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Issues of Fairness in Taxing Corporate Profit

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ABSTRACT

Any assessment of the 'fairness' of a tax requires making inter-personal comparisons. In the case of a tax on corporate profit, these require looking through the company to investigate the incidence of the tax – which individuals are worse off as a result of the tax. This incidence depends on the properties of the tax – for example, whether it falls on all income or only economic rent, and whether it is levied on a residence, source, or destination basis. Fairness involves consideration of the beneficiaries of the tax revenue, which in an international setting raises the issue of a fair allocation across jurisdictions of rights to tax profit earned by multinational companies.

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In recent years, there has been considerable political debate around the notion of a fair tax on corporate profit. Some politicians and activists and the general public seem to believe that companies should pay their 'fair share' of tax. They complain that multinational companies are currently paying less than a 'fair share' either because of flaws in the international tax system or because of their ability to game the system. Such disquiet is heightened by concerns of rising inequality, with the parallel belief that the rich, who have a disproportionate share of capital income, should pay more tax on that income.[1]

This paper examines whether these views on a fair tax on corporate profit are well grounded. It addresses two related, though separate, issues.

First, we investigate the fairness of the distribution of taxes on corporate profit amongst individuals. A key issue here is that we must look through the company to identify which individuals bear the effective incidence of the tax. In other words, we must distinguish between the 'nominal' or 'statutory' incidence and the 'effective' or 'economic' incidence of a tax. The former identifies the individuals or entities that remit the tax; the latter identifies the individuals that are economically worse off as a result of the imposition of the tax (in this paper, the term 'incidence' is used in the latter sense). In principle, this distinction is important in in the analysis of any tax. For example, basic economic analysis suggests that changing the rate of personal income tax on earnings is likely to affect the equilibrium market wage, with the consequence that the tax is likely to be shared by the employer and employee.[2] But identifying the incidence of a tax on corporate profit is particularly important because the company itself cannot bear the incidence. Only natural persons can bear the incidence of a tax, even if the tax is remitted to the tax authorities by legal persons – such as companies.

A commonly advocated justification for taxing corporate profit is that it is an essential element of the set of taxes on capital income (i.e., broadly, income that is not earned through labour).[3] That raises the much broader issue of the appropriate taxation of capital income more generally. That has been the subject of extensive academic debate, which has probably not yet reached a consensus.[4] For our purposes, we simply assume that there is a case for taxing capital income on accrual (i.e., broadly, when it is earned), and that other forms of capital income either are taxed, or ought to be taxed. Were that not to be the case, it would be much harder to justify any tax on corporate profit (unless it were constrained to fall only on economic rent; we discuss this concept further on). We therefore first ask, conditional on other forms of capital income also being taxed, what would be a fair approach to taxing corporate profit?

The second question concerns fairness in the allocation of revenue. In principle, this could also be traced down to the individual level: Who is better off because of government spending? However, that would clearly depend on the nature of the spending financed by the tax on corporate profit. Instead, we constrain our discussion to consider how the taxing rights for corporate profit in an international setting should be allocated amongst governments.

A. FAIR DISTRIBUTION AMONGST INDIVIDUALS

GENERAL COMMENTS ON INCIDENCE

Basic economics textbooks teach an invariance proposition: the 'nominal' incidence of taxes has no bearing on the 'effective' incidence of taxes.[5] The 'nominal' incidence falls on the person or entity with the responsibility of remitting (i.e., making the payment of) the tax to the tax authority. The 'effective' incidence identifies which individuals are worse off as a result of the

1 Recent evidence instead suggests that effective tax rates on labour and capital converged globally since the 1960s, due to a 10 percentage-point increase in labour taxation and a 5 percentage-point decline in capital taxation; see Bachas et al. [1].

2 In fact, incidence is largely ignored in the extensive literature on the optimal taxation of labour income. A recent extensive survey of this literature does not even mention the issue [2]. The classic approach of Mirrlees [3] assumes that the wage is based solely on the unobserved ability of the individual, which implies a perfectly elastic demand for labour at each level of ability. An exception is Allen [4], who explores general equilibrium considerations and finds that the general equilibrium effect may outweigh the direct effect of a tax.

