

# Multinational corporations, stateless income and tax havens

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This report provides evidence to show that the corporate income tax system is not 'broken' and that the corporate income tax base is not being eroded.

It offers a critique of the stateless income doctrine and the interaction between tax havens and multinational corporations.

# Multinational corporations, stateless income and tax havens

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‘The decline in corporate-tax collection in recent decades has contributed to budget deficits. It has also aggravated income inequality: a company’s shareholders ultimately pay its taxes, and with a smaller tax bill, shareholders, who tend to be much more affluent than the average American, see their wealth increase. It’s clearly a broken system.’

MICHELLE HANLON, AN ACCOUNTING PROFESSOR, MIT

‘Corporate taxes burst into the spotlight last week, with the release of a Senate committee report on Apple’s tactics to reduce its tax payments. More quietly, but perhaps more significantly, the House Ways and Means Committee has begun work on a potential overhaul of the tax code. Edward D. Kleinbard, a tax expert and former Democratic Congressional aide, said he had been impressed so far by the seriousness of the committee’s work.’

DAVID LEONHARDT, ‘WHO WILL CRACK THE CODE?’, *THE NEW YORK TIMES*, 25 MAY 2013.

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# 1. Introduction

It is commonly argued that the corporate income tax system is 'broken'. Twenty-five years of tax competition have seen corporate income tax rates reduced. The revenue actually collected by corporate income tax, however, has not declined as much. The latest theoretical argument suggesting that the corporate income tax base is likely to be eroded is the 'stateless income doctrine'. This report is a critique of that doctrine. First, the doctrine ignores the value of intellectual property. Second, it is not clear that the doctrine relates to the erosion of the corporate income tax base. Certainly there is no evidence to support the view that the corporate income tax base is being eroded. At best, the concern about the tax base is not so much that it is being eroded, but rather that multinational corporations do not pay tax in every host economy.

Public outrage over the 'low' amounts of corporate income tax paid by multibillion dollar corporations such as Apple, Google, and Starbucks has galvanised the UK and US governments into action. The British prime minister, David Cameron, has suggested that tax planning has become too aggressive. The US Senate has a sub-committee investigating the amount of tax that multinational corporations pay.

The difficulty facing both the UK and US tax authorities is that there is little evidence of any wrongdoing by any of the three corporations that are regularly singled out for abuse. It is true that these corporations do not pay as much tax in the UK or the US as those governments would like them to pay, but they pay as much tax as is required by the laws that those governments have passed.

The argument that we hear is that the 'digital economy' has challenged the

fundamental assumptions underlying corporate income tax rules, which originated when economic activity had 'an unambiguous physical location' and so could be taxed in that location (Australian Treasury 2013). Those assumptions of taxation have not been changed since the advent of the digital economy – the physical location of economic activity is simply not to the liking of the UK or US governments. Much of the activity that Apple, Google and Starbucks undertake is not sourced within the UK or US and hence is not taxable in those jurisdictions.

Recently, the *Wall Street Journal* (2013) explained what was going on:

'The Apple units are based in Ireland, so US law does not consider them to be US corporations subject to US corporate tax. But since they are managed and controlled by Apple in the US, Irish law doesn't consider them Irish companies and thus they are also not subject to the 12.5% Irish corporate tax. This isn't alchemy; it's accountancy...

'None of this required a Senate "investigation" to discover because Apple is constantly inspected by the IRS and other tax authorities. These tax collectors are well aware of Apple's corporate structure, which has remained essentially the same since 1980. An Apple executive said Tuesday that the company's annual US tax return adds up to a stack of paperwork more than two feet high.

'We wonder what the Irish think of the spectacle of an American Senator expressing outrage that an American company doesn't pay enough Irish taxes.'

It is important to note that these activities do not make use of bank

secrecy laws or any of the so-called abusive practices that the OECD has associated with the use of tax havens in reducing corporate tax liability. These corporations are fully compliant with the tax law in the jurisdictions in which they operate.

## SO WHY THE FUSS?

Most advanced economies have large fiscal deficits and little prospect of returning their budgets to surplus. It is quite clear that excessive expenditure is the basis for these fiscal deficits. One possible solution to the fiscal challenges that these economies face is to increase taxes. Increasing corporate tax is a politically desirable policy given the fiscal illusion that surrounds this form of taxation. First, there is a widespread perception that large corporations pay very little corporate income tax. Indeed the 'scandals' that surround Apple, Google, and Starbucks would appear to confirm that view. Secondly, it is not clear where the economic incidence of the corporate income tax falls.

The past 25 years or so have seen substantial tax competition between nations – this has resulted in a decline in corporate income tax rates. The question is whether this has resulted in large declines in the revenue that has been raised by this tax. Surprisingly, there is little evidence to support the notion that tax competition has reduced actual corporate income tax revenues. Nonetheless, that is the popular conception and the OECD and various European politicians have advocated tax rate harmonisation among nations.

The latest theoretical argument to support the notion of tax rate harmonisation is the so-called 'stateless income doctrine' developed by

Professor Edward Kleinbard of the University of Southern California. Under this theory, multinational corporations are able to generate income that is apparently untaxed. The 'double Irish Dutch sandwich' tax strategy is a mechanism for generating such income. This doctrine ignores, or at least seriously undervalues, assets such as intellectual property and trademarks. Consider, for example, the consumption of a coffee from Starbucks. The consumer is not simply consuming a coffee – an inexpensive, easily manufactured, homogeneous product. Rather consumers are consuming an experience where the coffee is only one component of a branded product. Drinking a Starbucks coffee is either a form of conspicuous consumption or a reduction in information and search costs for consumers in a strange city who wish to consume a product of known quality. The brand itself is the value and, unsurprisingly, a royalty payment for the use of that brand is paid to the owner of the brand. Again unsurprisingly, the owner of that brand locates the brand in the legal jurisdiction where its value is maximised.

