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Business Taxes

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Summary

- Business taxation has undergone important reforms under Labour, particularly in the first term. These include reductions in tax rates, changes to the payment system of corporation tax, tax increases for the North Sea oil industry and reforms of dividend taxation.
- There is no obvious definition of ‘taxes on business’. Using a definition suggested here, the reforms are found to have increased business taxes. Much of the increase was, however, temporary.
- Revenues from corporation tax peaked in 1999–2000 and have since been much lower. Government forecasts, however, continue to be optimistic about a rebound to previous highs, despite permanently lower tax rates.
- International pressures both from tax competition and the evolution of case law at of the European Court of Justice mean that more reform is likely in the future.

1. Introduction

While the first Labour term was marked by substantive business tax reforms, the reforms implemented in the second term were more modest, although a reform process is continuing. Since their peak in financial year 1999–2000, revenues from corporation tax have weakened, while some business representatives have been complaining about a rising tax burden on business.[1] This apparent contradiction suggests that an assessment of business taxes under Labour will require careful attention to detail.

This Election Briefing Note starts with a summary of tax reforms since 1997. This is followed by an assessment of the overall effect of these changes on the tax burden faced by businesses and on government revenues. The note concludes with a discussion of future trends in corporate taxation.

2. Reforms under Labour

2.1 The first term

In its first term, the Labour government introduced important changes to business taxation. There was one important one-off measure, the windfall tax. Then there were a range of

[1] The CBI made headlines by claiming that business taxes had increased by £54 billion under Labour. See Confederation of British Industry, ‘The UK as a place to do business: is the tax system a help or a hindrance?’, October 2003.

permanent changes to the tax system. Some of these – for example, the changes to the payment system of corporation tax – had very different effects in the short run from in the long run, as explained below.

The windfall tax

The windfall tax on privatised utilities was a one-off charge applied to utility firms, whose profits suggested that they had been privatised at a price below their value.[2] It was paid in two instalments in December 1997 and December 1998 and raised a total of £5.2 billion.

Because of its retrospective nature, such a tax creates uncertainty and may deter future investment. The scale of such effects depends on the credibility of being truly a one-off measure.

Moreover, it is uncertain to what extent the tax was borne by those shareholders who made large profits following privatisation. Some shareholders will have realised their profits by selling their shares before any news of the tax had appeared. Clearly, such shareholders bore none of the burden. Other shareholders, who purchased later than at the original flotation, may not have made any 'windfall' gain, but will still have suffered capital losses as news of the tax and of Labour's victory was priced into the stock market. Hence, even if one accepted the case of 'windfall profits' in some privatised industries, this tax could not be considered well targeted.

Dividend taxation

The reform of dividend taxation was implemented in two steps. First, in 1997 the payment of dividend tax credits was changed. Until then, all shareholders received a tax credit with dividends, which was intended to mitigate the 'double taxation' of profits at the corporate and personal level. The 1997 reform made this credit non-refundable, so that it became worthless to pension funds, which are tax-exempt. Tax-paying shareholders were unaffected. This measure raised £5 billion per annum. It is discussed in more detail in the IFS Election Briefing Note on pensions and saving.

This reform was followed in 1999 by the abolition of advance corporation tax (ACT). ACT was a tax charge that companies faced at the time of paying a dividend. For most firms, this was credited against corporation tax and thus affected the timing of tax payments only. Some firms, though, as a result of having a small UK corporation tax liability, were not able to reclaim ACT fully, and for these firms ACT was an additional tax, referred to as 'surplus ACT'. This was particularly likely to be a problem for firms with important foreign operations, as their UK profits could be small relative to their dividends. The abolition of ACT is welcome, as the tax may have made the UK a less attractive place to locate a firm's headquarters, and is likely to have been in breach of the non-discrimination provisions of the European Community Treaty.

The new payment system

When ACT was abolished, the payment system for corporation tax was also reformed. As explained above, ACT had the effect of bringing forward part of the corporation tax payment.

[2] See L. Chennells, 'The windfall tax', *Fiscal Studies*, 1997, vol. 18, pp. 279–91.

