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TUC

Corporate Tax reform and competitiveness

Contents

Section one

Executive Summary

This report:

1. Reviews the history of UK corporation tax, the history of UK mainstream corporation tax rates and the history of UK small company corporation tax rates.

2. Compares movements in UK corporation tax rates with those of a sample set of data drawn from more than 60 other countries.

3. Notes the history of corporation tax yields in the UK in isolation and in comparison to other main taxes, and then reviews forecast trends in these yields.

4. Describes, using examples, the proposed changes in UK corporation tax and the impact they might have on the tax base.

5. Speculates on the impact of the proposed changes on tax yield.

6. Reviews data on the relationship between corporation tax and growth in GDP and average employment rates in the EU15 states and selected other locations.

Based on these analyses it concludes:

1. That UK corporation tax rates have reduced over time, and that the differential between the mainstream and small company rates has also been eroded, to the detriment of the relative economic well being of the small business sector.

2. UK mainstream corporation tax rates are currently comparable with other countries of similar size and economic profile to the UK and that as a result there is no obvious pressure for a reduction in tax rates at this time.

3. UK small company corporation tax rates are highly competitive.

4. UK corporation tax yields are forecast to rise over the next five years, but at a much lower rate than for other major taxes.

5. That this fall in relative yields appears inevitable. If, as this paper suggests, tax yield is explained by the following formula:

   [Tax rate x Tax base] – Tax Gap = Tax Yield

   then action taken by the Government will mean that:

   - The tax rate falls;

   - The tax base is cut because a) the UK will now only tax UK source profits and will exclude from UK tax charge the worldwide profits of companies resident in this country and b) the proposed new treasury operations corporation tax rate is likely to encourage the relocation of formerly UK based profits to tax havens;

   - Investment in H M Revenue & Customs will decline considerably over the next few years offering no prospect of a reduction in the tax gap.

Having noted the Government assumption that yield might increase despite these observable facts the report concludes that the forecast rise in yields can only be based on the premise that profits will be relocated to the UK or on the expectation of growth stimulated by falling tax rates.

The report also analyses the relationship between corporate tax rates and growth and corporate tax rates and employment rates. This analysis suggests that there are only weak associations between declining tax rates and increased growth rates and declining tax rates and increased rates of employment. In addition, even these weak relationships do not prove causality. Such analyses also disguise aberrant data such as Ireland's high growth rate before tax rates were cut and the collapse in growth in that country after they were reduced. It therefore suggests that the impact of planned corporation tax cuts on growth prospects is weak at best and unlikely to be significant. Reference is made to other findings reaching the same conclusion.

As a result of this work it is suggested that:

1. There is no current competitive pressure to undertake these tax reforms;

2. The consequence of those reforms will be declining corporation tax yields at a time when increased revenues are needed to reduce the deficit;

3. A further consequence is that large companies will see a disproportionate decline in their tax charges when compared to small companies, creating an unfair competitive advantage for large companies. This will hinder internal tax competitiveness in the UK;

4. There is a significant prospect of there being outflows of profit from the UK as a result of proposed changes in the UK corporate tax base;

5. There will be some disadvantages for developing countries as a result of the proposed changes in the UK's corporate tax base that will harm their prospects of collecting the taxes legitimately due to them.

6. There is little prospect of significant growth resulting from these changes in corporation tax;

7. Consequently these tax cuts represent a poor use of government resources at a time when these are exceptionally scarce.

Section two

What is corporation tax?

The UK has had a corporation tax since 1965[i].

Until 1965 the profits of limited liability companies were subject to income tax, at income tax rates.

In the corporation tax system introduced in 1965 the profits of limited liability companies were for the first time subject to a corporation tax subject to its own tax rates, albeit calculated in much the same way, at least at that time, as income tax arising on the profits of a self-employment.

The new tax also covered capital gains made by companies: capital gains tax for individuals was a new tax introduced on the same day as corporation tax.

Since then this new tax has been subject to tax rates different to those used for income tax and, additionally, to different methods of calculation of the profits or gains subject to tax when compared to those taxes applied to individuals.

Section three

What is the rate of corporation tax?

Over the period since 1965 corporation tax rates in the UK have varied, but recent history has been of rates falling steadily. The history of corporation tax rates from 1965 to 2014, reflecting from 2012 onwards the stated intentions of the current government, is as follows[ii]:

Currently proposed cuts in the rate of corporation tax will reduce the headline rate to 23% in 2014. This is an unprecedentedly low rate in the United Kingdom. It is less than half the rate that prevailed in the 1970s and early 1980s.

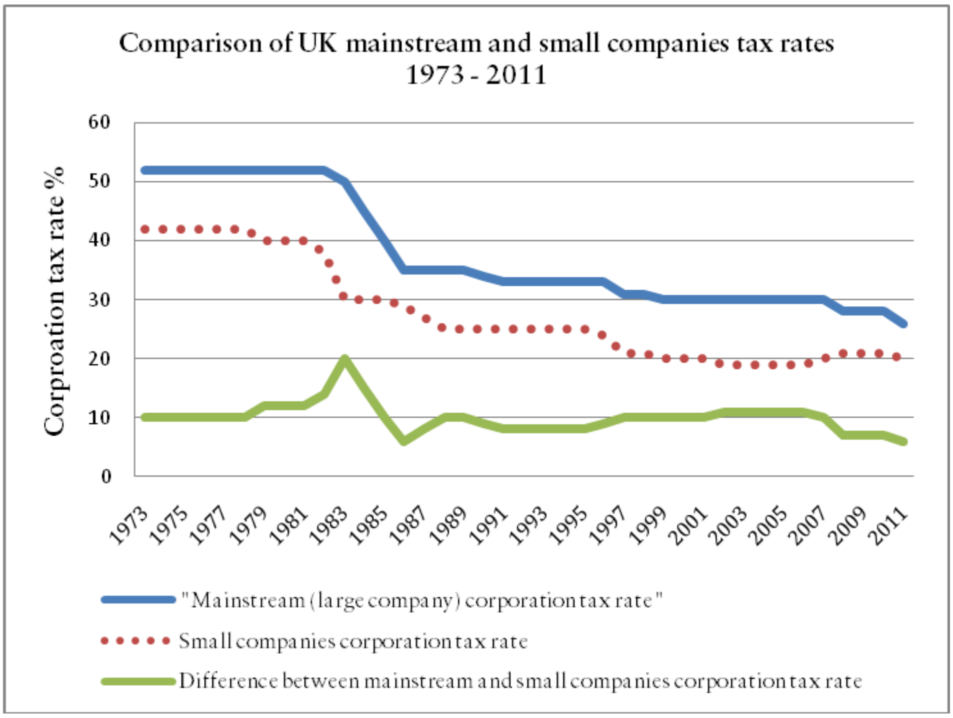
Section four

What is the small companies' rate of corporation tax?

It is important to note that unlike the vast majority of companies the UK has a two-tiered corporation tax system. Small companies in the UK have, since 1973, paid corporation tax at a lower rate than large companies.

'Small' in this context is defined solely in terms of the amount of profit a company makes. So, to use current rates as an example, a company making less than £300,000 a year in tax-adjusted profit pays tax at the small companies' rate. A company making profits of more than £1.5 million a year pays tax at the large companies' (or mainstream) rate. Between the two monetary limits a formula is applied to gradually adjust the tax rate from the small companies to the mainstream corporation tax rate.

