Why Ireland and developing countries should have a low corporate tax rate [1]

Written by **Tim Worstall** [2] | Saturday 25 May 2013

As you know there's much ventilating going on about corporate tax rates about the place. Special venom is reserved for Ireland's low rate and various development charities are turning the air blue with complaints about taxes in the developing countries. The thing is though, a small and open economy like Ireland should have a low corporation tax rate: and developing countries should probably have one of zero.

The reason is that thing called tax incidence. Companies don't pay corporation tax: it's some combination of the shareholders and the workers who do. This is not a point in argument: the only argument is about what the portions are, not the fact that the burden falls upon these two groups. We also know what it is that influences which group: it's how large the economy is in relation to the world economy and how open it is to capital movement. The smaller and more mobile, the more the workers get it in the neck.

The mechanism is simple enough. It's pretty much straight from Adam Smith in fact. There's an average rate of return to capital: a jurisdiction that taxes that return to capital will have a return lower than that global average. So, some domestic capital will flow out seeking the higher foreign returns, some foreign capital will not flow in for the lower domestic ones. There's thus less capital employed in the economy. Adding capital to labour is what drives up the productivity of labour: the average wages in a country are determined by the average productivity in that economy. So, tax companies, get less capital employed, wages are lower than they otherwise would be. The workers are bearing part of the burden.

As I say, the smaller the economy and the more open it is then the more of that burden is upon the workers. And in a wonderful result back in 1980 Joe Stiglitz showed that the burden upon the workers can actually be more than 100%. That is, the workers lose more in wages than the government gets in tax.

Ireland's a small economy, 3.5 million people or so and as it's in the EU has about as close to perfect capital mobility as it is possible to get. Thus it ought to have a lower corporation tax rate than larger economies. And it does, so that's just fine then. Attempts to push it up (as various EU types are currently muttering) would simply lower wages in that country.

And the effect is even greater in developing economies. By definition they're small economies: that's why we call them developing because they haven't developed a large economy yet. And the current rows about tax rates in them are all about foreign investment: so obviously we're talking about mobile capital here. And it's entirely possible that for some (actually, for the smallest, it's certain) that the burden on the workers' wages is more than 100% of the tax being raised. All of which makes Christian Aid's wafflings [3] about tax avoidance and evasion very interesting indeed. Given that it is the workers, those poorest of the poor, who are bearing the burden of corporation tax in such places then a charity committed to improving the condition of the poorest of the poor would be arguing for zero coroporation tax rates in such places.

Unless, of course, they were simply ignorant of the basics about tax incidence. But that couldn't be possible, could it? No one who is ignorant of a subject would be campaigning on it, would they?

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