Financial Scrutiny Unit Briefing

Corporation tax

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Under the current legislative framework the Scottish Government does not have powers to vary corporation tax. However, the Scottish Government has called for these powers to be introduced through the Scotland Bill currently before the UK Parliament. This briefing looks at why a Government charges corporation tax, why it may vary corporation tax and the potential benefits and challenges of corporation tax being devolved. It also provides information on corporation tax developments in other jurisdictions including Northern Ireland and Wales.
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EXECUTIVE SUMMARY

Taxes are used as a source of Government revenues, and as an economic tool. The main rate of corporation tax in the UK is currently 26%, although the Chancellor has announced that this will be reduced in annual 1% steps to stand at 23% from April 2014. Corporation tax is paid on a company’s taxable profits. Allowances and exemptions can significantly reduce taxable profits and hence the effective rate of tax.

Since the mid 1980s almost all OECD countries have made major structural changes to their tax systems. Corporate tax reforms have in general resulted in reduced rates, although a broader tax base. This change has tended to reduce the average effective rate of corporation tax paid by more profitable companies which countries compete for. Despite rate reductions, corporation tax remains one of the more important sources of UK Government tax revenue. In recent years it has accounted for 6-8% of all tax receipts.

There is a substantial body of literature which finds a relationship between levels of foreign direct investment (FDI) and average effective corporate tax rates. However, the degree to which corporate tax rates influence investment decisions relative to other factors is of great debate. Some research suggests that other variables (i.e. distance and market size) are the main determinants of FDI and of more significance than tax.

Challenges associated with lowering corporation tax in Scotland include:

- Brass plating/profit shifting by companies in order to evade tax, resulting in reduced overall UK tax revenues
- Increased tax competition, resulting in a “race to the bottom”
- Reduced and volatile tax revenues, impacting the level of public spending in Scotland
- Tax motivated incorporation, resulting in reduced overall UK tax revenues
- Additional administrative burdens for businesses and HM Revenue & Customs

Although the Scotland Bill does not include proposals for devolving corporation tax, the Scottish Parliament Session 3 Scotland Bill Committee concluded that if a scheme to vary corporation tax were to be available in some of the other devolved countries of the UK as a tool of the UK Government’s regional economic policy, it should also be available as an option for a Scottish Government to use. The Scottish Government, since the SNP election victory in May 2011, has demanded that the Scotland Bill should be amended to devolve corporation tax to the Scottish Parliament, with a like-for-like adjustment to the Scottish Budget.

HM Revenue & Customs have produced provisional figures which show that if the Scottish Government were to cut corporation tax to the same level as Ireland there could be a gap of more than £2.6bn in the Scottish budget. However, the Scottish Government have expressed concerns because this estimate does not take into account the positive effects on the economy from a reduction in corporation tax. The Scottish Government estimates that a reduction in corporation tax in Scotland, equivalent to a fall from 23% to 20%, would increase Scottish GDP by 1.4% after 20 years. However it should be noted that it is possible that this additional benefit to Scotland would occur at the expense of the rest of the UK if overall UK tax revenue were to reduce.
BACKGROUND

Although taxes are primarily used as a source of revenues to fund public expenditure, they can also be used to influence behavioural change (e.g., environmental taxes), to achieve other objectives, such as equity (e.g., progressive income taxation) or as a social or economic tool (e.g., tax relief for certain activities). When taking tax decisions it is not only the level of taxes but also the tax structures – the way in which different tax instruments are designed and combined – which the Government must consider. In addition, the Government will look to minimise taxpayers’ compliance costs and its own administrative costs, while also discouraging tax avoidance and evasion (OECD 2008a).

WHAT IS CORPORATION TAX?

UK corporation tax is a tax on the profits of limited companies and some organisations including clubs, societies, associations, co-operatives, charities and other unincorporated bodies.

Taxable profits make up the tax base for corporation tax purposes and this includes:

- profits from taxable income such as trading profits and investment profits (except dividend income which is taxed differently)
- capital gains - known as 'chargeable gains' for corporation tax purposes

In reality, the rate of tax borne by a company will vary depending upon factors such as levels of capital expenditure, expenditure on research and development and expenditure on interest payments, as well as their industry. Allowances and exemptions can significantly reduce taxable profits and hence the effective rate of tax.

If a company or organisation is based in the UK then corporation tax is also paid on all taxable profits - wherever in the world those profits come from. The UK has agreements with most other countries to ensure the avoidance of double taxation of the same taxpayer, in respect of the same subject matter and for identical periods. If a company is not based in the UK but operates in the UK - for example through an office or branch then corporation tax is only paid on taxable profits arising from UK activities (HM Revenue and Customs 2011a).

CORPORATION TAX RATES

The main rate of UK corporation tax is currently 26%. The Chancellor has announced that this will be reduced in annual 1% steps to stand at 23% from April 2014. A rate of 20% applies where profits are under £300,000 with a tapered increase to the main rate once profits exceed £1.5m (HM Treasury 2011). Chart 1 show that at 26% the UK rate of corporation tax is in the middle of the range for OECD economies but will move into the lower half as rates are reduced to 23%, assuming other countries do not reduce their rates.
The Scottish Government’s Corporation Tax Discussion Paper (2011a) points out that business decisions are more influenced by effective average and effective marginal tax rates than by headline rates. Chart 2 is from this Discussion Paper and shows that on this basis the UK effective average rate in 2009 was 24% putting it in the top quartile of OECD countries. Even if the planned 3 percentage point reduction in the headline rate resulted in a similar reduction in the effective rate, the average effective rate in the UK would still be above the OECD average.