The difference between the mainstream and small companies tax rate has been eroded over time[iii], as is shown below:

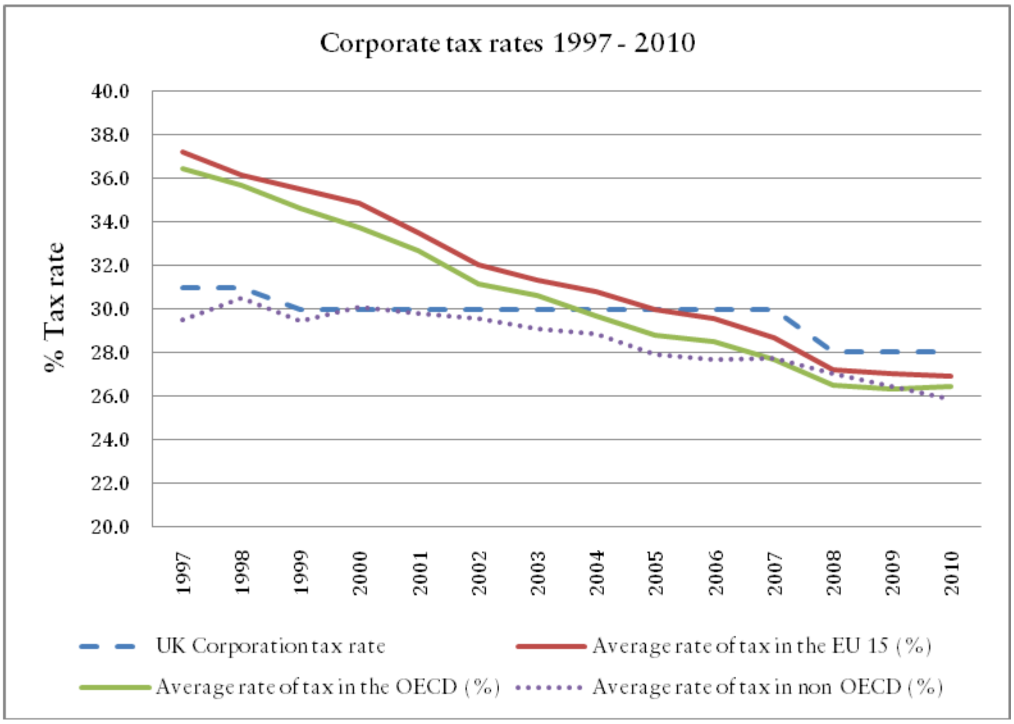


Section five

How do UK corporation tax rates compare to those found elsewhere?

The fall in UK corporation tax rates noted above can be compared with a wide variety of headline rates of corporation tax. The data used for this analysis comes from the KPMG surveys of corporation tax rates from 1997 to 2010 inclusive[iv]. The analysis is original to this report.

Comparing UK tax rates with those in the EU 15 states (i.e. those EU members from Western Europe) and with the KPMG sample split between OECD and non-OECD states shows this comparison for the period 1997 to 2010:

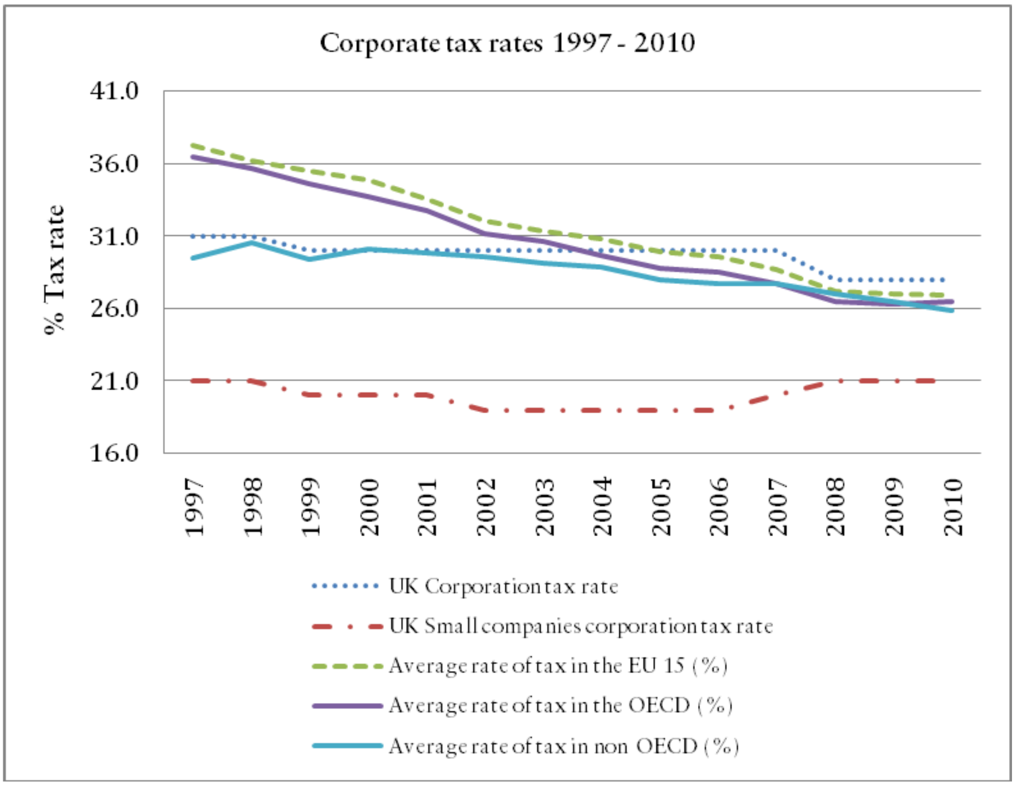


The UK mainstream corporation tax rate was in 1997 well below the average in the EU15 and OECD states (which have many overlaps in membership) and was close to the average for non-OECD states (mainly smaller and developing country states in this sample).

How do UK corporation tax rates compare to those found elsewhere?

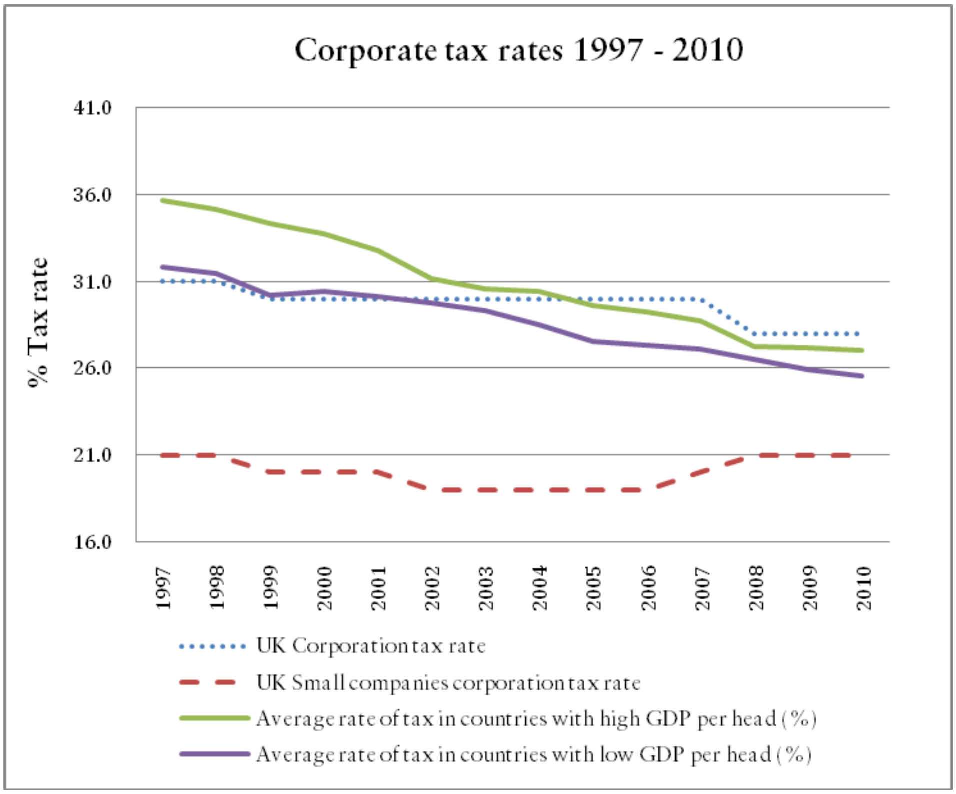
The trend in all cases has been downward, but with the UK headline rate now appearing higher than average, although there has been a marked trend for rates when looked at in this way to converge.

