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A British lesson in corporate income tax

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Over the last thirty years, OECD countries have significantly reduced the statutory rates of corporation tax (CIT) to attract increasingly mobile activities and profits. This trend had slowed by 2010 when the Coalition government took office. At that time, at the height of the global financial crisis, governments were struggling to reduce their budget deficits and there was little room for large tax cuts. The Coalition government had a very different plan, despite having inherited one of the largest deficits in the OECD. The goal was ambitious: to make the corporate income tax system the most competitive in the G20. There followed five years of intensive reforms, including a gradual cut in the statutory CIT rate from 28 to 20% and other interventions aimed at reducing the cost of capital (COC), such as the preservation of generous deductions for interest expenses and the modernization of the controlled foreign companies (CFC) legislation. The CFC regime now allows the financing of an international group through subsidiaries resident in low-tax jurisdictions.

To support innovation, the Coalition introduced the Patent Box (PB) with a rate of 10% on profits derived from patents and simplified and expanded the generosity of Research and Development (R&D) tax credits. The PB also aims to prevent the migration of intangibles to low-tax jurisdictions. The overall reform will cost between 20 and 24% of the average annual CIT revenues by 2015/16. These are substantial costs, funded by combining a higher deficit, a reduction in public spending and an increase in VAT.

What are the benefits of such a reform plan? The UK tax system is now very attractive for international companies, in particular for their headquarters and for companies with intangible assets. This explains, for example, the location of the headquarters of Fiat Chrysler Automobile in London and the transfer of the headquarters of General Electric Oil & Gas from Florence to the UK capital.

The current features of the UK business tax regime cannot be found jointly in any other comparable OECD economy. For example, France, Germany and Italy have high statutory CIT rates (see figure 1) and more restrictive regimes for the deduction of interest expenses and for the taxation of CFCs. French R&D incentives are more generous than the British ones and France even has a PB (15%). However, with a statutory rate of 33.3%, France has introduced an additional rate of 3.3% for companies with a global corporate income tax charge above EUR

763,000 and an additional surcharge of 10.7% for companies with more than EUR 250 million turnover. Apart from minor changes, Germany has not substantially altered its regime between 2010 and 2015. Italy has instead introduced some innovative measures. Despite a higher rate (15.7%), the Italian PB also applies to trademarks and designs, excluded from the UK PB. The Allowance for Corporate Equity (ACE) reduces the COC as it allows a notional deduction of the cost of financing with new capital. The ACE aims to equalize the tax treatment of equity financing with that of debt financing.

Despite some undeniable success, the British government has not fully hit the goal of having the most competitive regime in the G20. Three indicators measuring the costs of the tax system on business decisions are useful to assess this. The statutory CIT rate quantifies the incentive to shift profits where the rate is lower, regardless of where the real assets are located. When considering foreign direct investment (FDI), economists use the effective average tax rate (EATR). After investment has been located in a particular jurisdiction, the incentive to expand it is measured by the effective marginal tax rate (EMTR). In 2015, the UK statutory tax rate and the EATR are well below the OECD average (figure 1 and 2) but the EMTR remains well above that (figure 3).

This means that the UK is competitive in attracting profits and FDI, but it remains less so in terms of expanding real investment already located in Britain. A high EMTR depends on the regime for capital allowances, one of the least generous in the OECD and therefore relatively disadvantageous for sectors with large investments in machinery and buildings such as manufacturing. The picture does not change by referring to the G20 countries. The UK has the lowest statutory CIT tax rate along with Russia, Turkey and Saudi Arabia, but it ranks only fifth for the EATR. The EMTR is only in tenth place in a ranking that sees Italy in first place, because of the ACE and relatively generous capital allowances.

With elections looming, the question is what the new British government will do. If the Labour Party wins, it will not cut the 2015 CIT rate to 20% but it will maintain it at 21%. The difference is minimal and this reflects the current consensus for a rate of around 20%. More generally, many measures introduced by the Coalition had already been proposed by the previous Labour government, which has not really opposed the Coalition's competitiveness agenda. The opposition has instead come from some countries, particularly Germany, concerned about the possible erosion of their tax base through measures such as the PB.

If the pressure from other countries and the OECD grows, the UK could adapt some parts of its tax code to the international consensus, but at the same time, to maintain competitiveness, it could cut the statutory CIT rate even further. Some large companies already propose a rate of 15% but with a system that is for now competitive and a deficit which is still large, the priority will probably be to improve public finances.

