

The case for corporation tax: yesterday's debate in Mon...

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I debated with Dan Mitchell of the libertarian Cato Institute and Center for Freedom and Prosperity in Montreal last evening, before literally dashing for the overnight flight home.

We put corporation tax on trial. There were three propositions which I had to propose and Dan opposed.

We were then given a fourth, unscheduled topic, which was whether we believed technology now let us imagine that the shareholders of corporations could be taxed on their incomes instead of the corporation itself.

I may deal with that last topic in a separate blog when I am a little more awake than I am now (this is being written mid-Atlantic). But this is what I said (give or take) on the first three questions put forward in the debate.

For the record, I won on a vote. Poor old Dan. As he said during the debate, his dreams don't come true. And as I noted mine do: it's just thirteen years ago I realised when debating that I dreamt up country-by-country reporting. Nor has he ever won debating me, and this is not the first time we've done it. Anyway, these were my notes:

Submission 1:

First, be it resolved that: the current approach to corporate taxation is a necessary and appropriate means of raising tax revenue.

As we begin this debate I think it only fair to note that I've written a book called The Joy of Tax as if to prove my enthusiasm for the subject.

In that book I describe how I think an ideal tax system can be created. Let me assure you that included in that ideal tax base is a corporate income tax.

Saying that immediately demands that I offer you some definitions. The first explains what a corporate income tax is. It is a tax that charges some but not necessarily all of

the income of a corporation to tax after the offset of some but not necessarily all of the expenses that the corporation incurs.

I stress: this is not then a tax on profits. The UK is right to call it a corporation tax and not elaborate further because this is, like most taxes, actually a transaction tax. If you look at the definitions in, for example, the European Union's Common Consolidated Corporate Tax Base you will see that is exactly what they think such a tax is, and in fact the description I have just offered is remarkably like a Value Added Tax in very many ways.

This is important. That's because in the same book I suggest that to be effective any tax base must be capable of being taxed once only in the right place, at the right rate, at the right time and on the right person, where right means that the economic substance of what is declared matches the form in which declaration takes place.

I also suggest that a tax system as a whole should promote peace, which you might think of as economic harmony within and between states; equality, which I interpret as requiring a progressive tax system on both interest and capital; transparency, which I suggest means people should be able to tell that a fair tax deal is being applied to all, and finally simplicity, which is a theme I will come to later in this debate.

A corporate income tax meets all these needs.

First, it is only the corporation that undertakes the transactions that are subject to this tax: no one else does. So no one else can be taxed on them. The right person is paying this tax.

Second, although there are those — let's call them shareholders for convenience - who claim that they also enjoy the benefits of these transactions they are wrong. Some of them say taxing them in the corporation results in double tax. I do not agree. Shareholders either trade in the stock of a corporation, in which case their trade is entirely distinct from that of the corporation itself, and so is taxable in its own right, or they receive a dividend return from that corporation which may, or may not, equate very closely to the income of the corporation in the period in which it was paid.

In the first case the trades of the company and shareholder are unrelated. The tax bases are simply different and cannot be equated. If anyone can say that the high frequency trader profits or loses from the trades that the entity in whose stock they deal transacted in the micro second they owned its equity then they defy all logic and common sense.

Similarly, those who claim that the corporation should not be taxed because stockholders might in due course pay tax on dividends miss the point. I concede that the stock holder should be entitled to a credit for the tax the corporation has actually paid - and not a deemed payment which may well be of greater amount - but three

obstacles prevent the stockholder being the only tax payer.

The first is we don't usually know who they are so they can't be taxed.

The second is there is no guarantee the corporation will pay out all its income, so some or all could go untaxed.

And third, very obviously the dividend may come well after the profit was earned, meaning tax is paid late. All of these are the recipe for tax abuse.

In that case I could conclude on these grounds alone that the corporation should be taxed. But the argument would be incomplete if I stopped here. Corporations should, anyway, and as a matter of fact, be taxed in their own right.

