IPPR Commission on Economic Justice

Fair Dues

Rebalancing business taxation in the UK

Policy Paper

Grace Blakeley

The IPPR Commission on Economic Justice

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The IPPR Commission on Economic Justice

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Summary

60-SECOND SUMMARY

The system of business taxation should seek to be fair in its impact on different kinds of businesses and on different kinds of taxpayers, while supporting employment, wages and investment. The system we have today fails these tests in important respects. The principal rate of corporation tax in the UK has fallen from 30 per cent in 2008 to just 19 per cent in 2018, and the proliferation of reliefs and allowances has eroded its base. At the same time, the rate of employers' National Insurance contributions has increased. These changes have shifted the burden of taxation away from profitable but low-employment businesses to those with more staff but lower profits. The vast majority of businesses pay their taxes, but some multinationals have been increasingly able to avoid tax altogether through 'profit shifting' to low-tax jurisdictions, requiring more of the burden of taxation overall to be borne by domestic companies which cannot avoid tax in this way.

This report sets out a series of reforms to address these issues. First, it proposes a fiscally-neutral rebalancing of the two principal business taxes. It recommends an increase in the rate of corporation tax from 19 to 24 per cent, alongside a reduction in employers' National Insurance contributions from 13.8 to 11.8 per cent. This would ensure that the burden of business taxation falls primarily on shareholders rather than workers, and allow for an increase in wages. A higher rate of corporation tax would also raise the value of investment allowances, creating a larger incentive for investment. Second, an Alternative Minimum Corporation Tax (AMCT) should be introduced in order to reduce tax avoidance through profit shifting. This would be levied on a portion of a multinational firm's global profits based on its sales or turnover in the UK. Third, reliefs and allowances for corporation tax should be reviewed and reduced. Fourth, the UK should support international efforts to combat tax avoidance, including by implementing all the recommendations of the Base Erosion and Profit Shifting (BEPS) programme and clamping down on tax avoidance in the UK's crown dependencies and overseas territories.

EXECUTIVE SUMMARY

The IPPR Commission on Economic Justice seeks a system of business taxation which raises revenues in a way that is fair for different kinds of businesses and different kinds of taxpayers, while supporting employment, wages and investment.

The UK's system of business taxation does not now meet these criteria. Over the last 10 years, the rate of corporation tax has fallen, while the rate of employers' national insurance contributions has risen. The aggregate impact of these changes has been to shift the overall burden of business taxation: it has benefited profitable but low-employment businesses, and increased the share paid by less profitable businesses with more workers. Given the international evidence on the incidence of different types of tax, this has had the effect of shifting the burden of taxation from shareholders to employees.

Meanwhile, the proliferation of reliefs and allowances over the last 10 years has led to the erosion of the base for corporation tax and facilitated tax avoidance. On introducing the Corporate Tax Road Map in 2010, the

Government argued that cuts to corporation tax would have the effect of raising revenues, both by encouraging more businesses to locate in the UK and by incentivising investment. Neither of these effects has materialised: when adjusted for changes in the business cycle corporation tax receipts are in secular decline.

These changes have taken place in the context of increasing concerns that multinational corporations are able to avoid corporate income taxation in the UK and around the world. This is widely perceived within the business community as unfair, effectively requiring domestic businesses that cannot avoid tax in these ways to pay more in tax in order to compensate for the foregone revenues. The recently concluded Base Erosion and Profit Shifting (BEPS) negotiations were meant to address many of these concerns, but are widely agreed to have fallen short of their aims. Recent changes to the US system of corporate income taxation make international cooperation even more imperative in order to prevent a 'race to the bottom' between competing jurisdictions which will result in lower tax revenues everywhere.

This policy paper argues that the UK business tax system should be rebalanced. It proposes a fiscally-neutral shift, raising the main rate of corporation tax and reducing employers' national insurance contributions. At the same time, we propose that mechanisms are put in place to prevent profit shifting and to make it more difficult for multinationals to game the international tax system. We recommend the following.

1. **The corporation tax rate should be increased, and the proceeds used to fund a reduction in employers' national insurance contributions (ENICs). We model a rise in corporation tax from 19 to 24 per cent, which would allow a reduction in ENICS from 13.8 to 11.8 per cent.** This change will ensure that shareholders bear a greater portion of the burden of corporate taxation, allowing the proceeds to be passed on to workers through wage increases or additional employment. A higher rate of corporation tax would also raise the value of investment allowances, creating a larger incentive for investment. The changes would shift the burden of taxation away from less profitable businesses with high input costs onto more profitable ones.
2. **An Alternative Minimum Corporation Tax (AMCT) should be introduced.** We propose the introduction of an AMCT that apportions a firm's global profits to the UK based on its sales or turnover in the UK. This would ensure that the way multinational corporations are taxed maps more accurately onto the geographical distribution of their business activities.
3. **Reliefs and allowances for corporation tax should be reduced.** We support the Office of Tax Simplification (OTS) in its call for a 'roadmap' for the simplification of the corporation tax system, with a view to increasing the base. We argue that the annual investment allowance should be maintained at current levels. There is a strong case for the removal or reduction in the value of reliefs including the Patent Box and research and development (R&D) tax reliefs, the deductibility of corporate debt interest and the depreciation of write-down allowances. There should also be a presumption against introducing any additional reliefs, with a requirement to demonstrate that the desired effect could not be achieved through spending measures.
4. **The UK should engage proactively in international attempts to reduce tax avoidance.** The first priority should be the ratification and implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, including those the UK has not yet agreed to implement. The UK should also immediately introduce publicly available country-by-country reporting, extend the public register of company beneficial ownership to cover

overseas territories and crown dependencies, share with developing countries any tax and company data relevant to their tax affairs, and push for a new generation of global tax reforms to reduce avoidance and evasion still further.

A strong and broad tax base is critical to ensure that the UK can afford to pay for the public investment and service provision that society demands. Our reforms would improve the UK's system of corporation tax, raise revenues, and make the system fairer for both businesses and citizens, at both national and international levels.

Introduction

Over the last decade, the way in which businesses are taxed in the UK has undergone a marked shift. The effective rate of corporation tax has seen a substantial reduction, while employers' national insurance contributions (ENICs) have risen. Furthermore, the revaluation of business rates has seen a significant redistribution among businesses in different regions of the country.

These changes have occurred within a developing international context. A number of other countries have also reduced their headline rates of corporation tax, most recently the United States. At the same time there has been increasing public focus on corporate tax avoidance, both through the use of accounting procedures to minimise tax paid in different national jurisdictions and through tax havens.

The IPPR Commission on Economic Justice seeks a system of business taxation which raises revenues in a way that is fair for different kinds of businesses, while supporting employment, wages and investment.

This policy paper for the Commission examines the current structure of business taxation and suggests reforms which would meet these criteria. After a brief description of the present system in chapter 1, chapter 2 examines the arguments in favour of low rates of corporation tax and suggests some principles for effective business tax design. Chapter 3 looks at some of the problems arising from the current pattern of business taxes in the UK. Chapter 4 sets out four areas for reform, focusing on corporation tax and employers' NICs. (Reform of business rates is the subject of a separate Commission project.) In the context of current political realities, we have not attempted to describe fundamental reform, such as set out in the Mirrlees Review (2011). Rather, we have proposed a series of feasible changes within the current system to address its major problems.