There is no such thing as 'stateless income', rather there is income that the governments of the UK and the US do not tax because under their own legal systems that income is not sourced in their economy. When these governments complain about stateless income, the question rather should be, 'Why do the owners of intellectual property not locate their property in your economy?'

An implicit assumption of the stateless income doctrine is that multinational corporations maximise their value to society only when they pay tax. Of course, this is not the case. Multinational corporations provide investment, create jobs, facilitate innovation transfers, provide goods and services, and also pay tax. As it is, corporations do not pay only corporate income tax; they also pay payroll taxes, local rates, and a host of other charges and levies. The corporate income tax is only one among many other taxes. To judge the merit of a multinational corporation only by the corporate income tax it pays is to ignore the real economic value of these organisations.

The argument is that the corporate income tax base is being eroded by aggressive tax planning by multinational corporations – yet the evidence to support this argument is lacking. It is one thing to point out that multinational corporations do not pay tax in some jurisdictions but that says nothing about the actual corporate income tax base. To the extent that corporate income tax revenues have fallen in recent years, this is more likely to be a result of poor economic conditions than aggressive tax planning.

This report provides evidence to show that the corporate income tax system is not 'broken' as some suggest. So-called 'stateless income' is a return on intellectual property and the idea that there is such a thing depends on its proponents' disregard of intellectual property. The amount of actual income that could be described as being

'stateless' is small and the returns on a harmonised global tax system would also be small. There is no evidence to support the hypothesis that the UK or the US corporate income tax base is being eroded.

The next section will show that 'advanced economies' face a fiscal challenge. This creates the context for a tax grab. Following that is an explanation of the concept of fiscal illusion, and why corporate income tax is the ideal candidate for increasing the tax burden as a partial means of resolving the fiscal challenge that high-income economies face. There follows a critique of the stateless income doctrine and discussion of the interaction between tax havens and multinational corporations. Finally, this report presents evidence that the corporate income tax base is not being eroded.

A conclusion sums up the evidence presented.

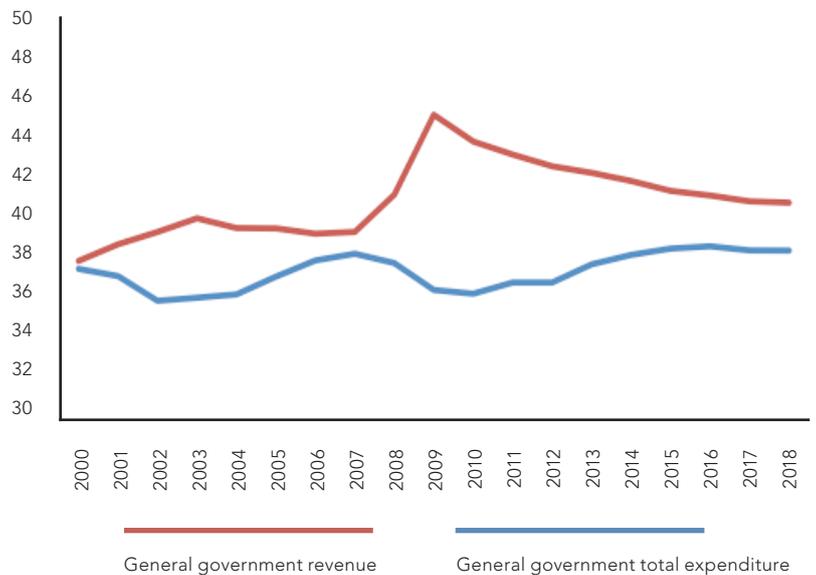
## 2. The fiscal challenge

The so-called 'advanced economies' of the world face a fiscal crisis. Since the start of the 21st century these economies have, on average, experienced budget deficits where government expenditure has massively outstripped government revenue. This budgetary behaviour preceded the 2008 financial crisis and the IMF forecasts that it will continue until at least 2018 (Figure 2.1).

This fiscal challenge becomes even more apparent when we consider the euro area. While the pattern of deficits is similar to that of the advanced economies overall, the quantum of expenditure and taxation has been much higher (Figure 2.2).

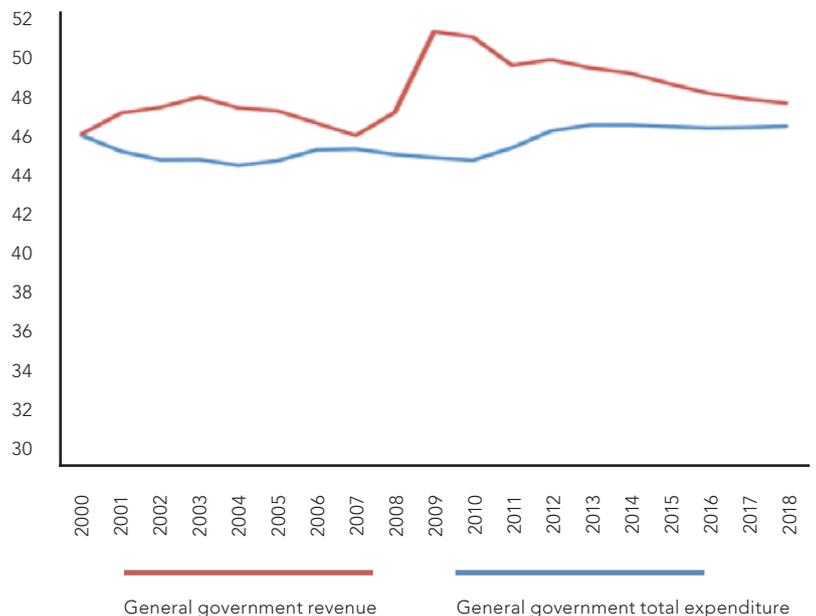
For all the talk of 'austerity' the fact remains that the IMF does not foresee that government expenditure will return to pre-2008 levels by 2018. At the same time, however, the IMF indicates that government revenue figures have already returned to pre-2008 levels.

