Written evidence submitted by the Institute for Fiscal Studies (TAX0041)

The Call for Evidence posed a large number of broad questions. It is impossible to answer so many complex questions fully in a short document. What follows is therefore a very brief response, with references to other published works that cover issues in more detail. Many of the questions are addressed in the Mirrlees Review (Mirrlees et al., 2011), which provides a comprehensive discussion of the design of the UK tax system and how it could be improved. We also refer the committee to a response that we submitted to the House of Lords Committee on Economic Affairs (Adam et al., 2013b), which addresses similar issues. We would be happy to provide further written or oral evidence to the committee.

The questions in the Call for Evidence focus primarily on corporation tax, and our responses follow suit. We emphasise, however, that in an overall evaluation of UK tax policy and the tax base, this focus may be misplaced: corporation tax provides only 6% of government revenue and there are problems elsewhere in the tax system that are equally deserving of attention.

Executive Summary

1. While there have been some welcome innovations since 2010 in the way that tax policy is made, long-standing problems such as hyperactivity, short-termism and inadequate scrutiny remain.
2. In the run up to the recession the corporation tax base (profits taxable in the UK) was growing, not shrinking; taxable profits declined during the recession and remain depressed. It is not possible to measure accurately how much bigger the tax base would have been in the absence of multinational profit-shifting, or how much profit-shifting might reduce the tax base in future.
3. Policy measures in recent years have tended to broaden the tax base, while at the same time substantially cutting the tax rate and therefore the revenue raised from a given tax base.
4. There are problems associated with attempting to tax corporate profits on a source basis. There is often no conceptually correct way to allocate profits across countries; firms have an incentive to move real activities in response to tax; and governments have an incentive to compete with each other to attract activities.
5. Existing tax rules could be modified or enforced more strictly in order to limit profit-shifting opportunities. In the short run, there are benefits to pursuing a set of policies, largely coming out of the BEPS project, to patch up the current tax rules. However, addressing the problems fully would require more fundamental reform that moved to a different principle for determining the UK tax base. Such a move is worthy of consideration. Below we highlight the properties of the two most commonly discussed alternatives, formulary apportionment and a destination-based tax.
6. When considering radical moves to alternative corporation tax systems, mitigating cross-border avoidance should not be the only, or even the main, consideration. There should be examination of a much broader set of advantages and disadvantages of alternative systems. There is no good justification for a turnover tax.

The making of tax policy

To what extent, if at all, has the Treasury complied with the principles of tax policy, set out in the annex?
1. An assessment of the extent to which recent tax policy has been fair, supported growth and encouraged competition, provided certainty, etc., is beyond the scope of a short document. Adam and Roantree (2015) and Miller and Pope (2015) provide an assessment of the 2010–2015 coalition government’s record on tax.

2. In terms of the way that tax policy is made, there have been some improvements since 2010 such as publishing a corporate tax road map in 2010, consulting somewhat more on plans, publishing most Finance Bill clauses several months in advance to elicit feedback, setting up the Office for Budget Responsibility to audit policy costings (among other tasks) and setting up the Office of Tax Simplification (OTS).

3. While helpful, these innovations have not removed the principal long-term problems with tax policymaking. Hyperactivity remains a concern, with a perceived need to pull rabbits out of the hat in Budgets, Autumn Statements and party conferences (as well as before elections). So does short-termism, with a focus on firefighting and headline-grabbing rather than long-term strategy. And tax policymaking within Westminster remains concentrated in the Treasury and HMRC, with few checks within government and parliament and consultation mostly restricted to technical detail.

Have the entities involved in tax policy (HM Treasury, HMRC and the Office for Tax Simplification) performed adequately?

4. Bowler (2014) reviews the OTS’s performance to date. It has done a worthwhile job, with some clear successes (though not all of its recommendations have been properly taken forward by government). But it has mainly achieved small improvements around the edges, because (a) it has been under-resourced (b) it has limited scope to address the fundamental drivers of complexity (principally underlying policy rather than detail and implementation) and its more substantive recommendations have often been ignored, and (c) it looks only at the existing tax system, not proposed changes: it is not involved in policy formulation.

