THE EFFECT OF TAXATION ON CORPORATIONS IN THE OECD COUNTRIES

Bachelor Thesis
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Abstract

This literature review answers the question: what is the effect of taxation on corporations in the OECD countries? Theoretical background is based on public economics and, in more detail, corporate taxation. I analyze how corporations are taxed and how the previous literature covers the topic. Through this comprehensive literature review, I will show the research results that taxes have on business decisions in operations and financing, foreign investments, and corporations’ international competitiveness. Finally, I will cover the main challenges related to corporate taxation: profit shifting, cross-border transactions, transfer pricing, tax avoidance, and fiscal adjustments. As a result, corporate taxation may reduce entrepreneurial innovation and investments, decrease the number of new business operations, encourage relocating local operations internationally, affect corporations’ financing and business operations decisions, and affect foreign investment decisions. The results are consistent with the knowledge that taxation significantly affects corporations and their efficient outcomes.

Key words: Corporate taxes; Multinational Enterprises; Transfer pricing; Foreign Direct Investment; Tax competition
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1. Introduction and motivation

This study aims to evaluate the effects that taxation has on corporations. The research question is:

What is the effect of taxation on corporations in the OECD countries?

The hypothesis is that tax changes impact corporate investments and capital expenditure, profitability, business expansion, international competitiveness, and innovation. Therefore, tax cuts would increase overall output and welfare since individuals pay corporate taxes after all.

This paper is a literature review that examines the connection between corporate output and taxation and adds to the discussion by including the latest trends of challenges created by globalization and how multinational enterprises work. This literature review focuses on Organization for Economic Cooperation and Development (OECD) countries. The OECD countries include 38 countries, which work towards addressing the policy challenges of our time, and one of the four key initiatives is to find solutions to avoid tax avoidance (OECD, 17.8.2023). Also, there is a specific need to understand in detail Multinational Enterprises (MNE) that transfer from one national setting to another (Kogut, 2001) due to the importance of international business operations to this literature review. Yearly focus starts from the 1990’s, and the most recent publications include research articles from 2023. A few examples used in the literature review include the United States and Finland policies. As a limitation of this literature review, this study will underline that taxing corporations is globally dependent on developing countries. Therefore, this narrow literature review and this approach have some limitations.

From the theoretical background, this Bachelor Thesis focuses on public economics, in which public economics "is the study of economic efficiency, distribution, and government economic policy" (Hindriks & Myles, 2013, p. 3). To summarize, public economics studies the relationship between the government and the economy. Like other economic entities, the government has both expenditure and revenue streams. This literature review focuses on the corporate taxes that create tax revenues for governments across the OECD member states.
The literature review starts with defining corporate taxation and then deepening the understanding of the trends between the 1990s and the beginning of 2020 (Chapter 2). After that, the focus is on understanding the effect of taxes on corporations through operative and financing decisions, foreign direct investments, and international competitiveness (Chapter 3). Then, the literature review focuses on the main challenges of taxing corporations, such as profit shifting, tax avoidance, and fiscal shocks and adjustments (Chapter 4). Finally, the literature review ends with conclusions (Chapter 5). References are at the end of the paper (Chapter 6.)

The importance of this paper underlies in deepening the understanding of economists and policymakers who contribute to the decisions related to corporate taxes: What could they learn from making the decisions related to taxes? How can we increase the government's overall tax revenue rather than focusing on optimizing the highest tax percentage? Furthermore, how do we avoid jumping into every obstacle that the dynamically changing world creates for multinational enterprises?

2. Corporate taxation and the trends between the 1990s to 2023

2.1. The reason behind corporate taxes

As this paper focuses on the effects tax changes have on corporations, it is crucial to define what corporation means. The definition of a corporation was first defined for lawyers at the beginning of the 19th century by Chief Justice John Marshall (1819) and later by Robert Hessen (1979), who brought up the importance of limited liability as a crucial corporate feature (Econlib, 8.8.2023). Limited liability means that the shareholders may only lose the amount of money they have invested in the corporation and not, for example, an attempt to recover their losses such as creditors. In this paper, the literature review relies on the definition of a corporation as a legal entity that is “separate and distinct from its owners” and has limited liabilities for stakeholders (Investopedia, 7.8.2023). In the parts identifying the opportunities and challenges of the global economy, the Multinational Enterprise (MNE) refers to a corporation as an organizational form by which the knowledge of how to coordinate and organize work is transferred from one national setting to another (Kogut,
The latter definition has a significant role when considering foreign direct investments and profit shifting.

