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Corporation Tax in a Globalised Economy

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The Competiveness of the UK Tax System

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You have a paper I prepared for this conference but I want to move on from that and try to draw together some of the views put forward today on what makes a competitive tax system, or put another way, how can a country provide a tax environment which encourages its businesses to remain in that country and foreign businesses to relocate to that country. The current financial crisis gives a new edge to this issue.

A starting point is a recognition that tax is increasingly important in the location decisions of an increasing set of business activities of corporations.

1) Removal of non-tax barriers and not just EU.
2) Shift to a service and intangible economy (easier to relocate intangibles than a factory).
3) MNEs are becoming truly global: integrating services, risk and finance as well as supply chain.

But clearly even in this new environment tax is not the only driver. Firms will first look at long-term profitability which in turn depends on access to markets, availability of skilled labour, political stability and unit costs. Also, don't ignore the "buzz" factor: young, single, hedge fund managers may find ZUG boring. They want a cosmopolitan environment and, of course, when you talk of the city you have many other factors that make London attractive: English law and language, agglomeration benefits, light regulatory environment, time zones. Paying £30,000 for these benefits is a pretty good bargain!

Of course, firms will prefer a low to a high cost country other things being equal. But other things generally are not equal. A relatively high tax country that spends the revenue on a first class physical and social infrastructure will generally be preferred to a low tax country without these productivity enhancing public expenditures.

What the debate in the UK has shown is that in an economy where much of the value added is derived from know-how and ideas, tax will increasingly influence where MNE place these intangibles (20% of US intangibles are held in Ireland, Singapore, Switzerland).

It is important to recognise that it is not just CIT that influences location decisions:

- Many countries levy non-profit related taxes (e.g. "taxe professionnelle") and these can weigh heavily on business decisions.
- VAT is also important (Luxembourg with its lowest rate of VAT in the EU has been very successful in attracting e-commerce).
- Social security contributions and PIT can add to the tax wedge on labour (the tax wedge is over 50% in France, Germany and Belgium, compared to 34% in the UK).
- Stamp duties can influence where a company puts its headquarters (Jersey).

But it is not only the tax system that is relevant. It is also how it is administered. For example,

- Are tax rules applied in a consistent, transparent, fair and predictable way?
- How responsive is the tax administration to the needs on the part of business for certainty and a quick-real-time resolution of issues?
- Does the administration consult openly and effectively with business?
- How nimble is the administration to respond to concerns of business?

- And how far is the government prepared to engage business in the process of formulating new rules?

Where does the UK stand vis-à-vis these different dimensions of tax competitiveness? (See table).