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Figure 1. Statutory corporate tax rate

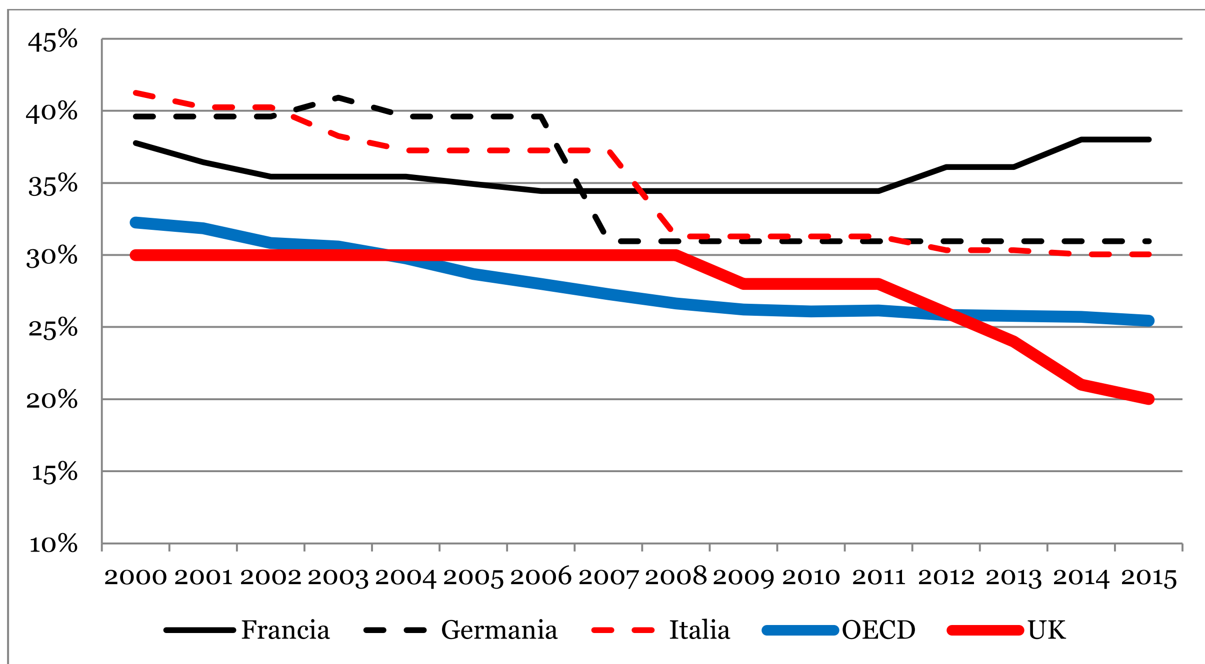

Figure 2. Effective average tax rate (EATR)

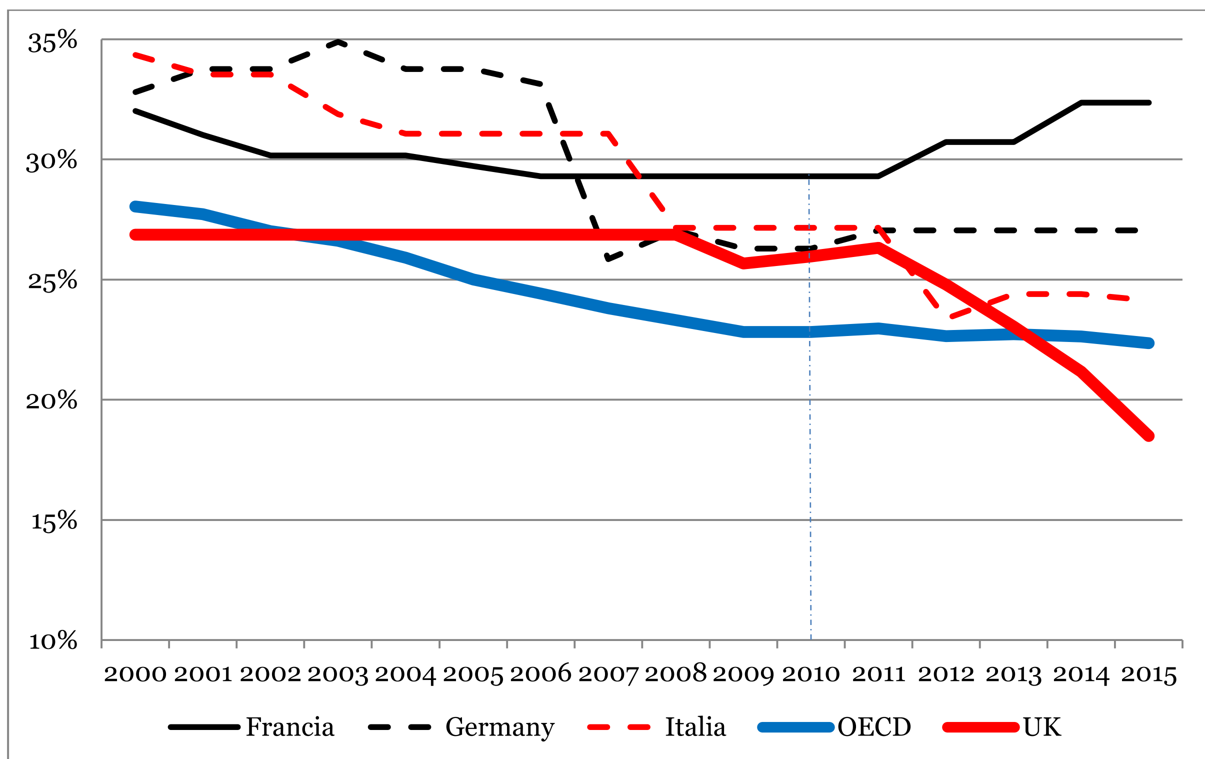

Figure 3. Effective marginal tax rate (EMTR)