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Briefing Note

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Corporation Tax

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Is Corporation Tax (CT) fit for purpose? This Briefing Note measures it against four key criteria, and finds that the answer to this question is emphatically no. The academic literature overwhelmingly finds that it drives down wages; it lowers returns for shareholders; and it raises prices for consumers.

The Chancellor announced a welcome cut in CT at the Budget in March 2011. Over the next Parliament, the headline rate will drop to 23 per cent, the lowest in the G7. However, the effective rate of CT on new investment in the UK – the real rates faced by firms and passed on to individuals – is currently 27.9 per cent, compared to an OECD average of 18.6 per cent.

Reducing the headline is a good signal to businesses, but more needs to be done to lower the effective rate. Focusing taxes on labour directly (rather than indirectly through corporations) can make everyone better off. Low skilled workers face just as high a burden from CT as high skilled workers; those concerned about the living standards of the least well off should be in favour of a lower, more predictable rate of corporate income tax.

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Introduction

Corporation Tax (CT) was officially enacted in 1965 as a levy on profits companies made trading in the UK and since then has become a key dividing line in the ideological debate about taxation.

Many argue that it is too high and penalises success. Others maintain that it is routinely abused and fails to keep pace with innovations by scrupulous tax planners. Indeed it's rare to find those who defend CT – but are the problems due to its present form, or with the entire system itself?

The purpose of this Briefing Note is to assess the present system of CT and ask some fundamental questions: What should the CT system do? Does it work? Is it fit for purpose?¹

To do this we need criterion by which to judge it, and following the report of the Tax Reform Commission lead by Lord Forsyth,² we will refer to four principles:

- **Efficiency** – it should be low enough to incentivise work and investment.
- **Fairness** – the burden should fall mostly on those who can bear it, it should have legitimacy, and it should be neutral with regard to economic decisions.
- **Simplicity** – it should be easy to collect and easy to understand.
- **Predictability** – it should enable planning by having minimal revisions.

This Briefing Note will look at each of these factors in turn.

¹ For a comprehensive analysis of corporate income tax see Devereux, Michael P. and Loretz, Simon, "Corporation tax in the United Kingdom", *Oxford University Centre for Business Taxation*, February 2011. For a recent call to abolish corporation tax in the UK see Worstall, Tim (2011) "UK Uncut Unravelling" *IEA Current Controversies Paper No. 32*

² "Tax Matters: Reforming the Tax System", The Report of the Tax Reform Commission, October 2006.

Is Corporation Tax efficient?

It is widely thought that excessively high rates of CT lead to declining economic activity and lower tax revenue than might be generated through lower marginal rates. Djankov et al. performed a study on 85 countries (including the developing world) to find that:³

“A 10 percentage point increase in the effective corporate tax rate reduces the investment to GDP ratio by about 2 percentage points (mean is 21 per cent), and the official entry rate by 1.3 percentage points (mean is 8 per cent).”

These dynamic effects suggest that reductions in CT may well increase revenues over time, and Brill and Hassett present evidence for these Laffer curve effects for international CT and that over time the revenue maximising point is falling and becoming steeper.⁴ A Conservative Way Forward report provides evidence of 13 countries that have increased CT revenue following rate cuts, and 4 who reduced revenue following rate rises.⁵

It is widely repeated that at 28 per cent the UK has one of the lowest headline rates of taxation in the G7, and it should be welcomed that this is set to fall progressively to 23 per cent by 2014-15. Indeed this is imperative, given the prevailing trend towards lower and more competitive rates. Devereaux, Lockwood and Redoano link the rise in tax competition with the relaxation of capital controls,⁶ suggesting that the UK is part of a global environment in which companies make real choices about their tax environment.⁷ Standing still is not an option.

However focusing on headline rates can cause people to miss the real picture. More important than the headline rate is the effective rate – i.e. the percentage of taxable income that companies actually hand over to the Treasury. The difference between the two is not tax evasion (although this would have an impact), but established and sensible provisions for things such as capital allowances, how previous losses are carried forward, profits on foreign subsidiaries, etc.

³ Simeon Djankov, Tim Ganser, Caralee McLiesh, Rita Ramalho, Andrei Shleifer, “The effect of corporate taxes on investment and entrepreneurship”, Working Paper, available at: <http://www.nber.org/confer/2007/pef07/shleifer.pdf> [Date accessed 1/2/11]

⁴ Brill, Alex and Hassett, Kevin A., “Revenue-Maximizing Corporate Income Taxes: The Laffer Curve in OECD Countries”, *American Enterprise Institute for Public Policy Research*, Working Paper No. 137, July 2007

⁵ They also acknowledge 3 countries that did not experience an inverse relationship between rate changes and revenue effects, which they discuss. Elliott, Matthew, Sinclair, Matthew, and Taylor, Corin, 2008, *How cutting corporation tax would boost revenue*, Conservative Way Forward

⁶ They reject alternative theories such as yardstick competition or “common intellectual trends” (p1,231)

⁷ Devereux, Michael P., Lockwood, Ben, Redoano, Michela (2008) “Do countries compete over corporate tax rates?” *Journal of Public Economics*, 92:1210-1235

Analysis by the Cato Institute estimates that in 2010 the effective CT rate on new investment for the UK was actually 27.9 per cent, compared to an average rate of 17.7 per cent across all countries studies. This also compared to an OECD average of 18.6 per cent.⁸ There is a convincing case for even lower corporation tax purely on economic efficiency grounds.