A word of warning is, however, appropriate. Well over 90% of all UK companies pay tax at the small companies' tax rate[v]. If this rate is added to the graph then the picture is very different:



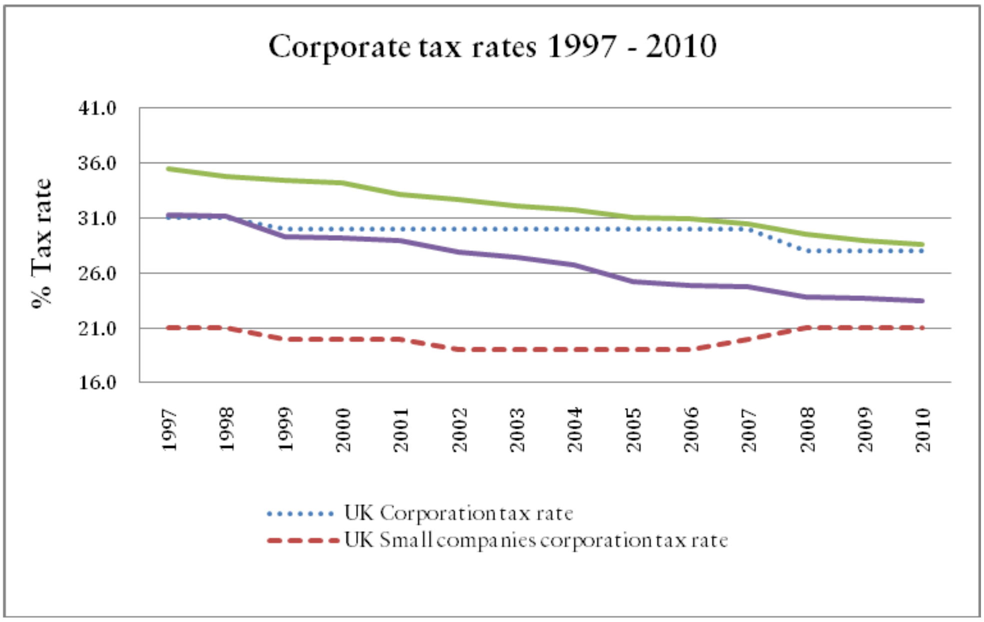
The suggestion that the UK has high corporation tax rates for most companies looks illusory in this light.

Comparison of other data suggests the same. For example the following graph compares the corporation tax rates of countries with high GDP per head of population (of which the UK was one) with those of countries with low GDP (less than US$25,000 per head in 2008):



In this context a tax rate of 28% in the UK in 2010 is very close to the average of comparable countries whilst the UK small companies corporation tax rate, paid by the vast majority of companies in the UK, appears remarkably low.

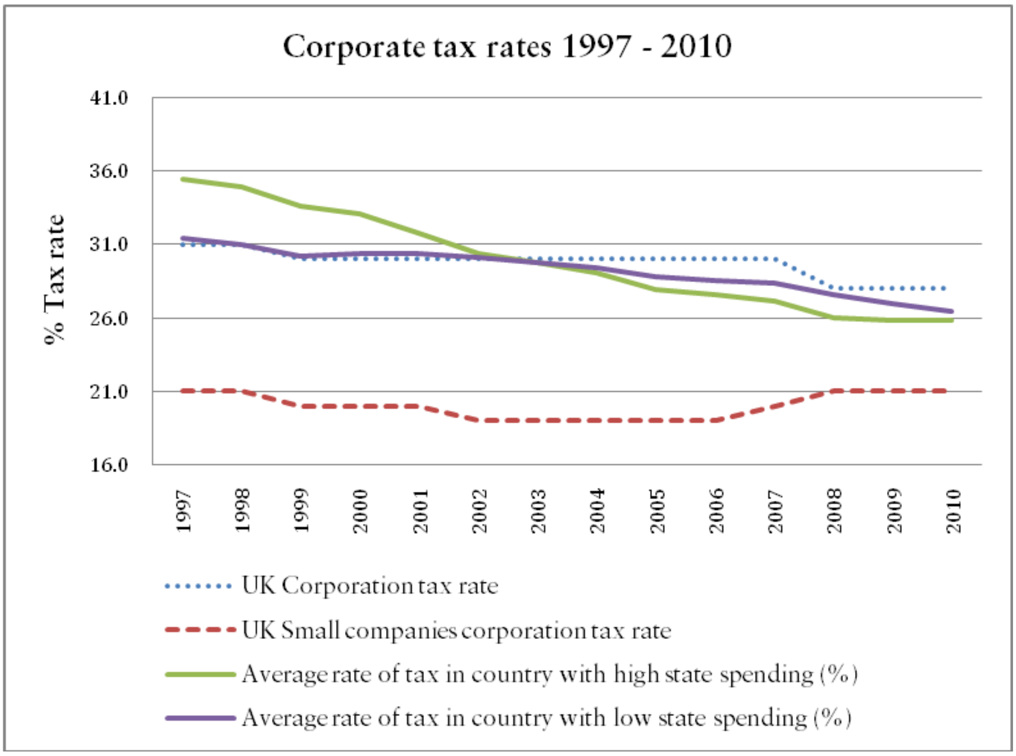
Again, if the tax rate data is weighted by population then the following analysis emerges:



How do UK corporation tax rates compare to those found elsewhere?

A large country is considered to be one with a population of more than 15 million in 2008, of which the UK was one. The analysis shows that larger states, having greater international obligations and more people to support, unsurprisingly have higher tax rates and that the UK's 28% rate in 2010 was below average for countries of a comparable population size. As all this data shows, the small companies' rate is well below average.

A final weighting, splitting the sample on the basis of those states with state spending of more than 30% of GDP (of which the UK is one) and those with less reveals an unusual trend: those states with low state spending have higher corporation tax rates.



Whilst the mainstream rate of UK corporation tax is slightly above average on this calculation the paradox that those states with low state spending have higher corporation tax rates is explained by quite high rates in many developing countries in the sample where personal taxation is hard to collect, not least because personal incomes are very low.

As is apparent throughout though, there was nothing unusual, or uncompetitive about the UK's 28% corporation tax rate in 2010 when compared to other countries with high state spending. And again, for small companies the corporation tax rate was very low.

As the OECD note[vi] the latest data on corporate tax rates in the UK's major equivalent states is:

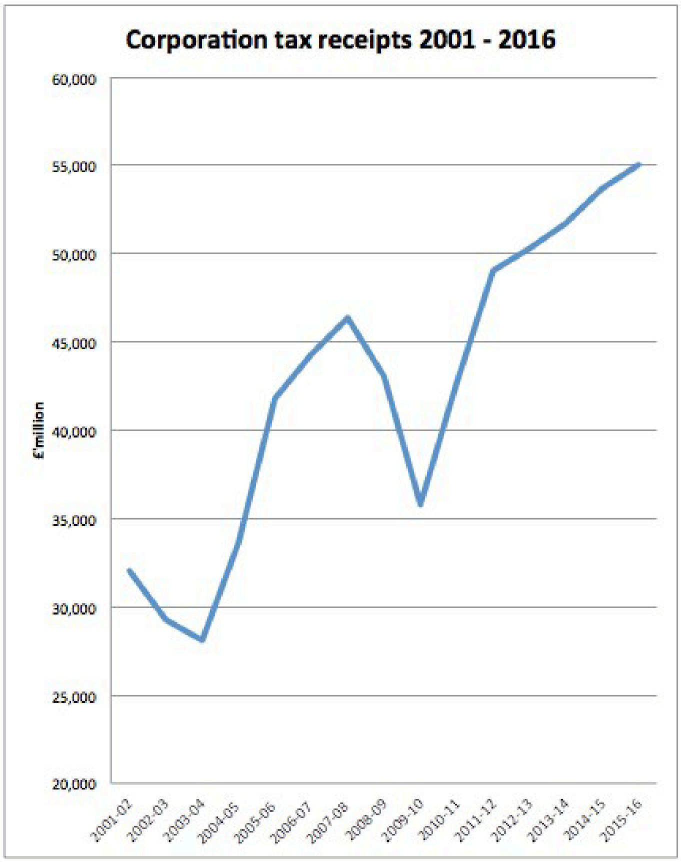
Country	Central government corporate income tax rate	Adjusted central government corporate income tax rate	Sub-central government corporate income tax rate	Combined corporate income tax rate
Japan	30.0	27.99	11.55	39.54
United States	35.0	32.7	6.47	39.21
France	34.43	34.43		34.43
Belgium	33.99	33.99		33.99
Germany	15.825	15.825	14.35	30.18
Australia	30.0	30.0		30.00
Mexico	30.0	30.0		30.00
New Zealand	30.0	30.0		30.00
Spain	30.0	30.0		30.00
Canada	18.0	18.0	11.5	29.52
Luxembourg	21.84	21.84	6.75	28.59
Norway	28.0	28.0		28.00
United Kingdom	28.0	28.0		28.00
Italy	27.5	27.5		27.50
Portugal	25.0	25.0	1.5	26.50
Sweden	26.3	26.3		26.30
Finland	26.0	26.0		26.00
Netherlands	25.5	25.5		25.50
Austria	25.0	25.0		25.00
Denmark	25.0	25.0		25.00
Korea	22.0	22.0	2.2	24.20
Greece	24.0	24.0		24.00
Switzerland	8.5	6.70	14.47	21.17
Turkey	20.0	20.0		20.00
Czech Republic	19.0	19.0		19.00
Hungary	19.0	19.0		19.00
Poland	19.0	19.0		19.00
Slovak Republic	19.0	19.0		19.00
Iceland	18.0	18.0		18.00
Chile	17.0	17.0		17.00
Ireland	12.5	12.5		12.50

The UK is far from being a highly taxed state and its small companies' tax rate makes it a very low tax state for most companies. The changes in tax rate proposed by the current government will however make the UK a country which for its size, GDP and level of government spending has a very low corporate tax rate.

