Corporate Tax Design in a Small Open Economy: Challenges and Possible Solutions

Keynote Lecture

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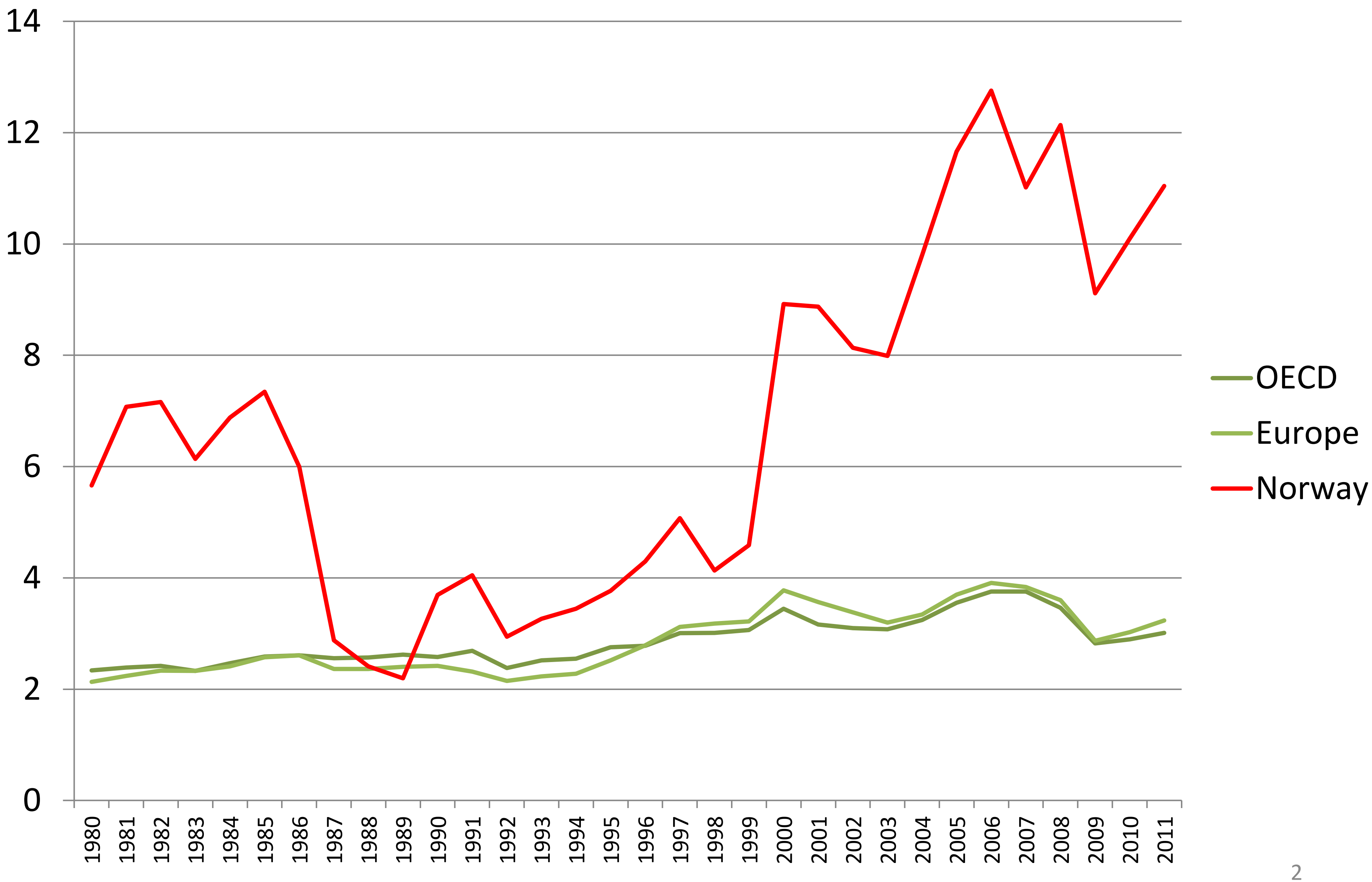
CIT Revenue, % GDP



Why have a CIT?

- Tax economic rents – especially relevant in NOR
  - … but doesn't require traditional CIT design
- Tax business owners at accrual
  - … but can lead to double taxation of equity
  - … and what about 'tax incidence'
- CIT as backstop for the income tax
  - Evidence: a 1%-pt change in CIT – PIT rate difference raises share of corporate activity by up to 0.7 pp. (e.g. number of firms; employment, sales)

Domestic challenges of the CIT

- CIT also creates (domestic) distortions
  - Features low in empirical 'growth rankings'