Effective Corporation Tax rates on new business investment in 83 countries

Country	Rate (%)	Country	Rate (%)	Country	Rate (%)
Argentina	43.1	Kazakhstan	19.9	Morocco	13.9
Chad	36.3	Tanzania	19.3	Botswana	13.6
Brazil	35.1	Sierra Leone	19.0	Trinidad	13.1
Uzbekistan	34.9	Sweden	18.9	Greece	13.0
USA	34.6	Georgia	18.9	Ghana	12.9
France	34.0	Denmark	18.5	Czech Republic	12.0
India	33.6	Finland	18.3	Vietnam	11.7
Russia	31.9	Malaysia	18.0	Slovenia	11.6
Japan	29.5	Jamaica	17.9	Slovak Republic	11.2
Korea	29.5	Ecuador	17.9	Ireland	10.9
UK	27.9	Jordan	17.6	Taiwan	10.9
Italy	26.9	Switzerland	17.6	Ethiopia	9.8
Australia	26.0	New Zealand	17.6	Croatia	9.5
Spain	25.4	Mexico	17.5	Iceland	8.9
Lesotho	25.3	Zambia	17.2	Romania	8.6
Austria	25.3	Thailand	17.0	Singapore	8.5
Costa Rica	25.2	Rwanda	16.9	Mauritius	7.8
Norway	24.7	Netherlands	16.8	Egypt	7.0
Pakistan	24.1	Luxembourg	16.8	Chile	6.7
Germany	23.8	China	16.6	Turkey	5.6
Peru	23.0	Hungary	15.9	Latvia	5.6
Bolivia	22.9	Uganda	15.4	Bulgaria	4.6
Tunisia	21.9	Nigeria	15.1	Kenya	4.5
Portugal	20.8	Madagascar	14.6	Hong Kong	4.0
Iran	20.6	Israel	14.6	Ukraine	3.1
Fiji	20.6	South Africa	14.5	Belgium	-1.7
Indonesia	20.5	Bangladesh	14.5	Serbia	-5.1
Canada	20.5	Poland	14.3	Average	17.7

⁸ Chen, Duanjie and Mintz, Jack, "New estimates of effective corporate tax rates on business investment" *Cato Institute Tax & Budget Bulletin*, No. 64, February 2011

Is Corporation Tax fair?

CT isn't neutral

A desirable tax code should be neutral in that it should not distort the consumption and investment decisions made by taxpayers. It should attempt to levy tax in a uniform manner with minimal distortions. Alan Viard provides three reasons why the US corporate income tax is non-neutral.⁹ Firstly, by taxing capital income it places a heavier burden on those who save and consume in the future. Secondly, it provides an incentive for companies to avoid incorporating themselves as corporations. Thirdly, since companies can deduct interest paid on debt (but not the dividends paid on equity) it only applies to the income that is paid to equity holders, not debt holders. This provides an obvious distortion in favour of debt.

The main evidence to suggest that CT creates distortions is “the existence of discrete jumps in the marginal rate structure... [which] has led to companies choosing to locate their taxable profit at kink points in the marginal tax rate schedule”.¹⁰ It is possible that this merely reflects accounting activity and not real economic decisions; however the existence of “kink points” suggests that the tax code is influencing the decision making of managers.

This matters because malinvestments can occur. According to Chen and Mintz, neutrality “allows businesses to make efficient decision that reduce the misallocations of resources and minimises tax planning and administration”.¹¹ Tax policy should be based on economic growth considerations, not short-term budgetary pressures. Indeed tax neutrality is more important than revenue neutrality.

CT harms workers

One of the popular allures of CT is that it is seen to shift the tax burden from ordinary people onto businesses. From an economic perspective, however, this is impossible. All taxes must ultimately be paid by individuals; and corporation tax can only be paid by investors (through lower returns on investment), customers (through higher prices), or employees (through lower wages).

