



Taxing Business

*Richard M. Bird**

Economists are sometimes accused of agreeing on almost nothing. An important policy question on which many economists appear to agree, however, is that there is not much to be said in favor of taxing business and especially not internationally mobile corporations.¹ The reason for such unanimity is primarily the substantial economic costs associated with business taxes, although the uncertainty as to who really “pays” such taxes in terms of their final incidence may also contribute to the disdain in which they are generally held by economists. But the world largely ignores conventional economic wisdom: people everywhere seem delighted to load as much of their tax burden as possible on “business” and particularly on large impersonal corporations. Could they possibly be right?

The Costs of Corporate Taxes

Numerous distortions and costs are created as a result of corporate taxes. Choices with respect to organizational form (the incorporation decision), financial structure (debt-equity ratio), and dividend policy (payout ratio) may be distorted by such taxes. Investment decisions with respect to industry, asset mix,

location, risk-taking, and timing may be influenced by variations in effective tax rates. Intertemporal decisions, like intersectoral decisions, are also affected by taxes on capital income, with the result that private savings are diminished. Moreover, the complexity of business taxation may impose significant costs and barriers to the expansion of new and small firms, while uncertainty as to the precise tax implications may act as a general deterrent to investment. The potential “dark side” of corporate taxation has convinced most economists that not only is there little to be said for corporation taxes but that there may well be substantial economic gains from reducing and even eliminating such taxes.

However, although corporate taxes have been lowered in many countries, in part in response to perceived competitive pressures, no country seems seriously to have considered eliminating such taxes. Politicians and the public do not see corporate taxes the same way that economists do. Why?

Broadly, three answers may be suggested to this question. Countries may impose taxes on corporations because it is desirable to do so, because it is

*The views expressed in this note are the author’s and must not be represented as those of The World Bank. This note was reviewed by Milan Brahmbhatt, Tuan Minh Le, and Eduardo Ley.

necessary to do so to achieve certain objectives, or because it is convenient to do so.

Why Taxing Corporations May Be Desirable

Taxation is often discussed as though all taxes are inherently bad in the sense that society would be better off in their absence. Quite apart from any offsetting benefits from public expenditure, this view is not correct. There are in fact four taxes that may make any particular country better off than it would otherwise be: a Pigovian tax (one that improves market efficiency by inducing economic agents to take social costs correctly into account), a “benefit tax” (if properly defined and applied), a tax on economic rent or pure profits that has no effect at the margin and hence imposes no economic costs, and, from the point of view of any particular country, a tax that is paid by a foreigner. From each of these perspectives some taxation of business may be considered desirable.

However, although business activity that gives rise to negative externalities may require appropriately corrective levies, such “green” taxation is of course quite separate from the question of general business taxation. The more relevant argument is that a considerable proportion of public expenditure may have cost-reducing benefits for businesses. Since it is strictly difficult to design and implement appropriate user charges, a limited case can often be made for taxation of business to cover “unattributable” benefits.² However, there is no reason to limit any such taxes to corporations alone. Another traditional argument for imposing a

special tax on corporations is to tap monopoly rents. This argument appears to have been motivated largely by distributive concerns and it is not clear why it should apply only to corporate profits. However, the efficiency case for taxing economic rents at the corporate level remains strong, and some recent proposals for reforming corporate taxation are aimed at taxing *only* the “rent” element of corporate profits.³ An important aspect of the argument for taxing rents relates to the taxation of foreign investment. Foreign firms are generally at an inherent disadvantage in domestic markets relative to domestic firms simply because they are foreign. Nonetheless, they may be able to compete successfully because they have some special advantage, in terms of know-how, skill, access to finance or markets, and so on that they can exploit to offset their “foreignness.” In other words, they possess some firm-specific assets that generate rents. Indeed, some assert that the simple existence of direct foreign investment suggests that the profits accruing to such operations must contain a rent element.⁴ Some authors even assert that the host country is simply entitled to a share of the profits generated by foreign investment as a matter of right.⁵ Still others have attributed the strength of this “source” argument to the simple fact that the country (or region) in which the rent-generating resource is located has, as it were, the first kick at the fiscal can.⁶ Although this so-called “national rental” argument for host-country taxation has a long tradition, whether one accepts it or not appears to be more a matter of taste than logic.

Why Taxing Corporations May Be Necessary

In any case, however, it may be argued that the existing international tax regime makes it virtually essential for countries to impose taxes on corporate profits. To put the point succinctly: one reason most countries tax corporate profits is because most countries tax corporate profits. The world-wide prevalence of a particular variety of corporate tax—the corporate income tax—makes it difficult for countries to deviate very far from this norm without incurring penalties in the form of loss of investment, or tax revenue, or both. The conventional corporate income tax undoubtedly has many defects, but so long as most countries have one, most countries should likely have one.