**Figure 2.1: The fiscal challenge faced by advanced economies**



Source: International Monetary Fund (2013).

**Figure 2.2: The fiscal challenge faced by the euro area**



Source: International Monetary Fund (2013).

This very simple analysis suggests that, in general, lax expenditure discipline is the primary driver behind the fiscal challenges that these economies face. This is unsurprising. As James Buchanan, the 1986 Nobel Laureate, and Richard Wagner explained in their 1977 book *Democracy in Deficit: The Political Legacy of Lord Keynes* (1977: 105–6):

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‘Democratic societies will tend to resort to an excessive use of debt finance when they have permitted Keynesianism to revise their fiscal constitutions....The post-Keynesian record in fiscal policy is not difficult to understand. The removal of the balanced-budget principle or constitutional rule generated an asymmetry in the conduct of budgetary policy in competitive democracy. Deficits will be created, but to a greater extent than justified by the Keynesian principles; surpluses will sometimes result, but they will result less frequently than required by the strict Keynesian prescriptions.’

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Democratic societies have a tendency to run budget deficits through excessive expenditure and this was the case even before the 2008 financial crisis. At the same time, however, government cannot be too brazen in its management of the budget and as such also engages in a political strategy known as ‘fiscal illusion’.

Fiscal illusion occurs when government attempts to distort citizens’ fiscal consciousness about the nature and scope of government expenditure or the burden of taxation. The objective here is to obscure the real cost of public goods and services (Buchanan 1967: 125–42). The debate surrounding corporate tax, multinational corporations and the role of tax havens is particularly prone to issues of fiscal illusion.

### 3. Corporate income tax and fiscal illusion

The first aspect of fiscal illusion to address here is the notion that tax revenue from corporate income tax is declining. This perception has arisen from the discussion surrounding the notion of 'tax competition'.

Richard Teather (2005: 25) has defined tax competition as 'the use by governments of low effective tax rates to attract capital and business activity to their country'. As Teather describes, in the late 1990s a number high-tax European economies began to fear that tax competition would undermine their own ability to raise tax revenue. Wouter Bos, former Dutch minister of finance, argued that tax competition was 'not just a "race to the bottom" but a "race to public poverty", ... where total tax income of the countries becomes too low for governments to finance a sustainable and sufficient level of public

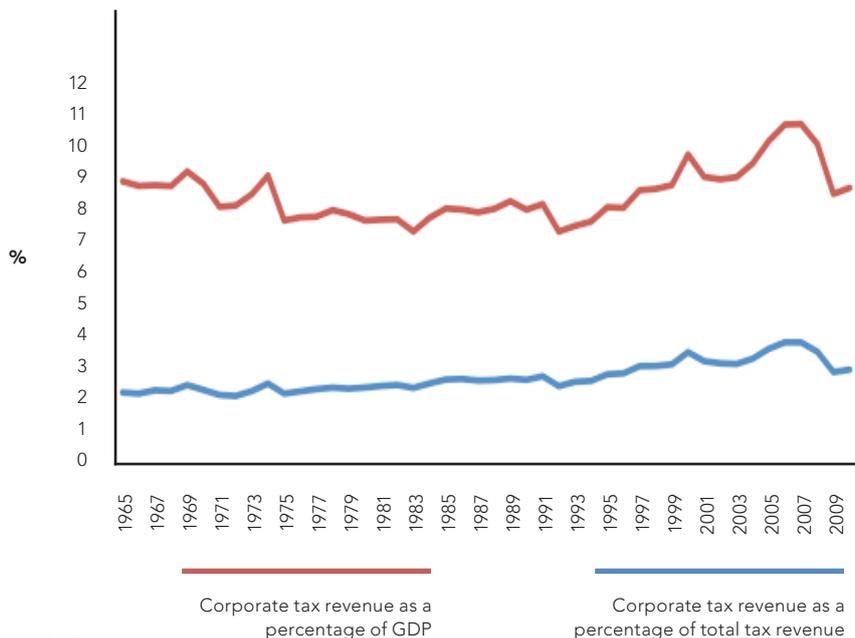
services' (Bos 2000). The particular fear is that government will be unable to raise revenue from taxing highly mobile tax bases. To the extent that this view is correct, one would expect to observe lower revenues being raised from corporate income tax as corporate income tax rates decline. In particular this effect would have been noticeable long before the 2008 financial crisis. What the data reveals, however, is a very different picture – corporate tax revenue has declined in the last few years but not in a manner consistent with tax competition. Rather, the data suggests that the corporate tax revenue declined after the 2008 financial crisis (Figure 3.1).

OECD economies raise a non-trivial amount of tax revenue from corporate income tax. In 1965 such taxes raised 2.2% of OECD GDP in revenue, while in

2010 that figure had increased to 2.9%. By 2006, however, that figure had increased to 3.76% – the decline in revenue from the corporate income tax since then is the source of some debate. It is important to recognise, however, that the trend in corporate income tax revenue collection remained positive over the period 1965–2010.