Corporations are legal fictions – in the same way that your television doesn't pay the license fee, and your house doesn't pay stamp duty, companies cannot ever pay tax, people do. The incidence of taxation (i.e. upon whom the burden falls) is a result of relative

⁹ Viard, Alan D., “Three cheers for the decline of the corporate income tax” *American Enterprise Institute Tax Policy Outlook*, No 2., April 2008

¹⁰ Devereux, Michael P. and Loretz, Simon, “Corporation tax in the United Kingdom”, *Oxford University Centre for Business Taxation*, February 2011 (p.7)

¹¹ Chen, Duanjie and Mintz, Jack, “New estimates of effective corporate tax rates on business investment” *Cato Institute Tax & Budget Bulletin*, No. 64, February 2011

elasticities.¹² Early attempts to measure this focused on capital,¹³ and other studies suggest that the burden can be exported.¹⁴ However if labour is less mobile than capital it is relatively easier for investors to escape the burden by investing in more favourable conditions, meaning the lion's share of the CT bill is paid for by employees. Feldstein shows that once you relax assumptions about a fixed capital stock, "For a wide range of plausible parameter values, a substantial fraction of the burden of a general profits tax is borne by labour".¹⁵

This process is not deliberate, it's the inevitable consequence of the fact that wages are driven by productivity, and by confiscating company profits you reduce investment and the types of productivity gain that can increase wages. This mechanism has been observed by Gentry:¹⁶

"Evidence on the degree of capital mobility across countries and the sensitivity of corporate investment to changes in tax policy also corroborate the possibility that the corporate income tax lowers wages by reducing the productivity of the work force"

Indeed there is overwhelming evidence to support the view that, "a significant portion of the burden from a country's corporate tax increases falls on its workers".¹⁷

Numerous empirical studies show that higher rates of CT tax lead to lower wages. A 2006 Congressional Budget Office report found that "domestic labour bears slightly more than 70 percent of the burden of the corporation income tax".¹⁸ A 2006 report for the American Enterprise Institute looked at the responsiveness of wages to CT in 72 countries and over 22 years, finding "a 1 percent increase in CT rates is associated with nearly a 1 percent drop in wage rates."^{19 20}

¹² Don Fullerton and Gilbert E. Metcalf, "Tax incidence" [Handbook of Public Economics, Vol 4 \(2002\) 1787-1872](#)

¹³ The classic study is Arnold C. Harberger (1962) "[The incidence of the corporation income tax](#)", *Journal of Political Economy* 70(3): 215–240, also see Auerbach, Alan J., (2005) "[Who bears the corporate tax? A review of what we know](#)", , NBER Working Paper 11686

¹⁴ Jane Gravelle and Kent Smetters (2001) "[Who bears the burden of the corporate tax in the open economy?](#)", NBER Working Paper 8280

¹⁵ Martin S. Feldstein (1974), "[Incidence of a Capital Income Tax in a Growing Economy with Variable Savings Rates](#)", *Review of Economic Studies* 41(4):505–513

¹⁶ William M. Gentry, (2007) "[A Review of the Evidence on the Incidence of the Corporate Income Tax](#)", Department of the Treasury – Office of Tax Analysis

¹⁷ Viard, Alan D., "Three cheers for the decline of the corporate income tax" *American Enterprise Institute Tax Policy Outlook*, No 2., April 2008

¹⁸ William C. Randolph, "International Burdens of the Corporate Income Tax", August 2006

¹⁹ Kevin A. Hassett and Aparna Mathur, "Taxes and Wages", *American Enterprise Institute*, June 2006

²⁰ An often reported study on this issue is Arulampalam, Devereux and Maffini, who claimed that, "54% of any additional tax is passed on in lower wages, even in the short run; other estimates are larger than this. In the longer run, a \$1 rise in the tax liability results in a fall in total employee compensation in excess of \$1". The citation is Wiji Arulampalam, Michael P Devereux & Giorgia Maffini, 2007. "The Direct Incidence of Corporate Income Tax on Wages," Working Papers 0707, Oxford University Centre for Business Taxation. However a more recent version dated August 2009 claims, "an exogenous rise of \$1 in tax would reduce the wage bill by 75 cents". And an October 2010 version revises this to be "an exogenous rise of \$1 in tax would reduce the wage bill by 49 cents".

This suggests that tax revenue generated through CT deprives workers of a larger amount in wages, and the income taxes such higher wages would generate. Using data from the Luxembourg Income Study, R. Alison Felix found that an increase in the CT rate by 1 percentage point lead to a fall in annual gross wages of 0.52 percent between 1992 and 2005.²¹ That would imply that a five per cent cut in CT would increase the median UK wage in 2009 of £21,221 by £552.

In a separate paper Felix and Hines controlled for difficulties in comparing counterfactual wage estimates by focusing on union vs. non-union wages in comparable jobs, and across US states with varying rates of corporation tax.²² They find that union wage premiums are \$1.88 per hour higher in low tax states, and that a 1 percentage point lower corporate tax rate is associated with a 0.36 percentage point increase in union wages. It makes intuitive sense that collective bargaining power will influence the extent to which reductions in CT are passed on to employees, but we are left with the curious finding that around 54 per cent of what might be paid as CT might otherwise be enjoyed as higher wages.