3 By capital income, we mean a broad notion of the return from saving or investment.

4 For recent contributions, see Diamond and Saez [5]; Mankiw, Weinzierl, and Yagan [6]; and Mirrlees et al. [7].

5 For a recent example, see the lecture notes of Stefanie Stantcheva for a 2021 course in public economics at Harvard, available at https://scholar.harvard.edu/files/stantcheva/files/lecture3_1.pdf.

tax being levied. Although there are specific cases where this proposition may not hold,[6] it is largely unchallenged as a general principle.

This proposition applies to all taxes. For example, the nominal incidence of taxes levied on earned income is typically on the employer. In most cases, the effective incidence of the tax will be shared by the employer and the employee. In a simple partial equilibrium model (i.e., a model that only takes account of the direct impact of the tax and ignores the secondary and subsequent impacts that follow), the effective incidence will be determined by the elasticity of supply and demand (i.e., how much supply and demand will change as a result of the tax). As a general rule, the more elastic the demand, the more the effective incidence will fall on the supplier, and vice versa.

This distinction is largely absent from the political – and, to a lesser extent, academic – debate about fairness in taxation. Instead, both debates on this commonly assume that the tax on earned income falls on the employee alone.[7] Although this is not the focus of this paper, we briefly speculate on why. One possibility is that many participants in the debate do not understand the distinction, although others clearly do. The latter presumably either have strong beliefs about the effective incidence or ignore the distinction in the interests of advocating a political position.

This issue is particularly pronounced in the case of taxes on profit, especially on corporate profit. In many instances the political debate is about the extent to which companies should pay their 'fair share' of tax. Although in principle, we can make interpersonal comparisons of welfare, it makes no sense to make comparisons between an actual person and a legal person such as a company. To make inter-personal comparisons, it is necessary to make assumptions about which individuals ultimately bear the tax. An unsophisticated view that corporate profit should be taxed could arise if the company is associated with either its shareholders or executives. But there is a considerable economic literature, dating back to Harberger [10], as to the extent to which such taxes are passed on to the labour force. Occasionally the issue of the extent to which such taxes are passed on to the labour force has been the subject of fierce political debate, perhaps most strikingly at the time of the 2017 US tax reform, which reduced the federal corporation tax rate from 35% to 21%.[8]

Unfortunately, the academic debate is at least partly misplaced for at least two reasons. First, the main focus of this literature is on whether a tax is borne by 'capital' or 'labour'. But this does not greatly help in considerations of fairness. The often unspoken assumption is that the owners of capital are wealthier or have higher income than the labour force or consumers. Consequently, the tax may be seen as progressive if it falls on capital, but not if it falls on labour. Although it may be true that owners of capital are on average better off than workers, that is unlikely to be true across the whole distribution. A key issue, which only recently has started to be addressed in the literature, is whether that part of the tax borne by labour affects those with higher earnings or lower earnings. In extreme, is the tax borne by the CEO or the cleaner?

A second issue is that the incidence of the tax should depend on market conditions. Consider two firms selling in different markets, for example. One faces a relatively elastic demand curve, and one faces a relatively inelastic demand curve. The latter should be able to raise prices further to accommodate the additional costs of a tax on profit. The owners of the former are likely to bear a higher share of the effective incidence. Therefore, we should not debate the incidence of tax on corporate profit but rather acknowledge that there must be a wide range of different outcomes depending on market conditions.

COMPARING INDIVIDUALS AND TAXES

However, even if we recognise the difficulties associated with identifying the effective incidence of a tax on corporate profit, two other issues arise.

6 For example, if opportunities for evasion differ across economic agents, see Kopczuk et al. [8]. See also Hansen et al. [9].

7 This is distinct from issues arising from the statutory incidence – for example, that third-party reporting helps in combatting evasion.