The remainder was due nine months after the end of the accounting year. The abolition of ACT would therefore have delayed tax receipts, if the system had otherwise remained unchanged. To prevent that, a new system of payments in quarterly instalments was introduced for large firms, with the first instalment due in the seventh month of the accounting year and based on predicted profits. In fact, the new system overcompensated for the abolition of ACT so that revenues were brought further forward than previously. As a result, companies had to pay more than a single year's tax bill in each year of a transition period from 1999–2000 to 2002–03, when the new system was phased in. The new system does not apply to small and medium-sized firms, so they had a net gain from the abolition of ACT, if they previously paid dividends.

Over the four-year transitional period, the introduction of the new payment system raised a total of around £9 billion. The long-run effect of the introduction of the new payments system was a slight increase in tax revenues in present-value terms, because of the earlier payment date, combined with a loss of revenue from surplus ACT. Moreover, compliance costs may have increased, as accounting-year profits are still unknown when the first instalments are made and firms therefore need to predict their profits.

Overall, the change from ACT to payment in instalments is welcome and has led to a system that is closer to practice in other countries. Its characterisation as a mere 'modernisation' (1997 Pre-Budget Report) was, however, inappropriate, as the change also caused a significant, if temporary, tax increase.

Corporation tax rate cuts

These reforms were accompanied by cuts in the tax rates. In 1997, the main rate was cut from 33% to 31%. This was followed by a further cut to 30% in 1999. Similarly, the small companies' rate was cut from 23% to 21% in 1997 and to 20% in 1999. Moreover, a new starting tax rate of 10% was introduced in 2000 for firms with profits of up to £10,000.

Since 1999, the main corporation tax rate has remained constant, but tax rates for smaller companies were further reformed in the second term. The policy of tax cuts is in line with those of previous governments and with similar policies in other countries. On average, the cuts were more modest than those in other EU Member States, so that the gap between the UK tax rate and the average of the pre-enlargement EU has narrowed (see Section 4).

Other changes

In addition to these main changes, there were a number of changes that affected only some companies. Small companies have benefited from more generous capital allowances since 1997. Companies undertaking research and development (R&D) benefited from the introduction of tax credits for such activities. These credits were first introduced in 2000 for small and medium-sized firms. Tax credits for large firms followed in 2002, i.e. in the second term. Both are described in more detail in the IFS Election Briefing Note on productivity.

2.2 The second term

In the second Labour term, corporate tax reform was still given almost continuous attention, with three major consultations and a number of smaller more technical ones. The reforms actually implemented, however, were of relatively minor importance. They include the introduction of transfer pricing legislation for domestic transactions, changes to small business taxation and changes to the taxation of oil companies on the continental shelf.

Transfer pricing

Transfer pricing legislation is one of the measures used to prevent multinational firms from artificially reporting profits in low-tax jurisdictions. This legislation forces groups to charge intra-group transactions as if they occurred between two unrelated parties (arm's length principle). Without such a rule, companies could manipulate the price charged in order to shift their profits to the subsidiary facing the lowest tax rate. This legislation used to apply only to international transactions, but since April 2004 it also covers domestic ones.

From an economic perspective, the case for applying such legislation domestically is very weak, as not much tax is at stake if firms shift profits between subsidiaries within the UK. This is because corporation tax is a national tax, with the same rate across the country and all revenues going to the central government. Any revenue effects of this legislation are thus likely to be very small[3] and therefore not worth the compliance costs of businesses and the administrative costs of tax inspectors. The reason for the reform is thus probably not an economic but a legal one: the previous system may have infringed EU non-discrimination provisions and could have led to a challenge in court.

Small business taxation

In 2002, the government cut the small companies' rate to 19% and reduced the then two-year-old starting rate of corporation tax from 10% to 0%. This latter, surprise measure had not been consulted upon and predictably had disastrous effects on tax payments by small businesses, which could benefit from the 0% tax rate by incorporating. The policy was reversed in 2004, although this was presented as the closure of a loophole. The resulting system is now rather complicated, with a minimum tax rate of 19% on distributed profits and a 0% tax rate on retained earnings if profits are less than £10,000.

