



**HM Revenue
& Customs**

Corporate Tax Reform: Experience in OECD Countries

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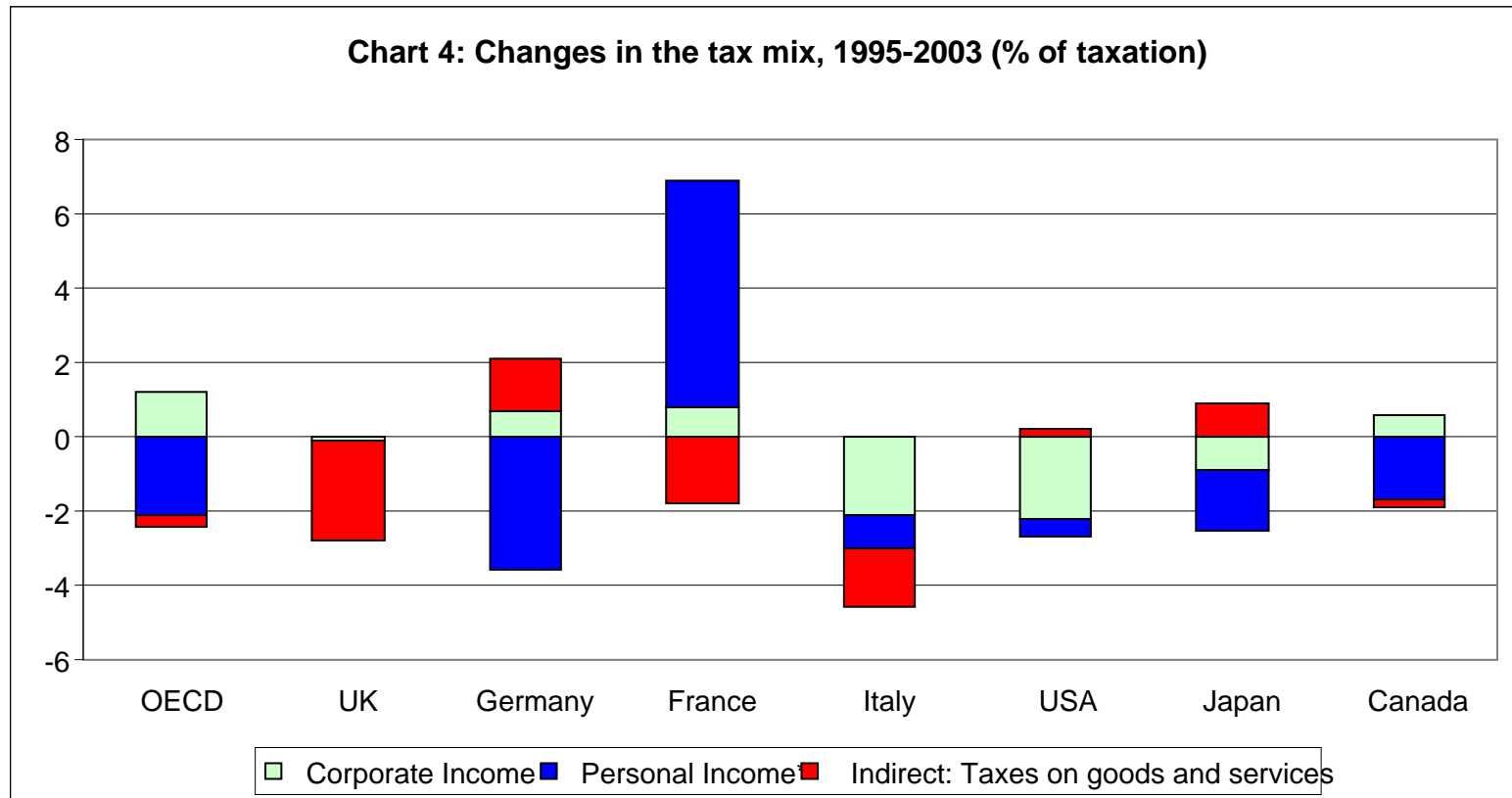
Issues we will consider:

- The importance of corporate tax
- Economic considerations
- Administration and design
- Some Policy Lessons
- Summary