TRENDS IN HOW CORPORATION TAX IS BEING SET

Across the OECD

Since the mid 1980s almost all OECD countries have made major structural changes to their tax systems. Corporate tax reforms have generally been rate reducing but base broadening – in order to maintain overall tax revenues. Top corporate tax rates in the 1980s were rarely less than 45% but by 2010 the OECD average rate was less than 26% and an increasing number of countries have rates below 25% (OECD 2011b). The observed tax reforms have had different effects on projects of different levels of profitability. Specifically, they have tended to reduce the effective average tax rate by more for more profitable projects. Governments often compete more intensely over such projects, either because they generate more benefits, or because they are more mobile (Devereux et al 2002).

Some policy makers have been concerned that this downward pressure on corporate income taxes will lead to a loss of revenue, and thus provide a constraint on government activity. There is also concern that this process is forcing governments to rely more heavily on taxes on labour, which may have negative consequences on the labour market. To prevent this happening, the European Commission and the OECD have made attempts at international coordination to counter what they see as “harmful” tax competition (Devereux et al 2002).

In the UK

UK corporation tax was raised to 52% in 1973 but was reduced steadily from 1983 in response to a belief that lower rates would attract and retain corporate activity and profits and boost employment and total tax receipts. Chart 3 shows how the UK rate has changed over time.

Chart 3 UK main corporation tax rate 1971-2015

![Chart 3 UK main corporation tax rate 1971-2015](chart3.png)

Source: HM Revenue and Customs 2011b
CORPORATION TAX YIELD AND THE WIDER BASKET OF TAXES

Despite rate reductions, corporation tax remains one of the more important sources of UK Government tax revenue. In recent years it has accounted for 6-8% of all tax receipts and over the last decade the yield has been exceeded only by income tax, national insurance contributions and value added tax.

The table below shows the actual and forecast yield from UK corporation tax, excluding North Sea oil and gas, over the period 2005 to 2015. The yield from all taxes is shown for comparison and the share of UK corporation tax attributable to Scotland is shown for the period to 2010.

Table 1 Trends in the yield of corporation tax (CT): UK and Scotland

<table>
<thead>
<tr>
<th></th>
<th>UK CT ex North Sea £bns</th>
<th>All UK taxes £bns</th>
<th>UK CT as % of all taxes</th>
<th>Scotland CT ex North Sea £bns</th>
<th>Scotland CT as % of UK CT</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005-06</td>
<td>34.3</td>
<td>456.8</td>
<td>7.5%</td>
<td>2.9</td>
<td>8.6%</td>
</tr>
<tr>
<td>2006-07</td>
<td>37.3</td>
<td>486.0</td>
<td>7.7%</td>
<td>3.3</td>
<td>8.7%</td>
</tr>
<tr>
<td>2007-08</td>
<td>40.4</td>
<td>516.0</td>
<td>7.8%</td>
<td>3.5</td>
<td>8.6%</td>
</tr>
<tr>
<td>2008-09</td>
<td>32.5</td>
<td>508.0</td>
<td>6.4%</td>
<td>2.7</td>
<td>8.3%</td>
</tr>
<tr>
<td>2009-10</td>
<td>30.3</td>
<td>490.3</td>
<td>6.2%</td>
<td>2.6</td>
<td>8.6%</td>
</tr>
<tr>
<td>2010-11</td>
<td>34.4</td>
<td>525.3</td>
<td>6.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011-12</td>
<td>36.7</td>
<td>562.4</td>
<td>6.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012-13</td>
<td>38.5</td>
<td>589.8</td>
<td>6.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013-14</td>
<td>40.6</td>
<td>661.7</td>
<td>6.1%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014-15</td>
<td>44.6</td>
<td>695.7</td>
<td>6.4%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: HM Revenue & Customs Corporate Tax Statistics Table 11.1, UK Budget 2011 Table C3, Public Sector Finances Databank Table C2, Government Expenditure and Revenue Scotland 2009-10

Although there are no forecasts available for Scottish corporation tax yield, if the share of UK corporation tax attributable to Scotland is in line with population share (8.3%) then by 2014-15 the yield would be approx £3.7bn.

CORPORATION TAX AND ECONOMIC GROWTH

Many studies have examined the link between corporation tax and economic growth. An OECD study (2008b) outlines that “Corporate income taxes appear to have the most negative effect on GDP per capita. These findings suggest that a revenue-neutral growth-oriented tax reform would be to shift part of the revenue base towards recurrent property and consumption taxes and away from income taxes, especially corporate taxes”.

In its paper on Devolving Corporation Tax in the Scotland Bill the Scottish Government (2011b) highlights several studies which show a link between a reduction in corporation tax and improved economic performance. This includes recent empirical work in the American Economic Journal which shows that “in the OECD, a 10% reduction in corporation tax has typically increased investment rates by over 2% points, doubled the number of entrepreneurs per 100 population and raised company registrations by 20%”.

