In recent years, the increased integration of national economies has made it more difficult to separate out domestic and international tax issues. Business increasingly is conducted on a global basis and non-tax barriers to the free movement of capital have largely been removed. The combination of these two trends in the world economy has led to concerns that differences in national tax regimes could become more important in determining corporate investment decisions. If investment does become more sensitive to tax differentials, governments will be under continuing pressure to reform their tax regimes to preserve their tax base and to maintain their competitiveness.

A recently published OECD report, "Taxing Profits in a Global Economy", analyses these issues and examines the ways in which corporate taxes may distort business behaviour. It also discusses whether corporate taxes form a barrier to a more efficient international allocation of investment. The report is likely to shape corporate tax policies over the coming decade.

The main policy issues addressed are: do corporate tax systems encourage incorporation? Do they affect the level of savings and investment in the national economy? How do they influence the financing decisions of enterprises? How can an even tax treatment of domestic and international investment be achieved? What is the most appropriate way to tax foreign source income? How should the revenues from cross-border investments be shared between the source and residence country?

The report makes three substantial contributions in discussing these questions. First, it describes the current tax regimes within a common framework and recent changes thereto (see Table 1). The schedule corporate tax rates as of 1991 are presented in Table 2. The second -- and perhaps the most important -- contribution to this debate is the calculation of "Marginal Effective Tax Rates" (METR) on new domestic investment and the rate of return which a company must earn on a new investment in order to be able to pay the ultimate financiers of the company a reasonable return on their capital after corporate and personal taxes. This approach is then extended to consider the case of a subsidiary in one country which is owned and financed by a parent resident in another country in order to identify the effective tax rates on transnational investment.
Table 3 shows the results of one set of METR calculations undertaken in the publication. The question that the tables address is: what is the pre-tax rate of return (i.e. before paying the corporate and personal income tax on profits) required to give the domestic investor a 5 per cent real rate of return after tax? For example, in the Netherlands a company undertaking a typical marginal investment financed by retained earnings must earn a pre-tax rate of return of 7.1% to give the investor a 5% after-tax rate of return. Where the figures in Table 3 are less than 5%, this shows that the tax system is providing an effective subsidy to marginal investments.

The third contribution of the report is to consider the domestic and international effects of different corporate tax systems on company behaviour, both theoretically and with reference to the actual policy choices made by national governments. Several conclusions result from the analysis. On domestic issues, the desirability of integrating the personal and corporate tax systems (what public finance experts refer to as the economic double taxation of dividends which arises because distributed profits are taxed at both the corporate level and in the hands of the shareholder) is still the subject of much debate and there is no clear global trend towards or away from integration. Debt finance is usually favoured over equity finance, which may make companies more vulnerable to fluctuations in external economic conditions. On average, the potential tax burden on direct investment flows from one country to another is generally higher than on purely domestic investment, mainly because of the operation of withholding taxes. In addition there is substantial variation in the tax burdens according to the country where a company invests and the effective tax rate on investments in a particular country varies according to the residence of the parent. Both the difference in taxes on domestic and transnational investment and the variation in tax burdens as between countries are reduced by the existing network of tax treaties for the avoidance of international double taxation. One conclusion of the report is that further reductions in the relatively adverse treatment of transnational investment could be achieved by reducing withholding taxes on dividends and interest paid to non-resident corporations.

Journalists may obtain a copy of the report from the OECD Press Division, 2 rue André Pascal, 75775 Paris cedex 16 (tel. 45 24 80 88 or 80 89).