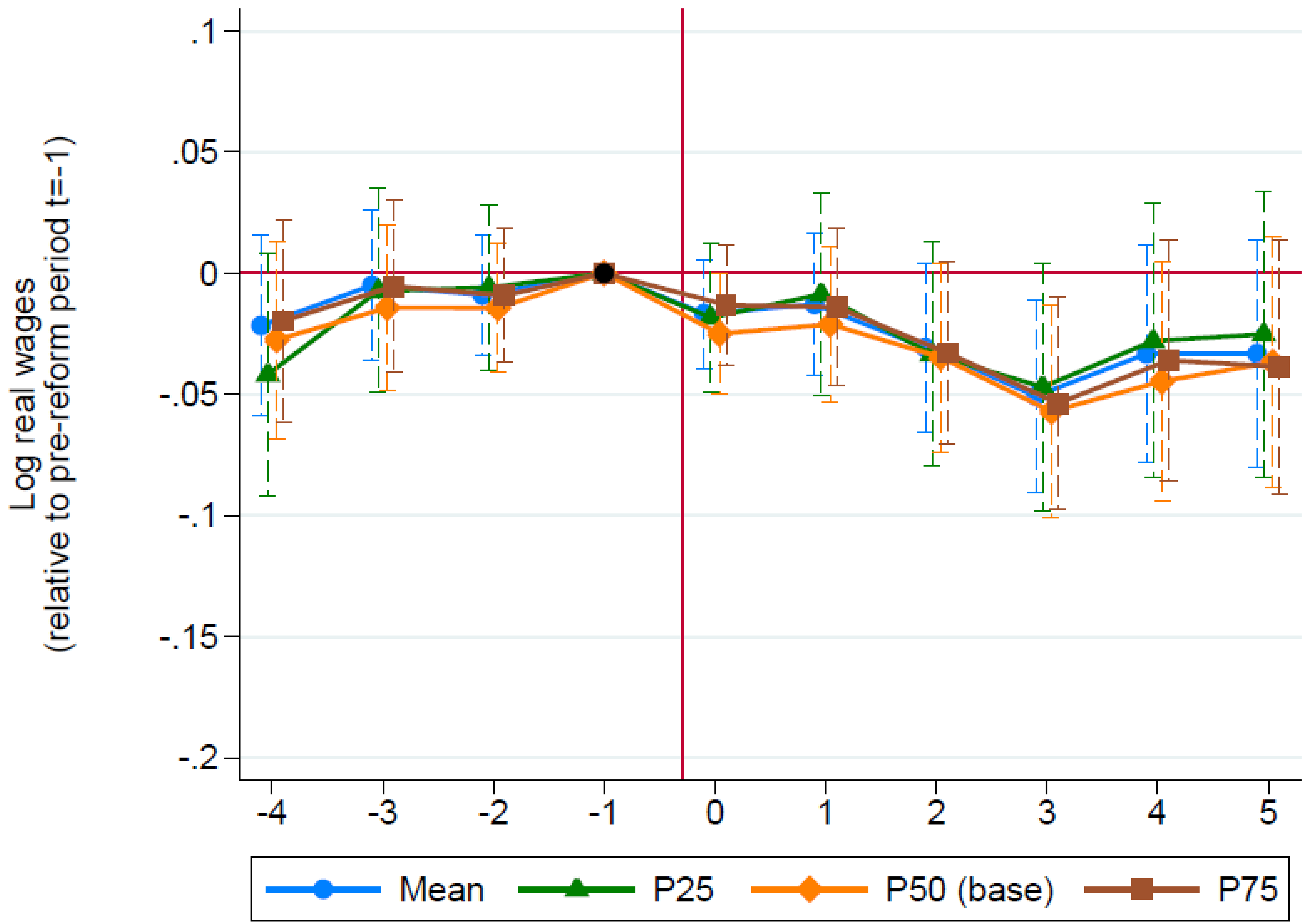
Panel B: Tax change vs. tax increases/decreases