Modelling work by the Scottish Government in the same paper estimates the impact of a reduction in corporation tax in Scotland equivalent to a fall from 23% to 20% (i.e. 3% points
below the rate planned to be introduced by the UK Government in 2014-15) under a balanced budget scenario. It estimates that this will result in:

- An increase in the level of Scottish GDP by 1.4% after 20 years;
- Overall employment in Scotland will increase by 1.1% (equivalent to around 27,000 jobs) after 20 years;
- An increase in overall investment in the Scottish economy by 1.9% after 20 years; and
- A boost to Scottish exports to the rest of the UK by 1.4% and to the rest of the world by 1.3% after 20 years.

The Scottish Government (2011b) has said that it will undertake and publish further modelling work in the coming weeks and investigate different policy options for reducing corporation tax in Scotland.

However, economic benefits to one region may be at the expense of other higher taxed jurisdictions. It should be noted that this modelling work does not provide estimates of the overall net effect of this reduction in Scottish corporation tax on the UK economy. Large variations in the rate between Scotland and the rest of the United Kingdom could result in different economic effects either side of the border. It is possible that this additional benefit to Scotland would occur at the expense of the rest of the UK if overall UK tax revenue were to reduce.

The Final Report by the Commission on Scottish Devolution’s Independent Expert Group states that “The arguments for setting a lower rate of Corporation Tax usually relate to the creation of a more competitive business environment that will attract Foreign Direct Investment at the expense of other, higher taxed, jurisdictions” (2009). The following section looks at how corporation tax policy can influence foreign direct investment.

THE ROLE OF CORPORATION TAX IN ATTRACTING FOREIGN DIRECT INVESTMENT

Foreign direct investment (FDI) is attractive as it can boost exports, enhance productivity if high-value firms are attracted and create general positive externalities, e.g., through technological spillovers or increases in competition (Devereux et al 2002). There is a substantial body of literature which finds a relationship between levels of FDI and average effective corporate tax rates. However, the degree to which corporate tax rates influence investment decisions relative to other factors is an issue of great debate. The “Review of Tax Policy in Northern Ireland”, the Varney Review (2007) explains that empirical studies differ substantially in their concepts of foreign capital data, tax rates, and in their methodologies, making it difficult for policy makers to draw conclusions regarding the scale of the effect of taxation on FDI.

Ernst & Young’s European Attractiveness Survey 2011 lists the most important factors that a company takes into account when deciding on a location in which to establish operations. Although 46% of respondents ranked corporate taxation as “very important”, a larger percentage of respondents ranked factors such as transport & logistics infrastructure and telecommunications infrastructure as “very important”. The results are illustrated in Chart 4.
Chart 4 The most important factors that a company takes into account when deciding on a location in which to establish operations (% candidates ranking criteria as very important)

<table>
<thead>
<tr>
<th>Factor</th>
<th>% Candidates Ranking Criteria as Very Important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transport and logistics infrastructure</td>
<td>63%</td>
</tr>
<tr>
<td>Telecommunications infrastructure</td>
<td>62%</td>
</tr>
<tr>
<td>Stability and transparency of political, legal and regulatory environment</td>
<td>62%</td>
</tr>
<tr>
<td>Potential productivity increase for their company</td>
<td>57%</td>
</tr>
<tr>
<td>Stability of social climate</td>
<td>54%</td>
</tr>
<tr>
<td>Local labor skill level</td>
<td>50%</td>
</tr>
<tr>
<td>Labor costs</td>
<td>50%</td>
</tr>
<tr>
<td>The country or region's domestic market</td>
<td>48%</td>
</tr>
<tr>
<td>Corporate taxation</td>
<td>46%</td>
</tr>
<tr>
<td>Flexibility of labor legislation</td>
<td>42%</td>
</tr>
</tbody>
</table>

Source: Ernst & Young 2011a

According to the Varney Review (2007) “Most research seems to suggest gravitational variables (i.e. distance and market size) as the main determinants of FDI and of more significance than tax. This is consistent with the findings of business surveys showing that the prime motivation for FDI is easy market access with low costs, as well as skills, infrastructure and telecommunications”.

Another Ernst & Young study (2011b) which looked specifically at the attractiveness of different aspects of the UK for new investors singled out the level of corporate tax, administrative burden and the level of personal tax as three key areas for the UK to address.

The case of the Republic of Ireland

High levels of FDI drove rapid growth in the late nineties as Ireland increasingly emerged as a favoured onshore location for multi-national corporations, such as Google and Dell, establishing regional or global headquarters to manage the profits, functions, and shareholdings associated with their international businesses. Some, such as the Economic Reform Group Northern Ireland (ERGNI), argue that this growth was largely a result of the low corporation tax rate that the Republic of Ireland has had in various guises since 1957. The ERGNI found that –

“The real reason for the Republic’s astonishing success has been a very low rate of corporation tax for most manufacturing sectors since the late 1950s. This attracted a large in-flow of investment in plant and machinery, much of it by US multi-nationals in high value-added sectors” (2010).