Firstly, that is because their owners enjoy a privilege from society for which they should pay though the proxy of a charge on the corporation they own: that privilege is, of course, limited liability, which imposes an externality on all others for which the corporation must pay by bearing a tax rate in excess of that due by an individual on similar transactions.

Second, the corporation is a highly efficient entity to tax: why chase unknown shareholders when one payment from the corporation does the job?

And third, as a matter of fact the corporation is usually in the right place to be taxed, which is where the substance of its trade occurs: this is where the tax is due in exchange for the licence to operate that it has been granted and the use of the infrastructure of the state of which it has availed itself. If we want to tax at source — and I really think we should — then the corporation is the right entity to pick up the bill.

To summarise: the corporate income tax charges transactions that would otherwise fall outside the tax system.

Charging the corporation ensures that those transactions are taxed in the right place, at the right rate, at the right time.

What is more that charge is proper exchange for the economic substance of benefit that the corporation has enjoyed and for which it must pay.

Whilst for anyone keen on tax efficiency a corporation tax offers the advantage of a simple, effective and low cost assessment mechanism.

One can, I suggest, ask for little more, especially as double taxation should never arise, nor non-taxation either, if care and cooperation are exercised.

The corporate income tax works. It raises significant revenue and wholly appropriately so. We should cherish it.

I move the resolution.

Submission 2:

Second, be it resolved that: corporate taxation is fundamental to preserve personal taxation.

I want to make it very clear that I am a big fan of markets. And of competition too. Left wing professor I might be, but I am also a chartered accountant who has in his time been senior partner of a firm and directed a range of entrepreneurial private sector companies that made goods and provided services that people wanted. In the process I have made profit for myself and others and have no intention of apologising to anyone for doing so. If you want to know how the micro-economy works I have some pretty powerful experience to draw on.

But let me tell you in that case that when it comes to tax governments do not work in the micro-economy. Tax systems are designed in the macro-economy. It's just a fact that they also have to function in the micro-economy. The inevitable consequence is that taking one economic view on any tax is just wrong. This is especially true of the taxation of corporations and other legal personalities such as trusts.

So the first thing to say is that despite the very obvious fact that limited liability for the members of a company is a flagrant breach of the human rights of those individuals with whom it trades society has found there is real merit, overall, in allowing this abuse to continue. We have learned that providing this choice pays.

And this is an important point. Choice is necessary in tax. This is where I pick up the theme of simplicity I mentioned earlier. If a tax system is to allow taxpayers to make the personal and commercial choices that the modern economy offers to them then there is no option but provide complexity to match that of the real world.

This requires, for example, that a tax system provide a relief on the cost of acquiring and using assets in the numerous ways that markets have dreamt up.

It also means charging appropriate and consistently similar tax whether a person chooses to operate as a limited liability entity that is taxed, or as one that is tax transparent, or is a partnership or just as an individual. Tax should not take these choices away: they are real options that have consequences in the real world and so must be respected. But consistency of outcome is the measure of simplicity that we need in that case.

Unfortunately right now that is not what we get. These choices have been used as an opportunity for tax abuse, and governments have permitted this too often in the mistaken belief that this will help the micro-economy. The result is a macroeconomic

cost because tax has not always been paid in the right place, at the right rate, at the right time and by the right person. And yet that's what we need if the tax system is to be both equitable and transparent.

Equitable does of course mean two things in this context. One is that income should be taxed at a consistent rate taking into account the circumstances of the beneficial recipient. I stress the word beneficial here: I am quite willing to look through the corporation for this purpose because no other method of ensuring equitable assessment is possible. And I would remind you of something else I just said: if the corporation is used to prevent a necessarily equitable assessment then the result is a breach of another's human rights: it's not possible to argue otherwise.

Vertical equity is the second part of this equation. It does, of course, mean that progressive tax rates are enforced, as is essential if equality of the marginal utility of the tax contribution a person makes is to be equalised, as I think micro-economic theory suggests appropriate.

