



Budget Submission 2011

IoD POLICY PAPER





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SUMMARY

- The IoD's 2011 Budget Representations call for 4 changes to the tax system which could substantially improve the competitiveness of the UK economy. The 4 proposals aim to kill the damaging perception of the UK becoming a high tax economy.
- The proposed tax changes involve either little/or no cost over the course of the Spending Review, or more significant cost beyond 2014-15. Even then the cost is easily manageable, with continued restraint in the growth of public spending.
- The 4 key changes are:
 - **A commitment to abolishing the 50 per cent top rate of Income Tax by 2014-15** – no fiscal cost prior to 2014-15, with the potential to be revenue positive thereafter. Coalition politics and the fiscal squeeze rule out early abolition but a clear statement about future abolition, by the Chancellor in the Budget, could significantly boost business confidence.
 - **Removing the withdrawal of the personal allowance on earnings above £100,000.** Annual cost of around £1.5 billion but potentially much less, given the lost output arising from the 62 per cent marginal rate on affected income at present. The median salary for IoD members is around £75,000 and so the withdrawal of the personal allowance directly impacts on their aspirations for future income.
 - **Extending the reduction in Corporation Tax to 15 per cent by 2020.** We want to aim for the UK having the lowest corporate tax rate in the world by 2020¹. On current estimates reducing the rate from 24

¹ Ireland has a 12.5 per cent rate at present but we assume this may rise in the wake of the financial crisis. Other countries may also try and reduce their rates to compete as well.

to 15 per cent would cost around £9 billion per annum (http://www.hmrc.gov.uk/stats/tax_expenditures/table1-6.pdf). This would be funded by continued restraint in public spending growth, simplification and removal of certain allowances, together with the dynamic impact on GDP growth from greater business investment in the U.K. Obviously implementation would depend on the outcome of the next General Election, but a clear commitment to such a policy by the Government (to be implemented if elected) could substantially improve perceptions of future competitiveness. Combined with the personal tax changes described above, it would send out a very strong message that Britain is open for business.

- **Introducing an exemption from future Capital Gains Tax for entrepreneurial investments** - made between now and 5th April 2012.

Introduction

The March 2011 Budget will continue the process of fiscal adjustment and deficit reduction outlined by the Chancellor in the June Budget and October Spending Review last year.

The IoD continues to support the Coalition Government's fiscal adjustment plan and does not think the Chancellor should resort to a so-called plan B for economic recovery – easing back on the Spending Review.

This does not mean we think there will be no short-term impact on the economy from the Spending Review and tax increases. Because in the absence of the deficit reduction plan the consequences for the economy could or would be even worse – owing to the negative impact on financial markets and business and consumer confidence.

Against this background of severe fiscal constraint it might be presumed there is little the Government can do to kick-start economic activity and strengthen the recovery. This would be the wrong conclusion. In February 2011 the IoD published its *Freebie* report (<http://press.iod.com/2011/02/07/%e2%80%98freebie%e2%80%99-growth-plan-published-by-iod/>) outlining the key supply-side decisions – deregulation, planning liberalisation, etc - the Government could take at little or no fiscal cost, but which would help stimulate economic growth.

In support of supply-side reform our Budget Representations identify 4 potential changes to the tax system, which could significantly improve the UK's future competitiveness - and prospects for economic growth - but will not have any significant short-term fiscal cost:

- **A commitment to reversing the 50 per cent top rate of Income Tax by 2014-15** – no fiscal cost prior to 2014-15 and the potential to be revenue positive thereafter.
- **Removing the withdrawal of the personal allowance on earnings above £100,000.** Annual cost of around £1.5 billion but potentially much less given the lost output arising from the 62 per cent marginal rate on affected income at present.

- **Extending the reduction in Corporation Tax to 15 per cent** – by 2020.
- **Introducing an exemption from Capital Gains Tax for entrepreneurial investments** - made between now and 5th April 2012.

The proposed tax reductions have the benefit of costing very little money between now and 2015. With regard to the 50 pence top rate of Income Tax we are calling for a clear statement by the Chancellor in the Budget that the hike will be reversed by 2015. Any fiscal cost is end-loaded. However, as our analysis shows, we believe there will be little or no fiscal cost to this reversal. There may even be a revenue gain.

Beyond 2015 there would be more significant fiscal cost attributable to the reduction in the main rate of Corporation Tax to 15 per cent. However, this cost is still easily affordable with continued restraint in the growth of public spending.

1. Abolishing the 50 per cent income tax rate

Taxes should only be levied if they will do more good than harm. In this chapter, we show that the 50 per cent income tax rate fails that test. It should therefore be repealed.

There are two main effects of a tax that might be regarded as benefits. It might raise revenue to fund public services. And it might ensure that the burden of public spending is allocated to people in a way that mirrors the ease with which they can bear that burden. One can debate the precise merits of different levels of progressivity in the tax system, but at the very least, there is political value in showing that the greatest burden falls on the broadest shoulders, especially when there is no slack in the public finances, and a heavy deficit to reduce.

