



Corporate Tax Reform and Investment: Experience in UK & OECD Countries

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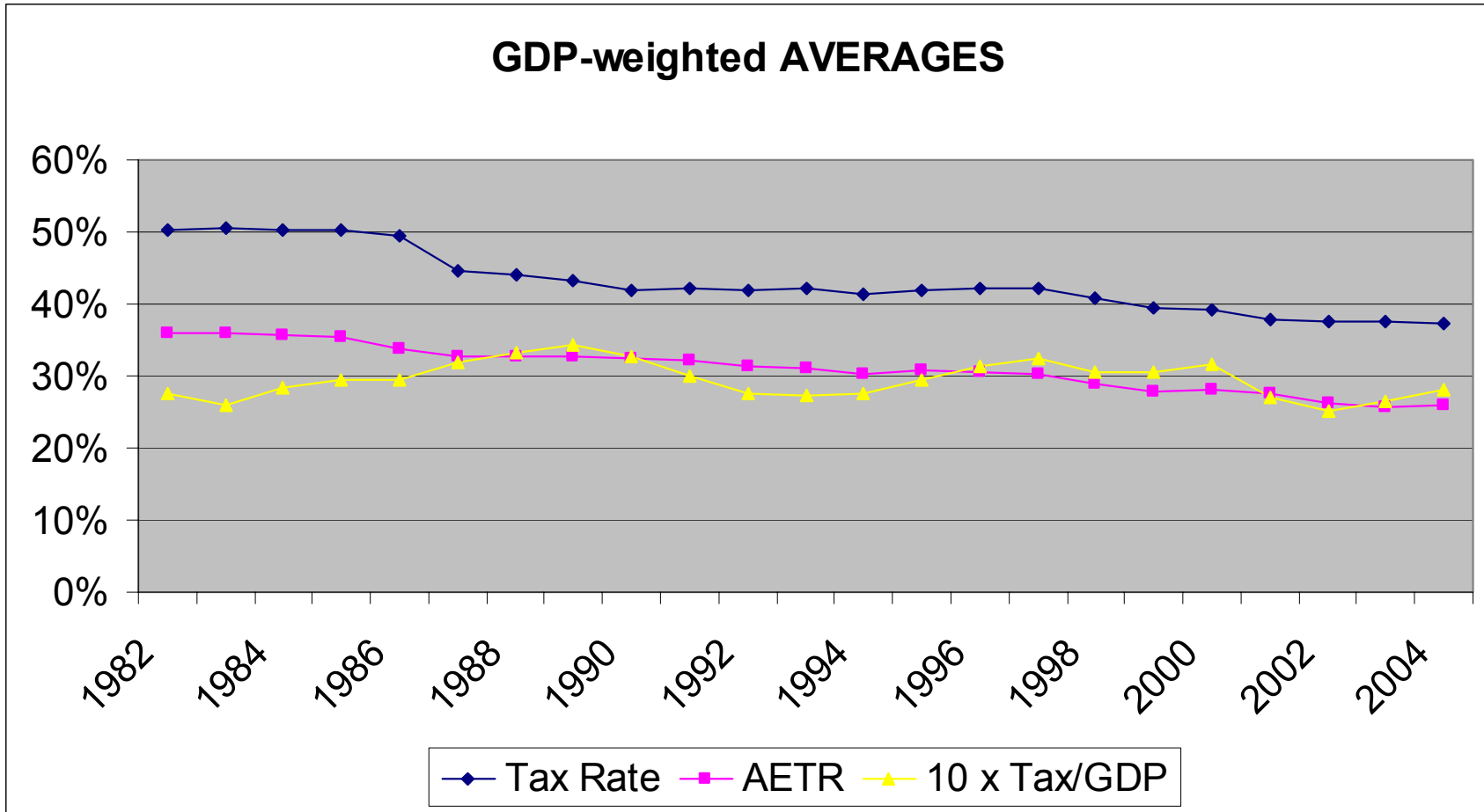
Issues we will consider:

- Trends in corporate tax amongst OECD countries
- Economic considerations
- Special incentives
- Some Policy Lessons
- Annex: A potted history of UK corporation tax

What is so important about corporate tax?

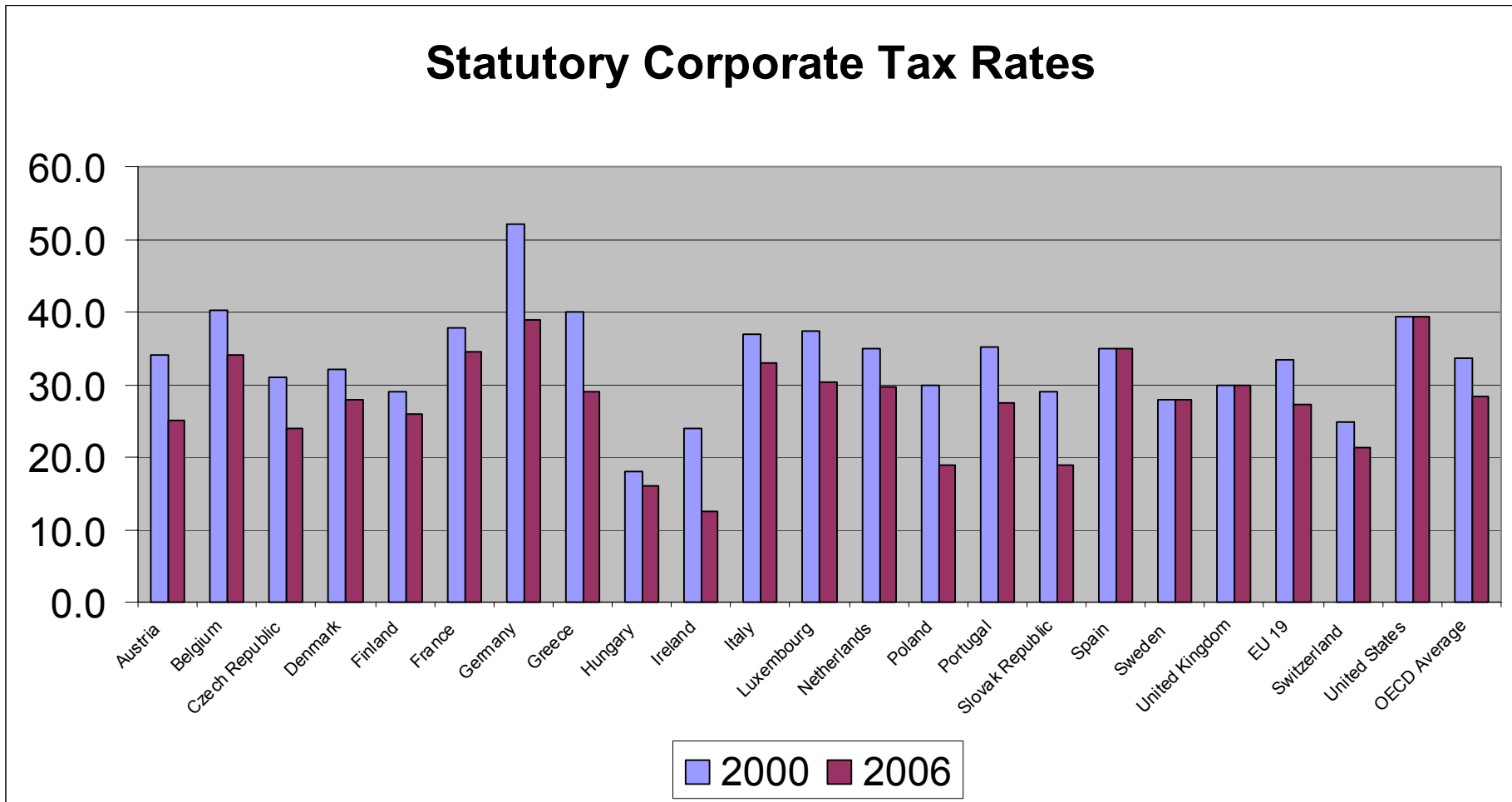
- A fairly minor part of tax revenue:
 - 9.3% for OECD, 8.1% for the EU15 (and much is relieved against PIT)
 - Personal income tax: 24.9%, 25.0%
 - Social security contributions: 26.1%, 28.8%
 - Sales taxes: 32.1%, 30.4%
- But has important effect on behaviour:
 - Affecting the level and composition of investment – and so affecting growth
 - Influencing the pattern of foreign direct investment