These facts, when put together have enormous implications for corporate tax policy. Let me spell out precisely what they mean in practice.

First, corporate tax rates must be above the usual base rate for personal taxation for most individuals in a jurisdiction. I stress, I do mean above as the additional rate is payment to society for the external costs a corporation imposes. That is just and equitable.

Next, that corporate tax rate must be enforced. Sadly experience suggests that this is not the case. For example, in the UK my work has shown that more than one million of our 3.6 million companies are not asked to submit tax returns each year. That is just wrong: there should be no unaccountable companies, anywhere.

It's also wrong that we have more than 400,000 companies 'disappearing' each year from our register of companies without filing accounts or proving they have paid the tax that they might owe. This is largely through deliberate neglect on their part that is not pursued by our authorities. In many cases we do not as a result have a clue who owns these companies and no idea if they have ever traded. I think these companies make a significant contribution to the UK tax gap.

And it's wrong that whilst we now demand automatic information exchange from tax havens on companies owned in other jurisdictions to track down tax evasion we do not do this domestically, whether I am talking the UK or almost any other jurisdiction. In my opinion every bank supplying services to any company must be required to disclose data on its ownership and trading to all tax authorities who might have an interest in its affairs. Nothing less will do.

And I make this point for the obvious reason that if the personal income tax is not to be

undermined by the simple existence of effectively unregulated companies then we must know who owns those companies, what they do, where, and what they might owe in tax.

That though is not enough to prevent abuse of the personal income tax. It's imperative that we offer corporations no favours.

So, corporations should not enjoy reduced capital gains rates, as they do in the UK.

Or R & D allowances not available to individuals.

And any and every distribution they make must be subject to tax, at the same rate as that on labour. I stress when saying this I think labour taxes include all social security contributions and payroll taxes. There is no case whatsoever for capital to be taxed at lower rates than that charged on the return to those who work and yet around the world this is normally the case.

Which argument also supports the case for capital gains on shares being taxed as if they are income.

My point is simple. Limited liability provides a benefit. But that benefit has to be paid for. And that requires that all tax due — including that due for the benefit of limited liability must be paid. Unless that happens the integrity of personal taxation and tax systems as a whole, are threatened.

Better no corporations than that.

But better still, lets make sure corporations do not undermine the personal income tax because in far too many countries that is exactly what they do right now in the mistaken belief that this will help the micro-economy when the cost to the macro-economy of this negligent thinking is far too high.

I move the resolution.

Submission 3

Third, be it resolved that: To the extent that governments tax corporate income, they should do so comprehensively, and not use tax incentives to favour selected types of investment or commerce.

I hope by now you have learned a number of important things about my views.

First, I believe that corporation tax can, and on occasion does work.

Second, I think that can only happen if corporation tax is both properly structured at a macro-economic level and properly enforced within the micro-economy.

Third, I have strong views about what tax is for.

So it may not surprise you to know that I have just as strong an opinion on what tax cannot do, which views extend to corporation tax.

One of those things tax cannot do is be a substitute for a government having an industrial policy.

I do believe in industrial policy. I firmly believe that governments can, should and do actually choose economic winners within their economy. In fact, they're rather good at it. As Prof Mariana Mazzucato of Sussex University has shown in her work, much of the technology on which we are dependent in the modern economy was created with government backing. If in doubt, look at your iPhone and realise that however cutely it's packaged many of the core technologies it contains were government funded and created.

It is vital that we realise this at present. Around the world major corporations are sitting on enormous cash piles running to hundreds of billions in whichever currency you care to denominate them in. The reason they're not investing these sums is not because of a shortage of tax reliefs: the world is awash with those. In fact, in the case of many of them, like most R&D allowances and patent box schemes, the ease with which inflated reliefs can be claimed is sufficient to have ensured most of the associated investment is in innovating the basis for tax refund applications.