8 For just one example of the debate, see Larry Summers's comments on the claims made by Kevin Hassett, then Chairman of the Council of Economic Advisors: http://larrysummers.com/2017/10/17/doubt-any-republican-economists-will-associate-with-hassetts-analysis/#more-33807.

First, what weight should be given to different residents and citizens, possibly with different characteristics? The optimal tax literature uses the social welfare function approach, which aggregates the welfare of the relevant individuals (i.e., it takes into account the total welfare of all relevant individuals). This can be a very general approach.[9] For the analysis here, we are primarily concerned with horizontal equity: Are two individuals with similar characteristics – for example, the same income, but from different sources – treated equally? A complication in an international setting is how to account for the welfare of non-residents and non-citizens, who may bear some of the tax levied in a country. We return to this later.

Second, should a tax on corporate profit be divorced from other taxes? That is, do we need a tax on profit to be fair, or can we instead aim for the tax system as a whole to be fair? One example of this distinction is the case for an expenditure tax (and a cash-flow tax on business). In theory, this does not tax the normal return to saving and investment (i.e., the minimum return required by a saver or investor for a given level of risk), although it does tax economic rent (i.e., the return above the normal return). Arguably, this may be seen as unfair because capital income is not taxed. But that is only part of the story. We should also take into account taxes on wealth and on the transfers of wealth, including inheritance tax. That is, suppose that all expenditure – defined as all outgoings, of whatever form – were taxed. Would there also then be a need for taxing capital income?

INCIDENCE OF TAXES ON CORPORATE PROFIT

In any case, the starting point for identifying the fairness of a tax on corporate profit has to be understanding which individuals bear the tax. That depends both on the design of the tax – what exactly is the tax base – and the conditions in the set of markets in which the company operates.

To illustrate the difficulties, let us first consider two approaches that give opposite conclusions with respect to incidence.

First, consider a tax that falls only on economic rent. This is a well-known option, which could be achieved by a flow of funds (or cash-flow) tax [12], or by giving full relief for the opportunity costs of finance as well as for the true costs of depreciation [13]. Theoretically, a tax on pure economic rent would not affect prices in the markets in which the company operates. That is because assuming the company aims to maximise post-tax economic rent (in present value terms), the tax does not affect the choices made by the company; with a tax falling purely on economic rent, maximising post-tax economic rent is equivalent to maximising pre-tax economic rent. But if the tax does not affect any of the company's decisions, it will not impact on markets, will not change prices, and will not be passed on to workers, suppliers, or customers. As a result, the tax would be borne by the owners of the business. Note that in the context of a conventional source-based tax, there is no reason why these owners would necessarily be residents of the country levying the tax.[10]

Second, consider a tax on the normal profit earned by a company, levied by a small open economy[11] on profit earned in that country (the source country). Suppose that the supply of capital to the economy is perfectly mobile but that labour is immobile. In this case, the required post-tax rate of return for foreign investors would be fixed on world markets As a result, any source-based tax would instead need to raise the pre-tax rate of return in order to maintain the post-tax required rate of return. If the source-based tax were passed on to the investors, it would lower their post-tax return below the investors' required rate of return. Because they can earn this required rate of return in other countries, they would invest in the country only to the extent that the pre-tax rate of return was high enough to generate the required post-tax rate of return. Introducing a tax on profit earned in the sources country may therefore be expected to induce an outflow of capital. The higher pre-tax rate of return must also come at the expense

9 See, for example, the recent contribution of Saez and Stantcheva [11].

10 The situation would be different with VAT-style border adjustments to create a 'destination-based cash flow tax'. In this case, basic theory suggests that the national price level would adjust, with the incidence of the tax then falling on domestic consumption from economic rent. See Auerbach and Devereux [14].

11 In this context, most market-based economies with a liberal international trade and investment policy qualify as 'small open economies'. The United States and perhaps China would not be deemed 'small' in this context.