Governments have different revenue streams, such as corporate and personal income taxes, value-added taxes (VAT), property taxes, and customs and import duties. This study focuses on corporations; therefore, it is necessary to understand the role taxing of profits has on governments. Governments tax corporations using corporate taxes (Gruber, J., 2011). According to OECD Corporate Tax Statistics published in November 2022, corporate taxes are a vital government revenue source. The corporate tax revenues as a percentage of total tax revenues in 2019 accounted for the OECD average of 9.6%, Latin America and Caribbean 15.8%, Asia and Pacific 18.2%, and Africa 18.8%. The data shows that corporate tax revenue is the most critical source for developing and emerging economies and a significant revenue stream for all governments. (Corporate Tax Statistics, 2022) Corporate taxes are essential in generating social welfare and enabling welfare states.

Taxing corporations may be the only way to ensure that corporations create revenues for governments (Gruber, J., 2011). Historically, taxing corporations rather than individuals has been convenient due to the lack of individual accounting. Also, as the corporations earn pure profits, meaning they exceed payouts to their production factors, it is better to tax profits rather than factors of production (Diamond & Mirlees, 1971) since it does not distort the decision-making process of the producer. Due to globalization, taxing corporations enables governments to tax foreign shareholders, disabling capital outflows from the producing country. There has also been an ongoing discussion related to corporate tax integration. It means that the corporate tax is removed and replaced by shareholder taxes. (Gruber, J., 2011). However, suppose the government only relies on individual taxation. In that case, it reduces its total tax revenues and makes it beneficial for corporations not to pay for their shareholders, thus making the government revenue streams vanish. Therefore, we need corporate taxes to finance government operations.

Governments balance raising tax revenues and incentivizing investments (Mongrain S. et al., 2023). The Corporate Tax Statistics data shows that governments have lowered the tax revenue as a percentage of total taxation during the past few decades to accelerate economic recovery. To compare the United States and Finland to the OECD average, the tax revenue as a percentage of total taxation was significantly lower in the 2000s. The result may imply
that the governments have lowered their tax rates to increase global competitiveness. Also, there are likely some policy shifts in Finland, approximately in the 2000s, and the United States in 2005 and 2006, as the corporate tax was relatively lower after these periods.

However, as corporate tax revenues only measure the total of tax revenues shared on tax revenues or GDP, statutory income tax measures the marginal tax of an additional income unit. Statutory income tax, therefore, helps to compare different jurisdictions over time – and helps to identify incentives that firms might have to benefit from tax regulations in different jurisdictions. The statutory income tax also shows a declining global trend across all regions. In the past 20 years, across all the regions, the statutory corporate tax rate was more significant than or equal to 20.0%, which was 85.0% in the OECD countries in 2000, 67.0% in 2010, and 60.0% in 2020. Higher statutory tax rates are now lower than before. The statutory corporate tax rate in Finland during the selected period was 20.0%, and in the United States, 21.0%, which is lower than in the OECD countries overall. (Corporate Tax Statistics, 2022) Therefore, the statutory tax rate and tax revenue as a percentage of total taxation show declining trends.

The Corporate Tax Statistics data shows that governments have used taxing during the past few decades to accelerate economic recovery and increase global competitiveness. However, in the past few years, the corporate income tax rates have stabilized, likely due to fiscal challenges caused by the COVID-19 pandemic.
2.2. The trends between the 1990s and 2023

Corporate taxation is the subject of extensive research and policy evolution over the past few decades. This journey is divided into several key phases.

