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REFORMING THE TAX SYSTEM FOR THE 21ST CENTURY: THE MIRRLEES REVIEW

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

The Nuffield Foundation

Globalisation demands reform of UK corporation tax, say studies prepared for the Mirrlees Review

Embargoed until 0001am, Thursday 5 June 2008

IMPORTANT: Please note that the research described in this Release is a submission to the Mirrlees Review and that the conclusions reached will not necessarily be adopted in the final report. We are publishing a number of such submissions over the coming weeks and the review team would welcome feedback to mirrleesreview@ifs.org.uk

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Corporation tax should be reformed or replaced by a higher VAT rate (offset by lower National Insurance contributions) to reduce disincentives to invest in the UK, according to two studies commissioned by the Mirrlees Review of the British tax system, which is being chaired by Nobel prize-winner Professor Sir James Mirrlees for the Institute for Fiscal Studies.

The studies both argue that globalisation and the growth of the financial sector require a new approach to the taxation of profits in a small open economy. Unlike most EU governments, the UK currently taxes dividends received by UK-resident firms from their foreign subsidiaries as well as profits earned in this country. This creates a disincentive to locate headquarters in the UK.

Rachel Griffith (IFS and University College London), James Hines (University of Michigan) and Peter Birch Sørensen (University of Copenhagen) recommend moving to a 'source-based' corporation tax that exempts dividends paid to UK companies by their foreign subsidiaries. [1] They also recommend exempting from taxable profits the normal rate of return (such as might be earned on a risk-free government bond): this Allowance for Corporate Equity ('ACE') approach would encourage investment and would thus increase national income and real wages.

The Government has already said that it wishes to move from a 'credit' to an 'exemption' system for foreign dividends, but the authors warn that the proposals published by the Treasury in 2007 are handicapped by the proposed treatment of intangible assets held by UK multinationals offshore. They argue that these proposals would add a further burdensome layer of anti-avoidance rules.

To discourage investors from hiding their wealth in foreign tax havens, the authors recommend exempting interest income from personal tax, and allowing shareholders to deduct an imputed normal return on the basis of their shares before imposing tax on dividends and capital gains. Abolishing the personal dividend tax credit and aligning the combined tax rates on corporate and shareholder income with that on labour income could then avoid some of the incentives to choose the legal form of a business for tax reasons

[1] http://www.ifs.org.uk/mirrleesreview/press_docs/international.pdf

identified in their contribution to the Mirrlees Review by Claire Crawford (IFS) and Judith Freedman (Oxford University).[2]

Alan Auerbach (University of California at Berkeley), Michael Devereux (Oxford University and IFS) and Helen Simpson (Bristol University and IFS) argue that taxable profits would be lower under an ACE than under the existing corporation tax.[3] This means that a higher statutory tax rate would be required to bring in the same revenue, increasing the potential gains to multinational companies from shifting their profits to jurisdictions with lower statutory tax rates.

These authors suggest moving to a form of 'destination-based' corporate tax, levied where the sale of a good or service is made to the final consumer. They argue that this would remove distortions to the location of investment, and substantially reduce the opportunity for companies to shift profits between countries. The authors suggest that moving to a destination basis could be achieved by introducing border adjustments, similar to VAT, in which exports of goods and services become tax-exempt, and imports of goods and services are taxed.

A similar result could be achieved by replacing corporation tax with an increased rate of VAT, partially offset by reducing National Insurance contributions. This reform might be hampered by EU restrictions on increases in the VAT rate, by EU rules requiring the financial and some other sectors to be exempt from VAT, and by the risk of increasing the scope for carousel fraud.