Such short-lived measures, which lack any prior consultation, provide an example of how not to conduct a stable economic policy. Any benefits of the current 0% tax rate, which is now only applicable in limited circumstances, are likely to be very minor, at the cost of a complicated system. Small businesses suffer disproportionately from compliance costs, and they might have benefited more from a simplification of the tax system.

North Sea oil fiscal regime

On the continental shelf, the government increased the tax burden in Budget 2002 by introducing a new supplementary charge to be paid on top of existing corporation tax and, where applicable, petroleum revenue tax. At the same time, investment allowances were made more generous. Licence royalties, which were a revenue-based tax and were still levied on oilfields explored before March 1982, were abolished from 1 January 2003. In Budget 2005, the payment of corporation tax and the supplementary levy were brought forward in time. The short-term revenues raised by this measure are substantial, at an estimated £1.1 billion in 2005–06, because, as in the case of the new payment system for large corporations, more than

[3] Corporation tax revenues may be affected in a few cases, e.g. if a firm shifts profits from a profitable subsidiary to one with trapped losses, which are not covered by group relief.

one year's tax is raised in financial years during the introduction. Thereafter, revenue implications are lower and the long-run effect is a tax increase in present-value terms only.

The abolition of licence royalties and raising of tax rates combined with more generous allowances have much to commend them, as they simplify the North Sea tax regime and bring it closer to one taxing economic rents. However, the pattern of raising oil taxes when prices are high and cutting them when they are low continued under Labour. It would be preferable to have a stable tax mechanism that automatically raised more revenue when oil prices were high. Moreover, the current system still suffers from the anomaly that oilfields are taxed differently, depending on their date of approval. Thus petroleum revenue tax is levied only on fields approved prior to 15 March 1993.

3. The overall trend in business taxes

Having discussed the broad range of reforms, including both revenue-raising and tax-cutting ones, the question arises of what the overall effect is on businesses. The answer to this question will depend on what we consider to be a tax on business. Moreover, as all businesses are differently affected by the reforms, the net effect of all the changes will differ across businesses.

3.1 What are taxes on business?

The answer to this question is far from obvious. At one extreme, one could argue that all taxes paid by businesses fall in this category. This would then include such diverse taxes as personal income taxes of employees raised through the PAYE system and VAT. Such an approach does not seem promising, though, as, for example, the PAYE transactions may be handled by companies but only on behalf of individual taxpayers.

An alternative would be to include all taxes that are, by law, levied on business. This definition would exclude personal income taxes paid on behalf of employees. It would include corporation tax, business rates and the employer's share of National Insurance contributions. The results of such an exercise would still be misleading, though, because the legal incidence of a tax does not determine the economic incidence, i.e. who bears the burden of a tax.

It would then appear appealing to include only those taxes whose ultimate tax incidence falls on business. The problem with that approach is that there are no such taxes: incorporated businesses are legal persons and therefore cannot bear any burden of taxation, which is instead borne by owners, customers and employees.

The approaches discussed above all have their limitations, which raises doubts as to whether the question of whether business tax has risen under Labour can ever be satisfactorily answered. We will proceed pragmatically by including any taxes that are levied on income streams to owners of a business.

3.2 Estimates of changes to business taxation

Table 1 provides an overview of the main business tax measures and their effects on tax revenues.

Table 1. Business taxes under Labour (£ billion)

	1997–98	1998–99	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05
Tax rate changes								
Budget 1997		–1.6	–2.2	–2.5	–2.9	–2.7	–2.8	-3.1
Budget 1998				–0.8	–1.1	–1.3	–1.4	-1.6
Budget 1999					–0.1	–0.1	–0.2	-0.2
Budget 2002						0.0	–0.3	-0.5
Budget 2004								0.0
Total		**–1.6**	**–2.2**	**–3.3**	**–4.1**	**–4.2**	**–4.6**	**-5.3**
R&D tax credits					–0.2	–0.6	–0.7	–0.7
ACT replaced by instalments		0.1	1.6	2.0	3.1	2.2	–0.5	*–0.5*
Dividend tax credits	2.3	4.0	5.4	*5.7*	*5.9*	*6.2*	*6.6*	*6.9*
North Sea taxation								
New 10% charge and allowances						0.1	0.5	0.6
Licence royalties abolished							–0.2	-0.1
Windfall tax	2.6	2.6						
Total revenue effect	**4.9**	**5.1**	**4.8**	**4.4**	**4.8**	**3.8**	**1.1**	**0.9**