In the 1990s and 2000, many countries reduced their corporate tax rates to accelerate economic growth and attract foreign investments. Scholars such as Devereux et al. (1994), Kirchgässner (1996), and Haufler (1999) thoroughly studied corporate tax asymmetries and harmonization in the EU, investments, and tax competition between different jurisdictions. As many corporations aimed to minimize their tax liabilities by shifting between low-tax and high-tax jurisdictions, the OECD took a proactive approach by instituting the Harmful Tax Competition project to address problems such as tax avoidance through tax havens and transparency between the tax jurisdictions of OECD countries and developing countries. The OECD made recommendations to policymakers to reduce harmful tax competition. (OECD,
Harmful Tax Competition, 1998). The most important recommendations include plans to require multinational enterprises to provide detailed information on their global operations to improve country-by-country reporting, exchanging information on tax regulations, and strengthening foreign company rules to prevent shifting income to low-tax jurisdictions as well as limitation for aggressive tax planning such as implementing transfer pricing rules. The trend of foreign direct investments remains relevant due to the digitalization in the global markets.

Almost a decade later, scholars such as Hassett (2002), Hines (2007), Arena and Kutner (2015), Gu (2017), as well as Albertus et al. (2022) study the world tax system and the impact taxing has on corporate policies of foreign investments. These studies focus on the relationship between corporate decisions regarding foreign investments in the evolving taxing landscape. Foreign direct investments are affected by national and international tax policies and economic growth or slowdowns, which affect corporate decisions. For example, different jurisdictions choose to tax global income, as others operate by taxing income generated within the country, which affects the attractiveness of different jurisdictions to the corporations.

Further, in the 2000s, Base Erosion and Profit Shifting (BEBS) gained attention, and this trend continued until the 2010s, as corporations used international tax rules to minimize their corporate tax obligations. Due to this, research further intensified the need for tax reform. In 2013, the OECD implemented Pillar One and Pillar Two action plans to reform international tax rules and reduce aggressive tax planning. One of the notable discussions around Pillar Two included ongoing discussion regarding global minimum taxation, in which the initiative is to tax multinational enterprises to a minimum level of tax regardless of the jurisdiction in which they operate. However, this proposition is yet to be implemented and could cause significant changes in international tax competition in the upcoming years. Furthermore, the newest academic studies on the topic aim to understand the tax competition in the presence of profit shifting (Mongrain et al., 2023) and the impact that the international tax reforms under Pillar One and Pillar Two have (Hanappi & Cabral, 2022). These studies provide valuable insight to policymakers and decision-makers to address the evolving landscape of corporate operations and taxation.
In early 2020, the discussion regarding taxation focused on tax reforms, which aim to tackle challenges created by the digital economy. In some countries, for example, the United States, the Tax Cuts and Jobs Acts in 2017 implemented corporate tax reforms to reduce tax evasion and encourage repatriation of profits. Due to the change, the corporate income tax rate decreased from 35% to 21% (Tax Foundation, 2018).

As the 2020 decade unfolds, we will know the focus of corporate taxation research. The topic is highly relevant and timely and will need further research in the upcoming years to deepen our understanding and to adapt to the changing landscape of corporate taxation.

3. Effects of taxes on corporations

In this chapter, the aim is to answer the question, what are the effects of taxing on corporations to operations and investment financing as well as foreign investments and international competitiveness. The effects of taxes on corporations have been studied by many, but the most recent and relevant research to answer the research question includes research articles from Djankov et al. (2010), Knoll (2021), Schröder & Sørensen (2022).

3.1. Business decisions in operations and financing

A country’s tax revenue depends on the operative decisions that the corporations make, as the corporations seek the most efficient way to operate and finance investments. For example, corporations make daily decisions related to the location of their operations as well as how to finance them. There has been a wide range of studies, such as Knoll (2021), Aghion (2016), and Djankov et al. (2010) who have addressed the topic of business operative decisions, where Djankov et al. (2010) and Gruber (2011) have focused on the studies related to financing business operations.

