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FOREWORD

This government was re-elected on the back of a clear vision to improve the lives and opportunities of the people of Scotland. We firmly believe that Scotland’s best interests are served by taking full responsibility for the key policy decisions which affect the Scottish economy. This is why we are committed to holding a referendum on independence in the second half of this new parliamentary term.

However, an immediate priority is to improve the Scotland Bill which is currently progressing through the UK Parliament. We are making the case for ‘economic teeth’ to be added to the bill to help Scotland fulfil its economic potential. Growing our economy is the greatest challenge that we currently face and is the key to delivering opportunities for all.

Corporation tax is one of the chief levers that any government can use to promote growth, investment and jobs over the long run. It is also a vital source of competitive advantage in an integrated, flexible global economy, helping to attract new businesses, key corporate functions and highly-skilled jobs.

In our manifesto, we gave a commitment to set out the arguments for devolving corporation tax to Scotland and to engage with the people of Scotland on the best options for reform. Following discussions between Scottish and UK Government Ministers since the election, the UK Government has agreed to consider our proposals. I believe we have a compelling case.

This report sets out the evidence on the opportunities that are available to countries which pursue an attractive, competitive corporation tax policy. A competitive corporation tax regime has been a feature of the economic success of many small independent economies. Within the UK, there is a growing consensus on the merits of devolving corporation tax, with the UK Government currently consulting on options for reform in Northern Ireland. In Scotland, a growing number of our most successful entrepreneurs and business leaders are calling for change.

With full responsibility for corporation tax, the Scottish Parliament would have a whole range of new, positive choices to help strengthen our economy. For example, Scotland could operate a lower tax rate, vary the tax base, simplify the tax system or use corporation tax as
a lever to encourage innovation and investment. These are important tools, which could deliver substantial economic dividends.

Scotland has a powerful case for gaining responsibility for corporation tax, to help build a world-class business environment and achieve strong, sustainable economic growth. With the established strengths of our workforce, high quality infrastructure, a strong research base and a competitive business tax regime, we could present an outstanding ‘offer’ to investors worldwide – and an environment in which Scottish business can thrive.

That is the vision that we believe is right for Scotland. As the global economy continues to recover, and we look to capitalise on the new opportunities that will emerge, it is vital that Scotland has the relevant policies in place to help create new jobs and deliver strong, sustainable, economic growth.

This report aims to provide a solid basis for discussion of a competitive corporation tax regime in Scotland. We encourage all partners to take a full and active part in this debate – across businesses, investors, trade unions, academics, citizens and leaders from the third sector and the public sector. We believe that this is a strong proposition. We want to hear from you on how it can work best for Scotland.

John Swinney MSP
Cabinet Secretary for Finance, Employment and Sustainable Growth
SUMMARY

- The Scottish Government is committed to creating an environment in which businesses in Scotland can grow, underpinned by a fair and efficient taxation system.

- Faster economic growth is ultimately the mechanism through which the country can reach its full potential and provide opportunities for all of Scotland to flourish.

- To achieve this aim, the Scottish Government has taken forward a range of initiatives including the implementation of the most competitive business rates package in the UK. As a result, over 70,000 business properties in Scotland during 2009-10 paid either reduced business rates or no rates at all.

- However under the current constitutional and fiscal arrangements, control of many of the key tax levers to promote business competitiveness remain reserved.

- The Scottish Government is committed to seeking responsibility for the setting of corporation tax. This would give Scotland a powerful new policy lever to promote growth and support jobs. The Scotland Bill provides an ideal opportunity for this economic policy lever to be devolved.

- Setting an attractive corporation tax strategy – in coordination with a wider strategy for growth – could improve the competitiveness of the Scottish economy and support jobs. As a result, it could bring wider benefits to the economy and boost living standards.

- Northern Ireland is currently in consultation with the UK Government on being granted authority to set a lower rate of corporation tax relative to the rest of the UK, making it all the more essential that Scotland is granted similar powers.

- As with any reform, there will be issues to be resolved with regard to implementation. However, it is clear that many other countries have successfully devolved corporation tax and continue to perform competitively.

- This report motivates the case for change and outlines a number of options for reform. The corporation tax debate is often characterised by simply a cut in the headline rate. But in practice there are a lot more opportunities, particularly with regard to using tax in sophisticated ways to reinforce and bolster Scotland's existing strengths and to address weaknesses.

- These include reducing the rate of tax paid, narrowing the tax base and/or simplifying the collection system. Each option has its own particular strengths and we welcome feedback on the regime best suited for Scotland.
1 INTRODUCTION

The Purpose of the Scottish Government is to improve Scotland’s rate of sustainable economic growth. Faster economic growth will create high-quality jobs, more successful companies, increased investment and greater wealth and prosperity.

Since 2007 the Scottish Government has put forward a range of measures to promote Scotland’s economy. For example, the Small Business Bonus Scheme has reduced the rates burden for businesses right across Scotland (74,000 properties in 2009/10 - with 63,000 paying no rates at all) and is taking forward plans for Scotland to lead Europe’s Renewables revolution with the Low Carbon Sector in Scotland estimated to support 130,000 jobs by 2020.

However under the current constitutional arrangements, many of the key job creating powers – particularly in relation to taxation – lie outside the remit of the Scottish Government. Approximately 90% of current Scottish tax revenues are controlled by Westminster and are not set with reference to the particular economic circumstances north of the border, or the preferences and needs of Scottish households or businesses. This lack of autonomy limits the flexibility of the Scottish Government to respond to key challenges or to take advantage of strengths or new opportunities within the Scottish economy.

It also constrains the Scottish Government’s ability to provide Scotland with a competitive advantage. This Government has argued consistently that Scotland should be granted responsibility for setting corporation tax to help Scotland become more competitive and to support Scottish businesses and create jobs.

The Scotland Bill

The Scottish Government is committed to making the case for Scotland to secure full financial responsibility under independence whereby the Scottish Parliament would be responsible for all public spending and all taxes collected in Scotland. This would provide the Parliament with the full range of economic and job creating powers, including control of key taxes such as Corporation Tax, North Sea Revenues and Green Taxes.
The Scottish Government will bring forward proposals for a referendum on independence in the second half of the current Parliamentary term to allow the people of Scotland to have their say on Scotland’s constitutional future.

The immediate priority however, is to seek to improve the Scotland Bill which is currently progressing through the UK Parliament.

The Scotland Bill offers an excellent opportunity to enhance the financial accountability of the Scottish Parliament and to provide genuine new economic levers to help Scotland fulfil its economic potential. Unfortunately, the Bill as it currently stands does not yet meet these objectives. A summary of the Scotland Bill is provided in Box 1.

**Box 1: Summary of Scotland Bill Financial Proposals**

The Scotland Bill includes a limited number of proposals to reform the funding arrangements for the Scottish Parliament. The key recommendation is for a share of income tax to be devolved to the Scottish Government. Stamp duty land tax, landfill tax and limited borrowing powers are also included.

However, such reforms are modest. Together these proposals would involve assigning the Scottish Parliament control of just over 15% of total tax revenues in Scotland – only a small increase from the 7% of total tax revenue in Scotland currently devolved\(^1\). Despite the recommendations of the Calman Commission responsibility for Aggregates Levy and Air Passenger Duty are not to be devolved.

The Scottish Government has raised two significant issues with the financial proposals contained within the current Scotland Bill. Firstly, the Scottish Government has expressed concern with regard to the detail of the income tax proposals. The unique nature of the proposals carries risks for public spending. Over the long-term by making future changes in the Scottish Budget largely dependent upon the performance of just one tax, there is the potential danger of a long-term deflationary bias emerging. It also carries short-term risks from volatility in revenues which are not sufficiently compensated for by adequate revenue borrowing powers\(^2\). The Scottish Government continues to press the UK Government to address these limitations.

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\(^1\) These calculations include a geographical share of North Sea oil revenues.

Secondly, the Scottish Government is clear that reform of Scotland’s financial powers must be more than simply an accounting exercise but something which establishes a new framework which allows the Scottish Government to do more to create jobs and make the economy more competitive and successful.

The lack of economic powers in the Scotland Bill is an opportunity missed. However, there is still time for the Bill to be reformed to allow for such powers to be added. The Scottish Government is therefore putting forward the case for new powers in a select number of areas. All these areas have attracted significant support in Scotland and will help address immediate policy priorities.

These include –
- control of corporation tax;
- immediate and substantial capital borrowing powers;
- responsibility for excise duties;
- authority over the Crown Estate;
- greater EU involvement; and,
- greater control over broadcasting.

**Corporation Tax**

The Scottish Government has consistently argued for responsibility of corporation tax to be devolved to Scotland. The 2007 Government Economic Strategy\(^3\) identified corporation tax as a crucial lever of growth, if used wisely alongside other levers such as investment in skills and training, infrastructure and planning.

The Scottish Government is not alone in the view that a competitive business tax environment can support growth, employment creation and ultimately prosperity for all. The UK Government are planning to lower the headline UK corporation tax rate as a central part of their growth strategy.

However, a key question is whether a centralised corporation tax system for the UK as a whole is appropriate for the unique challenges and opportunities that Scotland faces. The Scottish Government does not believe that this is the case.

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\(^3\) Government Economic Strategy, Scottish Government, November 2007

The UK Government has itself recognised the important role differential rates of corporation tax can have in boosting the performance of different parts of the UK economy. That is why plans for devolving corporation tax to help rebalance the Northern Ireland economy are currently under consultation and have been welcomed by all sides of the political spectrum in Stormont.

The Scottish Government is fully supportive of devolving corporation tax to the Northern Ireland Assembly, but firmly believes that Scotland should be granted the same power. This is a view shared by others. The previous Parliament’s cross-party Scotland Bill Committee chaired by Labour’s Wendy Alexander concluded that –

“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.”

In Wales, the author of the review into funding the Welsh Assembly Government is reported as having commented 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”

Gerald Holtham, chair of the Holtham Commission for Wales

The Scottish Government will therefore put the case to the UK Government to devolve corporation tax to the Scottish Parliament as part of the Scotland Bill.