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of other economic actors; they are most likely to be domestic residents, such as the local labour force.[12] This case is, in effect, a simple example of the incidence depending on the elasticity of supply and demand. Here, it is assumed that the supply of investment funds is perfectly elastic (i.e., it will move to another country if the required rate of return cannot be earned in a country as a result of a tax being imposed by that country), with the implication that the incidence falls on the demand side of the market.

These two examples are constructed to give extreme results. The first depends on the nature of the tax base; a broader tax base would generally lead businesses to change their behaviour with consequent effects on the markets in which they operate, including passing on part of the effective incidence beyond the owners. The second depends on extreme assumptions about capital and labour mobility and elasticities. Yet the assumption of a perfectly elastic supply of investment funds is surely not a bad approximation for many, if not most, countries.

There is a significant body of empirical work investigating the incidence of a tax on corporate profit. The central problem in such an investigation is to estimate the counterfactual: what would prices, profits, and wages be in the absence of the tax? That is particularly difficult to estimate given that there are likely to be general equilibrium effects of any tax (i.e., that the imposition of a tax has direct effects on certain individuals, such as business owners, which in turn produce secondary and further indirect effects of their own on other individuals, such as workers), which in turn means that it is difficult to find a suitable control group unaffected by a tax reform. As a result, part of the literature is based on general equilibrium models.

One recent survey summarised the findings of the literature as follows: 'Most studies focus on the question of whether labour bears a significant share of the corporate tax burden and confirm that this is the case. The results suggest that wages decline by roughly 50 per cent of the additional corporate tax revenue raised. These effects can be observed in a time span of one to four years after the tax change' [16].

However, the studies the survey considers reflect a wide range of estimates. Some of these can be traced to underlying assumptions in general equilibrium models. For example, the survey notes that Gravelle and Smetters [17] assume domestic and foreign goods cannot easily be substituted. That limits the mobility of capital and results in an estimate that labour bears just 20% of the burden. This assumption is criticised elsewhere by Harberger [18], who finds that labour is likely to bear 100% of the tax. In a more recent paper, Suarez Serrato and Zidar [19] also study a model with imperfectly mobile firms and workers and find that firm owners bear around 40% of the incidence, whereas workers bear 30–35% and landowners 25–30%.

Recent studies have addressed more directly the progressivity of the tax. Fuest et al. [20] estimate the incidence of taxes on profit on wages in Germany. They find that workers bear about 50% of the incidence. Perhaps more important, they find that low-skilled, young, and female employees bear a larger share of the tax burden. By contrast, Nallareddy et al. [21] use variation across US states and find that corporate tax cuts lead to increases in income inequality. Specifically, they find that tax cuts increase income for both top and bottom earners. However, the gains for the former are more significant. These results are important for understanding the fairness of taxes on corporate profit; but they clearly indicate that as yet, there is no consensus in the academic literature.[13]

TAX ON CORPORATE PROFIT AS A BACKSTOP FOR PERSONAL INCOME TAX

The classic argument in favour of maintaining a tax on corporate profit is that it is a necessary backstop for personal income tax. In other words, a personal income tax system cannot be run effectively if a corporation tax is not run alongside it. There are two elements to this claim, reflecting different parts of the personal income tax.

The first is that it is difficult to distinguish the return to the labour input and capital input for a small, owner-managed company. Suppose there were no tax on corporate profit and also no tax levied at the individual level on accruals to profit earned by the company. Then the owner

12 For a thorough analysis of this model, see Gordon [15].

13 Political statements – such as that by the Biden Administration that 'the corporate income tax is one of the most progressive taxes in our tax system' [22] – should therefore be treated with caution.

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would have an incentive to incorporate the business and declare a disproportionate share of the return as profit rather than labour income. The profit may (or may not) be taxed when it is distributed to the owner/shareholder, but there would at least be gains from deferral. The case for a corporation tax is then that such a tax is easier to administer than a tax on accrued profit levied at the personal level (i.e., the tax earned by such a company is taxed at the personal level in the hands of the owner as it accrues). A drawback is that the tax rate applied cannot easily be adjusted in the light of other income received by the owner, so there may continue to be a difference in the marginal tax rate applied to labour and capital income.