In a 2007 study, Desai, Foley and Hines conclude that:²³

"The results consistently indicate that corporate taxes depress both real wages and returns to capital, with most of the burden of corporate taxes borne by labor. The baseline estimate for the share of the burden borne by labor is 57 percent, and estimates vary between 45 and 75 percent, depending on the sample period and specification."

CT lacks public legitimacy

As an example of both the controversy and confusion surrounding CT consider the furore over Barclay's 2009 bill. In an article in The Guardian, it was revealed:²⁴

"Barclays Bank has been forced to admit it paid just £113m in UK corporation tax in 2009 – a year when it rang up a record £11.6bn of profits"

²¹ R. Alison Felix (2009) "[Do state corporate income taxes reduce wages?](#)", Federal Reserve Bank of Kansas City *Economic Review* 94:5-30

²² Felix, R. Alison and James R. Hines Jr. (2009), "Corporate Taxes and Union Wages in the US," NBER Working Paper 15263, August.

²³ Desai, Mihir A., C. Fritz Foley, and James R. Hines Jr. (2007), "Labour and Capital Shares of the Corporate Tax Burden: International Evidence," Working Paper, Harvard University, December.

²⁴ "Barclays bank forced to admit it paid just £113m in corporation tax in 2009" by Jill Treanor, The Guardian, February 18th 2011 [<http://www.guardian.co.uk/business/2011/feb/18/barclays-bank-113m-corporation-tax>]

It goes on to state that Barclays paid tax of “just 1 per cent of its 2009 profits”, and contrasted this with the 28 per cent rate of CT. A firestorm of internet debate ensued, and several errors and misrepresentations were discovered.²⁵

Firstly, the pre-tax profit figure of £11.6 billion incorrectly includes around £7 billion of discontinued items that relate to the sale of Barclays Global Investors. Disposing of a “substantial shareholding” is exempt from CT, so that capital gains taxes don't distort companies that wish to restructure. Barclays' 2009 Annual Report draws attention to this in the “Income Statement Highlights” (p.3), and clearly provides the actual pre-tax profit of £4.6 billion.²⁶

Secondly, The Guardian compares the (inaccurate) pre tax profits of Barclays Group (the global company) with the CT bill for the UK. This is highly misleading because companies only pay CT in countries where the profits were made – the £4.6 billion profits are not taxable income for HMRC. Provided you believe that subsidiaries of Barclays that operate in Ghana should pay their taxes in Ghana, this is not controversial. Indeed the total tax liabilities for Barclays in 2009 were in fact £1.07 billion,²⁷ which means an effective tax rate of 23.4 per cent. As John Band points out, the consolidated cash flow shows that in 2009 Barclays actually paid £1.18 billion in taxes – a rate of 26 per cent.

These two adjustments practically get us from a supposed CT rate of 1 per cent to the headline 28 per cent that might be expected. However there are some additional factors that are worth considering. For example, taxes are paid in arrears – when companies pay tax it is based on the profits made in the previous financial year.²⁸

HMRC does not operate with real time data, and therefore they don't tend to receive tax on profits that are made in the same financial year. If the tax bill for 2009 appears low, one should be looking at what happened to profits in 2008. *The Economist* recently showed the theoretical accounting charge vs. the actual cash tax paid by HSBC, RBS, HBOS, Lloyds Group, and Barclays. As would be expected, from 2001-2006 the big British banks paid slightly less in tax than the theoretical accounting charge. However in 2007 they paid more, and in 2008 they made significant losses and yet still paid almost £8 billion in corporation tax due to the previous year's activity. A lower bill in 2009 merely reflects the lag due to previous losses.

