Econ 133 – Global Inequality and Growth

Taxation in a globalized world

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What we've learned so far:

- There are equity reasons for taxing capital
- But also potential efficiency concerns
- However so far we assumed a closed economy

What we're going to learn in this lecture:

- How capital taxes can be avoided in a globalized world

- The magnitude and revenue costs of artificial profit shifting

- Potential solutions to these issues

1 Residence vs. source taxation

To think about capital taxation in an open economy, key distinction is **residence** vs. **source** base capital taxation

- Residence: capital tax based on residence of owner of capital (or location of headquarter for firms)

- Most individual income tax systems are residence based (with credits for taxes paid abroad)

- Can only escape tax through evasion or changing residence

- Source taxation: capital income tax based on location of capital

- Most corporate income tax systems are source based

- US is sometimes said to have a residence-based corporate tax, but in fact has more of a source-based tax because of deferral

Three main consequences of source-based taxation:

- Countries have incentives to lower tax rates to attract capital: lead to equilibrium where tax rates are too low

- Relocation of factors of production to low-tax countries: if big enough, shifts burden of capital taxes to labor

- Artificial shifting of tax base to low-tax countries

2 International profit shifting

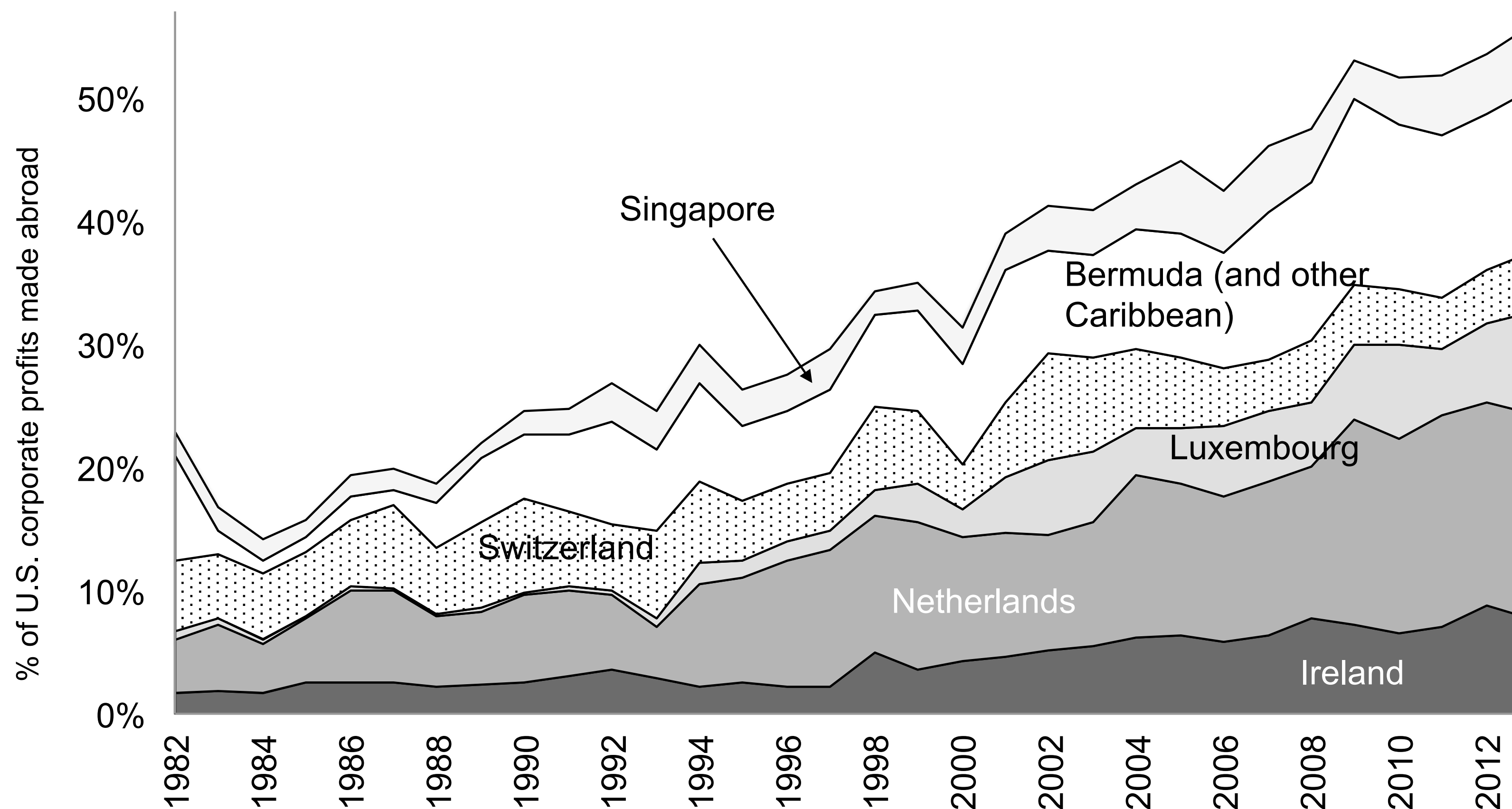
2.1 Empirical evidence

- Corporate taxes are to be paid to countries where profits have been made

- Problem: very easy to manipulate location of profits

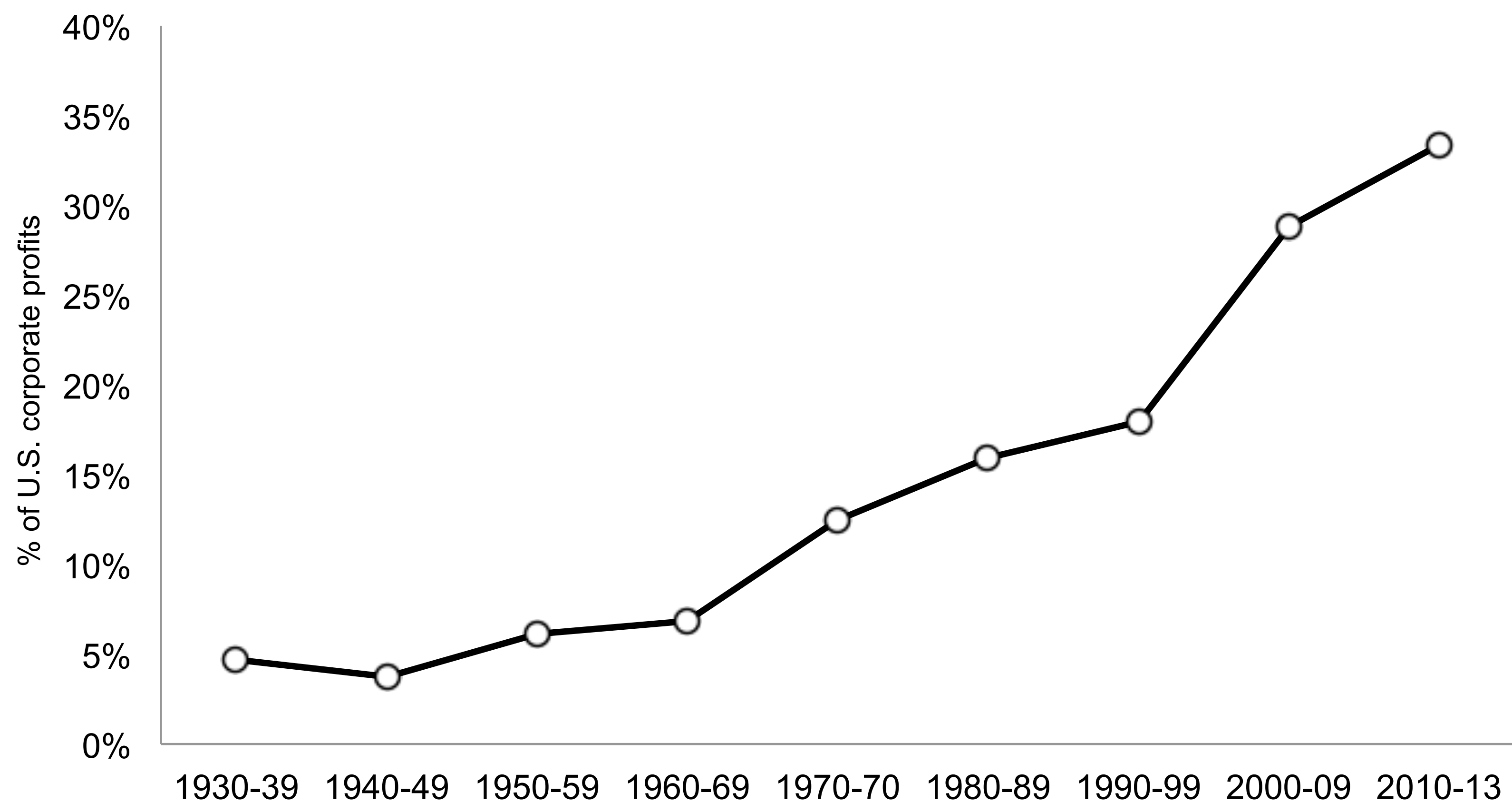
- This is done through the manipulation of transfer prices