Does the Treasury have the expertise to design tax policy? Does it make effective use of HMRC advice?

5. Bowler (2010) found significant problems in the way that HM Treasury and HMRC combined to produce tax policy. We have not conducted an updated assessment since then, but we note that the large reduction in funding since then is unlikely to have helped when shortage of resources and expertise was already a problem.

What simplification measures, whether or not considered already by the OTS, now need examination?

6. In a complex modern economy it is inevitable that the tax system will be complicated. But taxation in the UK is more complicated than it need be. The unnecessary complexities – and avoidance opportunities – are largely the result of attempting to draw distinctions between different activities: preferential tax treatment of certain products, income sources, assets, types of business, etc. requires a precise definition of what qualifies, and the incentive to avoid tax by dressing up activities to qualify for preferential treatment means that the definitions and anti-avoidance provisions often have to be extremely detailed and complicated. Moving towards a more neutral underlying tax policy, which taxes similar activities more similarly, would be the biggest step towards simplification. The Mirrlees Review identifies ways in which this could be
pursued across the whole tax system, ranging from taxing different forms of income more equally to adopting a more uniform VAT base, integrating income tax and National Insurance contributions and simplifying the morass of different schemes that seek to discourage greenhouse gas emissions.

The problem of the shrinking tax base

To what extent is the UK’s corporate tax base being eroded as business is increasingly conducted globally?

7. The UK corporation tax base has not been shrinking overall over the long term. While UK taxable profits fell during the recession and remain depressed, in the three decades before the recession corporate profits increased substantially as a share of national income. This explains why corporation tax revenues showed no systematic downward trend despite the headline rate being more than halved (see Griffith and Miller, 2014, for more details). However, this does not necessarily rule out an effect of more global activity in eroding the tax base: in its absence the UK tax base might have grown more rapidly.

8. Broadly, a more globalised environment could reduce the UK corporate tax base if: (a) profitable activities move out of the UK – there is little evidence that, as international mobility increases, the UK loses more activity to lower-tax jurisdictions than it gains from higher-tax jurisdictions; (b) avoidance opportunities increase – there are reasons to expect avoidance to be easier for firms operating in many countries.

9. Revenue could also be reduced in a more globalised environment if governments compete to attract taxable profits by lowering tax rates (such that less revenue is raised from a given tax base). There is some evidence of this happening (e.g. Devereux et al, 2008).

10. It is not possible to accurately measure the effect of avoidance on UK revenues. It can be difficult to define what counts as avoidance and there is no data source that provides full information on firms’ activities and income flows. Published estimates vary greatly (see Miller and Pope, 2016, for a discussion).

11. Not all revenue lost to avoidance is recoverable, because restricting avoidance opportunities would probably lead to other behavioural changes (e.g. making it harder to shift profits out of the UK may discourage some firms from coming to the UK in the first place: see Miller, 2013, pp.296-297 and Miller and Pope, 2016, pp.192-193).

12. Policy measures in recent years have tended to broaden the tax base (e.g. restrictions on loss offsets, and some of the moves in response to BEPS). Corporation tax receipts are forecast to be lower as a proportion of GDP in 2020–21 than 2015–16, primarily because of rate cuts (which cost more than is raised by base-broadening and anti-avoidance measures in the medium term).

Are there particular sectors that are more mobile and do those sectors make a disproportionate contribution to overall tax yield?

13. There is no good way to classify broadly defined industrial sectors (e.g. retail/pharmaceuticals/manufacturing) according to how mobile they are, or to relate that to the tax yield.

14. In general, immobile sectors will include locally provided services (e.g. plumbers, hairdressers, care homes – typically small businesses) and production that relies on UK-specific inputs (such as
UK institutions and regulations or North Sea oil and gas). Goods and services that can be produced anywhere and easily traded at a distance (either physically or online) are more mobile.