Table1: **Comparison of the UK Tax System to that of its Main Competitors**

	TAX/GDP ratio	% OF TOTAL TAX REVENUES				Top Statutory Personal Income Tax Rate	Top Corporate Income Tax Rate	Average Effective Corporate Tax Rate	Tax Wedge	Top Rate on Dividends	Standard VAT Rate
		Personal Income Tax	Corporate Tax	Social Security Contrib.	Consumption Taxes						
	2007 provisional	*2006*	*2006*	*2006*	*2006*	*2007*	*2008*	*2005*	*2007*	*2008*	*2007*
Australia	30.6 (**)	37.4	21.7	0.0	27.1	46.5	30.0	26.2	27.7	46.5	10.0
Belgium	44.4	29.3	8.3	30.5	25.6	53.5	34.0	26.4	55.5	43.9	21.0
Canada	33.3	36.3	11.0	14.8	24.3	46.4	33.5	28.4	31.3	49.4	6.0
France	43.6	17.5	6.7	37.0	24.8	47.8	34.4	25.4	49.2	55.9	19.6
Germany	36.2	24.5	5.9	38.4	28.4	47.5	30.2	31.5	52.2	48.6	19.0
Ireland	32.2	27.8	12.0	13.5	36.5	41.0	12.5	10.9	22.3	48.4	21.0
Italy	43.3	25.6	8.1	29.8	25.6	44.9	27.5	26.0	45.9	43.7	20.0
Japan	27.9 (**)	18.5	17.0	36.6	18.6	50.0	39.5	31.7	29.3	45.6	5.0
Luxembourg	36.9	21.0	13.8	27.7	27.9	38.9	30.4	--	37.5	44.0	15.0
Netherlands	38.0	18.8	8.5	36.1	30.5	52.0	25.5	25.1	44.0	44.1	19.0
Norway	43.4	20.7	29.4	19.8	27.3	40.0	28.0	24.2	37.5	48.2	25.0
Spain	37.2	18.9	11.5	33.3	27.2	43.0	30.0	26.1	38.9	42.6	16.0
Sweden	48.2	31.9	7.5	25.5	26.1	56.5	28.0	20.9	45.4	49.6	25.0
Switzerland	29.7	35.6	10.1	23.3	23.0	42.1	21.2	25.1	29.6	41.5	7.6
United Kingdom	36.6	28.6	10.8	18.5	29.0	40.0	28.0	23.9	34.1	46.0	17.5
United States	28.3	36.5	11.8	23.8	16.8	41.4	39.3	29.0	30.0	49.8	-
OECD average	35.9 (**)	24.8	10.7	25.3	31.5	42.6	26.6	--	37.7	42.1	17.7
G7 average	35.5 (**)	26.8	10.2	28.4	23.9	45.4	33.2	28.0	38.9	48.4	14.5
EU15 average	39.8 (**)	25.1	8.8	28.1	30.0	47.2	27.2	--	42.5	45.1	20.0
Brazil°	33.1	6.5	10.2	23.7	46.3	27.5	34.0	--	--	--	17.0
China*	16.1	7.3	14.9	--	76.6	45.0	25.0	--	--	46.4	17.0
India*	15.8	15.4	26.5	--	57.8	30.0	42.2	--	--	43.6	12.5
Russian Federation°	36.9	8.9	16.8	14.9	33.3	13.0	24.0	--	--	--	18.0
Singapore°	13.0	16.4	33.8	--	34.8	20.0	18.0	--	--	18.0	7.0

NOTES

- Tax wedge	measure of the difference between labour costs to the employer and the corresponding net take-home pay of the employee, which is calculated by expressing the sum of personal income tax, employee plus employer social security contributions together with any payroll tax, minus benefits as a percentage of labour costs. Total labour costs are determined as gross wage earnings of employees plus employer social security contributions and payroll taxes (if any). The tax wedge is shown for single individuals at 100% of average earnings, 0 children (Source: Taxing Wages (OECD), 2007)
- Top statutory personal income tax rate	these are the top statutory personal income tax rates (combined central and sub-central) (Source = OECD Tax Database)
- Top corporate tax rate	This column shows the basic combined central and sub-central (statutory) corporate income tax rate given by the adjusted central government rate plus the sub-central rate (Source = OECD Tax Database).
- Average effective corporate tax rate	Calculations based on a hypothetical investment for one period in plant and machinery, financed by equity or retained earnings. Taxation at the shareholder level is not included. The expected rate of economic profits earned is 10%. Other assumptions: real discount rate: 10%, inflation rate: 3.5%, economic depreciation rate: 12.25%. Source: Institute for Fiscal Studies (IFS).
- Tax as % of total tax revenues	Income categories in Revenue Statistics (OECD (2007)): Personal income taxes = 1100, corporate taxes = 1200, Social security contributions = 2000, consumption taxes = 5000
- Top tax rate on dividends	reports effective statutory tax rates on distributions of domestic source income to a resident individual shareholder, taking account of corporate income tax, personal income tax and any type of integration or relief to reduce the effects of double taxation of dividend income (Source: OECD Tax Database).

° 2005 data for Tax-GDP ratio and tax revenue data
* Most recent information not available: 2004 tax revenue data, 2006 information on top PIT rate and top rate on dividends
** 2006 final data; 2007 provisional data not available

(1) The overall tax burden in the UK at 36.6% GDP is slightly higher than the OECD average but lower than the EU average.

(2) The UK has a relatively balanced tax structure.

(3) Corporate tax rates look competitive, at least in relation to other large economies and the UK has one of the most generous regimes of any OECD country for the timing of corporate tax payments.

(4) Top personal income tax rates are below average.