Others argue that while the low corporation tax regime was undoubtedly attractive to foreign investors, the success was more likely to have been influenced by a wider range of factors. For example, an OECD study (1999) into the origins of the economic boom found that –

“Ireland’s appeal has been based on the quality, price and availability of its labour, the welcoming attitude to foreign investors, the use of the English language and exploitation
of ‘first-mover advantages’: once one producer in a sector establishes production facilities in Ireland, it is generally easier to attract its competitors. But there is no question that the robust and prolonged expansion of the US economy – the source of most of the direct investment flows – and the attractive policy and institutional setting in Ireland have been the major driving forces. A generally conducive and transparent regulatory framework, an open trade regime and competitive labour costs have generated this outcome. A long-standing favourable tax regime applied to tradeable goods sectors, financial incentives and substantial industrial support targeted at a small number of key dynamic sectors with spin-off potential, may also have been important in convincing major multinational incorporations to choose Ireland as a production location in order to serve at least the EU market”.

Given the unique combination of factors which led to Ireland’s success in attracting FDI, the OECD study (1999) concludes that there is “no single overriding policy that could be adopted elsewhere in order to emulate the Irish experience”. The study goes on to summarise that “most of the items that have contributed to the improvement are well known to other policy makers, but other countries’ situations may not be so propitious as to allow such a strong response”.

**THE ROLE OF CORPORATION TAX IN THE LEVEL OF DOMESTIC INVESTMENT AND ENTREPRENEURSHIP**

Another argument for lower corporation tax is that it can stimulate the economy through increased domestic investment and entrepreneurship. The effective marginal tax rate in relation to corporation tax will influence the level of investment, once the location decision has been made (Varney 2007). Typically, corporate taxes raise the cost of capital - the required rate of return on an investment - and therefore act as a disincentive to invest. The lower tax rate typically increases the incentive to invest. Devereux et al state that “Our data reveal a consistent and large adverse effect of corporate taxes on both investment and entrepreneurship” (2002).

**CHALLENGES ASSOCIATED WITH LOWERING CORPORATION TAX IN SCOTLAND**

**BRASS PLATING/PROFIT SHIFTING**

Brass plating, also known as profit shifting, arises where companies manipulate transactions so that their taxable profits arise in lower tax jurisdictions, while the activities generating those profits remain in a high tax jurisdiction (HM Revenue & Customs 2011c). The Institute of Chartered Accountants of Scotland (ICAS) warns that if there are lower corporation taxes in Scotland then cross-Border operations may simply play the game of profit shifting between its various UK bases to achieve the lowest bill. This will not automatically equate to more jobs and company headquarters shifting to Scotland (Scotland on Sunday 2011). If profit shifting occurs then economic benefit to Scotland may be at the expense of overall tax revenues to the UK Exchequer. The Varney Review (2007) outlined that “there is evidence within the econometric literature that a large degree of profit shifting does take place... Intuitively, one would expect in-country profit shifting to be more sensitive to the corporation tax rate than profit shifting between countries”. However, the Review goes on to say that “Evidence on in-country profit shifting is limited”.

10
HM Revenue & Customs raise specific concerns with regard to potential profit shifting by life assurance and general insurance companies in Scotland. It states “In the event of a rate cut it is extremely likely that all profits generated by life and general insurance companies domiciled in Scotland would be allocated there and thus taxed at the lower corporation tax rate... Moreover there would also be a strong behavioural incentive for large English and Welsh-domiciled companies in these sectors (who commonly have a Scottish presence/subsidiaries) to relocate their technical funds to Scotland, increasing the cost to the Exchequer. A similar issue is that a number of other large banking, other financial and industrial groups are headquartered in Scotland” (2011).

The Scottish Government (2011b), however, states that it “is committed to establishing a fair and transparent corporate tax system which attracts and retains genuine economic activity and will work with the UK Government to minimise any profit shifting”. There are ways of minimising the scope for profit shifting. The Independent Expert Group to the Commission on Scottish Devolution states that “It is not inconceivable to develop a means of apportioning Corporation Tax if different rates applied between Scotland and the rest of the UK that would reduce the scope for firms operating in both jurisdictions to shift profits. This might therefore result in real economic activity, rather than book profits, moving to the low tax jurisdiction. But this would in fact be incentivising firms to react to the tax differences alone rather than wider commercial factors and so would be incentivising economically inefficient action” (2009). The cross-party House of Commons Northern Ireland Affairs Committee, when discussing this issue in the context of Northern Ireland, recognised the issue of brass plating but concluded that the evidence suggests that this risk is sufficiently well mitigated against for it not to present a persuasive argument (UK Parliament 2011a).

Without some limits on profit shifting between Scotland and the rest of the UK there will be no guarantee that both economies will benefit as a result of a lower corporation tax in Scotland.

**RACE TO THE BOTTOM**

Policy makers have expressed concern that the practice of countries competing for foreign direct investment by lowering corporation tax rates will result in a “race to the bottom” and deteriorating tax revenues which will threaten the provision of public services (Devereux et al 2002). Supporters of the status quo argue that reducing corporation tax in Scotland would also compel a similar response from the rest of the UK, which may nullify the perceived benefits from FDI. They also question the longevity of investment given that large corporations can do business anywhere in the world and business can flow to regions that offer the best overall package.