But as I am told time and again, vast amounts of this R & D spend is so minutely incremental, and of such little import, that the net benefit to society is, I suspect, little more than the addition of an S to a product description.

There is good reason for this: providing such tax reliefs delivers almost no quality assurance on the work to be undertaken by the corporations making claims whilst there is no strategic element to the reliefs at all. These reliefs confuse quantity for quality and spending is considered a proxy for outcomes, and both represent serious errors of judgement. To put it another way, they are ill conceived from the outset. We might just as well throw money at companies and hope for the best, because that's pretty much what we're doing and that is typical of many of the tax arrangements put in place to encourage particular types of business activity around the world.

If, for example, the tax reliefs and allowances, let alone the tax holidays, provided to the extractive industries, were indicative of the marginal nature of their activity then you might believe that we lived in a world where the production of oil, gas, copper, iron ore, and even gold, only occurred because tax incentives made it possible. That, I can assure you, is simply not true: there are strong markets for each of these products. The tax abuses that have flowed from these tax incentives, which have in many cases meant the developing countries have lost out significantly in terms of asset exploitation in exchange for little or no return to their societies, do then simply represent what

might best be called economic rents that flow to those who have best chance to demand them, but least right to receive them.

Much the same is true of other new arrangements, such as that in the UK, to provide a low tax rate for the offshore treasury functions of multinational companies. There is not the slightest evidence that there is a need to provide a low tax rate to encourage any multinational company to use a tax haven and yet the UK has actually set up such a scheme to encourage them to do so. The economic logic is completely bizarre unless one remembers that places such as Jersey, Guernsey, the Isle of Man, the Cayman Islands, the British Virgin Islands and so on are all branch offices of the City of London, each offering a 0% corporation tax rate, and that if there is one vested interest that is powerful above all others in the UK then it is the City, which can quite correctly be considered a state within a state able to demand special privileges for its corporate electors who effectively control its government without consideration for the interests of the rest of the UK as a whole. In this they typify those who demand the creation of such schemes which do, by and large, represent the flooding up of wealth in society in direct contrast to the theory of trickle down economics.

My answer then on all these special allowances and reliefs is straightforward. We should abolish them, without exception. Most of the world's tax gaps and many of the world's government deficits could be significantly reduced to the mass benefit of humankind at large if we were to do that one, simple, thing.

In that case I make a very strong plea for a simpler tax system. This is one where tax relief is provided only when it reflects economic reality.

And one where when allowance is made for capital spending that it should not be given as a matter of right, because the deduction of all expenses against chargeable turnover is a matter of judgement in a corporate tax system, but should instead be intended to reflect the economic substance of what is really happening in the course of a trade.

Which idea of economic substance lets me make a last suggestion, which is that there is not, in my opinion, a blanket excuse for the offset of interest against income for corporate tax purposes. The generous interest regimes in places like the UK, where interest costs incurred in the course of the acquisition of a trade can be offset against the future income arising from it, lack any credible economic substance. These expenses are a cost of capital, and not of trade, and have been open to enormous abuse. It is my suggestion that in future all interest should be disallowed for tax purposes unless the benefit to the trade being taxed can be demonstrated: the onus of proof would lie upon the taxpayer.

All of which brings me back to my opening statement in this debate. I reiterate that a tax on corporations is a tax on certain transactions companies undertake, and not on their profits as properly defined. If the tax is to work then a broad base for the recognition of income is required or abuse of personal income tax results. As

importantly though, if a broader abuse is to be prevented, a cautious approach to the offset of expenditure is also necessary.

And we do need this tax to work: around the world, and especially in developing countries, it is a key tool of macro economic policy for governments. We cannot do without it but in that case our approach to its management has to be dictated by one keyword, and that is prudence.

Prudence underpins the effectiveness of corporation tax. It is time for us to remember that good accounting word. I may be excited by tax, but in a prudent sort of way. And I suggest you should be too.

I move the resolution.