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 in a closed economy
- These concerns are exacerbated in a globalized world

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

1.1 Residence-based 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

1.2 Source-based capital taxation

- Source: Capital income tax based on location of capital

- Most corporate income tax systems are source based

- 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
- Main problem today = artificial profit shifting

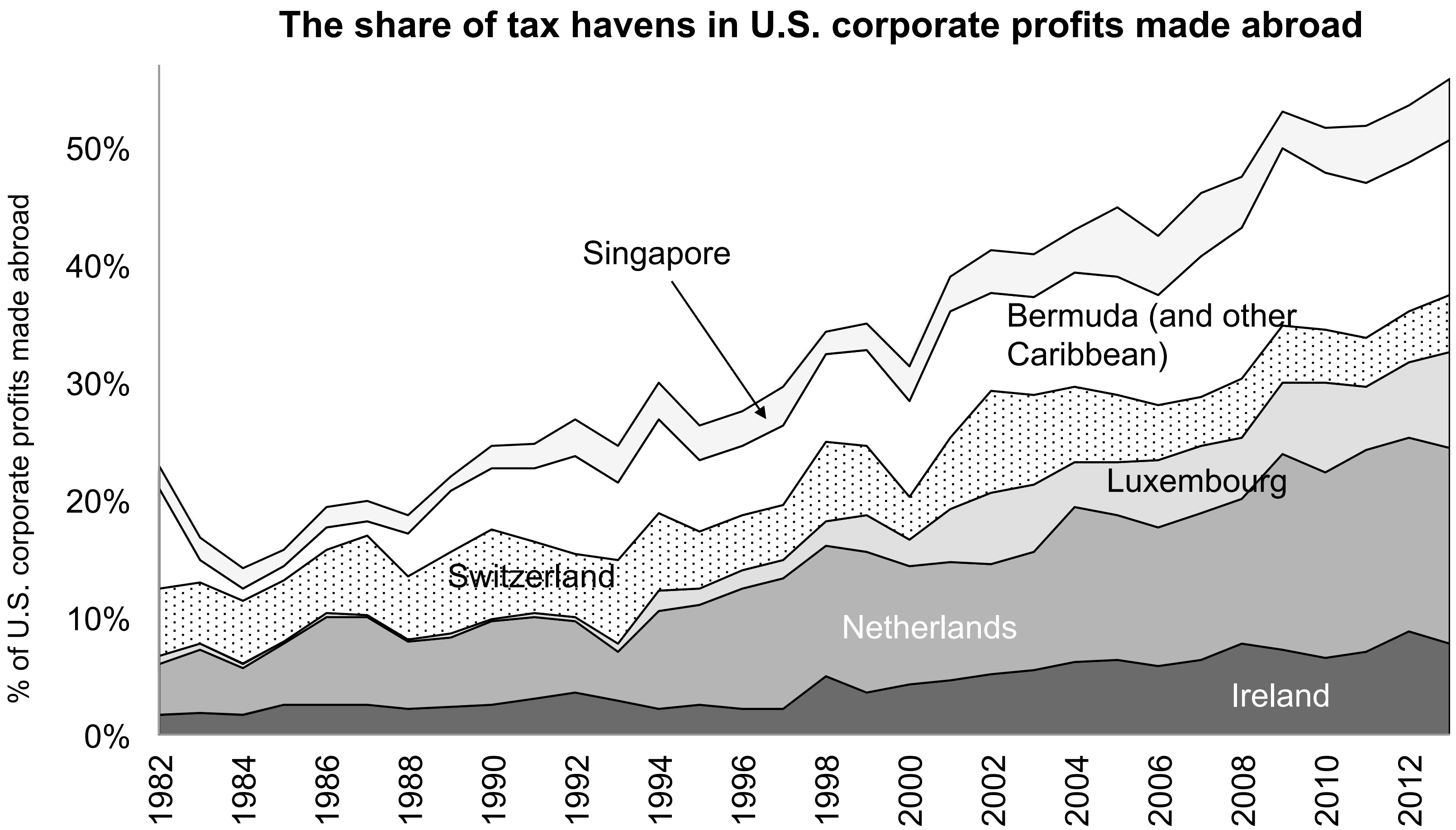
2 International profit shifting

2.1 Empirical evidence

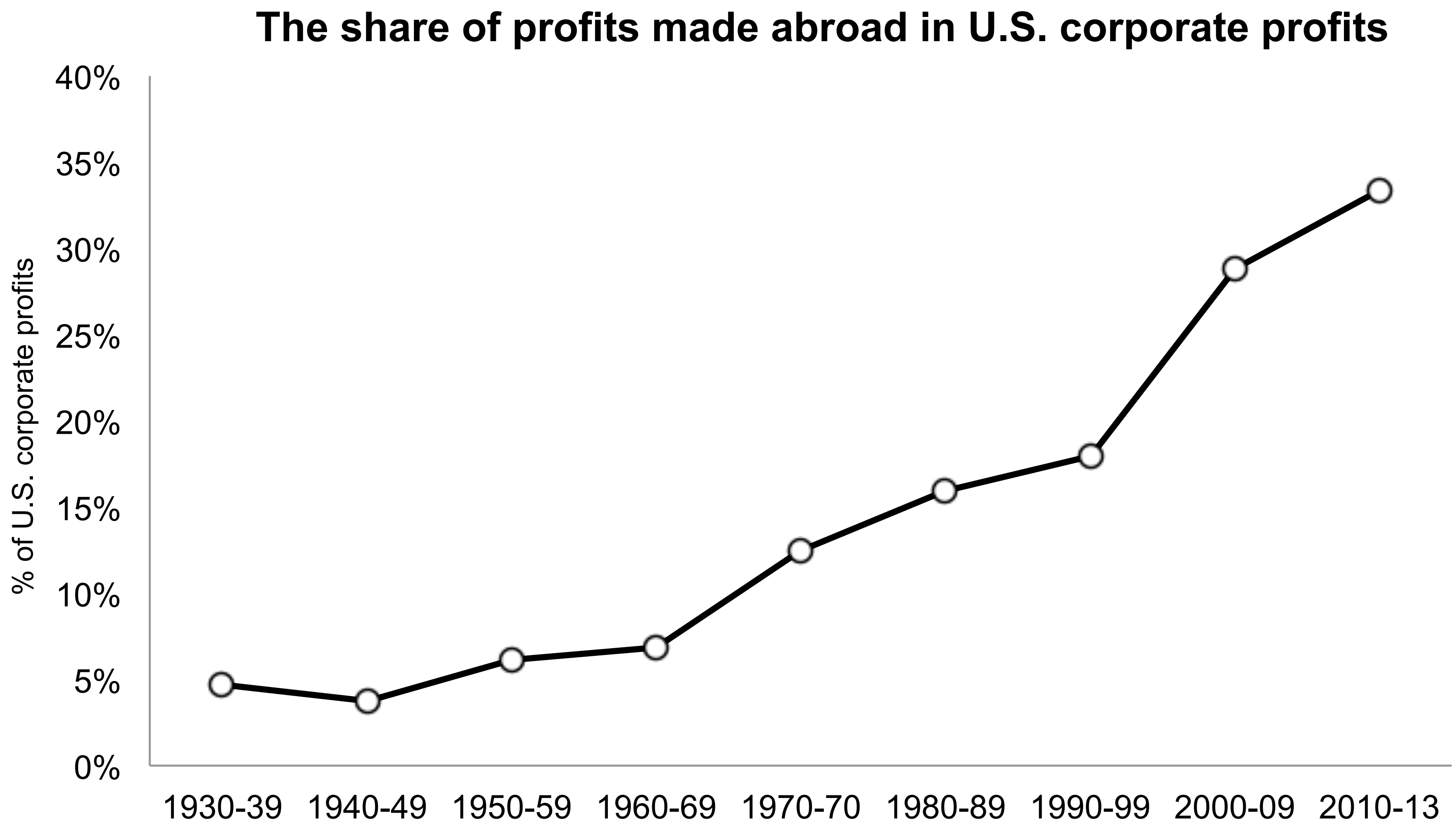
- Corporate taxes are to be paid to countries where profits have been made