The Chancellor of the Exchequer and the Secretary of State for Scotland have stated that they will consider proposals to add ‘economic teeth’ to the Scotland Bill. A number of detailed suggestions have already been set out to the UK Government outlining the clear

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10 Corporation Tax: Options for Reform
case for devolving these additional powers and the Scottish Government plans to submit the remaining proposals to the UK Government over the coming months. This includes the proposal for devolving control over corporation tax to the Scottish Parliament.

Prior to finalising the case for devolving corporation tax, the Scottish Government is keen to engage with businesses and the people of Scotland on a range of issues to be considered if the Scottish Parliament had control over corporation tax.

This discussion paper is part of this process. It summarises the evidence base supporting the link between a competitive corporation tax regime and economic growth and outlines the current corporation tax system in the UK.

In addition, the paper considers a range of potential options for reforming the current corporation tax system should these powers be transferred to the Scottish Parliament and discusses how these additional levers could be used to address the specific challenges facing the Scottish economy. These options include reducing the headline rate of tax paid, adjusting the rate for small and medium enterprises, providing allowances for particular activities and supporting economic development in specific areas of Scotland. Each option has their own particular strengths and challenges and we welcome comment on the regime best suited for Scotland.

Feedback on the proposals raised in this report are welcome. Initial comments by the 5th September 2011 will help inform the Scottish Government’s proposal for devolving corporation tax to be submitted to the UK Government this Autumn. Comments thereafter are also welcome as they will aid the Scottish Government’s longer-term work in this area. Feedback can be sent to the following email address – Economist-WebGroup@scotland.gsi.gov.uk

The structure of the report is as follows –

- Chapter 2 summarises the key arguments on the relationship between corporation tax and economic growth;
- Chapter 3 provides an outline of the current system in the UK; and
- Chapter 4 outlines some exploratory examples of possible options for reform should Scotland be granted responsibility for corporation tax.
2 Corporation Tax and Economic Growth

This chapter provides a brief outline of the links between corporation tax and economic growth.

Overview

The key driver of economic growth in the long-run is the private sector. Faster growth also provides greater opportunities to retain the wealth created in a society and to invest the proceeds in public services. Governments have an important role to play in establishing the right economic conditions to promote growth. They also have an essential role in ensuring fairness and equality and in providing opportunities for all of society to succeed.

Governments can influence economic activity through the use of a variety of economic levers. For example, a skilled and talented workforce is essential to building and maintaining a competitive advantage, and a country’s education system also plays a crucial role. In addition, the tax and regulatory environment a government puts in place influences economic activity and incentives within an economy.

It is widely accepted that the taxation of companies is a key determinant of economic competitiveness. Within this, corporation tax is arguably the most significant element. The corporation tax system can influence economic growth through a number of different channels. These are summarised in diagram 1 (overleaf).

Corporation Tax and Economic Growth

Broadly speaking, there are three principle channels through which corporation tax can influence economic growth. Holding all else constant, a more competitive corporation tax structure can boost corporate incentives to invest in physical and human capital, and in research and development (R&D)\(^7\).

\(^7\) Perhaps the easiest way to visualise this is to consider a corporation tax rate of 100% under which there would be no incentive to invest.
At the same time, lower rates of corporation tax increase firms’ profitability and ability to compete in both domestic and overseas markets. It also makes a country more attractive as a location for enterprise relative to jurisdictions with more competitive tax policies\(^8\), \(^9\). This is especially important in an increasingly globalised marketplace where multinational firms face a choice of a range of countries in which to locate their operations.

There is a significant body of academic and business research studying the link between corporation tax and economic growth. While analysis and conclusions varies from study to study – and the importance of other non-tax factors should not be dismissed – the Scottish Government believes that the body of evidence does point toward an important link between corporation tax and investment, economic growth and jobs. Critically however, it is how this

\(^8\) There is a range of evidence highlighting the link between the rate at which corporations are taxed and inward investment. An OECD report found that studies examining cross-border flows suggest that on average FDI decreases by 3.7% following a 1% point increase in the tax rate on FDI. However, research by Oxford Economics found evidence of a stronger link, with a 1% point decrease in corporation tax rate associated with an 11% increase in inward investment. Sources: OECD (2007) “Tax Effects on Foreign Direct Investment: Recent Evidence & Policy Analysis”, Tax Policy Studies No. 17, and Oxford Economics (2011) “Building Economic Competitiveness – Lessons from Small Peripheral European States”, paper for the Department for Enterprise, Trade and Investment.

\(^9\) Econometric analysis undertaken by the Economic Advisory Group to the Northern Ireland Executive found that corporation tax was the most significant variable explaining differences in FDI performance amongst 10 small peripheral economies over the period 2003-09. A 1% point reduction in corporation tax rate was estimated to - on average - lead to a 10% increase in the number of FDI jobs promoted (per capita).

Corporation Tax and Economic Growth

Corporation Tax: Options for Reform

lever is used in conjunction with other levers of growth, such as infrastructure investment, education and skills and so forth, which will ultimately influence how it can support economic growth.

For example, recent empirical work in the American Economic Journal 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%\(^\text{10}\). Furthermore, a study by the OECD\(^\text{11}\) found that corporate income taxes were the most harmful for economic growth, with investment adversely affected by corporate taxation as it reduces the after-tax return on investment. Elsewhere, a seminal econometric study by American economists Lee and Gordon (2005) found that in a sample of 70 countries over a thirty year period, and after controlling for other growth factors, lowering corporate tax rates by 10 percentage points was estimated to have led to economic growth increasing by between 1 and 2 percentage points per annum\(^\text{12}\). While such studies are difficult to interpret and apply directly to the Scottish context, they do suggest that there can be a link between corporation tax and economic growth, if used wisely.

In the business sector, the link between corporation tax and investment and growth is often cited as a key issue. A recent survey by Ernst & Young found that 81% of respondents thought that lower corporation tax in the UK would either “certainly” or “probably” stimulate economic growth\(^\text{13}\).

The UK Government has recognised the importance of corporation tax as a key economic lever. In the June 2010 Budget, the Chancellor announced that a reduction in the headline corporation tax rate would be at the heart of its growth strategy. Specifically, the UK Government now aims to create the most competitive tax system in the G20 with the headline corporation tax rate falling to 23% by 2014.


\(^\text{13}\) Ernst & Young UK Attractiveness Survey 2011, see figure 18.
Corporation Tax within the UK

The Scottish Government shares the view that having a competitive headline corporation tax rate is an essential component of an overall growth strategy – in full alignment with policies around skills, infrastructure, planning and regulation – but believes that as a key driver of growth, responsibility should be with the Scottish Government rather than the UK Government. This would allow a better targeted corporation tax policy for Scotland that was tailored to the unique characteristics of the Scottish economy.

While the Scottish Government has control over many of the levers to promote long-term sustainable growth in Scotland, it lacks the full range of economic tools available to other governments – particularly in relation to taxation. This limits the Scottish Government’s ability to align tax policies with devolved expenditure programmes (for example in relation to spending on apprenticeships/youth training vis-à-vis welfare spending) to maximise efficiencies or to put in place targeted tax policies to improve competitiveness.

The UK Government has itself recognised the important role differential rates of corporation tax can have in boosting the performance of different parts of the UK economy. They are now consulting on plans to allow a lower rate of corporation tax to be set in Northern Ireland, with a decision expected in the autumn.

This was emphasised by HM Treasury in their recent paper “Rebalancing the Northern Ireland Economy” -

“A lower corporation tax rate would, on its own, be likely to have a positive effect on local private sector investment and foreign direct investment (FDI) by increasing the return on capital to investors. In addition, a lower corporation tax rate means that businesses may have more post-tax profits available for internal investment. Increased investment, other things being equal, typically leads to increased growth and employment.”

Rebalancing the Northern Ireland Economy, HM Treasury, March 2011

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14 Research highlighted that there are few policy levers available to the Scottish Executive (now Government) to deliver a step change in Scotland’s competitiveness. Just about the only feasible policy lever which would have a large enough potential impact on Scotland’s competitiveness would be direct action on the level of key taxes, particularly corporation tax. “Can Fiscal Autonomy Improve a Devolved Scotland’s Economic Prospects?”, Jim Cuthbert and Margaret Cuthbert, Scottish Affairs, 2002, http://www.cuthbert1.pwp.blueyonder.co.uk/
HM Treasury estimate\textsuperscript{15} that the total level of investment in Northern Ireland would be around 6\% higher each year if corporation tax was devolved and reduced to 12.5\%, compared to if there was no change to the current corporation tax regime.

Separate modelling work\textsuperscript{16} has been undertaken by the Economic Advisory Group of the Northern Ireland Executive which estimates that if Northern Ireland were able to pre-announce a reduction in corporation tax to 12.5\% and introduce the policy in 2014, it would increase the rate of economic growth by 1\% point per year and generate 58,000 more jobs by 2030. Overall, the lower corporation tax is estimated to increase the standard of living in Northern Ireland by 13.5\%.

There is widespread support in Northern Ireland for a cut in corporation tax as a means of supporting growth and in rebalancing the economy. For example, the CBI Northern Ireland believe that –

\begin{quote}
“The result of lowering the CT rate to 12.5\% will lead to a transformational step change in the economic performance of the Northern Ireland economy”.