The second case is similar, except that the comparison is with other forms of capital income. If there is a general presumption that capital income should be taxed, then that should include any profit accruing inside companies owned by an individual. This argument broadly assumes that other forms of capital income are indeed taxed (or at least should be taxed) at roughly comparable rates, regardless of the form the saving take. Such an assumption is rarely, if ever, justified in practice.[14] Nevertheless, there is clearly a case for taxing all forms of capital income at comparable rates, which would include a tax on profit earned by a company.

These arguments may seem to add up to a convincing case for taxing profit, even abstracting from the incidence of the tax. However, it is worth trying to be explicit about incidence in this context. The most natural argument is that it would be both fair and efficient if all forms of capital income were taxed at the same rate. That would apply if the pre-tax, risk-adjusted rate of return on all forms of investment were the same due to arbitrage possibilities.

However, in a more complex setting, applying the same rate of tax to all forms of saving may result in a difference in incidence among individuals that invest in different forms. Suppose that the demand for funds differs across different forms of saving and investment: compare, for example, investing in education to improve one's human capital with investing in a private company. If the rates of return on these two activities differed, and if the markets for funds for each of those activities differed, then it is unlikely the effective incidence of the tax would be the same, even if the tax rate applied was the same. The fairness case for applying the same rate of tax therefore has to depend on the incidence being only approximately similar across different forms of saving (and hence across different individuals).[15]

In any case, there is a significant drawback using a tax on corporate profit as a backstop to personal income tax. Such a tax on corporate profit may be reasonable if it is part of a system of taxes applying to the worldwide income of the owner. But it is much less reasonable if the tax on corporate profit is levied on a source basis, especially in a small open economy.

To see this, consider a world made up of many small open economies, with free trade and investment across all countries. Setting aside risk and taxes, there would be an equilibrium rate of return on savings and investment across the world as a whole; call this r. Now consider the case in which country A introduces a residence-based tax on the returns from such savings and investments. Assuming country A is small, such a tax would not affect r. The tax would therefore have to fall on resident savers, reducing their post-tax rate of return. By contrast, suppose that another country, B, introduces a source-based tax on profit earned on capital located within its jurisdiction. Again, r would not be affected. Instead, as noted above, the pre-tax rate of return in B would need to rise to maintain r as the post-source-based tax rate of return. In this case, the owner clearly does not bear the effective incidence because r is unaffected. As noted earlier it may be extreme to assume that capital is perfectly mobile. There may be many reasons why different forms of investment and capital may have more limited mobility – for example, the need to be close to raw materials, other producers, or markets. However, capital is clearly mobile in a different way from the residence of the investors.

The key issue here is the nature of the tax. If the tax on corporate profit is levied on a residence basis, then it may have similar incidence properties as other taxes on capital income, which are also generally (though not exclusively) levied on a residence basis. But if the tax on corporate

14 In most countries, there is a wide dispersion of effective tax rates across different forms of saving and investment. For example, saving through pension funds and owner-occupied housing is typically treated more favourably than other forms of saving. But here we are considering the normative case.

15 An alternative approach would perhaps be a Ramsey-style case for differential taxation to achieve an equitable outcome in the case in which individuals choose to invest in different assets, which have different demand elasticities.

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profit is levied on a source basis, it is likely to have a very different incidence. This does not invalidate the fairness case for a tax on corporate profit, based on it being a backstop to personal income tax. But in an international setting, with many small open economies, it does appear to seriously weaken the fairness case for a source-based tax on corporate profit.[16,17]

A further caveat here is that there may be multiple levels of taxation associated with capital income. For example, suppose that an investor saves in a pension fund, which invests the accumulating capital in corporate shares. Then there may be taxation at the level of the company, the pension fund, and the individual. The same issue arises if the investor simply deposits funds into a bank that lends to the same company. Then the taxation of the bank's profit also comes into consideration. The notion that different forms of saving should be treated equally should therefore be taken to reflect all elements of taxation on a particular form of saving and investment.