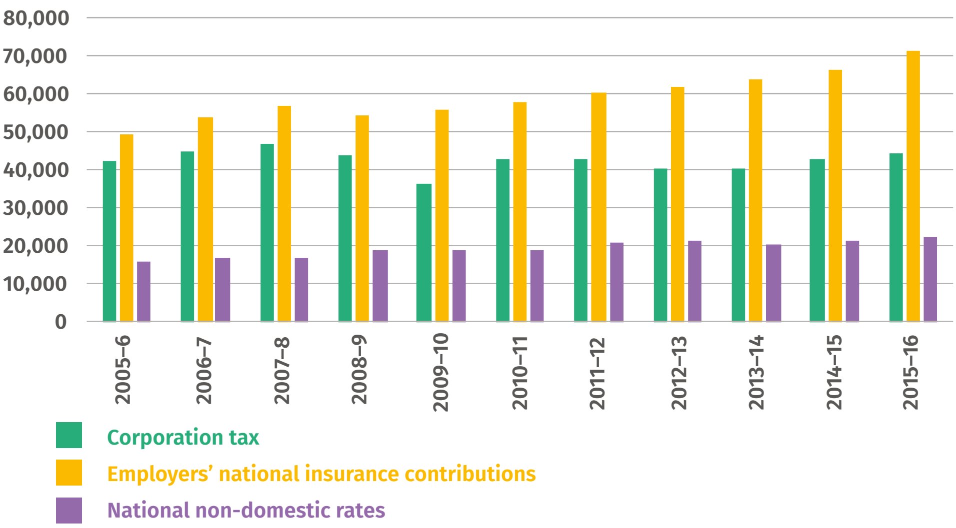
1. The current structure of business taxation in the UK

Legally incorporated businesses in the UK pay a number of different taxes. The most significant are corporation tax, business rates and employer's National Insurance contributions (ENICs). Together, these taxes are expected to raise £154 billion for the Exchequer in 2017/18 – corporation tax was expected to raise £53 billion, business rates £29 billion and ENICs £72 billion (OBR 2017a and OBR 2017b). Together, these receipts equated to around 7 per cent of Gross Domestic Product (GDP). Over the last decade, changes to the rates of these taxes, combined with rising employment levels, have seen a marked shift in the balance of receipts. Revenues from ENICs have grown considerably, while corporation tax receipts have remained largely unchanged (see figure 1.1).

FIGURE 1.1

Over the last decade, the share of total business tax receipts from employers' National Insurance contributions has grown considerably, while that of corporation tax has fallen

Total revenue from employers' National Insurance contributions, business rates and corporation tax (£m) 2005/06–2015/16



Source: Office for National Statistics (2017); HM Revenue & Customs (2017); Department for Communities and Local Government (2017)

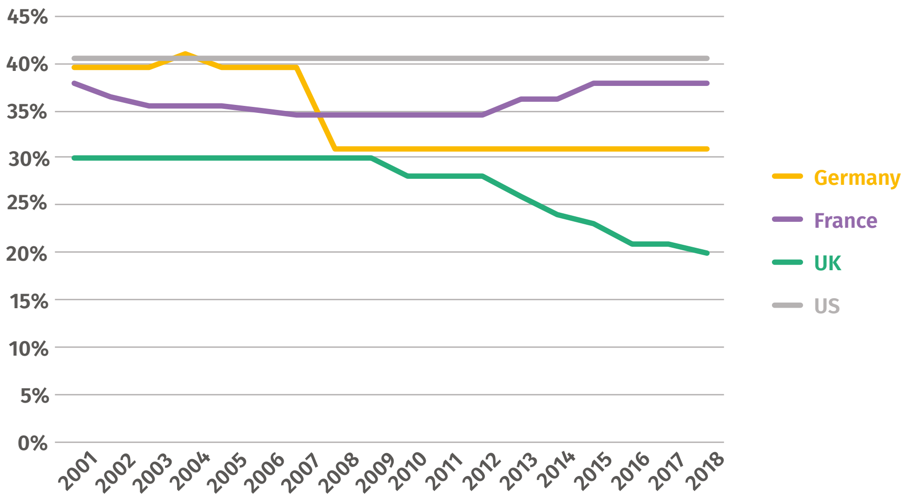
CORPORATION TAX

Corporation tax is levied on a company's profits, less any deductions or allowances. Since 2008, the main rate of corporation tax in the UK has been successively reduced, from 30 per cent in 2008 to 19 per cent today. This is the lowest rate in the G7, and one of the lowest rates in the 35 country-strong Organisation for Economic Co-operation and Development (OECD). The Government has announced its further intention to cut the rate to 17 per cent by 2020 (HMRC 2017).

Most countries have some form of corporate income taxation and, since the financial crisis, many have cut their headline corporation tax rates (OECD 2016). This has been part of a general pattern of 'rate-cutting, base-broadening', in which governments have reduced headline rates of corporation tax while reducing deductions and closing loopholes to expand the corporation tax base[1] (OECD 2011). However, since 2012 the UK has diverged from the norm, simultaneously increasing the value of reliefs and allowances available. These have included a significant increase in annual investment allowances (from £25,000 to £200,000) and the introduction of the Patent Box aimed at incentivising research and development. As a result of these changes, the average effective rate of corporation tax in the UK is now around 20 per cent, considerably lower than all other G7 economies (see figure 1.2).

FIGURE 1.2

The rate of corporation tax in the UK is now well below those of our major competitors
Corporation tax rate by country (%), selected economies, 2000–17



Source: Oxford University Centre for Business Taxation (2017)
Note: This does not include the changes in the rates of US corporation tax passed by Congress in December 2017.

EMPLOYERS' NATIONAL INSURANCE CONTRIBUTIONS

Alongside employees and the self-employed, all employers pay National Insurance contributions (ENICs) towards the UK's social security system. The main rate of ENICs, paid above a lower earnings limit, is 13.8 per cent. This rate was increased from 12.8 per cent in 2011. Rising levels of employment have combined with this change to raise the revenues from ENICs significantly (see figure 1.1).

1 The corporation tax base is the income or asset balance used to calculate the tax liability.

BUSINESS RATES

National non-domestic rates, generally known as business rates, are taxes levied on properties in commercial use. Business rates are calculated on the value of the property multiplied by a nationally-set multiplier, with a number of reliefs and exemptions that may reduce the final bill. The rateable value of a property is, in principle, assessed every five years by the Valuation Office Agency (VOA), based on its current market rental value, while the multiplier is set by central Government and the devolved administrations in Scotland and Wales. (A different system operates in Northern Ireland.) Business rates contribute to local authority revenues.

The most recent revaluation of business rates was carried out in 2017, having been delayed for two years. Although by law the total revenue from business rates is designed to be held constant, the revaluation led to a marked increase in the liability of businesses in London and other areas where land values have risen markedly (Sandford 2017). This led to widespread complaints from many businesses adversely affected, particularly smaller businesses and those such as retailers with large footprints (Federation of Small Businesses 2017).

2. How should businesses be taxed?

While some economists argue that businesses should not be taxed at all, on the grounds that they are mere ciphers for the individual shareholders and workers they comprise (Zuluaga 2016), most policy debate has centred on the appropriate rate of corporation tax, and the balance between the taxation of profits and labour.[2]

DO CUTS IN CORPORATION TAX RAISE REVENUES AND INVESTMENT?

The argument that high corporation tax rates are counterproductive arises from so-called 'optimal taxation' theory. This suggests that the relationship between the rate of corporate income tax and the revenue it raises is U-shaped rather than linear (Mankiw et al 2009, Martin 2012). Raising tax rates increases revenues up to a certain point, but above this level higher rates will reduce the tax base, and therefore revenues. The Laffer curve, developed by Arthur Laffer, depicts this relationship graphically.