The share of tax havens in U.S. corporate profits made abroad



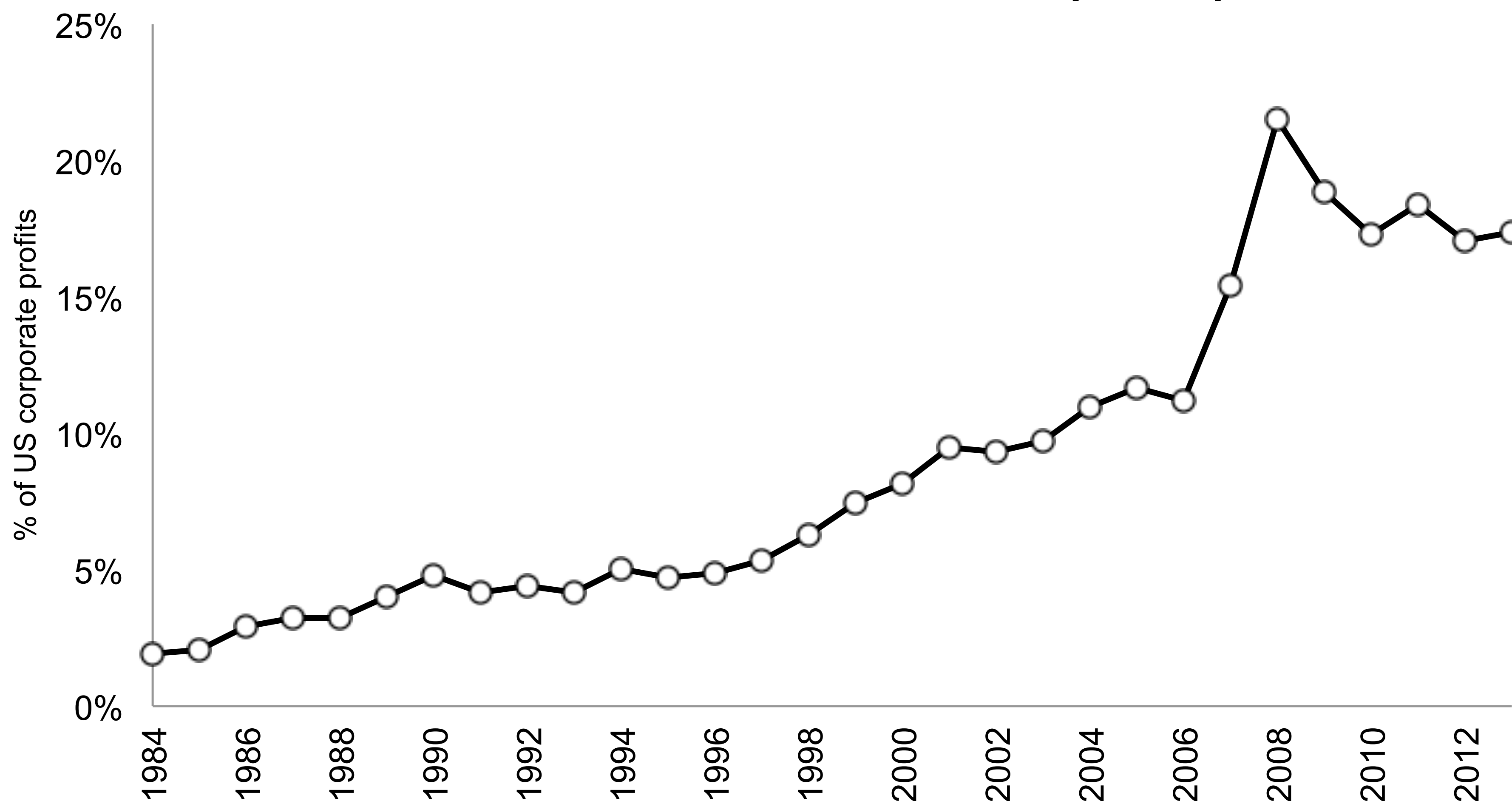
Notes: This figure charts the share of income on U.S. direct investment abroad made in the main tax havens. In 2013, total income on U.S.DI abroad was about $500bn. 17% came from the Netherlands, 8% from Luxembourg, etc. Source: author's computations using balance of payments data, see Online Appendix.