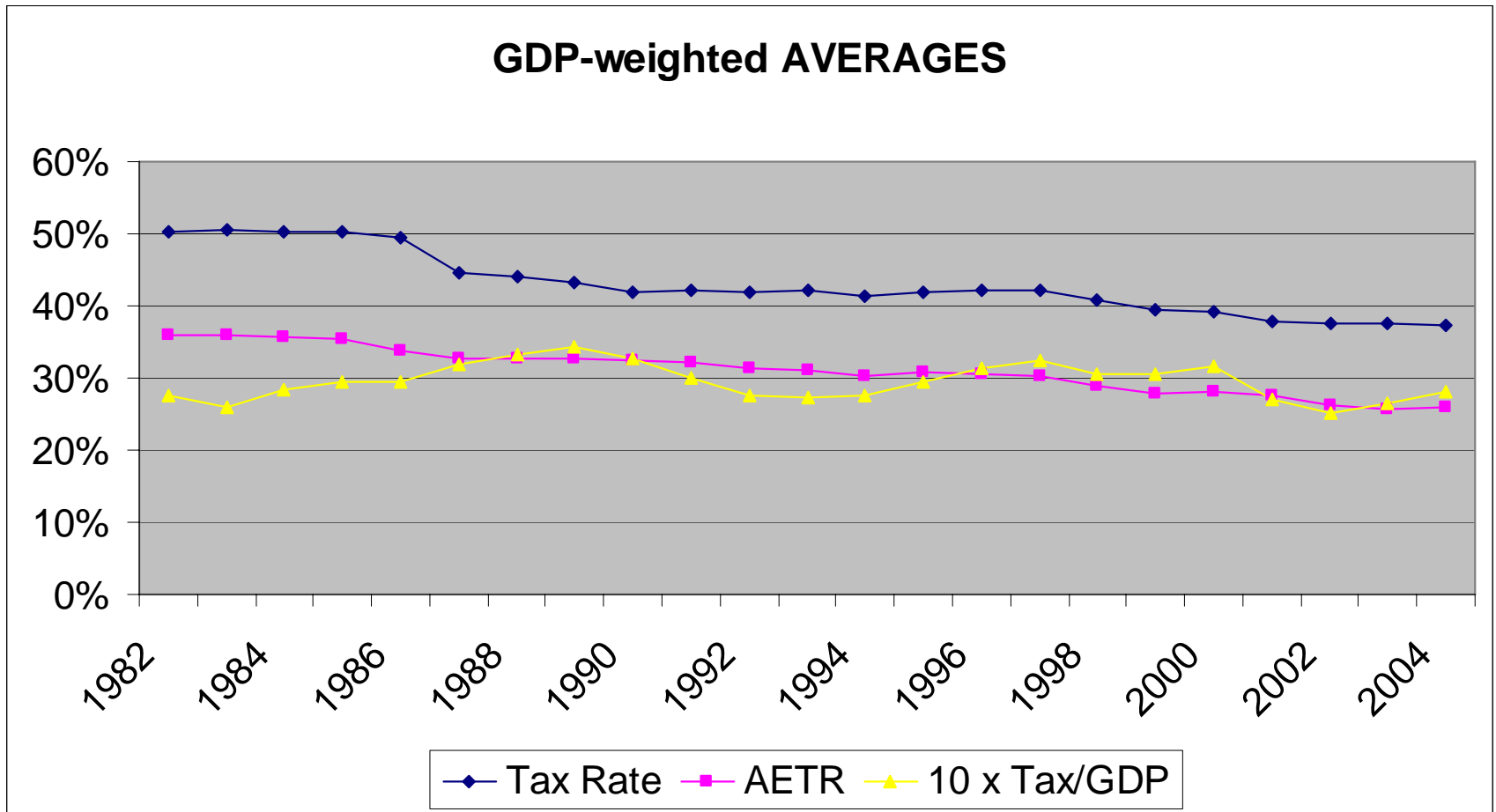
What is so important about corporate tax?