OECD-wide trends in corporate tax rates and revenues

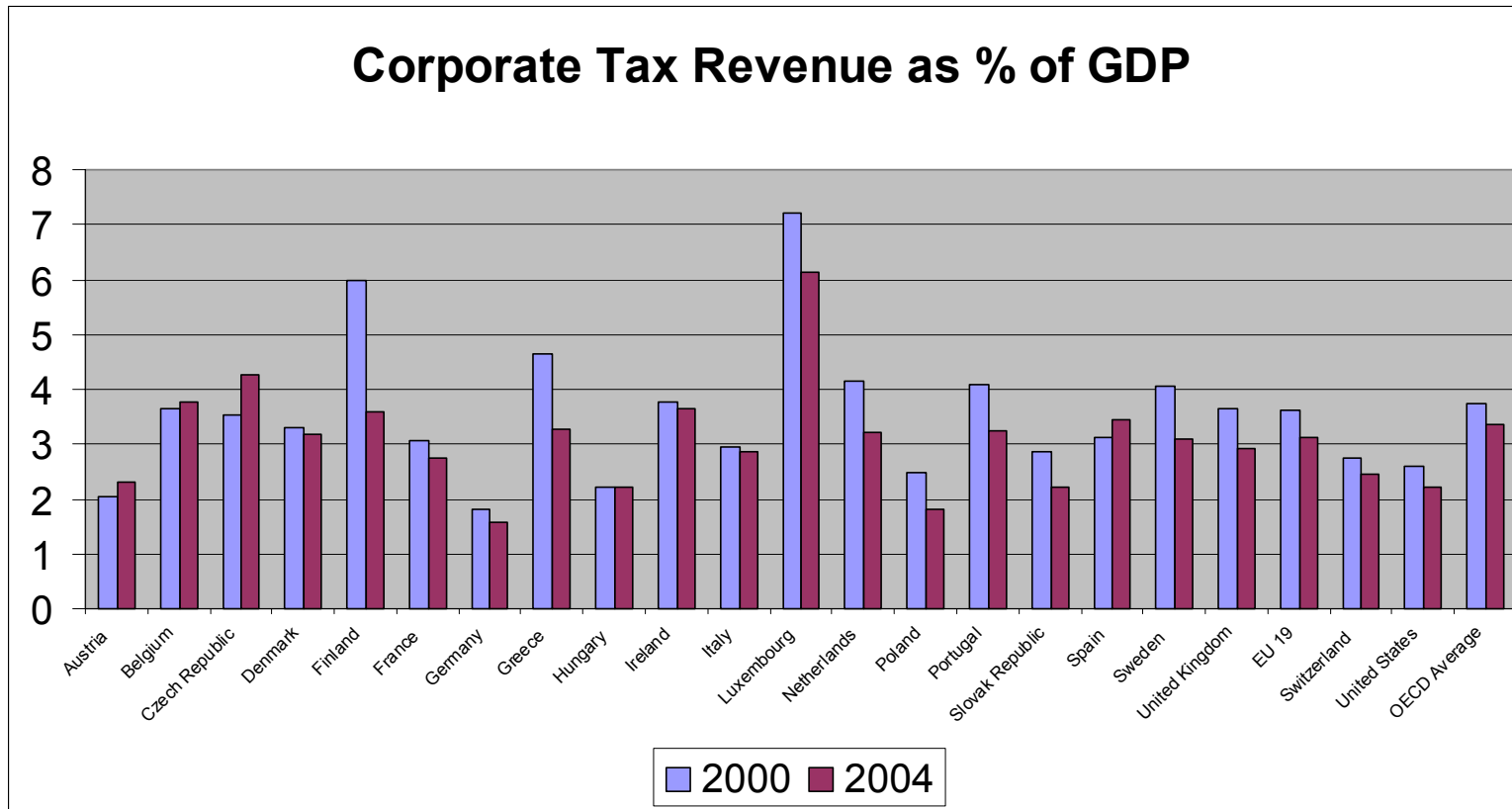


A wide range of rates

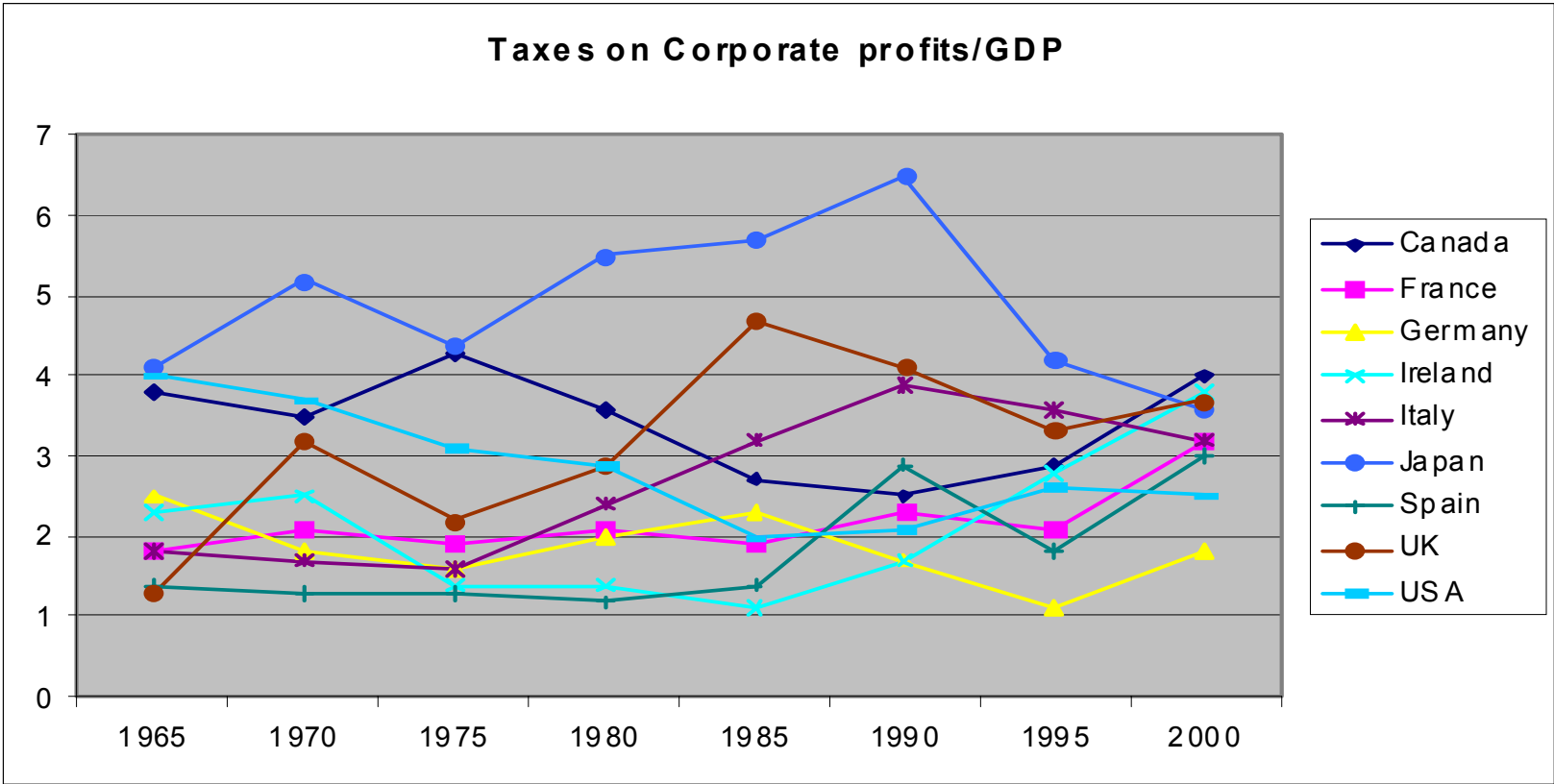
Statutory Corporate Tax Rates



A wide range of revenues



Business taxes tend to be cyclical



Ultimate Burden of Business Tax

- All taxes on businesses will have their final incidence on customers, owners (shareholders) or employees
- This is because businesses are legal entities and only people can pay tax so in the end even profits taxes on businesses are ultimately passed on to someone

Tax and Politics

- Companies don't vote but:
- Big companies can lobby effectively & individual voters don't really perceive true incidence of CT
- Politicians realise voters may not perceive impact of tax changes via CT
- Tensions between business and politics if marginal voters don't comprehend gains from cutting CT or costs of increasing it

Micro-economics of corporate tax

- Who pays CT?
- In small (capital importing) economy theory suggests workers (or other immobile factors) do via lower wages
- Assumes capital is perfectly mobile, traded goods are perfect substitutes
- Relaxing assumptions moves burden back towards capital
- Traditionally thought of as tax on owners of capital
- More recently seen as a way of extracting locational rents

Taxation and FDI

- Changing Views
 - Old View: Tax doesn't matter
 - New View: Tax matters
 - New New View: It matters, but not mostly for the reasons thought previously. Effect on ownership is what we should worry about.
 - Q: Can all be true? A: Yes (to a degree)

Tax incentives for FDI

- The dangers of special incentives
 - low or zero additionality (they would come anyway)
 - winners curse (officials bid too much for FDI)
 - me too (or how to complicate your tax code with sectoral special measures such as film production incentives)
 - more abusive tax shelters(“tax forests” and film tax credits again)
 - governance and corruption issues: especially in LDCS
 - re- labelling of domestic investment to get incentives (e.g. Chinese investment round tripped through Hong Kong)
 - revenue effects