All in all, what may be labelled the “international” arguments for taxing corporations and specifically corporate profits are impressive. To mention only a few points: First, since the international supply of capital is not perfectly elastic there is some room for nationally non-distortionary taxation. Second, taxes on international capital flows may be used to exploit revenue transfers from capital-exporting countries that have foreign tax credit systems. Third, when there are political constraints on high direct personal taxes, a source-based corporate tax may be the best way available to tax at least immobile factors.

More generally, quite apart from the international context, one important role for the corporate income tax is to close some of the gaps in the personal tax system, for example, by imposing some taxation on capital gains as they accrue at the corporate level. A corpo-

rate tax may further aid the enforcement of the personal tax by withholding tax on dividends paid to individuals that might not otherwise come to the attention of the fiscal authorities. For both domestic and international reasons, taxes on corporations seem necessary as long as direct personal taxes constitute part of the tax system.

Why Taxing Corporations May Be Convenient

The rationale for many taxes imposed at the corporate level is simple: “that’s where the money is” or at least where it is easiest to find. Most of the money earned and spent in modern economies passes at some point through the hands of corporations, which generally keep better records and are easier to locate and track than individuals. There is thus obviously a strong administrative rationale for collecting taxes as far as possible from corporations rather than individuals. The key to effective taxation is information, and the key to information in the modern economy is the corporation (including financial corporations such as banks). The corporation is the modern fiscal state’s equivalent of the customs barrier at the border. Or, if one prefers, it is the informational goose that produces the fiscal golden egg.

This general administrative rationale applies both with respect to using corporations as withholding agents for personal income taxes (for example, on wages, interest, and dividends) and as collection agents for sales and excise taxes or even, as in some countries, as “pre-payers” of income, sales, and other taxes legally due from unincorporated suppliers of goods or services to corpo-

rations or purchasers of corporate products. Taxes are paid in money, and most money at some stage passes through corporations. Taxes may be enforced effectively to the extent the authorities have adequate information about the existence and value of taxable transactions, and most of the essential information is in the hands of corporations. The modern tax system in a real sense rests on the extent to which the conduit of the corporation has replaced the customs house as the channel through which the tax base flows and where it can best be trapped, and tapped.

Of course, the simple convenience of levying taxes as income and expenditure flows impinge on or pass through corporations does not justify imposing taxes on corporations *as such*, except perhaps in the crudest of proxy arguments. In political economy terms, the main reason for the prevalence of taxes on corporations in most countries may simply be because they are there—what may perhaps be called the existence argument—combined with the obvious political feasibility—perhaps even the political necessity—of such taxes. Taxation is as much or more a political as an economic phenomenon. Governments go against popular perceptions of who should pay how much in what way only at their peril. If popular feeling, despite decades of economic argument to the contrary, is strongly that large corporations should pay large taxes, then it is usually incumbent on any government that wishes to stay in office to bow to these winds at least to some extent. Such expedients as minimum corporate taxes and corporate capital taxes seem

hard to justify on any other grounds. This rather disparaging comment does not mean, however, that the political argument alone may not be sufficient to justify such taxes. Quite apart from the obvious desire of any government to remain in office, if the political cost of raising taxes from corporations is low, even if the economic cost is high it may be rational to do so: both costs are real to decision makers.

Some taxes on corporations that seem economically irrational may thus make sense in the larger political economy picture. Such arguments must of course be used with caution lest all things that exist come to seem justified simply because they exist. When such taxes induce significant economic distortions, those costs—which are usually hidden from public and political eyes—need to be explicitly weighed against the possible “acceptability” gains from raising revenue in this way.

A final reason why taxing corporations is convenient is that it may be useful from a number of different policy perspectives to have a tax instrument through which to influence their economic behavior. Most economic activity in modern countries takes place in corporate form, and so long as governments wish to play an active role in shaping economic activity—that is, so long as governments exist—they would be foolish to reject out of hand the opportunity of doing so through corporate tax policy. Policies to encourage or discourage investment in general, in particular types of assets, in particular locations, policies to foster exports, investment abroad, foreign investment, or small business

or new business or technology-intensive business, or whatever is the economic or political flavor of the month have always been popular with governments and will likely continue to be popular. Of course, such policies may entail significant costs and may fail to achieve their goals, but tax policies are no different than other “instruments of governance” (expenditures, regulation) in these respects.

How to Tax Corporations

None of the possible rationales for taxing businesses and especially corporations mentioned above is, in itself, particularly strong. Moreover, none of them—except to some extent the “copycat” motive—lends much support to the present mix or structure of corporate taxes found in most countries around the world. The lack of a clear rationale for what we now do does not mean that it is therefore better to do something else, but it does perhaps raise some questions about the way such taxes are now structured.