On the other hand, there are several possible damaging effects of a tax. It may deter personal effort and enterprise. It may make the country internationally uncompetitive: a comparatively high-tax country is not going to attract either international capital, or workers who are highly-paid on account of their valuable skills. And it may introduce economic distortions.

The 50 per cent income tax rate is likely to do little or nothing to achieve either of the possible benefits. And it certainly does harm, of all the types indicated except, perhaps, the last. There has been enough political rhetoric in favour of the tax rate. But the numbers speak plainly against it. And numbers are a surer guide than rhetoric to sound policy.

Tax revenue

The 50 per cent tax rate, officially known as the additional rate, applies to income in excess of £150,000 a year. The personal allowance is irrelevant, because it is withdrawn before that level of income is reached. The introduction of this rate, to replace the 40 per cent rate that used to apply to income at that level, and still applies lower down the scale, would undoubtedly increase total tax revenue if people did not change their behaviour, and hence their gross incomes, in response to the introduction of the rate. But in fact, people will change their behaviour. The most substantial effects in cash terms, and the ones with the greatest knock-on effects on

the economy as a whole, will be on work incentives. At the margin, people will work less, because demanding work is less well-rewarded after tax. Even those who continue working to the same extent will find it more worthwhile to engage in tax planning in order to reduce tax liabilities.

These effects can even mean that an increased tax rate reduces total revenue, something that is directly counter-productive. The critical parameter is the *taxable income elasticity*. This is the ratio of the percentage fall in taxable income to the percentage fall in the proportion of gross income that is not taken in tax. A high taxable income elasticity implies that a given tax rise, implying a given percentage fall in the net income after tax, will lead to a substantial fall in taxable income. This will in turn raise the spectre of the tax rise being counter-productive.

Finding the value of the taxable income elasticity is not easy, and the value will vary with the level of income. Data can be collected when rates change, but marginal rates for high-income individuals have not changed since the late 1980s. Furthermore, the estimates that can be obtained are subject to considerable uncertainty. But these difficulties are no excuse for not being as accurate as possible. And recognition of the uncertainty highlights the risky nature of an increase in marginal tax rates.

The most relevant study we have was prepared in 2009 by Brewer and Browne². It considered the original proposal for a 45 per cent income tax rate, but the data on taxable income elasticity, and the analysis, can equally well be applied to the 50 per cent rate.

Brewer and Brown identify an estimate from the late 1980s of a taxable income elasticity, at high incomes, of 0.46, but with a standard error of 0.13 so that there was a one-in-three chance that the true value lay outside the range from 0.33 to 0.59, which is quite a large degree of uncertainty³. They also gave estimates supplied by the Treasury in 2008. The Treasury figure was in principle 0.4, but this was reduced to 0.35 by virtue of new restrictions on pension contributions⁴. The relevance of these restrictions is that one way for people to reduce their taxable income is to increase their pension contributions, and limits on those contributions limit the opportunity to

² Brewer, Mike, and James Browne. *Can more revenue be raised by increasing income tax rates for the very rich?* London, Institute for Fiscal Studies, 2009.

³ *Ibid.*, page 6.

do so. The new Government has announced plans to change the form of such limits, but they will remain pretty severe for those who are already in the habit of making substantial pension contributions. We will therefore work with a taxable income elasticity of 0.35, but will recognize the high degree of uncertainty that surrounds this figure by also seeing what would happen if the figure were 0.45. That higher figure would be well within the plausible range if the uncertainty that was established in the 1980s, and we have no reason to suppose that those uncertainties have diminished.

The fall in the income not taken in tax that is caused by moving from a 40 per cent tax rate to a 50 per cent rate might appear to be 16.7 per cent, but this figure neglects national insurance. Employees' national insurance at this income level will be 2 per cent in 2011-12, and employers' national insurance will be 13.8 per cent. Thus if an employer spends £11,380 on paying someone at this level of earnings, £10,000 will reach the employee, and the net pay will be £5,800 at a tax rate of 40 per cent and £4,800 at a tax rate of 50 per cent.

The overall effective tax rates are therefore 49.0 per cent and 57.8 per cent respectively, leaving 51.0 and 42.2 per cent of income not taken in tax. The fall in income not taken in tax is therefore $8.8/51 = 17.2$ per cent.

Applying the taxable income elasticities of 0.35 and 0.45 to this would give reductions in taxable income of 6.02 per cent and 7.74 per cent respectively.

Brewer and Browne give an income distribution for the UK, which show that we have a Pareto distribution with parameter 1.8. They then show how to compute the revenue-maximising tax rate⁵. The formula with this parameter is:

$$1/(1 + 1.8 \times \text{taxable income elasticity})$$

Applying the taxable income elasticities of 0.35 and 0.45 gives revenue-maximising rates of 61 and 55 per cent respectively. But these are the overall effective tax rates, and the 50 per cent rate gives an effective rate of 57 per cent, as against 49 per cent with a 40 per cent income tax rate. So if the taxable income elasticity really is 0.35, the move to a 50 per cent rate should increase overall revenue. But if it is 0.45, the move will actually decrease revenue.