  - Investment – depending on design
    - Measured by cost of capital / METR

  - Finance – depending on design
    - Debt bias

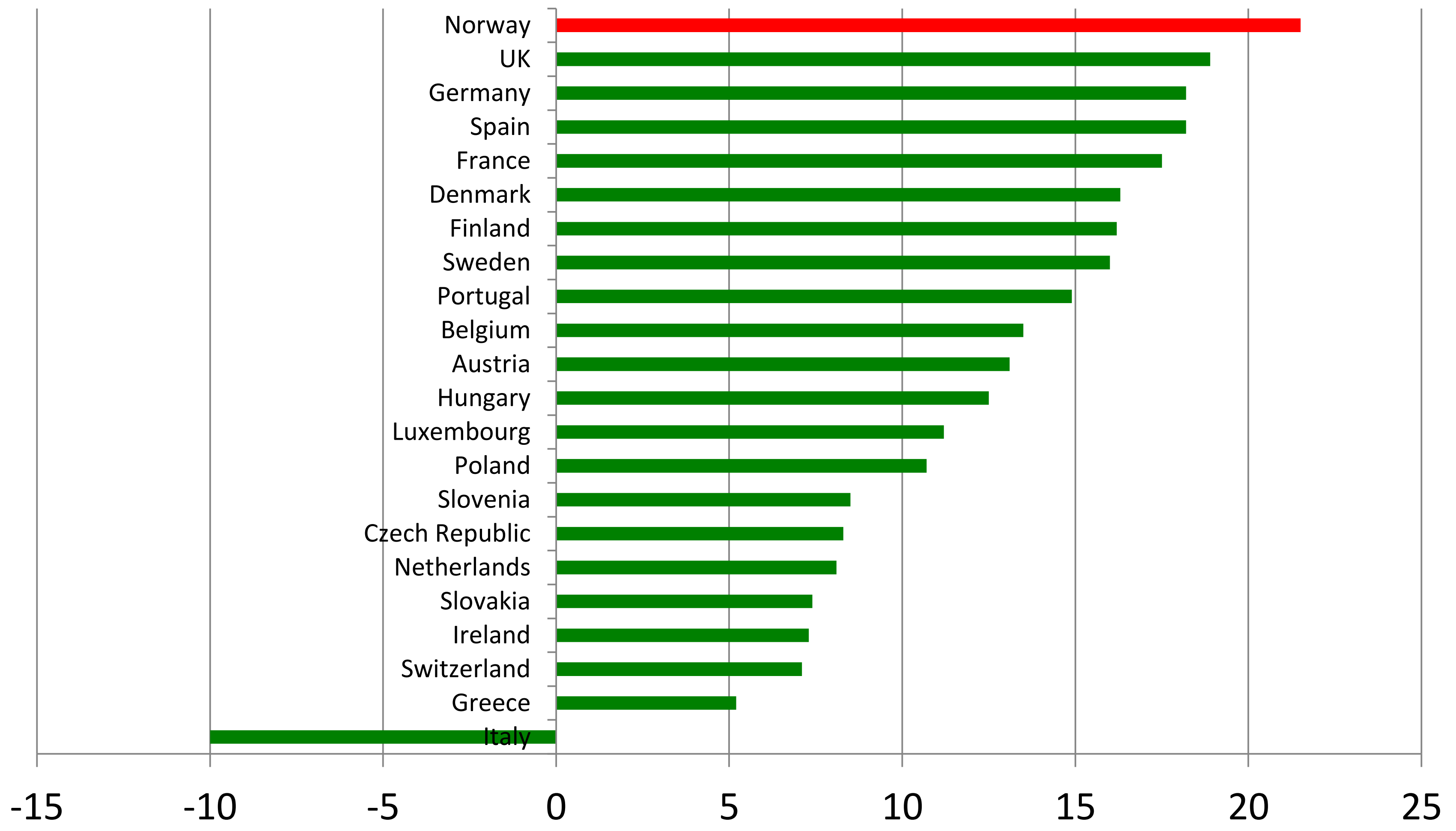
Investment

- Neoclassical investment theory
  - With DRS to capital, firm continues to invest until marginal investment project breaks even

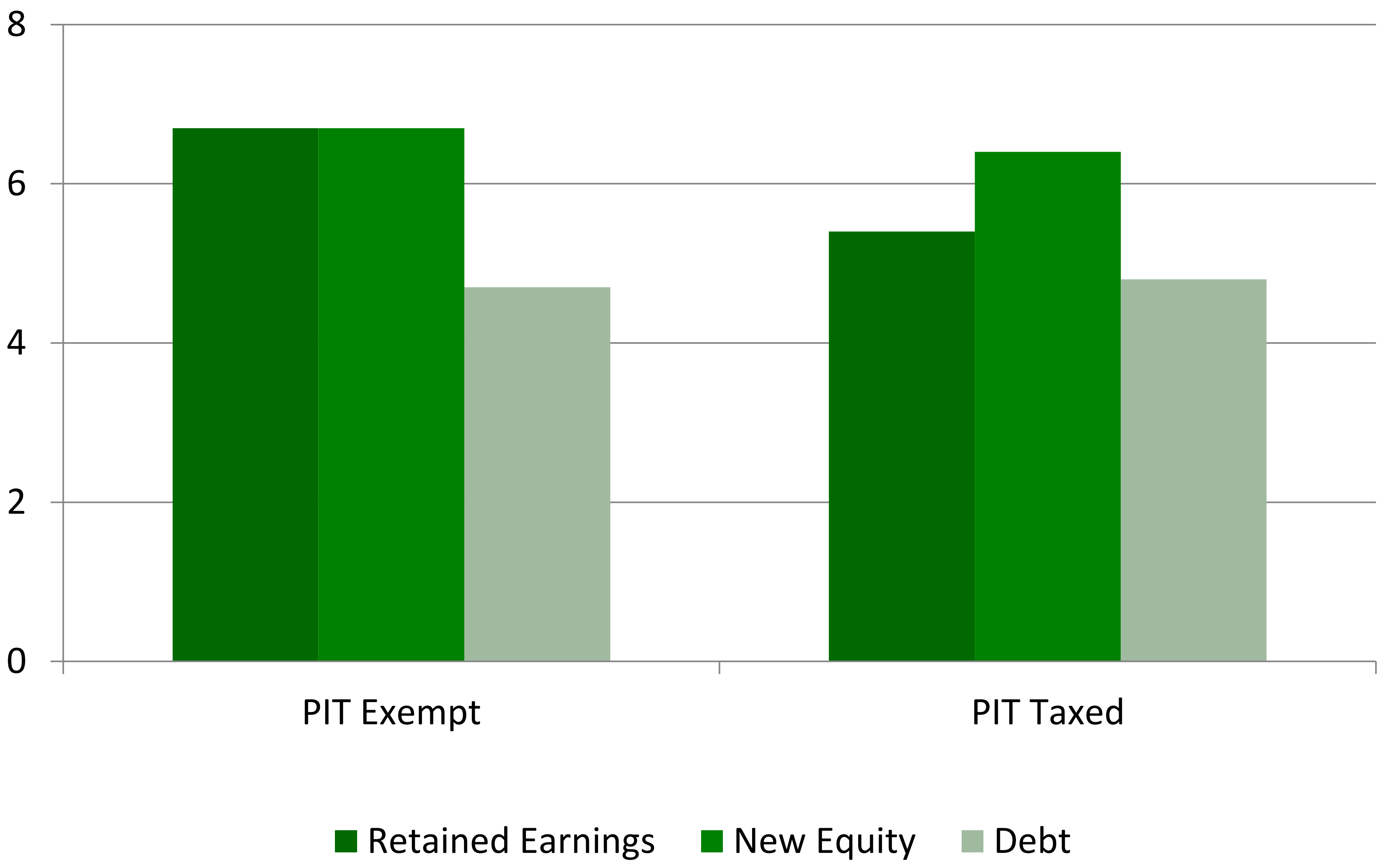
$$Log(\text{Investment}) = \alpha + \beta\tau^{metr} \qquad \beta < 0$$