Section six

How much does corporation tax raise?

Corporation tax raises significant revenue for H M Revenue & Customs and the Treasury, as is shown below:



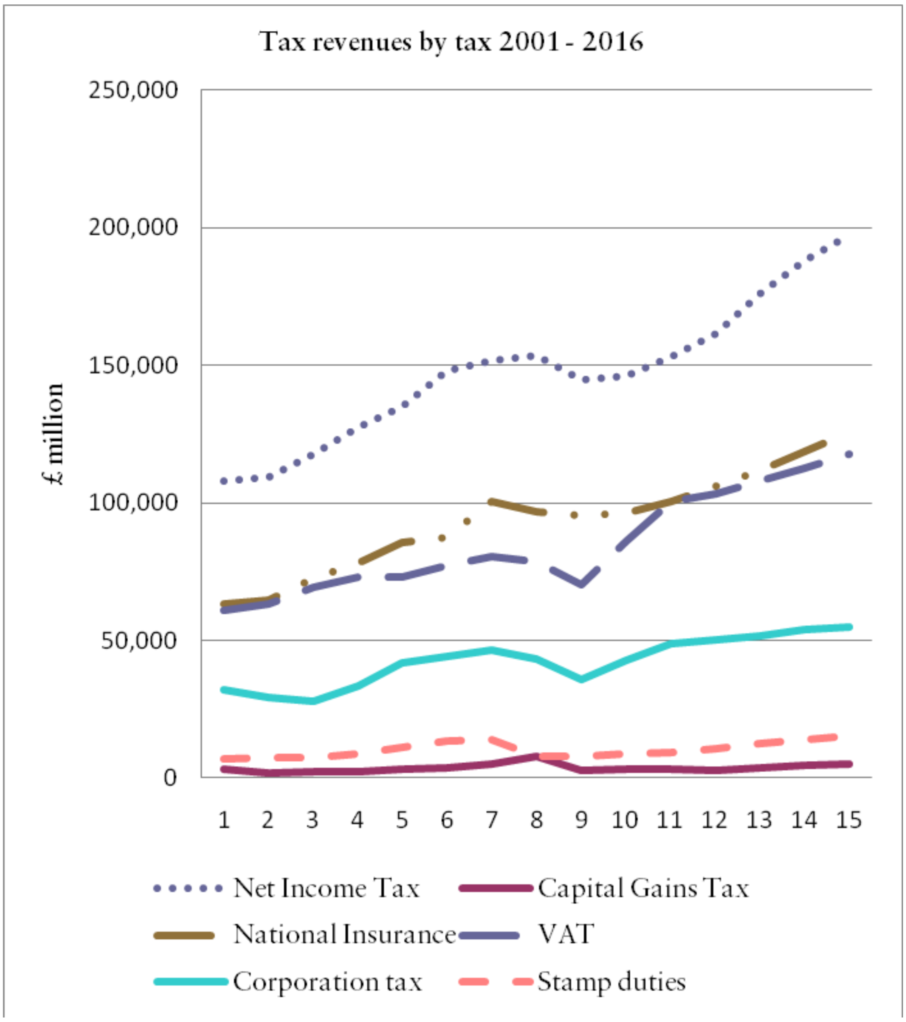
As is clear from the graph, corporation tax receipts are cyclical. Receipts fell during the post dot.com crash economic decline in 2001 to 2003 before recovering sharply. The fall from 2008 to 2010 was much more marked, contributed to heavily by falls in tax payments by banks. It is however assumed by the Government (as set out in the Red Book) that there will be a strong and pronounced recovery from 2010 onwards with revenues then rising. This is, of course, a forecast.

In addition the numbers by themselves do not tell the whole story. They are not inflation adjusted and they do not reflect the relative proportion of tax raised from corporation tax[vii].

Section seven

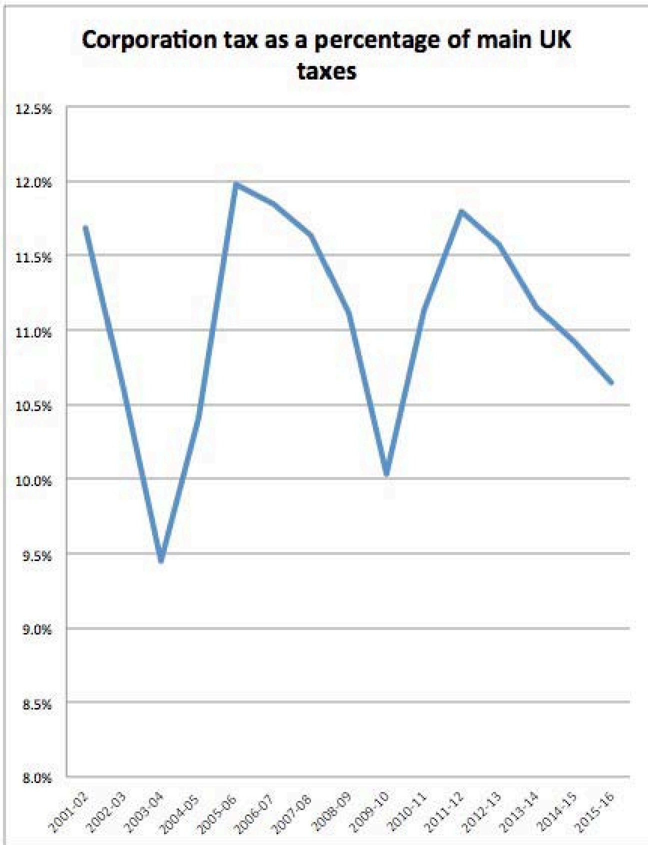
How does the corporation tax yield compare to other taxes?

Actual and forecast corporation tax revenues from 2000 onwards, compared to other taxes, have been or are as follows[viii]:



As is apparent, whilst income tax, national insurance and VAT receipts are all forecast to rise significantly in terms of their yield from 2011-12 corporation tax yields rise far more slowly in comparison.

The proportion that corporation tax represents out of total receipts of the above main taxes varied, or is forecast to vary, from year to year over the period noted, as follows:



The decline in corporation tax receipts as a percentage of all receipts from 2001 to 2003 was the result of the economic cycle (the fall in receipts following the dot.com crash). The recent downturn explains the fall in receipts from 2008 to 2010. The decline from 2011 is, however, something quite different: while the economy is forecast to be in recovery over this period the proportion of tax receipts arising from corporation tax will be falling. This decline will be the result of policy, not a result of the economic cycle. This is a change that is without precedent in the recent history of corporation tax.

Section eight

What are the current changes to corporation tax proposed by the government?

To understand the currently proposed changes to corporation tax put forward by the coalition government it is important also to understand some of the history of corporation tax, some of the differences between corporation tax systems, and some technical terminology with regard to these issues.

First of all, it is important to understand the difference between a classical and an imputation system of corporation tax. In a classical system of corporation tax a company pays tax on its profits and then when dividends are paid out of its after-tax profit the shareholder pays tax on that dividend in full, without any credit being given for the corporation tax already paid. This was the system of corporation tax introduced in 1965.