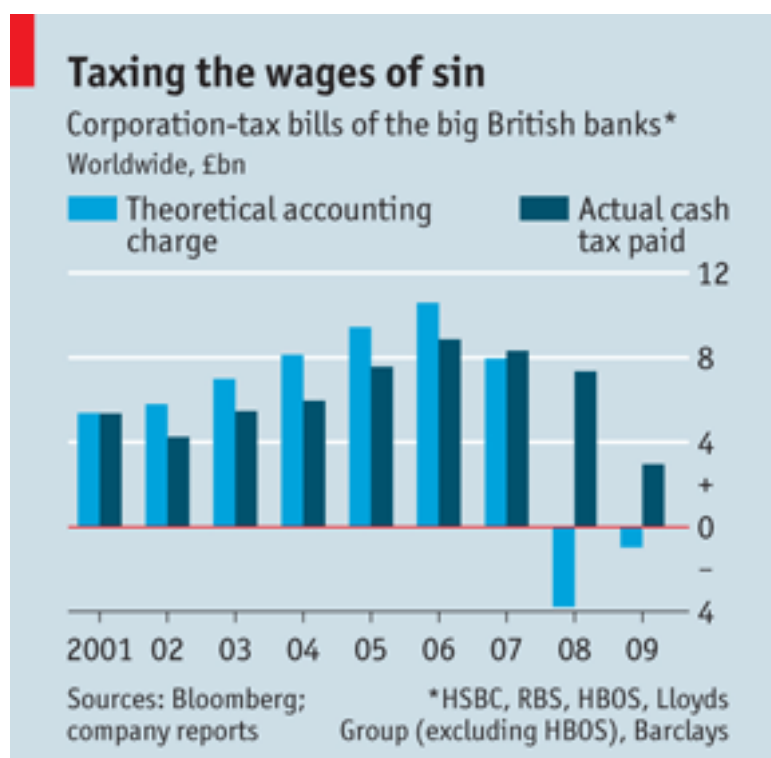
²⁵ What follows is analysis that derives from Tim Worstall, commentators at his blog, Christie Malry, and John Band. In particular see “Does Richard actually read his own blog?”, TimWorstall.com, February 19th 2011 [http://timworstall.com/2011/02/19/does-richard-actually-read-his-own-blog/]; “The five howlers made by The Guardian in reporting tax paid by Barclays”, FCA Blog, February 20th 2011 [http://www.fcablog.org.uk/2011/02/the-five-howlers-made-by-the-guardian-in-reporting-tax-paid-by-barclays/]; “UKUncut: blithering idiots once again”, TimWorstall.com, February 20th 2011 [http://timworstall.com/2011/02/20/ukuncut-blithering-idiots-once-again/]; “Barclays paid a billion quid in tax – but not to us”, March 1st 2011 [http://liberalconspiracy.org/2011/03/01/barclays-paid-a-billion-quid-in-tax-but-not-to-us/]

²⁶ Note 38 shows that the profit before tax from the discontinued operations was £726m, and the profit on disposal of the discontinued operation was £6,331m. The sum of these figures (£7,057m) is the adjustment that needs to be made to pre-tax figure of £11,642m used by *The Guardian* and the more accurate figure of £4,585m.

²⁷ Note 10

²⁸ Even if they make payments on account these will be calculated based on an extrapolation of historical profits

Figure 1: Corporation Tax bills for large UK banks²⁹



Indeed all companies receive tax relief on losses. If a company suffers a loss it is allowed to carry it forward to offset taxes on future profits. This is because CT is supposed to reflect, as Tim Worstall puts it, “cumulative profits over time, not just the profits in any one arbitrary time period”.³⁰ Christie Malry points out that Barclays offset £859m worth of losses in 2008,³¹ and “the utilisation of those losses will have reduced the amount of tax it handed over to HMRC in 2009”.³²

Throughout this debate one gets the impression that CT is the main (or possibly only) way that companies contribute to the public finances, but it isn't the only tax levied on business. They also make payments of Income Tax, National Insurance and PAYE, although sometimes in this regard they are acting as tax collectors to pass on employees taxes. However by increasing employment, purchasing goods and services, paying business rates, and generally participating in the wider market, well-run and successful firms increase tax receipts. This may seem trivial, but if the top rate of personal income tax is 50 per cent

²⁹ See “No squeaks from these pips” *The Economist*, Feb 24th 2011 [URL: http://www.economist.com/node/18233625?story_id=18233625, accessed April 14, 2011]

³⁰ “UKUncut: blithering idiots once again”, TimWorstall.com, February 20th 2011

³¹ Note 10

³² “The five howlers made by The Guardian in reporting tax paid by Barclays”, FCA Blog, February 20th 2011 [<http://www.fcablog.org.uk/2011/02/the-five-howlers-made-by-the-guardian-in-reporting-tax-paid-by-barclays/>]

(compared to the CT rate of 28 per cent), HMRC would receive more money if Barclays increased bonuses than paid the same amount in tax on corporate profits.

The final point is that some people imply that firms merely need to spend enough money on tax lawyers and they can pick and choose how much tax to pay. The Robin Hood Campaign's Max Lawson, claims that bankers are "unhampered by the inconvenience of paying tax".³³ Aside from the fact that banks do pay tax, CT is not voluntary. These so-called scandals are not examples of tax evasion or illegal behaviour, but companies operating under the law and utilising established procedures that were set up for these very situations.³⁴

It is tempting to believe that this debate is all down to ideological differences. But the idea that banks and large corporations aren't paying the 'right' amount of tax is too widespread despite the fact it is incorrect. Indeed the fact that the Barclays story coincided with protest groups that squatted in a branch demonstrates the scale of the problem – high passions and genuine belief are resting on some fairly basic misunderstanding. It is possible that some MPs, journalists and activists are all part of a conspiracy to deceive the public, but there is a simpler explanation – that the rules of CT are not well known and that people do not trust the system. In other words, CT lacks public legitimacy.