“There is a strong view in the business sector that a low and competitive CT rate for a sustained period would lead to a transformation in the economy over the medium/longer term.”
\end{quote}

Corporation tax in Northern Ireland – a CBI submission to the Northern Ireland Affairs Committee\textsuperscript{17}

In Scotland, there is also support, although admittedly this is not universal, for the principle of devolving responsibility for corporation tax.

\begin{quote}
“The Scottish Government should have substantial authority over those levers of power which most affect the Scottish economy… Fiscal federalism meets this criterion as it offers the opportunity for Scottish Ministers to control key taxes such as income tax or \textbf{corporation tax}, which could, as part of a wider economic strategy, be used to influence the direction of the Scottish economy.”
\end{quote}

The Steel Commission\textsuperscript{18}

\textsuperscript{15} http://www.hm-treasury.gov.uk/consult_rebalancing_ni_economy.htm
\textsuperscript{17} Corporation tax in Northern Ireland – a CBI submission to the Northern Ireland Affairs Committee 20 September 2010 http://www.cbi.org.uk/pdf/20111123-cbi-corporation-tax-northern-ireland.pdf
\textsuperscript{18} http://www.scotlibdems.org.uk/files/steelcommission.pdf
“Scottish Liberal Democrats believe there is a strong case for the division of the tax basket as outlined below… Scottish taxes: devolved with all revenues accruing directly to the Scottish Parliament: income tax; corporation tax; fuel duty and vehicle excise duty; tobacco and alcohol duties; betting and gaming duties; air passenger duty; insurance premium tax; climate change levy and landfill tax; inheritance tax; and stamp duties on property… Control of these taxes would mean that the Scottish Parliament had the fiscal levers necessary for greater influence over the direction of the Scottish economy.” Scottish Liberal Democrats written evidence to the Calman Commission, 2 April 2009

“People need a reason to bring their businesses to Scotland, and full financial responsibility with control over major fiscal levers, such as corporation tax, would provide the chance to create such incentives”, Jim McColl, Chairman of Clyde Blowers, The Scotsman, 11th December 2010

Moreover, while there may be a debate with respect to the merits or demerits of using corporation tax as a lever to promote economic growth, there is a growing consensus that – particularly if Northern Ireland is granted the opportunity to vary corporation tax – the Scottish Government (and Welsh Assembly Government) should as a point of principle have an equal opportunity to consider using this economic lever. The cross-party Scotland Bill Committee of the last Scottish Parliament concluded that any discussions over devolving corporation tax should involve all the devolved nations.

The public spending impacts of changes to corporation tax

The Scottish Government is clear that any change to corporation tax rates in Scotland must balance efforts to improve the competitiveness of the Scottish economy alongside ensuring that the country collects a fair and adequate level of tax revenue to invest in public services. Chapter 4 discusses a range of options for how this could be achieved although it is worth summarising at this stage a number of key issues.

20 http://news.scotsman.com/scotland/Jim-McColl-on-the-Scotland.6657408.jp
18 Corporation Tax: Options for Reform
The Scottish Government is seeking responsibility of corporation tax, with an equivalent reduction from the block grant. Therefore the net effect to the UK Exchequer would be zero. From this, future changes to Scottish corporation tax revenues would be a matter for the Scottish Parliament to decide.

At first glance, cutting corporation tax could be seen to lead to an immediate reduction in revenues collected in Scotland. If such a position was adopted, then decisions regarding budgetary priorities would be needed. However, experience has shown that, particularly over the medium to long-term, a more competitive corporation tax strategy may not necessarily imply lower revenues.

This is because cutting the headline rate of corporation tax has two effects on total revenues. Firstly, setting a lower rate reduces the amount of tax collected on existing profits. Secondly, by stimulating economic activity, the tax base upon which the lower rate is levied can expand, thus acting to increase revenues. This effect can be even more significant once consideration is given to the potential increase in other revenues that may also occur.

A number of countries have attempted to mitigate any short-term impact on tax revenues through a number of avenues. One option has been to pre-announce a future tax cut with the aim of stimulating investment and enterprise in advance of the actual cut in the rate. Another option, and one adopted by the current UK Government, has been to stagger any reduction in the tax rate to balance any short-term fiscal costs with more medium term improvements in the tax base. Indeed the latest forecasts from the Office for Budget Responsibility predicts that total onshore corporation tax receipts in the UK in 2013-14 will be higher than the pre-recession peak\(^\text{22}\), despite a sustained period of cuts to corporation tax rates.

Another key issue is the need to ensure multinational companies do not engage in shifting their profits from one jurisdiction to another to simply avoid paying tax. This is neither fair or desirable. That is why the Scottish Government is committed to establishing a fair and transparent corporate tax system which attracts and retains genuine economic activity in Scotland. In practice, significant institutional and accounting rules already exist both within the UK and internationally to ensure that this does not happen.

\(^{22}\) The Office for Budget Responsibility within the “Economic and Fiscal Outlook, March 2011” publication forecast that on-shore corporation tax receipts for the UK will be £41.6bn in 2013-14. This compares to the pre-recession peak of £40.4bn in 2007-08 reported in Government Expenditure and Revenue Scotland 2009-10.
It would therefore be about managing the implementation of a different corporation tax regime in Scotland carefully so that it mitigates against any efforts by companies to shift their profits rather than economic activity (so-called “brass-plating”) to Scotland. It would not be necessary to create an entirely new system, but instead ensure the efficient operation of the current system.

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 argument23. The Scottish Government shares this view.

Summary

The Scottish Government believes that the body of evidence, both from academic studies and the experiences of other countries, points to a persuasive argument in favour of a competitive corporation tax rate being utilised as a key lever of economic growth. Effective use of corporation tax – relative to that of competitors – can act to help boost private sector investment, capital formation, research and development and ultimately economic growth. Corporation tax is therefore a vital component of a country’s overall economic strategy to support long-run sustainable growth.

The Scottish Government believes that the Scottish Parliament must have this vital economic lever to be able to make the choice on the optimal corporation tax structure for Scotland. Ultimately with this responsibility it would be up to the people of Scotland, the Scottish Parliament and the Scottish Government to put forward an appropriate policy which balanced short-term fiscal demands and the funding of public services with long-term economic competitiveness. A range of possible options are put forward in Chapter 4.

3 Corporation Tax in the UK

This chapter provides an introduction to corporation tax in the UK and summarises key recent developments.

Core elements of corporation tax

Corporation tax is a tax levied on company profits. As with other taxes, the amount paid depends upon two components – the tax base and the tax rate.

The tax base defines the element that is subject (or ‘liable’) to be taxed. For corporation tax, the tax base constitutes an incorporated company’s ‘taxable’ profits. In the UK, this includes most earned profit and capital gains less relevant deductions and allowances. Examples of deductions and allowances include breaks for capital and research and development (R&D) expenditure and offsets for losses incurred in previous years. A ‘narrowing’ of the tax base occurs when the amount of profit liable for tax is reduced (for example, through more generous R&D tax credits). This generally results in less tax being paid24.

The tax rate is the amount of this ‘taxable profit’ required to be paid each accounting period. For example, a tax rate of 20% requires that 20% of ‘taxable profits’ are liable to meet a company’s corporation tax obligations (e.g. taxable profits of £1 million would lead to a tax bill of £200,000).

The current UK framework

UK resident companies are taxed on the basis of their global profits, with a series of rules and regulations governing profits earned overseas and in the UK25. Firms which operate as sole traders and partnerships do not pay corporation tax but instead pay tax on ‘earnings’ primarily through the income tax and capital gains tax regimes.

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24 Given the selective nature of allowances and deductions not all firms can take advantage of more generous treatment of certain activities. For example, R&D tax credits benefit R&D intensive sectors more than other sectors.

25 The definition of UK companies includes public corporations and unincorporated associations.
**Tax rate**

In the UK, the main rate of corporation tax is currently 26%. Companies with taxable profits up to £300,000 are subject to a reduced ‘small profits rate’ of 20%, with marginal relief for taxable profits between £300,001 and £1,500,000 as outlined in table 1.

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Profits per annum (£)</th>
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<tr>
<td>Small profits rate 20%</td>
<td>0 – 300,000</td>
</tr>
<tr>
<td>Marginal relief (between 20% and 26%)</td>
<td>300,001 – 1,500,000</td>
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<tr>
<td>Main rate 26%</td>
<td>Greater than 1,500,000</td>
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Source: HMRC

The UK Government has established the objective of creating a more competitive business tax system. The headline corporation tax rate is scheduled to fall to 23% by 2014. The Scottish Government shares the view that having a competitive headline corporation tax rate is an essential component of a growth strategy.

The difference between the small profits rate and the statutory rate (marginal relief) is tapered at a rate of 3/200 as illustrated in figure 1.

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26 Corporation tax paid by companies operating in the North Sea is subject to ring-fencing. The current rate is 30%. In 2002, a Supplementary Charge of 10% was introduced which has been subsequently increased to 32% making the overall rate 62%. The supplementary charge may fall in future, as part of the 'fair fuel stabiliser', introduced at the UK Government’s Budget 2011.

In practice, most companies paying corporation tax pay some form of the small profits rate. For 2007-08, it was estimated that only 5% of companies paid the full rate. However, between them they accounted for approximately 74% of total profits subject to corporation tax\(^{28}\).

**Tax base**

As highlighted above, the tax base is an important determinant of how much tax is paid. In the UK, allowances and deductions (i.e. spending which can be scored against a tax liability) are available for certain activities, with the most generous available for investment and R&D expenditure.

Most capital investment is subject to allowances and can be claimed in the year accrued, set against future profits or carried back for a short period of time. Plant and machinery expenditure can be written down on a 18% declining basis\(^ {29}\) (40% in year 1 for small and medium-sized enterprises (SMEs))\(^ {30}\).

Expenditure on R&D is subject to more generous treatment. R&D by SMEs is subject to 175% tax relief while larger companies can claim relief of 130%. Therefore, an SME investing £100,000 in R&D would reduce their taxable income by up to £175,000.

The planned declines in the corporation tax rate in the UK will be offset somewhat by a ‘widening’ of the tax base. For example, in the June 2010 Budget the UK Government reduced the scope with which plant and machinery expenditure can be written down from 20% to 18%. This has been criticised\(^ {31}\).

**The Effective Tax Rate**

This linkage between the tax rate and the tax base means that when assessing the corporate tax structure within a country, most businesses examine the ‘effective tax rate’. This is the measure which most accurately captures the impact of taxation on the after-tax profitability of a firm.