This system was changed in the early 1970s to an imputation system of corporation tax, with the corporation tax rate being increased at the same time. In an imputation system of corporation tax the company still pays tax on profits, but it is then assumed that when a shareholder receives a dividend at least part of the tax due on that dividend is cancelled as a result of credit given for tax already paid by the company. So, for example, during the 1990s when the notional UK corporation tax rate was 33%, with a small companies rate of 25% and the top rate of income tax was 40%, credit of 20% was given against the income tax liability of anybody who received the dividend, it being assumed that this was covered by the corporation tax already settled by the company that had paid the dividend. As a result double taxation of dividends was largely (but not entirely) eliminated whereas in a classical system there is always double taxation.

Technically Gordon Brown took the UK back to a classical corporation tax system in 1998 with reforms that had the effect of denying tax refunds to pension funds and other bodies that did not pay income tax on dividend income. However, because the top rate of income tax on dividends was at least technically reduced to allow for this the impact on ordinary taxpayers was not noticed, and in effect an imputation system has survived in use. There are no plans to change this at present.

What is changing is the basis on which corporation tax is charged on UK resident companies. All companies that are incorporated in the United Kingdom are resident in this country, as are companies incorporated elsewhere which are managed and controlled from the United Kingdom.

UK resident companies were from 1965 until 2009 taxable on their worldwide income. This made the system completely compatible with that applied to the income of all natural taxpayers (real human beings) bar those who were not domiciled in the UK. People who are tax resident and who are domiciled in the UK pay tax on their worldwide income. The consistency was no doubt not coincidence: it firstly reflects corporation taxes origins in income tax and secondly it no doubt reflected a desire to ensure consistency in the tax system to prevent undue advantage being given to one group of taxpayers over another.

In April 2009 the then Labour government announced a structural change to the corporation tax system of the UK. This change was twofold. First a plan for tougher Controlled Foreign Company rules (for explanation, see below) was announced, although details were not given at the time. Secondly, in exchange for such rules it was agreed that from April 2009 onwards any dividends paid by foreign subsidiaries to UK parent companies would not be subject to further tax in the UK on receipt. The logic was that since tightening Controlled Foreign Company rules would mean that such dividends could only be paid by genuine business activities located outside the UK it was not reasonable to then subject those profits to a second charge in the UK. There was, however, arguably a strategic error in the management of change in corporation tax: it would have been viable if the change in the rules on taxation of dividends had been introduced at the same time as the change in the rules on Controlled Foreign Companies. Having got the concession they wanted though business then went out of its way to hinder negotiations on the change in Controlled Foreign Company rules and these were not as a result put in place before the Labour government lost power. As a result the tax base was weakened and the opportunity for further change was created, supposedly based on this precedent.

It is important to note that until 2009 a company was not only itself taxable on its worldwide income, it was also ultimately (and admittedly, maybe over a period of time) taxable in the UK upon all the income of its subsidiary companies, whether that income of those subsidiary companies arose in the United Kingdom or elsewhere in the world. The way in which this was achieved, and the mechanisms that were used to enforce this process need explanation, because dismantling many of them is at the core of the changes currently proposed by the Government.

An example helps explain how the system in operation until 2009 worked, and how the system now proposed will change these rules. For this purpose suppose that a UK incorporated company (let us call it XCo) is the parent company of a group of international companies. It has three subsidiary companies.

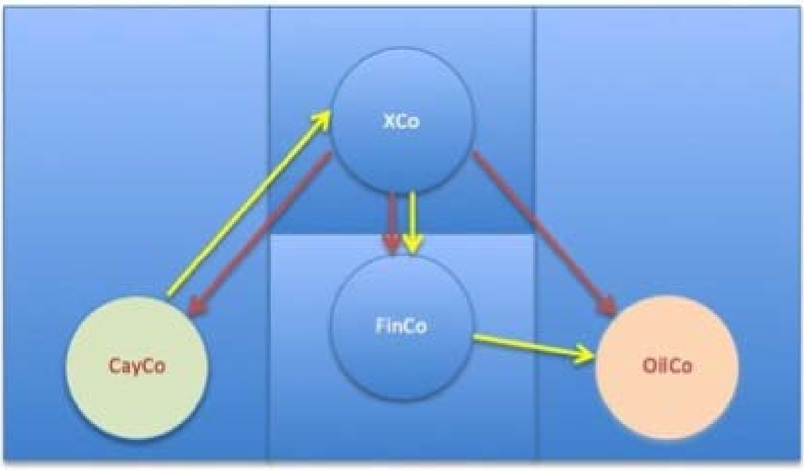
The first is a treasury company, which handles the group's finances and cash. This is, at the start of this example, located in the UK. Let us call it FinCo.

The second subsidiary company is in an African state where the prevailing corporation tax rate of 35%. It runs a successful oil well in that country. Let us call this OilCo.

The third subsidiary company is in the Cayman Islands. This company buys all the oil from OilCo and then sells it on to third party customers before sending the profits back to the UK as dividends.

This structure is, of course, simplified and so a little artificial, but it lets all the necessary points be demonstrated.

The structure looks like this:



XCo owns all the subsidiaries (the red lines). However, OilCo is financed through loans supplied to it via FinCo, which in turn has secured its money from XCo. FinCo gets its money through XCo buying shares in it. However, FinCo lends that money on as a loan at what it calls commercial rates to OilCo. These rates are high because OilCo is in a developing country where the risk of default is supposedly significant. The result is that a significant part of OilCo's operating profit is paid to FinCo as interest. These cash relationships, like all the money flows noted in the following paragraphs, are represented by the yellow lines on the diagram.

OilCo sells all its oil to CayCo. It is argued by XCo that CayCo, which owns intellectual property and marketing rights for the group of companies, adds significant value to the oil as a result and as a consequence the oil is sold out of OilCo at less than the eventual market price and a significant mark up is made in CayCo. This fact, together with the fact that large amounts of interest are paid to FinCo means almost no profit is earned and no tax is paid by OilCo in the African country where it is resident.

Note that OilCo is tax resident where it is incorporated – where the oil well is, hence its different background colour. In addition CayCo is Cayman resident, hence again its different background colour. Despite the fact that these two companies are both resident in other locations, the entire group was, eventually, taxable in the UK at least in theory until April 2009. Three arrangements were intended to enforce this.

The first such arrangement were the UK's transfer pricing rules. Transfer pricing takes place with ever two companies under common control trade with each other. There is nothing illegal about transfer pricing. It is normal, and takes place millions of times daily around the world. However, when two companies that are under common control trade with each other there would be, if there were no tax avoidance provisions, an obvious incentive for them to arrange the price at which they trade to ensure that the lowest overall tax liability was paid. So, it would obviously be advantageous for profit to be earned in a low tax location with costs being recorded in a high tax location, because this would overall reduce profit subject to tax.

It is unfortunately the case that transfer-pricing rules can only apply if they increase the profit in the country that challenges the transfer price, and can only be applied by a country with regard to transactions undertaken by its tax resident companies. As a result in the example used because the charging from FinCo to OilCo is for interest that increases UK based profits, and all other trade transactions outside the UK, transfer pricing is unlikely to have little impact in restraining the reallocation of profits within the group.

This then brings the second anti-avoidance measure into play. These are what are called Controlled Foreign Company (CFC) rules. These are complex, but in essence they can apply to any subsidiary company that is in a low tax jurisdiction (one with a tax rate that is usually less than three quarters of that applied in the UK) where the trade undertaken in that low tax jurisdiction is of an investment nature, or is purely importing and exporting connected to trades with other associated companies. It is immediately apparent that CayCo could be a Controlled Foreign Company of XCo in the period to April 2009. This is because it was owned by XCo, it was located in a jurisdiction where there was no corporation tax and its trade was solely importing and exporting products which it had acquired from a related company, OilCo.

If CayCo was as a result a controlled foreign company of XCo then whilst it might have been notionally tax resident in the Cayman Islands it was also tax resident in the United Kingdom. That would mean that its profits were immediately subject to UK corporation tax, even though its trade was not actually physically located within the UK. As a consequence its profits might then have been subject to tax in the UK. Given that the period under review in this example predates 2009 the appropriate tax rate might have been 30%.