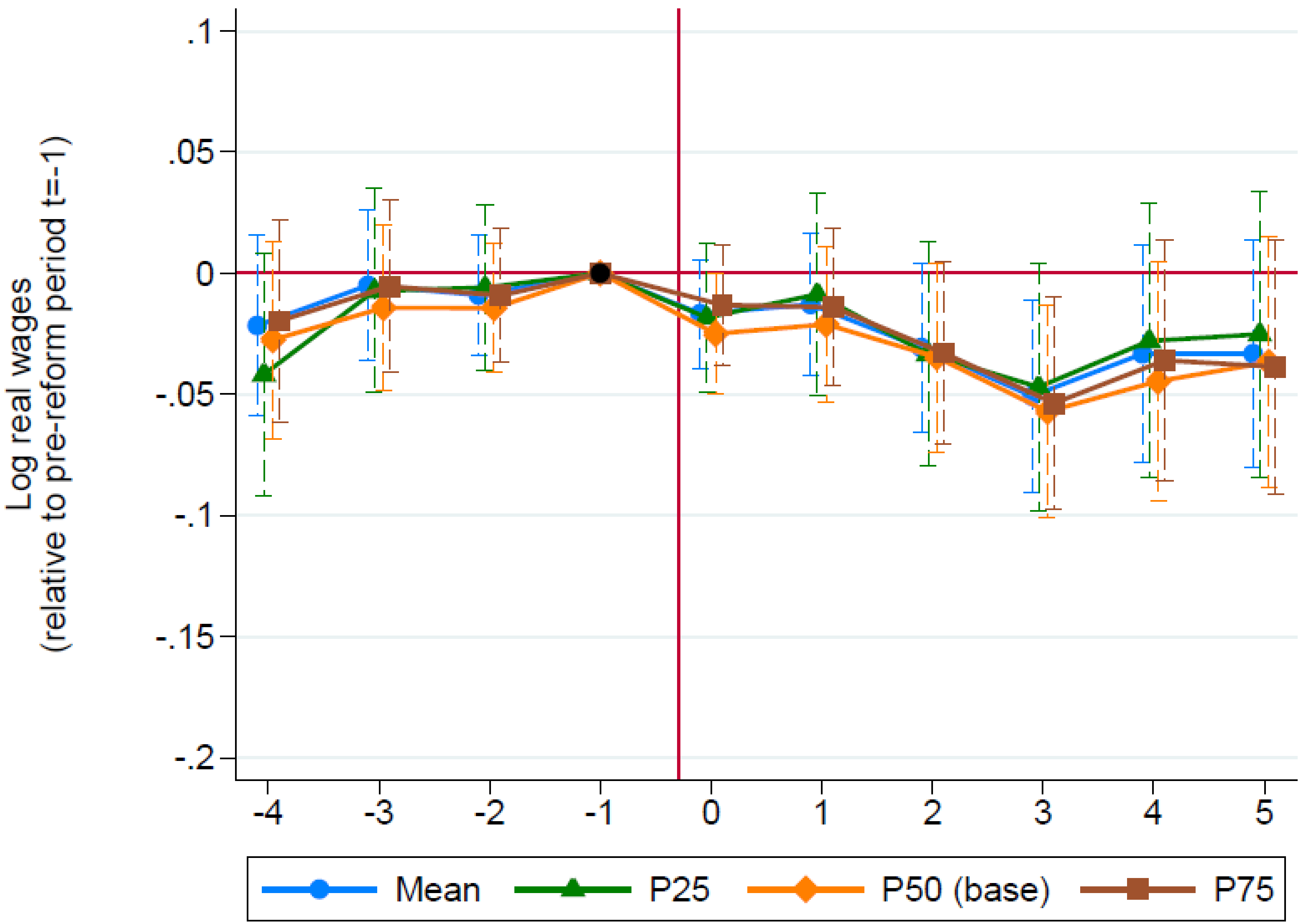
Panel A: Plants of single- vs multi-establishment firms



Panel A: Wage Quantiles



Panel A: Wage Quantiles



Results:

- On average collecting one additional Euro of corporate tax reduces wages by 25 cents, given the level of employment (‘direct effect’)
- Effects similar across qualification levels
- Larger effects in single plant firms with firm level union firm wage bargaining
- Smaller effects in large, multi-plant firms and firms with binding sector level wage agreements