- 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

Changing Tax Mixes

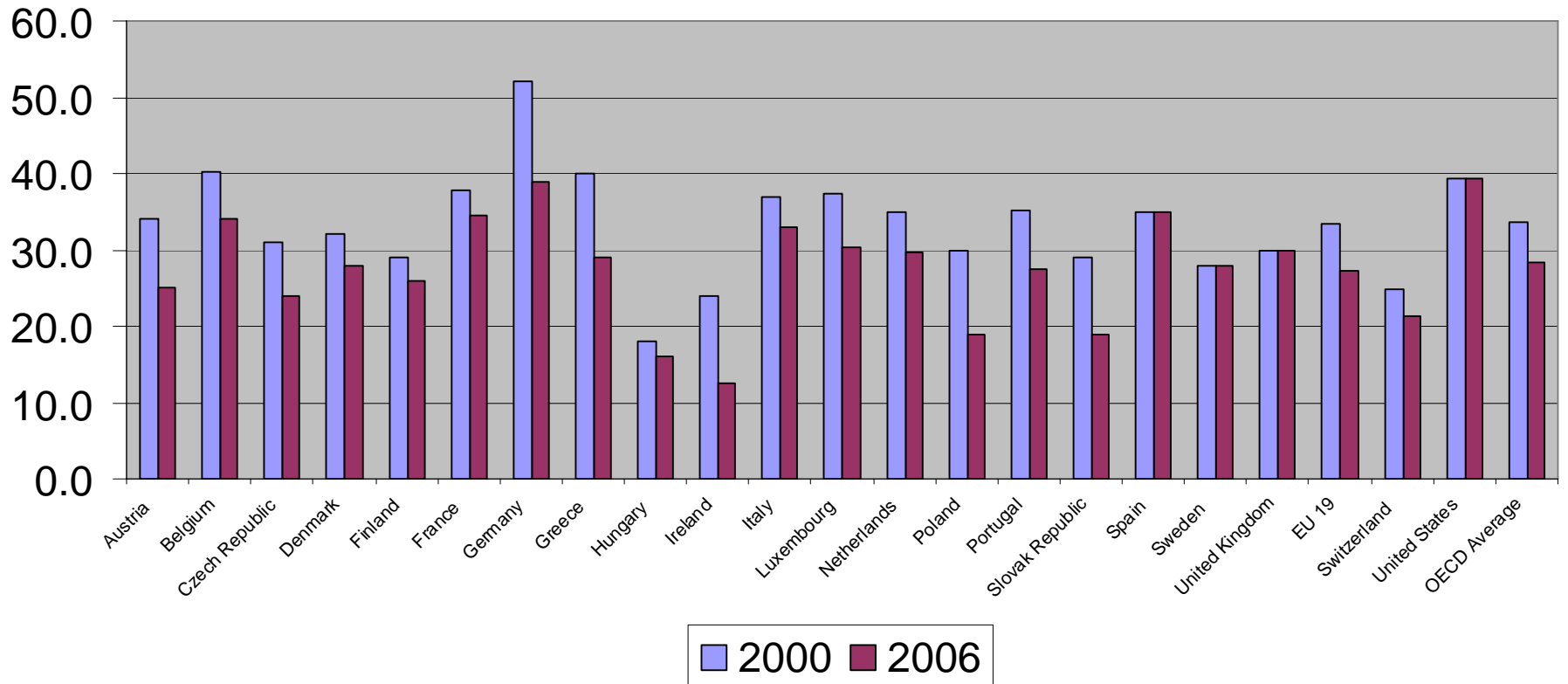


OECD-wide trends in corporate tax rates and revenues

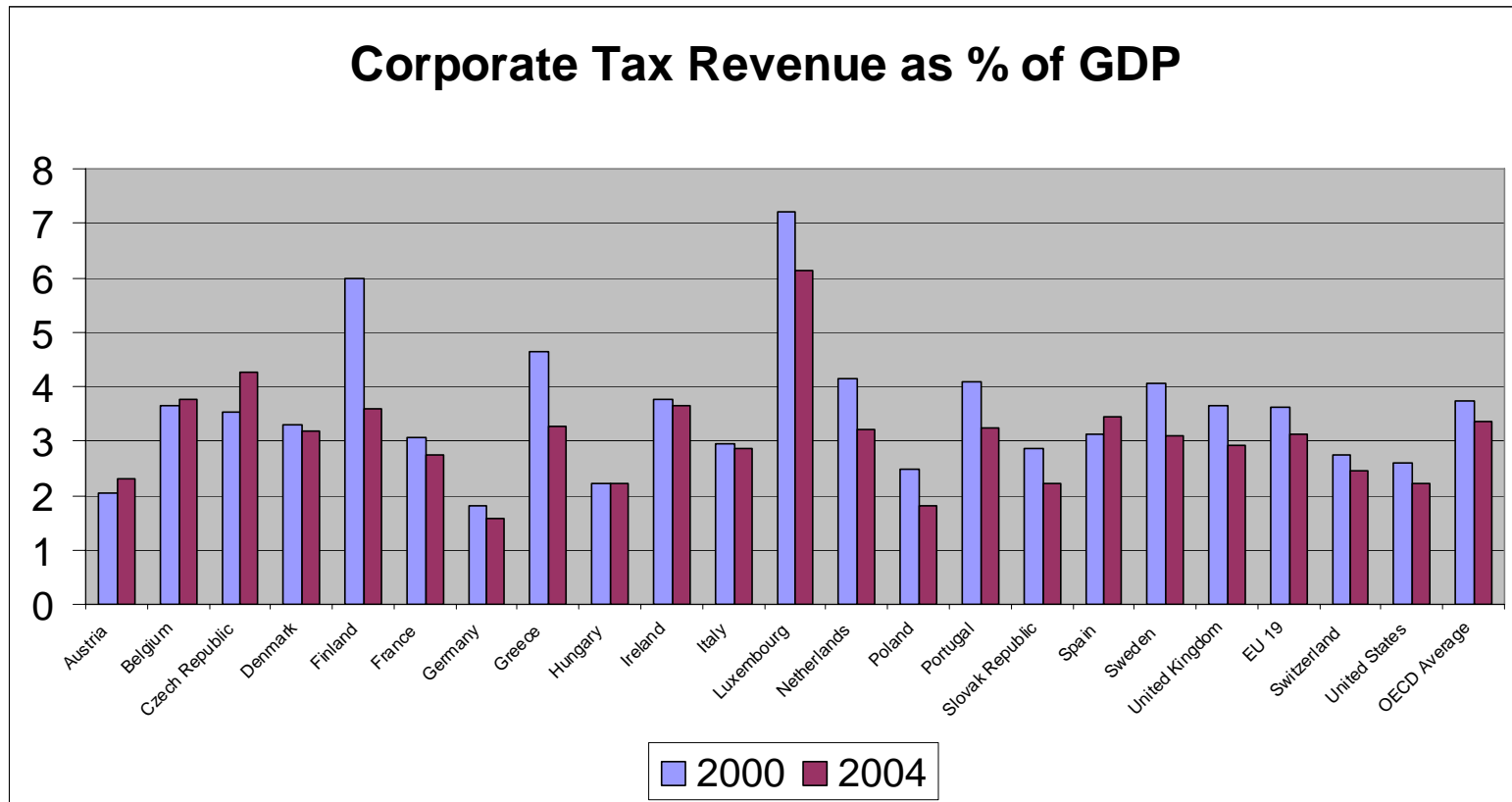


A wide range of rates

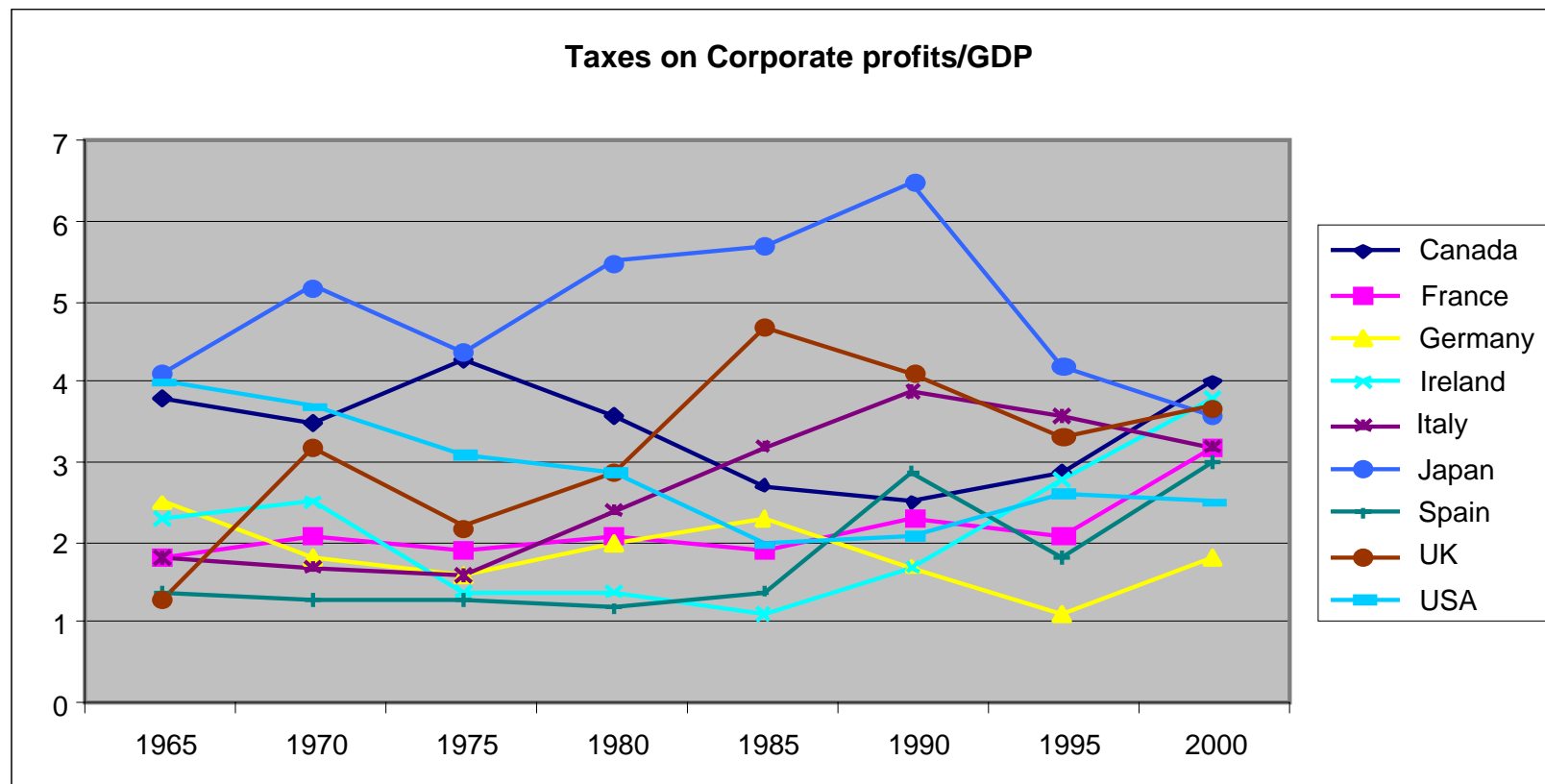
Statutory Corporate Tax Rates



A wide range of revenues



Business taxes tend to be cyclical



Some Basic Economic Principles Straight Out of the Text Book: Incidence

- The person/business that is legally responsible for paying the tax over to the revenue authority is not necessarily the same as the person/business who bears the tax burden
- Implication is that it doesn't necessarily matter who is formally responsible for paying the tax
- Economic burden is what ultimately matters (but you should try to minimise administrative costs)

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

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

Capitalisation of Asset Taxes

- A permanent change in the taxation of an asset (e.g. bonds or land) will be CAPITALISED into the price and hence incident on the current owner
- This means that changes in the taxation of assets can impose large capital gains and losses on current owners
- Announcement effects may be important as prices adjust to reflect future taxes. Effect occurs on announcement, not on implementation.