Similarly, the proportion of total tax revenue contributed by corporate income tax was little changed over the period 1965–2010. In 1965 the contribution of corporate income tax to total taxation revenue in the OECD was 8.8%, decreasing slightly to 8.6% in 2010. The minimum share for corporate income tax to total taxation revenue was 7.2% in 1992 with the maximum share in 2007 being 10.6%. As in the contribution of corporate income tax revenue to GDP, the amount of

**Figure 3.1: OECD corporate income tax revenue as a percentage of GDP and total tax**



Source: OECD 2013.

corporate income tax relative to total taxation has declined since the 2008 financial crisis, but again the point remains that the revenue from the corporate income tax has not declined as the tax competition argument would have us believe.

If anything, the composition of the tax base in OECD economies is inconsistent with the view that tax competition is reducing taxation revenue on mobile factors of production. Figure 3.2 shows that the various sources of taxation revenue are fairly stable. The share of taxation revenue from personal income tax has declined slightly over time and has been replaced by a slight increase in social security contributions. In other words one form of taxation has been substituted for another.

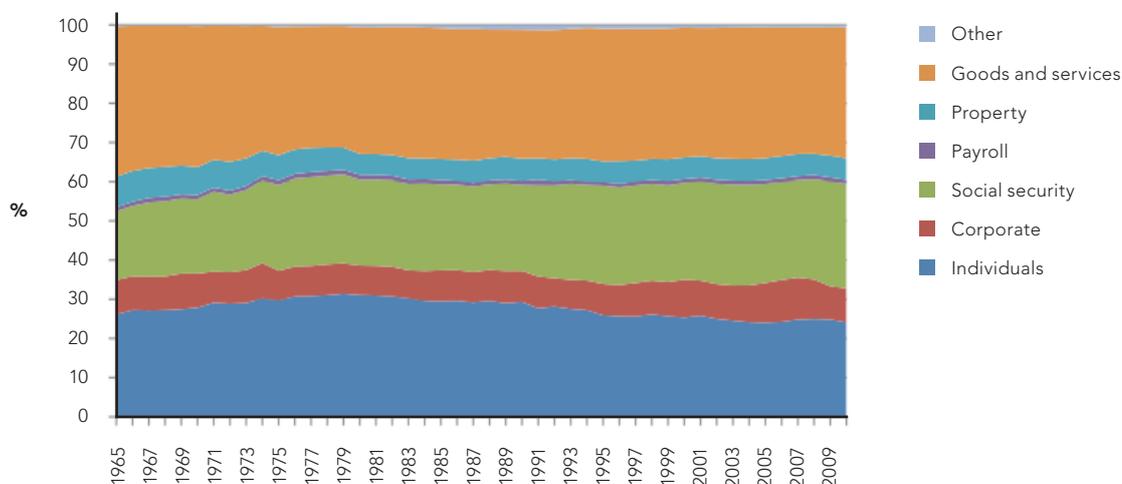
The second source of fiscal illusion to consider is the incidence of corporate income tax. The economic incidence of corporate income tax differs substantially from the legal incidence of the tax. The legal incidence of corporate income tax is clear – the corporation is required to pay some percentage of its taxable income to the taxation authorities each year. The question is whether corporations are able to shift the economic burden of the corporate income tax onto other parties, such as customers, employees, or investors. If the burden can be shifted to whom is it shifted? The old cliché is that corporations do not pay corporate income tax, people pay the tax. So the question is, ‘which people pay the corporate income tax?’

The fiscal illusion argument here is that corporations can be taxed at high rates

simply because the corporation bears the burden of the taxation and not individuals and, especially, not voters.

Economists, however, have long been of the view that the economic burden of the corporate income tax is not borne by corporations but is shifted. What economists are unsure about is where that burden is shifted. Kimberly Clausing (2012, 2013) has evaluated the theoretical literature and undertaken some empirical analysis of the incidence of the corporate income tax. It is not clear where the incidence of the corporate income tax lies. The important point here is that policymakers cannot be sure who is actually bearing the costs associated with corporate income tax and hence are making policy choices that have an unknown effect on the economy.

**Figure 3.2: Tax revenue by sector as a percentage of total taxation**



Source: OECD 2013.

## 4. A critique of the stateless income doctrine

Edward Kleinbard, professor of law at the University of Southern California, has developed the notion of 'stateless income' (Kleinbard 2011a, 2011b). This notion has become particularly influential in the current debate surrounding the amount of corporate income tax that is paid by multinational corporations, which will consequently be analysed in some depth here.

While Kleinbard's (2011a) definition of stateless income is quite convoluted, the basic idea is quite simple (2011a: 703).<sup>1</sup>

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Stateless income thus can be understood as the movement of taxable income within a multinational group from high-tax to low-tax source countries without shifting the location of externally-supplied capital or activities involving third parties.

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This particular phenomenon is not unknown or unusual – yet Kleinbard claims that stateless income is not equivalent to capital mobility or aggressive transfer pricing. This is an assertion on his part and he (2011a: 707) is left having to concede that: 'The phenomenon of stateless income risks appearing vague, and its analysis tedious'.

He attempts to overcome this very real difficulty by pointing to a tax strategy known as the 'double Irish Dutch sandwich'. This particular strategy has multinational corporations, such as Google, operating subsidiaries in Ireland and the Netherlands and consequently not paying very much corporate income tax in the US. This issue is not limited to the US; the governments of Australia and the UK, for example, have expressed some concern that multinational corporations, such as Google and Starbucks, are not paying very much corporate income tax in their jurisdictions.

The fact, however, that some multinational corporations do not pay (very much, if any) corporate income tax in any one particular jurisdiction is necessary but not sufficient evidence of wrongdoing on the part of those corporations. Indeed, working through Kleinbard's explanation of how stateless income is apparently generated it is difficult to understand whether there is a problem or any wrongdoing at all.