II. How significant is the problem of base erosion and profit shifting?

Numbers about tax revenue losses due to (corporate) tax avoidance

- Tax Justice Network: EU wide tax revenue loss of 1000 bn Euros per year due to tax evasion and avoidance

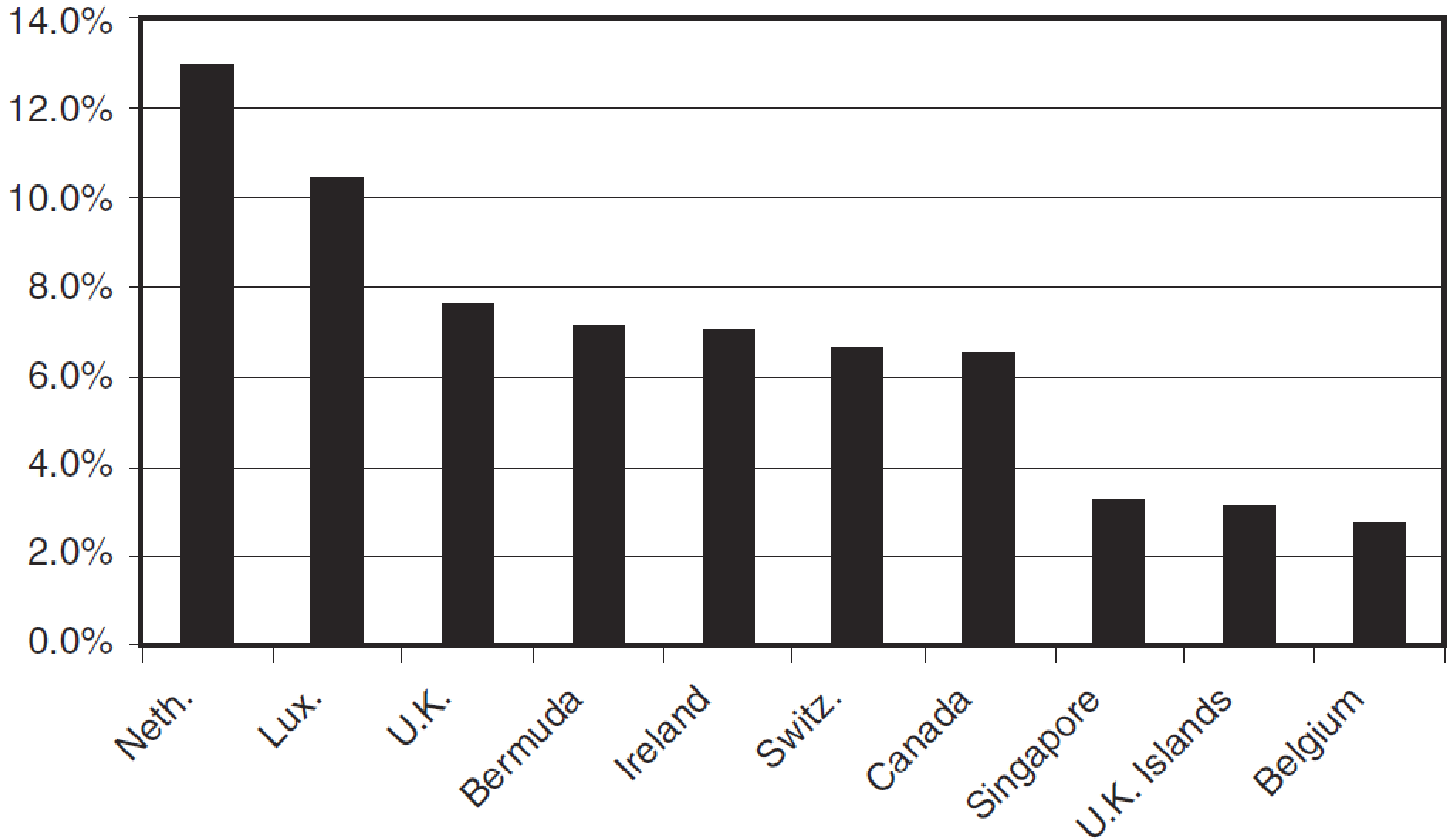
- Oxfam: Developing countries lose 50 bn US-Dollars each year through tax avoidance of multinationals