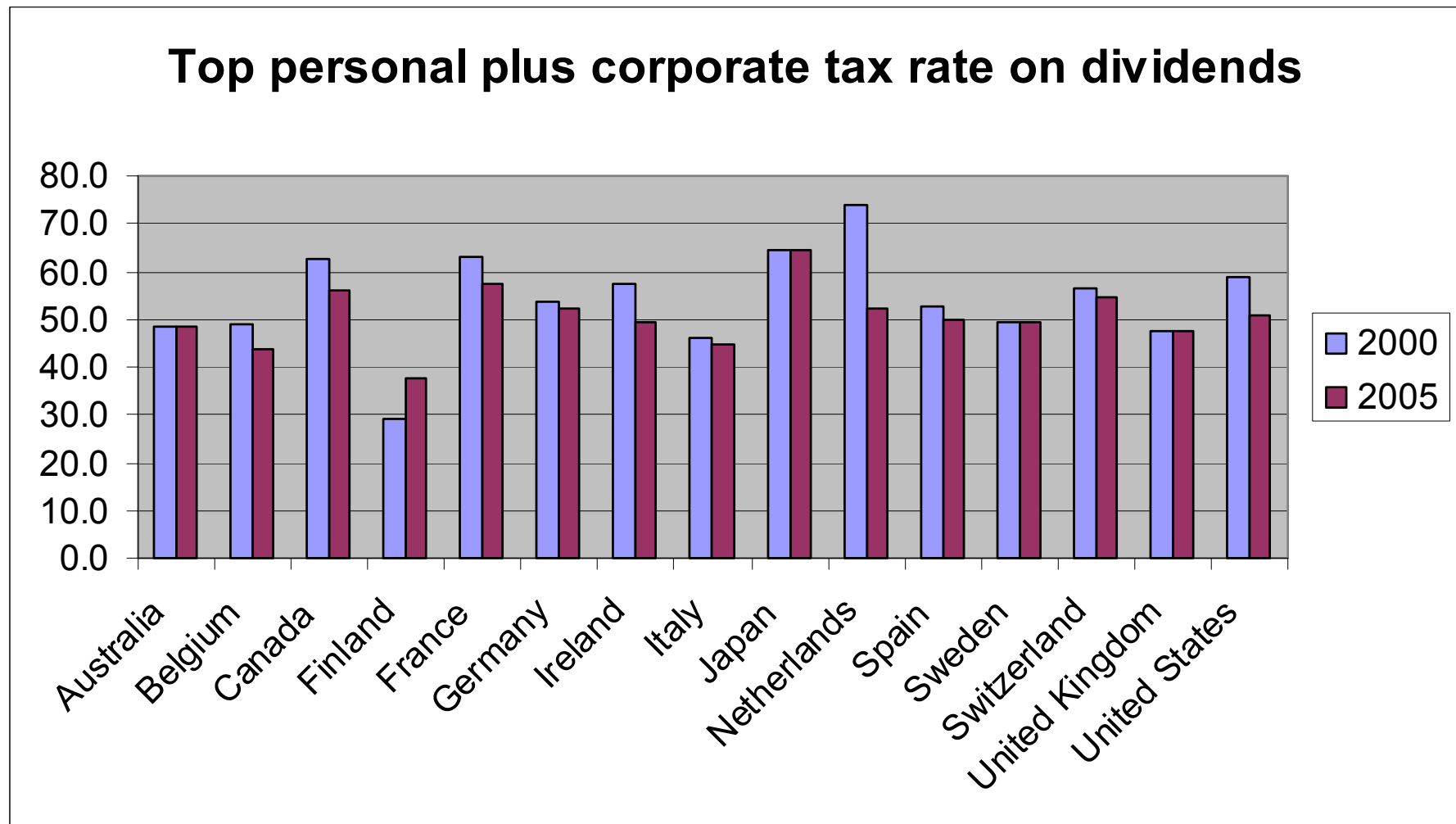
Alternative views of the "classical" corporate tax system

Theory	Influence of nontax factors on corporate financing decisions	Marginal Source of Finance	Marginal use of profits	cost of corporate capital ^a	Effect of dividend tax relief
"old" view ^b	Important	New equity important	Dividend payments	high above market interest rate	significant stimulus to corporate investment
Neutrality view ^c	unimportant	debt	financial investment in capital market	equal to market interest rate	no stimulus to investment
"New" view ^d	unimportant	retained earnings	dividend payments	slightly above market interest rate	windfall gains to existing shareholders; no investment stimulus
	unimportant	at time of establishment: new equity; after establishment retained earnings	reinvestment in real capital	starting very high above market interest rate, but falling over time	significant stimulus to the establishment and growth of new corporations
"Nucleus" theory of the firm ^e	unimportant	retained earnings	dividend payments	slightly above market interest rate	windfall gains to existing shareholders; no investment stimulus

Changes in the Taxation of Dividend Income (2000-2005)

Country	Reform Year	Pre-Reform System	Post-Reform System
United States	2003	Classical	Reduced PIT rate
Germany	2001	Full imputation	Partial inclusion
Finland	2005	Full imputation	Partial inclusion
Italy	2004	Full imputation	Partial inclusion
France	2001	Full imputation	Partial inclusion
Portugal	2002	Reduced PIT rate	Partial inclusion
Slovak Republic	2003	Classical	Personal tax exemption
Turkey	2003	Partial imputation	Partial inclusion

Taxation of Dividend Income



Administering Taxes

- Relatively cheap to collect for revenue authority because large amounts collected from few taxpayers
- In UK biggest 20 groups account for about 20% of yield
- CT as withholding tax for individuals
- Even if CT is undesirable per se argument is that it is needed as backstop to labour income taxation
- Ongoing war against avoidance and arms race - pages per finance bill seems ever increasing (in UK at least)

What influences revenues?