Kleinbard views the source of 'stateless income' as being, 'an inevitable by-product of fundamental international income tax norms' and 'nations' collective failure to agree on other critical international tax norms that would determine the "source" of income' (Kleinbard 2011a: 704 and 706). In other words, stateless income is generated by the architecture of the existing tax system and definitions of the corporate income tax base across various jurisdictions.

Yet notions such as separate tax personas, deductibility of interest payments, freedom of contract, limited liability, the veil of incorporation or even exploitation of private property are tried and tested principles of commerce and taxation and it is unsurprising that the nations of the world would be reluctant to deviate from these principles.

Kleinbard argues it is impossible to understand the concept of stateless income without understanding the consequences of 'stateless income tax planning' (Kleinbard 2011a). He claims three such consequences (2011a: 707):

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When unchecked, stateless income strips source countries (including the United States as the location of subsidiaries of foreign-controlled groups) of the tax revenues attributable to income generated in those jurisdictions. Its availability also distorts the investment decisions of multinational firms, and under current US rules distorts a US multinational firm's decision whether to repatriate that stateless income back to the US.

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Kleinbard spends a great deal of effort arguing that the norms and principles of commerce and taxation generate stateless income. If so, the tax base is not being eroded per se, because it is defined on the basis of those norms and principles. At best, his argument is that the tax base should be defined differently, but that is not an argument that the tax base is being eroded. The second consequence is that the

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1. Kleinbard (2011a: 702) defines stateless income as follows: 'By 'stateless income,' I mean income derived by a multinational group from business activities in a country other than the domicile (however defined) of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customers or the factors of production through which the income was derived, and is not the domicile of the group's parent company.'

availability of stateless income distorts investment decisions from what they otherwise would have been. He provides no evidence for this being so. In particular, he provides no evidence that the existence of stateless income is a unique source of distortion over and above the distortions introduced by the existence of corporate taxation itself. More importantly, he provides no evidence that this distortion (if any) is somehow inappropriate.<sup>2</sup> As discussed below, he does provide a thought experiment to support his claim that there is some distortion here (Kleinbard 2011b). The third consequence may constitute a corporate governance problem for US corporations, but it is not clear that this is a taxation problem.<sup>3</sup>

In sum, Kleinbard's problem with stateless income is that, 'it destroys any possible coherence to the concept of the geographic source of income, on which all territorial tax systems rely' (Kleinbard 2011a: 714). Unfortunately, not only has he failed to make the case for that proposition, it is also false. Stateless income tax planning does not make geographic sources incoherent – it transfers tax liability from one location to another. The real 'problem' here is that US multinational corporations are able to pay corporate income tax in low-tax jurisdictions because the US government has chosen to define its corporate income tax base in a way that allows that to happen.

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2. Kleinbard (2011a) explains that the Dutch authorities charge a fee for the use of their tax system in the double Irish Dutch sandwich. This tax strategy is a source of revenue for the Netherlands.

3. See Desai and Dharmapala (2009) for theory and evidence on this point.

## 5. Stateless income and tax rents

Kleinbard (2011a: 753 – 758) makes an argument that multinational corporations are able to create and capture ‘tax rents’ (especially at 2011a: 754).

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‘Stateless income tax planning offers multinational firms, but not wholly domestic ones, the opportunity to convert high-tax country pre-tax marginal returns into low-tax country inframarginal returns, by redirecting pre-tax income from the high-tax country to the low-tax one.’

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It is easy to see the problem here; for example, in an article in the Australian Financial Review it was revealed that a wholly Australian website, Carsales.com, paid \$27m in tax on sales of \$184m whereas Google Australia paid a mere \$0.78m on sales of \$1000m. (Bassanese 2013). If anything, this violates perceptions of equity within the tax system. For two apparently similar firms to face very different taxation regimes is a violation of horizontal equity.

It is not clear, however, that a differential due to differences in taxation is best described as being a ‘rent’.

The notion of ‘rent’ in economics implies the existence of a return over and above the minimum return necessary to keep a factor of production in employment; in other words what economists refer to as a ‘super-normal return’ or an ‘economic profit’. Rents occur when supply curves

for a factor of production are inelastic or when barriers to entry exist to prevent the rents from being competed away. Kleinbard, however, makes no argument about the existence of inelastic supply curves or barriers to entry. Rather, he (2011a: 755) argues that:

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Their inframarginal returns stem not from some unique high-value asset, but rather from their unique status as structurally able to move pretax income across national borders.

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If correct, then Kleinbard has identified a problem with the taxation system. In all his argument, however, Kleinbard appears not to recognise intellectual property as being an asset or having value. For example, in his description of the double Irish Dutch sandwich he argues, ‘there is nothing in the structure that relies on any unique business model or asset of Google’s’, as if Google’s business model itself is not intellectual property. Later, when discussing transfer pricing, he makes the point, following Mihir Desai and James Hines (Desai and Hines 2003), that, ‘the theory of the multinational firm can in large measure be explained by its role as a platform from which to exploit unique global intangibles’ (emphasis added) (Kleinbard 2011a: 735).<sup>4</sup> Yet he is unable to see that this exploitation of unique global intangibles plays an important role in the generation of his so-called stateless income.

In addition, the ability to move pre-tax income across national borders is not unique to specific organisations. There is no barrier to entry to any organisation creating valuable intellectual property and locating that property offshore. It is the existence of valuable intellectual property located in a low-tax environment that generates Kleinbard’s stateless income – income that can then hardly be described as being a ‘tax rent’. To be sure this is income that is not available to wholly domestic firms. Similarly, wholly domestic US firms will face a higher tax burden than do US multinational corporations but, again, there is no barrier to exit – there is no policy to prevent US firms from diversifying their activities beyond US borders. There is no basis for believing that the differential in tax treatment of domestic and multinational corporations is a source of rent.