15. Treasury policy costings assume that 50% of large company profits are mobile (i.e. profits may move out of the UK if the tax rate increases). For these profits they assume that a 1 percentage point decrease in the corporation tax rate results in a 2 per cent increase in the size of the mobile profit base. The remainder of the tax base is assumed not to move in response to the tax rate.¹

What other changes are occurring in the UK tax base, and how should the UK Government react to these changes?

16. There have been limited changes in the corporation tax base other than the issues of multinational avoidance highlighted above and base-broadening measures introduced by the government. Taxable profits fell in the wake of the recession and losses accumulated then continue to reduce taxable profits.

17. Other tax bases have been changing. We highlight two examples. The recovery from the recession has been employment heavy, including a shift towards self-employment, but there has been weak wage growth. This, in conjunction with large policy changes such as substantial increases to the personal allowance, has narrowed the income tax base (Crawford et al., 2016). And the move towards more fuel-efficient cars and the fact that fuel duties have been frozen in cash terms (cut in real terms) since April 2011 pose a threat to fuel duty revenues as well as reducing disincentives to clog up the roads (Adam and Roantree, 2015); the best response would be to move to a nationwide system of congestion charging.

Radical solutions to the problem of the shrinking tax base

Given the inevitability of some sort of tax gap and of differences in interpretation of the "correct amount of tax", should the Government address the problem of the shrinking corporate tax base through more radical changes to the tax system?

18. As highlighted above, it is not clear whether the UK corporation tax base is shrinking and how much larger it would be in the absence of tax avoidance etc. Nor is it necessarily the case that a fall in the share of revenue coming from corporation tax (which in recent years has been driven primarily by the decision to reduce rates) is a bad thing. However, it is clear that corporation tax as currently applied does cause some problems in an international context.

19. There are three main problems with taxing profits on a source basis (i.e. aiming to tax profits created in the UK):

19.1. Allocating profits between countries is difficult conceptually and in practice. Ambiguity around the ‘correct’ value of transfer prices (the mechanism used to allocate profits) is what makes it difficult to identify the ‘correct amount of tax’ and creates the potential for companies to shift paper profits to lower-tax jurisdictions.

19.2. Taxing profits where they are generated affects where multinational companies locate their real production activities.

19.3. Mobility of both real activity and paper profits encourages governments to compete to attract taxable profits, placing downward pressure on tax rates.

20. There are three broad approaches to addressing these problems.

21. First, the existing rules could be enforced more stringently. We are not well placed to judge whether HMRC should, for example, be more robust in challenging some of the transfer prices used by companies. Moves to require greater information disclosure and transparency may help in this respect.

22. Second, the rules could be adjusted to make profit-shifting more difficult, for example through changing transfer pricing rules. International coordination, as pursued by the BEPS project, is required here.

23. Both of these approaches, however, address only problems around the manipulation of transfer pricing for profit shifting. They can never fully resolve the conceptual problem that the ‘correct’ allocation of profits between countries has no single right answer. A third – and most far-reaching – approach would involve more fundamental reform that moved to a different principle for determining the UK tax base (Miller and Pope, 2016, discusses).

24. Whether or not the government wants to make a more radical change will depend on at least two factors. First, the government’s rationale for taxing corporate profits in the first place. If this rationale is inextricably linked to taxing profits on a source basis, this limits the options for reform. Second, the practical complications and likely trade-offs associated with alternative systems. Consideration of radical reform should depend not only on concerns over BEPS but on examination of a much broader set of advantages and disadvantages of alternative systems.

If so, what type of corporate tax structure could ensure that revenue is collected in accordance with the principles of tax policy and in a way which minimises the risk of base erosion? For example, should business taxation be based on turnover rather than profits?

25. Alternative corporate tax systems should be evaluated by considering both the ease of collecting the tax (including avoidance opportunities) and the ways in which the tax affects decisions over investment, location, financing, legal structure, etc.