⁴ *Ibid.*, page 7.

We are left in the dark as to whether the introduction of the 50 per cent tax rate increased or decreased revenue. We do, however, have reason to question the then Government's figure for the taxable income elasticity, the lowness of which makes the 50 per cent rate look productive:

- The then Government's underlying data and calculations have not been published. This does not mean that their figure is wrong. But it does mean that we have no grounds to prefer it to the figure of 0.46, even though that comes from a study that is more than 20 years old. There is no suggestion of dishonesty here. It is simply that for all we know, the figure could have been based on very limited data and on the use of judgement.
- In February 2010, Lord Myners, then Financial Services Secretary, acknowledged that the then Government's original estimate of the revenue that would be raised had been optimistic. He said "We have made adjustments for the behavioural consequences of the new higher rate of taxation and have accordingly significantly reduced the anticipated tax take"⁶. The clear implication is that on reflection, the Treasury had decided that its original estimate of the taxable income elasticity had been too low.

In the light of this, we have to ask whether the introduction of the 50 per cent rate was worth the risk, even in terms of its direct effect on tax revenue. It may well have reduced revenue, at a time when it was already clear that public finances were going to be under severe pressure. When we consider the indirect adverse effects, as we do below, it will become clear that the risk should not have been taken.

The allocation of the tax burden

There is another conclusion to be drawn from the risk that the introduction of the 50 per cent rate may reduce revenue. It makes the claim that the rate ensures that the broadest shoulders will bear the greatest burden ring rather hollow. It is true that with the 50 per cent rate, people with high incomes pay a higher marginal tax rate than others, and that they pay over a greater proportion of their actual taxable income than they would if only the 40 per cent rate applied. But if the taxable income of those

⁵ *Ibid.*, pages 8-11.

people falls enough to reduce the total tax paid, they will contribute fewer pounds to the Exchequer. Meanwhile, those who are not affected by the 50 per cent rate will presumably continue to contribute the same number of pounds. The overall effect is that a greater proportion of the total tax burden will fall on people whose incomes are below £150,000. The result may be more equality in after-tax incomes, but at the cost of making the lower-paid worse off. Even if they are not made worse off by any direct effect on their pay packets, the deficit will take longer to reduce, and public spending will have to be reduced or at least prevented from growing, more than would otherwise be the case. The only way to avoid these results would be to increase some other tax burden, and one that would very likely have an adverse effect on lower-income people. That would surely be a perverse result, when the intention was to shift the burden towards people with higher incomes.

Effort and enterprise

The fact that the taxable income elasticity is not zero shows that the 50 per cent tax rate will affect people's behaviour. In order to get an idea of how much this will matter, we need to know something about the people who have to pay it.

The number who will have to pay on their income from employment or self-employment is between 260,000 and 360,000⁷. While we do not have full data on the fields in which these high earners work, we do know that they are spread across a considerable range.

- The 2010 Annual Survey of Hours and Earnings gives 90th percentile levels of earnings⁸. The level is highest, not in finance but in healthcare, with a level of £127,521. Corporate managers come next, with a 90th percentile of £84,795. Neither of these figures would put someone into the 50 per cent tax bracket, but they do clearly show that high pay is not limited to the sectors that attract headlines.

⁶ *House of Lords Hansard*, 1 February 2010, column 6.

⁷ *HMRC table 3.6, Earned income, 2007-08*. This table gives the latest data that are available. In that year, 260,000 people had income from employment of £150,000 or more. An additional 102,000 had income from self-employment of £150,000 or more, but some of these would also have been included in the figures for employees.

⁸ *2010 Annual Survey of Hours and Earnings*, Office for National Statistics, table 2.7a.

- HMRC publish limited data on the distribution of high levels of income from self-employment across different sectors⁹. The figures for those with self-employment income of £100,000 or more, the highest band in the table, show 32 per cent of these high earners work in legal and accounting activities and 17 per cent in other financial, real estate, renting and other business activities (a very broad category). But while the concentration of high earners in those fields may not come as a surprise, we find a further 32 per cent in education, health and social work, 4 per cent in construction, 4 per cent in wholesale, retail and repairs and 4 per cent in other industries.

We cannot simply extrapolate the percentages from the HMRC data, either up to people with income over £150,000 or to those who are employees (because self-employment, often as a partner in a firm, is much more common in some sectors than in others). Nor can we conclude from the Annual survey that healthcare is where the highest earnings are to be found. But we can conclude that high earnings are widely spread across the economy, and that the impact of the 50 per cent tax rate as a deterrent to effort will be widely felt.

Not only will those who are already earning at or near the £150,000 level be less inclined to earn more, or to work in order to get promoted. Those who are thinking of starting a new business, perhaps by resigning from an existing secure position, are more likely to think twice if they will be taken into the 50 per cent band.

