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Corporate tax should be fair and shared



By John Kay

It is not difficult to understand why mere mortals are angry

Many multinational companies that appear to be operating successfully in Britain pay little or no corporation tax in this country. It is not difficult to understand why ordinary people on wages and salaries, and small British companies that pay tax at the normal rate on their profits, are angry. The origin of the problem is simpler to describe than to address. If a business operates in many countries, and makes a profit, in which country is the profit earned?

One answer is that the profit belongs to the country from which the business is managed, or controlled, or headquartered. This was a natural principle before multinational operations became as common as they are today, and vestiges of that approach are still to be found in the tax systems of most countries.

That rule could not and does not work very well, however. If a business makes money around the world, countries around the world will want to tax it. It is hard to identify the place where a company is controlled or managed or headquartered. It is often easy to shift that location if the effect is to reduce the corporate tax bill.

That would matter less if all countries taxed profits in the same way and at the same rate. But they don't. Even in an enlightened, co-operative world, different countries would choose to tax companies at different rates. There is an argument that low rates of corporation tax are one enticement a business friendly government can use to attract economic activity from other jurisdictions, and that such tax competition is beneficial. I am not sure this argument is very strong – the outcome is a beggar-my-neighbour process in which the winning country's gain is necessarily smaller than its rival's loss.

In any event, however, this is not the principal form of tax competition that actually takes place. The competition is less to attract business activity than to attract tax revenue. Ireland accounts for a share of global profit disproportionate to the size of the Irish economy. Not because business in Ireland is particularly successful but because reporting profits in Ireland is particularly attractive, since the standard rate of corporation tax is 12.5 per cent. Intriguingly, the consequent overstatement of Ireland's rate of economic growth contributed to the hubris of Ireland's era as the Celtic tiger.

Ireland is, however, a genuinely productive economy. The apotheosis of the problem of matching taxable capacity to jurisdiction is the haven in which profits are earned but no real economic activity takes place. These havens do not even have to be agreeable islands (although they mostly are); Scotch whisky brands, for instance, are "owned" by entities based in the Netherlands.

The states of America quickly experienced the problems encountered in a highly integrated economy with many different tax collectors. Many states dealt with the issue through profit apportionment. Instead of attempting to estimate what fraction of a company's total profit was earned in California and what amount in Wyoming, apportionment states taxed corporations on a share of their aggregate US profits corresponding to the share of their total US activity that took place in the state. The most common basis of apportionment is the "Massachusetts formula", which gives equal weight to sales, payroll and assets.

Some states, notoriously California, attempted to apply this principle on a global basis. Through more than a decade of aggressive lobbying by British multinationals, this arcane issue became a major cause of friction in Anglo-American relations. In the mid 1980s, the British claimed victory and the US agreed to limit apportionment to its own frontiers.

However, the battle that Queen Elizabeth's Conservative government won had little more legitimacy than the battle that King George's forces lost to America two centuries earlier. Well conceived apportionment is the best – perhaps only – answer to the problem presented by multiple company tax jurisdictions.

The analogy between the US and the EU is obvious. And while countries might pursue apportionment unilaterally, a global agreement would be far preferable. Not just to protect revenue. The repeated revelations that many major companies pay little or no tax, even if they do so by legal means, fuels a public sense that tax is mainly for little people. We need only look at Greece to see how socially, politically and economically corrosive that perception can be.

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