WILL CORPORATE INCOME TAXATION SURVIVE?

BY

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Summary

This paper explores the future of corporate income taxation, with special reference to the Netherlands. We review the empirical literature on a variety of distortions and arbitrage opportunities and pay due attention to effect sizes. An attempt is made to compare the size of various distortions in terms of the ex-post revenue impact of a corporate tax reduction. Thus, we learn which distortions impose the most serious threat to government revenue. This integrative approach allows us to understand recent developments in corporate tax regimes in the EU.

Key words: Corporate tax, distortions, effect sizes, tax competition.

1 INTRODUCTION

The Dutch government has proposed to reduce its corporate income tax rate from 34.5% in 2004 to 30% in 2007. The Netherlands is not the only country in Europe that is doing so. Austria has recently reduced its rate from 34% to 25%, while Belgium has made a similar move. During the past 5 years, more than half of all EU countries have cut their rates. This may have been triggered by the enlargement of the EU. On average, corporate tax rates in the new member states are 9%-points lower than in the old EU countries, while effective tax rates are estimated to be around half of the old EU-average (Jacobs et al. (2003)). The fear of losing capital to the new member states has induced the old member states to bring their corporate tax rates more in line with the entrants.

Yet, the reduction in tax rates is not a new phenomenon in Europe. The trend of declining tax rates has been taking place for 20 years (Griffith and Klemm, 2004). Apparently, changes in Europe have triggered corporate tax

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1 A lower rate of 27% applies to profits below 22 600 euro. The corporate tax rate has been reduced on January 1st 2005 from 34.5% to 31.5% (the lower rate for profits below 22 600 euro was reduced from 29% to 27%). The tax rate will be reduced further to 30.5% in 2006 and 30% in 2007 (lower rate to 26% and 25%, respectively).
reform long before the recent enlargement of the EU. In light of these developments, the question is: what will the future hold in store? Will the corporate income tax survive? In this connection, Michael Devereux has argued: ‘If I can make a bold prediction, I would say that corporate taxes will eventually just wither – there will be no corporate tax at all, partly because of the process of competition between states and partly as companies can organize their affairs effectively to reduce their corporation tax.’ (House of Lords (1999)).

This paper explores the future of corporate income taxation, with special reference to the Netherlands. We start by assessing the arguments for a corporate income tax. This provides an understanding of why it would potentially be harmful if the corporate tax were to disappear from the tax scene. Subsequently, we analyse several distortions of the corporate income tax which jeopardise its future. During the coming years, these distortions may well intensify in light of (international) economic trends.

The paper also reviews the empirical literature on various distortions and arbitrage opportunities imposed by the corporate income tax. This has regard to arbitrage relating to organizational form, corporate financial policy, and profit allocation by multinational companies, as well as real distortions in investment and location decisions. Whereas most studies primarily focus on hypothesis testing on these issues, this paper emphasizes the effect sizes found in the empirical literature. In particular, for each distortion, we provide a comprehensive overview of the available empirical studies in order to arrive at a consensus estimate. In addition, we aim to make the size of different distortions comparable in terms of the direct implications for the government budget. Thereby, we use data for the Netherlands. As the elasticities from the empirical literature apply to a variety of OECD countries, we may also interpret the results as for a typical OECD member state as long as the economic and tax data do not deviate much from those for the Netherlands.2 The analysis of the direct budgetary implications involves only a first-order approximation for the relative economic importance of distortions, e.g. in terms of welfare. It does, however, give an impression of how corporate tax cuts will affect fiscal revenue. This may indicate what type of reforms will most likely be imposed by politicians who aim to protect corporate tax revenue.

The next section starts by discussing the reasons for a corporate income tax. Then, we demonstrate its distributional consequences in section 3. Section 4 elaborates on domestic distortions. International distortions are discussed in section 5. Finally, section 6 concludes.

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2 Dutch tax rates are close to the OECD average. The Netherlands differs somewhat from other countries in terms of a relatively high foreign ownership share due to a large number of multinational companies.