The logic of the Laffer curve works in several ways. First, it is argued that, in the context of high levels of international capital mobility, businesses will 'shop around' for the most competitive tax rate. If they can find a jurisdiction in which they can pay less tax, they will relocate to that country, reducing the tax revenues of the country in which they were formerly based. Second, higher rates of corporation tax raise the cost of capital, which will lead businesses to invest less. This will reduce corporate profitability, thereby ultimately reducing tax revenues.

Laffer's insight that taxing companies at either zero or 100 per cent would yield no revenue is in many ways trivial (Blinder 1989). The question is whether current corporation tax rates around the world are above or below the rate at which further rises may reduce revenue. Many economists argue that the optimal rate of corporate taxation is likely to be much higher than the current average global rate (Blinder 1989, Mankiw et al 2009, Christensen 2012).

The main reason for this is that the corporation tax rate is not the only, or even the principal, factor in firms' decisions about where to locate, even where they are relatively mobile (Gravelle 2011, Devereux and Freeman 1995). The competitiveness of the business environment in a particular country depends upon a wide variety of institutional considerations. These include 'access to markets and profit opportunities; a predictable and non-discriminatory legal and regulatory framework; macroeconomic stability; skilled and responsive labour markets; and well-developed infrastructure' (OECD 2008). For most types of business, these factors are considerably more important than the rate of corporation tax. This explains why Germany and France, for example, have continued to have higher levels of business investment than the UK despite much higher corporation tax rates.

The elasticity of firms' location and investment decisions with respect to the tax rate does, however, display important differences between jurisdictions and firms. Several studies have found that tax havens are more likely to be affected by a rate change than more established jurisdictions, for the simple reason that businesses primarily decide to locate in these jurisdictions to take advantage of a low tax rate

2 The practical argument for taxing businesses is that if they were not taxed, individuals would just incorporate to avoid paying tax (Mirrlees 2011).

(Schwarz 2011, Hines and Rice 1990, Clausing 2011). For developed countries such as the UK, however, a 'low host country tax burden cannot compensate for a generally weak or unattractive FDI [foreign direct investment] environment' (OECD 2007; see also Gravelle 2011, Temouri and Jones 2016). The nature of the firm – particularly its capital intensity – also determines how responsive it is to changes in the tax rate. More capital- and technologically-intensive firms appear to be more responsive to tax rates than others (Dwenger et al 2013). As a developed country with a service-based economy, this suggests that increases in the corporation tax rate would not lead to a flight of UK-based companies to tax havens.

In terms of investment, many empirical studies do find a small upward impact of an increase in the corporation tax rate on the user cost of capital, but the impact is variable and uncertain (Djankov et al 2010, European Commission 2013). The 2010 meta-study by Djankov et al finds 'no statistically significant effect of the statutory tax rate on investment', but a marginal impact of the effective rate. It also finds that this impact varies across different sectors. Companies in service sectors are much less likely to be impacted than manufacturing businesses, which are more capital intensive. One way of countering the impact of a corporation tax rise on manufacturing firms is therefore to increase the value of capital investment allowances. Manufacturing now represents only 10 per cent of the UK economy.

In general, the consensus in the economic literature is that the cost of capital is less significant as a determinant of investment than the state of the business cycle (Bussière et al 2015). Businesses invest when they expect there to be demand for their products (Shapiro et al. 1986; Bussière et al 2015). According to Gennaioli et al. (2015), the company earnings expectations of CFOs (chief financial officers), which are strongly related to the business cycle, are by far the most important determinant of firms' investment decisions. As Maffini (2013) found in a study of the relationship between tax rates and investment under the Labour Government: 'Increases in real investment between 1997 and 2007 are largely explained by the economic cycle, while the reduction in the tax component of the user cost of capital was small.'

For these reasons, it is by no means evident that cutting corporation tax rates leads to greater business investment or, in turn, to higher revenues. Equally, there is little reason to believe that the rate of corporation tax in the UK cannot be raised without creating adverse economic effects. The rate of business investment is much more likely to be affected by policies aimed at sustaining effective aggregate demand, improving workforce skills and increasing infrastructure investment than by maintaining low corporation tax rates.

THE TAX BASE

Most political attention focuses on the headline rates at which business taxes are levied, but what really matters to a business is the 'effective' rate, which takes into account the base on which it is levied (Miller 2017). The more reliefs and allowances are available, the smaller the base, and therefore the lower the effective rate.

It is widely accepted in tax theory that the base for any tax should be as wide as possible, for three reasons: it allows rates to be lower for any given revenue requirement, it reduces administrative complexity and cost, and it reduces the opportunities for avoidance (Mirrlees 2011, National Audit Office 2013). The process by which tax systems accumulate reliefs, allowances and other allowable deductions is known as 'base erosion'.

There can, of course, be good economic arguments for tax reliefs. Investment allowances, for example, are widely supported to encourage companies to invest their profits, stimulating economic growth (Mirrlees 2011, Maffini 2013).

Depreciation allowances also enable firms to reduce the rates of tax they pay on capital as that capital naturally depreciates (Mirrlees 2011). However, the way in which these taxes are designed is important in determining their effectiveness (Office of Tax Simplification 2017). If they are set too high, or are made too complex, then they will erode the tax base without countervailing positive economic effects.

It is also important to ensure that a tax relief is actually the most effective way of incentivising a desired behaviour. Often reliefs are less effective – and less transparent – than public spending. There is evidence for this, for example, in the case of research and development tax credits, which are allowances against corporation tax designed to incentivise innovation. Analysis suggests that a considerable part of these reliefs may be 'deadweight' (subsidising investments which would have happened anyway), while targeted direct spending would be a more effective means of supporting new investment (Jacobs et al 2017). In general, most economists and tax experts agree that the proliferation of reliefs and allowances should be avoided.

THE INCIDENCE OF BUSINESS TAXATION

When analysing the distribution of taxes, economists are concerned with their final incidence – not on whom they are initially levied, but who pays them ultimately. For taxes levied on businesses, this depends on how the costs are passed on to a company's shareholders, workers or consumers. In turn this depends on the relative bargaining power of these groups. The more competitive its markets, the harder it will be for a firm to pass on its tax burden to its consumers through higher prices. The more mobile its capital, the easier it will be for shareholders to maintain their returns and pass the corporate tax burden on to the employees (Mirrlees 2011).

In practice, the evidence suggests that different types of corporate taxation do fall on different groups (European Commission 2013). Specifically, payroll taxes are more likely to be borne by workers, in the form of lower wages, while taxes on profits are more likely to be borne by shareholders (Ebrahimi and Vaillancourt 2016).

Most studies using sophisticated modelling techniques estimate the incidence of corporate income tax on labour at between 10 and 30 per cent (Dwenger et al. 2013). Small countries and tax havens lie towards the higher end of the estimate, and more developed countries at the lower end. Similarly, US Treasury modelling of tax changes found that 82 per cent of the incidence of corporate income tax falls on shareholders (Cronin et al. 2012). While less research has been conducted in the UK context, results from international meta-analyses suggest that these results are similar across developed countries. Surveying these studies, Clausing (2012) concludes that 'there is simply no clear and persuasive evidence of a link between corporate taxation and wages'.

'Labour' is also not a homogenous category. A number of different studies have found that the impact of corporation tax on wages and employment varies both by the type of firm under analysis, and the type of worker. Dwenger et al. (2013) find that the changes in corporate income tax on wages and salaries disproportionately impact skilled, highly remunerated professions, rather than lower-wage employees.