ALTERNATIVE TAXES

This raises the question of whether a reformed system of taxing corporate profit might be fairer. Two possibilities are worth briefly considering.

First, is it possible to tax corporate profit on the basis of the residence of the shareholders? This is likely to be extremely difficult in practice. For example, country A would need to identify and tax the profits of companies resident in country B, specifically the share of those profits attributable to each resident of A. Perhaps with continuing improvements in technology and information sharing, this may become possible in the future; it does not seem feasible now. Alternatively, country A could either tax the profit when it is distributed or impute an accrued income based on corporate valuations.[18] The case for doing so would need to balance the aim of improved fairness against other criteria such as the cost of implementation and administration and the likely impact on economic efficiency.

Second, in 2021, the G20/OECD's Inclusive Framework [26] agreed to implement a worldwide minimum tax of 15% on a form of corporate profit. The detail of the agreement is by no means straightforward to analyse,[19] but for current purposes, let us consider it as approximately a 15% minimum tax rate on profit earned worldwide, albeit still on a source basis. Let us set aside for the moment the issue as to which country receives the tax revenue.

At first sight, this does at least partly address the problems identified earlier, which arise if a single small, open economy introduces a tax on the returns to capital located there. In this case, let us assume that the agreement amounts to a 15% tax on the returns to capital wherever it is located, ignoring countries with a tax rate above 15%. That will clearly affect the equilibrium world rate of return, r. The incidence of this tax will therefore depend on the conditions found in the markets in which businesses operate, in a similar way to the position that would arise in a closed economy. It seems unlikely that the burden of this global tax will pass entirely onto the owners of the business, but that is also the case for other forms of taxation of capital income. It seems at least plausible that the incidence of the tax would be closer to the incidence of other forms of capital income taxation, certainly compared to a single source-based corporation tax.

However, the incidence of the global tax needs to be distinguished from the incidence of the tax levied in a specific small open economy. Suppose that the entire world, other than small open economy A, has a 15% tax on capital income. Conditional on that, if country A also introduces the same tax, then that would raise the rate of return required in investment in country A. In general, there would remain an incentive for country A to undercut the rest of

16 Note that in the case of deliberate evasion of personal taxes by rich individuals, who may use foreign-based companies to move and hide their wealth, reliance on source-based taxation is even less appropriate. We would distinguish this from avoidance by multinational companies that exploit the compromises of the existing system to make their profit appear in low-taxed jurisdictions.

17 Note in passing that these considerations also considerably weaken the case for integrating personal and corporate taxes on capital income within a country. See Devereux et al. [23] at p. 80–82.

18 Versions of the latter approach has been proposed. See, for example, Toder and Viard [24] and Grubert and Altshuler [25].

19 For further discussion, see Devereux, Vella, and Wardell-Burrus [27], which address several complications in the proposed tax. In particular, the agreement is for a minimum 15% tax on excess profit rather than all profit.

the world by having a lower tax and thereby encouraging greater inward investment. The G20/OECD proposal has several elements designed to remove this incentive.

B. FAIR DISTRIBUTION AMONGST COUNTRIES

We now turn to a different issue of fairness: Who benefits from the tax revenues collected? In principle, this question depends on the incidence of government spending, in much the same way that the fairness of who bears the tax depends on the incidence of the tax. However, the incidence of government spending depends on the nature of that spending, which is largely independent of the nature of the tax. We therefore limit ourselves to a more straightforward – though still challenging – question: How should the revenue derived from taxing international profit be shared amongst countries?[20] By presuming that government spending generally benefits its own residents, we can then infer at least a partial answer to the question of which individuals benefit from the use of the revenue.