- Empirical literature
  - E.g. Hassett & Hubbard (2002) and Chirinko (2003)
  - ‘Consensus estimate’ of β somewhere between −0.6 and −1.2, i.e. if METR declines from 20 to 10, investment expands by between 6 and 12 percent

METRs in Europe, 2012 (Oxford University Corporate Tax Rankings)



Cost of capital in Norway by type of finance



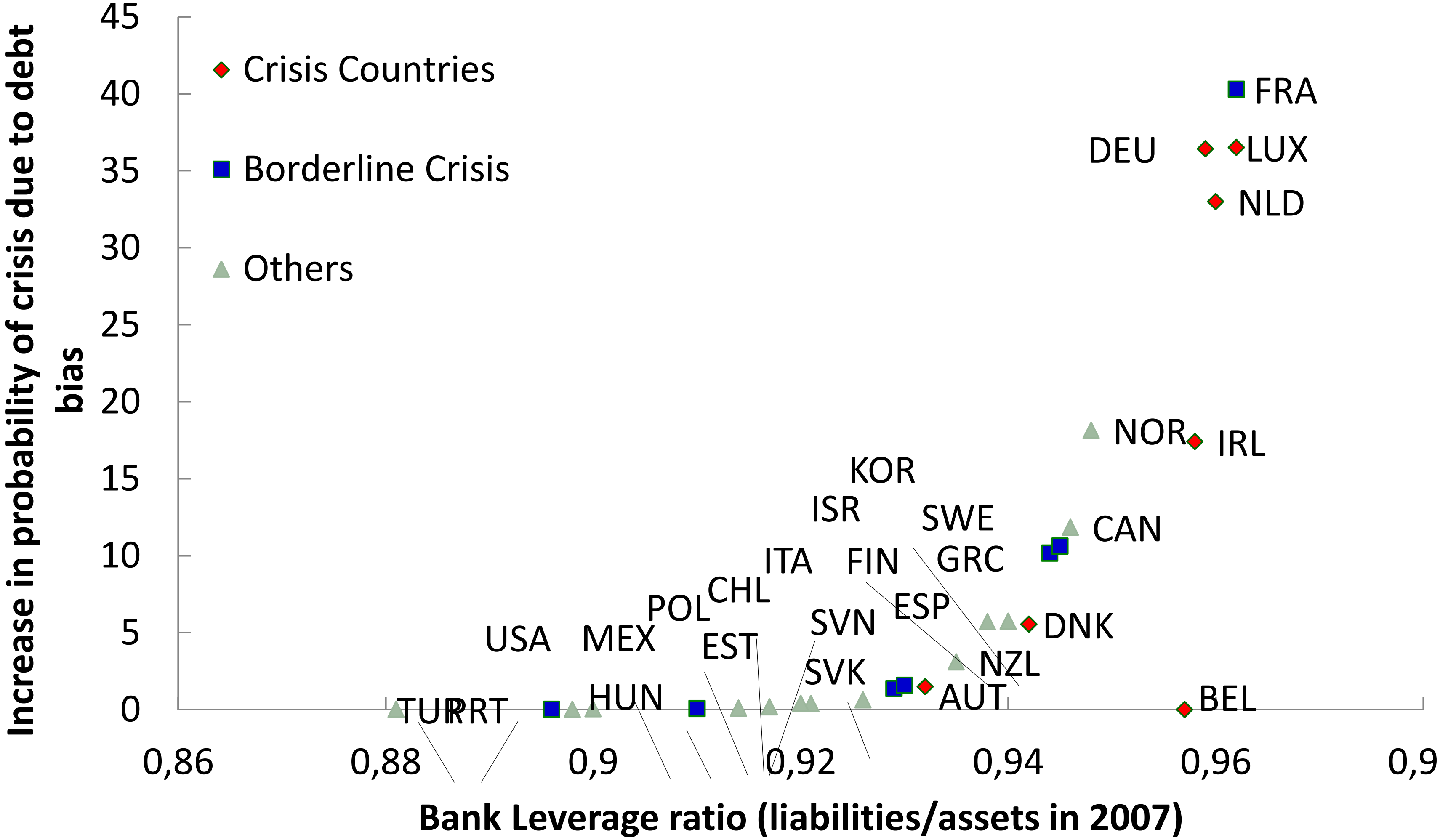
Financial Structure

- Debt bias literature

$$\frac{Debt}{Assets} = \alpha + \beta\tau^{CIT} \qquad \beta > 0$$

- Empirical literature
  - IMF WP 11/95 "*The tax elasticity of corporate debt: a synthesis of size and variations*": 'consensus estimate' of β <0.2; 0.3> i.e. if CIT declines from 30 to 20, debt ratio falls by between 2 and 3 percent
  - Recent series of studies of IMF and EC: CIT also matters for bank capital structure

Social cost of debt bias in banks?



