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Corporate tax escape trick is set to backfire

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INSIGHT

It is a feat worthy of Houdini. Even as public debts mount, the world's corporations have managed to break free from the grip of austerity.

Households are putting up with higher taxes and low wage increases yet non-financial businesses are contributing relatively little to the cost of repairing the damage caused by the credit crisis.

In the US, for instance, employee earnings have risen just 4 per cent in real terms over the past five years while personal taxation, relative to GDP, has climbed from 8 per cent in 2010 to 10 per cent. By contrast, corporate earnings have doubled since 2009 as lower taxes and labour costs have boosted net profit margins to record levels.

The imbalance is proving difficult for policy makers to defend. Challenges to the status quo are growing and, once the tide turns, corporate profitability could suffer.

A glance at taxation trends reveals how far companies have been shielded from austerity.

International Monetary Fund data show that while personal taxes have risen in most large advanced and emerging economies since 2010, corporate rates have moved in the opposite direction. Consumption taxes were raised in 19 countries but reduced in just one while more than twice as many nations (17) raised income taxes than cut them (eight). Set against this, only seven nations raised corporation taxes compared with 12 that reduced them.

Widening gap

The gap between business and personal taxes has widened further thanks to countless corporate tax loopholes. Contrary to the impression left by Pfizer's attempted takeover of AstraZeneca, US companies have been adept at keeping tax burdens low. The effective US corporate tax rate – the amount of tax actually paid – has been falling since the 1950s. Currently at 21 per cent, it sits 18 percentage points below the statutory rate.

But the problem of low tax rates extends beyond the US. A 2013 report commissioned by the G20 group of nations found that some of the world's largest corporations pay as little as 5 per cent tax.

The disparity is beginning to unsettle tax authorities. Leading calls for business tax reform has been the OECD. With the backing of the G20, it has set out detailed proposals to stem tax avoidance.

These include requirements for online multinationals with large distribution facilities outside their home countries to pay local taxes on profits made there. Multinationals will also be forced to disclose aggressive tax management structures to the relevant authorities. Moreover, the OECD is proposing broader measures to combat global tax competition, under which countries attempt to outdo one another in lowering business rates.

If successful, the OECD-led move should narrow the gap between statutory and effective corporate tax rates worldwide. While this should be welcomed by investors as it would make taxation more transparent and less complex, it would almost certainly have negative implications for corporate earnings prospects.

On this front, US companies look particularly vulnerable. That is because approximately 80 per cent of the earnings growth they have delivered since 2009 has come courtesy of higher net profit margins.

Cut to profit growth

According to our calculations, if the US effective corporate tax rate increases from 21 per cent to its 10-year average of 24 per cent in the next five years, this would reduce profit margins – currently at about 8 per cent – by up to half a percentage point. This would, in turn, cut profit growth by some 1 per cent a year. Other regions should see similar trends.

But shifting the burden of austerity from individuals to businesses is unlikely to stop at tax. With median wages in advanced economies having barely grown in real terms over the past several years, governments are facing pressure to reverse that trend.

Some have responded by intervening in the labour market. The UK has approved an above-inflation rise of 3 per cent in the minimum wage and has signalled a further increase to £7.00 an hour by 2015. Similar proposals have been made in the US. In Germany, meanwhile, a national minimum wage of €8.50 an hour will be introduced next year.

Such moves could bring an end to a 10-year decline in real earnings; they may also lead to significant increases in companies' labour costs.

The next five years, then, are likely to see companies faced with a more demanding environment. Their profits will be taxed more aggressively while government efforts to boost incomes can be expected to increase labour costs. Business conditions are about to become harsher. There will be no escaping that.

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