- OECD (2015): 100-240 bn US-Dollars global corporate income tax revenue loss per year due to BEPS (4-10% of overall corporate tax revenue)

Clausing (2009)

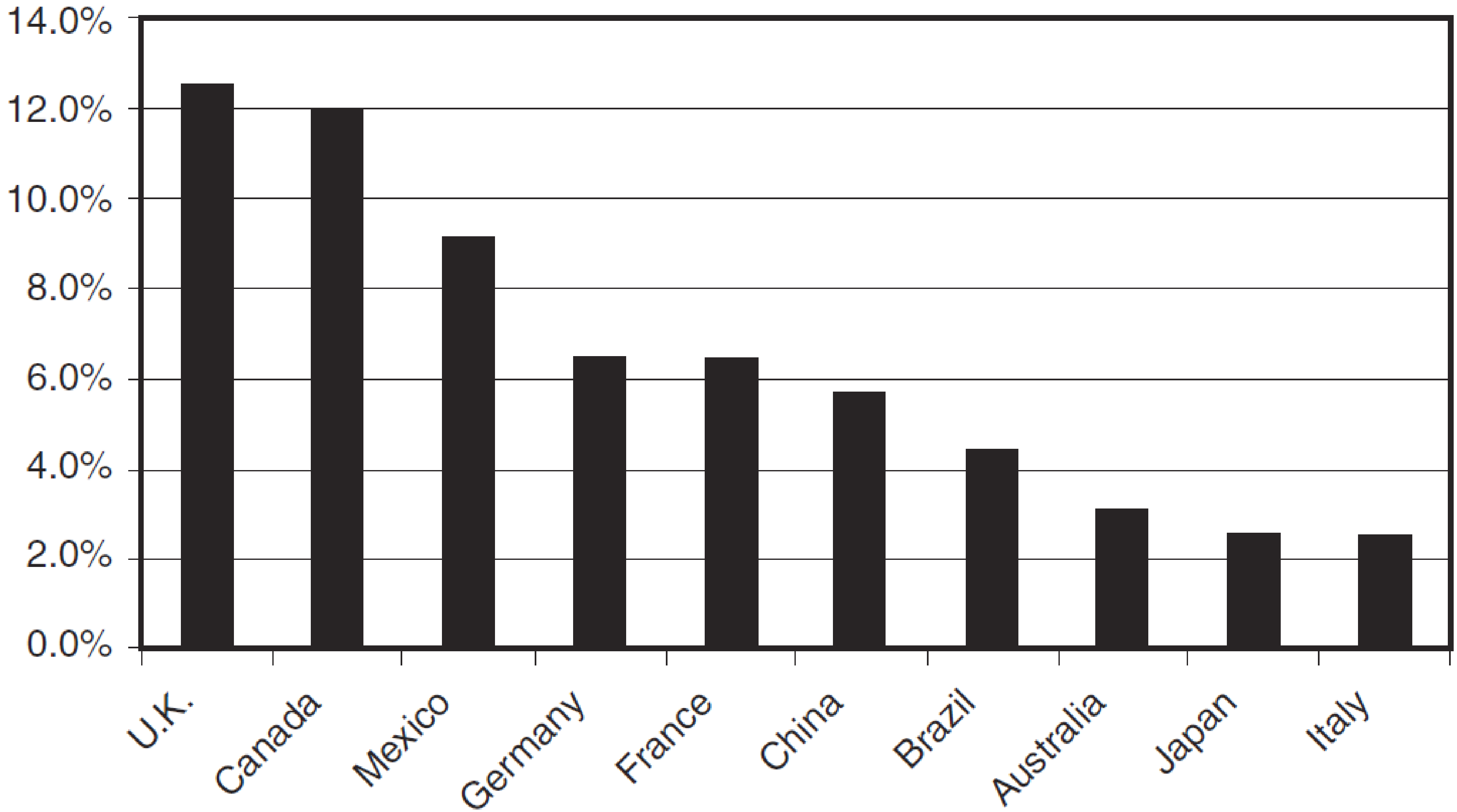
- Analysis of tax avoidance by US-Multinationals
- Mikrodata US-Foreign Subsidiaries1982-2005