- Problem: very easy to manipulate location of profits

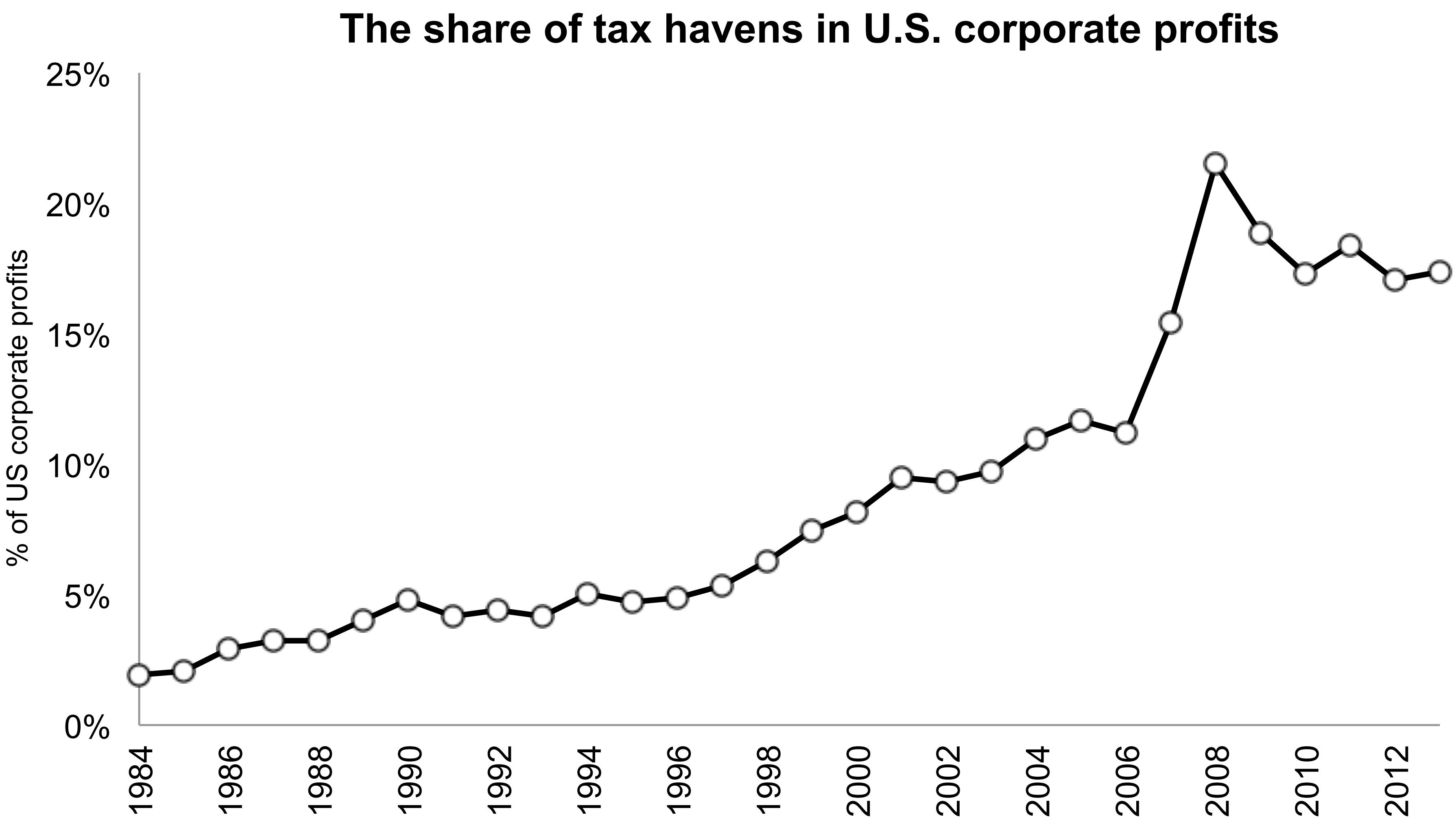
- This is done through the manipulation of transfer prices



