POLICY BRIEFING

Corporate Income Tax Reform in Times of Crisis: UK v Italy

Katarzyna Bilicka
Michael Devereux
Giorgia Maffini

March 21, 2012

While sustaining serious efforts to consolidate their public finances, Italy and the United Kingdom have recently reformed their corporate income tax to stimulate investment.

Since 2010, the UK has cut the statutory rate, while broadening the tax base by reducing allowances. In today's Budget, the Chancellor announced that the rate would be reduced to 22% in 2014, but capital allowances for plant and machinery will be reduced from 20 per cent to 18 per cent from April 2012.

The new Italian government has instead introduced an Allowance for Corporate Equity (ACE), along the lines of that proposed in 1991 by the Institute of Fiscal Studies and recently championed by the IFS *Mirrlees Review*. This gives an allowance to equity-financed investment which is broadly equivalent to the deductibility of interest payments available for debt-financed investment. But the statutory corporate income tax rate has been held at 27.5 per cent.

These reforms have different impacts on different decisions made by companies. This note briefly considers four such decisions.

The location of investment

The location of investment depends on the proportion of taxable profit taken in each potential location, and is measured by an Effective Average Tax Rate (EATR). Both the reforms reduce the EATR and so both increase the appeal of both Italy and the UK as locations for investment. The UK cut in the rate is more valuable for profitable investment, while the Italian ACE is more valuable for more marginal investment.

Figure 1 plots the Italian and the UK EATRs over a range of profitability, for an investment financed with a mix of retained earnings, new equity and debt. It shows the position for both UK and Italy in 2011 and after the reforms have worked through in 2014 (assuming no further changes are announced).

The two countries were fairly similar in 2011. However, the reforms had a dramatic impact. The introduction of the ACE in Italy substantially reduced the EATR at low levels of profitability, but much less so for more profitable companies. The reduction of the tax rate in the UK led to a much more uniform reduction in the EATR for all levels of profitability.

Under the new system, the Italian EATR is lower than the UK EATR for levels of profitability below 25 per cent, whilst the UK EATR is higher for higher profitability levels. This is slightly higher than the crossover point in 2011.

The scale of investment

Conditional on deciding where to locate an investment, a company must decide how much to invest. This is a marginal investment decision that, among other things, depends on the Effective Marginal Tax Rate (EMTR). This is also shown in Figure 1 – it is equal to the EATR at a low level of profitability. Clearly the introduction in the ACE in Italy has had a significant impact in lowering the Italian EMTR. As a result, the Italian corporation tax has a smaller distorting impact on decisions as to the scale of investment in Italy. The reduction in the corporation tax rate in the UK has had a much smaller effect.

Profit shifting

Companies have an incentive to shift profits to low tax countries. The incentive to shift an additional unit of corporate profit depends on the statutory corporation tax rate: the lower the rate, the weaker the incentive to shift income to a low tax jurisdiction. Clearly the low UK corporation tax rate is an advantage in this respect.

The choice between debt and equity financing

Standard corporate income tax systems favour the choice of debt financing over equity financing as interest payments are tax deductible. The introduction of the ACE in Italy corrects the bias by introducing an equivalent deduction for new equity. In the UK there is still an advantage to debt-financed investment, although it is reduced by the lower statutory rate. Nevertheless, the bias towards greater leverage, and hence riskier companies, is still in place in the UK.

Conclusions

- The recent UK reforms reduce the tax burden on highly profitable investments and ease the vulnerability of the UK to profit shifting. But they do not address the existing distortions towards debt financing.
- By contrast, by introducing an ACE, Italy has eliminated the bias in favour of debt finance. It has also reduced the rate of tax on less profitable investments.

Figure 1: EATRs at different profitability levels, Italy vs UK.