The share of profits made abroad in U.S. corporate profits

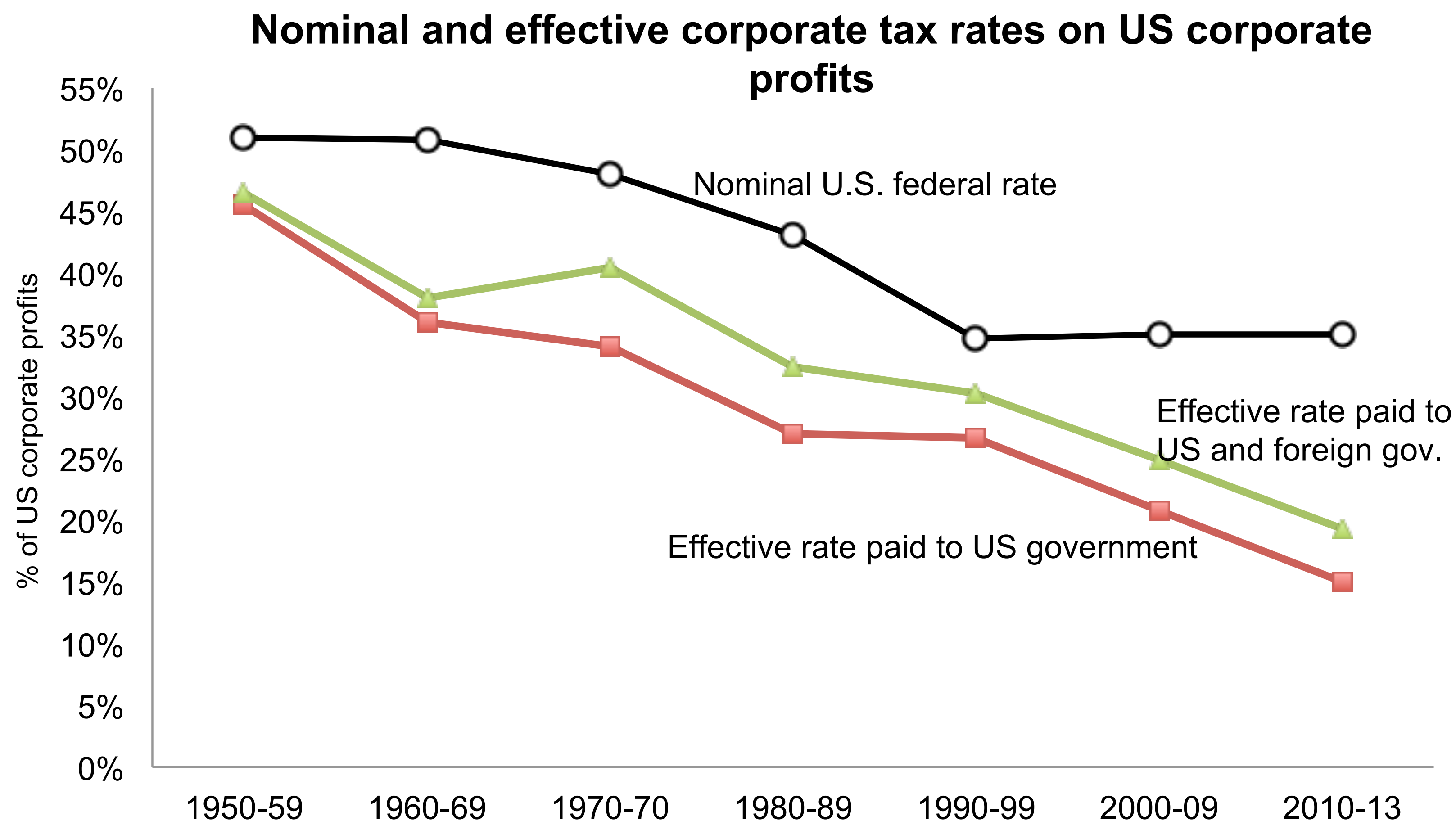


32% of US corporate profits are made abroad in 2013. Foreign profits include dividends on foreign portfolio equities and income on US direct investment abroad (distributed & retained). Profits are net of interest payments, gross of US but net of foreign income taxes. Source: author's computations using BEA data.

The share of tax havens in U.S. corporate profits



Notes: This figure charts the ratio of profits made in the main tax havens (Netherlands, Ireland, Switzerland, Singapore, Luxembourg, Bermuda and other Caribbean havens) to total US corporate profits (domestic plus foreign). Source: author's computations using NIPA and balance of payments data, see Online



