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Comment on “(Why) Do We Need Corporate Taxation? and Company Taxation and Growth: The Role of Small and Large Firms”

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Both contributions have in common that they argue for a lower capital taxation, especially for a lower corporate taxation (CT), whether by lowering CT rates or introducing a dual income taxation with a lower flat rate on capital income. They go, however, not so far as to propose to abolish these taxes at all, mainly because CT is a significant source of public revenue.

The main reason for reducing CT is seen to be international tax competition. Countries seem to be in a prisoner’s dilemma game, playing a beggar-my-neighbour policy, where eventually all of them are worse off. Economists and politicians overestimate the role of CT for real investment and capital accumulation. This may partly be due to the different meanings of the term “investment”, which are often mixed up.

If one looks, for example, at the Austrian Joint Stock Companies Statistics (2002), it is obvious that CT is of minor importance compared to other cost components and taxes.

Table 1: Cost Structure, Taxes and Net Profits of Joint Stock Companies

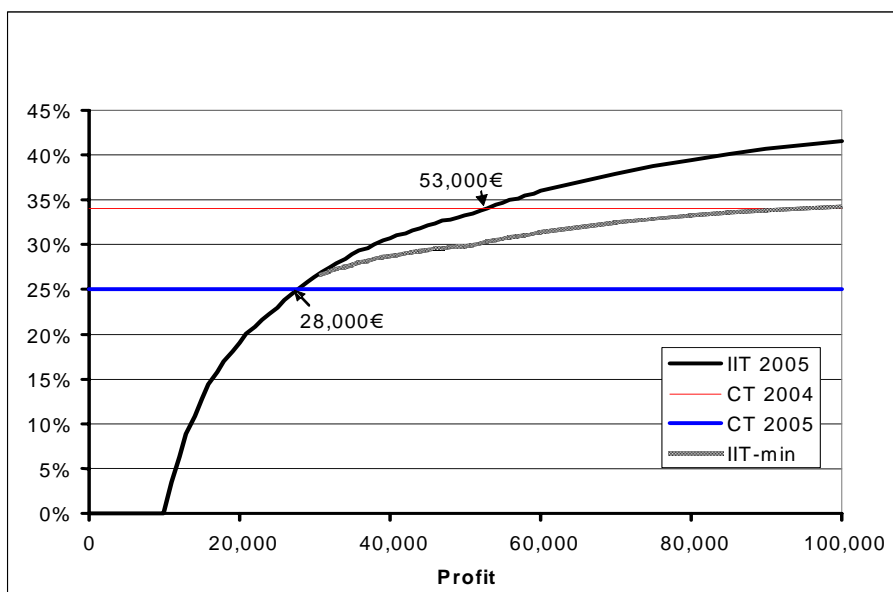
Turn-over of Austrian Joint Stock Companies 2002:	<i>EUR 62 billion</i>
Inputs (including excises)	<i>60%</i>
Wage (salary) cost of which taxes and SSC	<i>18–19%</i> <i>3–4%</i>
Other non-profit-related taxes	<i>1%</i>
Corporate tax	<i>1%</i>

Source: Austrian Joint Stock Companies Statistics (2002).

Employers' social security contributions and payroll taxes are more than three times as high as the corporate tax. Reducing payroll taxes of corporations by about EUR 1.5 billion (with constant prices meaning an increase of taxable profits and – applying the Austrian CT rate for 2004 of 34% – an increase of CT by about EUR 0.5 billion) would have a similar effect on net profits and public budgets as a CT reduction of EUR 1 billion (which is the cost of reducing the CT rate to 25% in 2005). Nevertheless the CT reduction is politically more attractive. As the base of payroll taxes is much higher than corporate profits, the percentage reduction for CT is, of course, much more pronounced, meaning a stronger “signal effect”.

Although CT rates seem to play a minor role for real investment (some investment promotion instruments, like investment allowances or accelerated depreciation, are even less effective with lower rates), tax competition is important and is likely to lead to a race to the bottom. Differences of rates between countries offer an incentive for tax planning, i.e. there is a tendency to shift taxable profits to low-tax-jurisdictions. As Weichenrieder points out, for smaller countries (or countries with a relatively small tax base in the past) it is, in general, less costly to reduce profit tax rates, because the potential of "imported" profits compared to domestic profits is much higher than for a large country. The following chart shows a comparison of the tax situation of corporations and non-incorporated firms which are due to Corporate Income Tax (CIT).

Chart 1: Individual and Corporate Income Tax



Source: Author's calculations.

One can see (from average taxation) that, because of the reduction of the CT rate, the break-even-point between firms taxed by individual income tax (IIT) and corporations fell from an annual taxable profit of about EUR 53,000 to EUR 28,000. Even taking into account the half-rate taxation for non-distributed (non-withdrawn) profits introduced in 2004 (under realistic consumption behaviour; IIT-min), leaves a significant gap. A trend towards incorporation can, therefore, be expected in the future.

According to Weichenrieder, the CT is mainly justified by the fact that the residence principle is not applicable for companies. But even in the closed economy case, where this principle is valid by definition, there are arguments for CT. Because IIT on dividends leaves withheld profits of companies untaxed, a missing CT would mean non-neutrality. Maybe that Weichenrieder's shareholder tax ("Teilhabersteuer") would avoid that, but it seems that such a system could be unnecessarily complicated.

The CT is not only important to make sure that income tax (IT) on profits is paid, but also that other taxes, like employers' social security contributions (SSC), payroll taxes and taxes on other inputs, are fully declared without too much control by the tax authorities.

Table 2: Profit Taxation and Wage Cost

Net earnings		437
Wage tax		383
Employees' SSC		180
Gross earnings		1000
Employer's SSC		219
Payroll taxes		75
Wage cost		1294
After-tax wage cost with IT-rate or CT-rate of		
(=wage cost of 1294 x (1-tax rate))	50%	647
	34%	854
	25%	971

Source: Author's calculations.

This example shows that, with a low tax rate on profits, the after-tax wage cost is considerably higher, meaning a stronger incentive for “unofficial” (non-taxed) wage payments.

Both, Keuschnigg and Weichenrieder use 2-period general equilibrium models for supporting their arguments. Like many (most?) mainstream models, they are based on utility- or profit-maximising representative (=identical) agents or firms, respectively. These assumptions seem highly unrealistic, especially for analysing income (profit) taxation, where income (re)distribution and the differences between individuals or firms play a major role. These models also assume full employment which does not seem feasible nowadays. And finally, the assumption that people consume their total wealth before they die is very unrealistic, too. Therefore, the results of the models are not really reliable.