The point here is that multinational firms have a comparative advantage based on their intellectual property that allows them to reduce their tax burden, but that is not equivalent to having an unfair advantage.

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4. Kleinbard (2011a) first acknowledges the notion that multinational corporations ‘exploit a core set of intangible assets’ at page 710 – yet he describes the organisational structure that facilitates this exploitation as being a ‘fantastic’ notion.

## 6. Tax havens and multinational corporations

This section addresses three questions. What sort of multinational corporations establish activities in low-tax jurisdictions? Does investment in low-tax jurisdictions crowd-out investment in high-tax jurisdictions? Finally if income shifting is occurring, how large are the quantities of potential tax revenue involved?

Each of these questions addresses issues raised in the previous section. For example, if those multinational corporations with high levels of intellectual property or unique business models establish operations in low-tax environments, then Kleinbard's notion of stateless income, which ignores or undervalues intellectual property, is seriously incomplete. Similarly the stateless income doctrine contains an implicit assumption that multinational corporations provide any benefit to the host economy only through paying corporate income tax. If multinational corporations provide other benefits for the host economy then reduced corporate income tax receipts may be a valuable price to pay for these other benefits. Finally, the question of how much money is at stake is always important.

Daniel Mitchell (2006) defines a tax haven as 'any jurisdiction, anywhere in the world, that has preferential rules for foreign investors'. Tax havens and tax competition are intimately related to each other. It is important to dispel stereotypical views about what constitutes a tax haven. That view may relate to some tropical island paradise with poor banking practices that allows money laundering and related criminal behaviour. To be sure, such places do exist, but they are not usually tax havens. Switzerland – the world's most famous tax haven – has none of those features. Dhammika Dharmapala and

James Hines (2009: 1058) have investigated the features of tax havens and report that they are usually well-run economies.

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Some of the characteristics of tax havens are well documented in the literature: tax havens are small countries, commonly below one million in population, and are generally more affluent than other countries. What has not been previously noted in the literature, but is apparent in the data, is that tax havens score very well on cross – country indices of governance quality that include measures of voice and accountability, political stability, government effectiveness, rule of law, and the control of corruption. Indeed, there are almost no poorly governed tax havens.

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This is an important finding – it is not just low rates of corporate income tax that are important in establishing a tax haven. These economies must also be well governed, so as to reduce the risks of expropriation of property.

On the flip-side, what sort of multinational corporations establish their operations in tax havens? Mihir Desai, Fritz Foley and James Hines Jr. (2006) consider the location and investment decisions of a sample of US multinational firms over the period 1982 – 1999. They report (2006: 529):

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Large firms with high shares of international activity are the most likely to have haven affiliates, and firms in industries characterized by high R&D intensities and significant volumes of intrafirm trade similarly exhibit the greatest demand for tax haven operations.

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This latter result is consistent with the stateless income doctrine in that large

multinational corporations with intrafirm trade are likely to be located in tax havens. The two results set out here, however, are also consistent with the critique set out in the previous section. R&D-intensive firms are very likely to have operations in well-governed economies that also have low rates of corporate income tax. Kleinbard either ignores or undervalues this aspect of multinational corporation behaviour.

Desai et al. (2006b) also report that tax haven activity increases economic activity in nearby non-tax haven economies. Owing to the higher after-tax returns that multinational corporations are able to enjoy as a consequence of tax havens, they are able to maintain higher levels of foreign investment than they otherwise would have been able to maintain. In other words, far from having a negative impact on their neighbours, tax havens have a positive impact on economic activity. In particular, 'a one per cent greater likelihood of establishing a tax haven affiliate is associated with 0.5% to 0.7% greater sales and investment growth outside of tax havens within the same region' (Desai et al. 2006b: 223). In other words, the use of tax havens by multinational corporations allows high-tax regimes to attract foreign investment that might otherwise not occur. This increases the economic welfare in those economies while also providing investors with greater returns than they would otherwise have earned.

Desai et al. (2009) also investigate the impact of US multinational corporations' offshore behaviour within the US. They report that those multinational corporations that expand their offshore activities also tend to expand their onshore activities. Foreign investment is complementary to domestic investment and not a substitute.

Dhammika Dharmapala and Nadine Riedel (2013) investigate the amount of profit shifting that actually occurs using 5400 European multinational affiliates over the period 1995–2005. In the first instance they report that profit shifting does occur. The magnitude of the profit being shifted, however, is only 2% of parent corporation profits. While they indicate that this amount is ‘substantial’ it is lower than many other (indirect) estimates of the amount being shifted. This result is consistent with estimates in the literature of the gains to be made from tax harmonisation.

There is a small academic literature that attempts to provide international evidence of the relative costs and benefits of tax competition and coordination. Ian Parry (2003) has estimated that the welfare costs from tax externalities are generally less than 5% of capital tax revenue. His conclusion is that his results ‘cast some doubt on the economic case for harmonizing capital taxes across a bloc of regions such as the Economic Union’. Peter Sørensen (2004) presents a far more comprehensive analysis of tax competition and coordination. He has developed a plausible and realistic general equilibrium model providing a synthesis of existing and has then estimated (by calibration) the magnitude of gains from coordination. Using an egalitarian welfare function, he has evaluated welfare under the alternative tax regimes. The best-case scenario is shown in Table 6.1.