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\(^{30}\) HMRC: [http://www.hmrc.gov.uk/capital_allowances/investmentschemes.htm](http://www.hmrc.gov.uk/capital_allowances/investmentschemes.htm)

\(^{31}\) See for example - [http://www.ft.com/cms/s/0/304f98f6-aa2d-11e0-94a6-00144feabdc0.html#axzz1RmDfuVl](http://www.ft.com/cms/s/0/304f98f6-aa2d-11e0-94a6-00144feabdc0.html#axzz1RmDfuVl)
There are two different effective tax rates, the effective *average* tax rate and the effective *marginal* tax rate. The effective average tax rate (EATR) expresses the ratio of tax paid to pre-tax profits, reflecting both the tax rate and the tax base (accounting for various allowances and deductions). By combining the tax rate and base, the EATR is therefore an important measure of the overall attractiveness of a country for doing business and is thought to be the most accurate measure of total tax paid.

Figure 2 shows the effective average corporation tax rates for selected OECD countries in 2009 estimated by the World Bank\(^{32}\). The UK had the 6\(^{th}\) highest average effective corporation tax rate in the OECD in 2009, with a rate four times as high as countries such as Belgium.

Therefore despite the UK Government’s planned reduction in the headline corporation tax rate, evidence suggests that the rate Scottish firms will face – both in terms of the headline rate and the average effective tax rate – is likely to still be high relative to many small European countries.

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\(^{32}\) For details on the analysis of effective average tax rate (EATR) and effective marginal tax rate (EMRT), see Hassett and Mathur (2011). http://www.taxcareerdigest.com/articles/tax-policy-outlook-aei-effective-corporate-tax-rate.pdf (Key assumptions as follows - real annual discount rate: 10%, financial return: 20%, expected annual inflation rate: 3.5%, economic depreciation rate: 12.25%).
Taxation of overseas operations

In light of globalisation and the ease in which profits can be moved from one location to another, an increasingly important aspect of the corporation tax system is the taxation of profits (and losses) made in different tax jurisdictions. The UK has a range of detailed rules, regulations and double taxation agreements to address the treatment of companies operating in more than one country.

Previously, UK companies operating in foreign countries through subsidiaries were, in general, subject to corporation tax when the profits were repatriated to UK parent companies, with credit given for foreign corporate tax paid by the subsidiary on the underlying profits. Following consultation and a clear risk of a number of UK based multinationals relocating to other countries, the UK Government introduced a system of exempting foreign dividends from corporation tax as part of the 2009 Finance Bill. This brought the UK into line with a number of EU countries which already provided exemptions from corporation tax for dividends received by resident firms from foreign subsidiaries.

Non-UK companies operating in the UK through a ‘permanent establishment’, such as a branch or agency, are charged on profits and capital gains made in the UK. They are therefore taxed in the same way as a typical UK based company. Most foreign companies do not pay tax on such profits in their ‘home’ country.

The UK Government plans to introduce new rules for Controlled Foreign Companies in the 2012 Finance Bill with the aim of allowing groups based in the UK to compete more effectively with those based overseas, while protecting against the artificial diversion of UK profits. The new rules intend to reduce the effective UK corporation tax rate on overseas profits to approximately 5.75% by 2014-15. Exact details are as yet unknown and it remains to be seen how effective the policies will be.

The historic trend of corporation tax in the UK and planned future changes

Corporation tax was introduced in the UK in 1965 and set at 40%. In 1973, it was increased to 52% alongside the introduction of a small companies’ rate of 42%. Since then it has been on a downward trend.

33 HM Treasury, Budget 2011, March 2011
Figure 3 highlights the time path of UK corporation tax rates since 1981, including the planned future reductions announced by the UK Government.

Throughout the 1980s and 1990s, both the main and small profits rates were lowered substantially before remaining broadly unchanged during the 2000s. The current UK Government has announced plans to reduce the headline rate of corporation tax by 1% in each of the next three years to reach 23% by 2014-15\textsuperscript{34}.

The historic decline in the corporation tax rate has been offset by a ‘widening’ of the tax base. For example, in the June 2010 Budget the UK Government reduced the scope with which plant and machinery expenditure can be written down from 20% to 18%. This reflects a worldwide trend to move from the principle of taxing economic rent to taxing the full return to equity. In particular, there has been a move to reduce allowances for capital expenditure\textsuperscript{35}.

Despite these significant reforms, the amount of revenue raised from UK corporation tax has remained relatively constant over the last three decades at approximately 3.5% of GDP and 9.5% of total tax revenues\textsuperscript{36}. During this time there has however, been a significant change in the share paid by individual sectors.

\textsuperscript{34} HM Treasury, Budget 2011, March 2011


\textsuperscript{36} OECD Tax Database
The recent recession has had a marked impact on corporation tax revenues in the UK, with total receipts from on-shore activity falling by over 25% between 2007-08 and 2009-10.\(^{37}\) However, despite the planned reduction in the headline corporation tax rate in the UK to 23% by 2014-15, the latest forecasts by the Office for Budget Responsibility predict that total on-shore receipts in 2013-14 will be higher than the pre-recession peak.\(^{38}\)

**Corporation Tax Revenue in Scotland**

There are no separately collated figures on the number of businesses within Scotland who pay corporation tax or the amount collected. Figures compiled by HMRC are not disaggregated below the UK level.

However, within the National Statistics “Government Expenditure & Revenue Scotland” (GERS) publication the Scottish Government provides an estimate of corporation tax revenue generated in Scotland. This is calculated by assigning a share of UK corporation tax receipts to Scotland based on the proportion of UK profits estimated to be generated in Scotland. In other words, and consistent with the fact that in practice corporate profits are taxed based upon location of activity, the corporation tax estimate is based on the proportion of economic activity estimated to have been undertaken in Scotland.

The latest statistics estimate that total receipts in Scotland from corporation tax, excluding those earned in the North Sea, were £2,597m in 2009-10.\(^{39}\)

As in all other countries, corporation tax receipts in Scotland were adversely affected by the recession – down 25.2% from the peak in 2007-08 (compared to a decline of 25.8% for the whole of the UK). This decline followed a sharp rise of 72% in corporation tax receipts in Scotland between 2003-04 and 2007-08. Such volatility would have to be managed, but could be achieved through appropriate cyclical revenue borrowing powers. This would allow money to be borrowed when revenues fell unexpectedly and then repaid when the economy recovered.

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\(^{37}\) Government Expenditure & Revenue Scotland 2009-10, Scottish Government

\(^{38}\) The Office for Budget Responsibility within the “Economic and Fiscal Outlook, March 2011” publication forecast that on-shore corporation tax receipts for the UK will be £41.6bn in 2013-14. This compares to the pre-recession peak of £40.4bn in 2007-08 reported in Government Expenditure and Revenue Scotland 2009-10.

\(^{39}\) Table 4.2, Government Expenditure & Revenue Scotland 2009-10, Scottish Government
When considering tax volatility, it is important to recognise that corporation tax generates a relatively small proportion of total tax revenue in Scotland. For example, corporation tax receipts in Scotland accounted for around 6.2% of total estimated tax revenue (excluding North Sea oil) generated in Scotland in 2009-10. This compares to income tax which in 2009-10 generated 24.7% of total non-North Sea revenues. Therefore, while there was a relatively much larger drop in corporation tax revenues between 2007-08 and 2009-10, the total amount of lower tax revenue between these years was £875m for corporation tax versus £861m for income tax – broadly the same.

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Source: Government Expenditure & Revenue Scotland 2009-10, June 2011

**EU State Aid**

Within the context of the Scotland Bill, it is important that plans to devolve any tax varying power satisfies EU rules and regulations which govern tax policy within Member States. In recent years a number of cases have been brought before the Courts concerning the ability of governments *within* Member States to set business tax rates which are different to those set for the Member State as a whole. Recent cases have concerned the corporation tax measures introduced in the Azores, Basque Country and Gibraltar.

In delivering judgement on the Azores case, the European Court of Justice (ECJ) ruled that to justify a different tax rate on businesses at an intra-Member State level the region/country must satisfy three conditions of autonomy; constitutional, procedural and financial. Institutional autonomy requires that the sub-central government has a political and administrative structure distinct from the centre. To comply with procedural autonomy, any decision by the sub-centre to change taxation must be taken without central interference. Finally to satisfy financial autonomy, the fiscal consequences flowing from a reduction in the tax rate must not be offset by aid or subsidies from the central government.

Whilst recognising that confirmation may be required from the European Commission and/or Courts, the Scottish Government is confident that, within the Scotland Bill, full devolution of corporation tax – including responsibility for the tax rate, base and financial implications in Scotland of changes to corporation tax policy – would be consistent with the Azores Case.
Indeed, based on their assessment of the conditions, HM Treasury concludes that devolving corporation tax to Northern Ireland would meet the Azores criteria of constitutional, procedural and fiscal autonomy. Given the broadly similar constitutional arrangements with the Scottish Parliament, it suggests that the devolving of corporation tax to the Scottish Parliament would also meet the Azores criteria.

“The Northern Ireland Executive has institutional autonomy as the Northern Ireland Assembly is elected by a separate process to that of the UK Government and has autonomy over a wide range of spending and policy issues.

The Northern Ireland Assembly would also have procedural autonomy, as the Northern Ireland Executive and Assembly would have the power to decide whether to raise or lower the rate of corporation tax. HMRC (the UK wide tax administration) could continue to collect receipts.

In order to meet the fiscal autonomy condition, the Northern Ireland Executive would need to bear the full fiscal consequences of changes in tax revenues resulting from a new Northern Ireland corporation tax rate. This means that Northern Ireland’s block grant would be adjusted to reflect the fiscal costs of a reduction in the rate of corporation tax. “

Rebalancing the Northern Ireland Economy, HM Treasury, March 2011

Summary

Corporation tax rates in the UK have followed a downward trend since the 1980s. Despite this, the revenue raised from corporation tax, as a percentage of GDP, has remained relatively constant. This is partly due to a broadening of the tax base which has increased the proportion of companies’ profits liable for tax but it also reflects the strong growth in corporate profits.