There is a body of literature which argues against the likelihood of a ‘race to bottom’ for a number of reasons. The Varney Review (2007) outlines these:

“Firstly, the cost benefit analysis for a large country is different to a small country simply because the immediate revenue cost stacks up relatively differently to the potential revenue gains from increased investment. It does not follow by analogy that the lower average tax rate in countries with smaller tax bases is an appropriate strategy for larger economies with larger tax bases. Secondly, there are many factors that affect cross-border investment, profits and revenues. Thirdly, the market place in global FDI is not shrinking. If it were, this could imply greater merit in tax-cutting strategy to attract taxable income from other countries. Rather, forecasts indicate that between 2007 and 2010 global FDI flows are projected to grow at an average annual rate of around 4.8 per cent”.
A paper by the [OECD](https://www.oecd.org) (2010a) finds that “The behaviour of sub-central tax rates over the long run remains an open question. The experience of Canada suggested that tax rates neither converged nor diverged systematically over time and no “race to the bottom” can be observed. The same apparently is true for the US, while in several countries sub-central tax rates even increased. In most countries, sub-central corporate income tax rates have come down”.

**REDUCED TAX REVENUES**

The level of corporation tax set has a direct effect on the level of corporation tax revenues. European State Aid rules stipulate that the fiscal consequences flowing from a reduction in the tax rate must not be offset by aid or subsidies from the central government. Thus, there are concerns that a lower rate of corporation tax would have a large effect on the overall Scottish budget and threaten the provision of some public services. The Scottish Government recognises that “As with any policy choice, a balance will be struck between setting a competitive corporation tax system which supports economic activity, and funding the delivery of world class public services” (2011b).

The full effect of a lower rate of corporation tax on revenues depends on a number of factors. Firstly, it depends on what the tax rate is relative to the revenue maximising corporation tax rate on the Laffer curve. The Laffer Curve is a term used to describe the relationship between a tax rate and the resultant tax yield. The populariser of the idea, Arthur Laffer, postulated that a tax rate of 0% or 100% will both result in zero tax yield. As the rate increases from zero the yield will rise but there comes a point where the yield will fall as the incentive to carry out the taxed activity declines. Similarly, a decrease in the tax rate could result in a rise in revenues as the incentive to carry out the taxed activity increases. Brill and Hassett (2007) found that, using evidence from the late 1980s, the revenue maximising corporation tax rate for OECD countries was then about 34% but that by 2007 this had fallen to around 26%. This suggests that if corporation tax is set lower than this rate then revenues are likely to decline.

Maximising tax yield is not the sole purpose of tax policy. The Scottish Government argues in its Discussion Paper that even if a reduction in the rate of corporation tax results in a reduction in corporation tax yield, this will be more than made up by an increase in the total tax base as a result of growth in the economy. The ERGNI report on [The case for a reduced rate of Corporation Tax in NI](https://www.ergni.org.uk) (2010) estimates that after a cut in corporation tax, increases in other taxes and reductions in benefit expenditure would mean that the cumulative effect on public finances would become positive after seven years.

[HM Revenue & Customs](https://www.hmrc.gov.uk) (HMRC) have produced provisional figures which show that if the Scottish Government were to cut Corporation Tax to the same level as Ireland there could be a gap of more than £2.6bn in the Scottish Budget (2011c). However, it should be noted that the Scottish Government have expressed major concerns over the methodology adopted by HMRC to produce this estimate - particularly because the analysis does not include any of the positive effects on the economy from a reduction in corporation tax. This means that the analysis shows the cost to the UK Exchequer rather than the financial implications for the Scottish Government. A paper produced by the economist Professor Hervey Gibson at economic consultancy [cogentsi](https://www.cogentsi.com) (2011) also outlines concerns with methodology underlying the estimate, including:

- A lack of detail on calculations, particularly for estimating tax motivated incorporation
- The unrealistic nature of the time period chosen which inflates the direct effect by as much as 29%
- Failure to take into account likely tax changes to small firm rate at UK level which could inflate the small firm cost by as much as 67%
- The method for estimating profit shifting.
VOLATILE TAX REVENUES

By analysing the trends in tax revenues within the UK it is evident that the yield from corporation tax has been more volatile than the total tax yield, indicating its sensitivity to economic conditions. Between 2005-06 and 2007-08 corporation tax grew both absolutely and as a share of total tax before declining by almost a quarter between 2007-08 and 2009-10. Over the same two year period total tax yield declined by just 5%. The Exchequer Secretary to the Treasury, David Gauke, stated that “corporation tax is a very volatile tax, and would create much more revenue risk for the Scottish budget... Such a large volatile income stream would place great risk on the Scottish budget” (UK Parliament 2011b). ICAS also warn that factors beyond the Government's control such as the yo-yoing profits of the banks don't make for a stable environment for devolving the tax (Scotland on Sunday 2011). The OECD (2010b) highlights the dangers of a sub-central Government depending mostly on corporate taxes which are more volatile than property or personal income taxes. It suggests that any subsequent tax competition could lead to a deterioration of fiscal stability at the sub-central Government level.

TAX MOTIVATED INCORPORATION

A rate of corporation tax which is lower than the rate of income tax can give employees and those who are self-employed an incentive to become a corporation to reduce the tax they pay. This type of behaviour is called tax motivated incorporation (TMI). The resultant effect is a reduction in income tax and national insurance revenues to the Exchequer, which is not fully compensated for by the increase in corporation tax revenues.