Corporation taxation plays a pivotal role in influencing the location of business operations. As highlighted by studies from Knoll et al. (2021) and Schröder and Sørensen (2022), corporations make strategic decisions based on tax incentives, often leading to relocations of business operations — and influencing the tax revenues of different jurisdictions as well as the structure of industries in different jurisdictions. Also, relocating business operations may benefit other countries at the expense of the domestic market and its economy (Knoll
et al., 2021). Therefore, by implementing taxation changes, jurisdictions can lure different industries to operate in certain jurisdictions.

Also, corporations relocate their research and development activities (Knoll et al., 2021) and run down their manufacturing investments (Djankov et al., 2010) to gain tax benefits. The tax incentive effect is enormous, especially for large and geographically close firms (Knoll et al., 2021). Corporations may scale down or reconsider their manufacturing operations in response to changing tax environments since manufacturing operations are often done in developing countries where the cost of production is significantly lower than locally. Reducing the cost-benefit may lead to reconsiderations. However, this effect is insignificant in producing services because the likely consumption is local. To conclude, scholars such as Aghion have even concluded that corporate taxation reduces entrepreneurial innovation and discourages investments that aim for growth in corporations (Aghion P. et al., 2016). All in all, corporate taxation is a tool that influences the strategic decisions of corporate decision-makers, including the operational locations and investment priorities.

As an intriguing fact, corporations also decide to work officially or unofficially. An increase in tax rates lures corporations to work unofficially. For example, by increasing the first-year effective tax rate by 10%-points, informal economic activity increased by 2%-points (Djankov et al., 2010). Similar results apply to Aghion et al. (2016), studying the effects of corruption on optimal tax rates. Therefore, increasing corporate taxation causes different operative planning. It influences corporations' location preferences, and in the worst-case scenario, high corporate taxes incentivize firms to work unofficially – all of which cause government tax revenues to diminish.

Another business decision that corporations make is related to financing their operations. Corporations can use retained earnings, debt, or equity to finance their investments. In equity financing, the capital can be either paid back to the shareholders in dividends or reinvested to increase the capital stock. Corporations' financing decision for new investments is not detached from taxation. Investment financing through debt does save corporation taxation of earnings. However, debt comes with requirements such as fixed payments, whereas equities do not - and this creates conflict – do the benefits from equity financing exceed the taxation benefits that the corporation acquires through debt financing?
Also, the banks apply this by charging higher interest rates to corporations with a more significant share of the debt. (Gruber, J., 2011)

To further understand the financing of investments, Djankov et al. (2010) study found “a large and significant positive association between the effective corporate tax rate and the aggregate debt-to-equity ratio”, which confirms that the corporate tax encourages debt as opposed to equity financing (Djankov et al., 2010). Financing decisions are affected but are heavily reliant on the corporation’s situation. Also, Hines J. (2007) states that in high-tax countries, foreign affiliates are financed by debt, and in low-tax countries, equity, and therefore, the income is accumulated in low-tax countries (Hines, 2007). Also, investment decisions are sensitive to tax incentives. For example, suppose taxes lower the cost of investment by 10%. In that case, it increases investments by 5% even though the statutory corporate tax rate includes treatment of depreciation, investment tax credits, and investment financing (Gruber, 2011). Tax policies impact corporations' business decisions in financing, domestic and international expansion plans, and how the corporation organizes its operations.

In conclusion, corporations make decisions influenced by taxation – whether it is the location of business operations or financing their investments. Therefore, countries and their policymakers need to find a balance between revenue generation and implementing a nourishing environment for business operations to thrive. After all, corporate decision-makers will choose the most efficient way to operate.

### 3.2. Foreign investments and international competitiveness

The importance of foreign investments and a country's ability to succeed in international competition plays a more prominent role now in the globalized world. Hindriks summarized that the taxation of capital has faced powerful implications due to globalization, as the mobility of capital has increased tax competition between different jurisdictions (Hindriks & Myles, 2013). Therefore, understanding helps the policymakers and decision-makers to make decisions to cope with the competition.