Notes: The units are nominal £ billion. The effects from rate changes include changes to the small companies' rate and the starting rate. Initial costings are based on Budget and Pre-Budget Reports; later figures are from Tax Ready Reckoners. In the case of R&D tax credits, the figures are the sum of the negative tax element as reported in the Tax Ready Reckoners and payable credits reported in *Inland Revenue Statistics*. Where no other data are available, figures from previous years were uprated by the growth rate of nominal GDP and are reported in italics.
Sources: HM Treasury, *Financial Statement and Budget Report* and related press releases, various years; HM Treasury, *Pre-Budget Report*, various years; HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, various years; *Inland Revenue Statistics*.

Based on the summary in Table 1, it appears that while revenues from business taxes have increased under Labour, this was mainly due to temporary measures, such as the windfall tax and the changes to the payment system. As a result of these, tax revenues overall increased by £4–5 billion per year during the first six years with Labour in power. During the last two years, the net effect was much smaller. Given the inaccuracies of the estimates, the reported tax increase of £0.9 billion in 2004–05 should not be regarded as significant.

This is not to say that businesses will be unaffected. Clearly, the costs and benefits of individual reforms had different effects across businesses. The losers from the reforms include those regulated utilities that were subject to the windfall tax and most offshore oil producers. The winners include firms undertaking R&D and firms with large foreign earnings, which previously had to pay surplus ACT.

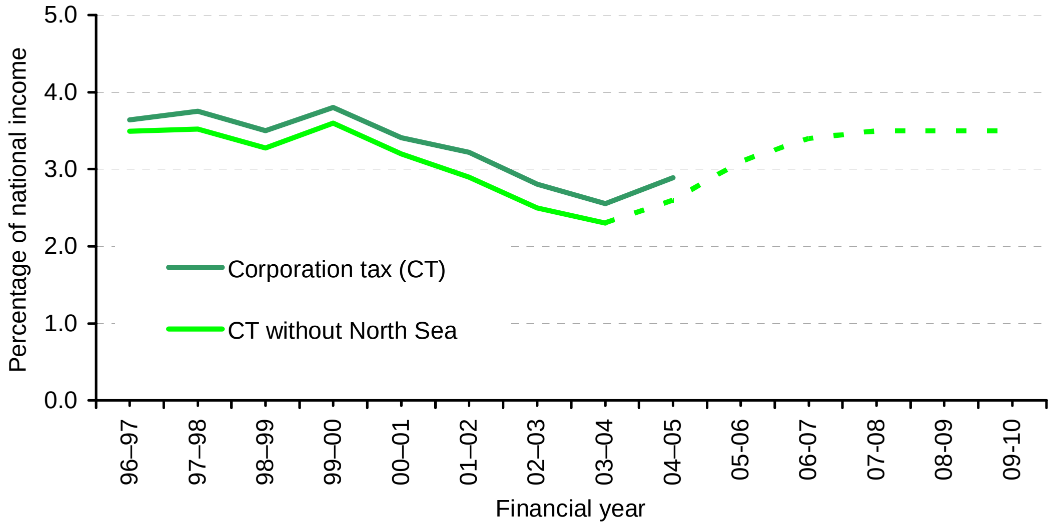
Among the permanent changes, the most important ones in terms of revenue were the abolition of repayable tax credits and the cut in corporation tax rates. The latter clearly benefited all businesses. But which firms suffered from the former? The IFS Election Briefing Note on pensions and saving argues that this tax increase is likely to affect mainly pension funds. Some businesses may, however, have suffered indirectly – for example, if they have contractual obligations to pay defined benefit pensions to their employees.

Overall, then, one may conclude that long-run business taxes have remained approximately constant since the beginning of the Labour government, although this has been masked by temporary tax increases during most years.

3.3 Development of tax revenues

The previous section examined the effect of changes in tax law on tax revenues. An equally important determinant of revenues is, however, the performance of the economy and changes in industry structure. It is thus possible for aggregate revenues to increase despite tax cuts, if profit growth is high. Figure 1 shows the overall revenues from corporation tax as a share of national income. It includes the effects of all tax measures detailed in Table 1 except for the windfall tax, the abolition of licence royalties and the changes to dividend taxation.