If Scotland had a lower corporation tax rate than the rest of the UK there is the possibility that non-corporations in the rest of the UK may decide to incorporate in Scotland to reduce the tax they pay. With regard to this prospect, HM Revenue & Customs notes that “Any such businesses that wanted to register in Scotland to benefit from the rate cut would still have to prove that their activities had legitimately been moved to Scotland. These new companies may be deterred to some extent by the additional administrative burdens placed on them” (2011c).

ADMINISTRATIVE BURDEN FOR BUSINESSES

ICAS believes that if corporation taxes are devolved then there will be “potentially significant additional administrative burden and tax compliance costs for companies throughout the UK” (2011) with companies having to account for profits in Scotland separately to those in the rest of the UK. However, in its paper on the Devolution of Corporation Tax the Scottish Government (2011a) argues that systems have been developed in other jurisdictions to minimise the administration costs to businesses. For example, it explains that companies operating in both the Basque Country and the rest of Spain are liable to corporation tax in both jurisdictions; however arrangements exist so that the smallest companies only pay corporation tax to one jurisdiction.

ADMINISTRATIVE BURDEN FOR HM REVENUE & CUSTOMS

If corporation tax was to be devolved and revenues were still collected by HM Revenue & Customs then changes would need to be put in place for it to be able to calculate and assign revenues. For example, Scottish earned profit would need to be defined, the tax residence of companies and their operations would need to be determined, new IT systems would potentially need to be put in place and the policing of tax evasion and profit shifting in relation to the devolution of corporation tax would need to be introduced. ICAS point to potential additional
costs to the Government from changes necessary to monitor profit-shifting through, for example, transfer pricing legislation (Scotland on Sunday 2011).

In its paper on the Devolution of Corporation Tax the Scottish Government argues that there are examples where systems have been developed to minimise costs of administration – “For example, corporation tax revenues in the USA are allocated to state governments using various measures of economic activity such as sales revenues” (2011a).

In Canada three provinces (Alberta, Ontario and Quebec) collect their own corporate income taxes with the remaining provinces allowing the federal government to collect the tax on their behalf. If corporation tax was devolved to Scotland it may be that the Scottish Government could collect its own corporate income taxes, but that would also likely result in large scale administrative set-up which could be very costly.

CORPORATION TAX AND THE SCOTLAND BILL

THE CURRENT LEGISLATIVE FRAMEWORK

The Scotland Act 1998 sets out the areas of competency reserved to the Westminster Parliament. Under Schedule 5, Head A1, fiscal policy is reserved including policy in relation to taxes.

THE CALMAN COMMISSION AND SUBSEQUENT SCOTLAND BILL PROPOSALS

The Commission on Scottish Devolution (Calman Commission) looked at which taxes were suitable for devolution to improve financial accountability in Scotland. The Independent Expert Group informing the Calman Commission raised a number of concerns in relation to the devolution of corporation tax:

“We recognise that devolving corporation tax would represent a shift in increasing the financial accountability of the Scottish Parliament, although arguably other taxes have a closer connection to the electorate. In terms of answering the specific consultation question, we think the scope for substantive reductions in the possible rate of corporation tax in Scotland are limited if it is desired to maintain comparable levels of public services, unless the Scottish Government is able to increase revenues from other sources. That is to say, we are not convinced that allowing the Scottish Parliament to determine a Scottish rate of corporation tax would produce harmful tax competition because the scope to vary the rate is, in effect, constrained. Even so, the potential for differing rates of corporation tax across the UK would create economic inefficiencies as firms react to tax considerations rather than commercial factors. We also think the potential administrative impacts of such a move are significant” (Commission on Scottish Devolution 2009).

This, together with other evidence supporting this analysis, led the Calman Commission to reject corporation tax as a candidate for devolution or tax assignment. The Scotland Bill has been laid before the UK Parliament to deliver the recommendations of the Calman Commission. Consistent with the findings of the Commission, the devolution of corporation tax is not included in the Scotland Bill proposals.
The Scotland Bill received written and oral evidence in relation to the devolution of corporation tax which it recognised was a “flagship” policy for many who support fiscal devolution.

Evidence received suggested that devolution of corporation tax might give the chance to set lower Scottish rates to incentivise businesses and promote investment in the Scottish economy. However there were concerns about the potential to create economic distortions given that corporate profits are hard to pin down geographically and companies have a strong incentive to recognise their profits in the place where they will be subject to the lowest tax rate. The Committee’s concerns are summarised as follows:

- First, it misallocates resources in an economic sense. Tax avoidance may be profitable for companies but is not a productive activity. Nor would it attract jobs and growth to Scotland.
- Secondly, it increases the risk of a race to the bottom in corporation tax rates (as one can see in other countries such as Switzerland) so that tax revenues are lost.
- Thirdly, and perhaps most serious, if Scotland were able to cut corporation tax, the risk is that all it would attract are ‘paper profits’ from companies elsewhere in the UK. The net effect of this would be that overall, less corporation tax was paid in the UK even though Scotland attracted more of it to support devolved spending. This has been referred to as “cannibalising” the tax base (Scottish Parliament 2011a).