Based on the OECD data and the study from Hines (2007), foreign direct investment flows have significantly increased internationally since the 1990s. Foreign Direct Investment
(FDI) flows record the value of cross-border transactions related to direct investment during a given period, usually a quarter or a year (OECD data, 14.8.). Below is a graph indicating that the foreign direct investment net flows in trillions of US$ have increased in the United States and the OECD countries on average. Also, the average foreign direct investments in Finland have increased during the past three decades; however, it is essential to note that the net flow of capital in Finland has been negative in 2009, 2011, 2013, 2018, and 2020. A negative net flow of capital implies that capital outflow is higher than inflow, causing the money to leave the country. Negative net flow of capital often indicates economic vulnerabilities, and it is likely to reduce economic growth and currency depreciation in the long term. Therefore, the data highlights the importance of understanding taxation’s effect on foreign investments.

**Figure 2:** Foreign Direct Investment, OECD – Average & United States, the World Bank [Last accessed on 2023-08-10]
Not all the OECD countries tax income similarly. Governments either tax the income of corporations through the territorial system or the global system, often called the worldwide system. A territorial tax system lets multinational enterprises exclude profits earned in foreign countries from their domestic tax base, as a worldwide tax system means corporate taxes are paid to their home country (Gruber, 2011). For example, the territorial tax system lets the corporation pay taxes only on domestic income, meaning that the country taxes all corporate income despite the original location of the corporation. In contrast, a worldwide tax system taxes corporate income, not depending on where it is generated initially.

In recent years, many OECD countries have transitioned from global to territorial tax systems (Tax Foundation, 16.8.2023). The shift represents a fundamental change in how multinational corporations are taxed and how governments capture revenue from international business activities. Both the United States and Finland operate in a fully territorial tax system. The United States, however, employed this system not earlier than in 2017, when they put into the Tax Cuts and Jobs Act, which changed the taxation. The United
States shifting from worldwide to territorial taxation is its most significant tax reform of the 21st century.

**Figure 4:** Tax Foundation, [Last accessed on 2023-08-16]

Territorial taxation allows corporations to exclude profits in a foreign country from their tax base, simplifies tax calculations, and may encourage repatriation of foreign earnings. Arguably, territorial taxation increases a country's attractiveness and competitiveness, reducing the tax burden on profits and influencing deductions and expenses. However, several years after the United States Tax Cut and Jobs Act taxation change, Albertus et al. (2022) have continued to apply to the existing literature by studying this change. As a result, their study shows that after the change, the foreign subsidiaries owned by United States corporations, invest 13.1% less in capital and 1.3% less in labor relative to subsidiaries owned by non-United States multinational corporations. The study shows no incentive to overinvest in foreign operations, even though the territorial taxation system allows corporations to exclude foreign profits from the domestic tax base. However, the study
concludes that the territorial tax system implements reductions that may improve productivity and diminish the inefficiencies in the worldwide taxation system. Also, reducing taxation could be an option to increase the government's greater international capital mobility by using tax reductions. (Albertus et al. 2022).

Alongside Albertus et al. (2022), the world’s tax system and the impact it has on corporate policies of foreign investments are studied by Hines (2007), Arena and Kutner (2015), Gu (2017), and Choi (2020).

The study by Arena and Kutner focused on the United Kingdom and Japan shifting from the worldwide tax system to territorial tax systems, and it found supporting evidence that the change from the worldwide to territorial tax system reduced foreign investments. The results comply with the results by Gu, showcasing that the United States multinational enterprises and firms generally are affected by taxation. Another study concluded that small reductions of corporate tax rates in high-tax jurisdictions may lead to relatively more considerable changes in foreign investments when the attractiveness of a country for business operations increases (Mongrain et al., 2023). Finally, another dimension for the topic comes from Choi et al. (2020), who argued that tax-motivated foreign direct investment could benefit consumers in some cases by improving social welfare (Choi et al., 2020).