Notes: The figure reports decennial averages (e.g., 1970-79 is the average of 1970, 1971, ..., 1979). In 2013, over $100 of corporate profits earned by US residents, on average $16 is paid in corporate taxes to the U.S. government (federal and States) and $4 to foreign governments. Source: author's computations using NIPA data, see Online Appendix.

2.2 How artificial profit-shifting works

Three ways to shift profits to low-tax countries:

- Manipulating intra-group import and export prices (*transfer prices*)
- Intra-group borrowing
- Locating intangibles in tax havens

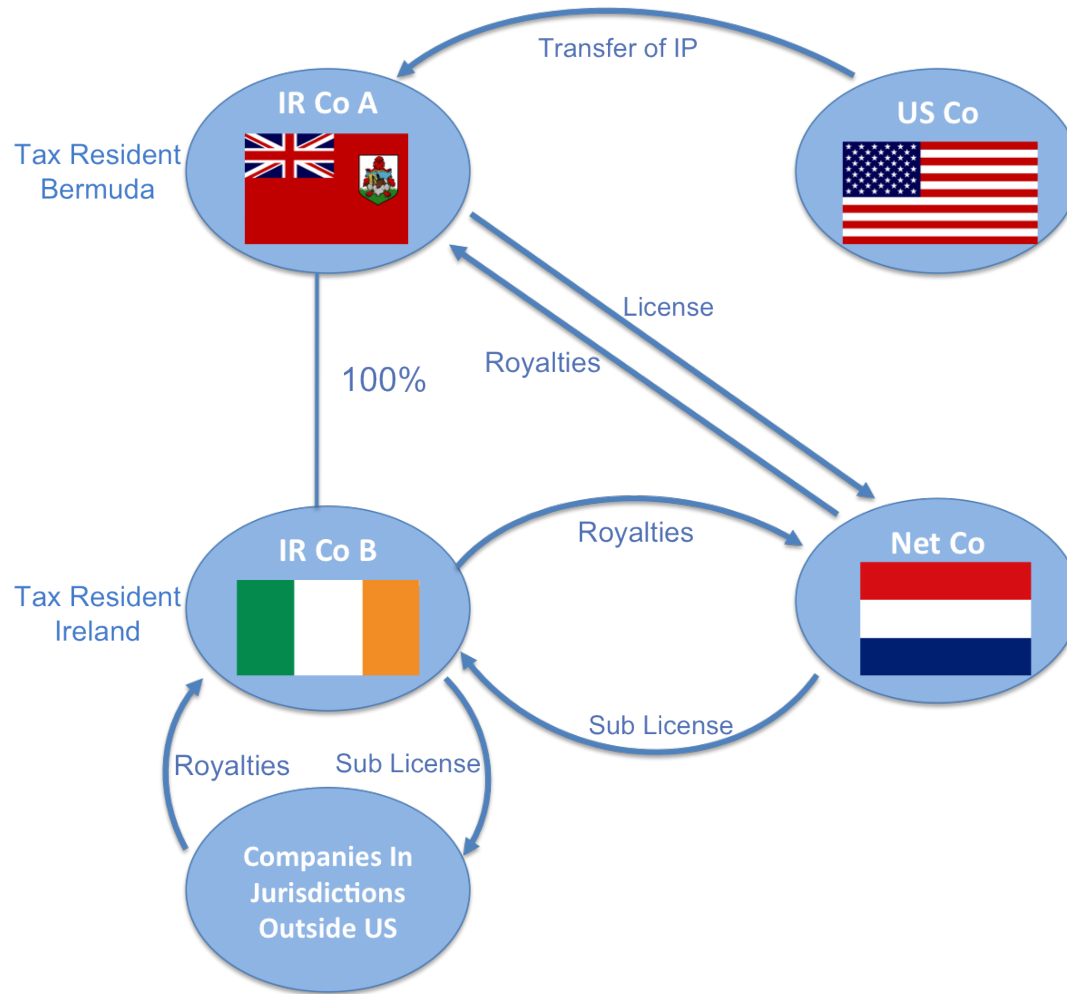
Strategic location of debt and intangibles