ACE –the love baby in public finance

- Neutral …
  - (Marginal) investment & finance
- Practically feasible …
  - Now operational in Brazil, Belgium, Latvia, Italy
- Potential fiscal cost can be mitigated
  - Some 0.3 pct GDP for Norway (De Mooij, FS 2012)
  - Lower if only for incremental equity (Italy, Latvia)
  - Lower if only for banks (discussed in UK)

ACE – Design

Base of the ACE

Initial equity base: zero (BEL) or base year (LTV, ITA)

+ taxable profit − CIT payable

+ dividends received − dividends paid

+ net new equity issues

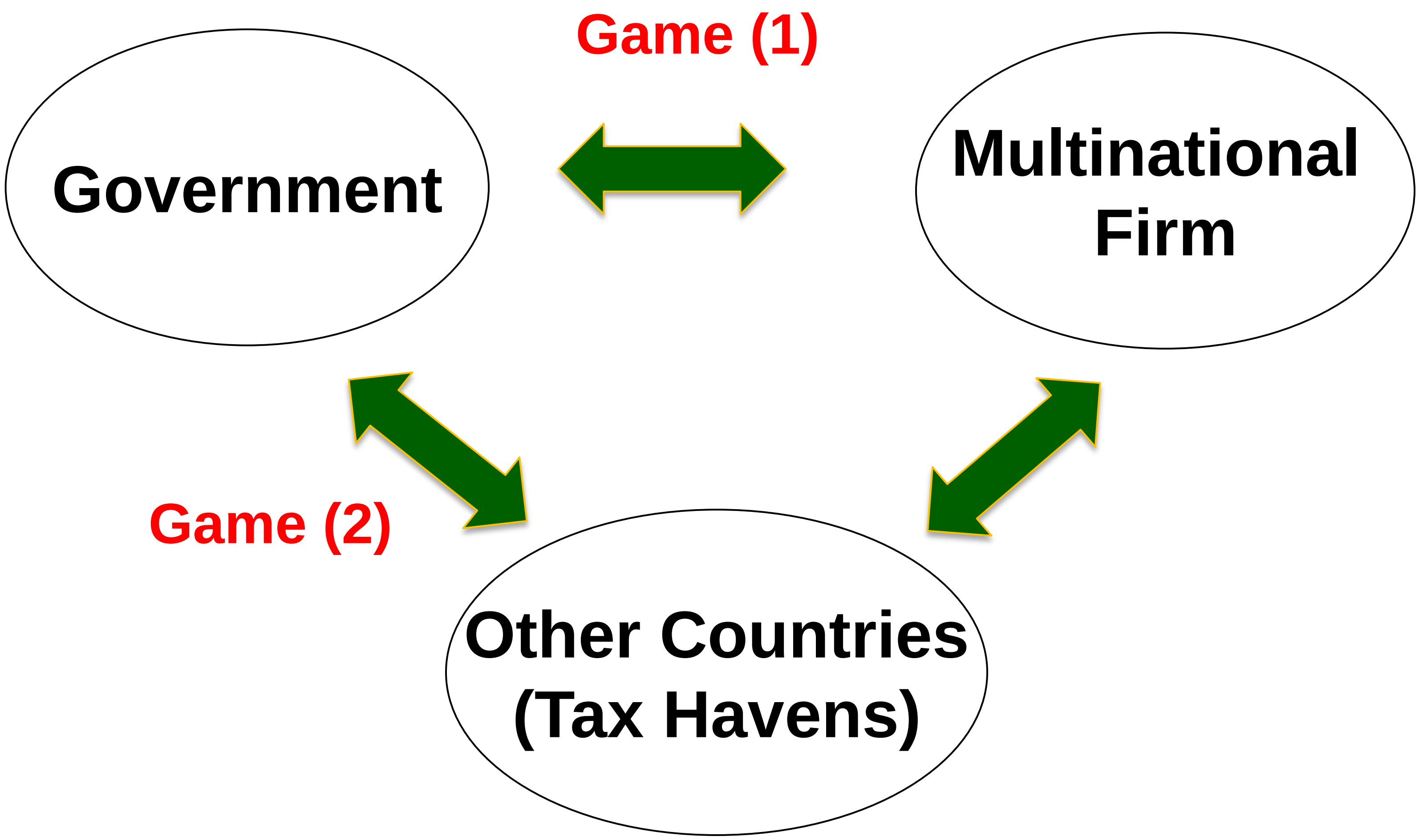
+ net revenue from sale/purchase of shares in other companies

x

Rate of the ACE

(risk-free rate of return)