Also, Djankov et al. (2010) research studies 85 countries regarding corporate income tax and highlights corporate taxes' effect on investment, mainly focusing on the OECD countries. The study focuses on the first-year to fifth-year effective tax rates. The study’s results outline a statistically significant effect that the statutory tax rate has on foreign direct investments. However, similar results did not apply to investments overall. As an estimation, by increasing the first-year effective tax rate by 10 % -points, the foreign direct investment is reduced by 2.2% points from the average rate of 21.5%. (Djankov et al. 2010). The study found the results within the Hassett-Hubbard range of elasticity between -0.5 and -1.0 (Hassett & Hubbard, 2002). Second, the study from Djankov et al. (2010) confirmed that the tax rate influences business densities as well as entry rates of companies. The study shows that the first-year increase of 10%-points also resulted in a drop in business density from 5 firms to 1.9 firms per 100 people. At the same time, the average entry rate drops from an average of 8 by 1.4%-points. The results are robust in different control groups, such as other taxes, number of tax payments, institutional controls, and inflation. In conclusion,
"Corporate taxes have a substantial adverse effect on investment and entrepreneurship and one that persists with a range of controls." (Djankov et al., 2010, p. 54). In conclusion, previous studies collectively emphasize the critical role tax systems play in shaping the behavior of multinational enterprises concerning foreign investments.

Corporate taxes have a significant impact on the attractiveness of a country for foreign direct investment. In the past three decades, many countries have continued to gather tax collections relative to the gross domestic product, even though the importance of luring foreign direct investments has increased. Based on the OECD Revenue Statistics in 2022, on average, the OECD countries' tax collections were 34.1% in 2021. Based on the World Bank data from 1990 to 2019, corporate tax revenue as a percentage of GDP has been relatively stable in Finland, the United States, and the OECD countries. The ratio fell slightly between 2001 and 2004 but rose again between 2005 and 2007, following the global financial crisis in 2008 and 2009. From 1995 until 2020, the average tax level in the OECD countries increased only by 1.4%-points. (OECD, 15.8.2023). Countries could increase their capital mobility and even collect higher tax revenues by reducing corporate taxes rather than keeping them stable. Why do countries not utilize this underlying opportunity to attract foreign investments to their country?

![Corporate Tax Revenue as % of GDP](image)

Financial Year: 1990 - 2019

- **Finland**
- **United States**
- **OECD - Average**
Figure 5: Corporate Tax Revenue as % of GDP in OECD – Average, US, and Finland – the World Bank [Last accessed on 2023-08-10]

The reason why governments do not fully utilize the opportunity of tax reductions to acquire better international competitiveness on the market is likely due to the following reasons: taxing corporations is easier for political reasons than taxing individuals, countries might not distinguish well enough mobile and less mobile capital, which may cause the government to tax less mobile capital highly, and countries do not consider favoring mobile investments by generous tax treatments. (Hines, 2007).

To conclude, the role of foreign direct investments has increased in the past three decades, mirroring the heightened competition and international competition across the OECD countries. Many countries have shifted from worldwide to territorial taxation systems, which is a considerable change in taxation. All in all, taxation significantly affects a country’s foreign direct investments, and there are opportunities for different countries to utilize the possibilities that attracting foreign investments and reducing corporate taxation gives.

4. The main challenges of taxing corporations

The main challenges of taxing corporations include profit shifting, tax avoidance, cross-border transactions in the digital economy, and transfer pricing. In the 21st century, global economies are interdependent, and many corporations operate internationally to seek benefits such as lower production costs, sales advantages, and lower logistic costs. The taxation of international income plays an increasingly important role in companies' decision-making, and a great opportunity comes with significant challenges.

4.1. Profit shifting

First and foremost, the Based Erosion and Profit Shifting (BEBS) is a commonly known “tax planning strategy used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying tax” (OECD 16.8.2023), which is made possible by the fact that the corporate tax systems differ significantly internationally (Corporate Tax Statistics, 2022).
Profit shifting is a common way to avoid tax obligations, showing a way of tax avoidance in which the corporation shifts income from a high-tax jurisdiction to a low-tax jurisdiction (Lampenius et al., 2021). Profit shifting is closely related to tax avoidance, cross-border transactions, and transfer pricing. Tax avoidance is often legal through cross-border transactions and more in-detail transfer pricing. Cross-border transaction refers to activities happening across countries, where transfer pricing is a way for multinational enterprises to exchange goods and services between divisions by charging high prices in high-tax countries and low prices in low-tax prices. Transfer pricing can affect the company revenue and, therefore, result in differences in reported profits of certain countries, helping the company avoid taxes legally.

