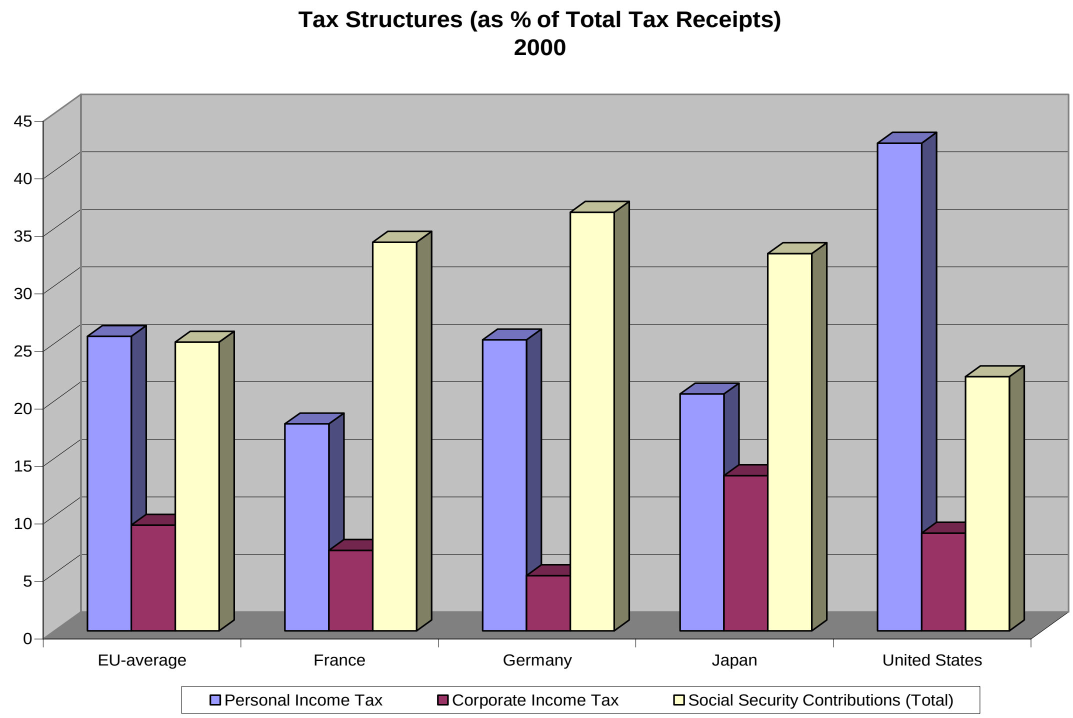
The Vanishing Corporate Profits Tax

Howard M. Wachtel*

Corporate profit tax receipts of governments have deteriorated while the legislated tax rate on corporate profits has not changed. The typical tax rate on corporate profits across countries that make up the highly advanced economies of the North is around 33%. Tax receipts as a proportion of total taxes from corporate profits taxes, however, have dwindled to an average of about 8% in the EU (in 2000), a little over 5% in France and only about 4% in Germany. In the United States it was 7.5%. These are all down from what they were 20 years ago when they were in double digits. These numbers, shown in the accompanying chart, remove social security taxes from total tax revenues of government and reflect what is collected for discretionary public spending.




*Source: OECD in Figures, Statistics on the Member Countries, OECD Observer 2003, Supplement 1 (pages 38-39)*

Personal income taxes in the United States in 2000 made up 42% of tax collections and 25% in the EU which relies more heavily on consumption taxes – the VAT (value added tax). The net result is

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*Professor of Economics, American University (Washington, DC) and Fellow, Transnational Institute (Amsterdam). His most recent book is *Street of Dreams-Boulevard of Broken Hearts: Wall Street's First Century*.

that individuals pay more than their fair share of taxes either in the form of personal income taxes or consumption taxes and corporations evade their statutory tax obligations. This leads to two negative consequences: governments, strapped for funds, reduce social expenditures which reinforces citizen displeasure with their tax burdens in the face of budget reductions for public needs.

The explanation for this apparent paradox between stable tax rates and diminishing tax receipts is that corporations have been able to reduce their tax base in highly taxed countries mainly through an accounting device known as transfer pricing in which global companies buy and sell to themselves within the corporation. They show high costs, and therefore low profits, in highly taxed countries of the North and low costs, high profits in low taxed countries in the South and in the transition economies of east-central Europe and the former Soviet Union. Global companies produce in one part of the globe, provide advertising and information technology from headquarters in another and import and export products and services from country to country inside the transnational company.

In an anomaly of the balance of payments accounting systems, products manufactured by a global company that are re-imported back to the home country show up as imports, and, similarly, services provided by the home country to itself in other parts of the globe show up as exports. For the U.S., nearly half of all recorded imports and exports involve American companies trading with themselves.

Global profits are distributed across countries in order to minimize tax obligations, thereby reducing the tax base in high-tax countries. While tax rates can remain high in the EU and the U.S., if the tax base is lowered in these places, government tax receipts fall or do not keep up with the growth in the profits of their global corporations.