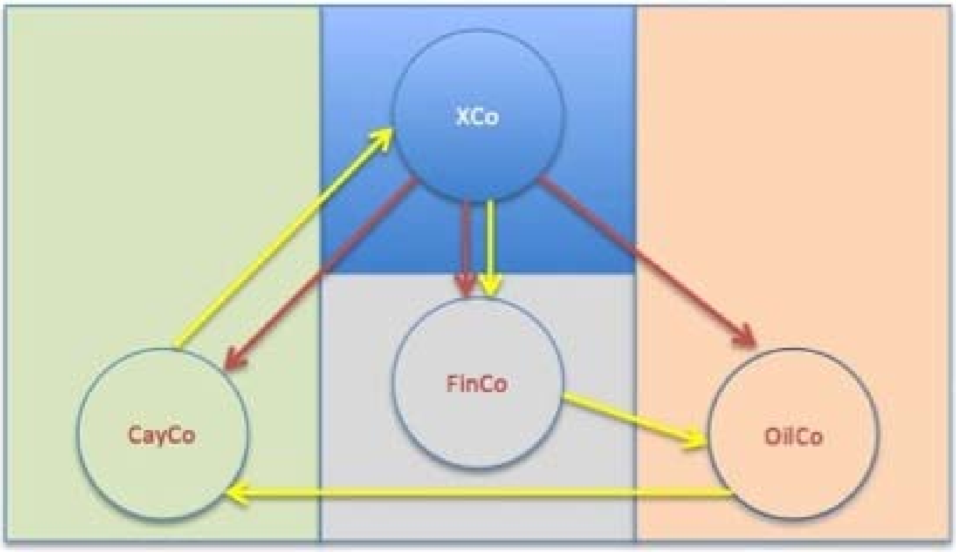
That, of course, offered little in terms of reduction when compared to the 35% charged in the country in which OilCo was located. As a consequence, UK Controlled Foreign Company rules did in this situation reduce the incentive to extract profits artificially from OilCo. That then protected the taxation revenues of the developing country, and so reduced the prospect of tax abuse in a tax haven of profits that should have been subject to tax in a developing country. That was a double advantage of the control foreign company rules as they operated at the time.

To explain the third protection measure with regard to UK taxation some simple changes in the assumptions are required. First, let us assume that the management of XCo have realised that putting their profits into the Cayman Islands is a mistake, because it triggers the Controlled Foreign Company rules. As a consequence they make CayCo tax resident in a country where they can pay an effective rate of tax at 23%. This still offers a significant saving over the 35% tax rate in OilCo's location, so encouraging the artificial transfer pricing of profits out of the developing country where OilCo is located into CayCo, but not now triggering the UK Controlled Foreign Company rules because the differential in tax rates is not sufficient to do so. In theory profits can now accumulate at this lower tax rate inside CayCo.

Under the rules that existed until April 2009, if and when CayCo paid a dividend to XCo so that the ultimate shareholders of the group could enjoy the benefit of that profit that dividend would have been taxed on receipt in XCo at the full UK corporation tax rate but with credit being given for any tax already paid within CayCo. The result would have been that a further 7% tax would have been paid in the UK, bringing the overall tax charge to the 30% rate due at that time.

The result of the new arrangement (the result of the 2009 changes) was that although OilCo still probably paid little or no tax on its profits full UK corporation tax did apply to them. This was because they either flowed to FinCo through the payment of interest, where as a result they were taxed in the UK, or to CayCo where some tax was paid with an additional sum due in the UK when they (eventually) flowed to XCo as a dividend. This meant that overall all profits were subject to UK tax within the group, with credit being given for tax paid elsewhere. Additionally, UK Controlled Foreign Company rules and the eventual tax charge on CayCo may well have reduced the incentive to abuse OilCo as much as would have happened if no CFC or profit on remittance of dividends rules were in place. As a consequence the policy helped developing countries.

This has all changed since April 2009, with the rules announced in December 2010 and to be included in the Finance Act 2011 significantly reinforcing this trend. These can now be worked through using the same basic structure, now shown by this diagram:



XCo owns all the subsidiaries still, but there are now significant changes from the situation that existed pre April 2009.

First of all, the UK has now abandoned a residence based tax system. The blue background in the first diagram that indicated that all profits arising in a group were potentially taxable in the UK has gone. The UK is now only subjecting the profits of companies arising in the UK to tax. This is the so-called 'territorial' basis for taxation the UK has now adopted.

This now makes the corporate tax system fundamentally different from the personal tax system for this first time. All but non-domiciled UK tax resident people pay tax on their worldwide income and gains, but now companies will not. This creates an immediate and fundamental injustice in the UK economy.

The consequence is that all areas not marked in blue on the diagram are now ignored for UK taxation purposes. Profits arising in other parts of the world will now never be subject to tax in this country. So, as a consequence, unless Controlled Foreign Company rules come into play the UK will recognise that the profits of OilCo should be taxed in the country in which is incorporated, and the profits in CayCo should again be subject to tax in the country where it is resident, and the profits in FinCo (which has now moved out of the UK) will be taxed, but subject to a special regime about which more is noted below.

The impact is significant. Suppose, as before, that the directors of XCo can ensure that CayCo avoids CFC rules – either by changing the trade sufficiently by ensuring it buys and sells other people's oil as well as that from within the group, or by adding some other qualifying activity or by, as before, paying some tax in the location in which it is resident - then the result is that the profits of OilCo can never be taxed in the UK and nor can those from CayCo because the dividends of the latter will now never be subject to tax on receipt back in the UK.

What are the current changes to corporation tax proposed by the government?

In addition, the Coalition Government has now announced that, to meet the constraints imposed on CFC rules created by the decision in what is called the Cadbury Schweppes tax case on treasury financing operations, the UK is to create a new special measure for such operations that will mean that if these group treasury operations are located in a tax haven with a 0% tax rate then the UK will treat them as being CFCs but will only subject them to a special low rate of tax of 5.75% by 2014. The profits of those treasury operations will not be subject to any additional tax when brought back to the UK. As a result the obvious thing for any company to do now is to shift their treasury operation out of the UK and to a tax haven – as XCo has done in the example. As a consequence the tax rates on the profits in the treasury function of this group (and almost every such group within the UK who chooses to make this arrangement) will reduce by 75%. It will be easy to manipulate this to ensure UK source operating profits move for tax purposes into such treasury companies.

Two of the three mechanisms used to prevent the undermining of the UK tax base by companies dedicated to tax avoidance have now been eliminated. In many cases only transfer pricing rules will be left, and with H M Revenue & Customs set to lose 15,000 staff over the next few years these will be much harder to apply simply due to a lack of resources.

There is also a secondary consequence. Whereas UK tax rules did in the past help protect developing countries in their task of trying to collect tax all protection for their interests have now gone: under the new arrangements in this example it is clearly in XCo's interests to seek to reduce profit in OilCo to as near zero as it can, especially by way of paying interest to FinCo at as high a rate as possible through the use of thin capitalisation techniques. There is as a result of these new rules a direct transfer of value from the population of the developing country to the shareholders of XCo. This is a matter of concern to many of the UK's development agencies.

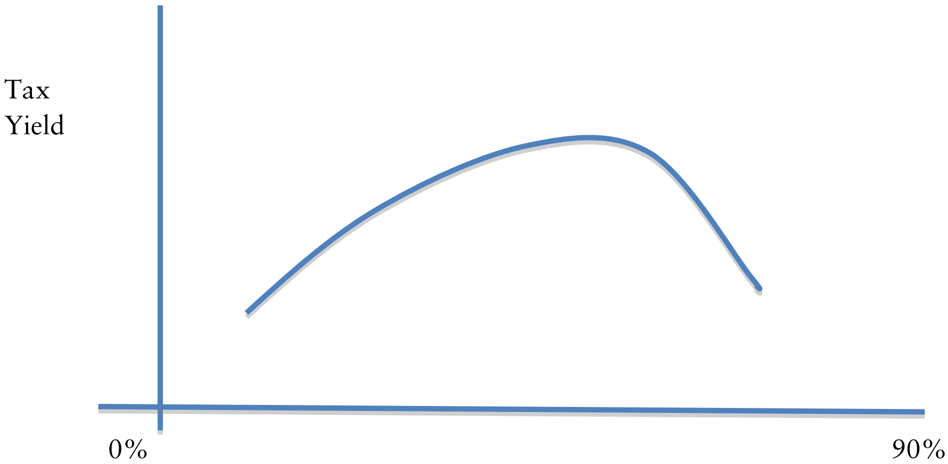
Section nine

The consequences of the proposed changes in corporation tax rules

The amount of money collected by any tax is explained by a quite simple formula, which is:

[Tax rate x Tax base] – Tax Gap = Tax Yield

It is often argued that reducing a tax rate increases the yield of a tax. This is the consequence of what is called the Laffer effect. The Laffer curve supposedly looks like this:



It is suggested by the proponents of this argument that at some point as tax rates increase (X axis) tax yield (Y axis) decreases so that the tax increase is counter-productive if its aim is to raise revenue. This is because, it is argued, as the tax rate increases the rate of return on effort expended falls so the amount of effort expended decreases disproportionately as the tax rate rises, so decreasing overall yield.