Figure 4
Where Were the Profits in 2005?
(Profits as a Percentage of the Worldwide Total)



Country	Effective Tax Rate (Percent)
Netherlands	5.1
Luxembourg	0.9
United Kingdom	28.9
Bermuda	0.9
Ireland	5.9
Switzerland	3.5
Canada	21.4
Singapore	3.2
U.K. Islands	1.9
Belgium	8.7

Figure 5
Where Were the Jobs in 2005?
(Employment as a Percentage of the Worldwide Total)



Country	Effective Tax Rate (Percent)
United Kingdom	28.9
Canada	21.4
Mexico	21.8
Germany	26.2
France	21.3
China	14.8
Brazil	18.1
Australia	12.1
Japan	34.7
Italy	24.9

Main result in Clausing (2009)

Corporate tax cut by one percentage point (holding constant the US tax rate US-Steuersatz) increases the ‘profitability’ (Gross profits/sales) of US-foreign subsidiaries in the country by 0,5 percentage points (3,3 per cent)

Meta-Study on Corporate Profit Shifting

Heckemeyer und Overesch (2013): Synthesis of 25 studies

Main result: Tax rate cut by 10 percentage points increases reported profits of multinational companies by 8% (one quarter of the effect is due to changes in financial structures)

- Various publicly debated numbers about tax revenue losses due to tax avoidance and evasion are derived with inappropriate methods

- But there is solid empirical evidence suggesting that multinational do systematically exploit possibilities to avoid taxes (this is not illegal, but that does not mean it is desirable)

III. How should the international corporate tax system work?

‘**Old view**’: Residence based taxation is superior

Issue: Does not hold if headquarters are mobile

‘**New view**’: Source based taxation has advantages but is not necessarily superior in all dimensions

‘Pragmatic Approach’

The international tax system should avoid non-taxation as well as double taxation of corporate income.

IV. What can governments do?

1. **Extend residence based taxation of worldwide income** (tighten CFC regimes…)
2. **Extend source based taxation (**restrict interest deductibility, change PE definitions, increased use of source based taxes on interest royalties, correspondence principle, exit taxation…)
3. **Fundamental reform of the corporate tax system** (CCCTB or ‘Destination based corporate income tax‘)
4. **Extend information requirements** (e.g. ‚Country by Country Reporting‘)
5. **Distinguish between ‚fair‘ and ‚unfair‘ tax practices** (crowd back discriminatory regimes)

Key Aspects

- Unilateral vs Bilateral/Multilateral action
- Conflicts of Interest between countries

European Commission (2015):

1. Re-establishing the link between taxation and where economic activity takes place.
2. Ensuring that member states can correctly value corporate activity in their jurisdiction.
3. Creating a competitive and growth-friendly corporate tax environment for the EU, resulting in a more resilient corporate sector, in line with the recommendations in the European Semester.
4. Protecting the Single Market and securing a strong EU approach to external corporate tax issues, including measures to implement OECD BEPS, to deal with non-cooperative tax jurisdictions and to increase tax transparency.

V. Conclusions

- Corporate taxation has significant economic effects on investment, wages, reported profits…

- Multinational companies do engage in international tax planning and do exploit tax incentives offered (willingly or unwillingly) by governments

- International tax competition to attract investment, jobs, headquarters, tax base will continue

- The BEPS debate will crowd back targeted fiscal regimes and extend source based taxation;

- This will intensify competitive pressures on headline corporate tax rates and bases

- Conflicts of interest between countries are the key obstacle to progress in international corporate tax coordination

- The EU should try to coordinate on basic rules for tax competition (like e.g. transparency with respect to special tax regimes) but preserve national autonomy in setting tax rates

- Common tax rates or a uniform tax base combined with unanimity principle can lead to lack of flexibility in corporate tax policy

Thank you very much!