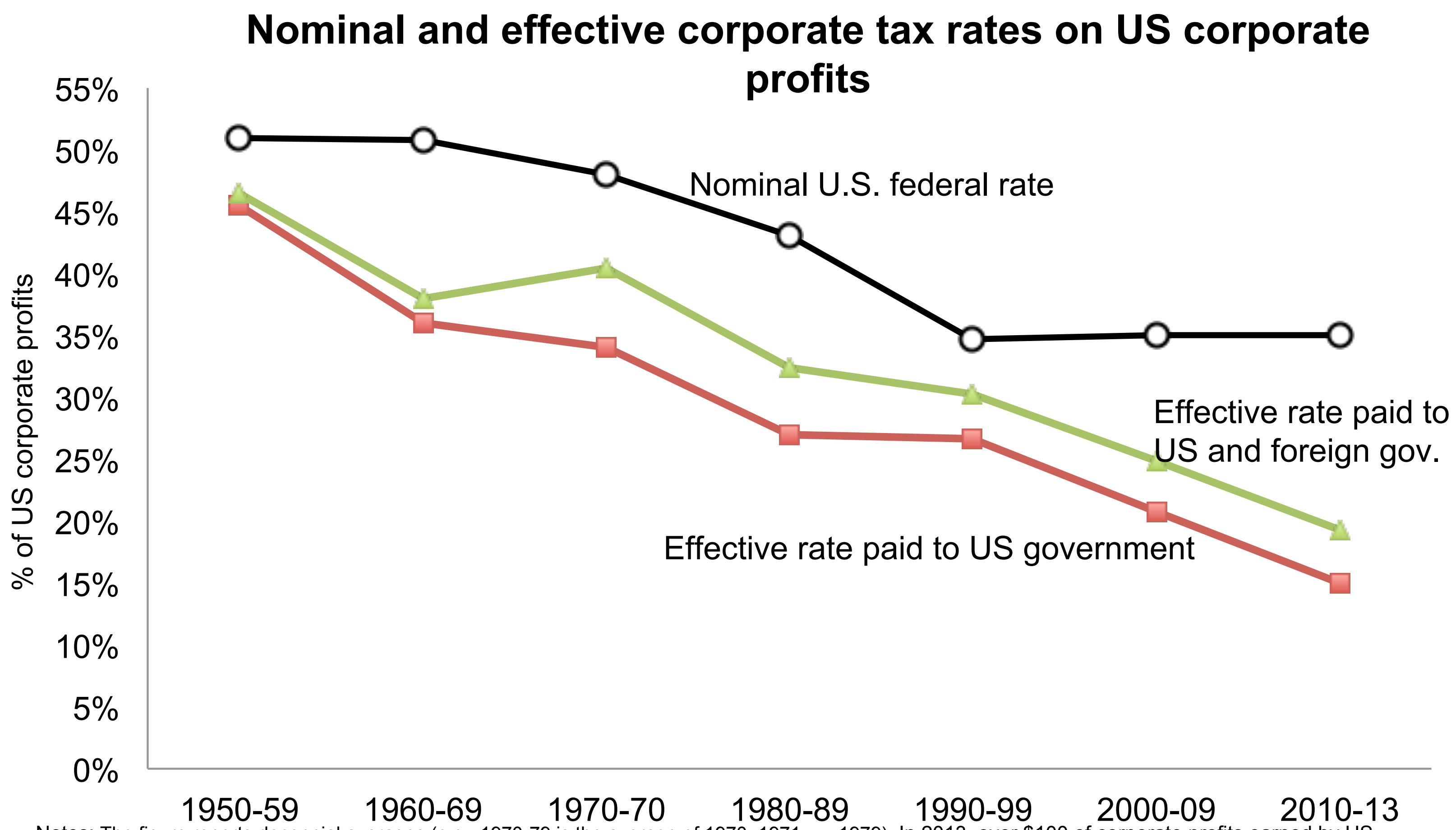
Notes: This figure charts the share of income on U.S. direct investment abroad made in the main tax havens. In 2013, total income on U.S.DI abroad was about $500bn. 17% came from the Netherlands, 8% from Luxembourg, etc. Source: author's computations using balance of payments data, see Online Appendix.



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.



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.

3 Solutions to artificial profit shifting

- Repeal of the corporate tax
  - Would undermine the individual income tax
  - Would increase inequality
- Make profit shifting more difficult
  - Strengthening of arm's length rules.

  - OECD base erosion and profit shifting

- Formula apportionment in lieu of arm's length pricing

  - Based on employment, capital, sales... (like for US States)

  - Would make artificial profit shifting impossible

4 Summary

- In an open-economy, capital taxation faces important challenges:
  - Tax competition for real investment
  - Tax evasion through hidden accounts (see lecture 19)
  - Artificial profit-shifting
- But these challenges are not insuperable

References

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