Figure 1. Corporation tax receipts



Note: Estimates are marked by dotted lines.
Sources: Corporation tax revenues are from *Inland Revenue Statistics*; the last year was updated using HM Treasury/ONS Public Sector Finances, March 2005. Revenue without North Sea and its forecasts are from HM Treasury, *Financial Statement and Budget Report 2005*. GDP is from National Statistics, series YBHA.

Figure 1 shows that revenues from corporation tax have been on a downward trend since 1999–2000, although there is a small increase in the current financial year.[4] Potential explanations for a fall in tax receipts, despite tax increases as detailed in the previous section, include the end of the stock market boom in 2000, which has reduced profit opportunities for financial firms. Moreover, there may have been an increase in tax avoidance, including by shifting profits to countries with lower taxes. This and other pressures on the corporate income tax system are discussed further in Section 4.

[4] Even if the additional revenues from higher taxation of dividends were added in, there would still be a net fall in this series.

In its yearly Budget, the government publishes its forecasts for corporation tax revenues excluding revenues from the North Sea. These are also shown in Figure 1. The forecasts suggest that corporation tax revenues will return to the high levels seen at the beginning of the Labour government. Considering that tax rates are permanently lower and that temporary tax increases have run out, this optimism seems puzzling.

4. Interpretation and outlook

In his first Budget, Gordon Brown stated that ‘in a global economy, long-term investment will come to those countries that demonstrate stability in their monetary and fiscal policies’ (Budget Speech 1997). If stability is such an important aim for the Chancellor, why have business taxes been under constant reform, and why were even more reforms considered in consultations? The reason for this is that the current UK corporate income tax system is under numerous pressures. These include international tax competition and recent decisions and pending cases at the European Court of Justice.

