

Can a revenue-neutral corporation tax reform enhance international competitiveness?

The corporation tax reforms announced in the Budget are intended to “promote growth by enhancing international competitiveness, encouraging investment and promoting innovation”. The pattern has become familiar in many countries since Nigel Lawson’s reforms in 1984: to reduce the tax rate and pay for it by expanding the tax base. Overall, the changes are intended to be revenue neutral.

The tax rate is coming down from 30% to 28%. Within Europe, this change moves the UK below the Netherlands and Luxembourg – two special cases for corporation tax anyway - but leaves the ranking relative to all the other countries unchanged. Meanwhile, allowances on plant and machinery will fall from 25% to 20% and allowances on industrial buildings are being phased out. There are other, smaller changes, including an increase in the R&D tax credit.

Can a tax change which leaves business paying the same overall amount of tax really enhance competitiveness? I can think of three possible reasons why the government might think so.

One argument says that the real impetus for tax competition is not attracting capital, but in attracting profit. Conditional on where economic activity takes place, companies are able to shift profits between jurisdictions, subject to the constraints imposed by revenue authorities. The incentive to shift profit is based on differences in the headline rate, because companies shift taxable profit after using up allowances.

But if this is the tax competition in which the UK is engaged, it has little to do with investment and rather more to do with preventing an outflow of taxable profit. How that affects tax revenue depends on how sensitive profit flows are. It is certainly possible that the UK is on the wrong side of the Laffer curve – that is, that a reduction in the rate may actually increase tax revenues. But the government does not appear to believe this: it predicts a cost of reducing the tax rate of over £2 billion.

A second argument concerns gainers and losers. If the reform is revenue neutral, then there must be losers – businesses which invest heavily in plant and machinery and in industrial buildings are obvious candidates. Gainers are likely to be more profitable companies. For more profitable companies, tax allowances are smaller relative to income and so the reduction in the tax rate is more valuable to more profitable companies.

So it is possible that the government seeks to promote more profitable companies over less profitable ones. It is also plausible that more profitable companies undertake more investment and innovate more. It is also plausible that they are more mobile, and likely to shift activities out of the UK to lower-taxed jurisdictions. If that is true, then it is just about plausible that the reforms will enhance competitiveness.

Is this really what Gordon Brown has in mind? It seems unlikely that this was the driving force for the reforms, but it may have been a factor. Though in any case the

argument may be offset to the extent that larger, more profitable companies are also more able to shift profits between countries.

A final possibility is that the government believes that companies make investment and location decisions only on the basis of the headline rate. It is true that the headline rate dominates popular discussion. But it seems unlikely that any sensible business which allows for taxes in its decisions will simply ignore the measure of income to which the 28% is applied.

So the enhancement of international competitiveness resulting from these reforms may be something of a mirage.

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