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Redistributive taxation, multinational enterprises, and economic integration

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Abstract

Increased activity of multinational firms exposes national corporate tax bases to cross-country profit shifting, but also leads to rising profitability of the corporate sector. We incorporate these two effects of economic integration into a simple political economy model where the median voter decides on a redistributive income tax rate. In this setting economic integration may raise or lower the equilibrium tax rate, and it is more likely to raise the tax rate of a low-tax country. The implications of the model are consistent with the empirical observations that effective corporate tax rates have not fallen in all OECD countries, and that corporate tax revenues have generally risen.

JEL classification: H20; F23
Keywords: Redistributive taxation; Profit shifting

1. Introduction

One of the most pronounced trends in the world economy over the last decades has been the rise in foreign direct investment and multinational activity. In the United States, for example, foreign profits made up around 5% of all corporate profits earned by U.S. firms until the late 1960s, but this share has meanwhile risen to more than 25%, and is probably even higher (Desai and Hines, 2004). As a consequence of this development national corporate tax bases have become more sensitive to tax changes.[1] Most of the literature on international tax competition has therefore modelled economic integration as a pure increase in the mobility of the capital tax base. In these models the typical result is that increasing capital mobility leads governments to undercut each other's capital income tax rates, resulting in underprovision of public goods as well as relatively higher taxes on immobile factors (see Wilson, 1999 for a survey).

Empirical evidence in support of this theoretical prediction is mixed, however. Table 1 summarizes the development of corporate tax rates and tax revenues in a representative sample of OECD countries. Two stylized facts stand out.

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[1] This tax sensitivity may arise either from the location and investment decisions of multinational firms, or from profit-shifting activities. The empirical evidence on the effects of taxes on firm location and profit-shifting is surveyed in Hines (1999) and, more recently, Devereux (2006).

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Table 1
Corporate income taxation (CIT) in OECD countries

Country	Statutory tax rate [a]		Effective marginal tax rate [b]		Effective average tax rate [c]		CIT revenue (% of GDP)	
	1982	2005	1982	2005	1982	2005	1982	2004
Australia	50	30	32	24	37	26	2.7	5.7
Austria	61	25	25	20	37	22	1.2	2.3
Belgium	45	34	31	22	35	26	2.2	3.6
Canada	45	36	9	25	25	28	2.7	3.4
Finland	60	26	43	17	45	21	1.6	3.6
France	50	34	26	20	34	25	2.1	2.8
Germany	62	38	47	29	48	32	1.9	1.6
Greece	43	32	33	12	36	21	0.9	3.3
Ireland	10	13	0	10	5	11	1.5	3.6
Italy	39	37	18	19	26	26	2.9	2.8
Japan	55	40	42	28	44	32	5.2	3.8
Netherlands	48	32	35	21	38	25	2.8	3.1
Norway	51	28	34	22	38	24	6.8	10.0
Spain	33	35	23	21	26	26	1.2	3.4
Sweden	60	28	43	16	45	21	1.5	3.2
Switzerland	35	34	21	21	26	25	1.7	2.5
United Kingdom	52	30	0	20	26	24	3.7	2.9
United States	50	39	22	24	32	29	2.0	2.2
OECD average	47.2	31.7	26.9	20.6	33.5	24.7	2.5	3.5

Sources: — IFS tax data (www.ifs.org.uk/publications.php?publication_id=3210); — OECD (2006): Revenue Statistics of OECD Member Countries 1965–2005, Table 12 (http://www.sourceoecd.org/rpsv/cw/vhosts/oecdthemes/99980169/v2006n7/contp1-1.htm).

[a] Including typical local income taxes and supplementary charges. In countries with more than one tax rate, the manufacturing rate was chosen.

[b] Investment in plant or machinery, financed by equity or retained earnings. Taxation at shareholder level not included. Real discount rate 10%, inflation rate 3.5%, depreciation rate 12.2%.

[c] Rate of economic rent: 10% (i.e. financial return 20%). Further assumptions as in footnote b.

First, statutory corporate tax rates have been significantly reduced in most OECD countries since the 1980s, but tax bases have simultaneously been broadened. As a consequence, effective tax rates on profits have fallen by much less than statutory rates, and in several countries they have not fallen at all.[2] Second, an even more significant deviation from the standard theory of tax competition arises with respect to the development of tax revenue as a share of GDP. Corporate tax revenue has increased significantly in most countries since the early 1980s, despite the average fall in effective tax rates.[3]

The present short paper proposes a simple model to reconcile the theory of tax competition with these empirical observations. Our central argument is that economic integration affects not only the mobility of the corporate tax base, but it simultaneously increases its size through a higher profitability of incorporated firms.[4] These twin effects of economic integration are embedded into a stylized political economy model. The simplicity of our framework allows us to derive reduced-form expressions for the optimal redistributive tax rates chosen by the median voter. In this model economic integration increases both the redistributive gains, but also the efficiency costs of taxation from the perspective of the median voter. Hence globalisation may raise or lower the redistributive tax rate in the political

[2] The measures shown in Table 1 are the *effective marginal tax rate* (EMTR) and the *effective average tax rate* (EATR). The EATR can be seen as a weighted average of the statutory tax rate and the EMTR, where the latter is the tax rate on an investment that just earns a net rate of return equal to the going interest rate. The weight of the statutory tax rate in the EATR rises with the profitability that is assumed for the underlying investment project. For a description of these measures and further details on the development of corporate taxation since the 1980s, see Devereux et al. (2002).

[3] The different time trends for different measures of corporate taxation also seem to be the main source of diverging results in the econometric literature that tests the relationship between economic integration and the level of corporate taxation. This relationship is typically negative if the latter is measured by statutory or effective average tax rates, but the negative sign disappears when tax revenue is the dependent variable. See Rodrik (1997), Bretschger and Hettich (2002), Swank and Steinmo (2002), Slemrod (2004) and Winner (2005).

[4] Another argument why corporate tax bases may have increased is that a rising share of firms has chosen an organizational form that subjects them to corporate rather than personal income tax. We do not further pursue this argument here, but acknowledge that it plays a complementary role in explaining the increase in corporate tax bases. See Sørensen (2007, Section 2.2) for further discussion.