³³ "Barclays bank forced to admit it paid just £113m in corporation tax in 2009" by Jill Treanor, The Guardian, February 18th 2011

³⁴ Note that *The Economist* described the tax bill as "paltry" by pointing to the fact that "half of its revenue is booked in Britain and its British retail-banking arm made pre-tax profits of £710m", "No squeak from these pips", *The Economist*, February 26th 2011

Is Corporation Tax simple?

One of the main sources of public resentment over CT (and indeed taxes more generally) are the efforts people make in order to understand them. A 2007 survey by ESCP Europe Business School found that 79 per cent of respondents deemed the tax system generally to be too complex, with 85 per cent admitting that they hadn't applied for any tax credits that year.³⁵ This lack of simplicity has a real impact. Evidence from a 2010 survey commissioned by HMRC suggested that 20 per cent of large British businesses have considered relocating abroad, with over two thirds claiming that red tape had risen that year.³⁶ Of course there's a large difference between what companies say they are considering compared to what they do, but it's also reasonable to posit that the 20 per cent figure is low as companies have a fiduciary duty to shareholders to consider such options.

A simple proxy for the complexity of a tax system is the number of pages in the Tolley's tax guide. A research brief by the 2020 Tax Commission found that the guidelines relating to corporation tax has risen by 185 per cent since 1999-00.³⁷ The Corporation Tax guide currently stands at almost 2,000 pages making it futile for any individual or small business to attempt to understand their obligations to the state.

It should therefore come as no surprise that this has a real economic impact. In 2006 a National Audit Office study found that 40 per cent of corporation tax returns were incorrect, with an average error of £2,700.³⁸ It is hard to enforce a tax code that the public don't understand, and increased complexity undermines the case for CT.

³⁵ Sola, Davide, Evans, Anthony J., Poenaru, Adina, "Enterprising Britain: Building the Enterprise Capital of the World" December 2007.

³⁶ "Tax regime drives 20pc of big businesses to consider leaving UK" by Angela Monaghan, *The Telegraph*, August 25th 2010

³⁷ "The length of Tolley's individual tax guides" 2020 Tax Commission Research Note 2, 11 February 2011

³⁸ See "Tax complexity blamed for CT errors" Bob Reynolds, *Accountancy World*, 31 January 2006

Is Corporation Tax predictable?

Taxes need to be predictable for two main reasons. Firstly, taxpayers should be able to engage in long term planning without fearing that their tax obligations are subject to sudden and arbitrary changes. The threat of tax reform is a type of regime uncertainty that harms the climate of investment. Ironically even well intentioned tax relief can have unintended consequences since tax breaks reduce predictability – companies won't make long term decisions based on temporary give-aways.

Secondly taxes also need to be predictable from the perspective of the Treasury. After all, the purpose of taxation is to fund government spending and governments are supposed to determine this based on reasonable forecasts of tax receipts, as Creedy & Gemmell outline:³⁹

“it is necessary for tax authorities to know whether, in the absence of budgetary changes, they can expect improving or worsening revenues from corporation tax both over the longer-term and within an economic cycle”.

The problem with CT is that it is notoriously volatile and thus an unreliable source of government revenue. According to Creedy & Gemmell, “experience has shown that corporation taxes are among the most difficult to forecast”.⁴⁰ With specific focus on the UK, Devereux and Loretz say, “corporation tax revenues are much more volatile, not only than real GDP, but also than personal income tax revenues”.⁴¹

Corporation Tax is heavily concentrated on a few firms and a few industries. Around 80 percent of the total revenue is paid by just 1 per cent of companies,⁴² and about two thirds of the receipts from large companies come from only three sectors: banking, insurance, and oil & gas.⁴³ One of the reasons for this is the link with economic conditions:⁴⁴

³⁹ Creedy, John and Gemmell, Norman (2009) “Corporation tax revenue growth in the UK: a microsimulation analysis” *Economic Modelling*, 26: p 622

⁴⁰ Creedy, John and Gemmell, Norman (2008) “Corporation tax buoyancy and revenue elasticity in the UK” *Economic Modelling*, 25: p37

⁴¹ Devereux, Michael P. and Loretz, Simon, “Corporation tax in the United Kingdom”, *Oxford University Centre for Business Taxation*, February 2011, p.14