In line with the theoretical literature, the empirical literature on payroll taxes has largely settled on the conclusion that their economic incidence falls primarily – though not wholly – on labour (European Commission 2015, González-Páramo and Melguizo 2013). The extent of this, however, depends upon the institutional framework in the country in question. One meta-regression that draws on 52 recent empirical papers finds that 'in the long run, workers bear between two-thirds of the tax burden in Continental and Anglo-Saxon economies, and nearly 90 per cent in Nordic ones' (González-Páramo and Melguizo 2013).

Given these empirical findings, it is reasonable to conclude that corporate income taxation is more likely to be borne by shareholders and higher-paid workers, while employers' social security contributions are more likely to be borne by workers further down the income scale. This matters, because it means that the balance of business taxation between corporation tax and payroll taxes will have a significant distributional and macroeconomic consequences. On average, shareholders have higher incomes and wealth than employees (Roberts and Lawrence 2017). Given the higher propensity of the low-paid to consume in comparison with those with greater wealth, reductions in taxes on labour are likely to have a greater impact on aggregate demand than cuts in taxes on shareholders.[3]

THE INTERNATIONAL CONTEXT

Many large businesses are multinationals, and pay tax in different countries. The UK's system of corporate taxation therefore interacts with the tax systems of other jurisdictions. Differences in national tax regimes and rates inevitably increase the opportunities for tax avoidance. Accounting practices such as transfer pricing, by which internal prices are adjusted to shift the apparent profit of an operation from one jurisdiction to another, enable profits to be accounted for in places where tax rates are lowest (Tax Justice Network 2015). In turn this has led some countries, such as Ireland, to seek to reduce their corporation tax rates in the hope of attracting inward investment. Such 'tax competition' can lead to other countries following suit, resulting in a 'race to the bottom' in which all countries ultimately lose tax revenue (Picciotto 2012, Van Apeldoorn 2016).

Over recent years, the OECD has attempted to coordinate measures among its members to reduce tax competition and opportunities for multinational tax avoidance (see box 2.1). It is clearly desirable for major economies such as the UK both to support greater coordination and to seek to conform to international rules where agreed.

At the same time, however, this should not rule out unilateral action to tighten domestic tax law. While loosening domestic tax law can undermine multilateral efforts, measures to make tax avoidance more difficult are likely to strengthen them (Avi-Yonah 2013). Indeed, unilateral action to protect a domestic tax system against avoidance on the part of a powerful country can serve to build wider international consensus (OECD 2013). Bilateral tax treaties should ensure that unilateral measures do not lead to double taxation of the same activities.

3 As a tax which falls largely on shareholders, a proportion of corporation tax is effectively a tax on the rents they receive, as well as on the returns to the risk they bear. Taxation of rents is generally regarded by economists as non-distortionary of economic behaviour, and therefore more justifiable than taxes on labour.

Box 2.1: The Inclusive Framework on Base Erosion and Profit Shifting (BEPS)

The Inclusive Framework on BEPS is the output of negotiations that have been under way since 2013, organised by the OECD. BEPS aims to target multinational companies that avoid tax through profit shifting, corporate lobbying and other mechanisms at both the national and international level. The aim is to prevent these firms from exploiting 'gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity' (OECD 2017). The BEPS process arose out of the 2012 G20 summit, which concluded that a system should be put in place to ensure that multinationals are taxed 'where economic activities occur and value is created'.

The BEPS convention has now been agreed, with 15 areas of action covering issues such as the digital economy, interest deductions and harmful tax practices. These actions each include a number of different recommendations on policies for countries to implement. Together, these actions would amount to a substantial rewriting of the rules for the international tax system.

However, many have argued that they do not go far enough to address the underlying issues that have resulted in the increase in base erosion and profit shifting in recent years (Spoors 2017, Picciotto 2017, Eurodad 2017). Moreover, the implementation of these initiatives is voluntary and is therefore likely to vary from country to country. Some countries have already determined not to implement certain aspects of the BEPS framework. BEPS is therefore an important step in the right direction for the international tax system, but arguably it does not go far enough.

3. Problems of the current system

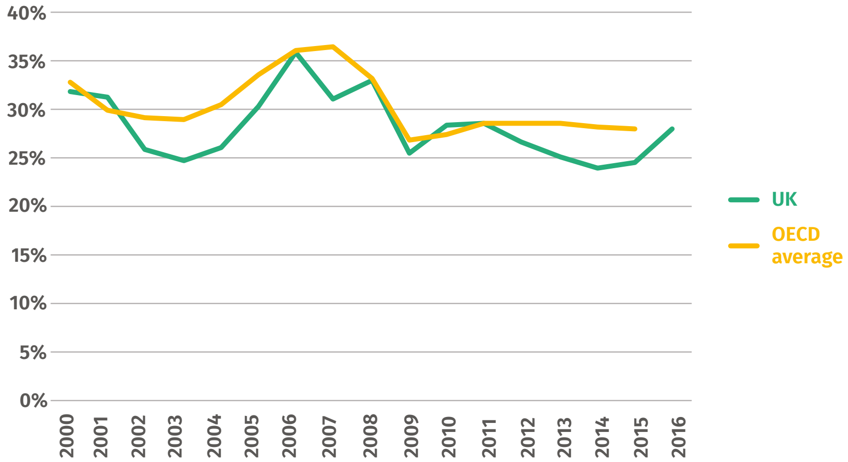
CORPORATION TAX REVENUES

In line with the expectations of the economic literature, corporation tax receipts as a percentage of GDP have fallen with the headline rate and the base, despite the economic growth experienced since 2010 (see figure 3.1). Although receipts have picked up since 2014, this reflects the fact that we are now either at or approaching the peak of the business cycle (OBR 2017). In 2006, at the peak of the last business cycle, when the headline rate of corporation tax rate was 30 per cent, receipts amounted to 3.5 per cent of GDP (OECD 2017).[4] Today, with the rate at 19 per cent, receipts total just 2.6 per cent of GDP. In fact, the Office for Budget Responsibility (2017) predicts that total corporation tax receipts will fall to just 2.4 per cent of GDP by 2021/22. As figure 3.1 shows, UK corporation tax receipts have been consistently lower than the OECD average since the early 2000s.

FIGURE 3.1

UK receipts from corporation tax fell below the OECD average in 2012 and have only recently starting to recover

Revenues from corporate income taxation (% GDP), 2000–16 UK and OECD average



Source: OECD (2017)

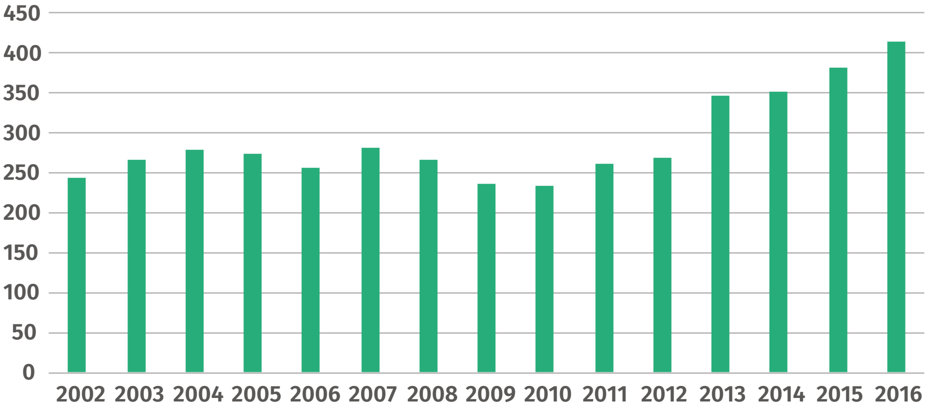
A proportion of the recent growth of corporation tax receipts may in fact reflect a form of tax avoidance. Reductions in the corporation tax rate have coincided with an otherwise unexpected surge in business creation (see figure 3.2). This may well be the result of individuals choosing to incorporate in order to take advantage of the lower rates of corporation tax relative to income tax (Murphy 2016).