As a result, the Committee concluded that:

“The Committee does not believe that Scotland should seek to maximise its tax income by becoming a tax haven for companies operating elsewhere in the UK. We therefore support the UK Government in not at this stage devolving corporation tax in the Scotland Bill.

The Committee notes that international experience does show some scope for differentiation of corporation tax, and that there are arguments that it can be used as an economic development tool, especially by small countries. It is therefore not something we would wish to rule out entirely for the future, especially if schemes were being developed within the UK which avoided the worst of the distortions that might be created.

... the Committee’s view is that if a scheme to vary corporation tax were to be available in some of the devolved countries of the UK as a tool of the UK Government’s regional economic policy, it should be available as an option for a Scottish Government to use also. Any discussions about this should involve all the devolved nations”(Scottish Parliament 2011a).

POST ELECTION DEVELOPMENTS AND THE SCOTTISH GOVERNMENT PROPOSALS

In its election manifesto the SNP stated:

“Our plan would see all tax raised in Scotland kept in Scotland. Instead of the Tory government in London deciding how much of our income we get to keep, the Scottish Parliament would make a payment for Scotland’s share of ongoing UK services such as pensions, foreign affairs and defence … Responsibility for Corporation Tax would allow Scotland to do even more to create jobs and make our economy more competitive and successful” (2011).
Subsequent to winning the election, in a statement to the Scottish Parliament on 26 May the First Minister Alex Salmond noted that the Government would “demand that corporation tax be devolved” (Scottish Parliament 2011b). In a debate on 1 June on the economic aspects of the new Government’s programme, John Swinney, Cabinet Secretary for Finance, Employment & Sustainable Growth, said the Government would “press for control of corporation tax, to enable us to help to improve the competitiveness of the Scottish economy and to attract companies to Scotland” (Scottish Parliament 2011c).

The Scottish Government has since published a discussion paper on options for reforming corporation tax. A subsequent paper outlines the Scottish Government’s proposition for devolving corporation tax:

- “The Scotland Bill should be amended to devolve corporation tax to the Scottish Parliament, with a like-for-like adjustment to the Scottish Budget. The net cost to the UK Exchequer would be zero;
- Following devolution, the Scottish Government would be responsible for the setting and collection of corporation tax receipts in Scotland;
- The Scottish Government is currently engaging with businesses, investors, trade unions, academics and leaders from the third sector and the public sector regarding the best corporation tax regime for Scotland. This feedback will inform the corporation tax system the Scottish Government will introduce” (Scottish Government 2011b).

CORPORATION TAX AND THE OTHER UK DEVOLVED ADMINISTRATIONS

Corporation tax remains a reserved matter for all the devolved administrations but consideration has been given to the case for devolving this tax to the devolved administrations in Northern Ireland and Wales.

NORTHERN IRELAND

The Varney Review (2007) concluded that

“a clear and unambiguous case for a 12.5% rate of corporation tax cannot be made. [T]here would be an up-front cost of near £300m per annum with no cost recovery in terms of tax receipts in a reasonable period of time.”

However, the UK Government has revisited the issue more recently and published a consultation paper on “Rebalancing the Northern Ireland Economy” which examined the case for reducing the corporation tax rate in Northern Ireland (HM Treasury 2011c). The paper suggests that a reduced tax rate could play a significant role in helping to rebalance the economy by encouraging private sector investment and growth. However, it also acknowledges that it is necessary to be cautious in assuming that a lower tax rate would have the same effect in Northern Ireland as in the Republic where low corporation taxes have been a key component of the government’s economic strategy.

Cutting the rate of corporation tax in Northern Ireland to match the rate in the Republic (12.5%) is estimated by HM Treasury (2011c) to result in a reduction in tax yield of the order of £225-270m within 5 years. In addition, tax yield in the rest of the UK would be reduced by about £85m but much of this would be offset by increases in other tax receipts such as VAT and income tax.
The Northern Ireland Affairs Committee conducted an inquiry into corporation tax in Northern Ireland and concluded that “On balance, we believe there is a convincing case for reducing the corporation tax rate in Northern Ireland, not least so it can better compete with the Republic of Ireland”. The Committee Report also states:

“It is worth repeating that the decision to devolve corporation tax, and how it would be implemented in Northern Ireland, would require cooperation and agreement between the Northern Ireland Executive and HM Government. A low rate of corporation tax is advantageous, but on its own would not be a panacea for all Northern Ireland’s economic ills. To maximise the benefit, there are other important steps that would need to be taken in conjunction, many devolved already, on other economic development policy mechanisms including planning, education, skills training, and incentives to encourage R&D and exporting. The measures need to be worked into a single, easily understood package, alongside corporation tax, that can be marketed to potential foreign investors and stimulate entrepreneurs and enterprise among indigenous businesses. We do not consider it necessary to devolve any further tax measures at the moment but, at the same time, urge the Government to avoid introducing measures that clearly make Northern Ireland a less competitive, less business friendly, location.” (UK Parliament 2011).

The Northern Ireland Economic Advisory Group has used an economic model to estimate the impact of a reduced rate of corporation tax on the Northern Ireland economy. The group concluded that without policy changes with regard to corporation tax there would be no convergence in living standards between Northern Ireland and the rest of the UK but a reduction in corporation tax to 12.5% would have a significant impact on living standards and employment in Northern Ireland by 2030 (2011). A paper by the Northern Ireland Assembly Research and Information Service (Northern Ireland Assembly 2011) estimates the direct cost to the Northern Ireland block could be in excess of £400m by year five.