International challenges of the CIT

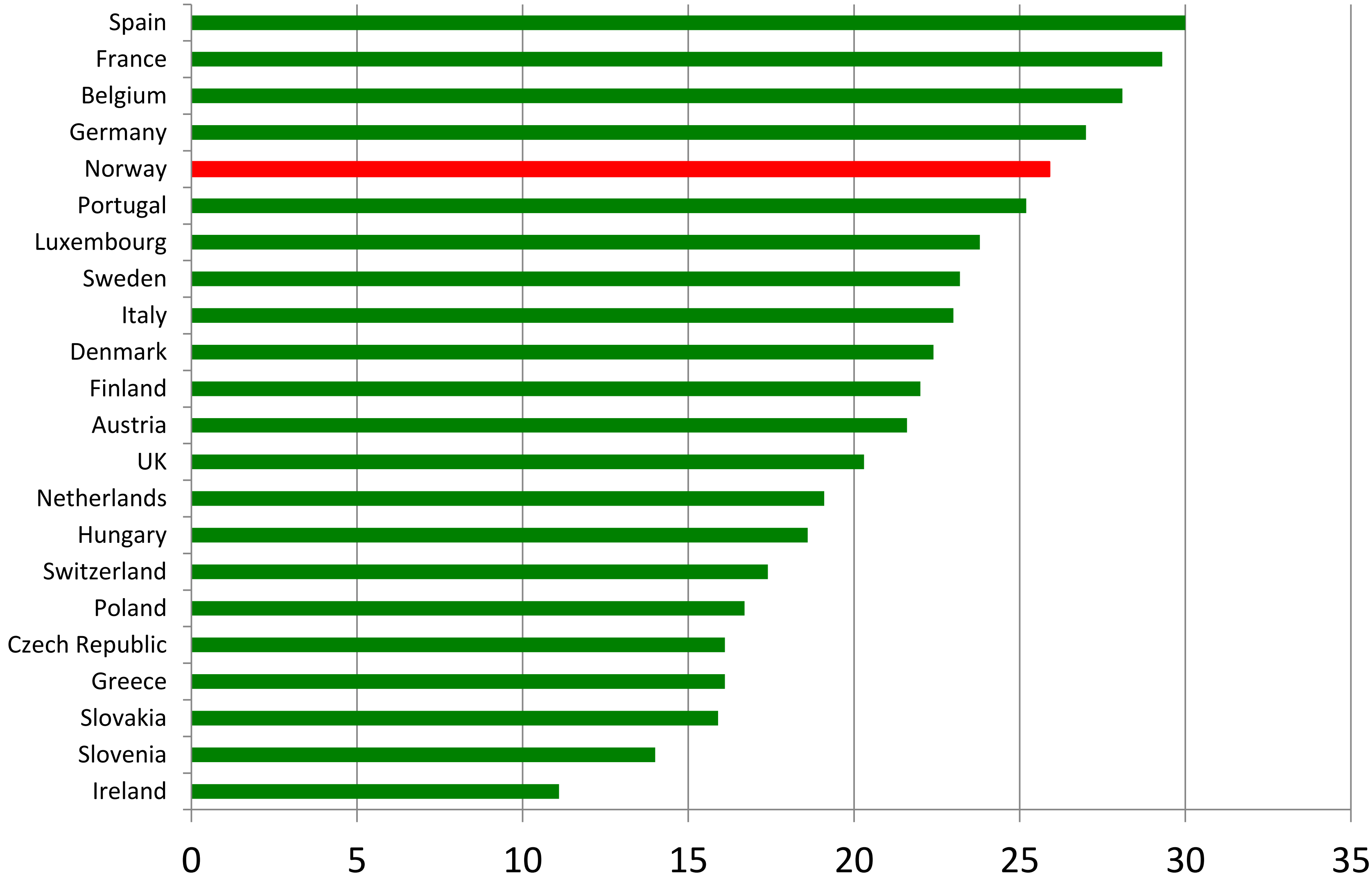


Game 1: How MNE's play?

$$\log(\text{FDI}) = \alpha + \beta\tau^{AETR} \qquad \beta < 0$$

- FDI: "Corporate tax elasticities: a reader's guide to empirical findings, *Oxford Review of Economic Policy*".
  - Effect of EATR on discrete location choice: 'consensus' value for β is −3.2, i.e. reduction in AETR from 25 to 15 raises foreign capital by 3.2 percent
  - Crowding out and small foreign capital stock may yet imply a small overall impact on the economy