4 OECD figures are measured on an annual basis rather than the financial year to allow for comparisons between countries, meaning that this figure is slightly different to the figures shown in figures 1.1 and 3.4.

FIGURE 3.2

Since 2012, there has been a sharp increase in business births in the UK

Creation of new UK enterprises ('000s), 2002–16



Source: ONS (2017)

BUSINESS INVESTMENT AND PRODUCTIVITY

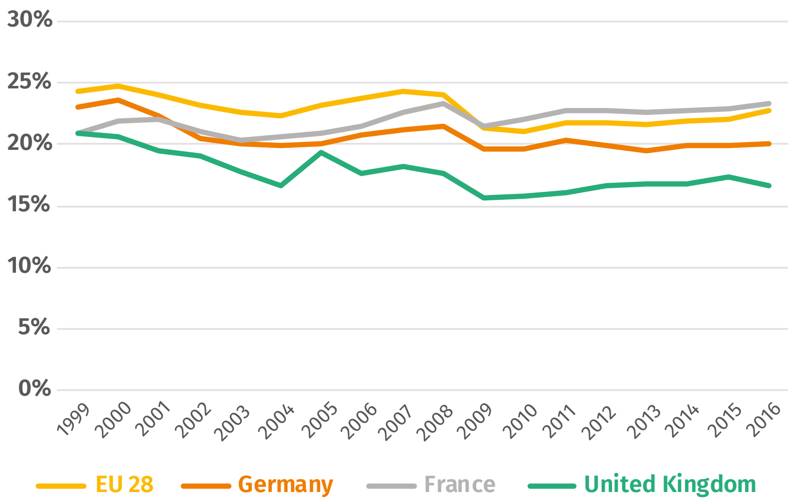
A key justification for reducing corporation tax rate was that it would increase business investment. In fact, business investment in the UK remains lower as a percentage of output (non-financial corporations' Gross Value Added) than it was in 2005 (see figure 3.3). Business investment in the UK is much lower than in Germany and France, where rates are considerably higher. Though this largely reflects the structure of these economies, with larger manufacturing sectors and stronger business investment conditions, it demonstrates at least the weak correlation of investment and corporation tax rates.

One of the reasons that business investment has not increased is that cuts to corporation tax have been accompanied by increases in employers' National Insurance contributions, and shifts in the burden of business rates. Rather than cutting taxes in general, this shift in the burden of overall business taxation has benefited some firms over others. As shown in figure 3.4, while corporation tax revenues have been declining as a proportion of GDP, revenues from ENICs and business rates have been increasing. This has benefited profitable firms with relatively low numbers of workers and a relatively small property footprint, but penalised larger and less profitable employers (PwC 2017).

Many of the latter are businesses in the UK's low wage and low productivity sectors, such as retail and wholesale, food and drink, social care, and tourism and hospitality, which have seen their productivity stall since the financial crisis (Jacobs et al. 2017). For these firms, which collectively employ around 60 per cent of the UK workforce, higher ENICs and business rates have raised costs, and are likely to have depressed investment, and therefore productivity. Higher input taxes have been cited by a number of small enterprises as factors making it more difficult for them to do business (Federation of Small Businesses 2017). For such firms, which are not highly profitable, lower corporation tax rates are of much less benefit than lower payroll taxes and business rates would be. For the UK economy as a whole, the tax shift may have contributed to our productivity problem.

FIGURE 3.3

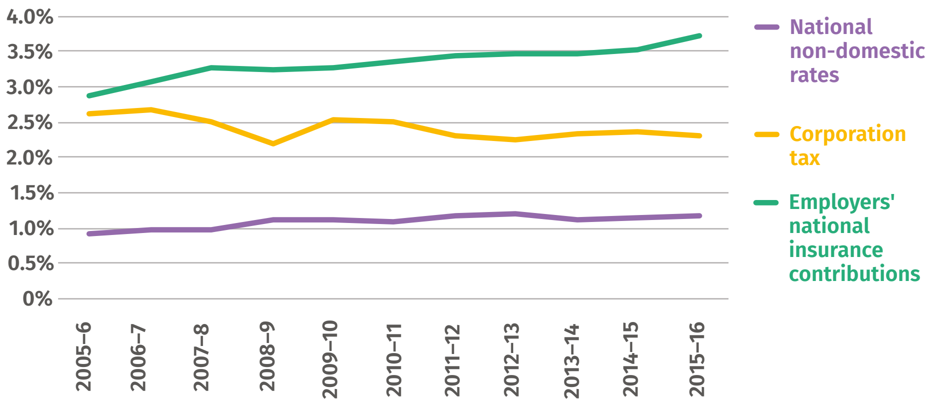
UK business investment has declined despite reductions in the rate of corporation tax, and is lower than in France and Germany, where corporation tax rates are higher
Investment rate of non-financial corporations as a percentage of non-financial corporations' Gross Value Added, 2000-2015 Q1, selected countries and EU 28 average



Source: Eurostat (2017)

FIGURE 3.4

Revenues from employers' National Insurance contributions and business rates have increased as a percentage of GDP over the last decade, while revenues from corporation tax have fallen
Revenues from business taxes in the UK (% GDP), 2005–06 to 2015–16



Source: ONS (2017); HMRC (2017); DCLG (2017).

INEQUALITY

In chapter 2, we noted that corporation tax is largely a tax on shareholders, and payroll taxes fall largely on labour. The business tax shift of the last decade will therefore have had an important distributional effect. Shareholders, whether through individual holdings or through pensions and other investment funds, are on average among the wealthier groups in society, with the size of shareholdings largely correlated with overall wealth and income (Roberts and Lawrence 2017). Cutting corporation tax while raising ENICs has almost certainly therefore contributed to greater inequality. At a time when average wages have been more or less stagnant for a decade (IPPR Commission on Economic Justice 2017), this is neither fair nor economically desirable.

REDUCTIONS IN THE CORPORATION TAX BASE

In a 2013 report, the National Audit Office (NAO) observed that there are now 119 separate reliefs for corporation tax, creating a highly complicated and non-transparent system. It noted that HM Revenue & Customs (HMRC) only collects data on the revenue impact of seven of these, which together cost the Exchequer £3.8 billion. Including capital allowances, which the NAO groups under 'income and corporation tax', that figure rises to £20 billion (ibid). Together, these reliefs substantially reduce the base for corporation tax, and it is very difficult to assess their performance against their intended goals.

Some reliefs compensate for the fact that corporate tax increases can increase the cost of capital for firms in specific sectors. The Annual Investment Allowance (AIA) appears to work well as an incentive for investment. However, the write-down allowance for capital depreciation has become a highly complex system based on different schedules of depreciation allowances for different assets. The disparities between the actual rate of depreciation and the schedules both reduce the tax base and are likely to have wider distortionary effects (Mirrlees 2011).