A decision on whether to devolve control over corporation tax to Northern Ireland is expected in coming months.

WALES

The Independent Commission on Funding and Finance for Wales, the Holtham Commission, considered the case for devolving corporation tax to the Welsh Assembly. The Commission estimated receipts from corporation tax levied on businesses in Wales at between £620 and £1,200m in 2008-09 depending on the methodology used, noted the volatility of these receipts and calculated that a 25% reduction in tax rates would lead to a loss of revenue of £250m per annum in the first year. The Commission stated that “since even the most favourable response would take time, some revenue sacrifice would continue for several years” (The Independent Commission on Funding and Finance for Wales 2010).

The Commission received several submissions suggesting the devolution of corporation tax to Wales as an economic tool to make a transformational change in Wales’s economic performance. It suggested that “One theoretical approach [to varying corporation tax in different parts of the UK] could be to make changes to the rate of corporation tax that were proportional to the difference between GVA per head in a given region and the UK average”. However, given that the extent to which corporation tax can be varied within an EU member state to promote economic development has been the subject of recent legal dispute (in relation to the Azores judgement) the Commission finds that “The most secure way of enabling corporation tax to vary in Wales relative to the UK therefore is to devolve the tax and to structure the powers devolved to Wales and their budgetary consequences in a way that falls within the Azores
criteria. To comply with Azores the decision on whether to reduce the corporation tax rate would have to reside exclusively with the Assembly Government as would the extent of any reduction, up to the GVA-determined limit”. The Commission went on to recommend:

“The Assembly Government should seek discussions with the UK Government and the other devolved administrations about the feasibility of devolving corporation tax. Any specific proposal will need evaluation to ensure its compatibility with European law, notably the question of whether any UK-wide agreement on limits to rate changes would be permissible. It is clear that the full budgetary impact of devolved corporation tax must fall on the Assembly Government. This would introduce substantial volatility into the Welsh budget”.

Gerald Holtham, the Chair of the Holtham Commission for Wales, stated earlier this year that “If Northern Ireland is allowed to cut corporation tax, it would be outrageous if Welsh politicians did not have the option of doing the same” (Click on Wales 2011).

THE DEVOLUTION OF CORPORATION TAX IN OTHER COUNTRIES – SOME EXAMPLES

Corporation taxes are often applied at more than one level of government as can be seen in Table 2 overleaf. Information on how corporation tax powers are devolved to regions in certain countries is subsequently provided.
Table 2 OECD countries where corporation tax powers are held by regions

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<tr>
<th>OECD Country</th>
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<td><strong>United States</strong></td>
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Source: [OECD] 2011a

Note – Spain devolves greater corporation tax powers to some sub central governments, but not all.

**SPAIN AND THE BASQUE COUNTRY**

Fiscal powers vary between the various regions in Spain. Catalonia, Navarre and the Basque Country have the most extensive powers. Specifically, the Basque Country has considerable fiscal autonomy, with wide ranging responsibilities over government expenditure and the collection of taxes. The fiscal relationship between Spain and the Basque Country is governed by an Economic Agreement. Under this agreement, the Basque Country Government has the authority to vary most forms of direct taxation including income tax, corporation tax and taxation on wealth and capital gains. The current main rate of corporation tax rate is 28%, compared to
the Spanish rate of 30%. However, GDP per capita in the Basque country is about 30% above the Spanish average and the Economic Agreement contains a number of general principles which are designed to ensure a degree of harmonisation between the Basque tax system and that in the rest of Spain. The Basque territories make payments to the Spanish government for services such as defence and foreign relations. The contribution is currently 6.24% of Spanish government receipts which compares to a Basque population share of 5% (European Autonomies’ Tax Web 2011).

USA

The main rate of federal corporation tax in the USA is 35%. Most states also levy corporation tax, at rates typically in the range 5-10%, but some states e.g. Texas, do not tax corporate profits and some local (county) governments do. This means there is wide variation in the effective corporate tax rate in the US. While this should provide abundant evidence of how tax yield and economic growth varies with tax rates, in practice the large number of different taxes levied at the state level makes empirical analysis of the impact of changes to a specific tax difficult to undertake using data from the USA (Holtham 2010).

CANADA

Canada is one of the most decentralised countries in terms of taxation. Corporation tax in Canada is levied by federal and provincial governments. The federal rate is currently 16.5% but due to fall to 15% from January 2012; the main provincial rates vary between 10% and 16% giving a combined rate of 26.5% to 32.5%. However the average effective rate of corporation tax in Canada is just 10% implying that exemptions are significant. Chart 5 shows how corporation income tax (CIT) rates have varied across Canadian provinces in recent decades.

Chart 5 Mean, Median, and Coefficient of Variation of Provincial CIT Rates 1975 to 2010

Inter-provincial tax competition also takes place through the use of R&D tax incentives, tax credits for certain activities and royalties on oil & gas production. Recent reductions in corporate taxation have been driven by international tax competition rather than inter-provincial tax competition (Dahlby 2010).
SOURCES


RELATED BRIEFINGS

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