- Booking assets in low-tax countries enables firms to deduct income in high-tax countries and earn interest & royalties in tax havens

- Problem is growing in importance with rise of intangible capital

- Anti-avoidance rules: thin capitalization, controlled foreign corporations

- Routinely avoided by exploiting inconsistency in tax laws



The Double Irish Dutch Sandwich

If the Cayman Islands has a low corporate tax rate and the U.S has a high corporate tax rate, then U.S. firms have incentives to:

A — Export at artificially high prices to their Cayman subsidiaries

B — Import at artficially high prices from their Cayman subsidiaries

C — Lend money at high interest rates to their Cayman subsidiaries

D — No incentive to shift profits to the Cayman Islands

3 International tax reform

3.1 Formula apportionment

- Tax base in country i based on shares of global sales, assets, and/or payroll made in i

- Used by US states for their own corporate taxes

- Key attraction: eliminates the opportunity for companies to engage in profit shifting

- Sales only apportionment removes incentives to move K abroad

- Potential problem of sales through low-tax resellers

3.2 Corporate tax integration

- Shareholders receive credits for previously paid corporate taxes

- Corporate tax becomes like a withholding pre-paid tax that is refunded when dividends are paid out to individuals

- Removes incentives to shift profits and move capital abroad

- Existed in Europe; still exists today in Canada, Mexico, Australia

- Can be combined with apportionment to ensure proper withholding at corporate level

3.3 Border adjustment

- Include in corporate tax base value of all imports and deduct the value of all exports

- Similar to VAT border-adjustment (Auerbach & Holtz-Eakin ’16)

- In theory, $ FX must adjust leaving trade balance unchanged

- Like sales apportionment and integration, border adjustment removes incentives to shift profits or move capital abroad

- If combined with full expensing and no interest deduction: DBCFT (House Republicans 2016 proposal)

4 Summary

- In an open-economy, capital taxation faces important challenges:
  - Tax competition for real investment
  - Tax evasion through hidden accounts
  - Artificial profit-shifting
- But these challenges are not insuperable

References

Auerbach, Alan J. and Douglas Holtz-Eakin "The Role of Border Adjustment in International Taxation", working paper, 2016 (web)

Zucman, Gabriel, "Taxing Across Borders: Tracking Personal Wealth and Corporate Profits" *Journal of Economic Perspectives* 2014 (web)