International competitiveness

More than ever before, countries must compete for highly-skilled labour. They must also compete as locations for new businesses, which groups can choose to place in any one of a number of different countries.

Consider a highly-skilled professional, for example an engineer, who can choose to work in any one of several different countries. Other things being at least roughly equal, she will prefer one with lower tax rates, and specifically, lower tax rates on high incomes. Or consider a group that wishes to set up a new business, the workforce of which will include a substantial proportion of highly-paid employees. Again the group will have a preference for countries with lower tax rates on high

⁹ HMRC table 3.9, *Self-employment income assessable to tax, 2007-08*. This table gives the latest data

incomes. Income tax comes out of employees' salaries, so it may appear to be a concern of employees rather than of employers, but if tax rates are high, gross salaries will have to be increased in order to make net salaries sufficiently attractive to lure staff away from opportunities in other countries. Thus income tax can be a burden on employers, just as much as on employees.

We therefore need to compare the UK's income tax and social security rates with those in other countries. A recent survey of 86 countries shows that the 50 per cent tax rate puts the UK in a far-from-ideal position¹⁰.

- Only three countries out of 86 had highest personal income tax rates that were above the UK's rate in 2010: Sweden on 56.6 per cent, Denmark on 55.4 per cent, and the Netherlands on 52 per cent. Three others had an equal highest rate of 50 per cent: Austria, Belgium and Japan. The other 79 countries had lower highest rates than the UK¹¹. By contrast, if the UK's highest rate were only 40 per cent, as it used to be, 20 other countries out of the 86 would have highest personal tax rates than the UK, six would have the same 40 per cent rate and 59 would have lower personal tax rates¹². This would still not be ideal, but it would be a great deal better to be able to point to a substantial number of countries with highest personal tax rates that were above the UK's, than to be able to point to only a handful.
- The effective income tax and social security rate on 100,000 US dollars of gross income in 2010 was 31.5 per cent. This was higher than in 57 other countries, and lower than in 23 other countries¹³. (Data were only collected for 81 of the 86 countries.)
- The effective income tax and social security rate on 300,000 US dollars of gross income in 2010 was 41.7 per cent. This was higher than in 64 other countries, and lower than in 16 other countries¹⁴. (Data were only collected for 81 of the 86 countries.)

that are available.

¹⁰ *Individual Income Tax and Social Security Rate Survey 2010*, KPMG, September 2010.

¹¹ *Ibid.*, pages 8-9.

¹² *Ibid.*, pages 8-9.

¹³ *Ibid.*, pages 10-11.

¹⁴ *Ibid.*, pages 12-13.

- The UK's 10 percentage points increase in its highest rate from 2009 to 2010, when the 50 per cent rate was introduced, was the highest increase between those two years of any EU member state and of any OECD member state. The next highest increases were seen in Greece (5 percentage points) and in Portugal (3.9 percentage points) in the EU, and in Iceland (9.1 percentage points), Norway (7.8 percentage points), Greece and Portugal in the OECD¹⁵.

Conclusion

We have seen that it is very doubtful that the 50 per cent rate raises revenue. If it loses revenue, which it may well do, it loses that revenue from the highly-paid. That would make its effect on the distribution of the burden of tax directly contrary to what was intended. Furthermore, it deters effort over a wide range of economic sectors, and makes the UK markedly less attractive than other countries, both to highly-skilled employees and to their potential employers. There are therefore plenty of reasons to abolish it.

These arguments for abolition are based on hard data. But we must also consider what overall impression the UK makes in the global economy. Do we want the UK to be seen as a high-tax country, or as a country that competes for business, and wins it?