Tax and Politics

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

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

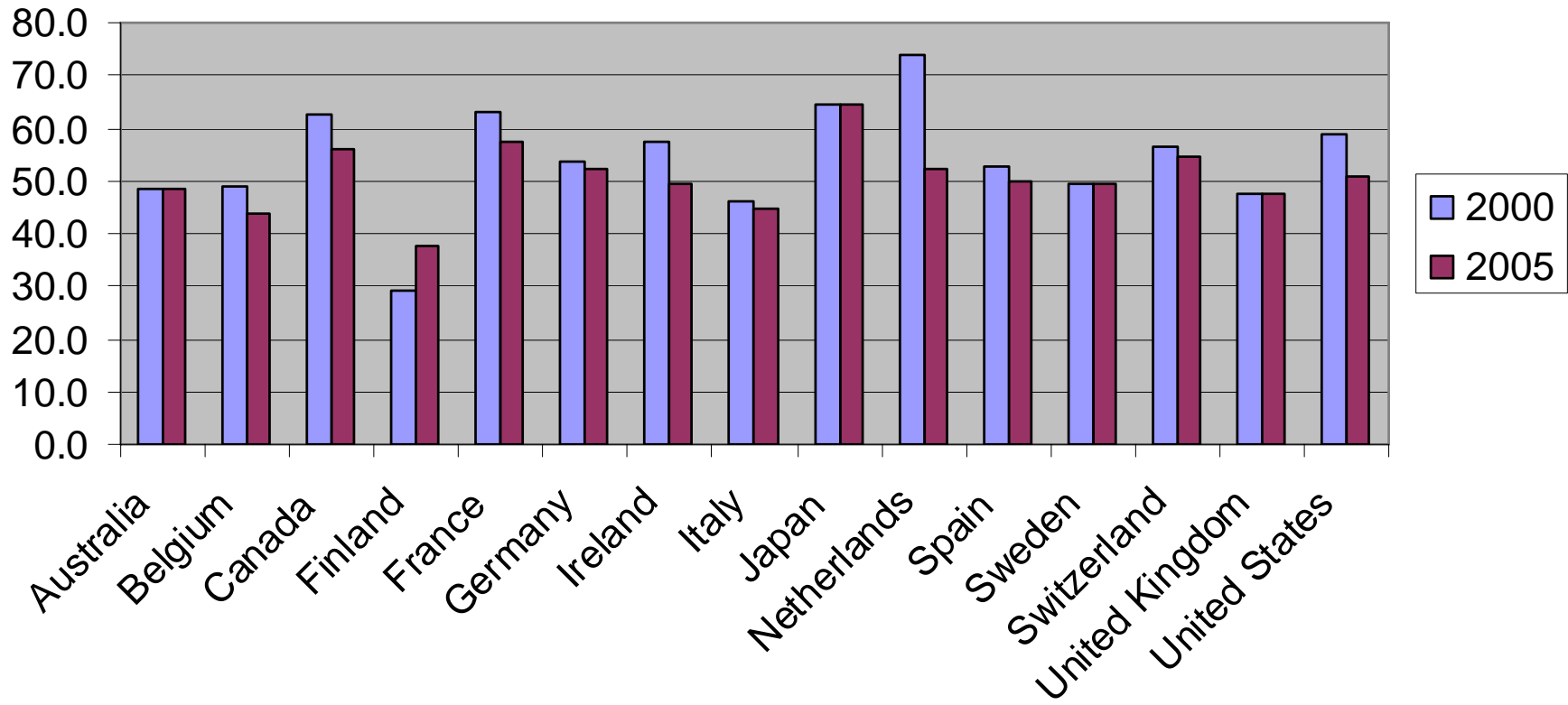
Theory	Influence of nontax factors on corporate financing decisions	Marginal Source of Finance	Marginal use of profits	cost of corporate capital ^a	Effect of dividend tax relief
"old" view ^b	Important	New equity important	Dividend payments	high above market interest rate	significant stimulus to corporate 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
"Nucleus" theory of the firm ^e	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
	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

Top personal plus corporate tax rate on dividends



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?