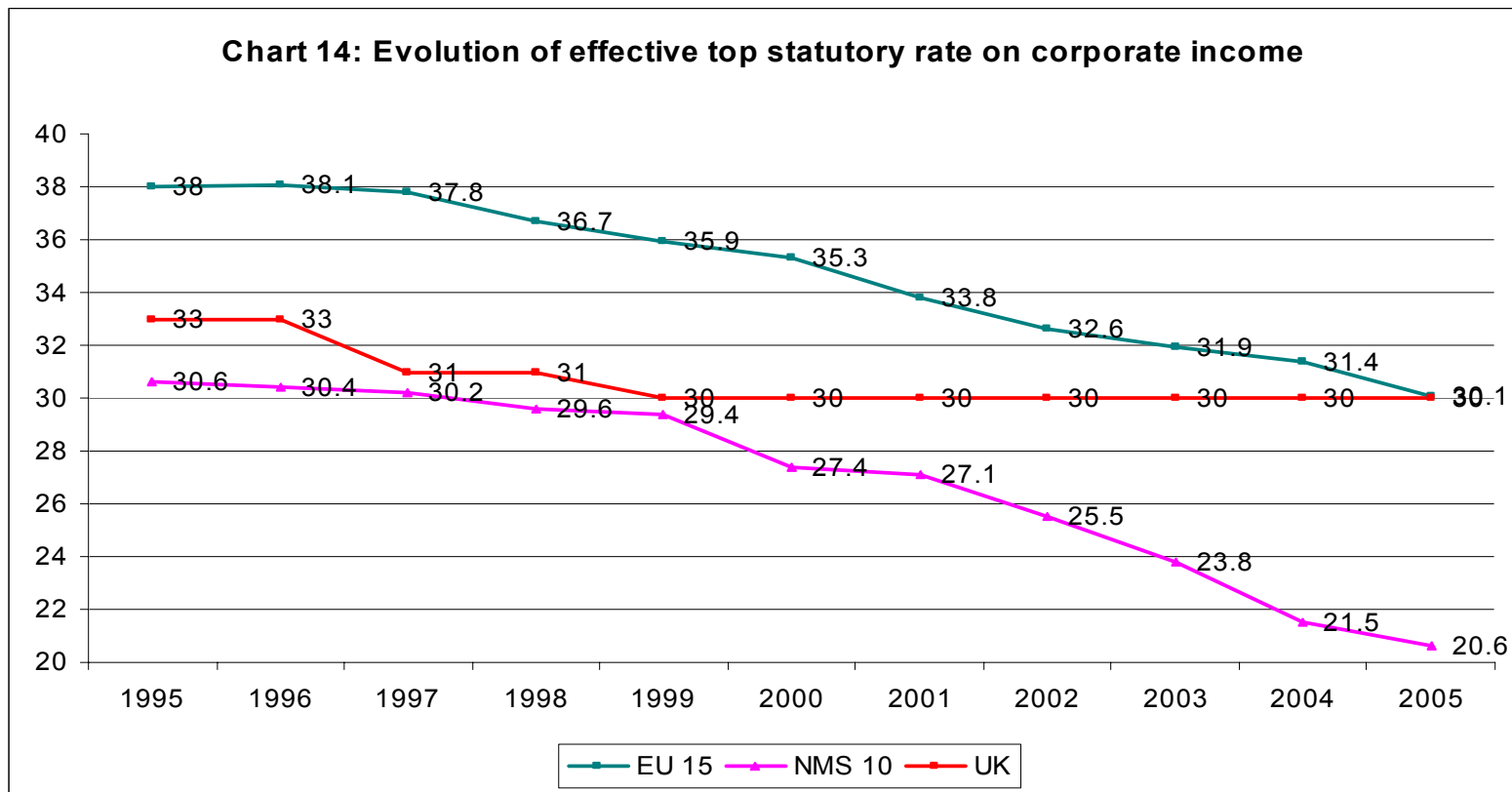
- Tax rate
- Depreciation and investment allowances
- Special exemptions and allowances
- Effectiveness of tax administration
- Share of gross profits in GDP
- Ratio of debt to equity financing
- Share of profits that are subject to **corporate** rather than personal income tax

The tax base: Key Decisions

System requires rules on:

- Income streaming? (in a schedular system like UK)
- Loss carry forward/carry back
- Tax deductibility
- Group relief
- Rollover relief for capital gains and indexing

Revenue neutral reform- rate reductions still funded by base broadening?



Fundamental Reform of Corporate Tax

- Many countries see problems with the preferential treatment of debt as compared to equity
 - Distortion of financing decisions
 - Opportunities for international tax planning
- Examples of country reforms that reduce the preferential treatment
 - Estonia with a 100% tax relief on re-invested profits (similarities to a cash-flow tax)
 - Belgium has introduced an Allowance for Corporate Equity
 - Germany is considering limiting interest deductions

Policy Constraints: A summary of Wider Considerations

Economic Theory:

Incidence in open economy
Effect on investment and economic growth
Tax rates across different types of assets

Political

Distribution
Comprehension of tax incidence

International

Tax shifting in the presence of credit regimes
Treaties
Unfair Tax Competition

Administrative

Corporate income tax as a backstop to labour income taxes
Collection Efficiencies

Summary of international trends

- Statutory corporate tax rates have been falling across the OECD but revenues have been relatively stable
- The EU has seen a recent fall in statutory rates and fall of revenues, but some of the revenue falls are due to the slowing of economic growth
- Countries have moved away from full imputation and reduced shareholder relief, but overall tax rates on dividends have generally fallen
- Some countries are introducing more fundamental corporate tax reforms

Basic Investment Incentives: Capital Allowances as a starting point

- Allow the cost of capital assets to be written off against a business's taxable profits.
- Take place of depreciation charged in commercial accounts. (Commercial depreciation is not allowed for tax in UK.)
- Specially increased allowances referred to as first year allowances (FYAs). Also called enhanced capital allowances.
- FYAs allow a greater proportion of the cost of an investment to qualify for tax relief against a business's profits of the period during which the investment is made. They can bring forward the time tax relief is available for capital spending.

Starting Point for Reform in the UK : Incentives to invest under standard CT rules

- Prior to 1984 reform the incentives to invest in UK were very different from now
- Large negative METRs where investment was debt financed
- Capital Allowances in UK now:
 - 20% year on a reducing balance basis for general spending on plant and machinery
 - 10% a year on long life assets (> 25 years)

Industry Specific Schemes

- Rare in UK (partly due to EU state aid rules)
- Only current example is film tax relief for low budget “British” films
- Support for film industry has been plagued by the use of tax incentives for avoidance schemes
- Cost in tax revenue out of all proportion to any benefit because of avoidance
- Constant changing of rules to limit avoidance.

Industry Specific Schemes: Films and Forests

- Avoidance by individuals via purchase and leaseback of film masters.
- Avoidance via re-labelling of television shows to get relief
- At one point it didn't even matter if film was even ever shown as tax break made underlying profitability of film irrelevant
- Film tax credit story not unique
- Tax incentive for forestry created similar problems

Encouraging Entrepreneurial Activity and Enterprise

- Started in 1983 with Business Expansion Scheme.
- Enterprise Initiative Scheme introduced in 1994 to replace BES
- Venture Capital Scheme introduced in 1995
- All designed to encourage individuals to invest in small unlisted trading companies in return for various tax reliefs (to the investors)

More Detailed History

- **Business Expansion Scheme.** Introduced in 1983 as a tax effective inducement to encourage investment in companies not quoted on the stock exchange. The scheme ended 31.12.93 and was replaced by the Enterprise Investment Scheme.
- **Enterprise Investment Scheme.** Introduced by the November 1993 budget as a replacement for the BES scheme which ended 31/12/93. Investors can invest up to £100,000 each year and get 20% tax relief; an additional 20% is available if the venture fails.
- **Venture Capital Trust.** A special type of investment trust on the Stock Exchange designed to provide start up or expansion capital for unquoted companies
- See handouts for details of where and how policy failed to live up to expectations