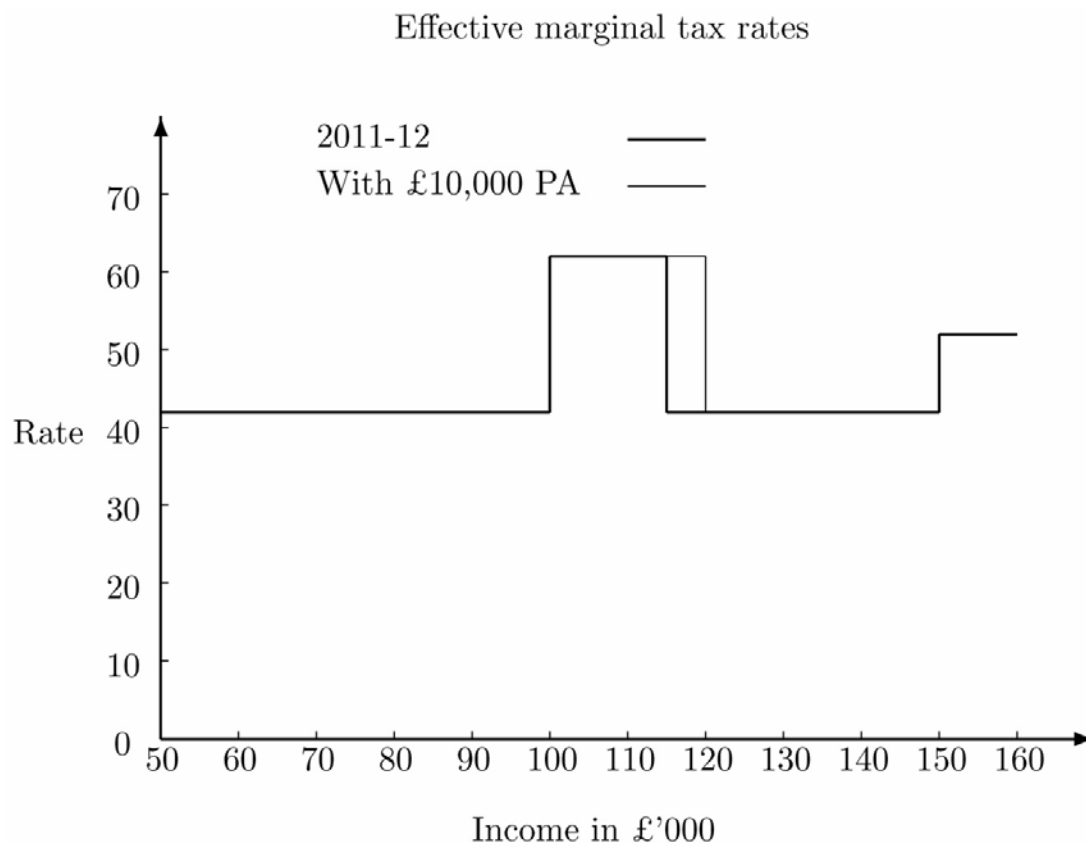
¹⁵ *Ibid.*, pages 8, 9, 18 and 25.

2. Withdrawal of the personal allowance

The previous government introduced a policy of withdrawing the personal allowance from people with high incomes. This is an inappropriate policy, which should be reversed as soon as possible.

A supposed justification is that when someone has a six-figure income, it is unfair to let them get the same bonus of receiving income tax-free as people on much lower incomes. In fact, this argument reflects a misconception. The personal allowance is effectively a zero per cent income tax band, that is followed by a 20 per cent band, a 40 per cent and finally a 50 per cent band. There is no reason to change the low-end tax bands when income falls within bands higher up the scale.

Chart 2.1



But the policy is worse than unjustified. It is also positively perverse in its effects. Governments have to balance the apparent desirability of higher proportionate tax burdens on high earners against the fact that high marginal tax rates deter effort and

enterprise. The last government decided that a scale of rates of 20, 40 and 50 per cent struck the right balance, although there is every reason to doubt that a 50 per cent rate is sensible. The withdrawal of the personal allowance creates a new rate of 60 per cent, in the band of income over which it is withdrawn. It does this because an extra pound of income not only generates 40p of tax. It also leads to 50p being taken off the personal allowance, transferring 50p of income from the 0 per cent band to the 40 per cent band and generating an extra 20p of tax. If we apply 2011-12 rates and allowances, and add the 2 per cent employees' national insurance that will apply on earned income, we find that there will be a 62 per cent tax rate on the band of income from £100,000 to £114,950. If the personal allowance is increased to £10,000, as the government plans, the rate will apply on the band from £100,000 to £120,000 (see: Chart 2.1). The following graph illustrates the bizarre pattern of marginal rates, from incomes of £50,000 to £160,000, both at 2011-12 rates and with the proposed £10,000 personal allowance.

The withdrawal of the personal allowance therefore creates a very substantial disincentive for people such as high-achieving head teachers, directors of medium-sized companies and those who have real prospects of being the next generation of leaders of large companies, people whose income can easily hover around £100,000. Is it going to be worth their while making the push to reach up to the next level, just beyond the affected income band, when well over half of the extra reward they can earn by getting up to that level will be taken in tax?

3. Reducing the rate of Corporation Tax

Successive governments have recognised that the main corporation tax rate is important. The rate was reduced from 30 to 28 per cent in 2008, and it is due to come down to 24 per cent by 2014. Both the 2008 reduction, and the forthcoming reductions are largely financed by reductions in the rates of capital allowances. That is, there is movement in the direction of a lower rate of tax on a broader base.

The path of corporation tax rates for the next three years is set. But we should look beyond that point. What should be the long-term objective? In this chapter, we set out the case for a 15 per cent tax rate and call for a timetable to get down to that rate.

Why the rate matters

We now live in global economy. Capital can be invested almost anywhere in the world. Investors naturally seek the best after-tax returns on their money. Some countries are particularly attractive because of non-tax factors, such as their labour supply or their infrastructure, which may allow high pre-tax returns to be earned. And it is important for countries to pay attention to such factors. But the difference between pre-tax and post-tax returns is just as likely to be significant.

Ultimately, investors care about what they obtain after all forms of taxation, both corporate and personal. But the investors in a given business may be in several different countries, so that there will be no single overall tax rate. The tax rate suffered by any company in which they invest will, however, be the same for all of them, and will have comparable impacts on most of them. The corporation tax rate in any one country will affect the attractiveness of companies within that country to investors from all over the world.