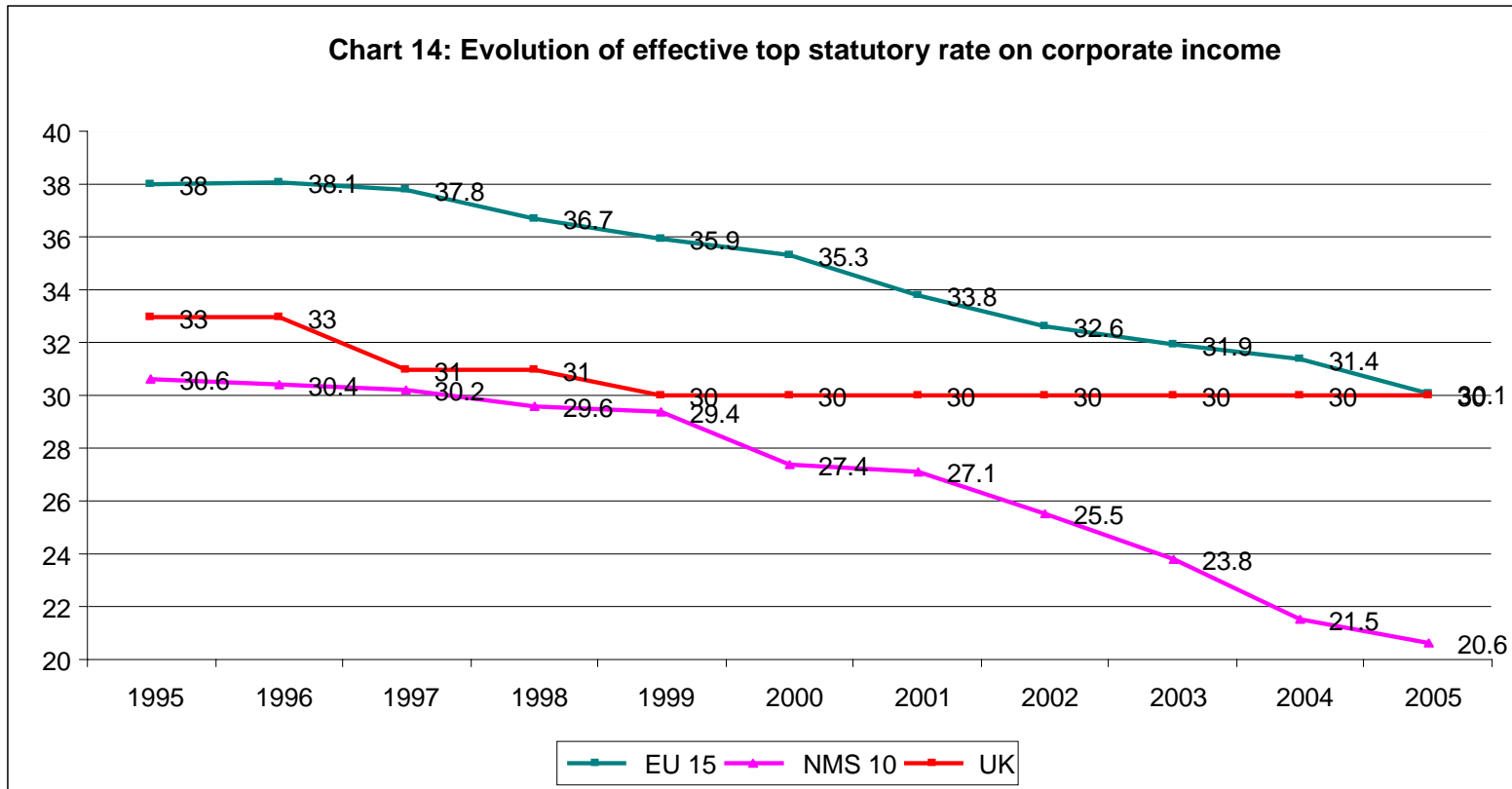
- Tax rate
- Depreciation and investment allowances
- Special exemptions and allowances
- Effectiveness of tax administration
- Share of gross profits in GDP
- Ratio of debt to equity financing
- Share of profits that are subject to **corporate** rather than personal income tax

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?

Chart 14: Evolution of effective top statutory rate on corporate income



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 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.

Why don't SMEs use reliefs available?