The Mirrlees Review team also asked leading international experts to comment on the proposals made by authors of the two papers and on the wider issues they discuss:

- Roger Gordon (University of California at San Diego) and Jerry Hausman (Massachusetts Institute of Technology) argue that company profits – and especially those of multinationals – are predominantly a return on the efforts of managers and entrepreneurs rather than on the capital invested by the shareholders. If this is true, they suggest there is a stronger case for retaining the existing UK system of company taxation, including the taxation of foreign-source dividends.[4]

- Julian Alworth (Oxford University) asks whether the exemption of foreign dividends from tax should also apply to the capital gains companies make when they sell assets. He also warns that while the move to an exemption system might be sensible for many countries, the US and UK may be exceptions because they account for such a large share of foreign direct investment.[5]

- Harry Huizinga (Tilburg University) argues that while deeper economic integration may make it more difficult to collect corporate tax revenue in future, requiring greater policy coordination within Europe, for now two factors may limit the erosion of the existing system: first, European tax polices, such as the Savings Directive and rulings of the European Court of Justice, are tending to

[2] http://www.ifs.org.uk/mirrleesreview/press_docs/small_businesses.pdf

[3] http://www.ifs.org.uk/mirrleesreview/press_docs/corporate.pdf

[4] http://www.ifs.org.uk/mirrleesreview/press_docs/gordon_hausman.pdf

[5] http://www.ifs.org.uk/mirrleesreview/press_docs/alworth.pdf

strengthen residence-based elements of capital income taxation, and; second, increased foreign ownership of UK companies discourages a ‘race to the bottom’ in corporate tax rates.[6]

- Jack Mintz (University of Calgary) argues that tax authorities are unlikely to abandon the existing source-based corporation tax while revenues remain as buoyant as they have been in recent years. He notes that moving to a destination-based corporation tax or to greater reliance on VAT might encourage people to shift their earnings and spending to other jurisdictions.[7]

Commenting on the study and commentaries, Robert Chote, Director of the IFS, said:

“Notwithstanding announcements by a couple more multinational companies that they are thinking of leaving the UK for tax reasons, the Treasury will be reluctant to abandon the domestic corporation tax while it continues to raise £50 billion or so a year. But these studies lay out some interesting directions for reform, both to make the existing system of company taxation more efficient and to provide a long-term alternative if corporation tax revenue goes into long term decline.

We are very grateful to the authors of the main studies, and to the commentators, for their important contributions. They are very valuable and interesting pieces of work in their own right, as well as providing food for thought for Sir James and his team when they draw up their final conclusions.”

ENDS

Notes to editors:

1. The Mirrlees Review, funded by the Nuffield Foundation and the ESRC, brings together IFS researchers and other international experts to identify what makes a good tax system for any open developed economy in the 21st century and to recommend how the UK tax system might realistically be reformed in that direction (http://www.ifs.org.uk/mirrleesreview). The project has been inspired by the 30th anniversary of the 1978 Meade Report, a landmark in the study of tax design and perhaps the most influential output of the IFS to date.

2. The Review is chaired by Nobel Laureate Professor Sir James Mirrlees of the University of Cambridge. The Commission’s work is being directed by Tim Besley (LSE, IFS and Bank of England), Richard Blundell (IFS and UCL), Malcolm Gammie QC (One Essex Court and IFS Tax Law Review Committee) and James Poterba (MIT). The editorial team comprises: Stuart Adam (IFS), Stephen Bond (Oxford and IFS), Robert Chote (IFS), Paul Johnson (IFS and Frontier Economics) and Gareth Myles (Exeter and IFS). The final report will be published by Oxford University Press around the end of 2008.

3. A wider group of more than 60 IFS researchers and leading experts from around the world has contributed chapters, commentaries and special studies on key themes of the research. Pre-publication versions are being released on the IFS website over the coming weeks: http://www.ifs.org.uk/mirrleesreview/publications.php. The final versions will be published by Oxford University Press as a companion volume to the final report.

[6] http://www.ifs.org.uk/mirrleesreview/press_docs/huizinga.pdf

[7] http://www.ifs.org.uk/mirrleesreview/press_docs/mintz.pdf