Fair share and fair taxation; a balancing act

In 1927, U.S. Supreme Court Justice Oliver Wendell Holmes observed that “taxes are what we pay for civilized society.” Reasonable people agree with this. However, like most things in life, balance is called for. Excessively high taxes can represent a cost to society because they dampen economic growth. The composition and mix of taxes are also important, because not all taxes have the same impact on the drivers of the economy. The choices that are made regarding how, what, and whom to tax are critically important to ensuring that the cost of civilized society is funded at the least economic cost to society.

Today, the concept of “fair taxation” has captured the public’s attention around the world. Reasonable people agree that everyone should pay their fair share. The focus of many headlines and blogs is on the particular question of whether multinational companies are paying enough tax. These stories often spark vigorous public and as such deserve thoughtful analysis. And, the right answer to the question of fair taxation should reflect due consideration of the impact of corporate taxes on the drivers of economic growth and prosperity.

Spurred in part by the public spotlight on the tax profile of multinational corporations and with the strong support of the G8, the OECD has embarked on a major project aimed at addressing government concerns about base erosion and profit shifting (BEPS). We welcome this project as the forum for a truly global discussion of the effectiveness of existing international tax policies and of potential changes to these policies that could have significant implications for cross-border trade and investment. However, it would be short-sighted for the G8 and OECD policymakers to limit their consideration of the issues and the solutions merely to corporate income tax. A holistic approach is called for, with thoughtful consideration given to the right mix of corporate and other tax revenue generating tools to best serve the fiscal needs of governments, while helping to foster economic growth, prosperity and the global recovery.

Many countries trade off lower corporate income taxes to stimulate jobs and investment, which in turn result in other non-corporate tax revenues. Policymakers seek to improve the lives and welfare of their citizens by attracting foreign direct investment, encouraging domestic investment and entrepreneurship, and incentivizing job creation. Government policies to stimulate investment, jobs, and entrepreneurship often take the form of lower corporate tax rates, accelerated depreciation allowances, corporate tax credits, and other tax incentives. The increased economic activity that is created with these supply-side policies often result in higher individual income, payroll, consumption, and property tax revenues. These increased tax revenues in turn offset some or all of the effects of the lower corporate income taxes.

Corporate taxes in a global economy are increasingly borne by workers. With greater mobility of global capital, recent economic analyses of the economic burden (or incidence) of corporate income taxes show a significant percentage of the corporate tax is borne by persons other than the owners of capital. Like the positive effects of many corporate tax incentives on jobs, personal income and the overall economy, the negative effects of corporate taxation are borne widely throughout a country’s economy. High corporate taxation makes a country less attractive for business investment, including inbound investment by foreign-headquartered companies. Less business investment reduces job opportunities, constrains the capital stock and limits productivity growth, the last of which is the primary source of national income growth that fuels worker compensation.
Corporate income taxes are more harmful to economic growth than other taxes. Recent OECD analysis shows that corporate taxes are more likely to reduce a country's economic growth than other taxes. Again, corporate income taxation lowers the after-tax return to capital, which slows the rate of capital accumulation that, in turn, reduces productivity, including labor productivity. The double taxation of corporate equity income both at the business and shareholder level results in an additional tax on saving and investment.

The economic costs associated with corporate income taxes are significant relative to total corporate tax revenues. The drag on a country's economy from the economic distortions caused by excessive corporate income tax is high compared to the actual revenues collected. Lower corporate tax rates reduce these economic distortions, as there is an exponential relationship between distortions and marginal tax rates. However, compliance costs borne by corporate taxpayers and tax administration costs borne by governments continue to be high. These compliance costs can be particularly onerous as a relative matter for small and mid-sized businesses (SMEs) – and, SMEs are the job creation engine of most economies.

Real reforms could reduce the economic costs of current corporate income taxes. It is not necessary to eliminate the corporate income tax to significantly enhance economic growth, reduce economic distortions, and reduce tax complexity. Reforms within the system could reduce the adverse effects of current corporate income taxation. A recent OECD report outlined several fundamental corporate tax reforms that would be beneficial, including integration of corporate and individual income taxes, a shift to a corporate cash-flow tax, and allowances for returns on corporate equity.

Reform of the corporate income tax also requires a recognition that business income is increasingly earned in non-corporate form through vehicles such as partnerships and trusts. Therefore, we must consider more than just the universe of corporate structures. Because business income can be earned in many forms other than through a corporate structure, governments must more broadly consider how business tax bases are impacted by the use of non-corporate structures. By focusing on taxing income from business activity irrespective of its legal form, governments may be able to raise more revenue, create a level playing field for all business and reduce the harmful impact on their economies.

Now is the time for the G8 and the OECD to seize the opportunity and expand the global discussion around BEPS beyond the current focus on corporate income tax. It is imperative that policymakers take a broader view of the global tax environment and consider the economic, policy, and revenue dimensions of the whole suite of tax approaches available to governments in funding civilized society. That is the key to ensuring truly fair taxation and fostering prosperity.