The future of the company tax

Mihir A. Desai and Dhammika Dharmapala explore innovative ways to overcome the difficulty of collecting tax from corporations

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In recent years, the company tax has been buffeted by global forces in sometimes conflicting directions. As the public's views on the social role of corporations have changed, the company tax has increasingly come to be seen as a mechanism for ensuring that business contributes to society. At the same time, the sustainability of corporate taxation is increasingly under challenge in a changing global landscape. This environment is characterised by the ability of corporations to relocate activity and profits in response to tax differences, and by the consequent rise of tax competition among governments (which has led to substantial reductions in corporate tax rates).

In our contribution to the first phase of the British Academy's 'Future of the Corporation' programme, we have surveyed how corporate taxation affects the behaviour of corporations and economic efficiency, and have analysed how the interests of corporate managers, shareholders, and the general public may clash or align in particular circumstances. We have gone on to describe three possible future paths that the company tax may take in response to the pressures and developments highlighted above – and we discuss these briefly in this article. We do not necessarily advocate any of these paths, but view each as being internally consistent in its aims and thus worthy of consideration. These alternatives differ significantly with respect to various policy objectives that are widely viewed as being important, including efficiency, administrability, corporate responsibility, the perceived legitimacy of tax systems, and progressivity.

Multilateral co-operation to preserve the company tax

One framework that is often used to discuss the current predicament of the company tax is that there has emerged a mismatch between the global reach of modern multinational corporations and the purely national reach of fiscal authorities. For policy-makers who wish to preserve corporate taxation, it would appear that an important role has to be played by increased multilateral co-operation and co-ordination, possibly even leading to multilateral taxing authorities analogous to the World Trade Organization and its global trade architecture.

This approach could enable the company tax to survive in its present form, by mitigating tax competition among countries and by limiting opportunities for firms to shift reported profits to lower-tax jurisdictions. It would also provide an opportunity to use the company tax as a regulatory tool in certain circumstances, and as a mechanism for enforcing contributions by business to society. However, an inevitable concomitant of this approach would be to maintain and perhaps exacerbate the distortions caused by company taxation to firms' behaviour (such as their choice of how much and in which locations to invest). This is because multilateral co-operation is likely to entail higher corporate income tax rates and lower levels of profit shifting than would prevail in its absence.

Large sections of the public clearly favour the idea of firms paying a 'fair share' of tax. (It is worth noting that the extension of fairness concepts to legal entities is problematic; and the actual distributional effects depend on the incidence of the corporate tax – especially the extent to which it burdens workers, through lower wages resulting from lower levels of investment, or through changes in locational choices.) However, the feasibility of a high level of multilateral co-operation is questionable, especially in a world that is witnessing a resurgence of extreme nationalism and a distrust of global institutions. Thus, our remaining two alternatives both involve the abolition of the corporate tax, although they take very different approaches to the design of the rest of the tax system.

Consumption taxation

Those who highlight the economic inefficiencies caused by the company tax are often tempted to propose its outright abolition. However, abolition would create new challenges for a fiscal regime in which (for both revenue and distributional reasons) the personal income tax plays a central role. In the absence of a corporate tax, corporations would function as tax shelters from the perspective of the personal income tax system (that is, individuals could establish corporations that would serve as recipients of their labour and capital income, and defer taxation of this income until it is needed for consumption purposes). Any attempt to eliminate the company tax must recognise that the personal income tax in its current form may no longer be sustainable.

One potential solution is to abolish both the corporate and personal income taxes, in favour of consumption taxation (which by design does not seek to tax capital income – i.e. the returns from investment). There are various mechanisms through which consumption taxes can be implemented, such as a cash flow tax on businesses (for instance, the 'destination-based cash flow tax', DBCFT, proposed by Auerbach, Devereux and Simpson in 2010). However, the world's dominant form of consumption taxation is the destination-based credit-invoice method VAT, which has important administrative advantages over other forms of consumption taxation; this is unlikely to change in the future.

There would be substantial efficiency gains from moving to a consumption-based tax system. Indeed, many tax scholars have long advocated such a reform. However, there would be significant challenges in replicating the degree of progressivity currently achieved by income taxation. Progressivity should ideally be assessed with respect to the overall tax-transfer system and not with respect to the revenue-raising mechanism alone. Thus, it is possible that with sufficient progressivity in public expenditures, a tax system consisting solely of a VAT may be quite progressive overall. Nonetheless, these distributional challenges represent an important concern with respect to this potential alternative future path.

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Reinforcing personal income taxation in the absence of a company tax

As discussed above, the absence of a company tax creates tax deferral opportunities for individuals facing a personal income tax. These opportunities exist primarily because of an integral feature of income tax law: the realisation requirement (that gains in the value of assets are typically taxed only at the time a realisation event such as a sale occurs, rather than continuously as the gains accrue). If the personal income tax were instead to be imposed on an accrual basis, then personal income taxation would continue to be viable even in the absence of a company tax. Thus, a third possible future path is to eliminate the company tax, while transforming the personal income tax to an accrual rather than realisation basis.

Tax law is reluctant to impose taxation upon accrual, when taxpayers will not necessarily have the cash to meet their tax obligations, or be certain about the amount of gain. While these are important concerns, mechanisms that address them – by deferring taxation until realisation while adjusting tax liabilities to eliminate the deferral advantage – have long been discussed. An alternative future path could potentially build on these proposals in order to eliminate the entity-level company tax, while retaining and indeed reinforcing the personal income tax. In such a world, the personal income tax can be used to achieve the distributional aims that are now pursued in part through the company tax (i.e. of taxing shareholders on their capital income); any degree of tax progressivity desired by society could in principle be implemented via the personal income tax.

It is possible that significant sections of the public may view an entity-level company tax as an essential component of a legitimate tax regime (even though any desired level of progressivity could be achieved through a personal income tax). Another major challenge for this approach is its considerable administrative complexity. Administrative challenges are likely to be especially significant for developing countries, which already face difficulties in effectively implementing personal income taxes. On the other hand, it is possible that future technological developments may make it easier for governments to keep track of taxpayers' assets, and so facilitate accrual-based taxation of individuals.

Conclusion

Navigating the rising expectations for, and the diminished capacity of, the company tax is likely to represent a major challenge for the world's governments over the next several decades. A central tension is between public perceptions of the company tax and the evidence and conceptualisations developed within academic scholarship. Perhaps the most important question for policy-makers is how to reconcile these public pressures with a commitment to evidence-based policy-making. Overall, the future of the company tax appears fairly uncertain. We hope that by mapping the contours of the leading conceptually coherent alternatives that exist for its future development, our framework can play a role in advancing this important debate.

Further reading

A fuller statement of the ideas expressed here, along with bibliographical references, can be found in: Mihir A. Desai and Dhammika Dharmapala, 'Revisiting the uneasy case for corporate taxation in an uneasy world', *Journal of the British Academy*, 6:s1 (2018).

How to extract appropriate amounts of tax from 'established tech giants' was discussed by the Chancellor of the Exchequer, Philip Hammond, in his October 2018 Budget speech. *Photo: by Jack Taylor / Getty Images.*