It is striking, for example, that only one argument mentioned above appears to support substantial taxes on corporate profits such as those that now exist in most countries, namely, the fact that almost everyone else has such a tax. But this is by no means an unimportant or trivial argument for most countries: most countries have profits taxes because their principal investment partners have such a tax. So long as this remains true, presumably such countries should continue to levy a tax on corporate profits. Moreover, to the extent it is not possible to recoup the marginal cost of cost-reducing public sector outlays through user charges or

to price negative externalities through appropriate charges, some form of additional broad-based general levy on business activity may be warranted. However, this rationale calls not for a profits tax but a more broad-based levy neutral to factor mix such as a tax on value-added.⁷

Perhaps particularly in developing countries, an administrative argument can sometimes be made also for imposing “minimum” corporate taxes based on gross assets. The argument is that a certain minimum rate of taxable income should be assumed to be earned on all assets employed by corporations. If the actual rate reported exceeds the presumed rate, the normal corporate tax applies. If the reported rate falls short, the presumed rate applies. Such levies may be justified in two ways. First, the companies subjected to the minimum alternative tax are cheating: they really earned at least the presumed return and have managed to hide their real profits. Second, if they really did not earn the presumed return, they should have done so: that is, they are using assets inefficiently and should turn them over to someone—preferably a taxpayer!—who can make better use of them.

A critical factor in determining what can and should be done with respect to reforming corporate and business taxes is the cost of change. Unless the expected present value (taking political and well as economic costs and benefits into account) clearly outweighs the costs of change, change should not be made. “Old taxes are good taxes” in the sense that the system is adjusted to their existence. When it comes to the main economic actors in the modern world,

corporations, the net benefits from any major change must be very clear to make it worthwhile. What this probably implies for most developing countries is that major structural reforms in corporate taxation (such as the introduction of some form of cash-flow tax) are unlikely to be high priority.

Notes

1. Since corporations are the major form in which business activity is carried on in most countries as well as the major source of capital income, the categories of corporate income, capital income, and business income clearly overlap, although they are equally clearly not identical. The present paper focuses mainly (but not exclusively) on taxing corporations and does not develop these distinctions in detail. Note that the difficult problems arising with respect to taxing small business are not discussed here: see IFC, *Designing a Tax System for Micro and Small Businesses: Guide for Practicioners* (Washington: World Bank Group, 2007).

2. This argument is often particularly appropriate at the subnational level: for further discussion see “Local Business Taxes,” *Perspectives on Fiscal Federalism*. WBI Learning Resources Series (Washington, DC: World Bank, 2006), pp. 225–46.

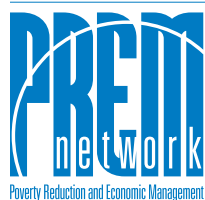
3. See P.B. Sorenson, “Can Capital Income Taxes Survive? And Should They?” CESifo Working Paper 1793, August 2006.

4. See R. M. Bird, “The Interjurisdictional Allocation of Income,” *Australian Tax Forum* 3 (1986), 333–54, and P.B. Sorensen, “Changing Views of the Corporate Income Tax,” *National Tax Journal* 48 (1995), 279–94.

5. P.B. Musgrave, “Interjurisdictional Coordination of Taxes on Capital Income,” in S. Cnossen, ed., *Tax Coordination in the European Community* (Amsterdam: Kluwer, 1987).

6. D.J.S. Brean, R.M. Bird, and M. Krauss, *Taxation of Interational Portfolio Investment* (Ottawa: Centre for Trade Policy and Law and Institute for Research in Public Policy, 1991).

7. The appropriate form of a “benefit” tax on corporations would appear to be a low-rate income-type value-added tax, or what has recently been called a “business value tax (BVT).” Such a tax differs from a normal VAT in that it is on an income rather than consumption base—that is, imposed on profits as well as wages—and also on production not consumption, which means it is in effect imposed on exports and not on imports: see the paper cited in note 2 for further discussion.



This note series is intended to summarize good practices and key policy findings on PREM-related topics. The views expressed in the notes are those of the authors and do not necessarily reflect those of the World Bank. PREMnotes are widely distributed to Bank staff and are also available on the PREM Web site (<http://www.worldbank.org/prem>). If you are interested in writing a PREMnote, email your idea to Madjiguene Seck at mseck@worldbank.org. For additional copies of this PREMnote please contact the PREM Advisory Service at x87736. PREMnotes are edited and laid out by Grammarians, Inc.

Prepared for World Bank staff