26. The UK should not tax companies based on turnover. Even if this could be introduced in a way that reduced avoidance opportunities, a tax on all turnover, and not just profit, would be highly distortionary, favouring low-cost-low-revenue activities over equally valuable high-cost-high-revenue activities. This implies a large disincentive to investment and a strong bias towards vertical integration, among other distortions. Profit, rather than turnover, is the appropriate base for taxation.

27. The appropriate definition of taxable profits, however – how (if at all) it should differ from accounting profits – is more complex. The Mirrlees Review argued for a tax on ‘economic rents’: one that levies no net tax on business activities that break even in present value terms, but taxes only profits in excess of a ‘normal’ (risk-free) rate of return on the funds invested in the company. There are two broad approaches to achieving this:

27.1. A Cash-Flow Corporation Tax (CFCT) – taxing firms’ net cash-flows. This is similar to a VAT (taxing firms’ sales less their input purchases), but allowing deduction of wages as an expense. The existence of the Annual Investment Allowance moves the current system some way towards being a CFCT for small firms.
27.2. An Allowance for Corporate Equity (ACE) – an allowance for the opportunity cost of equity finance (a risk-free interest rate multiplied by a measure of the stock of shareholders’ funds tied up in the company), similar to the deduction already given for the cost of debt finance. A similar system is currently in use in Belgium and Italy, and has previously been used elsewhere.

It can be shown that these two approaches are closely related to each other: in simple cases the present value of a company’s tax payments will be the same.

28. Either of these approaches would wholly or largely resolve a number of domestic problems with the existing corporation tax, including the bias in favour of debt over equity finance, commercially viable investments being made unviable by taxation, bias towards investing in assets that are treated more favourably by the capital allowances regime, bias towards current expenditure (which is fully tax-deductible) over capital expenditure (which is not), and sensitivity of effective tax rates to inflation.

29. If levied on a source basis, however, moving to a CFCT or ACE would not prevent the headline rate of corporation tax from affecting the UK’s attractiveness relative to other countries as a destination for mobile investment or profits. To address concerns specifically over international mobility, two other radical proposals are most commonly discussed.

30. First, unitary taxation, or formulary apportionment, would calculate the profit of a whole multinational at an aggregate level (preferably worldwide) before allocating profit among countries based on a formula.

30.1. The formula could be set in order to use easily identifiable proxies for the source of activities – e.g. based on the location of fixed assets, payroll and/or sales.

30.2. This approach would reduce avoidance opportunities by removing the need to attach transfer prices to transactions within firms (because profit would no longer be calculated at the individual subsidiary level).

30.3. Location decisions for employment, assets or sales would still be affected by tax if these factors were part of the allocation formula, though these may be less mobile than profits.

30.4. Unitary taxation would require widespread coordination. The European Commission has a proposal – the Common Consolidated Corporate Tax Base (CCCTB) – for formulary apportionment within the EU. Previous work suggests that the overall gains from a CCCTB would be negligible, but that it would create winners and losers (the estimated effect on the UK is around zero) (see Bettendorf et al., 2011). Transfer pricing (and the associated concerns) would still be required between the EU and the rest of the world.

31. A second option worthy of consideration is a destination-based cash-flow corporation tax (described by Auerbach et al., 2010, and developed in more practical detail by Devereux and de la Feria, 2014). The CFCT described above could be levied on a destination basis (i.e. based on UK sales, rather than UK production) – as VAT already is – with imports taxed and exports untaxed. Transactions within multinational companies would no longer affect profits taxable in the UK since the source of profits would no longer be relevant.

31.1. Under this system costs are deducted in the country in which they are incurred (unlike a system of formulary apportionment based on sales, where costs are effectively allocated based on the location of sales). As an example, consider a company that produces in the UK and exports all of its goods. Under formulary apportionment based on sales, the tax payable in the UK would be zero (there are no UK sales). Under a destination-based tax
the tax base would be negative (because UK-based costs would be deducted from sales of zero).

31.2. A destination-based CFCT should not distort firm location decisions, as the tax charge is the same regardless of where the goods are produced. This also reduces the incentive for governments to compete for activities.