Transfer pricing is discussed in academic writing by Rathke et al. (2020) and Rossing et al. (2017). Based on Rathke et al., the differences in domestic and global transfer pricing rules are the main reason for the challenges that exist in the global economy (Rathke et al., 2020). The OECD states that there are significant differences in transfer pricing rules across countries, and thus, this creates a vital topic to debate between tax authorities in different countries. Therefore, transfer pricing creates challenges like market fluctuations and regulatory compliance issues. However, studies show that, in the end, the most significant difference between different countries is how they implement and monitor transfer pricing regulations. (Rathke et al., 2020).

The shift from a global to a territorial tax system has caused new concerns, as companies do not face an additional tax on foreign-earned profits. Therefore, there is an incentive for corporations to shift domestic income to foreign markets for low-tax jurisdictions (Tax Foundation, 16.8.2023). Also, despite many countries working under a territorial taxation system, there are still significant differences between different jurisdictions and their corporate taxing policies.

The OECD Corporate Tax Statistics report outlines the risks of tax avoidance of multinational enterprises and, in response to this, highlights the importance of reforming international taxation. Based on data from the OECD Corporate Tax Statistics, there is an implication of misalignment between jurisdictions in which corporations report the profits and where they invest. As a limitation, the report outlines that the insights still need to be expanded since the anonymized and aggregated data has been collected only for three years,
and therefore, further research is needed. (Corporate Tax Statistics, 2022). Likewise, multinational enterprises use internal transfers to take advantage of the tax differences between different countries (Choi et al., 2020); Hines has addressed that one of the main problems to address regarding international investments is the possibility for multinational enterprises to adjust the location of their taxable profits (Hines, 2007).

According to the OECD estimation, tax avoidance accounts for 10.0% of global taxes due to profit shifting. Therefore, the OECD Action Plan 2013 aims to reduce base erosion and profit shifting between jurisdictions. There is an Action Plan called Pillar One and Pillar Two. Pillar One aims to make taxing rights fair, especially related to multinational enterprises, by implementing a new rule to reallocate taxing rights to the jurisdictions where multinational enterprises have business activities. Pillar Two includes Global Anti-Base Erosion (GloBe) Rules and treaty-based subject-to-tax rule (STTR). The first Global Anti-Base Erosion aims to apply minimum tax rules for each jurisdiction for corporations with revenues over 750 million EUR, where the Subject to Tax Rule helps to put limited source taxation below minimum rates into place. (OECD Progress Report, 2022) Academic studies confirm the findings of the OECD report. A recent study regarding the Pillar One and the Pillar Two tax reforms of multinational enterprises, which cover over 70 jurisdictions, shows that both Pillar One and Pillar Two would reduce effective tax rates (Hanappi & Cabral, 2022). Also, another study focusing on tax competition in the presence of profit shifting concluded that being stricter in profit-shifting control likely leads to lower equilibrium tax rates and could help to avoid a substantial portion of the global tax base, which might escape taxation (Mongrain et al., 2023). Significant breakthroughs exist in the OECD action plan, as starting in 2023, multinational enterprises will be subject to a minimum 15% tax rate (OECD 17.8.2023, 2.)

To continue, Mongrain et al. (2023) suggest that the elasticity of retained profit and capital mobility determines a substantial part of the equilibrium tax rates. Therefore, they continue to see that weak profit-shifting policies decrease the elasticity of profit and increase the elasticity of capital mobility, thus decreasing the profits reported in high-tax jurisdictions. (Mongrain et al., 2023).

To summarize, profit shifting is a significant challenge. While planning corporate taxes and taxation, profit shifting is an important topic, as many multinational enterprises are
adjusting the location of their profits and taking advantage of the tax differences in different jurisdictions. International plans to end the profit shifting of multinational enterprises are in action. As a result, policymakers and economists should consider the effects of new international decisions on the government.