Policy Lessons

- Policy rationale, support for risky investment, seemed sensible but:
- Investors and advisers used schemes in a way not foreseen or intended, e.g by universities as a way of getting cheap finance for student accommodation
- Once policy introduced, constant fixes needed and original policy rational lost, e.g. allowing extension to investment in private renting in 1988. Fixes to stop avoidance still needed despite redesign and renaming of original scheme.
- **Intentions of policy makers may be unrelated to actual outcome of policy intervention if users behaviour ignored!**

Policy Lessons and questions: Framework Conditions

- Industry specific support via tax (and subsidies) tightly constrained by EU state aid rules in UK.
- Can/should other countries develop similar institutional constraints on central government and provincial level?
- Strong economic rationale desirable for departing from general CT rules
- What objectives meet above test? R&D yes... Culture (films) Not really “strategic industries”...better to target externality at source

Policy Lessons and Framework: Policy Design

- Collect evidence about taxpayer behaviour before introduction of any tax incentive.
- Plan to evaluate tax incentives from outset.
- Be aware that some policies won't work - it is better to be prepared to abolish these than keep tinkering with them for face saving reasons.
- Tax incentives often go hand in hand with enhanced avoidance opportunities. Need to be able to spot and counter these if you go down this road.

Lessons from UK?

- Lower rate and broader base is a useful policy mantra
- Special small companies rate of CT hard to operate fairly given knock on effect on employment choice (discussed tomorrow)
- No obvious long run benefit from creating very complex pattern of changing capital allowances where used as policy sweeteners for other changes
- Lesson is try to avoid this as far as possible and line up capital allowances with economic depreciation rates .. but it has taken us 40 year to get there!

And finally.

- Big reforms are rare so worth getting it right first time as things left unfixed tend to stay unfixed
- “The current system (of schedular losses), based on income tax rules dating back to the 19th century” which is “widely seen as outdated and in need of reform” (from Corporation Tax Reform A Consultation Document 2003)
- 200 years stands as a warning to the danger of thinking we’ll fix it later!

History of Corporate Tax Reform in the UK

A Potted History

Origins of the United Kingdom's Corporation Tax

- Finance Act 1965 removed companies and associations from income tax (and a special company profits tax) and created:
- Corporation Tax, payable by UK resident companies and associations
- Tax borrowed its basic structure and many rules from income tax
- 1965 Finance Act also introduced a Capital Gains Tax (CGT). Companies don't pay CGT but are liable to CT on "chargeable gains"
- Rules have gradually diverged over time from those for income tax but some components linger on, e.g. schedular base.

The tax base:

- CT System has evolved rules on:
- Income streaming (in a schedular system like UK)
- Loss carry forward/carry back
- Tax deductibility
- Group relief
- Rollover relief for capital gains and indexing

Early History of Rates 1965 -1980

- Tax rate started out at 40% in 1965
- Raised to 45% in 1969
- Reduced to 42.5% in 1970
- Reduced to 40% in 1971
- Main rate of 52% introduced, and small companies rate of 42% in 1973.

Need for reform

- System prior to 1984 had
 - High rates
 - Narrow base
 - Negative effective marginal tax rates for some types of investment

Significant corporate tax reforms since 1980

- **1984 Major Reforms** - Announcement of major reduction in CT rates from 52% in 1982/3 to 35% in 1986/7. First year and initial allowances phased out by 1986/7. Small companies rate cut in one step to 30% from 83/84. Stock relief abolished.
- 1986 - Small companies CT rate cut from 30% to 29%.
- 1987 Small companies CT rate cut from 29% to 27%
- 1988 Small companies rate cut from 27% to 25%

Significant CT changes in the 1990s.

- 1991 Main CT rate cut from 35% to 34% in 1990/91 and to 33% from 1991/92. Loss carry back extended from one to three years. 1992 Temporary enhanced capital allowances between November 1992 and October 1993: first year allowances of 40% on plant and machinery and initial allowance of 20% on industrial buildings
- 1995 Small companies rate cut from 25% to 24%.
- 1996 Small companies rate cut from 24% to 23%. Writing down allowances for long life assets cut from 25% to 6%.
- 1997 Main CT rate cut from 33% to 31%. Small companies rate cut from 23% to 21%. Loss carry back reduced from three years to one year. Windfall tax imposed on privatised utilities.

Significant CT Changes in the 1990s continued.

- 1998 Main CT rate cut from 31% to 30%. Small companies rate cut from 21% to 20% from 1999/00. Advanced Corporation Tax abolished from 1999/00. System of quarterly instalment payments phased in from 1999/00
- 1999 New starting rate for small companies introduced at 10% from 2000/01