⁴² Devereux, Michael P. and Loretz, Simon, “Corporation tax in the United Kingdom”, *Oxford University Centre for Business Taxation*, February 2011 (p.18). A National Audit Office report published for the 2005-06 financial year showed that almost one third of Britain's largest businesses paid no corporation tax, with 30 percent paying less than £10m each. In 2006-07 54 per cent of CT was paid by “large” businesses, suggesting that half the total burden of CT fell to smaller companies. However they use a sample of 700 companies out of the 2,400 that use the “Large Business Service”. It is therefore possible that *other* large companies are footing this bill. See “Management of Large Business Corporation Tax” *National Audit Office*, 25th July 2007

⁴³ Gwyneth Rees, “A third of UK's 700 biggest business pay no corporation tax” *Daily Mail*, 28th August 2007. Famously J Sainsbury's paid no corporation tax in 2005/6 and 2006/7 due to payments made to pension funds that led to tax credits

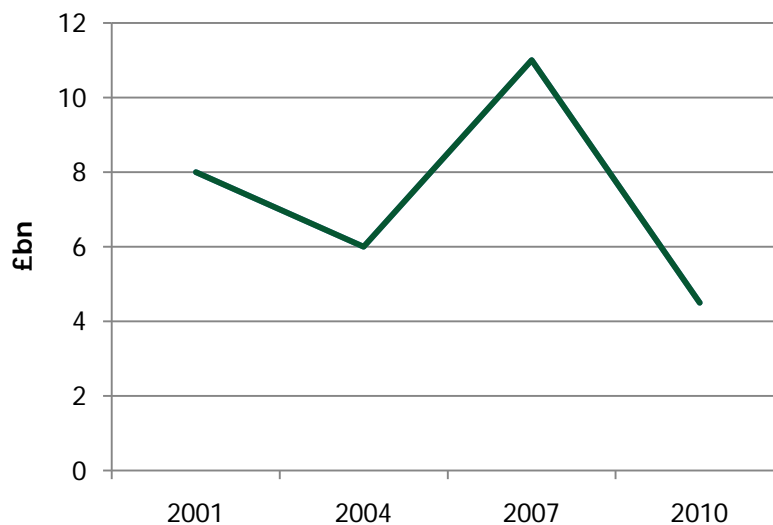
⁴⁴ Michael P. Devereux, Rachel Griffith and Alexander Klemm, “Why has the UK corporation tax raised so much revenue?” *Fiscal Studies*, Vol. 25, No. 4, December 2004

“The primary reason for the strength of tax revenues seems then to be the rise in the share of corporate profits in GDP, which was particularly marked in financial services”

This demonstrates the conventional view that “the growth of aggregate [corporation] tax revenue appears to be highly volatile in relation to the growth of profits”.⁴⁵ Given that profits are often driven by the general economic climate, CT receipts vary with the economy as a whole. It should therefore not have come as a surprise when the banking crisis led to a significant drop in CT. Some estimate that around 27 per cent of corporation tax receipts come from the financial sector,⁴⁶ explaining why receipts fell so dramatically in February 2009.⁴⁷

As the figure below shows not only are CT receipts volatile, but they are heavily reliant on financial services which are especially volatile.⁴⁸ The CT revenue from banking fell by half from 2007 to 2010.

Figure 2: Corporation Tax paid by financial services



As a share of HMRC net receipts it has fallen from almost 22 per cent in 2005-06 to under 19 per cent in 2009-10.⁴⁹

⁴⁵ Creedy, John and Gemmell, Norman (2009) “Corporation tax revenue growth in the UK: a microsimulation analysis” *Economic Modelling*, 26:614-625