(5) Tax wedge is below average.

(6) Standard VAT rate is above the OECD average but well below that of the EU.

So on the tax design parameters the UK tax system comes out pretty well (I know that business would prefer lower rates, and that's normal, although large economies will never be able to match the low tax rates found in places like Hong Kong or Singapore and perhaps don't need to).

What about the administrative aspects?

We have the World Bank's *Doing Business Indicators (DBI)*, where the UK comes out 16 out of 150 plus countries on business-friendly tax environment. We at the OECD are highly sceptical of the DBI methodology in the field of 'paying taxes' - a flower pot manufacturing firm isn't exactly typical of the current UK corporate sector, while the indicators used to assess the 'ease of paying' taxes are, in our view, extremely simplistic and unrealistic.

We have done some across-country work in the field of compliance costs/administrative burdens and here the UK is pretty much in line with other major economies, although, like many other countries, it is aiming at a further 25% reduction in administrative burdens. To its credit, HMRC has fairly aggressively taken up the challenge of administrative burden reduction and can already point to some progress. However, much more remains to be done.

In terms of service provided to large corporations, the UK is pushing ahead to implement recommendations of the Varney report (Review of Links with Business) which will certainly further improve the situation. In the same area, its Large Business Service continues to take shape as an effective service provider to large business.

So if the tax system seems reasonable and the administration is receiving a fair deal of attention, why has there been such a high profile and contentious debate over the perceived lack of competition of the UK tax system?

- Partly because the government has not been clear on its long-term tax strategy and this has generated uncertainty.
- Partly, I suspect, because business senses that in the tail end of this government it may be a good time to lobby for lower taxes.
- Partly because HMRC has sought a better implementation of the existing anti-abuse rule.
- Partly because the ECJ decisions continue to influence the ability of MS to protect their tax base (need a fifth freedom).
- This uncertainty has been accentuated by the merging of Custom & Revenue and the still evolving division of responsibility between Treasury and HMRC.
- Partially because some of the groups affected by these changes – the non-doms – have been very effective in their lobbying (never have so few tried to influence so many for so little!)
- The rise of levels of activity in new EU Member States, where tax rates are very low - but will these countries be successful in retaining and continuing to attract FDI i.e. as wages are bid up; as diffusion in costs of different infrastructural spending becomes apparent in the bottom line?

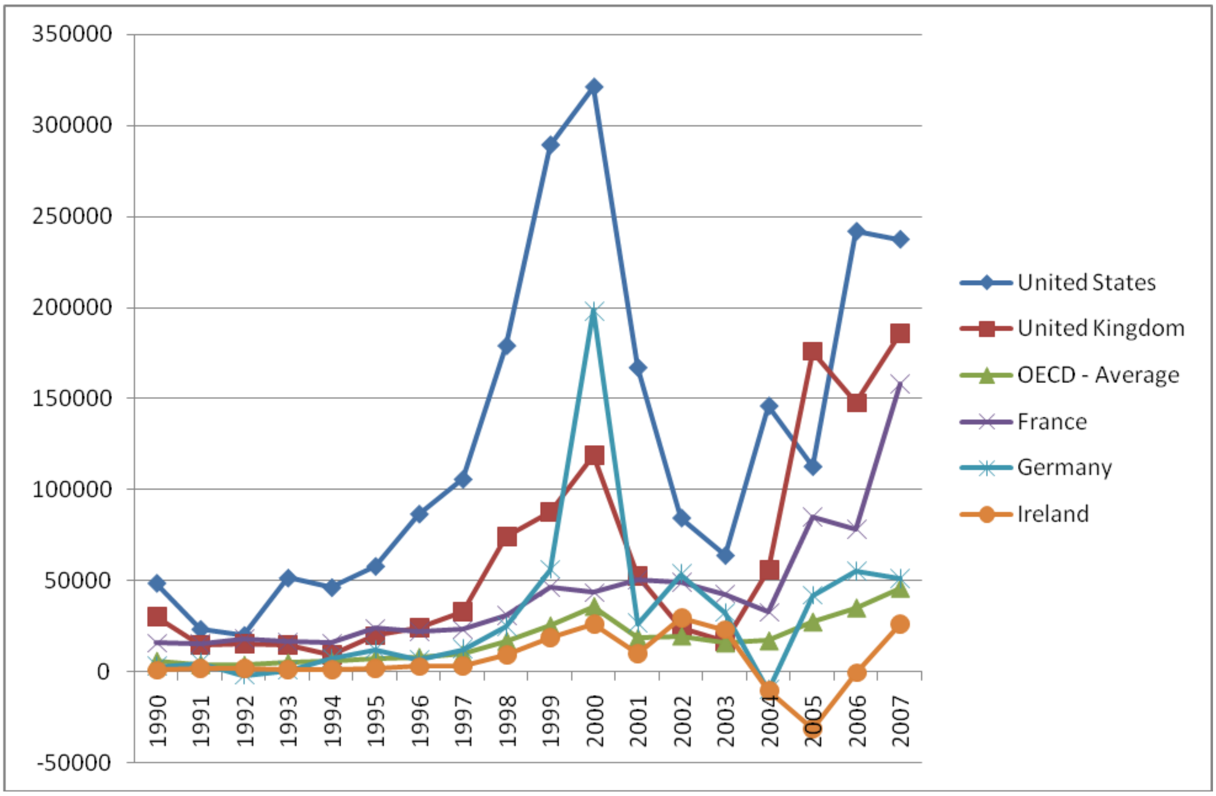
The debate on UK businesses relocating offshore needs to be based on facts:

(1) The vast majority of UK businesses have not relocated and the UK remains the number two destination for FDI, after the US (see graph below).

(2) The very small number of firms that have or are considering relocating are primarily in the service sector and in most cases the UK already represents a very small part of their business (i.e. they are global, not UK firms).

(3) When we talk of relocation we are talking about companies moving the top tier holding company from London to Dublin, Zürich and elsewhere. In practice this implies little change in the physical presence in the UK.

Graph 1: **Foreign Direct Investment**



Why are these service companies doing this? It's to make sure that their income from intangible assets, particularly those held in low tax jurisdictions, are not caught by a tighter application of the CFC rules (12.5% is more attractive than 28%, although not sure this is the type of business Ireland was targeting).

Is this a unique UK problem? No. Many OECD countries are going through the same debate.

- The US debate on corporate inversions and offshoring.
- The recent proposals in Germany and Sweden.
- The debate in many countries of whether to move away from a credit to exemption system and if yes, how to protect the revenue base.

More generally I see this UK debate as being very much at the centre of the OECD work on business restructuring – it is all about reallocating risk and intangibles within a multinational group (usually in low tax jurisdictions). If you look at the discussion draft we recently put out you can easily see how OECD countries facing the same challenge are exploring a variety of solutions.

In all these debates there are winners and losers: companies that will benefit from the shift to exemption plus tighter CFC and companies that would not. Countries that benefit from the relocations and countries that lose and, quite naturally, the losers tend to be more vocal.

How can we move forward in this debate?

- Agree on a set of rules on what is fair and unfair tax competition. The OECD and EU work has been very successful in this area but more needs to be done.
- Promote an international consensus on these issues that will decrease uncertainties for business and governments alike and decrease risks of double taxation (or unintended less than single taxation). This is what the recent OECD discussing draft on business restructuring is about.
- Identify areas where it is possible to have win-win reforms.

- Continue to move forward on what a recent OECD report (led by UK) referred to as an enhanced relationship between the Revenue, tax advisors and taxpayers. A relationship characterised by trust, transparency and openness.

- Useful, as the CBI suggests, to develop a shared long-term vision of where the UK tax system should be moving, as has been done in Canada and New Zealand. As Gordon Brown said in May, "business and government should come together to agree a manifesto for successful globalisation".

- Perhaps look at whether we need to adapt the rules of the game to the increased importance of mobile value drivers such as intangibles and risks.

I believe this debate must move on and hopefully this conference will help. If business and government can work together we can avoid a race to the bottom in CIT, maintain a well balanced tax structure with a significant contribution from the corporate sector, minimise tax barriers to growth and enable the government to achieve its broader, social objectives.