Within the context of large advanced economies, the UK Government has made it their intention to make the UK corporate tax structure one of the most competitive in the world. This has been the reason behind plans to reduce the headline corporate tax rate from 28% to 23% by 2014. This trend to a more competitive rate has been countered somewhat by a movement toward less generous reliefs, which has led to a widening of the profit base upon which the tax is levied. Moreover, within the context of countries of a comparable size to
Scotland, the rate levied by the UK (for Scotland) is typically higher, putting Scottish companies at a disadvantage. The following chapter discusses a range of possible options that could address this, and discusses the financial implications of various initiatives.
4 OPTIONS FOR REFORM

Increasing the size, competitive strength, productivity and ambition of Scotland’s business base is a major challenge – and opportunity – which will underpin the demand for high quality skills, infrastructure and services. The challenge is to create the best possible environment for competitive businesses, entrepreneurship and innovation to flourish. The Scottish Government believes that balanced alongside wider government policy objectives in skills, education, infrastructure investment and planning, a competitive corporation tax strategy can be a key lever in meeting this challenge.

This final chapter considers a select number of options for a devolved corporation tax system in Scotland which could act to support the specific challenges facing the Scottish economy. The chapter also discusses how the system could be administered. Comments on the various issues and questions raised in this chapter are welcome.

All this material and feedback will be used to help inform the submission by the Scottish Government to the UK Government for reforming the Scotland Bill and will aid the Scottish Government’s longer-term work in this area.

The devolving of responsibility for corporation tax would present a number of new policy opportunities for consideration. Four possible areas of reform are discussed below:

- Competitive headline tax rate;
- Increased support for small and medium sized companies;
- Greater tax incentives for particular activities; and
- Supporting regional economic development.

**Competitive headline tax rate**

The most obvious and visible reform would be to reduce the headline corporation tax rate in Scotland.

Such a cut would have a direct impact on all companies liable for the main corporation tax rate in Scotland.
4 Options for Reform

As highlighted in Chapter 2, a lower headline rate of corporation tax could encourage greater investment by Scottish and UK firms in both physical and human capital and in research and development (R&D) within Scotland.

At the same time, it could make the country more attractive as a location for multi-national investment. It could also act as an important signal to global companies and investors as to Scotland’s ambition to be a location for competitive business.

A lower headline rate of corporation tax for Scotland has been argued by a number of academics and commentators.

“The empirical literature on the effect of tax devolution on private sector incentives, supports the view that a cut in corporation tax can have a positive effect on economic growth and any short run shortfall in government revenues a result of such a tax cut can be offset by government borrowing or by the so-called headquarters effect. We believe this is an important and significant result and one which further supports our preferred system of fiscal devolution, namely fiscal autonomy”.

Hallwood and MacDonald 2008

One of the reasons behind Scotland’s relatively weaker economic performance over the past 30 years – and before the financial crisis - has been the relatively smaller corporate sector in Scotland relative to other parts of the UK and the EU. For example, the overall business base in Scotland accounts for only a 6.9% share of total UK turnover from VAT/PAYE registered enterprises in 2010, significantly below its UK population share of 8.4%. Furthermore, in 2010 Scotland had 672 private sector enterprises per 10,000 adults, around 25% lower than for the UK as a whole where there were 893 private enterprises per 10,000 adults.


42 http://stats.bis.gov.uk/ed/bpe/ See table 8
Traditionally, the level of business start-ups in Scotland have been lower than elsewhere in the UK. Between 2002 and 2009, business start-ups per 10,000 adults in Scotland, as proxied by new VAT registrations, were over 30% lower than the UK average. Moreover, Scotland has a relatively weak track record in producing medium to large sized companies from small companies. There are numerous examples of Scottish firms reaching a particular size and then being bought over by larger companies. There has also been evidence of a drift in headquarters from Scotland to south of the border.

Business investment by firms in Scotland has also traditionally been weaker than in other parts of the UK or in small EU countries, contributing to the smaller corporate sector in Scotland.

A lower headline corporation tax rate could – in theory – help address all of these issues. It could act as a greater incentive for Scots to start up their own business and provide Scottish firms with a competitive edge to help them grow into larger and more successful companies. Furthermore, firms would have greater profits to re-invest within their business which could act to strengthen Scotland’s corporate sector.

In addition, and as highlighted above, a lower headline rate of corporation tax could encourage foreign businesses to invest in Scotland. Thanks to the work of Scottish Development International (SDI), Scotland has in recent years attracted a disproportionately large share of UK foreign direct investment (FDI) over recent years and has been the third most successful location in the UK (behind London and the South East) at attracting FDI. However, there are many examples of small economies across the world – such as Singapore – who have been even more successful at attracting FDI. Furthermore, evidence suggests that Scotland attracts a disproportionately small share of FDI headquarters relative to the rest of the UK.

43 http://www.scotland.gov.uk/Topics/Statistics/Browse/Business/TrendData

44 “Corporate Headquarters in Scotland: their nature & contribution to Scotland’s economic development”, Ron Botham & David Clelland, 2005

45 The Ernst & Young UK Attractiveness Survey reported that Scotland has been the 3rd most successful location in the UK at attracting FDI since 2006. In terms of employment generated by FDI, Scotland has been the leading location within the UK over the period 1997 to 2009. http://www.ey.com/Publication/vwLUAssets/2010_UK_attractiveness_survey/$FILE/EY_2010_UK_attractiveness_survey.pdf

46 Between 2006 and 2010 Scotland attracted on average 3.3% of all FDI headquarter projects in the UK according to data from Ernst & Young European Investment Monitor.
The Scottish Government believes that a unified UK rate of corporate tax is neither desirable nor economically efficient. The current system means that a company based in Stornoway pays the same headline corporation tax rate as a company based in London. Given the competitive advantages of London relative to other parts of the UK (such as London’s position as one of the largest financial centres in the world, and its transport links with major cities worldwide etc) there is clear evidence that London (and indeed the South East of England) already has an in-built competitive advantage over not only Scotland but also other parts of the UK. Scotland needs the lever of corporate tax to consider a wider array of options than is currently the case to help address this imbalance.

The issue of ensuring a fair balance of competitiveness within the UK is even more important following the real possibility that corporation tax could be devolved to Northern Ireland. If corporation tax was devolved to Northern Ireland and not Scotland, this would limit the Scottish Government’s ability to maintain the competitiveness of the business environment in Scotland and put Scotland at a significant disadvantage.

What would be an appropriate rate of corporation tax for Scotland (balancing competitiveness on the one hand with maintaining a fair and transparent tax regime on the other)?

Increased tax incentives for small and medium sized companies

In addition to, or as an alternative to, a general reduction in the main rate, reforms could be targeted at small and medium sized companies. In this regard, one option would be to explore opportunities to lower the small profits rate below its current level. As highlighted above, it is estimated that only 5% of UK companies actually pay the full corporation tax rate\(^47\). Therefore, the small profits rate is of significant importance for most companies operating in Scotland.

Evidence from a survey undertaken by PriceWaterhouseCoopers (PWC) and the World Bank into the business taxation for small and medium sized domestic businesses found that while the total tax bill for a hypothetical medium sized domestic company in the UK was

\(^47\) Devereux, M, Loretz, S, 2011, “Corporation Tax in the United Kingdom”, Oxford University Centre for Business Taxation
lower than the OECD average, it was in fact higher than many small European countries including Ireland and Denmark\textsuperscript{48}.

As discussed in Chapter 3, the small profits corporation tax rate decreased during the 1980s and 1990s but has remained broadly stable over the past 10 years. The Budget 2011 outlined the UK Government’s intention to keep the small profits corporation tax rate at 20\% for the coming years which will narrow the difference between the headline rate and the small profits corporation tax rate to only 3\% points. This is significantly below the long-term average difference between the two corporation tax rates. The headline rate has averaged around 9\% points above the small profits corporation tax rate over the past 3 decades. Consequently, small companies are currently in line for a relative increase in their corporation tax rate compared to the headline corporation tax rate.

Small and medium sized companies are believed to be the lifeblood of small economies. They are often the engine of economic growth over the medium to long-term and the type of company that employs the most people. Such firms employ over one million workers in Scotland\textsuperscript{49} and create valuable spill-over effects such as sourcing their inputs from local suppliers.

The Scottish economy is predominantly made up of small companies, with the latest statistics reporting that companies employing up to 49 employees accounts for 93.3\% of all companies based in Scotland\textsuperscript{50}. Therefore setting the appropriate corporation tax rate to help these companies grow will be an important part of Scotland’s economic strategy.

Furthermore, as decisions to expand investment or R&D are often more volatile for small companies (as small changes in profitability can have significant effects on affordability), minimising tax burdens can have a significant influence on the level of such activities. More generally due to economies of scale, small and medium sized firms tend to face higher costs than larger companies. A reduction in the corporation tax rate targeted at this group would increase their profitability, potentially allowing them to grow and expand into new markets.


\textsuperscript{50} “Scottish Corporate Statistics 2010”, Scottish Government - \url{http://www.scotland.gov.uk/Topics/Statistics/Browse/Business/Corporate/scsspdf10}
This could be especially important for Scotland where there is clear evidence that many Scottish firms reach a glass ceiling where they either are not able to expand beyond a certain point, or are simply bought over by larger UK or European competitors. Giving such companies a competitive edge could boost their chances of success.

There are challenges with reforming the small companies rate – not least ensuring that any reliefs are targeted appropriately so that the right companies benefit (which may not always be perfectly correlated with size). Ideally a tax system should avoid creating its own distortions and be as transparent, straightforward as possible without encouraging artificial re-classification of firms from one legal definition to another. This would be an important consideration for any reform of policy in Scotland.

**Should greater support be given for small and medium sized companies from the corporation tax regime? What form should this increased support take?**

**Greater tax incentives for particular activities**

Aside from targeting reform toward particular types of companies, measures could be established to target types of corporate activity. Possible options include greater support for capital investment and research and development (R&D).