Average Effective Tax Rate – 2012

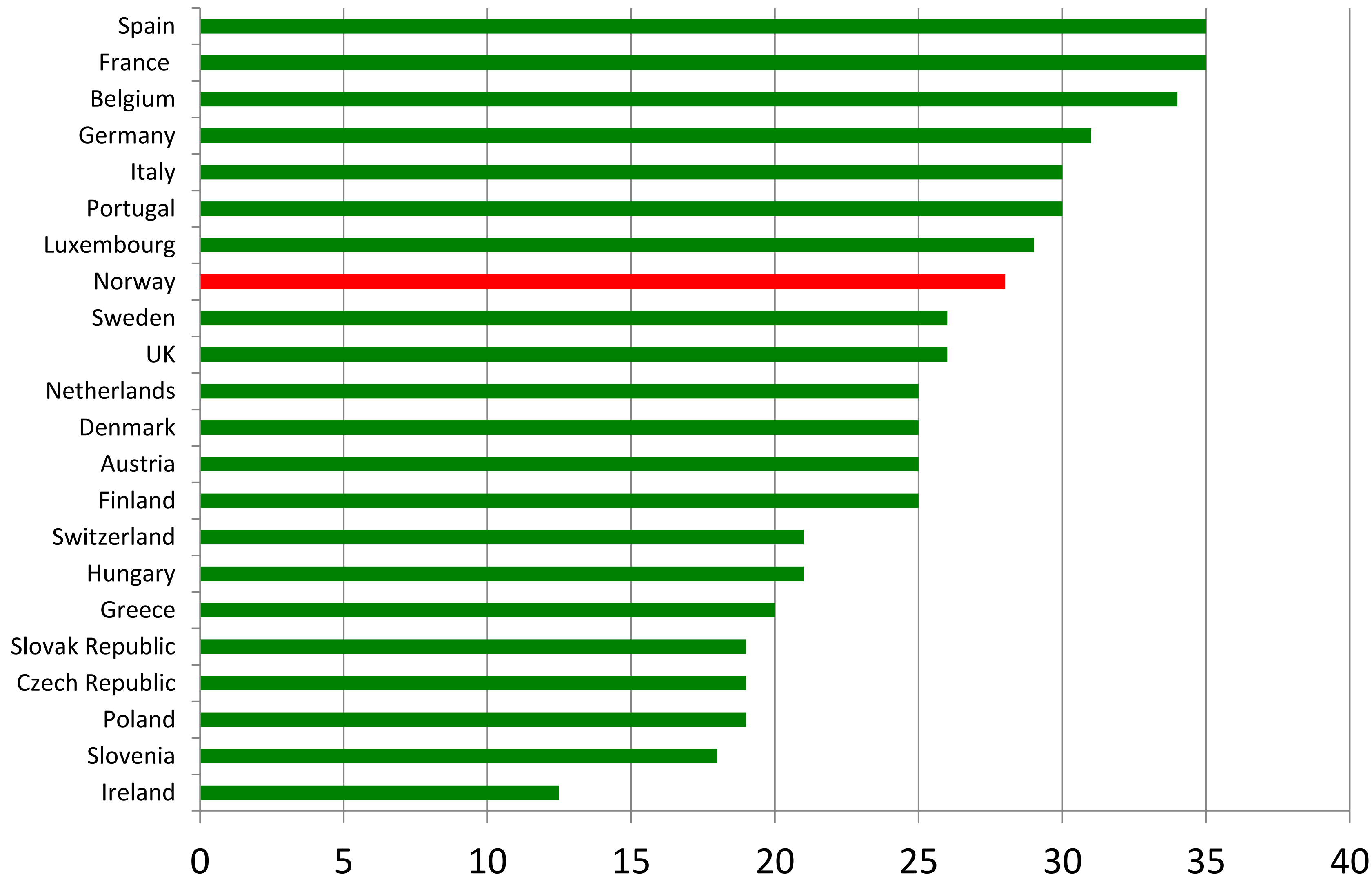


Game 1: How MNE's play?

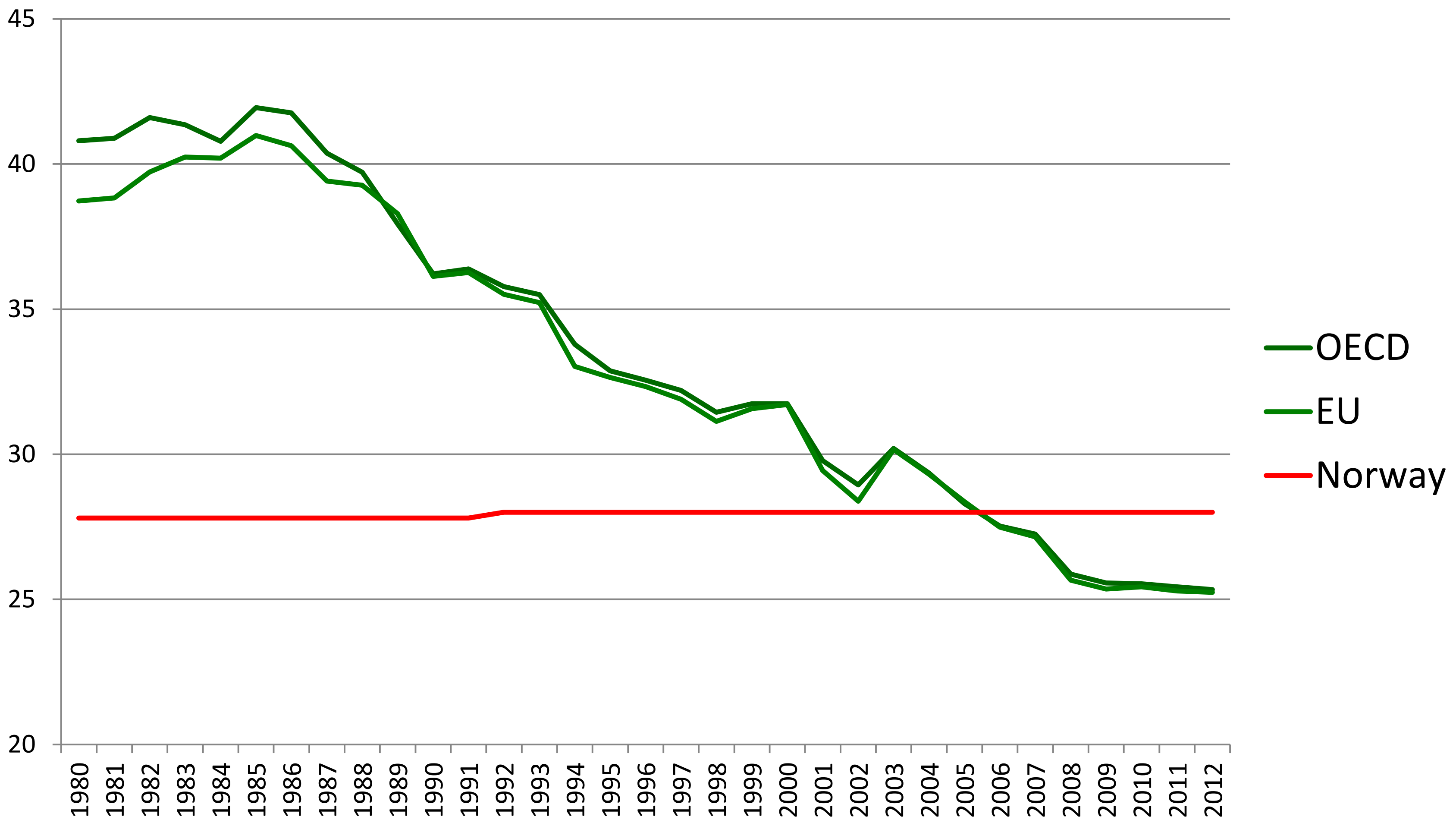
$$\log(\text{MNE income}) = \alpha + \beta\tau^{CIT} \qquad \beta < 0$$