We must also consider multinational groups. In such a group there is effectively a single investor, the holding company, that must decide where to locate group operations, where to create new operations and where to expand, contract or close existing operations. Again, the corporation tax rates in different countries will influence decisions, bringing business to lower-tax countries.

Rates will not influence group decisions merely because of their effects on the net returns from specific operations. Corporation tax rates in different countries can also influence group structures.

For example, it often makes sense to have intermediate holding companies in relatively low-tax countries, so as not to generate tax burdens at that level which cannot be relieved against tax at the level of the ultimate holding company. An intermediate holding company in a relatively low-tax country is also less likely than one in a relatively high-tax country to suffer extra taxes on the companies below it in the group structure, under controlled foreign company (CFC) rules. It can therefore be given subsidiaries in a substantial range of countries, giving it a significant role in the group as a whole. While an intermediate holding company may not employ many staff or generate much income on its own, a country can still benefit from hosting it. Its presence will create an attachment to its country of residence, allowing information on that country and on business opportunities to be at the fingertips of the board.

Similar points can be made about the locations of ultimate holding companies. These can no longer be regarded as fixed. Some major groups have relocated their holding companies. A low corporation tax rate both avoids adding to the tax burdens that have already been imposed in operating companies in different countries, and reduces the likelihood of tax charges being imposed under CFC rules. And ultimate holding companies are even more worth attracting than intermediate holding companies, because of the attachment that they can generate to their countries of residence. Directors will be very well aware of business opportunities in the country in which they hold their board meetings.

One might expect investors, whether separate owners of capital or group holding companies, to be concerned not with the published rate of tax in a country (the "headline rate"), but with the effective rate that is generated by the combination of the headline rate and the definition of the tax base. But while there is some merit in that thought, it under-estimates the importance of the headline rate. That rate matters greatly, for the following reasons.

- The headline rate is a much easier concept to grasp than the combination of the rate and the definition of the tax base. Investors, and the tax departments of multinational groups, have limited resources. They cannot consider every

possible combination of rates and reliefs. In order to reduce the number of options, they will start by concentrating on the countries with low headline rates.

- The tax base can easily change. In Britain, for example, rates of capital allowances have routinely changed. It would be unwise to base long-term investment decisions on an assumption that the tax base will remain the same. Headline rates have proved to be more reliable. The UK's main rate has not increased since 1973. (The small profits rate did increase slightly in 2007 and 2008, but that rate is of no interest to investors in substantial businesses.)
- When it comes to locating intermediate holding companies, the main concerns are the potential imposition of additional tax burdens that cannot be relieved further up the group structure, and the potential impact of controlled foreign companies legislation. The seriousness of these concerns depends on headline rates, rather than on reliefs for particular types of expenditure. The lower the headline rate in a country, the less such concerns are likely to deter the location of intermediate holding companies there. The same points apply to the location of ultimate holding companies: the only difference is that any tax burden that is imposed at the top of a group, in addition to tax burdens imposed on operating companies, cannot possibly be relieved further up the group because there are no higher companies.

The starting point for this discussion was the fact that capital can go where it pleases. A corporation tax rate that is lower than the norm can be expected to give a country an advantage. It is not the absolute rate that matters, so much as the rate relative to the rates on offer elsewhere. Capital is virtually bound to go somewhere, in order not to lie idle and earn nothing. But it will go where the best post-tax returns are available.

We therefore need to look at the UK's position relative to other countries, particularly but not exclusively other developed countries that are comparable in respect of factors other than tax. What headline rate would put the UK ahead of the pack, and would give long-term investors confidence that the UK would remain ahead of the pack for some considerable time, rather than being overtaken by several other countries within a few years?

The UK and other countries

Corporate income tax rates for the 34 member countries of the OECD in 2010 ranged from 39.54 per cent (Japan) down to 12.5 per cent (Ireland), with a median of 25.75 per cent (interpolated between the Netherlands and Finland)¹⁶. The UK's rate was 28 per cent, which was above the median and significantly closer to the highest rate than to the lowest rate. To be precise, 21 of the 34 countries had lower rates than the UK.

We can make comparisons with other groups of countries too. The EU average corporate tax rate in 2009 was 23.22 per cent, while the global average was 25.51 per cent¹⁷. And a study of 80 countries found that the UK's effective corporate tax rate was higher than the effective rate in 66 of them¹⁸. On these measures, the UK's 28 per cent rate is clearly too high to impress businesses or investors.

Now let us consider the planned reduction to 24 per cent. If other countries do not also reduce their rates, the UK's rate will fall to a little lower than the global average, but will still be above the EU average. So there will be some improvement, but not a dramatic improvement.