Such activities are clearly driven by a wide range of factors and taxation is often only a small element in company decisions. For example, private sector R&D is influenced by the skills, education and quality of a country’s workforce and such effects are likely to be the overriding determinant of the level of investment made. However at the margin, studies have shown that changes to the tax structure may have important effects. Therefore, in this context the key opportunity for Scotland would be all about aligning existing powers with any new opportunities arising from control of the corporation tax lever.

**Capital Investment**

As highlighted in Chapter 3, the current UK corporation tax system provides a range of allowances for capital investment. These work in a similar, although not identical way to...
reductions in the tax rate. By offering credits, this in effect lowers the amount of tax that a company pays.

Research exploring why UK productivity lags behind other advanced economies identified that different levels of investment in physical capital accounted for the largest proportion of the gap\(^5\). For example, it accounted for 50% of the gap with the US and 70% of the gap with France in 2004. Furthermore, evidence also suggests that a large part of the productivity gap between the UK and the US is due to differences in how information and communication technology (ICT) investment has been utilised, as opposed to differences in the actual levels of investment in ICT\(^\)\(^3\).

While UK productivity has lagged behind many major advanced economies, productivity in Scotland has historically been around 5% lower than the UK\(^4\). Analysis studying the reasons why Scotland’s long-term growth rate has lagged behind that of the UK suggests that the key reason for this has been a lower rate of productivity growth\(^5\).

One of the reasons cited for lower productivity in Scotland is the weaker presence of more capital intensive sectors which act to constrain overall productivity of the Scottish economy\(^6\). Therefore greater investment by firms in Scotland will strengthen the capital stock in the Scottish economy which will enhance Scotland’s productivity performance.

Furthermore, tax breaks for certain types of investment could help facilitate the transition towards a low carbon economy. For example, investments by companies in green technology could attract increased support through greater capital allowances for investment in environmentally friendly construction, implementation of new technologies and so forth. An

\(^5\) “Cross-country Productivity Performance at Sector Level: the UK compared to UK, France and Germany”, Department for Business Enterprise and Regulatory Reform, Occasional Paper, 2008. See Table 3.2


\(^4\) See Table 4b of the Scottish Government’s Economic Pocket Databank. http://www.scotland.gov.uk/Topics/Economy/Factfile/EPDFeb11

Note that Scotland’s productivity performance in 2009 was the same as the UK. This reflected the sharper deterioration of labour market conditions in Scotland in 2009 relative to the whole of the UK which boosted Scotland’s productivity performance. Further discussion on this can be found in pages 33 to 34 of the State of the Economy July 2011 publication. http://www.scotland.gov.uk/Topics/Economy/state-economy/latestSoE

\(^5\) See Chapter on Longer-Term Trends of the Scottish Economy in the latest State of the Economy publication: http://www.scotland.gov.uk/Topics/Economy/state-economy

\(^6\) http://www.scotland.gov.uk/Publications/2009/12/01144044/12
extension of such policies may encourage investment in these areas and could complement other fiscal instruments such as green taxes and emissions trading schemes.

The relative importance of taxation in determining levels of investment can be established by analysing the attitudes and opinions of companies. Ernst and Young conducted their annual survey of over 800 multinational companies to reveal the factors that influence their investment decisions. Alongside factors such as transport infrastructure and labour costs, corporation tax is deemed to be of considerable importance. Nearly half of companies - around 46% - ranked corporation tax as ‘very important’ in investment decisions57.

While the level of investment undertaken by a company will be determined by a wide variety of factors, governments have a vital role to play (e.g. infrastructure investment and skills) and within the broader context of a well targeted economic strategy, corporation tax can play an important role. It therefore follows that one avenue to help encourage greater capital investment, by Scottish companies but also by UK and foreign firms, in operations within Scotland would be to use the capital allowances regime more effectively.

Research and Development

Greater support could also be offered for R&D expenditures. Whilst universities in Scotland have traditionally undertaken significant levels of R&D, business R&D investment has generally been low in comparison to other countries. In 2009, the value of business enterprise research and development (BERD) in Scotland was £644 million, 4% of the UK total. This is less than half of Scotland’s share of UK population or GDP58,59. Scotland lags behind many other regions of the UK such as the South East and London but also the Midlands and the North West.

Further afield, in 2009 average expenditure in the EU on business R&D as a percentage of GDP was 1.17% - over double the rate in Scotland (0.56%). In fact, leading countries such as Finland (2.94%) have R&D expenditure levels around five times higher60.

59 Scotland’s share of the UK population in 2008-09 was 8.4 per cent. Scotland’s share of UK less extra-regio GVA was 8.2 per cent (General Registers for Scotland and ONS Regional Accounts).
Scotland’s industrial composition contributes to its low levels of R&D, but notwithstanding this fact, levels of R&D in Scotland are underperforming. By offering more generous treatment of R&D activities, this could encourage R&D intensive companies to re-locate and/or expand their operations in Scotland. This has the potential to create agglomeration and spill-over effects such as building upon existing and growing alliances and partnerships between private sector companies and higher education and public sector institutions. The benefits of such effects are clearly visible in sectors such as Life Sciences.

Once again, a competitive and targeted corporation tax strategy could provide a useful policy lever for the Scottish Government to improve Scotland’s record in R&D. This would be especially powerful if used alongside wider support around continued investment in universities and skills and training.

Support for Other Activities

The corporation tax system can be effectively used to support sectors facing specific challenges. For example, in the past the UK Government has specifically provided support to the UK film industry, through eligibility for Film Tax Relief (FTR), which can increase the amount of expenditure that is deductible for tax purposes.

Indeed the previous UK Government also considered a similar policy for introducing specific tax relief for activities within the computer games industry given the support offered by other countries. However this policy was not included in either the 2010 and 2011 UK Government Budget proposals. This places computer game developers in the UK at a disadvantage because they are having to compete against countries that offer significant tax advantages. This could have consequences for developers in Scotland, such as the games cluster in Dundee. In Quebec, for example, the government pays a third of the salary costs of development staff and offers tax holidays for foreign investors. The incentives have prompted some publishers to set up studios in Montreal, often downscaling British investment in the process. Australia, South Korea and the US offer similar positive incentives.

61 The films that qualify for the relief are British films that are intended to be shown commercially in cinemas and where at least 25 percent of the total production costs relate to activities in the UK. Film production companies can opt out of these rules if they wish, however their films will not then be eligible for the additional relief. A film is British for these purposes if it meets a 'cultural test' or qualifies by virtue of an internationally agreed co-production treaty.
Summary

Control of corporation tax, and the ability to vary not just the headline rate but the tax base, can be a useful tool of economic policy, particularly when aligning incentives alongside existing non-tax policy initiatives.

It should be noted that the use of corporation tax in this manner is likely to have an impact at the margin. Capital investment and R&D are generally determined by a wide range of factors and not just taxation. However, a range of options would be available to Scotland if corporation tax was devolved and these could be integrated with wider fiscal and economic policies to create a coherent and well targeted strategy for economic development.

Of course, there are challenges with such an approach which would have to be managed – for example, a need to ensure that any changes lead to real additionality (i.e. incentives simply did not displace investment that would otherwise have already occurred) and do not lead to wider distortions elsewhere in business activity, the tax system and the wider economy.

However, to the extent that a future Scottish Government wished to encourage investment in particular activities, greater incentives could be offered through the corporation tax system than currently exist and would provide a powerful new policy lever.

Should particular areas of business activity receive greater support from the corporation tax system and what form should such support take?

Supporting Regional Economic Development

A corporation tax system can also be used to support economic development within local areas. The Enterprise Zone policy, first introduced by the UK Government in 1980, included capital allowance tax breaks which enabled the investment undertaken by companies within the zone to be offset against the tax on any UK earnings for the year in question.

Within the 2011 Budget, the UK Government announced plans to revive Enterprise Zones in England with more generous capital allowances within the corporation tax system rather than business rates relief potentially available in zones where there is a strong focus on manufacturing. There is the opportunity for introducing Enterprise Zones in Scotland which
the Scottish Government is currently considering but it is not yet clear exactly what the extent of any enhanced capital allowances will be. With responsibility for such policy in Scotland a system could be tailored to Scottish needs.

While there is the need to ensure that such capital allowances generate additional activity – as previous evaluations questioned whether Enterprise Zones did in fact generate additional activity\(^{62}\) – capital allowances for corporation tax can potentially still be an important lever in supporting different sectors and parts of the Scottish economy.

**Should particular parts of Scotland, such as Enterprise Zones, receive capital allowances in order to support economic development?**

**Financial Implications**

Setting public policy – including decisions regarding taxation – is always a balancing act and corporation tax would be no different. However, critically these would be decisions that Scotland could take on its own.

The Scottish Government recognises the need to balance improvements to competitiveness alongside protecting vital public services in Scotland – particularly at a time when the Budget is being cut by Westminster. That is why the Scottish Government would take a responsible approach to corporation tax – like with our tax varying powers in Non-Domestic Rates and (in partnership with local authorities) Council Tax – to ensure that it supports sustainable growth while delivering world class public services. Any decision over changes to corporation tax in Scotland could be made as part of our overall strategy for the economy and any changes to the amount of revenue raised would be managed both carefully and responsibility.

The Scottish Government is seeking responsibility of corporation tax, with an equivalent reduction from the block grant. Therefore the net effect to the UK Exchequer would be zero – i.e. using the Government Expenditure and Revenue Scotland figures the UK Exchequer would no longer receive the estimated £2.6bn corporation tax revenues raised in Scotland but there would be an equivalent reduction in the block grant for Scotland. From this, future changes to the Scottish corporation tax rate – and the subsequent impact on revenue – would be a matter for the Scottish Parliament to decide.

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\(^{62}\) “Do Enterprise Zones Work?”, The Work Foundation, Feb 2011
At first glance, a more competitive corporation tax policy could be seen to lead to an immediate reduction in revenues collected in Scotland. If such a position was adopted, then decisions regarding budgetary priorities would be needed. However, experience has shown that, particularly over the medium to long-term, a more competitive corporation tax strategy may not necessarily imply lower revenues. These issues are discussed in greater detail below.