4.2. Fiscal shocks and adjustments

Corporate taxation also depends on fiscal shocks, which affect economic outputs. In a study regarding fiscal policies, both the changes in taxes and changes in government spending found that the effects on output depend on current economic conditions (Alesina et al., 2016). Tax adjustments, especially in contractionary policies or economic slowdowns, came with more significant output losses in the short run (Alesina et al., 2016; Edgerton, 2010). However, tax incentives are most likely put into place during challenging times (Edgerton, 2010), and GDP loss in a recession is often more harmful than in a time of growth (Alesina et al., 2016).

To continue, Alesina et al. research aimed to solve how fiscal adjustments affect economic outputs. The researchers studied 16 OECD countries between 1978 and 2014 and their tax-based or expenditure-based plans. They measured business cycles and expected outcomes. Their main finding was that the tax-based adjustments caused broad output losses, as big as three percent of GDP in a few years. In contrast, the expenditure-based adjustments caused output losses near zero – indicating that some of the changes created comprehensive losses and others significant expansions. (Alesina et al. 2016).

Therefore, politicians and economists can make research-based decisions by deepening an understanding of fiscal shocks and adjustments and the timing of corporate taxation changes.

5. Conclusion

In conclusion, even though the trends of academic studies considering corporate taxation have changed from 1990 until today, the taxation of corporations plays a crucial role in corporate behavior and the country's international competitiveness. Corporate taxation, as
a crucial revenue stream for all governments, continues to be controversial since it is often considered the only acceptable tax, especially for politicians seeking votes.

This literature review aims to answer the question, what is the effect of taxation on corporations in the OECD countries? The thesis deepens the understanding of the effects of taxation on decisions related to operations and financing, as well as foreign investments and international competitiveness, which are considered in the following chapters.

First, as the decisions regarding corporate taxation influence business operations and financing as well as foreign direct investments and international competitiveness, it is essential to understand the effect that taxation has. First, increasing corporate taxation may reduce entrepreneurial innovation and investments, influence entry rates of new emerging corporations and densities of new business operations, and encourage local companies to relocate their operations to low-tax jurisdictions. Second, business decisions in financing depend on corporate taxation, which may lead to a situation in which income accumulates in low-tax countries. Therefore, corporate tax policies are great tools for affecting the financing decisions of corporations. Third, foreign investments and international competitiveness are increasingly important when considering corporate taxation. However, many governments still need to fully utilize this underlying opportunity to get ahead of international competition by luring foreign direct investment and reducing taxation.

As it often is, great opportunities have significant challenges. The main challenges of taxing corporations include profit shifting, cross-border transactions, transfer pricing, tax avoidance, and fiscal shocks and adjustments. First, since many multinational enterprises adjust the location of their profits and take advantage of the tax differences in different jurisdictions, politicians, decision-makers, and economists should understand the challenge it creates. Second, transfer pricing requires corporations to obey rules and regulations but opportunities to benefit from differences in countries’ ways of implementing or monitoring regulations. Lastly, fiscal shocks and adjustments affect the total impact of corporate tax on the total revenue and the tools often used in situations where the effects are not the most beneficial. As many of these challenges need to be tackled internationally, policymakers and economists should consider the effects of the decisions on the government and how to adjust local operations to fit today’s needs.
The initial hypothesis is that tax changes impact corporate investments and capital expenditure, profitability, business expansion, international competitiveness, innovation, and tax cuts would increase overall output and welfare. The result is that tax changes significantly impact corporations, especially corporate investment and operative decisions. Governments must carefully consider their tax policies to find a balance between generating government revenue, promoting economic growth, and maintaining attractiveness for multinational enterprises in the global marketplace. The best results, as Aghion et al. (2016) concluded, do not come by optimizing current taxes but rather by improving the efficiency with which the government is using the acquired revenue streams.

To conclude, for further research, I would suggest focusing on optimal corporate taxation in multinational corporations and how Finland could best adjust to international opportunities and challenges by making corporate taxation decisions that best increase its social welfare. Also, further research is needed on corporate profitability and innovation, as well as the welfare effect of taxation.
6. References


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