If we look at the effect on the OECD rankings, we can see what a modest reduction in the headline rate achieves, and what it does not achieve. A 24 per cent rate will be below the OECD median. If other countries do not reduce their rates, only 11 out of the 34 OECD countries will have lower rates than the UK. This is a great improvement in the ranking, but a modest rate reduction can only lead to such a great improvement because the rates of many countries are bunched together in the middle. The lower quartile is at 20 per cent, and the upper quartile is at 30 per cent. Correspondingly, modest rate reductions by a few other countries could easily push the UK back down the ranking.

A much lower rate, on the other hand, would make it much less likely that the UK would fall far back down the ranking. If the UK's rate were only 15 per cent, only one

¹⁶ OECD Tax Database, table II.1. Of the four countries that joined the OECD in 2010, only Chile, which joined in May, is included in the 31 countries covered in that table. Figures for Slovenia, Israel and Estonia have been obtained separately.

¹⁷ *UK Tax Competitiveness Survey 2009*, KPMG, page 7.

country, Ireland, would have a lower rate, and only one other, Iceland, would have an equal rate. If all countries apart from the UK reduced their rates by, say, 4 per cent, the UK would still be beaten by only three countries, would be on a par with four others, and would still be ahead of the remaining 26 countries.

Effects of reducing the rate

Tax revenues

If a tax rate is reduced and nothing else happens, then tax revenues will fall. But there is every reason to suppose that other things would happen, so that in the medium term tax revenues would at worst remain stable, and would probably rise. There are three effects to consider: the encouragement of growth, the attraction of international capital and the attraction of profits.

- There is ample evidence¹⁹ that lower tax rates lead to higher economic growth, and hence to a higher tax base.
- As already mentioned, international capital will prefer destinations where the best after-tax returns can be obtained. Tax is not the only factor in that computation, but it is an important one. And it is the corporation tax rate that handicaps the UK here. If that can be reduced significantly, overseas investors can reap the benefits because the UK's extensive network of tax treaties already facilitates the payment of profits made in the UK to foreign shareholders without excessive tax burdens.
- A multinational group can justifiably attribute profits to the use of all of its assets. But some of these assets, in particular intellectual property, can be located anywhere in the world. Group intellectual property management companies will naturally be located in countries where the tax on the profits that can be attributed to them will be lower, rather than higher. If the UK has a lower tax rate, it will become more attractive as a location for such companies. Both the last Government and the current Government have recognized this point, by promoting a regime that would tax income from

¹⁸ *Cutting the Effective Corporate Tax Rate*, Tax & Budget Bulletin number 50, Cato Institute, October 2008.

¹⁹ *Tax Matters – Reforming the Tax System*, The Report of the Tax Reform Commission, October 2006.

patents at only 10 per cent. If the UK's main corporation tax rate is low enough, internationally mobile assets will tend to be located in the UK anyway, increasing the tax base, without the need for special tax rates.

Tax avoidance

Governments fight a continual battle against tax avoidance. There is a delicate balancing act for them to perform. Anti-avoidance legislation that is very precisely targeted can be avoided in turn, using new schemes that stay just outside the ambit of the legislation. But legislation that is less precisely targeted can both interfere with normal commercial transactions, and give rise to uncertainty. Two current policy developments illustrate the problems well. One is the formulation of a new CFC regime, where there are difficult questions about how income from monetary assets and from intellectual property should be treated²⁰. The other is the Government's consideration of a general anti-avoidance rule, which might be very effective against avoidance, but which could easily lead to massive uncertainty.

A lower corporation tax rate would not dissolve the problem of avoidance, even avoidance of that particular tax. Tax at 15 per cent on substantial profits can still be worth avoiding. But a significantly lower corporation tax rate would greatly reduce the amount of avoidance in some areas, freeing up Revenue resources to concentrate on other types of avoidance, or even on improving services to taxpayers.

- One of the most difficult areas, both for groups and for the Revenue, is transfer pricing. Goods and services that are supplied by one group company to another, across national boundaries, need to be priced at market rates in order to ensure that profits are correctly allocated to different countries. Where there is no open market for the goods or services, there is no easy way to determine a market price. Huge amounts of effort are expended in order to reach agreement on prices. But the Revenue are only really concerned when a group company that has a transaction with a UK group company is located in a country with a lower tax rate than the UK: without that difference in rates, the group would have no reason to use artificial prices in order to divert profits from the UK. If the UK's corporation tax rate were reduced significantly, far more transactions would be with group members in

countries with higher tax rates, and would be of no interest to the UK Revenue. This would also increase certainty for groups about UK tax charges. At the moment, transfer pricing disputes can drag on for years, preventing the liability for a given year from being settled.

- The CFC regime taxes, in the UK, profits of certain subsidiaries of UK companies which are resident in low-tax countries. “Low-tax” means less than three quarters of the UK tax rate. When the regime appears to apply, there can be technical arguments about whether it really does. Then if it does, extensive computations are needed in order to determine amounts of tax payable. As with transfer pricing, the process can use up a lot of resources. But if the UK tax rate were significantly lower, far fewer countries would count as low-tax countries. Then far fewer subsidiaries would be potentially within the scope of the regime.