Of course, for a tax cut to have this beneficial effect the country making the cut needs to be on the right hand, downward sloping, side of the graph. Academic studies have suggested that examples of places on that part of this function, if it exists, are very hard to find. This suggests either that at best the tax rate at which yields fall is very high.

The argument also requires it be believed that a corporation collectively acts in the same way as an individual might.

It would seem that the government believes that this is the case and that a cut in the corporation tax rate of 5% will increase yields. Their forecasts suggest that yields will rise, albeit much more than for other taxes modestly and largely (at best) to reflect inflation after a period of initial recovery from the economic crisis.

Their assumption cannot be based upon growth in the existing tax base. As the above examples show, adoption of a territorial basis for corporation tax is bound to reduce the tax base of existing UK based companies as overseas profits now subject to tax will be excluded from the tax base in future.

The increase in yield is also unlikely to be the result of a reduction in the tax gap: the reduction in the number of staff at H M Revenue & Customs makes it very unlikely that there will be any reduction in that gap as other recent work by Tax Research LLP has shownix.

So, although the tax rate has fallen, the tax base has reduced and evidence that the tax gap is unlikely to reduce, the Government forecast is that they will rise, albeit modestly.

It must follow that the government assumes that because of the new low corporation tax rate that profits will be relocated to the UK, or that the UK will enjoy a period of significant profits growth as a result of the lower tax rates.

The first of these assumptions appears untenable: since the UK government is itself providing incentive for profits to be relocated outside the UK by allowing a special low rate of tax on group treasury operations and by refusing to re-tax in the UK profits previously located in locations such as Ireland and Hong Kong, which will still offer tax rates substantially lower than the UK, the chance that corporations will voluntarily relocate profits to the UK to pay 23% tax when lower overall rates can be enjoyed by locating them elsewhere seems highly implausible.

That necessarily means that the government must be assuming that the lower corporation tax rates that it will be offering will boost the domestic tax base to overcome all these other disadvantages to an increased tax yield that its policies will create.

This hypothesis needs to be explored, because it is the only tenable explanation for government policy.

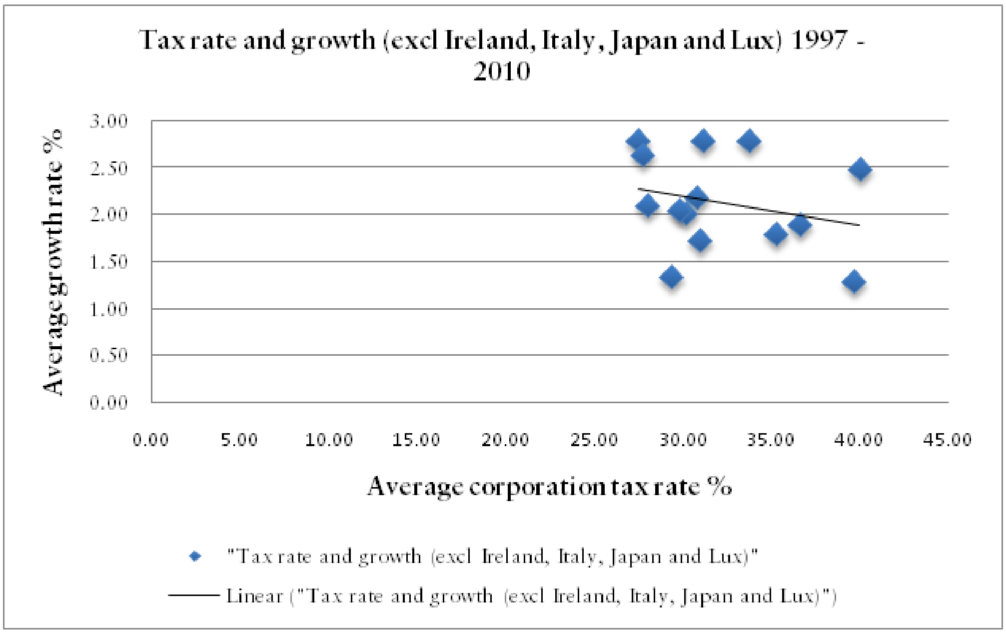
Section ten

Do lower tax rates boost growth?

Claim has been made, for example by the OECD, that lower tax rates induce higher rates of growth in an economy. Below we examine this claim by looking at the correlation between corporate tax rates and jobs and GDP growth.

While cross-tabulations between two variables rather than regression analysis do not control for any other differences between countries which might affect the outcome variable, two-way analyses using scatter plots are nonetheless a useful starting point as they provide a feel for what the relationship between specific variables may be.

It transpires that analysis of the correlation between tax rates and growth in OECD countries (excluding the top and bottom outliers) finds that at best the relationship between the two variables is weak, with the r^2 coefficient less than 7%:

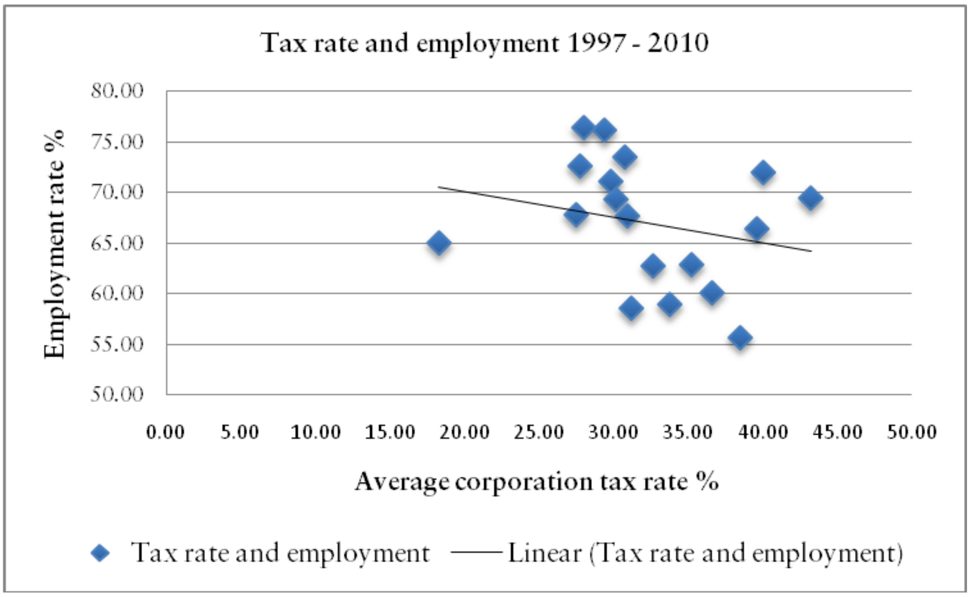


Tax rate differentials of between 27% and 40% over a period of 14 years are clustered so weakly around growth rates that these growth rates only vary between 1.9% and 2.3% per annum as a result.

The relationship of changing tax rates over time (which is what the UK government is proposing to do) and growth is weak based on this data. The linkage between the two as suggested by the resulting correlation coefficient that might reasonably be expected to apply to the UK suggest that over 90% of growth in this range is explained by factors other than tax. In that case cutting tax rates to stimulate growth appears a poor choice of economic policy.

Relationships between tax rates and employment also appear weak, as the following chart, using Eurostat employment data, shows:

Do lower tax rates boost growth?



The r^2 correlation coefficient in this case is only 6%, meaning that 94% of the variation in employment rates is explained by factors other than the tax rate. Once again, the implication is clear: lower tax rates cannot adequately explain changes in economic activity or in jobs growth.