**Competitive Headline Corporation Tax Rate**

HMRC have estimated that a cut in the corporation tax rate in Scotland to 12.5% (both the headline and the small profits rate) could result in a £2.6bn reduction in corporation tax receipts in Scotland. To put this figure into context, as highlighted in Chapter 3, the National Statistics publication GERS estimates that, for the most recent year available, total corporation tax revenues in Scotland were just under £2.6bn. The Scottish Government, along with external commentators, has major concerns over the methodology used by HMRC to produce this estimate. For example, not only does it consider the potential cost to the UK Exchequer rather than the financial implications for the Scottish Government, but also the analysis completely ignores the positive effects on the economy from a reduction in the corporation tax rate. Box 2 summarises some of the limitations of the analysis produced by HMRC.

**Box 2: Limitations of HMRC’s Estimates of Reducing Corporation Tax in Scotland**

Following a statement by the UK Exchequer Secretary, on the 21st June 2011 that reducing the corporation tax rate to 12.5% in Scotland would lead to a funding gap in the Scottish Government’s budget of more than £2.6bn, details were published 3 weeks later by HMRC on how this figure was reached. The Scottish Government has a number of concerns with the analysis.

Firstly, rather than estimating the impact on the Scottish Government’s budget from the full

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63 www.scotlandoffice.gov.uk/scotlandoffice/15622.html

64 See for example, see the paper produced by Hervey Gibson, Congent Strategies, which was published on The Scotsman website: http://www2.jpscotland.co.uk/scotsman/editorial/hmrc.pdf

devolution of corporation tax to the Scottish Parliament, HMRC have modelled the impact on
the UK Government’s public finances of the UK Government setting a 12.5% corporation tax
rate in Scotland. This is not the Scottish Government’s proposal – which has yet to be set
out to the UK Government. As highlighted above, the Scottish Government will seek
responsibility for the devolution of corporation tax to Scotland with a corresponding reduction
in the block grant. Therefore, the net effect on the UK Budget would be zero. It would then
be up to the Scottish Government and Scottish Parliament to consider the appropriate
corporation tax system taking into account the impact this will have on tax revenues north of
the border. Indeed, this is what is proposed to happen with income tax, and the other taxes,
already in the Scotland Bill.

Secondly, the estimates explicitly ignore the positive effects on the economy – and ultimately
tax revenues - from a reduction in the corporation tax rate (see Chapter 2). Indeed that is the
entire motivation for setting a more competitive corporation tax rate. HMRC have not
modelled these effects and therefore have excluded the potential impact this would have on
tax revenues in Scotland (corporation tax, income tax, national insurance etc).

Thirdly, the approach taken has ‘charged’ the Scottish Government around £1bn per annum
for an estimated loss of revenue to the rest of the UK as a result of companies switching
their activities and profits to Scotland\(^66\). In fact, the HMRC analysis shows that in terms of a
Scottish Exchequer, much of the impact is likely to be positive. Based on HMRC’s analysis,
the potential cost to a devolved or independent Scottish Exchequer could be closer to
£300m per annum if all these elements are added back in to Scottish revenues. In fact in
year 1, the impact could be positive.

But aside from this, the Scottish Government is committed to ensuring that only real
economic activity is subject to tax. The HMRC analysis does not take into account actions
which could be taken to minimise the extent of profit shifting which may potentially take
place. In practice, significant institutional and accounting rules already exist both within the
UK and internationally to ensure that this does not happen. Rather than charging Scotland
for the loss in revenues, effective operation of existing rules and regulations by HMRC would
avoid any such artificial transfers.

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\(^{66}\) As an aside, it is not possible to comment on the accuracy of the figures provided by HMRC or to verify many of the
assumptions regarding the figures provided. The information has not been shared with the Scottish Government either prior or
since publication.
The forthcoming reduction in the corporation tax rate for the UK is estimated by the Office for Budget Responsibility\textsuperscript{67} to reduce the tax revenue received by the UK Exchequer by between £800m to £1,000m for every 1\% point reduction. By calculating this reduction as a percentage of total tax revenue in the UK and then applying it to total tax revenue in Scotland, it is estimated that a 1\% point reduction in corporate tax would result in a reduction in total tax revenue in Scotland of between £67m to £83m.

However, this methodology is simply a static (or ‘ready-reckoner’) calculation of the potential effects of such a policy. It does not take account of the dynamic effects arising from faster (or slower) economic growth.

Cutting the headline rate of corporation tax has two effects on total revenues. Firstly, setting a lower rate reduces the amount of tax collected on existing profits. Secondly, by stimulating economic activity, the tax base upon which the lower rate is levied can expand, thus acting to increase revenues. This effect can be even more significant once consideration is given to the potential increase in other revenues that may also occur.

For example, the modelling work\textsuperscript{68} undertaken by the Economic Advisory Group of the Northern Ireland Executive estimated that although corporation tax receipts generated from moving to a rate of 12.5\% in 2014 would be lower as a result each year over the period to 2030, the overall tax yield (including sources such as income tax and national insurance) would break-even by 2021\textsuperscript{69}. In summary, this modelling highlights the potential for a short-term fiscal cost from lowering corporation tax (relative to what would have happened if the tax was not cut) but the longer-term fiscal gain from increased tax revenues associated with stronger economic growth.

The OECD reports that in both Ireland and the UK revenue from taxes on corporate income were almost 4\% of GDP in 2006 (before the volatility in revenues caused by the financial crisis), despite the corporation tax rate in Ireland being 12.5\%, less than half the UK rate\textsuperscript{70}.

\textsuperscript{67} “Economic and Fiscal Outlook”, Office for Budget Responsibility, March 2011.


\textsuperscript{69} The report estimates that net corporation tax receipts are negative (compared to the base case where the corporation tax rate remains unchanged) up until 2035. However, when all taxes are included the break-even point is in 2021 and if only income tax, national insurance and business rates are included then the break-even point is in 2023.

\textsuperscript{70} OECD (2010) - Revenue Statistics 1965-2009 - Table 12
In short, while the amount of tax collected for each unit of profit in Ireland was lower than in the UK, the actual level of profit being generated was significantly higher.

Indeed a reduction in the headline tax rate would not necessarily reduce tax receipts from corporation tax. For example, despite the planned reduction in the headline corporation tax rate in the UK to 23% by 2014-15, the latest forecasts by the Office for Budget Responsibility predict that total on-shore receipts in 2013-14 will be higher than the pre-recession peak.\footnote{Economic and Fiscal Outlook, March 2011, Office for Budget Responsibility.}

In summary, under the right circumstances a more competitive headline corporation tax rate has the potential to boost economic growth in Scotland. Such action should be considered alongside potential implications for the Scottish Budget, at least in the short term, and wider considerations of fairness and efficiency of the overall tax system.

**Other Targeted Measures**

Reducing the small profits rate would also have implications for the Scottish Government Budget. As discussed above, depending upon the possible impact on economic activity this is likely to reduce revenues in the short run but may boost revenues in the medium to long term. Based on figures published by HM Treasury, reducing the small profits rate by 1 percentage point in 2010/11 would reduce tax revenue by around £450 million across the UK.\footnote{HM Treasury (2008) Pre Budget Report \url{http://webarchive.nationalarchives.gov.uk/20100402134147/http://hm-treasury.gov.uk/d/pbr08_taxreadyreckoner_287.pdf}} By calculating this reduction as a percentage of total tax revenue in the UK and then applying it to total tax revenue in Scotland, it is estimated that a 1% point reduction in small profits corporation tax would result in a reduction in total tax revenue in Scotland of around £38m.

A range of capital allowances can be used to incentivise capital investment. For example, in the 2011 Budget the UK Government announced proposals to increase the time limit of the disposal period of short-life assets from 4 years to 8 years after the end of the chargeable period in which the asset was bought. This move is estimated to cost the UK Government £170m per annum\footnote{HM Treasury Budget 2011 Policy Costings \url{http://www.hm-treasury.gov.uk/d/2011budget_policycostings.pdf}} and by calculating this reduction as a percentage of total tax revenue in the UK and then applying it to total tax revenue in Scotland, it is estimated that it would reduce Scottish tax receipts by around £14m.
Furthermore, changes to tax credits can be used to stimulate R&D activity by firms. The UK Government has announced plans to increase the amount of R&D expenditure small and medium enterprises' can deduct against profits from 175% to 225% by 2012-13. This move is estimated to cost the UK Exchequer around £100m per annum in lost revenues. By calculating the cost of increasing the R&D tax credit for SMEs as a percentage of total tax revenue in the UK and then applying it to total tax revenue in Scotland, it is estimated that it would reduce Scottish tax receipts by around £8m.

**Administering a separate corporation tax system in Scotland**

HMRC does not breakdown administration costs on a regional basis but estimates that corporation tax costs £340 million to administer across the UK in 2008-09. Therefore Scotland's share (based on population) would equate to around £28m.74

Setting a different corporation tax in Scotland from the rest of the UK would require the appropriate institutions and administrative procedures to separately assess, monitor and collect corporation tax revenues in Scotland. The recent consultation paper HM Treasury on “Rebalancing of the Northern Ireland Economy” highlighted that extra costs associated with varying the corporation tax rate in Northern Ireland would arise under three main headings:

- “Start-up costs: such as changes to HMRC IT and operational systems and online filing services to enable a new regime to commence;
- On-going costs: arising from maintaining new systems and procedures (both IT and operational) to administer a new regime; and
- Additional anti-avoidance and compliance resource: ensuring that only “genuine” economic activity within Northern Ireland benefited from any new regime.75"

However, HM Treasury has not yet provided an estimate of the administration costs associated with devolving corporation tax in Northern Ireland.

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74 Separate research by Shaw, Slemrod and Whiting (“Administration and Compliance”, Paper prepared for The Mirrlees Review: Reforming the Tax System for the 21st Century, 2008) suggests that it costs HMRC around 0.8% of revenues to administer corporation tax collection. On this basis, the administration costs for collecting corporation tax receipts in Scotland would be around £21m (i.e. 0.8% of £2,597m of corporation tax revenue estimated in Government Expenditure and Revenue Scotland).