**Table 6.1: Best-case scenario of tax competition and coordination.**

	Competition	Coordination
<b>Policy variables</b>		
Capital tax rates	12.7	42.3
Labour tax rates	44.4	44.4
Transfers	100.0	177.0
Infrastructure spending	100.0	95.0
<b>Other variables</b>		
Capital stock	100.0	88.0
Employment	100.0	99.0
Profits	100.0	95.0
GDP	100.0	95.0
Average real wage rate	100.0	96.0
Real interest rate	100.0	109.0
Welfare gain %GDP		0.94

Source: Adapted from Peter Sørensen, 2004, Table 1.

In the model, tax competition had no impact on labour income taxes. Furthermore, the largest impact of tax competition was not under-provision of public goods, but rather too little income and wealth redistribution. In particular, relative to full-blown tax competition, tax coordination would lead to higher taxes on capital, and higher redistribution; but lower infrastructure spending, lower capital stocks, lower profits, lower real wages, lower GDP, and higher real interest rates. All these changes would result in an increase in social welfare of less than 1% of GDP, but only if taxpayers have egalitarian objectives. What happens in the model is that GDP falls but inequality falls by a greater amount with the net effect being an increase in the median voter’s level of satisfaction. It is not clear that taxpayers would have

egalitarian welfare functions as is assumed in the model. In short, this assumption supposes that taxpayers would be ‘happier’ because they would all be equally poorer.

Enrique Mendoza and Linda Tesar (2005) provide evidence that tax competition can lead to welfare improvements. They examine tax competition in a two-country dynamic, neo-classical general equilibrium model with perfect international capital mobility. Using data from European economies they then calibrate the model and examine the consequences of tax competition and harmonisation. The results are quite stark; the gains from coordination are very low even when tax competition does cause a race to the bottom. They (2005: 202) explain their results as follows:

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'In the case in which the fiscal solvency externality triggers adjustments in consumption taxes, Nash competition in capital income taxes produces a staggering "race to the bottom" in capital tax rates. However, contrary to the conventional wisdom that this reduction in capital taxes is harmful to society, we find that European countries could make welfare gains of about 0.7 per cent in lifetime consumption compared to the pre-tax competition equilibrium. The race to the bottom is harmful in the formal sense that the cooperative equilibrium dominates the Nash outcome, but we find that quantitatively in this game of capital – for – consumption taxes the gains from tax coordination are negligible at less than 0.04 per cent.'

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They conclude that the structure of European taxation already reflects the outcome of a competitive process and any gains from coordination are likely to be very small.

This literature is important to understanding Kleinbard's stateless income doctrine, as Kleinbard has advocated tax harmonisation with a global corporate income tax rate of 25% (Carswell 2013). The primary difficulty with Kleinbard's position is illustrated in Table 6.1. All the economic indicators are more favourable under tax competition than under tax harmonisation.

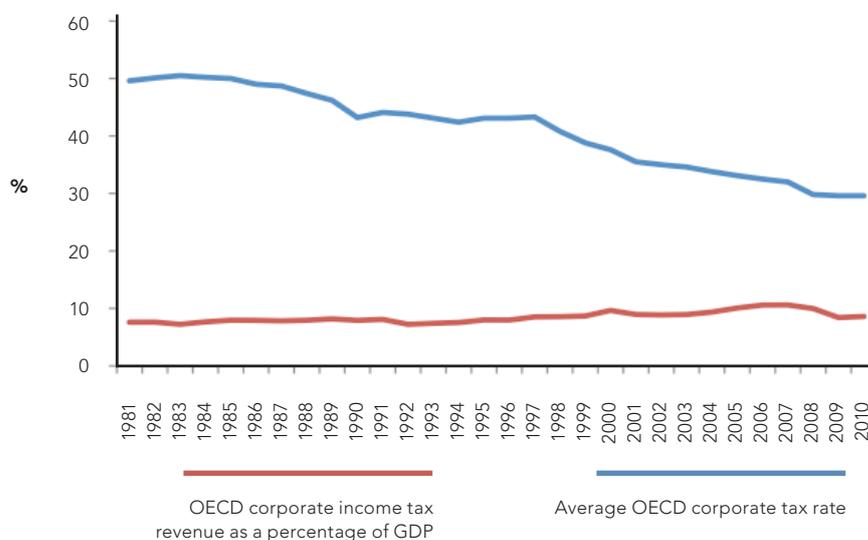
## 7. Is the corporate tax base being eroded?

The notion that corporate income tax is unsustainable has been debated for some time. Indeed, some argue that the survival of such tax is something of a puzzle. It is certainly true that capital is highly mobile and tax competition among states often quite fierce. Corporate income tax rates have reduced quite substantially over time – yet corporate income tax revenue has not.

Figure 7.1 shows the 30-year history of corporate income tax revenue as a percentage of GDP for OECD economies and the (weighted) average of OECD corporate income tax rates. The average OECD corporate income tax rate has declined from a high of 50.5% in 1983 to 29.6% in 2010. By contrast, the revenue to GDP that has been collected from the corporate income tax has increased from 7.6% in 1981 to 8.6% in 2010. Corporate income tax revenue reached an all-time high in 2007 of 10.6%.

Looking at Figure 7.1 it is somewhat difficult to accept the argument that corporate income tax is unsustainable. Clearly, high corporate income tax rates are not, but the corporate income tax itself does raise a significant amount of revenue and continues to do so even since the 2008 financial crisis.

**Figure 7.1: OECD corporate tax revenue and corporate tax rate**



Source: OECD (2013) and Jane Gravelle (2012: Table A-1).

The key to understanding what is happening is that as corporate income tax rates have declined, so the corporate income tax base has increased. What the stateless income doctrine suggests is that the tax base is now being eroded. That proposition, however, is an empirical question.