- BEPS: Overesch & Heckemeyer (2013): *MNE's profit responses to tax differentials*.
  - 'Consensus' tax-rate elasticity of income for EBIT −¾; after interest 1¼
  - Hence, reduction in CIT rate from 30 to 20 broadens the CIT base for MNEs by 12.5 percent
- Anti-avoidance measures
  - ALP − OECD guidelines (BEPS project)
  - Debt shifting − thin-cap rules
  - 'Stateless income' – CFC rules
  - Tax havens − forum on transparency

Statutory CIT rate – 2012



Game 2: How governments play – CIT rates



Game 2: special tax incentives

- Banned by EU code of conduct against harmful tax practices and state-aid rules
  - Though countries still have ‘investment laws’

- Popular in Latin, Caribbean, Africa, MENA
  - Tax holidays & special economic zones

- Evaluations not quite positive
  - If they work, crowding out / deadweight loss
  - Problematic governance (corruption)

Game 2: ... but EU now has IP boxes

	Year Intro	Regular CIT	IP Box rate	Acquired IP	Trade marks	Expensed at standard CIT
Belgium	2007	34	7			Y
Cyprus	2012	10	2	Y	Y	
France	2000	34.5	15.5	Y		
Hungary	2003	19	9.5	Y	Y	Y
Luxembourg	2008	29	2.5	Y	Y	
Malta	2010	35	0	Y	Y	
Netherlands	2007	25	5			
Spain	2008	30	15			Y
UK	2013	23	10			