It is also important to note that considering data over long periods such as this can be misleading, as can the use of headline tax rates. For example, Ireland appears to have seen a fall in its headline tax rate over this period from 36% to 12.5% with an average tax rate of 18.3%, but even in 1997 many companies in Ireland enjoyed the 10% manufacturing rate. It's growth rates appear to imply the positive impact of low tax rates: average growth at 4.75% was the highest in the data set for the period. However, that ignores the fact that its growth rate fell dramatically as the tax rate fell and that in 2009 its economy contracted by more than 7%. Tax rates alone cannot explain growth rates.

Other evidence suggests the same conclusion. For example, a study of tax changes and business investment rates in Canada for the period 1961 to 2010 by Jim Stanford for the Canadian Centre for Policy Alternatives concluded[x] that:

"This paper reviews longer-run empirical trends in fixed non-residential capital spending by Canadian businesses. Since the first of several rounds of business tax reforms and reductions was implemented in 1988, business investment has declined by 1 full percentage point of GDP —even though after-tax business cash flow has increased (in part as a direct result of the tax reforms) by 3 to 4 percentage points of GDP.

The proportion of after-tax cash flow which Canadian firms re-invest in fixed non-residential capital has declined from near 100 percent before the tax reforms, to less than 70 percent today.

Since 2001, Canadian corporations have received a cumulative total of $745 billion in after-tax cash flow which they have not re-invested into Canadian fixed nonresidential capital projects.

This growing wedge of excess corporate savings has translated into several outcomes which have undermined the vibrancy of Canada's recovery from the recent recession—including excess accumulation of cash and short-term financial assets, a noted increase in the rate of payout of corporate dividends, and a sustained reduction in leverage by non-financial corporations.

The paper conducts an original econometric analysis of historical Canadian data on business fixed non-residential investment, and confirms that tax rates have had no direct, statistically significant impact on investment.

Moreover, the indirect impact of tax rates on investment (experienced via their enhancement of after-tax business cash flow) has become less important in recent years. Business investment is more sensitive to GDP performance, interest rates, exchange rates, and oil prices than to cash flow."

These conclusions support those noted in this paper that there is no reason to think from the data noted in this report that falling corporate tax rates are strongly associated with growth.

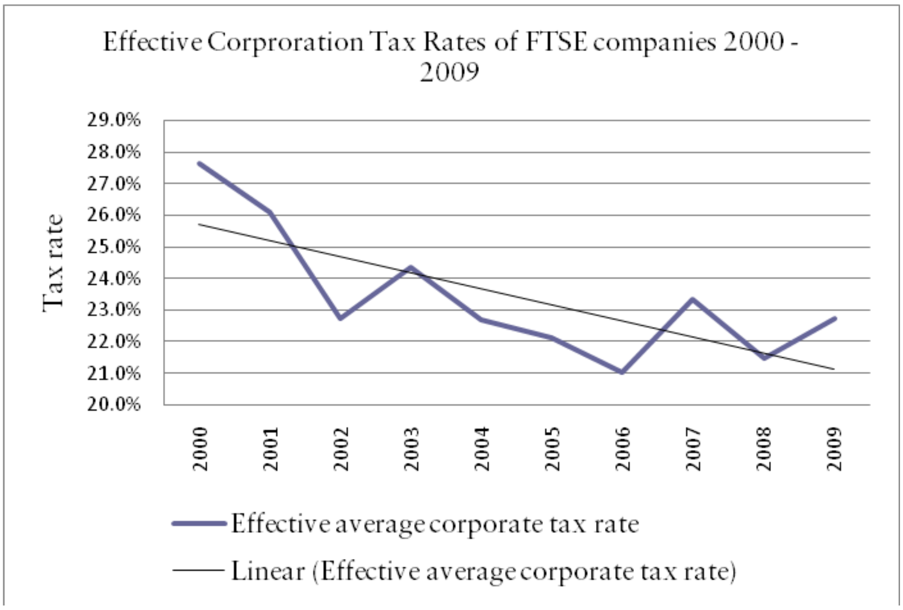
Section eleven

The tax gap

This conclusion is reinforced by another consideration. It is usually suggested that it is headline tax rates that attract companies to jurisdictions. It is for this reason, for example, that it is argued by the government that headline rates of UK corporation tax must be cut for large companies that engage mobile capital. However, few companies actually pay tax at the headline rate. This is because many large companies, in particular, can use many of the tax allowances in the tax system (such as those for R&D, relief for buying capital assets, reliefs from paying tax on capital gains) to their advantage in a way that few small companies enjoy.

In addition because of their international nature large companies tend to have many more opportunities to tax avoid, using tax havens and transfer pricing for example, to reduce their overall tax rate. As a result PricewaterhouseCoopers say in their 'Paying Taxes 2011' report for the World Bank that the effective tax rate of UK corporations is 23.2%[xi].

Work undertaken for the TUC suggests that this almost certainly overstates tax paid by the UK's largest companies. Working with Tax Research UK the TUC showed in 'The Missing Billions'[xii] ,published in 2008, that the largest 50 companies in the FTSE share index not only paid considerably less tax than the UK headline tax rate suggested they should, but that their effective tax rate was falling steadily even when the headline tax rate was static. This work was updated in October 2010 when the following graph showing trends in effective corporate tax rates was published[xiii]:



The trend is apparent: over a period of a decade the effective tax rate of major UK companies has fallen heavily even though the headline tax rate fell by just 2% in this period. With headline rates now falling much further (the UK headline rate for large companies will fall to 23% in 2014) it is highly likely that over time UK large companies will pay tax at lower effective rates than the UK's small companies. Indeed, the Oxford Centre for Business Taxation suggested before the 2011 budget that this may already be the case[xiv]. However, as the evidence in this paper shows, that is unlikely to result in either significant growth in GDP or employment in the UK.

Section twelve

Endnotes

[i]http://en.wikipedia.org/wiki/United_Kingdom_corporation_tax

[ii] http://www.hmrc.gov.uk/rates/corp.htm and http://www.hmrc.gov.uk/stats/corporate_tax/rates-of-tax.pdf

[iii]http://www.hmrc.gov.uk/stats/corporate_tax/rates-of-tax.pdf

[iv]KPMG data was consistently used, with the 2008 data being the main benchmark for the sample set. In most years 67 countries are used as the basis of calculation. EU and OECD member states are as at 2008: those countries joining the OECD in 2010 are treated as non-OECD as they were for mist of the period. Countries with high GDP per head have GDP per head of more than US$25,000 in 2008 per the CIA FactBook. High government spending is more than 30% of GDP in 2008 according to the CIA FactBook.

[v] http://www.hmrc.gov.uk/stats/corporate_tax/table11-6.pdf

[vi]http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_1,00.html#C_CorporateCaptial

[vii] http://www.hmrc.gov.uk/stats/tax_receipts/tax-receipts-and-taxpayers.xls and 2011 Budget Red Book forecasts.

[viii] http://www.hmrc.gov.uk/stats/tax_receipts/tax-receipts-and-taxpayers.xls and 2011 Budget Red Book forecasts.

[ix] See http://www.taxresearch.org.uk/Documents/500000Final.pdf

[x]http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb020

[xi] In statistics, the coefficient of determination R2 is used in the context of statistical models whose main purpose is the prediction of future outcomes on the basis of other related information. It is the proportion of variability in a data set that is accounted for by the statistical model. It provides a measure of how well future outcomes are likely to be predicted by the model. From http://en.wikipedia.org/wiki/Coefficient_of_determination

[xii] See for explanation of the case on Ireland http://www.taxresearch.org.uk/Documents/CorpoTaxlores.pdf . Luxembourg is a state of just 503,000 people and therefore smaller than many UK cities. https://www.cia.gov/library/publications/the-world-factbook/geos/lu.html

[xiii]http://www.policyalternatives.ca/sites/default/files/uploads/publications/National%20Office/2011/04/Having%20Their%20Cake%20and%20Eating%20It.pdf

[xiv] http://www.pwc.com/gx/en/paying-taxes/pdf/paying-taxes-2011.pdf table 4

[xi] http://www.tuc.org.uk/touchstone/Missingbillions/1missingbillions.pdf

[xvi] http://www.tuc.org.uk/extras/corporatetaxgap.pdf

[xvii]http://www.sbs.ox.ac.uk/centres/tax/Documents/Corporate%20tax%20in%20the%20United%20Kingdom.pdf

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