Another significant distortion in the current system is the deductibility of debt interest – an issue taken up by the OECD's BEPS initiative. The tax deductibility of debt interest payments gives firms an incentive to finance investment through debt rather than equity (ibid). Debt financing is less flexible than equity financing, because the former has to be repaid regardless of a firm's performance. The system also creates incentives for avoidance, as multinational companies are able to use intra-group loans to shift interest expenses from one member of a group to another (Miller and Pope 2016). The BEPS process has recommended the implementation of a 'fixed ratio rule', which would limit interest deductions to between 10 and 30 per cent of earnings. The UK has since committed to following through with this recommendation, using the upper limit of 30 per cent.

The UK's Patent Box scheme, designed to incentivise research and development (R&D), also goes directly against the recommendations outlined in BEPS. Between them, the Patent Box and R&D tax relief, which have a similar purpose as reliefs claimable against corporation tax, cost the Exchequer £3.5 billion in 2016. They mainly benefit large businesses in well-established sectors such as pharmaceuticals. Yet the evidence suggests that they have little impact in bringing forward innovations that would not otherwise have been developed. In a recent report, IPPR estimated that the deadweight loss of R&D tax credits is around 70 per cent, or something over £1.8 million a year (Jacobs et al. 2017).

The range and complexity of the reliefs and allowances for corporation tax erodes the tax base, increases administrative costs and creates opportunities for tax avoidance. Though both the National Audit Office (2013) and the Office of Tax Simplification (2017) have conducted reviews, their recommendations have yet to be implemented.

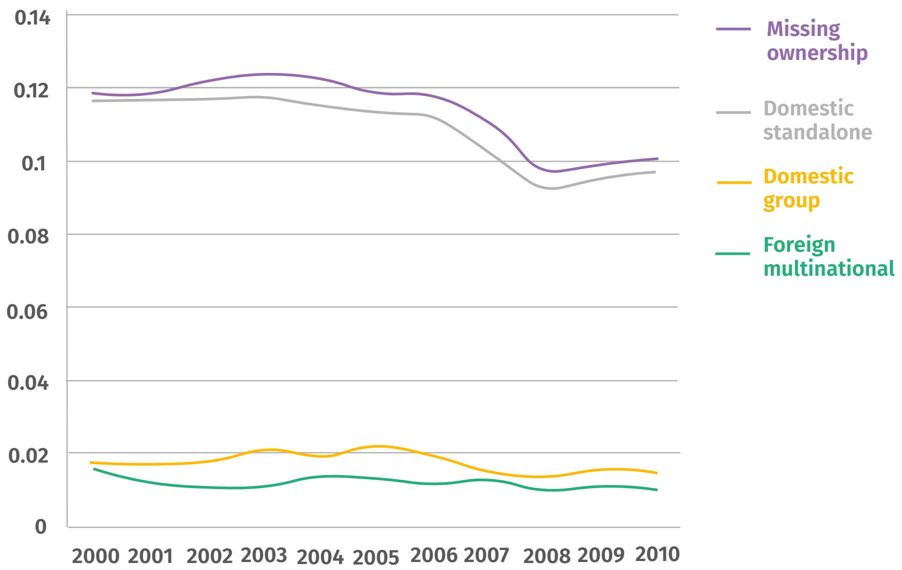
MULTINATIONAL TAX AVOIDANCE

Reducing the rate of corporation tax was intended to reduce the incentives for multinational corporations to avoid tax. But there is little evidence that this has happened (Liu et al. 2017). According to the National Audit Office (2013), 50 per cent of the largest 800 businesses in the UK paid less than £10 million each in corporation tax in 2012/13, with 20 per cent paying no corporation tax at all. While some of these cases may reflect the genuinely low profits of their UK operations, it is evident that this is not the case for all. International profit shifting, generally through perfectly legal methods, has become widespread (Ylönen and Teivainen 2015, Tax Justice Network 2015). As specific cases have come to public attention, it is notable that some of the most vociferous complaints have come from domestic businesses which are unable to avoid tax in this way and therefore see such tax avoidance as unfair. This in effect amounts to a shift in of the tax burden onto less mobile companies (European Commission 2015, Hope and Hughes 2016).

FIGURE 3.5

Multinational corporations report much lower profits as a proportion of their assets than companies that operate only in the UK

Weighted ratio of taxable profits divided by total assets calculated for each ownership type and for each year, 2000–11, balanced selected sample of types of companies



Source: Habu (2016) based on merged HMRC and Fame data

The amount lost to tax avoidance in this way is hard to estimate, partly because there is little agreement as to what constitutes avoidance and partly because, in the absence of country-by-country tax reporting, it is more or less impossible to get reliable data. HMRC (2017) puts the amount of revenue lost to corporation tax avoidance at £3.3 billion. However, its calculations do not capture base erosion and profit shifting by multinationals, and are therefore likely to be an underestimate (Miller and Pope 2016). A study in 2010 by the Trades Union Congress estimated that £12 billion of revenue is lost each year through the tax avoidance of the largest 700 companies in the UK, equivalent to almost 30 per cent of that year's revenues (TUC 2010).

One recent study from the Oxford University Centre for Business Taxation uses an innovative method to estimate both the types of firms that are more likely to avoid tax, and the extent of their avoidance activities. Habu (2017) compares the tax liabilities of different companies (by sector and structure) to their total assets. The results are shown in figure 3.5. Multinationals pay much lower rates of tax than standalone companies. They are also much more likely than other kinds of businesses to report zero profits. Domestic multinationals are the most likely to have reported zero profits, followed closely by foreign multinationals. Habu argues that the differences between the tax liabilities of these different structures are down to the multinationals' ability to use profit shifting in order to avoid tax in high-tax jurisdictions.

TAX HAVENS

As evidence of the extent of international tax avoidance has come to light in recent years, attention has focused on, among other things, the role played by the UK in supporting tax havens in its crown dependencies and overseas territories (Shaxson 2012). A recent study categorised the world's 'secrecy jurisdictions' as either 'sinks' or 'conduits' – the former being small jurisdictions with low or zero corporate tax rates in which multinational corporations and wealthy individuals can keep their capital, and the latter being more developed states that act as intermediaries, channelling capital between sinks and other jurisdictions (Garcia-Bernardo et al. 2017). Much of the money that ends up in this network is channelled through the City of London: the UK is believed to be the second most significant global conduit for multinational tax avoidance and evasion after the Netherlands (ibid).

As Oxfam (2015) and Eurodad (2017) argue in recent reports, the UK lags behind other countries when it comes to ownership transparency. While the implementation of the Public Beneficial Ownership Register (PBOR) and the UK's commitment to implement country-by-country reporting have been welcome steps in the right direction, serious concerns remain about both. The PBOR relies on self-reporting and is only required for individuals who own more than 25 per cent of a particular company. Furthermore, it does not cover the crown dependencies and overseas territories where much illicit activity is believed to take place. A proposal to call for six overseas territories to implement such a public register as part of the Sanctions and Anti-Money Laundering Bill was rejected by the House of Lords earlier this year. Moreover, the country-by-country reporting that the UK is introducing as part of BEPS will only cover multinationals with a consolidated turnover of €750 million or more, and the information gained from this will not be available publicly.

4. Improving the system

To address the problems arising from the current system of business taxation, we propose four principal directions for reform. These are:

- reversing the recent reductions in corporation tax and increases in employers' national insurance contributions
- introducing an Alternative Minimum Corporation Tax
- reducing the value of reliefs and allowances through a systematic review
- strengthening the implementation of multilateral measures to reduce tax avoidance.