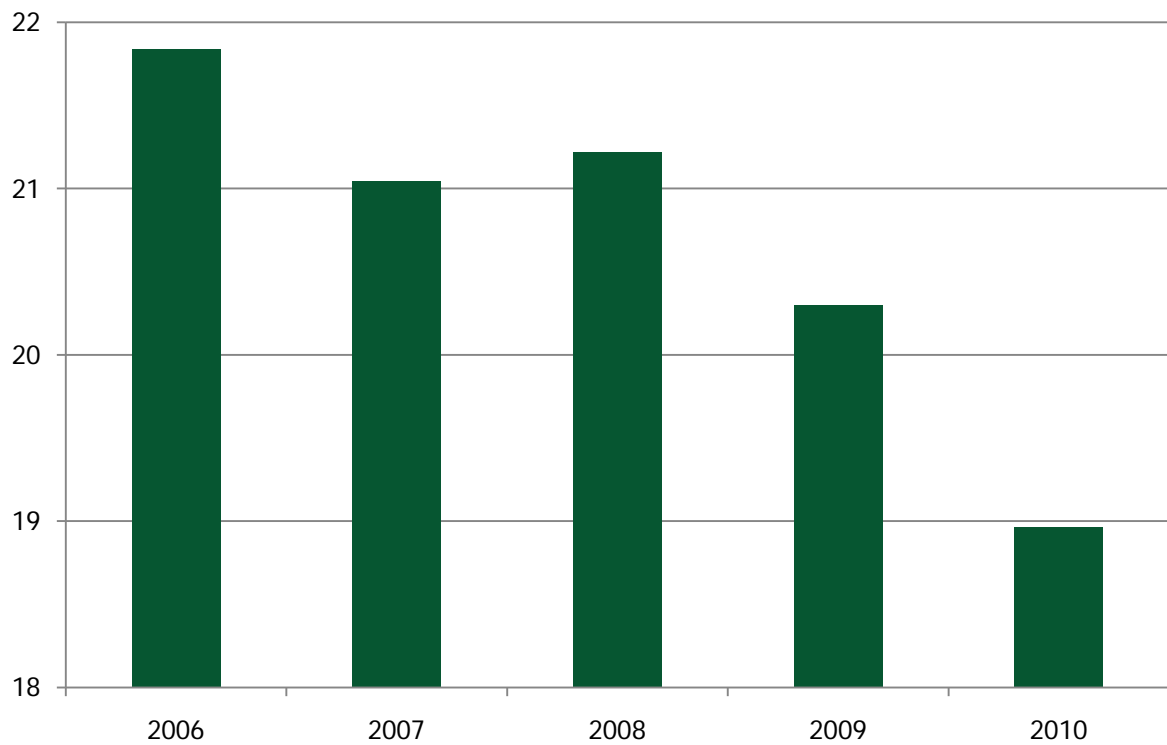
⁴⁶ See Alistair Osbourne, “Tax revenue projections dive £39.4bn in five months to Budget 2009” *Daily Telegraph*, 23rd April 2009

⁴⁷ “Corporation tax receipts tumble by 24%” *Daily Mail*, 19th February 2009

⁴⁸ Data taken from Devereux, Michael P. and Loretz, Simon, “Corporation tax in the United Kingdom”, *Oxford University Centre for Business Taxation*, February 2011 (p.15)

⁴⁹ Data from Table 2.1C, Financial Statistics No. 585 January 2011.

Figure 3: Corporation Tax as a percentage of total tax



Some might conclude that the solution is reform, however “much of the observed volatility is inherent to the corporation tax system”.⁵⁰

⁵⁰ Creedy, John and Gemmell, Norman (2008) “Corporation tax buoyancy and revenue elasticity in the UK” *Economic Modelling*, 25: p 24

Conclusions

CT is expected to generate around £40 billion in 2010-11, which is about 8 per cent of overall government revenue. This is hardly inconsequential, but as Robert Peston says, “personal taxation is so much more substantial than corporate taxation”.⁵¹ But what is the corporate income tax? It is actually a tax on retained earnings (i.e. savings), when done through equities, by firms that happen to take on a particular corporate structure.

The general public do not seem to understand how CT affects them. Indeed it appears that the main reason people favour CT is that they do not realise that they pay it themselves. However there can be no denying that CT is a burden that falls on employees, and it comes at a substantial price:⁵²

“the cost of raising revenue via a corporate tax may be more costly and cause more distortion in the economy than a tax on labour income” .

Felix estimates that for the US economy if CT is increased by one percentage point, the marginal burden on labour is 4.2 times higher than the additional revenue collected through CT.⁵³ In short, focusing taxes on labour directly (rather than indirectly through corporations) can make everyone better off. And since she finds that low skilled workers face just as high a burden as high skilled workers, one would think people who are concerned about living standards of the least well off should be against corporate income tax.

Indeed here are a few stylised facts about CT:

- Corporation tax is not well understood by the general public
- Corporation tax is primarily a tax on wages
- Corporation tax is a volatile source of revenue concentrated in a few sectors

For these reasons CT is ripe for reform, and a more rational system would attempt to focus on taxing income streams rather than economic entities. The debate would also be improved if discussion moves away from headline rates to a more detailed understanding of effective rates, and to appreciate the power of incentives by placing greater emphasis on marginal (rather than average) rates.

⁵¹ Is Cameron giving companies the mother of all tax breaks?“ March 2nd 2011

[http://www.bbc.co.uk/blogs/thereporters/robertpeston/2011/03/is_cameron_giving_companies_th.html]

⁵² Felix, R. Alison (2007), “Passing the Burden: Corporate Tax Incidence in Open Economies,” Working Paper, Federal Reserve Bank of Kansas City, October

⁵³ Felix, R. Alison (2007), “Passing the Burden: Corporate Tax Incidence in Open Economies,” Working Paper, Federal Reserve Bank of Kansas City, October

Whether taxes should be more progressive or flatter, or whether they should be higher or lower, are separate arguments to those presented in this paper. But even those who wish to increase the tax burden on the most profitable companies can take a serious look at how CT functions and conclude that it is not fit for purpose.