There is one area where a significantly lower corporation tax rate might be expected to increase avoidance. It might encourage small businesses to incorporate and take profits out as dividends, leading to significantly lower overall tax liabilities. But while this would be a risk, it could be addressed by amending other elements in the tax regime. And it would be a trivial concern, compared to the great prize of encouraging growth and the location of business in the UK.

The incidence of corporation tax

It is easy to suppose that a reduction in corporation tax rates would simply benefit shareholders. This might in turn be seen as politically unacceptable, given that income tax or VAT might be reduced instead. But there are good reasons not to allow such a thought to deter us from reducing the main rate of corporation tax.

- Shareholders include plenty of people on modest incomes who, for example, have shares in individual savings accounts (ISAs), or who depend on the value of shares for the value of their defined contribution pensions. It is a serious mistake to think that only rich people have a direct interest in the value of shares.

²⁰ *Corporate Tax Reform: delivering a more competitive system*, HM Treasury, November 2010, pages

- The economic evidence is that shareholders are not the only people who suffer the burden of corporation tax, and correspondingly, are not the only people who would benefit directly from a reduction in the tax rate. The UK has an open economy, and capital can come and go. The UK's economy is also not markedly larger than all or most competing economies. When an economy has those characteristics, the burden of corporation tax falls at least partly on labour, because capital will only stay if it can achieve a high enough pre-tax return to compensate for the burden of corporation tax. The rewards to labour will then be depressed for a variety of reasons, most obviously that lower wages may be the only way to generate adequate returns to capital and make the capital that is needed to run businesses available in the country concerned. The actual division of the burden of corporation tax between capital and labour can vary greatly, depending on a range of factors. Labour's share of the burden can easily range between one quarter and three quarters of the total²¹. But despite this wide range of uncertainty, it is clear that wages can benefit directly from reductions in corporation tax rates, quite apart from the indirect benefit of promoting economic growth and raising living standards generally.

Getting to a 15 per cent rate

It would not be feasible to reduce the main corporation tax rate to 15 per cent immediately. There would be a short-term impact on the Exchequer's cash flow that could not be risked in the current fiscal circumstances. But that is no reason not to set out a plan to get down to that rate, perhaps by 2020. Any government's commitment to such a long-term plan would have to be contingent on the outcome of the next election, but that need not prevent a plan being set out.

29-36.

²¹ For a survey of the theory and of empirical studies, see Jennifer C. Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis*, Congressional Budget Office Working Paper 2010-03. The reservations that are set out in that paper about the usefulness in principle of the models discussed relate to the particular position of the United States in the world economy, and to the effects when many countries change their corporation tax rates at much the same time. Another study, Wiji Arulampanem, Michael Devereux and Giorgia Maffini, *The Incidence of Corporate Income Tax on Wages*, ETPF conference paper, April 2007, gave a short-run central estimate of 54 per cent of any increase in corporate income being passed on in lower wages, and found that in the long run, the fall in total employee compensation would exceed the extra revenue raised by increasing a tax on corporate income.

A timetable would have the great benefit of building the confidence of long-term investors. It would also make abandonment of the target politically awkward. The Government was right to set out its plan to reduce the main corporation tax rate to 24 per cent by 2014. We call on it to radically extend that plan to 15 per cent by 2020. On current estimates reducing the rate from 24 to 15 per cent would cost around £9 billion per annum (http://www.hmrc.gov.uk/stats/tax_expenditures/table1-6.pdf). This would be funded by continued restraint in public spending growth, simplification and removal of certain allowances, together with the dynamic impact on GDP growth from greater business investment in the UK.

Conclusion

The Government should set out a timetable to reduce the main rate of corporation tax to 15 per cent, because that would bring all of the following benefits.

- It would greatly improve the UK's position in international rankings of tax competitiveness, and would secure that improvement against modest reductions in tax rates by other countries.
- It would attract capital and businesses to the UK, bringing jobs and wealth.
- It would improve economic growth.
- It would encourage the location of both group holding companies and intermediate holding companies in the UK.
- It would encourage the location of mobile profit centres, such as those that are related to intellectual property, in the UK.
- It would reduce the pressure on anti-avoidance legislation, giving businesses increased certainty and freeing Revenue resources for more productive uses.
- It would increase returns both to capital, which is widely held by people of modest means, and to labour.
- A timetable would build the confidence of long-term investors.

4. CGT on shares

If a new company starts in business between now and 5th April 2012 then the people who subscribe for shares in it within that period would be exempt from Capital Gains Tax when they sold those shares, whenever they sold them. This would encourage the injection of fresh equity capital into businesses (only shares subscribed for would qualify, not shares bought from existing shareholders).

The tax benefit would be available to owner managers, including sole owners of companies, as well as to outside investors. It would therefore be much more widely available than the Enterprise Investment Scheme.

There would be no immediate tax cost because the benefit would only come on the sale of shares after they had increased in value. The long term cost would be modest and spread over many years. There might be a cash limit on the qualifying amount of shares but this could be set generously.