31.3. This system could in principle be introduced unilaterally by a single country. Once some countries introduced the tax, other countries would have an incentive to start taxing corporate income on a destination basis (Auerbach et al., 2010, page 886).

31.4. There are several concerns with destination-based taxation that would need to be addressed before introduction, including the treatment of losses, cross-border shopping, and how, in practice, this system would interact with the source-based system in operation in the rest of the world.

31.5. A destination-based CFCT is far removed from the current corporation tax system. However, it can be shown that a destination-based CFCT is equivalent to a VAT plus a wage subsidy. Therefore, a change in the tax base similar to a move to a destination-based CFCT could be achieved by reducing rates of corporation tax, increasing rates of VAT (which is already destination-based and is a cash-flow tax to boot, thus killing two birds with one stone), and reducing employer NICs rates. In practice, lower rates of corporation tax and higher rates of VAT is broadly the direction in which the UK and most other developed countries have been moving for decades. The domestic and international problems associated with corporation tax will be much less severe with a 17% tax rate than if the tax rate were still 28%, let alone 52% as it was until the early 1980s.

Should the Government consider other forms of taxation (such as the proposals of the 2020 Tax Commission) when considering how to raise tax in the future, particularly from businesses and wealthy individuals?

32. The Mirrlees Review was set up specifically to identify the features of a good tax system for an open economy in the 21st Century and to suggest how the UK tax system could be reformed to move in that direction. It was carried out by a large number of the world’s leading tax experts under the chairmanship of Nobel laureate Sir James Mirrlees. The review made a broad set of recommendations, summarised in its concluding chapter.

33. The proposals of the 2020 Tax Commission include some desirable elements, but also some elements with which we would disagree. The proposals also entail a very large overall tax cut, on which we do not express a view but which do note would require very large cuts to government spending and/or a belief that the behavioural response to tax reductions would be very large.

34. Tax reform should always be viewed from the perspective of the whole system rather than a single part in isolation: not every tax needs to achieve every objective as long as the system as a whole does, and the interaction between different parts of the system is crucial for the effective functioning as a whole. And it should be remembered that all taxes are ultimately paid by people. Raising tax from businesses means imposing a cost on individuals; which individuals bear the burden will depend on the form of the tax.

35. The taxation of wealthy individuals could certainly be rationalised, whether the aim is to raise more or less from this group overall. A range of policy options is discussed in Adam et al. (2013a).
Is there a case for a wholesale review of capital taxation?

36. Capital taxation – including the taxation of personal wealth, savings and unincorporated businesses as well as company profits – is one of the most important and most difficult parts of the tax system to get right.

37. The current system is grossly deficient, causing problems ranging from tax-motivated incorporation to a bias in favour of debt finance, an inheritance tax that is poorly targeted at the wealthiest, and the bizarre institution of ‘salary sacrifice’ pensions. Decades of capital gains tax policy going round in circles, with rates rising and falling in response to competing concerns over avoidance opportunities and saving disincentives, is one illustration of successive governments’ failure to take a strategic view of capital taxation. A wholesale review of the entire system is badly needed.

38. The Mirrlees Review provides a holistic review of capital taxation and makes comprehensive proposals for reform.

Other mitigations of the problem of the shrinking tax base (addressing tax avoidance and non compliance)

To what extent will projects such as the OECD’s Base Erosion and Profit Shifting (BEPS) project and common reporting standards help in tax collection?

39. There are benefits from tackling avoidance through internationally coordinated efforts. A chapter of this year’s Green Budget (Miller and Pope, 2016) looked in detail at the BEPS recommendations and their likely impact. The success or otherwise of the BEPS process will vary across the 15 actions and depend in part on the policy choices of other governments. The likely result is a reduction in some forms of avoidance behaviour. Some changes in particular (e.g. the definition of permanent establishments) represent improvements on the current system. However, the BEPS actions are not a silver bullet; some avoidance opportunities will remain and some measures may come at the expense of distorting genuine commercial activities (e.g. this is a concern with the new restrictions on interest deductibility).

References


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