RAISING CORPORATION TAX AND REDUCING EMPLOYERS' NATIONAL INSURANCE CONTRIBUTIONS

The arguments set out in this paper suggest that the recent reductions in corporation tax and the accompanying increase in ENICs have been a mistake. They have hurt major employers with low productivity and profitability, and shifted the burden of taxation from shareholders to workers. We therefore propose that this shift be reversed.

There is no 'correct' rate of corporation tax or ENICs. For the purposes of illustration, we have therefore proposed a fiscally neutral reform. This would increase the rate of corporation tax to 24 per cent and use the revenues to reduce the rate of employers' National Insurance contributions to 11.4 per cent. We believe this to be a practicable and politically feasible proposal which could be achieved over, say, a five-year period.

SETTING THE RATE

When determining an appropriate level for the corporation tax rate, a number of factors require consideration. One is the rate of corporation tax levied by the UK's competitors. There is some empirical evidence to support a 'Stackelberg model' of competition on corporation tax rates. In this scenario, the US is the 'price leader', and sets the top rate of corporation tax under which other countries compete (Kumar and Quinn 2012).

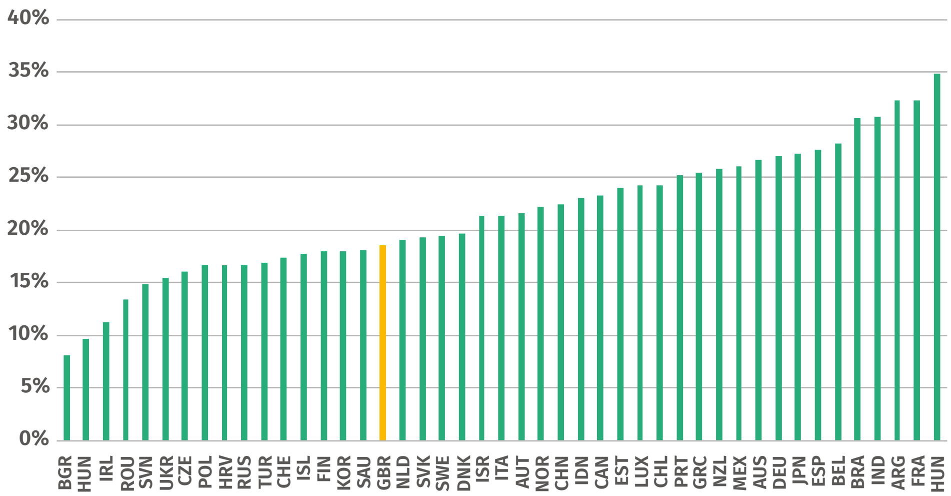
In this context, the tax cuts recently introduced in the US complicate matters. The headline rate of corporation tax has been reduced from 35 to 21 per cent. At the same time the US's Alternative Minimum Corporation Tax has been eliminated and the system changed from a worldwide model taxing the global profits of US corporations to a territorial system in which only domestic profits are taxed.

The reduction in the US rate does reduce other countries' room for manoeuvre on corporate income tax. However, 21 per cent is not the effective US rate. Taking into account the separate corporation tax rates levied in 44 US states, with rates ranging from 3 to 12 per cent, the real effective average US corporation tax rate is much higher. The UK's effective average corporation tax rate is also much lower than the rate of 27 per cent in Germany and 32 per cent in France. A headline rate of 24 per cent would therefore leave the UK well within the range of its major competitors.

FIGURE 4.1

The UK's effective average corporation tax rate is well below its major developed country competitors

Effective average corporation tax rate by OECD country (2017)



Source: Oxford University Centre for Business Taxation (2017)

Note: This does not include the changes in the rates of US corporation tax passed by Congress in December 2017.

FISCAL IMPACT

HMRC provide a database of estimates of the total fiscal effects of illustrative tax changes over the course of three financial years.[5] Table 4.1 shows HMRC's estimates for a one percentage point increase in both corporation tax and employers' National Insurance contributions. These 'ready reckoners' show that a one percentage point increase in ENICs would yield more than double the amount of revenue brought in by a one percentage point increase in corporation tax over the course of three years.

TABLE 4.1

Direct effects of illustrative tax changes: HMRC estimates

	£ billion		
	2018–19	2019–20	2020–21
Increase corporation tax by 1 percentage point	1.9	2.4	2.7
% GDP	**0.08**	**0.1**	**0.08**
Change Class 1 NI employer rate by 1 percentage point	5.6	5.7	5.9
% GDP	**0.24**	**0.23**	**0.19**

Source: HMRC (2018)

5 HMRC's estimate of the direct effect of illustrative tax changes differ from those made by the Office for Budget Responsibility (OBR) in successive forecasts of the impact of reductions in the corporation tax rate since 2008. The OBR's estimates differ from the HMRC ready reckoner, partly because the system of allowances and reliefs for corporation tax has changed across time, and partly because HMRC attributes receipts in the year in which the relevant economic activity took place, making no allowance for tax liabilities being shifted from one year to the next.

Multiplying these estimates by our proposed percentage point changes gives us an estimate of their total direct fiscal effects over three years. A five percentage point increase in the rate of corporation tax could be rendered broadly fiscally neutral (on average over a three-year period) through a two percentage point decrease in the rate of employers' National Insurance contributions.

TABLE 4.2

Direct effects of proposed tax changes

	£ billion		
	2018–19	2019–20	2020–21
Increase corporation tax by 5 percentage points	9.5	12.0	13.3
% GDP	**0.41**	**0.48**	**0.42**
Reduce Class 1 NI employer rate by 2 percentage points to 11.8%	-11.1	-11.4	-11.7
% GDP	**-0.47**	**-0.45**	**-0.37**
Net effect	-1.6	0.6	1.6

Source: IPPR calculations using HMRC (2018) data.

It is important to note that these figures are simple estimates of the first-round effects of the tax changes, which don't take into account potential behavioural changes. Each percentage point increase in corporation tax is likely to bring in marginally less revenue, so the actual increase may be smaller than that modelled here. Moreover, the changes may lead to changes in investment by companies of different kinds, which may affect their profitability and therefore revenues.

The direct effects modelled by HMRC also do not take into account wider macroeconomic effects. Given the empirical findings on economic incidence outlined in chapter 2, the majority of the gains from the fall in employers' NICs can be expected to be passed on to workers in the form of either greater employment or, more likely given current employment and wage levels, higher wages. This will boost workers' spending power. Since shareholders overall are likely to have a lower marginal propensity to consume than employees, the combination of the reduction in ENICs and increase in corporation tax is likely to lead to an increase in consumption in the economy as a whole.

DISTRIBUTIONAL IMPACT

While the overall effect of these changes is fiscally neutral within £1 billion over three years, the change in individual firms' tax bills would depend on their specific characteristics, notably their profitability and number of employees.

Unfortunately, there is no publicly available data from HMRC on industry or firm-level corporation tax or ENICs. However, PwC (2017) compiles an annual report on the total tax contribution of their 100 Group, the 100 largest UK firms and corporations that submit their tax data to PwC's surveys. We have used PwC's latest data to model the impact of our proposed changes on the combined business tax liabilities of the 100 largest companies in the UK.

TABLE 4.3

Direct effect of proposed tax changes on PwC 100 Group companies

	Current rate	Actual 2017 contribution (£m)	New proposed rate (NPR)	2017 contribution under NPR (£m)	Difference (£m)
Corporation tax	0.19	6,262	0.24	7,910	-1,648
Employers' NICs	0.138	6,755	0.118	5,776	979
Total		**13,017**		**13,686**	**669**
% Change					**1.05**

Source: IPPR calculations using PwC (2017) data.
Note: Not all columns will sum due to rounding error.