In principle, in considering the taxation of multinational profit, the question of which country collects the tax is independent from the question of which country receives the revenue. For example, it is possible to envisage a UN agency collecting tax on profit worldwide, as well as the revenues being allocated to countries in a way that is completely independent of the location of the multinational itself. However, in practice, countries do not generally give away their tax revenues (and the UN does not collect taxes). We will therefore confine the discussion by assuming that the government that collects the tax keeps the tax revenue.

When corporate profit arises from cross-border activity two or more countries may have a claim to tax it. A basic function of the international tax system is to co-ordinate the exercise of these claims, or rights; this is often referred to in the literature as 'allocating taxing rights'.[21] Very broadly, taxing rights over the profit of a multinational could be allocated to countries in one of four locations: (1) the residence of the ultimate individual shareholders (or possibly an intermediary mutual fund); (2) the residence of the ultimate parent company; (3) the location in which the business' functions and activities take place, including for example, management, production, purchasing, marketing, financial management, advertising, and many other aspects of the business; and (4) where sales are made to third-party customers. The issue here is whether notions of fairness can guide the appropriate allocation of taxing rights over corporate profit to countries in one or more of these locations.

Claims that the current allocation of taxing rights amongst governments is unfair have been influential in leading to agreement over fundamental reforms to the international tax system in 2021 (OECD/G20 [26]). In part, this is due to concerns of profit shifting by multinationals. But concerns have also been raised about the reliance of the existing system on physical presence, something that seems less appropriate in a digital age.

In the previous section, we discussed the rationale for a tax on corporate profit as a backstop to the personal income tax. In general, although not exclusively, capital income is taxable in the place of residence of the recipient, irrespective of where the income is generated. Under this rationale, then, corporate profit should in principle be allocated to the ultimate shareholders and taxed by the government of the country in which shareholders are resident. Earlier, we concluded that such a system seems unworkable at present.

Beyond that, the existing system seems in search of a different rationale. In the political debate as well as in academic writing, fairness has instead been linked with concepts such as the 'value creation principle',[22] which stipulates that profit should be taxed in countries where value is created, although most advocates of this principle argue that for these purposes value is

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20 Much of the public and political debate on international corporate taxation focuses on fairness, and there is a growing academic literature pursuing this angle. See, for example, Stark [28], Christians and van Apeldoorn [29], Hongler [30], and Stewart [31]. There is much to be said about the fairness of the institutional architecture and processes used to develop international corporate tax norms and law – see, for example, Brauner [32, 33], Oei [34], and Hearson [35] – but this section focuses on substantive fairness.

21 On the basic structure of the international tax system, see Devereux et al. [23], chapter 3.

22 The authors have previously outlined a number of reasons to doubt the coherence and usefulness of the notion of value creation; see Devereux and Vella [36, 37]. For a more positive view regarding whether value creation see Langbein and Fuss [38] and Petruzzi et al [39]. On value creation more generally, see the contributions in Haslehner and Lamensch [40].

deemed to be created by supply, rather than demand side activities (i.e., activities involved in the creation of goods or services rather than their sale).[23] This is a rather odd view of value creation from an economic perspective.

This concept of value creation appears to have some popular appeal, though we find it hard to see why. In practice, it is virtually impossible to identify where value is created. Many factors contribute to the generation of a multinational's profit, including its shareholders, its functions and activities (e.g., management, R&D, production, sales and marketing), and its customers, and these may be spread in countries across the globe. The digitalisation of the economy has made identifying where value is created even harder [42]. But even if it were possible to identify precisely where value is created and how much value is created in each location, it is not at all clear why an allocation of taxing rights based on this would be fair. It is not necessarily the country in which the recipients of the profit reside, nor necessarily where the majority of the labour force are employed, nor where the customers who are paying for, and consuming, the product reside. However, in principle, it might be a country in which the inventor of an extremely valuable patent happened to be passing through on the day on which she had the idea for the patent. It is hard to justify such an allocation on the basis of fairness.