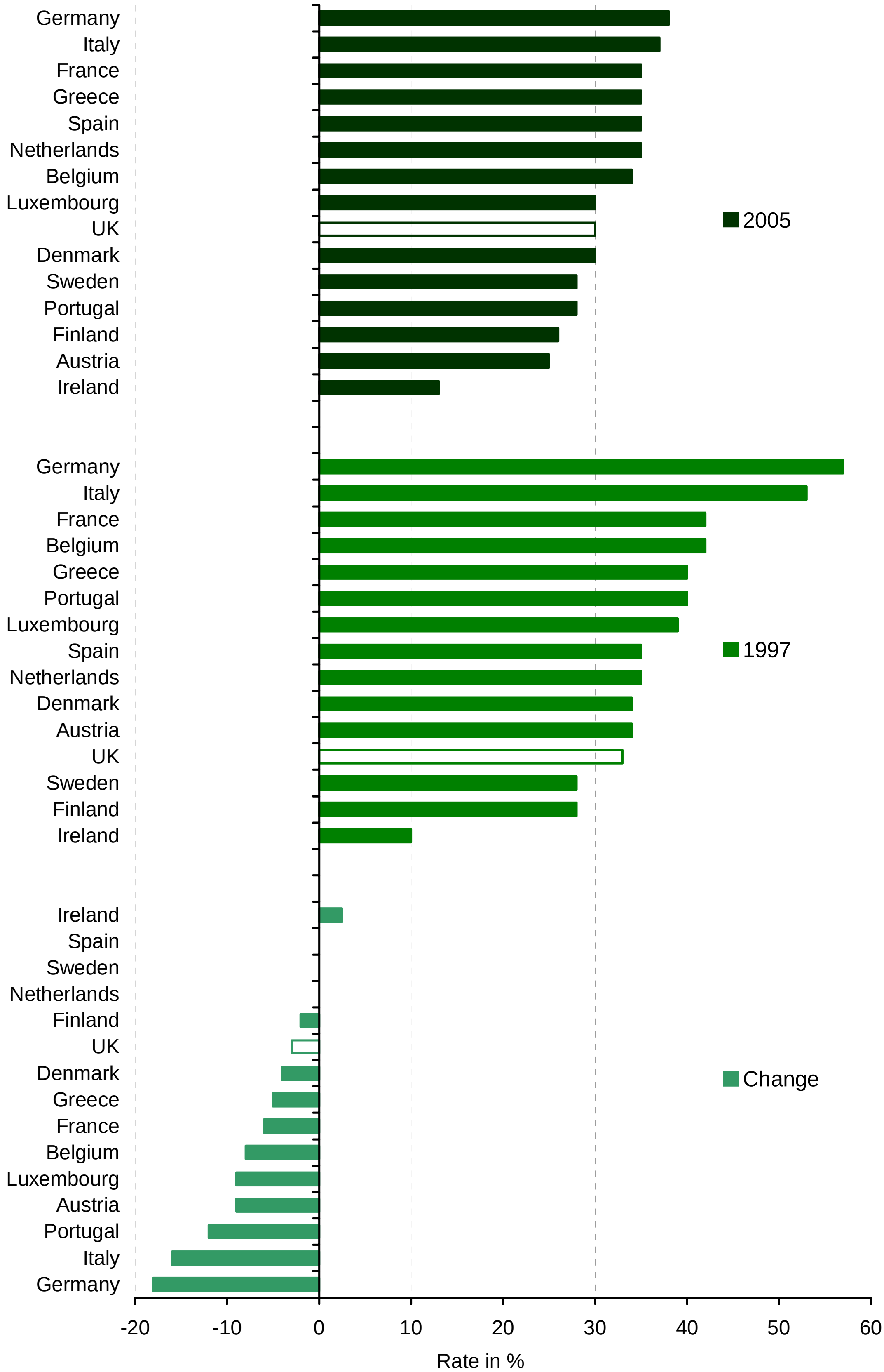
International tax competition refers to the idea that countries may try to attract internationally mobile capital and reported profits by cutting their corporate income tax rates. While this is a worldwide phenomenon, it is arguably particularly prominent in the EU, with numerous Member States having reduced their corporate income tax rates since 1997. Figure 2 shows how the UK’s relative position in the pre-enlargement EU has deteriorated since then, despite the tax cuts undertaken by the Labour government. Nevertheless, the UK tax rate is still below the average of the pre-enlargement EU. Compared with the new EU Member States, however, whose average tax rate is just 18.7%, the UK tax rate appears high. The low tax rates in the new Member States have already led Austria to cut its rate from 34% to 25% in 2005. In Germany, a reduction of the federal rate from 25% to 19% has been proposed by the government. It is likely that the next UK government will also feel the pressure for further tax rate cuts.

The other main pressure is the evolution of case law created by decisions at the European Court of Justice. In recent years, companies have been increasingly successful at taking national governments to court over infringements of Treaty rights, such as the fundamental freedoms and non-discrimination provisions. These rights limit the extent to which cross-border transactions can be taxed differently from purely domestic ones.

As more tax is at stake in international transactions than in domestic ones, most tax systems are discriminatory and apply stricter standards to such transactions. When a particular tax rule is considered discriminatory, there are in principle two ways to achieve conformity with European law. Either the more beneficial rules for domestic transactions can be extended to foreign ones, or the more stringent rules can be applied domestically as well.

So far, the UK has followed the latter approach, as in the case of transfer prices discussed in Section 2. Similarly, the treatment of finance leasing is under reform, and is planned to be made less generous from 2006. But the most important reforms are probably still outstanding. For example, group relief, which allows firms to deduct the losses of loss-making subsidiaries from the profits of profitable ones, is restricted to UK subsidiaries. If the courts decide that

Figure 2. Statutory corporate income tax rates in the pre-enlargement EU



Note: These tax rates include typical local and supplementary corporate income taxes where applicable. For countries with more than one tax rate, the manufacturing rate is shown.

group relief does not conform to EU law, then the UK government will face the choice of repealing it entirely or allowing it within the EU. The former would increase taxes for profitable UK groups with loss-making subsidiaries, while the latter would imply giving tax relief for losses abroad.

Whoever forms the next government will thus face a number of difficult questions. As no party has proposed a major corporation tax reform, it is likely that policy will continue to be reactive in the face of increasing international tax competition and judgements by the European Court of Justice. Stability in business taxation is therefore the least likely outcome for some time to come.