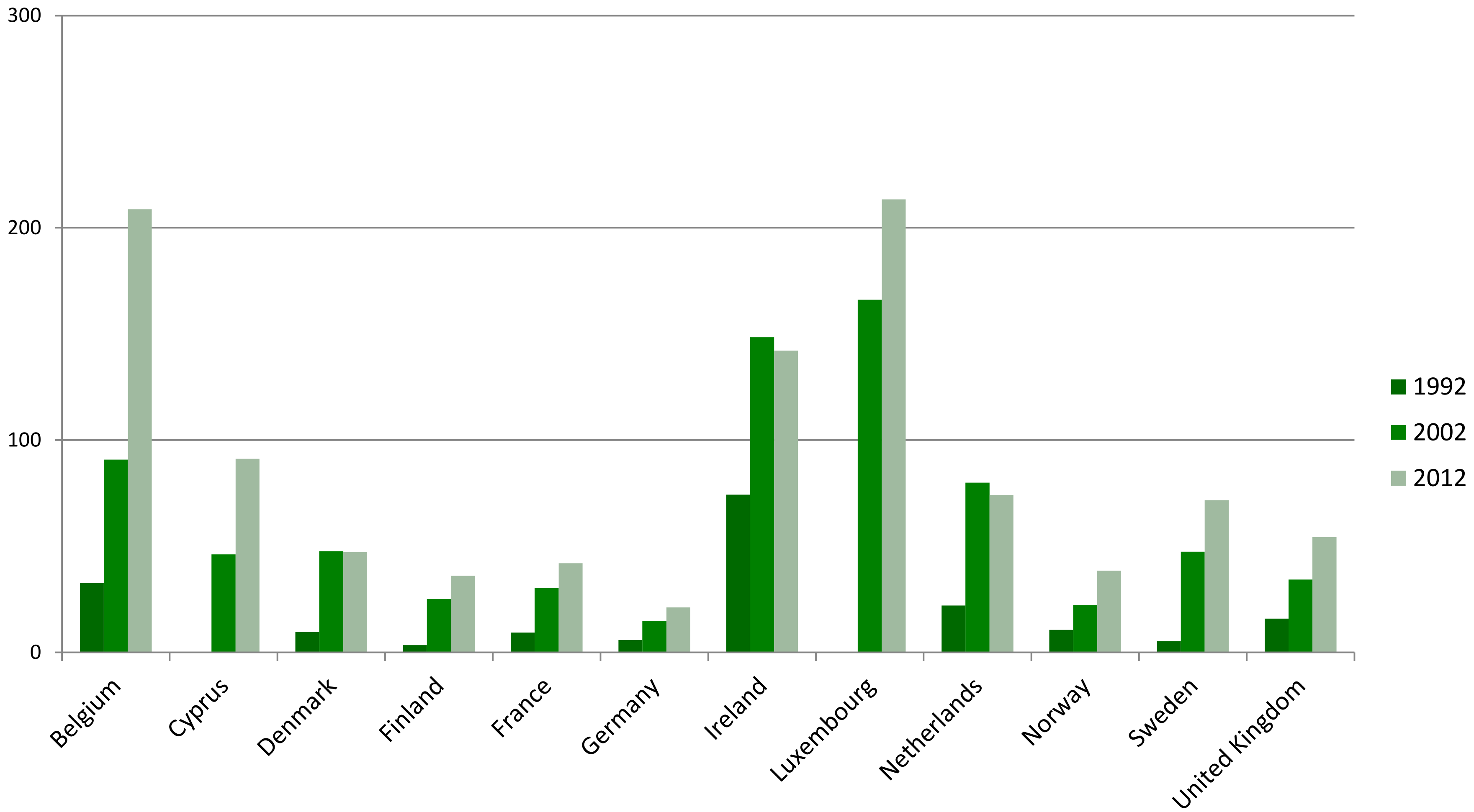
Game 2: holding regimes

- Special holding regimes banned in EU
  - BEL coordination centers; NLD CFR regime

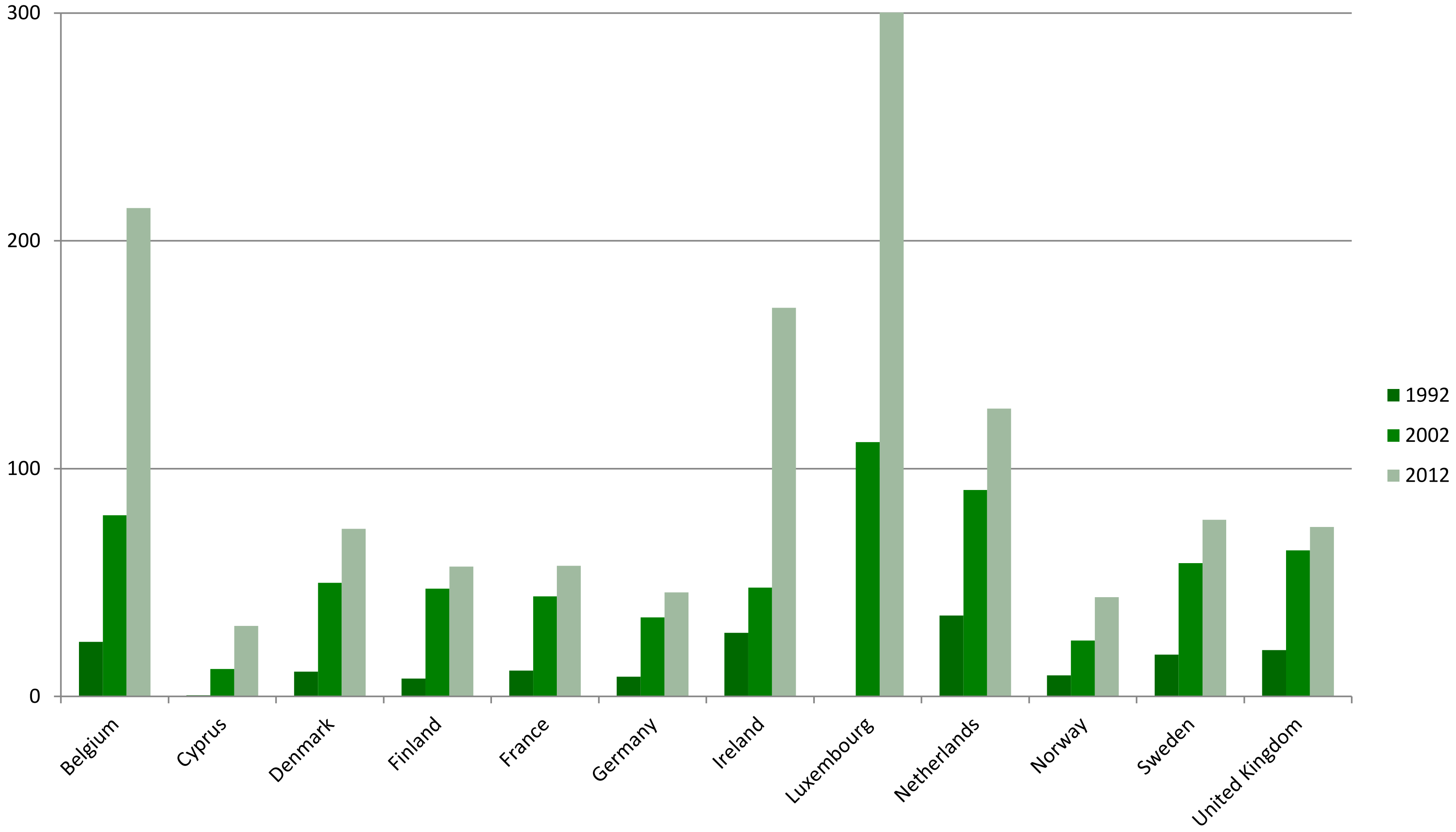
- Now attractive general holding regime means
  - Participation exemption (incl. capital gains)
  - Large DTT network, zero withholding taxes
  - Binding APAs and Advanced Rulings

- Examples: NLD, BEL, LUX, SWI, LTV, DNK
  - I&R directive made this more attractive

Inward FDI / GDP



Outbound FDI / GDP



International cooperation initiatives

- EU
  - CCCTB proposal from 2011
- BEPS …
  - Technical improvements of ALP
  - Addressing mismatches
- … and beyond
  - Fundamental review of principles
  - Formulary principles
  - Addressing tax competition more broadly

Summing up

- CIT has an important functions domestically
  - Though design might be improved (ACE)

- CIT raises challenges in small-open economy
  - Game with multinationals
  - Game of tax competition

- International architecture under discussion
  - BEPS and beyond