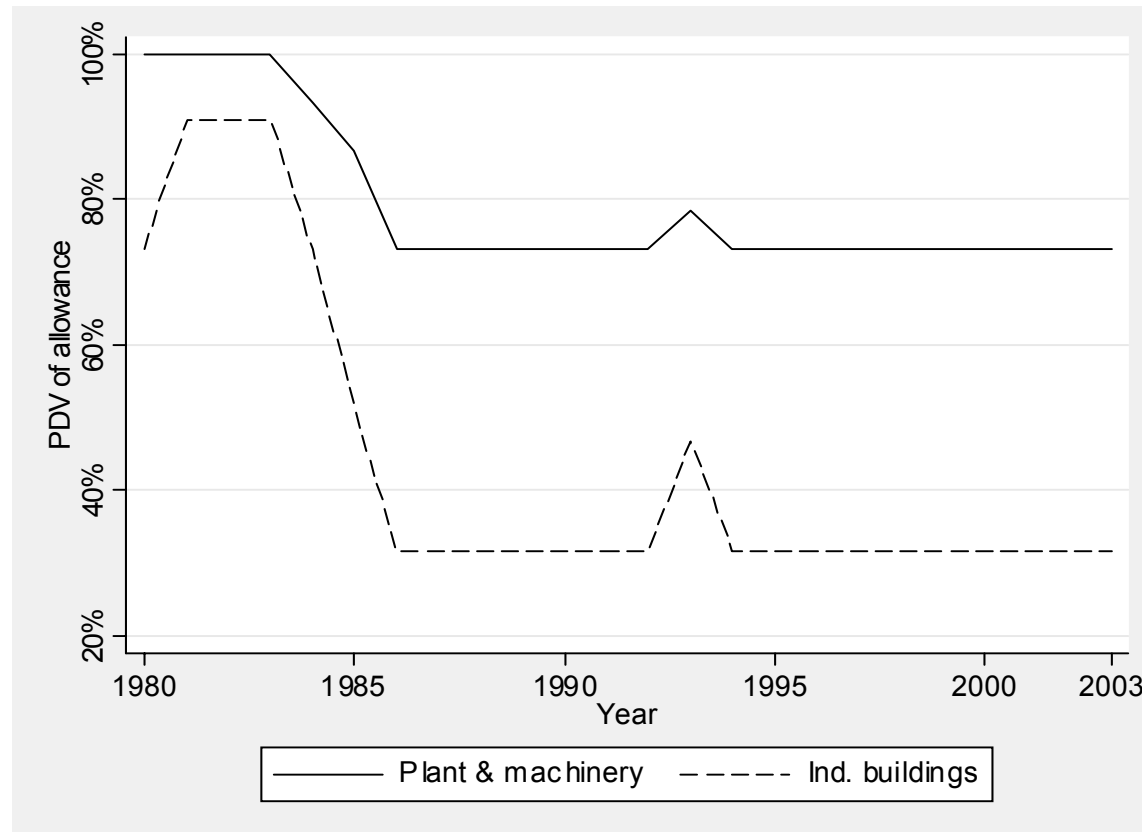
CT changes since 2000

- 2002 Small companies rate cut from 20% to 19%. Starting rate cut from 10% to 0%.
 - 2004 Non-corporate distribution rate(NCDR) of 19% introduced. First year investment allowances for SMEs raised to 50% for one year.
- 2006 Abolition of 0% rate and NCDR. All profits up to £50,000 to be taxed at 19% small co. rate.

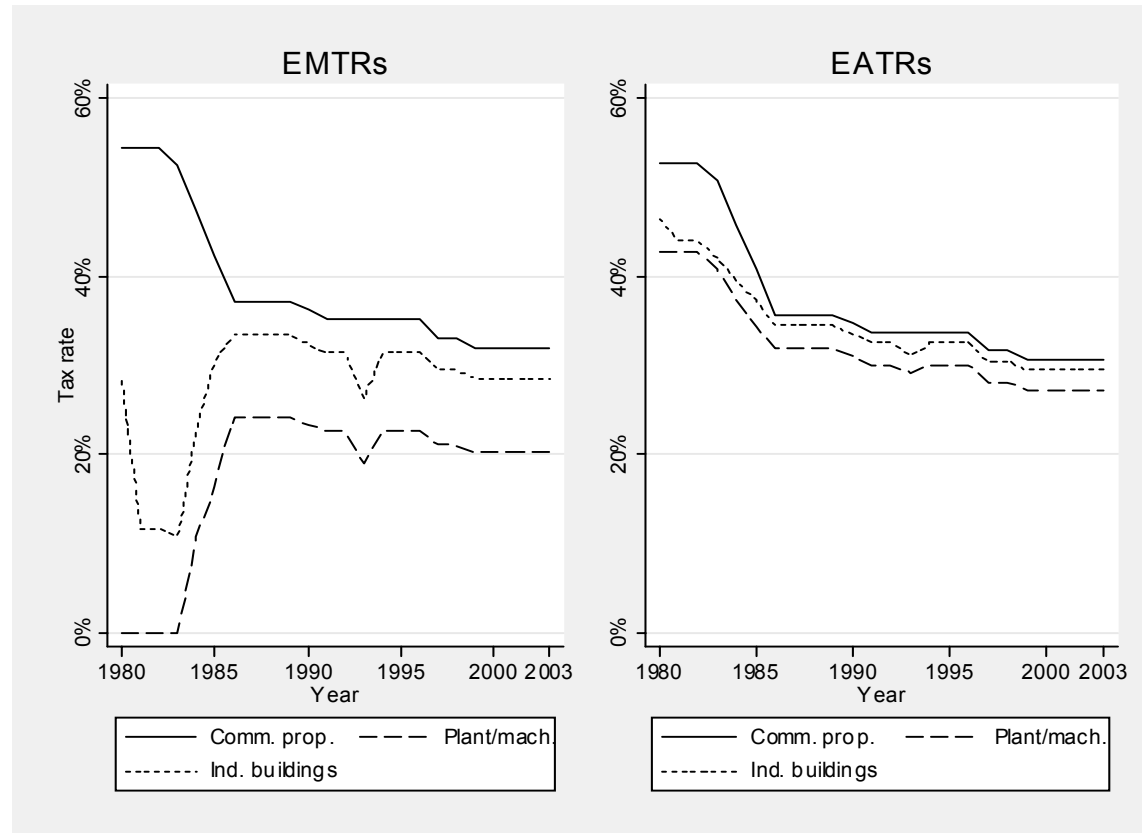
Current UK CT System: Lower rate & broader base

- Elimination of very high negative EMTRs which could result in investment where no economic case because of effective subsidy via tax system
- Revenues maintained