Overall, these changes would have increased the tax burden of the top 100 group by a little over 5 per cent in 2017, ignoring any behavioural changes or macroeconomic effects. Since PwC's top 100 largest companies are almost all (by definition) highly profitable, this can be taken as generally representative of those businesses which would be likely to pay more tax under the proposed reforms. Many other businesses would pay less.

AN ALTERNATIVE MINIMUM CORPORATION TAX

In principle, the most effective way of taxing multinational corporations would be through a unitary taxation system in which companies would be taxed as single entities at an agreed international rate, and the resulting revenue apportioned to individual tax jurisdictions according to some measure of the company's activities (Picciotto 2012). In practice, such a system is not on the immediate horizon. In the meantime, therefore, there is a strong case for the introduction of a unilateral Alternative Minimum Corporation Tax (AMCT).

An AMCT is a tax rate levied on a company to ensure a minimum corporate tax liability. The US (until recently) and Italy are among the countries to have used an AMCT as a 'backstop' to tackle multinational tax avoidance. Following Murphy (2016), our proposal is for an AMCT that apportions a firm's global profits to the UK based on its sales or turnover in the UK. Under such a tax, a multinational operating in the UK would be liable to pay at least the AMCT rate. A unilateral AMCT would allow the UK tax authorities to claim the UK's share of a multinational's profits based on the firm's UK turnover, while allowing other countries to adopt a similar tax to claim their equivalent portion of its global profits. As such, an AMCT can be seen as a unilateral step towards the development of an international unitary tax system.[6]

There are a number of different issues involved in designing an AMCT. First, there is the question of the base on which the tax will be levied. The AMCT in the US used a calculation of profits as the base, while the Italian AMCT uses a firm's national assets. The former was widely considered to be too complex,

6 Under a unitary taxation system, multinational companies would be required to submit a 'single set of worldwide consolidated accounts in each country where it has a business presence, then apportioning the overall global profits to the various countries according to a weighted formula reflecting its genuine economic presence in each country' (Picciotto 2012).

often reducing firms' tax liabilities rather than increasing them (Michel 2005). The latter, on the other hand, is insensitive to losses and cannot account for many new firms, particularly in the digital sphere, which are able to generate substantial profits on a small asset base. By levying the tax on a company's UK turnover, our proposal avoids these problems. It uses the simplest indicator of the scale of a firm's activities in a country.

Secondly, a decision has to be made on when to trigger an AMCT. In Italy, the assets-based AMCT is levied after a firm declares zero profits for five consecutive years. The research conducted by Habu (2017) suggests that this timeframe is about right. She finds that foreign multinationals report zero taxable profits for six years on average, while domestic 'standalone' companies tend to report zero taxable profits for an average of three years (ibid). However, there is a good case to make the triggering profit declaration higher than zero, since that simply invites a company to record minimal but non-zero profits. One option could be to trigger the AMCT when a firm's declared profitability in the UK diverged by a given amount from the global profitability of the company as a whole.

Our proposed AMCT would therefore apportion a firm's global profits to the UK based on its turnover in the UK at the main rate of corporation tax, and would be triggered if a firm declared profits below a certain percentage of its global profits for more than five years.

It is difficult to measure the fiscal impact of this proposal because it is impossible to know how many firms are currently engaging in tax-avoiding behaviour which would be 'caught' by an AMCT. But we do have a range of estimates of the 'corporate tax gap' (uncollected corporate taxation), which can be used to suggest the amount an AMCT could raise. This is likely to be somewhere between the corporation tax gap estimated by HMRC (2017) of £3.3 billion, which does not include the bulk of multinational profit shifting and, say, the £12 billion estimated by the TUC (2010).

THE REDUCTION OF RELIEFS AND ALLOWANCES

The Office of Tax Simplification (2017) recently conducted a detailed review of the simplification of the corporation tax system, which includes a number of recommendations about the design of corporation tax reliefs. We support the OTS's recommendation for the implementation of a 'roadmap' of progressive simplification. Specific reliefs and allowances which should be considered for removal or reduction include the Patent Box and R&D tax credits, the deductibility of corporate debt interest and the depreciation of write-down allowances. The Annual Investment Allowance should be retained: there is a good case for this to be stabilised at its current rate in order to promote greater certainty. It should be noted that the increase in the rate of corporation tax we have proposed will effectively increase the value of the investment incentive, thereby further incentivising investment.

We would argue for a presumption against introducing any additional reliefs, with a requirement to demonstrate that the desired effect could not be achieved through spending measures.

STRENGTHENING MULTILATERAL EFFORTS TO REDUCE TAX AVOIDANCE

The UK should ensure that it participates actively in multilateral efforts to harmonise the international tax system. A priority should be the ratification of the Multilateral Convention on BEPS, committing to implement all of the recommendations laid out in the final agreement.

As well as supporting multilateral efforts to reduce tax avoidance, there is a strong case for the UK to undertake some unilateral measures to improve the international fairness of its own tax system. As recommended by BEPS, the UK has recently introduced country-by-country reporting for multinational companies operating in the UK with a consolidated turnover of €750 million or more. This information will be made available to HMRC and other relevant tax authorities around the world. In line with the recommendations of the Tax Justice Network and Oxfam, we recommend that the information HMRC receives from the implementation of country-by-country reporting should be made available publicly (Spoors 2017, Pearce 2017).

Secondly, the UK should extend its public register of company beneficial ownership to cover the overseas territories and crown dependencies. Thirdly, the UK should provide developing countries with any tax and company data that might be relevant to their tax affairs, and tax treaties with developing countries should be reviewed in light of the effect that they are likely to have on such countries' tax base.

Finally, the UK should push for a new generation of global tax reforms to seek to reduce tax avoidance and evasion still further. The implementation of an AMCT in the UK could in particular help catalyse an international move towards the unitary taxation of multinational companies.

Conclusion

The UK's current system of business taxation fails to raise revenues fairly, efficiently or sustainably. The burden of taxation falls too heavily on companies with a large number of employees but relatively low profitability, compared with those which are highly profitable but employ few workers. Tax avoidance by multinational companies is too easy, shifting the effective burden onto domestic companies. We believe the reforms set out here would go some way towards rebalancing the UK's system of business taxation, making corporation tax more effective, raising overall revenues, and making the system fairer for businesses and society at both national and international levels.

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Fair Dues

Rebalancing business taxation in the UK

Policy Paper

The IPPR Commission on Economic Justice is a landmark initiative to rethink economic policy for post-Brexit Britain. The Commission brings together leading figures from across society to examine the challenges facing the UK economy and make practical recommendations for reform.

This policy paper argues for a rebalancing of the business taxation system. Over the last decade a substantial reduction in the effective rate of corporation tax has been accompanied by a rise in employers' national insurance contributions. At the same time there has been increasing public focus on corporate tax avoidance, both through the use of accounting procedures to minimise tax paid in different national jurisdictions and through tax havens. The paper sets out a series of reforms aimed at achieving a fairer burden of taxation between different kinds of businesses and taxpayers, while supporting employment, wages and investment. It proposes a fiscally-neutral increase in the rate of corporation tax, alongside a reduction in employers' national insurance contributions; and an increase in the base for corporation tax through a simplification and reduction in reliefs and allowances. It also proposes the introduction of an Alternative Minimum Corporation Tax in order to reduce profit shifting by multinational corporations, alongside greater support for international efforts to combat tax avoidance.

The IPPR Commission on Economic Justice

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