Another option would be to base taxing rights on the 'benefit principle',[24] which can be interpreted in this setting as justifying an allocation of taxing rights in proportion to the value received by the multinational company from the public goods and services provided by the countries in which the multinational operates. However, in practical terms, this could be as difficult to implement as the value-creation principle. In principle, it would require an analysis of the incidence of the benefits of publicly provided goods and services. Leaving these immense practical difficulties to one side, optimal tax theory has generally not favoured the notion of the benefit principle. Instead, it has relied on a more general social welfare approach, although Weinzierl [48] makes a case on the grounds of adapting the classic approach of Mirrlees [3] by making individual ability a function of the use of public goods.

The social welfare function approach could, in principle, incorporate various preferences about the distribution of post-tax incomes and wealth. In this spirit, another view of fairness in the allocation of taxing rights is that lower income countries should be favoured. This also presents both theoretical and practical challenges. Political philosophers and others involved in the debate disagree on the demands of international distributive justice, including whether justice demands redistribution within or across countries.[25] But even if there was a theoretical consensus that supported redistribution from rich to poor countries, it is not clear why this would be best achieved by a reallocation of taxing rights over corporate profit towards lower income countries. The provision of aid to low-income countries could be achieved in a more straightforward and transparent manner, such as through direct transfers between states. Indeed, rather than reallocating taxing rights over corporate profit to provide aid, countries that impose and collect the corporation tax could pass on the revenue collected[26] through direct transfers.[27] Although direct transfers between states face a number of challenges [51], one is hard-pressed to find a more complex and less transparent instrument to provide aid than the corporation tax [52].

Location-specific rent arising from the exploitation of natural resources may be thought to constitute a special case. It appears natural that these resources should benefit the residents of the particular country where they are found, and therefore, a potentially stronger fairness-based case may be made to allocate taxing rights over such rent to the country where the natural resources are found. But even this case is not straightforward. The rent earned from

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23 See, for example, HM Treasury [41].

24 See, for example, Vogel [43, 44, 45]. More generally on this principle, see Schön [46, 47].

25 A range of views are held, but we here only note two important but diverging views: 'statist' and 'cosmopolitan'. The former view is that justice only requires redistribution within a country but not across countries, the latter view is that justice does indeed require redistribution across countries. See Dagan [49], Stark [28], and Stewart [31], and the citations therein to the literature on this topic.

26 The properties of a tax are determined by which countries impose the charge and collect the tax. They are not determined by which countries ultimately receive the revenues collected.

27 The recent proposal by Kane and Kern [50] appears to us to move towards this approach.

the exploitation of natural resources may also partly depend on factors in other countries,[28] including, for example, the demand for these resources.

C. CONCLUSIONS

The discussion in this paper has perhaps raised more questions than answers.

A central issue is that notions of fairness require making inter-personal comparisons. To make sense of any argument for the fairness of a tax on corporate profit, it is necessary to look through the company to investigate which individuals are likely to be worse off because of the tax. Only then can we deploy philosophical arguments as to how the overall burden should be allocated amongst individuals. Because there is currently no real consensus on the incidence of the tax, it is perhaps premature to jump into the philosophy.

The international dimension raises issues about inter-personal comparisons amongst people resident in different countries, which further complicates the philosophical argument. But in some ways, it simplifies the analysis of economic incidence, because in an international setting, small open economies cannot affect world rates of return. It then becomes clear that, for example, to the extent that a corporation tax is seen as a backstop for personal income tax, a source-based corporation tax is a poor proxy for a residence-based personal income tax.

Coordination of the rights amongst governments to impose such a tax is no more straightforward. The political debate tends to be around whether the existing system creates a fair allocation of taxing rights, or whether the current allocation could be improved in favour of lower income countries. But critics who would prefer the system to favour lower income countries must justify why taxes on corporate profit are the most appropriate way to transfer income and wealth across countries.

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COMPETING INTERESTS

The authors have no competing interests to declare.

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28 On this point, see Devereux et al. [23] at p. 39 and 74–75, as well as Kane and Kern [53].

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