Peter Sørensen (2007: 177–8) has provided a test where the ratio of corporate income tax revenue to GDP is decomposed into its component parts:

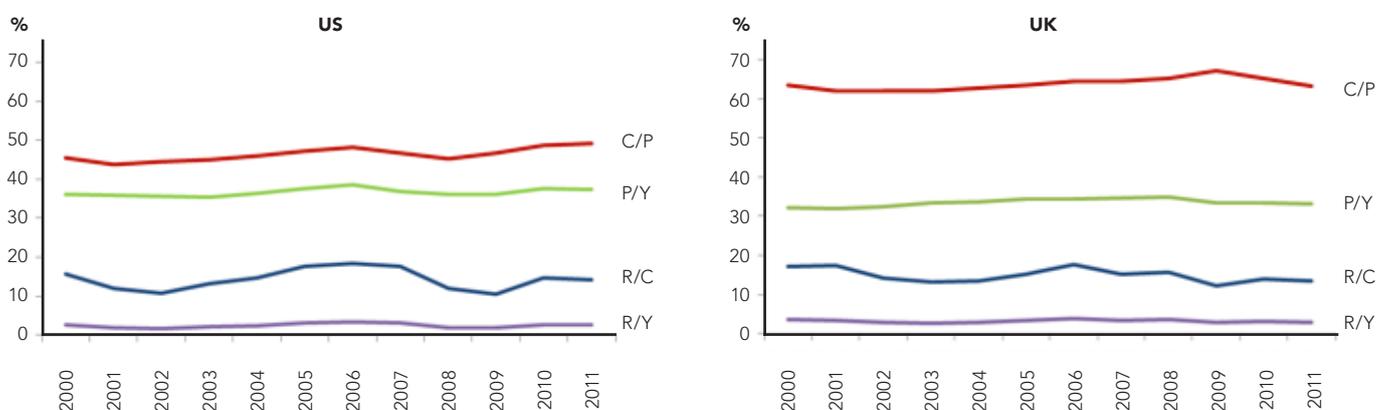
Where  $R$  = corporate tax revenue,  $Y$  is GDP,  $C$  is total corporate profit and  $P$  is total profit earned in the economy.  $R/C$  is a proxy for the average effective corporate income tax rate,  $C/P$  is the share of corporate profits and  $P/Y$  is the profit share of the economy. This decomposition allows us to determine whether any changes in the corporate

tax revenue to GDP ratio are due to changes in the effective corporate tax rate or in the corporate tax base (defined as the interaction of the share of corporate profits and the profit share of the economy).

Following Sørensen, Figure 7.1 captures the data for this decomposition from the OECD and employs corporate operating surplus as a proxy for total corporate profit and total operating surplus as a proxy for total profit. Sørensen provides the decomposition for several OECD economies over the period 1981–2003. The analysis below replicates the decomposition for the period 2000–2010 for the UK and the US. The governments in these two countries have been particularly critical of multinational corporations and the corporate income tax that they pay.

The data does not support the view that the corporate income tax base in either of these two economies is being eroded. It is the case that the average effective corporate income tax rate appears somewhat volatile – but that can be attributed to the 2008 financial crisis, regular business cycle effects, accumulated tax losses and the like. The stateless income doctrine does not predict declines in the corporate income tax rate; it predicts erosion of the tax base. Tax competition between nations leads to a reduction in the corporate income tax rate. Stateless income should lead to the erosion of the corporate income tax base – the data for the UK and the US does not support that doctrine.

**Figure 7.1: Corporate tax decomposition for the UK and the US**



Source: OECD 2013.

## 8. Conclusion

The corporate income tax system is not broken. It is true that some multinational corporations do not pay as much tax in their host economies as their consumers and voters in those economies might expect. Yet this does not necessarily imply any wrongdoing on the part of those corporations. As Kleinbard makes clear, multinational corporations are fully compliant with the law of the land in those economies where they operate and the governments of those economies have been unwilling to change the international income tax norms and tax architecture.

It is in this environment that fiscal illusion can be deployed to increase the tax burden on corporations. Yet there is no evidence to support the view that the revenue already collected by corporate income tax has declined in recent decades. There is no evidence to support the view that the corporate income tax base has been eroded in recent years. There is no evidence to support the view that a decline in corporate tax revenue has contributed to current budget deficits. If anything it is clear that expenditure decisions, not decreased revenue, has contributed to these deficits.

Nonetheless, the stateless income doctrine may be used as a catalyst for re-writing the corporate income tax system. In the same way that an old tax is a good tax, so an old tax system is likely to be a good tax system. If one were to accept Kleinbard's argument at face value, then governments would need to modify substantially how corporate income tax works and various norms underpinning international double taxation agreements in order to redefine stateless income as being sourced in either the UK or the US (or indeed in any other economy).

The question that needs to be answered is this: 'What would be the consequences of expanding the definition of source for corporate income tax purposes?' At present 'stateless' income is not stateless at all, it is simply not UK- or US-source income. Stateless income is not some form of economic rent, as Kleinbard would have us believe. Rent can be taxed with impunity. To the extent that stateless income is really a return on the development and ownership of intellectual property, then increasing taxation will have allocative efficiency consequences. At the same time it would also adversely affect the Irish and Dutch tax bases.

It is known, however, that multinational corporations add value to both their home economies and their host economies. Tax havens add value by allowing multinationals to reduce their tax liabilities while increasing their investments in high-tax economies. An increase in their tax burdens would reduce those levels of investment, leading to reduced employment opportunities, reduced consumption and reduced innovation.

It is not clear that tampering with the tried and tested norms of corporate income tax to (possibly) generate more corporate income tax revenue while reducing the corporate income tax collected in foreign economies, and possibly reducing investment at home, employment at home and consumption at home, is good policy.

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