- Mainly because not relevant but:
- Perception that they are difficult to claim with detailed and complex criteria (which generally exist to deal with avoidance issues)
- Uncertainty as to whether claim would succeed
- Lots of SMEs unaware of their existence so questions over communication strategy used by government

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

International

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

Political

Distribution
Comprehension of tax incidence

Administrative

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

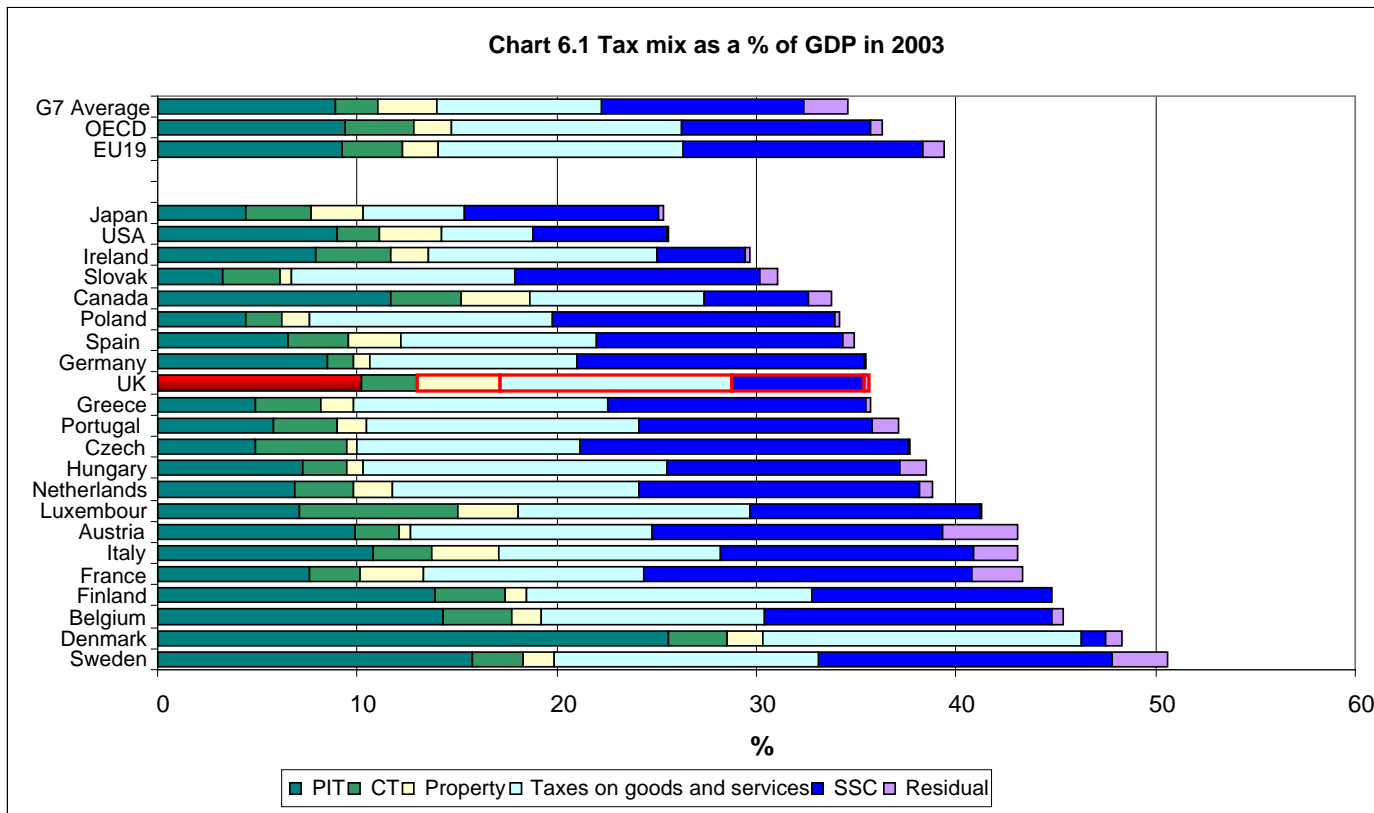
Summary

- 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

Annex

- Memo Items

How important is corporate tax as a source of revenue?



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