75 [http://www.hm-treasury.gov.uk/consult_rebalancing_ni_economy.htm](http://www.hm-treasury.gov.uk/consult_rebalancing_ni_economy.htm)
A decision would need to be taken over how future corporation tax receipts in Scotland would be collected if the powers were devolved to the Scottish Parliament. There are potential options for this, the first would involve contracting HMRC to administer and enforce a Scottish corporation tax regime, the other would be to establish a Scottish tax collection agency reflecting the ambition for greater fiscal autonomy.

The first option would see HMRC collect corporation tax receipts in Scotland as the Scotland Bill makes provision for HMRC to operate the collection of devolved taxes on behalf of the Scottish Government. The indicative administration costs provided in the Regulatory Impact Assessment for the Scotland Bill\(^76\) estimate that the income tax proposals will be £45 million of one-off costs, plus ongoing costs of £4.2 million per year thereafter. The Scottish Government’s view is that if such costs have to be paid, then it is best to focus any reform on real economic levers where the costs could be recouped through faster economic growth, rather than a mechanism which is focussed on changing the budgetary regime.

As part of the Scottish Government’s consideration of this option we would need assurance that the tax collection system would provide value for money, and the flexibility to change not only the rate of corporation tax but also the exemptions and thresholds. A further consideration would be the efficiency and effectiveness of HMRC to collect taxes. Research undertaken by the Work Bank\(^77\) showed that the average time for businesses in the UK to complete tax returns was 110 hours, higher than Luxembourg (59), Switzerland (63), Norway (87) and Ireland (76). However this option would, at least in the short-run, provide a relatively low risk tax collection mechanism.

Alternatively, a new organisation could be set up to administer the collection of corporation tax receipts in Scotland. With this option there would of course be the saving of the estimated £28 million that Scottish taxpayers already pay the UK Government for administering UK corporation tax. One of the primary aims of this would be to make the Scottish collection system less administratively burdensome than the current UK system.


There are many examples of small countries who are able to administer their tax systems effectively. For example, there is one tax administrator for every 903 people in Finland compared to one tax administrator for every 695 people in the UK\textsuperscript{78}.

The Scottish Government would fully consider all the relevant issues, options and costs before deciding on which of the two options outlined offers greatest value for money to Scottish taxpayers. We will look to refine cost estimates and will involve experts in helping us to robustly examine the options and costs. Alongside this we will look for any tax collection system to fulfil a number of specific criteria. These include:

- Minimising the burdens on taxpayers (personal and corporate);
- Simplifying the tax systems, in consultation with taxpayers, over the medium term; and
- Ensuring that the overall burden on businesses does not place them at a disadvantage to our key competitors.

In addition to the costs faced by the Scottish Government, businesses may also face additional costs as they could be required to report separate returns to Scotland and the rest of the UK. This would increase the administrative burden faced by firms operating in Scotland although this could be compensated for by setting a more competitive rate and working with businesses to establish a simplified and more transparent system. HM Treasury estimate that the additional administrative burden on businesses in Northern Ireland from a different corporation tax system would be around £50m a year.

However, if corporation tax is devolved in Northern Ireland, many of the reforms required to the UK tax system to assist the devolution of corporation tax will be worked through and this would be an advantage to Scotland. Moreover, the principles applied in the Scotland Bill for transferring power over income tax and stamp duty land tax could be extended to corporation tax. Overall, the current reform provides an ideal opportunity to explore options for Scotland.

Evidence provided to the House of Commons Northern Ireland Affairs Committee indicate that the burden on businesses may not necessarily be significant:

\textsuperscript{78} Data on the number of tax administrators in Finland and the UK is taken from OECD - Tax Administration in OECD Countries and Selected Non-OECD Countries 2009 while the population figures are taken from the World Bank.
“I suspect that would have to be seen as a cost to the company and of course it would be negative; only a tiny one in the great scheme of things, but the extra bureaucracy would be a negative.” John Whiting, Chartered Institute of Taxation and the Office of Tax Simplification.

“No, honestly, no one has raised that one [the issue of administrative or financial burden due to a lower corporation tax rate in Northern Ireland]." Secretary of State for Northern Ireland.


The Scottish Government does not believe that the administration changes required to devolve corporation tax to Scotland are insurmountable or would be sufficient to counteract the wider benefits from being able to set a corporation tax policy that was best suited to the challenges and opportunities in Scotland’s economy. Particularly if these changes were handled in a responsible manner.

As the world economy has become more interlinked, companies are now used to operating in multiple tax jurisdictions and have systems set up to handle the administration implications.

“We as a company in Clyde Blowers operate in 27 different countries around the globe and in the US we operate in a number of different states. They all have different tax systems. We don’t find it a problem.”

Jim McColl, Chairman of Clyde Blowers, The Times 4th June 2010

The experience of other countries offers some important insights. Corporation tax is devolved in a number of countries and they all continue to perform effectively and competitively.

There are also examples of other countries that, depending upon the fiscal framework put forward, systems can be developed to minimise costs of administrating different corporation tax regimes across jurisdictions. For example, corporation tax revenues in the USA are allocated to state governments using various measures of economic activity, such as sales revenues.
A similar system could be introduced in Scotland and extended to include additional measures such as employment levels and adjustments for the location of high valued activities such as R&D and headquarter operations. The establishment of a separate tax system in the Basque Country relative to the rest of Spain offers an alternative option for reform as outlined in Box 3.

**Box 3: Corporation tax in the Basque Country**

The Basque Country enjoys considerable fiscal autonomy, with wide ranging responsibilities over the collection of tax receipts and government expenditure, while remaining part of Spain. GDP per capita in the Basque Country is approximately 30% higher than the Spanish average.

The fiscal relationship between Spain and the Basque Country is governed by the Concierto Económico, or Economic Agreement consistent with the Statute of Autonomy (1977). 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.

Under this agreement the Basque Country Government now has a headline corporation tax rate of 28%, compared to the Spanish rate of 30%. The tax incentives and reliefs available in the Basque Country have also traditionally differed from those provided in the rest of Spain with more generous allowances available for R&D investment, staff training and environmental programmes. However the Economic Agreement also 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. Constraints therefore remain on the policy leavers available to the Basque Government.

There are many examples where at least part of corporation tax is devolved below the national government level. For example, in Canada corporate income tax is levied by both the federal and provincial governments and therefore the combined rate varies depending upon the province or territory where a corporation conducts its activity. In 2011 the combined federal and provincial rates for manufacturing companies’ tax rates varies from 19% to 32.5%. Similarly, in Germany companies are subject to a corporate income tax levied by

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79 OECD Reviews of Regional Innovation, Basque Country, Spain, 2011 [http://dx.doi.org/10.1787/9789264097377-en](http://dx.doi.org/10.1787/9789264097377-en)

the federal government and a local trade tax imposed by local municipalities where the company is based. The local trade tax is currently set at between 7% and 17%.

What approach to submitting tax returns for businesses would be the most efficient under a system where corporation tax was devolved to the Scottish Parliament?

Summary

With greater fiscal autonomy and the ability to set corporation tax in Scotland, a number of policy options would be available to the Scottish Government. The most significant and visible reform would be to reduce the statutory corporation tax rate to a level comparable with other small European countries. Other possible reforms include providing more generous allowances for small companies, greater support for companies engaging in R&D or investing in green technology, and support for economic development in particular areas of Scotland.

5 CONCLUSIONS

This discussion paper has examined the links between corporation tax and economic growth and identified issues relevant to the establishment of a competitive corporation tax regime in Scotland.

The Scottish Government is committed to making Scotland one of the best places to do business in Europe. To this end, we have already implemented a range of policy initiatives within the current fiscal framework, such as introducing the Small Business Bonus Scheme. However, with control over corporation tax we could go further and commit to introducing a more competitive corporation tax regime in Scotland.

A number of preliminary conclusions can be drawn from this discussion paper.

Firstly, the Scottish Government is persuaded by the evidence that there can be economic benefits from lowering corporation tax burdens on businesses. A competitive tax structure can be a positive factor in boosting private sector investment, capital formation, R&D and ultimately economic growth. It can also encourage greater foreign direct investment and make regions and countries more attractive for the location of headquarters and other corporate activities.

Secondly, there is scope to make the corporation tax regime in Scotland more competitive. The current system is relatively competitive in comparison to large countries such as the G7. However, when contrasted with many comparable small EU countries the tax regime in Scotland – even with the planned reduction of the UK corporate tax rate to 23% by 2014-15 – imposes a larger burden on business. And within the context of the UK, devolution of corporation tax would provide a useful lever to counterbalance the in-built distortion and competitive advantage provided to London and the South East.

Thirdly, corporation tax can be a key element of a country’s overall economic strategy as it can promote economic growth and job creation by enhancing international competitiveness and encouraging innovation and investment. Setting a competitive corporation tax system can, alongside polices to improve the skills of the labour force, the quality of infrastructure and the overall tax burden, form a crucial role in delivering the Scottish Government’s economic agenda.
Finally, there are a number of options for reform. The headline tax rate is only one element within the corporation tax system which could be reformed. Other options include adjusting the rate for small and medium enterprises, providing greater allowances for particular activities and supporting economic development in specific areas of Scotland. All these options would require financing, at least in the short term.

Feedback on the proposals raised in this report are welcome. Initial comments by the 5th September 2011 will help inform the Scottish Government’s proposal for devolving corporation tax to be submitted to the UK Government this Autumn. Comments thereafter are also welcome as they will aid the Scottish Government’s longer-term work in this area. Feedback can be sent to the following email address –

Economist-WebGroup@scotland.gsi.gov.uk

Alternatively, views can be sent by post to the following address:

Corporation Tax Discussion Paper
Office of the Chief Economic Adviser
Scottish Government
4.WR,
St Andrew’s House
Regent Road
Edinburgh
EH1 3DG