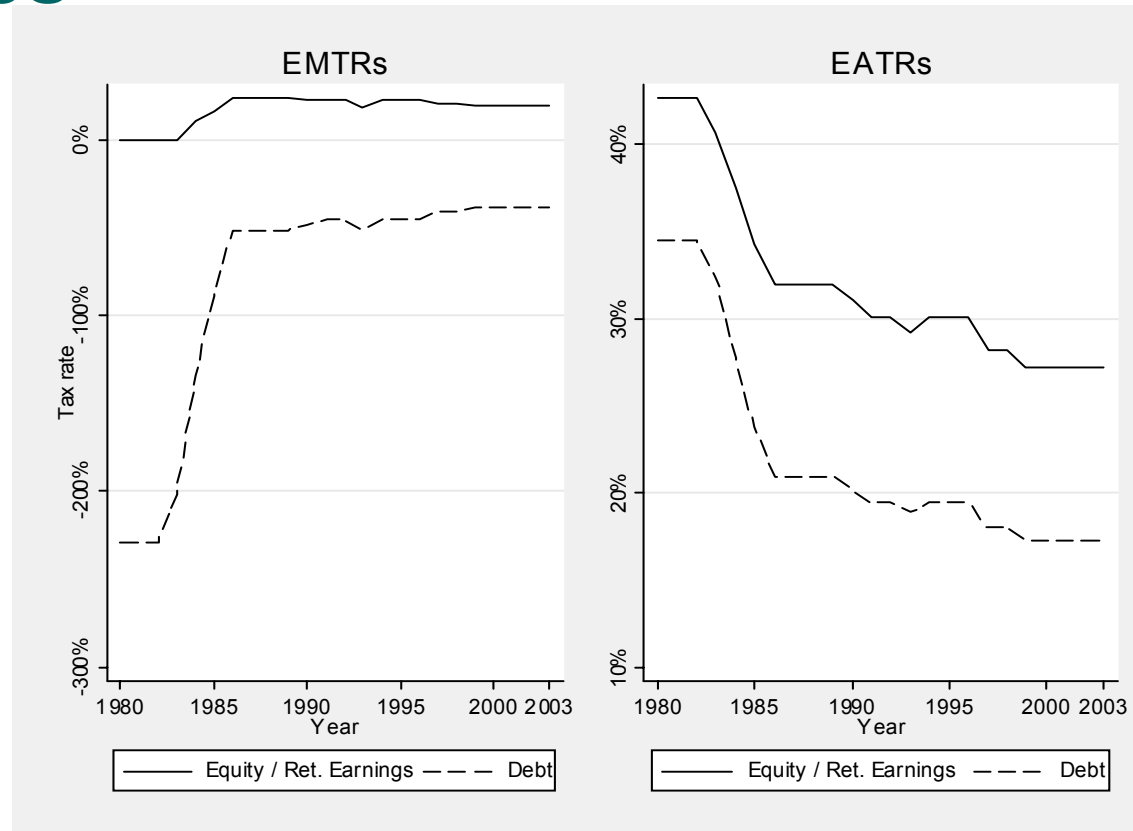
Investment Allowances for Different Assets



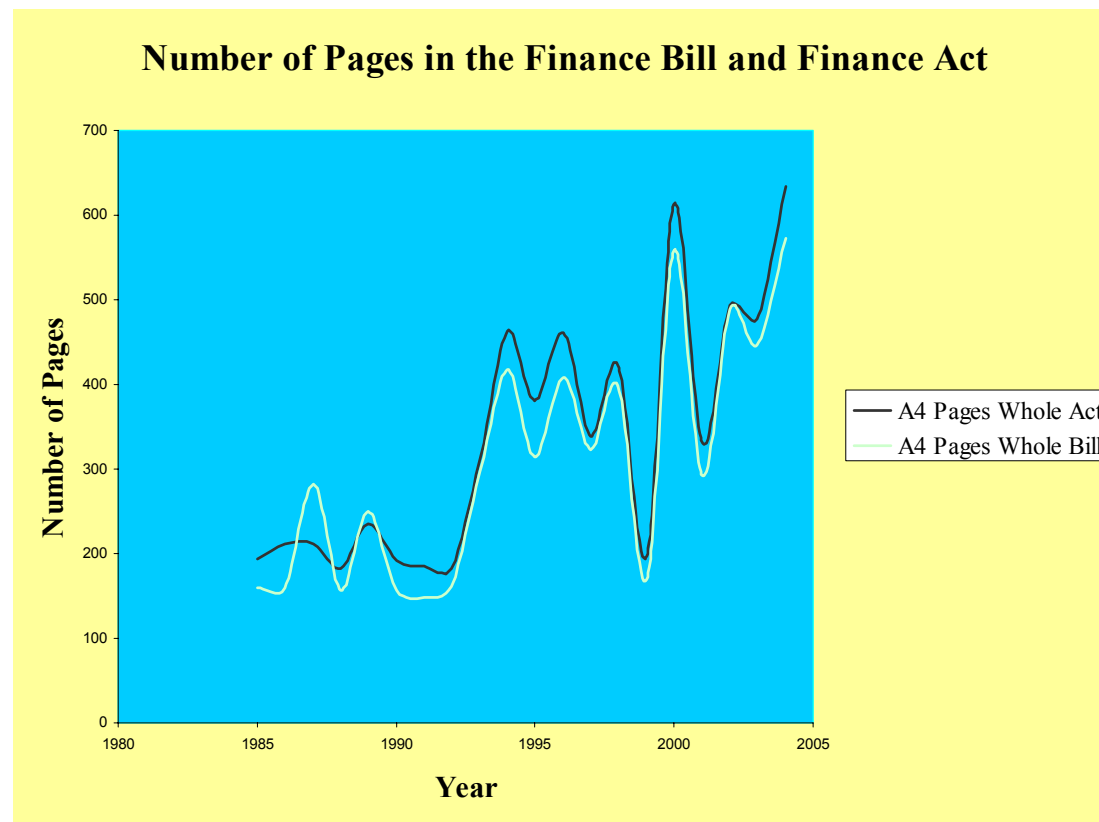
Effective Tax Rates for Investments in Different Assets



Effective Rates for Plant and Machinery Investments Financed from Different Sources



The complexity of the tax system is growing



Budget 2007 CT package - details

- streamline the system ensuring allowances better reflect economic depreciation
- **Phased increase in the small companies rate** to 22%, starting from April 2007
- Cut in the main **corporation tax** rate from 30% to 28% from April 2008
- Extension to April 2008 of the 50% first year capital allowances for small-sized firms
- New **annual investment allowance** of £50,000 available to all businesses from April 2008
- Increase in the **large company R&D tax credit** from 125 per cent to 130 percent from April 2008
- Increase in the enhanced deduction element of the **SME and mid-sized R&D tax credit** from 150 percent to 175 per cent from April 2008

Budget 2007 :Impact of 2007 changes

- Cut in main rate of CT:
 - Reduces firms cost of capital by around 1%
 - Ensures UK remains an attractive investment location.
 - **Stimulating growth** by encouraging increased domestic investment and FDI - offering spill over effects for UK firms, with potential positive effects on productivity growth

Budget 2007

- Small companies:
 - Small Companies' Rate change aimed at tackling individuals incorporating to minimise tax
 - Annual Investment Allowances reduce costs of capital, and provide cash flow benefits

In the context of fiscal rules since 1997 which decree:

- **Golden rule**
 - Over the economic cycle, the Government will borrow only to invest and not to fund current spending
- **Sustainable investment rule**
 - Net public debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level (40%)