The problem arises from a uni-dimensional and dated definition of profits, which allowed for an effective tax base for several decades after World War II when corporate taxes on profits produced a fair share of revenues for governments. Globalization, however, has rendered profit taxes increasingly difficult for governments to capture because of the mobility of capital and the ability of multinational companies to escape high tax jurisdictions through transfer pricing, buying and selling to itself with more or less fictive prices. Key to this is the nature of profit, an elusive concept and a slippery accounting category for tax purposes, because it involves both revenues and costs and the costs can be shown to originate in the corporation’s country of choice.

There are two remedies for this phenomenon of globalization, one within the nation state and the other through a new global tax jurisdiction. Both take advantage of the fact that companies want to trumpet their worldwide global profits to impress shareholders and financial markets, while minimizing their profit disclosure to the treasury of any individual country. The nation state policy remedy is called a unitary tax, which starts with accounting categories that are known and cannot easily be distorted: aggregate worldwide profits, total global revenues received, and revenues earned in a particular tax jurisdiction. To discover the profit base for tax purposes, a calculation would be made as follows: divide revenues acquired through sales in a country by total worldwide revenues. Then apply this percentage to global profits to identify profits earned in the country's tax jurisdiction. This becomes the profit base on which a national tax is levied.

For example, assume a company makes worldwide profits of $600 million. It receives 60% of its worldwide revenues from sales in the United States. The profits earned in the U.S. are then $360 million and the corporate profit tax rate is applied to that base. The advantage of this unitary tax is that the problem of transfer pricing disappears. The three statistics — worldwide profits and sales revenue, and sales revenues in the country tax jurisdiction – are known or can readily be obtained by tax authorities. Opportunities for evasion are few.

A variant on this first policy adaptation to globalization of corporate tax obligations is to establish an alternative minimum tax, which exists for individual taxpayers in the U.S. A company would be required to calculate profits on a unitary tax base and if it is higher than its transfer-priced profits, an average of the two would constitute its tax base. The advantage of this approach is that it would be more attractive in the current poiltical climate.

The second policy for the vanishing profits tax establishes a new global tax jurisdiction. It starts with the assignment of a tax rate to a global company's worldwide profits, deducts taxes actually paid in all the countries in which the company pays taxes, and identifies the residual taxes as untaxed global profits which are allocated to a new global financing facility for economic development. The tax rate used could be the average for national tax rates, 33% for the countries of origin of the global companies. For example, the American company that earns worldwide profits of $600 million would be taxed globally at 33%, owing a worldwide tax obligation of $200 million. It pays taxes to the United States, based on its own transfer-priced calculation of profits, of say $100 million and elsewhere pays taxes in other countries the equivalent of $50 million. The unassigned residual is then $50 million, and this is allocated to the global financing facility for economic development.

The justification for this policy derives from the character of globalization itself. If corporations claim to operate transnationally, outside of national borders, and therefore owe limited tax obligations to the countries in which they operate, then the argument can be made that their residual tax obligation is also global, owed to a transnational financing facility for economic development. Globalization is not an argument for not paying statutory tax obligations somewhere. It is only a question of where the taxes are paid, how they are allocated across nations, and with this proposal, to the global universe in which the new age corporation operates. Today the companies decide how to allocate their tax obligations in order to minimize tax payments. But this ignores the facilitating role that nation states have offered which enables the global companies to fulfill what they see as their global business mission. Alongside this business mission there remains a global public mission to use globalization not as a device to avoid legislated tax obligations and pass those tax burdens either onto individuals or in the form of reduced public services.

This way of inserting the global public into the revolutionizing phenomenon of globalization has the advantage of not contravening any principles of free and open trade, which in theory is based on organic market advantages not on the politically manipulated corporate profits tax base in the companies' country of origin or the leveraged tax holidays offered by the host countries. Since this policy idea is neutral with respect to any individual country and only establishes a new facility to capture the residual unpaid taxes, it does not prejudice trade or investment in any specific nation.

A global fund financed by untaxed residual global profits has the added advantage of reducing incentives on vulnerable host countries to engage in tax competition, offering lower rates in order to attract global companies in a competitive race toward zero profits taxes, eliminating the corporate profits tax completely, which is the case in Estonia, for example – one of the new members of the expanded EU. If a country that minimally taxed corporate profits sees receipts going to a global fund, it will ask itself why it is forgoing this potential revenue. It may then decide to tax the global company directly for its national budget, thereby reducing the harmful competitive tax race to the bottom.

What if some of the host countries do not disclose global corporate profit tax receipts in the face of pressure from companies not to comply with the new global tax? A formula could be used to circumvent this non-transparency that would simply assign an arbitrary half of the untaxed residual to the global fund, thereby establishing another type of alternative minimum tax.

Since transnational companies want to advertise their global profits as a mark of success to shareholders and financial markets, transparency is more easily assured than are profits identified with an individual country's taxing authority.

The sum of both the unitary tax and global development fund tax is to reverse the degeneration of the corporate profits tax base and align global public tax policy with the private global corporate project. It begins to re-affirm the informal social contract of the mid- twentieth century in which corporations and individuals would share national tax obligations in order to finance public services. The three legs of this tax stool – corporate profits, personal income, and consumption taxes – is short one leg and the stool is unsteady, leaving national governments with inadequate resources that leads both to citizen opposition to taxes and diminution of the social market economy.

If globalization is to be celebrated for its rewards, the companies that brandish it cannot be allowed to circumvent their tax accountability.